

CONDUCT OF MONETARY POLICY

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

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND
URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

—————
FEBRUARY 5, 7 and 21, 1991
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Printed for the use of the Committee on Banking, Finance and Urban Affairs

Serial No. 102-3



U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 1991

38-800

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

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OVERALL STATE OF THE ECONOMY

Tuesday, February 5, 1991

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

The subcommittee met, pursuant to call, at 10:15 a.m. in room 2128, Rayburn House Office Building, Hon. Stephen C. Neal [chairman of the subcommittee] presiding.

Present: Chairman Neal, Representatives Barnard, Ackerman, Roth, Duncan, and Campbell.

Chairman NEAL. I would like to call the subcommittee to order at this time.

This morning we begin hearings on monetary policy and the state of the economy. Today's witness will be the Assistant Secretary of the Treasury for Economic Policy. Thursday we will hear from a panel of private economic analysts and forecasters. This testimony should help us evaluate the Federal Reserve Semiannual Monetary Policy Report to Congress which Chairman Greenspan will present to this subcommittee on Thursday, February 21.

It is often the custom for Members of Congress to use their opening statements to advance their own advice and conclusions concerning policy. I want to resist that temptation at this time. We should use these hearings to learn what we can about the current state of the economy and the stance of monetary policy and then jump to conclusions. I would like to review a few of the questions which should guide our inquiry.

The most basic is so simple it is often overlooked. What is the cause of the current recession? Was it inevitable in the sense that our economy naturally produces these cycles with only the timing uncertain, or was it caused by identifiable policy mistakes? If so, what were they?

The second question we should try to answer concerns the nature of this recession. Is it more or less like past recessions or is it somehow unique, novel, different? If so, how and if so do its special characteristics call for special policy responses?

The third question concerns monetary policy: Should it be used to revive the economy as quickly as possible? Can it even be effective in light of the so-called credit crunch? What, in fact, is a credit crunch? Have we been experiencing one? If so, what data support that interpretation, and if so, what is the proper policy response?

A related issue concerning monetary policy is a bit technical, but may well lie at the heart of our problem. The Fed has been portrayed as easing for some time now because it has been lowering

the Fed funds rate and the discount rate, but does this accurately measure what we mean by easing? Monetary growth, though within the Fed's target ranges, has been decelerating rather consistently throughout the year. The Fed has apparently become concerned about weak monetary growth. This suggests that contrary to the appearance of easing fostered by a fixation on the Federal funds rate, policy may well have been tightening all along, though inadvertently. It is simply not true that a lowering of the Fed funds rate necessarily represents an easing of policy. If in the face of mounting economic weakness the Fed has concentrated on keeping money growth at or above the mid point of its target range, accepting whatever Fed Funds rate that would require, it is quite conceivable that the current downturn would have been significantly mitigated or forestalled altogether.

Finally, whatever the cause and possible policy errors that underlie the recession, we should not overlook the possible longer range benefits. I refer to the possibility that we could come out of this recession with a much lower range for inflation, in fact a rate of inflation within striking distance of what we call zero inflation or price stability.

In considering its response to the current state of the economy, the Fed should be careful not to sacrifice the gains we may soon be reaching in terms of lower inflation. If that temptation is resisted, if we come out of this recession with inflation tolerably close to zero, the only serious argument lodged against our proposal to mandate a zero inflation objective for monetary policy would disappear.

That argument was simply that the transitional cost of moving to see zero inflation would be too high. Once those costs have been paid, however, no reason would remain for not looking in a permanent commitment to stable prices or zero inflation.

Our witness today is the Honorable Sidney L. Jones, Assistant Secretary for Economic Policy at the Department of the Treasury. Before recognizing Mr. Jones, I would like to yield to our distinguished ranking minority Member, Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman. I want you to know how excited I am about serving on this subcommittee and serving as the ranking Member on this subcommittee. It is one of the most important subcommittees we have, especially in this session of Congress. I agree with you that opening statements should be concise, but Members do have strong opinions, and rightly so, otherwise, Mr. Chairman, they probably wouldn't serve on this subcommittee. I notice from the roster on your side and on our side we have, I think, some of the most active Members in the Congress dealing with issues related to the economy. I am very pleased on our side to have Mr. Duncan, and Mr. Campbell, two of our brightest Members serving on this subcommittee with us.

I am also impressed with the Members that you have on your side on this subcommittee also.

I join you today in welcoming Assistant Secretary Jones. It is safe to say that our economy is now subject to an unprecedented set of pressures, both here at home and worldwide.

Domestically the engine of our economy is laboring against the combined effects of a diminished consumer confidence, high levels

of personal and corporate debt, weakness in the financial sector, and a Federal budget that is still out of control.

Internationally we are encountering tougher obstacles in our exports, some imposed by our supposed allies, and we have conflicting monetary policy, such as Germany's actions just last week and, of course, the war. When you add up all these pressures, a major question becomes: Can we rely on monetary changes to effectively stimulate growth?

Put more plainly, my question is, when everyone is up to their eyeballs in debt, will lower interest rates and more credit really strengthen the economy? And yet, while we are here in Washington examining these questions, the American economy is working. The downturn has been mild, and the prognosis is good. It is useful to remember that mind-set is an important influence on economic activity, whether in business, a household, or here in Washington.

Several days ago, I met with a group of owners in Appleton, WI. I was struck by their optimism. In the face of all the economic news they are out every day building their businesses and creating jobs. I think one part of government strategy must be to help people like those business owners in Appleton to maintain a good, positive image of the future because trust and confidence is vitally important in steering ourselves through the difficult times.

Thank you, Mr. Chairman.

Chairman NEAL. Thank you, sir, Mr. Roth.

Mr. Barnard. Are there any other opening statements?

Mr. Duncan.

Mr. DUNCAN. Mr. Chairman, I will just say that I am pleased to be here. It is an honor for me to serve on this committee and this important subcommittee, and I appreciate the kind remarks of Mr. Roth, and I will save my comments for the questions that I have.

Thank you very much.

Chairman NEAL. Thank you, sir.

Mr. Ackerman.

Mr. ACKERMAN. Thank you, Mr. Chairman.

I will take your advice about not offering any at this time.

Chairman NEAL. Well, thank you, sir.

I certainly want to welcome all of you to the subcommittee. Mr. Jones, I thank you for being with us this morning, and we will put your entire statement in the record without objection, and please feel free to summarize as you will.

**STATEMENT OF SIDNEY L. JONES, ASSISTANT SECRETARY FOR
ECONOMIC POLICY, DEPARTMENT OF THE TREASURY**

Mr. JONES. Thank you, Mr. Chairman and members of the subcommittee.

I am pleased to be with you to discuss the economic situation. As you indicate, I have written a brief statement, which I would like put in the record, and with your permission, I would like to go directly to some charts and tables which the Treasury has prepared.

We have about 120 charts and tables we use to track the economy. We have put these on personal computers for the use of government officials. We have found them to be very successful, and we believe it is a good summary of the economy.

With your permission, then, perhaps I could cover just a few of these charts and tables and then reserve the time for your questions that you would desire.

Chairman NEAL. Absolutely.

Without objection, we will put your entire statement in the record, and we have copies of those charts, and we will follow along with you.

Mr. JONES. If you would join with me on page 5 of the charts, we have the economic forecasts, which have been prepared.

Yesterday, we announced the Troika, or the administration, forecast in which we anticipate moderate growth in 1991 of 0.9 percent. You will notice by the yellow bar that the Congressional Budget Office has a slightly more optimistic forecast of 1.3 percent, and the Blue Chip forecast, which is a consensus of 52 private forecasters, in their January forecast have exactly the same figure as the Troika administration forecast of 0.9 percent.

You will notice that in 1991 we expect a moderate snapback in the economy; that it will grow about 3.6 percent in 1992. Typically, when you have an economic expansion begin during the postwar period, during that first 12 months of expansion the economy normally would grow about 6 or 6½ percent during the first 12 months. So the Troika, I believe, is being relatively modest in calling for a growth rate of about one-half of that in 1992.

Mr. BARNARD. Mr. Jones, who is the Troika again?

Mr. JONES. It is Treasury, Council of Economic Advisors and the Office of Management and Budget. When I say Troika, that is basically the administration forecast, the one that was announced yesterday in the budget.

Mr. BARNARD. Treasury, the Council of Economic Advisors and—

Mr. JONES. Office of Management and Budget.

Chairman NEAL. These are the assumptions that are used in the overall budget?

Mr. JONES. Yes, sir. For inflation, we are slightly more pessimistic than both the private sector and the Congressional Budget Office. We anticipate inflation of about 4.5 percent in 1991, and about 4.3 percent in 1992. I would like you, if you would, on just this one occasion to go back to my testimony.

I make only one reference to my written testimony, but on page 8 we show the quarterly pattern. What is striking about this is that all of the forecasters, both the Congressional Budget Office, the private forecasters, the Blue Chip people, and a very representative group of major econometric models, DRI, Larry Myer Associates, the Wharton Model, they all have pretty much the same quarterly rate.

That is significant because there is general agreement that the recession, that evidently began perhaps in September and October, will be a relatively mild one by historical standards, and according to over 70 percent of the private forecasters, it will be over by June 1991. So that is a partial answer to one of your questions.

We do not see anything that seems to be accumulating here. This seems to be following a relatively typical pattern. Going on then, on page 6, and I will speed up considerably, on page 6 we see the real growth pattern for 1990. Here you see a very sluggish period

of growth, and here again is a partial answer to one of your questions.

From the beginning of 1989 until the third quarter of 1990 we did have growth, but it averaged only 1.2 percent at an annual rate. You will notice in that small window in the left-hand part of the chart typically the economy grows more rapidly than that. During the last 20 years, it has grown at about a 2.7 percent annual growth rate. So the 1.2 percent annual growth rate of early 1989 until the third quarter of 1990 was a very sluggish pattern.

Very tentative and very preliminary estimates of the fourth quarter results indicate a 2.1 percent annual rate of decline during the fourth quarter. That figure, combined with the previous 9 months for the entire year, gives you an 0.3 percent growth rate for all of 1990.

Again, the Troika forecast was slightly more pessimistic than that. We thought the fourth quarter would go down at an annual rate of about 3.4 percent; that would result in zero growth for all of 1990. Again, this figure will be revised many times, and we may turn out to be right or the original figure may hold up.

On page 7 we show our forecast for 1991, the administration Troika forecast relative to other major forecasts. You see the great similarity of estimates for 1991. You see considerable similarity in 1991 with the Blue Chip consensus view, the Congressional Budget Office, the administration, and most of the major econometric models all anticipating about 1 percent growth rate.

All of the forecasts anticipate growth in 1992, but once again a relatively modest snap back. On page 8 we show the inflation rates on a similar comparison, and as indicated earlier, we are slightly more pessimistic than other people. Page 9 shows the OECD estimates, (the 23 industrial nations located in Paris). Based on their measurements, the U.S. economy is expected to grow about 1 percent, consistent with the others, and the inflation rate on page 10 will be in the 5 percent zone, slightly higher than our own forecasts.

Finally, on page 11 we show our outyear forecasts. As you can see, for the real GNP, the figure that is paid the most attention to, we have a sluggish growth estimate for 1991 as the expansion begins by mid year, followed by a modest snap back in 1992, and then the economy gradually returns to its underlying growth capability of about 3 percent, which is fairly typical of the long-term.

We show inflation continuing to moderate, to an annual 3.3 percent, which does not match the goal that you began your statements with. We see the total unemployment rate peaking this particular year and then slowly going back to the 5 percent zone that has been typical.

We see unemployment coming back down and we see interest rates moderating very slowly. Well, those are our forecasts, and if you will permit me, I would like to go through very quickly a few more charts and tables summarizing where we are at the moment.

On page 13, we show the real GNP growth over a period of years. You notice the stagnation period of 1978 to 1982, then the record peacetime expansion for almost 8 years. That expansion probably ended early in the fourth quarter, perhaps in October.

On page 14 we see perhaps the most important screen that we have in our group. This chart summarizes the growth of real personal disposable income, and that, in turn, has a major impact on real consumer spending. Real consumer spending represents two-thirds of the gross national product, so obviously personal disposable income is a crucial variable in the economy.

It is significant, perhaps a major explanation of the economic downturn, that real disposable personal income turned negative for 1990. In the fourth quarter this figure went down at a 3.5 percent annual rate. As a result, personal consumption, again two-thirds of the economy, also had very modest growth in 1990 and in the fourth quarter turned out to be negative.

On page 15 we show retail sales. This category makes up about half of the total personal consumption figure. Retail sales have been flat, in real terms, for about 3 years, suggesting weakness in the automobile sector, furnishings for households, appliances, and other consumer goods. In chart 16, we show the personal saving rate, which is at a relatively low rate compared with history.

I would like to pause for a moment on page 17 because this chart also ties into one of your beginning questions. With regard to confidence, you will notice there are two measures of consumer confidence. These are psychological or qualitative questions, both of which have been relatively strong during the record peacetime expansion beginning at the end of 1982 and down until early in 1990.

You will then notice, beginning in mid 1990, a remarkable deterioration in consumer confidence. Indeed, the Conference Board measure, the blue line, has dropped 50 percent since January—since the beginning of the year 1990. We believe that is directly related to the oil shock and the war shock that occurred last summer, and growing concerns about financial institutions and growing concerns about prospects for the Federal budget deficit.

In passing, I might comment that when oil shocks have occurred in the past, for example in 1973 to 1974, when oil prices approximately doubled during that period, consumer sentiment dropped by 11 percent. The same thing happened in 1979–1980, when oil prices again doubled; consumer confidence dropped again by 11 percent.

This time, oil prices briefly doubled from \$16 to \$34; consumer confidence has dropped 40 to 50 percent, obviously a very remarkable development.

On page 18, we show housing starts which have been in decline for a considerable period of time. This trend reflects the demographic patterns, particularly in the multi-unit dwellings shown on the bottom of the chart. On chart 19 we show business fixed investment. This is about 10 percent of the economy. This is a very important sector, which has held up relatively well in 1990. But the surveys, the most recent one taken in October–November, point to very modest, if any, growth in business investment during 1991.

On page 20 we show real construction activity measured this time in dollars. The earlier housing starts were in units. On the blue line at the top you will see the sectoral decline of housing, dramatically affected by interest rates and consumer confidence in 1990.

The red line at the bottom is extremely important. That is largely State and local government spending for public construction. As

you can see that has held up rather well despite the deficits in State and local government budgets. The green line is business investment in plants, which has been flat for many years, and in the last few months has turned down a little bit.

Page 21 shows one of the stronger parts of the economy, the merchandise trade deficit. This is the census figure, the monthly figure. You will notice a record level deficit in 1987. At that time exports began to improve dramatically, imports began to moderate. Since then we have reduced the trade deficit to the current annualized rate of about \$104 billion during the first 11 months of 1990.

Even more progress had been made prior to the oil shock when the increase in prices began to drive the monthly figures higher. On page 22 we show the figure that goes into the gross national product, the so-called net export figure. This is a combination of the merchandise trade figure, income flows from dividends, interest, and earnings from foreign investments, and services.

America is a surplus country in services and becoming more so as tourism increases. Our business services also have increased. Page 23 shows the trade weighted exchange rate of the dollar. One of the explanations for our improving trade position has been the moderation of the dollar.

Page 24 shows the monetary aggregates, a question of great importance to your committee. You will notice that the M2 measure, after tracking its targets fairly well early in 1990 and in the spring and early summer, has decelerated and is currently running near the bottom of its target zone.

M3, which reflects the withdrawal of savings from savings and loans, actually has broken through the bottom of the target cone. Page 25 shows selected interest rates. We had a spike of interest rates in mid year, partly reflecting the rise in German and Japanese interest rates, partly reflecting the shock of the oil and war prospects, but since the late summer, interest rates have declined. That is one of the variables we look to for strength in the economy.

Page 26 is a very important chart which shows changes in establishment employment. This is the payroll survey that is taken each month. You will notice that it has been in steady decline, providing very early signals of a slowing economy beginning as early as 1989, and certainly by the fourth quarter of 1990. Payroll employment declined by about 600,000 jobs during the fourth quarter.

We lost another 200,000 jobs in January. So we have lost close to 800,000 payroll jobs during the last four months. Page 27 shows consumer prices. The blue line is the total Consumer Price Index. You will notice that measure broke in 1986 when oil prices collapsed. There have been occasional flurries of price increases such as following the drought of 1988, the freeze of December 1989, and following the Iraq-invasion-of-Kuwait oil shock, but other than that the inflation rate, what economists call the core rate, has been relatively stable at 4.4 percent during most of the 1980's. It did rise in 1990 briefly, but seems now to be returning to its more normal level.

Chairman NEAL. This is the Consumer Price Index?

Mr. JONES. Yes, sir.

Finally, on page 29, we summarize changes in producer prices. You can see, even more dramatically, the effects of the oil shock.

On page 29 the crude materials price measure, the green line, prior to the Kuwait invasion, had been basically brought under control. Most crude prices were coming down measured year over year.

Then the oil shock that occurred in early August exploded energy prices by 34 percent, causing that green line to rise very precipitously. Now that oil prices have come back down from the \$30 plus zone back into the \$20 to \$22, \$23 zone, those crude prices have reversed themselves and are rapidly moving back toward neutral.

The red line indicates changes in intermediate producer prices, such as textiles, flour, rolled steel, something in the intermediate stage. Prior to the oil shock intermediate prices were not rising at all. The blue line represents price changes of finished goods, such as shirts, or refrigerators, or bread, products actually ready for sale. Finished goods prices were about 3 percent rate above the level 12 months earlier. We are hopeful that finished goods prices will return to their more favorable behavior that we saw earlier in the year.

I believe this review has probably taken enough of your time. I would be glad to answer questions on the charts or tables at your discretion.

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

Chairman NEAL. Thank you, sir, very much.

I find your presentation fascinating and useful, and we will be spending some more time with it as time goes along. I am curious about a couple of things before we really get into the monetary policy questions. Mr. Darman has said a couple of times that the war has had a significant impact on inflation.

I noticed on television—I think it was this morning he was asked to explain the current recess. He mentioned the war. Do you understand that to be a major cause of the recession? If so, how would you explain that?

Mr. JONES. Well, if you go back to page 27, which is the Consumer Price Index, Mr. Darman's comment does have some validity to it. You can see a very sharp run up in that blue line, which is the total Consumer Price Index, and that begins about the middle of 1990 and is certainly related to the explosion of oil prices.

Oil prices in July were about \$16 a barrel. In fact, if you would like to go back to page 66, you can see the oil prices there on page 66.

Chairman NEAL. So, in other words, what he is talking about is the impact of energy prices on the economy.

Mr. JONES. That would have had a very major impact, not the total impact, but a very major impact on the acceleration of inflation which we now think is somewhat unwinding.

Chairman NEAL. Is there something else or would that be what he is talking about?

Mr. JONES. Well, there is also—if you look on page 30, I am sorry to keep bouncing around, but I think it is useful to see the charts. If you look on page 30 you will notice the behavior of wages and salaries (the blue line) and of total compensation, which includes fringe benefits. You will notice that there was a small upward drift from the low point of about a 3½ percent wage and salary in-

creases during the mid 1980's. By 1989, that red line had flattened out again.

There was a little flurry of increases of wages and salaries somewhat linked to the increase in the minimum wage law that occurred in 1990. Also, food prices increased somewhat during that period, but I would say most of the what we consider to be temporary surge of inflation, which took it out of the 4 to 4½ percent zone up temporarily to 7 and 8 percent that we saw in the late summer and early fall. That surge would be largely attributed to the oil shock.

Chairman NEAL. The main focus of our series of hearings is on monetary policy. As you know, the administration has commented several times on monetary policy. Usually representatives of the administration have suggested that the Fed should have been, and I think now should be somewhat looser in its monetary policy. Would you agree with that? Is that official administration position? And, if so, what precisely do you all mean by that?

Mr. JONES. I think Secretary Brady, over the past months, has expressed his view, both to Chairman Greenspan in their weekly meetings they conduct and also on occasion in his public speeches, that we felt at the Treasury that of the difficult compromise between the various goals of economics—one stable inflation, the other maintaining growth—that we at the Treasury felt that there was room for—I think the Secretary has used the term “ample” room—to reduce interest rates. As recently as yesterday he repeated that statement, that there is ample room for interest rates to come down, and he expressed agreement in his press conference yesterday with the reduction of the Federal funds rate, the most significant one, which is the most obvious one, and also referred to the monetary aggregates.

As we indicated on page 11 in passing, chart 11, it is on page 24, as we indicated in passing earlier, the monetary aggregates have been in the bottom part of their target cone for several months now. So it is my understanding of Secretary Brady's comments that he has agreed with, welcomed, and encouraged the reduction of interest rates. And at the present time he agrees with Chairman Greenspan, who, I believe, in the last few weeks has commented about—has referenced—his concern about the very modest growth of the monetary aggregates.

I believe Secretary Brady would support the view that we would like to see the monetary aggregates more in the middle of their cones. If you will look on page 44, you can see what their targets have been. This was Chairman Greenspan's earlier Humphrey Hawkins testimony, which you will be hearing later in the month. You will notice that for the M2 category on page 44, they had called for growth of 3 percent to 7 percent. During the last year it has grown at 3.7 percent, barely into their targets.

For 1991 they have called for growth of M2 of 2.5 to 6.5 percent, and they are beginning the year, at least, near the bottom of that target. If you will look at page 47, you will see the actual growth of the money supply aggregates, and you will notice, this table is a little hard to read, but you will notice about in the middle of the page where it says 3 months ending in December, that during the

last 3 months of 1990 the M2 grew at an annualized rate of only one-tenth of 1 percent.

Chairman Greenspan has emphasized that he is concerned about the growth of the monetary aggregates. He has stated that he is going to pay more attention to the monetary aggregates, and we at Treasury would support that particular orientation.

Chairman NEAL. Well, I do, too. You know, we finished the year with, according to the Consumer Price Index, about a 6 percent rate of inflation.

Mr. JONES. Six point one for 1990.

Chairman NEAL. Is that acceptable?

Mr. JONES. No, and we don't think it is prospective, either. We anticipate the inflation rate this year coming down to about 4.5 percent, and we anticipate it coming down further in the outyears into the 3 percent zone.

Chairman NEAL. I have been told that my time has expired. We are going to try to stick pretty closely to the 5-minute rule here so everyone will have adequate opportunity, and we will come back to some of these questions.

Thank you, sir. Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman.

Mr. Jones, in the past downturns we have relied on lower interest rates and looser credit to stimulate the economy. In essence, that strategy depends on borrowing, but today's businesses and families are carrying unprecedented levels of debt. The Government's own figures show that corporate debt, in particular, is nearly half of its total capital.

In these circumstances, won't more borrowing merely aggravate the problem in the long run?

Mr. JONES. I think that basically what we have is you have to break the aggregate figures down into specific company or specific family or specific government situations. There are certainly examples during the 1990's that have considerable abuses, references to the junk bond industry in some cases.

For a company with that kind of debt in their structure to borrow further would, of course, be very unwise. For the aggregate of our American companies, however, who do have good growth prospects, who have very minimal inventories at the moment, which is one of the major reasons for our guarded optimism about the economy, there is room for the traditional working capital borrowing for inventory replenishment, which would simply buy the inventory to be held for a relatively brief period of time and then sold. This is the traditional role of the commercial banking system. That would be desirable.

We would not expect to see an extensive growth of borrowing among those who loaded up during the 1980's.

Mr. ROTH. But isn't it true that our business and families are carrying unprecedented levels of debt today?

Mr. JONES. Consumers do have, relative to their income flows, 18, 19 percent debt service charges as part of their income, and that is at an historically high level. It has been at that level since about the mid 1980's and has drifted down slightly during this period of concern during 1989 and 1990. And basically, the consumers are going to pick up their savings rate, as we discussed earlier. The

consumer has been making relatively modest use of consumer credit during the last year, much of that reflecting the downturn in automobile sales. So I agree with your basic proposition that debt has been widely used, but in the case of the consumer they are beginning to make some correction, and in the case of many of our business firms that is true also.

Mr. ROTH. Well, I am trying to get at the facts here. On your chart 16, you show personal savings, which is often cited as a major weakness of our competitive position internationally, and as you point out on chart 16, personal savings are still far below the last four decades.

Mr. JONES. This is correct. In fact, in 1987 they reached a 50-year low, 2.9.

Mr. ROTH. That brings me back to my earlier contention. I want to see this economy grow and grow strong. After all, I am a Republican, but I am just looking at the facts as they are here.

It seems to me that loosening up more credit and stimulating more borrowing, with today's debt levels is like giving a drunk another drink. Maybe I am missing something here.

Mr. JONES. No, I don't believe anyone would advocate a windfall or a massive expansion. What we are concerned about is that the banks continue their traditional policy of making good loans to good customers for their working capital purposes, but that is in the immediate time frame. And in a longer time frame, I believe that the saving investment imbalance, the lack of national savings, is possibly our number one economic problem.

Mr. ROTH. In the remaining couple minutes I have, let me just ask you, how would you stimulate more savings then? Would we go with the IRAs, capital gains cut, what are we going to do?

Mr. JONES. Well, again, I hate to jump around so much, but if you would look at page 82, I think we have a very dramatic chart.

Mr. ROTH. In that case I want to take a look at it.

Mr. JONES. This is our U.S. gross national saving ratio. You will notice that for approximately one hundred years, with the exception of the Great Depression and the Second World War, that the gross national saving rate averaged about 16½ percent of the gross national product.

That figure is about one-half of the Japanese rate or about two-thirds of the European rate. If you will jump over to page 84, you will see that the personal savings rate during, again, an extended period of time did ratchet down during the 1980's. Much of that change reflects demographic trends. We have had 80 million baby-boomers, that is one out of every three Americans alive, in the 25- to 40-year age bracket, and that tends to be a spending period of time.

But the real answer, I believe, is on page 85. Here we see the explosion of the Federal budget deficit, from a typical deficit of about 1¼ percent of the gross national product, into the 4 and 5 percent zone. The result, shown on page 86, has been an extraordinary amount of Federal borrowing.

This is a familiar story from your other committee work. Finally, as to your question of what accounts for that decline in national savings? Well, if you read along the lines here on page 87, there was a small erosion in personal savings, again somewhat demo-

graphic, and we do hope that the baby-boom generation will begin to save more. Business savings remained about the same.

The overwhelming explanation for the reduction in the gross national savings available for gross national investment was the enlargement of the Federal budget deficit. So the number one thing to do to improve the gross national savings rate is to reduce the Federal budget deficit.

Now, in addition to that, the administration, once again, this year, has put forward proposals which we believe would be helpful, including the capital gains tax rate proviso, the family savings account, making IRA accounts somewhat more attractive by allowing first-time home buyers to withdraw savings without a penalty. But the overwhelming factor in improving the gross national saving rate will be the prospective reduction in the Federal budget deficit.

Mr. ROTH. Well, Mr. Jones, I want to tell you something. You are very articulate and very well-reasoned, but it doesn't seem to add up to me. When it comes to savings, we want our people to save more, right?

Mr. JONES. We would like them to go back into their traditional zone. If they saved a lot more at the moment, it would make the consumption sector even more difficult for us, but we would like to return to an average saving rate.

Mr. ROTH. That is my entire argument. First of all, we say we want people to save more. On the other hand, we have Chairman Greenspan, Secretary Brady and others saying, we have to loosen up credit, to get out of the recession. We are chasing our tail in a way, aren't we?

Mr. JONES. I believe if you look at page 14, this is possibly the most significant thing I could say today.

Mr. ROTH. I know one thing, the next time I run for office I am getting one of these charts, and when some guy says something, I will say turn to page 14.

Mr. JONES. If you look at page 14, I believe, there has been a fundamental change in the U.S. economy. You can see very clearly the slowing down of U.S. personal consumption, which was driving the economy in the early and mid 1980's. I believe that trend will be typical of the 1990's in which you will have less personal consumption and America will become more of an exporting nation.

We are already the world's largest exporter, but exports, and investment to produce those exports, will be more of the driving force in the economy. So I think that when we say save more, we don't mean save everything or really cut back. What we do mean is go back to your more traditional zone of 6 to 6½ percent personal savings rate.

Personal savings total about \$200 billion. Again, the crucial variable is reducing the Federal budget deficit.

Mr. ROTH. So what you are really telling me is, go back to the Foreign Affairs Committee and make sure we have more exports?

Mr. JONES. You won't get more exports until we get the deficit in alignment so you don't have to pay for it with the exports.

Mr. ROTH. Thank you.

Chairman NEAL. Mr. Barnard.

Mr. BARNARD. Mr. Jones, I have heard some questions raised as to how we are really measuring inflation today. We are putting a

lot of attention to the CPI, but yet we have an inventory of just a tremendous amount of real estate that is in the RTC and the banks that have lost so much in value, and as a result we are not—I haven't seen where we are measuring the loss of that value in our economy, which would in turn bolster the Troika's feeling that there could be a further lowering of interest rates without affecting inflation.

We really have more deflation today. We have less inflation today than even the CPI would indicate because of the fact is we have such a downturn in values in the marketplace. Can you explain to me, if we are taking into consideration the value of real estate and if not, why not?

Mr. JONES. The consumer price index includes relative weights of about 20 percent in the food sector, about 9 percent is in the energy sector, and about 40 percent of it is in the housing sector, and that is divided up into fuels or services, repairs, but much of it is, and this is technical—we try to impute the rental value of the home. If you are living in a home, we try to impute what would you have to pay to rent that house. And it is certainly true until about October or November that there was an apparent anomaly between walking around the block and seeing homes for sale that you knew were not getting the prices that they had posted 6 months earlier, or a year earlier, and the consumer price index, which continued to show that housing sector continuing to rise.

I have asked my staff to investigate that several times. I would be glad to send you the results of our analysis.

By October or November, the change finally began to show up. The housing sector now is rising at an annual rate of only about a tenth of 1 percent. So your analysis is correct, that the housing sector is a crucial variable in the consumer price index and that the dampening down of home values resulting in, say, the last 18 months is finally beginning to show up in the index, but there was an anomaly up until about October.

Mr. BARNARD. If we had a further reduction in interest rates, how would that reflect in government borrowing and why wouldn't it be possible that that government borrowing, the reduction in the cost of that government borrowing, instead of being passed on to Federal spending and help reduce the 281 projected deficit for 1992, why couldn't that be given toward reducing taxes on interest on savings?

Mr. JONES. The net interest payments in 1992 will be about \$206 billion. With a \$3.2 trillion national debt, a 1 percent rundown of interest rates would save us about \$30 billion of interest payments, and that would be a major contribution to lowering overall government outlays.

The difficulty is the lowering interesting rates should reflect market conditions. The market conditions have come down, and as we have seen in the charts on page 25, you can see the interest rates have run down a considerable amount during the last—since the summer highs.

The Treasury would like to see lower interest rates. I think everyone would. It is just a matter of would it reflect sound policy, avoid the windfall or the overheating of the economy that 9 months from now or 15 months from now you simply then paid

with more inflation, which you had paid a very painful cost to reduce.

Yes, we would like to see lower interest rates. Yes, it would have a significant benefit on government outlays, 1 percent, about \$30 billion, but it has to be balanced carefully.

Mr. BARNARD. What is the Treasury doing to support what Mr. Roth is talking about? What are we doing to stimulate individual savings? I mean, we have really—we have had policies, and I am including Congress in this. Our policies have all been toward making it less attractive to save because in recent years we have eliminated the tax deductibility of interest that consumers pay on goods and services, and that is good, but on the other hand, we are continuing to tax individuals for the interest that they earn on even modest savings.

Mr. JONES. The administration a year ago did propose the family savings account. That is a very flexible program if you will put money into a family savings account up to a limit of \$2500, you get no tax deduction coming in, but if you will hold those savings for 7 years, you can then withdraw them without any tax on the earnings that accrue during that period of time.

I personally happen to think that is a very good program, but in the discussion of taxes last year, it sort of got buried in the overall discussion.

Once again, however, we have proposed it, and I personally support the family savings account.

Mr. BARNARD. I think, personally, that the biggest mistake we made was when we repealed the IRAs. I think the IRAs had a great motivation with the public to put money away for their future retirement, which we have, you know—

Mr. JONES. Yes, and we would promote the IRAs, try to make them even better by allowing a withdrawal for the first home owner purchase. But the family savings account provides more flexibility because you only have to hold it 7 years. You don't have to wait until you are 59½ or the entire long period of time.

Mr. BARNARD. I guess the thing that troubles me most about the period between 1980 and 1990, in that economic growth is look what it has cost us. You know, that economic growth has been very significant, but when you talk about what it has cost us from the standpoint of, what, tripling the national debt, that is why we just don't consider that sometimes. That really worries me. I am sure it worries a lot of folks.

Chairman NEAL. Since Mr. Barnard brought up the IRAs, let me ask you a question about them. They certainly are attractive, but have you done any studies to determine how much new savings were generated by the IRAs as opposed to the shifting of savings from some other source?

Mr. JONES. I have not done them personally, but I have seen studies. The early evidence—they began about 1981—the early evidence was there was considerable churning. That was you would take money out of taxable accounts and put it into your tax shield IRA accounts. The evidence seems to indicate, however, by 1985 that most of the savings going into those IRA accounts were basically fresh savings. By then, we were accumulating \$36 billion a

year in IRA accounts, and the evidence is that early on there was churning, but by the end of the time period it was fresh savings.

For the family savings account, I went out and did some studies. We did a major reduction from what the public opinion polls were telling us, and even if you cut it by 50 percent and assumed that 80 percent of the deposits were simply churning, it still represented about a \$10 billion or \$15 billion increase in savings from the family savings account.

The administration estimates that the proposed Family Savings Account would lose about \$300 million of tax revenues during the first year or about \$6.5 billion over the 5-year period.

I don't think that is the right point to be made. The purpose of the family savings account or the purpose of the IRA is to encourage thrift. It is to change behavior. It is to communicate to people that it is desirable to save, and if you do this meritorious thing you will then avoid the taxation, as Mr. Barnard indicated, of relatively small amounts of savings which we used to do by exempting \$250 in dividends or \$400 of interest at an earlier period. So our studies are that, yes, there has been a lot of churning. But the average family only has about \$3700 of liquid assets in depository institutions.

You cannot transfer those for very long. You run out fairly quickly, and so from that point forward, the incremental amount of savings going into IRAs or a prospective family savings account would be incremental savings.

Chairman NEAL. Did this new savings come from average income families, or mostly from upper income families?

Mr. JONES. In the earlier period there was a greater incentive for the upper income families to save, but the amounts of savings involved were relatively small. There was a cap of \$2000 for the wage earner, \$250 for a nonworking spouse, so they were fairly well sealed off.

As you know, since 1986, higher income people have been precluded from using the IRAs.

Chairman NEAL. When were these new savings generated?

Mr. JONES. Then 1984, 1985, 1986 would have been new savings basically, and that would have been somewhat diversified somewhat among across most of the income scales.

Chairman NEAL. Was it fairly evenly distributed?

Mr. JONES. I would have to look at the figures to be certain.

Chairman NEAL. Do you have a chart in here on the GNP deflator?

Mr. JONES. No, we only have our projections, which are—

Chairman NEAL. I saw that. Do you know the final figure for the deflator for 1990?

Mr. JONES. I can get it. Yes, it was 4.5 for the GNP deflator in 1990.

Chairman NEAL. What is administration's message to the Fed for next year? Is it to stick with their target ranges but stay within the mid point of the ranges?

Mr. JONES. I believe the way the Secretary has indicated it, he feels there is room to reduce interest rates, and that has somewhat occurred, and he also has stated yesterday again that he believes that the monetary aggregates should move up into the middle of

their cones, or there is room for stronger growth of the monetary aggregates. He would not want to see an explosion of credit, an explosion of money creation, because that, again, as Mr. Roth was describing, would simply recreate the problems we fought with periodically over the last 20 or 30 years.

Chairman NEAL. So the suggestion would be to keep the same target ranges for M2 that are suggested for this year for next year?

Mr. JONES. Yes, he has suggested that a little stronger money supply growth would be appropriate.

Chairman NEAL. And to stay near the mid point of that range?

Mr. JONES. At least get into the mid point of the range. They have been at the bottom of their cones.

Chairman NEAL. So it is not a major disagreement?

Mr. JONES. No, sir.

Chairman NEAL. It is a very minor disagreement?

Mr. JONES. Our concern has been that we felt interest rates could have come down. They stayed there from December 1989 until July 1990. They stayed at eight and a quarter on the Fed funds rate.

During that period of time we argued that we thought there was room to come down, and subsequently they have come down to six and three quarters early in January, perhaps slightly lower in early February.

Chairman NEAL. In response to Mr. Roth's comments, you offered up a list of proposals that would encourage savings, such as the family savings account, capital gains tax cuts, and so on. But at the same time, don't they also contribute to dissavings in the gross sense, that is to say they add to the budget deficit?

Mr. JONES. In the case of the family savings account, I believe the amount is about \$300 million in the first year would be lost from revenues by allowing that.

The Treasury has just published its explanation of the President's tax proposals. We would be glad to send that to your committee.

In the case of—the family savings account was \$300 million in lost revenues. It grows to \$2.3 billion by 1996. In the case of the IRA proposal, we estimate that that would cost about \$100 million of lost revenues.

As you know, in the case of the capital gains differential, there is a disagreement between the Treasury and the Joint Tax Committee staff. The President has asked Chairman Greenspan to look into the technical dispute.

Chairman NEAL. At this time, let me recognize Mr. Campbell. Mr. Campbell, welcome to the subcommittee. We are delighted to have you here.

Mr. CAMPBELL. Thank you, Mr. Chairman. I appreciate your recognizing me. I apologize I wasn't here sooner. We had an organizational meeting on another committee.

If I may, I apologize, but I would like to ask a question. If it was asked before, I would be more than happy to tell it was asked before, and I will just look at the record.

Mr. Secretary, I am interested in two questions in particular. One deals with the economic impact of borrowing versus taxing to raise revenue for an unusual nonrecurring item.

Now, what is on my mind is Desert Storm, but it could be another context. The economics of it will be about the same.

My question is, if we have a need of, let's say, \$15 billion, which is the place holder in the President's budget, as an economist, what is your assessment of how the economy would respond to raising that money by borrowing it in the present economic context or raising it by a tax, and in order to assist your response to me, let us assume that that tax is an increase in the income tax, a one-time surcharge so that it mirrors the progressive structure of our income tax.

We can discuss other variations, but just from that point of view, which is more harmful to the economy, borrowing the \$15 billion or raising it with a one-time surcharge?

Mr. JONES. It is extremely difficult to respond to because of the unique situation of Desert Shield where we have offsetting revenues coming in. At this point in time, we have so far, collected pledges of approximately \$51 billion. If you simply shift it to a more abstract concept—

Mr. CAMPBELL. Stipulate we have the need for the moment. Stipulate that whatever the allies provide, stipulate we have a \$15 billion need.

Mr. JONES. There again, one has to try to determine whether or not it is a sustained need or a very brief need. If it is truly a brief need—

Mr. CAMPBELL. Nonrecurring was my question.

Mr. JONES. Nonrecurring, then one should set the tax system based on a longer term goal. We did that in 1986. We tried a very serious analysis of tax policies in 1989. One of the caveats about tax policy is the best tax policy is an old tax policy. We change it every year, so we have never had the same Tax Code 2 years in a row. So basically if it is truly a temporary or windfall situation, then the borrowing is not disadvantageous.

On the other hand, if one goes along for an extended period of time, as we have, in which the outlays continuously exceed the revenues that are generated with the existing Tax Code, then you have an obvious problem. You must either reduce spending or eventually borrow the money or tax the money back.

If you raise revenues by borrowing or taxes it still takes a dollar out of the savings pool that is available as the national savings. The advantage of taxing the money is that you don't create future interest burden payments. That is the advantage of raising the needed funds with taxes.

The disadvantage of that approach is that if it really is a temporary need, then you have created an unnecessary burden, which is contradictory to what you wanted to do in the longer term.

I am afraid I have given you a typical economist's answer. It depends on whether the revenue need is really temporary or sustained.

In the case of Desert Shield, you have an unprecedented situation where we have been able to solicit approximately \$51 billion of contributions, which basically will cover the bulk of the initial outlays.

Mr. CAMPBELL. With the chairman's permission, I would like to pursue.

Chairman NEAL. Certainly.

Mr. CAMPBELL. Thank you, medicaid.

I am not going to let you off that easy. Two-handed economists are standard, as you know. Let me create a hypothetical because I understand it is very difficult to ask this in the context of the present Desert Storm/Desert Shield, so forget Desert Storm/Desert Shield. Hypothetical, \$15 billion nonrecurring, I really mean it, absolutely only this time need, temporary, not going to happen again. Is it wiser relative to the conditions in the economy as of this moment to borrow that or to raise it by taxes?

Mr. JONES. Well, let me begin by stating that the President and the Secretary of Treasury have both stated explicitly that there will be no discussion of taxes, so I want my response to be in that particular context. Given the present economy that we have, I believe that the borrowing would be a superior approach at this point in time in this economy.

Mr. CAMPBELL. Might I prompt you to say that that is the case because the marginal increment in debt represented by \$15 billion is relatively small for whatever crowding out-phenomenon that might cause; would you agree with that?

Mr. JONES. That is an unfortunate truth, given the enormity of the budget deficits we have accumulated and the national debt we have accumulated.

Mr. CAMPBELL. But I appreciate your candid answer. I have only one other inquiry, and that is, last year when we were dealing with the budget there was discussion of a millionaire's tax and a capital gains tax reduction and possible trading one off for the other.

I am interested in your view as an economist, and I am going to ask you another hypothetical.

Assuming that it was just a millionaire's tax and not the opening wedge into a wholesale revision of our tax structure or increase in our rates, assuming, in other words, that we are discussing an increment on the income tax on those whose adjusted gross income is greater than \$1 million, is that a source of revenue whose benefit from reducing the Federal deficit outweighs its negative from reducing the incentive to create wealth?

Mr. JONES. The Treasury would stand with the three rates that we have in place at the moment, would not like to see such a tax discussed. In the purely hypothetical context that you are describing here, the revenue implications of that would be very small, and in my personal opinion would not justify the incentive disruption or the discriminatory disruption that would result from it, but that is an abstract answer, and it has no relevance to 1991 or 1992.

Mr. CAMPBELL. I worked in the Reagan administration. I remember you have to answer hypothetically when you have got a boss, so I do appreciate that. I will take you only as a hypothetical.

The last follow-up, and then I am done, Mr. Chairman, you spoke of the disincentive effect and then the discriminatory effect. I understand the discriminatory effect. That is really not an economic concept as it is so much a social one, but the disincentive effect, it seems to me, turns on what the propensity of millionaires to consumer happens to be.

Mr. JONES. Which is lower than—they have a lower propensity to spend because their income covers the basic needs.

Mr. CAMPBELL. Without putting words in your mouth, would you agree that a millionaire's tax, extracting from the societal implications is a bad idea because you are taxing people who tend to spend the marginal dollar on investment and savings?

Mr. JONES. Back in the university classroom, if I were teaching tax policy, yes, it would be a disincentive which would curtail the national savings, which is our major concern.

Mr. CAMPBELL. Thank you so much.

Mr. JONES. But only in the classroom, not in the context of the political give and take.

Mr. CAMPBELL. Thank you.

Chairman NEAL. I appreciate this line of questioning. I would like to pursue it for a moment because, if I could.

I don't quite understand the logic of that. Why would there be a net reduction in savings? It would seem to me if you put a higher tax on wealthier people, it is true that they wouldn't have that money to save themselves, but the money would go into national savings; wouldn't it?

Mr. JONES. This is the nature of the argument. Economists, at least, would argue that the propensity to spend is much higher among the low income people and, therefore, if you want to encourage savings, one should not tax the higher income people in the penalty sense.

The taxes collected, if they truly were used to reduce the Federal budget deficit, then it would be an offset in the national savings account, but our evidence has been that the increased revenues tend to show up in increased spending and that those improved savings never accrue, never result in reality.

Chairman NEAL. Right. So it is a two-part answer. The first part, the answer to his question is—

Mr. JONES. If it then did reduce the Federal budget deficit, that would be a wash.

Chairman NEAL. This is where I missed some of your answer. During the 1980's, we made the choice that we would rather borrow than tax for consumption, and the result of that was essentially a tripling of the national debt, so we added \$2 trillion to the national debt. I have come to see that as a whole new Federal program, that is new interest on new debt, and at today's rates that would be, what, \$160 billion a year, something like that?

Mr. JONES. It has gone from about \$50 billion to about \$206 billion.

Chairman NEAL. So \$160 billion of a wholly new Federal program with no benefit that I can see. What would you say about that? Is that analysis flawed in some way?

Mr. JONES. I would turn, first, to page 38. Here we see that from 1950 to 1980 the average government outlays were 19.2 percent. There was a small run-up during the Korean War. There was a small run-up at the peak of the Vietnam spending war. There was a small run-up during the 1974-1975 recession, but, in general, outlays tended to average about 19.2 percent of the gross national product.

The revenues, on the other hand, averaged 18 percent. So we have had a deficit in 30 of the last 31 years, but it was typically about 1¼ percent.

As to revenue, there was a brief run-up during the excess profits tax of the Korean War, President Johnson's temporary income surtax of June 1968, and then there was the inflation creep or bracket creep of the late 1970's when inflation became so dominant. But other than those examples, the revenues have been relatively stable.

What is interesting about this chart is that the revenues have now returned to their historical high, and in 1991 and 1992 we will be well above any historical average on the revenue side. They are running 19.4, 19.5 percent of the GNP. Indeed, if we had the same average level of outlays, that is spending as a share of the GNP as we had for the preceding 30 years, the budget in fiscal year 1992 would be in surplus.

So what happened was we had a very sharp run-up in outlays. This is a familiar story. Defense spending doubled, \$134 billion to \$273 billion from 1980 to 1986. Income security spending, which is largely social security, government pensions, a little bit for unemployment compensation benefits, for food stamps, for SSI, and for other cash payments, went up 50 percent, from \$200 billion to over \$300 billion, and health care spending went up.

Then, as you correctly stated, the interest payments going from about \$50 billion at the beginning of this period to about \$200 billion, these are net interest payments, going to about \$200 billion in fiscal year 1992 explains why spending has risen to a level of 24 or 25 percent of GNP.

The Budget Summit meetings attempted to begin the corrective process. We at Treasury are very emphatic that that agreement should be enforced. And if it is enforced, in the individual three categories, we believe that the—particularly as the outlays for the savings and loan program are reversed as a claim against the budget—reverses in 1993 and 1994 when the Government liquidates some of the working capital requirements by selling some of those assets—we believe that the Federal budget deficit will come down rather quickly as these temporary pressures are resolved. But the key point is, and which is the nature of your question, if you are only able to raise about 19 percent of GNP in revenues from the tax system that your people are evidently willing to accept, then much more significant control of government spending is required. I think that is what the Budget Summit agreement was all about.

Chairman NEAL. I agree with all that. But, I really ask this question to help inform us for the future. If you had it to do all over again, would it have been a good idea to do it this way? That \$150 billion a year of new interest on our new national debt would go a long way toward putting the budget in balance. I am sure that it did produce a small spurt in economic activity—at least it may have. I guess there was some growth generated that may not have been otherwise, although. I am not even sure of that.

I think probably it was more driven by monetary policy than fiscal policy, but I am not sure. I welcome your comments. We can not do it over, but if we find ourselves in this kind of situation in the future, based on our experiences of the 1980's, do you think this would be the wise way to do it?

Mr. JONES. Well, in retrospect, from an economist's viewpoint, at least, it has been very unfortunate that we have raised the gross national debt from about \$908.5 billion in 1990 to \$3.2 trillion at the present time. However, that is perhaps a selfish view as an economist because it has to be put in the context of what were national security priorities, what were income security policies.

Chairman NEAL. Let's say that we felt that it was necessary to do everything else that we did—to increase defense spending, to increase medicare spending and all of those other things. That was current consumption. Would it have been better to have paid for that on a current basis than to have postponed paying for it, passing the bill along to someone else and adding these huge interest costs?

Was that the best way to do it? Would it have been better to have done the politically less popular thing; that is, to say to the American people, if we are going to spend this, we ought to pay for it. Or, did we do it the best way, in economic terms now, not political terms.

Mr. JONES. This is extremely difficult because of the nature of the time period and the political ramifications.

Chairman NEAL. Right, it is a political question.

Mr. JONES. It is almost more of a political question than an economic question.

Chairman NEAL. I don't really think so. Well, let's try. Could you try or is it impossible to separate out the politics?

Mr. JONES. Well, in pure economics, the debt weight loss, the payments created by this are disadvantageous. They get no programmatic benefits, as you correctly state. The difficulty, however, again in economics would be sorting out how much of the growth was created by the tax incentives which were put in place in 1981. There are many economists and the administration which led that effort, of which I served as an under secretary in, that would have argued that the tax incentives were a major factor in the economic growth that occurred, and had it not been for that, you may not have gotten the benefits you had anyway, so—

Chairman NEAL. Let's see, you have a chart on the GNP growth during that period.

Mr. JONES. It averaged 3.6 percent from the fourth quarter of 1982 until the third quarter of 1990.

Chairman NEAL. Historically, isn't that pretty close to the growth rate we have always experienced?

Mr. JONES. Well, it has been 3.3 percent from 1948 to 1988, and an annual average real growth of 3.6 percent from 1982 to 1990.

Chairman NEAL. So really we paid \$2 trillion in national debt and a permanent new program of \$160 billion a year for three-tenths of 1 percent of growth?

Mr. JONES. If you go back to page 13, I think it would also have to be noted that that growth followed a period of severe stagnation and decelerating growth for an extended period of time. The average real growth rate during the seventies and eighties actually averaged only 2.7 percent, so you had had a considerable period of time of disappointing growth. The people who argued for the tax incentives felt that it was necessary to stimulate the economy and

that one was not talking about simply a three-tenths of a percent gap.

One was really talking about 2.7 of the seventies and eighties, and one would have even more significantly been talking about the period of stagnation from the end of 1978 to the end of 1982.

Chairman NEAL. Now of course this brings me to the subject of these hearings, and that is monetary policy. We had very mistakenly run a very high level of inflation during the late seventies and then under the leadership of Mr. Volker and with Congress' initial blessing, the Fed essentially ground that out during the early 1980's, and brought us back to a sustainable or acceptable in some people's eyes, rate of inflation, which we have essentially maintained ever since.

What is your feeling about that? If we had followed that monetary policy and a more balanced fiscal policy, do we not have expected roughly the same amount of growth?

Mr. JONES. I think that most economists would argue that somewhat tighter fiscal policy and a more stable and accommodative monetary policy is a better policy mix. The deficits that resulted have been unfortunate.

Chairman NEAL. May I ask you about the so-called credit crunch. Is there a credit crunch, and is there a credit crunch apart from the monetary slowdown generated by the Fed's supposedly more restrictive monetary policy?

Mr. JONES. If you would look at page 51, we have a very interesting chart there. This is an attempt to track cumulative business loans from the beginning of the year, how much you accumulate during the year. You will notice that the green line along about April or May—the cumulative extension of business loans, the C&I loans, the traditional lending responsibility—began to contract. For all of 1990 there was some contraction of C&I loans, falling well behind the pattern of 1988 and 1989.

If you then look at the next page, page 52, we refer to this as real estate loans. There again, although there was expansion during 1990, the rate of expansion was considerably slower than it was in the preceding 3 years.

Finally if you look at page 50, you will see another category which is short-term business credit. Here again, beginning in April, you begin to see some moderation in the use of short-term business credit. That trend was temporarily offset by the use of commercial paper by larger corporations in the fall of the year, but since October and November there has been some constraint again.

The term, "credit crunch," is an aggregate term which is very difficult to apply to specific situations. If you go through and break it out by area, you begin to discover that Boston, for example, is a major explanation for the overall curtailment of lending. Boston has had a very sharp rundown of lending.

We have these charts by district banks. I would be glad to get those for you. Other areas, such as the New York District Bank, the Philadelphia Bank, the Cleveland Bank, the St. Lewis Bank and the Minneapolis Bank also had rundowns in commercial industrial loans, but at the same time you had rather a ebullient growth of credit in the Richmond district, in the Atlanta district, in the Kansas city district, and by the end of the year in the San Francis-

co district. So what we have had is a relatively patchy kind of situation in different parts of the country, with the constraint focused largely in the New England and the Atlantic Seaboard area.

The St. Louis area, where the effects of McDonnell-Douglas layoffs have been very severe, and a few other areas have experienced difficulty. In general, however, the problem also varies by category. Real estate loans have taken on a very severe treatment in the credit extensions, whereas the other types of loans have not been hit as hard. So, the question has there been a credit crunch is extremely difficult to answer.

It is geographically very diversified, by sectors it is diversified, and one really can't tell how much of this slowdown is the result of regulatory emphasis or the result of simply a bad economy where potential borrowers don't come in and ask for loans.

Third, it is a natural and in some cases desirable reaction among banks who have earnings problems, who have capital problems, and who have in some cases some deterioration of portfolio quality, to constrain loans. So having wandered through all that, I would answer your question by saying, yes, there has been some reduction in the extension of credit. It has been geographically very disparate, sectorally very disparate, and why it occurred cannot be broken out neatly into those three categories as near as I can tell.

There is a lot of anecdotal evidence that regulatory authorities have been more restrictive. My son happens to be a bank examiner. I query him frequently, and he keeps arguing that they are simply enforcing the existing standards. Yet there are too many anecdotes to ignore the specific cases. It seems to be almost more of a rifle shot issue than an aggregate situation.

Chairman NEAL. Just looking at the reference, in the banking system they have not changed much.

Mr. JONES. That is true. They haven't changed since 1987, in fact.

Chairman NEAL. So does that tell you anything?

Mr. JONES. I think it confirms our view that the Federal funds rate at $8\frac{1}{4}$ was perhaps set too high and that this simply drained reserves out of the system because the credit demand was not there. We welcome the change of the policy in the summer and late fall.

Chairman NEAL. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman, and Mr. Jones. I heard the first part of your testimony, then I had to go to another subcommittee meeting. You covered my main question. I got in on the tail end of your answer on this credit crunch. You know, yesterday on the front page of the *Wall Street Journal* they had an article about the credit crunch that is going on, and you say it exists some places and some places not.

It seems to me that it exists far too many places, and if we are going to ever come out of this recession, some of the regulators are going to have to ease up to some extent. With all due respect to your son, who I am sure is a fine man, and most banking examiners are very fine people, but still if you ask them are they exceeding their authority or are they being too rough on the banks, their answer is obviously always going to be, no.

Yet the home builders, the realtors, the people out there on the firing line, they tell me, and apparently they are telling other members all across this Nation and the bankers also, and the others involved, directly involved in the economy say that the regulators are just going crazy today because they have been given almost absolute power. And the old saying, "Power corrupts and absolute power corrupts absolutely," is starting to apply. And I think it is having a dampening or a weakening effect on the economy.

Is there any hope that we can reach sort of a middle ground between having enough regulation to get the crooks, but, you know, there are many, many good people still involved in the banking industry, the savings and loan industry, the real estate industry, and some of these other areas.

I don't think the Government should treat everybody like they are crooks or like they are enemies.

Mr. JONES. I would certainly agree that the anecdotal evidence is too pervasive to simply shrug it off. I certainly did not mean to do it by reference to the bank examination process. The Treasury has formed a committee, which is chaired by the Deputy Secretary John Robson.

They have been meeting frequently with the regulators, Mr. Clarke, Mr. Seidman, and Mr. Greenspan has joined in. There is a consensus view that we would like to encourage adjustment of the process or a much more sensitive response to credit needs right now.

The President tried to put that in his State of the Union Message. The Secretary of Treasury, going back for several months, has argued banks should make loans to good borrowers. One of the difficulties we are having is sorting out anecdotes from reality. The Secretary of the Treasury has said bring us specific examples.

Don't simply come in and tell us that the examiners are doing this, that, and the other. Bring us specific examples so we can respond to them more specifically.

Mr. DUNCAN. Well, the President mentioned it in his State of the Union, but if you have bankers and other lenders who are afraid to make loans because any loan, there is some risk attached to any loan, but apparently a lot of places today, the only people who can get loans are the people who don't need the loans. And if that situation continues or grows worse, then the economy is not going to perk back up, I don't believe.

Perhaps it would be good to, in addition to listening to the regulators, and certainly they are entitled to present their side, but it would be good to listen to some of the people involved in the different industries.

Mr. JONES. Sir, we definitely have—I meet once a week or once every 2 weeks with some delegation from the shopping centers or cable television, and they have made their case persuasively. At a much more senior level they have met with Secretary Brady. About a month and a half ago, the President met with business leaders in two different groups, with business borrowers to express their concern.

Mr. DUNCAN. Let me ask you something on another line just very briefly. You know, they tell us that the deficit is going to be at

an all time record this year and even greater than next fiscal year, and always they say that this is not counting the cost of the war or not counting the cost of the savings and loan bailout and not counting various other things, too.

Do you—I assume that even if we play some fiscal game and don't count it, the economy still counts it. Is that correct?

Mr. JONES. Yes. The total budget deficit, the \$318 billion figure for fiscal 1991 and the \$281 billion figure for fiscal 1992 does include the RTC—and the savings and loan outlays—but it does not include the undetermined cost of the Desert Shield. A marker has been put in there, and then once we sort through the actual outlays beyond March, for example, and what the collections are, the actual outlays will be filled in with a supplemental. But the total budget deficits of the \$318 and \$281 billion, that total does include everything. That is what economists used to call the unified budget.

That is what the economist is concerned about—the unified Federal budget.

Mr. DUNCAN. Assuming that the Congress does not pass the budget the President submitted, which is, I think, a pretty good assumption, and he has submitted a budget of \$1.45 trillion. Already there is a great cry against the cuts in medicare. Of course medicare spending is going up by about \$10 billion from this fiscal year to next, but still it is a cut as compared to what they wanted.

But let's assume that the Congress passes—we have a very liberal Congress now, and let's assume the Congress passes a much greater budget and the deficit is significantly greater than what you are predicting. What effect do you think that will have on the economy and what can we do about it?

Mr. JONES. First, I believe that the reconciliation agreement that was made after the budget summit agreement will limit that possibility. You have the three categories with mini sequesters within each of the three categories. If adjustments are made in one program, that change must be matched within that category by a curtailment of spending or by raising revenues within that particular category.

The budget includes defense, international, and discretionary spending. There are, for the first time, specific retroactive and current constraints on exceeding specific totals because now you don't have to cut out IRS field offices or the air controllers to get at a specific overrun in a specific category, which was always the problem in the past. The Government could never use the sequester tool because it would have been necessary to cut out some 50 percent of non-exempt defense spending or many of the IRS agents, that type of thing. There are constraints in place now that would preclude that.

Going back to your question, if the Federal budget deficit does not follow the path that is sketched out in the President's proposal, that is the budget deficit coming down in the outyears, then I believe that the negative reaction to that from both the financial community, and certainly in the international financial communities, would be very negative and would be very counterproductive.

Mr. DUNCAN. So if the war was to continue for a long period of time and if the savings and loan bailout cost more than is current-

ly predicted and the banks had some problems and all of these things add together to make the deficit much greater, then what, speaking in just common laymen's terms, what do you think the effect would be?

Are we—do you feel that we are near an economic collapse in this country or do you think that we have sort of a margin of safety there that is greater than it may appear on the surface?

Mr. JONES. I think that the U.S. economy output of \$5½ trillion has a resiliency and a creativity to it that would preclude that type of collapse. It is true that the Federal budget deficit is very large, and no one has criticized it more than I have over the last 20 years, but it is 3 and 4 percent—at the moment about 5.7 percent—of the gross national product. So the kinds of marginal changes that would occur are constrained by the budget agreement and the technical assumptions are revised for economic purposes.

In the case of Desert Storm, which was purposefully taken off budget because costs could not be predicted nor could the collections offsetting them be predicted in advance, the marginal changes there would certainly not be enough to create the kind of collapse that you are talking about. It is more of what Charles Schultz, the distinguished former Chairman of the Council of Economic Advisors under President Carter has referred to as “termites in the basement”.

It is really the cumulative effects, as the chairman indicated earlier, of going from \$50 billion of net interest payments to \$206 billion of net interest payments. If we do not fulfill the budget summit agreement and do not reduce the Federal budget in the future, I don't think it will show up as a cataclysmic collapse in the economy. I just think we will continue to have inadequate national savings. The major explanation of that inadequacy is the acceleration of the Federal budget deficit.

We will fail to get the national investment that we need in plant equipment, in technology, and in human resources development. It will be an erosion of our gross rate rather than a collapse of it. I don't think Armageddon is the result, but a failure to fulfill our potential is more likely to be the result.

We take very seriously the fulfillment of those targets. We realize that Desert Storm is unique and will have to be sorted out as events unfold. The savings and loan outlays, are built into the budget. It is about \$76.1 billion in net outlays, including working capital (\$43.1 billion) and loss proviso (\$33.0 billion for fiscal year 1992. We then think in fiscal 1994 such outlays are reversed. That is a major explanation for why nominal government spending is cut back quite sharply in those two fiscal years.

Mr. DUNCAN. All right. Thank you very much. Thank you, Mr. Chairman.

Chairman NEAL. I am trying to understand the impact of what appears to be a free fall in real estate prices in some areas of the country. I am not even sure this exists, but I am getting reports from around the country that in fact real estate prices are dropping significantly in many areas. I don't know whether that is true or not, but I am sure hearing a lot about it. But I also know that real estate prices don't operate in a vacuum. Economic changes, tax law changes, and other changes of the early 1980's encouraged

a lot of capital to enter into real estate business. The tax law change of 1986 then discouraged investment in real estate. I am wondering since real estate values have such an enormous impact on the banking system, the savings and loan industry, the pension funds, insurance industry, if we ought not to take a much closer look at real estate prices. Maybe you have already done this? Do you understand exactly what is going on and what, if any, policy changes need to be made to try to do something about it.

Mr. JONES. This is a subject area I am not that facile with. I would be glad to look into it and send you my response. My superficial observation is that the median prices of new homes in aggregate are off somewhat but not by a massive amount.

One is talking perhaps \$121,800 January median price down from December's \$126,900 or something of that order.

Chairman NEAL. I am not thinking, of course, of only residential real estate. I am thinking of office buildings, apartment buildings and so on.

Mr. JONES. This is such a complex subject, I think, I would really have to get back to you on that.

Chairman NEAL. Would you do a little work on it?

Mr. JONES. Yes, I could.

Chairman NEAL. It does seem to me that it has enormous implications if, in fact, the change is significant. It has big implications for a lot of industries that are problems for us right now.

Mr. JONES. I would be glad to ask my staff to look into it.

[The referred to material can be found in the appendix.]

Chairman NEAL. As we both mentioned, the Fed has been within its target ranges, albeit on the lower portion of the cone, as you referred to it. So clearly it can be said that they have done what they said they were going to do, but we still have a recession as a result of that. Does that lead you to think that maybe the target ranges are too broad or are they so broad that they are almost useless? What would you say about that?

