

# CONDUCT OF MONETARY POLICY

(Pursuant to the Full Employment and Balanced  
Growth Act of 1978, P.L. 95-523)

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## HEARINGS

BEFORE THE

SUBCOMMITTEE ON  
DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND  
URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

ONE-HUNDREDTH CONGRESS

SECOND SESSION

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JULY 28, AND SEPTEMBER 8, 1988

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# FEDERAL RESERVE'S MONETARY POLICY REPORT TO CONGRESS

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Thursday, July 28, 1988

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

The subcommittee met at 10:05 a.m., in room 2128 of the Rayburn House Office Building, Hon. Stephen L. Neal [chairman of the subcommittee] presiding.

Present: Chairman Neal, Representatives Barnard, Hubbard, McCollum, Leach and Saxton.

Also present: Representatives Gonzalez, Flake and Wortley.

Chairman NEAL. I'd like to call this meeting of the subcommittee to order at this time. This morning, we are pleased to welcome the Chairman of the Board of Governors of the Federal Reserve System, Hon. Alan Greenspan, who will present the Federal Reserve's Monetary Report to the Congress.

Today we face an economy that few could have predicted with great competence last February at the time of the last Humphrey-Hawkins report on monetary policy. At that time, the potential fallout of the stock market crash was still awaited with great trepidation and uncertainty. In the intervening months, the economy has performed beyond any reasonable expectation, to the point where overheating and the consequent resurgence of inflation are the dominant concerns.

The Fed has reacted by a noticeable, though modest, tightening over these months. The main question for the remainder of 1988 seems to be: will the economy slow down a bit on its own or will the Fed have to induce a slowdown by further tightening? Inflation is at present more or less stable in the 3 to 4 percent range typical of the past few years. Whether it is poised to move up to a higher range is unclear, though indicators of potential inflationary pressures are easy to find. It seems abundantly clear, however, that it is not poised to move to a lower range. Approaching the zero level, we all seem to recognize, at least rhetorically, as our long-run objective.

Reasons abound why we cannot at present move quickly to a zero-range for inflation. We still have a large trade deficit which might eventually require further dollar depreciation. The decline in the dollar over the past few years is just now causing major increases in import prices. Moreover, the current drought may cause a one-time run up in food prices. These temporary obstacles may

well rule out a move to zero inflation in the immediate future. But we must not give up the ground we've already won and we must never waiver from our goal of zero inflation. Stabilizing inflation in the 3 to 4 percent range should be the minimum we ask and expect of monetary policy in the near term. If that requires serious further tightening, so be it, and the sooner the better.

Mr. Chairman, I would like to welcome you this morning. Thank you for joining us. Without objection, we will place your entire statement in the record and would ask you to proceed with however you would like to summarize that statement.

Are there other Members who would like to make some opening comments.

If there are no requests for opening statements, Mr. Chairman, please proceed.

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

Chairman GREENSPAN. Thank you very much Mr. Chairman, and Members of the committee.

I welcome this opportunity to discuss monetary policy with you.

When I testified last February, the after-effects of the stock market plunge on spending and financial markets were still unclear. Most Federal Open Market Committee members were forecasting moderate growth. But rapid inventory-building and some signs of a weakening of labor demand meant that the possibility of a decline in economic activity could not then be ruled out.

To guard against this outcome, the Federal Reserve undertook a further modest easing of reserve pressures in late January. In the event, the economy proved remarkably resilient to the loss of stock market wealth. Economic growth remained vigorous through the first half of the year. As the risks of faltering economic expansion diminished, the dangers of intensified inflationary pressures re-emerged. Utilization of labor and capital reached the highest levels in many years and hints of acceleration began to crop up in wage and price data.

In these circumstances, the Federal Reserve was well aware that it should not fall behind in establishing enough monetary restraint to effectively resist these inflationary tendencies. The system, accordingly, took a succession of restraining steps.

The monetary actions were undertaken so that economic expansion could be maintained. We recognized that to do so, additional price pressures could not be permitted to build. We do expect economic growth to continue and inflation to be contained.

The central tendency of FOMC members' expectations for real GNP is for 2¾ to 3 percent growth over this year and 2 to 2½ percent over 1989. Although an erratic month-to-month pattern can be anticipated in our trade deficit, improvement in the external sector on balance is expected to replace much of the reduced expansion in domestic demands.

Employment growth is anticipated to be substantial through 1989, though some updrift in the unemployment rate may occur. Capacity utilization could well top out soon as growth in demands for manufactured goods slows to match that of capacity.

Considering the already limited slack in available labor and capital resources, a leveling of the unemployment and capacity utilization rates is essential if more intense inflationary pressures are to be avoided. Otherwise, aggregate demand would continue growing at an unsustainable pace and would soon begin to create a destabilizing inflationary climate.

Prospective increases in import and agricultural prices also have accentuated inflation dangers. We must not let these price level adjustments spill over to a sustained higher rate of increase in wages and prices.

The costs to our economy and society of allowing a more intense inflationary process to become entrenched are serious. The long-run costs of a return to higher inflation and the risks of this occurring under current circumstances are sufficiently great that Federal Reserve policy at this juncture might be well advised to err more on the side of restrictiveness than of stimulus.

We believe that monetary policy actions to date, together with the fiscal restraint embodied in last fall's agreement between the Congress and the administration, have set the stage for containing inflation through next year.

The FOMC believes that efforts to contain inflation pressures and sustain the economic expansion would be fostered by a growth of M2 and M3 over 1988, well within their reaffirmed 4 to 8 percent annual ranges. The debt of nonfinancial sectors is anticipated to remain near the midpoint of its reaffirmed 7 to 11 percent monitoring range.

For 1989, the FOMC has underscored its intention to encourage progress toward price stability over time by lowering its tentative ranges for money and debt. We have preliminarily reduced the growth range for M2 by 1 percentage point to 3 to 7 percent. That is, a range of 3 to 7 percent. We have lowered the tentative 1989 range for M3 by  $\frac{1}{2}$  a percentage point, a range of  $3\frac{1}{2}$  to  $7\frac{1}{2}$  percent.

The monitoring range for domestic nonfinancial debt for 1989 also has been reduced by  $\frac{1}{2}$  a percentage point to a tentative  $6\frac{1}{2}$  to  $10\frac{1}{2}$  percent range. The specific ranges chosen for 1989 are, as usual, provisional. The FOMC will review them carefully next February in light of intervening developments.

Anticipating today how the outlook for the economy in 1989 will appear next February is obviously difficult. A major reassessment of that outlook will have implications for appropriate money growth ranges for that year.

Despite the changes in the economic setting over the last 6 months, massive deficits in our external payments and internal fiscal accounts remain. As a Nation, we are still living well beyond our means. Our current account deficit indicates how much more deeply in debt to the rest of the world we are sliding each year.

As a Nation, we cannot expect our foreign indebtedness to grow indefinitely relative to our servicing capacity without added inducements to foreigners to acquire dollar assets. These added inducements could take the form of either higher real interest rates or a cheaper real foreign exchange value for dollar assets, or both.

To be sure, such changes in market incentives would have self-correcting effects over time in bringing our domestic spending more into line with our income.

But simply sitting back and allowing such a self-correction to take place is not a workable policy alternative. Trying to follow such a course could have severe drawbacks now that our economy is operating close to effective capacity and potential inflationary pressures are on the horizon.

Fortunately, we have a better choice for righting the imbalance between domestic spending and income, one over which we have direct control—that is, to resume reducing substantially the still massive Federal budget deficit. The Federal Government remains the most important source of dissavings in our economy. The fall in the dollar we have already experienced over the last few years, even allowing for the dollar's appreciation this year, has set in motion forces that should continue to narrow our external deficits.

The associated loss of foreign funds needs to be replaced by greater domestic savings. A sharp contraction in the Federal deficit appears to be the only assured source of augmented domestic net savings. Such a fiscal cutback should help counter future tendencies for future increases in U.S. interest rates and declines in the dollar. It would instill confidence on the part of international investors in the resolve of the United States to address its economic problems.

The schedule under the Gramm-Rudman-Hollings law is a good baseline for a multi-year fiscal strategy. I trust the Congress will stick with it. But we should go further. Ideally, we should be aiming ultimately at a Federal budget surplus. Then Government savings could supplement private domestic savings in financing additional domestic investment.

The strategy for monetary policy needs to be centered on making further progress toward, and ultimately reaching, stable prices. Price stability is a prerequisite for achieving the maximum economic expansion consistent with a sustainable external balance and high employment. Price stability reduces uncertainty and risk in a critical area of economic decision-making.

By price stability, I mean a situation in which private decision-makers can safely ignore the possibility of sustained, generalized price increases or decreases.

In the process of fostering price stability, monetary policy also would have to bear much of the burden for countering any pronounced cyclical instability in the economy. This is especially true if fiscal policy is following a program for multi-year reductions in the Federal budget deficit.

In these circumstances, monetary policy has to remain flexible to respond to unexpected developments. A perfectly flexible monetary policy, however, without any guideposts to steer by can risk losing sight of the ultimate goal of price stability.

Money growth has an undisputed, long-run relation with inflation, but in a shorter-run context, monetary aggregates have drawbacks as rigid guides to monetary policy. Financial innovation and deregulation in the 1980's have altered the structure of deposits. They also have made the velocity of money more sensitive to interest rates.

Still, I don't want to leave the impression that the aggregates have little utility in implementing monetary policy. They have an important role and it is quite possible that their importance will grow in the years ahead.

Currently, M2 and M3 are among the indicators influencing policy adjustments.

At times, in recent years, we have intensively examined the properties of several alternate measures. An analysis of the monetary base appears as an appendix to the board's Humphrey-Hawkins report. The FOMC's view is that its behavior has not consistently added to the information provided by M2 and M3. The committee, accordingly, has decided not to establish a range for this aggregate.

Because the Federal Reserve cannot rely solely on signals from the monetary aggregates to guide short-run operations, we have to interpret the behavior of a variety of economic and financial indicators as well. Judgments about the balance of various risks to the economic outlook need to adapt over time to the shifting weight of incoming evidence.

To be sure, we should not overreact to every bit of new information because of the transitory noise in economic statistics. But we need to be willing to respond to indications of changing underlying economic trends without losing sight of the ultimate policy objectives.

To the extent that the underlying economic trends are judged to be deviating from a path consistent with reaching the ultimate objectives, the Federal Reserve would need to make mid-course policy corrections. Deviations from the appropriate directions for the economy will be inevitable, since the effects of previous policy actions are delayed and uncertain.

Numerous unforeseen forces not related to monetary policy will continue to buffet the economy. The limits of monetary policy in short-run stabilization need to be borne in mind. The business cycle cannot be repealed. But I believe it can be significantly damped by appropriate policy action.

Price stability cannot be dictated by fiat. But governmental decision-makers can establish the conditions needed to approach this goal over the next several years.

Thank you very much, Mr. Chairman.

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

Chairman NEAL. Thank you, Mr. Chairman. You headed the commission that looked into the social security system not too long ago. I have become increasingly concerned about several things in this area. One is that we continue to kid ourselves about the level of the budget deficit because we count the building surpluses and the social security trust funds into the overall unified budget and use those surpluses to offset deficits in other aspects of the budget. This results in statistics that show the real deficit that is considerably higher than it appears because we are using trust funds to offset part of the real numbers. The social security trust fund surpluses are anticipated to grow dramatically, building, some say, to a trillion dollars. Wouldn't it be a good idea to remove the social



security fund entirely from the budget, to stop counting it in the unified budget. I'd like you to comment on this.

Second, we are operating under the assumption that, because of demographic changes down the road, roughly somewhere after the turn of the century, the ratio of working people to retired people will be lower than it is now. Some even suggest that there will be one retired person for every two working people at that time. We are building the social security trust funds to meet the requirements of that time.

While that is one way to look at it, it seems to me equally as valid to think that when the time comes, when this ratio changes, that there will still be a significant amount of work to be done in this country and that we will in fact invite people in from other countries, either as guest workers or under some other agreement, to do the work. And, if we have people here from other countries doing work, these people would pay under our social security system. I would think that it wouldn't be too hard to see how they could pay in at that time. Wouldn't it be a good idea, less of a drain on the economy, for us to keep a 7-month, 10-month, or year-surplus in those trust funds to meet the current needs. We might want to adjust the social security rate—it could be higher or lower, maybe once a year—to maintain that 7- to 12-month reserve instead of building massive reserves beyond that point, with the anticipation that we would then fund the retirement of those people who will be retiring around 2020 from payments made by guest workers and other American workers.

Chairman GREENSPAN. Well, in answer to your first question, Mr. Chairman, I think that there is a bit of unwarranted euphoria about the outlook for the total fiscal accounts of the United States because of the prospective very large surplus which will surface inevitably under the existing structure in the social security funds.

The Congress, as I understand it, does contemplate eventually—in a few years—taking social security off budget and, in a sense, dealing with the remaining budget process excluding the social security trust funds.

The problem I have in evaluating this is that while it is certainly the case that we will be building, according to plan, a very substantial social security surplus, the longer-term outlook for the non-social security trust fund part of the budget is likely to be deteriorating. To balance that segment of the budget is going to be very difficult to do, and it's going to require very great effort on the part of the Congress to make certain that that is done in the years ahead.

As a consequence of that, I think the presumption that we're somehow going to very readily slip into the unified budget surplus of the type which I had discussed in my prepared testimony, is, I think, a bit overdone.

Congress and the next administration are going to have a very tough problem in restoring fiscal balance, even with the social security trust funds on budget. If we take that surplus off, obviously, it's going to be very significantly more difficult.

When in the commission we were discussing this question of on-budget, off-budget, there were lots of pluses and minuses.

We should not, in any event, and we will not, completely eliminate the concept of the unified budget deficit because from an economic analysis point of view that is the best statistic that we have that measures the net claim on the Nation's resources from the Federal Government.

So that number will continue to be something which the Congress should and will be continuing to focus on and that's the number which I think we should ultimately have in surplus.

Implicit in that, of course, is that the remaining non-social security trust fund budget will be in deficit to some respect and that it will be covered by the social security surpluses.

I think that is the appropriate way to look at that. The commission essentially decided to move toward very large surpluses because the alternate procedure of looking at the issue of variable tax rates induced the types of fluctuations and rates which we on the commission thought would be too unstable and difficult to deal with in an economic policy basis. It would also be difficult to deal with politically because you would be increasing and decreasing taxes quite often in a way which I don't think would be easy or, from a long-term fiscal policy point of view, perhaps all that easy to implement.

We decided in the commission to move away from the historic pay-as-you-go social security procedure largely for this reason. We recognize the great difficulty that is created by building up this huge fund and letting it down, but we consider that the least worst alternative to this particular problem.

Chairman NEAL. I would like to point out that as the trust fund builds, there is going to be ever more temptation to spend it. It is also noteworthy, it seems to me, that we will be financing a huge portion of our Federal budget with the most regressive of the taxes that we use anywhere.

Chairman GREENSPAN. Well, Mr. Chairman, I think that that issue can be redressed in different areas of our tax code. I would be disinclined to move away from the type of recommendations which we at the commission made and which the Congress embodied into law, fully recognizing the issues that you have raised in your earlier remarks.

What we found in endeavoring to find a better solution was that the alleged better one created even more difficulties in one form or another.

Chairman NEAL. I thank you. Let me yield to the distinguished gentleman, Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

First, let me welcome you, sir. You're one of the great, distinguished economists of our age. I think it's interesting that you began your conversation with a rather revolutionary exhortation, and that is for Congress to not simply think in terms of a balanced budget, but to think in terms of surpluses.

Well, from a legislator's perspective, let me turn it back and ask for some accountability from your position as well.

It strikes me that, and I hesitate to continually pursue one subject, that you are in a position that not only observes the entire economy, but you are personally accountable for regulating one aspect of the economy, and that is banking.

The General Accounting Office, which is an arm of the U.S. Congress, recently did an audit of the auditors that did not reflect well on the Federal Reserve Board or the Office of the Comptroller.

From a basic economic perspective, it suggested that accounting principles were not adequately carried out. It also suggested that LDC debt had not been adequately written off. It also suggested that the law of the United States had not been adequately implemented, particularly the ILSA statute.

These are very serious charges coming from a very serious wing of the U.S. Congress.

In the response to the GAO study, the Board sent a letter to the Senate of the United States. Some of the Board's observations were quite reasonable and understandable. But there's one part of that letter and one sentence that I'd like to repeat back to you that I think exemplifies the problem, and I would truly ask for its re-examination.

At one point in the letter, the assertion was made, and I quote: "Bank management is in the best position to determine the appropriate levels of reserves" that should be taken against LDC debt.

Well, that strikes me as a cop-out of regulatory accountability. By giving the definitional power to banks of what is a good loan and what is a bad loan, you're allowing them to regulate themselves. I find this philosophy offensive. It also has certain implications for just how far the regulators want to go.

In any regard, I just think that it's proper for Congress to suggest toughness in regulation from regulators, even though this is a deregulatory climate. It has enormous implications for the economy. As we found with the LDC debt issue, the only way to save the economic fabric of the world clearing systems, is to make sure that the people who have been lent money have the capacity to repay it. This implies the United States importing more than we export because that's the way you pay back the money center banks.

It skews economic growth and has enormous implications for some sectors of our economy. It, strangely enough, comes back to whether regulators at an appropriate period of time demanded adequate capital ratios for the banks involved.

Now, to the credit of the Fed, you've moved in the direction of the BIS standards. To the credit of the Fed, the national banking system is stronger today than 4 or 5 years ago.

But I do think that we in the Congress have the obligation to press on this issue.

But I'd like to turn to a little different direction in terms of regulation. The Fed also has accountability as a lender of last resort. In another statute, the FSLIC bill passed last year, Congress asserted that the thrift regulators should have the exact same powers of regulation that banking regulators do.

I know there have been an increasing number of inter-agency workings with thrift regulators. This is somewhat new in terms of its intensity. But my sense is that macro-economics has not been applied to the subject matter and Fed oversight and coordination with the thrift regulators have not occurred in a very serious manner. Let me cite some examples.

We have a circumstance today where net worth certificates are being used by a bankrupt fund which impels growth in the indus-

try and represents a claim on the U.S. taxpayer at some point in the future.

I would wonder what the Fed position is on the extensive use of net worth certificates. We have a circumstance in which, thrifts with negative net worths are allowed to grow. Last year, over 100 thrifts with negative net worths grew more than 10 percent a year. A few even doubled in size.

What is the position of the Federal Reserve Board on this subject matter?

We have other circumstances in which "rescued" thrifts are planning to double in size over a 6- or 7-year time period.

We have another circumstance in which the Chairman of the Federal Home Loan Bank Board asserts that the thrift industry should expand by 7 percent a year for the foreseeable future. This expansion rate is above the inflation rate.

I would like to ask you, as Chairman of the Federal Reserve Board of the United States, with the prospect of using your resources at some point in time to bail out the thrift industry, whether you and your staff are urging the thrift regulators to hold the line on growth.

You've urged Congress to develop surpluses, a revolutionary concept.

I would say to you as a regulator, isn't it time that certain aspects of the financial community "shrink." What are you doing to achieve this objective? And does this objective seem reasonable given that Congress may be looking at a taxpayer bail-out in the not too distant future?

Chairman GREENSPAN. Mr. Leach, let me make a few comments with respect to the issues you have raised.

First of all, let me just say that regulation, per se, does not mean and should not mean lax supervision. I think that one has got to be very careful about that issue because it can very easily slip and one could inappropriately evaluate many problems which currently confront depository institutions as problems of deregulation when, in fact, it was lax supervision over the years which basically was a problem in some areas.

The question with respect to our view that bank management is best suited to make a determination of the quality of individual loans really rests on the issue that the first judgment as to the nature of that loan is best left in the hands of those who have made the loan and understand it.

That does not mean that there are not overriding supervisory actions taken on occasion which override one way or another what management views are.

The whole ICERC process, for example, is directed in precisely that area and enforces certain actions which management may or may not have taken previously.

But it is a mistake to presume that regulators, irrespective of their detailed evaluation of the whole process, have the level of knowledge that management and loan officers have, or the boards of directors who supervise the loan officers within an individual bank. It's a mistake to believe that any of us have the information relevant to making the judgment.

It is required—

Mr. LEACH. Mr. Chairman, at the risk of presumption.

Chairman GREENSPAN. I'm sorry.

Mr. LEACH. It would be inconceivable for the superintendent of the State of Iowa banking system to say that about an Iowa rural bank. They look at regulation and supervision in a very different way.

I'm thunderstruck by the series of quotes you've just made. They are in essence saying that you are going to continue to refuse to write off a higher percentage of LDC bank loans because individual banks have a better view of the strength of these loans.

It's nuts.

Chairman GREENSPAN. No, I'm not saying——

Mr. LEACH. That is not how the Iowa superintendent of banking would treat a farm loan in a rural bank.

Chairman GREENSPAN. No, I'm not saying that, Mr. Leach. What I am saying is this. That basically, each individual bank has certain types of loans and I'm saying there is a body of information that is held in that bank which we do not have a level of access to that they do. What I'm trying to say is that the initial judgment should, of necessity, be the individual bank management.

That is not to say that in supervision we don't obviously override it. That is the purpose of supervision. That's what we do.

But what I don't want us to be doing is to dictate to the bank in advance of their judgments what we think of particular loans. What that will do is to undercut the process which is crucial to our whole credit extension intermediation process in this country which puts the burden on bank management to the shareholders of the banks in a manner which enables them to balance risks in a manner which we cannot do.

But I am not saying that supervision merely automatically accepts whatever management chooses to say about a loan.

On the contrary, the whole purpose of the supervisory process is to review the previous actions of management and, where desirable, question and, where appropriate, change those decisions.

But the emphasis I want to place here is the appropriate balance of what supervision should be. It's a combination of appropriate evaluation of risk and reserving by management with oversight by supervisory authority.

Mr. LEACH. Could you comment on the thrift issue?

Chairman GREENSPAN. I'm sorry?

Mr. LEACH. Could you comment on the thrift issue?

Chairman GREENSPAN. The thrift issue is a difficult one because it has emerged in a period as best I can judge, having been in the private sector at the time—when a number of things happened which made supervision rather difficult and, in retrospect, clearly less than would be required and was required at the time.

I, myself, have a periodic breakfast with the other regulators, including the Chairman of the Federal Home Loan Bank Board. And we discuss a number of the issues, Mr. Leach, which you have raised and we do comment back and forth and I give my opinions to him on occasion as they are relevant.

Mr. LEACH. Can you tell us, have you suggested to him that the industry should grow or shrink?

Chairman GREENSPAN. I have not raised that specific issue with him.

Mr. LEACH. Have you raised the issue of whether institutions with a negative net worth should increase in size?

Chairman GREENSPAN. Well, no. I think he is aware of that fact and his view is that they have at this stage controlled the problem. I certainly would agree with you, as he would, that institutions with negative net worth should not be growing inordinately.

Mr. LEACH. Mr. Chairman, my time has expired. All I would say is that this Congress expects the regulators to work together to constrain the thrift problem to diminish as much as possible public taxpayer liability.

Chairman GREENSPAN. I couldn't agree with you more, Mr. Leach.

Mr. LEACH. Fine. Thank you.

Chairman NEAL. Let me explain to my colleagues. I will try to give everyone the amount of time that they need. At this time, I'll yield to Mr. Barnard.

Mr. BARNARD. I will yield for a question to Mr. Saxton.

Mr. SAXTON. Thank you very much, Mr. Barnard. I appreciate it because, I guess as all of us this morning, my time is somewhat limited and I appreciate going out of turn.

I'm tempted to return to Chairman Neal's question about social security because I have recognized, as he has, the direction in which we're heading with regard to the fact that the social security trust fund is developing a rather substantial surplus and that it appears to many as though that offset in our unified budget in terms of the use of that surplus, at least for bookkeeping purposes, gives a somewhat false impression of where we are with regard to our budget deficit.

However, I stop short of the position that Mr. Neal seemed to be heading in with regard to putting social security back on a money-in, money-out basis. One of the things that he did that was right was to show the American people that we do have a way to guarantee that long term, or at least medium term, in the social security trust fund will be in good shape.

We went through the 1972 crisis, the 1977 crisis, the 1983 crisis. Subsequent to all of that, the surplus makes middle-aged and older Americans feel good.

I think that, while I understand Mr. Neal's position, I just wanted to say that there are some of us who appreciate very much where we are with regard to the trust fund.

The question that I'd like to turn to, however, has to do with a little bit different subject, with regard to our economic situation and where we find ourselves with the labor market.

As I travel through New Jersey and the surrounding area, I find the economy so good that employers are having a very, very difficult time finding people to work.

I've even had situations where I've pulled up to a gas pump at my favorite gas station. The owner comes out and expresses his frustration at not being able to find people to work for him, to the point where he's beginning to wonder if it's a good idea to even keep his gas station open.

I'm wondering what kind of influence, long term, that will have, that kind of an economic situation will have on labor and on wages. Won't, in your opinion, there be a tremendous surge, or at least a tendency to dramatically increase the cost of labor because of the short supply that we seem to be experiencing currently?

Chairman GREENSPAN. Well, Mr. Saxton, I think that whenever we get into periods of major business cycle expansion and falling unemployment rates, there are inevitably areas of the economy in which labor is perceived of as short. That in many respects is good, not bad, in that it is implicit in any vigorous economy that one does run into shortages here and there. It's the extreme case which we're trying to avoid.

During the second quarter of this year, New Jersey had a 3.6 percent unemployment rate, which was almost 2 full percentage points under the average for the quarter. And despite a rate in New Jersey and up through New England that is well below the current average, we do not yet have any really major, very difficult shortages of workers nationwide.

In fact, there is a considerable amount of what I would call migration arbitrage going on in this country in which various different areas of the country which have excess and tight labor markets tend to interact to average out the demand and supply.

That's one of the reasons why, even though there's been some quickening in the pace of wage increases in recent months, we still don't have the type of tight accelerating markets which would best be characterized by really having difficulty finding people and keeping businesses open.

We don't have that at the moment in any general sense and I can't imagine that emerging in the period immediately ahead. But it is unquestionably something which we have to keep an eye on.

Mr. SAXTON. Thank you very much, Mr. Greenspan. Again, thank you, Doug, for permitting me to go out of turn.

Mr. BARNARD. Mr. Chairman, it's a pleasure to have you with us today. Certainly, your report is of great interest to us, even though at this short night that we just spent, it's maybe a little bit difficult to comprehend.

I've got several areas that I'd just like to ask a question.

Number one, since we're on social security this morning, I would just like to ask, has the Fed given consideration to the increase in the percentage of debt that's held, Federal debt, that's held by the social security system and the other Government trust accounts, and the fact that it's increasing as it is? That along with the fact that the demographic trends show there is an aging of the baby boomers which they have forecast there would be increasing savings.

So, therefore, the demographics would be that there would be less demand on borrowing and probably a greater increase from that sector on savings.

Now, if those parameters are anywhere at all correct, the question I was asking is what effect is that going to have on some of the financial institutions if mortgages seem to decline and bond interest rates decline? Is that going to have an ulterior effect on some of our financial institutions?

Chairman GREENSPAN. Well, first, let me say, Congressman, that the special issues which are held by the social security trust fund, special treasury issues, are not something which we at the Fed are particularly concerned about because these are not public issues. They are not the types of issues which appear in the market and which we have to keep a close eye on. These are merely the form in which the surplus is accumulating in the social security trust fund.

It's an intra-Federal Government transfer and, as a consequence, it is not something which creates problems for monetary policy.

The shifting demographics, as you point out, does have an effect on the mortgage market in this sense—as you begin to shift the population structure, the rate of increase in household formation begins to slip as a percent of the population and you do get some downward pressure for net new home demand and net new mortgage credit demand.

However, an increasing part of mortgage credit extensions—in fact, currently, perhaps the most important part—is the extension's net of mortgages on existing homes. That stock, of course, is continuing to rise with the population.

It may well be that the net credit demand for existing homes, which will be continuing to rise, will offset the amounts that are required on extensions for new homes.

So, overall, I don't expect that the mortgage market, per se, is going to become a significantly different form or different position in the overall financial system. As a consequence, it is not likely to be a significant factor impacting the structure of our financial intermediary institutions.

Mr. BARNARD. Mr. Chairman, in looking at the report and sort of reviewing the parameters that you suggest on the money aggregates, I don't see that you share the same euphoria that's seemingly being expressed about the economy. On page 6, I was especially taken with the statement that you made that a more serious long-run threat to price stability could come from Government actions that introduced structural rigidities and increased cost of protection.

So sometimes I think that the public gets the impression from the dictum that comes from various sources that we are on a roll, that a trend has developed. So, therefore, caution and concern maybe for fiscal policy maybe will go out of the window.

That troubles me because on the heels of that, nobody wants to talk about taxes and, as a result, it troubles me how we talk about trying to control the Federal deficit which you continue and I think rightfully so, try to alarm us about.

So I would just say that it looks like the FMOC is monitoring the fiscal affairs of Congress, what we're doing, and I think rightfully we should be.

But I do get the feeling from your statement that you are very much concerned that we are not on a trend toward economic improvement.

Chairman GREENSPAN. Well, I'm certainly very much concerned about the fiscal situation. I think that it is a far more difficult problem to resolve than I think we understand. It is a very deep-



seated, political resource allocation problem which is as difficult a problem that a democratic society has.

I think that we certainly have made considerable progress in the last several years. I am concerned that we will cease to realize the need to make certain that the deficit continue down until it ceases to become a destabilizing force.

The problem with this is that—as you well point out, Congressman—it is very difficult to convince people that we have a problem when, indeed, we have an unquestionably very vigorous economy, one which is by most indicators doing exceptionally well. What can be wrong?

That could very readily lead to a degree of euphoria and unwillingness to come to grips with difficult problems. We will ultimately find that when the problem hits, it is very late in the game and very difficult to deal with.

I think that the Gramm-Rudman-Hollings targets have been very helpful, in retrospect. I understand we've played games with them. We've done a number of things which, really, one could readily argue is not quite appropriate. But I think the process has been working. I think it's very crucial that we resolve the budget issue while the economy is doing well because the business cycle, as I indicated earlier, is not dead. Sometime it will re-emerge. Fiscal problems are very difficult to handle under those conditions.

Mr. BARNARD. Of course, I know that you don't want to get into the political aspects of this, but how detrimental would it be if, to further reduce the deficit, hopefully in 1991 to zero, would an increase in taxes be?

Chairman GREENSPAN. Well, I have always argued that the major thrust of cutting the Federal deficit has got to be on the expenditure side to be effective over the long run because, ultimately, the Congress will fund whatever is appropriated for expenditure. Taxes will ultimately meet the expenditures or we will be running chronic deficits.

If we are capable of getting expenditure growth down by either program elimination or program contraction, we have the best capability of resolving the budget deficit problem.

I dislike the issue of moving on the tax side largely because I'm not certain it's fully effective. I have in this forum and in others advocated a gasoline tax which could be quite significant, but I advocated that in part largely because I think it has other economic purposes which are important for long-term energy policy.

But I recognize that at some point taxes have to be part of the package. It would be a mistake, however, to make it a key and fundamental part of the deficit reduction package because I think, in the end, we'll find that it doesn't work anywhere near as well as one which emphasizes cuts in expenditures.

Mr. BARNARD. But don't you think we have had an unusual reduction in revenues in the last 7 years?

Chairman GREENSPAN. Well, as a percent of the gross national product, they have not changed all that significantly. Those who argue that the big deficit rise occurred as a rise in expenditures as a percent of the GNP over the long run, I think have got the better of the argument in the numerical sense.

Mr. BARNARD. Thank you very much.

Chairman NEAL. Thank you, sir. Mr. Hubbard?

Mr. HUBBARD. I would yield to Chairman Gonzalez.

Mr. GONZALEZ. No, no. Go ahead.

Mr. HUBBARD. Thank you, Mr. Chairman. I appreciate your being with us.

We did meet 15 hours yesterday and this morning to complete a major banking bill quite different from the Senate version which passed earlier.

Your recent letter to House Banking Committee Chairman Fernand St Germain was frequently mentioned yesterday during the discussion of the banking bill.

Let me please mention to you that, as you know, one controversial part of that bill is that 14,000 banks across the United States of America, if the House version prevails, would be required to cash Federal, State and local government checks. You mentioned this provision in your letter to Chairman St Germain.

There would be no exclusions the way the bill finally passed the House committee this morning at 3 a.m. So the big banks in New York, Chicago and Los Angeles would be required to cash Federal, State and local government checks and so would banks in my district, such as the bank of Farmington, the bank at Lowes, and the bank of Tileen, very small banks, one employee, assets at one of those banks being less than \$1 million.

Could you give us your views on what the effect of this will be upon the banking community relating what you mentioned in your letter to Chairman St Germain. But now that the House Banking Committee has passed that provision with no exemptions, could you give us your views on how difficult this will be for banks to abide by this if our version became law?

Chairman GREENSPAN. Well, I haven't had a chance to read the final version that came out of that extraordinary session early this morning. I do understand, however, that you did lower the \$3,000 upper limit to—was it \$1,500? So that helps in part.

The major difficulty that we have with that is the potential for significant increases in fraud. The little I learned about what you did this morning was that there were some indications of tightening up on that issue.

But I do think that it's going to be quite important, if that eventually prevails, to keep a very close eye on whether or not fraud accelerates because it can very readily do in a small bank. One bad check or series of bad checks—fortunately, at the much reduced level—can eat into resources quite readily.

This is the reason why we advocated either variable fees rather than the fixed fee that was involved or any of a number of other methods involved to make certain that the banks, especially the smaller banks, are protected from any acceleration in counterfeiting or misuse of Government checks.

Chairman NEAL. Would the gentleman yield to me briefly on that point?

Mr. HUBBARD. Sure.

Chairman NEAL. We ended up with an agreement with a provision that would work as follows: There will be a two-tiered bank account offered to low income people, including a provision, those who do not want the regular services of a bank. This is instead of,

as the bill originally called for, people going to a bank and registering if they want to use the bank for Government check-cashing. They now will have the choice of any of the range of the accounts that the bank has to offer, if they want. But there is also a provision in the bill that requires so-called lifeline account, which many banks offer now, such as 10 checks a month and a fee of \$3 or \$4.

In addition, we have added a new kind of bank account, which is a check-cashing account. People open the account, wait 20 days, in any case, so that there can be an adequate verification of signature, residence, and so on. From that time on, if a person wanted just to use the account for cashing a check, they would take the check to the bank and the maximum charge would be \$2 per check. We used that figure because that was what was in the bill.

The benefit, we think, over the long haul is that we would encourage direct deposit. We do not want to force anyone to do anything they do not want to do. But we would hope that VA, social security, and other welfare agencies, would put notices in with the checks suggesting that people could get same-day cash for the check if they would go for direct deposit.

I believe this would reduce fraud and abuse significantly. It seems to me we've made a lot of progress in this area.

Mr. HUBBARD. That's all right.

Chairman NEAL. If you do not like the idea, let us know. It seems to me we have come up with something that is both practicable and workable.

Chairman GREENSPAN. When we see the print, we'll take a close look at it.

Chairman NEAL. We would be interested in your comments on it.

Mr. HUBBARD. Efforts by the banks to go into the insurance and real estate industries failed yesterday.

Would you comment on current restrictions on banks expending into insurance and real estate sales, as well as provisions that would stop banks from underwriting mutual funds?

Chairman GREENSPAN. Well, we basically as a Board reviewed the whole set of issues related to insurance and security powers, and real estate powers.

The Board of Governors essentially signed off on, so to speak, S. 1886. All I can say to you is our general position is consistent in support of the Senate bill in those areas.

Mr. HUBBARD. Last, would you comment about the Senate Banking Bill, which, if our version prevails in the House, then we go to conference and the Senators come forth with their version, which only had two votes in opposition.

How do you feel about the Senate Banking Bill that Senator Proxmire is so proud of and the Senators have almost unanimously endorsed?

Chairman GREENSPAN. As I said, we at the Board especially reviewed that legislation and concluded that we would unreservedly support that bill; that is, the Senate print.

Mr. HUBBARD. Thank you, again, Chairman Greenspan, for being with us today.

Chairman NEAL. Mr. McCollum?

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

Chairman Greenspan, I apologize for being a little late this morning. It was not the hour that we were up last night, though I know that some of your staff was with us and we appreciate their staying until the wee hours of the morning. But I happen to be chairing—not chairing, but being the ranking Republican—wish I could be chairing once in a while—another subcommittee over in Judiciary that’s involved with the drug issues today, and it did consume me earlier.

But I did have a couple of questions that I don’t believe from listening to my colleagues and talking with staff you’ve had occasion to fully address this morning.

Yesterday’s economic figures came out and I know that they are certainly showing some more heating of the economy, if you will. I guess in some quarters the figures were lower than expected and to some, perhaps, they were too high. The market certainly reacted in the afternoon to them.

I’m curious to know what you make of those figures. Are they consistent with what you would have anticipated? I know you’ve expressed concern—obviously, we always are concerned with inflation and where it may lead and higher growth in the economy. I know you’ve talked about the labor problem and employment.

But what do we make of those figures yesterday?

Chairman GREENSPAN. I think in the physical volume sense, they came out pretty much as we expected because the GNP accounts are not new data. In other words, it’s not as though new information has come out.

What it is is a very detailed combination of previously published information which we at the Fed have as well as the Department of Commerce. So it depends on how one evaluates what those numbers are.

The only thing that I found a bit surprising was the extent of the rate of inflation published for the second quarter, that the fixed weight index for the GNP deflator at 4.7 percent seemed somewhat larger than I would have expected one would come up with, coming from the already published sets of data.

The reasons for that are the different ways of evaluating certain numbers. But remember that we have nothing more than effectively the Consumer Price Index, some agricultural prices, wholesale prices, and we recombine them in somewhat different ways. And we seasonally adjust them somewhat differently.

But aside from that, I think the numbers continue to essentially indicate that the economy is clearly in a relatively sustained expansion. And we did not, as a consequence of all of the data that we had, really have to review the Humphrey-Hawkins report which was done prior to those data because, in a sense, the numbers essentially came out reflecting the type of economy that we had previously been evaluating.

Mr. McCOLLUM. Mr. Chairman, I know every person in your position has the difficult tightrope to walk of wearing two or three different hats, managing the Federal Reserve System, giving advice to Congress on fraud policy questions with regard to where we go with issues such as Mr. Hubbard was asking about in the banking area and, of course, advising, counselling, voting, encouraging or

whatever, open market considerations, which is the monetary policy area that we specifically are talking about today.

In wearing those hats and in walking that tightrope, I never have asked questions, and I'm not going to this morning, ask you to project or indicate any movement in specific actions of monetary policy by the Open Market Committee because I think that's inappropriate.

But I am concerned, as I always am, with the media and with the financial markets' response, sometimes erratically, to comments that are innocuously made that you have to make in public forums such as this, and your reactions to questions such as I just asked. Sometimes they read all kinds of things into what seem very straightforward.

Chairman GREENSPAN. I've noticed.

Mr. McCOLLUM. So I traditionally like to ask the question which allows the Chairman to not comment on where it's going, but to give you a chance to breathe some room into the whole process.

The question I'd like to ask in that light, over the last 3 or 4 weeks, has there been anything that's occurred in the economic picture, including yesterday and those figures you just discussed, that would radically alter your advice or what we might anticipate with respect to open market policy, as opposed to the basic policy movement that you've been conducting here in the last few weeks?

Chairman GREENSPAN. I wouldn't think so, Mr. McCollum. There have been a lot of data that have come out in recent weeks. Some have been stronger than I would have expected, some weaker. But none has altered either my or, as far as I can judge, the Board's general view as to where we are going and where we have been.

That will inevitably happen. This is, in a certain sense, a period in which there have been fewer surprises than normal, talking back into the spring, let's assume. That can't continue. History tells us that we are going to be surprised by a number of different things, and if I knew what they were, I wouldn't be surprised.

Mr. McCOLLUM. Well, I can respect that and I know that we're going to have to vote, Mr. Chairman. I'd just like one brief follow-up, and that is to this extent.

My observations in listening to you over the last several weeks since you've been in office and we've had occasion to have you here as a witness and so forth, have been that the general drift of what is going on with the open market policy has been to try to manage a pretty steady-as-you-go ship of state over there.

I don't—and this is just my observation and you can either comment on it or not as you choose—I don't see from what you've told us today any reason for us to expect dramatic movement toward huge discount rate increase to make a change or huge opening of the floodgates of money to flood the market place, that you're still looking at the parameters that are pretty steady as you go here and there to make sure that we don't go radically one way or the other.

If you want to comment, you can. I don't want to, again, get you into a specific area that you don't want to be in.

Chairman GREENSPAN. Let the record show that I was uncommunicative. [Laughter.]

Mr. McCOLLUM. That's fair enough. Thank you, Mr. Chairman.

Chairman NEAL. Thank you, sir.

We have a vote underway now on the rule for the Drought Assistance Act, so we will recess for 10 minutes. Then we will hear from Mr. Gonzalez.

Mr. GONZALEZ. Mr. Chairman, let me say, I'm not a Member of this subcommittee, so I'm here as sort of a guest. There's no use interfering with the regular Members, even though Mr. Hubbard very generously offered to accede to me.

I just wanted to say that, first, to thank the Chairman for being here. But I'm very much disturbed to hear some of the things here. I know that everybody's loathe to think or talk about taxes or Texas. [Laughter.]

But since that issue was mentioned, I would like to point out that if you do have regular meetings with the regulators, and particularly the Home Loan Bank Board, that we make sure that we realize the dimensions of that problem.

The Chairman came before us the last time, and on the eve of his appearance, upgraded his size of the hole in Texas 100 percent. The figures that we're getting indicate that even that revised figure is very modest and not accurate and that we've got to expect another 100 percent just in Texas alone.

Now, I think that we've got to recognize that we're not going to be able to isolate this crisis to Texas. It's going to spill over. We're going to have to confront it. I think we have to recognize the limitations as to what the industry itself can do and where Congress should come in.

Now, I know that everybody wants to hold everything together until November. But I'm just wondering, in case it doesn't.

I just wanted to leave that thought because I think that we've got to think of taxes and Texas because if we don't admit to the cause of the dilemma of this monstrous deficit, and that, I think, is the fact that we drained the Treasury of \$755 billion worth of revenues over a 5-year period.

Now, we've got to make it up somewhere. So we've got to think of taxes. But in the meanwhile, we have the crisis in our financial institutions, and particularly in these hard-hit areas that seem to be isolated now, but I think will soon be national.

Thank you, Mr. Chairman.

Chairman NEAL. Thank you, sir. We will recess for 10 minutes and be back as soon as we can and pursue some other questions on monetary policy.

Thank you, Mr. Chairman.

[Recess.]

Chairman NEAL. The committee will now resume its hearing.

Mr. Chairman, I would like for you to help us understand the recent appreciation of the dollar. According to one popular explanation, the major central banks of our trading partners are cooperating to induce some dollar appreciation to help dampen inflationary pressures in the United States and keep our interest rates from rising substantially. What have other central banks, particularly Germany and Japan, been doing over the last few months in terms of exchange market intervention? What has the Fed been doing?

For sometime, the G7 countries have apparently been operating under secret ranges for exchange rates. Why are they secret? Why

aren't they announced? Have they played any role in encouraging the dollar's recent strength?

Finally, isn't the dollar's recent strength something a bit worrisome, given that we have only recently begun to make some progress toward reducing our trade deficit? It appears that the rest of the world is all too ready to bid up the dollar as soon as it hears the slightest positive news about our trade performance. If that continues, will they constantly thwart serious and sustained progress on trade deficit reductions?

Chairman GREENSPAN. Well, Mr. Chairman, let me first just quickly comment on the issue of why we don't make ranges of intervention limits public.

To the extent that specific fixed ranges are made public, we are in fact on a fixed exchange rate regime. In other words, basically, going back to the gold standard when we had just so-called gold point spreads between bid and asked on the currencies and through the Bretton Woods agreements, we had announced fixed rates.

That is one type of operation for exchange rate regimes which could be implemented.

The difficulty of doing that in today's environment I believe is that we would find that we would probably in the process destabilize the system. That is, we would have very great difficulty locking into a specific set of exchange rates in today's environment and I think that that's generally agreed upon by all of the major trading partners.

Nonetheless, we also agree that stability is clearly superior to volatility and, as a consequence, there have been agreements since the Louvre accord amongst the G7 to foster stability of exchange rates and that is essentially what the G7, in consultation, has endeavored to do.

The degree of intervention, as many of our reports have indicated and as many have assumed quite correctly, has obviously been a good deal less in 1988 than in 1987. Clearly, with the improvement of the American trade accounts, stability of the American dollar emerged and has been fostered by actions by the G7 in concert, and we hopefully will be capable of doing that into the indefinite future.

The recent strength would become worrisome if, in the words of the communique which the G7 issued late last year, the dollar rose to a point which would essentially create difficulties in the international stabilization process; that is, it would be counter-productive to the type of adjustments which we are all endeavoring to do.

That, in effect, is something which clearly we have stipulated as a group we would find undesirable.

So, in general, I think the central thesis is stability, and it is stability because it is in our judgment—for all parties, all economies of the G7—the exchange rate regime which will most foster at this particular stage the implementation of the type of corrective actions which are required to bring down the cumulative trade surpluses, on the one hand, and specifically our very large trade deficit on the other hand.

Chairman NEAL. Well, is that correct? Is stability at the current exchange levels the best way to bring our trade deficit down?

Chairman GREENSPAN. What I am saying is that the adjustment process is contributed to best by stable exchange rates in this area.

The reason I say that is, as I've indicated previously, further downward adjustments in the dollar would not at this stage create any accelerated improvement in the nominal trade deficit. It is clear that the process that is already underway and the effects in the pipeline toward a major rise, in the physical volume of exports and slowed growth in imports, are a consequence of previous declines in the exchange rate and improved productivity and a number of other factors. It is not clear that we have capacity in our industrial area in the United States to actually significantly improve on that export-import change in physical volume terms.

Chairman NEAL. Because we are producing at near capacity.

Chairman GREENSPAN. Yes. If that is the case, a decline in the dollar will show up as higher import prices, which will make the nominal deficit worse, not better. So, as we see it, from the point of view of the United States, and there are comparable issues in Germany and Japan, that the adjustment process that is currently going on is moving at a reasonably rapid pace, perhaps about as fast as one can expect to be achieved. I would say there's really nothing that would improve that process by moving away from the central focus of stability.

Chairman NEAL. I must say, in general terms, I agree with you. However, if the dollar were to continue to appreciate in value, the impact, it would seem to me, would be on balance negative.

Chairman GREENSPAN. I agree with that. I think that the G7 stipulated that and reaffirmed it at the Toronto summit.

Chairman NEAL. So you would see this recent appreciation as perhaps an aberration in the longer term trend of stability.

Chairman GREENSPAN. Well, I don't want to comment on specific movements, Mr. Chairman. I would like to just leave my comments stay where they are.

Chairman NEAL. It is important to me to know whether the Fed is or is not actively trying to encourage appreciation of the dollar.

Chairman GREENSPAN. I've read stories that had all sorts of implied secret conspiracies involved which I thought were absolutely bizarre.

I think that what is in the communiques of the G7 are actually what went on in the G7 meetings, what people had in mind. People looking for secret meanings in these things, I think they're looking beyond reality.

Chairman NEAL. That does not interest me, either.

If I may direct your attention to the chart on the wall which depicts Federal Open Market Committee monetary growth target ranges and actual M2 and M3 growth.

[A copy of the chart may be found in the appendix on page 83.]

Chairman NEAL. It suggests monetary ease early in the year and some tightening beginning in the spring as the aggregates approached their upper target ranges.

Would you say this is an accurate depiction of the thrust of monetary policy? Can we say it was fairly easy in the first quarter, then began to tighten? Given the expected strong growth of the economy, wouldn't it be wise for the Fed to induce the aggregates



to continue the downswing they have now initiated—to finish the year somewhere below the mid-range?

Chairman GREENSPAN. Certainly, that chart does depict precisely what it is that we are endeavoring to do with respect to the monetary aggregates. We are endeavoring to hold M2 and M3 within target.

It's very difficult to say precisely where within the range we will end up. But, clearly, we are focused to try to be well within the range because to be significantly on the edge or outside of it would suggest that our general view of the way we thought that the economy was emerging had changed.

Since, as I indicated earlier, it has not, one can reasonably presume that we will be, if it continues according to our judgments as to where it's likely to end up, pretty much in the middle of the range, or substantially there. But whether it's a bit above or a bit below is, I think, not too easy to determine.

Chairman NEAL. Thank you, sir. Let me yield to Mr. Flake at this time.

Mr. FLAKE. Thank you very much, Mr. Chairman. I'd like to express my thanks and appreciation to the Chairman for coming to share his wealth of information with us this morning and to our Chairman of the Banking Committee for making it possible, in spite of having kept us out half the night and morning, to get up even at this early hour to follow through.

Mr. Chairman, I have three questions that are basically unrelated, but may be of some interest.

First of all, having read some of your comments over the last couple of weeks as it relates to the CRA requirements that have been bandied back and forth here on the Hill in relationship to new banking policy and the new banking bill, is how might we be able, to get the banking community involved in the process of redevelopment, and rebuilding? Then we should be able to move the persons who are a part of that potential labor force into more legal, productive kinds of jobs than what they're doing now, which in most instances is a choice of selling drugs on street corners?

Chairman GREENSPAN. Mr. Flake, I think you're raising one of the really very difficult problems which is essential for this country to address and address in a way which is not at the margins, but essentially, it comes to grips with the fundamental issue.

I don't think it's strictly a banking question. I think it is partly a banking question. But I think what has to be done is for us to find ways which have been done partly successfully in certain areas, to find the means of getting business and investment into these areas which create jobs, create profits, create an environment of growth and confidence in the future.

Under those conditions, banks come in very rapidly. I'm concerned that we not work it in reverse because the banks are there basically to service credit needs and economic needs, and it's very important for us to get the economies going in those sections through a lot of different activities.

We should try to find successful ventures where we begin to build up some of those areas. I find it really is extraordinary that we've made very little progress in a number of those inner city areas.

If we can do that, I think what we're going to find is that banks will just normally flock in. It's where their business is. It's where their opportunities are. And competition will basically bring a proliferation of banking.

The one point I want to leave with you, however, is not to think that we can do it in reverse. The banks are not the first ones in there. They're sort of somewhere in the middle. We've got to find investment. We've got to find businesses. We've got to find job-creating activities, financed initially from outside of the area, and then you get a synergism which develops which we've seen time and time again happen.

That's the process which I think we've got to find a way of initiating.

Mr. FLAKE. Could we not expand some of our ideas that have been operative in the development of some Third World nations where we actually use risk capital? It is a risk situation when we're dealing with unstable dollar and unstable governments.

Perhaps if we could rethink what it means for us to engage in domestic development. Since I realize that we're taking a big hit in some of those Third World nations, it seems to me that the hit would be much less when we're dealing with the same government, and the same monetary system. Perhaps we ought to give that a great deal more thought and perhaps more priority than we do in developing those areas.

Chairman GREENSPAN. Well, I certainly agree. It's risk capital that we need. Risk capital emerges when there are opportunities. I think what we've got to figure out is a way to create opportunities to get that sort of capital in and find programs which initiate it.

But I think that's exactly the area which is the cutting edge of the solution, as best I can see it.

Mr. FLAKE. The second question, realizing that you have really not had an opportunity to see what came out of this body last night, but have had some opportunity to look at the Senate version of the banking bill and the numbers that have been given over the last several weeks in the Wall Street Journal and some other papers as it relates to the top 25 banks in the world, of which there is no bank in the United States listed.

What is your feeling in relationship to what the potential bank bill that we ultimately come out with will do to improve our competitive standing in the world market place? I'd like to know if you have any particular observations on that?

Chairman GREENSPAN. I certainly don't get concerned by that ranking of who is first, who is second, who is 25th or 28th or what have you.

The best and most competitive international bankers are not necessarily those directly on the top. There's a lot of other issues which create international competitiveness. It's an issue of capital. It's an issue of managerial skills. It is not an issue of size, after one gets beyond a certain point.

So I, frankly, have given very little thought to the international competitive aspects with respect to either the Senate bill or the bill that's emerging here because I'm not sure it's really all that relevant an issue.

I wouldn't, myself, think of the needs of this type of legislation to give us greater international competitiveness. That comes from other areas and I think that's not a size question. I don't find myself particular disturbed by the numbers you are suggesting.

Mr. FLAKE. The last question I guess is of interest regardless of where people are in terms of the socio-economic ladder. What is your projection as it relates to the remainder of this year and the beginning of 1989 in terms of interest rates?

Chairman GREENSPAN. Well, Mr. Flake, I've avoided forecasting interest rates and I think so has the Federal Reserve Board. I think I'd just like to leave it at that.

Mr. FLAKE. All right. Thank you very much.

Chairman NEAL. Mr. Wortley?

Mr. WORTLEY. Thank you, Mr. Chairman.

Chairman Greenspan, you look a lot livelier this morning than some of your staff people who are sitting behind you who had a long evening.

Chairman GREENSPAN. I should certainly hope so. [Laughter.]

Mr. WORTLEY. I will testify to the fact that they were here. I don't think they've been home yet.

Congressman Flake just alluded to the competitiveness of American banks. I certainly don't think myself that the consumer aspects of the bill that was marked up in this chamber at the early hours of this morning is going to contribute anything positively to the competitiveness of American banks.

I know you haven't had an opportunity to read the bill. But do you have some basic observations based upon what your staff may have told you transpired here this morning?

Chairman GREENSPAN. Well, as you know, Mr. Wortley, I had a number of reservations about the earlier prints and communicated that to the chairman of the committee.

From what I understand, there has been, in my view, improvements in the bill, clearly both in the securities titles and elsewhere.

Until I've had a chance to read and discuss it with our technicians—where some of the problems may emerge—I really don't feel competent to give you a judgment as to anything more detailed than that.

Mr. WORTLEY. Sure. I can understand.

Chairman NEAL. Would the gentleman yield to me on that point for just a second?

Mr. WORTLEY. Certainly.

Chairman NEAL. We would like to see your comments when you have a chance to review it. We worked on it a long time yesterday. Though we made some improvements, there are still more improvements needed. But your ideas on the subject would be useful to all of us.

Chairman GREENSPAN. By all means.

Mr. WORTLEY. Thank you. Let's look a little beyond next year and the balance of this year into the last decade of this century. Glance at the 1990's and we see what's going to happen in 1992 over in Europe, the European Common Market, when they drop all of their trade barriers, presumably.

What effect do you think that's going to have on the U.S. economy? Is that going to mean that we're going to have to become a

little sharper in the competitive arena? Will it bode well for the United States because we seem to be a few steps ahead of Western Europe in our productivity and the like?

Let's also factor into consideration the final decade of this century when there will be a shortage of people in the U.S. labor market, which may raise the cost of doing business. On the other hand, it may also make us more efficient and work smarter than we've been working in the past because we will have an older, more experienced work force.

Looking at some of these factors, do you feel bullish about the last decade of this century?

Chairman GREENSPAN. I do. I think that I do largely because there is a very significant underlying trend that has emerged in the world in, I'd say, the last decade. That is a growing recognition that market economies are the way in which economic wealth can be created.

We've seen this not only in Europe, where there have been quite significant changes. We view it as sort of a political shift toward conservatism. But I think it's fundamentally more an issue not of conservatism, but of agreement of free market oriented type of economies. We're even seeing it, obviously, in the socialist bloc, not only with respect to the Soviet Union, but elsewhere, and most importantly, in the Third World.

That's a deep-seated philosophical recognition of how societies and economies should be organized.

When one looks at long-term economic growth, I think it is a mistake to look at demographic factors and econometric projections. I think you have to look at the philosophical culture which the system functions under. I think that the movement of Europe toward integration is a very significant, positive force for the world as a whole.

The negative possibilities are exactly the anti-market issues. For example, would the Common Market become, in and of itself, a protectionist vehicle which would raise its barriers to the United States and the rest of the world? The answer is, if they are on their current trend, no. To the extent that that is no and to the extent that they develop, it clearly enhances us because we can trade with them. It's been very obvious in the post-World War II period that enhanced trade has been a major factor toward the growth of standards of living throughout the world.

Mr. WORTLEY. Expanded trade will determine how successful our own economy will be.

Chairman GREENSPAN. Yes, most certainly.

Mr. WORTLEY. If the European Common Market is prospering, the U.S. economy should prosper, assuming they keep the trade barriers down and do not revert back to what you might have suggested a moment ago.

How do you look at the Pacific Rim and where we will stand? Do you think there will be more concentration of American efforts toward Western Europe when 1992 rolls around, to the neglect of the Pacific Rim market, or do you just see the whole thing exploding all around us?

Chairman GREENSPAN. I think one of the extraordinary events of the last generation has been the major improvements in world tele-

communications and in travel. We have really, obviously, in a figurative sense, brought the world together.

Thirty years ago, to make a telephone call to London was a big deal. Now you call London to get the weather. It's that easy and it's that cheap.

The costs of communication and transportation having, in relative terms, fallen, has brought us all closer together, and I would think in those terms, we are going to see significant increases in international trade and a continued integration of the world economy, both on the Pacific Rim and in Europe, so far as the United States is concerned.

Mr. WORTLEY. Well, the market place is certainly open 24 hours a day, whether you're talking about the stock markets or whatever else.

Just one final question here. The FOMC forecast implies a somewhat slower growth of the economy during the second half of this year. What really accounts for that projected slowdown? Is it the fact that the committee itself is considering tightening the money supply or do they really see other elements there?

Chairman GREENSPAN. People rarely ask that question and the answer actually is I don't really know. Let me tell you why.

Mr. WORTLEY. Are you a right-handed or a left-handed economist?

Chairman GREENSPAN. I'm a left-handed economist. I don't know what that means, but—

Mr. WORTLEY. We're looking for the one-armed economist.

Chairman GREENSPAN. Yes. What we do is we poll the voting members of the FOMC and the nonvoting members and we ask them for their projections. Each obviously has his own view as to what he thinks will happen and why it will happen, but that's not part of the survey.

So all we can get in that context is basically the average judgment as each makes that judgment without knowing precisely why in each individual case. Now, obviously, we can make broad, general judgments as to why those things occur. And we have, in effect. One obvious explanation of a slowing is we are approaching low unemployment rates and restraint on capacity. We assume that most of the members had that in mind.

But that's an inference, and it's not something I can tell you I know for a fact.

Mr. WORTLEY. Well, that was a very clear and concise answer. Thank you, Mr. Chairman, very much.

Chairman NEAL. Your projections for real growth have been in the range of  $2\frac{3}{4}$  to 3 percent for 1988. Based on statements you have made, it appears that you think that real growth near  $2\frac{1}{2}$  percent, is about what we can count on without encountering inflationary pressures.

One of the promises of the Reagan administration's economic policies, in particular its tax policies, has been that we will grow our way out of the deficit. Do you think that this is a realistic and prudent expectation, if, in fact, if we were to pump growth up beyond the range that the FOMC projects—over 3 percent. Won't that cause other problems for the economy. Is this a prudent vision of what it takes to solve our economic problems?

Chairman GREENSPAN. Mr. Chairman, I do think that there have been members of the Reagan administration who have, in a sense, implicitly or explicitly argued that.

My recollection, however, is that that is not the official position of the President or his key advisors at any point that I particularly remember.

My own impression is consistent with that. I don't think that one grows out of this particular deficit. If I believed that, I wouldn't be as forceful as I hope I have been on the need to take actions to bring it down. If we're going to grow out of it, no actions are required. I don't believe that that's a feasible policy goal at this particular stage, nor has it been.

Chairman NEAL. I would agree with that.

Mr. Leach?

Mr. LEACH. Well, thank you. First, just an aside on this particular issue.

I think that all of us should recognize that whether or not your policies are exactly right or wrong at this time, they reflect a great deal of integrity because they're designed to slow down economic growth at the time of the election. That implies an independent Federal Reserve Board.

Some of us on this side of the aisle, Mr. Chairman, think that this might ultimately lead to disaster, a Democratic administration. But that being said, I think we should honor the integrity with which the Federal Reserve Board is currently being managed.

But I would like to move away from the larger world view, and I'm sorry, return again to the sectoral.

We seem to have a problem with Federal insurance of depository institutions because it's rational for individuals to put their money in an institution with the highest rate of interest as long as it's federally-backed or perceived to be secure. This implies that institutions which are poorly managed or are in extreme deficit positions can grow rather extraordinarily, unless there's regulation to curb this growth.

It's my sense that there has not been enough attention placed on this issue. It may be that the only way we can protect the Federal insurance system without changing it dramatically is to reduce Federal insurance for those institutions least able to manage growth.

You made a remarkable statement earlier, and I think it's somewhat newsworthy, that you think insolvent thrifts should not be allowed to grow.

Last night, in considering the banking bill, I proposed an amendment that did not receive a great deal of support in this committee. I suggested a plan to retard the growth of the thrift industry. In this plan those institutions with a negative net worth should be required to shrink on an annual basis of three times their percentage negative net worth.

So if an institution has a minus 3 percent negative net worth, it would shrink 9 percent a year. Those in the 0 to 4 percent positive category would not be allowed to grow. Those with a 4 to 6 percent net worth could grow at 2 times their positive net worth. Those above 6 percent could grow without limit so long as they stayed above 6 percent.

I don't want you to comment precisely on that plan. But one of the aspects of putting forth that amendment was to suggest that people think in terms of a plan. A plan that comes from a Republican Member of Congress is not likely to carry much weight. But it strikes me that if a Republican Member of Congress can devise a plan in the shower, the Chairman of the Federal Reserve Board, with the enormous staff behind him, could derive a Greenspan plan, or a regulators plan, to deal with the macro-economics of the thrift problem. Such a plan would stop a \$50 billion headache from becoming a \$100 billion migraine.

There are tools that regulators can use. One of the most important tools is the power to remove institutional executives and directors.

I would suggest to you that the regulators in concert, led by the Chairman of the Federal Reserve Board, ought to establish an approach and announce that approach and announce that institutions that violate this approach will have their management, directors and executives removed.

It's the only way to curb growth that is excessive. It's the only way to avoid far harsher kinds of approaches that will be very disruptive to world commerce, such as changing the deposit insurance system. It's the only way to avoid a much greater taxpayer liability as time goes on.

In effect Congress has developed a scheme by which high fliers only incentives are to take risky steps. Congress can only then protect itself if regulators rein in these unwarranted risk takers.

Does the idea of coming up with such an approach strike you as reasonable? You have acknowledged earlier that zero growth, at a minimum, for insolvent thrifts makes sense.

Can you follow it with the idea that for those that violate that prescription, there ought to be steps taken? For example, the removal of officers.

Chairman GREENSPAN. Well, Mr. Leach, let me just go back and take a look at what the nature of the extreme problem is in certain instances.

The extreme of this issue occurs when an institution, a depository institution, finds that, for example, not only does it have inadequate interest earnings to pay interest on its deposits, but the amortization of its asset base, in combination with interest earnings, is inadequate to pay that interest.

What we find under those conditions is that institutions went out and expanded merely to get deposits to pay interest. It became a cumulative process which at the root of this issue.

The problem we have is a much broader issue, however, which I think is going to inevitably require considerable focus by this committee and others within the Congress and the next administration on the issue of deposit insurance. We have not really reviewed the system since its initiation. We've all conceptually understood that the so-called moral hazard question was inevitably a threat to the system and created many perverse incentives.

I don't, frankly, know what the actual issue is, but the underlying thrust is going to have to be to review the whole system to basically try to find what our alternatives are and restore the system to the type of balance which we clearly need.

Without commenting on your specific proposal, I think that my concern is that the issue has to be broadened out. But, clearly, specific issues of the type you raise, and without commenting, I'm not sure whether it's a good or a bad idea. I'd have to really think it through.

But let me just say that we will have to spend a good deal of time rethinking the system to make certain that we can restore it to what it is supposed to be. In that regard, obviously, we at the Fed have been thinking about this question, will be thinking about it, and we will be prepared at the appropriate time to be of what assistance we can be to the Congress when it revisits this issue in more detail later.

Mr. LEACH. I appreciate that. But let me come back to Federal Reserve Board responsibility. I don't want to play ping-pong with who's at fault. On the deposit issue, there are a lot of alternatives that one can visualize. One is to take away insuring interest and just insure the deposit itself.

Another is to have differing levels of deposit insurance for institutions, depending on the institutions capital-to-asset ratios.

I'm a little alarmed at your statement that you will make recommendations to the next Congress. First, there is a regulatory responsibility to act. Second, there is a timeframe that cannot be delayed any longer. Sometimes, timing is with us, sometimes it isn't. But timing-wise, it strikes me----

Chairman GREENSPAN. I agree with that.

Mr. LEACH. That the regulators are going to have to come together and address the problem, that the Fed ought to exercise leadership. You, yourself, have an appropriate background in this area. You have a particularly appropriate staff. You have the capacity to look at this issue in a macro way, unrelated to my approach.

Approaches can generate other approaches. But any approach should lay down principles that everybody in the industry understands. And if these principles are violated, there should be punitive action, such as the removal of the violators.

Chairman GREENSPAN. Yes. But we have the legal authority to do that.

Mr. LEACH. You surely do. Now let me come back and note what has happened in the last 6 months, without the Federal Reserve Board in opposition.

At the Federal Home Loan Bank Board, one institution got into some difficulty because regulators tried to be too tough, and so the FHLBB changed regulators. Unprecedented in the history of regulating agencies. I have not heard a peep from the Federal Reserve Board about this case.

We have instance after instance where agreements have been made to allow insolvent institutions not only to continue, but to grow. Again, let me talk about the Ben Franklin Savings and Loan in San Antonio, TX, a totally insolvent thrift. Its rescue plan is to let it grow from \$2½ billion in size to \$5 billion in size over the next 5 to 6 years.

Incredible thought! You rescue it by impelling growth.

The net worth certificate issue is not only one that puts the taxpayer on the line; it impels growth in the industry.



All I'm saying is that somewhere, people have got to come forward. This Congress is institutionally incapable of getting too tough on an industry this much in trouble. Therefore, I think we have to look to you to do something within your realm of jurisdiction.

Just as one Member of Congress looking at an institution that is semi-independent, semi-public, and part creature of this body, all I would ask is for you to put your best minds to work, come up with a plan, and take responsibility.

I think you're going to have to do it soon.

Mr. Chairman, I have no further comments.

Chairman NEAL. On the question of FSLIC, not long ago, we had Chairman Wall of the Federal Home Loan Bank Board before the committee and we discussed for some time the current situation. Different opinions were expressed about the magnitude of the problem and our ability to deal with it. I asked Chairman Wall if, based on the best information he had, did he think that the roughly \$42 billion that the FSLIC will have for dealing with the thrift problem over the next several years, would be adequate for the task at hand? His answer to me in that public forum was that, to the best of his knowledge—I'm paraphrasing—it was an adequate amount of money and they thought they could deal with the problem.

I raise this point because there have been a number of press reports which followed that meeting, which did not reflect that at all. Indeed a number indicated that the resources have been inadequate and so on. Do you have a view on this?

Chairman GREENSPAN. There is an underlying problem with the issue which really relates to how one makes that estimate. The major problem is that we have to have a judgment as to what is the market value of the properties which underlie the mortgages because when you're getting toward a very difficult situation, the mortgages essentially become nonrecourse loans on properties which then essentially become the asset of the depository institution.

The one thing that is very difficult to make a judgment on is to what extent that market value is adequate or inadequate, or to what extent one has to discount it to meet the requirements of the institution.

Since the amount of property that underlies these mortgages is so huge, small changes can generate very large dollar amounts relative to what the whole is.

So when somebody tells me that the whole is some particular number, my assumption is he either has extraordinary insight or access to information that we don't have.

Nonetheless, you do have to make judgments and you are making them and we are—I mean, we obviously follow this issue very closely and are very much acutely aware of the issues which both you, Mr. Chairman, and Mr. Leach have been raising. But we know of no way, at least I know of no way, to get that fine-tuned to a number which everyone says: "This is the accurate number."

I think what we do know is that we have a large problem, and I think that that is in the process of being addressed, hopefully, and it will be something which is going to grab our attention, I think, for the next period of time.

Chairman NEAL. Mr. Wall pointed out that he was not estimating the size of the problem. He was saying that what we do know is that that system will have roughly \$42 billion to work with over the next several years. The question is, based on his best information today, is that going to be adequate to the task? I would not be critical of him if his judgment changed. Judgments change and circumstances change.

But he seemed to feel confident that that would be enough. Is there any reason, at this point, based on what information you have, to doubt that? That is to say, is there something that we need to do that we are not doing at this point to deal with this problem?

Chairman GREENSPAN. I don't think so. I've talked to Chairman Wall on numerous occasions and I think he's quite realistic about what the nature of the problem is, as best I can judge. He has actually got the best data base of anybody I know.

My view would basically be that his data sources have got to be as good as anybody's and his judgment in this respect has got to be as good as anybody's. I would see no reason to try to second-guess him in this respect.

Mr. LEACH. Mr. Chairman?

Chairman NEAL. Yes, sir.

Mr. LEACH. Could I raise something in this regard?

Chairman NEAL. Certainly.

Mr. LEACH. Your point about how real estate goes up and down in value, the staggering number of properties involved, and therefore, the difficulty to predict a bailout cost, also highlights certain issues of judgment.

One issue concerns an amendment that I offered last night to the banking bill which the committee didn't find very worthwhile. Federal banking regulators, in their long history, have had doubts about using Federal insurance to leverage other people's money in direct investments.

In the savings and loan industry, some institutions of a given type are allowed to leverage 300 percent of capital for direct investments, such as buying a piece of real estate, buying a stock market investment, buying a Wendy's, whatever it may be. This is a rule and regulation of the Federal Home Loan Bank Board and it's something that distinguishes the thrift industry from the banking industry in terms of powers. The weakest of America's two principal financial banking industries has substantially greater powers to leverage.

Now, as Chairman of the Federal Reserve Board, which has some accountability to the banking industry, do you think this is reasonable, that thrifts should have this extra power to make direct investments?

Chairman GREENSPAN. Actually, I think there's another issue involved in this question. My major problem with savings and loan institutions and the nature of the difficulties they have been in really rests to a large extent on the mismatch between the maturities—

Mr. LEACH. Short and long term.

Chairman GREENSPAN. Of the assets and the liabilities.

While one may raise the question you raised, Mr. Leach, de novo, right from the beginning, nonetheless, there is an aspect of direct

investment which is beneficial in this context in the sense that it tends to be a vehicle which offsets in part the asset liability maturity mismatch. My view of the ultimate resolution of the savings and loan problem is to make certain that we try to bring that issue into place.

Mr. LEACH. Let me just say, of all the economic judgments I've heard you express, that is one that I find the least credible because in most instances, it's using short-term money for long-term investments—the purchase of a piece of real estate to be owned by the institution.

That accentuates the mismatch; it doesn't bring it in line.

Chairman GREENSPAN. To the extent that it does, it can, but it doesn't have to.

Mr. LEACH. It doesn't have to. But, generally, most of this has been used to buy real estate.

Chairman GREENSPAN. I would just say to the extent that it does increase the mismatch, it is wrong. To the extent, however, that it doesn't, it could be beneficial.

Chairman NEAL. Last night, I argued against the gentleman's amendment because I felt that we simply do not know. As I look out there, there are some very unhealthy savings and loans who have engaged in a lot of direct investment. Some of the very best managed savings and loans, most profitable thrift institutions in the country, are ones that engage in a lot of direct investment. In fact, in understanding their philosophy, they are doing precisely what Chairman Greenspan would recommend. That is to say, they are matching maturities. If they can take a deposit in for 20 years at a fixed rate, then they're willing to lend that amount of money for the same 20 years at a higher rate. If they take it in for 30 days, they put it into something that matures in 30 days. That kind of management, whether it has been in direct investment or home mortgages, or whatever, has seemed to me to be what sets apart the successful institutions from the unsuccessful ones. I have not been able to see the evidence, although if I saw it, I have no love for direct investment. That's not the question, it seems to me. I just don't see any evidence——

Mr. LEACH. Well, if the gentleman will yield to me?

Chairman NEAL. Yes, I'll be happy to yield.

Mr. LEACH. Basically, the problem of direct investments is that if the institution guesses right or has good judgment, it works to the advantage of the institution. It's heads, the institution wins. But if it's the reverse, it's tails, FSLIC loses.

So what we're really doing is honoring a speculative kind of investment with Federal insurance. There are good investments in America. Each of us as individuals can make them. But that doesn't mean that we ought to be federally insured when we attempt to do this.

Now as far as the evidence is concerned, 2 years ago there was a Federal Home Loan Bank Board study. This study found that in closed institutions, enormous problems developed with direct investments which caused enormous losses disproportionate to all others.

Now, my own guess is that the really smart investor today might do well. The real high flier might guess wrong, but with the high

flier the taxpayer is on the line. If it's such a good idea to have direct investments, it's interesting that the Federal banking regulators have never authorized it to this degree, and they have good reason not to have authorized it, in my judgment.

But if I could just return to one other issue, and that's the net worth certificate issue.

It strikes me that this not only impels growth in the industry; it becomes a Government-induced Ponzy scheme. All I want to throw out to you, sir, is that these issues ought to be looked at. As the Federal banking regulator, first you may be called upon for emergency funding, if Chairman Wall is wrong. Some of us think the amount of funding will be large and some of us think it will be needed sooner rather than later. Second, you're responsible for an industry, the banking industry, that is competing on a surprisingly unequal playing field.

Now, we all hear many, many times about a level playing field. But the fact of the matter is that Federal deposit insurance gives an advantage to anyone that can get a charter, no matter how weak they are, unless the regulators constrain them.

Chairman GREENSPAN. I agree with that.

Mr. LEACH. So the institutions that you have first and primary responsibility in regulating are being disadvantaged because another regulator is weaker than you. If I were in your position, I would be standing on the table doing backflips because you're going to have growth in the deposit base in those institutions with the weaker regulators. It's that simple.

Therefore, as one regulator responsible for one industry, you should say to the other regulator—"You've got to match my standards or you're messing around with my institutions and their ability to make money."

It's a matter of a level playing field, of fairness, as well as, very interestingly, of taxpayer liability. The taxpayer is concerned with limiting the liabilities to him or her.

All I'm saying is that somehow, somewhere, the Federal banking regulators, out of deference to another industry, have been very light-handed. I think it's time for the deferential approach to cease. Somehow, there's got to be a joint merging together of talent and judgment within Government to bring some sort of sanity to this game.

I just wish Congress were willing to act in a more forthright way, but there are lots of honest differences of opinion. The Chairman and I differ on this one issue for very reasonable reasons.

On the other hand, I can believe a regulator might share a different perspective from either of us. But my only argument is to develop a perspective and once a perspective is developed, to do everything in your power to ensure that it's followed.

I think, frankly, that means telling the industry that you're going to replace management. When there are no incentives to make money, as with hopelessly insolvent thrifts, there become enormous incentives to pay oneself well, to develop perks, to grow. If that's the worse thing for the economy, then the only way to rein it in is to put constraints on growth and to remove people from office without receiving any perks if they don't follow prudential regulatory guidelines.

Well, I don't mean to be presumptuous in my judgment, but I do think that these issues have to be looked at in a really comprehensive way. I would like a response from the Chairman the next time he comes before this committee or another committee of Congress, on whether he supports a timetable or will agree to come up with a plan.

Is there any way I can elicit that kind of commitment?

Chairman GREENSPAN. Well, I don't know that I can give you a commitment, Mr. Leach, but I've been listening to you very closely.

Mr. LEACH. OK. Thank you, sir.

Chairman NEAL. Mr. Chairman, I believe I would state your opinion accurately to say that once GNP starts growing at much above 3 percent real growth, we run into some serious inflationary and capacity problems. Japan seems to be able to grow at over 4 percent without running into those same kinds of problems. The reason appears to be that they are able to save more.

Do you agree with that analysis? If so, what would you think that we could do, what would be the most powerful thing that we could do to increase savings here domestically?

Chairman GREENSPAN. Well, Mr. Chairman, I certainly agree with you that the fundamental reason for the differential growth is the domestic savings rate.

We have over the years tried innumerable initiatives through tax incentives, through varieties of other actions, to increase the domestic savings rate in this country. The evidence suggests we've not been wholly successful.

One of the reasons why I have argued for moving not to a Federal budget balance, but toward a surplus, is that it strikes me as the only effective, short-term way—intermediate short term—that we can sufficiently increase the domestic savings rate in this country, such that we can increase capital investment and, accordingly, improve the growth in the standard of living of the American people.

I wish there were another way of doing it. I wish there were simpler ways of doing it. But I must admit to you that, having been through long series of alternate procedures, I'm pretty much convinced that while we might find other ways, that surplus is going to become crucial to us in the 1990's.

Chairman NEAL. Well, I do not see it, either. Historically, we have saved at a very low rate and in recent years. Through the economic policy we have been following in the last 8 years has promised to increase savings, clearly, it has not. The savings rate has gone down to historic lows.

I am not saying that in a political sense. I am saying that is just the fact. So tax cuts do not do it. We have built into the tax code in some of our other policies incentives to spend and not to save—they are disincentives for saving. We ought to be able to reverse that at some point.

How would running Federal budget surpluses help us in putting those savings to productive use?

Chairman GREENSPAN. When one looks at the balance of savings and investment in an economy, especially such as ours, what is very clear is that since our gross private savings generation is modest, and since the Federal Government deficit is a use of those savings, an absorption of those savings, what is available for pri-

vate investment is gross domestic savings minus the Federal deficit adjusted for the net foreign savings that comes in, or the net American savings that goes out.

Since the Federal Government, by its nature, can finance whatever is required to meet the difference between expenditures and receipts, it will pay whatever interest rate is required. It, essentially, by that fact, has the first call on domestic savings. It will outbid anybody else.

Chairman NEAL. Right.

Chairman GREENSPAN. Therefore, while we may not be able to increase the gross private savings, if we reduce the Federal budget deficit to zero and then to a surplus, what we are in effect doing is adding to the domestic savings so that we can finance much higher levels of investment in this country.

Chairman NEAL. Yes, at lower rates of interest, it would appear, also.

Chairman GREENSPAN. Yes.

Chairman NEAL. All right. Mr. Chairman, thank you very much for being with us today.

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



# THE CURRENT STATE OF THE ECONOMY

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Thursday, September 8, 1988

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

The subcommittee met pursuant to call at 2 p.m. in room 2222, Rayburn House Office Building, Hon. Stephen L. Neal, [chairman of the subcommittee] presiding.

Present: Chairman Neal, Representatives Barnard, Hubbard, and Leach.

Chairman NEAL. I would like to call the subcommittee to order. Today we are delighted to welcome a distinguished panel of business economists who have been invited to offer their analyses of the current state of the economy, with particular attention to potential threat of inflation and the proper response of voluntary policy.

This hearing is designed to help the subcommittee assess the most recent Federal Reserve report to the Congress on monetary policy. In the 1980's the monetary aggregates have lost much of their previous usefulness as reliable indicators of the future impact of monetary policy on our economy. No other kind of indicator has as yet been able to fill the void. Assessments of monetary policy must therefore be based on a reading of the overall performance of the economy, obviously a more complex and demanding task than the analysis of a single indicator or several indicators.

Potential for error is large since many forces other than monetary policy affect the economy. Moreover, monetary policy is a powerful but blunt industry. It tends to affect economic activity and inflation with different, changing, and uncertain lags. The potential is thus very real that we will be tempted to cure problems in the overall economy through changes in monetary policy, even though monetary policy is not the real cause of the problem, and can not offer an effective solution. And, given the lag sense impact, we also face the danger of misusing monetary policy and trying to steer the current economy since the force of major policy changes will fall on the economy several months and often several years from the time of the action. We have asked our witnesses to draw for us the shape of the economy as they see it today, its major strengths and weaknesses and thus the major dangers and risks that we will face in the future.

From this picture, adjustment on the proper course of monetary policy should emerge. The picture gained most attention of late is that of an overheating economy, one about to burst its capacity,



constraints and ignite a serious acceleration of inflation. That is the picture the Federal Reserve has implicitly drawn by actions and statements over the last few months.

Is it accurate? Has the Fed overacted or is the Fed still too cautious trying to dampen inflationary expectations with tough talk, but small steps? Today's witnesses from whom we can expect definitive and unambiguous answers are Mr. Donald Paris, manager of the Economic departments for the Caterpillar Company; Jerry Jasinowski, chief economist, National Association of Manufacturers; James Pate, senior vice president, Pennzoil Company, and Richard Rahn, chief economist, U.S. Chamber of Commerce.

I would like to welcome all of our witnesses today. Thank you for being with us. We will proceed in the order in which I mentioned your names. We will put your entire statements in the record. We would like to urge you to summarize, if you can, so we can have more time for question and answer. Mr. Paris, please proceed.

**STATEMENT OF DONALD G. PARIS, MANAGER, ECONOMICS  
DEPARTMENT, CATERPILLAR CO.**

Mr. PARIS. Mr. Chairman and Members of the committee, it is a pleasure to be here today and to try to help resolve a very difficult question I know you all wrestle with. I am Don Paris. I am the chief economist at Caterpillar. I have been with the company 26 years and I was educated at the University of Kentucky.

I have three degrees from there and I feel a certain affinity for this committee in that Representative Carl Hubbard is in my home district. As you know, Caterpillar is a major multinational company. We engage in the manufacture and sale of construction equipment throughout the world. And last year we had sales of about \$8.2 billion, half of that outside of the United States.

We were the tenth largest exporter. So whenever questions about monetary policy and exchange rates come up, we naturally become very interested. The questions posed by your committee are of great interest.

Interest rates and exchange rates have been a major factor in the recovery of the U.S. manufacturing sector and I was particularly struck by Chairman Greenspan's recent comments before the Senate when he indicated that he would rather risk a recession than to be overly stimulative and have a runaway inflation.

In my view, as you had indicated in your opening remarks, that is skating a little bit close to the edge. There has been no Federal chairman to my knowledge who ever deliberately created a recession. They have always been trying to knock inflation down, and calm down an inflationary boom.

We don't have a boom to calm down as yet. I certainly don't quarrel with the Fed's desire to get the inflation rate down because we paid a terrible price when we got it in the seventies, and we also paid a terrible price for it in the eighties when we had to get rid of it. But I guess, as you indicated, the relevant question is whether or not we have the right tools to deal with and to fine-tune the economy. It is unfortunate that we have to deal with either forecasts or past history.

Now, forecasters haven't been particularly accurate in the last several years. As a matter of fact, they have called recessions in 3 out of the last 4 years and they have said that inflation was just around the corner at any moment. And our headlines today seem to reflect that same kind of feeling. I guess I would have to say we have got to be a little closer than we were because of time.

Aside from a forecast, we have to rely somewhat on history. I think an argument can be made that maybe we ought to give a little extra weight to history. In many analysts' opinion, the tightening of policy through the course of 1987, in order to protect ourselves from perceived inflationary pressures and also to maintain the dollar within some confines of the Louvre Accord, helped precipitate the October 19 crash.

It is important for you to understand that I am not being critical of the Fed's performance after the October 19 crash. They injected liquidity and did what needed to be done as did central bankers of the world. We had the strongest first half economic growth worldwide we have seen in many years and the inflationary pressures weren't all that bad either.