Mr. JONES. I think Chairman Greenspan is correct in emphasizing the monetary aggregates are more of a proxy or representative of what is happening in the credit markets. The low growth in monetary aggregates in the short run, at least, may reflect the things that Mr. Duncan and I were talking about earlier.

There has been some regulatory restraint. There may have been a lack of borrowing demand because of the slowing economy. This is a chicken and egg kind of sequence. There may have been some banks in a difficult situation unable to make loans for legitimate reasons, or they may not make loans and then blame it on the regulatory authorities.

I would not be surprised if some banks in dealing with the customer say I would like to make this loan, but I can't because of these young 25-year-old bank examiners who are all over my shop. I think the Fed has used a fairly eclectic approach, not targeting monetary aggregates as they might have done in the early seventies.

I don't think they have targeted only interest rates as some have accused them of doing in the late eighties and 1990. I think they have used a rather eclectic approach, and that Chairman Greenspan now appears to be focusing on is the slow growth of the mone-

tary aggregates which he interprets as a sign of the credit restraint he is concerned about.

You have to approach that, we believe, by changes in the discount rate, changes in the Fed funds rate. Both of those action have occurred, along with changes in reserve requirements on off-shore Eurodollars and non-personal time accounts. All these things have to be taken as a package.

The meetings held with regulators are helpful. But basically the monetary aggregates will probably remain fairly sluggish until the economy begins to improve and loan demand improves.

At the moment, we have reports of a negative fourth quarter. We will probably report a negative first quarter. The financing of inventories is a traditional bank lending responsibility. Inventories are remarkably low. Normally at the beginning of a recession, inventories begin to pile up, and then companies quit producing unwanted products, and that is what causes a recession.

What has happened this time is that inventories—because this has been a long-anticipated slowdown, going back to early 1989—the business community evidently got out in front for a change and began to pare down their inventories beginning a year, year and a half ago. The inventory to sales ratio is actually declining rather than rising, as you would expect in a normal recession.

The low inventory to sales ratios, along with lower inflation rates, lower interest rates, and hopefully an improved confidence situation once the war sorts out and the financial institutions can be stabilized, these are the reasons we think that the current downturn will be fairly mild and brief.

If we are correct, and if growth does resume by midyear, then the monetary aggregates will pick up. We believe there has been ample room to reduce interest rates and we would like to see the Fed in somewhat of the mid points of their targets.

Chairman NEAL. Let me ask you about something else. What is your understanding of the amount that we had collected from other countries?

Mr. JONES. We now have pledges of about \$51 billion, as I understand it.

Chairman NEAL. How much collected?

Mr. JONES. A much smaller amount. Those are pledges only at this point. I don't know the collected amount.

Chairman NEAL. I thought I heard you say we had collected.

Mr. JONES. No, we have had pledges.

Chairman NEAL. I think that is right. I think the collections have been maybe 15 percent of that. But, I think we will collect a good deal of the rest. As I understand it, these contributions that are made from abroad to Desert Storm will represent a capital inflow in balance of payments terminology. For that to represent a real capital inflow, it will also show up as an equivalent increase in exports from other countries, and if that is correct, doesn't that mean that we will increase our trade deficit by whatever the amount of that capital inflow is?

Mr. JONES. The pledges are \$41.7 billion for 1991, the collections in cash at the moment are \$5.3 billion according to the latest statistics. I apologize for not knowing the answer. That is the type of question I have to get an answer to.

In computing the gross national product the goods and services have to be produced in the United States. If we receive in kind contributions of petroleum or other services, that would count as an import to the United States, but I would have to go back and get the technical details of it. I don't know the answer to that.

Chairman NEAL. OK. Thank you. Mr. Duncan, do you have anything else?

Mr. DUNCAN. Let me ask you this one other question. You know, I certainly don't know—I am not an economist, and I don't know nearly as much as you do, but just looking at it from a distance and being a non-expert, it looks like to me that when we have a downturn the first things that are hit are the automobile industries and the home building industries, those two.

When those two go bad, the whole rest of the economy goes bad. Is there some accuracy in that, and if there is; are we starting to see any improvement in the automobile industry, for instance, or home building and other construction?

Mr. JONES. The home building statistics are summarized on page 18. Your description was correct in a cyclical sense. Until fairly recently home building always was on the tip of the spear, the first sector to be affected. But with the removal of the regulation Q requirements and other restraints of that type, borrowers willing to pay a very high mortgage rate were able to get a mortgage loan, even during the mid 1980's.

What has happened, as you can see, beginning about 1985, 1986 is that we have had a sector decline in housing. That decline has been going on for a much longer period of time than could be explained by a simple cyclical development.

It is true that there has been a recent rundown, so we are back down to recession levels in the housing industry. Given the national demographics and given the nature of how we allocate resources, the housing sector will not snap back in the near term.

In the case of automobiles, we used to sell about 11 million cars per year; about 2½ million were imports; about 9 million were domestic name plates. At the moment we are selling about 6½ million domestic name plates and again about 2½ million imports, so the imports have risen as a share of the total.

Of those name plates about a million of them are foreign producers with plants located in the United States. You have identified the two industries in which we are having the greatest difficulty. In the case of housing, I would not expect any near-term snap back. In the case of automobiles, the sales do not seem to be developing an accumulative downturn, but there is no particular strength at the moment in the sector.

Again, these problems are largely based on confidence, which as we said earlier in a discussion, has suffered a major hit. Consumers have not been using credit for automobile purchases, and that has somewhat improved their balance sheets. One of the good things is that the automobile industry really pared back their production schedules in the fourth quarter.

That is a major explanation for why we had a negative fourth quarter. While we don't expect a quick resumption of sales, again, we don't see the production schedules or the current sales in a cumulative downturn.

Mr. DUNCAN. thank you.

Chairman NEAL. Yes, sir. Thank you. Almost at the beginning of your testimony, it seemed to me I heard you say something about a trade off between growth and inflation. Is it the position of the administration that there is a trade off there?

Mr. JONES. A trade off—I probably did use that term. I think that is the wrong term, and I would correct it. It is my personal view that you will either get progress against both inflation and unemployment by having a healthy economy or you won't get progress against either one.

I do not agree with the sort of traditional Philips curve concept. What I meant to say, and should have used more precise language, is that there may be a difference in emphasis on the goals. The Federal Reserve Board, I think correctly, has a major emphasis on the inflation goal because basically they are the only ones who would have that kind of emphasis, whereas the Treasury, and the Secretary has mentioned this in his public addresses before, Treasury, of course, might place greater emphasis on sustaining growth.

It doesn't mean that we are unconcerned about inflation or that the Fed is unconcerned about growth. It is a matter of degree in the two. But I would not count them as tradeoffs, no.

Chairman NEAL. Even then I must say it troubles me a bit. I have come to understand the way the economy works is essentially that the only way you can sustain growth is to control inflation; that there is no trade off, you can not get sustained growth if you allow inflation, and in fact the only sure fire way to sustain growth is to be sure that you don't get inflation.

So, in other words, by the Fed targeting inflation, they are, in effect, doing the very best thing they can do for sustaining growth at the very same time.

Mr. JONES. I agree wholeheartedly with that, and again let me repeat, the only way to get progress against inflation and unemployment is to have a healthy economy and vice-versa; the only way to have a healthy economy is to control inflation.

One, however, can have segments of time in which the long-term goals may have to recognize that there are risks on the economic growth side which, at least earlier in the year, would have justified action because there was room for interest rates to come down somewhat more.

It wasn't a fundamental difference of viewpoint, and I wholeheartedly endorse what you just said, that if you don't control inflation there is little hope of getting sustained economic activity.

Chairman NEAL. Well, I thank you very much for your excellent testimony and the very useful charts. I appreciate it, and we certainly welcome your advice as we move along here.

Mr. JONES. If your committee staff would like to see the computer presentations, we would be glad to cooperate in any way.

Chairman NEAL. Thank you. We have discussed a couple of questions here that I would certainly welcome your responses to.

The subcommittee stands adjourned, subject to the call of the Chair. Thanks again.

[Whereupon, at 12:15 p.m., the hearing adjourned, subject to the call of the Chair.]

OVERALL STATE OF THE ECONOMY

Thursday, February 7, 1991

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

The subcommittee met, pursuant to call, at 11:35 a.m., in room 2222, Rayburn House Office Building, Hon. Stephen L. Neal [chairman of the subcommittee] presiding.

Present: Chairman Neal, Representatives Roth and Richard Neal.

Chairman NEAL. I would like to call the subcommittee to order at this time. I apologize.

We had a meeting of the full committee that I simply couldn't—full committee caucus, the Democrats on the full committee, that I just couldn't avoid, so I am really sorry to keep you waiting. And I must tell you, this sort of thing happens around here all too often, and I have not found a way to avoid it.

Today we continue our hearings on monetary policy and the state of the economy in preparation for the Federal Reserve semi-annual policy report to the Congress. I would like to repeat briefly the chief questions, at least some of the chief questions, I think, that these hearings should help us answer.

First, what is the cause of the current recession? Was it inevitable in the sense that our economy naturally produced these cycles, with only the timing uncertain, or was it caused by identifiable policy mistakes; and if so, what were they?

The second question concerns the nature of this recession. Is it more or less like past recessions, or is it somehow unique, novel, or different? And if so, how? And if so, do its special characteristics call for special policy responses?

Third, should we use monetary policy to revive the economy as quickly as possible? That is, should the past focus of monetary policy on reducing inflation now be totally abandoned in favor of stimulating recovery? Can monetary policy even be effective in light of the so-called credit crunch?

What, in fact, is this credit crunch? Have we been experiencing one? If so, what data supports that interpretation; and if so, what is the proper policy response?

These issues are a bit technical but may be important in helping understand the causes and the depth of the recession.

The Fed has been portrayed as easing for some time now because it has been lowering the Federal funds rate and the discount rate. But does this accurately measure what we mean by easing?

Monetary growth, though within the Fed's target ranges, has been decelerating rather consistently throughout the year. The Fed has apparently become concerned about weak monetary growth. This suggests that contrary to the appearance of easing fostered by a fixation on the Federal funds rate, policy may well have been tightening all along, though inadvertently.

In the face of a weakening economy, and a falling demand for money and credit, a real easing of policy will try to keep money growth from decelerating. If the Fed had concentrated on keeping money growth at or above the midpoint of its target range, accepting whatever Federal funds rate that would require, it is conceivable that the current downturn could have been significantly mitigated. Has their focus on the Fed funds rate been a mistake?

Finally, is it possible or likely that we could come out of this recession with a much lower range for inflation, in fact, a rate of inflation within striking distance of what I call zero inflation or price stability?

In considering its response to the current state of the economy, the Fed should be careful not to sacrifice the gains we may soon be reaping in terms of lower inflation. If that temptation is resisted, if we come out of this recession with inflation tolerably close to zero, the only serious argument lies against my proposal to mandate a zero inflation objective for monetary policy would disappear.

That argument was simply that the transitional costs of moving to zero inflation, price stability would be too high. Once those costs have been made, however, I can see no remaining argument against zero inflation as the primary target for monetary policy.

I thank our witnesses for being with us today. They are Martin H. Barnes, managing editor of The Bank Credit Analyst of Montreal; Professor Saul Hymans, director, Research Seminar in Quantitative Economics, the University of Michigan; John Silvia, first vice president and chief economist for Kemper Financial Services.

We will put the entire statements of our witnesses in the record, urge that you summarize so we might have a bit more time for questions and answers, and if you have no objection, I would just recognize you in the order in which I mentioned your names.

Is that satisfactory with you?

All right. Well, again, thank you very much for your patience and thanks for being with us this morning.

Mr. Barnes, I would like to recognize you to lead off here.

**STATEMENT OF MARTIN H. BARNES, MANAGING EDITOR, THE
BANK CREDIT ANALYST OF MONTREAL**

Mr. BARNES. Thank you.

Mr. Chairman, I am grateful for this opportunity to present you with my views on the economic outlook and the important challenges facing policymakers.

The U.S. economy and financial system currently face the most difficult environment since the Great Depression. That was the only other period in modern history when a recession began at a time of massive debt burdens.

The increased role of government, financial safety nets and floating exchange rates will prevent a new depression. However, these

are no times for complacency because many of the preconditions for a debt deflation are in place.

A debt deflation occurs when a widespread scramble for liquidity causes a vicious cycle for retrenchment and deepening recession.

The current recession typically has been blamed on one or more of the following events. The Gulf conflict, the bank-imposed credit crunch, and overly restrictive monetary policy. However, it is important to recognize that these events were not the underlying cause of the economic downturn, but merely act as catalysts.

The roots of the recession lie firmly in an unprecedented buildup in debt that was associated with a major misallocation of resources into non-productive areas, real estate being the most notable example.

Sustained economic health cannot be restored simply by a reduction in interest rates or by lower oil prices. There are no easy, quick-fix solutions.

Economic problems in the United States require long-term remedies such as increased savings, a redirection of spending towards investment and a restructuring of the banking system. The United States must become more competitive rather than retreat into a protectionist's shell.

Monetary policy must continue to aim for lower inflation, and further action must be taken to cut the Federal deficit. This is not a normal recession. The inventory cycle has not played a significant role in the downturn, and interest rates began to fall long before economic activity peaked.

These developments will prevent a repeat in the sharp declines that arose in 1974, 1975, and 1981, 1982 recessions. However, the economy is afflicted by severe structural problems, such as an excess supply of commercial real estate, over-capacity in banking and weak balance sheets in a number of sectors.

Cyclical problems of the economy should start to recede by mid year. The Gulf War, hopefully, will be over or well on the way to resolution by that time, and the worse of the cutbacks in employment and spending will be in the past.

But a strong recovery should not be expected because the structural impediments to growth will take much longer to correct.

My economic forecast is more pessimistic than the consensus because I expect that the recession will last around a year with a peak decline of real GNP of between 2 and 2½ percent.

This would place it broadly in line with the post-war average. Moreover, unemployment and bankruptcies could continue to increase for some time after the recession has ended. In other words, the statisticians may proclaim the end of the recession, but the perceptions of consumers and businessmen will likely be very different.

On a positive note, inflation should ease significantly during the course of 1991. The core inflation rate likely will drop below 4 percent before the end of the year. The risks lie very much on the side of an even sharper decline in inflation.

The Federal Reserve is expected to reduce interest rates further in response to the recession, but the Federal funds rate falling to at least 5½ percent by the third quarter of 1991.

The yield on the 30-year Treasury bond is expected to decline to between 7 and 7½ percent. The uncertainties surround the outlook appear biased to the negative rather than the positive side.

The Persian Gulf War represents an obvious threat to the outlook. Initial fears of higher oil prices no longer seem justified, but consumer and business confidence could be further eroded if the conflict drags on for a long time or if there are major setbacks when the ground campaign begins.

A quick rebound in confidence can be expected when the war ends, but any accompanying rise in spending will be subdued until the fundamental background to consumer incomes improves.

The increase in defense spending associated with the Gulf War is unlikely to have much effect on the economic growth. The rebuilding of missile and ammunition stocks will boost output, but the contribution to GNP growth should be small.

The cost to U.S. taxpayers will be spread out over time and will be minimized by contributions from other countries in the coalition. There are other uncertainties that include the economic outlook.

For example, the economy is threatened by the high probability of further bank failures during the next year. The Federal Reserve would move quickly to prevent the spreading financial panic, but confidence could be damaged and other banks could become even more restrained than their lending policies.

I suggested earlier that recent developments were consistent with the onset of a debt deflation. The banking, government, consumer and corporate sectors are all trying to rebuild liquidity at the same time.

However, each sector's attempts to improve its financial situation inevitably undermines the position of other sectors. Indeed, the increases in Federal and State and local taxes at a time of recession are part of this process. There is no easy way to quantify the debt deflation danger, and a close watch needs to be kept on the trends in credit amounts and debt to income ratios.

I would now like to turn to the role of the so-called credit crunch in the cycle. Anecdotal evidence have made it perfectly clear that banks have tightened their criteria for lending, and it is very difficult to disentangle the effects of weakening loan demand and supply sight restraint.

Bank lending growth has been slowing steadily since the mid-1980's, broadening in line with an easing in total credit growth. Indeed, the decline in bank lending growth has not been far out of line with the expedience of past recessions.

The Federal Reserve's attitude towards bank behavior seems ambiguous. The central bank has supported the need for higher bank capital ratios, and it had been uncomfortable about the speculative edge to the surge lending for commercial real estate and highly leveraged transactions.

A return to prudent banking has been long overdue, yet the consequences in terms of restrained lending activity appear to have caused undue concern.

The reality is that there is no painless way to make the transition to healthier balance sheets in the banking, corporate and government sectors. It will be necessary to reduce current over-capac-

ity in banking in order to improve the sectors profitability and thus its ability to correct balance sheet weaknesses.

At the same time, policy should focus on ways to impose more market discipline to bank behavior in order to prevent a behavior of past lending excesses.

With regard to the conduct of economic policy, the Federal Reserve appears to be on track for a significant reduction in inflation over the long term. One of the most durable economic relationships is the close tie between the growth rates of M2 and nominal GNP. M2 rose at an average compound rate of around 4½ percent in the 3 years ended December 1990.

If that level of money growth is sustained, then it would be consistent with both inflation and real GNP growth in a 2 to 2½ percent range within the next few years.

Nevertheless, some acceleration in monetary growth will be required in the short term in order to keep M2 on its 4 to 5 percent trajectory. M2 rose by only 3 percent in the 12 months ended December 1990, a rate too low to be consistent with economic recovery.

The stubborn weakness of the monetary aggregates in the face of lower interest rates has raised concerns that the Federal Reserve may be powerless to prevent a continued contraction in monetary growth and a deepening recession.

Such concerns are overdone, but it is important to recognize that the Federal Reserve is somewhat constrained. The Federal Reserve can stimulate money growth if it pushes interest rates down far enough.

Policy is inhibited, however, by the vulnerability of the dollar. U.S. interest rates already are very low by international standards, and the dollar has fallen sharply against most major currencies during the past year.

Rates are starting to edge lower in some countries, but they remain firm in Germany and Japan, the two large global creditor nations.

There is a limit to how far the United States can narrow interest rate differentials between Germany and Japan before triggering a destabilizing decline in the dollar.

Recent remarks by Federal Reserve Chairman Alan Greenspan suggest that policy will continue to be eased until the decline in monetary growth is arrested.

Lags in information mean that there is a very high probability that policy ultimately will be eased too much, triggering and overly rapid upturn in money and credit growth.

In that case, the Federal Reserve should move quickly to tighten its stance in order to restore M2 growth to a 4 to 5 percent path. The Federal Reserve must make every effort to avoid a debt deflation and restore money growth within an appropriate level, but it must be equally careful to avoid that which would impede progress toward sounder balance sheets and financial institutions and corporations.

There can be a high degree of comfort that policy is on the correct track if M2 gross by 4 to 5 percent, long-term bond yields are stable to falling and commodity prices are under control.

A firm dollar would be a further indicator of sound U.S. policy, although the exchange rate also is affected by the stands of foreign central banks.

The best contribution that Congress can make to the economy is to build on last year's budget agreement and seek ways to achieve further reductions in the growth of government spending.

That may seem an inappropriate recommendation in a recession, but there are long lags between the passage of budget legislation and the impact of any changes on the real economy.

In a world of scarce capital, a lower U.S. budget deficit will free resources for the necessary upturn in private sector investments.

Thank you.

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

Chairman NEAL. Thank you, sir, very much.

Mr. Hymans.

STATEMENT OF SAUL H. HYMANS, DIRECTOR, RESEARCH SEMINAR IN QUANTITATIVE ECONOMICS, THE UNIVERSITY OF MICHIGAN

Mr. HYMANS. Thank you, Mr. Chairman.

I am pleased at the invitation to appear before the subcommittee, and with the opportunity to present my views on the economic outlook and the appropriate role for monetary policy.

By the closing months of last year, the combination of 2½ years of tight monetary policy, from early 1988 through the middle of last year, along with loan rationing by the banking system trying to cure its balance sheet of a shaky asset portfolio, and oil price shock, and the prospect of a serious American entanglement in the Persian Gulf managed to put the economy into a recession.

American consumers now seem to be about as uncertain or depressed as they have been in a long time. And in expectation of weak consumer markets, businesses are behaving with extreme conservatism in trying to avoid any buildup of unwanted stocks of inventory, even though existing stock/sales ratios are about as spare as they have ever been at the start of a recession.

Clearly this is a most unusual time, fraught with economic uncertainties. Are we now just at the start of a recession that is going to get a lot worse before it gets any better, or are things already about as bad as they will get so that we are actually near the start of economic recovery?

There are at least three good reasons to think that the economy could be nearing the end of the recession. The Federal Reserve system has clearly switched to an expansionary monetary policy. Reserves are being pumped into the banking system and interest rates have come down sharply.

Oil prices are back into a normal range, about \$22 a barrel for the benchmark West Texas intermediate crude, compared with an average of \$32 a barrel in the fourth quarter of last year.

We are seeing an increase with more to come in the Federal Government's demand for U.S. production as the war in the Gulf continues.

And in this respect, it doesn't matter how much of the cost is offset by cash contributions from our allies. There is still a fresh new demand for U.S. output being imposed by the Federal Government.

Important as these expansionary factors are, however, it is not clear that they have to dominate the situation and pull us out of the recession quickly. For one thing, there is substantial uncertainty about the size of the new defense call on the economy.

Is Desert Storm going to raise defense spending by \$20 billion, \$50 billion, by a hundred? And over how brief or protracted a period of time? Will oil prices stay near \$20 a barrel? To what extent will continuation of the fighting in the Gulf, with all the ups and down in the news that can be expected to accompany such hostilities, be associated with a depressed or even worsening state of consumer sentiment?

And unconnected with the Persian Gulf situation, how much of the economy's natural tendency to expand is going to be offset by a stingy supply of loanable funds in our troubled financial sector?

Let me make note of seven key assumptions on which my economic forecast is based. First, I am presuming that the Gulf War proceeds with reasonable smoothness toward an outcome favorable to U.S. interests and lasts about 3 months, for which you can read 2 to 4 months.

Second, the additional call on the domestic economy for prosecution of the war and replacement of equipment and weaponry, I assume, will amount to something over \$50 billion in real terms, with \$20 billion of additional demand during fiscal 1991, another 15 or more billion in fiscal 1992, and most of the balance in fiscal 1992.

So that even if we have a 2 to 4 month war, I am presuming that the expenditures in terms of replacement of many items of weaponry and equipment will be spread over a fairly long period of time.

Third, excluding the effects of Desert Storm, I am assuming the Federal budget remains on the track established in the October budget agreement.

Fourth, until the favorable outcome of the war is firmly established, consumer sentiment remains depressed, but once that favorable outcome is established, a clear recovery in sentiment is assumed to occur and will manifest itself in a strengthening demand for big ticket consumer durables.

Fifth, the price of oil, I am assuming, will stay in the \$20 to \$25 per barrel range.

Sixth, the financial sector continues to stunt the recovery of home building and commercial construction activity, until the economy is already headed upward without any initiating construction boom to get it going.

And seventh, that economic expansion continues in Japan and Germany, while the economic decline in Canada hits bottom late this year.

Based on these assumptions, my view of the economic outlook is summarized in some detail in Table I, and I will highlight some of the main figures.

Real GNP is forecast to decline for another quarter. That is the quarter we are currently in. Real GNP growth is then forecast to

edge above the zero line in the second quarter of this year, registering a positive growth of only about eight-tenths of 1 percent at annual rate.

Positive growth for GNP forecast for the second quarter is the net result of a jump up in consumer demand and a drop down in the defense budget as the rate of spending for Desert Storm flattens relative to the first quarter. By the middle of this year, I am forecasting the civilian unemployment rate at about $6\frac{2}{3}$ percent, about at its peak.

Inflation in consumer prices is forecast to be in the 4 to $4\frac{1}{2}$ percent range in the middle of the year, housing starts at a depressed annual rate of only about one million units, and sales of cars and light trucks will just be getting back to a 13 million unit pace, still a weak pace of car sales.

The second half of this year is forecast to register real growth at an annual rate in excess of $2\frac{1}{2}$ percent, and the unemployment rate is forecast to be heading down.

But I do not see the subsequent recovery being anything that one would call a boom in economic activity.

During 1992, our forecast has GNP growing at a rate fairly steady rate of about $3\frac{1}{4}$ percent. That is hardly a boom. From late 1991 to late 1992, the unemployment rate is forecast to be only down to 6.3 percent by the end of 1992, and that is back to where it is now.

Under this economic scenario, how should monetary policy proceed? It is evident that the economy that has just been described is going to need a supportive monetary policy for most of this year. Nor does this forecast, as I mentioned, develop in such a way as to justify monetary tightening until well into 1992.

There is no boom coming in the short run. And indeed, I think the stability of the financial system probably depends quite importantly on the Federal Reserve being supportive of a period of continued recovery during which bank balance sheets can heal.

Perhaps the most fragile assumption in the forecast that I have given you is that the Persian Gulf war ends in approximately 3 months with an outcome favorable to U.S. interests.

I am basically in agreement with Chairman Greenspan that a much longer war is likely to be bad for the economy. I am not quite sure why he thinks that, but my concern is that anything that begins to resemble the Viet Nam War and an accompanying protracted debate on how best to pay for such a war is going to produce nothing but bad vibes in American households, perhaps enough to keep the economy on the skids even with a hefty defense budget in a longer war.

Thank you. I will be happy to answer any questions you have. [The prepared statement of Mr. Hymans can be found in the appendix.]

Chairman NEAL. Thank you, sir, very much.

Mr. Silvia, we would like to hear from you.

**STATEMENT OF JOHN E. SILVIA, FIRST VICE PRESIDENT AND
CHIEF ECONOMIST, KEMPER FINANCIAL SERVICES**

Mr. SILVIA. Thank you, Mr. Chairman, for the opportunity to speak with you today. This statement indeed is my own and does not represent what Kemper Financial Services may have to say on some of these issues.

I am particularly delighted that you asked some very specific questions up front, and I will give you some specific answers. Economists don't always evade the issues.

First, you asked about the cause of the current recession, whether it was natural or not. Do—I do not believe it was natural. The inventory sales ratios did not indicate that inventories were extremely high in this economic recovery period.

Also, you noticed going into this recession monetary policy as measured by the Federal funds rate was actually easing. So here you have a situation where you did not have excess inventories, and you did not have a situation where the Fed created the recession by raising the Federal funds rate. So I do not see that the cause of this recession was natural.

You asked a second question about the nature of this recession. Is it usual, the type of recession, or is it slightly different? I believe it is quite different. I believe there is a confluence of not only a cyclical weakness in this economy but also secular changes in the way we do financial business in this economy.

In the longer testimony that I submitted, you will see a number of charts indicating that the role of banking system and the role of other financial institutions is quite different today than what it was 5 to 10 years ago. So I think the nature of this recession is, indeed, quite different.

The third question you asked about monetary policy, can monetary policy be effective in the face of a credit crunch, basically, I would answer this as yes, monetary policy can be effective.

I think what the chairman needs to recognize here is that the effectiveness depends on what goes on in the broader financial system. We are not talking about a Fed pushing on a string, and we are not talking about a Fed pushing on a steel rod. We are talking about something in between happening here.

And again, referring to the longer testimony, which in the interest of time we will not go over, notice that each step along the way and the monetary policy process there are developments, there are problems, there are little mole hills that we have to climb that have changed the way the monetary policy works through this economy.

So yes, monetary policy can be effective, but its effectiveness has been reduced because of the changes and some of the difficulties going on in this economy.

You asked as a fourth question easing portrayed by a lower Federal funds rate, and does that accurately measure the easing going on in this economy?

This is a very old debate, and I think, chairman, as you are very sensitive to inflation, you must know the history of the late 1970's, when inflation was rising over time, that drove up the nominal Federal funds rate.

So as the Federal funds rate rose, it was perceived that the Fed was tightening, when in fact money supply was growing very rapidly, was pushing the economy towards higher levels of inflation, and what was rising was nominal interest rates and real interest rates were actually declining.

Today we may, in fact, have, or at least over the last year or so, we may have the reverse of that process. When the economy becomes weak, the demand for loans and the demand for money, the demand for reserves declines. The Federal funds rate is sort of that equilibrium interest rate that tries to ration reserves among banks.

As the economy weakens, the demand for reserves declines. That would tend to lower the Federal funds rate. If the Fed, in fact, targets the Federal funds rate and keeps reserves tight to keep the Federal funds rate up, then the Fed is inadvertently tighter than what they might otherwise be.

This is an old debate, and I am sure your staff, Mr. Chairman, is very well aware of this debate and certainly can give you some historical evidence on this in terms of what is going on.

You ask if M2 had been sort of in the mid target of its range, would this downturn have been mitigated? My basic answer to you, Mr. Chairman, is yes. I do see the weakness in M2 growth, and particularly if you look at real M2 growth, which is one element of the leading economic indicators, as a sign that indeed if that real M2 growth or the nominal M2 growth, however you want to look at it, would have been stronger, this downturn would have been mitigated.

Finally you ask, and I think it is very interesting and refers exactly to, I think, the last page of my testimony, we talk about getting out of this recession with a lower range of inflation and not sacrifice the gains of inflation.

I would simply refer you to that the classic historical problem about Germany in the 1920's, that indeed if, in that situation, in that society, a monetary flourish floods the economy to just bail everybody out of debt, then there is no confidence in the value of the currency or in financial institutions or in any debt contracts over time.

And you would certainly reflect this economy, save all the debtors and then generate much higher inflation expectations over time.

Those are my basic answers to your questions. If I may be just allowed a few more minutes just to make three major points that I would leave with you today and certainly questions we can get into the longer testimony, first major point I would like to leave with you in your mind, despite the decline in Federal funds rate, total reserve growth has been flat.

As a result, what is viewed as Fed easing through a lower Federal funds rate is not being transmitted through the banking system.

The second major point I would like to make to you today is that the effectiveness of monetary policy has been limited by a number of developments independent of the actual process of monetary policy. Bank lending has been on a secular decline; in other words, a long-term decline relative to other credit sources in this economy.

So again, you know, to the extent that the Fed works through the banking system and the banking system itself is less critical for

the supply of credit in this economy, then monetary policy itself is less of a force moving through this economy.

Quality spreads or the difference between private market instrument rates and Treasury rates have indeed risen for many months, and they were rising before the United States ever moved against Iraq in the war.

Quality spreads, as you know, have oftentimes been used as a good leading indicator of this economy. The high yield in corporate bond market have seen a reduction in credit flows far before any events of July and August.

Equity markets are voicing their disapproval of financial institutions in general, not just commercial banks. It is important to realize, if you look at the S and P idiosyncrasies of insurance companies, brokerage firms and banks, they are all declined relative to the overall S and P index, suggesting relative disappointment in the marketplace in financial institutions, not just commercial banks.

Regulatory policy itself may have macroeconomic consequences, far beyond what the regulators themselves intended or even anticipated.

My third and final major point I would like to leave with you today is again, there is a real possibility that the success of the Federal Reserve's anti-inflation policy in reducing inflation expectations may be interacting with the current recession to produce a confluence of secular and cyclical constraints on credit growth.

Remember again, oftentimes people will take on debt in the expectation that it will be repaid with much cheaper money down the road. If, in fact, the Fed changes people's expectations of inflation, then there is no cheaper money down the road, and so they will be disappointed, and so maybe some of the debt problems, the debt repayment problems we have today is simply a disappointment of those inflation expectations.

Thank you for your attention and time, and again, like the other panelists, I will be glad to answer any questions.

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

Chairman NEAL. Thank you, sir. Thank all of you very much for helping us this morning.

Let me ask you, just as a general comment on quality of our economy, there is something I don't understand. They say that the stock market—they say a lot of things about it, but one is it sort of anticipates the future a bit and is a pole on the economic conditions.

It has been. I don't know what is going on today, but over the last few days, it has been going up fairly dramatically and yet when I look out at the economy and what I believe I hear all of you saying this morning is that there is a good deal of softness in the economy.

I just don't understand this. What positive signs do you think the market participates re responding to? What is going on here?

Mr. BARNES. Well, my view is that the stock market is responding to a very powerful message from the Federal Reserve, an unusual message that interest rates interest rates will be reduced to whatever level is necessary to get money growth up, not as really

telling the market that money is going to be thrown at the economy until the economy recovers and it's therefore prepared to look beyond current difficulties to those good times ahead.

I still think there is a risk that the time lags may be rather longer than the stock market currently anticipates, or the strong move that we are seeing at the moment may not be sustained.

That is my view what is driving it. And, of course, also investors remember very clearly what happened after the October crash of 1987 where the gloom and doom in the economy was not translated into a bad stock market, and they worried that they were going to miss another similar strong move.

Chairman NEAL. If that, according to this view, if the Fed in fact were not going to do that, would that reverse all of this? I mean—

Mr. BARNES. Well, as I say, I think it is going to some extent reverse anyway because I do believe the Federal Reserve will lower interest rates to whatever level is necessary, but it may just take longer than the stock market thinks or it probably will lose patience along the way.

And in the meantime, we are going to see some disappointments continuing to come on the economy and on corporate earnings, and that will sing into the market cycle.

Chairman NEAL. Your thinking is it is all based on anticipation of an eased monetary policy?

Mr. BARNES. Yes. And I think it particularly is looking very far ahead at the moment, the stock market. I think maybe too far.

Mr. HYMANS. I must say I rarely think I understand what the stock market is doing from day to day or month to month. I am also surprised when the analysts tell me that well, the market went up because something that had been discounted into the market turned out not to come out quite as the smart money had anticipated.

One thing that one can point to, which is a comment on what you said in the question you asked about the softness out in the economy, there was less than a month ago all of the smart money was betting on 4 to 5 percent GNP decline in the fourth quarter.

So it is possible that the fact that we had a mere 2.1 percent decline posted in the preliminary numbers issued a few weeks ago was a very pleasant surprise, that maybe the economy is not as bad as had been thought.

In terms of the amount of softness out there, I think the softness is not spread uniformly either through industries or geographically.

For a happy change, the midwest is not in bad shape compared to other parts of the country. They aren't running nearly as bad as the press, the financial press, the business press paints the picture as being.

For example, in an industry that happens to be very important where I live, the automobile industry, car sales, domestic car sales are running at somewhere in the range of 6.3 to 6.5 million units at annual rate.

That is not disaster, even compared to a recession—compared to, say, a recession like 1982. Five million car sales at an annual rate, that would be a serious disaster.

It is hardly profitable, but it is not all that bad compared to other recession periods, besides which, the automobile industry has been playing it very close to the vest these days in the past 6 months, unusual brilliance on the part of the domestic automobile industry in not letting stocks run well ahead of the sales pace.

We had a major drop in the automobile production, the rate of automobile production in the United States in the fourth quarter. In fact, the rate of automobile production, if everything else in the economy, if every other sector of GNP were flat between the third and fourth quarter last year showing zero growth, the downturn in the automobile sector itself would have produced more than a 3 percent decline in real GNP in the fourth quarter.

So there were plenty of other sectors that were expanding in the economy for us to wind up with only something in the range of a 2 percent rate of decline in the fourth quarter.

If there is any beginning of a pick up in car sales, firming in car sales, the industry is simply not going to have the stock out there.

Production is going to turn around on a time, compared to what has often happened in prior recessions where an easing in the rate of decline of sales then just provides the producing sectors an opportunity to grow into their excess inventories.

There aren't any excess inventories now. So production will turn around quite quickly, and that is something that I suspect the stock market is aware of.

Chairman NEAL. That is true throughout the economy, I think.

Mr. HYMANS. I think that is a general truth; that is correct. The possibilities of weakness are localized geographically and industrially. None of the economy other than perhaps Raytheon producing Patriot missiles in Massachusetts, for example, and pockets of that kind are in a boom.

But there are many, many parts of the economy that are still expanding.

Chairman NEAL. Mr. Silvia.

Mr. SILVIA. Thank you, Mr. Chairman.

To address the issue, stock prices again are forward looking, and they try to look at earnings discounted by some interest rate. To the extent that the Fed is lowering those interest rates, it is suggested that the volume of those future earnings go up in time.

The market is sensing that whenever the Fed has eased aggressively, the economy historically has come out of recession and that stock prices are validated by the higher earnings in the recovery, 6 to 9 months out.

I think basically that gets at your point of what is happening to the stock market.

I think they see Fed easing, they recognize that historically Fed easing has been successful and has got this economy going. One of the interesting comments before this meeting Mr. Roth made was that the decline in interest rates, would it be enough to get the economy going.

I think one of the interesting problems we have now is that if you look at what people said 6 months ago, a lot of debate was, well, if the Fed cuts the interest rates 50 basis points or maybe a hundred, that will get the economy going again.

I think it is an interesting problem to recognize that the decline in interest rates has been much more significant than what the consensus expected a few months ago, and we still have negative GNP numbers, and we still don't have money growth.

I think that is an interesting problem. I don't know what the Fed's position on all this is and what is going on here, but again, I would reemphasize to you that what we are talking about here is the process of monetary policy.

We are talking about interest rates going down more than we expected and yet not getting the kind of money growth or reserve growth that we would have expected.

There is something going on here that makes it different today than what happened in the past.

Thank you.

Chairman NEAL. My time has expired.

Now I want to get back to this in a few minutes, but let me recognize Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman.

I want to join you and our other colleague, Mr. Neal, for—we have two Neals here.

Chairman NEAL. We are ganging up on you, taking over.

Mr. ROTH. I want to join my colleagues in welcoming you to our subcommittee. I have a lingering, nagging question, and it wasn't lessened any by last Tuesday's hearings, and that is, the central question is whether our traditional reliance on looser credit is going to help us in the long run?

I think it goes back to what Mr. Silvia had mentioned here, given the unprecedented levels of debt in our economy, personal debt, corporate debt, government debt.

When I go back home and I talk to people—and it's completely different than Greenspan's view. Greenspan says, let's bring interest rates down. We say in the Congress, bring interest rates down but the people back home, they already have so much debt, they cannot make their monthly payments now.

And as a conservative, I frankly am skeptical that stimulating more borrowing which is the essence of the goal to looser credit, is this good for our country at this stage?

In the long run, is this really what we are looking for? And I hope that our witnesses here today can shed some light on that.

I would like to ask a question of all three of you, and let me start with Mr. Barnes. Mr. Barnes, you represented in your testimony a reduction in the deficit through lower spending, right?

Mr. BARNES. Right.

Mr. ROTH. Now, there are some in Congress who favor higher taxes. I mean, there is another way you can balance a budget for lower spending. You can also increase taxes. Would higher taxes hurt the economy and impede the recovery? What is your opinion?

Mr. BARNES. I would certainly prefer to see the deficit reduced through lower spending rather than higher taxes. I do believe that a tax burden in the United States economy has risen significantly in the last few years, and given the weakness of consumer confidence already, the fact that taxes at the State and local level are rising, that an increase in Federal taxes would add unnecessarily to the burden of consumers at this time.

I think one of the problems with the debt buildup that you expressed concern about, and I share your concern, as I mention in my testimony is that it has not gone into productive resources.

If the debt buildup had been used to finance capital expenditure, infrastructure spending, there would have been much less problem because the money is going into an area where you are generating a rate of return on those investments and then that rate of return can help finance the debt.

The problem with the government debt is a lot of spending has been in non-productive areas, medical care, however much you want to justify that on moral or social grounds, defense spending, which I know has been justified to some extent by developments in the Gulf.

But basically it gives no rate of return, given a huge buildup in debt on one side of the balance sheet and no productive assets on the other.

So I would like to see government spending cut for that reason, that would be the best way to balance the debt.

Mr. ROTH. You are absolutely right. The reason I was detained at this other committee, we are debating our foreign aid bill this morning. We are increasing foreign aid by 10 percent. Deficits are so high we are drowning in debt deficits, but we are increasing foreign aid every single year.

It is absolutely nonsensical. I realize that. No economy is going to remain the same. No nation remains the same. You are always either moving up or down economically and so on.

What are the danger signals of us moving into, becoming another Argentina? People say, oh, that will never happen. It can happen. It can happen to our country. It has happened to other countries.

What are the danger signals and what will be the signals to take our economy to the strength that we had in the 1950's? I mean, if we were looking for guideposts, if we were going down paths, what guideposts are we looking for?

Well, starting from here you have a position of really very unpleasant high debt levels, as did Latin America. If it became the sort of national solution to get rid of this debt was not to have an uncomfortable long recession, long painful adjustment period recessions, but let's just devalue the debt. Let's pay back as Mr. Silvia suggested and pay the debt back in cheaper dollars in the future.

I would call that the Latin American solution, and that would be a disaster because inflation did not help Latin America get into its debt position. In fact, it just ended up with inflation and deflation side by side, a pretty unpleasant combination.

So I would say that the sign posts to look for in terms of a Latin American solution would be acquiescence to higher inflation on the part of the Government and more importantly, the Federal Reserve, because at the end of the day, even if the administration decides to vote for higher inflation, as long as you have a strong, independent central bank controlling the purse strings, then the Government's ambitions will be worthless.

I don't expect a Latin American solution to be taken because I have confidence in the Federal Reserve wouldn't allow that to happen.

In terms of what could make the United States stronger——

Mr. ROTH. I am sorry for interrupting, but the Federal Reserve does not have all the purse strings. I mean, if Congress keeps spending, we drive up these deficits to \$400 billion, doesn't it mean that at some point the Federal Reserve is going to have to acquiesce?

Mr. BARNES. Well, then you hit crunch time. I mean, basically those deficits have to be financed. If the Federal Reserve kept money growth tight, did not help the Government finance the deficit by purchasing government securities, then you would have sharp rise in interest rates.

You would drive the economy into a recession. Then I guess you would have the national debate about priorities, which at that point the country would have to make the decision, do you take away the Federal Reserve's independence and open up the purse strings and get the economy out of this recession trap, or do you take the position to cut the deficits?

Mr. ROTH. I am just interested at what point are we going to have to bite that bullet? I mean, first it was \$200 billion deficit, and last October it was \$225 billion, and now we are told \$325 billion, and that is not including the \$78 billion for the Persian Gulf. That is over \$400 billion.

At what point do we have to bite the bullet?

Mr. BARNES. Well, a couple of points there. First of all, I think that the very large deficit numbers that we hear talked about do exaggerate the extent of the budget problem because of the deposit insurance, which is a cost per se; but it really is a financial transaction within the economy.

I am more watching the budget deficit excluding the trend in deposit insurance, which is still too high, which is still a concern, but not quite so alarming.

Well, you could argue that to some extent you are facing the bullet now. You are facing the issue now. And I have to say the Federal Reserve is holding steadfast. It has eased policy, but as has been pointed out, it hasn't eased policy enough to get reserves going.

And if it was really panicking here and really throwing in the towel, why isn't the Federal funds rate 4 percent instead of 6 percent?

So, I think it's going to be a constant debate, I guess, over the next year. But I think last year's budget agreement was a step in the right direction. I think the Fed is hanging tough, and I am reasonably confident that the Federal deficit will start coming down again.

Mr. ROTH. OK.

My time is up. Otherwise, I would have asked when.

Chairman NEAL. When what?

Mr. ROTH. You said the deficit, you feel confident the deficit is going to start coming down again, and I was going to ask when and what would lead you to believe that it is going to come down?

Mr. BARNES. Well, I think there are a couple of circumstances at the moment which are pushing it up, particularly rapidly ones, this deposit insurance, which is probably reaching a peak over this year and next and measures that are taken to reform the banking structure.

Those deposit insurance costs should start to come down fairly dramatically, as indeed forecasted by the administration in the Budget Office. We do have a cyclical problem. The recession won't last forever, however gloomy one might want to be about the economic outlook. So it is going to improve on those grounds.

Demographics will help, Social Security surplus will continue to rise in the years to come. And I am hoping that the action taken last year will be built on. I think it was an important mechanism put in place there to control spending.

I think there are some favorable trends in place, but perhaps more needs to be done.

Chairman NEAL. The Gulf War costs are essentially one-time expenses.

Mr. BARNES. That is also true, yes.

Chairman NEAL. Mr. Neal.

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

I have a question that perhaps any of the panelists might respond to. Given the current problems in the New England economy, what role do you think that the credit crunch has played in exacerbating those problems?

Mr. HYMANS. Well, I think the credit crunch is very much an aspect of the New England problem. The problem in New England was a rate of growth that simply could not be sustained, and that rate of growth of the New England economy, far above any reasonable conception of what could have been maintained, then generated all manner of construction, real estate activity that took place in the New England area as people flooded in, took advantage of the job growth potential, as people moved around, new shopping centers, everything like that.

That sort of, was kind of a speculative boom if you wish on top of a real economic boom, and the speculative boom couldn't last because the real economic boom couldn't last to keep feeding it.

And things happened in the financial sector, not only in the savings and loan section, but in the commercial banking sector, which led the commercial banks to be more willing to go ahead and finance what in other circumstances in other times would have been regarded as shaky opportunities.

For example, I mean we talk about the savings and loan problem having developed in very large part because the opening up of the financial sector and the sharp rise in interest rates in the late 1970's and early 1980's.

That was mentioned earlier in this testimony by Mr. Barnes—or Mr. Silvia, I am not sure which one, but these savings and loans in a situation where their earnings were limited by the fact that they had made long-term commitments to mortgages at low interest rates and simply couldn't compete any more for the funding.

Well, the banking sector ran into a similar problem when check writing activity moved further afield at commercial banks so that one could write checks on money market accounts and so on and earn money on checking accounts at the same time.

And the banks had to start paying money on demand deposit, paying interest on demand deposits, a very big piece of the bank's balance sheet, demand deposits in the balance sheet which used to

be free money to the commercial banking sector now even though they had to pay 4 or 5 percent, something piddling compared to what was being paid in the open market on similar kinds of check writing capability, a very, very big increase in the cost of funds took place in the banking system.

And that induced them, as in the case of the savings and loans, to look for higher earning assets to pay for that, for the fact that a very big chunk of their deposits used to carry no interest payments.

No liability for the bank to pay interest, and now suddenly they do. So there were all kinds of reasons for that. As a result, the balance sheets got shaky, and the credit rationing took place.

Now I think in the New England area, it may have had the effect which we will appreciate some time later helping to shut off a speculative set of speculative activities in the real estate area, sooner than might otherwise have been the case, but they would have had to come to an end.

There was no enduring Massachusetts miracle. We knew that, and that had to come to an end. So yes, it has had an impact, but I don't think it is something that has been completely independent—that was totally avoidable because there were real ones for these kinds of activities to come to an end in the real estate area.

Mr. NEAL OF MASSACHUSETTS. Do you think Mr. Greenspan was short in his estimate of the role the country played.

Mr. HYMANS. Yes, but in very good company. I don't think—I know for sure that I didn't appreciate it until—the significance until the middle of 1990, and I know very few people who have not been—very few people who did realize how bad the credit crunch was going to get.

Now, you know, I don't think that we are in a credit crunch situation that cannot be reversed and cannot be cured. And it is significant. I don't think it is horrendous now. It is horrendous in one area; the housing market is in a depression. There is no question about that. We are running below a million in starts.

But it is not only the credit crunch that did that. The Tax Reform Act of 1986 also had implications which slowed down the construction industry. There was over-building in certain regions. Some of it was tied to what happened in the Southwest as a result of the weakness of the oil market until very recently.

And so yes, there are problems with the credit crunch, but I don't think it is by any means the whole story in the weakness of the economy.

Mr. ROTH. Mr. Neal, would you yield to me for a second?

This credit crunch, what do you mean by "credit crunch"? As I see it, our people, our credit cards, I mean, they were up to the gills in debt now.

Mr. HYMANS. Well, it is true that the—first of all, it is not nearly as scary looking if you take Federal Government debt out of the calculation, if you just look at private debt relative to disposable income or something of that sort. It is clear that it has grown, no question about that.

However, if you look at repayments, the obligation to pay interest and principal on accumulated consumer debt and look at that

relative to income, it is not nearly as scary as if you just look at the debt because the debt has been stretched out.

Mr. ROTH. If Mr. Neal would just yield one more second, I was just reading in the paper yesterday about a record number of small businesses going bankrupt and so on.

Mr. HYMANS. That is a recession phenomenon for sure, and it may be exacerbated by the fact that we know that what banks are doing now is protecting their best customers. Few banks are interested at the moment simply because the regulators are on their necks, not unjustifiably, and perhaps late.

But nonetheless, regulators are on their necks to be very, very stingy in terms of what is done with their assets. So what they are doing is protecting their best customers, and the result of protecting their best customers is that they are not being very respectful to the new customers and they are the small businesses and also people who want to buy cars and finance homes and everything else.

Mr. ROTH. I know what you are saying. I come from the real estate industry back home, and if a contractor has a house that is worth \$150,000, the bank will loan him \$225,000 on that. There is no such thing as credit crunch. They are happy to loan the money.

And I think that is where part of our problem lies. I think that—what I am saying here is basically the theory is that there is so much debt out there now, the people that come to us and say, hey, loosen up the credit so people borrow more, I say, that is like giving a drunken sailor another drink.

But if I am wrong, I am just trying to resolve this in my own mind.

Mr. HYMANS. Surely there are potential customers who should not further increase their debts. There is no question about that, but that is always true. And maybe there is a somewhat higher proportion of the people in the country who should not.

But that does not mean there aren't plenty of opportunities that are worth supporting, that are worth lending to. And right now, banks are feeling the problem.

One of the things that is quite interesting about what is happening to money growth right now, we talked somewhat loosely, I think, today about the fact that reserves are not growing rapidly.

If you look at narrow measures of reserves, essentially at what the Federal Reserve is pumping into the financial system, that is growing rapidly and has been growing rapidly in the latter half of 1990 and the beginning and early part of this year.

What isn't growing rapidly is something like M1 or M2. Not surprising about M1, but quite surprising about M2.

Mr. BARNES. Are you talking about currency?

Mr. HYMANS. I am saying if you look at the monetary base, for example.

Mr. HYMANS. There is either a big currency drain or excess reserves in the banking system if you look at the data at the end of 1990 and the very beginning of this year, but through the month of January, the end of 1990 and through the month of January, not within the last week, but there was a huge increase in excess reserves in the banking system.

Mr. BARNES. Since collapsed.

Mr. HYMANS. I said not in the last week. So we may be in a position where we are going to see M2 growth accelerating.

Mr. ROTH. Thank you very much, Mr. Neal.

Mr. NEAL OF MASSACHUSETTS. Mr. Chairman, could I get another minute?

Chairman NEAL. Absolutely.

Mr. NEAL OF MASSACHUSETTS. If I might respond to Mr. Roth's suggestion. It is interesting in New England that many of the complaints are coming from the realtors, from the real estate industry, that the banks are routinely turning down good prospects, in addition to which they are questioning more vigorously what heretofore had been considered to be good credit risks as well.

I guess the argument that I am making is that Mr. Greenspan's denial of the credit crunch in the early months of the New England problem, coupled with the psychological problems that were created at that time; and given the downturn, all of these ingredients arrived at once to contribute to the debacle that we know as the New England economy today.

My argument is, I don't disagree with you that the average consumer in America has taken on too much debt; that is a reasonable conclusion. But I would argue that New England banks right now are not in a position to lend a lot of money, because a lot of them don't have a lot of money to lend.

But what they are doing is they are routinely turning down good credit risks, people that have done business with them for two and three decades, and much of it has to do with the psychological impact of Chairman Greenspan's position early on.

Mr. ROTH. Maybe the New England bill will help us then, because we are doing away with interstate banking and then the banks from all over the country can come to New England and make those loans.

Mr. NEAL OF MASSACHUSETTS. We could always use an infusion of new capital.

Mr. SILVIA. But again, as consumer confidence changes, that impacts the ability of monetary policy to move this economy. And so what we are saying is that as New England confidence fell, that the ability of banks to lend or the willingness of banks to lend changed.

So while the Fed is sitting here going over market operations, increasing reserves, it doesn't flow through the banking system to get this economy going again. So again, the process of monetary policy is being impacted by a number of events, a number of changes that are taking that, any given changes in monetary policy, and making it less effective.

Mr. HYMANS. Could I make a comment on that? The business of not getting through the banking system, if reserves are being increased, there is only—it cannot get into the banking system, except in two ways. It gets to the banking system and they simply sit on it in the banking system, excess reserves, which is silly, because it doesn't earn any interest. Treasury bills at least earn interest. It is a big cash drain. It is kind of a mystery now, especially why excess reserves went up so dramatically, but that seems now to have collapsed.

Chairman NEAL. You know, the numbers we have indicate that the excess reserves as a percent of total reserves averaged about 1½ percent throughout 1990, which is essentially the same as a long-term trend, and that there was a jump up in December, 1 month?

Mr. BARNES. About 2 weeks, and that is widely believed that was associated with just a technical adjustment to the change.

Chairman NEAL. I don't see any change in trends here at all.

Mr. HYMANS. There was a short period of time, that is right. But in that had nothing to do with it, then it is hard to see what else could have been the story, because there isn't any—I mean, arithmetically there are no other options. It is either a currency drain or excess reserves. The monetary reserves go in through the Fed, if the Fed pushes them in, they got to get in.

Chairman NEAL. I don't think there has been any—I don't think there has been any essential growth in money supply. What you are saying is there have been some reductions in the interest rates, the Fed-funded rate, most notably, but it looks to me like the loan demand is soft. In fact, I was with a group of North Carolina bankers yesterday, and I asked them about this—these were bankers of all sizes. I think bankers are up from all over the country for their annual meeting or something.

And anyway, these were our larger regional banks all the way down to the community banks. Are the regulators doing anything different in essence? Essentially what they said was no, that the regulators are asking them to better document some of their loans, financial statements on people and that sort of thing, and asking them to essentially tighten up lending activities a little bit in ways that they frankly think are quite reasonable.

But that there does not appear to be any shortage of credit. No, in fact, I would say no credit crunch. It is just that loan demand is soft. We are in a relatively soft economy.

Is that not correct, or am I wrong?

Mr. SILVIA. If I could—

Mr. BARNES. I would agree with that. I have a chart in my testimony which supports that notion, that the trend in bank lending is not out of line with past cycles in terms of its relationship with the economy. It is slowing, but the economy is in recession, and bank lending growth always slows in a recession. What we are seeing is a return to prudent banking, and we are seeing a transition from a period where regulations were probably too lax in terms of criteria for lending to a more reasonable set of criteria, and that probably feels like a credit crunch, but it is basically banks adopting standards that they should always have adopted all along.

Chairman NEAL. Mr. Hymans? What are we missing?

Mr. HYMANS. We are still seeing, for example, the simplest case is to look at some M1 or M2, and M1 is not interesting here, but if you look at M2, the so-called money multiplier, the credit expansion, that is weak. And I am not sure we know why it is weak, is what I am saying.

And you can't explain that by weak loan demand. That is not the issue.

Mr. BARNES. There certainly does seem to be a change in both bank behavior, the way they maintain reserves and operate

through the discount window on the Federal Reserve on the one hand, and household savings behavior on the other. And the Federal Reserve believes that this has a lot to do with why money growth has not responded to the interest rates. Because on the basis of normal relationships, money growth should have picked up, given the kinds of declines in interest rates that we have seen; and the Federal Reserve has acted reasonably in the sense that it has cut interest rates, money growth should have recovered, it didn't. So it cut them further.

Chairman NEAL. Well, what that says is there is a slow economy.

Mr. BARNES. Well, it is beyond that. There has to be a change in behavior, but it has nothing to do with the credit crunch, I don't think.

Mr. HYMANS. It may not, it is a mystery beyond the credit crunch, and we haven't sorted it out yet. But it cannot have to do with weak loan demands. Just simply arithmetically, it has simply got to be permanent increase in borrowing, in excess reserves, or a currency drain. Because there is just no other way that it doesn't get into something like M2.

Mr. SILVIA. With respect to excess reserves, I think if your staff just goes through the data, they will see that there is a very definite end-of-year pattern in which they spike upwards. It happens at the end of every year.

Chairman NEAL. So there is nothing different here.

Mr. SILVIA. Yes, Mr. Chairman. I think it is primarily just a seasonal pattern. Look at what it is doing over the last few weeks and you will see that there really is no change in trend.

As far as the banks, when the Fed does deal in market operations, they supply reserves to the bank, the bank can do a lot of different things with this. And I think from the private sector point of view, what is happening is there is a suspicion that a lot of bank dividend payments are being maintained because of the additional reserves supplied by the Fed. There is a lot of suspicion that a lot of that money goes to make up loan loss reserves. There is a lot of sense that banks are simply buying Treasury bills.

So it is not showing up in getting loans. As far as loan demand being soft, I agree with you. If you look at the fundamentals behind why anyone would borrow money, the fundamentals is what will it do to the economy. If you look at business confidence, business confidence has fallen. These fundamental factors suggest that despite the fact interest rates may have come down some, those fundamentals about why somebody borrows money are not favorable.

So loan demand is soft and it is soft for some very fundamental reasons.

Mr. HYMANS. That is true, but it doesn't explain why the ration of M2 to reserves is low. It cannot explain that.

Chairman NEAL. May I just briefly move—

Mr. ROTH. I was going to ask, Mr. Chairman, there is a, what is his name, Proctor or something, has written a best-selling book about the economy goes in waves and cycles and people become negative-minded and so on. Is there anything to that? Is this guy selling a book, or—

Mr. HYMANS. Yes, he is selling a book; yes, there are waves of optimism and pessimism in the economy that we have known forever, sure.

Mr. BARNES. Interesting work done by Professor John Sturm at MIT, and he is a proponent of the long wave theory and he has a soundly based, credible theory of long waves in the economy, and his view is that the economy has been in a down wave pretty much since the late 1970's, which explains why although you have had an economic expansion, it hasn't been one that has been riddled with prosperity; and the buildup in debt, the imbalances are all associated with this down wave characteristic.

He sees that culminating in a big recession, and a washout, maybe this is it now, and then an up wave starting later in the 1990's.

Mr. ROTH. Before we have a washout, you know we are going to have a huge, huge inflation, because we are going to try to save it. Does this mean that Argentina is coming?

Mr. BARNES. I don't think so. I don't think you are going to have a big inflation.

Mr. SILVIA. Mr. Roth, with respect to your psychology issue, if you look on one of the charts I did on consumer confidence and the ratio between M2 and the monetary base, there is a very strong relationship there, suggesting that waves of consumer confidence could influence how the Federal Reserve's monetary policy is getting translated into money growth.

So there is a definite tie there, and again if you look at currency as Professor Hymans has mentioned, currency drain. There may be a number of factors going on. But as consumer confidence ebbs, there is a tendency for people to hold more currency. That may be one of three or four factors going on there, but definitely the ability of the Fed to ease, to get money growth going, has been offset by this currency drain, and it is responding to exactly the consumer confidence, wave up and wave down that you talked about.

Mr. ROTH. OK.

Chairman NEAL. Most of what you all have said about—I am not putting the question correctly. I think all of you have suggested in one way or another that you think the Fed is going to ease considerably to try to thwart the recession or something like that. For one reason or another you think the Fed will ease considerably.

What if it doesn't? What if the Fed in fact says that it is going to stay on its anti-inflation fighting path, and what would that mean in terms of today's economy? I don't mean by that to tighten considerably, but essentially stay, say, toward the low end of its cones in terms of money growth.

Mr. HYMANS. I am the one who didn't say that the Fed is going to ease further, so why don't I try it, that if in fact we don't wind up in a protracted Gulf War, if the Gulf War is indeed over by the spring, then I think we get an economic recovery and the Fed will not ease further, will not feel either the need to ease further, or would fear to ease further because inflation will come back as public enemy number 1. And they will simply be accommodative to the economic expansion, but not try to drive interest rates down any more. So I don't think they will.

Now, on the other hand, it is a different story if we go into—if the Persian Gulf War turns out to be a very long, protracted, ugly event, instead of a short ugly event.

Chairman NEAL. This is a digression, I think, but why would the war have any great impact on the economy? The only impact I can see it is having would be on oil prices, and they shot up, but they have essentially come back down; and also most of the costs of the war, it seems to me, are ultimately going to be borne, probably 85 percent of them borne by foreign interests instead of us. I can't see it having a very big impact on the economy at all.

Mr. HYMANS. The impact will be the impact that wars always have, namely you have got to produce new planes and new bullets and new bombs.

Chairman NEAL. I don't think so.

Mr. HYMANS. If you carry out a long war, of course you have to.

Chairman NEAL. Well, you know, we built this military machine to fight the Soviet Union and we are fighting a country the size of California, so I mean, I don't know that you have to—

Mr. HYMANS. If there is no replacement and no need for new tanks, new planes, new armaments, if—it is all very minor, then there is virtually no impact in a pure economic sense. The impact comes from the fact that—would come from the fact that you had to produce more in the United States, stuff that you then blow up and throw away and doesn't produce any new goods for people to buy in the United States, and the people doing the producing are being paid income and don't have anything more to buy, and then you worry about do you finance it appropriately to avoid inflation and so on. And then it has a very major impact.

If indeed we can run this war without needing to increase production of war material in the United States, and whether that is paid for by us or by somebody else, it doesn't make any difference.

In that respect, the basic element that gets in there is whether you have to produce war material in the United States or not. And if you do, then you have a big impact—

Chairman NEAL. That would be a positive impact, wouldn't it?

Mr. HYMANS. It would be a positive impact unless it generates such a state of consumer dismay and lack of confidence in the economic future, which this war might do, or which many people think this war might do, then that could beat the economic stimulus.

But if you don't have that kind of reaction, if people are initially depressed about it, but short of that depression, you know, people can be habituated to almost anything, the psychologists tell us, if they get habituated to this war and they still go out and spend incomes and so on in almost the usual way, a long, protracted war in which we had to produce would have a major stimulative effect on the economy.

Chairman NEAL. Jump in at any time.

Mr. ROTH. No one has greater insight into the Congress than you do when it comes to the economy. I realize that, and when I throw out these suggestions, more or less just my thinking, to try to clarify my thinking. I would think this war is going to have a huge impact, and the reason I say that is because our national debt will

be going up so much more, and that is something that has to be addressed, and the costs after the war.

How much is that going to cost us? And our National Guard units and the Reserves now taken out of a country, that has got to have some impact.

And Iraq does have the fourth largest army in the world, so it is not going to be easy, plus you had mentioned the psychological effects. I hope it doesn't have much of an impact, but thinking about it from that angle, it seems that it might have a big impact.

The question that I am wrestling with also is what is going to happen with your banks? Maybe the three of you could try to—or give us some advice. Do we have to worry about our banking system taking a look at the economic situation we are in?

I mean, just how serious is this banking situation? Are we going to go down the same route of the S&Ls, or are we just—you know, is there just somebody crying wolf out there?

Mr. BARNES. It is a very serious situation indeed. I don't think it is the same as the S&L situation, because banks are much more highly capitalized as an industry than the S&Ls, and one would hope that there isn't the same degree of fraud and mismanagement as became apparent in the thrift industry. But it is a very severe problem and I think that has been recognized by the authorities, and if you look at the thickness of the Treasury's green book, proposing reforms suggests the level of concern perhaps.

There are too many banks; the banking industry—and by that I don't necessarily mean in terms of the number of banks, but just the size of the industry. The banking industry grew up significantly in the 1980's in the back of this whole credit explosion. It was financing commercial real estate, highly leveraged transactions in the corporate sector, it was lending significantly overseas.

Those areas of growth are now gone. You have a banking industry that was of a size to—you know, where it is too large to support the basic business, which is bread and butter main line, commercial and consumer lending, maybe residential mortgages.

Mr. ROTH. What does that mean, that the administration's bill is going to help resolve the problem?

Mr. BARNES. It is going to help resolve the problem. I think it recognizes some very important things you need to do.

First, instill some market discipline on the sector so that they are not using federally insured funds to engage in speculative activities. That has got to alter. Breaking down the nationwide barriers to banking makes an awful lot of sense.

The one that is far more contentious is Glass-Steagall and allowing banks into non-banking areas. While there is very strong feelings on both sides of the fence, I would be a bit concerned because banks have proven that they cannot operate very efficiently in their own business, and you want to let them into other businesses where they are already very competitive and very crowded; and those businesses cannot make money, either.

So to pretend that letting banks into the securities business is to compensate that they performed so badly in their mainstream lending is quite alarming, but it certainly is a case for broadening the powers of banks.

But I think the size of the sector has to shrink. We have to probably see some of the money center banks consolidate. No painless way of doing it.

Chairman NEAL. Back to the question, if I can, about the, about the Federal policy.

What if the Fed doesn't ease, what if it stays toward the lower end of its growth path that it has suggested in recent times for the main money aggregates?

Mr. HYMANS. Mr. Chairman, the Fed does not control the money aggregates, as you know. When we look at a chart like this one that shows what M2 is doing, that it has been trailing down, that is not Federal Reserve activity. Federal Reserve activity has to do with the Fed's buying and selling of bonds in the debt market, and/or reserve requirements, or things of that sort.

In that regard, the Fed has been expansionary. Now, for whatever reason, whether it is the cash—maybe there is a big cash drain. If that is the reason that M2 isn't expanding, that is not the Fed's fault in essence.

The Fed has been carrying out its monetary policy activities by having the monetary base growing at double digit rates. That is a lot. It has been growing at 8 percent or 10 percent or rates of that size. That should have been monetary easing.

It was enough monetary easing to drive interest rates down in conjunction with the weakness of the economy, which tends to let interest rates come down anyway. But it isn't—the Fed is not acting to get M2 toward the lower bound of its range.

It is basic in terms of its instruments of activity in a way that M2 should have been at a higher level than it has gotten, and that is the problem. It is not the Fed's behavior.

Mr. BARNES. I have to disagree with Professor Hymans, Mr. Neal, if I can make a point.

The Federal Reserve is capable of stimulating money growth. It just hasn't yet found a level of interest rates that will do the job. It had thought that by getting interest rates down to these levels, money growth would have picked up.

It can bring the Federal funds rate down the 1 percent if there was no other constraints. I am sure that money growth at that point would head for the stratosphere.

So I think to argue that the Federal Reserve cannot influence money growth is wrong. It can be more aggressive in pushing up reserves, and that is on the same point. They have not yet found a level of interest rates that is consistent with growth and bank reserves. They will get there.

The real issue, I think, of what you are asking is the level of money growth at the moment acceptable in some sort of long-run sense and does it mean that we end up getting a much worse recession.

That is a tough one to answer. As I said before, I mean, the relationship between money growth and GNP is a pretty sound, stable relationship over the long haul.

I think in the short run, money growth is a bit too weak. I would be concerned that if it stayed at, say, current 3 percent rate, then we are going to end up with 2 percent nominal GNP growth over the long haul.

I think that may be consistent with your objectives of zero inflation, but I think that would be a pretty painful transition. I would like to see the transition take place in a more gradual, controlled way.

So I would like to see them get money growth up to 4½ percent, let's say, hold it there for a couple of years, bring it down to 4, 3, do it that way.

I think if you just ignore the current level of money growth and say let's just stick with it, because it suits our long-term objectives anyway, that that would be quite a painful recession, much deeper than necessary recession.

Mr. SILVIA. I think, Mr. Chairman, it has to get back to the really basic problem of why is M2 growth at the lower end of the range. To what extent is it institutional changes or other problems in the economy?

If you really expect people to go out there and borrow money and banks to loan the money, you have to figure out what is changing with respect to consumer confidence, what is changing with respect to industrial production; and it is a very difficult process here.

Going back to your basic question, number four, we portray easing as lowering the Federal funds rate. We view that as somehow that is the magic. It certainly has been conveyed in the marketplace that the Fed's—every time they do an open market operation to get the average Federal funds rate down. Yet it doesn't show through in terms of M2 growth.

I would really focus in on that. I think that is a major question.

Chairman NEAL. What do you think personally? What do you think is going on that is new and different and so on?

Mr. SILVIA. Well, go back to just the basic fundamentals. I think Mr. Roth is quite correct. Confidence has changed. The outlook for the economy has changed.

And as you go through the steps of how monetary policy actually works, those steps are being offset, they are being ineffective than what they were otherwise. And they are certainly much more ineffective than what I believe even Chairman Greenspan believes or expected them to be.

I really honestly feel that given the amount of the decline in the Federal funds rate, that the consensus on economic forecast would never have looked at GNP being so negative in both the fourth and first quarter.

So I think you've got to look at the process. There are other things going on here, and it probably is the major issue facing us today.

Chairman NEAL. Let me ask you all this. Inventory is low. That is very positive for the economy. But what else is positive? Why are you anticipating a—I think, Professor Hymans, you referred to it as an economic recovery? Why? What else?

Mr. HYMANS. Well, the inventory is one. The other is—I mean, if we forget about a long war scenario, so we are not talking about the defense budget being a stimulant. Inventory is one. The strength of export demand, demand for U.S. goods abroad is another. The demand, fundamental demand for increased modernization of capacity in American industry is still very strong.

There is a problem right now, I think firms are wondering whether this is a good time to be doing that if product demand is going to be weak at the moment because of the recession.

But fundamentally, that is still a strong area of demand in the economy. We now are in a situation where we probably will see no boom in the housing market, but if the credit problem eases somewhat, we are not going to stay at a housing start rate under a million. We will get to a million two, or a million three, which is quite different from going down from a million three to under a million.

Going back up is a very positive factor.

Chairman NEAL. But aren't there a number of very negative factors? Mr. Roth has pointed out levels of debt, earnings aren't great, the huge—

Mr. HYMANS. Little economic recovery is the best thing for earnings.

Mr. BARNES. I think it is important to understand, I mean, we have had some differences here, but why we are in recession, Professor Hymans cited the Gulf and some various things which caused the recession.

I think maybe my best analysis, a bridge where the foundations have been eaten away by termites, the train goes over the bridge and the bridge collapses; what causes the bridge to collapse, the train or the termites?

I think if you blame the recession on the Gulf War, on tight money or credit crunch, you are blaming the train. I would be more inclined to blame the termites, weakened balance sheets which are really eroding the economy's ability to withstand any slight shocks.

I mean, if you had had very sound balance sheets, very sound banking system, the kind of money policy that we have seen over the past year would have been perfect, exactly in line with the kind of long-term policies that you favor.

The economy would have been able to withstand much better the developments associated with the Iraqi invasion, and I think it is because this economy has been so fundamentally weakened by high debt levels that has left it exposed to any slight outside ripple.

I blame debt on the termites rather than the train.

Chairman NEAL. And where is the improvement in that?

Mr. BARNES. There has been no improvement. In fact, it just got worse because people cannot climb out from under it.

Chairman NEAL. Why would you be very optimistic about the economy?

Mr. BARNES. But I am not. I think I was one of the more pessimistic ones here.

Mr. SILVIA. I would just reemphasize your earlier point about the war. We had no reserve growth before the war. Economic indicators were going down. Quality spreads were rising. The New England credit crunch happened way before the war.

All of this was going on before Iraq every showed up on a CNN screen. I think it is very clear that other things are going on here.

Perhaps in part I share Martin's point of view. I think it is the termites. I don't think it is the train. If you blame this economy on the train of Iraq, I think it is misplaced.

I think the process of monetary policy, the way it is conducted and how it has impacted on the economy is different today than what it was 6 months or 2 years ago. And oftentimes if we just lower the Federal funds rate, it will work.

I think there are other things going on here.

Chairman NEAL. How would you characterize your outlook for the economy over the next year or 2 years, 5 years?

Mr. SILVIA. Well, you have got confluence of two different things; cyclical weakness in the economy, but you have also got this fundamental issue about debt. And the point of view is that many people, New England, for example, took on debt in the expectation that it was going to be repaid and oftentimes repaid because of higher inflation rates.

When you have a system that changes, the dynamics are changing and you are saying, we will no longer validate 6 or 7 percent inflation, the high rate of growth of housing prices, which essentially is a real asset, and those housing prices going up is inflation, we are not going to validate that system, you are going to have a lot of people disappointed because their house prices are not going up as fast as the cost of the debt on those houses with interest rates staying up.

And so what happens is the dynamics of that process have changed. So you have cyclical weakness on the top of the process that you are trying to change. You are trying to wipe out a secular view that inflation also goes up.

You have got the two things combined together. It is a difficult situation, and I think we need to recognize that there are two things going on here at the same time. It is not just the cyclical weakness in the economy. We are also trying to rid inflation expectations out of the higher debt levels.

Chairman NEAL. Professor Hymans.

Mr. HYMANS. Well, I think that is the reason why I think that when the economic recovery is going to start slow and that we are going to get, even when we are in 1992, we are barely going to get above 3 percent growth for a while and now—we are not going to go up from there, that it is going to be a slow process of getting unemployment rate down.

We are going to wind up after a year and a half of recovery with an unemployment rate that is still well over 6 percent. We will not have taken inflation completely out of the system by any means at that point, though I think the core inflation rate will be down around 3 percent.

But I think there is nothing in the system that is going to generate a boom, an economic boom, and that is for the same reasons that these guys are very pessimistic, my view is yes. The issues that they are talking about in terms of the fundamental structural issues that have to be dealt with and the basic debt levels in the system that have to be dealt with, I think they are going to have an effect.

But in my view, the effect is taking an economy which would have a tendency to grow over a long period of time at perhaps a 3½ percent rate, and that is going to turn out to be barely a peak rate that we are going to reach for a very short period of time and not even be able to stay there.

Mr. ROTH. I have been following the arguments you three have been making. I can see that you are very astute. The question I have, if that is the case, what does that mean for people like the chairman and myself here in the Banking Committee? What does that mean for our banking industry?

That means we have got a real big problem on our hands, doesn't it?

Mr. HYMANS. Yes, of course it's a problem, and I think Mr. Barnes addressed that and said that what we are going to have to have clearly some consolidation in the banking system and a set of regulations which permit the system to be profitable and so on.

And some economic growth, even if it's sub-par or barely par economic growth will go a long way to helping secure the balance sheets.

Mr. BARNES. I think it is important to accept that a period of slow growth is going to be an acceptable and necessary cost of making the adjustment to sounder finances in the banking system and private sector.

The worst thing to do would be to make an objective policy to get credit growth really strong again, as you are implying, get people borrowing again. That is the last thing we want here. You certainly want to stabilize the situation some.

But you want to get credit growth down low and keep it low and allow these debt burdens to be worked off. I would hate to see the Federal Reserve desperately trying to get people to lend and borrow aggressively. That is how we got here in the first place.

Mr. ROTH. I don't know if any of you are psychic or soothsayers, but I would like to ask you, how many banks do you think are going to fail this year? Anyone looked at that?

Mr. BARNES. We have had a study done by a bank consultant who basically plugged in sort of moderately severe recession, maybe sort of average kind of recession, and superimposed sound banking criteria in terms of the amount of loans that should be written off, well, the amount of loans you could expect to go bad and then how many should be written off.

And I think he came up with a conclusion, I may not be totally accurate here, but it was something in the order of banks accounting for, I think it was between 20 and 30 of total bank assets would fail to meet the capital standards.

So it is pretty significant. That is not the same as saying 30 percent of banks will fail. That does give you some indication of the magnitude of the problem.

Mr. SILVIA. Mr. Roth, I would just give you two guidelines here. One, you should recognize that the role of banks in supplying credit in this economy has been going down for a number of years, so that in your deliberations on the Banking Committee, please do not treat this as simply a short-term cyclical problem.

There is long-term issue here involved. The second thing in all your deliberations in terms of banking reform, you must recognize that regulatory changes do have macroeconomic impacts. I think it is clear one of the tragic lessons of the last 2 years is that regulators, in effect, almost trumped the Fed in terms of its conduct of monetary policy, that regulators either didn't know or didn't un-

derstand that any changes in regulations do have macroeconomic impacts.

I think those two guidelines should help you.

Mr. ROTH. OK.

I want all three of you guys to run for office because no one said how many banks were going to fail, and I think that is wonderful.

I am going to keep this testimony and a year from now and see how many actually did fail.

Thank you very much.

Chairman NEAL. Anything else any of you all would like to add? If not, I sure do thank you for helping us with these questions. We would welcome your advice any time.

Thanks again for coming, and the subcommittee stands adjourned subject to the call of the Chair.

[Whereupon, at 1:15 p.m., the hearing was adjourned, subject to the call of the Chair.]

FEDERAL RESERVE'S SEMI-ANNUAL MONETARY POLICY REPORT

Thursday, February 21, 1991

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

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal of North Carolina, [chairman] presiding.

Present: Chairman Neal of North Carolina, Representatives Barnard, Neal of Massachusetts, Kennedy, Hoagland, Roth, Campbell,

Chairman NEAL. I'd like to call the subcommittee to order at this time. Today we continue our hearings on monetary policy and the state of the economy, with the Federal Reserve's semi-annual Monetary Policy Report to Congress.

As well as presenting this report, I hope that Chairman Greenspan will take some time to address some of the following important questions about the current state of the economy and where we are going from here. First, what is the cause of the current recession? Was it inevitable, in the sense that our economy naturally produces these cycles, with only the timing uncertain? Or was it caused by identifiable policy mistakes? If so, what were they.

The second question concerns the nature of this recession. Is it more or less like past recessions, or is it somehow unique, novel, different? If so, how? If so, do its special characteristics call for special policy responses?

Third, should we use monetary policy to revive the economy as quickly as possible? That is, should the past focus of monetary policy on reducing inflation now be totally abandoned in favor of stimulating recovery? Can monetary policy even be effective in light of the so-called "credit crunch"? What, in fact, is a "credit crunch"? Have we been experiencing one? If so, what data support that interpretation? And, if so, what is the proper policy response?

The fourth issue is a bit technical, but may be important in helping understand the causes or the depth of the recession. The Fed has been portrayed as "easing" for some time now, because it has been lowering the Fed Funds rate and the discount rate. But does this accurately measure what we mean by "easing"? Monetary growth, though within the Fed's target ranges, has been decelerating rather consistently throughout the year. The Fed has apparently become concerned about weak monetary growth. This suggests that, contrary to the appearance of easing fostered by a fixation on

the Fed funds rate, policy may well have been tightening all along, though inadvertently. In the face of a weakening economy, and a falling demand for money and credit, a real easing of policy would try to keep money growth from decelerating. If the Fed had concentrated on keeping money growth at or above the midpoint of its target range, accepting whatever Fed funds rate that would require, it is conceivable that the current downturn could have been significantly mitigated. Has their focus on the Fed funds rate been a mistake?

Finally, is it possible, or likely, that we could come out of this recession with a much lower range for inflation—in fact, a rate of inflation within striking distance of what I call “zero inflation,” or price stability. In considering its response to the current state of the economy, the Fed should be careful not to sacrifice the gains we may soon be reaping in terms of lower inflation. If that temptation is resisted—if we come out of this recession with inflation tolerably close to zero—the only serious argument lodged against my proposal to mandate a zero inflation objective for monetary policy would disappear. That argument was simply that the transitional costs of moving to zero inflation—price stability—would be too high. Once these costs have been paid, however, I can see no remaining argument against a “zero inflation” target for monetary policy.

Today we welcome the Honorable Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System for the presentation of the Federal Reserve’s semi-annual monetary policy report to Congress.

Chairman NEAL. Before recognizing Chairman Greenspan, I would like to ask other members of they have any opening comments? Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman. I will be very brief. I just want to make a short opening comment. Mr. Chairman, I join you in welcoming Chairman Greenspan to be with us today. What a difference a day makes. I see everything was clogged in the corridors yesterday. I did not realize, chairman, that your real remarks were saved for today. So, we all want to join the chairman in welcoming you here today.

As a new ranking member on this subcommittee, I look forward to working with you, Chairman Greenspan, and your very able staff. You have done a terrific job and we want you to know we appreciate the tough decisions that you have made to work as you have done.

Judging from the news, Mr. Chairman, you bring us some hopeful news today. But we also have to recognize that we will face a very difficult set of pressures. For example, our high level of personal and corporate debt, weakness in the financial institutions and unprecedented high Federal deficit, tougher obstacles in exports and, of course, the War.

Naturally, we all our focused on how to get out of this recession. But, to me, our long-term economic security must be of real concern. Where will our future economic growth come from, when our domestic consumers are so deeply in debt? When does our national debt burden, private and government, start to lead us in the same direction as Brazil and Argentina? To bring us back to today’s sub-

ject; can we rely on traditional monetary controls to effectively stimulate growth while we hear your optimistic report that short-term prognosis is good?

I hope that you can address these longer term questions as well, because we in the Congress, I think, have to be very sensitive to this because the decisions we are making now, I am fearful, are going to have tremendous repercussions in the future as far as our economy is concerned. Because of the emerging world competition, our National security depends as much on our economic strength as in our military strength, and we just have to get our economic house in order.

For that reason, Mr. Chairman, I am delighted to have you here today to give us some guidance and some reflection where Congress should be moving. Thank you.

Thank you, Mr. Chairman.

Chairman NEAL. Thank you, sir.

Mr. Barnard.

Mr. BARNARD. No, sir.

Chairman NEAL. Mr. Neal.

Mr. NEAL OF MASSACHUSETTS. Mr. Chairman, I would like to save my remarks for the question period.

But I would like to say that I hope Mr. Greenspan would have an opportunity to touch upon the economic problem within New England this morning.

Certainly, I would point out that, at the opening moment, that I do not share the view of the Bush administration, that the recession has been short and mild. Anybody who has visited New England knows that the recession has not been mild.

Thank you.

Chairman NEAL. Yes, sir.

Mr. Hoagland.

Mr. HOAGLAND. Only briefly, Mr. Chairman. I would like first to note that really, with our fiscal policy, tighter monetary policy is the only weapon that we have at this point to fight the recession.

I think the Chairman and the Board deserve considerable credit for having done a good job of reacting aggressively to the current recession situation.

I think the signals that have been put out by the Federal Reserve Board have had a very positive effect on the markets.

I would note only, however, that our policy now is quite different from that of Germany and Japan. Germany is recently raising the discount rate, as I understand it, and Japan is staying steady while we are loosening things up and opening things up a little bit.

I guess the only concern I have about this policy that has been good in every other respect virtually, is how it is going to effect the capital flow situation.

Whether it might make it more difficult for us to fund our debt, dependent as we are on overseas financing. And if it does turn out that the capital flow situation neutralizes a lot of the beneficial effects of the Fed's policy, what Fed might do to respond to that.

Thank you, Mr. Chairman.

Chairman NEAL. Thank you.

As always, it is a pleasure to welcome Chairman Greenspan. Without objection, we will put your entire statement in the record, and ask that you proceed, Mr. Chairman.

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

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

As always, it is a pleasure and a privilege to appear before this subcommittee, especially when you are dealing with the monetary policy oversight hearings. We make a special effort to focus on these hearings because we believe this subject the core of our policy orientation.

Mr. Chairman, I should like to start with an overview of the economic outlook. As you know, business activity turned down in the latter months of 1990, and appeared still to be declining through the early part of February. With the unpredictability of events in the Middle East compounding the usual uncertainties attending any economic projection, it would be most unwise to rule out the possibility that the recession may become more serious than already is apparent. Nonetheless, the balance of forces does appear to suggest that this downturn could well prove shorter and shallower than most prior post-war recessions.

An important reason for this assessment is that one of the most negative economic impacts of the Gulf war—the run-up in oil prices—has been reversed. Another is that the substantial decline in interest rates over the past year and a half—especially during the past several months—should ameliorate the contractionary effects of the crisis in the Gulf and of tighter credit availability.

The major danger to a near-term recovery is that the erosion in purchasing power and frayed consumer and business confidence stemming from the recession and war could interact with a weakened financial system to produce a further decline in the economy. The recent actions we have taken, along with the ranges for growth of money and credit this year, have been designed to reduce the probability of such an outcome and to support a resumption of sustainable economic growth in the context of progress toward price stability.

When I testified on our monetary policy objectives in July, the economy appeared likely to continue growing, though moderately. The objective of restoring a clear downward tilt to the path of underlying inflation while maintaining the economic expansion thus seemed attainable. Indeed, data that became available subsequently indicated behavior of economic activity in the third quarter consistent with that appraisal.

That said, evidence in July of weaknesses in certain regions and sections of the economy signalled caution. Notably, deteriorating market conditions for commercial real estate were limiting the ability of some borrowers to service loans, which, along with the restructuring of thrift institutions, induced lenders to pull back from extending credit to this sector. Banks also were becoming less willing to make business loans. In mid-July, to better ensure the economy's continued growth, the Federal Reserve adopted a slightly more accommodative stance in reserve markets to counter the

potential effect on spending of this tightening of credit terms at depository institutions.

The invasion of Kuwait in early August dramatically altered the economic landscape. Oil prices surged, simultaneously worsening prospects for both real income and inflation. The higher world oil prices transferred domestic purchasing power to foreign oil exporters, while uncertainties about how the crisis would be resolved shook household and business confidence. After the invasion, spending held up for a time before starting to soften, while the jump in oil prices fed through quickly to measures of overall inflation. Amid considerable volatility in financial markets and concern about the inflation outlook, bond rates moved back up. When a budget accord was finally reached in late October, its promise of fiscal restraint over the next several years was reflected in somewhat lower bond yields. Against a backdrop of weakening economic activity and in light of the passage of the multiyear deficit reduction package, the Federal Reserve again eased money market conditions.

This policy action proved to be only the first of a series of easing moves extending through early this month. These moves were prompted in part by subsequent information pointing to sizable contractions of consumer outlays and economic activity stemming from the marked weakening of consumer confidence and purchasing power. Following continued moderate expansion in the third quarter, real GNP turned downward, led by the decline in consumer spending, but also reflecting reduced construction activity and business inventory investment. Industrial production began a rapid descent in October. Private employment also started to fall steeply, and the unemployment rate rose further.

The widening economic slack helped prevent the energy price surge from becoming embedded in the ongoing wage and price inflation. The success of Coalition military operations after the outbreak of war in mid-January was seen in oil markets as reducing the odds of wide-ranging supply disruptions, and oil prices retreated, further improving the near-term outlook for inflation.

This reduction of cost and price pressures has given the Federal Reserve scope to move aggressively to counter contractionary influences on the economy without contributing to market concerns about the inflation outlook. Absent such a lessening of price pressures, monetary policy easing probably would have risked a heightening of inflation expectations, which could have put the foreign exchange value of the dollar under severe downward pressure and fed through to long-term interest rates, perhaps even pushing them higher.

The easing of policy also was keyed to the meager expansion since September of the broader monetary aggregates. The slowdown in money growth was worrisome because it seemed to reflect a further tightening of credit availability as well as the weakening in spending. The surfacing of additional asset quality problems has heightened financial strains in many banking institutions, placing pressures on capital positions and boosting funding costs. In turn, banks have progressively tightened their standards for granting loans and have set still more restrictive terms and conditions on the loans they have made. Strains also have been evident at other

intermediaries and many securities have been downgraded by the rating agencies, suggesting that even those borrowers not relying on banks in many cases have faced higher costs and more restrictive terms.

In responding to evidence of economic weakness, to a lessening of inflation pressures and to slow monetary growth, the Federal Reserve has used all three of its key policy tools. More accommodative reserve positions through open market operations, together with two cuts in the discount rate, totaling a full percentage point, have brought the Federal funds rate down to around 6¼ percent. This important short-term rate has fallen 2 percentage points since mid-1990 and roughly 3½ percentage points or more over the past 2 years. We also reduced the remaining reserve requirement on non-personal time and similar accounts from 3 percent to zero. This action was aimed specifically at relieving the tightening of credit availability at depository institutions.

These economic, financial, and monetary conditions form the starting point for the Federal Reserve's view of economic prospects and plans for monetary policy in 1991. An important aspect of the outlook is the unusually high degree of uncertainty about how these conditions will evolve, in the face of the Gulf war and financial strains. Another is the recognition that there may be substantial lags between changes in financial conditions—notably, the decline in interest rates and the depreciation of the dollar in recent months—and the response of spending. The assessment of the Federal Open Market Committee is that the odds favor a moderate upturn in activity in coming quarters. The lower oil prices, if they persist, will help damp overall inflation as will slack in labor and capital resources.

The forces currently at work in restraining spending can be readily identified. Consumer and business confidence still looks to be quite depressed, evidently because of the high degree of uncertainty, as well as the weak economy. Moreover, problems in many parts of the real estate sector are not going to be resolved soon. It also will take a while to correct the associated financial difficulties facing many lenders who are likely to remain quite conservative in making new loans. Finally, secondary effects on aggregate demand of the recent decline in our economy's output and real income are now in the process of running their course. Fortunately, several stimulative forces are in motion that enhance the chances of economic recovery. Monetary policy easings have brought about a significant drop in short-term interest rates. The decline started more than a year before the business cycle peak, a pattern unique in post-war experience and one which should help cushion the current recession. Moreover, short-term rates have declined substantially further in recent months. Long-term rates also have come down appreciably; reduced mortgage rates already have improved the affordability of housing, and that should help to revive housing sales and starts. The enhanced international competitiveness of our industries augurs well for the net export component of GNP. Furthermore, the fall in oil prices, which was especially marked in mid-January, has restored considerable domestic purchasing power. With most businesses having kept their inventories lean, the an-

anticipated pickup in aggregate demand should show through relatively quickly in rising production.

The 1991 ranges for money and debt growth were selected by the Federal Open Market Committee to promote sustainable economic recovery consistent with progress over time toward price stability. In keeping with a long-term disinflationary path, the FOMC ratified the provisional ranges set last July which embody a ½ percentage point reduction in the M2 range compared with the limits for 1990.

These money and debt ranges are wide enough to afford scope for policy reactions, should the economy or its relationship to these financial aggregates diverge from FOMC expectations. Economic forecasters typically have had great difficulty in projecting business cycle turning points, that is, judging when the relative strength of contending economic forces of contraction versus expansion will reverse. Moreover, the current outlook is unusually clouded, in part, by uncertainties about the war and its effects. The Federal Reserve will need to remain alert to possible contingencies and will have to continue to respond flexibly to information about evolving trends.

Downside risks in the economic outlook are obviously there and not difficult to identify. For example, an extended war with Iraq clearly could carry some risk of further undercutting public confidence in spending. Additional restraint on credit availability at depositories or increased public concern about the health of the banking system would be negative factors as well, and could show up initially as continued subpar money growth.

The worry has been expressed that, under current conditions of restrained willingness of depository institutions to extend credit, monetary policy easing moves may have only a minimal impact on lending and hence on overall spending. Mr. Chairman, I believe this risk is exaggerated. Our easings and reserve requirement action have lowered bank funding costs appreciably. Some of this decline has been passed through to borrowers in the form of a lower prime rate; even with this reduction, funding costs have fallen relative to loan rates, and with higher profit potential, banks should be more inclined to extend credit. Moreover, monetary policy stimulus works through other channels, as well. Some potential borrowers will be encouraged by lower market interest rates to undertake additional expenditures financed, either directly or indirectly, by issuance of securities. Spending effects also can appear through routes involving price responses in equity and foreign exchange markets, but monetary policy cannot resolve market imperfections in which credit for some financially sound projects is more expensive or less available than might otherwise seem warranted. Structural problems involving imperfections in credit and capital markets require structural solutions. To the extent that current banking regulations are impeding the efficient functioning of these markets, a more promising approach would lie along the path of revising those regulations.

The Federal Reserve is working with the other bank supervisory and regulatory agencies to ensure that bank examination standards are prudent and fair and do not artificially encourage or discourage credit extension. The intent of these efforts is to contribute

to a climate in which banks make loans to creditworthy borrowers and work constructively with borrowers experiencing financial difficulties, consistent with safe and sound banking practices. For example, the agencies are studying steps to clarify that the supervisory evaluation of real estate collateral is to be based not solely upon liquidation prices but upon the ability of a property to generate cash flow, given reasonable projections of rents, expenses, and rates of occupancy over time. We need a balanced evaluation process that endeavors to reflect the long-term value of an illiquid asset, rather than the exaggerated appraisals that have been evident in both the upside and the downside of the real estate cycle in recent years.

The supervisory agencies also are seeking to encourage banking institutions to provide additional public disclosure on their nonperforming assets. Under present circumstances, as best we can judge, the market tends to suspect the worst. Additional disclosure would supplement data on the level of non-performing loans with information on the amount of such loans that are, in fact, generating substantial cash income. Other similar steps are under consideration.

In general, Mr. Chairman, we have emphasized our view that prudent lending standards and effective and timely supervision should not inhibit banking organizations from playing an active role in financing the needs of sound, creditworthy borrowers.

Such an approach can contribute to the efficient functioning of credit markets and thereby complement monetary policy in promoting the attainment of the nation's overall economic objectives.

Thank you very much.

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

Chairman NEAL. Thank you, sir.

Let me ask a basic policy question here. You say that the Fed began easing about mid-year 1990.

Mr. GREENSPAN. Sorry. That is mid-year 1989.

Chairman NEAL. Mid-year 1989.

Mr. GREENSPAN. Actually, May was the turning point.

Chairman NEAL. If you look at reserves—not go week to week but monthly averages—there is more of a consistent pattern. It appears that reserves rose during 1989, and then from mid-1989 through early 1990, they fell off rather dramatically—in fact, down to a negative 4 percent, and then back up to a high of about 2½ percent. In fact, reserve growth was negative for much of 1990. I did not know you were talking about 1989, but really, the point I am trying to get at is that, looking at this, doesn't it suggest that monetary policy was relatively tight throughout 1990 and that perhaps by focusing almost exclusively or too much—I do not know how that would be best described—on the Federal funds rate, that you have missed the significance of weak money growth, particularly in the growth of reserve?

Mr. GREENSPAN. I think not, Mr. Chairman. Let me separate this into two areas—one, the technical aspects of following reserve balances as a measure of monetary policy and a number of other related issues which are implied in your question.

At the moment, and even before we reduced reserve requirements, the vast majority of reserves are required reserves under and supporting transaction balances only. What this basically means is that the pattern of reserves will tend to fluctuate fairly closely with transaction balances. Demand deposits, as we have discussed previously, are showing a tendency to weaken relative to other elements in the monetary aggregates. Very specifically, demand deposits have had and, indeed, still have a substantial component represented by compensating balances put there by companies who get services from the bank and are using these non-interest bearing demand deposits, in a sense, as a means of compensating the bank for the services. In recent years, the trend has been increasingly toward banks accepting fees for those services, and as a result, compensating balances have declined. Consider an extreme example now, this is not the case, but I think it makes the point. If it were the case that demand deposits were coming down much more substantially than NOW accounts were growing while time deposits and all the other elements of M2 were also going straight up, reserves—I should say required reserves and, surely, total reserves, because excess reserves are not a large number relative to the underlying required reserves, reserves would decline markedly at the same time that M2 would be growing rapidly.

We have not been using reserves as our means of implementing monetary policy. It is certainly the case that we are implementing policy while working through the Federal funds rate, but that's the tool, not the mechanism, which we are focusing on with respect to the interaction of monetary policy and economic activity. What we basically do is to watch a number of things.

For example, when we were observing a significant slowing down of M2, which would suggest that the markets were tightening up, we also looked at another measure of monetary policy, which is the spread between short-term interest rates and long-term interest rates. It is fairly clear and pretty much unambiguous that when short-term rates are significantly above long-term rates in a so-called inverted yield curve, that is unequivocally a period of tight money and almost invariably one in which the Federal Reserve is leaning very heavily against the markets. Conversely, when the slope is moving upward, it is usually reflective of ease or of neutrality, one way or another.

Obviously, we were as concerned about the possibility that we were not, in fact, easing during the latter part of 1990, for example, after September, as the money supply flattened out for precisely the reasons you indicated in your opening statement.

But after evaluating other aspects of the markets, while we are and continue to be concerned about M2, we would not conclude that during that period that the Fed was not easing. Indeed, all of the available evidence that we have got is that indeed we were in a obviously rather dramatic downward posture—inducing a whole set of easing pressures.

That does not resolve the issue of the money supply fully, although I must say to you the moves of recent weeks coupled with earlier moves seem finally to be working their way through to M2. The bulk of M2, remember, is not subject to reserve requirements. It basically does not move in line with required reserves, except for

the transaction balance component, which is part of M1, and obviously also part of M2, as well.

At the moment it appears as though the latest data—the last several weeks of money supply growth—appear to be bringing us out of that period of stagnation. We don't know that for sure at this stage, and we're watching very closely, but at least the data of recent weeks do suggest that the effect, as we see it, of the credit crunch on the money supply is certainly not accelerating, and if anything it seems to be easing off.

However, I would say to you—as I'm sure questions will arise—the evidence that the credit crunch is easing off is still very minimal, if at all.

Chairman NEAL. My time has expired.

Mr. GREENSPAN. I'm sorry about that, Mr. Chairman, I just carried on.

Chairman NEAL. No, sir. I was glad to hear your answer, thank you.

We will try to stick with the 5 minute rule so everyone will have an ample chance to question. We may have several rounds.

Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman.

Chairman Greenspan, I thank you for your excellent testimony.

Let me ask you a question that Main Street America is asking today. How do you feel about a tax increase to balance the budget or basically a tax increases at this time? It seems like a lot of people in Congress are talking about a tax increase and wouldn't this just cut the legs out from underneath your recovery?

Mr. GREENSPAN. I assume you are referring, Mr. Roth, to the notion that we need a tax increase to fund Desert Storm, the war.

As I indicated to the House Budget Committee several weeks ago, I think that is much, very much premature. It would certainly have adverse economic effects and my suspicion is, in the end, that it will not be perceived to be financially necessary—that is, the funding of the war will proceed as best I can judge pretty much along the lines that the administration has spelled out.

Mr. ROTH. At this time would it be fair to characterize your views at this time you do not feel that a tax increase would be warranted or would be helpful to the economy?

Mr. GREENSPAN. I think it would be unhelpful at this point.

Mr. ROTH. Mr. Chairman, we have heard a lot of, you know, when you have been here before and so on about the deficit. Of course, the deficit is getting larger and larger.

Again, I would like to ask you, what do you recommend Congress do to balance this budget and do something with the deficits?

Mr. GREENSPAN. Well, Congressman, I have indicated to this committee previously that while I did not fully feel comfortable with all the choices that were made in the budget compromise last year, the fact of the matter is when you look at it in some detail, it did produce a very dramatic decline in the total borrowing requirements that will confront the Treasury over the next several years.

While I have been extraordinarily concerned about the size of the deficit and continue, obviously, to be concerned, I see nothing at this stage which suggests to me that the forces which will bring down the deficit, and which are now in law will not prevail, and so

it may be a bit premature but I would certainly expect that, one, as the economy comes out of this recession, and, two, as the RTC funding requirements reverse—meaning we start to liquidate the working capital positions which are on-budget outlays—we will see a fairly dramatic decline in the published budget data.

I would say to you, Congressman, that in periods such as this the very special form of budget calculation that is made by the Department of Commerce in its National Income and Product Accounts which eliminate all financial transactions for purposes of evaluating the direct impact of the deficit on the economy, is a much better measure of what is happening to the underlying deficit, even with the recession. This, of course, shows numbers quite significantly below the unified budget deficit.

I would expect that both of those numbers will converge again as they have for most of the history of those series within several years, and the convergence will be at a much lower level of budget deficit than we see at the moment.

Mr. ROTH. Well, that sounds encouraging from your perspective.

Mr. GREENSPAN. I might conclude, Congressman, as a consequence, I see the need for no significant budgetary actions at this stage. And considering the state of the economy, I am not certain that they would actually be a major contribution one way or the other.

Mr. ROTH. I thank you.

You mentioned in your testimony the importance of bank reform. I believe that would be accurate to characterize it as such. Could you tick off—because this committee is going to be studying that legislation and—well, we are working on it now—what you would see as some of the key elements in that plan, from your perspective something that Congress really has to focus in on?

Mr. GREENSPAN. You are talking now about the President's proposal?

Mr. ROTH. Yes, the President's bank plan.

Mr. GREENSPAN. I would only briefly address this issue, Mr. Roth because we at the Board are still in the process of trying to evaluate a number of technical aspects of it. But preliminarily, if one were to say where the real payoffs are, I would say that it is in amending the McFadden Act and moving more toward a national bank branching system.

The reason I say that is that it is fairly clear from whatever evaluations we can make that there are very substantial cost savings involved if we can move in that direction. If capital is the problem in commercial banking, the way you get capital is by increasing prospective income. The clearest way that I foresee commercial banking at this stage obtaining significant changes in income is from the cost side. There are obviously fairly pronounced gains from increased powers which I've testified on before this committee previously, and I would repeat that testimony. But what I have not emphasized previously is the potential extent of cost savings, a very large part of which would flow down to the bottom line.

In that respect I would emphasize that, of the initiatives which the President is putting forward, which were innumerable and the vast majority of which we, the Board, support, I myself, personally, would focus more on McFadden Act revision than most of the other

elements in that package. Although, obviously, all of the elements require very considerable attention and thought.

Mr. ROTH. Thank you, Mr. Chairman.

Chairman NEAL. Before recognizing Mr. Barnard, may I ask you to say what you mean when you use the term credit crunch?

Mr. GREENSPAN. Sure.

Chairman NEAL. I think there will be further discussion of it, and by using the term credit crunch I guess by saying that there is one?

Mr. GREENSPAN. Yes. Let me be very specific. There are many types of credit crunches. We have had them through the years in which we have had Reg Q creating a real compression of credit and a real stringency in credit markets. The term really originates back there. What we have today is a special version which I do not recall seeing previously.

When I use the term credit crunch I am really referring to today's variant which is really different from those which were induced either by monetary policy in the past or the combination of monetary policy and Reg Q which induced very significant stringencies.

What we have today, to the extent that there is a clear supply restraint on lending, is activities of commercial bankers to protect their capital positions, having been clearly too lax in lending in the mid 1980's and ending up with very severe increases in non-performing loans, cutbacks in capital and lowered quality of the asset side of their balance sheets.

The bankers have all of a sudden become very chary about extending credit which would undercut their capital positions and, wholly independently of the regulatory issues, commercial bankers are concerned about being perceived by the market as having inadequate capital.

Having inadequate capital would mean an inability to fund the loans at rates which are profitable. So that there is this renewed concern about their state of capital, and that is pretty much the same concern as a view which encompasses concern about the quality of their assets. Because their concern about the quality of their assets is really tantamount to a view that that will be charged against capital, so you can view it wholly in terms of capital.

What is basically occurring is a pulling back of lending to otherwise creditworthy customers for fear that their capital positions would erode to the point where it undermines the franchise value of the banking institution.

On top of that, obviously, are concerns—some of the valid, some of them invalid—that supervisors and examiners will come in after a loan is made and write it down.

There are apocryphal stories which probably are false but give you a notion of the state of lending officers' concerns: They fear if they go out and make a real estate loan with 50 percent down to a high quality customer, the bank examiner may come in the back door and immediately mark the loan down because it is a real estate loan.

Now that has not happened, obviously. Nothing even remotely close to that is happening. But the fact that you get in a joking sort of way bankers suggesting that that is what is going on is an indi-

cation of their state of concern. While you do not take it literally, it does suggest to you where the issues lie.

We also have another symptom of this phenomenon, which is the disinclination to use the discount window at the Federal Reserve, because it is perceived that if you are borrowing at the discount window, you must be in trouble with your capital account and that this would create difficulties with funding costs. So, we've got an extraordinary psychology out there which has had the effect of, as best we can judge, the pulling back of the supply of loans, clearly having some impact—not a huge impact, but some—on economic activity, and it's one which disturbs us quite significantly, basically because it is, at this moment, an indication that our credit system is not functioning the way we think it should be functioning.

Chairman NEAL. Is there a shortage of capital? It seems to me that there is a real shortage of capital in the banking system?

Mr. GREENSPAN. That's right, there's a real one.

Chairman NEAL. The shortage of capital, is that real?

Mr. GREENSPAN. Well, not in the total sense. In other words, if you look at the \$200 billion-plus equity capital base of the commercial banking industry, you can't really validly argue that, in and of itself, it is a shortage. It is true that in a large number of banking organizations, capital should be higher, and, indeed, a lot of banks are increasing their capital. If one takes a much longer look down the road, one doesn't see a capital shortage, but one does see the desirability of more capital if, for no other reason than it would make a number of the problems which confront supervisors moot.

For example, as I testified before this committee last year, I think that the too-big-to-fail issue is a very tough issue. The only way in which I think it can be satisfactorily addressed is by bringing capital up to the point where the issue no longer becomes a relevant consideration.

Similarly, capital is a substitute for deposit insurance and the greater the capital, obviously, the less pressure on the deposit insurance system. So, greater capital is desirable down the road—and I emphasize “down the road” because, clearly, at this particular point, our short-term problems are capital-related, and we have no intention, obviously, of trying to enforce higher capital standards at this stage. That would be clearly counterproductive.

When I talk about increased capital, I'm talking about capital at the point when the banking system is back functioning. If you're looking at ways in which we can essentially improve on the system, then I would say, down the road—I don't know how many years we're talking about—it's clear that we probably would have a better functioning commercial banking system with more capital than we have now, but I wouldn't describe that, in any meaningful sense, as a capital shortage in the short-term sense.

Chairman NEAL. Mr. Barnard.

Mr. BARNARD. Mr. Chairman, the schedule that was provided in your testimony shows that the Fed funds rate has been reduced from approximately 9.5 from 1989, down to less than 6.5 now?

Mr. GREENSPAN. I think it's down from $9\frac{3}{4}$ or $9\frac{7}{8}$ to $6\frac{1}{4}$.

Mr. BARNARD. Can you tell us what objectives have been accomplished as far as the Federal Reserve is concerned, with the reduc-

tion of this Fed funds rate? I mean, you had objectives in doing that. Have those objectives been met?

Mr. GREENSPAN. Partially. The basic purpose that we embarked upon in the spring of 1989, after having, as best we could judge, started to significantly defuse the inflationary pressures that had built up, was to try to gradually bring the rate structure down in a manner which would be consistent with further reductions in the rate of inflation, and gradually to impart support to economic activity so at the end of the process, we would be at a point where inflation rates would not be a threat to the level of economic activity; would not be causing a destabilizing imbalance, while at the same time, we would be in a position where the economy would then be able to start to grow at its potential in a noninflationary way.

As I indicated in my prepared text, we were arriving at that period in the summer, prior to August 2, but we got dislodged by events we did not anticipate—namely, the invasion of Kuwait.

Mr. BARNARD. Have we significantly seen, though, any increase in the earnings of banks because of this?

Mr. GREENSPAN. No, not in the sense of published earnings, obviously, because what we're dealing with is very substantial write-offs, periodically. But there have been a number of banks that have done rather well, and clearly, the most recent period is one in which operating margins have opened up in the sense that the cost of funds to the banks has fallen somewhat more than the average loan rate. I think, however, at this stage the writeoffs are still eating into earnings at a very significant pace.

Mr. BARNARD. You know, I could interpret your comments in the latter part of your statement today, on pages 16 and 17, that it may be the view of the Fed that the supervisory agencies, the OCC and others, have probably counteracted what you were trying to accomplish in reducing the Fed funds rate because of this over-supervision, over-aggressive criticism of bank operations and bank loans.

Am I just—

Mr. GREENSPAN. I would not agree with that. I do think, as I have indicated—

Mr. BARNARD. I didn't quite—you said?

Mr. GREENSPAN. No, I do not agree with that. As I have indicated recently, I do think that supervision has been in more of a cycle than it should have been. First, it was too lax and then too stringent. But I would not argue that it was of an order of magnitude which in any marked manner would offset the policies of the gradual ease that we are implementing through the money markets.

Mr. BARNARD. So you believe that, if the war had not taken place in August, then the progress of eliminating the credit crunch and more credit being made available by the banks would have occurred?

Mr. GREENSPAN. It is extremely difficult to figure out what history would be when it does not turn out that way.

In other words, all I can say, Congressman, is that my impression in July last year was that the chances of our coming out of a period of slow growth without a recession were modestly better than fifty-fifty.

Subsequent data actually, in my judgment, increased that probability. In other words, what the data in the third quarter suggested to us is that, had we not run into the sharp contraction in consumer confidence, the odds were a good deal better than fifty-fifty that we would have skirted a recession.

But having said that, I want to emphasize that the ability of economists or anybody else to forecast this extraordinarily complex economy is limited. I am giving you only an impression and not one which I would like to stand up on the barricades with analytical conviction.

Mr. BARNARD. You know, there is still a question in the minds of some about the use of reserves, period, in managing monetary policy.

Of course, we—those of us who have been around for a little while—know the extreme costs that reserves are to the banking industry. I mean, any projection will show that over the last 20 years maintaining reserves with the Fed has cost the banks billions and billions of dollars.

Is the Fed as entrenched as ever that reserves are that necessary, as far as managing monetary policy is concerned?

Mr. GREENSPAN. First of all, some form of balances are very helpful. There are many ways to implement monetary policy. I might add that you could manage monetary policy if we paid interest on reserves and that would solve your particular problem.

Mr. BARNARD. Would you recommend that?

Mr. GREENSPAN. Well, the Federal Reserve has always recommended that. There is another issue here, though. It is the question that the foregone interest used to be—and I suspect still is—presumed to be the payment for the safety net for these special aspects of banking which are subsidized, namely, the deposit insurance, to the extent that the premiums do not fully pay for the risks, access to the discount window, and the payment system, all of which have economic value to commercial banks.

The issue of not paying interest on reserves and, hence, essentially charging the banks has always been—

Mr. BARNARD. Let me ask you a question. Has that been a quid pro quo?

Mr. GREENSPAN. Well, I do not—

Mr. BARNARD. I mean, the Federal Government has not supported the banking industry to the degree that the banks have provided that income to the Federal Treasury.

Mr. GREENSPAN. No. It's an interesting question as to whether it is a quid pro quo. No one has really focused on this, in my judgment, looking at the pros and the cons. All I can say to you in answering the question is, one, it clearly is an issue of the nature of the benefits and the disadvantages of holding a commercial bank charter. There are a lot of subsidies and charges implicit in that activity. Whether they balance out is something on which I don't know how to make a particular judgment.

Going directly to your specific question, what we need in this type of money market is some type of balance over which the Federal Reserve has a monopoly. By that I mean some account, whether it is a clearing account, reserve account, or something which we ourselves alone can adjust the size.

If the size of the total market for this type of instrument is large enough, we can obviously determine what the interest rate is on that by affecting its supply. To the extent that it is a large part of the market, it will arbitrage against other interest rates in the market and you will get the full effect of monetary policy.

If we did not have a monopoly, we still could do it, obviously, but it would be far more difficult working in the marketplace. Clearly, you are asking: Do we need reserves, per se, very specifically? Clearly no.

We could implement monetary policy in a quite similar manner if we had other types of deposits or even if interest were paid on reserves.

Mr. BARNARD. I'd love to see you have a monopoly, even further than you have, by extending your powers over to the securities industry and in some of these other areas where reserves could very possibly be helpful as monetary policy is concerned.

My time is expired.

Chairman NEAL. Mr. Campbell.

Mr. CAMPBELL. Mr. Chairman, you've been very gracious to me and bipartisan, in that I came here after my colleagues, Mr. Hoagland and Mr. Neal. If you'd be kind enough to call on me next, I would yield out of order, so long as you don't forget there's a Republican over here with questions. It might be gracious of me to do that.

Chairman NEAL. Mr. Neal.

Mr. NEAL OF MASSACHUSETTS. Mr. Roth, I think that I'm going to demonstrate my bipartisanship—

Mr. ROTH. We have collegiality here. Would you yield for just 30 seconds?

Mr. NEAL OF MASSACHUSETTS. Yes.

Mr. ROTH. I thank you very much for yielding to me, Mr. Neal.

Mr. Chairman, I just want to bring this up before we go on to others, because I think it's an important point; at least it is to me.

I must respectfully disagree with you, sir. You had mentioned using your definition of credit crunch. I think the reason we were having problems is not that lending is off. As I interpret what you're saying, it's that the credit system isn't working properly. When I see the high levels of personal and corporate debt, I don't think that people can borrow any more.

I mean, it's like you're a bartender, and I'm sitting here. Here's another person. I'm saying, Mr. Chairman, he's got a problem. And you're saying, Well, he's going out in the road to drive home. I know he's drunk; what we have to do is give him another drink.

What I'm saying is that he has had too much to drink already. Eighty percent of the American people today are living from paycheck to paycheck. They can't borrow any more. I think that's the problem.

You had mentioned to Chairman Neal at the end of your answer that the problem was that banks have enough money but they're not lending it. I'm saying that people can't afford to borrow any more. They're up to the gills with debt.

Mr. GREENSPAN. Mr. Roth, I'm not terribly certain we disagree, in this respect: I would still argue—in fact, I have—that by far the largest part of the weakness in loans is demand-induced, in part be-

cause of the level of debt that individuals have. Although I think we have to qualify exactly how bad the debt situation is, I wouldn't characterize it quite in the terms that you have, but I stipulate that that is a crucial, important question.

All I am saying is that there is a small but significant part of the contraction which reflects the unilateral actions on the part of bankers and is not related to weakness in demand or an unavailability of credit-worthy borrowers. The vast majority of the lending problem is the issue of people not wanting to borrow. I'm saying, however, that there is nonetheless a part which is truly what I'm defining as a credit crunch, and that that is a big enough issue to be concerned about, even though it is very clearly a significant minority of the lending weakness that we have seen.

Mr. ROTH. I think you, Mr. Neal, for yielding. I appreciate it.

Chairman NEAL. Mr. Neal.

Mr. NEAL OF MASSACHUSETTS. Thank you, Mr. Chairman, and thanks, Mr. Campbell, for that appropriate measure.

I take a lot of satisfaction that this morning, as we discussed the credit crunch, that I was one of the first members of this committee, and certainly one of the first members from the Northeast, to start to raise questions about what the credit crunch was doing in New England and throughout the Northeast, but if you can, Mr. Chairman—Incidentally, we've gone back forth on this before, you and I, and my feeling remains very strong that the Fed was very late in addressing the problem in New England, or at least reluctant to speak directly to the problem. But what, in your estimate, will be the impact of the Treasury plan, the banking reform plan, on the credit crunch? Is there any connection?

Mr. GREENSPAN. That's a good question, Mr. Neal. I'm not sure that I see any immediate areas of connection, but obviously you cannot have an extensive banking plan of the dimensions that the President is putting forward without some effect, directly or indirectly. My impression is that, in most of the areas on which I can immediately focus, there would be a tendency to ease the credit crunch, but I'd have to go provision by provision, and I'm not really prepared to do that, on the grounds that I haven't really given it the type of thought that I think is required to make the type of conclusion that you're asking for.

Let me just respond to the issue of whether the Federal Reserve was late. I think there's a difference here of how one perceives this. We did not deny that there were credit pressures beginning to emerge early in 1990 and even late in 1989, but we perceived the first part of what has become known as the credit crunch as something healthy, not something which was an element to be concerned about. Indeed, most of the pulling back to more conservative lending principles we considered a necessary and desirable change from what we perceived to be the excessive laxity in the standards of several years earlier. So we did not become basically concerned about the problem until July of last year, when we began to perceive that it had gone over that invisible line from being a healthy development to something which was actually creating significant problems for the economies of not only New England but, increasingly, most of the country.

I'm not sure, even in retrospect, that I would consider the changes in the first half of 1990 to have been undesirable.

Mr. NEAL OF MASSACHUSETTS. Would you grant me that perhaps there was an overreaction?

Mr. GREENSPAN. Well, there is now.

Mr. NEAL OF MASSACHUSETTS. There is now.

Mr. GREENSPAN. Certainly. In fact, that's basically the way I would read it. I would say that the overreaction, if one can actually put a dividing line—we have to, obviously, know it's a relatively arbitrary line—is somewhere around mid-year last year.

Mr. NEAL OF MASSACHUSETTS. What role does individual savings play in our current economic problems, and in banking problems as a whole—the lack of individual savings?

Mr. GREENSPAN. Well, Mr. Neal, as I've said to this committee probably many times—and you've heard it in other fora when we have been together—the lack of saving in this country is our major long-term economic problem. We've got a vast number of other problems currently, so we have basically pushed aside concerns about that, and understandably so. We do have a number of short-term issues which we really have to focus on, because we have clear priorities at this particular stage. But over the long term I hope we don't lose sight of this issue.

As far as its impact in the short run, it's hard to judge. One thing that I find a little surprising is that the saving rate has not risen more than it has in view of the uncertainties and drop in consumer confidence that has occurred, but I would suspect that it may be, when the data are fully developed and revised, that we see somewhat higher saving in this immediate period than appears to be occurring at this stage.

Aside from that comment, I'm not sure that I can add very much to the issue, because I'm not sure it's something which is a major factor in what we're dealing with at the moment.

Mr. NEAL OF MASSACHUSETTS. Could I have one additional minute?

Chairman NEAL. Yes.

Mr. NEAL OF MASSACHUSETTS. This morning, when I leave here, I'm going to introduce legislation to restore the IRA and grant an opportunity for the first-time home-buyer to utilize it as well. Without asking you to cast immediate judgement on that proposal, maybe you could offer a survey of how you feel about the IRA.

Mr. GREENSPAN. Well, I've waxed back and forth on that issue myself, because it's difficult, often, to know whether what we're dealing with is a net increase in saving or a shifting of assets from one account to the other. I would say the evidence on this is mixed. Some conclude that it is a net positive factor; others are more dubious. I do think, however, that the issue of saving is something which we should keep evaluating and find ways to improve upon, so I would certainly not discourage seeking ways to improve saving. But without looking at the specifics of your bill, I really would be unable to give you any helpful judgement as to how I think it would come out.

Mr. NEAL OF MASSACHUSETTS. Thank you.

Mr. Chairman, I hope that, during the course of the next few months, this subcommittee will have an opportunity to schedule

some discussion and debate about restoring the IRA as a pool to enhance savings.

Chairman NEAL. I would love to. However, I do not believe that we have that jurisdiction.

Mr. NEAL OF MASSACHUSETTS. Maybe we can just assume it.

Chairman NEAL. I guess we can look at what we want.

Mr. Chairman, there was something I was not quite clear on. When you talked about the overreaction if I understand you are saying that it was largely responsible for the credit crunch, as you define it. That is just because banks were, or still are, acting to preserve capital, if they are worried that their capital might erode if they make a particular loan, why is that not a wise policy, and where would the overreaction come? I mean, would that not suggest that you are saying they should make more risky loans?

Mr. GREENSPAN. No. What I'm responding to is fairly significant anecdotal and other evidence which suggests that bankers are pulling back to a point where they may be threatening their franchises. The job of commercial banking is to make illiquid loans. That is risky. It is also more profitable. It's a type of business in which one must balance risks in a manner to maximize the rate of return on capital.

What I perceive to be occurring at this stage is that there is a degree of caution that is a pulling back from risk well beyond, in many cases, where I think the optimum long-term rate of return in banking probably resides, and that if the basic purpose of one's dealing with borrowers and, obviously, depositors, is to build up a banking franchise, I'm suggesting that, in many instances, bankers have pulled back to a point where it is not in their interests I'm not talking about the national interest; I'm just essentially raising the question as to whether or not they're not doing potential damage to their individual banking franchise.

Chairman NEAL. Thank you, sir.

Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman.

Thank you, Mr. Chairman.

I'd like an economics lesson, please—I ask that sincerely—on the question of high-powered money.

Mr. GREENSPAN. I'm sorry. What?

Mr. CAMPBELL. On the question of high-powered money. What troubles me is this: In a previous committee on a previous occasion, you and I discussed our mutual affection for Milton Friedman, and he of course predicts every inflationary experience in America from the money supply with a variant lag structure. If you ever get the lag structure right, you've got a Nobel prize, I guess. What I see as a danger is that we are presently increasing the money supply, at least the high-powered money components of it—and here's where I'm asking for the lesson, so please feel free to correct me on anything; I'll be done just in a second—but my assumption is, we're increasing the high-powered money components of the money supply by lowering the reserve requirement, by targeting a lower Federal discount rate, and that, as we come out of our recession—which, God willing, will be this summer or this autumn—we'll run the risk of having an easing credit situation, a return to the traditional money supply components from the commercial

banking sector, and much more high-powered or base money than we otherwise would have had, because of the actions of the Fed during the downturn.

If I'm right, we then ought to anticipate a serious bout of inflation—five points, maybe, above where we presently are. Could you kindly respond or tell me where I'm wrong?

Mr. GREENSPAN. Well, no, I wouldn't say that you were wrong at all, Mr. Campbell. I'd say the basic purpose why we have targeted ranges for the money supply is precisely to try to avoid that sort of phenomenon. As I've indicated to some of your colleagues in the other body yesterday, it's at periods such as this, close to turning points, that major mistakes in monetary policy tend to occur. The type of policy mistake that is very easy to make in this particular period is the form of policy mistake which you are suggesting, which has, regrettably, occurred many times in the past.

The advantage of having targets in this particular area is that you have a sense of where the long-term, sustainable, noninflationary growth pattern is when the economy has turned. If you keep that closely in mind and keep the growth in money within targets which, as best we can judge, are consistent with the restoration of lower rates of inflation and hence potentially much greater growth as a consequence, we have tended to find that M2 is probably the best proxy to be looking at. The high-powered money numbers as such, which include, as I indicated to the chairman originally, reserves and currency, we have problems with, because such a very large part of our currency is held outside the country and is not related to the credit-engendering effects inside the system.

Following M2 growth helps us to avoid, on the one hand, what we perceive now, namely, a situation in which, up until very recently, we perceived the money supply growing much too slowly, but on the other side of that issue, we have an upper range as well as a lower range. The reason we do that is that it gives us a high-way path, so to speak, to work our way through. This does not mean that we have to be within the range all the time, under any conditions, because if we go outside it, we want to know why we're outside it, but it is very helpful to steer policy through the business cycle.

Mr. CAMPBELL. If you'd be so kind to answer a couple of very quick questions, I might be able to make my point. Could you kindly tell me—I don't have it in my memory—what the increase of M2 has been, generally speaking, in the fourth quarter of 1990 and first quarter of 1991, what your target would be? Ballpark would be fine.

Mr. GREENSPAN. Well, let me give you exact numbers here. The fourth quarter of 1990 was 2.2; third quarter was 3.0. The year as a whole, for comparison, was 3.9. We're now running, obviously, above that level.

Mr. CAMPBELL. I compare that with the economic report of the President, which, from memory, has GNP declining at 2.1 percent in the fourth quarter of last year and estimated decline even more sharply—3.6—in the first quarter of this year.

Mr. GREENSPAN. That's real GNP, yes.

Mr. CAMPBELL. Which is the relevant consideration, not deflated—real GNP.

What, therefore, is wrong with my conclusion that, if real GNP is going down at the same time that the money supply is going up, it is inevitable we will have inflation equal to the difference between the two?

Mr. GREENSPAN. I'm not sure—did you say 3—What was the number you gave for the administration?

Mr. CAMPBELL. Again, I'm ready to be corrected, but my understanding is, 2.1 percent is the estimate of the real decline on an annualized basis—

Mr. GREENSPAN. That's correct for the fourth quarter.

Mr. CAMPBELL. For the fourth quarter, and it's anyone's guess, but I heard a prognostication of 3.6 decline for the first quarter. If that's too pessimistic, I stand corrected.

Mr. GREENSPAN. Well, no. You said the administration has forecast it. I'm not sure that's correct.

Mr. CAMPBELL. The basis of my testimony was the Undersecretary for Treasury, who presented a series of estimates. It could well be that I am giving you the consensus of the various estimates, as opposed to—

Mr. GREENSPAN. It may have been somebody, but be that as it may—

Mr. CAMPBELL. Put that to one side. The difference between the growth of M2 and the growth of the GNP, it seems to me, has to be inflation, unless you expect the velocity of money to change.

Mr. GREENSPAN. But that's precisely the point, Mr. Campbell. We have set forward a long-term model which relates exactly these variables, which we call the P-star model, which endeavors to track exactly this issue. What might be helpful, if I may, is to send you a copy of the work we've done, and it will save some trouble in my trying to explain this issue.

Mr. CAMPBELL. Fine. With that, I'd yield back the balance of my time. If you'd be so kind as to send it to me; otherwise, I'll call you.

Mr. GREENSPAN. I'd be delighted, and any comments you might have would be most appreciated.

Mr. CAMPBELL. Thank you, Mr. Chairman.

Chairman NEAL. Mr. Hoagland.

Mr. HOAGLAND. Let me ask you, Mr. Chairman, in my opening comments I talked briefly about the fact that Germany is increasing its discount rate; Japan is staying steady; you're loosening up our money supply here. What effect do you think that might have on capital flows? If it has a negative effect, will there be a way of dealing with that?

Mr. GREENSPAN. Well, obviously, Mr. Hoagland, we have been monitoring that issue very closely, and indeed, I've had continuous conversations with my colleagues at the Bundesbank and elsewhere on the various divergencies that are going on in different aspects of the world economy. The crucial issue would be, if we ran into a situation in which the markets perceived that we were going into some inflationary pattern in the United States, I would suspect that we would find that we would be confronted with an exceptionally weak exchange rate, and clearly that would create a lot of problems relative to financing in this country, as well as have an impact on interest rates.

In calibrating our policy over recent months, we obviously have been quite aware of the potential implications of various things which might go on in the international financial markets which would affect us back here and obviously affect the levels of economic activity here. Indeed, in our deliberations at the Federal Open Market Committee and in our directives from the Federal Open Market Committee to the Federal Reserve Bank of New York's desk, which implements policy, that issue is constantly on the particular list, because we perceive it as a domestic economic issue since clearly it will affect the behavior of our GNP in this country.

At the moment, we are looking at what has been a decline in the dollar which I in my prepared remarks have indicated was unwelcome. Clearly, some of the weakness that we had been perceiving is not something that we felt comfortable with. All I can suggest to you is that it remains an issue, as I indicated in my prepared remarks, in how we formulate domestic economic policy. We obviously are in continuous discussions on world coordination and policy among the G-7 and the G-10. I or my colleagues meet with the governors of the central banks in the G-10 countries almost every month, and there are a lot of telephone conversations in between. So it's an issue, clearly, that we are aware of and continue to monitor at all times.