That episode should have taught us there is risk of deflation out there in the world economy. It seems to me that if we run that risk and do incur a recession, the consequences are much more dire than a little extra inflation. I think we ought to be very careful about that. There is no question that the economy is stronger today than it was in 1987. But what I am questioning is the relative risk of creating a recession or heading off inflation that may not be just around the corner.

Now, of course, there are all kinds of anecdotal evidences about shortages throughout the economy. Some give great validity to those capacity utilization figures which I don't think are very accurate. What really isn't appreciated is the impact of the globalization of markets on price behavior. There is still a lot of excess capacity outside of the United States.

Foreign manufacturers are willing to utilize their capacity to retain their employees to retain their customers or their share of market and to keep their distribution outlets alive. They are not going to lose market share by indiscriminately raising prices to jeopardize those gains.

Some are even investing in the United States to build their base for the long haul, and I ask you to think back on how long it has been since we have had eight auto manufacturers domiciled in the United States? That is a tremendous amount of competition.

I think the declining dollar has been a major catalyst in reviving the U.S. manufacturing sector. After 5 years of expansion it is easy for us to forget that we came very close to losing our industrial base during that strong dollar period of the early eighties. There are those who say that, well, manufacturing really wasn't hurt that bad. We have become a service oriented economy and maintained a 20 percent share of the total output throughout that period. So what are you worried about?

I would say to you that I would worry about that because who is to say that shouldn't have gone to 25 percent? If manufacturing had been allowed to grow during that period, we could very well not be facing some of presumed capacity shortages we are today.

Caterpillar closed five plants during that period and we changed our strategy and started shopping the world for the lowest priced parts and components.

Many of our suppliers had to make similar adjustments, and those who didn't in time, didn't survive. But there was a lot of restructuring going on. Until recently, the dollars decline had helped level the playing field for them and provided better export profits to pay for the capital expansion we have got underway. Our company raised its production schedules 27 percent this last year and our employment has increased around 4,500 people.

The weaker dollar and stronger domestic economy were major factors in this recovery. I guess the thing that is frightening to me is seeing the dollar strengthening again, which could wipe out some of those gains from hard work that we put in to level that playing field. The improvement in our trade deficit and growth in capital investments have depended upon restoring U.S. manufacturers' international competitive position.

I am amazed at how people worry about the well-being of the financial markets. These Wall Street Portfolio managers move in and out of stocks and bonds in a matter of minutes, but we in manufacturing can't do that. Once we put somebody on the payroll, it is a great economic cost and hardship to let them go once you find out you can't afford them.

If you get a factory started and get halfway finished and we have a few of those, it is a great economic loss when you have to switch course in mid stream and leave that. This kind of tightening up and stop and go is difficult for the manufacturing sector.

To make one other point about small manufacturers. Many are in the South and in the Midwest. They are more vulnerable than larger companies that have access to the money center banks and so forth some of these smaller companies have higher borrowing costs and maybe can't easily handle those currency hedges, for example.

These small manufacturers are providing about two-thirds of the growth and manufacturing jobs and they have been one of the primary sources of job creation. I think we have to worry about that?.

We intend to use millions of extra profit dollars from the weaker dollar to pay for our modernization program as we strive to make our factories more competitive. If we lose that, we will be put behind in our schedule. It will hurt our ability to compete internationally.

Whenever we think back, and your opening remarks addressed that, really the world economy is in pretty good shape right now. A lot of the things that the experts said had to occur are really taking place. First, the budget deficit had to come down and it has. Obviously we would like to see it a little smaller, but getting a recession is not any way going to bring the budget deficit down. To the contrary, worse things always happen than that.

Second, we asked overseas economies to expand, and they are doing that with a vengeance. Most overseas manufacturers are still growing and their economies are growing. Japan has been growing much more rapidly than anybody anticipated and they were one of the principal targets for that.

The third thing is we needed higher capital investment so we can be a producing nation as opposed to consuming nation. We have got a capital spending boom going on now and a large part of that is due to increased exports and the increased cash flow that resulted from a more realistic dollar. That, of course, is necessary to fund a more modern plant and the new capacity that we need so much.

The fourth thing is that the U.S. economy had to slow down consumer spending, we were too much of a consumer Nation. We slowed it down to about 2½ percent real growth rate, which compares to around 4 or 5 several years ago. The inflation resistance in this kind of background is strong; the competition in the finished goods market is extremely intense.

We have had consumers who have shown an amazing resistance to price increases. Most major manufacturers were offering rebates, and if your wife goes to the store, you clip a few coupons for price cuts. They have whole lines for coupons. That all indicates that people are not willing to spend willy nilly on any price thrown out to the consumer.

Wages and manufacturing have been in the 3 percent range and they make up about 70 percent of the cost of goods.

So I can't see that there is anything to explode either the consumer spending, or to push through higher prices. Productivity is also improving. The concern about the drought is really a structural phenomenon, not one that should be considered in the monetary sense.

A lot of people take commodity prices as an indicator of inflation. I think that is the wrong thing to do. Intermediate goods prices always fluctuate more than the price of finished goods and whenever the economy is slowing down or going into recession, those intermediate prices have dropped dramatically. Those people lost profits and stopped investing and the manufacturers were able to keep the profits.

When prices go up, manufacturers have to give them back, because you still have a great deal of resistance to price increases by consumers.

[The information below was subsequently received for the record]

One commodity price that is rising is steel. Those price increases are not due to market-determined factors but rather to Government-imposed quotas. At Caterpillar, steel plate prices are up 17 percent for example. Monetary policy is not the correct instrument to control these price increases. Instead, I suggest steel quotas be terminated.

I would like to start summarizing that I am concerned that we are risking a recession here with very tight monetary policy. We have two-thirds of the economy slowing down already.

Twenty-five percent of the economy is made up of capital spending and exports, the sectors that are providing the growth. This was needed to redress our ravaged manufacturing sector and to improve our trade balance. This will be dramatically affected by higher interest rates and a run-up in the dollar.

I would urge the Fed to be aware of the risk of precipitating an unwanted recession by clinging to current policy too long. I know how forecasters like to wait for one more piece of data before they

make up their minds. I am sure that is what the Fed Chairman did in the past whenever we got into recessions.

I have been in the forecasting game a long time. One of the worse things you can do is deal in conventional wisdom. I hope the Fed advisors and the Fed will be cognizant of the need to reverse policy quickly. There may be a need to do that much quicker than the evidence and forecasts suggest.

I hope we won't develop a notion that a weaker dollar, more realistically competitive dollar, is bad news. I thank you.

[The prepared statement of Donald Paris can be found in the appendix.]

Chairman NEAL. Thank you, sir. Mr. Jasinowski?

**STATEMENT OF JERRY JASINOWSKI, CHIEF ECONOMIST,  
NATIONAL ASSOCIATION OF MANUFACTURERS**

Mr. JASINOWSKI. Thank you, Mr. Chairman. I would like to make six points in summary and to introduce the theme of those six points. My theme is that we are really extremely fortunate to be in as good an economic situation as we are at this stage of the economic cycle. There are not many major problems around, despite some long-term problems and imbalances; that the Fed has done a pretty good job; that we who are outside of the Fed always can find ways in which we think it could be improved. The National Association of Manufacturers wrote to the Open Market Committee and the chairman in the early part of this year and expressed our concerns about being too tight following the stock market crash, but in retrospect it seems to me that the Fed has done a pretty good job in the period following the crash.

Having said that, I would urge them to retire their efforts to fight inflation at this point and recognize that the economy is beginning to slow a bit, and that there should be no further moves on the part of the Federal Reserve at this time to tighten monetary policy. Now, they ought to take the time to relax. Let's see where the economy is going from here.

Having made that summary, Mr. Chairman, let me elaborate with six brief points which are outlined in the testimony and in the executive summary that you have before you. I will do it in the context of the letter that you have written to me asking six major questions because I think that that is a useful focus for my summary.

First, point Number 1, why has the economic expansion continued in as healthy a fashion as it has? First of all, it has changed its character entirely, going from a consumption driven economy in the early part of expansion to one driven by trade and capital investment and the come back in manufacturing.

In 1988, 50 percent of the growth in real GNP will be from trade improvements, and 25 percent will come from capital spending, and that is a complete reversal of what we had at the early stage. We have had two economic expansions that followed together very nicely. It has been very good luck, to some extent, but it has also been a result of, I think, stimulative tax policy in the early stages and the administrations good sense to change their exchange rate

policy in 1985, for which Secretary Baker deserves substantial credit.

I see this as continuing over the next 12 months and no signs of a recession on the horizon right now. The only other thing I would say here is we are beginning to see a few signs that the economy is modestly settling down and I would expect trade to slow as you move into 1989, and capital spending is not going to go on raising long at the rate it is, but the picture looks remarkably healthy.

Second, do we have a stable inflationary picture? I don't think we do. Even though I have been reluctant to come to the view that inflation is picking up modestly, and I still hold the view that the long-term outlook for inflation is one in which prices will be stable, or declining in 1989 and thereafter. A lot of this has to do with longer term structural conditions, having to do with the world economy, excess supplies, whether it be agriculture or energy or others.

While there are structural changes that are working against price increases, I think the evidence clearly indicates that there has been some modest pick-up in inflation in the last several months, and that has been due to some underlying wage cost increases that by some measures are up over 4 percent, and a substantial increase in nonwage costs. Most people seem to think that labor costs are all wages. About 40 percent is tied up with all these health care cost increases and social security increases and other increases which are really substantial and have been accelerating.

There are also capacity constraints and there is more than an anecdotal evidence that steel, plastics, paper, and other commodity prices are increasing at this point, and are significant.

Finally, although I agree that the food price increase is a temporary phenomenon, it will nevertheless cause prices to increase in the short run. That is to say, the fourth quarter, and as a result of all these factors, I see the consumer price index accelerating to about 6 percent by the end of the year. I think that one can't deny some inflationary pressures.

Having said that, I would underline that I think these are recent. They are modest. They are signs that the economy is slowing down and the long-term outlook for inflation is one which should not cause people to push the panic button.

Item Number three, how do we evaluate the current state of monetary policy? We have been concerned about the Fed being too tight, both in and around the stock market crash and then following it. I think the Fed has erred from time to time, as you look over Federal Reserve policy from 1980 to 1982, but in general its been pretty good.

People complained about the Fed through most of that time that they were not expansionary enough. Our analysis leads to the conclusion that had they been far more expansionary, we would have had a less durable recovery. We could have had more inflation, so it would have been good in the short term and not necessarily good in the long term. Those of us who looked at the whole period recognize that the large budget deficit has played an important role in rising interest rates and other factors.

Having said all that, and not objecting to the recent Federal Reserve actions to raise the discount rate, and frankly, thinking that

the Fed didn't leave itself with glory in and around the time of the stock market crash, until after the crash, when I did think it acted promptly, and it made a serious mistake by trying to peg the dollar in 1987, which makes no sense from a trade point of view, and from a monetary policy view.

Nevertheless, the current stance is about what you could hope for, given all the factors involved and now I would, as I said, suggested before, urge the Federal Reserve to retire in glory and not take any further actions at this time to tighten monetary policy because of the risks that are involved and the fact that the economy seems to be slowing.

My fourth point, which has to do with your question about are there particular economic developments that we should particularly look at relative to monetary policy, I would say that there are at least a couple. One, keep your eye on growth. This is not just an inflation game. And the Fed should be just as concerned about growth at all times as it is about inflation, and if there are any signs of a slow down and a major deterioration of growth, they ought to act to loosen monetary policy.

Second, don't mix up monetary policy and trade policy. We must continue to improve our exports and continue to improve trade. It is a major mistake for the Federal Reserve, which they are not doing now, to peg the dollar, because to some extent against some countries the dollar is still not at appropriate rates and we ought not to be trying to peg the dollar.

Point Number five, causes for concern as we look ahead: I think we are in remarkably good shape overall. I certainly do not think that the drought is a major cause for concern on either the growth or inflation side.

I have just come back from Iowa. I don't think Iowa has recovered but my discussions with people out there lead me to conclude that they are going to do—they are going to come out of this better than people thought and there is more optimism, at least among business leaders that I spoke to in that State than I would have expected.

There is great cause for concern in the savings and loan crisis, but I think that we are stepping up to that plate and dealing with it, and beyond that, there is cause for concern about the overall level of debt. If you look on page 9 of my testimony, you find that, our level of debt has almost doubled, public and private debt, compared to a post war average.

I think it is healthier debt than we had at an earlier time. But it has increased substantially. More importantly, I am concerned that the ratio of debt service to cash flow is at record levels. I would underline this for you, Mr. Chairman. We now have the—the share of pre-tax earnings of non-farm, non-financial corporation devoted to debt service is now over 50 percent compared to 30 percent in the seventies and 15 percent in the fifties.

As we look to the long term, these levels of debt is an increased risk, particularly relative to monetary policy.

Item six, I will not summarize to save time. It asks for what policy changes we need. I will just say that we really need policy changes that keep our eye on being competitive in world markets and that means everything from further reductions in the budget

deficit to implementing the sensible trade policy in this trade bill we just passed. We still got exchange rates and a lot of trade issues before us and tax policy and the other issues before the Congress should be weighed in the context—does it make America more competitive? Thank you, Mr. Chairman.

[The prepared statement of Jerry Jasinowski can be found in the appendix.]

Chairman NEAL. Thank you, sir. Mr. Pate?

**STATEMENT OF JAMES L. PATE, SENIOR VICE PRESIDENT,  
PENNZOIL CO.**

Mr. PATE. Mr. Chairman, Members of this committee, my name is James Pate. I am senior vice president of Finance and Treasury of Pennzoil Co. headquartered in Houston, TX. So I am not, at the present time, a practicing economist, but I am more than a casual observer. I appreciate very much this opportunity to share my views with you and appear before this committee. I have provided, as you suggested, Mr. Chairman, a rather lengthy written statement, so I will keep my oral remarks brief, and merely summarize my views on the economy and monetary policy.

At the outset, I would like to emphasize that I am in general agreement with the Federal Reserve's conduct of monetary policy in recent months, and I am in essential agreement with Chairman Greenspan's testimony before Congress on July 28. The recent effort on the part of the Federal Reserve to make small anticipatory changes in an effort to avoid big disruptive reactive kinds of changes is, in my opinion, a welcomed improvement in the conduct and implementation of monetary policy. This approach does, as my colleagues have pointed out, place major reliance on accurately assessing economic conditions and forecasting economic developments.

In recognition of this fact, Chairman Greenspan indicated that if the Fed were to err, that he would prefer to err more on the side of restrictiveness rather than stimulus. I can't disagree with that. I think that is probably the only position the Federal Reserve can take, but as Don Paris pointed out, erring on the side of restrictiveness poses some very serious risks of causing another financial crisis and precipitating a recession.

I am sure that the Federal Reserve is aware of this risk, but I think it deserves emphasis and I also believe that perhaps the threshold for interest rates is a lot closer, than you might infer from some of the very upbeat economic data that have been reported recently. Specifically, I do not think the economy is overall nearly as robust or that inflationary pressures are nearly as great as generally perceived. Recent strength in the economy has been highly concentrated in exports and export related segments of manufacturing. During the past four quarters exports directly contributed \$83.3 billion of the \$157 billion increase in real final sales, over half of the increase in real final sales in the past four quarters has been attributable solely to exports.

Indirectly, it has been estimated that exports have contributed another \$40 billion to business spending during this period. This is a lot of stimulus, a lot of thrust to come from a component which is



only about 11 or 12 percent of GNP. On the other hand, consumer spending, which accounts for roughly two-thirds of total GNP, has contributed only about \$30 billion to real growth in the past year with almost all of this gain centered in services, not in goods, but in services. Fixed investment has increased about \$27 billion, with all of the increase in equipment, not in business structures and not in residential construction expenditures, but in equipment. So economic growth, in my opinion, is very uneven. It is almost lop-sided and extremely vulnerable to foreign exchange rate changes and, therefore, to interest rate changes.

With respect to inflation, I don't believe there is any question wages and prices are headed higher. The consumer price index has increased during the past year at a 4.5 percent annual rate. In the month of July it went up 5.2 percent. The producer price index for all commodities increased 4.2 percent during the past year, 7.8 percent in the last 3 months. Prices of intermediate commodities increased 5.9 percent during the past year; 9 percent in the last few months. Volatile commodities rose 5.6 percent in the last 3 months. Labor cost picked up, in part because of the increase in social security. Hourly pay for nonfarm workers rose at an annual rate of about 2.2 percent in the first quarter and about 5.2 percent in the second quarter. So signs of higher wages and prices abound, but this should be no surprise because most of my colleagues that are active forecasters, I think, have been anticipating higher inflation in 1988, and 1989 now for some years.

In fact, I would suspect that a careful study would reveal that more forecasters have overestimated inflation in recent years than have underestimated inflation. There are no signs of any inflationary surge or wage-price spiral in my opinion. The so-called core rate of inflation as measured by the producer price index for finished goods, excluding food and energy products, was up only 3.4 percent for the year ended in July, compared to 2.2 percent for the calendar year 1987. The widely discussed capacity constraints appear to be rather minor, and again centered primarily in export related industries. Operating rates for most major industries remain well below past cyclical peaks. So the recent heightened concerns about an overheating of the economy and of inflation, I believe, are a bit exaggerated.

As I mentioned earlier, the current economic strength of the economy is very much centered in exports. More than half of the economic growth in the past year has been due to exports. Exports are expected to remain strong and even increase for several more quarters. However, they are not likely to contribute thrust to the economy in the quarters ahead, to the extent that they have during the past year. At the same time it is difficult to see other sectors of the economy that might pick up this slack and, therefore, sustain the high real growth rates that we have seen.

Consequently, economic growth is expected to slow appreciably in the months ahead. Our forecast is that overall real economic growth will slow from 3.3 percent in the first half of this year to about 2½ percent in the second half of this year. On a fourth quarter to fourth quarter basis, growth is expected to be about 3 percent in 1988 and about 2 percent or less in 1989.

Our forecast is for a moderate acceleration in the rate of inflation with the increase in the consumer price index averaging slightly over 4 percent in 1988 and roughly 5 percent in 1989. This may appear to be a rather encouraging outlook. However, my concern is that we are approaching, we are not yet there, but we are approaching, getting very close to what I would consider to be a danger zone for interest rates. We recently ran some simulations with a widely used econometric forecasting model and found it does not take a very large increase in interest rates in 1988 to produce a flat economy in 1989. We also found that if you combine a slight increase in interest rates with just a slight decline in consumer confidence, you can generate two or more quarters of negative real growth very, very easily.

Since March, interest rates have been pushed up 130 to 190 basis points. They are now back to or very close to and in some cases above the levels that they were at just prior to the October crash. The financial markets are very, very jittery. The ½-point increase in the discount rate on August 9 was quite unnerving and in my opinion, not fully supported by economic fundamentals.

However, it was probably unavoidable and warranted on the basis of perceptions and expectations, especially inflationary expectations that were starting to build in the financial markets. There has developed an enormous preoccupation with the release of every single economic statistic. The financial community is now attaching far more significance to small month-to-month changes in economic data than is justified on the basis of their statistical integrity.

In conclusion, I want to emphasize once again that we are approaching a danger zone in interest rates. Although the prospects for overall economic growth and inflation appear rather good at this time, the risk of pushing rates too high and creating another financial crisis and recession, I believe, are substantial. Unfortunately, fiscal policy is on hold because of the large budget deficit and the upcoming presidential election, so the burden of sustaining economic growth falls at this time entirely on the Federal Reserve. I think it is extremely important that growth be sustained until the next administration has the opportunity to deal with the Federal budget deficit problem, the trade imbalances, the Third World debt problem and the seriously unstable situation with our financial institutions, thrift institutions and commercial banks alike.

In my opinion, our best chance, indeed our only chance, of dealing effectively with these problems is in an environment of economic growth. Thank you, Mr. Chairman, and Members of the committee for giving me this opportunity to express my views. Thank you.

[The prepared statement of James Pate can be found in the appendix.]

Chairman NEAL. Thank you very much. We have had the second bell now for a floor vote. We will recess at this point and be back in 7 or 8 minutes.

[Recess.]

Chairman NEAL. I would like to call the subcommittee back to order. I apologize for the interruption. We would like to hear from Mr. Rahn, at this time.

**STATEMENT OF RICHARD RAHN, CHIEF ECONOMIST,  
U.S. CHAMBER OF COMMERCE**

Mr. RAHN. Mr. Chairman, thank you very much on behalf of the U.S. Chamber of the Commerce. We greatly appreciate your inviting us to testify today.

At the outset, let me commend the members of the Federal Reserve Board for their recent efforts in striving to meet the mandates established for them by law.

I want to state for the record our total agreement with and support for the objective of achieving non-inflationary economic growth. Any disagreement we have with the Fed in this regard is over the means, not the end, of monetary policy. While we may have preferred a more gradual reduction in the inflation rate and have chosen a different method to reduce inflation, the fact is the Federal Reserve Board was instrumental in breaking the inflationary spiral of late 1970's, and for that we are thankful.

The question we now face is what should Fed policy be today?

We find the following: Today's persistent inflation in the 4.5 percent range is the remnant of earlier Federal Reserve Board mistakes, which greatly increased the growth of the money supply to drive down the value of a dollar in 1985 and 1986.

Two, sustained inflation is always a monetary phenomenon and the trend in the real economy, when divorced from changes in monetary growth, have little bearing on past, present and future inflation.

Fed policy is highly discretionary. The long-term goal of monetary policy should be zero inflation.

Consequently, the Fed should establish both price and quality rules in managing the monetary aggregates. Let me expand on that very briefly.

We think that in the absence of rules, you will tend to get what you have had for really the 70 years in which the Fed has been in existence and that is overshooting the targets. First, there was too much pressure on the accelerator, and then too much pressure on the break.

Monetarists, I know, like strict monetary rules. We feel that particularly since you can't forecast velocity with precision, a strict monetary rule in itself will not accomplish the goal of stable prices. We think a monetary rule coupled with a price rule, and by that I mean targeting a basket of commodities which are highly sensitive to change in monetary policy, will do the job.

In fact, I will go further, and given the worldwide economy we now have, I think it is important that we all try to target a single basket of commodities, and we should encourage the central banks of other countries to do the same thing.

I think if we had the G-7 nations all targeting the same basket, this would greatly mitigate the huge fluctuations we have in exchange rates and at the same time move all the major industrial countries toward a zero rate of inflation.

Current Federal policy is inconsistent. While managing a policy of monetary restraint at home, the Fed, in 1988, has been expanding the money supply internationally to hold down the value of the dollar.

In fact, what happened in recent months I can only say is ridiculous—with the Fed increasing the interest rates here and at the same time going around selling billions of dollars, particularly to Europe, to bring down the value and exchange rate. Those dollars are sent right back to the United States, which inflates our own domestic money supply. It is like taking money out of one pocket and putting it into the other pocket.

We accomplish nothing productive by doing that. The secrecy surrounding Federal policy making and unannounced changes greatly adds instability in financial markets.

The Fed should make its deliberations open so that policy changes can be anticipated and the impact on the economy minimized.

You now have a provisional group of "Fed Watchers." Businessmen and lenders and borrowers of funds know that you have an inflationary risk premium in any interest rate.

We also now have a Federal policy risk premium in addition to the inflation risk premium because people are trying to figure out what the Fed's reaction will be. That is why on the nightly news, good news is reported as bad news and bad news as good news, and the next day you see these perverse reactions of the markets to the "good" news and the "bad" news.

I think that part of that risk could be minimized if the Fed operated with much greater openness. They don't have a black box there full of answers.

We know the folks at the Fed are an able, dedicated group, but they don't have a monopoly on wisdom or knowledge, and we give them very blunt instruments. Their information is no better information than any of the rest of us have and yet we expect them to be wiser.

Of course, they can't be, so they hide behind a veil of secrecy that serves nobody's interest. A high interest rate policy designed to slow economic growth is an inappropriate policy at the moment because it interferes with the credit markets and adds instability to the economy. And, contrary to intent such a policy, may actually add to inflationary policies. I will get into more detail on that in a second.

Again, the Fed is trying to do too much with too little information and too crude instruments. The result is flawed economic policy. They embarked on a misguided policy of pushing interest rates up in the erroneous believe that uncontrolled and unguided economic growth produces inflation.

Growth is neither inflationary or deflationary. It is monetary policy that determines the rate of inflation. If you have economic growth where investment is at least equal to growth in consumption, or higher than the growth of consumption, inflationary pressures will be stable or falling.

If we have high levels of investment, like we currently have, and new capacity coming down stream, particularly in those industries that are approaching high levels of capacity, then in my judgment, you will see a reduction in inflationary pressures from these industries, rather than increasing bottlenecks.

In the late 1970's our rate of economic growth was not all that rapid. Our problem was a lack of capital investment. That is why

we ended up with the so-called inflationary bottleneck or the production bottleneck. Demand in many cases was exceeding supply back then. That was a failure of investment.

The Fed rapidly expanded the money supply in 1985 and 1986 to reduce the value of the dollar in world markets. As a result, the dollar dropped against all major foreign currencies by so much, the Fed began to fear it was falling too fast.

The Fed then appears to have slammed on the monetary breaks and attempted to avert both the free fall of the dollar and inflation. This is typical of Fed behavior.

If you look over the last 70 years, you find that the Fed tends to do this in extremes. They often say their job is to lean against the wind. The problem is again they have no more wisdom, and I think all the people at the Fed are extremely able, but they don't have any more wisdom and knowledge than the rest of the financial markets.

If you look at history, you find the Fed has tended to lean with the wind, and that is why they always are over correcting at a later time. As long as we have a totally discretionary monetary policy, we are going to have problems in using a sensitive commodity basket. You could go back to gold, but that carries a lot of baggage that I am not necessarily advocating.

Finally, part of our public debate over the appropriate monetary policy as focused on non-inflationary growth potential of the American economy. Recently U.S. real economic growth is above the post war average and causes concern for many.

There are many elements in the debate, few answers. It is conceivable that growth potential is a great deal higher than the approximately 2.5 percent real growth the Fed assumes in the policy deliberations. Macro-economic theory sheds little light on growth potential, but reality does. Currently the labor forces is growing by 1.5 percent, labor productivity is up 1.4 percent annually.

The industrial capacity is growing about 2.5 percent. When these elements of overall economic growth are added they give an estimate of potential growth in the GNP of over 5 percent.

Whether this is accurate to a decimal point is not the issue. The point is the Fed may be severely underestimating potential GNP growth.

How you base these estimates and how these estimates effect policy should be of vital interest to Americans. Therefore, we suggest the Congress consider a first step in opening up the Fed policy-making procedures by requiring it to publish its Fed open market committee minutes within 48 hours of completion of the meeting.

In summary, we believe that it is not economic growth that is causing inflation or making inflation more of a threat to the U.S. economy. Today's inflation is a remnant of an earlier Fed mistake.

Unfortunately, Congress can't instruct the Fed to use proper economic reasoning, but in current and future hearings held by the committee, debate over how to view the economy should be expanded. The economy is moving along, I think, at a very good rate.

We are almost at the 6-year anniversary of record peacetime expansion, and we must remember that economic expansions do not stop or die because of old age. They die because of policy mistakes, and a major shift in economic policy by too much acceleration or

tightening up too much would be a mistake. In my judgment, the rise in the discount rate was a mistake, not a fatal mistake, but I hope that the Fed would now begin to allow interest rates to drop a bit.

I think inflation pressures will be mitigating. Oil prices and a number of other commodity prices have begun to fall.

The recent economic statistics show softening in the economy. Clearly the economy is not overheating. A couple of the other things that are critical to economic performance are more directly in the control of Congress. I think, for example, it would be a great mistake to increase taxes.

I think if Congress meets the Gramm-Rudman targets just on the spending side alone and gets us approximately to a balanced budget by 1993, that we would be largely out of the woods on the deficit side. I would urge the Congress not to re-regulate the American economy, including adding such things as a mandated benefits, which increase the cost of doing business and make us less competitive.

Mr. Chairman, again I thank you very much for the opportunity to testify today.

[The prepared statement of Richard Rahn can be found in the appendix.]

Chairman NEAL. Thank you, sir.

I have a bias and that is against inflation. I wish we had better tools to fight it. I used to think that we had adequate ways to judge Fed policy when the relationships between monetary growth and inflation were clearer. Unfortunately, they are now not as clear, and that creates new complexities for the policy makers and other businessmen.

Mr. Rahn, you have criticized the Fed pursuing a high interest rate policy. I must say that seems inconsistent with the rest of your testimony. You think as I do that inflation is a monetary phenomenon, that the Fed should follow rules in managing the aggregates. I would like to get back to that point in a minute.

Money growth expanded too much in 1985 and 1986. It ought to have as its goal zero inflation, and I agree with that goal. But, if the Fed tries to restrain money growth at a time of increasing inflation and fairly strong real growth in the economy, as it appears to be doing now, wouldn't interest rates surely rise? In other words, how can you get to the goal zero inflation—at least move in that direction—without some initial increase in interest rates? It seems inconsistent to me.

Mr. RAHN. Well, you have got a couple of different effects here. One is that short-term interest rates are higher than they need to be because the Fed is selling dollars abroad, which causes the dollar to fall and in turn induces the Fed to raise interest rates to prevent foreign capital from pulling out of U.S. paper. This means the Fed is caught in a vicious circle in which it ratchets up both ends of the interest rate equation.

The Fed should stop selling dollars abroad, and get out of manipulating the value of the exchange rate.

You can't set the value of the exchange rate and maintain economic growth and get to zero inflation all at the same time. The Fed is trying to do too many different things.

As I pointed out in the testimony, monetary growth was too rapid during 1985 and 1986. It brought the dollar down very sharply and further in my judgment than it needed to go. So, of course, in early 1987, they put down the screws and we had relatively slow monetary growth and a rise in interest rates which is somewhat responsible for setting off the collapse in the stockmarket last October. Part of the problem then were reactions by foreign central banks who also constantly engage in discretionary manipulation of interest rates and foreign exchange rates.

Now, yes, you have to raise interest rates somewhat to keep a real positive real rate of return, if you are going to get yourself down close to zero inflation.

Our recommendation to the Fed earlier in the year was to step gently. When they really started slowing down the rate of monetary growth and increasing interest rates, we said they over did it.

Seriously, some rise was appropriate, but our dilemma is, the lags between changes in monetary policy and the effect on inflation can be as long as 18 to 24 months. However, the lags on the immediate impact on the economy, whether we are spurring economic growth or contracting economic growth, as a result of monetary policy can be very short—from a matter of weeks to just a very few months.

So, the Fed now is fighting the very inflation they generated in 1985 and 1986, but they can't affect that inflation. All they are doing is slowing down the real economy. You don't want to overdo that. That is why I think much more work needs to be done in developing an appropriate basket of sensitive commodities.

Now, a few years ago, about 4 or 5 years ago, several of us started working on this project, but it takes a lot of time. I am arguing the Fed doesn't have the information at hand right now to bring inflation down precisely, but they, in our judgment, did overreact in August. Not that I didn't want to see a little bit of increase in the interest rates and the slowing of monetary growth. I think they went too far, which they have typically done when you look at it in hindsight.

Chairman NEAL. I agree with that goal of zero inflation because, to me that means we are going to have low short- and long-term interest rates.

Mr. RAHN. If I can add one thing.

If the financial markets knew that we were really going to have zero inflation and they knew the commodity—what commodity basket was being targeted, then these huge inflation and uncertainty premiums that are put into interest rates would quickly disappear.

The reason really, and I am not claiming I have it all worked out, is how to get from where you are now to where you want to be, without putting the economy in trouble. We don't want to go through an experience like in 1981 and 1982.

Again, I have enormous respect for the members of the Fed, and I know they have a very difficult time here. But I think that they need to be more explicit on saying how they are going to get there and at least open it up much more to public discussion than they have.

Just opening up that decision-making process will help. Now, like you, a number of us talked to them privately and to the staffs and they are going through the same intellectual struggles we are going through.

I don't think it hurts confidence to open that up and get many more people involved. It would reduce the inflation and the Federal Reserve risk premiums in these interest rates.

Chairman NEAL. I notice, especially the other three witnesses have a real concern about the potential for a down-turned economy—a recession. I was pleased with the response of the Fed to the October 19 stock market decline—announcing that they were clearly not going to let the situation get out of hand. They supplied the needed reserves quickly. I was pleased when they decided to continue their inflation fighting mode again. I agree that they pumped out too much money over the last several years. They were correcting their own faults, and they had other reasons for that. We held some hearings on this idea of using commodities as a guide for the Fed, and we brought up the subject several times.

The Fed is conducting studies on that internally, and we will see them sooner or later. So far, however, it appears that the evidence is fairly inconclusive that there is any relationships that we can count on over time. We certainly ought to look at every possible option for generating more growth, non-inflationary growth. But any new approach must be carefully analyzed before it can even be considered.

Mr. Rahn, you mentioned the Fed's mandate in the early part of your statement. Where do you find the mandate?

Mr. RAHN. The Employment Act of 1946.

Chairman NEAL. As amended over time?

Mr. RAHN. Over time Congress has given the Fed a number of instructions. I sound a bit radical today, but I think the Fed has a problem today of being both a banking regulator and also responsible for monetary policy, and these things at times can put them internally in conflict.

Congress has deliberately put them in a situation where they at times have conflicting goals.

I think, perhaps, even a broader look over time if you look at all the things that the Members of Congress in the last 70 years instructed the Fed to do and be responsible for, you would find that no set of humans, could do all that. Perhaps there ought to be some division of powers here and limit the Fed's responsibility more to what we can expect knowledgeable and reasonable people to really accomplish.

Chairman NEAL. We were also concerned when it appeared that maybe the Fed was following orders from the Treasury Department concerning the Louvre Accord. We were critical there and the Fed made it clear that they were not.

It is my strongly held impression and their testimony will say the same thing, that they are not fooling around with the value of the dollar.

Mr. RAHN. They did follow the Louvre Accord. If you take a look at their actions, it was explicit, and in my own judgment, even though I tend to be a partisan for this administration, I think the Louvre Accord was a great mistake. And, I conveyed this over to



them. None of us know what the proper foreign exchange rate ought to be. That is assuming a degree of wisdom that we as economists and I think policy makers don't have. That is why we were forced to go to fluctuating exchange rates.

When you run the gold system you have a North Star. There were a lot of problems with the gold, and I am not advocating gold today. But, it gave a kind of anchor.

None of the currencies now have any kind of anchor, none of the major currencies. And this puts us all in an endless difficulty—the Bank of Japan and the Bank of England and all the rest of them. That is why we have come to feel more strongly about trying to identify at least the basket of internationally traded commodities at a one world price can lead us toward more of an anchoring on a North Star of stability in the system—so we don't have to rely on the good judgment of people like Secretary Baker and his colleagues around the world.

They are not able—not that they are not very capable men—to accomplish what they set out to do. We expect more than they can deliver.

Chairman NEAL. I couldn't agree more. But, the market is so huge we can't fundamentally alter them alone. We can jiggle them a little bit here and there, but we can't overcome the fundamental direction.

Mr. Barnard?

Mr. BARNARD. I apologize to these gentlemen for being tardy, but as you probably know we have some extensive hearings today on another very important subject of which will effect the economy, whether you in the manufacturing, or oil business or the caterpillar business, as we attempt to bail out the savings and loan industry, I guarantee it is going to have its ramifications nationwide, and that is one of the real serious problems we have been in those hearings today about.

I would reiterate what the chairman has said. I think inflation has not been resolved.

I don't think that we can just bask in the sunlight of the last 3 or 4 years and think it wouldn't raise its ugly head.

I am not a Federal Reserve banker, but I do watch very closely what they do do, in the terms of whether they are overreacting or underreacting.

I think that is one of the good feature of this committee and other Members of the committee and Congress, that they do take very seriously the oversight of what the Fed is doing, both in the discount rate and monetary policy. So it is very interesting.

It is very popular today for Members of Congress to take a position because it is a sensitive political issue in the country today, and that is about taxes.

I don't know whether in your testimony you discussed taxes or not, but do you have an opinion as to whether or not we can anticipate taxes at all without offering some imbalance in the economy?

The ideal would be for us to balance the budget as quickly as possible by cutting Federal spending. I think you will find both of the Members of this panel in agreement to that, even though we come from the other side of the aisle. But we are faced with the situation and, in fact, I can't recognize that any candidate for the presidency

today has given us many concrete proposals as to how they are going to balance the budget by reducing Federal spending alone.

I think the time has come for us to just anticipate that if we can't do that, are taxes—and I am certainly not proposing taxes, and I have to always say that because the press likes to take myself as one of the most conservative Democrats in the country, even from Georgia, and say, aha, he has succumbed to the ills of raising taxes. I think we at least have to put it on the table to talk about it.

I am asking you all, do you have a sense that raising taxes is going to be absolutely unacceptable in any form or fashion?

Mr. RAHN?

Mr. RAHN. I have sort of definite views on this.

What do we know about tax increases? First of all, we know tax increases slow economic growth. It is going to have an impact on economic growth if it is at all sizable.

We know historically that tax increases have not led us to smaller deficits. They have frequently led us to bigger deficits. We think of TEFRA in 1982, which was supposed to bring down the deficit and growth and spending, \$3 for each \$1 dollar of tax increase. Everybody seemed to accept it at the time. Now you can't seem to find anybody party to the agreement in the administration or Congress.

Since World War II there is not much evidence, or any evidence at all, that taxes have even brought down Government spending or diminished the deficit.

Mr. BARNARD. Why do you think that is so?

Mr. RAHN. Because with a tax increase—part of the problem is with the models we use in our revenue estimating. A tax rate increase never brings in as much revenue as it appears on paper it should, given the proportion of the rate increase, and the other side, a tax rate reduction never loses as much revenue as you would expect, as you would expect in a linear cut—that is, if the fall in revenue were directly proportional to the tax rate cut.

We all know our individual behaviors are changed. Congress tends to overestimate the revenue coming in from the tax increase and, of course, the pressures on you gentlemen and all your colleagues from your constituents are always to spend more.

Even in the business community we all talk about how we want less Government spending, but they always want their additional amounts of spending for their projects and labor and consumers and everybody else. Thomas Jefferson clearly identified this when they had the great deliberations in the Federalist Papers.

So I don't think the empirical evidence is there that a tax increase can get you out of the woods. We are in a better position now than we were a few years ago to get to a balanced budget, or close to one, just from restraint in the growth in spending.

After the 1981 tax changes we had a period of years where Federal revenues grew more slowly than nominal GNP growth. Now, as a result of a number of the tax changes and other changes you all have made, Federal revenues will grow slightly faster over the next 5 years than nominal GNP. That means we can have fully funded social security without any changes in the program, pay all the interest on the Federal debt, increase all other Federal spend-

ing on the average at the rate of inflation, and still have a little bit left over.

Now, if you want to increase programs—more child care or whatever the priorities of whoever the new President and Congress are—that means you have to reduce the growth in some of the other programs. I don't think this is impossible, particularly since you passed Gramm-Rudman.

If you refrain from tax increases and comply with Gramm-Rudman, you are basically going to get out of the woods.

Mr. BARNARD. You don't think, though, that some of the programs which we will have to decrease funding in and of itself will be in the infrastructure—roads, highways, airports and so forth—you don't think that burden that is going to be passed on to local communities will offset—won't taxes have to be raised at that level to offset what we would have normally done by raising taxes?

Mr. RAHN. I am not sure that necessitates a shift to increase the tax burdens for States and localities. In some cases that may well hurt, as it has in recent years, but I am not sure that is all bad.

Philosophically I tend to be one that believes government is best closest to home, and a lot of this responsibility got transferred to the Federal Government over the last few decades that I think could more appropriately be done in State and local governments. That is my own philosophical bias on that.

Mr. BARNARD. It can't be done if we don't turn loose some of those trust funds. You see, that is the thing that concerns me. When we are using the trust funds which are special purpose taxes, when we are using the airport trust fund and highway trust fund to balance the budget, and then when we expect the States to continue to build the roads and the bridges and the airports, which the populus is going to ask them to continue to do, that means at the State level the State is going to have to raise taxes.

Mr. RAHN. I grant you, the way we are doing some of these things—part of the airport trust fund, for example, makes no sense. If we are going to have user fees, user fees ought to be real user fees and not general revenue sources.

When I say no tax increases, that doesn't mean having no changes to make the tax system a bit more rational by reducing the impediments on work, saving, investment or not overfunding trust funds that you are not going to utilize immediately and then using user fees improperly.

Mr. BARNARD. Does the Chamber support a broad-based consumption tax?

Mr. RAHN. No.

Mr. BARNARD. Does the National Association of Manufacturers?

Mr. JASINOWSKI. We do, and we think that it is an important option to consider if we are not able to reduce spending to the amount necessary.

I would agree with Mr. Rahn that that is where the emphasis should be. But if it is not possible, it then becomes a question of what do you do and what are the political trade-offs and what are the economic effects of different kinds of taxes.

Certainly a broad-based consumption tax would help increase savings in this country, would have favorable effects on investment and would be a favorable tax from the point of view of internation-

al trade. It carries a lot of controversial baggage with it, both in terms of its impact on inflation and its option for opening up additional revenues to be spent and the fact that politically it is not something anyone has hitched on to, that we will continue to advocate a broad-based consumption tax.

Chairman NEAL. There was one Congressman, and he is no longer with us.

Mr. BARNARD. He is probably better off, too, financially.

Mr. JASINOWSKI. It is interesting how good your memories are on things like that.

Chairman NEAL. Would the gentleman yield to me?

Mr. BARNARD. I have taken more time than I deserved.

Chairman NEAL. None of us likes taxes. If we try to separate the politics out for a moment, I now see that about 75 percent of our budget is in three items. It is clear that we are not going to do anything about social security; the defense budget has been holding fairly level for about 3 years; interest on the national debt we can't do much about.