Mr. HOAGLAND. Let me switch tracks, if I can, and ask you about an issue that a lot of us on the Banking Committee are increasingly concerned about. I'd be interested in your general views, to the extent you feel comfortable in offering them. We're confronted with three basic issues in the Banking Committee in relation to banking legislation: recapitalizing the BIF, deposit insurance reform, and general structural changes—the revisions to McFadden you alluded to earlier and various affiliation proposals. I'm wondering, in an ideal world, what you would recommend—which of those three issues you would recommend that we deal with this year; whether we should split off—there are various members of the committee that would prefer to deal with certain of those issues without the others. I just wonder what your thoughts are, number one.

Second, the importance that you attach to dealing with the structural issues, how important it is in your opinion that we deal with those this year.

Mr. GREENSPAN. Obviously, the BIF recapitalization is a priority that has to be addressed, and sooner rather than later, but I do think that a number of the structural issues which are in the President's program are, I think, pretty close up on the agenda, as far as I'm concerned. As I indicated to the chairman earlier, I thought that the issue of the amendments to the McFadden Act and the elements involved in reducing costs that that would imply are really important.

Mr. HOAGLAND. And important that we deal with sooner rather than later.

Mr. GREENSPAN. I would think so, yes.

Mr. HOAGLAND. Now, how about the affiliation proposals in the administration's plan and the Financial Services Council proposal? How much importance do you attach to bringing those regulatory changes about quickly?

Mr. GREENSPAN. I'm sorry. The affiliation——

Mr. HOAGLAND. The affiliation proposals——

Mr. GREENSPAN. You're talking about the commerce and banking question?

Mr. HOAGLAND. Right, the commerce and banking changes.

Mr. GREENSPAN. Obviously, that is a lower priority than some of the others. It's an issue which has confronted this committee and the banking industry for a good number of years. There are pros and cons to this, and I think you'll find that it is probably well worth while for this committee to get testimony. You'll find it really quite interesting, because it's going to outline the whole question of where banking should be going in the future. All I can say to you is that we've had innumerable discussions at the Federal Reserve Board, and I can scarcely argue that we've come out with a uniform position amongst the members of the Board. We reflect, I think, all various different forms of opinion on this question.

Mr. HOAGLAND. I think I have time for one more question, a short one.

Chairman NEAL. Yes.

Mr. HOAGLAND. What other issues would you rate as important as McFadden reform?

Mr. GREENSPAN. What other issues?

Mr. HOAGLAND. Yes.

Mr. GREENSPAN. Well, obviously, the BIF recapitalization, I would say, clearly is there. I would still say that the powers question, which this committee has debated for a number of years, should be high up on the agenda. I would hesitate to go much beyond that at this stage, because I don't yet feel comfortable that I've been able to glean from my colleagues on the Board of Governors exactly what their opinions are on a number of these different issues. I'd like to, when the time comes that you're reviewing this, to be able to bring to this committee not my own personal view, but a view of the Board in total, which would actually add to the deliberations.

Mr. HOAGLAND. OK. Thank you.

Thank you, Mr. Chairman.

Chairman NEAL. Yes, sir.

Mr. Kennedy.

Mr. KENNEDY. Thank you very much, Mr. Chairman. First of all, let me thank you for allowing me to sit in on your hearing this morning. I appreciate it.

I also want to thank Chairman Greenspan for putting up with some more questions.

About a year ago, Chairman Neal, you and I questioned Chairman Greenspan with regard to the issue of the credit crunch, and at the time, I think the chairman might recall, you indicated that you didn't think there was such a thing as a credit crunch. I notice that in this morning's American Banker you say that it's, quote, "the most serious problem in the economy." You go on to say, "What we've seen is a tightening of standards that goes beyond what we see necessary for the long-term safety and soundness." I guess in some fashion it's nice to see that the problem is being rec-

ognized, but what I really want to concentrate on is what can be done about it.

Specifically, I read with some interest a few weeks ago an article in the *Wall Street Journal* that had been written by Marty Feldstein, where he put forth the notion of establishing a new facility at the Fed that would allow commercial loans to be purchased by the Fed, which thereby could free up some liquidity and bring the capital-to-asset ratios down for various banks; that would allow them more freedom in making loans. I think it also might have the effect of sensitizing the Fed to issues such as the bifurcation issues that also might pertain to the valuations that are put on the loans, whether they are immediate or long-term. I am anticipating dropping a bill next week that would have that, as well as a number of other issues, attached to it, to try to deal with the credit crunch.

I wonder if you might have some comments on that specific idea, and then I want to follow up with a couple of others.

Mr. GREENSPAN. You mean specifically Feldstein's idea?

Mr. KENNEDY. Yes.

Mr. GREENSPAN. Well, it's an issue that we have been struggling with for the last couple of months, about whether or not there is a capability at the Federal Reserve essentially to take on what amounts to a commercial banking role. The difficulties that we have had in trying to come up with a mechanism—for example, taking Feldstein's proposal—is getting around the obvious problem that the Federal Reserve would have if we were out there directly lending when we have no credit capability of understanding what individual loans credit quality is—in other words, taking on a commercial lending role.

What he is suggesting, as I recall, is that those loans from companies with investment-grade commercial paper ratings would automatically be acceptable for purchase by the Federal Reserve, as one. Well, my judgement is that's not where the credit crunch problem is. That is, those people have the capability of borrowing in the markets probably without too much difficulty.

Mr. KENNEDY. Mr. Chairman, though, with regard to the issue of your capabilities, my understanding is that under section 13 you do in fact have the capability of moving forward with it.

Second, with regard to the ability to understand the loan market, the fact is that you've got a lot of people moving around these banks today that are categorizing loans with various strengths and weaknesses that are certainly telling the banks how they can categorizing a particular loan.

Third, I'm not suggesting that the larger corporations—first of all, I don't think there's anything in section 13 that restricts this, as Feldstein did in his initial notions, that this would be just a large grade A corporation. I think the fact is that this can be expanded much beyond that, number one, and still have very good loans. Number two, it does seem to me that you're in a situation where you're not talking about necessarily helping the corporations out with cheaper money; what you're really doing is helping the banks out by allowing them to take the loans that they've got on their books at the moment and sell them to the Federal Reserve—get a fee for them—and as a result of doing that providing them with great liquidity and also helping them in their asset-to-capital

ratio that will enable them and send a very strong signal that not just is the Fed talking about this issue, and not is only Secretary Brady and others talking about it as an issue, but that actual, concrete action is being taken.

Mr. GREENSPAN. Well, let me say this, Congressman. This is an issue which we put on the table a couple of months ago internally, ourselves, to see whether or not there was a facility that we could construct, either with or without legislation from the Congress. It's a fairly complex problem. For example, we are confronted with the issue that the historic way in which these types of actions were taken is that recourse to the individual banks was always involved in accepting these types of discounted paper, which is where Feldstein's original idea comes from. If that were the case today, in my judgement, it wouldn't help at all, because the liability would still be there.

The question, basically, which we have to confront is: Should the Federal Reserve become effectively a commercial banker, which is really what it amounts to, or should we maintain the standard practice of what a central bank is and endeavor to create the forms of liquidity in the individual institutions, which basically will enable them to extend loans?

In my judgement, the key problem that we have got is not so much the capability of selling off loans; they have that capability and do that. What is crucially involved here is capital. What we need is to find a way of moving capital into these institutions, or an alternate facility somewhat similar to the type of plan that you're discussing. This is something we discussed, I believe, in this committee a year ago: the Small Business Administration as a vehicle by which we could induce to offset the failure of some of the banking institutions in New England, by creating as much credit as was needed. I will say to you that we are obviously looking at very much the same things that you are. We read everybody's recommendations; we try to see if we can find a way to employ them; and we're working in that direction.

Mr. KENNEDY. I appreciate that.

Mr. GREENSPAN. We're doing a lot of things, but we're trying to find practical ways to do things which will work.

Mr. KENNEDY. Right. I appreciate that, Mr. Chairman, but it really isn't the idea of the practicality of these ideas that I think I'm trying to address at the moment. I sat in a meeting in Boston well before Christmas where Secretary Glauber came up and acknowledged the issue of bifurcation. I sat in this very room almost 2 months ago, when Mr. Clark from the OCC said that there ought to be bifurcation. For the first time, he sat there, in the same seat you're in—I think you were here in the hearing—and he acknowledged that the bifurcation of loans was something that ought to take place.

We have met with Secretary Brady now going on 2 weeks ago, where he said he would have a plan in to deal with bifurcation. The trouble is that banks are going out of business up in New England. The economy is being strangled. Unless we get some action, people are going to be studying these problems. You talked about putting together a whole new arm of the SBA and actually getting appropriations and everything else done to do it; the fact is that

you have the ability, within the Federal Reserve, to accomplish this right at the moment. That is specifically what section 13 is set up for.

You say, without recourse. Even with recourse, it's still going to help the banks. I'm not saying it's going to solve the problem, but it will still help. It will help their capital assets.

Mr. GREENSPAN. I don't see how. I mean, how do you help if you are still legally liable for the loan?

Mr. KENNEDY. Because the loan costs less against the capital.

Mr. GREENSPAN. No, but I don't think that's in fact the case. I think you'll find that, if recourse remains, you haven't gotten anywhere.

Mr. KENNEDY. The fact is—Feldstein addressed that specific issue in his article, number one. You can look at this and say, the glass is half empty, or, the glass is half full. You have acknowledged in the newspapers that you view this as the most serious problem in the economy—

Mr. GREENSPAN. No, it isn't.

Mr. KENNEDY. Well, listed, Mr. Chairman—

Mr. GREENSPAN. I want a practical solution, one that works.

Mr. KENNEDY. Fine. I'm trying to come up with a practical solution that you have the ability to solve right at the moment, right within your hands. You have that under section 13 if you choose to take advantage of the powers that you're given. If not, you also have the powers to go out and buy bank stock. Now, maybe you don't want to buy bank stock in New England, but maybe—

Mr. GREENSPAN. I wasn't aware we have powers to buy bank stock.

Mr. KENNEDY. Yes. Well, that's what—well, maybe it's the FDIC. I'm sorry. But what I'm trying to suggest is that there are lots of ideas, if people in your positions could be out there trying to advance them. But we have heard now this issue be denied for a full year; finally, a year later, people are talking about it; meanwhile, the unemployment rate in my State has gone from 2 percent to well over 8 percent. This is a diverse economy. If the loans were provided, if the businesses were able to go out and continue loans that were good yesterday, were good last year, and will be good next year—but because the banks are forced to offset against their real estate loans, they take a good performing loan away from a small business. It is craziness.

Mr. GREENSPAN. I don't disagree with that statement. We've got a very serious problem, and what we have been endeavoring to do is to move in directions where we think we can do something that will work. If you want to discuss it further, one on one, I'd be more than delighted to do so.

Mr. KENNEDY. Terrific. I'd love to. Thank you very much, Mr. Chairman.

Mr. GREENSPAN. Well, you're welcome to come by, and we'll argue.

Mr. KENNEDY. OK. Hopefully we'll solve something. That's what I look forward to.

Mr. GREENSPAN. It's conceivable that—if you can come up with certain things that say that what we are doing is wrong, and you

can demonstrate that, and we can find a way to do so, I'd be delighted.

Mr. KENNEDY. Great. Listen. I'm going to call you this afternoon, and I'm going to set up that appointment.

Mr. GREENSPAN. Sure.

Mr. KENNEDY. Thank you very much.

Chairman NEAL. Mr. Campbell wanted to ask a quick question.

Mr. CAMPBELL. Thank you, Mr. Chairman. Just one quick one.

In answer to a previous question you were asked, about what was the most important thing for improving the situation financial institutions' capitalization, you responded, the interstate banking, McFadden. I wanted to pursue what you didn't say, namely, Glass-Steagall.

Mr. GREENSPAN. Oh, I am fully supportive of repeal of the Glass-Steagall Act, as I've said many times in earlier hearings, you may recall. It was maybe as long as 3 years ago when we were really going through this issue in some detail. I must say to you, Mr. Campbell, I don't see any change in any of the members of the Federal Reserve Board on this issue. We are supportive of it.

Mr. CAMPBELL. Three years ago, I was a professor at Stanford.

Mr. GREENSPAN. I remember that.

Mr. CAMPBELL. But in Glass-Steagall, by negative implication, I took it that you're not changing your position, but it's not your A-number-one way of increasing capitalization at banks.

Mr. GREENSPAN. No. I still think that it's a desirable priority. When I was talking about powers I was mentioning before—

Mr. HOAGLAND. Fine. That's what I meant.

Mr. GREENSPAN. But the issue that has surfaced in the last 2 or 3 years is some willingness to look at the McFadden Act as a vehicle which now is well over 60 years old and requires some thoughtful restructuring.

Mr. HOAGLAND. Thanks. I was concerned about the negative pregnant of your previous answer.

Mr. GREENSPAN. I'm sorry if I gave you that impression.

Mr. HOAGLAND. Much obliged.

Thank you, Mr. Chairman.

Chairman NEAL. Mr. Chairman, your report indicates that the Federal Open Market Committee members are predicting a range for the Consumer Price Index measure of inflation of from 3 to 4½ percent and a central tendency prediction of from 3¼ to 4 percent. Do you come to a similar judgement concerning other measures of inflation, the GNP price deflator, for example?

Mr. GREENSPAN. Obviously, internally the staff makes detailed estimates of almost every major price index. What those numbers are is our survey of the individual Governors and Presidents with respect to how they personally would project the outlook.

Chairman NEAL. I understand.

Mr. GREENSPAN. They are not our goals. They are not even analytically necessarily consistent, but those are the only questions we ask.

Chairman NEAL. You don't ask them to use another measure of inflation.

Mr. GREENSPAN. No, Mr. Chairman.

Chairman NEAL. You just use the Consumer Price Index.

Mr. GREENSPAN. Correct. Yes.

Chairman NEAL. Well, would you want to venture an opinion? It just seemed to me—and we have had this discussion before—that the GNP price deflator is probably a more accurate measure of inflation. Do you still hold to that view?

Mr. GREENSPAN. Well, it's a different type of measure. The GNP deflator is a measure of the value added to the cost structure. I should say it's a measure of the internal cost structure within the United States. For example, it is not affected, directly at least, by import prices. The Consumer Price Index, for example, includes import prices. For example, when we have a very sharp rise in the price of oil, since only part of the oil price is reflected in the GNP deflator—only to the extent that it affects domestic margins—what you end up with is a Consumer Price Index which is showing a much higher rate of inflation. In that example, the GNP deflator and the CPI are measuring two separate things, and basically, for purposes of gauging inflation, I would be more inclined to look at the CPI as a useful measure.

I would think generally we should stay with that, even though it has a lot of faults. One of my colleagues points out that we implicitly forecast the GNP deflator. To the extent that there's a nominal GNP and a real GNP in the projections, one can infer what the GNP deflator forecast is, and it turns out that the implied GNP deflator, at about 3½ percent, is about the same as the CPI in this particular instance.

Chairman NEAL. Are your own personal projection for these numbers among those that are considered for this report.

Mr. GREENSPAN. Yes. I don't find myself at great variance with the numbers.

Chairman NEAL. You're fairly comfortable with these numbers.

Mr. GREENSPAN. But I do want to emphasize, as we have in our written comments, that there are really quite significant ranges in potential uncertainty in these forecasts, more than is usually the case.

Chairman NEAL. Let me ask you to respond to another idea that has been floated lately. Earlier in the day we talked about the so-called sterile reserves that the banks are required to hold, and I think you said that you would not object to interest being paid on those reserves. An idea was mentioned to me the other day that in fact interest be paid on those reserves and that that money be used to re-fund the FDIC, as a way of getting at that problem. Does that make any sense?

Mr. GREENSPAN. Well, remember that those interest on reserves basically would be a subtraction from the net earnings of the Federal Reserve System, which, in turn, would mean that there would be a reduction in the budget receipts of the Treasury, and the deficit would rise accordingly. If, however, they are moved directly into the FDIC, my recollection is that it might turn out to be a book-keeping wash, but remember, we're still dealing with taxpayer funds.

Chairman NEAL. It's still the same pot.

Mr. GREENSPAN. Exactly.

Chairman NEAL. The economic considerations would be the same.

Mr. GREENSPAN. Yes.

Chairman NEAL. It would just be nominally different. It may be politically different, somehow, as it would be seen as the banks somehow paying their own way—well, I think under all proposals on the table now banks would pay their own way in terms of funding whatever is needed for the FDIC.

Mr. GREENSPAN. Yes.

Chairman NEAL. Do you see any advantage to approaching it this way, as opposed to some other way?

Mr. GREENSPAN. There are so many different variations to this that I would frankly prefer, Mr. Chairman, to await an actual recommendation by the administration on this issue and then, presumably, to the extent that you call us to testify, we could give you a thoughtful reaction to that proposal, rather than discuss pieces of this without regard to the whole.

Chairman NEAL. What would you reckon that the interest amount would be on those reserves? I think I heard the figure of \$10 billion.

Mr. GREENSPAN. Oh, no. We're talking about an order of magnitude of reserves of \$20 billion. If you figure the Federal funds rate, we're talking about \$1.2 billion or \$1.3 billion.

Chairman NEAL. So you're talking about total sterile reserves of about \$20 billion.

Mr. GREENSPAN. Yes.

I wouldn't call them sterile. They're actually working balances there, and an interesting issue that we're running into with respect to reducing these required reserves is that we find that, with the hundreds of billions of dollars a day which are transacted by the commercial banks, the working balances are not small, and it's by no means clear that the actual working balances are that much below, if at all, required reserves at this stage, plus certain clearing reserves which the banks choose to hold.

Chairman NEAL. I want to mention something that troubles me a little bit. The President mentioned in his State of the Union address that he was going to ask you to head up some sort of a committee to look into the advisability of reducing the capital gains tax rate. I don't know what's come of that, but if in fact you do that, I hope that somehow it's done in a way that doesn't lead to unwanted political ramifications. That issue is not only an economic one. There are all sorts of political baggage that goes with it, having to do with lots of things, not the least of which is undoing the 1986 tax bill, and others that are just purely involve partisan politics. It would seem to me to be a shame to run any risk of reducing any degree of Fed independence by somehow getting in the middle of a political dogfight of some kind.

Mr. GREENSPAN. I'd say, Mr. Chairman, that I'm acutely aware of that issue. What the President had in mind was a very much narrower question, which really harks back to the experiences we had with the Social Security Commission, in which there were very significant philosophical differences about how that fund should be handled, which were highly partisan, as you may recall. But we were able to put together a commission in which part of the advances we made was to agree on what certain statistical facts were, and that was done fully on a bipartisan basis. I think the President fully understands what I believe the Speaker of the House indicat-

ed the other day—namely, that the issue of capital gains is a philosophical issue more than it is a technical issue, and I would certainly subscribe to that. I'm sure the President would subscribe to that. It's an issue here of perhaps narrowing some of the technical differences which would occur if a group of analysts under the sponsorship of the President and the bipartisan leadership of the Congress were able to come together and look at certain data and affirm certain technical facts.

In my judgement, that is not a political issue, and I can assure you I have no intention of getting involved in any of the philosophical questions. To the extent that we could reproduce something similar to what was done in the Social Security Commission, that would be of value. Whether that's technically feasible is yet to be determined.

Chairman NEAL. Since the value of real estate has a big impact on the value of banks, savings and loans, influences the health of insurance companies, pension funds, a whole range of other financial instruments, and big sectors of the financial services industry, and since real estate does not operate in a vacuum—that is to say, the tax laws of the early 1980's encouraged investment in real estate; the 1986 tax law discouraged investment in real estate—is there anything that we ought to do from a policy point of view that would more directly involve or impact on the value of real estate? Would it make sense to try to look at the recent history of those things that have influenced real estate prices and see if an inordinate amount of harm is being done because prices have fallen, or should we leave it alone?

Mr. GREENSPAN. Well, that's a very complex issue. You're quite correct. We've all recognized in retrospect that some of the changes in tax rules in the early 1980's induced a rather significant expansion of real estate investment, and it became recognized in the 1986 tax reform bill that a lot of the issues relevant to passive investment and how real estate was handled had been overdone, and in a sense the loophole, if you want to put it that way, which is what it was called at the time, was closed. But there was a huge amount of construction in process, which eventually ended up with substantial vacancies and with dramatic effects on real estate values.

Opening up the whole question of the 1986 act would probably be ill-advised at this particular stage. Obviously, as I think I've discussed here at a meeting of this committee not too long ago, there are technical things that one can do in capital gains and the like which would affect the values of the properties, but it is an extraordinarily important issue which has got to be handled in a way which whatever is done, is not counterproductive, and implicitly recognize that we have indeed a very large overhang of commercial real estate which we will have to work our way through. Obviously, a recovery here in economic activity would clearly help, but there is no simple way to absorb that overhang very quickly, and all we can do is work at the edges and try where we can to minimize the problems which those real estate values have created for our financial institutions.

That, in fact, in many respects, is what we are doing when we look at some of the procedures with respect to appraisal and examination of real estate loans, and that's an issue which will be dis-

cussed in more detail within the next few days in a forum sponsored by the Treasury and including the regulatory agencies.

Chairman NEAL. Will there be a discussion, then, of the possibility of some accelerated depreciation or anything like that?

Mr. GREENSPAN. I don't think so, no. The only issue that will be discussed there is relevant to the examination processes.

Chairman NEAL. On that one particular kind of policy change, would that make any sense to you?

Mr. GREENSPAN. Accelerating depreciation?

Chairman NEAL. Yes. On existing real estate.

Mr. GREENSPAN. Well, what you want to do is find ways to increase the market value of existing property. I'm not sure that you want to put in place policies whose purpose it is to construct—

Chairman NEAL. No, no. I said on existing properties.

Mr. GREENSPAN. I'm sorry?

Chairman NEAL. I said on existing properties.

Mr. GREENSPAN. Oh, I'm sorry. I misheard you, Mr. Chairman. I mean, obviously it has the same effect as capital gains tax changes have on the changes in the potential market value.

Chairman NEAL. But it's very specific to one industry.

Mr. GREENSPAN. Yes.

Chairman NEAL. This keeps occurring to me, because it seems to me the ripple effect of these real estate prices has been very dramatic in the economy. And it's not as if real estate operates in a perfect free-market environment. We may be closer to it now, after having made the changes in 1986; that's on balance desirable, but it does seem to me that it is playing such a big role in so many current problems that it might be worthy to look at it.

Mr. GREENSPAN. It plays a big role in the financial area, because, even though commercial real estate is such a small part of the gross national product, meaning the amount of actual construction that is involved is very small relative to the GNP—something like 1 percent of it—because real estate is such a long-lived asset, the stock builds up very dramatically relative to the stock of other assets in the economy, and it is a major element of collateral in our financial intermediaries—

Chairman NEAL. That is what I am talking about.

Mr. GREENSPAN. And in that respect has a fairly pronounced impact on the economy overall.

Chairman NEAL. Do you think that it would be better left alone, or do you think it is worthy of looking at more closely?

Mr. GREENSPAN. Anything is worthy of looking at. One has to look at it for the pluses and the minuses. I haven't given this terribly much thought, so I would resist giving you an off-the-top-of-my head answer.

Chairman NEAL. Could you and your staff take a look at that and let me know what you think?

Mr. GREENSPAN. Certainly. I'll be glad to look at it and maybe give you a more thoughtful evaluation than I can at this particular moment.

Chairman NEAL. Thank you, and thank you for your appearance today and for all your help and great service to our country.

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I appreciate that.

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

[Whereupon, at 12:15 p.m., the hearing adjourned subject to the call of the Chair.]

APPENDIX

February 5, 1991

**TESTIMONY OF SIDNEY L. JONES
BEFORE THE
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE HOUSE BANKING COMMITTEE
U.S. HOUSE OF REPRESENTATIVES
FEBRUARY 5, 1991**

Mr. Chairman and Members of the Committee, I am pleased to meet with you to discuss the general economic outlook. My comments will concentrate on reviewing current economic conditions and the Administration's economic forecasts published in the President's FY 1992 budget.

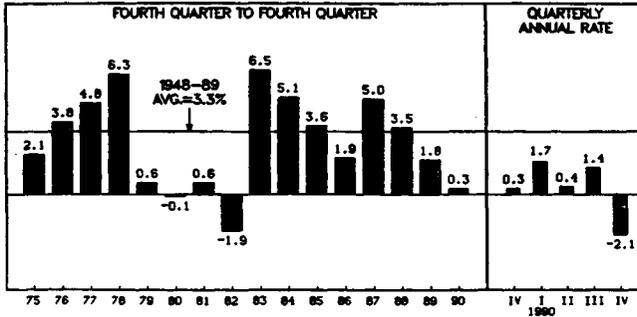
CURRENT ECONOMIC CONDITIONS

During the 1980s, rapid changes occurred throughout the world economy leading to structural reforms in Western and Eastern Europe and the continued emergence of new economic forces in the Pacific Basin and Latin America. In the United States, the cyclical expansion that began in November 1982 created almost eight years of sustained economic growth, relatively stable inflation, and the addition of more than 20 million jobs. The U.S. economy grew at an average rate of 3.6 percent from the fourth quarter of 1982 through the third quarter of 1990, a record peacetime expansion. This sustained growth is even more impressive when compared with the stagflation that preceded it -- a combination of sluggish economic activity, double-digit inflation rates, chronic unemployment problems, and unusually high interest rates.

From early-1989 through the third quarter of 1990, however, the pace of economic activity in the United States slowed to an average annual real GNP growth rate of 1.2 percent. During the last three months of 1990 the real output of goods and services declined at a 2.1 percent annual rate according to the preliminary GNP figures. The negative fourth quarter estimate reduced the 1990 annual growth rate to only 0.3 percent from the 1.8 percent pace reported during 1989. The GNP price deflator rose 4.0 percent in 1990, slightly more than the 3.7 percent increase in 1989, and the unemployment rate moved up from the 5.3 percent level reported during the first half of the year to 6.1 percent by December 1990.

GROWTH OF REAL GNP

PERCENT CHANGE



The disruptive effects of the oil price shock beginning last August eroded consumer and business confidence at a time when economic activity already had slowed. Consumer spending, which accounts for two-thirds of the GNP, had been soft for many months, particularly the purchases of automobiles and other durable goods. Residential building had been in decline since the mid-1980s and new housing starts had fallen to the low level last reported during the 1981-82 recession. Business investment in new plant and equipment had contracted and surveys of future plans had become more pessimistic. Government spending had responded to fiscal pressures, particularly the restraint of defense spending. The creation of new jobs had decelerated in manufacturing, construction, and some service industries.

The combination of marketplace forces, particularly the distorting effects of inflation and the collapse of confidence caused by oil and war shocks, disrupted the U.S. economy. During the last quarter of 1990, widespread declines occurred in consumer spending, particularly for durable goods, business fixed investment, residential construction, and inventory investment.

Partially offsetting these declines were strong improvement in the net export balance, increasing State and local government spending, and a large rise in Federal defense outlays. Real final sales for the fourth quarter remained flat and the overall decline in the quarterly GNP reflects the rundown of inventories. Businesses reduced their inventories by more than \$16 billion in real terms during the fourth quarter following an increase of about \$5 billion in the third quarter, a swing of \$21 billion dollars of inventories.

Despite the negative fourth quarter result, most analysts believe that the current downturn will be relatively brief and mild. The major arguments supporting this consensus outlook include:

- o Stocks of inventories remain low relative to current sales and have been declining for several months rather than rising as typically occurs during the early stages of an economic downturn. The aggregate inventory-sales ratio actually declined in the fourth quarter. But the liquidation of inventories does not appear to be gathering downward momentum. This suggests that production activity to replenish inventory stocks may respond quickly when consumer and business spending resumes. For example, auto inventories are at relatively low levels because of cutbacks in production during the fourth quarter of 1990. Orders placed with durable goods manufacturers also have held up well.
- o Exporting industries continue to register strong sales. Merchandise exports grew in real terms at a strong 15 percent annual rate during the final quarter of last year. For all of 1990, merchandise exports were up 7-1/2 percent while real nonpetroleum merchandise imports increased only 2-1/4 percent during the year. Further declines in the U.S. dollar since mid-1990 have improved the competitive position of American farmers and companies in foreign markets. Export sales should remain strong despite the slowdown of economic activity in some countries, the disruptive oil and war shocks, and the disappointing delay in completing the important Uruguay Round of multilateral trade negotiations.
- o The surge of inflation linked to the runup of oil prices appears to be moderating. The implicit GNP price deflator, which is affected by shifts in the composition of output, increased by only 2.8 percent in the fourth quarter, down from a low 3.7 percent pace during the third quarter. Continued easing of price pressures will help restore purchasing power and confidence needed to stimulate personal consumption and business spending.
- o Business investment in new plant and equipment is expected to remain flat during 1991 according to recent surveys. There does not appear to be any widespread erosion of spending plans.
- o The rapid growth of Federal government spending in FY 1991, for both defense and non-defense programs, will contribute to sustaining economic activity. State and

local government spending also has continued despite the growing size of their budget deficits.

- o Economic activity should be stimulated by the large reduction in interest rates that has occurred. Since their late summer highs, Treasury 3-month bill interest rates have declined approximately 150 basis points to the 6 percent zone and Treasury 30-year bond interest rates have dropped 65 basis points to the 8-1/4 percent zone.
- o The Fed has eased policy by:
 - oo Reducing the target for the Federal funds rate from 8 percent in August to 7 percent by the end of the year and to 6-3/4 percent in early January.
 - oo Eliminating reserve requirements on nonpersonal time and Euro-dollar liabilities on December 4.
 - oo Cutting the discount rate from 7 to 6-1/2 percent on December 18. On February 1 the discount rate was cut to 6 percent.
- o We share Chairman Greenspan's concern about the sluggish growth of the money supply in recent months and support his increased emphasis on monitoring the growth of money and credit in the formulation of monetary policy.
- o The Treasury Department has tried to serve as a "catalyst" by encouraging banks to grant loans to worthy borrowers. Officials have met frequently with bank regulators to encourage them to be more sensitive to tight credit conditions.

In summary, the decline in real output during the fourth quarter of 1990 does not appear to be turning into a cumulative downturn. The decline in payroll jobs in January demonstrated that the pattern of recovery will not be a simple upward trend line, but the fundamental factors needed for resuming economic growth are in place.

ECONOMIC ASSUMPTIONS USED IN PREPARING
THE FY 1992 BUDGET

Current events -- particularly the oil and war shocks and uncertainty about resolving structural weaknesses in domestic financial institutions -- make economic forecasting unusually difficult. Nevertheless, there is widespread agreement with the Administration's recent forecast published in the FY 1992 budget that the current downturn is likely to be relatively mild and brief. For Calendar 1991, the Congressional Budget Office (CBO),

Blue Chip Consensus (an average of approximately fifty private economic forecasters), and several private econometric models agree that moderate growth will be registered for the entire year. There is further agreement that the upturn will continue in 1992.

Outlook for Real GNP Growth		
(Percent, 4th qtr. to 4th qtr.)		
	1991	1992
Administration (Troika)	0.9	3.6
CBO (1/91)	1.3	3.4
Blue Chip (1/91)	0.9	2.8
Data Resources (1/91)	1.0	3.7
Meyer & Assoc. (1/91)	0.5	3.3
Wharton (1/91)	2.2	2.6

The CBO and Blue Chip Consensus estimates also agree with the Administration's view that positive economic growth will begin during the second quarter of this year. Of the private forecasters participating in the Blue Chip panel, 70 percent the downturn to end by June.

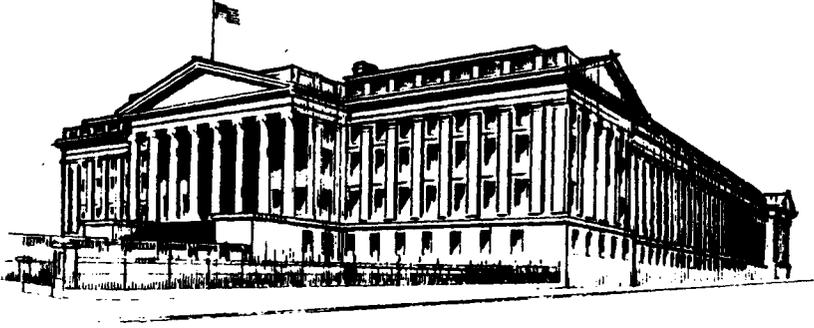
Quarterly Pattern of Forecasts of Real Growth					
(Percent Change, Annual rate)					
	1991				Decline Peak to Trough*
	I	II	III	IV	
Administration (Troika)	-1.3	0.3	2.0	2.8	-1.2
CBO (1/91)	-1.7	0.8	2.3	3.9	-1.0
Blue Chip (1/91)	-1.4	0.3	2.0	2.7	-1.0
Data Resources (1/91)	-2.1	-0.4	3.0	3.6	-1.4
Meyer & Assoc. (1/91)	-2.1	-1.1	2.4	2.9	-1.6
Wharton (1/91)	-0.9	2.3	4.1	3.3	-0.8

*Including decline in 1990-IV. Total decline not at annual rate.

As to the possible depth of the current downturn, the Administration estimates a decline of 1.2 percent from the cyclical peak in the third quarter of 1990 to the trough in the first quarter of 1991. The Blue Chip Consensus and CBO both project a similar decline of 1.0 percent. The average decline during the previous eight post-war recessions has been 2.6 percent. Therefore, the current cyclical downturn is expected to be relatively mild.

Turning to the Administration's intermediate-range economic projections, we anticipate a return to more normal growth rates following the current downturn. A moderate snapback of activity is expected in 1991 leading to a sustained period of expansion, improving inflation and unemployment rates and lower short- and long-term interest rates. The annual figures prepared by the Administration for the five-year budget estimates are summarized below.

Summary of Administration Economic Assumptions								
	<u>Actual</u>	<u>Preliminary</u>	<u>Short-term Forecast</u>		<u>Longer-term projections</u>			
	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>
	<u>Percent change, 4th qtr. to 4th qtr.</u>							
Nominal GNP	5.6	4.3	5.3	7.5	7.1	6.8	6.5	6.4
Real GNP	1.8	0.3	0.9	3.6	3.4	3.2	3.0	3.0
GNP deflator	3.7	4.0	4.3	3.8	3.6	3.5	3.4	3.3
Consumer price index	4.6	6.3	4.3	3.9	3.6	3.5	3.4	3.3
	<u>Percent, average for calendar year</u>							
Total unemployment rate	5.2	5.4	6.7	6.6	6.2	5.8	5.4	5.1
3-mo. Treas. bill rate	8.1	7.5	6.4	6.0	5.8	5.6	5.4	5.3
10-yr. Treas. notes	8.5	8.5	7.5	7.2	6.8	6.6	6.4	6.3



**Office of the Assistant Secretary for Economic Policy
Department of the Treasury**

ECONOMY WATCH

- REAL GNP FELL AT 2.1% ANNUAL RATE IN THE FOURTH QUARTER. MARKED END OF EXPANSION OF NEARLY EIGHT YEARS. GROWTH HAD TURNED SLUGGISH DURING LATE STAGES OF EXPANSION, AVERAGING A 1-1/4% RATE DURING THE LAST YEAR AND ONE-HALF. INCLUDING DECLINE IN Q-IV, REAL GNP UP ONLY 0.3% ACROSS FOUR QUARTERS OF 1990.

... continued

- FOURTH-QUARTER DECLINE IN REAL OUTPUT LESS THAN GENERALLY EXPECTED. SHARP CUT-BACK IN INVENTORIES, BUT FINAL SALES WERE UNCHANGED. LATTER THE RESULT OF A BALANCING OF WEAK PRIVATE DOMESTIC DEMANDS WITH STRONG RISE IN EXPORTS AND INCREASED FEDERAL AND STATE AND LOCAL GOVERNMENT SPENDING.

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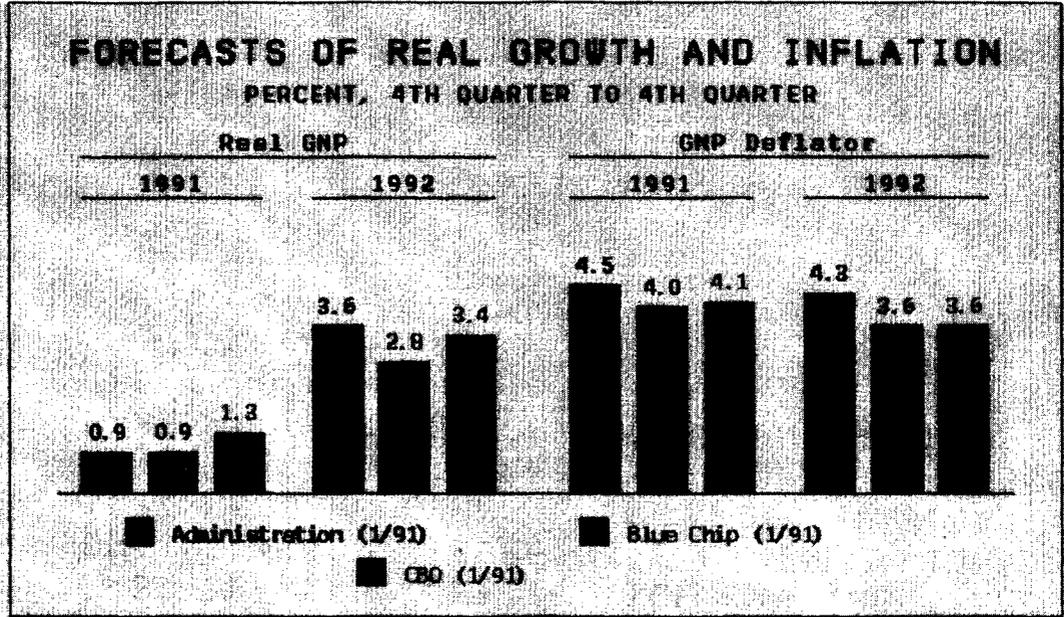
- EARLY EVIDENCE ON FIRST QUARTER DISAPPOINTING. EMPLOYMENT AND WORKHOURS FELL SHARPLY IN JANUARY, INDICATING POSSIBILITY OF ANOTHER SIZEABLE DROP IN GNP. WEATHER PLAYED A ROLE IN JANUARY DECLINE, SO MAY SOMEWHAT OVERSTATE INTENDED CUTBACKS IN BUSINESS ACTIVITY. EVEN SO, BUSINESSES APPEAR TO BE CURBING ACTIVITY MORE THAN EXPECTED IN VIEW OF LOW INVENTORY LEVELS.

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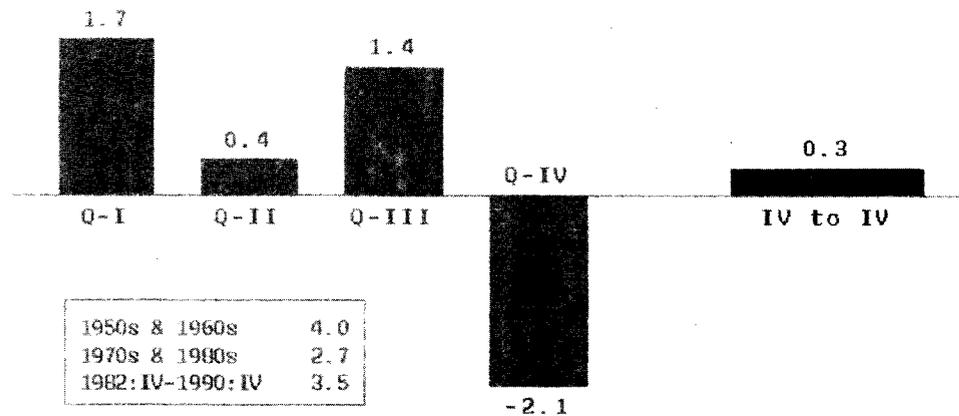
- SPURT IN ENERGY PRICES FOLLOWING MIDDLE-EAST FLARE-UP LEFT LITTLE LASTING IMPACT ON INFLATION. CORE RATE OF INFLATION (CPI LESS FOOD AND ENERGY) UP AT 3.8% RATE IN FINAL THREE MONTHS OF 1990, ABOUT SAME AS AVERAGED DURING SECOND HALF OF THE 1980'S.

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REAL GROWTH IN 1990

Seasonally Adjusted Annual Rates in Percent



FORECASTS OF REAL GROWTH
(4TH QUARTER TO 4TH QUARTER)

	<u>1990</u>	<u>1991</u>	<u>1992</u>
Administration (1/91)	0.0	0.9	3.6
CBO (1/91)	0.2	1.3	3.4
Blue Chip (1/91)	0.2	0.9	2.8
Nat. Assoc. of Bus. Economists (11/90)	0.7	1.1	n.a.
Data Resources (1/91)	0.1	1.0	3.7
L.H. Meyer & Assoc. (12/20/90)	0.1	0.5	3.3
WEFA (12/28/90)	0.3	2.2	2.6
Merrill Lynch (1/2/91)	0.0	-0.2	n.a.

FORECASTS OF INFLATION*
(4TH QUARTER TO 4TH QUARTER)

	<u>1990</u>	<u>1991</u>	<u>1992</u>
Administration (1/91)	4.5	4.3	3.8
CBO (1/91)	4.4	3.1	3.6
Blue Chip (1/91)	4.5	4.0	3.6
Nat. Assoc. of Bus. Economists (11/90)**	6.4	4.5	n.a.
Data Resources (1/91)	4.1	3.1	2.9
L.H. Meyer & Assoc. (12/20/90)	4.6	3.1	2.2
WEFA (12/28/90)	4.2	2.9	3.3
Merrill Lynch (12/90)	4.5	4.2	n.a.

*Based on GNP deflator

**CPI

OECD REAL GROWTH FORECASTS FOR G-7 COUNTRIES
(2nd half year to 2nd half year)

	<u>1990</u>	<u>1991</u>	<u>1992</u>
United States	0.8	1.2	1.9
Canada	0.3	1.5	2.5
Japan	5.6	3.7	3.9
France	2.5	2.1	2.6
Germany	4.4	3.3	2.5
Italy	2.8	1.9	2.9
United Kingdom	0.3	1.5	2.5
Total - All G-7 Countries	2.5	2.1	2.5

Source: OECD Economic Outlook, December 1990.

OECD INFLATION FORECASTS FOR G-7 COUNTRIES*
(2nd half year to 2nd half year)

	<u>1990</u>	<u>1991</u>	<u>1992</u>
United States	4.3	5.1	4.4
Canada	3.5	4.6	3.6
Japan	1.6	2.1	1.8
France	3.5	3.6	3.2
Germany	3.6	4.4	3.9
Italy	6.9	7.1	5.7
United Kingdom	6.3	6.6	5.3
Total - All G-7 Countries	3.8	4.4	3.8

*Based on GNP deflator

Source: OECD Economic Outlook, December 1990.

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Summary of Administration Economic Assumptions										
	<u>Actual</u>	<u>Preliminary</u>	<u>Short-term</u>		<u>Longer-term projections</u>					
	<u>1989</u>	<u>1990</u>	<u>Forecast</u>		<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>
			<u>Percent change, 4th qtr. to 4th qtr.</u>							
Nominal GNP	5.6	4.3	5.3	7.5	7.1	6.8	6.5	6.4		
Real GNP	1.8	0.3	0.9	3.6	3.4	3.2	3.0	3.0		
GNP deflator	3.7	4.0	4.3	3.8	3.6	3.5	3.4	3.3		
Consumer price index	4.6	6.3	4.3	3.9	3.6	3.5	3.4	3.3		
			<u>Percent. average for calendar year</u>							
Total unemployment	5.2	5.4	6.7	6.6	6.2	5.8	5.4	5.1		
3-mo. Treas. bill rate	8.1	7.5	6.4	6.0	5.8	5.6	5.4	5.3		
10-yr. Treas. notes	8.5	8.5	7.5	7.2	6.8	6.6	6.4	6.3		

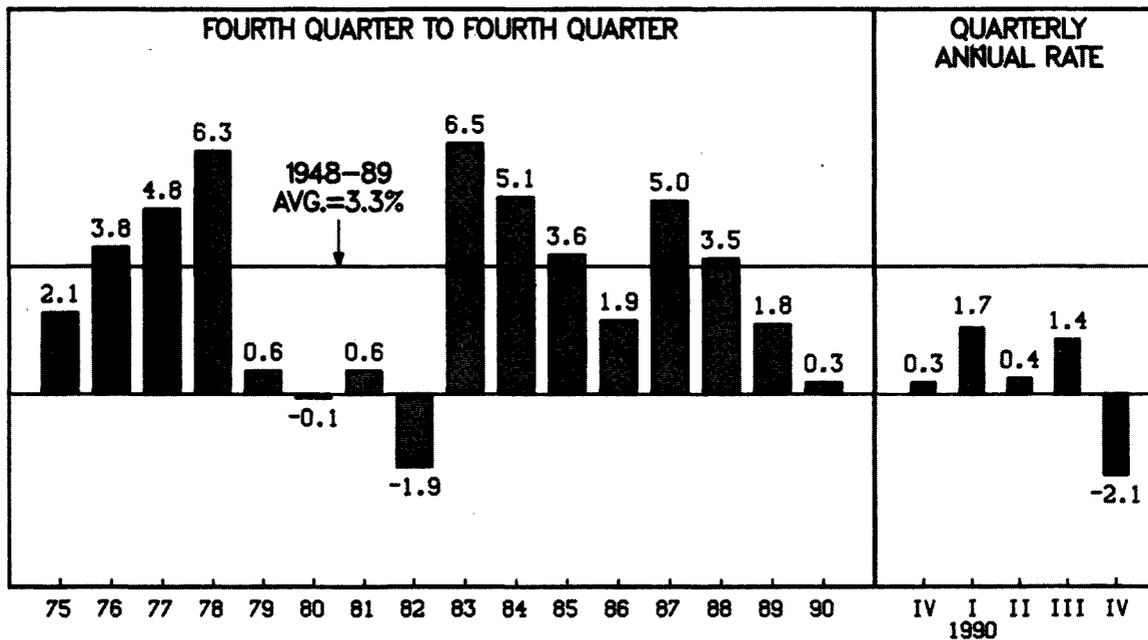
ECONOMIC DATA CARDS

- | | |
|----------------------------------|--------------------------------------|
| 1 - GNP | 14 - Consumer Prices |
| 2 - Personal Income | 14A - Components of Consumer Prices |
| 3 - Retail Sales | 15 - Producer Prices |
| 4 - Personal Saving | 16 - Employment Cost Index |
| 5 - Consumer Confidence | 17 - Productivity |
| 6 - Housing Starts | 18 - Industrial Production |
| 7 - Plant & Equipment Spending | 19 - Durable Goods Orders |
| 8 - Construction Activity | 20 - Capacity Utilization |
| 9 - Merchandise Trade | 21 - Leading Indicators |
| 9A - Real Net Export Balance | 22 - NAPM Index |
| 10 - Exchange Rates | 23 - Federal Deficit |
| 11 - Monetary Aggregates | 24 - Federal Outlays and Receipts |
| 12 - Interest Rates | 25 - Corporate Cash Flow and Profits |
| 13 - Employment and Unemployment | |
| EX - Exit | |

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1. GROWTH OF REAL GNP

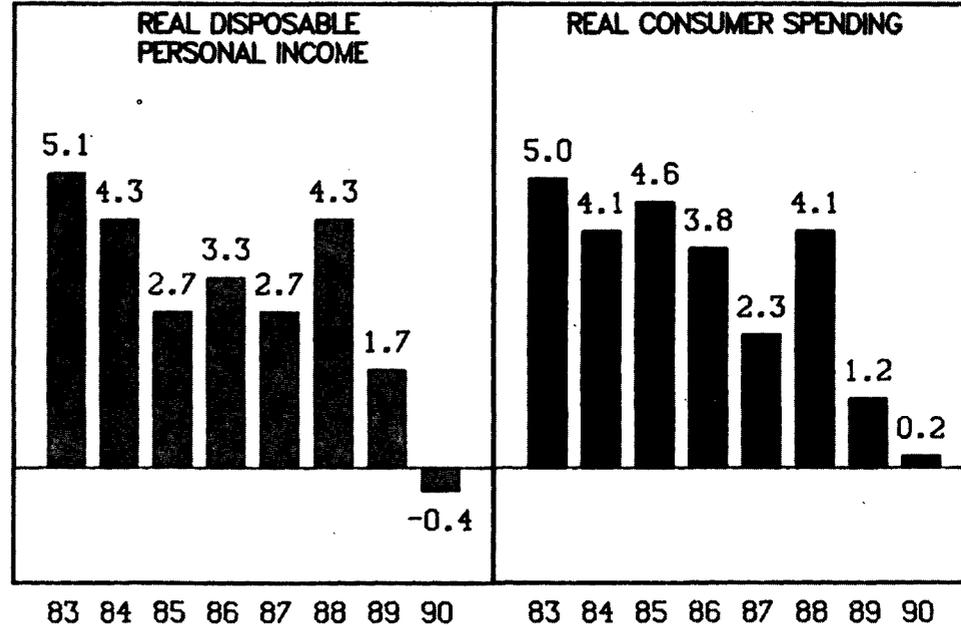
PERCENT CHANGE



114

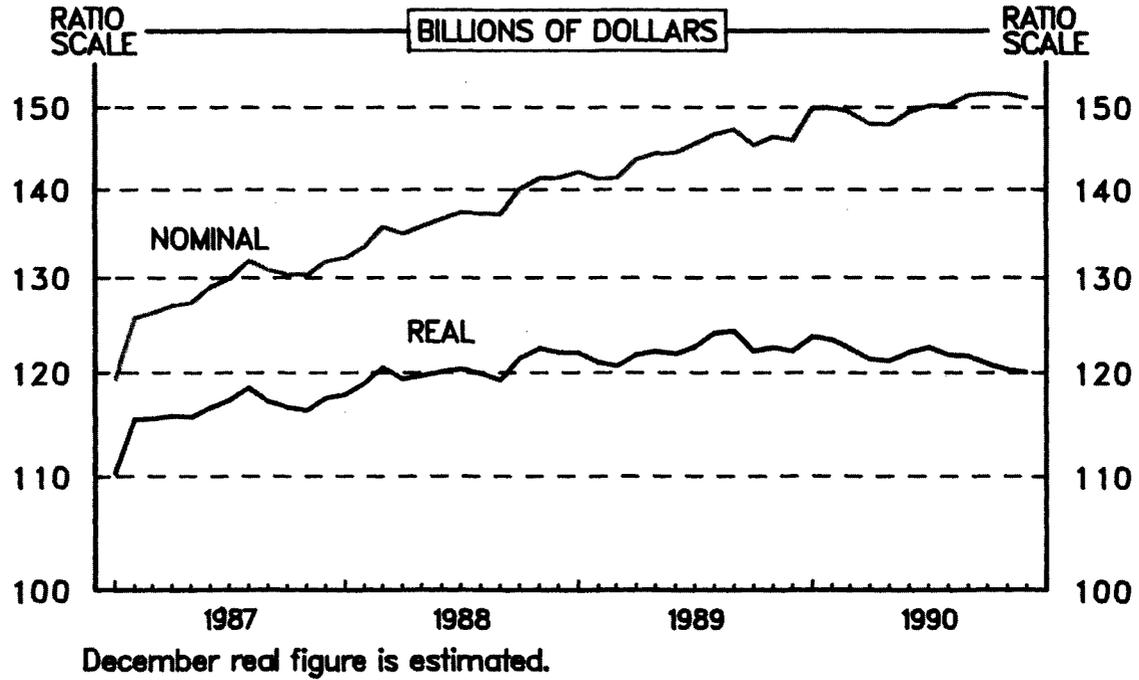
2. PERSONAL INCOME AND SPENDING

PERCENT CHANGE, FOURTH QUARTER TO FOURTH QUARTER



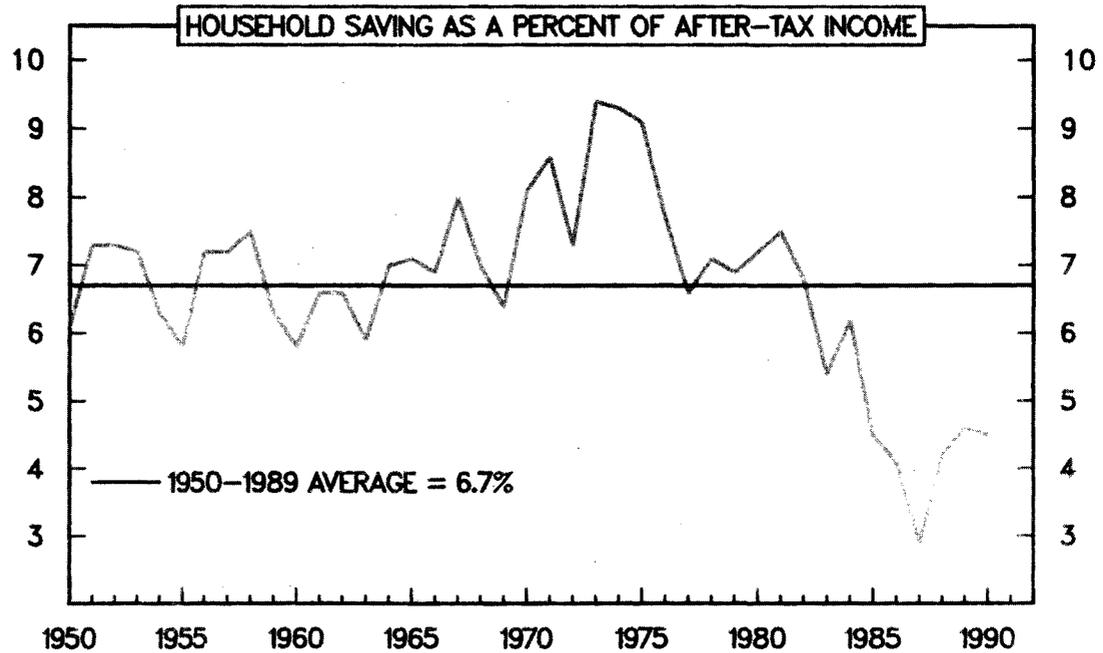
115

3. RETAIL SALES



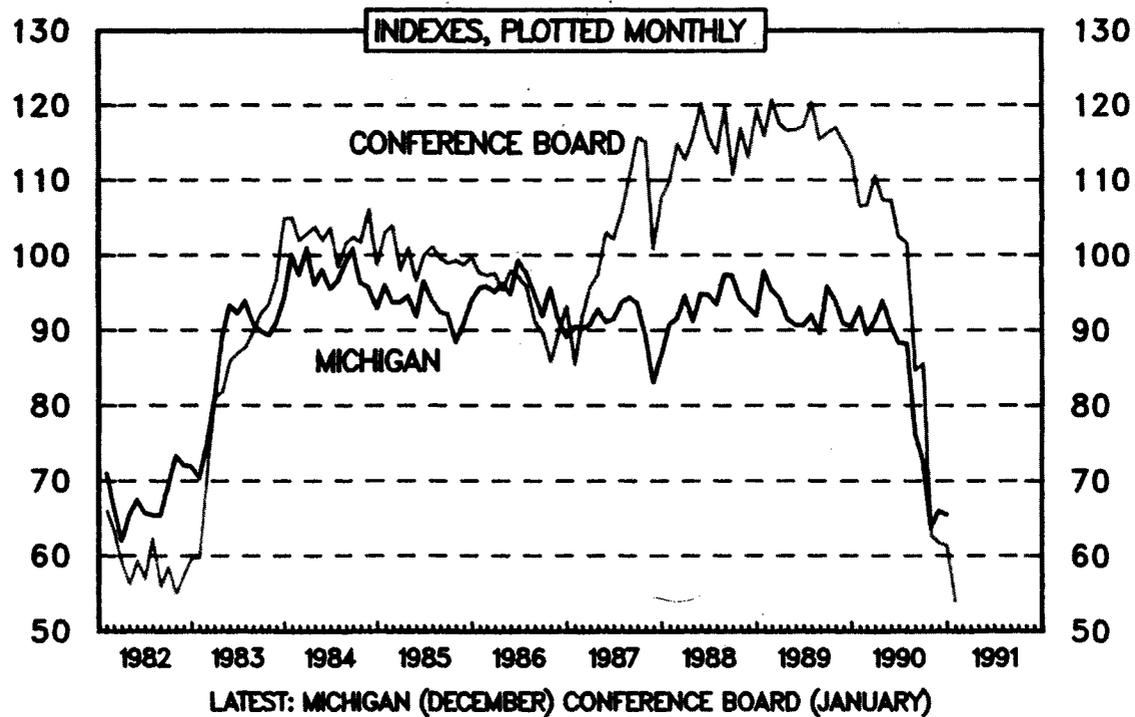
116

4. PERSONAL SAVING



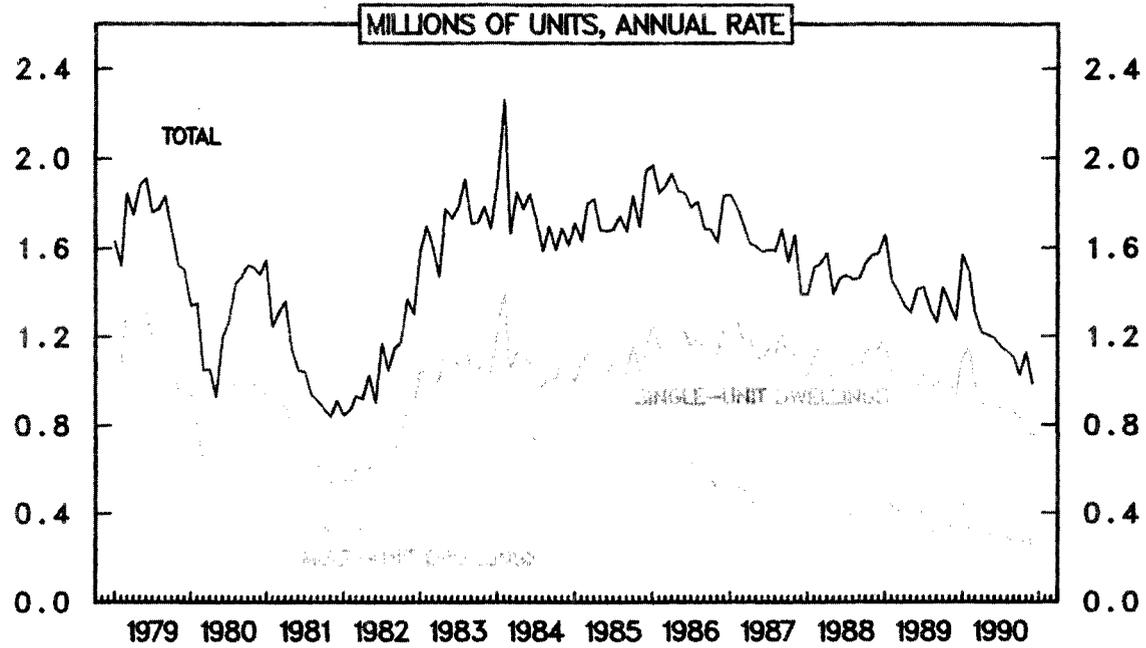
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5. CONSUMER CONFIDENCE



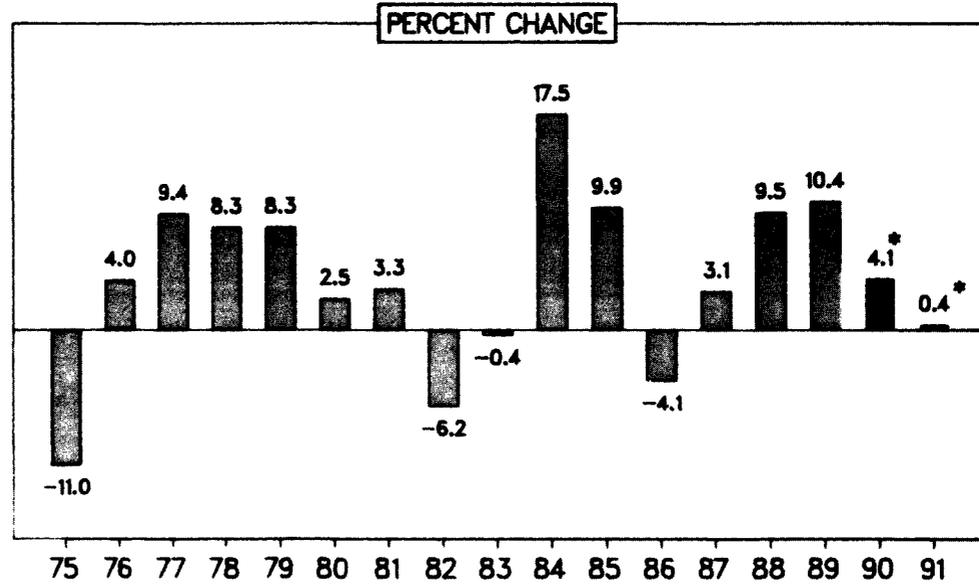
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6. NEW HOUSING STARTS



119

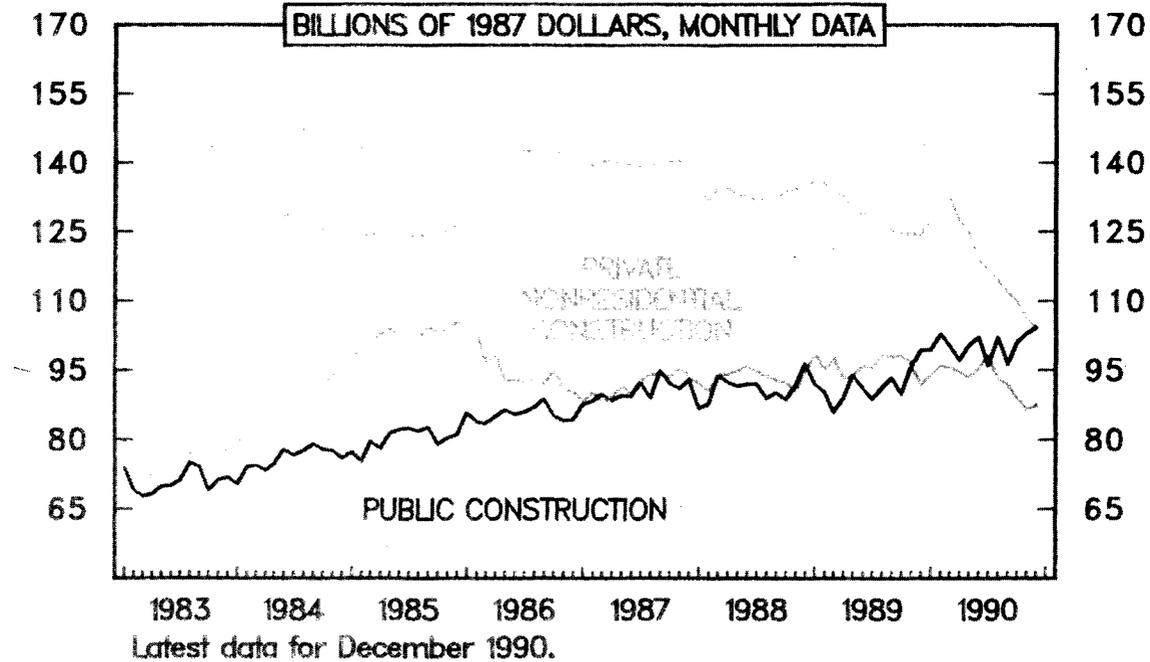
7. REAL PLANT AND EQUIPMENT OUTLAYS



120

* Estimates from October and November survey.

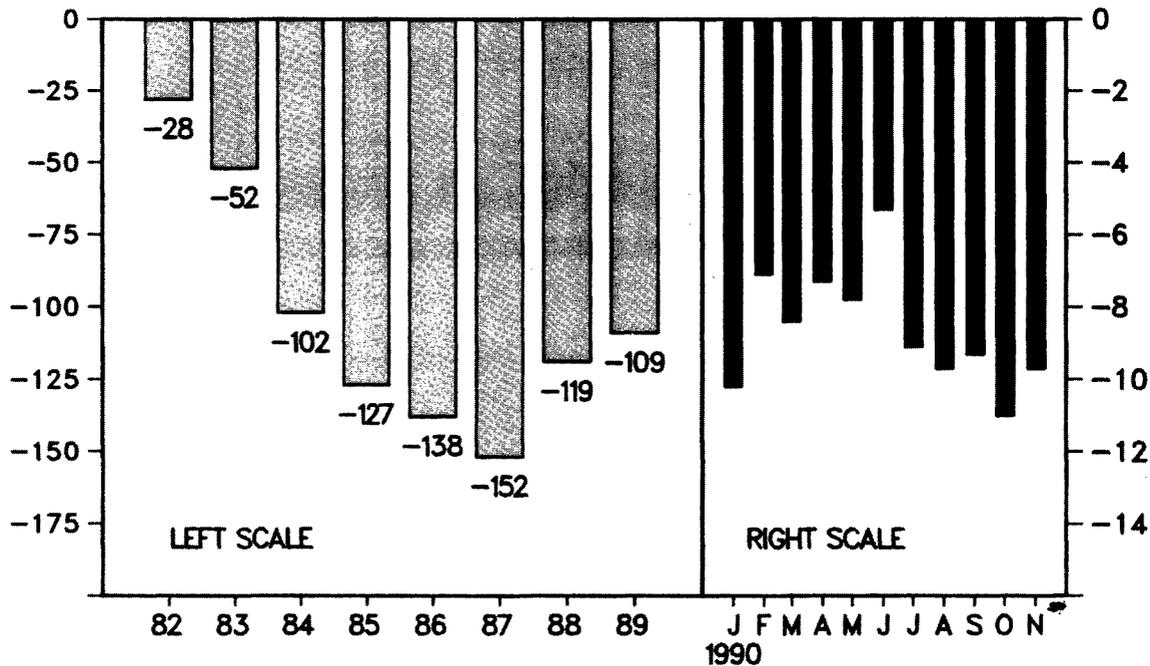
8. REAL CONSTRUCTION ACTIVITY



121

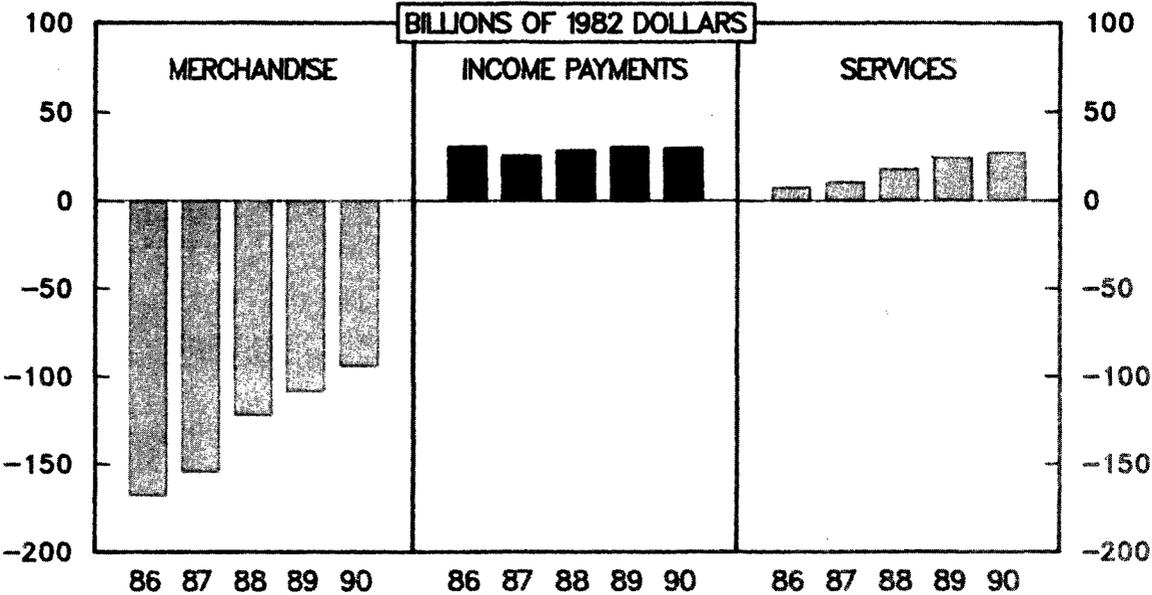
9. MERCHANDISE TRADE DEFICIT

BILLIONS OF DOLLARS. CUSTOMS BASIS.



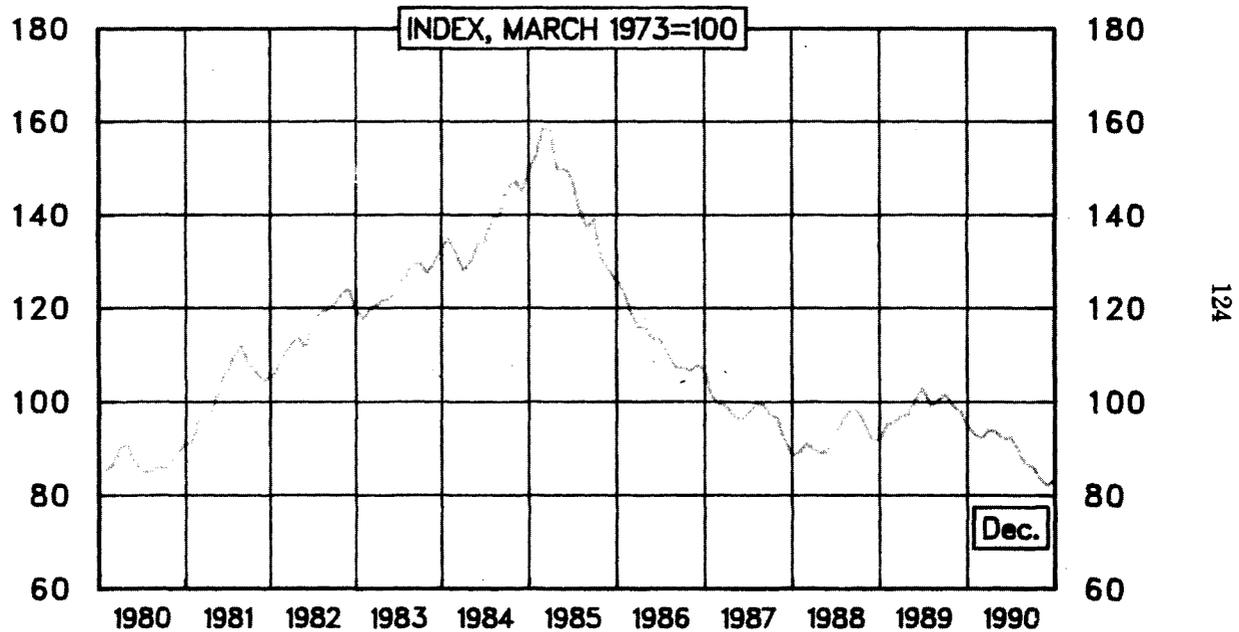
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9A. COMPONENTS OF REAL NET EXPORTS BALANCE ON THREE MAJOR COMPONENTS



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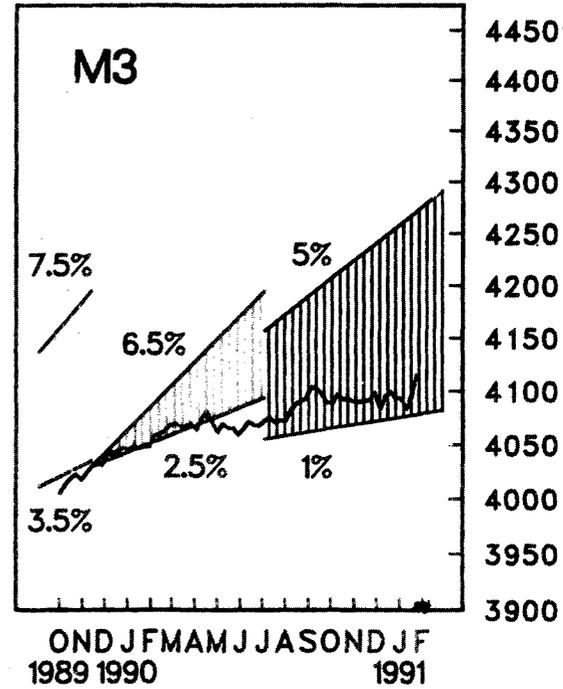
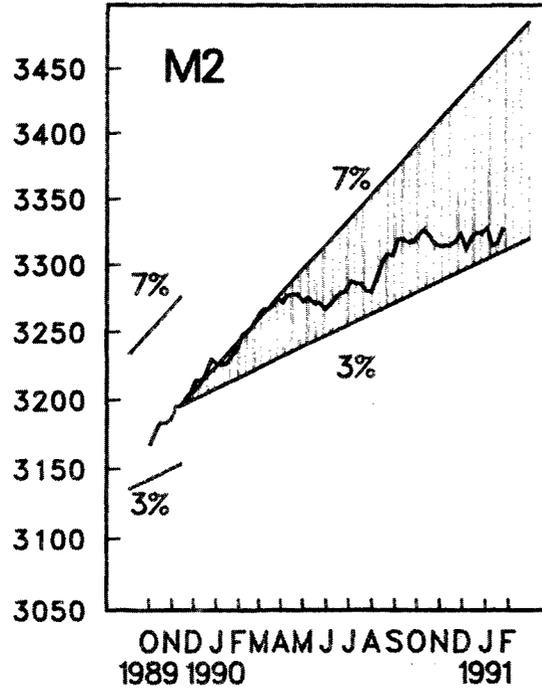
10. TRADE-WEIGHTED EXCHANGE RATE* OF THE DOLLAR AGAINST OTHER G-10 CURRENCIES



*Federal Reserve series plotted monthly.

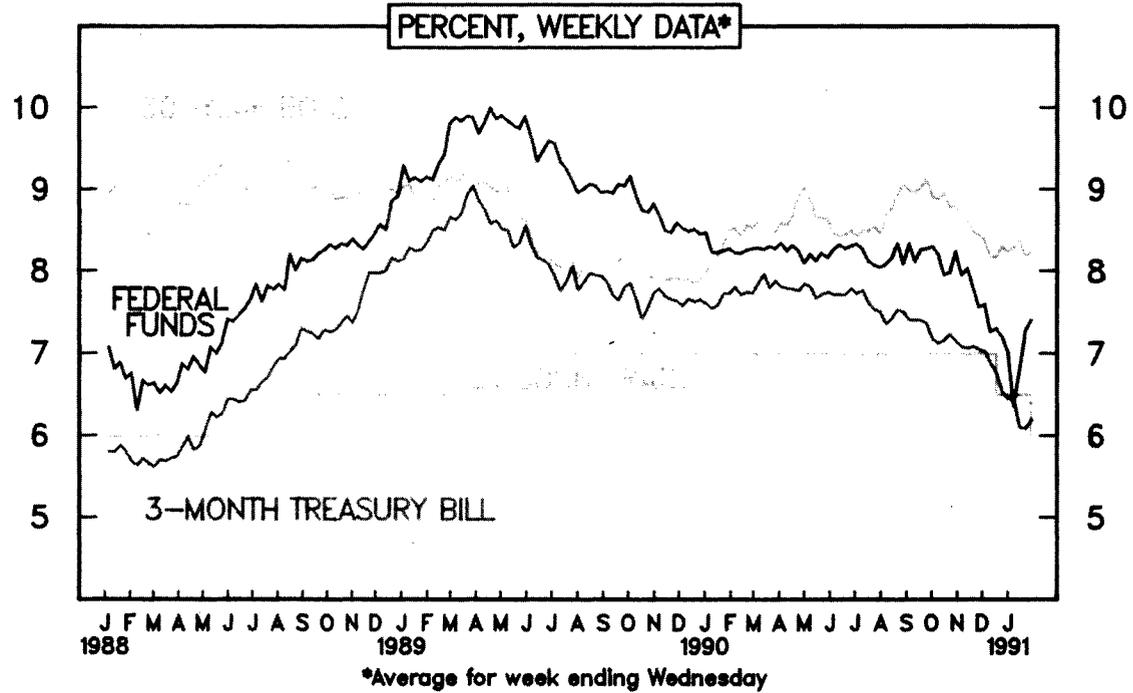
11. MONETARY AGGREGATES

WEEKLY DATA, BILLIONS OF DOLLARS, RATIO SCALE



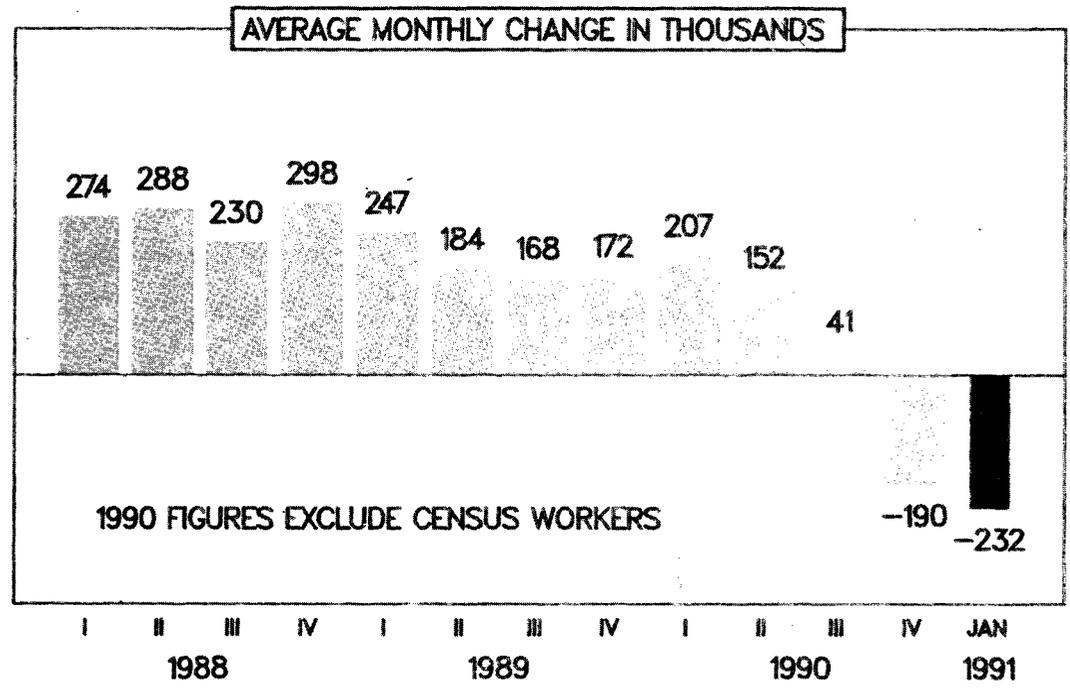
125

12. SELECTED INTEREST RATES



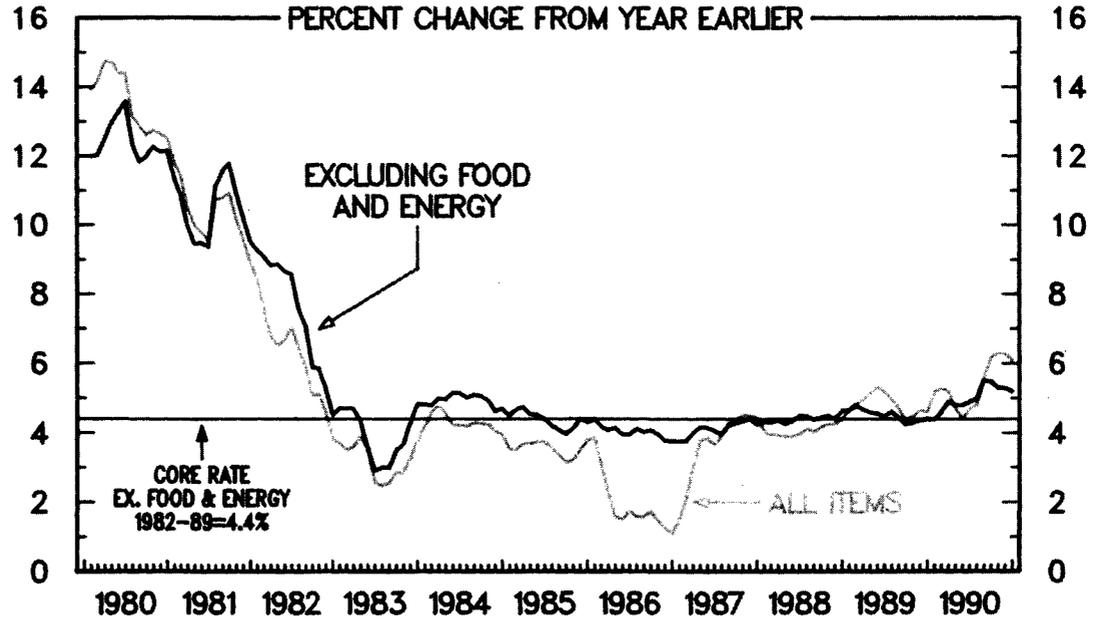
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13. ESTABLISHMENT EMPLOYMENT



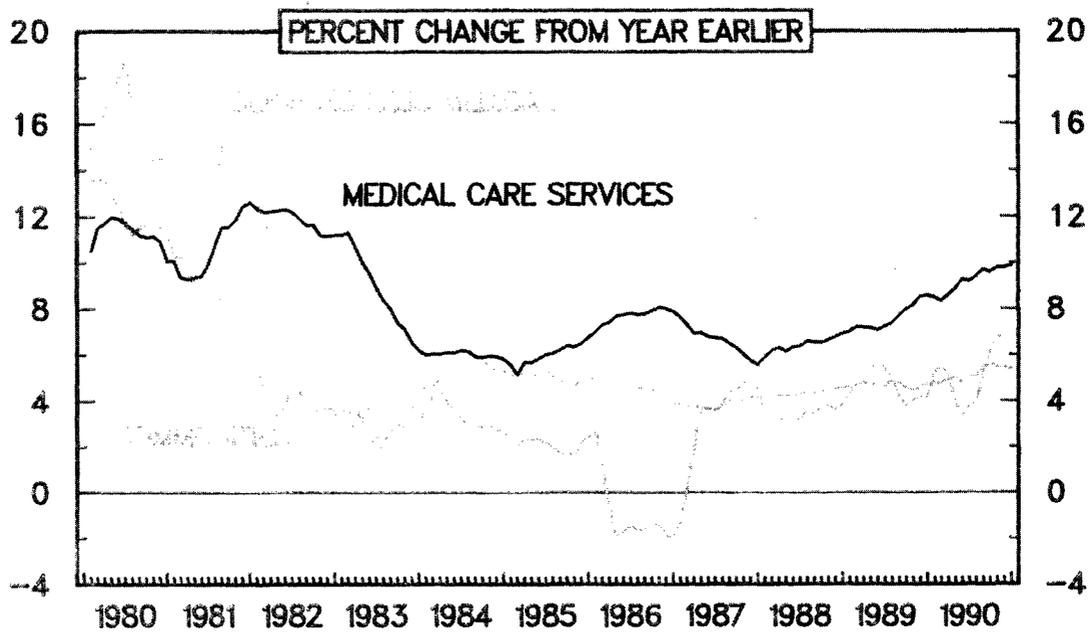
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14. CONSUMER PRICES



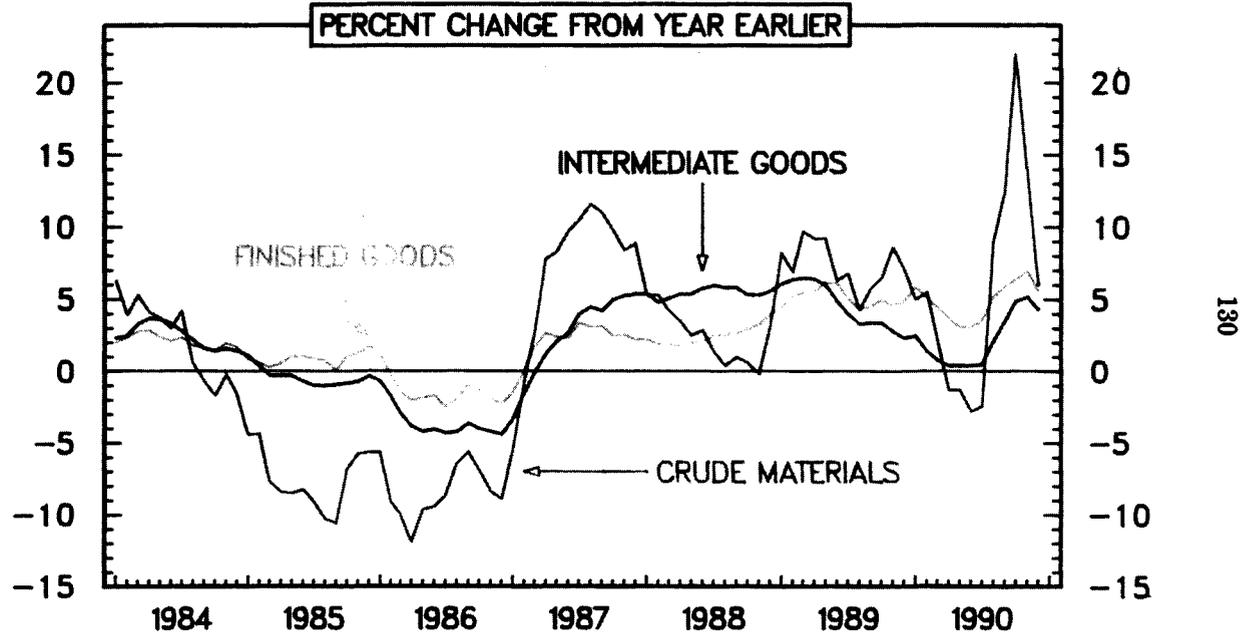
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14A. COMPONENTS OF CONSUMER PRICES



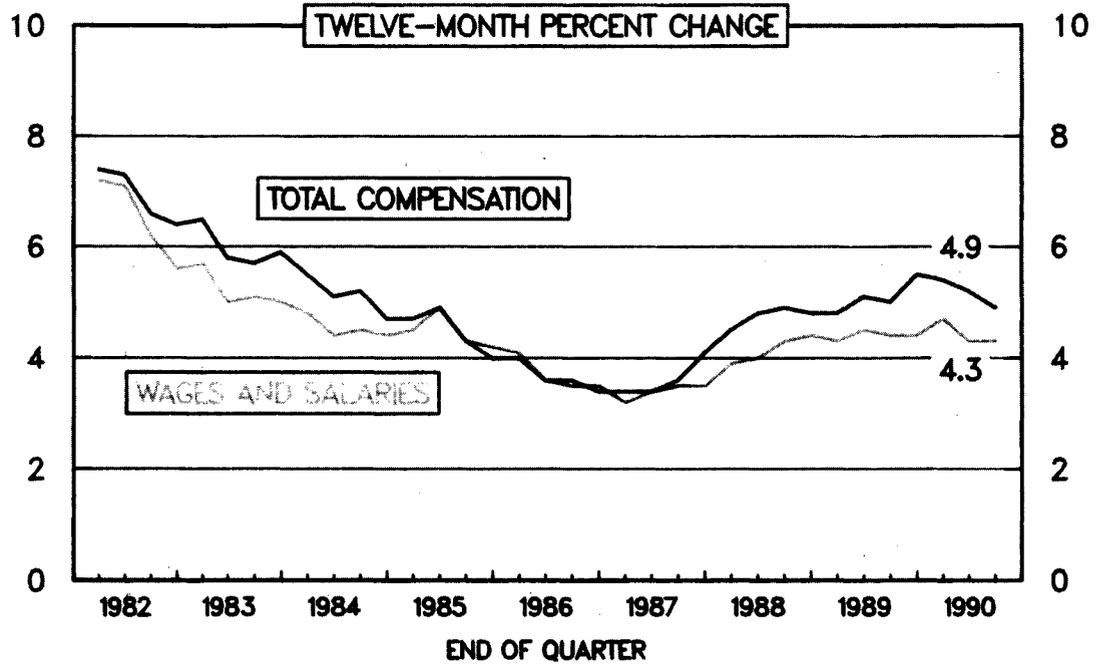
129

15. PRODUCER PRICES



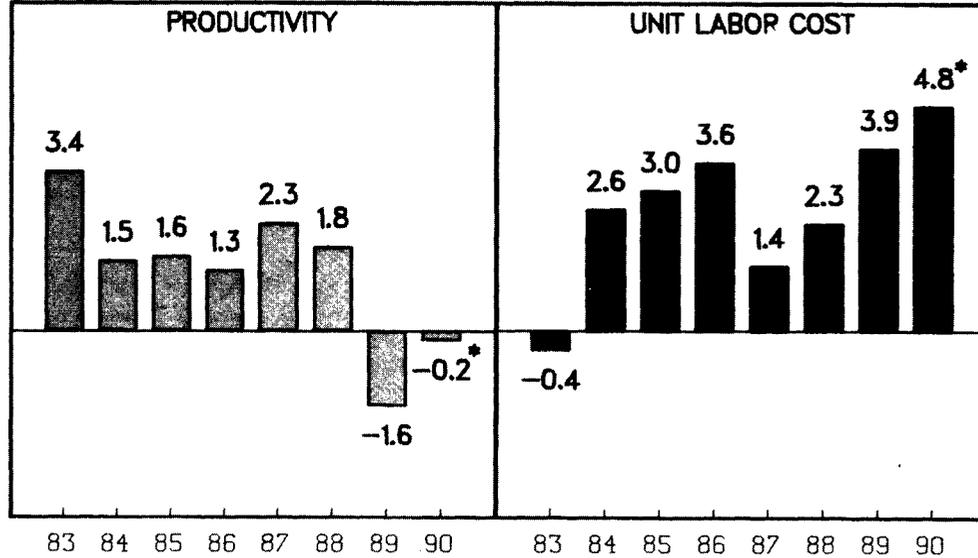
16. EMPLOYMENT COST INDEX

PRIVATE NONFARM AND STATE & LOCAL WORKERS



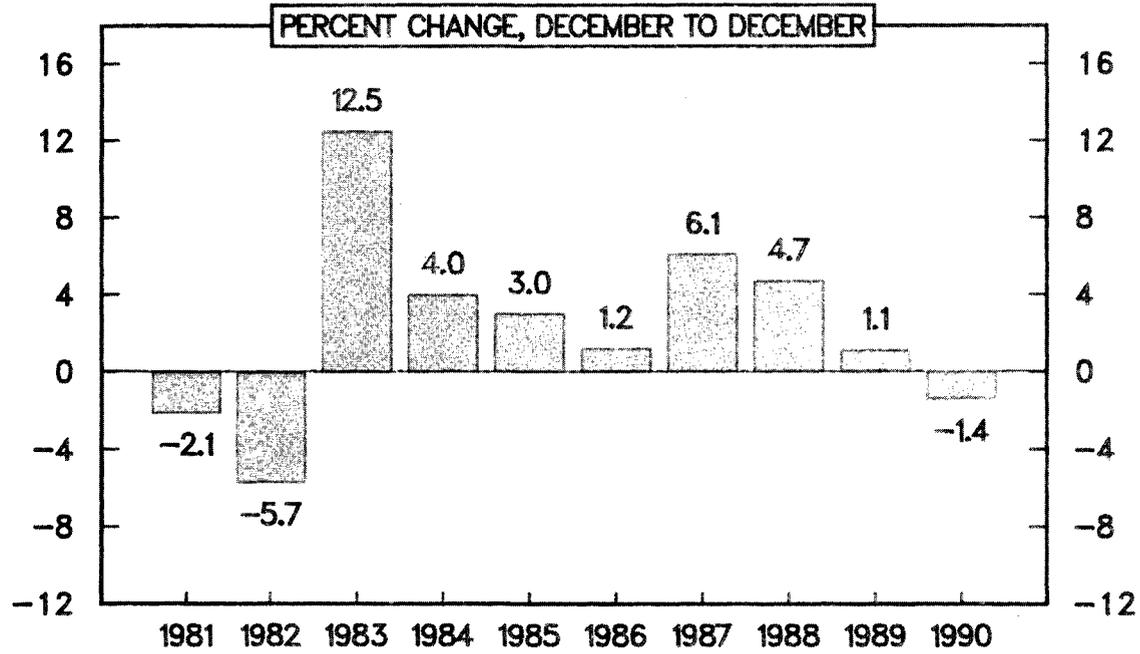
17. NONFARM PRODUCTIVITY AND UNIT LABOR COST

PERCENT CHANGE, FOURTH QUARTER TO FOURTH QUARTER



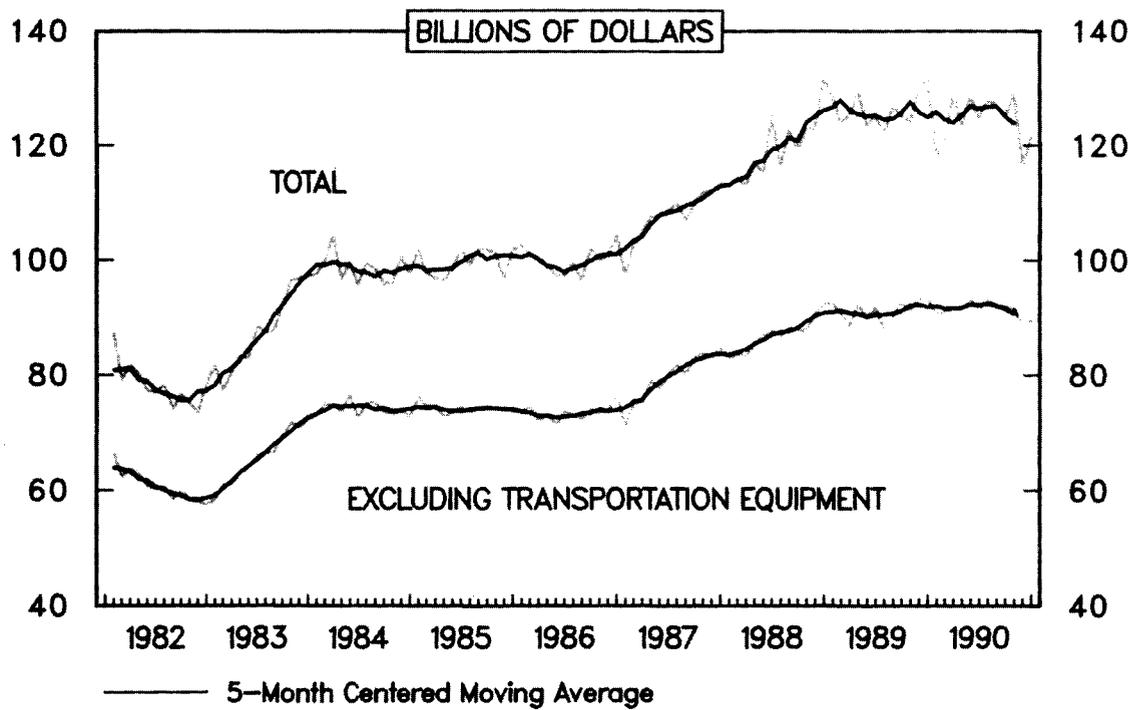
*Growth during first three quarters of 1990 at an annual rate.

18. INDUSTRIAL PRODUCTION



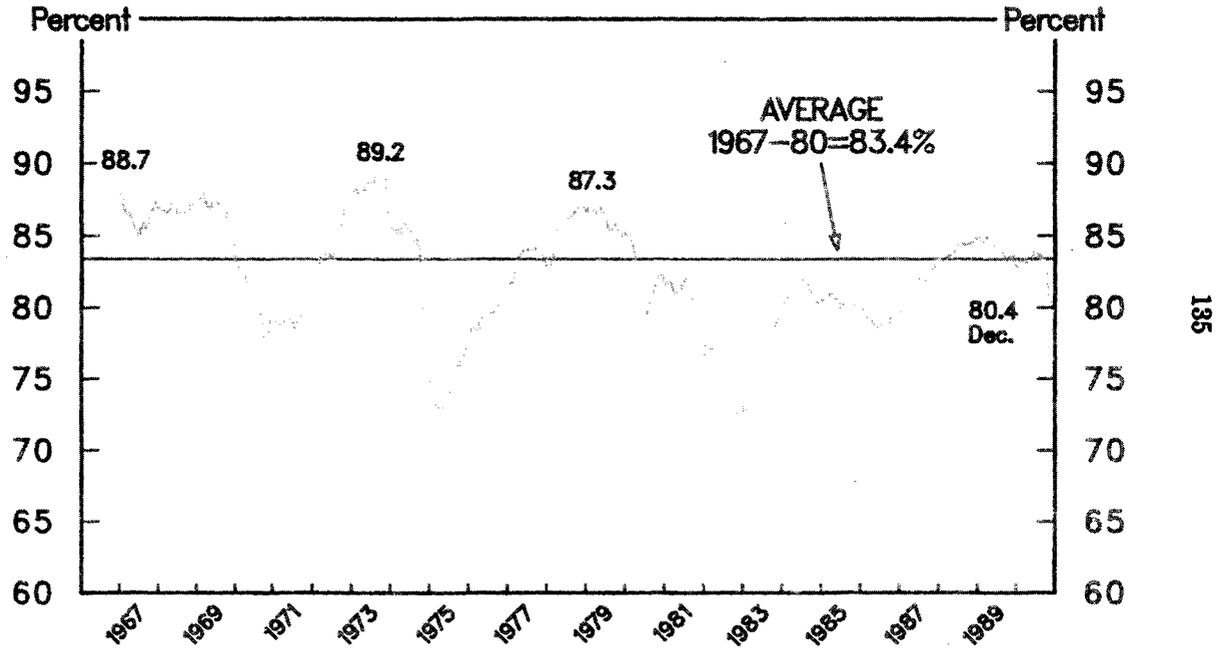
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19. NEW ORDERS FOR DURABLE GOODS



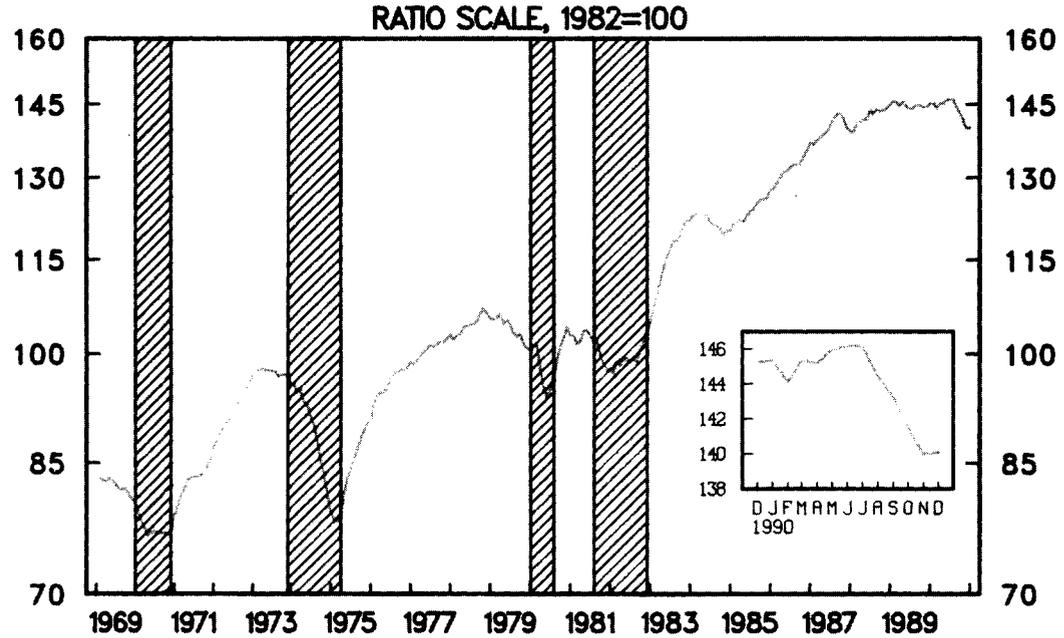
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20. INDUSTRIAL CAPACITY UTILIZATION

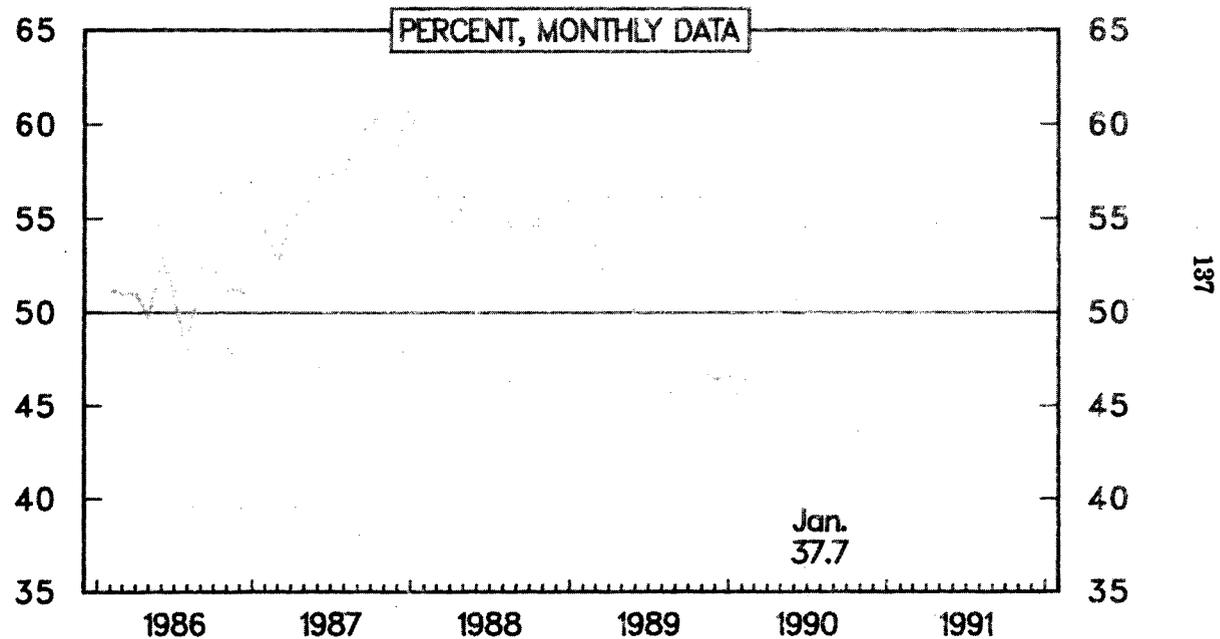


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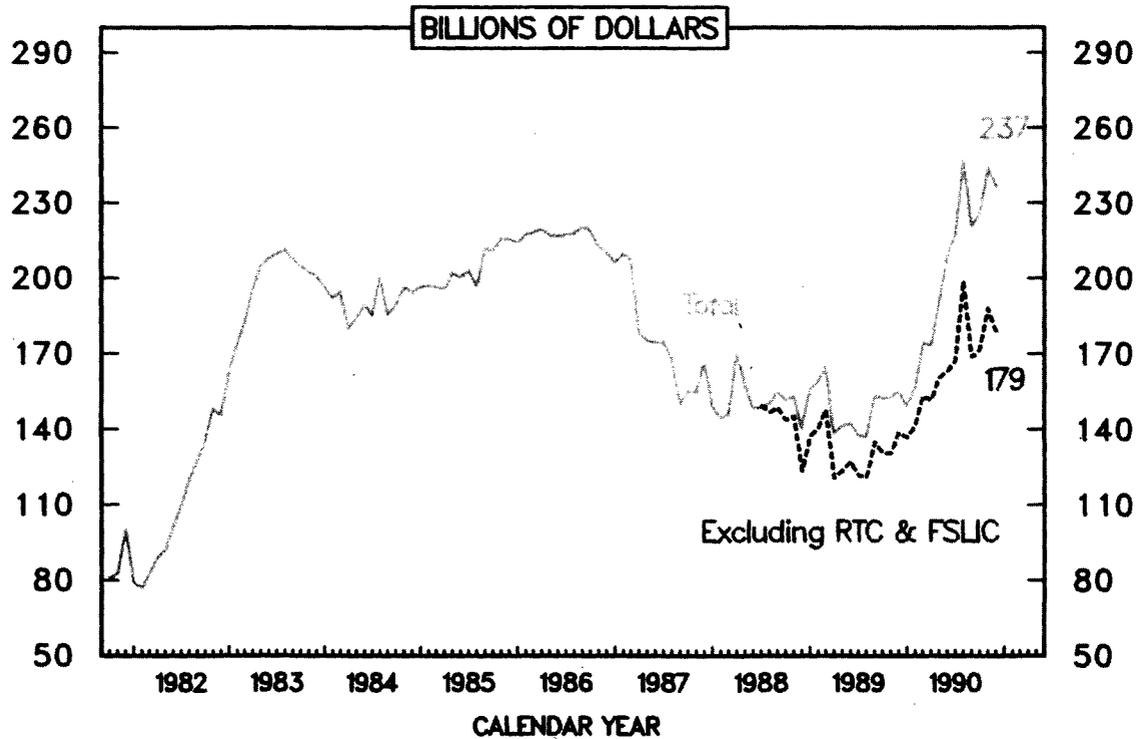
21. LEADING INDICATORS



22. NATIONAL ASSOCIATION OF PURCHASING MANAGEMENT COMPOSITE INDEX

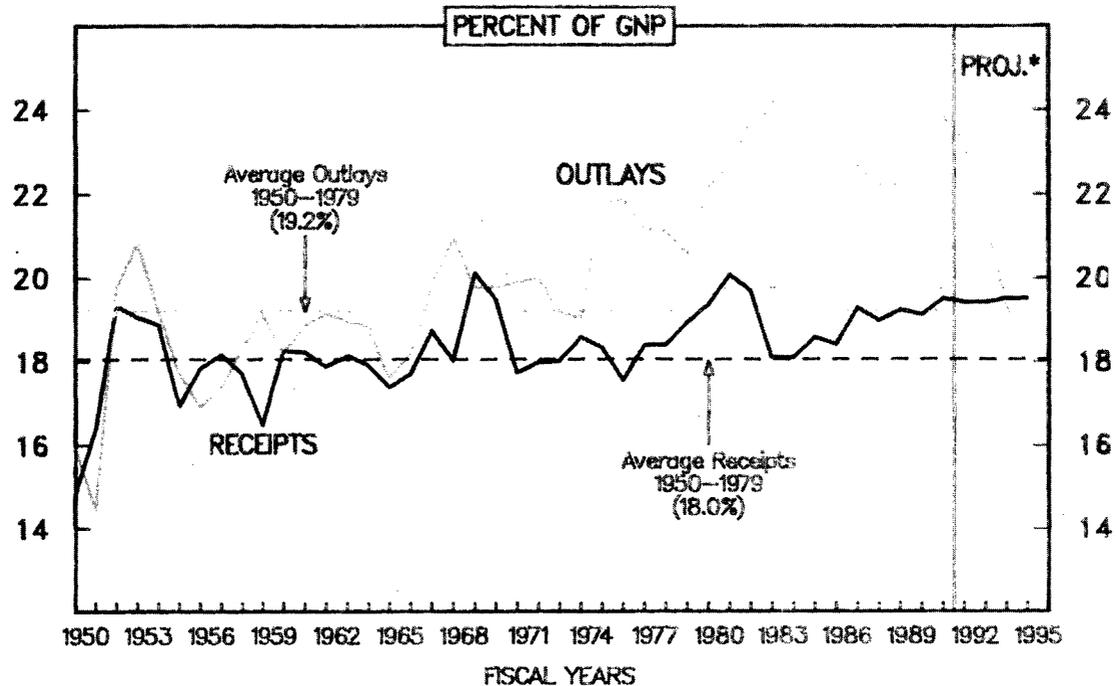


23. FEDERAL DEFICIT SUM OVER THE LATEST TWELVE MONTHS



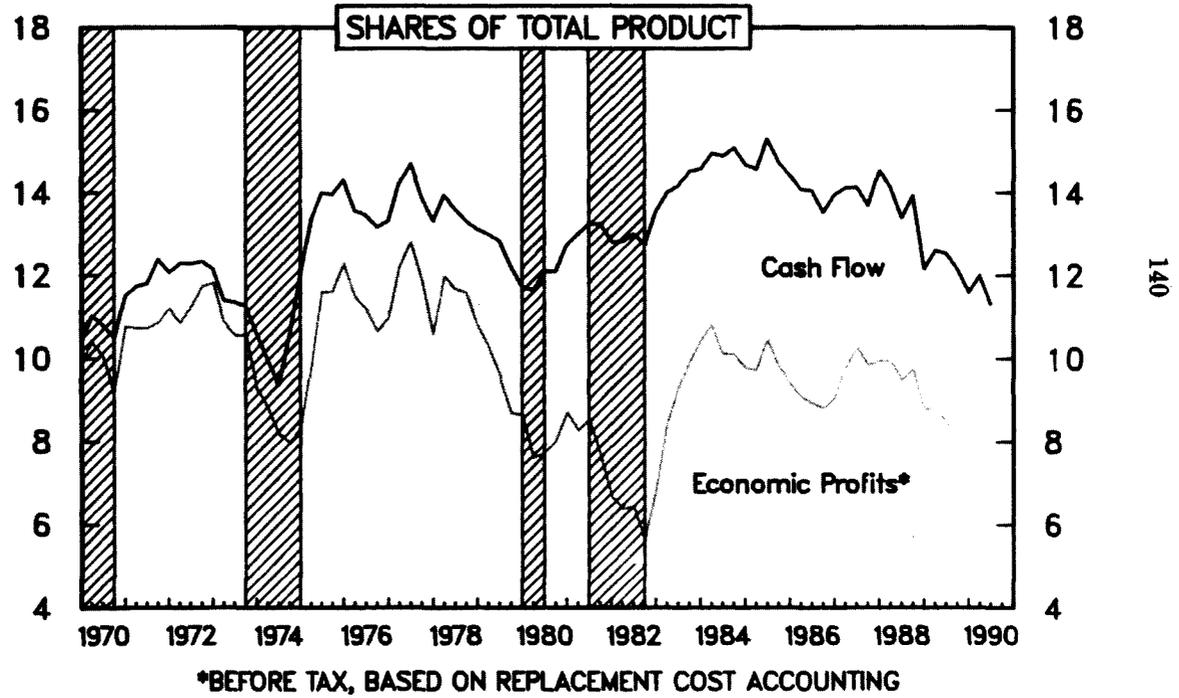
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24. FEDERAL OUTLAYS AND RECEIPTS AS A SHARE OF GNP



* Budget Summit Agreement projections.

25. CASH FLOW AND PROFITS NONFINANCIAL CORPORATIONS



MONETARY POLICY

- FED REDUCED FUNDS TARGET FROM 8-1/4% TO 8% IN MID JULY. MARGINAL EASING.
- SELECTIVE TIGHTENING OF CREDIT BY LENDERS AND SLOW MONETARY GROWTH CITED AS REASONS FOR JULY ACTION.
- FED ALSO CAUTIOUSLY SUGGESTED IT WOULD RECONSIDER ITS POLICY STANCE IF THERE WERE MAJOR, SUBSTANTIVE, CREDIBLE CUTS IN THE FEDERAL BUDGET DEFICIT.

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- FED SIGNALLED A 1/4 POINT REDUCTION IN THEIR FUNDS TARGET TO 7-3/4 PERCENT FOLLOWING THE COMPLETION OF BUDGET NEGOTIATIONS IN LATE OCTOBER.
- WEAKENING ECONOMY INDUCED FED TO DECIDE AT NOV. 13 FOMC MEETING TO EASE FURTHER. NEW FUNDS TARGET OF 7-1/2 PERCENT.
- FED ALSO RECOGNIZED GROWING SIGNS OF REDUCED BANK LENDING. ELIMINATING 3% RESERVE REQUIREMENT ON CORPORATE CD'S AND EURO CURRENCY DEPOSITS.

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... continued

- IN WAKE OF WEAK NOVEMBER EMPLOYMENT RESULTS, FED LOWERED ITS FUNDS TARGET TO 7-1/4% IN EARLY DECEMBER.
- FOLLOWING DECEMBER 17 FOMC MEETING, FED LOWERED DISCOUNT RATE FROM 7 TO 6-1/2 PERCENT IN LONG AWAITED ACTION. CITED WEAK ECONOMY, TIGHT CREDIT AND SLUGGISH MONEY GROWTH. FUNDS TARGET LOWERED TO 7 PERCENT AND TO 6-3/4 IN EARLY JANUARY.

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... continued

- CITING FURTHER DECLINES IN ECONOMIC ACTIVITY, WEAKNESS IN MONEY AND CREDIT GROWTH, AND EVIDENCE OF REDUCED INFLATIONARY PRESSURES, THE FEDERAL RESERVE LOWERED THE DISCOUNT RATE FROM 6.5% TO 6.0% ON FRIDAY, FEBRUARY 1.
- FED MOVED AGGRESSIVELY ON FRIDAY, FEB. 1 TO SUPPLY RESERVES TO MARKET. SUGGESTS REDUCTION IN FUNDS TARGET MAY HAVE ACCOMPANIED CUT IN DISCOUNT RATE.

144

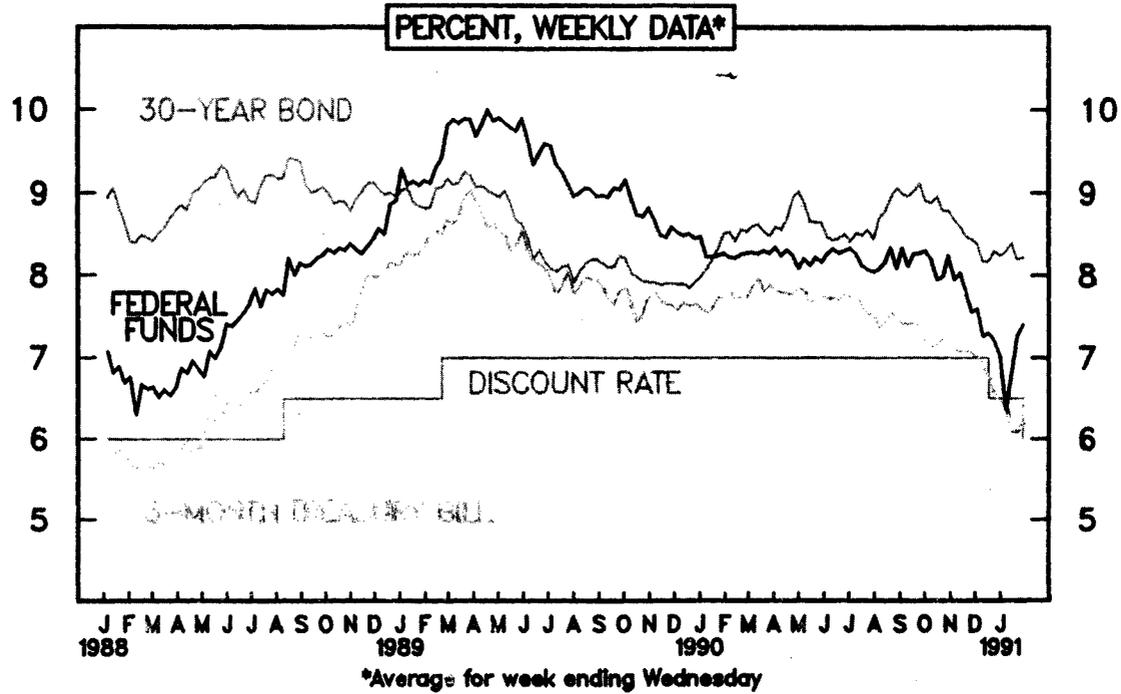
Federal Reserve Economic Projections for 1990 and 1991
(Percent Change, Q4 to Q4)

	<u>Actual</u>	<u>FOMC Midyear Projections</u>	
	<u>1989</u>	<u>1990</u>	<u>1991</u>
Nominal GNP	5.6	5-1/2 to 6-1/2	5-1/4 to 6-1/2
Real GNP	1.8	1-1/2 to 2	1-3/4 to 2-1/2
CPI	4.6	4-1/2 to 5	3-3/4 to 4-1/2
M2	4.6	3 to 7	2-1/2 to 6-1/2*
M3	3.3	1 to 5	1 to 5*

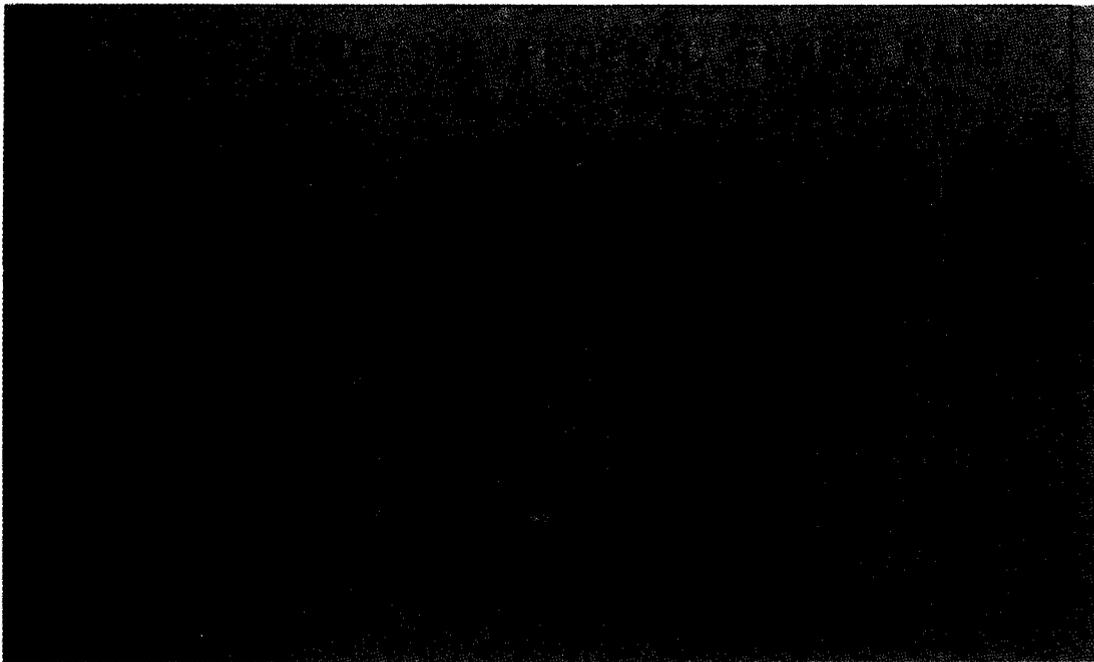
*Provisional

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SELECTED INTEREST RATES



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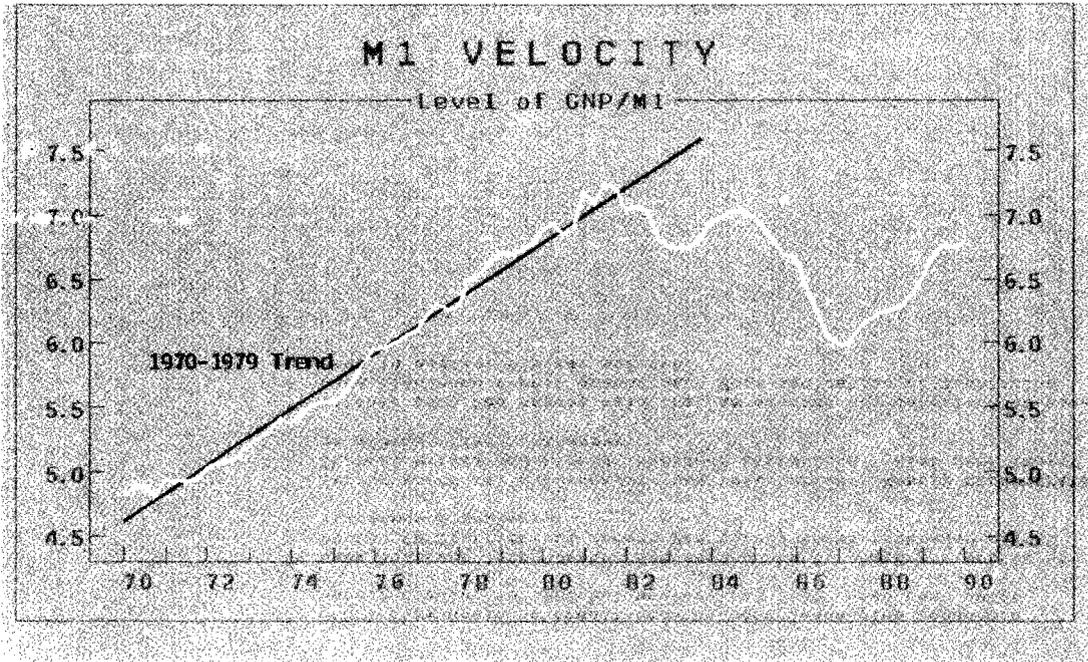
147

BEHAVIOR OF THE MONETARY AGGREGATES

1970-1980				
	<u>M1</u>	<u>M2</u>		
Volume	6.6	10.0	Real GNP	2.8
	10.2	10.4	Total	10.4
1980-1989				
	<u>M1</u>	<u>M2</u>		
Volume	7.9	8.0	Real GNP ..	2.9
Velocity	-0.4	-0.5	GNP deflator	4.4
	7.5	7.5	Total	7.4

Annual Rates of Growth

	<u>M1</u>	<u>M2</u>
1982-II - 1988-II	12.2	10.5
1988-II - 1989-II	0.4	2.6
1989-II - 1990-II	3.9	6.0
1989-IV - 1990-IV	4.0	3.7
3 months (December 1990)	1.5	0.1
6 months (December 1990)	3.9	2.3
12 months (December 1990)	3.8	3.1
18 months (December 1990)	4.4	4.7

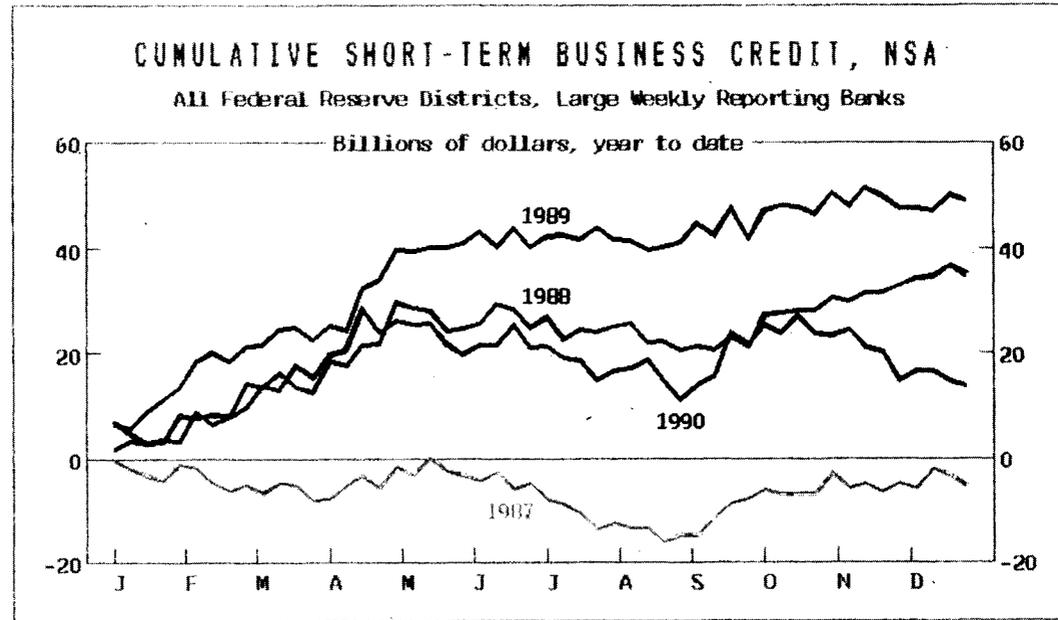


149

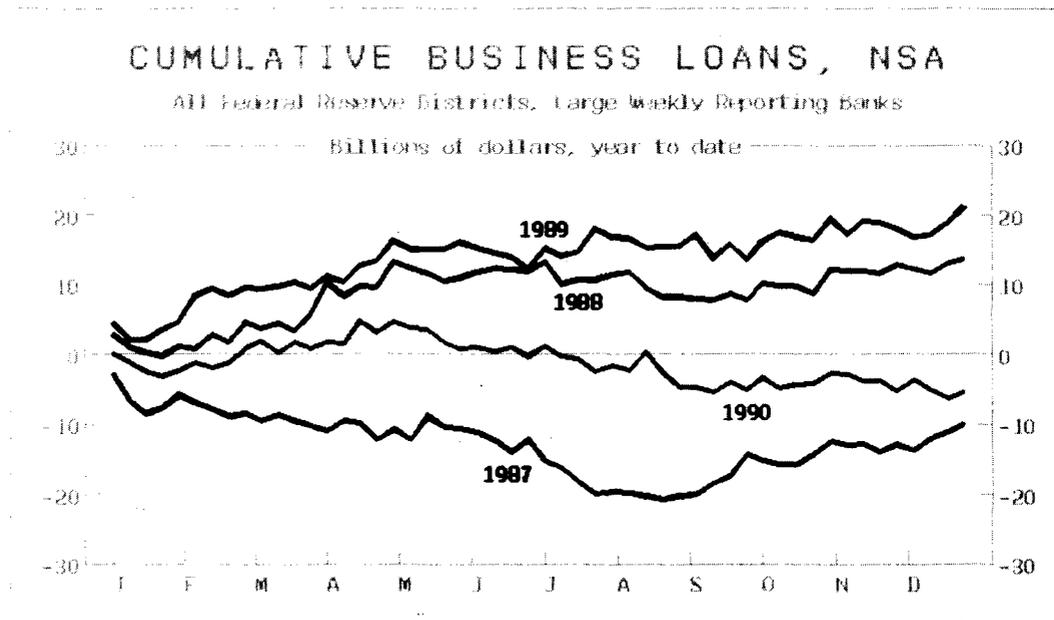
A REGULATORY CREDIT CRUNCH?