The rest—education for example—both the presidential candidates and most of us other candidates say we ought to improve our education. Some people like to say we are going to get better by spending less. That is political talk. That is not the way it works in the real world, I don't think. I must say it is very rare that we can get more for less. Maybe it can happen.

Doug mentioned one area. I hope that you are all aware more than most of us that we need to invest in the infrastructure of the country for the future. Roads and highways and bridges are deteriorating. We have some problems that will impact the life of us all if we don't do something about them over time. I am talking about big problems like greenhouse and acid rain and toxic dump waste and so on. This costs money. You don't get more for less there, for sure. You have got mammoth environmental expenditures possible, mammoth infrastructure expenditures, and we want to improve our educational system.

To leave out of it the social concerns that are arising to our consciousness such as homelessness and hunger, it seems unrealistic to me to think we are not going to somehow have to deal with those things.

Mr. BARNARD. Let me throw in one more consideration, and the thing that concerns me with all of this is another part of the equation, and it is how are we going to increase our rate of savings in this country?

Chairman NEAL. You have all criticized higher interest rates. I agree with you, but a good fraction of those higher interest rates today are the result, it seems to me, of an inflationary expectation which is directly related to our budget deficit. Real interest rates remain at historically high levels. It would seem to me in the interest of lower interest rates and increased savings, as Doug mentioned, that we ought to give this deficit a much higher priority.

Mr. JASINOWSKI. If I can make two quick responses to your point, one I will go back and emphasize again, this idea of a broad-based consumption tax which deals with most of those problems. I recognize—

Chairman NEAL. Let me go one step further. If we put a dollar a gallon on tax on gasoline, for example, that would discourage consumption and would generate a significant amount of money toward the deficit reduction—some say close to \$100 billion. However, it is just not going to happen. It is really not realistic to think we are going to be able to cut spending on the one hand in the face of these obvious needs. If we don't do them, someone has to do them.

Mr. JASINOWSKI. Let me finish my two points. I go back to the consumption tax at number one, and I don't think over the long term it is going to be regarded as outrageous and unrealistic.

The second thing is, I certainly don't mean to be presumptuous to preach to the Congress about how they should manage the reduction of spending, but I have to say from the point of view of manufacturing corporations that we have reduced employment and costs by 25 percent plus, and that has not happened in most areas of the Federal Government. There are areas where that may have occurred, but it has not happened overall.

So I have to say, Mr. Chairman, that we have——

Chairman NEAL. Where is it comparable? You can increase your productivity by getting new machines, but machines can not handle constituent problems or make laws.

Mr. LEACH. So can we.

Chairman NEAL. Yes, we can, but so much of what we do is not of that nature.

Mr. BARNARD. We had an opportunity——

Mr. JASINOWSKI. NAM reduced its staff by about 25 people.

Chairman NEAL. Federal Government employment has stayed the same for 20 years.

Mr. JASINOWSKI. That needs to change.

Mr. BARNARD. We had an opportunity to cut spending across the board 2.5 percent. It was called a 2 percent deficit package. It got 2 percent of the vote of Congress. I think something like 50 Members voted for it.

But the problem is, I am not of the opinion that we can't across the board arbitrarily reduce spending 1 or 2 percent and expect that we are going to have to go out of business. I don't believe we will do that.

Chairman NEAL. Jim.

Mr. LEACH. I will take 1 or 2 minutes, because the time is about up.

I would say this is frankly a very alarming conversation from a Republican's—these two marvelous conservatives want to raise taxes. My gosh.

Mr. BARNARD. Like everything else, you came in too late.

Mr. LEACH. I just have a couple of quick questions, one for Mr. Paris. Moving from macro to micro, you have done so well creating all these 4,500 new jobs in the last year. Do you want to return to your other plant and fill it?

Mr. PARIS. I wish we could, but those increases were at existing facilities.

Mr. LEACH. We are disappointed you moved out.

Perhaps a question for Mr. Pate.

The Fed made a fairly controversial decision on raising the discount rate, and I sense in this whole group there is some dissent, but obviously the premise behind it was fine tuning. Subsequent to that decision we had a little stutter in the July statistics, and in your industry, Mr. Pate, we appear to be seeing peace at work in the Middle East, which may imply a little lower priced oil.

One of the questions is, if one accepts the fine tuning premise, that that is all right, should they fine tune in the very immediate future and reverse their decision based on those two factors?

Mr. PATE. With respect to the August 9 increase in the discount rate that I discussed, I was very disappointed that the Federal Reserve did that. I didn't think it was justified by the economic fundamentals. Of course, that was in large part due—

Mr. LEACH. Forgetting the decision made then on those economic fundamentals, has there been a little change in those fundamentals? I mean, petroleum really, as we understand it, kind of cuts across the economy and looks like it is going to be a little lower priced.

Mr. PATE. I think that is right.

Mr. LEACH. The July statistics—is that a basis of those that might have made a close decision in one direction to make one in another, or is the Fed too caught up with its own—frankly I think a factor is the psychology of wanting to be independent of the elections and, for an honorable person, of course you want to be independent in the elections.

I personally felt that might have had as much to do with it as the concern about inflation. I could be wrong on these close decisions, but might there be a little different case that might be presented, and would you like to say publicly, as an executive vice president of a major petroleum company, that prices are coming down?

Mr. PATE. I think that is a good point. Obviously oil prices are much weaker than most of us had expected. The general forecast was for oil prices to average about \$19.50 this year. The forecast now is that the price will probably be around \$16.50 at best. The price currently is \$14.24, so it is coming down, and with the improved inflation outlook should provide more flexibility to the Federal Reserve.

Mr. LEACH. One other quick concluding sentence.

Mr. Rahn, on page 3 of your statement, it is about the best paragraph I have ever seen for George Bush to use in a debate for Michael Dukakis: the strength of the American economy. I have never seen it more succinctly put. It is impressive.

Chairman NEAL. Thank you all very much for being with us. I am sorry the hearing has been disjointed, but we value your testimony. If you have any other ideas in the future, we want and need them. Stay in touch with us.

Thank you.

[Whereupon, at 3:50 p.m., the hearing was adjourned.]

APPENDIX

JULY 28, 1988

Statement by  
Alan Greenspan  
Chairman, Board of Governors of the Federal Reserve System  
before the  
Subcommittee on Domestic Monetary Policy  
Committee on Banking, Finance and Urban Affairs  
U.S. House of Representatives  
July 28, 1988



Mr. Chairman, and members of the Committee, I appreciate this opportunity to review with you recent and prospective monetary policy and the economic outlook. I would also like to provide a broader perspective by discussing in some detail our nation's longer-term economic objectives, the overall strategy for fiscal and monetary policies needed to reach those objectives, and the appropriate tactics for implementing monetary policy within that strategic framework.

The economic setting and monetary policy so far in 1988.

The macroeconomic setting for monetary policy has changed in some notable respects since I testified last February. At that time, the full after-effects of the stock market plunge on spending and financial markets were still unclear. While most Federal Open Market Committee members were forecasting moderate growth, in view of rapid inventory building and some signs of a weakening of labor demand, the possibility of a decline in economic activity could not be ruled out. To guard against this outcome, in the context of a firmer dollar on exchange markets, the Federal Reserve undertook a further modest easing of reserve pressures in late January, which augmented the more substantial easing following October 19. Short-term interest rates came down another notch, and with a delay helped to push the monetary aggregates higher within their targeted annual ranges.

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In the event, the economy proved remarkably resilient to the loss of stock market wealth. Economic growth remained vigorous through the first half of the year. Continuing brisk advances in exports, together with moderating growth in imports, supported expansion in output, especially in manufacturing. Some strengthening also was evident in business outlays for equipment, especially computers, and consumer purchases of durables, including autos.

Financial markets also returned to more normal functioning. Although trading volumes did not regain pre-crash levels in many markets, price volatility diminished somewhat and quality differentials stayed considerably narrower than in the immediate aftermath of the stock market plunge. In response, the Federal Reserve gradually was able to restore its standard procedure of gearing open market operations to the intended pressure on reserve positions of depository institutions. We thereby discontinued the procedure of reacting primarily to day-to-day variations in money market interest rates that had been adopted right after the stock market break.

As the risks of faltering economic expansion and further financial market disruptions diminished, the dangers of intensified inflationary pressures reemerged. Utilization of labor and capital reached the highest levels in many years, and hints of acceleration began to crop up in wage and price data. Strong gains in payroll employment that continued through the spring combined with slower growth in the labor force to lower

the unemployment rate by about 1/4 percentage point, even before the strong labor market report for June; the industrial capacity utilization rate moved up as well. In part reflecting the payroll tax increase, broad measures of hourly compensation picked up somewhat in the first quarter. Prices for a wide range of domestic and imported industrial materials and supplies rose even more steeply than last year. Finished goods price inflation has not reflected this step-up in price increases for intermediate goods, in part as productivity gains kept unit labor costs under control. Even so, continued increases in materials prices at the recent pace were seen as pointing to a potential intensification in inflation more generally, since based on historical experience, such increases have tended to show through to finished good prices.

In these circumstances, the Federal Reserve was well aware that it should not fall behind in establishing enough monetary restraint to effectively resist these inflationary tendencies. The System took a succession of restraining steps from late March through late June. The shortest-term interest rates gradually rose to levels now around highs reached last fall. Responding as well to the unwinding of a tax-related buildup in liquid balances, M2 and M3 growth slowed noticeably after April.

In contrast to the shortest-maturity interest rates, long-term bond and mortgage rates, though also above February lows, still remain well below last fall's peaks. The timely

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tightening of monetary policy this spring, along with perceptions of better prospects for the dollar in foreign exchange markets in light of the narrowing in our trade deficit, seemed to improve market confidence that inflationary excesses would be avoided. Both bond prices and the dollar rallied in June despite increases in interest rates in several major foreign countries and jumps in some agricultural prices resulting from the drought in important growing areas.

The economic outlook and monetary policy through 1989.

The monetary actions of the first half of the year were undertaken so that economic expansion could be maintained, recognizing that to do so, additional price pressures could not be permitted to build and progress toward external balance had to be sustained. The projections of FOMC members and nonvoting presidents indicate that they do expect economic growth to continue, and inflation to be contained.

The 2-3/4 to 3 percent central tendency of FOMC members' expectations for real GNP growth over the four quarters of this year implies a deceleration over the rest of the year to a pace more in line with their expected 2 to 2-1/2 percent real growth over 1989 and with the long-run potential of the economy. The drought will reduce farm output for a time, and it is important that nonfarm inventory accumulation slow before long, if we are to avoid a troublesome imbalance. Still, further gains in our international trade position should continue to provide a major stimulus to real GNP growth through next year,

reflecting the lagged effects of the decline in the exchange value of the dollar through the end of last year. Although the month-to-month pattern in our trade deficit can be expected to be erratic, the improvement in the external sector on balance over time is expected to replace much of the reduced expansion in domestic final demands from our consumer, business, and government sectors.

Employment growth is anticipated to be substantial, though some updrift in the unemployment rate may occur over the next year and a half. Capacity utilization could well top out soon, as growth in demands for manufactured goods slows to match that of capacity.

Considering the already limited slack in available labor and capital resources, a leveling of the unemployment and capacity utilization rates is essential if more intense inflationary pressures are to be avoided in the period ahead. Otherwise, aggregate demand would continue growing at an unsustainable pace and would soon begin to create a destabilizing inflationary climate. Supply conditions for materials and labor would tighten further and costs would start to rise more rapidly; businesses would attempt to recoup profit margins with further price hikes on final goods and services. These faster price rises would, in turn, foster an inflationary psychology, cut into workers' real purchasing power, and prompt an attempted further catchup of wages, setting in motion a dynamic process in

which neither workers nor businesses would benefit. The hard-won gains in our international competitiveness would be eroded, with feedback effects depressing the exchange value of the dollar. Excessive domestic demands and inflation pressures in this country, with its sizable external deficit, would be disruptive to the ongoing international adjustment of trade and payments imbalances.

Not only the reduced slack in the economy but also several prospective adjustments in relative prices have accentuated inflation dangers. One is the upward movement of import prices relative to domestic prices, which is a necessary part of the process of adjustment to large imbalances in international trade and payments. Another is the recent drought-related increases in grain and soybean prices. It is essential that we keep these processes confined to a one-time adjustment in the level of prices and not let them spill over to a sustained higher rate of increase in wages and prices. Elevated import and farm prices must be prevented from engendering expectations of higher general inflation, with feedback effects on labor costs. A more serious long-run threat to price stability could come from government actions that introduced structural rigidities and increased costs of production. Protectionist legislation, inordinate hikes in the minimum wage, and other mandated programs that would impose costs on U.S. producers would adversely affect their efficiency and international competitiveness.

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The costs to our economy and society of allowing a more intense inflationary process to become entrenched are serious. As the experience in the past two decades has clearly shown, accelerating wages and prices would have to be countered later by quite restrictive policies, with unavoidably adverse implications for production and employment. The financial health of many individual and business debtors, as well as of some of their creditors, then would be threatened. The long-run costs of a return to higher inflation and the risks of this occurring under current circumstances are sufficiently great, that Federal Reserve policy at this juncture might be well advised to err more on the side of restrictiveness rather than of stimulus.

We believe that monetary policy actions to date, together with the fiscal restraint embodied in last fall's agreement between the Congress and the administration, have set the stage for containing inflation through next year. The central tendency of FOMC members' expectations for inflation in the GNP deflator ranges from 3 to 3-3/4 percent over this year and 3 to 4-1/2 percent next year. But in one sense the GNP deflator understates this year's rate of inflation, and the comparison with next year overstates the pick-up. The deflator represents the average price of final goods and services produced in the United States, or equivalently domestic value added, using current quantity weights. This measure was artificially held down in the first quarter by a shift in the composition of output, especially by the surge in sales of computers whose

prices have dropped sharply since the 1982 base year used for constructing the deflator. Indeed, if the deflator were indexed with a 1987 base year, it would have risen appreciably faster in the first quarter.

Another understatement of inflation in the deflator this year arises from its exclusion of imported goods, which are not directly encompassed because they are produced abroad. In part because import prices have continued to rise significantly faster than prices of domestically produced goods, consumer price indexes have increased more than the GNP deflator.

The FOMC believes that efforts to contain inflation pressures and sustain the economic expansion would be fostered by growth of the monetary aggregates over 1988 well within their reaffirmed 4 to 8 percent annual ranges, followed by some slowing in money growth over the course of next year. M2 should move close to the midpoint of its range by late 1988, if depositors react as expected to the greater attractiveness of market instruments compared with liquid money balances that was brought about by recent increases in short-term market rates relative to deposit rates. M3 could end the year somewhat above its midpoint, though comfortably within its range, if depository institutions retain their recent share of overall credit expansion. The debt of nonfinancial sectors, which so far this year has been near the midpoint of its reaffirmed 7 to 11 percent monitoring range, is anticipated to post similar growth through year-end.



For 1989, the FOMC has underscored its intention to encourage progress toward price stability over time by lowering its tentative ranges for money and debt. We have preliminarily reduced the growth range for M2 by 1 full percentage point, to 3 to 7 percent; last February, the FOMC also had reduced the midpoint of the 1988 range for M2 by 1 percentage point from that for 1987. We have adjusted the tentative 1989 range for M3 downward by 1/2 percentage point, to 3-1/2 to 7-1/2 percent. This configuration is consistent with the observed tendency for M3 velocity over time to fall relative to the velocity of M2; over the last decade, the Federal Reserve's ranges frequently allowed for faster growth of M3 than of M2. The monitoring range for domestic nonfinancial debt for 1989 also has been lowered 1/2 percentage point to a tentative 6-1/2 to 10-1/2 percent.

The specific ranges chosen for 1989 are, as usual, provisional, and the FOMC will review them carefully next February, in light of intervening developments. Anticipating today how the outlook for the economy in 1989 will appear next February is difficult, and a major reassessment of that outlook would have implications for appropriate money growth ranges for that year. Unexpectedly strong or weak economic expansion or inflation pressures over the next six months also could have implications for the behavior of interest rates and their prospects for 1989. The sensitivity of the monetary aggregates to movements in market interest rates means that the appropriate growth next year

in M2, M3, and debt could seem different next February than now, necessitating a revision in the annual growth ranges. As the aggregates have become more responsive to interest rate changes in the 1980s, judgments about possible ranges for the next year necessarily have become even more tentative and subject to revision.

The persistent U.S. external and fiscal imbalances.

Despite the changes in the economic setting over the last six months, other features of the macroeconomic landscape remain much the same. Most notable are the continuing massive deficits in our external payments and internal fiscal accounts. As a nation, we still are living well beyond our means; we consume much more of the world's goods and services each year than we produce. Our current account deficit indicates how much more deeply in debt to the rest of the world we are sliding each year.

The consequence of this external imbalance will be a steady expansion in our external debt burden in the years ahead. No household or business can expect to have an inexhaustible credit line with borrowing terms that stay the same as its debt mounts relative to its wealth and income. Nor can we as a nation expect our foreign indebtedness to grow indefinitely relative to our servicing capacity without additional inducements to foreigners to acquire dollar assets--either higher real interest returns, or a cheaper real foreign exchange value for dollar assets, or both. To be sure, such changes in market

incentives would have self-correcting effects over time in reducing the imbalance between our domestic spending and income. Higher real interest rates would curtail domestic investment and other spending. A lower real value of the dollar would make U.S. goods and services relatively less expensive to both U.S. and foreign residents, damping our spending on imports out of U.S. income and boosting our exports.

But simply sitting back and allowing such a self-correction to take place is not a workable policy alternative. Trying to follow such a course could have severe drawbacks now that our economy is operating close to effective capacity and potential inflationary pressures are on the horizon. The time is hardly propitious to discourage investment in needed plant and equipment, to add further impulses for import price hikes on top of the upward tendencies already in the making, or to push our export industries as well as import-competing industries to their capacity limits.

Fortunately, we have a better choice for righting the imbalance between domestic spending and income--one over which we have direct control. That is to resume reducing substantially the still massive federal budget deficit, which remains the most important source of dissaving in our economy. The fall in the dollar we have already experienced over the last few years, even allowing for the dollar's appreciation from the lows reached at the end of last year, has set in motion forces that should continue to narrow our trade and current account deficits

in the years ahead. The associated loss of foreign-funded domestic investment is likely to adversely affect overall investment unless it can be replaced by greater domestic investment financed by domestic saving. A sharp contraction in the federal deficit appears to be the only assured source of augmented domestic net saving. Such a fiscal cutback should help counter future tendencies for further increases in U.S. interest rates and declines in the dollar, partly by instilling confidence on the part of international investors in the resolve of the United States to address its economic problems.

Fiscal restraint in the years ahead would assist in making room for the needed diversion of more of our productive resources to meeting demands from abroad. Domestic demands will have to continue growing more slowly than our productive capacity, as seems to have been the case so far this year, if net exports are to expand further without resulting in an inflationary overheating of the economy. Absent this fiscal restraint, higher interest rates would become the only channel for damping domestic demands if they were becoming excessive. If a renewed decline in the dollar were adding further inflationary stimulus at the same time, upward pressures on interest rates would be even more likely. The restrictive impact would be felt most by the interest-sensitive sectors--homebuilding, business fixed investment, and consumer durables.

In terms of federal deficit reduction, the schedule under the Gramm-Rudman-Hollings law is a good baseline for a

multi-year strategy, and I trust the Congress will stick with it. But we should go further. Ideally, we should be aiming ultimately at a federal budget surplus, so that government saving could supplement private domestic saving in financing additional domestic investment. Historically, the United States was not a low saving, low investing economy. From the post-Civil War period through the 1920s, the United States consistently saved more as a fraction of GNP than Japan and Germany, and we saved much more as a share of GNP than we have since the end of World War II. A turnaround in our current domestic saving performance is essential to a smooth reduction in our dependence on foreign saving, and the federal government should take the lead.

It is also apparent that redressing our external imbalances must encompass cooperative policies with our trading partners. These include both the established industrial powers, the newly industrialized economies, and the developing countries, whose debt problems must be worked through as part of the international adjustment process.

This is the strategy that U.S. fiscal policy as well as economic policies abroad should follow in most effectively promoting our shared economic objectives. The strategic role of U.S. monetary policy is implied by a clear statement of what those ultimate objectives are. We should not be satisfied unless the U.S. economy is operating at high employment with a sustainable external position and above all stable prices.

High employment is consistent with steadily rising nominal wages and real wages growing in line with productivity gains. Some frictional unemployment will exist in a dynamic labor market, reflecting the process of matching available workers with available jobs. But every effort should be made to minimize both impediments that contribute to structural unemployment and deviations of real economic growth from the economy's potential that cause cyclical unemployment.

By a sustainable external position, I am referring to a situation in which our foreign indebtedness is not persistently growing faster than our capacity to service it out of national income. Our international payments need not be in exact balance from one year to the next, and the exchange value of the dollar need not be perfectly stable, but wide swings in the dollar, and boom and bust cycles in our export and import-competing industries, should be avoided.

By price stability, I mean a situation in which households and businesses in making their saving and investment decisions can safely ignore the possibility of sustained, generalized price increases or decreases. Prices of individual goods and services, of course, would still vary to equilibrate the various markets in our complex national and world economy, and particular price indexes could still show transitory movements. A small persistent rise in some of the indexes would be tolerable, given the inadequate adjustment for trends in quality improvement and the tendency for spending to shift toward goods

that have become relatively cheap. But essentially the average of all prices would exhibit no trend over time. Price movements in these circumstances would reflect relative scarcities of goods, and private decision-makers could focus their concerns on adjusting production and consumption patterns appropriately to changing individual prices, without being misled by generalized inflationary or deflationary price movements.

The strategy for monetary policy needs to be centered on making further progress toward and ultimately reaching stable prices. Price stability is a prerequisite for achieving the maximum economic expansion consistent with a sustainable external balance at high employment. Price stability reduces uncertainty and risk in a critical area of economic decision-making by households and businesses. In the process of fostering price stability, monetary policy also would have to bear much of the burden for countering any pronounced cyclical instability in the economy, especially if fiscal policy is following a program for multi-year reductions in the federal budget deficit. While recognizing the self-correcting nature of some macroeconomic disturbances, monetary policy does have a role to play over time in guiding aggregate demand into line with the economy's potential to produce. This may involve providing a counterweight to major, sustained cyclical tendencies in private spending, though we can not be overconfident in our ability to identify such tendencies and to determine exactly the appropriate policy response. In this

regard, it seems worthwhile for me to offer some thoughts on the approach the Federal Reserve should take in implementing this longer-term strategy for monetary policy.

The appropriate tactics for monetary policy.

For better or worse, our economy is enormously complex, the relationships among macroeconomic variables are imperfectly understood, and as a consequence economic forecasting is an uncertain endeavor. Nonetheless, the forecasting exercise can aid policymaking by helping to refine the boundaries of the likely economic consequences of our policy stance. But forecasts will often go astray to a greater or lesser degree and monetary policy has to remain flexible to respond to unexpected developments.

A perfectly flexible monetary policy, however, without any guideposts to steer by, can risk losing sight of the ultimate goal of price stability. In this connection, the requirement under the Humphrey-Hawkins Act for the Federal Reserve to announce its objectives and plans for growth of money and credit aggregates is a very useful device for calibrating prospective monetary policy. The announcement of ranges for the monetary aggregates represents a way for the Federal Reserve to communicate its policy intentions to the Congress and the public. And the undisputed long-run relation between money growth and inflation means that trend growth rates in the monetary aggregates provide useful checks on the thrust of monetary policy over time. It is clear to all observers that



the monetary ranges will have to be brought down further in the future if price stability is to be achieved and then maintained.

But, in a shorter-run countercyclical context, monetary aggregates have drawbacks as rigid guides to monetary policy implementation. As I discussed in some detail in my February testimony, financial innovation and deregulation in the 1980s have altered the structure of deposits, lessened the predictability of the demands for the aggregates, and made the velocities of M1 and probably M2 over periods of a year or so more sensitive to movements in market interest rates. Movements in short-term market rates relative to sluggishly adjusting deposit rates can result in large percentage changes in the opportunity costs of holding liquid monetary assets. Depositor responses can induce divergent growth between money and nominal GNP for a time. I might add that it was partly these considerations that led the FOMC to retain the wider four percentage point ranges for money and credit growth for this year and next.

Nonetheless, the demonstrated long-run connection of money and prices overshadows the problems of interpreting shorter-run swings in money growth. I certainly don't want to leave the impression that the aggregates have little utility in implementing monetary policy. They have an important role, and it is quite possible that their importance will grow in the years ahead. Currently, the FOMC keeps M2 and M3 under careful scrutiny, and judges their actual movements relative to assessments of their appropriate growth at any particular time.

In this context, these aggregates are among the indicators influencing adjustments to the stance of policy, both at regular FOMC meetings and between meetings, as the FOMC's directive to the Federal Reserve Bank of New York's Trading Desk indicates. The FOMC also regularly monitors a variety of other monetary aggregates. At times in recent years, we have intensively examined the properties of several alternative measures, and reported the results to the Congress. These measures have included M1, M1-A (M1 less NOW accounts), monetary indexes, and most recently the monetary base.

An analysis of the monetary base appears as an appendix to the Board's Humphrey-Hawkins report. This aggregate, essentially the sum of currency and reserves, did not escape the sharp velocity declines of other money measures earlier in the 1980s. Its velocity behavior stemmed from relatively strong growth in transactions deposits compared with GNP, which was mirrored in the reserve component of the base. In this sense, some of the problems plaguing M1 also have shown through to the base, though in somewhat muted form. Moreover, the three-quarters share of currency in the base raises some question about the reliability of its link to spending. The high level of currency holdings--\$825 per man, woman and child living in the United States--suggests that vast, indeterminate amounts of U.S. currency circulate or are hoarded beyond our borders. Indeed, over the last year and one half, currency has grown

noticeably faster than would have been expected from its historical relationships with U.S. spending and interest rates.

Although the monetary base has exhibited some useful properties over the last three decades as a whole, the FOMC's view is that its behavior has not consistently added to the information provided by the broader aggregates, M2 and M3. The Committee accordingly has decided not to establish a range for this aggregate, although it has requested staff to intensify research into the ability of various monetary measures to indicate long-run price trends.

Because the Federal Reserve cannot reliably take its cue for shorter-run operations solely from the signals being given by any or all of the monetary aggregates, we have little alternative but to interpret the behavior of a variety of economic and financial indicators. They can suggest the likely future course of the economy given the current stance of monetary policy.

Judgments about the balance of various risks to the economic outlook need to adapt over time to the shifting weight of incoming evidence; this point is well exemplified so far this year, as noted earlier. The Federal Reserve must be willing to adjust its instruments fairly flexibly as these judgments evolve; we must not hesitate to reverse course occasionally if warranted by new developments. To be sure, we should not overreact to every bit of new information, because the frequent observations for a variety of economic statistics are subject to

considerable transitory "noise". But we need to be willing to respond to indications of changing underlying economic trends, without losing sight of the ultimate policy objectives.

To the extent that the underlying economic trends are judged to be deviating from a path consistent with reaching the ultimate objectives, the Federal Reserve would need to make "mid-course" policy corrections. Such deviations from the appropriate direction for the economy will be inevitable, given the delayed and imperfectly predictable nature of the effects of previous policy actions. Numerous unforeseen forces not related to monetary policy will continue to buffet the economy. The limits of monetary policy in short-run stabilization need to be borne in mind. The business cycle cannot be repealed, but I believe it can be significantly damped by appropriate policy action. Price stability cannot be dictated by fiat, but governmental decision-makers can establish the conditions needed to approach this goal over the next several years.

PRESENTATION OF FEDERAL RESERVE  
MONETARY AGGREGATE TARGET RANGES

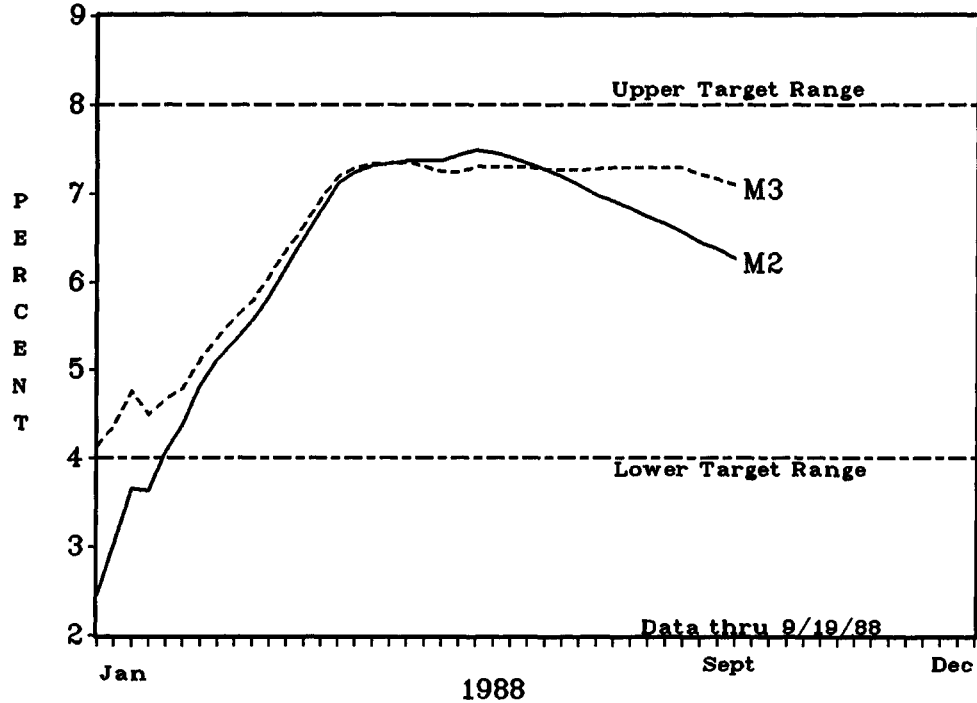
The Federal Reserve establishes annual percentage growth target ranges for monetary aggregates. The Fed depicts these ranges in terms of "cones" or "parallel lines" superimposed on a graph of the actual path of the monetary aggregate. This tends to suggest that if the monetary aggregate falls within the upper and lower points of the cones, or parallel lines, at the end of the year, then the aggregate will be "on target" for the year. It also suggests that it should more or less stay within the cone, or parallel lines, during the course of the year.

But these suggestions are misleading. If the aggregate is plotted monthly or weekly, it could easily fall outside the end-of-year range, and the aggregate nonetheless be on target, or it could fall within the end-of-year range, and the aggregate nonetheless be off target, for the year. The targets are set as percent changes from the fourth quarter of one year to the fourth quarter of the following year -- using quarterly averages of the aggregates. Thus, the final (one or two) monthly observations, or the final (one through twelve) weekly observations, could, in principle, be anywhere on the graph, and the aggregate could nonetheless be on-target (or off-target), since the quarterly average, not the final observations, determine the outcome.

It would be preferable to show the actual percentage growth ranges established by the Fed, and to depict the growth of the aggregate so that it is on-target or off-target, for the year, according to whether the last observation is inside or outside the established ranges. This is accomplished by the weekly plotting of the annualized percent change of a 13-week moving average, calculated from the last 13-week average of the previous year. That last 13-week average of the previous year is, in fact, the aggregate for the last quarter of the previous year. And the last 13-week average for the current year will be the aggregate for last quarter of the current year. (13-week moving averages may differ slightly from reported quarterly aggregates since not every quarter has exactly 13 weeks, but such differences are imperceptibly trivial.)

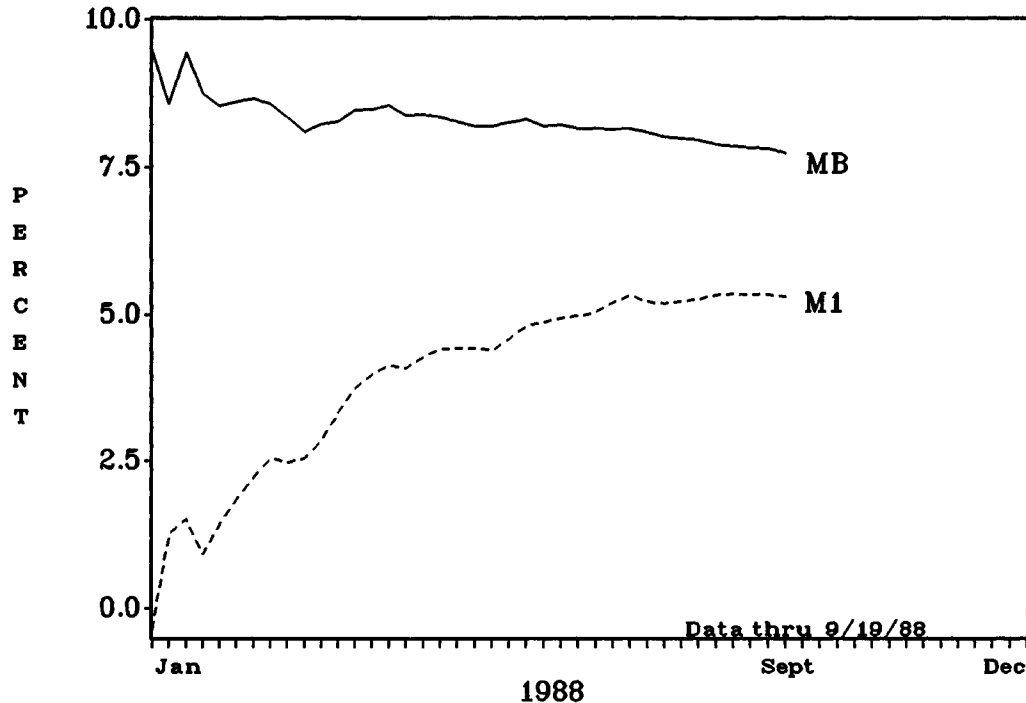
The Fed does not interpret its established growth ranges as necessarily implying any particular path over the course of the year. Strictly speaking, the growth ranges apply only to the aggregates for the last quarter of the current year, compared to the last quarter of the previous year. There is, strictly speaking, no sense in which the path between those end points is "on-target" or "off-target". Nonetheless, it is important to convey information, during the course of the year, on how the aggregates are growing, relative to their final growth target ranges. These 13-week moving average graphs convey that information more usefully than the typical cones or parallel lines.

# M2 & M3



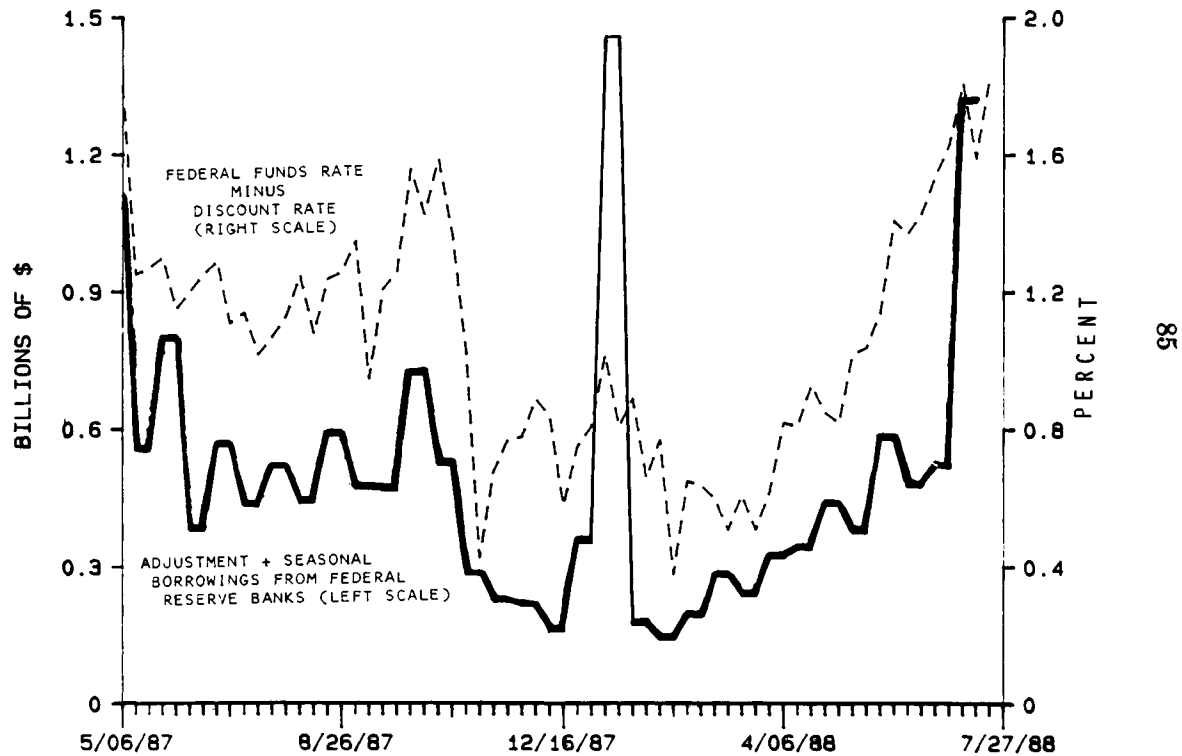
Weekly Data for M2 & M3 are annualized percent changes of 13-week moving averages for M2 & M3, calculated from the 4th quarter 1987 average.

# MONETARY BASE & M1



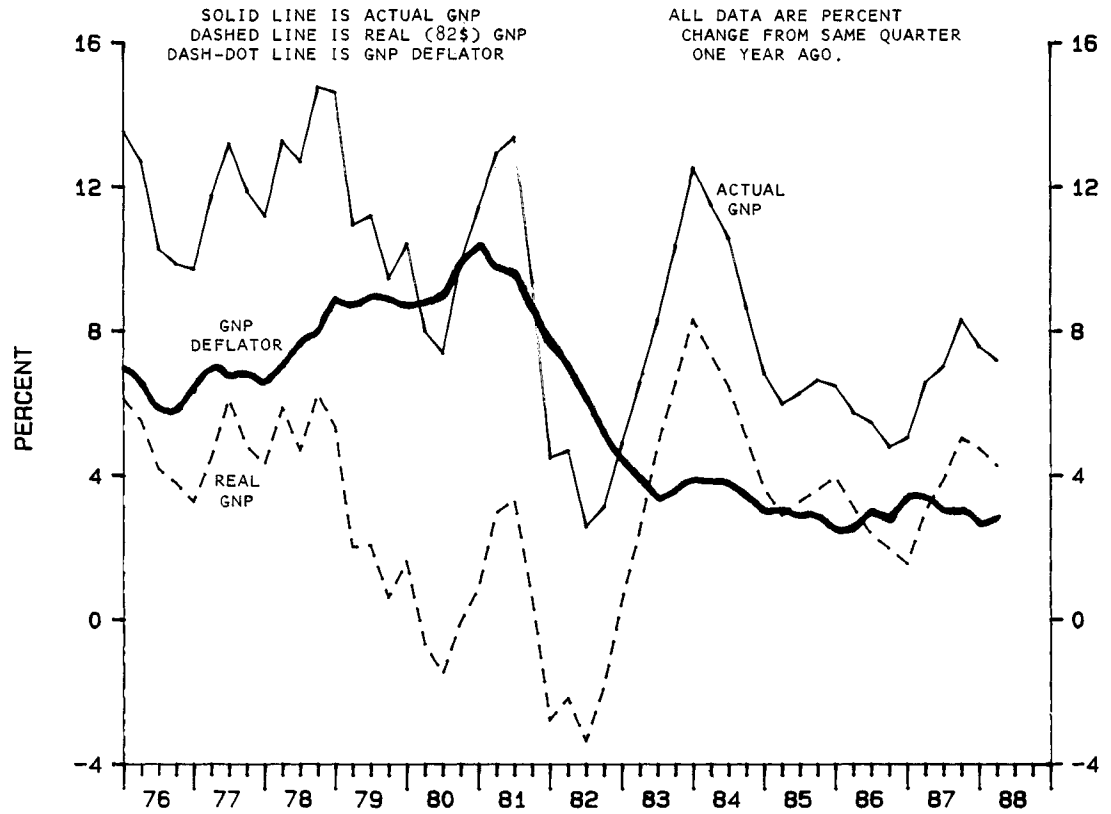
Weekly Data for the FRB Monetary Base (MB) and M1 are annualized percent changes of 13-week moving averages for MB and M1, calculated from the 4th quarter 1987 average. The Federal Reserve has established no growth ranges for MB or M1.

FEDERAL RESERVE BORROWINGS VERSUS INTEREST RATE DIFFERENTIAL





# GROSS NATIONAL PRODUCT



**For use at 10:00 a.m., E.D.T.  
Wednesday  
July 13, 1988**

**Board of Governors of the Federal Reserve System**



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

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**July 13, 1988**

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## Letter of Transmittal

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BOARD OF GOVERNORS OF THE  
FEDERAL RESERVE SYSTEM  
Washington, D.C., July 13, 1988

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 1988 and 1989

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The economy continued to expand rapidly in the first half of 1988, displaying impressive resilience in the wake of last fall's stock market break. Especially encouraging has been the fact that the expansion in activity this year has been propelled largely by rising exports and business investment, which bodes well for the restoration of better balance in the economy.

With the industrial sector continuing to enjoy greater growth, capacity utilization rates have crept higher. At the same time, the civilian unemployment rate has declined since year-end, and the average of 5-1/2 percent in the second quarter was the lowest in nearly fifteen years. Despite the tightening of labor markets, wage increases to date have been notably restrained, on balance, helping to contain cost pressures in many sectors. Most measures of price inflation among finished goods and services also have shown little if any pickup, although basic commodity prices have risen considerably, most recently reflecting the effects of drought on agricultural markets.