- Short-term business credit growth (bank loans plus commercial paper) similar to 1988 but weaker than 1989. See next chart.
- Bank business loans weak. See second chart. Weakness mostly in Boston FR District but recent Fed survey shows tightened credit standards elsewhere.
- Strong anecdotal evidence of loan restriction. Mostly concentrated in real estate and highly leveraged operations. Also some impact on medium-sized businesses.
- October 1990 Fed survey said that as economy has deteriorated banks have tightened credit standards. More indication of tightening than in earlier similar surveys.

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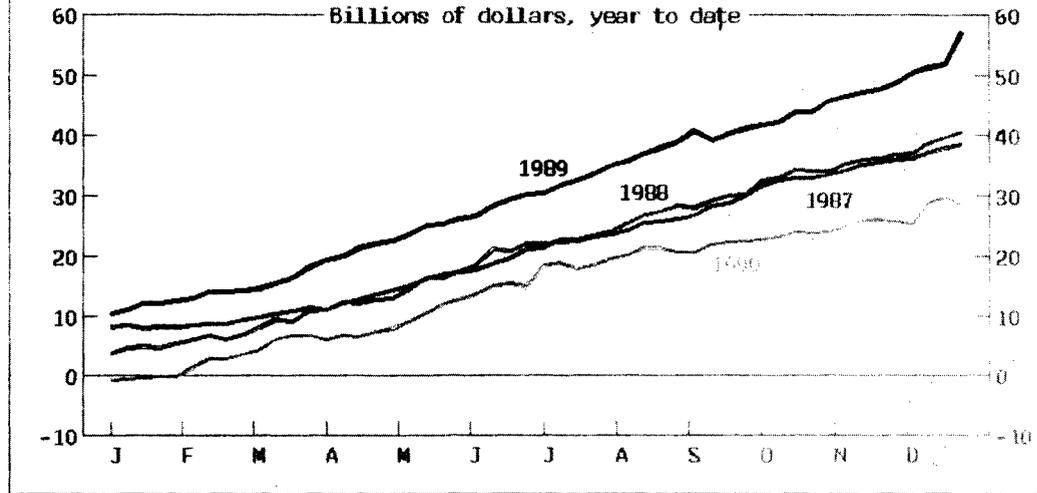
151



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CUMULATIVE REAL ESTATE LOANS, NSA

All Federal Reserve Districts, Large Weekly Reporting Banks



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TRACKING THE BUDGET DEFICIT

- DEFICIT FOR FY-1990 AT \$220 BILLION, EQUIVALENT TO 4.1% OF GNP. COMPARES WITH \$152 BILLION (3.1% OF GNP) IN FY-1989. ABOUT ONE-HALF OF INCREASE DUE TO BAILOUT OF S&L's.
- PRELIMINARY CBO ESTIMATES PLACE THE FY-1991 DEFICIT AT \$253 BILLION (4.5% OF GNP), AFTER ALLOWANCE FOR \$35 BILLION OF REDUCTION FROM THE 1990 OMNIBUS RECONCILIATION ACT. WOULD BE LITTLE CHANGE FROM FY-1990 ASIDE FROM SUPPORT OF FINANCIAL INSTITUTIONS.

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continued

- WEAKER ECONOMY, HIGHER DEFENSE SPENDING MEAN THAT THE CBO FIGURE WILL BE MARKED UP SHARPLY WHEN NEW ESTIMATES ARE RELEASED IN LATE JANUARY AND WILL SIMILARLY IMPACT ADMINISTRATION ESTIMATES TO BE RELEASED IN EARLY FEBRUARY.
- IN FIRST THREE MONTHS OF THIS FISCAL YEAR, DEFICIT OF \$87 BILLION ABOUT \$16 BILLION AHEAD OF YEAR EARLIER. ABOUT ONE-THIRD OF THAT RISE DUE TO SHIFTS IN TIMING OF OUTLAYS.

155

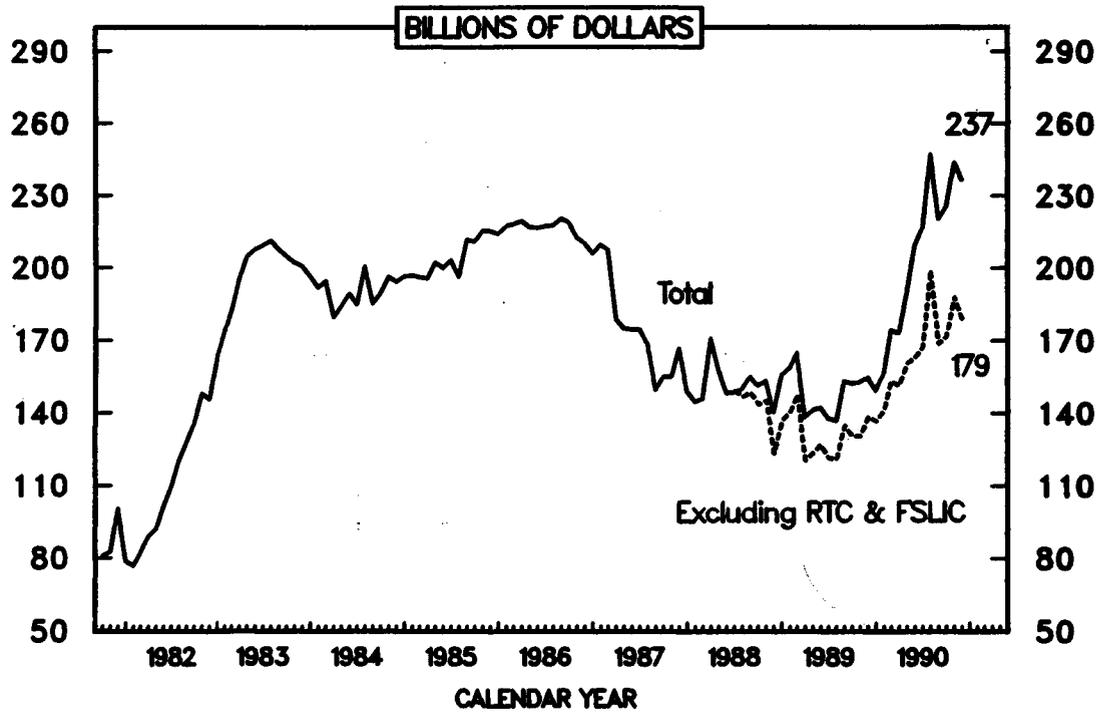
SUMMARY OF BUDGET TOTALS

	<u>FY-89</u>	<u>FY-90</u>	1st 3 Mos. <u>FY-91</u>
	(-- Billions of dollars --)		
RECEIPTS	990.7	1031.5	253.8
OUTLAYS	1144.0	1251.9	340.7
DEFICIT	-153.3	-220.4	-86.9
	(---- Percent change ----)		
RECEIPTS	9.0	4.1	10.9
OUTLAYS	7.5	9.4	13.8

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FEDERAL DEFICIT

SUM OVER THE LATEST TWELVE MONTHS



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REVISED GRANN-RUDMAN PROCEDURES

- Potentially significant reform in deficit reduction package are new procedures to enforce budget discipline.
- Yearly spending ceilings set for defense, international programs, other domestic programs along with overall deficit targets (excluding social security and S & L bailout).
 - » Targets and ceilings adjusted for changing economic conditions, technical considerations.
 - » However if cap in one category exceeded by appropriation bill or some other measure and offsetting savings are not specified, then sequester automatically triggered across all non-exempt programs in that category.
 - » Similar rules apply measures which reduce taxes or boost entitlements.
- OMB designated as referee of entire process.

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DEFICIT TARGETS
(fiscal year totals in billions of dollars)

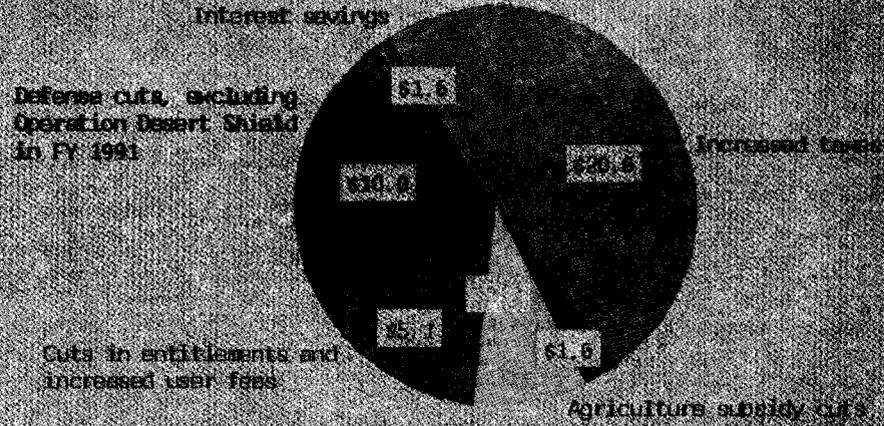
	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
Mid-Session Projections (July)	231.4	205.0	135.2	79.6	76.8
Adjustments for slower economy, S&L outlays, technical factors	62.3	101.1	92.1	36.2	7.7
Current baseline consolidated deficits	293.7	306.1	227.3	115.8	84.5
Proposed savings (cumulative 1991-95)	NEW DATA WILL BE AVAILABLE SHORTLY				
Resulting projected deficits (+) or surplus (-)	NEW DATA WILL BE AVAILABLE SHORTLY				

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SPENDING CUTS AND INCREASED TAXES

FY 1991, BILLIONS OF DOLLARS

TOTAL = \$42.6



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FY 1991-95, BILLIONS OF DOLLARS

TOTAL = \$496.3

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REVENUE INCREASING PROVISIONS
(Fiscal years 1991-1995; billions of dollars)

High-income taxpayer provisions	40.2	Air travel tax	11.9
Medicare wage cap	26.9	State and Local OASDI	9.2
Gasoline and gas guzzler taxes	25.4	Insurance company amortization	8.6
Beer, wine, tobacco and luxury excises	16.1	Unemployment insurance surtax	5.4
Telephone excise tax	13.1	Other	7.9

TOTAL REVENUE INCREASE = \$164.6 BILLION

(Enter next screen **DEF9** for Revenue Decreasing Provisions)

162

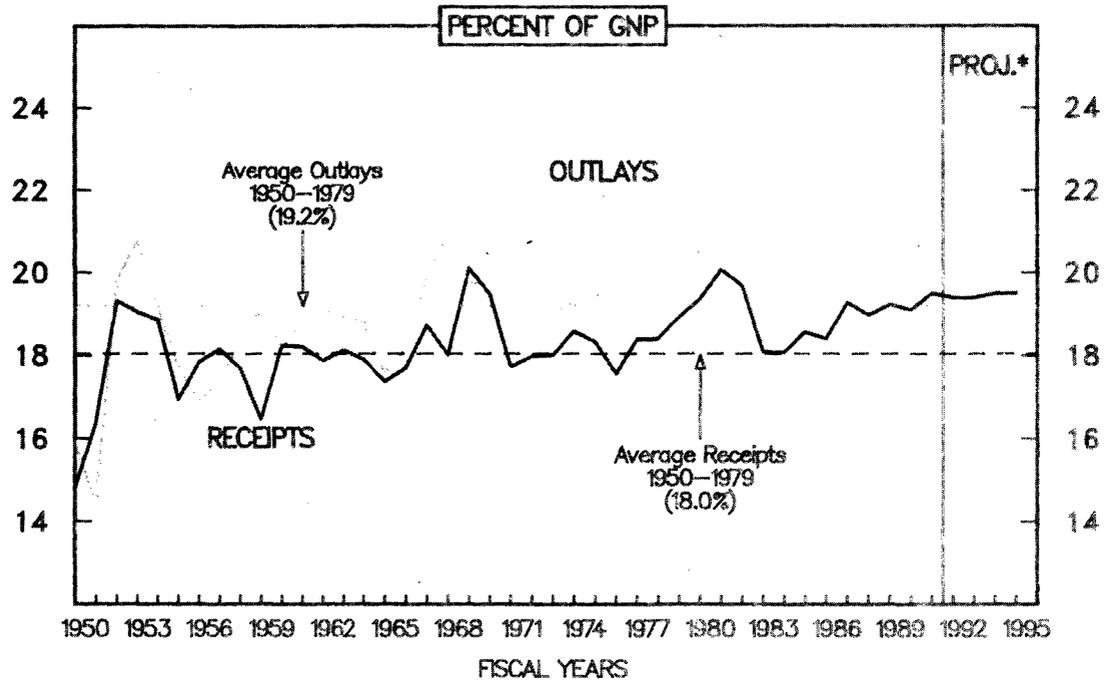
REVENUE DECREASING PROVISIONS
(Fiscal years 1991-1995; billions of dollars)

Earned income tax credit	12.4
Other progressivity-enhancing measures	5.9
Energy incentives	2.5
Extension of R & E tax credits	2.0
Extension of other expiring provisions	3.8
Small business incentives	<u>0.8</u>

TOTAL REVENUE DECREASE = \$27.4 BIL.

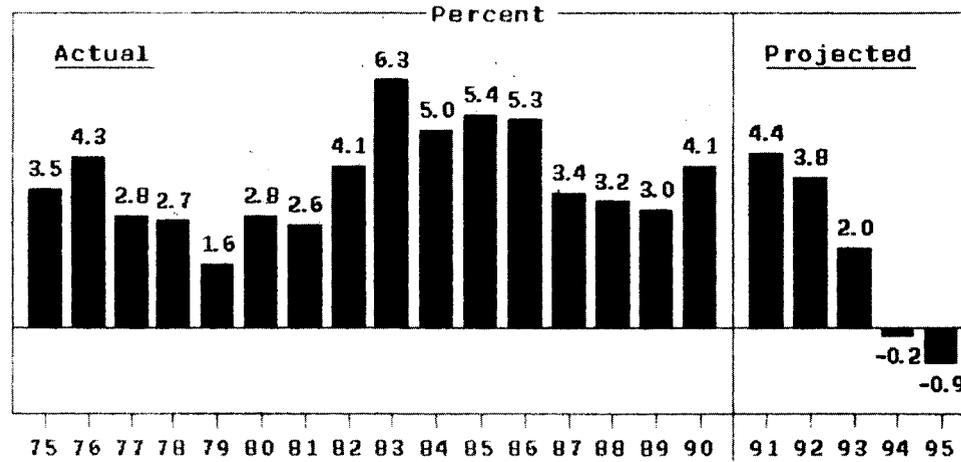
163

FEDERAL OUTLAYS AND RECEIPTS AS A SHARE OF GNP



* Budget Summit Agreement projections.

BUDGET DEFICITS IN RELATION TO GNP*

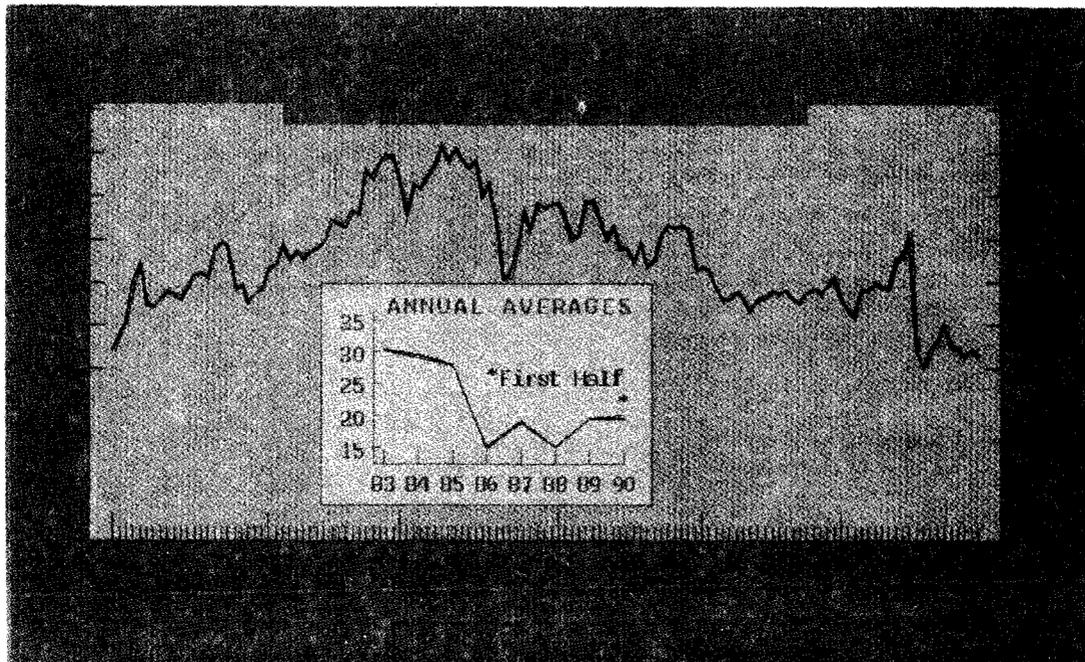


*On and off budget as percent of fiscal year GNP, September Budget Agreement.

ENERGY OVERVIEW

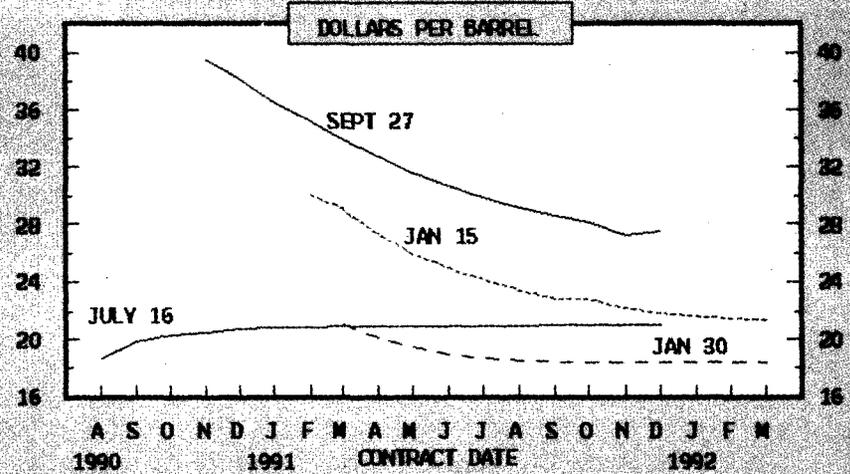
- MID-EAST TURMOIL DISRUPTED OIL MARKETS. PRICES UP TO OVER \$40 IN EARLY OCT. IN DEC. SETTLED INTO NARROW RANGE BETWEEN \$26 TO \$27-1/2.
- LACK OF PROGRESS IN TALKS ON PERSIAN GULF CAUSED PRICES TO SWING WILDLY. BUT APPARENT SUCCESS OF U.S.-ALLIED MOVE AGAINST IRAQ CAUSED PRICES TO PLUMMET.
- OVERALL, IMPACT OF HIGHER PRICE FOR OIL SHOULD NOT BE AS GREAT AS SHOCKS OF 1973 AND END OF 1970'S. ECONOMIES NOW MORE ENERGY EFFICIENT.

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CRUDE OIL FUTURES PRICES

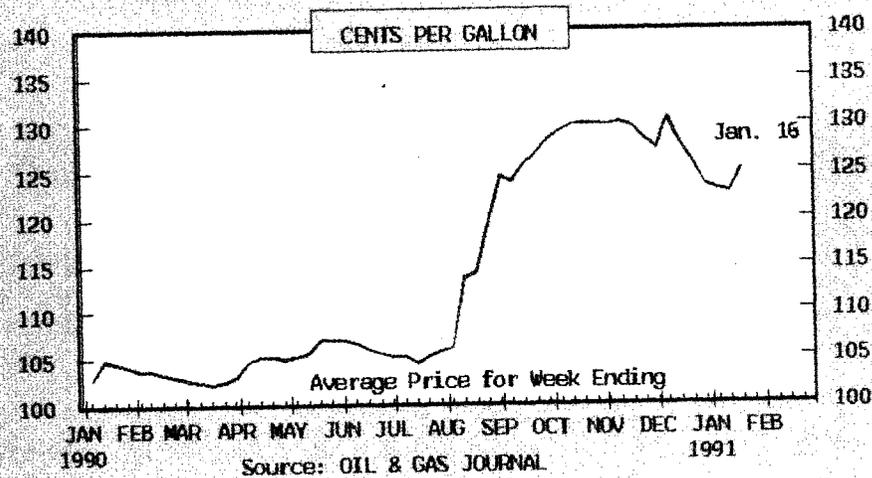
NEW YORK MERCANTILE EXCHANGE, LIGHT SWEET CRUDE



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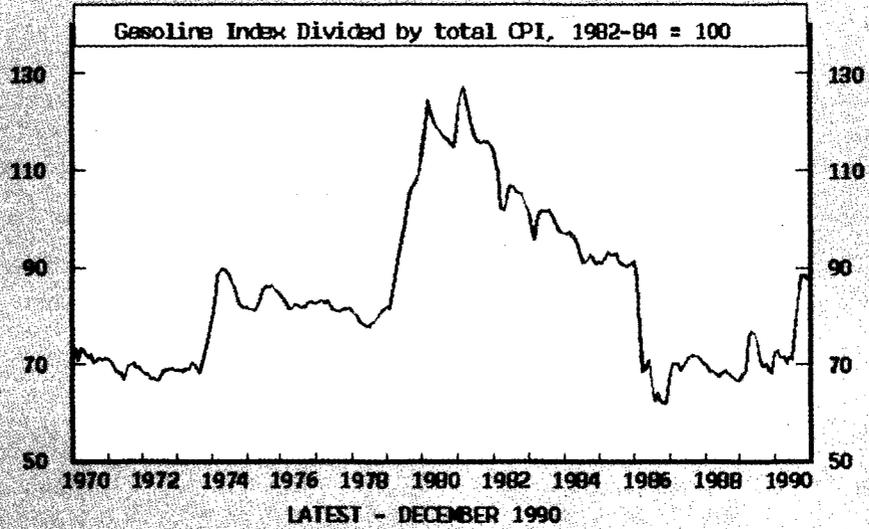
GASOLINE PRICE AT THE PUMP

UNLEADED REGULAR, SELF-SERVICE



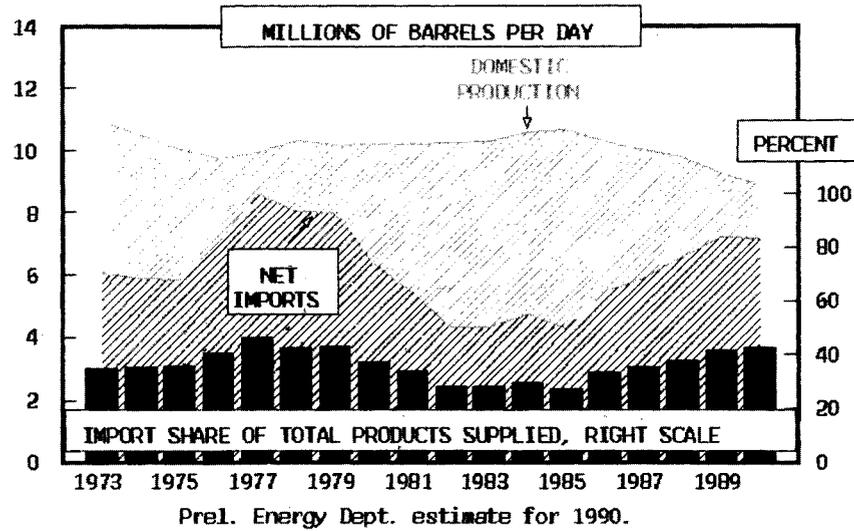
169

REAL GASOLINE PRICES



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U.S. OIL PRODUCTION AND IMPORTS



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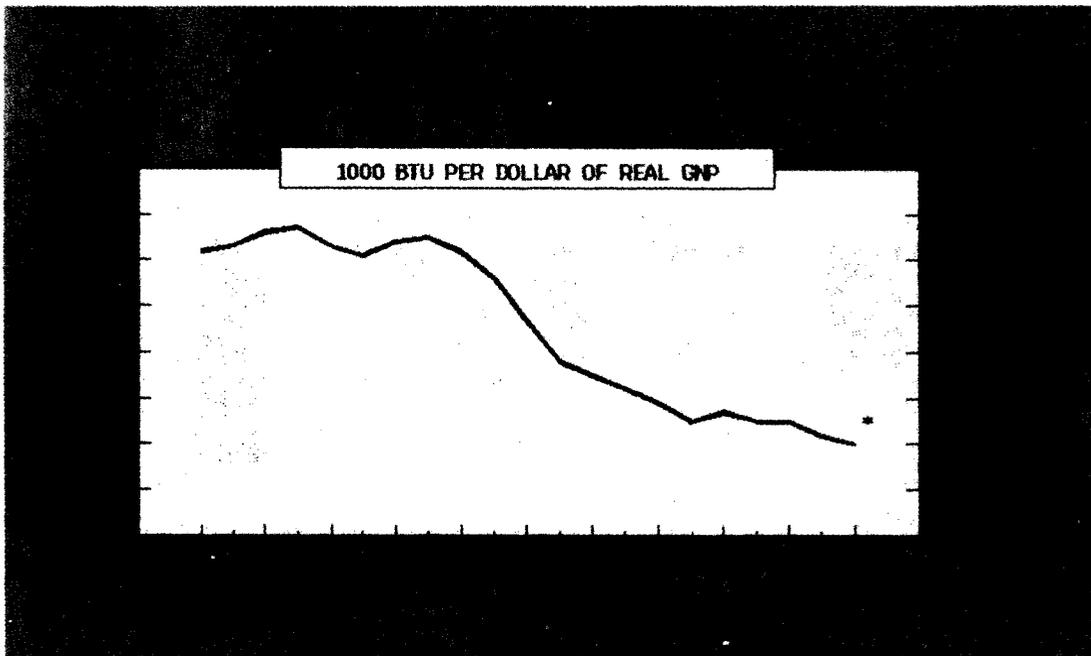
WORLD CRUDE OIL PRODUCTION
(Millions of Barrels Per Day)

	Volume		Percent	
	8-Mos.		8-Mos.	
	1989	1990	1989	1990
TOTAL	59.5	60.3	100.0	100.0
Market Economies	44.9	46.2	75.6	76.5
U.S.	7.6	7.3	12.8	12.1
Other Non-OPEC	14.7	15.1	24.7	25.0
OPEC	22.6	23.8	38.1	39.4
Persian Gulf	15.0	15.6	25.3	25.9
(Iraq, Kuwait)	4.6	4.5	7.8	7.5
Other OPEC	7.6	8.1	12.8	13.5
U.S.S.R. & China, E. Eur.	14.5	14.2	24.4	23.5

Note: Figures do not include production of natural gas liquids of roughly 5 mb/d worldwide, 1-1/2 mb/d in U.S.

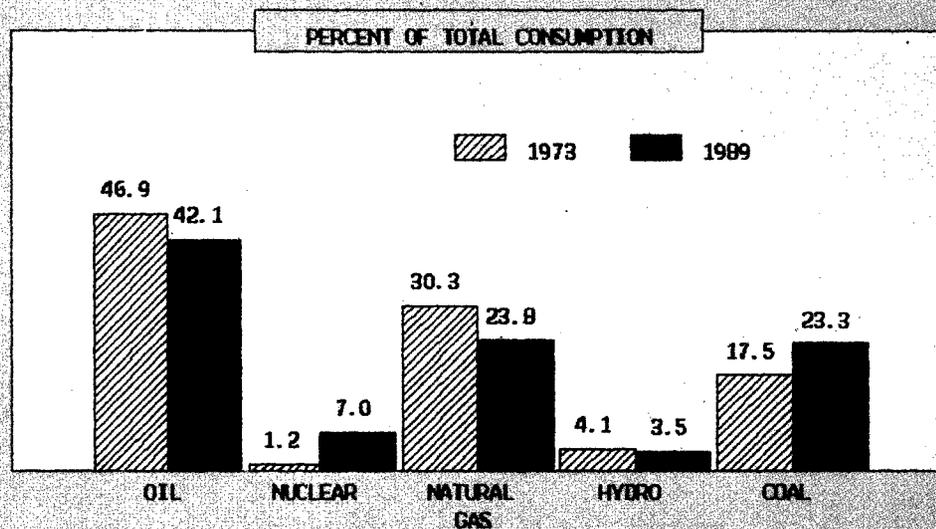
Source: Energy Information Administration

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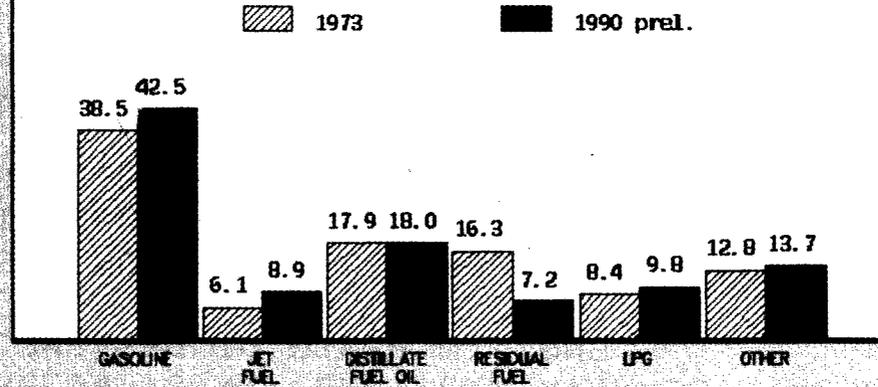
U.S. CONSUMPTION OF ENERGY BY SOURCE



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U.S. PETROLEUM USE

PERCENT DISTRIBUTION OF DEMAND

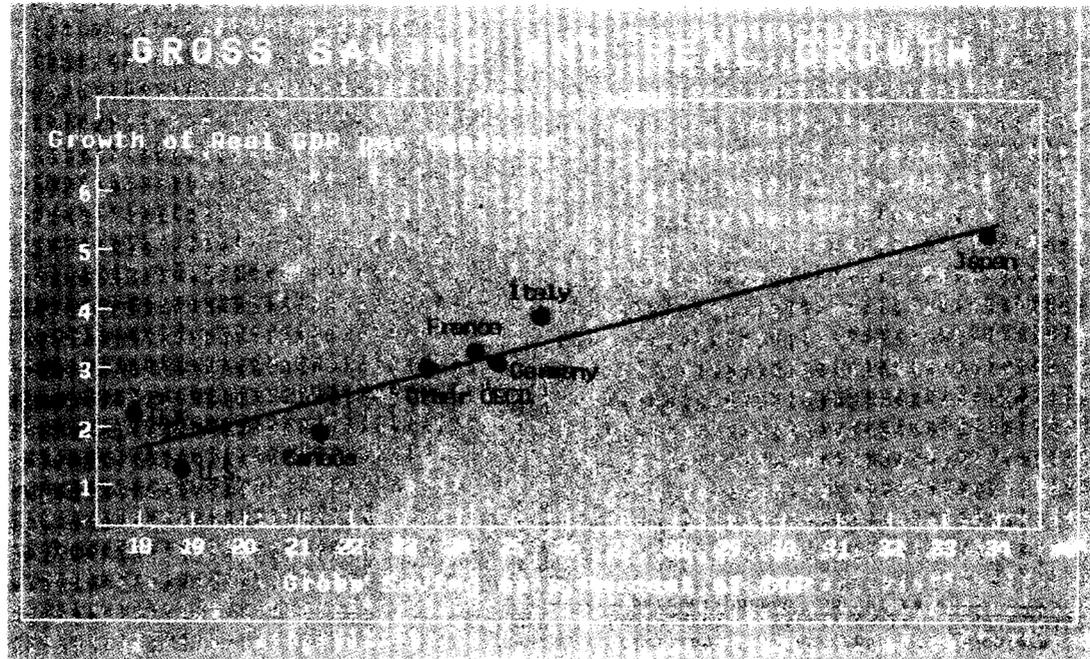


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SAVING AND INVESTMENT

- U.S. GROSS SAVING RATE WAS 13.3% IN 1989 AND 12.5% IN FIRST HALF 1990 -- WELL BELOW 16.4% LONG-TERM AVERAGE. ALSO WEAK COMPARED TO OTHER NATIONS.
- SAVING PROVIDES FUNDS FOR INVESTMENT AND IS RELATED TO GROWTH OF PRODUCTIVITY AND REAL GNP.
- PRIMARY CAUSE OF DECLINE IN U.S. SAVING RATE DURING 1980S WAS FEDERAL DEFICIT BUT PERSONAL SAVING WAS ALSO LOWER.

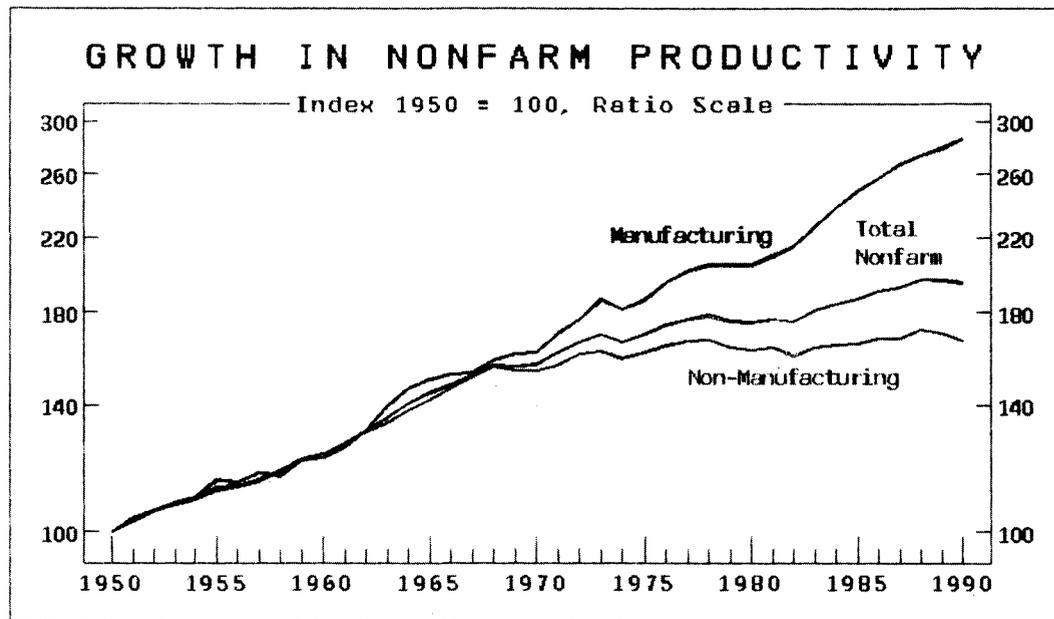
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SLOW GROWTH OF PAST TWO DECADES
REFLECTS WEAK PRODUCTIVITY PERFORMANCE

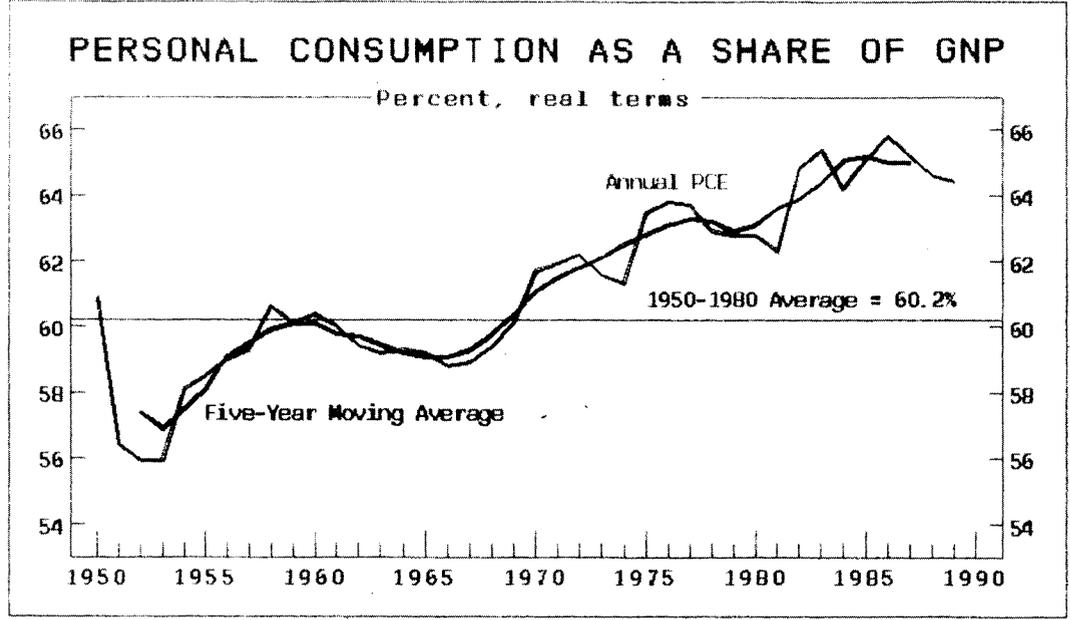
<u>Decade</u>	<u>Real GNP</u>	<u>Civilian Employment</u>	<u>Average Weekly Hours</u>	<u>Nonfarm Productivity</u>
	(-----percent change, annual rate-----)			
1950's	3.9	1.1	-0.2	2.6
1960's	4.1	1.9	-0.4	2.5
1970's	2.8	2.4	-0.7	1.2
1980's	2.6	1.7	-0.2	1.1
 <u>Memo</u>				
1950's & 60's	4.0	1.5	-0.3	2.6
1970's & 80's	2.7	2.1	-0.4	1.2

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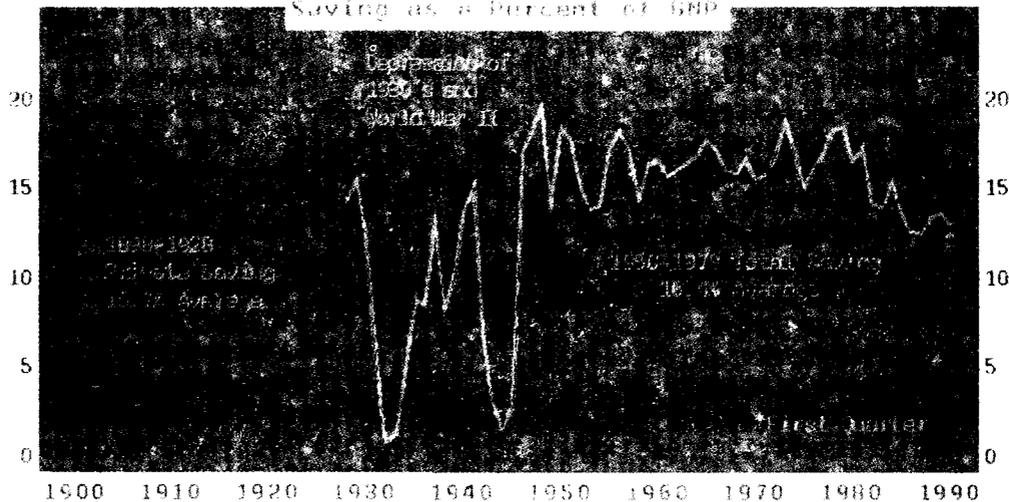
**PRIVATE, GOVERNMENT AND NATIONAL CONSUMPTION AS PERCENT OF
EXPANDED* NET NATIONAL PRODUCT, SELECTED YEARS**

	Private Consumption/ NNP	Govt. Consumption/ NNP			Natl. Consumption/ NNP
		Total	Federal	State- Local	
1950	62.9	23.5	13.8	9.7	86.4
1960	63.7	25.1	14.4	10.7	88.8
1970	65.4	25.6	12.7	12.9	91.0
1980	67.9	22.0	8.6	13.4	89.8
1985	69.0	21.3	8.7	12.6	90.3

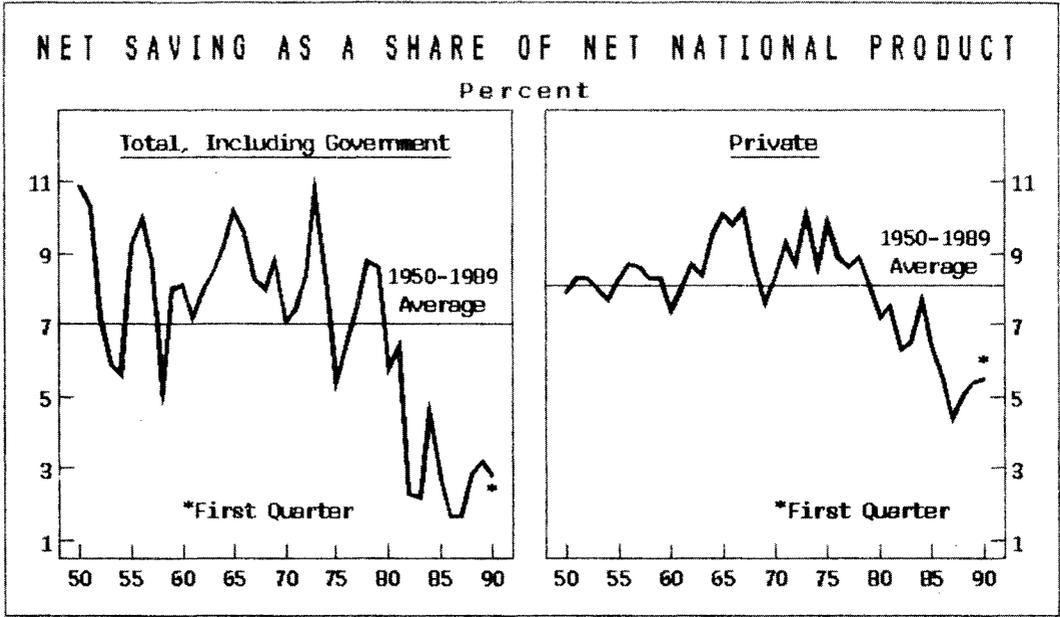
*Includes imputed returns to government capital and consumer durables.

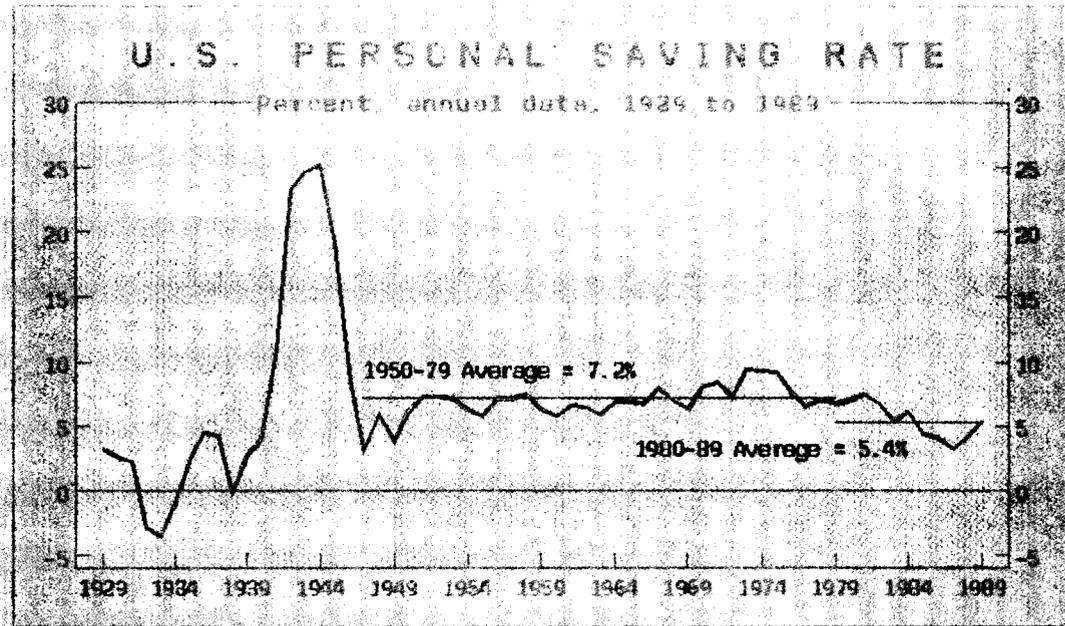
U.S. GROSS SAVING RATIO, 1898-1990

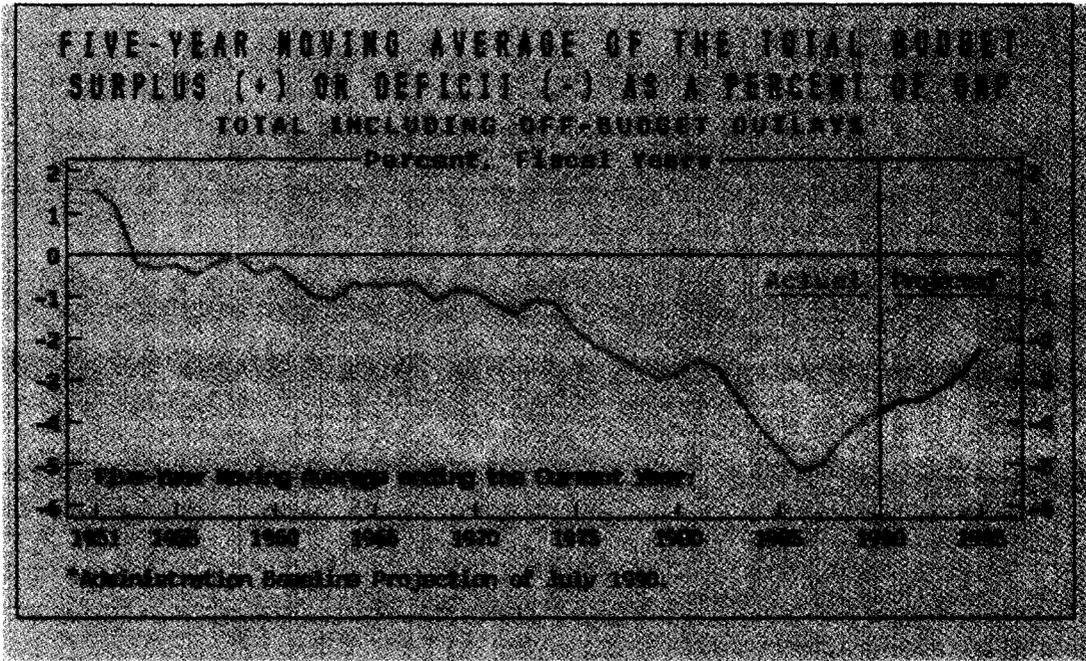
Saving as a Percent of GDP



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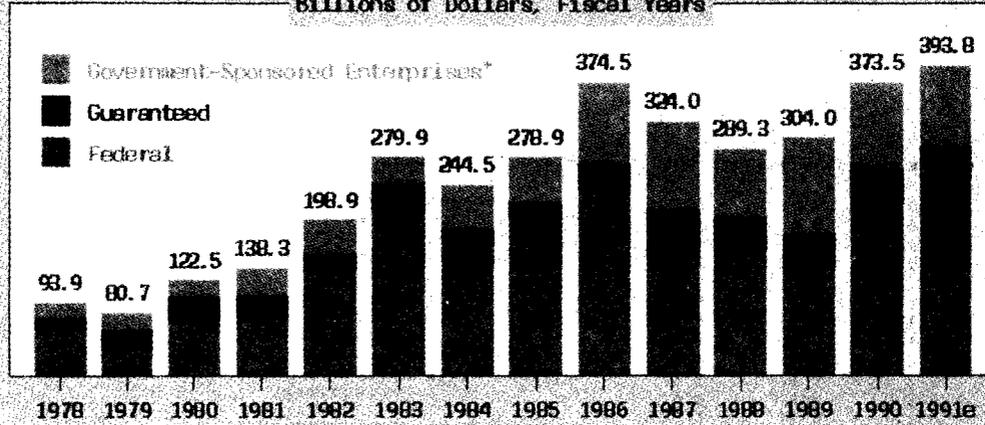






**BORROWING FROM THE PUBLIC UNDER FEDERAL AUSPICES
EXCLUDING HOLDINGS OF U.S. GOVERNMENT ACCOUNTS**

Billions of Dollars, Fiscal Years



*Excludes holdings of guaranteed debt and debt of other ISAs.

e: estimate

GROSS SAVING AND INVESTMENT AS SHARES OF GNP

	<u>1950's</u>	<u>1960's</u>	<u>1970's</u>	<u>1980's</u>
	<u>(-----Percent of GNP-----)</u>			
<u>Total Gross Domestic Saving</u>	16.1	16.3	16.7	14.1
<u>Private</u>	16.2	16.6	17.6	16.6
Personal	4.7	4.6	5.6	3.8
Corporate Undist. Profits	2.8	3.5	2.5	1.7
Depreciation Allowances	8.7	8.5	9.6	11.1
<u>Government</u>	-0.1	-0.3	-1.0	-2.5
Federal	0.1	-0.3	-1.7	-3.8
State & Local	-0.2	0.0	0.8	1.2
<u>Total Gross Investment</u>	16.3	16.2	16.7	14.0
<u>Gross Private Domestic Invest.</u>	16.2	15.5	16.4	15.7
Business Fixed Investment	9.6	9.9	10.7	10.8
Net Foreign Investment*	0.1	0.6	0.2	-1.6

*National Accounts counterpart of the current account balance.

Insert for the Record, P.68

U.S. REAL ESTATE MARKETS: TRENDS AND CURRENT CONDITION

The strength of U.S. real estate markets varies both by region and by type of property because demand factors depend heavily upon local and/or regional needs. These needs reflect the demands of business for office, industrial, retail, and other types of space for local/regional business use, as well as the demand of individuals for local housing. Consequently, the following tables report a variety of measures indicating trends and current condition.

NATIONAL HIGHLIGHTS

o Nationwide nonresidential construction activity (Table A.1) declined in 1990, particularly office construction, reflecting slowdowns and overbuilding in many areas.

o Nationwide vacancy rates (Table A.2) have increased for all types of commercial property since 1980, particularly office buildings. National average rents appear to have fallen slightly over the first part of 1990 (Table A.3). Vacancy rates in many metropolitan areas (Table A.4) have increased over their 1987-89 average.

o Home resale price increases slowed nationwide in 1990, led by the declines in the Northeast, and sales of existing homes declined. (Tables B.1 and B.4)

o Commercial banks are the largest holder of commercial real estate construction loans. Commercial banks and life insurance companies hold the majority of long term commercial real estate loans. Savings institutions and investors in mortgage pools hold the bulk of residential real estate loans. (Table C.1)

REGIONAL CONDITIONS

The national data mask substantial differences in the condition of regional real estate markets. Deteriorations in these regional markets can lead to declines in the health of financial institutions with substantial regional portfolio exposure.

The Texas experience over the past decade is a case in point. The decline in the Texas commercial real estate market and the subsequent collapse in the Texas commercial banking sector offer a pattern with which to identify the components of this cycle. Because the pattern may prove useful in identifying potential future problems, data tracking the Texas cycle is included in this report.

Because of recent declines, one such potential problem may be the New England real estate market. Accordingly, data on this regional market is also presented, with comparisons to the Texas pattern.

TEXAS HIGHLIGHTS

o The problems in the Texas commercial real estate markets were rooted in the behavior of the gas and oil industry over the 1980s. Oil price inflation in the 1970s and early 1980s prompted expansion in office and industrial building. As the industry weakened, the building trend persisted, causing substantial overbuilding, and consequent increases in vacancies (Table A.5). The 1986 tax law changes, which reduced the tax benefits of owning real estate, caused additional pressure on properties. The impact of this law was most severe in overbuilt areas, in which properties depending on the tax law for value were prevalent.

o The weakness in the gas and oil industry put some pressure on residential real estate markets, but the extent was considerably less, due to the diversity of the Texas economy. (Mining and manufacturing industries constituted 16 percent of employment in Texas in 1985).

o The commercial real estate problems had an overwhelming impact on the primary holders of debt backed by this real estate, the Texas-area commercial banks. Over the past decade, but particularly since 1985, 425 Texas commercial banks failed or required FDIC assistance, causing the FDIC to incur losses of nearly \$11 billion.

o Studies suggest that the banks were slow to react to the changes in the commercial real estate market. Holdings of construction and commercial real estate loans (Table C.3) increased long after the increases in office vacancy rates (due in part to previous loan commitments).

NEW ENGLAND HIGHLIGHTS

o Recent studies conclude that New England commercial real estate markets are currently suffering from problems similar to Texas--declines in the leading sectors of its economy and an consequent weakness in commercial real estate.

o However, comparisons suggest that New England did not experience the overbuilding characteristic of Texas. (Table A.6) New England commercial bank portfolios do not show the concentrations in commercial real estate typical of the Texas institutions, but, instead, hold greater proportions of residential real estate. (Tables C.3 and C.4).

The following documents provide further information on national and regional markets and on the Texas and New England situations:

FDIC Real Estate Market Indicators, March 1991

"The Texas Banking Crisis: Causes and Consequences, in the FDIC Banking Review, Winter 1990

"New England Banks and the Texas Experience" in the New England Economic Review, September/October 1990.

COMMERCIAL REAL ESTATE MARKET INDICATORS

Table A.1: New Nonresidential Construction (\$ Billions)

Year	Total	Industrial	Office	Hotels /Other Comm'l
1980	55.43	13.84	13.32	19.56
1981	64.70	17.03	17.47	20.50
1982	69.36	17.34	23.05	18.34
1983	65.68	12.86	20.77	20.22
1984	81.15	13.75	25.94	28.92
1985	95.32	15.77	31.58	35.35
1986	91.17	13.75	28.59	35.62
1987	91.99	13.71	26.43	36.40
1988	97.10	14.93	28.04	36.85
1989	103.36	18.51	28.60	38.41
9/90*	101.82	20.22	25.48	35.41

*Figure for 9/90 is monthly value at seasonally adjusted rate.

Source: Construction Review, U.S. Department of Commerce.

Table A.2: Vacancy Rate (Percent of Square Feet)

Year	Office	Industrial	Retail
1980	4.6	4.0	9.2
1981	5.0	4.4	9.7
1982	9.3	5.4	9.8
1983	13.7	5.4	9.2
1984	14.7	5.1	8.6
1985	16.6	5.8	8.4
1986	18.1	6.6	8.9
1987	17.9	6.5	9.3
1988	17.5	6.8	9.8
1989	18.1	7.4	10.4
6/90	18.5	8.0	11.2

Source: FDIC Real Estate Market Indicators (from Coldwell Banker Commercial/Torto Wheaton Services and F.W. Dodge).

Table A.3: Gross Office Rents*
 (\$ Per Square Foot)

Year	Mean Rent (\$)	Growth Index (1987.2=100)
1985.4	21.17	94.2
1986.2	21.19	94.3
1986.4	21.73	96.7
1987.2	22.47	100.0
1987.4	22.39	99.6
1988.2	22.61	100.6
1988.4	23.06	102.6
1989.2	23.44	104.3
1989.4	23.52	104.7
1990.1	23.61	105.1
1990.2	23.46	104.4

*Rents reflect all occupancy costs, including rent concessions and operating cost chargebacks. Values generally reflect Class A properties in central business districts.

Source: National Real Estate Index, Published by Liquidity Fund.

Table A.4: Metropolitan Areas with Increasing Office Vacancy Rates*

Area	Current Rate (12/90)	3-Year Average (1987-89)
Baltimore	17.6	16.1
Boston	18.2	14.2
Chicago	17.6	14.7
Cincinnati	17.2	14.9
Cleveland	17.9	15.0
Detroit	18.9	15.4
Jacksonville	17.4	14.8
Los Angeles	17.9	16.0
Philadelphia	16.8	15.0
Washington, D.C.	16.8	14.2
National	19.5	17.8
Albuquerque	22.2	20.0
Hartford	24.2	17.4
Long Island	22.5	16.5
Nashville	21.6	20.6
Phoenix	26.3	23.7
Ventura County, CA	27.1	16.7

* Current rate exceeds 3-year average by more than one percent.

Source: Adapted from FDIC Real Estate Market Indicators (from Coldwell Banker).

**Table A.5: Texas Office Market Trends: Four City Total
(Austin, Dallas, Houston, San Antonio)**

Year	Office Starts (mil sq ft)	Office Vacancy Rate (percent)
1980	34.40	5.6
1981	70.75	3.0
1982	50.60	3.4
1983	37.60	4.9
1984	39.32	11.5
1985	68.58	15.4
1986	32.43	24.8
1987	7.16	29.7
1988	5.72	29.9
1989	5.02	30.6

Source: FDIC Banking Review, Winter 1990 (from F.W. Dodge).

Table A.6: East Regional Office Market Trends

Year	Completions (000s)	Vacancy Rate (Percent)
1984.2	14.0	9.4
1985.2	15.5	11.1
1986.2	16.8	11.9
1987.2	17.6	12.3
1988.1	16.4	12.4
1988.2	15.0	12.9
1989.1	15.1	12.8
1989.2	14.3	14.2
1990.1	8.8	15.4

Source: Coldwell Banker Commercial/Torto Wheaton Services.

RESIDENTIAL REAL ESTATE INDICATORS

Table B.1: Single Family Residential Market Indicators

Year	Housing Starts (000s)	Existing Homes Sold (000s)	Median Sales Price of Existing Homes (\$000)
1980	852	2,973	62.2
1981	705	2,419	66.4
1982	663	1,990	67.8
1983	1,068	2,719	70.3
1984	1,084	2,868	72.4
1985	1,072	3,214	75.5
1986	1,179	3,565	80.3
1987	1,146	3,526	85.6
1988	1,081	3,594	89.3
1989	1,003	3,440	93.1
1990	894	3,293	95.5

Source: Construction Review, Department of Commerce and FDIC Real Estate Market Indicators (from National Association of Realtors).

Table B.2: Texas Single Family Residential Market Indicators

Year	Existing Homes Sold, Texas (000s)	Median Sales Price of Existing Homes, South (\$000)
1980	251	58.3
1981	221	64.4
1982	165	67.1
1983	191	69.2
1984	197	71.3
1985	204	75.2
1986	199	78.2
1987	224	80.4
1988	239	82.2
1989	229	84.5
1990	249	85.8

Source: FDIC Real Estate Market Indicators (from National Association of Realtors).

Table B.3: Median Sales Prices of Existing Single Family Homes, Texas Metropolitan Areas (\$000)

Year	Dallas	Houston	San Antonio
1987	90.8	65.9	70.2
1988	90.8	61.8	65.0
1989	92.4	66.7	64.2
1990.1	89.8	70.7	62.6
1990.3	90.8	72.2	65.5

Source: Home Sales, National Association of Realtors.

Table B.4: Northeast Single Family Residential Market Indicators

Year	Existing Homes Sold (000s)	Median Sales Price of Existing Homes (\$000)
1980	403	60.8
1981	353	63.7
1982	354	63.5
1983	493	72.2
1984	511	78.7
1985	622	88.9
1986	703	104.8
1987	685	133.3
1988	673	143.0
1989	589	145.2
1990	517	141.2

Source: FDIC Real Estate Market Indicators.

IMPACT ON FINANCIAL INSTITUTIONS

**Table C.1: Holdings of Construction and Mortgage Debt
in 1988 (\$ Billions)**

	Total (1)	Comm'l Banks	S&L's	Life Ins Co's	Fed Cred Agcy	M'gage Pools
Ttl Mtge Credit	2,926	640	770	232	169	764
Constr Loans	199	125	52	1	1	-
1-4 Family Homes	40	16	20	-	-	-
Multif'ly Resident'l	39	15	15	*	-	-
Nonresid'l	121	93	16	1	-	-
Long-term Mortgages	2,676	490	693	230	168	764
1-4 Unit Homes	1,896	283	512	14	118	736
Multif'ly Resident'l	223	17	77	24	28	20
Nonresid'l	505	175	104	183	5	*

* = Less than \$500 million

(1) Total includes lenders and loan categories not shown separately.

Source: Statistical Abstract of the U.S., 1990 (data from Department of Housing and Urban Development),

**Table C.2: Commercial Bank Real Estate Holdings
(Percent of Assets)**

Year	1-4 Family	Comm'l	Construct'n	Other
1980	7.91	3.43	1.97	1.17
1981	7.64	3.31	2.22	1.18
1982	7.22	3.29	2.38	1.14
1983	7.14	3.48	2.59	1.17
1984	7.24	3.83	3.03	1.29
1985	7.27	4.15	3.27	1.38
1986	7.58	4.77	3.63	1.56
1987	8.78	5.58	4.00	1.65
1988	9.64	6.04	4.10	1.79
1989	10.64	6.53	4.12	1.80
9/90	11.55	6.82	3.94	1.93

Source: FDIC Real Estate Market Indicators.

**Table C.3: Texas Commercial Bank Real Estate Holdings
(Percent of Assets)**

Year	1-4 Family	Commercial	Construction
1980	3.12	3.17	4.07
1981	3.08	3.17	4.16
1982	3.28	3.60	5.02
1983	3.83	4.87	6.53
1984	4.59	5.77	8.30
1985	5.37	6.59	8.11
1986	5.89	7.64	7.70
1987	6.32	9.11	6.25
1988	6.65	8.27	3.66
1989	6.49	7.25	2.38

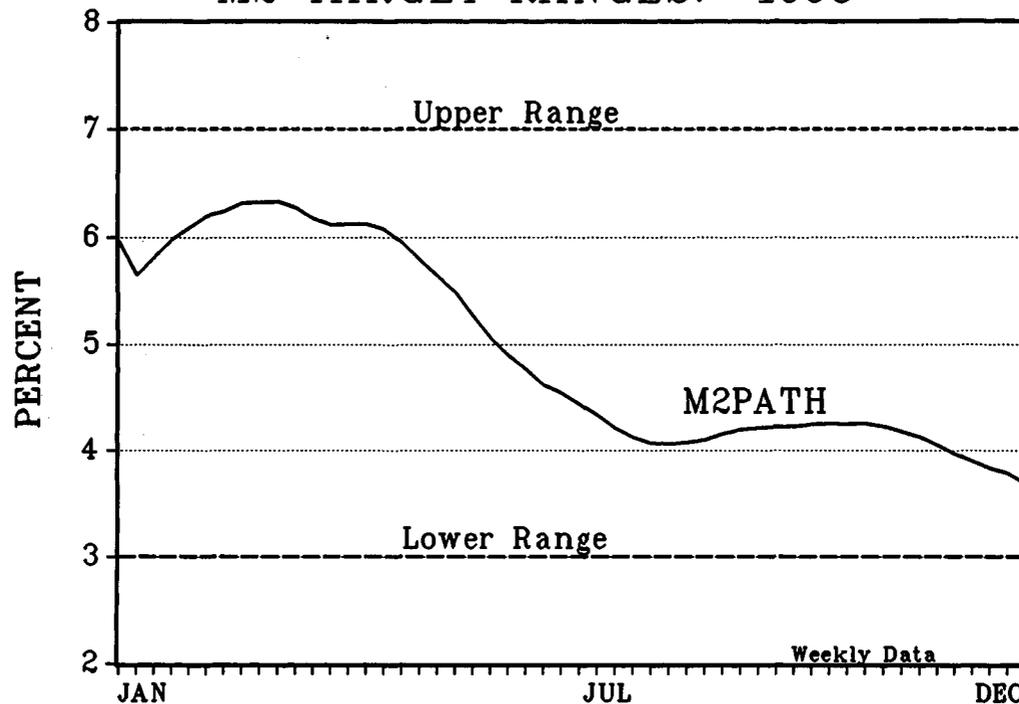
Source: FDIC Banking Review, Winter 1990.

**Table C.4: Northeast Commercial Bank Real Estate Holdings,
(Percent of Assets)**

Year	1-4 Family	Commercial	Construction
1980	5.38	2.30	1.25
1981	5.31	2.15	1.47
1982	4.80	2.07	1.69
1983	4.60	2.16	1.84
1984	4.63	2.31	2.22
1985	4.84	2.61	2.59
1986	5.61	3.33	3.21
1987	6.96	4.04	3.88
1988	7.78	4.49	4.27
1989	8.63	5.14	4.22
9/90	8.98	5.31	3.87

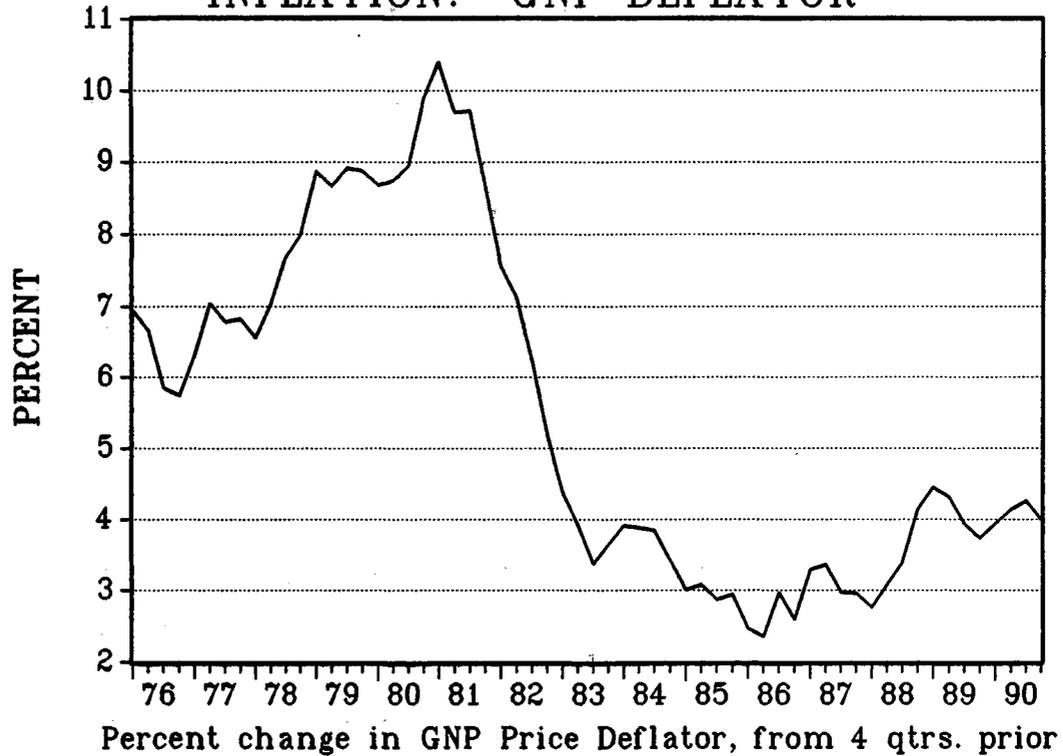
Source: FDIC Real Estate Market Indicators.

M2 TARGET RANGES: 1990

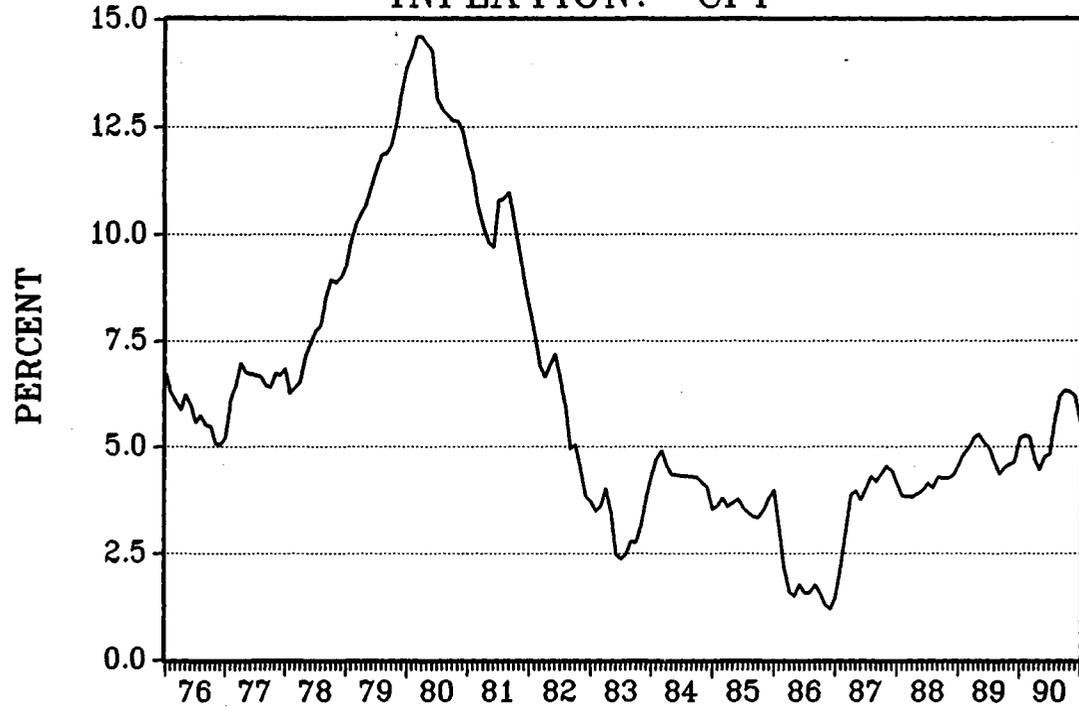


M2PATH is the annualized percent change of a 13-week moving average of M2, from the 1989 4th qtr. average.

INFLATION: GNP DEFLATOR

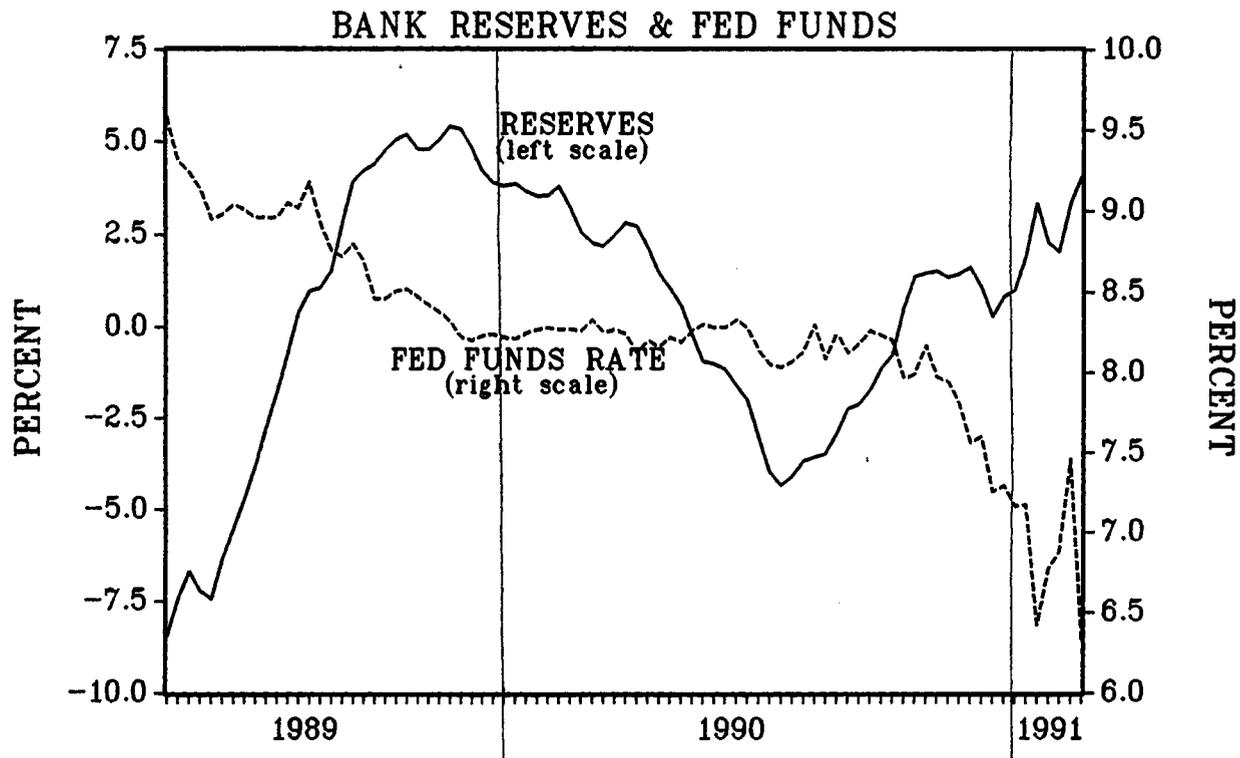


INFLATION: CPI



Percent change in Consumer Price Index, from 12 mos. prior

207



RESERVES plots the annualized percent change of a 13-week moving average of Total Reserves of Depository Institutions, from 13 weeks prior

A P P E N D I X

February 7, 1991

**Credit Concerns and the Monetary Policy Process
or
How the Fed was Waylaid on the
Road to Economic Recovery***

"Prepared Statement"

John E. Silvia

**First Vice President & Chief Economist
Kemper Financial Services**

January 14, 1990

*** Testimony submitted before the U.S. House of Representatives, Committee on Banking Finance and Urban Affairs, Subcommittee on Domestic Monetary Policy. Special thanks to Gerard Fancovic and Debbie Thomas for research support.**

Credit Concerns and the Monetary Policy Process
or
How the Fed was Waylaid on the
Road to Economic Recovery*

Have the actions of the commercial banking system limited the effectiveness of the Fed's easier monetary policy? Evidence presented below suggests that the full extent of Fed easing is not being passed through to the markets - but it is not entirely being prevented either! Moreover, it is not entirely the purposeful actions of the banks that is setting the tone for monetary policy. Commercial banks are not as significant a part in the financial intermediation process as they once were. To the extent that the Fed works its magic primarily through bank reserves and the banking system then the impact of any given policy move on the economy today is likely to be smaller than in the past. This result is not likely to be reflected in most structural macro economic models.

Monetary policy is a multi-step process. The analysis here suggests that the effectiveness of monetary policy in stimulating money and economic growth has been diminished, but by no means eliminated, due to developments in the real economy and credit markets. The steady decline in the money multiplier is particularly key. A declining multiplier means the Fed must provide increasing amounts of the monetary base over time to achieve the same money supply levels.

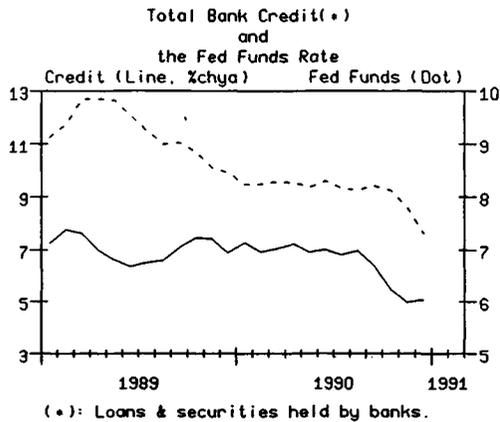
A number of developments have limited monetary policy effectiveness. Bank lending was already on a secular downtrend in importance in business finance and the recent tighter regulatory supervision has only reinforced this decline. Quality spreads on private market instruments were rising prior to this recession. These increases offset, at least partially, any Federal Reserve easing through a lower fed funds rate. An index of all S&P financial stocks, not just bank stocks, has declined relative to the S&P industrials. This suggests that credit quality concerns are not limited to banks. Mutual fund inflows to corporate bond funds have turned down sharply while high yield bond spreads have risen sharply. These developments suggest a much more difficult environment for issuing corporate debt since ultimate buyers are less able and/or willing to enter the market. Crowding out does appear to be a reality. Total domestic nonfinancial debt has slowed. Moreover, the composition has shifted away from private and towards public debt. While bank lending to corporations has been on a secular decline, market share gains have been seen for corporate bonds, foreign sources, finance companies and commercial paper. Banks are also losing their share of total credit supplied in the US economy to mortgage pools, life insurance companies and foreign sources. In conclusion, banks are less of a conduit for credit in the U.S. than in the past. Therefore, for any given change in bank reserves by the Fed, it would appear that less stimulus is applied to the US economy.

I. Getting the Ball Rolling: Fed Conducts Open Market Operations

Open market operations are the means by which the Fed plants the seed of high powered money, the monetary base, for credit and economic growth. To supply reserves to the banking system, the Fed buys Treasury securities and issues a credit to commercial banks in the form of an increase in bank reserves at the Fed. For the past few months, the Fed has signalled its easier monetary policy by supplying reserves at or below a fed funds level which the market perceives as the equilibrium level. For example, on November 16, the Fed conducted system repurchase agreements at 7 3/4% fed funds, the old equilibrium. This action was interpreted by the money market as a sign of Fed easing. As a result, the money market began pricing short term instruments to the new perceived target level of 6.5 percent.

Once the ball gets rolling, the popular assumption is that the Fed pushes on a steel rod, that is, any increase in reserves is automatically transformed by the banking system into new loans and money growth. But this, in fact, did not happen in 1990, and has not yet happened this year. Let's see why.

Despite Fed easing to reduce the fed funds rate, credit growth has slowed, not rebounded, as conventional wisdom would have expected. As seen in the chart below, credit growth has slowed despite the decline in the Fed funds rate.

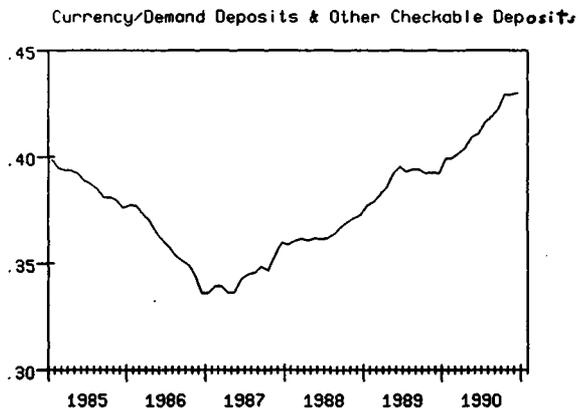


II. Detours on the Road to Monetary Ease: What Happens if the Money Multiplier doesn't Multiply?

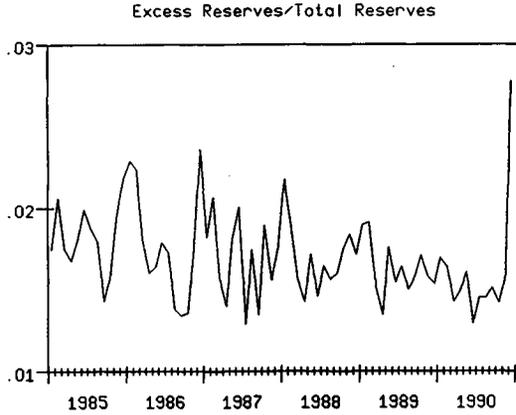
If the Fed were pushing on a steel rod then any increase in the monetary base would generate a commensurate increase in loans and the money supply. But in 1990 the money multiplier, the ratio of money to the monetary base, has actually fallen. Consequently increases in the monetary base by the Fed were not fully reflected in the growth of the money supply. In part, the Fed is pushing on a string as its easing moves are not producing the intended boost to economic growth.

A. Weak Economy Encourages Fed Easing But Private Market Caution

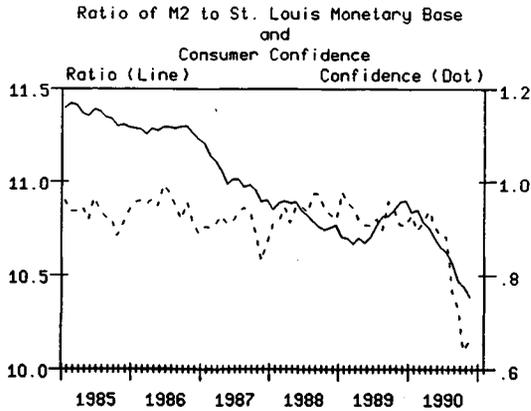
Two developments are key to explaining why the money multiplier has declined. First, currency demand by the public has risen steadily since 1987. In part, this may reflect concern since the stock market crash. In addition, recent increased pessimism due to the war with Iraq and the weak economy have given further pause to the consumer. Currency demand may also have risen simply due to the clamp down on money laundering through commercial banks. Increased currency demands effectively reduce the turnover of the monetary base and thereby the money multiplier since currency acts as a drain in the money creation process.



A second problem development is the recent rise in excess reserves (reserves held at commercial banks and not loaned to bank customers). Increases in excess reserves tend to occur during periods of economic uncertainty and reduce the money multiplier. Since June, 1990, average excess reserves have risen to \$1.7B from \$774M. While this primarily reflects the recent lowering of reserve requirements, the existence of an upward trend in excess reserves since late 1990 and their continued high level in 1991 are, *effectively*, reducing the easing thrust of monetary policy regardless of the source of these excess reserves since these reserves sit idle. They are simply not being loaned.

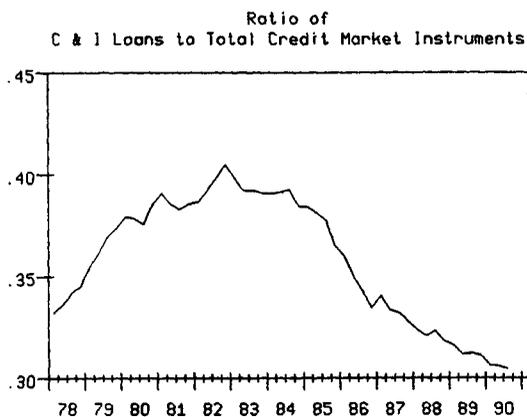


High levels of economic uncertainty are reflected in reduced consumer confidence. Therefore, it is reasonable that declines in consumer confidence correspond to a decline in the drop in the money multiplier as clearly seen below in the chart.

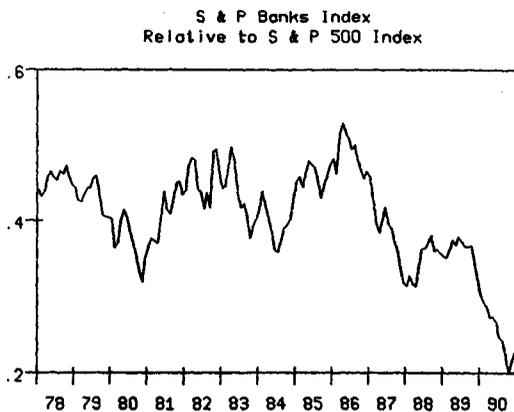


B. Secular and Cyclical Change Compounded

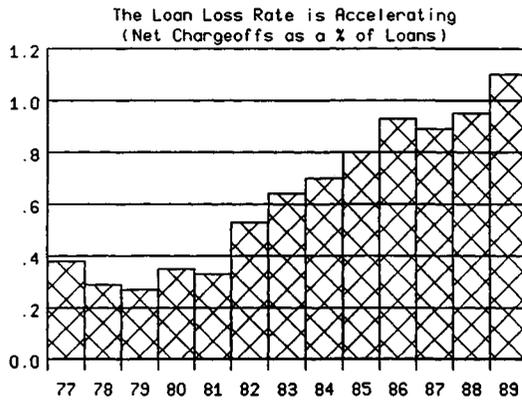
Talk of a cyclical downturn in bank credit fails to recognize that the secular trend for bank financing of non-financial corporations has been declining for some time.



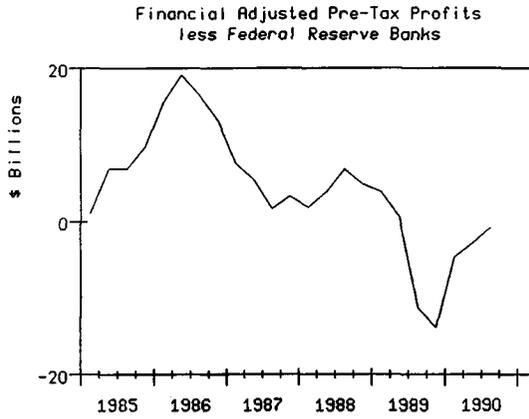
In fact the relative decline in the attractiveness of bank stocks should have been an early warning that the long run outlook for banks was deteriorating and that more fundamental problems exist than can be addressed through a lower fed funds rate alone.



Bank profitability declined sharply during the 1980s. From 1977 to 1980 return on equity averaged 17.9 percent but has fallen to 11.7 percent during the years 1985 to 1989. One major negative has been the steady rise in loan loss provisions from 0.25 percent of assets in the late 1970s to 0.84 percent of assets the past five years. Losses in commercial real estate and construction have been particularly significant, but loan losses for C&I loans still dominate. These losses reflect the underpricing of risk as banks tried to compete with commercial paper as a source of short-term business financing. This competitive urge led banks to underprice risk - particularly in an environment of expected continued economic expansion. Today, banks may be just discovering how much they underpriced risk in HLT lending. This discovery process may stick with us for several years.



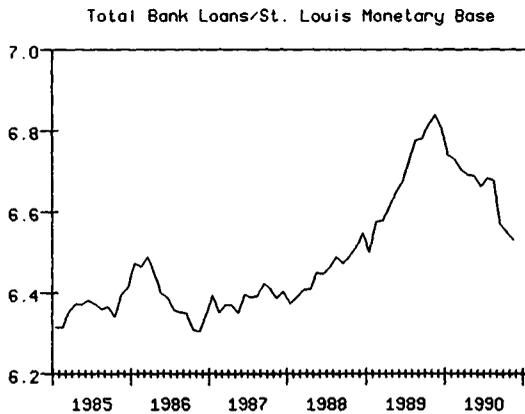
In fact, financial sector profitability in general has been flat to negative since 1986.



III. Loan Growth: Ability Doesn't Guarantee Willingness

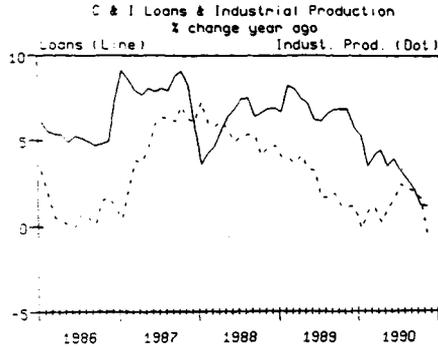
While an increase in reserves by the Fed gives banks the ability to make loans, it doesn't guarantee that banks will actually do so. Bank credit is composed of two components - loans and securities purchases. A bank's willingness to make loans reflects its expectations with respect to economic growth, inflation and risk. As evidenced by today's data, banks are simply less willing to make loans for any given level of total reserves. In this sense, bank behavior is offsetting, at least in part, the easing moves of the Fed.

For much of 1990, total bank loans have declined sharply relative to the monetary base. If Fed easing was passed through completely, this ratio would remain unchanged. Several factors have led to this decline.

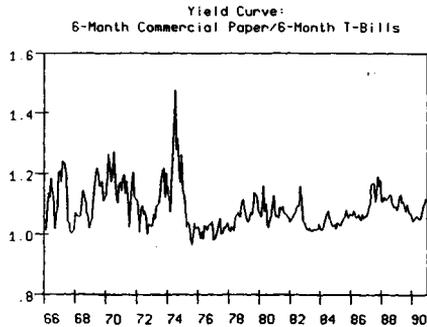


A. Loan Growth Slower: Both Cyclical and Longer-Term

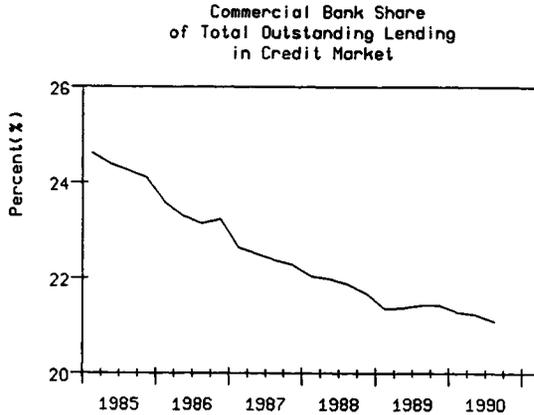
First, banks are, for the most part, acting prudently, not foolishly, in reducing their loan portfolio. On a risk-adjusted basis, the return on loans has been negatively impacted by a poorer economic outlook and perceptions of increased risk. In fact, the decline in bank commercial and industrial loans is very much in line with the slowdown in industrial production. Two points are important here. First, C&I loans track production very closely so that if there is a significant "credit crunch" in C&I loans from the supply side it is being masked by the impact of economic weakness. Note also that the peak in industrial production and in C&I loan growth preceded the oil shock so that the oil shock does not appear to have caused these declines.



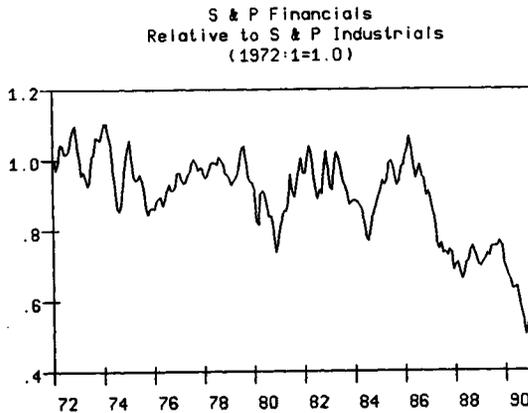
Second, increased risk perceptions are evidenced quite clearly by the sharp rise in quality spreads between private market instruments and Treasury bills or the Fed funds rate. Therefore, it is not at all surprising that banks have become more cautious given the twin negatives of slower economic growth and greater risk. Once again, economic weakness is not just due to an oil shock as evidenced by quality spreads in the private sector which had been rising prior to the onset of the oil shock. One quality spread, the ratio of 6 month commercial paper to Treasury bills, tends to lead business cycles. This ratio bottomed in February 1990 at 1.04 and has risen steadily to 1.1 now.



However, the slowdown in bank lending is not just a cyclical issue. Bank lending as a share of total credit supplied has been steadily declining since 1985. This secular decline in the importance of bank lending puts a new twist on the cyclical downturn in bank lending and its policy implications.



Finally, note that the financial markets' negative assessment of banking is also applied to other financial institutions - such as insurance companies and stock brokerage firms. This suggests that the credit supply problem is not just related to banks, but is part of a general concern for many financial intermediaries—many of whom are outside the direct influence of the Federal Reserve.



B. Total Net Lending: Changing Market Shares

So who is providing the credit? The table below illustrates that the share of credit from savings and loans has also fallen sharply since the end of 1988. Mortgage pools have been the big winners as their share rose from 4.1 to 7.6 percent. Money market funds and life insurance companies have also gained shares.

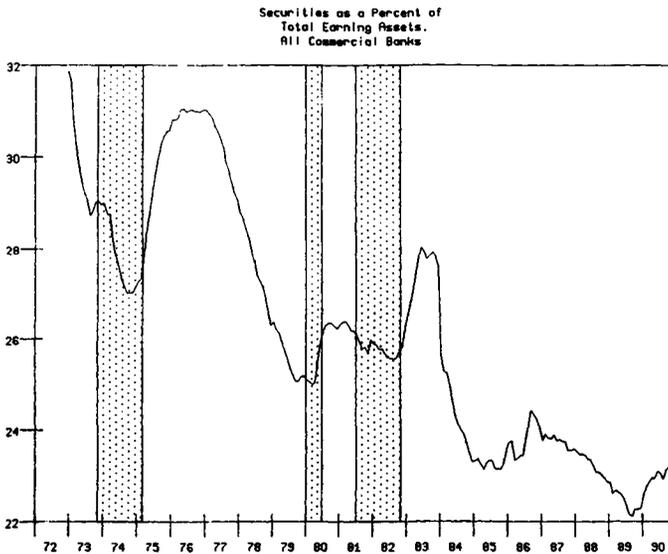
	Total Net Lending Percent of Total by Sector	
	1985:1	1990:3
Banks	24.6	21.1
Life Insurance Co.	7.9	8.4
Mortgage Pools	4.1	7.6
Money Market Funds	2.4	2.7
Finance Companies	4.1	4.1
S&Ls	11.6	7.6
Other Finance	20.1	21.4
Households	12.8	15.5
Foreign	4.3	5.7
Government	3.2	1.8

C. Bank Assets: Recessions Bring Reallocation

At commercial banks, Securities as a percent of Total Earning Assets usually increase during recessions and decrease during economic expansions. This behavior reflects cyclical changes in credit demand and supply. During a recession, expansionary monetary policy along with weaker business and consumer loan demand usually leaves commercial banks with excess cash to invest in securities. During an economic expansion, stronger loan demand and tighter monetary policy creates funding shortfalls. Commercial banks meet this shortfall by selling securities.

Beyond the cyclical trend, there is a secular downward trend that reflects two factors. First, liability management to control liquidity allows commercial banks to keep a higher proportion of funds in more profitable loans. Second, deposit deregulation has forced commercial banks to emphasize yield relative to liquidity.

In the chart below the secular downward trend is readily evident. During each of the dotted recession periods the percentage of securities turned upward as expected. But on a cyclical basis, the percentage of securities rose during the 1985-86 non-recession period, reminiscent of its behavior during recession. From the peak in September 1986 this percentage has renewed its secular decline but then bottomed at 22.1 percent in September 1989. The upswing in 1989-1990 reflects lender caution in the face of economic weakness.



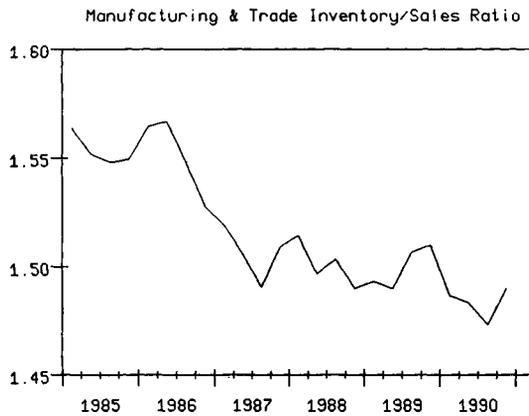
IV. But Who Wants These Loans Anyway?

Loan growth is the product of the demand and supply of loans. Therefore, no matter how willing banks are to lend, someone must borrow. For an individual company, this willingness to borrow often reflects their desire to expand production by adding capital. But capital expansion depends on the cost of capital relative to the expected rate of return. Unfortunately, expectations of returns have been diminished significantly due to four factors. First, economic growth has slowed. Therefore, it is not surprising that C&I loan growth has declined in line with slower year-over-year gains in industrial production. This suggests that much of the weakness in loan growth is related to the economy and not solely due to a "credit crunch." Second, corporate profits have fallen steadily and this too suggests a decrease in business demand for capital expansion. Effectively, lower corporate profits, in part, are offsetting the stimulative impact of a lower Fed funds rate. Lower corporate profits have also meant lower interest coverage ratios for corporations which have weakened business spending and increased corporate credit quality concerns. Third, business optimism has fallen sharply. The Small Business Optimism Index published by the National Federation of Independent Business has fallen from 100.7 in January 1990 to 90.2 in December. Finally, tax increases in 1991 have reduced the expected return to capital.

Concerns of economic weakness have led to a reduced willingness to lend to private business. This is evidenced by rising quality spreads - especially on high yield bonds relative to Treasuries.

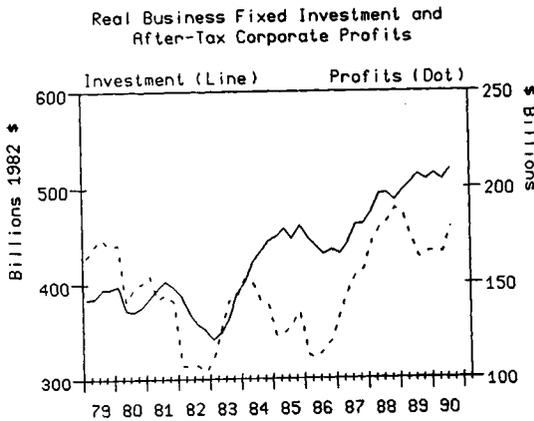
A. What Did the Standard View of the Economy Miss?

Neither escalating inventory - sales ratios nor a rising fed funds rate led this recession. What did change was the financial backdrop to economic activity. In addition, discussion of a credit crunch misses the point that much of the decline in credit originates from the demand side as firms exercise greater caution in borrowing when the economic outlook is so poor. the point is cooborated by the Fed's own surveys of senior lending officers that for larger borrowers reduced demand was the primary reason for the slower pace of lending.

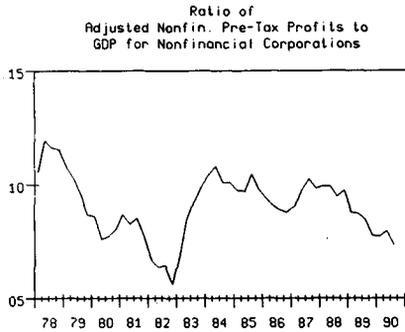


B. Business Fixed Investment: Is Capital Spending Possible in a Capital Deficient Market?

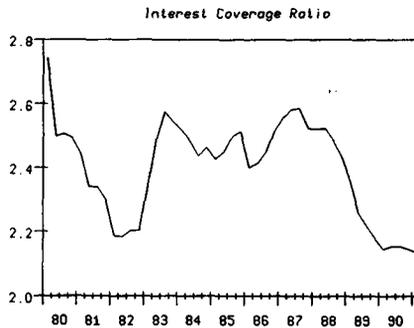
Capital spending depends upon expectations of future economic activity and the current level of capital usage (capacity utilization). But, unfortunately, capital spending has one draw back - it must be financed. As shown below, the weakness in corporate profits means that corporations will find it difficult to finance capital spending internally so capital spending will be curtailed as it was in 1980-82 and 1985-86 during periods of similar profit weakness. Weak profits will offset, at least partially, some of the stimulative effect of Fed easing.



Financing can come internally - through profits - or externally - by debt or equity. Internal funds have been a disappointment for some time. Pre-tax profits adjusted for inflation have been declining fairly steadily since 1987. Profits were just \$156.7B in the third quarter of 1990, down \$22.2B or 12.4 percent from a year ago. Corporate cash flow (which includes depreciation) peaked at \$412B in the fourth quarter of 1988 and stood at \$351.7B in the third quarter of 1990. Weak internal fund growth means a reduced ability of business to purchase equipment out of retained earnings.

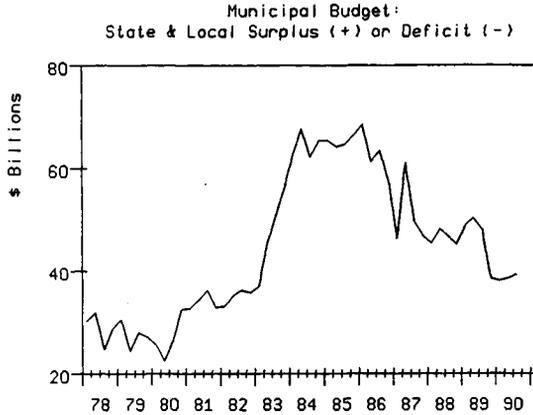


Yet, even these reduced internal funds are subject to a further constraint. Interest coverage, already at recession low levels by the third quarter of 1990, had begun to decline in the second quarter of 1988. This was far before any sign of recession! The low level of coverage reflects the heritage of the rapid debt expansion of the 1980s and suggests that the ability of internal funds to cover interest expense is "dangerously" low. Therefore, there is a reduced likelihood that business will increase capital spending soon from internally generated funds.

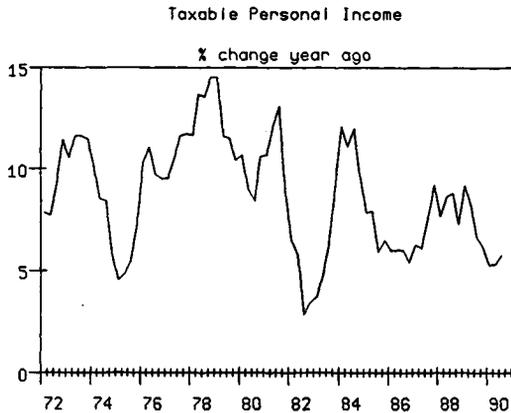


C. Municipal Finance: Can We Afford to Improve Our Infrastructure?

While popular cries for improved infrastructure are heard everywhere the ability to finance that spending is unlikely to be found anywhere. Declining budget surpluses (which includes social insurance funds) are clearly evident below in the chart. To the extent that public and private capital spending are complements these declining surpluses mean reduced productivity and competitiveness for US producers.



Reduced retail sales and slower taxable income growth are setting severe revenue limits on public spending. Until public expectations of public service levels are downsized, local governments will face large budget deficits, significant debt financing needs and little prospect of meeting the promise of long term infrastructure needs.



Quality problems also limit the ability of municipal government to stimulate the economy. Debt downgrades, in dollars, are up significantly in the first half of 1990 relative to the entire year of 1989 or 1988. Moreover there is a strong regional disparity in credit experience. This quality constraint will only further hinder the infrastructural improvements needed in many older, Northeastern, states.

Table 1

Municipal Bond Ratings

	Rate Changes		Debt Affected	
	Up	Down	Up	Down
First Half of 1990	102	84	19459	20952
All of 1989	240	186	23863	13683
All of 1988	338	315	38946	8097

Rating Changes by Region

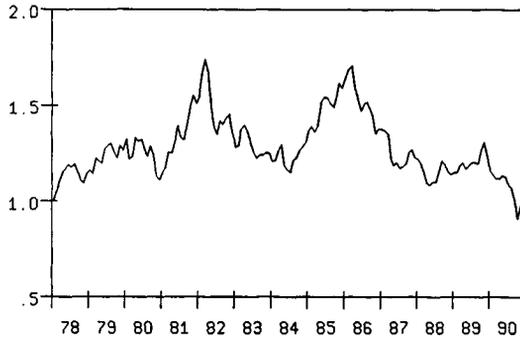
First Half of 1990

	Up	Down
New England	2	8
Mideast	12	16
Great Lakes	26	20
Plains	7	11
Southeast	23	8
Southwest	4	13
Rocky Mountains	1	2
Far West	26	5
Other	1	1

D. How Widespread Are The Implication of Financial Constraints?

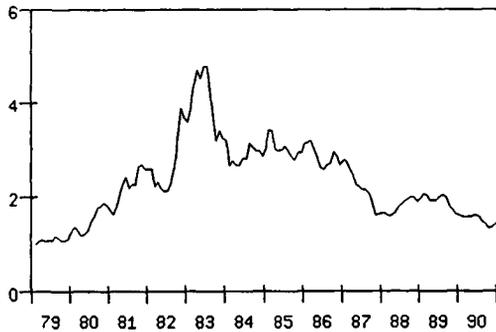
Equity markets suggest the implications are quite widespread. This is both a warning and a lesson. The warning appears to be that financial institutions, in general, are having some difficulties. The lesson is that credit concerns are much more widespread than just commercial banks.

S & P Insurance Index
Relative to S & P 500 Index
(1978=1.0)

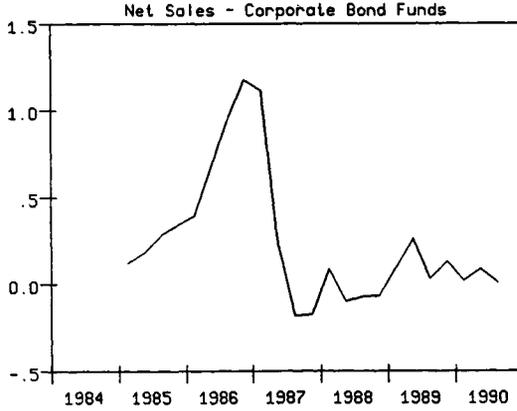


While the financial markets obviously have little confidence in the banking sector, there is also very little confidence in the ability of other financial institutions to support economic growth.

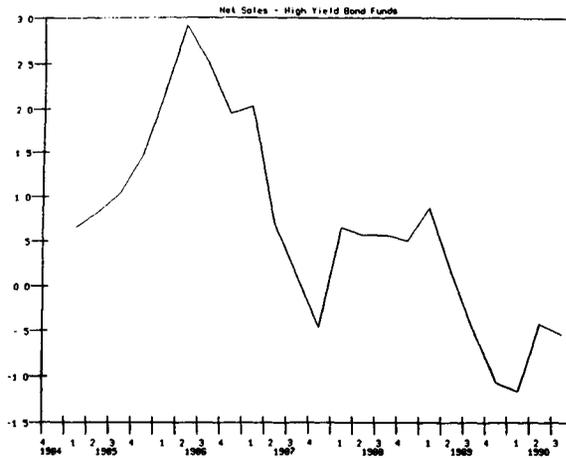
S & P Brokerage Firms Index
Relative to S & P 500 Index
(1979:2=1.0)



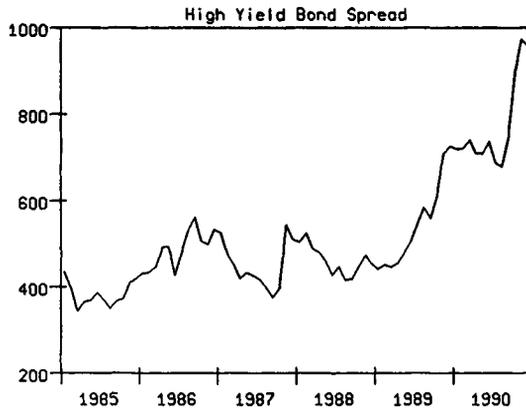
Mutual fund flows suggest a sharp reduction in the ability of those funds to help finance corporate spending through bond finance. Net sales (sales less redemptions) have dropped to zero from the \$1B plus monthly average of late 1985-1986.



Meanwhile, net sales of high yield bond funds have dropped from plus \$3B in late 1985 - early 1986 to actual net redemptions for most of 1989 and all of 1990.



High yield corporate bonds are very unlikely to provide the support to capital spending that they did in the mid-1980s. As investor interest in high yield bonds collapsed, the quality spread dramatically rose. Quality spreads for high yield bonds have jumped from 416 in August-1988 to almost 1,000 today (see chart below). At the same time, high yield bond issuance has dropped off dramatically from \$25B in the first half of 1989 to essentially zero now.



E. Real Estate Difficulties and Life Insurance Companies: Problems Not Just at Banks!

Average office vacancy rates for downtown areas rose sharply from 5 percent at the start of the 1980s to over 16 percent by the end of the decade and, for selected markets, over 25 percent in the past year. Real estate difficulties are not just the province of commercial banks. Data from the latest quarterly survey (September, 1990) of the American Council of Life Insurance (ACLI) indicate that the average delinquency rate for all mortgages rose to 3.35 percent from 3.03 percent in June and 2.92 percent a year ago (detailed data are provided on the next page). The average foreclosure rate rose to 1.66 percent in September from 1.59 percent in June and 1.52 percent a year ago. While these rates are "high" relative to rates earlier during this recovery, delinquency rates are still below 1986 levels. By reducing mortgage commitments, both banks and insurance companies are reacting to the worsened prospects for real estate projects and a more stringent regulatory environment.

Regional Disparity

By region and type of mortgage there are significant disparities.

For single family homes, mortgage delinquencies are up sharply for 1) New England, 2) Middle Atlantic and 3) East South Central (AL, KY, MS, TN) regions. Mortgage delinquencies are actually down in the Mountain and Pacific regions (despite all the negative publicity on California).

Commercial mortgage delinquencies have soared in New England but also the West North Central region (IA, KS, MN, MO, ND, SD). Delinquencies have declined in the east North Central (IL, IN, MI, OH, WI), West South Central (TX) and Mountain regions.

Table 3

Property Type by Geographic Division
Mortgage Loan Delinquency and Foreclosure Rates by Amount

(Note: Data by geographic divisions were reported by companies accounting for 88% of 1-4 family; 95% of commercial;
78% of agricultural; and 94% of total mortgages for the current quarter. See Table 2 for underlying data.)

Property Type Geographic Division	Quarter Ending September 30, 1989		Quarter Ending December 31, 1989		Quarter Ending March 31, 1990		Quarter Ending June 30, 1990		Quarter Ending September 30, 1990	
	Delinq	In Process of Forecl	Delinq	In Process of Forecl	Delinq	In Process of Forecl	Delinq	In Process of Forecl	Delinq	In Process of Forecl
1-4 FAMILY - TOTAL	1.31%	.29%	1.38%	.33%	1.35%	.32%	1.49%	.33%	1.52%	.39%
New England	.74	.09	1.16	.12	1.37	.10	1.45	.40	1.80	.50
Middle Atlantic	.93	.16	1.02	.29	1.30	.33	1.59	.32	1.56	.51
East North Central	1.41	.41	1.58	.40	1.48	.35	1.60	.32	1.56	.36
West North Central	1.55	.39	1.51	.29	1.49	.21	1.48	.58	1.65	.72
South Atlantic	1.44	.22	1.32	.28	1.30	.28	1.48	.33	1.62	.39
East South Central	1.52	.21	1.72	.20	1.75	.17	2.31	.15	2.36	.19
West South Central	2.00	.55	2.57	.53	2.31	.51	2.32	.45	2.48	.45
Mountain	2.33	.50	2.40	.84	2.31	.64	2.44	.70	2.27	.70
Pacific	.81	.22	.84	.19	.60	.16	.69	.11	.66	.11
Other	1.69	.04	1.25	.24	1.79	.18	3.15	.25	2.08	.22
COMMERCIAL - TOTAL	2.79	1.48	2.42	1.36	3.04	1.56	3.00	1.62	3.36	1.70
New England	1.12	.19	1.25	.50	3.26	.90	3.45	1.12	4.09	1.59
Middle Atlantic	1.37	.49	1.63	.89	1.56	.82	1.89	.88	2.94	1.33
East North Central	2.61	1.39	2.39	1.22	2.52	1.45	2.47	1.46	2.35	1.49
West North Central	3.52	2.26	2.17	1.52	4.19	1.59	4.49	3.35	6.66	3.46
South Atlantic	2.31	1.35	2.15	1.27	2.67	1.43	2.45	1.41	3.37	1.40
East South Central	2.76	1.31	2.81	1.12	2.87	1.32	2.97	1.23	2.86	1.42
West South Central	7.16	3.61	5.68	3.02	6.87	4.26	6.88	3.81	6.08	3.07
Mountain	7.95	3.88	7.27	4.08	8.20	5.99	7.62	4.36	6.76	4.13
Pacific	1.24	1.06	1.00	.76	1.71	.93	1.33	.75	1.20	.71
Other	.61	.21	.90	.19	.58	.22	.86	.21	.36	.18
AGRICULTURAL - TOTAL	7.40	3.75	4.76	2.28	5.56	2.45	5.26	2.23	4.88	2.06
New England	73.02	73.02	2.41	2.41	2.43	2.43	2.45	2.45	2.55	2.55
Middle Atlantic	10.53	7.90	10.63	8.59	9.32	7.59	10.26	7.89	10.28	7.28
East North Central	13.18	6.87	10.09	4.91	10.61	5.69	8.86	5.37	9.90	5.36
West North Central	7.11	3.89	4.16	1.81	5.33	1.74	4.93	1.35	4.57	1.48
South Atlantic	3.62	1.37	1.83	.21	2.68	.39	3.61	.33	3.64	.37
East South Central	9.29	5.25	5.29	3.30	6.18	1.78	6.76	2.64	7.61	2.08
West South Central	11.06	6.86	9.73	4.41	8.38	4.50	7.68	2.74	6.03	2.56
Mountain	13.63	8.23	8.88	6.50	10.07	6.49	10.49	6.53	9.85	6.26
Pacific	6.97	2.90	3.71	1.77	6.37	2.52	5.21	2.54	4.64	2.25
Other	2.76	.36	3.31	.46	.44	.46	1.03	.75	.72	.13
TOTAL MORTGAGES	2.92	1.52	2.67	1.33	3.07	1.54	3.03	1.59	3.35	1.66
New England	1.13	.21	1.25	.49	3.18	.88	3.38	1.10	4.02	1.56
Middle Atlantic	1.37	.48	1.62	.88	1.56	.81	1.88	.86	2.90	1.31
East North Central	2.81	1.48	2.52	1.28	2.65	1.50	2.57	1.50	2.46	1.53
West North Central	3.79	2.35	2.33	1.49	4.18	1.53	4.59	3.07	6.31	3.20
South Atlantic	2.90	1.30	2.11	1.21	2.61	1.36	2.43	1.34	3.30	1.53
East South Central	3.04	1.44	2.89	1.19	3.01	1.29	3.17	1.26	3.12	1.40
West South Central	7.01	3.57	5.64	2.94	6.67	4.04	6.65	3.56	5.87	2.90
Mountain	8.11	4.05	7.14	4.10	8.04	4.01	7.59	4.35	6.77	4.13
Pacific	1.53	1.12	1.14	.79	1.91	.98	1.52	.82	1.38	.77
Other	.65	.20	.91	.19	.62	.22	.96	.22	.45	.18

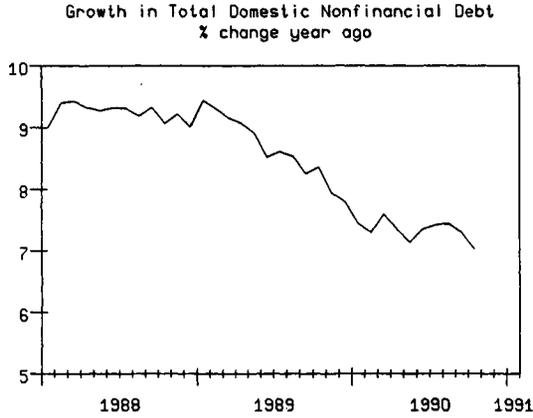
Delinquent loans include loans in process of foreclosure.

See Appendix for the Scope and Methodology of the Survey.

Source: American Council of Life Insurance, Quarterly Survey of Mortgage Loan Delinquencies and Foreclosures, Sept. 30, 1990.

F. Who Is Making Credit Available?

Total Domestic Nonfinancial debt growth has slowed - but it has been slowing since early 1989. There does not appear to be any sudden crunch in 1990.



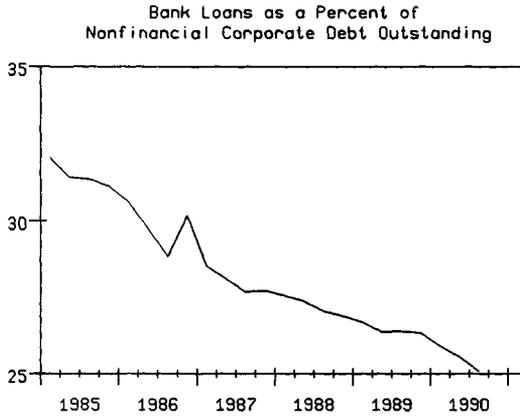
Crowding Out?

But the composition of credit growth has shifted away from private and towards public debt. Is this crowding out? Note how the total debt has kept up a healthy \$350B pace the last six months but the other (non-Federal) and other (non-tax exempt) have declined.

	Total	Other US Govt	Other (Non-Federal)	Other Tax Exempt	Non-Tax Exempt
Oct 1989 to April 1990	333.6	101.3	232.1	5.9	226.3
April 1990 to Oct 1990	350.4	158.3	192.3	11.8	180.4

G. Nonfinancial Corporate Borrowing: Recent Cyclical Weakness Maybe Disguising Secular Change.

Today the headlines focus on the cyclical decline in bank lending to business. But this is occurring within the context of a broader secular decline in bank lending. In fact, the claims of a recent "bank credit crunch" are not supported by the data in the chart. Part of this decline in relative bank lending may reflect bank securitization of loans. Unfortunately, I couldn't find any data on securitization by banks so the extent of the phenomenon is unknown.

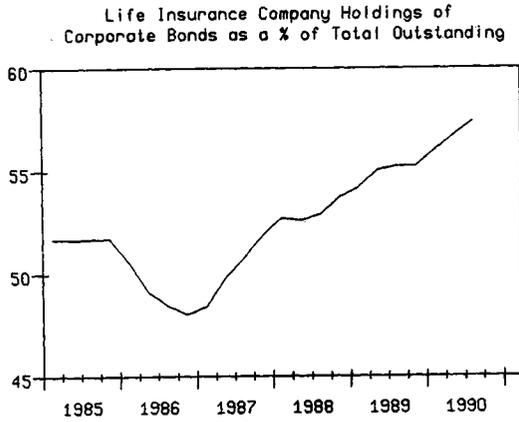


However, the following data illustrate quite clearly the change in the source of borrowing by nonfinancial corporations.

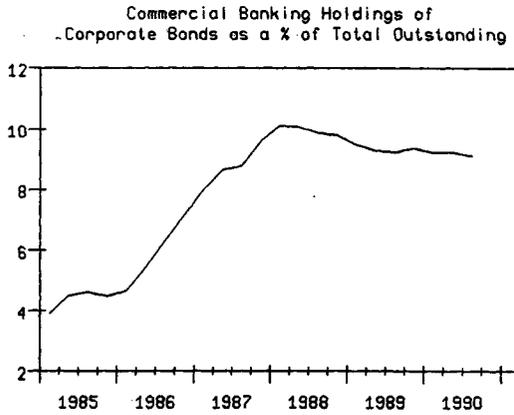
	Nonfinancial Corporate Business Percent of Debt	
	1985:1	1990:3
Bank Loans	32.0	25.1
Finance Companies	5.8	6.5
Commercial Paper	5.1	6.2
Bonds	39.0	44.9
Foreign	2.4	3.9

H. Corporate Bonds: Whose Buying?

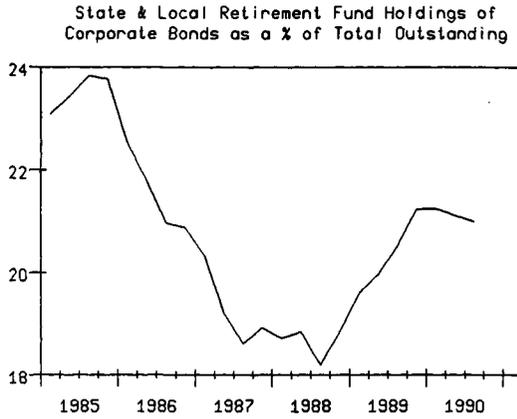
Life insurance companies have been aggressive buyers of corporate debt as their holdings of outstanding debt have risen from 48 percent in 1986 to over 57 percent today.



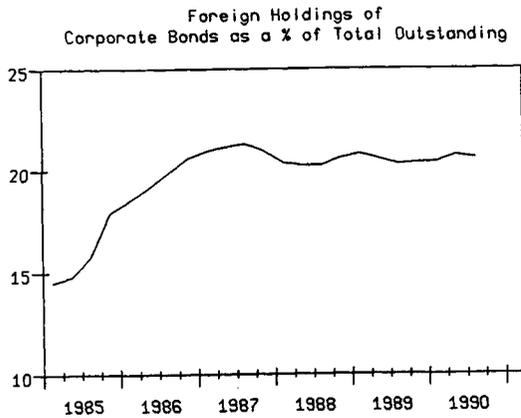
Commercial bank purchases of corporate debt rose sharply from 1985 to late 1987 then stalled out and has drifted down now to 9.1 percent of all outstanding corporate bonds.



Bond holdings are quite volatile for state and local retirement funds.



In a similar way, foreigners were aggressive net buyers from 1985 to late 1987 and then they stopped. They now hold just over 20 percent of all U.S. corporate bonds.



V. Role of Disappointed Inflation Expectations: Is the Debt Slowdown Evidence that the Fed Winning the Inflation Fight?

Credit problems today are, in part, the legacy of the inflationary history of the 1960's through 1980s. When a whole generation grows up with inflation they tend to incorporate inflation in all their economic decisions. Consumption is favored over saving. Debt is favored relative to equity since debt can be repaid with inflation-depreciated dollars. This is especially relevant when debt is accumulated to speculate on rising inflation of real assets, especially real estate.

However, if monetary policy is to be successful in reversing the long-term upward trend of inflation then this policy must mean that expectations of rising inflation must be disappointed. As a result, the real expected cost from past debt finance will rise and the returns from real assets like real estate must be less than originally expected by investors. As a result, expectations of wealth will be disappointed. Over time, the public, on the whole, will therefore reduce their propensity to borrow since lower inflation expectations suggest the burden of debt will be higher going forward.

It may, in fact, be that the slowdown in domestic nonfinancial debt growth for the past three years is a signal of the Fed's success in reducing inflation expectations. Reducing inflation below what was expected will increase the real burden of debt. As this burden becomes recognized other economic agents become less willing to take on debt.

One policy choice before the Fed is the choice to reflate. If the Fed reflates by printing money then it is likely to lead to higher inflationary expectations and higher nominal interest rates. Debtors may be saved but, as was the case in Germany during the 1920s, saving and work effort may be destroyed. In this respect, the fruits of the Fed's labors are spoiled, indeed.



Research Seminar in Quantitative Economics
The University of Michigan
Ann Arbor, Michigan 48109

Saul H. Hymans
Director

**STATEMENT IN TESTIMONY BEFORE
THE SUBCOMMITTEE ON DOMESTIC MONETARY POLICY OF
THE HOUSE BANKING COMMITTEE,
FEBRUARY 7, 1991.**

by

**Saul H. Hymans
Professor of Economics
The University of Michigan**

I am grateful for the privilege of appearing before the Committee, and am pleased to present my views on the economic outlook and the appropriate role for monetary policy.

- By the closing months of 1990 the combination of
 - 2 1/2 years of tight monetary policy (early 1988 through mid 1990),
 - loan rationing by a banking system trying to cure its balance sheet of a shaky asset portfolio,
 - an oil price shock,
 - and the prospect of a serious American entanglement in the Persian Gulf
- combined to put the economy into a recession. American consumers now seem to be about as uncertain and/or depressed as they've been in a long time. And in expectation of weak consumer markets, businesses are behaving with extreme conservatism in trying to avoid any build-up of unwanted stocks of inventory -- even though existing stock/sales ratios are about as spare as they've ever been at

"The Michigan Model"

the start of a recession. Clearly this is a most unusual time, fraught with economic uncertainties.

Are we now just at the start of a recession that's going to get a lot worse before it gets any better? Or are things already about as bad as they'll get, so that we're actually near the start of an economic recovery?

Why might it be thought that the economy could be nearing the end of the recession? There are at least three good reasons:

- The Federal Reserve System has clearly reversed its monetary policy. Reserves are being pumped into the banking system, and interest rates have come down sharply:

- The Fed Funds rate is down at 6 2/3 percent, compared with more than 8 percent a few months ago, and the discount rate was just cut to 6 percent after having been reduced from 7 to 6 1/2 percent in mid December.

- Oil prices are back into a normal range, about \$22 per barrel for the benchmark West Texas Intermediate, compared with an average of \$32 per barrel in the fourth quarter of 1990.
- And we're seeing an increase, with more to come, in the Federal government's demand for U.S. production as the war in the Gulf continues. And in this respect, it doesn't matter how much of the cost is offset by cash contributions from our allies; there's still a fresh new demand for U.S. output being imposed by the Federal government.

Important as these expansionary factors are, it's not clear that they'll dominate and that we'll pull out of the recession quickly. For one thing, there's substantial uncertainty about the size of the new defense call on the economy. Is Desert Storm going to raise defense spending by \$20 billion or by \$50 billion? And over how brief or protracted a period of time? Will Oil prices stay near \$20 per barrel? To what extent will continuation of the fighting in the Gulf -- with all the ups and downs in the news that can be expected to accompany such hostilities -- be associated with a depressed, or even worsening, state of consumer sentiment?

And, unconnected with the Persian Gulf situation, how much of the economy's

natural tendency to expand is going to be offset by a stingy supply of loanable funds in our troubled financial sector?

To get somewhere on these questions, let me make the following assumptions:

- 1) The Gulf War proceeds with "reasonable" smoothness toward a "favorable" outcome, and lasts about three months.
- 2) The additional call on the domestic economy for prosecution of the war and replacement of equipment and weaponry amounts to about \$52 billion:
 - with \$20 billion of additional demand during fiscal '91, another \$15+ billion in fiscal '92, and most of the balance in fiscal '93;
 - and a cash contribution from our allies of about \$25 billion, all paid during this fiscal year.
- 3) Excluding the effects of Desert Storm, the Federal budget remains on the track established in the October budget agreement.
- 4) Until the favorable outcome of the war is firmly established, consumer sentiment remains depressed; but once that favorable outcome is established, a clear recovery in sentiment occurs and is manifest in a strengthening of demand for big-ticket consumer durables.
- 5) The price of oil stays in the \$20-25 per barrel range, during and following the Gulf War.
- 6) The financial sector continues to stunt the recovery of homebuilding and commercial construction activity until the economy is already headed upward (without any initiating construction boom).
- 7) Economic expansion continues in Japan and Germany, while the economic decline in Canada hits bottom later this year.

What then is the economic outlook consistent with these assumptions? For the very near term (see Table 1):

- Real GNP declines for another quarter (1991.1), but only by 6/10 of one percent at annual rate;

- Real GNP growth edges above the zero line in the second quarter of this year, registering positive growth of about 8/10 of one percent at annual rate;
- The small positive for GNP growth forecast for the second quarter is the net result of a jump up in consumer demand, and a drop down in the defense budget as the rate of spending for Desert Storm slows down relative to the first quarter.

By mid-year:

- The civilian unemployment rate is forecast to be at about 6 2/3 percent;
- Inflation in consumer prices is forecast to be in the 4 to 4 1/2 percent range;
- But private housing starts will still be at an annual rate of only about one million, and sales of cars and light trucks will just be getting back to a 13 million unit pace.

The second half of this year, on the other hand, is forecast to register real growth at an annual rate in excess of 2 1/2 percent, and the unemployment rate is forecast to be heading down at or about yearend from a peak of some 6 3/4 percent.

Under this economic scenario, how should monetary policy proceed? It is evident that the economy that has just been described is going to need a supportive monetary policy for most of this year. Nor does this forecast develop in such a way as to justify monetary tightening until well into 1992; there's just nothing to indicate that the economic recovery is going to shift into an economic boom. Indeed, the stability of the financial system probably depends quite importantly on the Fed's being supportive of a period of continued recovery during which bank balance sheets can heal.