During the first half of the year, the Federal Reserve continued to direct its policies toward providing monetary and financial conditions that would foster price stability over time, promote sustainable economic growth, and contribute to an improved pattern of international transactions. It was recognized that progress toward these goals in 1988 would require relatively slow growth of domestic demand, which would allow the economy to accommodate rising external demands on U.S. producers without generating overall inflationary pressures. Consistent with continued external adjustment and with its commitment to achieving price stability over time, the Federal Open Market Committee (FOMC) in February lowered its 1988 target growth ranges for M2 and M3 to 4 to 8 percent.

At the beginning of the year, the conduct of monetary policy was complicated by excep-

tional uncertainty about the state of the economy. Some signs of weakness had begun to emerge, seemingly lending support to the widely held view that economic activity would falter after the stock market break. In particular, inventories had accumulated at a rapid rate in the fourth quarter of 1987, producing some overhang of stocks at the retail level. Moreover, other indicators suggested that the rate of increase in labor demand had slackened. At the same time, financial markets seemed to be somewhat fragile, as conditions had not yet returned to normal following the plunge in stock prices. The Federal Reserve thus was faced with the challenge of countering the apparent near-term weakness of the economy, while taking account of the longer-range need to ensure that growth in domestic demand would not become excessive.

In this situation, and with the dollar firming on foreign exchange markets, the Committee loosened slightly further the easier reserve conditions that had been adopted following the stock market plunge. Market interest rates edged down, which—in conjunction with earlier declines in rates—helped lift M2 and M3 to near the top of their 1988 target ranges and resulted in a modest fall in their velocities (the ratio of nominal GNP to the money supply) during the first quarter. Given the risk that economic activity was weakening, as well as the still unsettled conditions in financial markets, the Committee viewed the more rapid growth in money as appropriate.

By early spring, however, the bulk of the incoming data indicated that business activity had, in fact, remained robust. Additional information available later in the second quarter confirmed the strength of the economy, and high and rising levels of resource utilization pointed to a greater potential for a build-up of inflationary pressures. The costs of allowing inflation to intensify were seen as quite high, based on the expe-

rience of the early 1980s, when the reversal of the inflation process led unavoidably to sizable losses in output and to an extended period of high unemployment.

Against this backdrop, the Committee tightened reserve conditions somewhat in a series of moves beginning in late March. Market interest rates responded to the strength in the economy and to the Federal Reserve's actions by moving upward. Over the past four months, most short-term interest rates have increased around one percentage point on balance. Long-term rates generally rose substantially through late May, but have declined a little on net since then. The better performance of the bond market recently has occurred at a time when investor sentiment toward investment in dollar-denominated assets has been buoyed by better trade statistics and may also have reflected favorable market response to the Federal Reserve's demonstrated resolve to fight inflation.

Despite the Committee's tightening actions, M2 and M3 continued to expand rapidly through April, in response to earlier decreases in interest rates and to a bulge in transactions balances associated with unusually large individual tax payments. As the tax-related surge unwound and the influence of higher interest rates began to be felt, the two broad aggregates grew at a reduced pace in May and June, and ended the first half of the year in the upper halves of their target ranges.

#### **Monetary Plans for the Remainder of 1988 and for 1989**

At its meeting last month, the Federal Open Market Committee agreed to retain the 4 to 8 percent target growth ranges for M2 and M3, measured from the fourth quarter of 1987 to the fourth quarter of 1988. In addition, the Committee retained the 7 to 11 percent monitoring range for the debt of domestic nonfinancial sectors and again set no range for M1. Recognizing the variability of the relationship of these measures to the

performance of the economy, the Committee agreed that operating decisions would continue to be made not only in light of the behavior of the monetary aggregates, but also with due regard to developments in the economy and financial markets, including attention to the sources and extent of price pressures and to the performance of the dollar in foreign exchange markets.

In the absence of any significant economic and financial disturbances, the Committee expected growth in M2 to moderate over the remainder of the year, placing the aggregate around the middle of its target range at year-end. Growth in M3 this year is expected to exceed that of M2 but to remain comfortably within its range, on the assumption that asset expansion at depository institutions would remain fairly robust in the second half. The debt of domestic nonfinancial sectors is expected to remain near the middle of its monitoring range, which would put its growth for the year around the slowest annual pace registered in the past decade.

For 1989, the Committee set, on a tentative basis, target growth ranges of 3 to 7 percent for M2 and 3-1/2 to 7-1/2 percent for M3, measured from the fourth quarter of 1988 to fourth quarter of 1989; the monitoring range over the same period for domestic debt was set at 6-1/2 to 10-1/2 percent. Although uncertain about how strong the economy might be over the coming year or so, the Committee recognized that, given the current high levels of resource utilization, it was necessary to be particularly attentive to inflationary risks. An acceleration of inflation could undermine the sustainability of the economic expansion and the international competitive position of U.S. producers. The lower ranges tentatively adopted for 1989 were believed consistent with a monetary policy that would curb any tendency for inflation to worsen and would contribute over time to the restoration of price stability. However, the Committee also noted that developments over the next half year could alter substantially the rates of money growth needed to

foster satisfactory economic performance in 1989 and beyond. Consequently, it stressed the provisional nature of its decision and the possibility that the ranges for 1989 might need to be adjusted when they are reviewed early next year.

The Committee again decided not to set a range for M1, given the sharp swings in its velocity in recent years, resulting in part from its increased sensitivity to movements in market interest rates since deposits were deregulated. In considering narrow monetary measures, the Committee also has discussed whether the monetary base could play a useful role in the conduct of policy. This measure comprises the major monetary liabilities of the Federal Reserve System—currency in the hands of the public and reserves of depository institutions—and represents, in a sense, the “base” of the broader monetary aggregates.\* The Committee decided against establishing a range for the monetary base, because it seemed unlikely to provide a more reliable guide for policy than the aggregates for which ranges already are established. Although the base has been less variable in relation to economic activity and prices than M1, its velocity nonetheless has fluctuated appreciably and rather unpredictably from year to year.

### Economic Projections

As is indicated in the table on the next page, the central tendency of the forecasts of Committee members and nonvoting Reserve Bank presidents—premised on the monetary policy objectives outlined above—is for growth in real GNP of 2-3/4 to 3 percent in 1988, with a modest slowing of expansion in 1989. Such a pace of growth likely would generate employment gains sufficient to hold the civilian unemployment rate close to its average second-quarter level of 5-1/2 percent. Prices, as measured by the implicit deflator for GNP, are generally expected to rise 3 to 3-3/4 percent over the four quarters of 1988, similar to last year’s rate of advance. For 1989, projections of the increase in the GNP deflator are of course more uncertain, and the central-tendency range widens to 3 to 4-1/2 percent.

The Administration forecast for 1988 is quite similar to the central tendency of forecasts of FOMC members and nonvoting presidents. For 1989, the Administration is projecting stronger growth of real output than indicated by the FOMC forecasts, but its expectation for inflation is in the middle of the range of FOMC forecasts. The Administration’s projection of nominal GNP in both years is around the upper end of the

Ranges of Growth for Monetary and Credit Aggregates  
(Percent change, fourth quarter to fourth quarter)

	1987	1988	Provisional for 1989
M2	5-1/2 to 8-1/2	4 to 8	3 to 7
M3	5-1/2 to 8-1/2	4 to 8	3-1/2 to 7-1/2
Debt	8 to 11	7 to 11	6-1/2 to 10-1/2

\* The characteristics of the base and its behavior are discussed in detail in an appendix to this report.

central-tendency ranges and within the full ranges, suggesting that the Administration's economic forecast and the FOMC's monetary ranges are broadly compatible.

Continued improvement in the external sector is expected to provide the main impetus to U.S. economic growth over the next year and a half. Real exports of goods should remain on a strong upward path, reflecting the improved competitive position of U.S. producers. At the same time, the growth of real imports is likely to be restrained, owing to the lagged effects of the depreciation of the dollar through the end of last year. This continued shrinkage of the real trade deficit is expected to be sufficient to generate some reduction in the nation's deficit on current account during 1988 and a further decline in 1989.

In contrast to the boost provided by the external sector, domestic demand is projected to remain relatively subdued. Consumer spending, in particular, has been on a sluggish growth trend

since late 1986, and that pattern seems likely to persist. Moreover, in an environment of more moderate growth of overall activity, economy-wide spending on new plant and equipment may not rise as swiftly as it has on average over the past year. Even so, within manufacturing, improved profitability and higher capacity utilization have stimulated a healthy pickup in capital spending, which should continue for some time.

The performance of the interest-sensitive sectors, most notably homebuilding and business investment, will be influenced considerably by the extent to which the federal government is competing for available supplies of credit. Accordingly, continued fiscal restraint is essential if we are to free up resources to support private investment. In this regard, the budget summit agreement reached last December was a favorable first step, and the Federal Open Market Committee members and other Reserve Bank presidents have assumed that the necessary legis-

Economic Projections for 1988 and 1989			
FOMC Members and nonvoting FRB Presidents			
	Range	Central Tendency	Administration
<i>Percent change, fourth quarter to fourth quarter</i>			
Nominal GNP			
1988	4 to 7	5-3/4 to 6-3/4	6.6
1989	4 to 7-1/2	5 to 7	7.1
Real GNP			
1988	1 to 3-1/4	2-3/4 to 3	3.0
1989	1 to 3	2 to 2-1/2	3.3
Implicit deflator for GNP			
1988	2-3/4 to 4	3 to 3-3/4	3.5
1989	2 to 5	3 to 4-1/2	3.7
<i>Average level in the fourth quarter, percent</i>			
Civilian unemployment rate			
1988	5-1/4 to 6-1/2	5-1/4 to 5-3/4	5.5
1989	5 to 7	5-1/2 to 6	5.3



ative action will be taken to implement the agreement. There is a clear need for further initiatives to deal with the out-year deficits, which remain distressingly large; financial events later this year and in 1989 could be substantially affected by the developments in the fiscal arena.

Although little change is expected in the overall pace of inflation this year, as compared with 1987, the sources of actual and potential price pressure appear to have changed. In 1987, a rebound in oil prices was a major factor boosting the general price level; assuming that world oil prices remain fairly stable, domestic energy prices should not be a significant inflationary force in 1988-89. Labor markets have tightened considerably since last year, however, and most measures of wage and compensation rates have firmed. Although the overall rate of industrial capacity utilization is not high by historical standards, plants are being used very intensively in some materials-producing sectors; sharply rising materials prices have raised costs for manufacturers generally. Food prices also have been a less favorable element in the inflation picture recently, and are likely to experience some further

acceleration as a consequence of drought conditions; however, it is important to recognize the temporary nature of this phenomenon, which should have no lasting effect on overall inflation so long as it does not become embedded in wage trends.

For 1989, the FOMC central-tendency range for the GNP deflator widens on the upper end, suggesting the possibility of a pickup in inflation from the pace this year. However, this apparent acceleration of prices largely reflects the arithmetic implication of an eccentric movement in the deflator for GNP in the first quarter of this year. Shifts in the composition of output caused the deflator to rise at less than a 1-1/2 percent annual rate during that quarter; these shifts are not expected to be so noticeable in coming quarters. The view that inflation next year will not differ significantly from the pace anticipated over the final three quarters of 1988 reflects the expectation that business and labor—recognizing the realities of a highly competitive international marketplace—will continue to exercise restraint in setting prices and wages.

## Section 2: The Performance of the Economy During the First Half of 1988

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The economy continued to expand briskly in the first part of 1988. Activity was boosted by strength in capital spending and growth in foreign demand for U.S. goods. The rise in overall output during the first six months of this year supported the addition of about 1-3/4 million jobs to nonfarm payrolls, and the civilian unemployment rate, which had trended down throughout 1987, dropped somewhat further since the beginning of the year to an average level of 5-1/2 percent in the second quarter.

Despite the greater tightness in labor markets and the higher rates of capacity utilization now prevailing in some industries, tendencies toward additional inflation have been limited. Prices of materials and components have risen sharply, but for finished goods there are only hints of price acceleration outside the food sector. Wages, on the whole, have continued to be fairly well behaved, suggesting a recognition on the parts of labor and management of the need to maintain competitive cost structures.

The continued resurgence of manufacturing has been one of the most notable economic developments this year. During the first five months of 1988, industrial production expanded at nearly a 4 percent annual rate, and the rate of capacity utilization for total manufacturing rose 1/2 percentage point between December and May to just over 83 percent, the highest level during the 1980s. Owing to these advances in production, manufacturers have embarked on substantial programs to invest in plant and equipment, pacing an economy-wide pickup in the rate of capital spending. The better balance of expansion also has been visible in agriculture, although the upturn in that sector has been jeopardized by recent drought conditions.

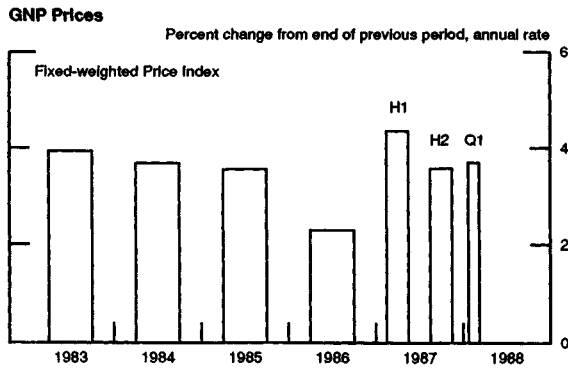
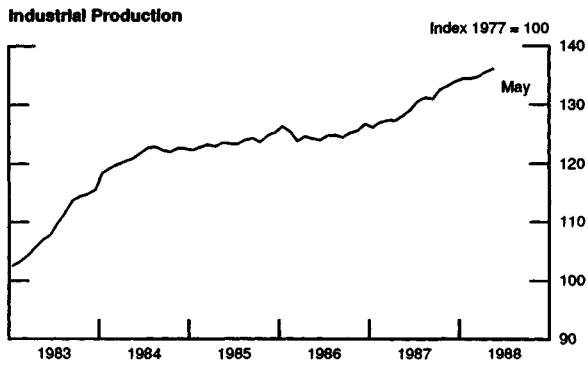
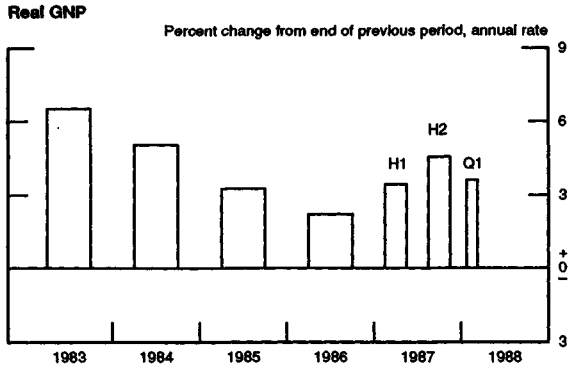
The improvements in manufacturing and agriculture are, in part, reflections of a broader

adjustment of the U.S. external position. The combination of a lower dollar and domestic cost containment has translated into a marked turnaround in real net exports. That process also has been aided by stronger economic growth in other large industrial countries.

### The External Sector

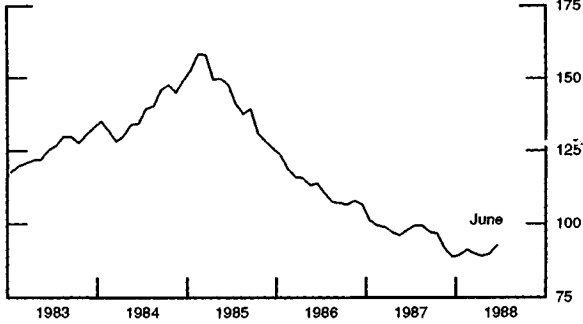
After having trended down for nearly three years, the dollar has appreciated substantially thus far in 1988 against most major foreign currencies. The dollar rose sharply at the beginning of the year, responding in part to coordinated central bank intervention. In recent months, sentiment toward the dollar has been improved by the release of better-than-expected trade reports and the firming actions of the Federal Reserve.

The U.S. merchandise trade deficit for the first quarter was \$144 billion at a seasonally adjusted annual rate, substantially below the figures for the fourth quarter and for 1987 as a whole. In April, the trade deficit narrowed further. Exports have continued to expand rapidly, while import growth has slowed considerably. The strong growth of exports can be attributed primarily to the increased price competitiveness of U.S. goods, which reflects the decline of the dollar in recent years and the tight control over production costs exercised by domestic firms. This growth of exports continues to be broadly based, and foreign sales have been particularly strong for industrial machinery and for computing equipment. On the import side, the volume of purchases rose less than 1 percent in the first quarter and apparently declined in April. Imports of consumer goods excluding autos were essentially unchanged in the first quarter, continuing the pattern of 1987, while auto imports fell somewhat. In contrast, imports of capital goods rose considerably, stimulated by the surge in equipment outlays by domestic firms.



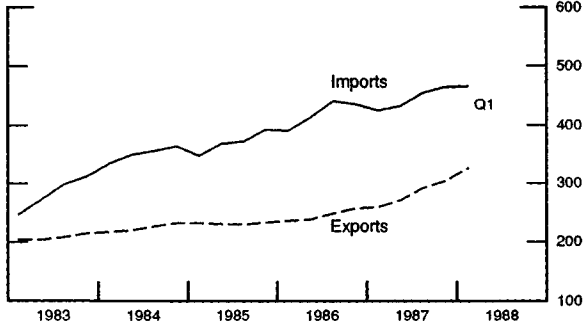
**Foreign Exchange Value of the U.S. Dollar \***

Index, March 1973 = 100



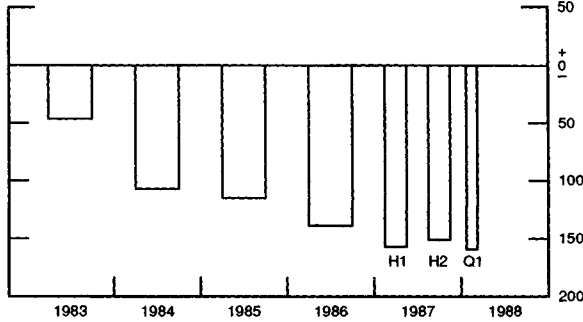
**U.S. Real Merchandise Trade**

Annual rate, billions of 1982 dollars



**U.S. Current Account**

Annual rate, billions of dollars



\* 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.

Economic expansion abroad has continued at a moderate pace, on balance, so far this year, providing some support for an improved U.S. trade position. Activity increased sharply in the major foreign industrial countries in early 1988, while growth in the smaller industrial nations remained subdued. In the newly industrialized countries of Asia, economic activity continued to expand rapidly. In contrast, growth slowed in Latin America, primarily due to a sharp deceleration of activity in Brazil. In the OPEC countries, activity appears to have stabilized in 1988, after a decline in 1987, as higher volumes of oil exports have offset the effects on government revenues of a slight softening in prices.

### **The Household Sector**

Consumer spending showed some vigor in early 1988, after declining in the fourth quarter of last year. Real outlays increased at a 3-3/4 percent annual rate in the first quarter, as purchases of motor vehicles bounced back with the expansion of manufacturers' incentive programs, outlays for other durable goods were strong, and expenditures on services continued to post appreciable gains. Data for April and May suggest, however, that the growth of consumer spending slowed from the rapid first-quarter rate.

The buoyancy of consumer spending early this year can be traced to robust income growth. Real disposable personal income rose at a 5 percent annual rate, on average, during the fourth quarter of 1987 and the first quarter of 1988, substantially above the 2 percent rate posted for 1987 as a whole. However, disposable income growth appears to have slowed considerably in the second quarter, as a result of a spurt in nonwithheld tax payments and a slower pace of employment gains.

Although the pace of consumer spending thus far this year has been stronger than many expected, the stock market break probably did exert some restraining effect. This is evident in the personal saving rate, which has averaged 4-1/2 percent for the seven months after October—one

percentage point above the average level during the first three quarters of 1987. While most households experienced little direct loss of wealth from the stock market decline, the startling dimensions of the event obviously affected consumer sentiment last fall. With each passing month, however, confidence has grown and helped to sustain the growth of spending.

Residential construction was weak during the first half of 1988. Total housing starts averaged about 1-1/2 million units at an annual rate through May, almost 9 percent below the 1987 total. In the multifamily sector, building declined from the already depressed 1987 level. Starts in this sector have been falling since the end of 1985, as near-record vacancy rates and changes in the tax laws have reduced the incentive to build new units. In the single-family sector, building has fluctuated from month to month, influenced by movements in interest rates and perhaps by weather; on balance, the average level of starts through May was roughly 6 percent below the 1987 pace.

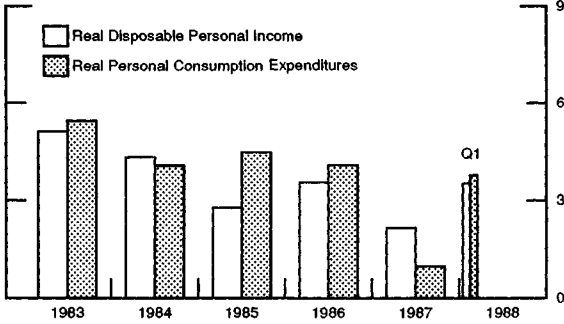
### **The Business Sector**

Business fixed investment advanced sharply in the first quarter of 1988, owing to a large increase in purchases of equipment. In recent months, spending appears to have remained near the high first-quarter level. Surveys of capital spending plans, taken this spring, point to appreciable growth in investment outlays over the second half of 1988.

Real outlays for computing equipment jumped at more than a 90 percent annual rate in the first quarter, but fell back considerably in subsequent months. Smoothing through this volatility, it appears that demand for such equipment has emerged from the lull that prevailed during 1986 and the first half of 1987, when excess computing capacity—as well as concerns about the usefulness of available software—limited purchases. Outlays for other types of equipment also have been strong, on balance, since the turn of the year, largely reflecting the buoyancy of overall eco-

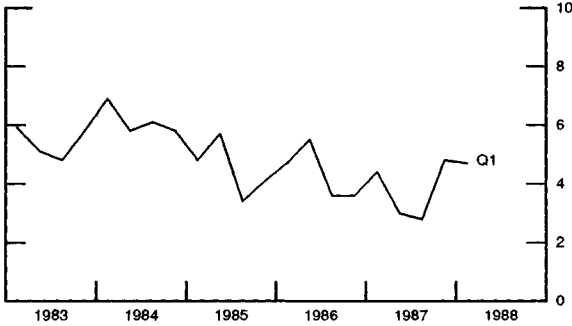
**Real Income and Consumption**

Percent change from end of previous period, annual rate



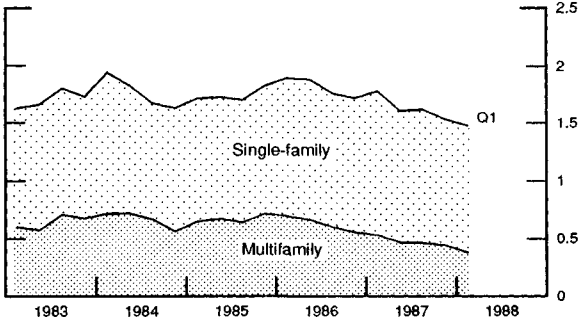
**Personal Saving Rate**

Percent of disposable income

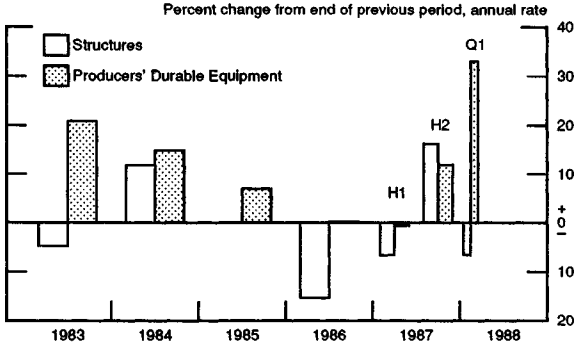


**Private Housing Starts**

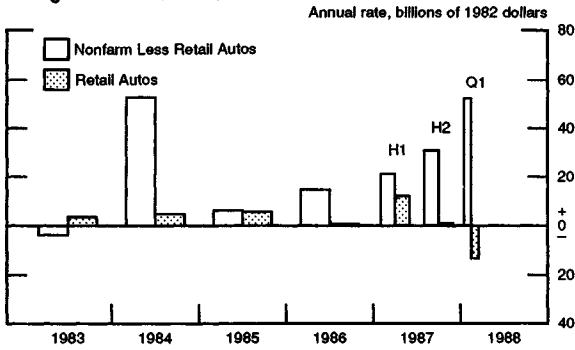
Annual rate, millions of units, quarterly average



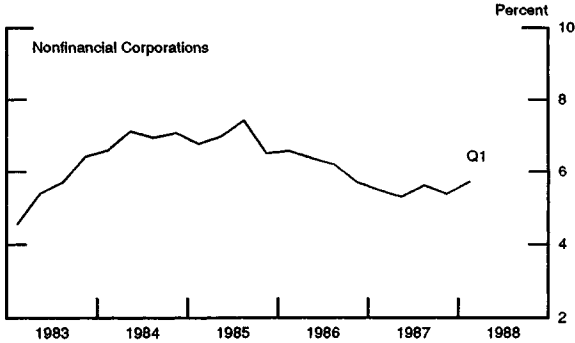
**Real Business Fixed Investment**



**Changes in Real Business Inventories**



**After-tax Profit Share of Gross Domestic Product \***



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

conomic activity. In particular, with utilization rates now at elevated levels in many manufacturing industries, equipment investments have been an attractive way of removing bottlenecks and achieving a relatively rapid improvement in effective capacity.

Although the data for May showed a surprising jump in nonresidential construction activity, real outlays in this sector were sluggish overall during the first five months of the year. Commercial construction, the largest part of this aggregate, continues to be restrained by an overhang of vacant space. In addition, oil and gas drilling, which was up more than 20 percent in 1987, has changed little since last fall, owing in large part to the general weakness of petroleum prices over this period. Industrial construction, in contrast, has risen briskly in recent months. Nonetheless, even here, the picture is cloudy. Although capacity utilization is high in a number of sectors, manufacturers apparently remain cautious about making the large, long-range commitments involved in building new plants, and new contracts for industrial construction actually have trended down since the beginning of the year, after rising in 1987.

The pace of business inventory investment moderated somewhat during the first four months of 1988, reducing the concern about excessive stocks that had arisen earlier this year. This concern had focused on the retail sector, where inventories at auto dealers and at certain outlets for nondurable goods (primarily general merchandise and apparel stores) appeared high relative to sales at year-end. By cutting production early in the year and offering a variety of sales incentives, automakers have been able to bring their inventories into better alignment with sales. In contrast, inventory-to-sales ratios for nondurable retail goods continue to hover at levels that are high by historical standards. At the manufacturing level, inventory positions through May appeared fairly lean in general, given the pace of shipments. Much of the recent building of

factory stocks has been in industries where market demand has been robust, such as aircraft, machinery, chemicals, and paper.

Before-tax economic profits of nonfinancial corporations continued to be strong in the first quarter, with manufacturing firms posting substantial gains. After-tax profits also rose noticeably, as the maximum tax rate on corporate profits was reduced from 40 to 34 percent, a change mandated by the Tax Reform Act of 1986. Owing to the strong growth of profits, the internal cash flow of nonfinancial corporations has increased considerably since mid-1987, reversing the slide of the previous year.

### The Government Sector

In real terms, federal government purchases of goods and services—which add directly to GNP and account for about one-third of total federal expenditures—fell during the first quarter and appear to have remained relatively weak in recent months. This dropoff reflects the winding down of some major defense procurement programs, restraint on domestic discretionary spending, and net reductions in farm inventories held by the Commodity Credit Corporation. However, on a budget basis, total outlays have been growing rapidly, owing to continued increases in entitlements, greater demands on deposit insurance agencies, and increasing net interest payments.

Meanwhile, growth of federal government revenue has slowed compared with the sharp increase in FY1987. Although tax receipts have been pushed up by the robust gains in income and by an increase in the payroll tax rate, this upward impetus to revenue has been tempered by the final reductions in income tax rates from the reforms enacted in 1986. In contrast to its effects this year, tax reform had provided a substantial boost to revenues in FY1987. On balance, it is quite possible that the budget deficit this year will exceed the \$150 billion shortfall recorded last year.

The state and local sector continues to operate under budgetary pressure, as operating



and capital accounts (which exclude social insurance funds) have been in deficit for the past year and a half. In the first quarter of 1988, this combined deficit stood at \$9 billion, similar to the shortfall recorded during 1987. Many states have acted to curb this fiscal erosion, using a combination of tax hikes—primarily sales and excise taxes—and budget cuts. As a result, the growth of real spending slowed considerably in the first quarter, reflecting a sharp decrease in construction outlays. This was the third such decline in the past four quarters, and this downtrend in construction activity has occurred despite continuing needs to expand and upgrade the basic infrastructure.

### Labor Markets

Early in the year, incoming data seemed to signal some weakening of labor demand. Initial claims for unemployment insurance, which had trended up during the final months of 1987, rose even further just after the turn of the year. Moreover, the first report on nonfarm payroll employment for January showed the smallest monthly increase since mid-1986. Taken together, these indicators conveyed a picture of deterioration in the labor market. However, as subsequent data were released, it became clear that the underlying pattern of labor demand had, in fact, remained healthy. Claims for unemployment insurance dropped back to relatively low levels and the anemic employment gains for January were revised up substantially. Moreover, since January, nonfarm payroll employment has advanced more than 300,000 at a monthly rate, somewhat above the average increase in 1987. Although the gains have been concentrated in the service-producing sector, manufacturing has posted an average monthly increase of about 30,000 jobs thus far this year, with the largest advances in the machinery and metals industries.

The combination of strong gains in employment and slower growth of the labor force over the first half of 1988 lowered the civilian jobless rate to 5.3 percent in June from 5.8 percent

at the end of last year. Jobless rates fell for a broad spectrum of demographic groups over the first half of the year, and the June rate of unemployment represents the lowest monthly figure since mid-1974. The June level, however, may be artificially low, owing to the difficulty of adjusting for seasonal swings in employment at the end of the school year.

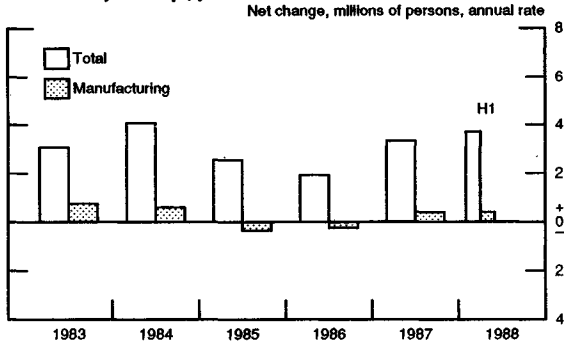
As the unemployment rate dropped last year, compensation increases—which had been moderating for several years—leveled out. In the early part of this year, there were some signs of an acceleration in labor costs. Hourly compensation, as measured by the employment cost index, advanced nearly 4 percent between the first quarter of 1987 and the first quarter of this year, about 3/4 percentage point more than in the previous 12-month period. Although this pickup was related in large part to the strength of labor demand, it was exacerbated by the rise in the payroll tax rate that took effect on January 1. By sector, the sharpest uptick in compensation rates occurred in manufacturing, where increases in production have led to a firming in labor demand. This pattern stands in contrast to trends in the early 1980s, when pay gains in manufacturing lagged far behind those in the service-producing sector.

Since 1980, output per hour in the nonfarm business sector has risen at an average 1-1/2 percent annual rate. Although this rate is somewhat above the sluggish pace of the 1970s, it remains far below the advances registered earlier in the postwar period. In contrast, productivity gains in manufacturing have been quite rapid in recent years. The first-quarter rise in factory output per hour was nearly 3 percent at an annual rate, in line with the average increase registered during 1986 and 1987; these productivity advances have continued to hold down unit labor costs, which fell 1/2 percent over the year ended in the first quarter of 1988.

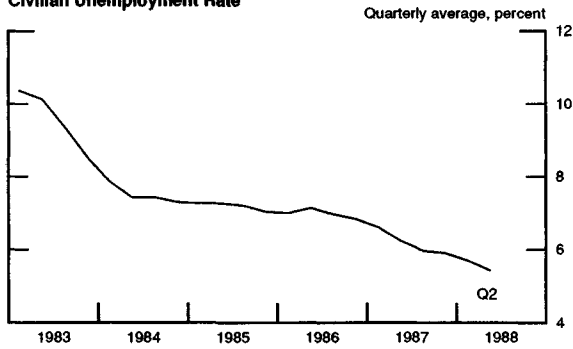
### Price Developments

Upward pressures on prices appear to have grown stronger this year, reflecting the

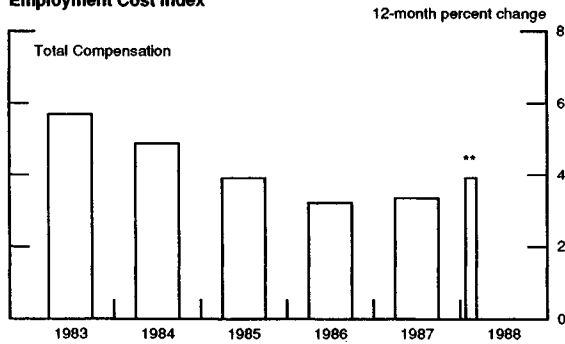
**Nonfarm Payroll Employment**



**Civilian Unemployment Rate**



**Employment Cost Index \***



\* Employment cost index for private industry, excluding farm and householdworkers.  
 \*\* Percent change from March 1987 to March 1988.

lagged effects of the earlier depreciation of the dollar, as well as tighter markets for labor, industrial materials, and farm output. Energy prices, in contrast, have been restrained this year, on balance, and have provided some offset to these pressures. For the most part, signs of higher inflation have been confined to price indicators for commodities and intermediate goods, which have posted sharp increases. The consumer price index—a measure of inflation for finished goods and services—showed no acceleration during the first five months of 1988, rising at the 4-1/2 percent annual rate registered for 1987 as a whole.

In the energy sector, spot prices for crude oil plummeted after OPEC failed last December to reach a credible agreement to limit production. The contract price for West Texas Intermediate (the benchmark crude oil in the United States) fell from about \$18 per barrel in December to about \$16 per barrel in March. Reflecting these developments, retail prices for gasoline fell considerably in the first quarter. During March and April, prices for crude oil drifted up and, in response, consumer energy prices rebounded in April and May. More recently, however, crude oil prices have receded again, as OPEC's June meeting adjourned without an agreement on production cuts.

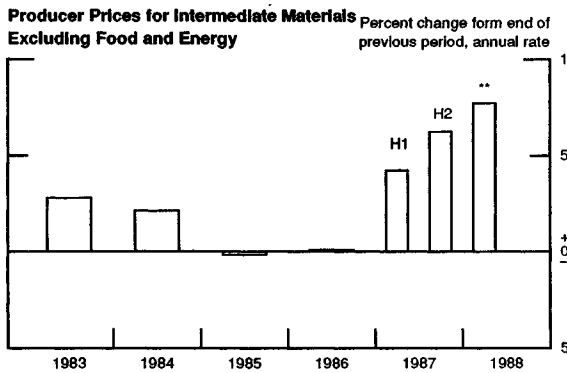
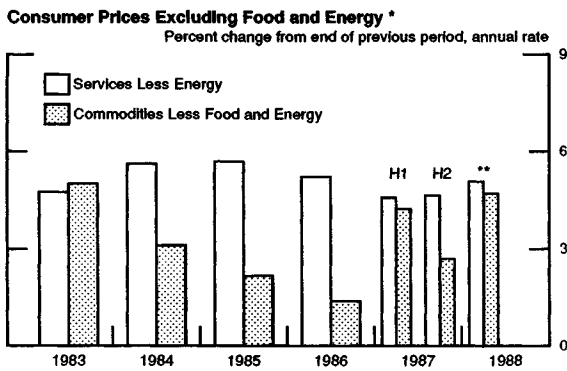
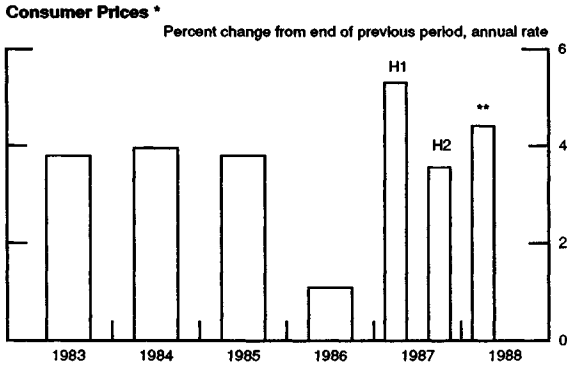
In the agricultural sector, tighter crop inventories and stronger grain exports pushed up farm-level prices early in 1988. In addition, prices for grains and soybeans recently have surged in commodity markets, owing to the drought in major growing regions. It now appears likely that retail food prices will accelerate in coming months and exert some upward pressure on aggregate consumer price inflation.

Excluding food and energy, prices at the consumer level rose at about a 4-3/4 percent annual rate during the first five months of this year. Consumer price inflation has remained at this relatively high rate partly because of continued

increases in import prices spurred by the earlier depreciation of the dollar. Particularly noteworthy has been a jump in clothing prices, which have been affected not only by the dollar's movement, but by quotas on apparel imports. In the service area, medical care costs have continued to rise rapidly.

At earlier stages of processing, inflation appears to have picked up for a wide range of items. On commodity markets, prices of crude industrial materials have remained on an upward course this year, although the price hikes have been less pervasive than in 1987. Reflecting, in part, these developments, the producer price index for intermediate materials other than food and energy rose at nearly an 8 percent annual rate over the first five months of this year, up from the 5 percent pace registered last year. Price increases have been especially large for materials used by producers of metals, chemicals, paper, and plastic, where output has been strong or capacity utilization rates high.

The upward movement of intermediate goods prices relative to finished goods prices at the producer level has been quite substantial. Although divergences in the two series, such as the one that has arisen over the past year, are not unprecedented, disparities typically have not persisted for long. Historical evidence indicates that higher materials costs, on average, pass through rather quickly into finished goods prices. In the recent period, the effect of the sharp rise in materials prices may have been cushioned by restraint on unit labor costs, by the spreading of overhead costs over larger sales volumes, and, perhaps, by efforts to save on or substitute away from higher cost materials. Nonetheless, past experience suggests that, even if there may not be a significant delayed pass-through in coming months, the risks of an acceleration in finished goods prices would be considerable if the pressures on materials prices do not ease soon.



\* Consumer Price Index for all urban consumers.  
\*\* Percent change from December 1987 to May 1988.

### Section 3: Monetary Policy and Financial Developments during the First Half of 1988

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The Federal Open Market Committee has sought monetary and financial conditions that promote price stability over time, support sustainable economic growth, and contribute to an improved pattern of international transactions. To this end, the Committee at its February meeting established target ranges, measured as growth rates from the fourth quarter of 1987 to the fourth quarter of 1988, of 4 to 8 percent for both M2 and M3. It also set a monitoring range of 7 to 11 percent for the growth of domestic nonfinancial debt and chose, once again, not to stipulate a range for M1 growth. The 1988 target ranges for M2 and M3 represented reductions from last year's ranges of 5-1/2 to 8-1/2 percent for both aggregates and resulted in a lowering of the midpoint of the target ranges by one full percentage point.

In widening the target ranges for M2 and M3, the Committee cited the high degree of variability in the relationship between money and aggregate demand that had appeared in recent years. As a result of this development, which stemmed largely from an increased sensitivity of money growth to interest rate changes, it was felt that a wider range of monetary growth rates could be compatible with satisfactory outcomes for the economy. At the time of the February FOMC meeting, broader ranges seemed particularly appropriate in light of the uncertain outlook for spending. More specifically, the eventual effects on domestic demand of the October stock market plunge and the subsequent drop in interest rates remained unclear. M1 had become even more interest sensitive, and it had varied more widely relative to GNP than had the broad aggregates, thus making it even more difficult to interpret; consequently, the Committee decided against establishing a target range for this aggregate.

In setting a monitoring range for domestic nonfinancial sector debt, the Committee an-

tipicated that debt growth would slow in 1988, owing to less government borrowing. Nonetheless, the rate of expansion of domestic debt was expected to exceed that of income. As was the case for the monetary aggregates, considerable uncertainty surrounded the prospects for debt growth, leading the Committee to widen the monitoring range by dropping the lower limit one percentage point from the previous year's rate.

During the first part of 1988, monetary policy was conducted against a backdrop of data suggesting some weakness in the economic expansion. Reflecting concern about the outlook for economic growth, the Committee moved in January to ease slightly the degree of pressure on reserve positions. On balance, interest rates fell during January and February, which, in conjunction with rate declines that followed the stock market drop in October, contributed to a pickup in M2 and M3 growth over the first quarter of the year.

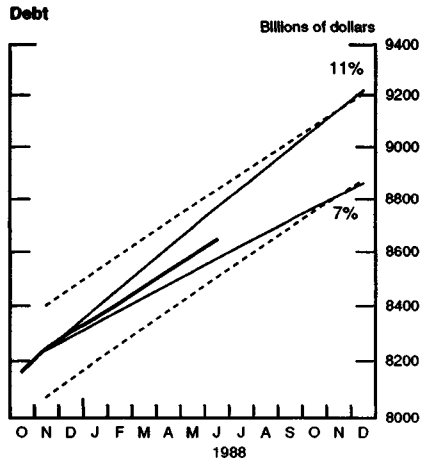
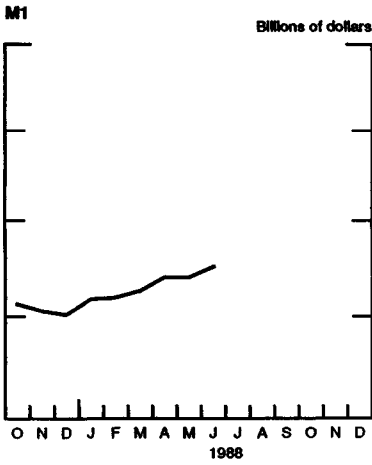
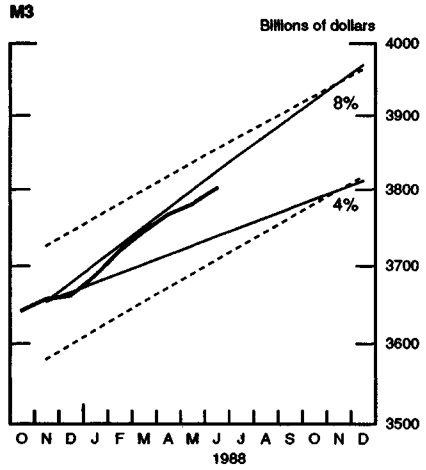
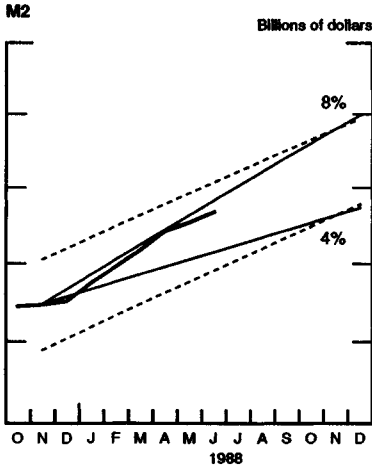
As information suggesting greater economic strength and an increased potential for a build-up of inflationary pressures became available in March and in subsequent months, and with M2 and M3 running near the upper ends of their growth ranges, the Committee moved, in several steps, to tighten reserve pressures. Owing to the force of credit demands and the Federal Reserve's less accommodative posture, interest rates rose on balance over those months. Late in the second quarter, growth in the aggregates moderated, leaving both well within their target ranges as the first half of 1988 ended.

#### Behavior of Money and Credit

From the fourth quarter of 1987 through June 1988, M2 increased at about a 7 percent annual rate, a noticeable increase over its 1987 rate of 4 percent. The faster growth can be attributed primarily to the lagged reaction of the public's de-

<b>Growth of Money and Debt</b>				
<b>Percentage changes at annual rates</b>				
	<b>M1</b>	<b>M2</b>	<b>M3</b>	<b>Debt of domestic nonfinancial sectors</b>
<b>Fourth quarter 1987 to second quarter 1988 e</b>	5.0	7.4	7.1	8.5
<b>Fourth quarter 1987 to June 1988 e</b>	5.1			
<b>Fourth quarter to fourth quarter</b>				
1979	7.7	8.2	10.4	12.3
1980	7.5	8.9	9.5	9.6
1981	5.2 (2.5)*	9.3	12.3	10.0
1982	8.7	9.1	9.9	8.9
1983	10.2	12.1	9.8	11.3
1984	5.3	7.6	10.4	14.2
1985	12.0	8.9	7.7	13.3
1986	15.6	9.4	9.1	13.3
1987	6.2	4.0	5.4	9.6
<b>Quarterly average</b>				
1987 Q1	13.2	6.5	6.5	10.5
Q2	6.6	2.7	4.6	8.6
Q3	0.8	2.8	4.5	7.9
Q4	3.9	3.9	5.4	10.1
1988 Q1	3.8	6.7	7.0	8.4
Q2 e	6.1	7.9	7.1	8.3
* M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.				
e - estimated				

Ranges and Actual Growth of Money and Debt



mand for M2 balances to decreases in market interest rates relative to deposit rates that occurred in late 1987 and early 1988. In the second quarter of 1988, however, the "opportunity cost" of holding M2 reversed its downward trend, and growth in M2 moderated toward the end of the period. Also contributing to the May-June slowdown was the runoff of an unusually large, tax-related build-up of transactions balances that inflated both M1 and M2 in April. On balance, M2 velocity is estimated to have declined slightly over the first half of the year, in contrast to its upward movement in 1987 when market interest rates and the opportunity cost of M2 were generally increasing.

A number of the components of M2 contributed to its strengthening in the first half of year. After declining steadily over the last half of 1987, liquid retail deposits—the sum of other checkable deposits, savings deposits, and money market deposit accounts—registered a solid gain over the first half of 1988, as reductions in market interest rates during the winter combined with the slow adjustment of rates on these deposits to increase their relative attractiveness. Growth in small time deposits also was particularly strong, as was that in M2-type money market mutual fund assets early in the year. Falling market interest rates, coupled with slow adjustment of returns on fund assets, provided money funds with a rate advantage in the first quarter, thereby leading to higher asset growth. Rising market rates of interest and the apparent use of money funds to pay taxes, however, significantly slowed their growth in the second quarter.

M3 growth increased in the first half of 1988 to a 7 percent rate, following a 5-1/2 percent increase in 1987. Credit expansion at banks and thrift institutions, which heavily influences the overall behavior of M3, remained at roughly the same pace as last year, but it was financed to a greater extent over the first half of the year by liabilities included in M3. In particular, inflows to banks from their foreign branches and borrow-

ings by savings and loans from Federal Home Loan Banks, which are not included in M3, dropped off sharply compared with 1987.

M1 grew at a 5 percent rate during the first half of the year, which although below the 6-1/4 percent rate for all of 1987, was higher than its growth in the second half of last year. The sluggish growth of M1, especially in comparison to that of M2 and M3, owed entirely to weakness in demand deposits, which have been declining over the past year and one-half. In contrast, growth in currency and other checkable deposits was robust.

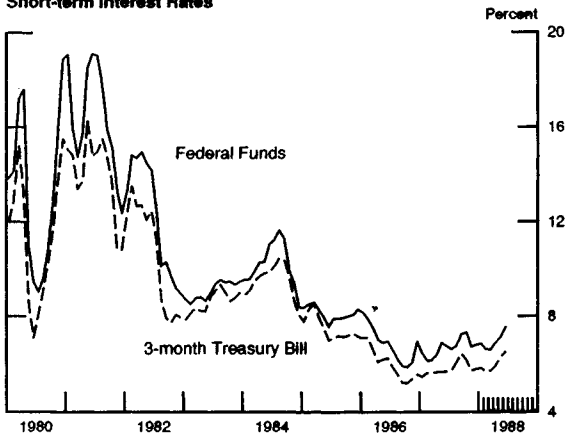
Domestic nonfinancial debt grew at a 8-1/2 percent rate from the fourth quarter of 1987 to June, according to estimates based on partial data. Debt growth in the first half represented a slowdown from last year's 9-1/2 percent rate and a substantial decline from the 13-1/4 percent rate of expansion in 1985 and 1986. Nonetheless, debt continued to grow faster than nominal GNP. Reflecting the effects of smaller federal deficits during the calendar year, growth in federal debt slowed from last year's pace and remained at a rate well below that recorded over most of the 1980s. Nonfederal debt also expanded at a somewhat slower rate, as the growth of the debt of households and state and local governments declined modestly. In the household sector, a falloff in mortgage borrowing associated with weaker housing expenditures offset a pickup in consumer credit. Business borrowing expanded at roughly the same pace as in 1987, with rising interest rates in the second quarter causing firms to shift more of their borrowing to short-term instruments.

### Implementation of Monetary Policy

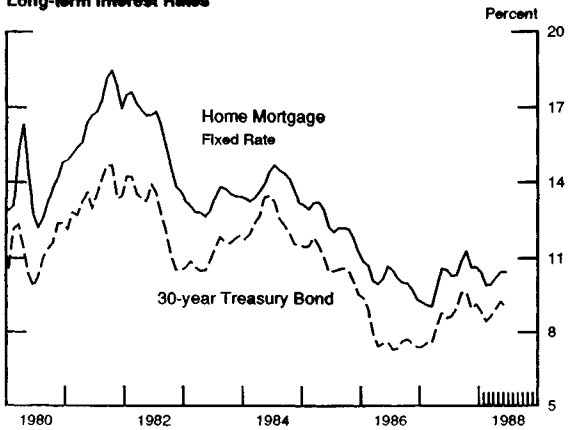
In conducting monetary policy, the Federal Reserve directed its operations during the first three months of 1988 at either maintaining or easing slightly the degree of reserve pressure that had prevailed since the October stock market collapse. Thereafter, the System moved in several steps to firm reserve positions.



**Short-term Interest Rates**



**Long-term Interest Rates**



NOTE: Last observation is for June 1988.

The early months of 1988 were marked by widespread concern that the economic expansion might be faltering. Data available in January and February pointed toward a weakening in domestic final demand, as evidenced by a substantial build-up of inventories in the fourth quarter of 1987 and some softening in labor market data. At the same time, inflationary pressures and expectations appeared to have diminished somewhat, and after coming under pressure in late December, the dollar first rebounded and then stabilized against most major currencies.

In these circumstances, the Committee moved in late January to ease slightly the pressure on bank reserve positions. The provision of non-borrowed reserves through open market operations was increased, the level of discount window borrowing declined, and the federal funds rate edged downward. Other market interest rates declined as well; in spite of lower interest rates, the dollar was relatively stable against most major currencies.

The downward trend for most market interest rates came to an end in late February and early March, when incoming information indicated that the economy was considerably stronger than it was earlier thought to be, and in light of emerging pressures on industrial capacity and labor markets, the risks of a pickup in inflation appeared to have risen. In this environment, monetary policy began in late March to become less accommodative. The restraint in policy was aimed at moderating potential inflationary pressures by damping domestic demand in order to facilitate a shift of resources to the external sector. As information pointing to substantial economic strength became available in April and May, and with the monetary aggregates growing at rates near the upper end of their target ranges, the Committee moved again to apply slightly greater pressure on reserve positions. Reflecting both the System's actions and market concerns about inflation, market interest rates moved higher. Since late May, however, long-term interest rates have

fallen on balance, despite further increases in short-term interest rates. The resulting narrowing of the spread between long- and short-term rates apparently reflects some lessening of concerns about inflation, brought about in part by the firmer monetary policy. Long-term yields also have benefited recently from the upward movement of the dollar against most major currencies, as the trade balance has continued to improve. The change in attitude toward the dollar apparently has encouraged investments in relatively high yielding dollar assets.

In the aftermath of the stock market crash last October, the Committee modified the System's procedures by placing greater emphasis on money market conditions and less on bank reserve positions in carrying out day-to-day open market operations. In doing so, it was neither the Committee's intention to alter its operating procedures permanently nor to ignore bank reserve positions completely. Rather, the thrust of the modification was to permit greater flexibility in System operations in light of the volatility and fragility characterizing financial markets at that time. During this period, it was considered important to assure the markets of the System's intention to provide adequate liquidity, and it was feared that significant variation in money market conditions could add to the unusual uncertainties already in the markets.

As markets exhibited signs of increased stability this year, the Committee responded by gradually placing greater emphasis on reserve positions in conducting System operations, allowing money markets to respond more sensitively to changing economic circumstances. The transition back to the pre-October approach was completed in the spring.

#### **Other Financial Developments**

The collapse of equity prices last October heightened public concerns about the volatility of stock prices and the fragility of financial institutions and markets. These concerns became the subject of studies by a Presidential commission,

governmental agencies, and the securities industry. Recommendations from these groups and from a follow-up Presidential working group focused on ways to avoid excessive stock price volatility and to strengthen the ability of markets and related systems to deal with large price movements. Progress has been made in this regard, with steps having been taken by market participants to address some of the problems revealed by the market break in clearing and settlement systems. Additional steps have been taken to coordinate trading halts triggered by extreme price moves and to strengthen capital positions of specialists and other market makers.

In considering the possibility of future regulatory action in this sphere, it is noteworthy that the stock market break has not been followed by any major aftershocks. In part, this reflects the basic resilience in this period of the economy and financial markets. In addition, it attests to the general adequacy of the current regulatory framework and monetary policy institutions in cushioning financial disturbances, so that they do not spread to the economy as a whole. Thus, while the additional steps initiated by private entities to strengthen market mechanisms certainly are desirable, a major extension of the governmental regulatory apparatus does not seem necessary.

The banking industry also has been the subject of considerable concern, arising from its well-publicized difficulties with energy, agricultural, real estate, and developing country loans. These problems have been highlighted by the many bank closings and the rescue by bank regulators of several large banks. As a result of large banks choosing to make sizable increases in loan loss reserves, profits reported by the banking industry as a whole in 1987 were down nearly 80 percent from 1986. Despite these difficulties, some bright spots emerged last year, especially the improved performance of agricultural banks. It is important to note, however, that throughout this period of stress in the industry, the commer-

cial banking system has continued to play its crucial role as a provider of credit to the economy.

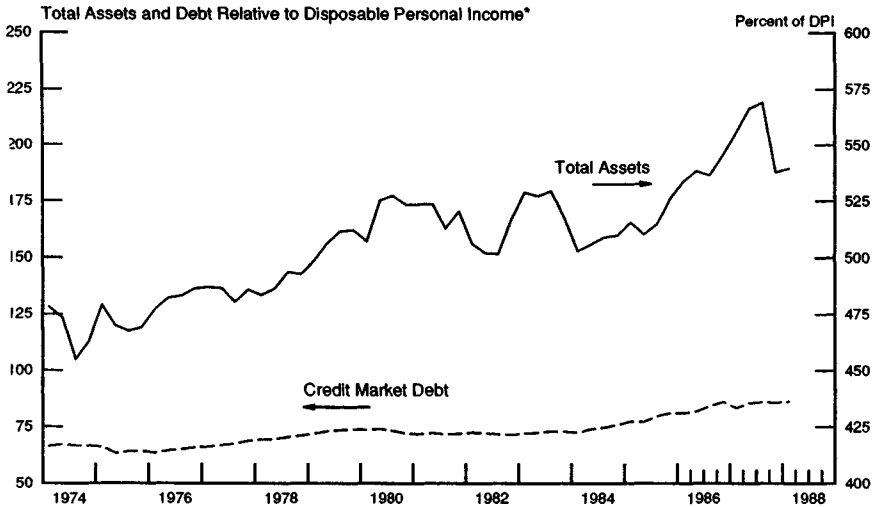
The savings and loan industry continues to be under financial stress. Although the majority of savings and loans are healthy and reasonably profitable, the industry as a whole reported enormous losses in 1987 and in the first quarter of 1988. Roughly one-sixth of the institutions are insolvent when evaluated in accordance with generally accepted accounting principles, and their aggregate losses increased in 1987 and in the first quarter of 1988. The prospects for the recovery of the insolvent institutions are not bright, implying that the Federal Savings and Loan Insurance Corporation (FSLIC) will be required either to liquidate them or to assist in their absorption by stronger institutions.

The deterioration of the savings and loans industry has affected the financial condition of FSLIC, whose net worth became more deeply negative in 1987. Congress approved a plan last year providing nearly \$11 billion to recapitalize FSLIC. This action has helped FSLIC liquidate several large and especially troubled savings and loans, but concerns persist in the market that the total available new capital may fall short of that needed for FSLIC to deal fully with the problem institutions.

The difficulties of many individual depository institutions have been associated, in most cases, with specific types of loans or certain regions and countries. However, concerns have been expressed more generally about the financial health of households and businesses—especially about the ability of these sectors to service their debts if interest rates were to rise sharply or business conditions were to weaken significantly.

With regard to households, the rapid growth of their debt during the current economic expansion has outstripped that of disposable income. The ratio of household sector indebtedness to income is at an all-time high (as may be seen in the accompanying chart). Recent information

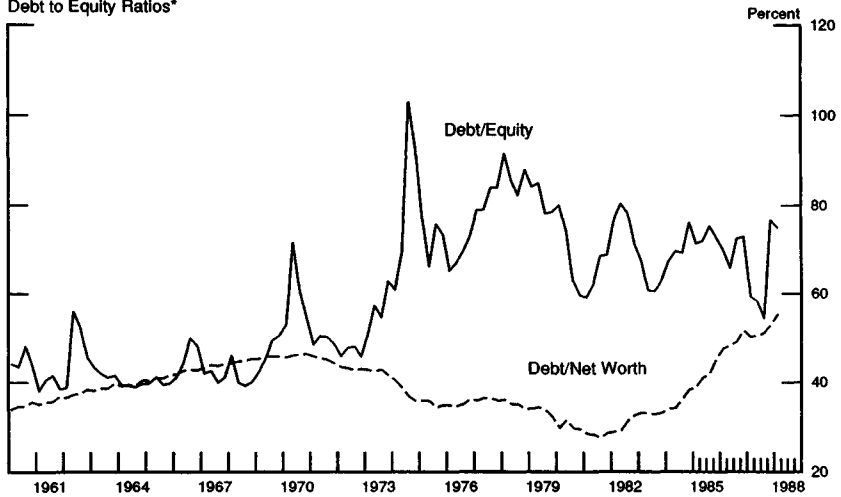
**Household Assets and Liabilities**



\*Debt and fixed-income assets are at book value; other assets are at either market value or replacement cost.

**Nonfinancial Corporations**

**Debt to Equity Ratios\***



\*Debt and equity are at market value. In computing net worth, tangible assets are valued at replacement cost or market value, while financial assets are valued at cost.

also shows a rising level of personal bankruptcies and a relatively high level of delinquencies on certain types of consumer loans.

Although these developments suggest that debt burdens may be difficult for some households to manage, other evidence indicates that most households are able to meet their debt obligations reasonably well. The trend toward longer repayment schedules has held down debt-service payments. The increased use of adjustable-rate mortgages has made the financial positions of many households more vulnerable to increases in interest rates; however, at the same time, deposit deregulation has meant that household interest income is more responsive to changes in rates. Furthermore, for the sector as a whole, assets have risen more rapidly than debt, implying increases in household net worth. Indeed, survey information indicates that many families with consumer debt have substantial amounts of financial assets that could be tapped to meet debt-service obligations in the event that incomes proved to be inadequate.

Like households, businesses have added greatly to their indebtedness in recent years. Many companies have dramatically increased their leverage through debt-financed merger, buyout, and share retirement activity. Reflecting heavier debt loads, the bite that interest payments take out of corporate cash flow is near historically high levels for the nonfinancial corporate sector

as a whole. A downturn in earnings would place serious debt-servicing strains on many individual firms. In addition, heavy reliance on floating-rate loans and short-term debt obligations has rendered many firms vulnerable to a significant rise in borrowing costs. In reflection of this situation, downgradings of corporate debt have continued to exceed upgradings by a large margin.

Firms would not have been able to assume these greater financial exposures were it not for receptive attitudes among lenders and equity investors. Companies engaging in restructurings that have involved the addition of massive amounts of debt to their balance sheets have been rewarded with sizable run-ups in their share prices; this is reflected in the absence of an uptrend during the 1980s in the market-value based "debt/equity" measure shown in the lower panel of the chart. Moreover, lenders are exacting relatively small risk premiums on debt obligations incurred by firms, as reflected, for example, in the spreads between yields on high-grade corporate bonds and Treasury securities or even those for below-investment grade "junk" bonds. Nonetheless, our financial history provides numerous reminders of the fragility of this type of situation: last fall, for example, when confidence was jolted by the stock market break, yield spreads widened dramatically, and the availability of new credit to riskier borrowers was sharply curtailed.

## Appendix: The Monetary Base

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In recent years, the monetary base has received increased attention as the behavior of other monetary aggregates—especially M1—has diverged from historical patterns. In part, the appeal of the base has resulted from the notion that it may have a reasonably stable relationship with nominal spending. In addition, it is perceived as being more directly under the control of the Federal Reserve than are the broader aggregates. This appendix reviews the historical and analytical characteristics of the monetary base. It discusses its definition, its relation to income and other economic variables, and its control by the Federal Reserve.

### Concepts, Definitions, and Measurement

The monetary base consists of currency in the hands of the nonbank public and reserves held by depository institutions—both reserves required to be held against deposits and the additional, “excess” reserves that depository institutions choose to hold. Because reserve requirements are substantially higher for transactions deposits (that is, checkable deposits) than for nontransactions deposits, the bulk of required reserves—about three-quarters—is related to transactions deposits. In turn, transactions deposits consist primarily of demand deposits and other checkable deposits, which are the principal components of the narrow monetary aggregate M1. Thus, both through its currency component and its reserves component, the monetary base is closely related to M1. The links between the monetary base and broader measures of money, such as M2 and M3, are much looser because

most savings-type instruments in these measures either are not reservable or have a much lower reserve requirement applied to them. Moreover, currency accounts for an even smaller share—on the order of 5 percent—of these aggregates.

Looking at the base as currency and reserves focuses on the monetary liabilities of the Federal Reserve—frequently referred to as the “uses” of the base.\* Alternatively, the base can be measured from its “sources” in the Federal Reserve balance sheet, the assets held by the System less its nonmonetary liabilities. The two concepts are identical if all components are measured contemporaneously.

There are two publicly available measures of the monetary base. One, corresponding to the uses concept, is constructed by the Board and the other, a sources concept, is produced by the Federal Reserve Bank of St. Louis. Besides the difference in accounting approach, which affects the treatment of vault cash used to meet reserve requirements, the two measures differ in the method of adjustment for changes in reserve requirements and in the method of seasonal adjustment.

The Board measure constructs the base from the currency component of the money stock (currency held by the nonbank public) (76 percent), total reserves (lagged vault cash, up to required reserves, plus reserve deposits at the Federal Reserve banks) (23 percent), and a third component that includes current surplus vault cash held at depository institutions plus service-related balances (1 percent).\*\*

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\* Technically, the base also encompasses a relatively small amount of U.S. Treasury liabilities.

\*\* *Vault cash* included in total reserves is lagged four weeks, reflecting its use to meet reserve requirements. *Surplus vault cash* is bank holdings of currency in excess of required reserves. *Service-related balances* comprise other balances held by depository institutions at the Federal Reserve, including required clearing balances and adjustments to compensate for Federal Reserve float.

The St. Louis measure, consistent with its sources concept, comprises Federal Reserve credit—holdings of U.S. government securities, discounts and advances, Federal Reserve float, and other Federal Reserve assets—plus other sources, including the gold stock, special drawing rights and Treasury currency outstanding. It subtracts several categories of liabilities, namely, Treasury and foreign deposits at the Federal Reserve, Treasury holdings of coin and currency, and certain miscellaneous items. Implicitly, all vault cash is treated contemporaneously.\*

Chart A-1 portrays the St. Louis and Board measures of the monetary base. The upper panel shows that the two measures have moved together over time, though the St. Louis measure generally lies above the Board measure, reflecting differences in techniques for adjustment of breaks caused by changes in reserve requirements. The lower panel shows that, in terms of growth rates, the two series track each other closely.

Growth of the monetary base has been much smoother on average than that of the other monetary aggregates (chart A-2).\*\* In large measure, the smooth growth of the base can be attributed to its large currency component, which over long periods of time has expanded in a relatively stable fashion. Between 1959 and 1987, the average quarter-to-quarter fluctuation of growth in currency in circulation was less than one-fifth

of the quarterly fluctuation in growth of total reserve balances.

While growth in the base has been relatively smooth, its longer-run pattern has not differed markedly from that of other narrow aggregates. Specifically, the velocity of the monetary base has behaved similarly to M1's velocity (chart A-3), with a pronounced break in the 1980s from its earlier behavior. Between 1960 and 1980, the velocities of the base, M1-A (currency plus demand deposits), and M1 all rose, in part reflecting the effects on money demand of the generally rising trend of interest rates. Chart A-4 shows that fluctuations of base velocity around its trend during the 1960s and 1970s were comparable to those of the other aggregates.\*\*\* And, in the 1980s, velocity of the base and M1 declined both absolutely and relative to the earlier trend as deregulation and falling market interest rates encouraged a large volume of funds to move into transactions deposits.

Statistical methods of relating growth in income to past growth rates in the base produce results that echo this pattern of velocity behavior. When these relationships are estimated using data through 1980, they make substantial errors in predicting nominal GNP in subsequent years, much as do equations involving other aggregates—especially the narrow aggregates. Techniques that allow for a break in behavior in the early 1980s make somewhat smaller but still large errors in

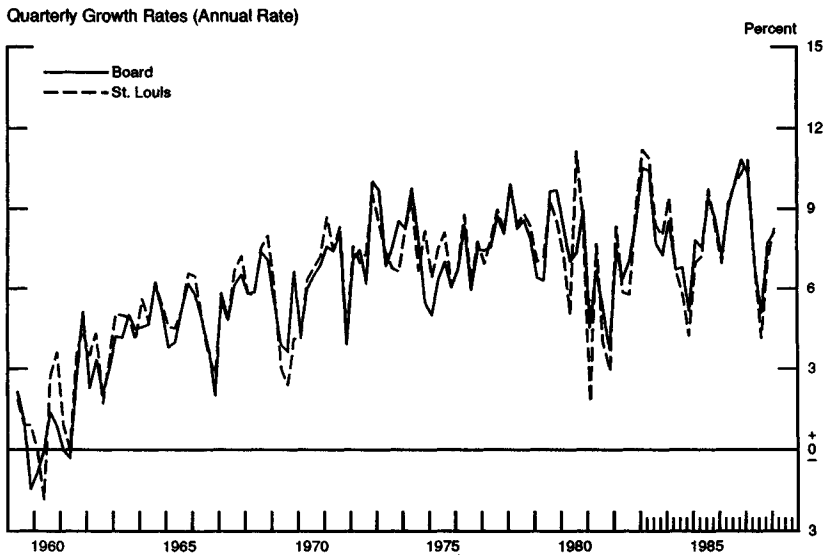
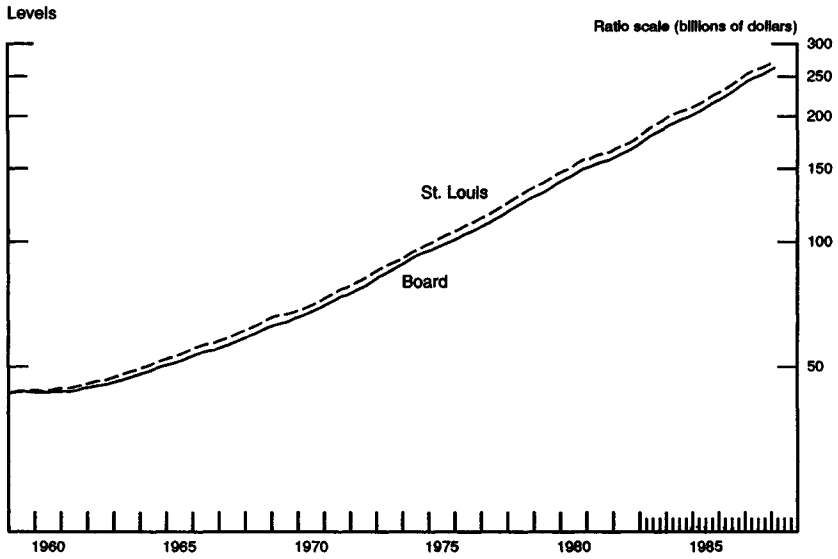
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\* There are two other differences between the Board base and the St. Louis base concerning seasonal adjustment and adjustments for changes in reserve requirements. St. Louis seasonally adjusts the whole base directly after adding a reserve adjustment magnitude (RAM) to account for regulatory changes in reserve requirements as well as changes in composition of deposits. For the Board measure, currency, total reserves, and the residual component are seasonally adjusted separately, after applying to the reserves and residual components certain break adjustment factors, and finally the components are summed. The Board's break adjustment method is intended to adjust only for regulatory changes in reserve requirements.

\*\* This and subsequent mentions of the monetary base refer specifically to the Board measure of the base but, in view of the close relationship between the two measures, should apply nearly as well to the series produced by the Federal Reserve Bank of St. Louis.

\*\*\* Chart A-4 presents velocity measures that remove the time trend estimated from 1960 to 1979.

Chart A-1  
**Measures of the Monetary Base**<sup>1</sup>



1. Seasonally adjusted and adjusted for breaks caused by changes in reserve requirements.



Chart A-2

Levels of the Monetary Aggregates  
(billions of dollars)

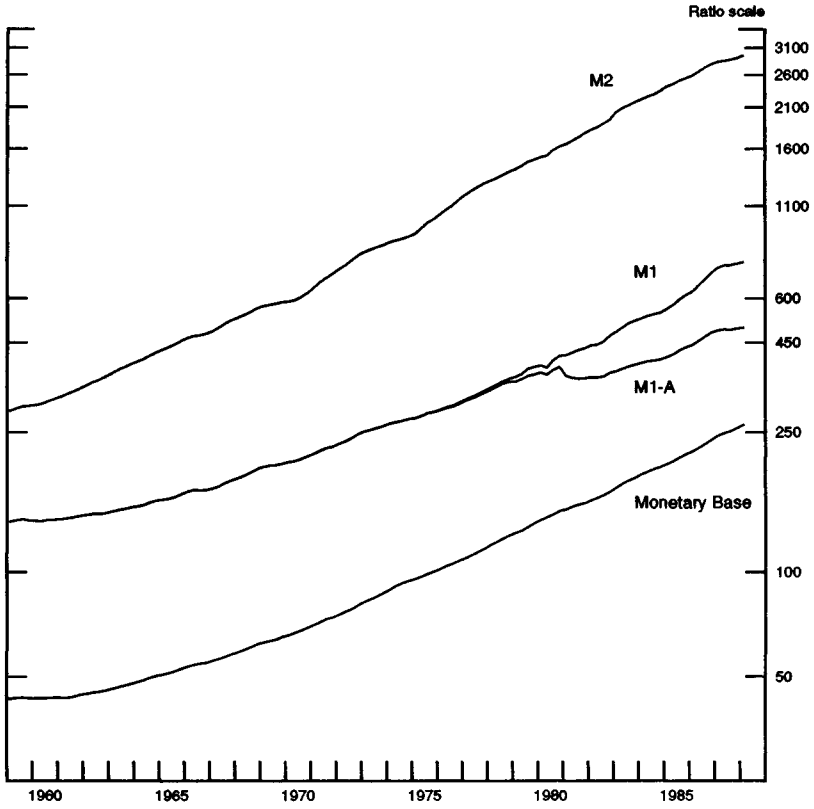


Chart A-3

Velocities of the Monetary Aggregates

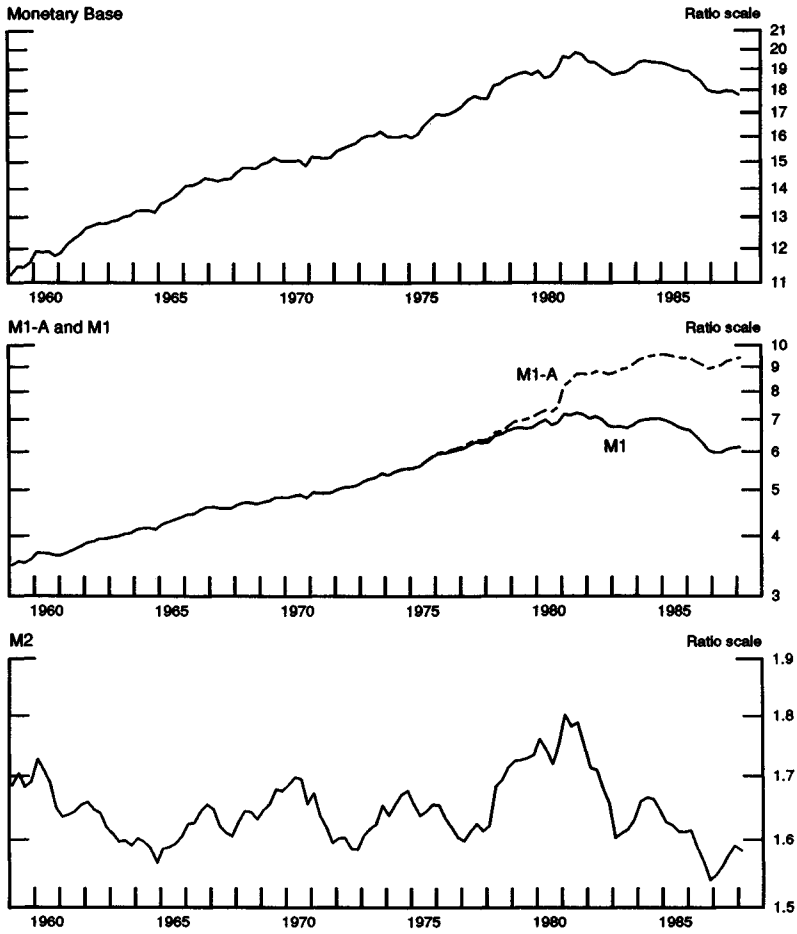
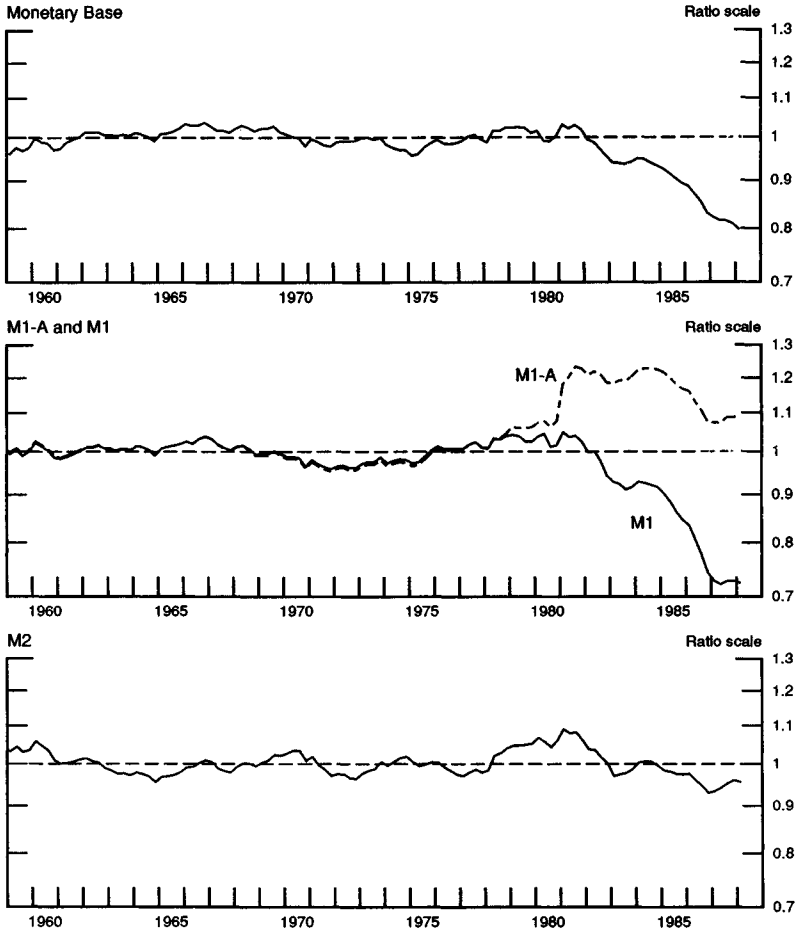


Chart A-4

Normalized Velocities of the Monetary Aggregates



the 1980s and leave unanswered questions about the potential for additional shifts in the relationships.

An examination of the demand properties of the base can shed light on the determinants of the behavior of its velocity and the errors made in predicting GNP. The demand for the base is derived from demands for its components, currency and reserves. The demand for reserves, in turn, depends on demands for excess reserves and for reservable deposits—primarily the transactions deposits that are included in M1 but also some that are not in that aggregate, such as interbank and U.S. government deposits, and certain time and savings deposits.

Board staff analysis has found that the demand for the base has substantial interest sensitivity, mainly reflecting the interest sensitivity of demand deposits and other checkable deposits.\* This interest responsiveness, together with the drop in interest rates during the 1980s, helps to explain the turnaround in base velocity, much as it explains the movements in the velocities of other monetary aggregates—especially M1—in recent years. However, the base probably is less interest sensitive than are the other monetary aggregates, because of the importance of the currency component, which does not respond very much to changes in interest rates. This implies that efforts to control the base to predetermined target ranges could involve very wide swings in interest rates. Whether those fluctuations would be beneficial to the economy depends in part on the stability of the demand relationship. If the demand for the base is relatively stable, the interest rate movements would tend to stabilize GNP in the face of disturbances to spending. But if base demand tends to move unpredictably, the interest

rate movements associated with controlling the base would tend to destabilize GNP.

Over long periods of time, the demand for the base appears to be fairly predictable, especially compared with M1-A and M1. Movements in transactions deposits, especially demand deposits, often have been somewhat erratic, tending to loosen the relationships of M1-A and M1 with GNP, but their effects on base demand are muted by the fractional nature of reserve requirements. Another factor contributing to the relative stability of the demand for the base is that unpredictable movements in transactions deposits at times have tended to offset unexplained changes in currency, perhaps owing to substitution between currency and demand deposits. However, there is considerable variability in the relationship of the base to income and other variables over periods of a year or less—and evidence suggests that at least over these shorter periods it is no more stable than M2.

In considering the past and prospective degree of stability of demand for the base, attention must be directed to its largest component, currency. Analysts have noted the extraordinarily large volume of dollar currency outstanding relative to measured U.S. economic activity or the number of households. Although available data are inadequate to determine even approximate magnitudes, it seems likely that a substantial part of U.S. currency is being employed in support of activity that is not reflected in U.S. GNP—in particular, activity outside our borders. Especially to the extent this activity and the currency to support it move independently of U.S. GNP, this would tend to reduce the usefulness of the base as an indicator or target.

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\* An estimated demand equation for the base was derived from the Board staff's standard models of demand for currency and demand for required reserves on transactions accounts in M1 only. Demands for other components of reserves were not explicitly modeled, as the effects of these components on required reserves are relatively small.

Not only is it difficult to account fully for the level of currency outstanding, but growth occasionally has been at variance with expectations, despite the relatively stable long-run relationship with measured income. For example, in the past year and a half, growth of currency has been roughly twice as rapid as would be expected on the basis of historical experience, judging by the Board staff's quarterly econometric model, with no obvious explanation for the strength.

### **Controllability of the Monetary Base**

For the most part, the Federal Reserve historically has supplied the monetary base to accommodate its demand. This has been a consistent policy with regard to demands for currency. With respect to reserves, the interactions have been more complex. Except in the early 1980s, reactions to deviations of reserves from expectations have been quite indirect. Any increases or decreases in the demand for reserves have been completely accommodated in the short-run. However, over time persistent deviations in money (and implicitly reserves) from objectives have prompted adjustments in monetary policy when those deviations were judged likely to be associated with unwelcome developments in the economy.

Even in the period from late 1979 through late 1982, when the Federal Reserve used nonborrowed reserves as an operating target to achieve goals for money growth over time, total reserves were not closely controlled because borrowed reserves adjusted in response to deviations in money growth from objectives.

Because of the remaining two-day lag between the ends of the reserve computation and reserve maintenance periods, control of total reserves or the monetary base would need to be indirect, working through the effects of changes in interest rates on the demand for the components of the base in the short run. In this respect, control of the base is achieved in the same way as for the broader aggregates. It is likely that the base, or for that matter any of the broader aggregates, could be controlled reasonably well over a span of several quarters—a period that would be meaningful in terms of the effects of monetary policy. However, the degree of interest rate volatility under base targeting could be quite substantial, especially in the short- to intermediate-run. Changes in the quantity of the base demanded that caused the base to deviate from its target would need to be offset in the short run mainly by changes in reserves (given the low interest sensitivity of currency demand), which would have multiple effects on the quantity of money.

**A P P E N D I X**

September 8, 1988

**MANUFACTURING**  
**≡ CREATES ≡**  
**AMERICA'S**  
**STRENGTH**

TESTIMONY ON  
THE RECOVERY AND MONETARY POLICY

BY

JERRY J. JASINOWSKI  
EXECUTIVE VICE-PRESIDENT AND CHIEF ECONOMIST  
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY  
OF THE HOUSE COMMITTEE ON  
BANKING, FINANCE AND URBAN AFFAIRS

SEPTEMBER 8, 1988



**National Association of Manufacturers**  
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Washington, DC 20004-1703 (202) 637-3000

The National Association of Manufacturers is a voluntary business association of more than 13,500 corporations, large and small, located in every state. Members range in size from the very large to the more than 9,000 smaller manufacturing firms, each with fewer than 500 employees. NAM member companies employ 85 percent of all workers in manufacturing and produce more than 80 percent of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.



## EXECUTIVE SUMMARY

1. The 1983-88 cyclical expansion has been unusually long, but growth rates have been unusually slow. The causes slow growth did not have to do with unnecessarily restrictive monetary policies, despite recurrent claims that the Federal Reserve was "too tight." Instead, they lie primarily with the overvaluation of the dollar and the resulting deficits on net exports, which in turn trace back to the excessively expansionist stance of fiscal policy. The finding of econometric simulations conducted at NAM is that a more restrictive fiscal policy during the early to mid-1980s would have mitigated many of the imbalances in the recovery and would have been commensurate with a more stable growth path than what was actually achieved.

2. Since early 1988, the economy has moved into a period of growth led primarily by trade and capital investment. The expansion is projected to continue for at least the next 12 to 15 months, although a recession during the latter part of 1989 remains a possibility. The major risk is a rise in inflation followed by a rise in interest rates, effectively choking off demand. At the same time, the narrow geographic base of the trade boom could lead to a slowdown in exports, which in turn would depress capital spending.

3. The Federal Reserve has done a decent job in managing monetary policy over the business cycle. By avoiding continuous stimulus, it was possible to avoid the destabilizing cycles of reflation-overheating-recession that characterized the 1970s. Moreover, we do not subscribe to the view that monetary policy was excessively restrictive during the 1980s. If the Federal Reserve had been looser in 1980-82, the economy would have achieved only temporary gains in output relative to actual history, but at the expense of a higher inflation rate, and these transitory gains would have been completely lost in a few years.

4. The stance of monetary policy is becoming more restrictive. Given the strength of expansion, the Federal Reserve has aggressively raised interest rates in a pre-emptive move designed to prevent the economy from overheating and reduce inflationary expectations. We consider current policies to be appropriate inasmuch as it was necessary to stabilize expectations. However, we would not endorse any further restrictive measures that might increase the risk of a sharp slowdown. Further, in the event that the economy shows signs of weakness, we would urge a countercyclical loosening of monetary policy. As a general principle, we believe that the Federal Reserve's commitment to controlling inflation should be balanced by a similar commitment to keep the economy on its equilibrium growth path. At the same time, we do not recommend explicitly targeting the exchange rate in order to achieve disinflationary objectives. This runs the risk of inhibiting improvements in the trade deficit while causing unnecessary increases in domestic interest rates.

TESTIMONY ON  
THE RECOVERY AND MONETARY POLICY

BY  
JERRY J. JASINOWSKI  
EXECUTIVE VICE-PRESIDENT AND CHIEF ECONOMIST  
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE  
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY  
OF THE HOUSE COMMITTEE ON  
BANKING, FINANCE AND URBAN AFFAIRS

SEPTEMBER 8, 1988

I am Jerry Jasinowski, Executive Vice-President and Chief Economist of the National Association of Manufacturers. On behalf of our members, I welcome this opportunity to present our views on monetary policy and the recovery. In accordance with the substantive areas listed in your letter of invitation, this statement will address two major themes. Part I will deal with the current cyclical expansion, its past history, and prospects for its continuation. Part II will deal with monetary policy.

I. The Current Cyclical Expansion

1.1 The Recovery in Retrospect The cyclical expansion that began in December 1982 is now in its 70th month, making it unusually long by postwar standards. However, its length and durability are subject to the caveat that growth rates have been unusually low. Table 1 compares the average growth rates of GNP and industrial production during six prior expansions and the 1983-88 recovery. During the current recovery, GNP achieved an annual average growth rate of only 4.3 percent, compared to a postwar average of 5.3 percent. Similarly, the average rate of growth in industrial production during the 1982-87 cycle

was only 5.9 percent, compared to a mean value of 8.8 percent during the six major previous expansionary cycles.

**Table 1: A Comparison of Major Postwar Recoveries\***

Dates of Cyclical Expansion	Length (Months)	Average Annual GNP Growth	Average Annual Industrial Growth
Oct. 1949 - July 1953	45	7.2%	13.2%
May 1954 - Aug. 1957	39	4.0	6.7
Apr. 1958 - Apr. 1960	24	5.1	11.3
Feb. 1961 - Dec. 1969	106	5.3	8.4
Nov. 1970 - Nov. 1973	36	5.5	8.7
Mar. 1975 - Jan. 1980	58	5.0	7.3
Weighted Average of Above	51.3	5.3	8.8
Nov. 1982 - Sept. 1988	70	4.3	6.0

\*Two periods are omitted. The 37-month expansion from October 1945 to November 1948 is not comparable, since the economy was dominated by demilitarization after World War II. The twelve month bridge between the 1980 and 1981 recessions also is omitted on the grounds that this was not a recovery so much as a transitional period between two successive phases of a longer-term downturn.

In essence, the expansion went through successive phases; 1) a rapid initial recovery led by domestic demand in 1983:1 to 1984:2, 2) an extended period of stagnation characterized by massive trade deficits in 1984:3 to 1986:4, 3) a second rise in growth characterized by gradual trade improvement from 1987:1 onward.

The causes of the slowdown did not have to do with restrictive monetary policies, despite recurrent claims that the Federal Reserve was "too tight." Instead, it was primarily caused by the overvaluation of the dollar, and the resulting deficits on net exports, which in turn trace back to the excessively expansionist stance of fiscal policy. Some econometric studies have linked as much as two-thirds of the rise in interest rates

and the appreciation of the dollar to the structural budget deficit.

NAM has reached similar conclusions. In order to ascertain the effects of the fiscal policies of the 1980's, we have conducted historical econometric simulations using the Washington University Macromodel, a large-scale model with neo-classical properties. The baseline path was set to replicate history exactly; policy changes imposed retrospectively at earlier points in the 1980's enable the model to simulate the path that the economy would have followed if policies had been conducted differently at the time. The finding was that in simulations where the structural budget deficit was reduced or eliminated, with monetary policy held constant, the appreciation of the dollar was significantly reduced, and the net export deficit was reduced by more than half. The implication is that a more restrictive fiscal policy during the early to mid-1980s would have mitigated many of the imbalances in the recovery and would have been commensurate with a more stable growth path than what was actually achieved.

1.2 The Future Path of the Economy The economy managed to survive the 1987 stock market crash without going into recession, and as of mid-1988 appears to be achieving a stable growth path. In 1988 there have been two major sources of strength that propelled the economy to an unexpectedly strong growth rate, improvement in real net exports and an upturn in investment.

Trade The devaluation of the dollar has generated a major improvement in trade, with more of the impetus derived from exports than from import-substitution. Even so, the strength of the trade improvement has been notable. Since the peak of the real trade deficit in 1986:3, net exports have improved by \$66 billion in constant 1982 dollars. While real exports have risen by \$112 billion. The trade improvement is, however, subject to several risk factors, which raise the possibility that the export boom could slow at

some future time. First, the exchange rate realignment has occurred primarily against Europe and Japan, with very little devaluation occurring against Canada and the Pacific NICs. Simultaneously, the countries that were the major markets for American exports during the 1970s, OPEC and Latin America, are experiencing chronic weakness in demand because of low world oil prices and high foreign indebtedness. A final problem is that because of the relative price advantages enjoyed by the Asian NICs, decreased imports from Europe and Japan have been reflected in some industries not so much in recovery of market share by American producers but rather by corresponding increases in imports from Taiwan and Korea. Despite these limitations, net exports should improve by roughly \$40 billion over the forecast horizon.

Capital Investment The strength of capital spending reflects several factors. First, the decline in investment induced by tax reform in 1986-87 lowered the capital stock below its optimal level, creating the potential for a rebound. Simultaneously, the trade improvement has led to greater demand for capital goods in the exporting and import-substituting industries, particularly in sectors undergoing capacity pressures. A third factor is revealed in the sectoral composition of the investment boom, with just under half the increase in equipment comprised by computers and office automation. The high spending on data processing equipment is explained largely by a fall in relative prices. Thus, while tax reform raised the user cost of capital by increasing effective tax rates, this has been outweighed by the falling relative price of data processing equipment. As a result, spending on equipment is projected to increase by 12.3 percent in 1988.

For all its strength, however, the boom in equipment spending cannot conceal a series of asymmetries in the composition of investment. Residential investment has been declining since early 1987, due to a combination of overbuilding of the housing stock, tax reform and higher mortgage interest rates, and is projected to decline -3.4 percent in

1988. Spending on nonresidential structures has been weak throughout the entire business cycle, with spending on factories, mines and utilities lower in real terms than at the end of the last recession. While some recovery in structures is anticipated due to high capacity utilization, outlays for nonresidential buildings are projected to be approximately level in 1988.

Consumption Consumer activity has held up primarily because of the tax rate reduction and rapid gains in employment, with the result that spending should average 2.5 percent growth for the year. This is scarcely robust, but well above the anemic growth in consumption recorded in 1987 when high debt levels, diminished savings and declining real wages held expenditures to a 1 percent increase. Real wages should grow more rapidly this year while unemployment is projected to continue falling, implying faster growth in disposable income, although debt loads and high interest rates remain a constraint on consumers. The growth in jobs has been sufficient to maintain consistent growth in real incomes.

Inflation The major risk for the economy at this juncture is the possibility of an acceleration in inflation. As of the second quarter, there was evidence of renewed upward pressure on prices. The implicit price deflator for GNP jumped from an average of 2.5% in the previous three quarters to 4.1%; the fixed-weight GNP price index increased from an average of 3.6% to 4.7%, generally higher than anticipated. The CPI is projected to temporarily approach 6% in 1988:4.

In order to understand the sources of increased inflationary pressures, it is useful to think of the rate of inflation as a weighted average of several components. The underlying rate is determined by the trend movement in unit labor costs. The demand-pull component is influenced by the rate of growth and capacity utilization. Finally, the relative price component reflects factors such as changes in food and energy costs, and

changes in import prices resulting from the exchange rate.

The critical factor driving the underlying rate is the degree of pressure in labor markets, which is a function of the difference between the current unemployment rate and its equilibrium or natural level, below which further declines imply continuously accelerating wages. While the natural rate of unemployment has fallen during the 1980's due to slower labor force growth -- differing estimates yield a mean value of about 5% -- unemployment is declining more rapidly. Until this year unemployment was sufficiently above its natural rate that increases in employment raised demand by boosting incomes without generating any major rise in wage pressures; as of 1988:1, compensation per hour had risen only at the moderate pace of 3.4% over the same quarter of 1987. However, there is evidence of considerable emerging pressure in labor markets in the second quarter, with preliminary estimates suggesting that labor costs are increasing at an annualized rate of 4.5%.

At the same time, unit non-labor payments -- payroll taxes and employee benefits, which account for as much as 40% of total costs per worker in some industries, underwent some acceleration over the last twelve months. In 1987, non-labor costs jumped at an average rate of 8% in the first three quarters, partly as a result of higher Social Security taxes, although they declined toward the end of the year. Some of this increase has yet to be fully reflected in price movements, pointing to additional pressure on employment costs in 1988.

Working against the acceleration in employment costs, however, is the faster rate of increase in productivity growth. Output per manhour surged at an atypically high 3.7% in 1988:1, and during the current cyclical expansion manufacturing productivity has averaged just below 4% per year, above its postwar trend. The high projected growth rate of capital spending suggests that this increase will be sustainable, implying a considerable

offset to unit labor costs.

The effects of demand on inflation have so far been relatively modest, and in fact have worked for the most part in holding prices back. From 1984:3 until 1986:4 the economy experienced almost continuous stagnation, and growth rates did not begin to pick up until 1987. On a fourth quarter-to-fourth quarter basis, however, revised estimates show real GNP increasing 5.0% in 1987. Although this was primarily a result of the inflation rate having been revised downward, the pace of expansion implies that the economy will converge to full capacity more rapidly. Capacity pressures have already emerged in individual industries, particularly the booming export sectors. By mid-1989, capacity utilization will imply additional pressure on output prices.

A greater threat in the near-term has to do with relative price movements. The rise in energy costs in early 1988 has now abated, but the severe drought now ravaging the nation's agricultural regions has unfavorable implications. The devastation of agriculture actually implies upward pressure on commodity prices in the fourth quarter. A second factor is the anticipated fall in the dollar. In this respect, import costs are partially responsible for the substantial spread that has emerged between the CPI and the more broadly-based GNP Deflator, which is less sensitive to import costs. Some of the effect of the lower exchange rate have been absorbed in the form of lower profit margins by foreign exporters, and the fall in the dollar projected here is not sufficient to set off a major new round in inflation.

Given the above, the upward shift in inflation projected here emerges primarily as the result of rising wages, non-labor costs, and relative price movements, with some increase in demand pressure. Specifically, we project that the underlying rate of inflation will be in the area of 4.5% by the end of the year; most of the increase above this level is a relative price phenomenon. It should be noted that the Federal Reserve is not expected to



accommodate the rise in prices. Tight money in and of itself does not imply that inflation will not accelerate in the next few quarters, but does effectively inhibit a return to the high rates of inflation of the 1970's.

A First Look At 1989 In general, two scenarios can be outlined for 1989, 1] slow stable growth, or 2] a slide into recession toward the end of the year. In the stable growth alternative, the dollar remains strong enough and wages moderate enough to inhibit further acceleration in inflation, while the export boom continues to reduce the trade deficit. For this to take place, however, requires continuous growth abroad as well as steady gains in employment and further demand for capital goods. Although this depends on a series of favorable developments taking place simultaneously, it is by no means outside the realm of possibility.

Recession Risks Nevertheless, a series of factors could combine to throw the economy into recession. The main risk is that rising inflation will cut into real incomes while higher interest rates choke off demand. This is of course the conventional mechanism generating business cycle downturns in the United States, but it would normally operate only at higher inflation rates than those projected here. Still, this would be sufficient to insure a downturn if it operated in conjunction with other factors. In this respect, a second risk is that the narrow geographic base of the export boom will lead to its exhaustion as growth rates overseas slow down. The European community is currently projected to attain only a 2 percent growth rate in 1988 and may slow further in 1989. Under the circumstances, exports could stagnate, and this would also slow the pace of domestic growth due to the diminished export multiplier. We rate both of these risks as low at this time.

Credit and the Business Cycle A long-term risk to economic stability, which could also seriously aggravate any forthcoming recession has to do with the buildup in aggregate

debt. As of 1988:1, total Federal and private debt came to \$8,498.9 billion, or 182% of GNP, compared to a postwar average of 135% of GNP until the early 1980's. By comparison, the ratio of debt to GNP in 1929 just before the Great Depression was 210%, although a much larger share of this debt was private and much of it was poorly collateralized. Of the total volume of private debt (\$6497.4 billion), \$2,907 billion was comprised of credit to business, while \$2,285 billion was in the form of mortgages on residential properties and \$633 billion consisted of consumer installment credit. The ratio of corporate debt to the market value of corporate assets is roughly comparable to the peak values of the 1970's, although high by historical standards. However, the ratio of debt service to cash flow is at record levels: the share of the pretax earnings of nonfarm nonfinancial corporations devoted to debt service payments is now over 50%, compared to about 30% in the 1970's and about 15% in the 1960's. Similarly, the ratio of individual mortgage and non-mortgage debt to personal disposable income is now approximately 80%, a postwar record.

The debt buildup implies two major risks. On the one hand, in the event of a recession, the need to service debt could force a major curtailment of business and individual spending, leading to a deeper contraction in demand. A more speculative possibility is the type of "debt-deflation" scenario that was responsible for prewar recessions and was identified more than a half-century ago as the mechanism primarily responsible for the Great Depression. In this scenario, cash-flow constraints and the need to service debt lead to massive deflationary liquidations of collateralized assets, driving prices down and thereby raising the real value of outstanding obligations. The fall in the value of collateral in turn triggers bank failures and contraction of the money supply, exacerbating losses in real activity. This is the same type of mechanism that took place in the agricultural and energy sectors in the mid-1980's, and is also

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largely responsible for the wave of bank failures during the last few years. However, the possibility of debt-deflation taking place throughout the economy rather than in specific sectors must be judged remote at the present time. Nevertheless, it is indicative of the risks associated with high levels of private sector indebtedness.

The External Balance and the Business Cycle One of the results of the increasing foreign indebtedness of the United States is the threat of repatriations of foreign assets coupled with a plummeting dollar, which would force the Federal Reserve to tighten in response. While it is possible that this threat will become more serious as the buildup in external debt produces a loss in foreign confidence in the dollar, there is as yet no evidence that foreign investors will engage in a speculative flight from the United States during the forecast horizon. In part, this is the case because of more attractive returns on financial assets in the United States. Consequently, the possibility of widespread remissions of foreign assets and a collapse of the dollar should be regarded only as a longer-term risk factor for the 1990's.

## II. The Conduct of Monetary Policy

2.1 The Federal Reserve and the Recovery The Federal Reserve has done a good job in managing monetary policy over the business cycle. By avoiding continuous stimulus, it was possible to avoid the destabilizing cycles of reflation-overheating-recession that characterized the 1970s. The length of the current expansion traces back in part to the Federal Reserve's well-timed countercyclical moves--stimulus in 1982:3 to 1983:2, offsetting restraint in 1983:3 to 1984:2, accommodation in 1984:3 to 1986:4, and moderate restraint thereafter.

We do not subscribe to the view that monetary policy was excessively restrictive

during the 1980s. In order to ascertain the probable effects of looser monetary policy over the last decade, we again used a retrospective simulation of the Washington University Macromodel. In a counterfactual simulation, we imposed a significantly looser monetary policy in 1980-81 and 1984, while retaining historical money growth rates otherwise. The result was that the 1981-82 recession was milder, but the reduction in inflation was also considerably less. The economy went into recovery with an inflation rate two points higher than actual history, and inflation began to accelerate as early as 1985, due to lower unemployment. The result was that the economy went into recession in 1986. By 1987, the last year for which the simulation was run, GNP and employment were lower than in actual history. The implications are significant, inasmuch as they undercut the claim that the Federal Reserve "sabotaged" the 1981 tax reductions through tight money. If the Federal Reserve had been looser in 1980-81, the economy would have achieved only temporary gains in output relative to actual history, but at the expense of a higher inflation rate, and these transitory gains would have been completely lost in a few years. In this sense, by achieving greater disinflation in 1980-82, the Federal Reserve set the stage for a longer and more sustainable period of expansion.

In the wake of the 1987 stock market crisis, NAM member firms were sufficiently concerned over the risk of recession to warrant urging the Federal Open Market Committee for a relaxation of monetary policy. In retrospect, we concede that the dangers were less than we anticipated. The Federal Reserve correctly gauged that the loosening measures it took in the immediate aftermath of the crash were sufficient to raise liquidity and restore confidence. Once the danger was over, the Federal Reserve correctly estimated that the economy would move into a period of accelerated expansion, and that additional loosening measures were not necessary.

2.2 Monetary Policy and the Exchange Rate The major area in which NAM has been critical of recent Federal Reserve decisions lies with the 1987 Louvre Agreements. These forced the central bank to peg the exchange rate well above its equilibrium values, and caused interest rates to rise more rapidly than they would have otherwise, thereby precipitating the stock market collapse. In our view, pegging the dollar at an overvalued level has two negative consequences: it not only requires unnecessary monetary restraint, but also delays the reversal of the trade deficit that would result from a lower exchange rate. Given a choice between supporting the dollar as a disinflationary move and allowing the dollar to devalue further, the Federal Reserve should in general permit additional depreciation. Although this could entail some additional pressure on inflation and slower growth in domestic demand, these represent the inevitable tradeoffs for reducing the trade imbalance.

2.3 Monetary Policy in 1988 The Federal Reserve's targets for the monetary aggregates and the actual growth rates recorded in the first half are given below. In essence, the monetary and debt aggregates were all comfortably within their target ranges, notwithstanding the increased demand for money implied by higher economic activity. In its mid-year report to Congress, the Federal Reserve concluded that none of the aggregates were rising too rapidly or too slowly, and that the current targets would be maintained until the end of the year. The provisional targets for 1989 call for some further reduction in the growth rates of the aggregates, which would be appropriate in view of the expected slowdown in the economy, and consequently in the demand for money. In general, we view the Federal Reserve's targets as commensurate with stable expansion in 1988.

In the wake of the velocity fluctuations of the 1980's which have made the monetary aggregates somewhat less reliable as policy indicators, increasing emphasis has been

placed on interest rates. In this respect, rates fell initially after the stock market crash, due more to decreased demand for credit than the Federal's Reserve's well-timed loosening actions. After reaching a trough in early 1988, interest rates have climbed in response to market forces, i.e., higher inflation and increased demand for credit.

Table Two: Money and Credit in 1988

Target and Actual	M1	M2	M3	Debt
Target, 1988	None	4-8	4-8	7-11
Actual, 1988:1	3.8	6.7	7.0	8.4
Actual, 1988:2	6.1	7.9	7.1	8.3
Provisional target, 1989	None	3 to 7	3.5-7.5	6.5-10.5

Source: Federal Reserve

2.4 The Current Stance of Monetary Policy During the summer, the stance of monetary policy went from moderate to aggressive restraint. After a series of mild tightening moves since late 1987, the Federal Reserve undertook the significant move of raising the discount rate in August. This followed in the wake of increasing fears that the economy was overheating, and can be read as a pre-emptive measure aimed at reducing the inflationary expectations of the private sector. In so doing, Federal Reserve Chairman Greenspan also went out of his way to demonstrate that the central bank would not engage in a pre-election reflation, and that it would not accommodate the emerging acceleration in wages. The desire on the part of the central bank to establish a reputation for toughness in fighting inflation in 1988 is paralleled by the early years of the Volcker Chairmanship, in which the Federal Reserve undertook drastic measures in order to convince

the private sector that the OPEC-induced jump in inflation would not be accommodated, and that the stimulative stance of fiscal policy announced by the newly-elected Reagan Administration would not be ratified by a looser monetary posture.

Since trade and investment are still projected to experience continued expansion, we do not consider current policies to be sufficiently restrictive to be a risk factor for recession, although they are somewhat tighter than what NAM recommended to the FOMC late last year. Nevertheless, we would not recommend any further restrictive measures at the current time, since there is some evidence that the pace of economic expansion is cooling off. For instance, in July the leading indicators fell by -0.8 percentage points, and in August the unemployment rate increased from 5.4 to 5.6. In keeping with a pragmatic approach to monetary policy, the option of relaxation at some future point should not be ruled out. For instance, in the event that a recession should develop in 1989, we would endorse a countercyclical loosening of monetary policy. In our view, the inflation rate is not sufficiently high that a long period of slack would be desirable.

### III. Conclusions

The recovery has exhibited unexpected resiliency, and should run for at least an additional 12 months. Part of this durability traces back to the Federal Reserve's decision to "front-load" the disinflationary process in 1980-82: by lowering inflation at the expense of temporary output losses, the Federal Reserve set the stage for a more sustainable expansion. Our current view is that while monetary policy is inclining toward restraint, it is not inappropriately tight. As a general principle, NAM supports the Federal Reserve's commitment to controlling inflation, but we believe that this should be balanced by a similar commitment to keeping the real growth rate on its equilibrium path.

Therefore, monetary policy should be loosened in the event of a cyclical downturn. We do not believe that the central bank should peg the dollar at an overvalued level in order to achieve inflation targets.

With respect to policy options currently open to Congress, one advantage afforded by the continuing expansion is that this provides some breathing space to carry out additional fiscal restraint. Obviously, it would be difficult to achieve deficit reduction targets if the economy were to go into recession in 1989. However, if the expansion can be sustained well into next year, a reduction in the structural fiscal deficit remains a practicable possibility.



Testimony Before The  
U.S. House of Representatives  
Subcommittee on Domestic Monetary Policy  
of The  
Committee on Banking, Finance and Urban Affairs  
One Hundredth Congress  
Washington, D.C.  
September 8, 1988

My name is Don Paris. I am the Chief Economist at Caterpillar Inc. I have been with Caterpillar for 26 years and have been in my current position for 20 years. I have a BS, MS and Ph.D. from the University of Kentucky. I was born and raised in Mr. Hubbard's district.

Caterpillar is a major multinational headquartered in Peoria, Illinois. We manufacture and sell construction and mining equipment, lift trucks, diesel engines, turbines and replacement parts for distribution around the world.

Our 1987 sales were \$8.2 billion -- about half inside the United States and half outside. We exported about \$2.2 billion of product, making us America's 10th largest exporter.

We and our customers are directly affected by U.S. monetary policy. Naturally, we and other U.S. manufacturers have a great interest in the questions posed by Chairman Neal. I want to compliment you on the questions.

Interest rates and exchange rates have a dramatic impact on U.S. manufacturers. I was particularly struck by Chairman Greenspan's recent comments before the Senate. He said he'd rather risk being overly restrictive to prevent inflation than to risk being overly expansive to prevent a recession. In my view, that's skating too close to the edge.

No Fed Chairman has ever deliberately set about creating a recession; they have all occurred because they were trying to let an inflationary boom down easily. But we don't have an inflationary boom yet either.

I don't quarrel with the Fed's desire to be sure we don't ever again experience the inflation of the '70's. We had to pay a terrible price for it when we had it and again when we got rid of it.

A relevant issue is whether or not the tools the Fed has to work with are precise enough to fine tune the economy. Even if we're fortunate enough to have the right tools or indicators to monitor, a decision must be based on either forecasts or actual results.

Forecasters haven't been particularly accurate in the last three years as they have called recessions in three of the last four years and the resurgence of inflation any moment. The headlines today read just about the way they have for the last three years.

Aside from forecasts, the Fed has to lean on historical performance. An argument could be made to give more weight to what has actually happened in recent years as a guide to setting policy as opposed to forecasts.

In many analysts' opinion, the Fed slowed money growth and raised interest rates to restrain perceived inflationary pressures and to abide by the Louvre accord during 1987. This restraint was overdone and precipitated the crash of October 19.

It is very important for you to understand that I have to be complimentary of the Fed's performance in the post October 19 crisis. They injected liquidity into the system, restored calm to the markets and helped register the best worldwide noninflationary performance in the first half of '88 that we have experienced in many years.

That episode should have taught us a lesson. There is still a risk of deflation out there in the world economy; its consequences are probably "direr" than inflation.

Since spring, we have been witnessing a striking similarity to the events leading up to October 19.

I don't question that the economy is stronger than it was during 1987, but I am questioning whether or not it is worth the risk of a recession and a resurging dollar.

Anecdotal evidence of shortages abound as do questions about the validity of capacity utilization figures. What isn't appreciated, though, is the impact that the globalization of markets has on price behavior.

There is still excess capacity outside the U.S.

Foreign manufacturers are willing to utilize that capacity to retain employees, customers and distribution outlets in the U.S. They aren't going to lose market share by indiscriminately raising prices, jeopardizing recent gains.

Some are investing in the U.S. to build on their base for the long haul. It's been a long time since the United States had eight companies making cars domestically.

The declining dollar has been the catalyst to reviving the U.S. manufacturing sector. After five years of expansion, it's easily forgotten how close we came to losing our industrial base during the strong dollar days.

Now I know some studies show that manufacturing has remained about 20% of the real economy through the '80's. They take these data to mean manufacturing wasn't hurt by the strong dollar. Well, we would have more capacity today. Who's to say that manufacturing shouldn't have reached 25% of the economy? Wouldn't we have had a healthier economy if manufacturing had grown to 25%? Capacity shortages wouldn't have been as likely.

Caterpillar alone closed five plants in the U.S. and we shopped the world for the lowest price parts and components. We had to do this to survive globally. Our suppliers made similar adjustments. They survived with major cost reduction programs and restructuring their businesses.

The dollar's decline has now helped level the playing field, and improved export profits are paying for capital expansion.

Caterpillar raised production 27 percent and increased employment over 4500 in U.S. factories in the last 12 months. The weaker dollar and strong domestic market were major factors in this recovery.

Now we see U.S. policy strengthening the dollar again, which in a short time may wipe out months of hard work, sacrifice and investment. The improvement in our trade accounts and the growth in capital investment have depended upon restoring U.S. manufacturing's international competitive position.

I am always amazed at how people worry about the nerves and well-being of financial markets. Wall Street portfolio managers can move in and out of stocks and bonds in a matter of minutes.

Manufacturers don't have that luxury. They have to be cautious in hiring people because they want to keep them employed. When a plant is started, they have to finish it, but this requires several years. Stopping in the middle and switching strategies causes financial loss for the economy.

Small manufacturers perhaps are more vulnerable than large companies to interest and exchange rate changes. They are not necessarily as well capitalized as the larger Fortune 1000 companies. They have higher borrowing costs and can't easily hedge currency risk.

Small manufacturers have been adding people, expanding production, and getting more into exports. They have been the primary source of manufacturing job creation.

We estimate that the declining dollar produced \$300 million of additional before-tax profit in the last 18 months for Caterpillar. We intend to spend more than that each of the next five years to carry out our factory modernization program. This activity could be delayed by higher interest rates and a stronger dollar ... and that would hurt Caterpillar's ability to compete.

Aside from the October 19 stock market crash, the world economy has adjusted in line with what needed to be done. The economy is in good shape today.

1. The U.S. budget deficit had to come down and it has. I am not alone in saying that more spending cuts are needed to reduce it faster. I don't think risking a recession will cut the deficit. In fact, recessions always increase deficits.
2. Overseas economies had to stimulate their internal demand to provide a larger market for U.S. goods. That has been occurring, and in Japan, to a greater measure than expected.
3. Capital investments had to increase, and we are, in fact, enjoying a capital spending boom. The declining dollar has generated significant cash flow increases for corporations to fund their capital spending plans for modernization and new capacity.
4. The U.S. had to slow consumer spending. Real consumer expenditures in the U.S. have slowed to a 2.5 percent real annual growth rate in since the end of 1986, in contrast to 4 percent to 5 percent in prior quarters.

Competition for finished goods is very intense throughout the economy. Consumers have shown an amazing resistance to price increases by shifting their purchases to lower-priced goods, waiting for a sale, and clipping coupons and rebates. Consumer incomes are restraining their ability to absorb price increases. They don't appear to need as much help in resisting price increases as you might think.

Wages in manufacturing are very restrained and are increasing less than 3 percent. When adjusted for volume gains and productivity, unit labor costs are growing even less. Wages probably make up 70 percent of the costs in the economy; and they just haven't exploded yet, and are not providing the income gains for the consumer to go on a spending binge.

Some analysts point to the drought and the rise in industrial material prices as indications of a revival of inflation. I don't share this view. During the period of falling commodity prices, those industries lost money and the final manufacturing sector used those losses to shore up their profits.

Investment in these primary producing industries declined. Mines were closed or cut back substantially. Higher commodity prices are bringing jobs and investment back into U.S. mining now. So we're seeing the market system at work rather than inflation.

In this period of improving primary goods prices, manufacturers can't indiscriminately pass on cost increases. So it is coming out of their profits.

The weaker dollar has been an important factor in the recovery of the forest products, pulp, and paper industries.

With their international competitiveness restored, these industries are operating at high rates and plowing profits back into investments.

- 8 -

In short, dangers of inflation are further into the future than present policy suggests. Consumer spending is growing less than 2.5 percent, and government spending on goods and services is about flat in real terms. About 75 percent of the economy is growing slowly by anyone's measure. Clearly, housing is headed down.

About 25% of the economy composed of exports and capital expenditures are making up most of the growth. These sectors will be adversely effected by high interest rates and stronger dollar.

It follows, therefore, that current policy will delay capacity expansion and lengthen the time it will take to adjust our trade imbalance.

In conclusion, I urge the Fed to be aware of a risk of precipitating an unwanted recession by clinging to current policy too long.

I have been in the forecasting game a long time, and recognize that indicators and relationships aren't always stable and reliable. Furthermore, conventional wisdom is equally capricious.

I hope the Fed's advisors and the Fed itself will be cognizant of the need to reverse course quickly. This may need to be done before all the evidence is in.

I hope we don't develop the notion that a weaker, more realistically competitive dollar is bad news.



Testimony  
Before The  
U.S. House of Representatives  
Subcommittee on Domestic Monetary Policy  
of The  
Committee on Banking, Finance and Urban Affairs  
One Hundredth Congress  
Washington, D.C.

By  
James L. Pate  
Senior Vice President—Finance and Treasurer  
Pennzoil Company  
Houston, Texas

September 8, 1988

Mr. Chairman, and members of the Subcommittee on Domestic Monetary Policy, my name is James L. Pate. I am Senior Vice President - Finance and Treasurer of Pennzoil Company, headquartered in Houston, Texas. I appreciate very much the opportunity to appear before this committee.

At the outset, I would like to emphasize that I am in general agreement with the Federal Reserve's conduct of monetary policy in recent months and I am in essential agreement with Chairman Greenspan's testimony before this committee on July 28.

The recent tendency of the Federal Reserve to make small anticipatory adjustments in an effort to avoid big reactive changes is, in my opinion, a welcome change in the implementation of monetary policy. However, this approach does heighten the importance of accurately gauging business conditions and anticipating economic developments. In recognition of this fact, Chairman Greenspan has indicated that he was prepared to "err more on the side of restrictiveness rather than of stimulus."

Although I understand the Federal Reserve's position, given my view of economic conditions and the potentially grave consequences of an economic downturn, this bothers me somewhat and I would like to consider the issue, that is, whether the Fed should err on the side of restraint or ease, in the context of the questions you provided, Mr. Chairman, in your letter of invitation.

Many analysts are surprised at the continuing robust expansion of the economy, in light of the persistence of large budgetary and external imbalances, major swings in exchange rates and the unprecedented shock of last year's collapse of the stock market. To what do you attribute the current strength of the economy? Is our current growth rate more or less sustainable without major shifts in economic policy?

The strength and resiliency of the current economic expansion has been surprising, especially in view of the unprecedented shocks that have rocked the economy—\$200 billion budget deficits, \$170 billion trade deficits, recession in the "Rust Belt," depression in the oil industry, a gyrating dollar, a record plunge in the stock market, and then a drought that even threatened to dry up the Mississippi River. However, from the beginning this expansion has been unusual and very uneven—almost lopsided.

About the only thing typical about this expansion is that consumer spending played its usual role of providing the initial impetus to the recovery. Even so, there were widely divergent growth patterns among industries. Those industries that were interest-rate sensitive or dependent on foreign markets suffered widespread plant closings even in the midst of overall economic recovery because of the extreme strength of the U.S. dollar and persistent high real interest rates.

The dollar peaked in early 1985, consumer spending moderated in late 1986, and the decline in the value of the dollar started fueling exports and reviving manufacturing

activity just in time to pick up the slack from consumer spending and sustain the expansion (see Exhibit I). Growth is now very much concentrated in exports and export-related segments of manufacturing. During the past four quarters, exports directly contributed \$83.3 billion of the \$165.1 billion increase in real Gross National Product (GNP). Indirectly, exports contributed as much as another \$40 billion to the rise in spending for business equipment. That is a lot of thrust from a component that accounts for only about 12 percent of total GNP. Exports are expected to remain strong for several more quarters and even to increase, but they are not likely to contribute to overall economic growth to the extent that they have in recent quarters. It is very difficult to see other sectors of the economy accelerating to such an extent as to sustain recent GNP growth rates. Thus, economic growth is expected to slow appreciably in the months ahead.

Our forecast is for a continuation of the export-led recovery in manufacturing, reinforced by capital investment, particularly in equipment. However, overall real growth is expected to slow from the 3.3 percent pace in the first half of this year to about 2.5 percent in the second half of 1988. On a fourth-quarter-to-fourth-quarter basis, growth is expected to be about 3 percent in 1988 and 2 percent or less in 1989.

Beginning with the recovery of 1983 the current expansion has combined strong real growth with declining and then

stable inflation. Can this fortunate pattern persist? Do you see evidence, from your vantage point, of serious inflationary pressures building up in our economy?

Inflation rates are clearly headed higher. The Consumer Price Index (CPI-U) has increased at a 4.5 percent annual rate so far this year and rose at a 5.2 percent rate in July. The Producer Price Index (PPI) for all commodities increased 4.2 percent during the past year and 7.8 percent in the last three months (see Exhibit II). Prices of intermediate commodities increased 5.9 percent during the past year and 9.0 percent in the last three months. The highly volatile crude commodities prices increased 1.0 percent during the past year and 5.6 percent during the last three months.

The Commodity Research Bureau (CRB) Futures Index of prices rose over 16 percent from the end of April to late June, reflecting sharply higher food prices. (The index has fallen 8.5 percent since then.) The CRB Spot Index rose 9.0 percent for industrial materials from March to June but has exhibited little change in the past two months. The Journal of Commerce Sensitive Commodity Price Index, which concentrates on industrial commodities, has increased 4.3 percent since early March.

Labor costs have also picked up this year, in part because of the increase in social security taxes. Hourly pay for non-farm private workers rose at an annual rate of 5.2 percent in the second quarter. That was more than double the 2.2 percent rate in the first quarter and was the largest quarterly gain

since the third quarter of 1982. Hourly earnings in manufacturing rose 4.6 percent in the second quarter compared to 1.3 percent in the first quarter.

Overall, the outlook is definitely for higher wages and prices. However, higher rates of inflation in 1988 and 1989 have been widely anticipated for the past two years. Recent anxiety over inflation has probably been somewhat overdone. There are no signs of a wage-price spiral such as the one that plagued the 1970's. And, while capacity utilization rates are high in several major industries, they are in most cases below the peak rates reached in previous expansions (see Exhibit III).

Forecasts of inflation in 1989 have been revised upward somewhat in recent weeks due to the anticipated effect of the drought on food prices. But even this concern appears to have been overdone. The recent rain in the Midwest, the decline in oil prices, and the unexpected rebound in the dollar have been tempering influences. The so-called "core" rate of inflation, as measured by the PPI finished goods index (excluding food and energy products), was up only 3.4 percent for the year ended July (up from 2.2 percent for calendar year 1987).

Our forecast is for a moderate acceleration in inflation, with the CPI averaging slightly over 4 percent in 1988 and roughly 5 percent in 1989.

Many observers view the Fed as applying modest restraint very gradually and cautiously, in an attempt to calm inflationary expectations without retarding real growth. Is this an accurate reading of current monetary policy? Given your assessment of the threat of inflation, is the current stance of monetary policy appropriate?

The Federal Reserve has shown intense concern about inflation by tightening four times this year and pushing interest rates up 130 to 190 basis points since March. To date, the Fed's actions appear appropriate and fully justified. However, most short-term rates have been pushed back up to levels equal to, or higher than, what they were prior to the October crash. This is cause for some concern. The half-point increase in the discount rate on August 9 was quite unnerving and, in my opinion, not fully supported by economic fundamentals. However, it was probably unavoidable and warranted on the basis of perceptions and expectations that were starting to develop in the financial markets.

The financial markets are still very jittery following the events of last October, and there are good reasons to believe that even in the absence of any further tightening, overall economic growth will slow appreciably in the second half of this year. Thus, the risks of erring on the side of restrictiveness and causing another financial crisis or precipitating a recession in 1989 are substantial. With our continuing budget deficits, troubled financial institutions, and Third World debt problems, a recession must be avoided at least until a new Administration has the opportunity to deal with these persistent problems.

The task confronting the Federal Reserve is formidable. Somehow it must strike a balance between preventing a sharp acceleration in inflation and sustaining economic growth while seeking to stabilize the dollar. Fiscal policy is on hold until the next Administration takes office, so monetary policy is the only available means of stabilizing the economy.

Are there particular economic developments which should weigh heavily on the current conduct of monetary policy? For example, some economists think we will need further dollar depreciation, yet the dollar has been surprisingly strong on the foreign exchange markets. Is this a cause for concern indicating that monetary policy might now be too tight? Or is it a welcome development, one that will help keep inflationary expectations in check and interest rates at lower levels than otherwise possible?

As long as the United States continues to run huge budget deficits and large trade imbalances, international financial considerations are going to play an important role in the conduct of U.S. monetary policy.

The recent increase in the value of the dollar has been due primarily to comparative interest rate differentials and the anticipation that U.S. monetary authorities will raise rates further. In the past month, the interest rate advantage for dollar investments (overnight to three months) has been more than 3 percent relative to both yen and deutsche mark deposits.

Although foreign central banks have reacted by increasing their own short-term interest rates in an effort to support



their currencies, fundamentals favor some further rise in the value of the dollar near-term. In the long run the U.S. dollar should move lower to improve the U.S. trade balance. However, I very much agree with Chairman Greenspan that a sharp decline in the value of the dollar at this time could be counterproductive, raising import prices and adding to inflationary pressures.

To mention other examples, do the current drought conditions affecting the agricultural sector, or the emerging heavy losses among thrift institutions, pose particular problems that should influence the conduct of monetary policy?

The drought conditions are causing substantial upward revisions in food price forecasts. Before the drought, food prices were generally expected to rise 4 percent in both 1988 and 1989. Now the forecasts for 1989 are in the 5-6 percent range. From a policy point of view, the drought should be regarded as a serious but temporary condition that need not have any lasting effect on overall inflation. Raw agricultural commodity costs represent a very small proportion of the prices of food products. The risk is, however, that even small increases in retail food prices will affect inflationary expectations and become embedded in wage trends because grocery stores are where workers first notice higher prices.

The situation among financial institutions is more critical, and it extends beyond thrift institutions and the problems of the Federal Savings and Loan Insurance Corporation

(FSLIC). It includes problems affecting some of our nation's largest commercial banks. Despite more than five years of economic growth and an extended period of declining interest rates, banking problems continue to mount. Between 1981 and 1987, commercial banks' annual write-offs of bad loans rose from roughly \$4 billion to \$16 billion. Historically, write-offs double or even triple during recessions, with roughly one-third concentrated among the weakest 20 percent of the banks. That means that even a mild recession at this time could easily wipe out the capital of at least 20 percent of our commercial banking system.

An additional consideration in assessing the risks of higher interest rates and recession is the increasing sensitivity of consumer spending to interest rate changes. Consumer spending accounts for roughly two-thirds of gross national product and has become extremely vulnerable to rising interest rates because of increased consumer borrowing and a rising proportion of variable rate debt such as adjustable rate mortgages, variable rate credit cards, and home equity loans tied to market interest rates.

Another concern is the highly leveraged condition of American corporations. During the 1980's, corporations made substantial changes in their capitalization, adding significant debt and buying back substantial amounts of stock. This has raised their net interest expense substantially. Since 1982, net interest expense has equalled between 40 percent and 60

percent of "profits before tax" (see Exhibit IV). Prior to 1982, it never exceeded 40 percent; during the 1960's, it was close to 10 percent. The relationship between net interest expense and pretax profits with inventory and capital consumption adjustment (INV&CCADJ) is similar.

This current, highly leveraged condition means that businesses would be much harder hit by high interest rates and a recession today than in the past. During the 1982 recession, profits fell 29 percent, the largest decline in the 1960-1987 period. The burden of high interest expense contributed to the greater volatility in profits. In 1981, net interest expense equalled \$67.5 billion or 37.2 percent of profits before tax and 46.8 percent of profits with INV&CCADJ. In 1987, the corresponding percentages were 46.9 percent and 41.5 percent. In 1973, prior to the 1975 recession, the corresponding ratios were in the 23 percent to 27 percent range, indicating a much lower sensitivity of profits to interest rate peaks and economic slowdowns.

The dividend payout rate has also increased substantially. Dividend payments in the 1980's, as a percent of either profits before tax or operating profits, substantially exceeded levels in either the 1960's or the 1970's. At the same time, undistributed profits, as a percent of either measure of profits, in 1987 remained near the record low of 1986.

There are undoubtedly many contributing factors to this trend toward a highly leveraged corporate sector. One

unexplored view is that the inflation-fighting monetary policies of the early 1980's resulted in high nominal and real interest rates. The equity securities of nonfinancial corporations, as one of many competing assets, had to provide a rate of return to investors comparable to other financial instruments. This was achieved by taking on additional debt and consolidating firms and/or buying back stock to keep stock prices attractive, as well as increasing dividend payout rates to further support the return on holding the stock of non-financial corporations.

What all this means is that vulnerability to high interest rates and recession goes far beyond thrifts and other financial institutions. Consumers and corporations will be hit hard in the next recession—much harder than in the past.

On a more general level, considering macroeconomic policy as a whole—spending, taxing, monetary policy, exchange-rate management—what significant policy changes, if any, do you see necessary, in the next Administration, in order to continue reasonable and sustainable economic growth, without generating serious inflation?

The most urgent business for the next Administration will be to reduce the federal budget deficit. Until this happens, interest rates will remain high and we will continue to depend on foreign investors to finance our budget deficits.

Also, the next Administration will need to move quickly on a national energy policy. Until this happens, the U.S.

is going to continue to experience large trade imbalances. The trends of declining domestic production and increasing consumption guarantee that oil imports will rise. For example, through June of this year total oil imports were up 13% from the comparable 1987 period and up 23% from the comparable 1986 period. Currently, oil imports account for roughly one-third (\$42 billion) of our trade deficit (see Exhibit V). In 1995 it is estimated that our oil import bill will be more than \$116 billion. In addition, the loss of U.S. domestic production and the rise in our import dependence will increase our vulnerability to economic shocks from future oil price spikes.

In brief summary, Mr. Chairman, I am concerned that interest rates are approaching—they probably are not yet there, but they are getting very close to—levels that could precipitate a recession. My company recently ran some simulations with a widely used econometric model and found that it does not take a very large increase in interest rates in 1988 to produce a flat economy in 1989 and, if you combine a small increase in interest rates with just a slight decline in consumer confidence, you can get two or more quarters of negative real growth rather easily. So we are, in my opinion, approaching a danger zone for interest rates. In this regard, it is comforting to hear from Chairman Greenspan that the Federal Reserve does not contemplate any sharp upward adjustments in interest rates.

I, too, am concerned about the possibilities of a reacceleration of inflation. However, the price increases we have seen to date are widely scattered and in most cases related to special circumstances or transitory developments. They are not the kind of general price increases that would be significantly reduced by higher interest rates and a slowing of aggregate demand.

My concern is that the consequences of a recession at this time could be quite serious. Our best chance, in fact I believe our only chance, for reducing our huge budget deficit, dealing with Third World debt problems, and restoring strength to our fragile financial institutions is in an environment of economic growth, albeit slow growth.

Mr. Chairman, and members of this committee, thank you again for this opportunity to present my views.

CHANGES IN GROSS NATIONAL PRODUCT (8/25/88 Release)  
(Billions of 1982 Dollars)

	1985				1986				1987				1988	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Gross National Product	\$42.3	\$21.7	\$36.6	\$26.6	\$56.9	(\$7.7)	\$9.7	\$13.4	\$42.0	\$46.3	\$42.3	\$57.7	\$33.1	\$32.0
Personal Consumption	38.0	18.3	38.5	10.9	28.3	25.8	37.6	7.7	4.0	26.4	28.6	-13.5	28.1	17.4
Durable Goods	11.6	5.5	18.8	-12.7	6.9	10.9	30.9	-7.8	-19.0	13.0	15.2	-18.9	13.5	8.2
Nondurable Goods	7.0	4.9	7.0	8.2	12.2	10.5	0.5	3.9	4.6	-0.1	2.1	-1.4	2.2	0.0
Services	19.4	7.9	12.7	15.4	9.2	4.4	6.3	11.6	18.3	13.5	11.3	6.9	12.3	9.3
Investment	-21.4	13.2	-29.4	29.9	30.0	-25.9	-24.5	-11.1	29.9	13.7	7.8	56.8	4.2	-11.2
Fixed Investment	4.6	12.0	-8.5	18.3	-8.0	-3.9	-3.9	2.4	-10.4	15.7	22.6	2.7	5.3	18.7
Nonres. Structures	3.9	0.3	-5.8	4.2	-4.7	-18.5	-5.0	2.2	-2.8	-0.1	7.1	4.1	-8.1	3.6
Prod. Durable Equip.	-0.1	9.2	-4.9	9.6	-9.4	4.4	-2.2	-0.4	-6.3	16.7	20.9	-2.0	16.7	14.7
Residential Invest.	0.7	2.6	2.1	4.4	6.1	10.2	3.3	0.7	-1.3	-0.8	-5.5	0.6	-3.2	0.5
Change in Business Inv.	-25.9	1.1	-20.9	11.7	38.0	-22.1	-20.6	-13.5	40.3	-2.0	-14.8	54.1	-1.1	-30.0
Net Exports	13.4	-21.0	-5.5	-17.4	9.6	-24.5	-11.6	9.4	9.6	6.8	-4.7	4.7	17.0	18.9
Exports	-5.4	-3.6	-5.0	4.8	7.1	-2.4	7.0	8.7	7.1	21.5	24.5	18.3	27.0	13.5
Imports	-18.8	17.4	0.5	22.1	-2.4	22.2	18.5	-0.7	-2.5	14.6	29.3	13.6	9.9	-5.4
Government	12.3	11.2	33.1	2.9	-10.9	17.0	8.1	7.6	-1.6	-0.7	10.7	9.7	-16.2	6.9
Federal	8.5	4.3	27.6	-0.3	-17.9	10.9	3.1	3.8	-6.5	-1.9	10.0	5.6	-19.9	3.2
Military	4.7	3.4	10.6	-2.6	-0.3	9.7	9.9	-7.6	3.9	7.8	4.7	-1.3	-3.6	-1.4
Other	3.8	0.9	17.0	2.3	-17.6	1.2	-6.8	11.4	-10.4	-9.7	5.3	6.9	-16.3	4.6
State & Local	3.7	7.0	5.5	3.2	7.0	6.1	5.0	3.8	4.9	1.2	0.7	4.1	3.8	3.6
Real Final Sales	68.2	20.6	57.5	14.9	18.9	14.4	30.3	26.9	1.7	48.3	57.0	3.7	34.2	62.0
GNP Price Deflators (% Change, SAAR)														
Implicit Price Def.	2.6%	3.3%	2.6%	3.3%	0.7%	3.6%	4.7%	2.1%	3.5%	3.5%	3.1%	2.4%	1.7%	5.1%
Fixed Weight Def.	3.7	3.3	2.9	3.2	2.1	2.5	3.2	2.8	4.2	4.2	3.7	3.8	3.5	4.7

SOURCE: U.S. Department of Commerce

PRODUCER PRICE INDEXES

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YR:Month	All Commodities			Finished Commodities			Intermediate Commodities			Crude Commodities		
	Percent Change			Percent Change			Percent Change			Percent Change		
	Level	3 Month	1 Year	Level	3 Month	1 Year	Level	3 Month	1 Year	Level	3 Month	1 Year
1986:1	1.032	1.2	-0.2	1.054	1.9	1.3	1.023	-0.4	-0.8	0.942	0.0	-5.7
1986:2	1.017	-6.4	-1.5	1.039	-5.9	-0.2	1.011	-5.7	-1.7	0.904	-19.7	-9.0
1986:3	1.003	-12.1	-2.7	1.029	-11.2	-1.2	0.999	-11.2	-2.6	0.883	-26.3	-9.6
1986:4	0.996	-13.2	-3.6	1.023	-11.3	-2.2	0.990	-12.3	-3.8	0.854	-32.4	-11.7
1986:5	1.000	-6.5	-3.4	1.029	-3.8	-1.9	0.988	-8.8	-4.2	0.868	-15.0	-9.5
1986:6	0.999	-1.6	-3.3	1.029	0.0	-1.6	0.987	-4.7	-3.9	0.862	-9.2	-9.5
1986:7	0.994	-0.8	-3.7	1.023	0.0	-2.4	0.980	-4.0	-4.4	0.864	4.8	-8.9
1986:8	0.993	-2.8	-3.3	1.027	-0.8	-1.8	0.980	-3.2	-4.2	0.866	-0.9	-6.7
1986:9	0.994	-2.0	-2.6	1.030	0.4	-1.1	0.986	-0.4	-3.6	0.865	1.4	-5.8
1986:10	0.997	1.2	-3.1	1.034	4.4	-1.4	0.982	0.8	-4.1	0.875	5.2	-7.1
1986:11	0.998	2.0	-3.5	1.035	3.2	-1.9	0.983	1.2	-4.2	0.874	3.7	-8.5
1986:12	0.997	1.2	-3.8	1.034	1.6	-2.5	0.984	-0.8	-4.4	0.866	0.5	-9.1
1987:1	1.005	3.2	-2.6	1.039	1.9	-1.4	0.990	3.3	-3.2	0.891	7.5	-5.4
1987:2	1.010	4.9	-0.7	1.041	2.3	0.2	0.996	5.4	-1.5	0.899	11.9	-0.6
1987:3	1.012	6.2	0.9	1.045	4.3	1.6	0.998	5.8	-0.1	0.906	19.8	2.6
1987:4	1.019	5.7	2.3	1.051	4.7	2.7	1.002	4.9	1.2	0.923	15.2	8.1
1987:5	1.026	6.5	2.6	1.053	4.7	2.3	1.008	4.9	2.0	0.943	21.1	8.6
1987:6	1.030	7.3	3.1	1.054	3.5	2.4	1.013	6.1	2.6	0.946	18.9	9.7
1987:7	1.035	6.4	4.1	1.057	2.3	3.3	1.019	7.0	4.0	0.956	15.1	10.6
1987:8	1.038	4.8	4.5	1.060	2.7	3.2	1.024	6.5	4.5	0.967	10.6	11.7
1987:9	1.037	2.7	4.3	1.064	3.8	3.3	1.027	5.6	4.2	0.960	6.1	11.0
1987:10	1.041	2.3	4.4	1.061	1.5	2.6	1.032	5.2	5.1	0.961	2.1	9.8
1987:11	1.042	1.6	4.4	1.062	0.8	2.6	1.036	4.8	5.4	0.949	-7.2	8.6
1987:12	1.042	1.9	4.5	1.059	-1.9	2.4	1.038	4.4	5.5	0.947	-5.3	9.4
1988:1	1.046	1.9	4.1	1.062	0.4	2.2	1.042	3.9	5.3	0.939	-8.8	5.4
1988:2	1.048	2.3	3.8	1.060	-0.8	1.8	1.044	3.1	4.8	0.946	-1.3	5.2
1988:3	1.049	2.7	3.7	1.065	2.3	1.9	1.048	3.9	5.0	0.941	-2.5	3.9
1988:4	1.058	4.7	3.8	1.069	2.7	1.7	1.056	5.5	5.4	0.953	6.1	3.3
1988:5	1.065	6.6	3.8	1.074	5.4	2.0	1.062	7.1	5.4	0.964	7.8	2.2
1988:6	1.074	9.9	4.3	1.078	5.0	2.3	1.072	9.5	5.8	0.977	16.2	3.3
1988:7	1.078	7.8	4.2	1.083	5.3	2.5	1.079	9.0	5.9	0.966	5.6	1.0

SOURCE: Bureau of Labor Statistics, U.S. Department of Labor



**CAPACITY UTILIZATION BY INDUSTRY  
(Percent)**

Industry	1973-75 Cycle		1978-82 Cycle		Most Recent*	Most Recent Minus Previous Highs	
	High	Low	High	Low		1973-75	1978-82
Foods	85.8%	77.6%	85.1%	76.5%	80.1%	-5.7%	-5.0%
Textile Mill Products	92.1%	58.9%	88.3%	70.6%	89.6%	-2.5%	1.3%
Paper & Products	95.6%	67.7%	92.7%	80.2%	92.8%	-2.8%	0.1%
Chemical & Products	88.6%	69.2%	82.9%	67.6%	85.9%	-2.7%	3.0%
Petroleum Products	99.6%	83.7%	91.7%	68.8%	84.9%	-14.7%	-6.8%
Rubber & Plastics Products	97.5%	59.5%	89.4%	68.7%	88.4%	-9.1%	-1.0%
Stone, Clay, Glass & Concrete Products	89.3%	67.1%	86.6%	62.9%	82.4%	-6.9%	-4.2%
Primary Metals	101.9%	67.0%	97.1%	45.8%	89.5%	-12.4%	-7.6%
Fabricated Metal Products	85.0%	64.7%	87.4%	61.3%	83.4%	-1.6%	-4.0%
Nonelectrical Machinery	89.4%	68.2%	86.0%	62.9%	82.6%	-6.8%	-3.4%
Electrical Machinery	85.7%	63.7%	89.9%	66.9%	78.0%	-7.7%	-11.9%
Motor Vehicles & Parts	97.1%	52.7%	93.3%	47.0%	81.6%	-15.5%	-11.7%
Instruments	89.2%	74.9%	88.9%	77.8%	81.5%	-7.7%	-7.4%
Electrical Utilities	98.7%	83.0%	87.6%	78.2%	86.3%	-12.4%	-1.3%

\* June or July, 1988

Source: Board of Governors, U.S. Federal Reserve System

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Exhibit III

NONFINANCIAL CORPORATIONS

Profits with Inventory and Capital Consumption Adjustment (\$ Billions)

	Profits								Net Interest Expense	Category as Percent of Total Profits with Inventory and Capital Consumption Adj.			Category as Percent of Profits Before Tax				
	Profits After Tax							Inventory & Capital Consump. Adj.		Net			Net				
	Total	Profits Before Tax	Profits Tax Liab.	Total	Dividends	Undist. Dividends	Total			Dividends	Undist. Dividends	Dividends	Undist. Dividends	Interest Expense	Dividends	Undist. Dividends	Interest Expense
1960	\$39.2	\$39.7	\$19.2	\$20.5	\$10.6	\$9.9	(\$0.5)	\$3.5	27.0%	25.3%	8.9%	26.7%	24.9%	8.8%			
1961	\$40.1	\$39.5	\$19.4	\$20.1	\$10.6	\$9.5	\$0.6	\$4.0	26.4%	23.7%	10.0%	26.8%	24.1%	10.1%			
1962	\$47.3	\$44.2	\$20.7	\$23.5	\$11.4	\$12.1	\$3.1	\$4.5	24.1%	25.6%	9.5%	25.8%	27.4%	10.2%			
1963	\$52.8	\$48.9	\$22.7	\$26.2	\$12.6	\$13.6	\$3.9	\$4.8	23.9%	25.8%	9.1%	25.8%	27.8%	9.8%			
1964	\$59.3	\$55.4	\$24.0	\$31.4	\$13.7	\$17.7	\$3.9	\$5.3	23.1%	29.8%	8.9%	24.7%	31.9%	9.6%			
1965	\$69.1	\$65.2	\$27.2	\$38.0	\$15.6	\$22.4	\$3.9	\$6.1	22.6%	32.4%	8.8%	23.9%	34.4%	9.4%			
1966	\$73.7	\$70.3	\$29.5	\$40.8	\$16.8	\$24.0	\$3.4	\$7.4	22.8%	32.6%	10.0%	23.9%	34.1%	10.5%			
1967	\$70.5	\$66.5	\$27.9	\$38.6	\$17.5	\$21.1	\$4.0	\$8.8	24.8%	29.9%	12.5%	26.3%	31.7%	13.2%			
1968	\$74.8	\$73.1	\$33.6	\$39.5	\$19.1	\$20.4	\$1.7	\$10.1	25.5%	27.3%	13.5%	26.1%	27.9%	13.8%			
1969	\$69.6	\$69.6	\$33.4	\$36.2	\$19.1	\$17.1	\$0.0	\$13.2	27.4%	24.6%	19.0%	27.4%	24.6%	19.0%			
1970	\$55.4	\$57.0	\$27.2	\$29.8	\$18.5	\$11.3	(\$1.6)	\$17.1	33.4%	20.4%	30.9%	32.5%	19.8%	30.0%			
1971	\$65.2	\$65.6	\$30.0	\$35.6	\$18.5	\$17.1	(\$0.4)	\$18.1	28.4%	26.2%	27.8%	28.2%	26.1%	27.6%			
1972	\$75.7	\$76.8	\$33.8	\$43.0	\$20.1	\$22.9	(\$1.1)	\$19.2	26.6%	30.3%	25.4%	26.2%	29.8%	25.0%			
1973	\$82.4	\$96.9	\$40.2	\$56.7	\$21.1	\$35.6	(\$14.5)	\$22.5	25.6%	43.2%	27.3%	21.8%	36.7%	23.2%			
1974	\$69.4	\$107.2	\$42.2	\$65.0	\$21.7	\$43.3	(\$37.8)	\$28.3	31.3%	62.4%	40.8%	20.2%	40.4%	26.4%			
1975	\$91.6	\$109.2	\$41.5	\$67.7	\$24.8	\$42.9	(\$17.6)	\$28.7	27.1%	46.8%	31.3%	22.7%	39.3%	26.3%			
1976	\$113.3	\$138.3	\$52.9	\$85.4	\$27.8	\$57.6	(\$25.0)	\$27.5	24.5%	50.8%	24.3%	20.1%	41.6%	19.9%			
1977	\$134.9	\$160.5	\$59.9	\$100.6	\$32.0	\$68.6	(\$25.6)	\$30.6	23.7%	50.9%	22.7%	19.9%	42.7%	19.1%			
1978	\$146.0	\$182.1	\$67.1	\$115.0	\$37.3	\$77.8	(\$36.1)	\$35.9	25.5%	53.3%	24.6%	20.5%	42.7%	19.7%			
1979	\$139.1	\$195.7	\$69.6	\$126.2	\$39.3	\$86.9	(\$56.6)	\$43.5	28.2%	62.5%	31.3%	20.1%	44.4%	22.2%			
1980	\$123.1	\$181.8	\$67.0	\$114.8	\$45.5	\$69.3	(\$58.7)	\$55.5	37.0%	56.3%	45.1%	25.0%	38.1%	30.5%			
1981	\$144.2	\$181.5	\$63.9	\$117.6	\$53.4	\$64.2	(\$37.3)	\$67.5	37.0%	44.5%	46.8%	29.4%	35.4%	37.2%			
1982	\$111.9	\$129.7	\$46.2	\$83.5	\$59.7	\$23.8	(\$17.8)	\$76.6	53.4%	21.2%	68.5%	46.0%	18.3%	59.1%			
1983	\$165.6	\$159.4	\$59.5	\$99.9	\$66.5	\$33.4	\$6.3	\$69.8	40.2%	20.2%	42.1%	41.7%	21.0%	43.8%			
1984	\$222.4	\$196.1	\$73.5	\$122.5	\$69.5	\$53.0	\$26.4	\$80.3	31.3%	23.8%	36.1%	35.5%	27.0%	40.9%			
1985	\$225.3	\$170.2	\$69.8	\$100.4	\$72.2	\$28.2	\$55.1	\$81.1	32.0%	12.5%	36.0%	42.4%	16.6%	47.6%			
1986	\$230.6	\$172.6	\$76.8	\$95.8	\$74.8	\$21.0	\$58.0	\$84.3	32.4%	9.1%	36.6%	43.3%	12.2%	48.8%			
1987	\$237.4	\$210.2	\$99.0	\$111.2	\$83.8	\$27.4	\$27.2	\$98.6	35.3%	11.5%	41.5%	39.9%	13.0%	46.9%			

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Exhibit IV

SOURCE: Bureau of Economic Analysis, U.S. Department of Commerce

Exhibit V

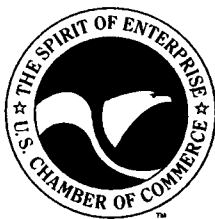
## U.S. OIL AND PRODUCT IMPORTS AND THE U.S. TRADE DEFICIT

	1977	1985	1987	1995
	-----	-----	-----	-----
<b>US OIL PRODUCTION &amp; CONSUMPTION</b>				
-----				
Petroleum Products Consumption (MMB/d)*	18.4	15.7	16.7	17.7
Oil Production (MMB/d)	9.9	10.6	10.0	7.2
Crude Oil & Products Imports (MMB/d)	8.8	5.1	6.7	10.5
Percent of U.S. Use From Imports	47.8%	32.2%	40.1%	59.3%
<b>IMPORT PRICES</b>				
-----				
Crude Oil (\$/bbl)	\$14.31	\$26.66	\$17.71	\$30.42
Average Crude & Products (\$/bbl)	14.00	27.31	17.35	30.40
<b>BALANCE OF PAYMENTS IMPACT</b>				
-----				
Crude Oil & Products Imports (\$Billion)	-45.0	-50.5	-42.3	-116.5
Balance of Payments** Without Crude Oil & Products Imports (\$Billion)	30.5	-65.9	-118.4	11.9
Total Balance of Payments** (\$Billion)	-14.5	-116.4	-160.7	-104.6

\* May not equal sum of production and imports because of inventories.

\*\* Current Account Balance of Payments: estimate for 1995 developed using Data Resources Inc. model.

SOURCE: Pennzoil Company



# Statement of the U.S. Chamber of Commerce

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**ON: MONETARY POLICY**  
**TO: SUBCOMMITTEE ON DOMESTIC MONETARY POLICY OF THE  
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS**  
**BY: DR. RICHARD W. RAHN**  
**DATE: SEPTEMBER 8, 1988**

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The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents nearly 180,000 businesses and organizations, such as local/state chambers of commerce and trade/professional associations.

More than 92 percent of the Chamber's members are small business firms with fewer than 100 employees, 59 percent with fewer than 10 employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business—manufacturing, retailing, services, construction, wholesaling, and finance—numbers more than 10,000 members. Yet no one group constitutes as much as 31 percent of the total membership. Further, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the 56 American Chambers of Commerce Abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross section of its members serving on committees, subcommittees and task forces. Currently, some 1,800 business people participate in this process.

STATEMENT  
on  
MONETARY POLICY  
before the  
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY  
of the  
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS  
for the  
U.S. CHAMBER OF COMMERCE  
by  
Dr. Richard W. Rahn  
September 8, 1988

I am Richard W. Rahn, Vice-President and Chief Economist of the U.S. Chamber of Commerce. On behalf of our 180,000 member businesses, associations, and state and local chambers of commerce, we thank you for the opportunity to present our thoughts on the current state of the economy and on the conduct of monetary policy.

At the outset, let me commend the members of the Federal Reserve Board (Fed) for their recent efforts in striving to meet mandates established for them by law. I want to state for the record our total agreement with and support for the objective of achieving noninflationary economic growth. Any disagreement that we have in this regard is over the means, not the end, of monetary policy. And while we may have preferred a more gradual reduction in the inflation rate and may have chosen a different method to reduce inflation, the fact is that the Federal Reserve Board was instrumental in breaking the inflationary spiral of the late 1970s. And for that, we are thankful. The question that we now face is what should Fed policy be today?

We find the following:

- o Today's persistent inflation in the 4.5 percent range is the remnant of earlier Fed mistakes when it greatly increased the growth in the money supply to drive down the value of the dollar.

Sustained inflation is always a monetary phenomenon, and trends in the real economy, when divorced from changes in monetary growth, have little bearing on past, present and future inflation.

Fed policy is highly discretionary. The long term goal of monetary policy should be zero inflation. Consequently, the Fed should establish both price and quantity rules in managing monetary aggregates.

Fed policy is inconsistent. While following a policy of monetary restraint at home, the Fed in 1988 has been expanding money supply internationally to hold down the value of the dollar.

The secrecy surrounding Fed policy-making and its unannounced changes in course greatly adds to instability in financial markets. The Fed should make its deliberations open so that policy changes can be anticipated, and the impact on the economy can be minimized.

High interest rate policy to slow economic growth is inappropriate policy because it interferes in credit markets, adds instability to the economy and, contrary to intent, may add to inflationary pressures.

#### FED POLICY HAS BEEN TOO TIGHT

Since the beginning of 1987, Fed policy has been relatively tight, with the exception of the short period following the stock market crash of October 1987. Since the end of April of this year, Fed policy has become increasingly tighter as it pursues restraint in the growth of bank reserves and pushes up interest rates. Growth in monetary aggregates has been well within its target ranges for M2 and M3, while M1 has grown at a 4.9 percent annual rate.

The Fed's current high interest rate policy comes as an over-reaction to the inflation that was caused by its earlier mistakes. Given the inevitable long time lag (18 to 24 months) before sudden increases in the money supply show up as inflation, today's high interest rate policy cannot affect the inflation that was baked in yesterday -- it can serve only to slow economic growth below what we could otherwise reasonably expect.

Between 1985 and the end of 1986, the Fed engineered extremely rapid money growth, while presenting the public with rhetorical statements in favor of monetary restraint. For instance, between the fall of 1985 and the spring of 1987, M1's 52-week growth rate remained consistently above 10 percent.

Under prevailing economic conditions at the time, the only policy objective consistent with this behavior by the Fed was that of influencing the foreign exchange value of the dollar. By 1985, the dollar had hit an all-time high, and many believed that a weakened dollar was the only solution to the nation's exploding trade deficit. It appears that the Fed agreed.

It is no coincidence that the dollar began retreating from its historically strong position against the yen and the mark at about the same time that the Fed stepped on the monetary accelerator. Between January 1986 and January 1987, the dollar depreciated almost 25 percent against the mark. During the same period, the two-year average growth rate of M1 almost doubled.



As an increased supply of dollars began to flood the world's currency markets, the dollar's value on foreign exchange markets declined against all major currencies. Unfortunately, the Fed seems to have overshot its mark and, by the end of 1986, began to fear that the dollar was falling too far, too fast.

While the value of the dollar was falling, prices of imports were rising. This adjustment in relative prices between imports and exports coincided with other inflationary signs beginning to show up in the economy after almost two years of intoxicating monetary growth. It was also becoming apparent that money growth could not remain at such an extraordinary level for much longer without risking a resurgence of inflation.

The Fed then appears to have slammed on the monetary brakes in an attempt to avert both a free-fall of the dollar and reignition of inflation. The Federal Reserve Board had become hoist on its own petard.

#### **INFLATION IS A MONETARY PHENOMENON**

What is apparent in reviewing both the Fed's performance and the deliberations of the Federal Open Market Committee is that the Fed is acting in a highly discretionary manner, attempting to manage the course of the U.S. economy according to its own judgment of where the economy is now and where it will be in the next several quarters. It is trying to do too much with too little

information, too crude instruments and flawed economic theory.

After 70 months of continuous economic expansion, real Gross National Product (GNP) growth continues to be strong; inflation remains stable; and unemployment is at 5.6 percent. For the first time since World War II, both inflation and unemployment have come down in tandem.

Not only is this economic expansion of record duration, but it also has achieved the highest continuous peacetime average real rate of economic growth (4 percent) during any five-year period in our nation's history. Inflation has averaged only 3.5 percent over the same five-year period. We now have a record-high percentage of our adult population at work, a record rate of new job creation concentrated in high- and middle-wage categories, a record rate of industrial output, a record rate of new business incorporations, a record rate of real per-capita personal income and the highest absolute rate of manufacturing productivity of any country in the world.

This is very good news, one might think. But in today's topsy-turvy world, all of this good news seems to be worrisome to many economic analysts and policymakers. Many people have convinced themselves that too much economic growth causes inflation and that to control inflation, the rate of economic growth must be constrained. This belief is fundamentally in error, and basing policy on it will have undesirable consequences.

This brings me to the crux of our disagreement with the Fed. The Fed has embarked on a misguided policy of pushing interest rates up, based on the erroneous belief that uncontrolled and unguided economic growth produces inflation. This fundamental theoretical error then produces expectations of inflation when such expectations should not exist. These false expectations, in turn, lead the Fed to see accelerating inflation where no acceleration exists.

To the Fed, it appears that all of the good economic news is scary. According to pronouncements by Fed members, inflation is thought to be caused by rapid growth in the real economy -- from "overheating," "bottlenecks" and "overconsumption." There appears to be little or no recognition that sustained inflation is always a monetary phenomenon and that trends in the real economy, when divorced from changes in money growth, have little bearing on past, present and future inflation.

#### PRICE STABILITY BASED ON USING RULES

The problems with day-to-day discretionary monetary policy are that it greatly alters the workings of credit markets and it is carried out in secrecy. Fed policy of this type is never well understood or enumerated. Almost all new releases of government economic indicators provoke currency traders and stock and bond

market participants to dwell heavily on the likely response of the Fed. Speculation on the timing and magnitude of Fed intervention is a major source of uncertainty in credit markets and of instability in the economy.

In the spirit of greater openness with the benefits of reducing risk and providing a more stable reaction on the part of market participants, many analysts have proposed that the Fed concentrate its efforts following established rules that are flexible enough to be changed periodically as conditions warrant.

One such rule is to establish target ranges for money supply growth, which the Fed has done, which allow for sufficient monetary growth to facilitate economic growth. Another rule is to monitor how well any given money growth is promoting price stability by developing some index of sensitive prices that gives timely, early warnings of new "inflationary pressures." The carefully selected index should have a target range as well. As long as the index falls within the known target range, no change in policy direction is necessary. If the index exceeds this range, it would be understood that the Fed would alter monetary growth policy accordingly.

Any combination of rules is not foolproof. However, rules tend to indicate clearly the intent of Fed policy. The question is desirability of the alternative -- ever-changing Fed intervention in financial markets to meet secret monetary policy shifts.

The long run goal of price stability should be zero inflation, with some tolerably small error about that target. Starting from today's approximately 4.4 percent rate of increase in prices, inflation should be brought down gradually without interfering with the process of real economic growth. This requires a clear commitment to set a long-range monetary policy that can be followed with little deviation. Every time the Fed disregards the goal of reducing long-term money supply growth, for instance, to lower the value of the dollar, inflation tends to crop up anew some 18 to 24 months later.

As we look at the performance of the economy during the postwar era, we cannot help but conclude that the Fed played an important role in exaggerating business cycles in the U.S. economy. This pattern has been especially clear since 1965. By stimulating recoveries well beyond the point where inflation becomes a problem, the Fed has been forced to adopt policies of severe stringency to reduce the inflation that it largely induced. Left to its own judgement, the Fed will persist in the roller coaster policy of ease and restraint generating new levels of inflation, and the U.S. and world economies will suffer accordingly.

With reasonably firm rules guiding Fed actions, there would be no need constantly to guess what policy the Fed is pursuing at any given time and how the Fed will react to a wide variety of economic events. In today's economy, any good news on economic growth is accompanied with more than a twinge of concern over the

reaction of the Fed. Although inflation as measured by the Consumer Price Index (CPI) has moved very little in the past 18 months, there have been continual expressions of concern over accelerating inflation by analysts and the media. Much of this speculation has been fueled by statements and actions of the Fed.

#### FED POLICY IS INCONSISTENT

There is a significant complicating factor in assessing the conduct of monetary policy this year. It is becoming more apparent that the Fed has embarked upon a policy of intervening in foreign exchange markets to manipulate the value of the dollar. In 1987, the Fed and central banks of other nations purchased dollars to try to halt periodic dollar depreciation. In the last eight months, the Fed and other central banks have sold dollars in the face of a rising dollar.

This policy is puzzling and dangerous given the Fed's concern with U.S. "external imbalances." If the Fed is attempting to maintain a small range for the value of the dollar, it may be inhibiting the one economic variable that can remove the "imbalances." Equilibrium in the balance of payments requires a freely fluctuating exchange rate.

There is a further complication with selling dollars on international markets at a time when there is pressure for the dollar to rise and the Fed is pursuing monetary tightening at home.

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Selling dollars accommodates the increased demand for dollars internationally. Yet, if these dollars are spent and invested in the United States, the Fed is contributing to an increase in the nation's money supply. It may be a Catch-22 situation. High interest rates at home make investment in U.S. securities attractive to foreign holders of dollars. They demand more dollars and the dollar rises. The Fed then supplies more dollars in order to stabilize exchange rates, which, in turn, come into the United States. This prompts the Fed to raise interest rates even more in pursuit of its tightening strategy.

In this way, a policy of tightening money supply at home is inconsistent with a policy of stabilizing exchange rates abroad. One of these policy objectives must be dropped. The Fed should stop intervening in foreign exchange markets.

#### ECONOMIC GROWTH DOES NOT CAUSE INFLATION

Inflation represents a general rise in prices or, to put it another way, a decline in the value of money. History shows that any given level of inflation can occur with a wide variety of growth rates in the economy. What is important is the difference between the amount of money growth required to keep prices stable at a given rate of economic growth, and the actual amount of new money created.

Because it seems to have so much trouble finding the right amount of money growth, the Fed appears to try to manipulate the rate of economic growth -- a truly perverse outcome. It's as if the Army Corps of Engineers determined that its surveying instruments were so imprecise and its engineering theory so flawed that it could not erect the bridge at the proper elevation or even get a drawbridge to work right. Undaunted, it attempts to lower the river.

By invoking the phrase "inflationary pressures," the Fed is saying the river is too high. The pressures to which they are referring are related to excessive economic growth, an economy operating too close to full employment, and domestic demand that is supposedly about to explode.

Today's economic growth does not threaten accelerating inflation. In testimony before Congress last month, Fed Chairman Alan Greenspan gave a litany of things related to economic growth that cause inflation. (Notable by omission was his failure to mention that inflation is always a monetary phenomenon.) Perhaps the things he mentioned were intended to assuage Congress and the American people, to show the Fed was on top of things and more than ready to be restrictive in an effort to fight inflation. But perhaps the Fed analysts believe that growth causes inflation. If they do, they are wrong.

What does the Fed emphasize as being important in gauging "inflationary pressures"? It talks about "overheating" in the



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economy stemming from economic growth, which is creating capacity constraints and tightening labor and product markets, and the threat of excessive demand, which is heating up from consumers, government, investors and foreign buyers. Among the most prominently mentioned "inflationary pressures" are the falling unemployment rate, increased capacity utilization, rising wages, rising commodity prices, droughts, higher import prices, a falling dollar and the desire for greater profits.

The notion that falling unemployment will lead to rising wages and prices, the "Phillips Curve" in economics, is a discredited theory. High rates of inflation are associated with high, low, and medium levels of unemployment. For much of the 1980s, inflation and unemployment have fallen. In the United States in 15 of the last 38 years, there have been below-average unemployment rates along with below-average inflation rates. In the other 23 years, in which unemployment was above 5.4 percent, the rate of inflation averaged 4.8 percent, considerably above the average since 1950.

Rising capacity utilization is one of the most frequently cited indicators of "inflationary pressure." In July, the utilization rate for total U.S. industry rose in July to 83.5 percent, 2 percentage points above the 1967 to 1987 average of 81.5 percent. However, supply "bottlenecks" are less of a problem today. Capacity utilization in primary processing, those industries that supply inputs to "advanced" processing, has declined since December.

The same Fed statistics also show that, due to increased investment, capacity growth has increased. The recent peak for capacity utilization was reached in 1973. To reach that same peak utilization rate by late 1989 with today's capacity growth, output growth would have to almost double -- a highly unlikely occurrence.

As to rising commodity prices and rising import prices, these are not inflationary. They represent relative price changes due to supply and demand conditions for the goods in question. Increases in certain prices cause a reallocation of demand toward goods that become relatively cheaper. There are ample substitute suppliers for imported goods and most commodities, which make reallocation a simple, normal part of everyday business activity.

Even profit-seeking businesses cannot add to inflation. As much as they would like to raise prices and add to their profits, they cannot, unless demand is strong enough and competitors go along. If one seller raises prices, the others may not follow suit for the simple reason that they become more competitive relative to the seller who raises prices. Their incentive is to undercut the price rises unless demand is sufficient enough that they can sell all they want at the higher price.

No business can, therefore, raise its prices just because its costs go up. Whether wages rise or prices of other inputs into production rise, businesses can only profitably raise prices they charge if competitors also raise prices. The rise in competitiveness in the U.S. economy has been a major factor inhibit-

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ing inflation, and there is no evidence that competitive pressures are slowing down. Indeed, the competition is more intense due to the larger amounts of output that must be sold every day.

As to fears of rising and "excessive" demand, there is no evidence that consumption spending is out of control. Since 1980, consumption growth has been just under the increase in overall GNP growth. The latest numbers show that consumption is growing more than a full percentage point below GNP growth. During the past year, real GNP grew by 4.3 percent, and consumption grew by only 2.4 percent. Foreign demand for U.S. exports, however, has increased. Yet, current governmental statistical releases indicate that retail sales and other indications of consumer spending are rising less than production.

The problem with raising interest rates is that it attacks the supply-side of the economy first by lowering investment and, hence, production. Households or consumers, however, will experience a rise in disposable income from rising interest rates. Households are net creditors and rising interest rates increase their income. Thus, the Fed has unwittingly chosen a sure path to reducing economic growth and placing more pressure on prices to rise. Households that are not net creditors, mainly lower-income workers, will not experience rising incomes. If Fed policy retards economic growth, this will cut back the growth in low-income jobs.

**IS INFLATION ACCELERATING?**

There is no clear trend in reported price statistics. Some government statistics on indexes reported recent rises. However, most indexes, including the CPI and the GNP deflators, have risen less in the past year than in the previous year. For example, the rate of increase in the CPI had been falling from the second quarter of 1987 through the first quarter of 1988. That served to bring the year-over-year rate of inflation down from 4.5 percent in August 1987 to 3.9 percent in February 1988. The July 1988 CPI has risen to a 4.1 percent rate of inflation over July 1987, a lower rate of increase than the economy experienced one year ago.

There are other indicators of inflation that are pointing to less inflation. Commodity prices, which are considered an early warning of higher prices generally, have stopped increasing at 10 percent rates. In the last two months, commodity price indexes increased by only about 4 percent.

Another indicator of inflation is the value of the dollar, which has been signalling disinflation pressures for most of 1988. A final indicator, the interest rate yield curve, is also showing that inflation is not accelerating. The difference between short-term and long-term interest rates is considered to be an indication of how much inflation expectations are built into interest rates. A small difference (a flat yield curve) indicates a lack of concern over accelerating inflation. For most of 1988, the yield curve has

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become flatter, as short-term interest rates have risen and long-term rates have risen to a lesser degree.

#### CONCLUSION

Part of the public debate over appropriate monetary policy has focused on the noninflationary growth potential of the American economy. Recent U.S. real economic growth is above the postwar average, and this causes concern for many.

There are many elements to the debate, but few answers. It is conceivable that growth potential is a great deal higher than the approximately 2.5 percent real growth that the Fed assumes in its policy deliberations. Macroeconomic theory sheds little light on growth potential. But reality does. Currently, the labor force is growing by 1.5 percent; labor productivity is up by 1.4 percent annually; and industrial capacity is growing at about 2.5 percent. When these elements of overall economic growth are added, they give an estimate of total potential growth in GNP of over 5 percent.

Whether this method is accurate to a decimal point is not the issue. The point is that the Fed may be severely underestimating potential GNP growth. How it makes these estimates and how these estimates affect policy should be of vital interest to Americans. Therefore, we suggest that Congress consider a first step in opening the Fed policymaking procedures by requiring it to publish its Federal Open Market Committee minutes within 48 hours of

completion of its meetings.

In summary, we believe that it is not economic growth that is causing inflation or making inflation more of a threat to the U.S. economy. Today's inflation is the remnant of earlier Fed mistakes. We have shown that the evidence of accelerating inflation is unconvincing, and argued that the theory underlying the belief that growth is inflationary is flawed.

Unfortunately, Congress cannot instruct the Fed to use proper economic reasoning. But in current and future hearings held by the Committee, the debate over how to view the economy should be expanded and improved.

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**U.S. House of Representatives**  
 SUBCOMMITTEE ON DOMESTIC MONETARY POLICY  
 OF THE  
 COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS  
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July 12, 1988

I am pleased to invite you to appear before this Subcommittee and present your views on the current state of the economy. The Subcommittee is particularly concerned with the potential problem of inflationary pressures stemming from the current economic expansion. Though you may structure your testimony as you wish, you may find the following questions a useful guide:

(1) Many analysts are surprised at the continuing robust expansion of the economy, in light of the persistence of large budgetary and external imbalances, major swings in exchange rates and the unprecedented shock of last year's collapse of the stock market. To what do you attribute the current strength of the economy? Is our current growth rate more or less sustainable without major shifts in economic policy?

(2) Beginning with the recovery of 1983 the current expansion has combined strong real growth with declining and then stable inflation. Can this fortunate pattern persist? Do you see evidence, from your vantage point, of serious inflationary pressures building up in our economy?

(3) Many observers view the Fed as applying modest restraint very gradually and cautiously, in an attempt to calm inflationary expectations without retarding real growth. Is this an accurate reading of current monetary policy? Given your assessment of the threat of inflation, is the current stance of monetary policy appropriate?

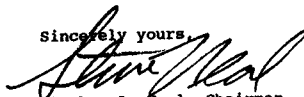
(4) Are there particular economic developments which should weigh heavily on the current conduct of monetary policy? For example, some economists think we will need further dollar depreciation, yet the dollar has been surprisingly strong on the foreign exchange markets. Is this a cause for concern, indicating that monetary policy might now be too tight? Or is it a welcome development, one that will help keep inflationary expectations in check and interest rates at lower levels than otherwise possible?

(5) To mention other examples, do the current drought conditions affecting the agricultural sector, or the emerging heavy losses among thrift institutions, pose particular problems that should influence the conduct of monetary policy?

(6) On a more general level, considering macroeconomic policy as a whole -- spending, taxing, monetary policy, exchange-rate management -- what significant policy changes, if any, do you see necessary, in the next Administration, in order to continue reasonable and sustainable economic growth, without generating serious inflation?

Please regard these questions as a catalogue of the issues of concern to the Subcommittee, and feel free to pick from them the ones you deem most appropriate for the focus of your testimony.

Sincerely yours,



Stephen L. Neal, Chairman  
 Subcommittee on Domestic Monetary Policy