Perhaps the most fragile assumption in this forecast is the 3-month Persian Gulf War with an outcome favorable to U.S. interests. I am basically in agreement with Fed Chairman Greenspan that a much longer war is likely to be bad for the economy. I'm not sure why he thinks this; but my concern is that anything that smells like the Vietnam War, and a protracted debate on how best to pay for such a war, is going to produce nothing but bad vibes in American households -- perhaps even enough to keep the economy on the skids even with a hefty defense budget.

TABLE 1.
THE U.S. ECONOMIC OUTLOOK

	1990.3- 1990.4*	1990.4- 1991.1	1991.1- 1991.2	1991.2- 1991.4	1991.4- 1992.2	1992.2- 1992.4
Percent Changes at Annual Rate						
Real GDP and Components						
Real GDP	-2.1	-0.6	0.8	2.6	3.2	3.2
Personal Consumption Expenditures	-3.1	0.1	2.2	1.9	2.0	1.8
Durable Goods	-8.6	-4.5	5.5	4.5	3.4	2.9
Nonresidential Fixed Investment	-4.6	-6.9	-4.8	1.8	4.8	5.2
Government Purchases	4.9	7.8	-1.6	-3.0	-0.6	-2.0
Federal Defense	15.0	19.4	-8.3	-12.2	-4.4	-9.8
Prices						
Private Nonfarm GNP Deflator	2.5	5.5	3.8	2.9	3.5	3.1
Personal Consumption Deflator	7.1	4.1	4.0	4.7	4.8	4.7
Value of U.S. Dollar	-18.9	6.9	-4.3	-4.2	-4.3	-3.7
Levels in Terminal Quarter						
Civilian Unemployment Rate	5.9	6.3	6.6	6.7	6.5	6.3
3-Month Treasury Bill Rate	7.0	5.9	5.9	6.0	6.1	6.1
Conventional Mortgage Rate	10.0	9.5	9.4	9.3	9.2	9.2
Real Net Exports of Goods and Services	-23.6	-21.7	-26.4	-28.6	-19.1	0.9
Private Housing Starts	1027	975	955	1105	1266	1278
Light Vehicle Sales	12.9	12.3	12.6	13.4	13.7	13.9
Price of Oil	31.8	24.0	21.3	22.2	22.7	23.1
Federal Budget Deficit	165	162	161	161	151	119

* Preliminary published data.

RSOE, The University of Michigan, February 7, 1991.

ECONOMIC PROSPECTS AND THE CHALLENGES FACING MONETARY POLICY

**TESTIMONY OF
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**SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES**

FEBRUARY 7, 1991

ECONOMIC PROSPECTS AND THE CHALLENGES FACING MONETARY POLICY

It is a great pleasure to provide testimony to this Subcommittee about the prospects for the U.S. economy and financial system and the important challenges facing economic policymakers.

The current recession in the U.S. ended almost eight years of uninterrupted growth, the longest peacetime expansion on record. Economic expansions do not die of old age. Typically they are caused by the actions of policymakers or by unanticipated external shocks. However, it is important to note that the underlying cause of this recession was not restrictive fiscal or monetary policies nor was it the sharp rise in oil prices that followed Iraq's invasion of Kuwait. Instead, the recession was the inevitable result of deep structural problems that accumulated during the 1980s.

The roots of the economic downturn are embedded firmly in the unprecedented build-up of debt during the past decade. There is nothing wrong with debt per se. However, in the case of the U.S., the increase in debt was related to a major misallocation of resources into non-productive areas such as real estate, defense, medical care and imported consumer goods. There would be much less reason for concern if the debt had been used largely to finance income-producing investments.

The balance sheets of the nation's federal government, corporate sector and banking system were dangerously weakened by the lack of productive assets to match the increased debt load. Against this background, it was only a matter of time before growing debt burdens forced a return to financial prudence on the part of both lenders and borrowers. The other side to this necessary financial retrenchment has been recession.

The U.S. economy and financial system face their greatest challenge since the Great Depression. That was the only other time when a recession began with massive debt burdens and severe financial fragility. The increased role of government, financial safety nets and floating exchange rates will prevent a renewed depression. Nevertheless, there are no grounds for complacency because the conditions for a debt deflation are in place and the Federal Reserve has so far been unable to arrest the credit contraction.

Sustained economic health cannot be restored simply by a reduction in interest rates or by lower oil prices. There are no easy quick-fix solutions. Economic problems in the U.S. require long-term remedies such as increased savings, a redirection of spending towards investment and a restructuring of the banking system. The U.S. must become more competitive rather than retreat into a protectionist shell, monetary policy must continue to aim for lower inflation and further action must be taken to cut the federal deficit.

The Background to the Recession

The recession appeared to take many economists by surprise. The National Bureau of Economic Research has given a preliminary judgement that the business cycle peaked in August 1990. Nevertheless, Federal Reserve Board Chairman Alan Greenspan was

reflecting the consensus view when, in his July 1990 Humphrey-Hawkins testimony, he stated that "the economy still appears to be growing, and the likelihood of a near-term recession seems low, in part because businesses have been working hard to keep their inventories in line with sales trends". It took until late November for Mr. Greenspan to acknowledge that the economy had entered a "meaningful downturn".

The mistake made by many forecasters was to focus too much on traditional business indicators and not enough on other more serious measures of excess in the economy and financial system.

The widespread and growing burden of debt in the last few years has long warned of impending economic problems. The growth in total credit demand peaked decisively at the end of 1986 with the 12-month rate of change falling from 13.5% to 7% by mid-1990 (see Chart 1). However, income growth slowed even more rapidly during the period and the debt-to-GNP ratio continued to climb to new peaks (see Chart 2). The inability of the public and private sectors to climb out from under their debt burdens is the classic prelude to a debt deflation.

The October 1989 failure of the United Airlines leveraged buyout (LBO) was a more specific warning sign of troubles ahead. The withdrawal of Japanese support for the deal not only sounded the death knell of the junk bond and LBO manias but also highlighted the vulnerability of U.S. financial markets to an interruption of international capital flows. The collapse of the junk bond market played a key role in bursting the inflated bubble of investor and business optimism that had distorted the perceived trade-off between risk and reward.

It also became increasingly clear in recent years that the speculative boom in real estate had been pushed to an extreme. Bank lending for commercial real estate surged during the second half of the 1980s despite soaring office vacancy rates and a steady increase in problem loans. There was approximately a 10-year excess supply of office space by mid-1990. At the same time, the prices of residential real estate in many parts of the U.S. Northeast and West Coast moved far above the levels justified by underlying economic prospects. The current real estate recession reflects little more than the workings of the laws of supply and demand.

A final indicator of imminent stress for the U.S. economy was the restrictive stance of monetary policy in foreign economies. The central banks in most other major industrialized countries have kept short-term interest rates at very high levels in order to combat inflation. It was apparent by mid-1990 that Canada and the U.K. were entering recession and that many European economies were experiencing sharp economic slowdowns. This made it clear that the growth of U.S. exports was bound to decelerate despite a weak dollar.

The Gulf conflict undoubtedly played a role in the severe deterioration in economic activity in the fourth quarter of last year. However, it is important to note that the conflict was only the catalyst for a collapse in confidence that was bound to occur. Consumer sector finances were under mounting pressure between mid-1989 and mid-1990 yet confidence remained surprisingly firm. The collapse in confidence in the past few months merely put it in line with the trend in real incomes (see Chart 3).

In sum, there have been many reasons to expect recession or, at least, a major deceleration in the pace of economic growth. It is not obvious why the majority of economists chose to ignore so many indications of a deeply troubled economy. Indeed, the consensus view remains optimistic with a short and mild recession expected. Such complacency is not justified and the recession could easily be at least as severe as the post-war average. This implies that it could last a year with a peak-to-trough decline in real GNP of between 2% and 2.5%.

The Economic Outlook

This is not a normal recession. The inventory cycle has not played a significant role in the downturn and interest rates began to fall long before economic activity peaked. These developments will prevent a repeat of the sharp declines in output that characterized the 1974/75 and 1981/82 recessions. However, the economy is afflicted by severe structural problems such as an excess supply of commercial real estate, overcapacity in banking and weak balance sheets in a number of sectors.

The cyclical problems of the economy should start to recede by mid-year. The Gulf war hopefully will be over or well on the way to resolution by that time and the worst of the cutbacks in employment and spending will be in the past. However, a strong recovery should not be expected because the structural impediments to growth will take much longer to correct. In addition, it should be noted that the absence of a strong inventory cycle in manufacturing works in both directions. It may moderate the scale of the economic downturn but it also means that there will not be a strong rebound in production.

At best, the economy will start to show a modest recovery during the second half of 1991. Lower interest rates should contribute to a gradual improvement in the residential housing market while consumer incomes should benefit from a stabilization in employment. Exports likely will continue to post moderate growth against a background of a competitive exchange rate but weak overseas activity.

The economic downturn is expected to be more severe than implied by the length and depth of the recession. There is unlikely to be an early return to sustained above-potential GNP growth and this means that unemployment probably will continue to increase for some time after the recession has ended. In addition, financial strains will remain intense with a continuing risk of corporate and financial failures. In other words, the statisticians may proclaim the end of the recession but the perceptions of consumers and businessmen will likely be very different.

On a positive note, inflation should ease significantly during the course of 1991 because of increasing economic slack and subdued monetary growth. The core inflation rate (consumer prices excluding food and energy) likely will drop below 4% before the end of the year. The risks lie heavily on the side of an even sharper decline in inflation.

Our forecast assumes that the Federal Reserve will continue to reduce interest rates in response to the recession with the federal funds rate falling to at least 5.5% by the third quarter of 1991. The yield on the 30-year Treasury bond is expected to decline to between 7% and 7.5% during the year.

Risks to the Outlook

The Persian Gulf war clearly represents a major source of uncertainty with respect to the economic outlook. However, the initial fears of a major spike in oil prices no longer seem justified. Lost oil output from Kuwait and Iraq has been offset by increased production from other countries, global energy demand has eased, oil stocks are very high and, most importantly, Iraq does not appear to have the military capability to disrupt oil production or exports from Saudi Arabia or other Gulf states.

The war's main threat to the economy is that confidence could be further eroded if the conflict drags on for a long time and/or if there are major setbacks when the ground campaign begins. A quick rebound in confidence can be expected when the war ends but any accompanying rise in spending will be subdued until the fundamental background to consumer incomes improves.

The increase in defense spending associated with the Gulf war is unlikely to have much effect on economic growth. The replenishment of missile and ammunition stocks will boost output but the contribution to GNP growth should be small. The cost to U.S. taxpayers will be spread out over time and will be minimized by contributions from other countries in the coalition.

There are other uncertainties that cloud the economic outlook. For example, the economy is threatened by the high probability that one or more major banks will fail during the next year. The Federal Reserve would move quickly to prevent a spreading financial panic but consumer and financial market confidence could be seriously damaged and other banks could become even more restrained in their lending policies.

It was suggested earlier that recent developments were consistent with the onset of a debt deflation. The banking, government, consumer and corporate sectors are all trying to rebuild liquidity at the same time. However, each sector's attempts to improve its financial situation inevitably undermines the position of other sectors. The risk is that a self-defeating vicious cycle of retrenchment and debt default will develop. Indeed, the increases in federal and state and local taxes at a time of recession are part of this process. Unfortunately, there is no easy way to quantify the debt deflation danger and a close watch needs to be kept on the trends in credit demand and debt-to-income ratios.

The Impact of the "Credit Crunch"

There has been much debate about the extent to which bank restraint towards lending has contributed to the recession. Anecdotal and survey evidence have made it perfectly clear that banks have tightened their criteria for lending. A number of factors have been responsible for this: regulators have forced banks to adopt stricter accounting for problem loans; many banks are struggling to meet the new tougher capitals ratios; and the weakening economy dictated the need for more prudent lending policies.

The Federal Reserve has supported the need for higher bank capital ratios and it had been uncomfortable about the speculative edge to the surge in real estate and LBO lending. Nevertheless, there has been concern that banks have become overly cautious in their lending policies and have denied finance to creditworthy customers. There may be some

justification for these concerns but the scale of the problem probably has been overstated in terms of its contribution to the recession.

Bank lending growth has been declining steadily since the mid-1980s, broadly in line with a general fall in the overall demand for credit. The decline in bank lending growth accelerated during 1990 but it is not possible to disentangle the effects of weakening credit demand and supply-side restraint. Chart 4 shows that the decline in lending growth is not far out of line with the experience of past recessions.

It will be vital to achieve major improvements in the profitability and balance sheet health of the banking industry. At the same time, debt burdens in the corporate and household sectors must be reduced. There is no painless way to make the adjustments and it will be necessary for credit demand to remain weak for an extended period. In other words, the growth of spending must be kept below that of incomes in order to rebuild savings. It is inevitable that, during this process, some creditworthy customers may find it difficult to raise finance.

A quick improvement should not be expected in the health of the banking sector. Further write-offs of commercial real estate loans will be required and defaults on consumer and business loans will increase. Loan problems can lag the economic cycle by up to a year and losses may continue to mount until far into 1992.

Policy should focus on ways to impose more market discipline on bank behavior in order to prevent a repeat of past lending excesses. At the same time, it will be necessary to reduce the current overcapacity in banking in order to improve the sector's profitability and, thus, its ability to correct balance sheet weaknesses.

Any moves to soften the accounting treatment of problem loans should not be taken lightly. Creative accounting was tried during the savings and loan crisis and the results were disastrous. At the same time, repeal of the Glass-Steagall Act is not the solution to the sector's problems. Banks have incurred huge losses in areas where they have expertise so why let them enter businesses where current participants cannot operate profitably?

The Federal Reserve should make every effort to avert a debt deflation. But it should be equally careful to avoid triggering a major upturn in the credit cycle that would impede progress towards achieving sounder balance sheets in financial institutions and corporations.

The Conduct of Economic Policy

Economic policymakers often must tread a difficult path between short-term and long-term goals. The budget package passed last autumn was aimed at significant reductions in the federal deficit during the next few years. Nevertheless, it is doubtful whether such large cuts would have been made if the current recession had been anticipated.

On a similar basis, the Federal Reserve's stated long-term objective is to reduce inflation. However, the Federal Reserve usually is under pressure to give less prominence to that objective when recession dictates the need for lower interest rates.

From a long-term perspective, Federal Reserve policy appears to be on track for a significant reduction in inflation. One of the most durable economic relationships is the close tie between the growth rates of M2 and nominal GNP. For example, the 7.5% mean annual growth in M2 between 1950 and 1990 compared with 7.8% growth in nominal GNP. M2 rose at an average compound rate of around 4.5% in the three years ended December 1990. If that level of money growth is sustained, then it would be consistent with both inflation and real GNP growth in a 2% to 2 1/2% range within the next few years.

Some acceleration in monetary growth will be required in the short term in order to keep M2 on its 4% to 5% trajectory. M2 rose by only 3% in the 12 months ended December 1990, a rate too low to be consistent with economic recovery.

The reduction in interest rates during the past year has failed to boost monetary growth. In other words, velocity has been much higher than expected. Velocity has increased partly because banks have discouraged deposit inflows by keeping deposit rates at uncompetitive levels (the opportunity cost of M2 has risen). A contracting banking system does not need strong deposit growth. However, velocity has been above expected levels even after allowing for the increase in the M2 opportunity cost.

The stubborn weakness of the monetary aggregates has raised concerns that the Federal Reserve may be powerless to prevent a continued contraction in monetary growth and a deepening recession. Such concerns are overdone but it is important to recognize that the Federal Reserve is somewhat constrained.

The Federal Reserve could stimulate money growth and restart the credit cycle if it pushed down interest rates far enough. Policy is inhibited, however, by the vulnerability of the dollar. U.S. interest rates already are very low by international standards (see Chart 5) and the dollar has fallen sharply against most major currencies during the past year. Rates are starting to edge lower in some countries but they remain firm in Germany and Japan, the two large global creditor nations. There is a limit to how far the U.S. can narrow interest rate differentials between Germany and Japan before triggering a destabilizing decline in the dollar.

The Stance of Monetary Policy

There is conflicting evidence about the current stance of monetary policy. The combination of weak money and reserve aggregates and falling commodity prices suggests that policy is on a disinflationary path and that there is scope for further easing. In contrast, the steep upward-sloping yield curve and the weak dollar are indicative of lingering inflationary pressures.

A key test of the stance of policy will be the trend in private sector credit demand. Recent declines in interest rates have not been sufficient to reverse the downturn in credit growth. In other words, the private sector has behaved as if interest rates were very restrictive. The demand for credit is falling not because interest rates are high but because debt burdens are excessive and confidence is low. To the extent that the decline in credit growth represents a structural long-term trend, it may not be altered easily.

The Federal Reserve should continue to ease policy until it successfully arrests the decline in monetary growth. Lags in information mean that there is a very high probability that policy ultimately will be eased too much, triggering an overly rapid upturn in money and credit growth. In that case, the Federal Reserve should move quickly to tighten its stance in order to restore M2 growth to a 4% to 5% path.

Conclusions

The excessive build-up of debt during the 1980s has weakened the fabric of the U.S. economy and financial system. The most appropriate way to address the problem is to take action which will boost savings and bring down inflation. The reduction in short- and long-term interest rates that would follow a drop in inflation would play a major role in easing debt financing burdens during the transition to improved balance sheets.

A major resurgence in credit demand should not be an objective of policy. An increase in borrowing to finance consumption or financial transactions would not help to reduce structural imbalances in the economy. However, increased borrowing to finance capital investment should be welcomed. From the point of view of the banking system, a more prudent approach to lending is long overdue.

The Federal Reserve faces a difficult task in preventing a deepening recession without compromising its long-term goal of reducing inflation. So far it has underestimated the severity of the economy's problems and further easing will be needed if monetary growth fails to respond to the last round of interest rate reductions. There will be a high degree of comfort that policy is on the correct path if M2 grows by 4% to 5%, long-term bond yields are stable to falling and commodity prices are under control. A firm dollar would be a further indicator of sound U.S. policy although the exchange rate also is affected by the stance of foreign central banks.

The best contribution that Congress can make to the economy is to build on last year's budget agreement and seek ways to achieve further reductions in the growth of government spending. That may seem an inappropriate recommendation in a recession but the lags are long between the passage of budget legislation and the impact of any changes on the real economy. In a world of scarce capital, a lower U.S. budget deficit will free resources for the necessary upturn in private sector investment.

Chart 1
THE GROWTH IN NON-FINANCIAL DEBT

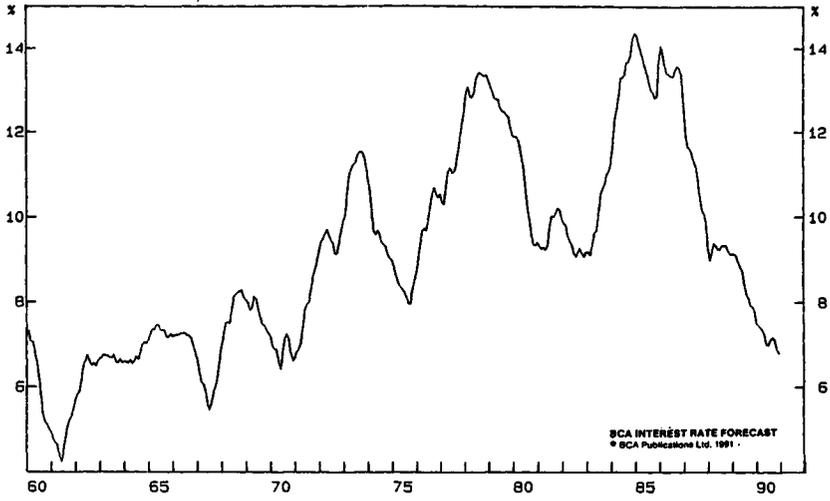


Chart 2
THE DEBT/GNP RATIO

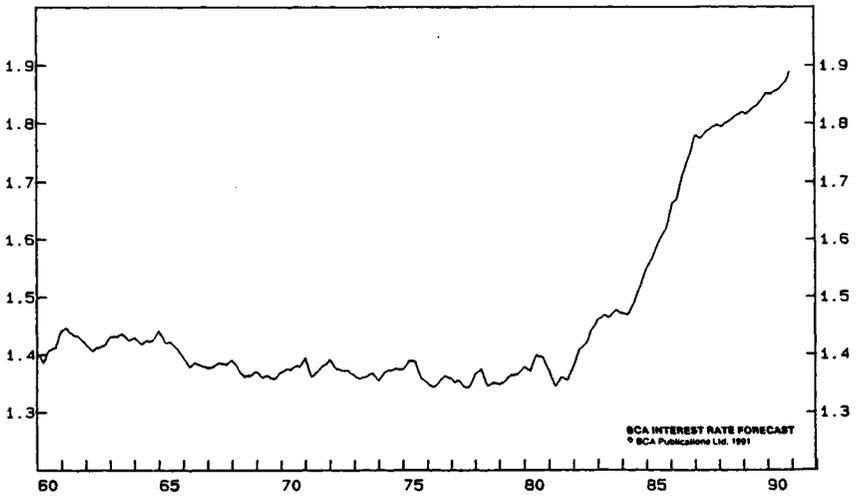
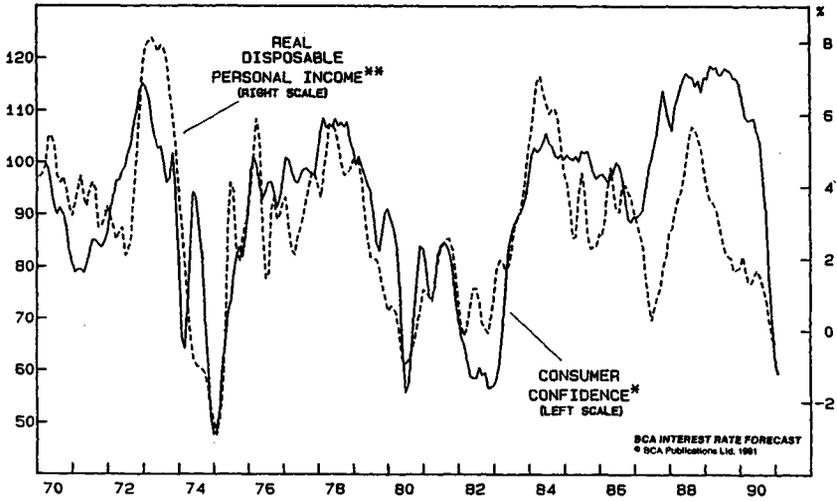


Chart 3

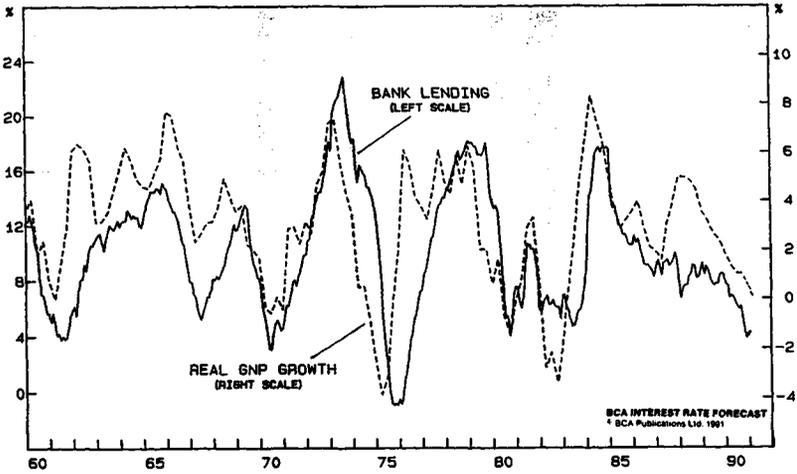
CONSUMER CONFIDENCE AND REAL INCOMES



* SOURCE: THE CONFERENCE BOARD, 3-MONTH MOVING AVERAGE
** 3-MONTH MOVING AVERAGE OF ANNUAL GROWTH

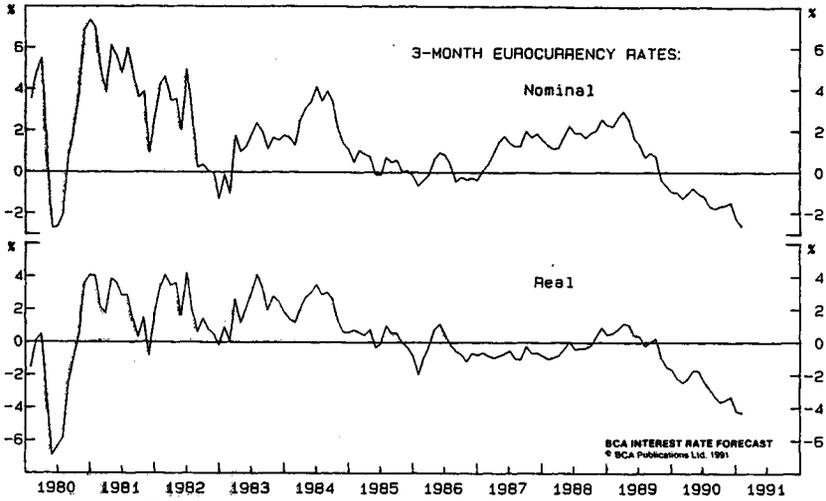
Chart 4

BANK LENDING AND REAL GNP GROWTH



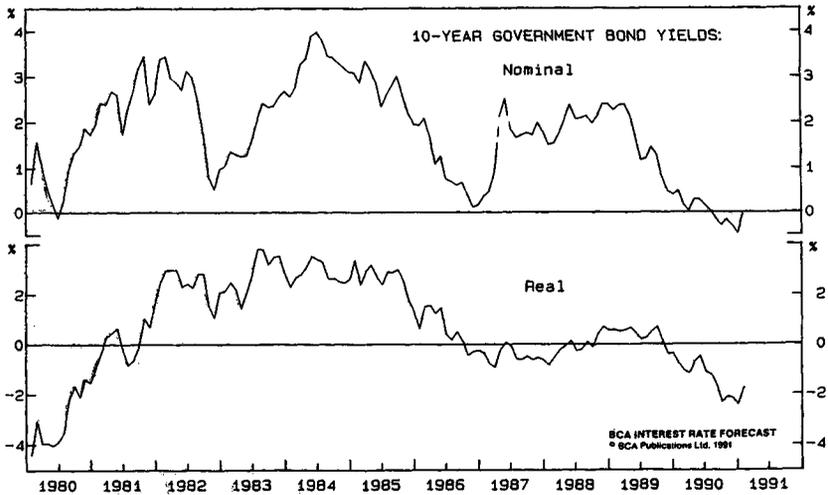
NOTE: SHADED AREAS REPRESENT NBER-DESIGNATED PERIODS OF RECESSION.

Chart 5
U.S. VS. FOREIGN RATE SPREADS



NOTE: FOREIGN RATES: A WEIGHTED SUM OF CANADA, FRANCE, GERMANY, JAPAN AND U.K. REAL RATES ARE DEFLATED BY THEIR RESPECTIVE CPI.

U.S. VS. FOREIGN YIELD SPREADS



NOTE: FOREIGN BOND YIELDS: A WEIGHTED SUM OF CANADA, FRANCE, GERMANY, JAPAN AND U.K. REAL YIELDS ARE DEFLATED BY THEIR RESPECTIVE CPI.

APPENDIX .

February 21, 1991

Testimony by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

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

of the

U.S. House of Representatives

February 21, 1991

Mr. Chairman and members of the Committee, I am pleased to appear before you again at these monetary policy oversight hearings. As is the convention on these occasions, I shall focus my remarks this morning on monetary policy and the current situation in the economy. However, the events of the past year have once again underlined the ways in which the state of our nation's banking system can affect the transmission of monetary policy to the economy. Consequently, I think I should comment at least briefly on some of the regulatory issues bearing on the willingness of banks to extend credit.

I should like to start, however, with an overview of the economic outlook. As you know, business activity turned down in the latter months of 1990, and appeared still to be declining through the early part of February. With the unpredictability of events in the Middle East compounding the usual uncertainties attending any economic projection, it would be most unwise to rule out the possibility that the recession may become more serious than already is apparent. Nonetheless, the balance of forces does appear to suggest that this downturn could well prove shorter and shallower than most prior post-war recessions. An important reason for this assessment is that one of the most negative economic impacts of the Gulf war--the run-up in oil prices--has been reversed. Another is that the substantial decline in interest rates over the past year and a half--especially in the past several months--should ameliorate the contractionary effects of the crisis in the Gulf and of tighter credit availability.

The major danger to a near-term recovery is that the erosion in purchasing power and frayed consumer and business confidence stemming from the recession and war could interact with a weakened financial system to produce a further decline in the economy. The recent actions we have taken, along with the ranges for growth of money and credit this year, which I shall be discussing in a moment, were designed to reduce the probability of such an outcome and to support a resumption of sustainable economic growth, in the context of progress toward price stability.

Economic and Monetary Policy Developments in 1990 and Early 1991

When I last testified on our monetary policy objectives in July, the economy appeared likely to continue growing, though moderately. The objective of restoring a clear downward tilt to the path of underlying inflation while maintaining the economic expansion thus seemed attainable. Indeed, data that became available subsequently indicated behavior of economic activity in the third quarter consistent with that appraisal.

That said, evidence in July of weaknesses in certain regions and sectors of the economy signalled caution. Notably, deteriorating market conditions for commercial real estate were limiting the ability of some borrowers to service loans, which, along with the restructuring of thrift institutions, induced lenders to pull back from extending credit to this sector. Banks also were becoming less willing to make business loans--not only for highly leveraged transactions, but more generally where industry or local economic conditions looked at all

unfavorable. Tendencies toward such restraint, which might normally have been expected in a time of uneven and generally less robust business prospects, were exacerbated by pressures on the capital positions of many institutions. In mid-July, to better ensure the economy's continued growth, the Federal Reserve adopted a slightly more accommodative stance in reserve markets to counter the potential effect on spending of this tightening of credit terms at depository institutions.

The invasion of Kuwait in early August dramatically altered the economic landscape. Oil prices surged, simultaneously worsening prospects for both real income and inflation. The higher world oil prices transferred domestic purchasing power to foreign oil exporters, while uncertainties about how the crisis would be resolved shook household and business confidence. After the invasion, spending held up for a time before starting to soften, while the jump in oil prices fed through quickly to energy prices more generally and to measures of overall inflation. Amid considerable volatility in financial markets and concern about the inflation outlook, bond rates moved back up and stock prices moved down, as many investors shifted to more liquid instruments. Treasury bill rates eased, and a surge in purchases of money market mutual fund shares boosted growth of the broader monetary aggregates in August and September.

Oil prices, which peaked at more than \$40 per barrel in early October, seemed to be the primary source of financial market uncertainty and volatility; however, the fitful progress toward agreement on measures to reduce the federal deficit also contributed. When the budget

accord was finally reached in late October, its promise of fiscal restraint over the next several years was reflected in somewhat lower bond yields. Against a backdrop of weakening economic activity and in light of the passage of the multi-year deficit-reduction package, the Federal Reserve again eased money market conditions.

This policy action proved to be only the first of a series of easing moves extending through early this month. These moves were prompted in part by subsequent information pointing to sizable contractions of consumer outlays and economic activity stemming from the marked weakening of consumer confidence and purchasing power. They also were taken in response to a lessening of wage and price pressures and decidedly sluggish growth in the monetary aggregates after their surge in August and September. Following continued moderate expansion in the third quarter, real GNP turned downward, led by the decline in consumer spending, but also reflecting reduced construction activity and business inventory investment. Industrial production began a rapid descent in October, with the motor vehicle industry accounting for an especially large share of the drop. Private employment also started to fall steeply, and the unemployment rate rose further. The associated rise in layoffs brought increased uncertainty to the household sector, which in turn has kept consumer spending subdued.

The widening economic slack helped prevent the energy price surge from becoming embedded in ongoing wage and price inflation. The increases in nominal wages and broader compensation measures diminished in the fourth quarter, after exhibiting initial signs of slowing in the

preceding three months. In September, the non-energy component of the Consumer Price Index began to rise at a slower pace. And in the final two months of the year, inflation in the overall CPI fell back, as energy prices topped out in November and declined in December in the wake of lower crude oil prices. The success of Coalition military operations after the outbreak of war in mid-January was seen in oil markets as reducing the odds of wide-ranging supply disruptions, and oil prices retreated still more, further improving the near-term outlook for inflation.

This reduction of cost and price pressures has given the Federal Reserve scope to move aggressively to counter contractionary influences on the economy without contributing to market concerns about the inflation outlook. Absent such a lessening of price pressures, monetary policy easing probably would have risked a heightening of inflation expectations, which could have put the foreign exchange value of the dollar under severe downward pressure and fed through to long-term interest rates, perhaps even pushing them higher.

The easing of policy also was keyed to the meager expansion since September of the broader monetary aggregates. As I shall be discussing more fully, the slowdown in money growth was worrisome because it seemed to reflect a further tightening of credit availability as well as the weakening in spending. The surfacing of additional asset quality problems has heightened financial strains on many banking institutions, placing pressures on capital positions and boosting funding costs. In turn, banks have progressively tightened their standards

for granting loans and have set still more restrictive terms and conditions on the loans they have made. Strains also have been evident at other intermediaries, and many securities have been downgraded by the rating agencies, suggesting that even those borrowers not relying on banks in many cases have faced higher costs and more restrictive terms.

In responding to evidence of economic weakness, to a lessening of inflation pressures, and to slow monetary growth, the Federal Reserve has used all three of its key policy tools. More accommodative reserve provision through open market operations, together with two cuts in the discount rate totaling a full percentage point, have brought the federal funds rate down to around 6-1/4 percent. This important short-term rate has fallen 2 percentage points since mid-1990 and roughly 3-1/2 percentage points over the past two years. We also reduced the remaining reserve requirement on nonpersonal time and similar accounts from 3 percent to zero. The requirement to hold non-earning reserves at the Federal Reserve in effect imposes a tax on credit intermediation at banks and thrifts. This action lowered this tax and was aimed specifically at relieving the tightening of credit availability at depository institutions.

Other short-term market interest rates generally have fallen nearly as much as the federal funds rate since mid-1990. Long-term interest rates also have retreated, and rates on fixed-rate mortgages are now in the vicinity of their lows of the past decade. Lower interest rates and oil prices have helped to lift some major stock price indexes to all-time highs. After firming in December and early January

on safe-haven demands, the exchange value of the dollar has shown unwelcome weakening tendencies at times recently.

The Behavior of Money and Credit in 1990 and Early 1991

As I indicated earlier, sluggish expansion of the monetary aggregates was an important ingredient in the decisions to ease policy during recent months. The broader aggregates ended 1990 well down in the lower halves of their annual growth ranges. The Federal Open Market Committee recognized that the relationship between M2 and spending is uncertain, but the slower growth of M2 in the latter part of 1990 and early 1991 brought the aggregate so far below our expectations that it seemed highly likely to be inconsistent with the Committee's longer-run objectives for the economy.

The weakness in M2 is a complex development and requires careful interpretation. The shortfall from our expectations appeared to be related to the stalling of nominal income in the fourth quarter, and also to the circumstances surrounding the extraordinary decline in assets at depository institutions last year, which in turn had implications for future as well as current spending. As their willingness or capacity to expand their assets diminished, banks and thrifts became less eager to attract deposits of all kinds. Hence, they paid unusually low rates on retail deposits in M2 relative to market interest rates. Moreover, public attitudes toward deposits also seemed to have been adversely affected by developments in the depository sector; publicity about thrift closings, Bank Insurance Fund losses, and credit quality

problems at commercial banks evidently encouraged shifts of funds into Treasury securities or alternative nondeposit instruments.

The shifting of credit intermediation away from depositories appeared likely to be having a dampening effect on the spending of those borrowers without ready access to alternative sources of funds at comparable interest rates. Thus, part of the slow growth in retail deposits could be seen as symptomatic of developments in the credit granting process with adverse implications for contemporaneous and future aggregate demand.

However, a portion of the credit flows no longer being intermediated by depositories has been readily replaced by alternative suppliers. In particular, markets for securities backed by mortgages and consumer loans have allowed demands for these types of credit to be met with little or no increase in costs to the ultimate borrowers. And some businesses with relatively high credit ratings have had little difficulty switching from banks to commercial paper markets and other sources of short-term funding. The reduction in funding through retail deposits associated with this type of shift in credit flows would not signal a weakness in current or future spending. Some of the surprising weakness in M2 growth has been reflected simply in a higher velocity than otherwise, rather than having been indicative of restraint on spending. M2 velocity last year did not exhibit the decline that would be expected with the drop in short-term market interest rates in late 1989 and 1990.

But with not all of the weakness in M2 likely to be offset by a lasting shift in velocity, the behavior of this aggregate seemed

increasingly to signal a weaker path for the economy than consistent with the Committee's intentions. Our policy easings over recent months were keyed partly to reinvigorating growth of M2 to a rate more likely to be consistent with satisfactory economic performance. If history is any guide, the policy-induced declines in interest rates on market instruments relative to returns on M2 balances will generate the desired speed-up in M2 growth; indeed, we have begun to see some evidence of that in recent weeks, though it is still too early to be very confident that a new, more robust growth trend has been established.

Restrained growth of M3 last year was expected once the size of the runoff of thrift assets and of RTC activities became clear. But its increase was further depressed by a larger-than-expected decline in bank credit growth. The fall-off in total depository assets had an especially pronounced effect on M3 because this aggregate includes, in addition to retail deposits, certain managed liabilities whose issuance is more sensitive to overall depository funding needs. In fact, currency and money market mutual funds more than accounted for the expansion in this aggregate over 1990. M3 growth has picked up this year, but so far it has reflected the substitution by some depositories of large time deposits for non-M3 funding sources rather than a renewed expansion of their credit.

Although credit outstanding at depositories contracted last year, credit flows at other intermediaries and in the open market were better maintained. Some borrowers undoubtedly felt the effects of

tightening lending terms, but nonetheless the debt of domestic, non-federal sectors rose 5-3/4 percent last year. This growth rate, though considerably lower than in recent years, was well in excess of the percentage increase in nominal income. Growth of federal debt by contrast surged to 11 percent, of which more than 2 percentage points represented federal funding of Resolution Trust Corporation activities. Buoyed by federal government borrowing, the total debt of domestic nonfinancial sectors grew 7 percent, the midpoint of the FOMC's monitoring range for the aggregate.

Economic Prospects in 1991 and Monetary Policy Plans and Objectives

These economic, financial, and monetary conditions form the starting point for the Federal Reserve's view of economic prospects and plans for monetary policy in 1991. An important aspect of the outlook is the unusually high degree of uncertainty about how these conditions will evolve, in the face of the Gulf war and financial strains. Another is the recognition that there may be substantial lags between changes in financial conditions--notably, the decline in interest rates and the depreciation of the dollar in recent months--and the response of spending. The assessment of the FOMC, as captured by the central tendency of the individual projections of Board members and Reserve Bank presidents, is that the odds favor a moderate upturn in activity in coming quarters. Real GNP for the year as a whole is anticipated to grow in the area of 3/4 to 1-1/2 percent. Unemployment is likely to rise further before the recovery takes hold, and consequently the expectation is that the jobless rate will be somewhere between 6-1/2 and 7 percent at year-end.

The lower oil prices, if they persist, will help damp overall inflation, as will slack in labor and capital resources. Most of us believe that consumer prices will rise 3-1/4 to 4 percent this year--the best performance in several years.

The forces currently at work in restraining spending can be readily identified. Consumer and business confidence still looks to be quite depressed, evidently because of the high degree of uncertainty, as well as the weak economy. Moreover, problems in many parts of the real estate sector are not going to be resolved soon. In particular, the large stock of vacant commercial properties is virtually certain to limit activity in that sector for some time. It also will take a while to correct the associated financial difficulties facing many lenders, who are likely to remain quite conservative in making new loans. Finally, secondary effects on aggregate demand of the recent decline in our economy's output and real income are now in process of running their course.

Fortunately, several stimulative forces are in motion that enhance the chances of economic recovery. Monetary policy easings have brought about a significant drop in short-term interest rates. The decline started more than a year before the business cycle peak, a pattern unique in post-war experience and one which should help cushion the current recession. Moreover, short-term rates have declined substantially further in recent months. Long-term interest rates also have come down appreciably; reduced mortgage rates already have improved the affordability of housing, and thus should help to revive housing sales

and starts. The enhanced international competitiveness of our industries augers well for the net export component of GNP. Furthermore, the fall in oil prices, which was especially marked in mid-January, has restored considerable domestic purchasing power. With most businesses having kept their inventories lean, the anticipated pickup in aggregate demand should show through relatively quickly in rising production.

The 1991 ranges for money and debt growth were selected by the Federal Open Market Committee to promote sustainable economic recovery, consistent with progress over time toward price stability. In keeping with a long-term disinflationary path, the FOMC ratified the provisional ranges set last July, which embody a 1/2 percentage point reduction in the M2 range compared with the limits for 1990. The midpoint of the 2-1/2 to 6-1/2 percent range for M2 growth matches the midpoint of the central tendency of the projections by the governors and presidents for nominal GNP growth. The recent sizable declines in short-term market rates normally would be expected to elevate the growth of M2 relative to that of nominal GNP. However, the FOMC anticipates that, as an offset, the ongoing restructuring of the thrift industry, combined with continued hesitancy of many banks to expand their assets, will again create an environment that restrains M2 growth relative to nominal GNP expansion and buoys M2 velocity. An outcome this year involving little change in M2 velocity would be quite similar to last year's experience.

The 1 to 5 percent range for M3 growth this year is the same as the sharply reduced range for last year. It again is lower than the

bounds for M2 growth because M3 is likely to continue to be more depressed than M2 by restructuring of the thrift industry and restrained growth in bank credit. The annual monitoring range for debt, however, has been reduced 1/2 percentage point relative to last year's specification, to 4-1/2 to 8-1/2 percent, in line with the sustained deceleration of this aggregate in recent years.

Risks to the Economic Outlook

These money and debt ranges are wide enough to afford scope for policy reactions should the economy or its relationship to these financial aggregates diverge from FOMC expectations. Indeed, the individual forecasts of Board members and Reserve Bank presidents for the economy cover a relatively wide range. This divergence of opinion has its roots in the major uncertainties facing all forecasters today. Economic forecasters typically have had great difficulty in projecting business-cycle turning points, that is, judging when the relative strength of contending economic forces of contraction versus expansion will reverse. Moreover, the current outlook is unusually clouded, in part by uncertainties about the war and its effects. The Federal Reserve will need to remain alert to possible contingencies and will have to continue to respond flexibly to information about evolving trends.

Monetary policy thus will depend on how trends in economic activity and inflation actually unfold. Downside risks in the economic outlook are obviously there and not difficult to identify. For example, an extended war with Iraq clearly could carry some risk of further

undercutting public confidence and spending. Additional restraint on credit availability at depositories or increased public concern about the health of the banking system would be negative factors as well, and could show up initially as continued subpar money growth.

The worry has been expressed that, under current conditions of restrained willingness of depository institutions to extend credit, monetary policy easing moves may have only a minimal impact on lending and hence on overall spending. I believe this risk is exaggerated. Our easings and reserve requirement action have lowered bank funding costs appreciably. Some of this decline has been passed through to borrowers in the form of a lower prime rate; even with this reduction, funding costs have fallen relative to loan rates, and with higher profit potential banks should be more inclined to extend credit. Moreover, monetary policy stimulus works through other channels as well. Some potential borrowers will be encouraged by lower market interest rates to undertake additional expenditures financed, either directly or indirectly, by issuance of securities. Spending effects also can appear through routes involving price responses in equity and foreign exchange markets. Finally, the anticipated economic recovery itself will help allay problems of credit availability at, and public trust in, depository institutions. Indeed, there is some possibility that once the economy turns around, the expansion could become fairly robust, sparked by a return of consumer and business confidence and fueled by increasing availability of credit.

Regulatory Initiatives

Monetary policy will continue to be conducted to foster attainment of important macroeconomic objectives. In so doing, we will need to remain mindful of any impediments to the process of credit intermediation. But monetary policy cannot resolve market imperfections in which credit for some financially sound projects is more expensive or less available than might otherwise seem warranted. Structural problems involving imperfections in credit and capital markets require structural solutions. To the extent that current banking regulations are impeding the efficient functioning of these markets, a more promising approach would lie along the path of revising those regulations. I would like to offer several thoughts along these lines, some of which are in only the formative stages.

We already have taken the step, as noted, of reducing reserve requirements on nontransaction accounts at banks and thrifts so as to eliminate the reserve tax on lending financed through these sources. This action lowered non-interest bearing required reserve balances at Federal Reserve Banks by some \$11-1/2 billion. The Federal Reserve Board also has the authority to reduce the required reserve ratio on transaction deposits from its current 12 percent to as low as 8 percent. However, unusual volatility in the federal funds rate appeared in January and early February, as required reserve balances moved to a seasonal low point. This experience suggests that reserve balances had fallen so far that many depository institutions were encountering difficulties in managing their reserve balances to meet day-to-day clearing

needs. Subsequently, volatility in the federal funds rate has diminished, as required reserve balances have begun to move above their seasonal lows, and as institutions have enlarged their clearing balances. These developments should continue for a time. Even so, the experience early this year suggests caution in considering further reductions in required reserve ratios, at least for a while. We shall, however, continue to assess this situation.

The recent episode of more volatile funds trading also has underscored the increased reluctance depositories have exhibited in recent years in availing themselves of short-term adjustment credit at the discount window. The reluctance has stemmed from fears of being identified as having more fundamental funding problems. Because of depository reluctance, the discount window in recent years has been a less effective safety valve in relieving transitory pressures in the reserves and funds markets. Tapping the window for adjustment credit, when alternative sources of funds temporarily are not available on reasonable terms from usual sources, is not indicative of longer-term stresses at borrowing institutions. Despite bank reluctance, borrowing has been somewhat higher on occasion this year as banks were in the process of adapting to the lower reserve requirements. We would not be surprised to see somewhat higher adjustment borrowing persist. The Federal Reserve has no desire to circumscribe the legitimate use of the discount window, and market participants should not interpret such use as indicating underlying problems for the institutions involved.

Another regulatory area in which possible steps are being considered pertains to the guidelines used in the supervisory process. The Federal Reserve is working with the other bank supervisory and regulatory agencies to ensure that bank examination standards are prudent and fair and do not artificially encourage or discourage credit extension. The intent of these efforts is to contribute to a climate in which banks make loans to creditworthy borrowers and work constructively with borrowers experiencing financial difficulties, consistent with safe and sound banking practices. For example, the agencies are studying steps to clarify that the supervisory evaluation of real estate collateral is to be based, not solely upon liquidation prices, but upon the ability of a property to generate cash flow, given reasonable projections of rents, expenses, and rates of occupancy over time. We need a balanced evaluation process that endeavors to reflect the long-term value of an illiquid asset, rather than the exaggerated appraisals that have been evident in both the upside and the downside of the real estate cycle in recent years.

The supervisory agencies also are seeking to encourage banking institutions to provide additional public disclosure on their nonperforming assets. Under present circumstances, as best we can judge, the market tends to suspect the worst. Additional disclosure would supplement data on the level of nonperforming loans with information on the amount of such loans that are in fact generating substantial cash income. Other similar steps are under consideration.

In general, we have emphasized our view that prudent lending standards and effective and timely supervision should not inhibit banking organizations from playing an active role in financing the needs of sound, creditworthy borrowers. Such an approach can contribute to the efficient functioning of credit markets and thereby complement monetary policy in promoting the attainment of the nation's overall economic objectives.

**For use at 9:45 a.m., E.S.T.
Wednesday
February 20, 1991**

Board of Governors of the Federal Reserve System



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

February 20, 1991

Letter of Transmittal

**BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 20, 1991**

**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 1991

When it reported to Congress last July, the Federal Reserve was anticipating that the economy would continue to grow in the second half of 1990. Although the first half had been far from robust, with problems clearly evident in some industries and regions, the economy still was expanding and was afflicted with neither the inventory imbalances nor the escalating inflationary pressures that had preceded past cyclical downturns. Indeed, it seemed at midyear that the goal of achieving a reduction of inflation in the context of continued expansion might well be attainable.

But in August the economy was jolted off course by the Iraqi invasion of Kuwait. The surge in oil prices that followed the invasion gave additional impetus to inflation, and it also portended a weakening of activity as the price increases cut sharply into domestic purchasing power. Uncertainties about the course of the economy were heightened enormously, and household and business sentiment plummeted almost overnight, a response that perhaps grew in part out of memories of the difficult adjustments that had followed previous oil shocks in the 1970s. At the time of the invasion, and on into the autumn, sentiment also was being affected by the considerable uncertainty that existed regarding the course of fiscal policy.

Actual production and spending held up for a time after the oil shock, but started to decline in early autumn. The production cuts reduced real incomes still further and added to the cumulating forces of contraction, which included a continued shift toward greater caution by lenders. The economy thus fell into recession in the latter part of 1990, and, given the further declines in employment and production that were seen in January, that recession clearly has continued into the early part of 1991.

The secondary wage-price pressures that many had expected to see after the oil shock have not been much in evidence, probably because those pressures have been countered by the softening of aggregate demand. The underlying rate of increase in prices began to drop back over the last few months of 1990. In addition, the rate of increase in nominal wages and benefits, which already had started to slow in the third quarter, decelerated further in the fourth quarter. These wage and price developments, coupled with the drop in oil prices since mid-autumn, have given the Federal Reserve greater latitude in recent months to focus on steps that will aid in bringing about economic recovery, without jeopardizing continued progress toward price stability.

In fact, as it became clear that the inflationary spillover of the oil shock was being effectively contained, and that an appreciable economic contraction posed the greater risk, the Federal Reserve did ease policy markedly. Earlier in the second half, policy already had moved to a slightly more accommodative stance, first in July, to offset the effects on the economy of apparent restraint in private credit supplies, and again in October, when prospective reductions in federal budget deficits enabled interest rates to decline. Over the balance of the year and into 1991, money market rates were reduced substantially further through open market operations and two half-point decreases in the discount rate. In total, most short-term rates have fallen nearly 2 percentage points since mid-1990, with most of the decrease occurring during the last few months, and long-term rates are about a half percentage point lower than they were at midyear. Falling interest rates have contributed to an appreciable decline in the dollar since mid-1990.

The behavior of the monetary aggregates and credit was an important consideration in the Federal Reserve's decisions to ease policy over recent months. M2 and M3 ended 1990 within the ranges set by the Federal Open Market Committee (FOMC), but they were in the lower parts of those ranges, and their expansion over the fourth quarter and into early 1991 has been quite sluggish. The sluggishness of the aggregates during this period was worrisome because it suggested that the economy was weaker than anticipated and because it indicated the possibility of some undesirable restraint on future spending through constricted credit intermediation by depository institutions. In particular, the thrift industry has been contracting, and banks, concerned about the credit quality of borrowers and facing pressures on capital positions, have become increasingly reluctant to lend, raising interest margins and tightening nonprice terms. To bolster lending incentives, the Federal Reserve in December eliminated the reserve requirements on nonpersonal time deposits and net Eurocurrency liabilities.

To a significant extent, however, overall credit flows have been sustained by sources outside depositories; thus, debt of the domestic nonfinancial sectors grew 7 percent in 1990 and ended in the middle of the FOMC's monitoring range for this aggregate. The effective substitution of non-depository credit for depository credit made it possible to achieve a greater amount of nominal income and expenditure growth for a given expansion of the money stock. One facet of this process was a shifting by the public out of assets that are

Ranges for Growth of Monetary and Credit Aggregates

	1989	1990	1991
<i>Percentage change, fourth quarter to fourth quarter</i>			
M2	3 to 7	3 to 7	2½ to 6½
M3	3½ to 7½	1 to 5	1 to 5
Debt	6½ to 10½	5 to 9	4½ to 8½

included in the monetary aggregates and into holdings of Treasury issues and other securities. Velocity, the ratio of nominal GNP to the money stock, exhibited surprising strength: M2 velocity was about unchanged in 1990, even though declines in interest rates ordinarily are associated with falling velocity, and M3 velocity registered an unusually large increase.

Monetary Policy for 1991

In considering its plans for monetary policy for 1991, the Federal Open Market Committee focused on two objectives, consistent with the goals of the Full Employment and Balanced Growth Act: One was to foster an upturn in activity and thus higher levels of employment and real income; the other was to contain and reduce inflation over time, to maximize the efficiency of resource allocation and long-range growth and to minimize the capricious and inequitable effects of inflation on the wealth of savers. The translation of these objectives into specific ranges for money and debt was complicated by the effects of the ongoing restructuring of credit flows. Again this year, a number of insolvent thrift institutions are likely to be closed, with many of their assets ending up at the Resolution Trust Corporation (RTC) or disbursed to a wide variety of investors; at other thrifts and at banks, restraints on lending may moderate a bit, but growth in depository credit is likely to continue to be constrained by pressures on capital positions. The rechanneling of credit outside of depository institutions is expected to continue to distort the relationship of money to income, buoying the velocities of both M2 and M3.

Taking account of these effects, the Committee decided that the ranges for 1991 that were chosen on a provisional basis last July remain appropriate for achieving its objectives. The ranges for M2 and debt are a half percentage point below those for 1990—a

further step to ensuring that longer-run trends in money and credit growth are moving toward consistency with the achievement of price stability. At the same time, they allow for money and credit growth sufficient to support a rebound in the economy this year; moreover, the ranges should provide ample room for any policy adjustment that may be required by unanticipated developments in the economy or the financial sector as the year progresses.

The M2 range for 1991 is 2½ to 6½ percent. Growth in this aggregate is expected to strengthen from the sluggish pace of recent months, partly in lagged response to the substantial easing of money market conditions over the past few months. While acknowledging some uncertainty about developing velocity relationships, Committee members stressed that M2 expansion noticeably above the lower end of the range likely would be needed to foster a satisfactory performance of the economy in 1991.

The 1 to 5 percent range for M3 was not reduced from that for 1990. That range was already at an unusually low level in recognition of the accelerated pace of the restructuring of the thrift industry. Credit growth in 1991 is expected to be moderate and to occur largely outside of depositories. Consequently, total funding needs of depositories are expected to be damped, keeping the growth of M3 quite low and raising its velocity further.

The monitoring range for nonfinancial sector debt for 1991 was set at 4½ to 8½ percent. Federal borrowing is expected to be robust, owing in part to the RTC, and also to the effect of the weak economy on the federal budget deficit. By contrast, borrowing by domestic nonfederal sectors is likely to be slow, though still consistent with a rebound in the economy. On the demand side of the credit market, households and businesses appear to be returning to sounder financial

Economic Projections for 1991

Measure	Memo: 1990 Actual	FOMC Members and Other FRB Presidents		Administration
		Range	Central Tendency	
<i>Percentage change, fourth quarter to fourth quarter¹</i>				
Nominal GNP	4.3	3½ to 5½	3¾ to 5¼	5.3
Real GNP	.3	- ½ to 1½	¾ to 1½	.9
Consumer price index ²	6.3	3 to 4½	3¼ to 4	4.3
<i>Average level in the fourth quarter, percent³</i>				
Unemployment rate	5.9	6¼ to 7½	6½ to 7	6.6

1. Average for the fourth quarter of the preceding year to the average for the fourth quarter of the year indicated.
2. Actual and FOMC forecasts are for all urban consumers; Administration forecast is for urban wage earners and clerical workers.
3. Percentage of the labor force. Actual and FOMC forecasts are for the civilian labor force; Administration forecast is for the total labor force, including armed forces residing in the United States.

practices, seeking a healthier balance between debt and the income available to service it. At the same time, restraints on the supply of credit also may continue to play a role, with some private borrowers facing higher interest rates and tighter nonprice terms on credit, in part because of the stresses faced by many intermediaries. In that regard, the Federal Reserve is working with other federal regulatory agencies to ensure that bank supervisory practices, while prudent and fair, do not unduly impede the flow of funds to creditworthy borrowers.

Economic Projections for 1991

The economic outlook is unusually difficult to assess at this time, owing not only to the obvious uncertainties associated with the war in the Gulf, but also to some unresolved problems in the economy. However, the members of the Board of Governors and the presidents of the Reserve Banks, all of whom participate in the discussions of the FOMC, believe that the most likely outcome is that the economy will swing back into expansion later this year. At the same time, they also anticipate that inflation will be much lower in 1991 than it was in 1990.

With regard to real gross national product, the central tendency of the FOMC participants' forecasts is for a gain over the four quarters of 1991 of ¾ to 1½ percent. This is in line with the projection of the Administration, which anticipates an output gain of

0.9 percent. With these GNP forecasts so similar, the forecasts of unemployment also are about the same: the Committee's central tendency projections fall in a range of 6½ to 7 percent in the fourth quarter of 1991, a range that brackets the Administration forecast. On the other hand, the Board members and Bank presidents are more optimistic on average than is the Administration with regard to the prospects for reduced inflation. The central tendency range for the CPI increase this year—3¼ to 4 percent—compares with an Administration projection of 4.3 percent. The Administration's forecast for nominal GNP is at the upper end of the FOMC central tendency range, and thus also would be compatible with the FOMC's monetary ranges.

In discussing their projections, the Board members and Bank presidents stressed that the war introduces a major imponderable into an outlook that, even before, had been subject to considerable uncertainty. The demands of the war on the economy are not fully clear at this point. Nor is it possible to forecast with any precision how household and business confidence will respond to the course of events in the Gulf. Among the significant unresolved economic and financial problems elsewhere in the economy are those in the real estate markets; commercial construction, in particular, still is plagued by a large overhang of vacant space that will severely limit new construction for some time to come. On the financial side, the overexuberance and

loose lending practices of the 1980s have given way to large losses and extreme caution among some lenders, who may not be able or willing at present to shift quickly back toward more normal lending behavior. Because of these problems, the Board members and Bank presidents perceive that, in the near term, the risks to the economy may be skewed to the downside.

On the other hand, some of the potential underpinnings of recovery also are evident. For example, with the further decline in oil prices since the start of 1991, much of the surge that followed the Iraqi invasion of Kuwait now has been retraced; in a reversal of the effects seen earlier, this drop in oil prices is taking pressure off inflation, and it also is augmenting real purchasing power, which will help to bolster spending. Also working in the direction of supporting spending is the decline in interest rates since the spring of 1989. In contrast to past business cycles, when declines in rates usually did not come until the economy was softening, this decline began far in advance of the peak in activity and its effects on spending should begin to be felt, especially in sectors like housing, where affordability has been considerably enhanced over the last year and a half. Meanwhile, the prospects for exports, and for our overall trade and current account balances, continue to look favorable, given the improved competitiveness of

U.S. producers. And, any pickup in final demand, whether from domestic buyers or from abroad, should translate fairly quickly into increased production, in view of the success that businesses seem to have had in preventing a buildup of inventories in recent months.

As noted above, the Board members and Reserve Bank presidents project a marked slowing of inflation in 1991. A key assumption underlying these forecasts is that oil prices will hold in their recent range, at a much lower level than prevailed through the autumn of 1990. The pass-through of these lower oil prices to consumers is expected to result in a sharp decline in retail energy prices. In addition, increases in wages and benefits seem likely to be more moderate this year, reducing the pressures of labor costs on profit margins and prices. To be sure, there are some near-term negatives in the inflation picture: labor expenses are being boosted by legislated increases in employers' contributions for social security and by a further rise in the minimum wage, and prices are being affected by a rise in postal rates and increases in various excise taxes. All told, however, the coming year appears likely to be one in which overall price increases will be considerably smaller than in 1990 and in which the downward tilt of the underlying inflation trend should begin to stand out more clearly.

Section 2: The Performance of the Economy in 1990

When 1990 began, the economy was in its eighth year of expansion, and it remained on a positive course into the summer. During this period, problems were evident in some sectors of the economy, notably construction, where activity was being damped by the persistence of high vacancy rates, and finance, where a significant number of institutions were encountering difficulties that reduced their ability or willingness to provide credit. Overall, however, production and spending still were on a course of expansion at mid-year, and while the rate of price increase had not yet started to abate, there were indications that the groundwork for achievement of slower inflation was coming into place without major disruption to the economy.

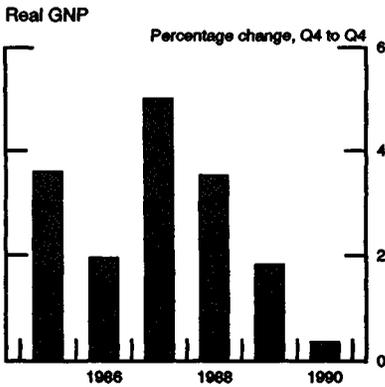
Then, in early August, the Iraqi invasion of Kuwait set off a chain of events that gave further impetus to inflation and tilted the economy from a path of slow growth to one of contraction. Declines in output and employment were widespread during the remainder of 1990. Real gross national product fell at an annual rate of about 2 percent in the fourth quarter, and the gain over the four quarters of the year amounted to only 0.3 percent. The civilian unemployment rate, which had held around 5 1/4 percent through the first half of the year, moved up steadily in the second half, to 6.1 percent in December. In January of this year, the rate edged up further, to 6.2 percent. The consumer price index rose 6.1 percent from December of 1989 to December of 1990, the largest annual increase in nearly a decade.

A key link in the chain of events after mid-year was a surge in the price of crude oil, from around \$20 per barrel in the spot markets in late July to more than \$40 per barrel in early October. That surge sent the prices of energy products soaring, sapped household purchasing power, and put further pressures on business profits, compounding the squeeze brought on by rising costs and sluggish sales. Another, less tangible link was the enormous uncertainty about how, and when, tensions in the Mideast might be resolved. Symptomatic of that uncertainty, the various indicators of household and business sentiment remained low toward the end of 1990, even as oil prices dropped back part of the way from their October peaks.

While surging energy prices accounted for much of the acceleration in inflation in 1990, they were by no means the only source of upward price pressure. The year-to-year rate of increase in the CPI excluding food and energy—a rough indicator of basic inflation trends—maintained a gradual upward tilt through the first three quarters of 1990, peaking at a rate of 5.5 percent in August and September; a slight easing of price pressures over the balance of 1990 brought that rate back down to 5.2 percent by year-end. The year-to-year rate of increase in nominal labor compensation, as measured by the employment cost index, also moved up in the first half of 1990; after mid-year, however, wage pressures moderated, and the rise in nominal compensation over the year ended up at 4.6 percent, slightly less than the increases recorded in each of the two previous years.

Support for growth of real activity continued to come from the external sector in 1990, as real exports of goods and services rose 5 percent over the four quarters of the year; this gain, however, was considerably smaller than the increases seen in each of the four previous years. Gross domestic purchases, the broadest indicator of domestic demand, fell about 1/4 percentage point, on net, over the four quarters of 1990; within this category an increase in government purchases was more than offset by weakness in consumption, homebuilding, and business fixed investment and a swing in inventories from moderate accumulation late in 1989 to decumulation in the fourth quarter of 1990.

As was true during much of the long expansion of the 1980s, economic trends in 1990 varied appreciably across different regions of the country. The New England economy, which had been very strong through much of the 1980s, slumped in 1990; by year-end, unemployment rates in that region had moved well above the national average. By contrast, the economies



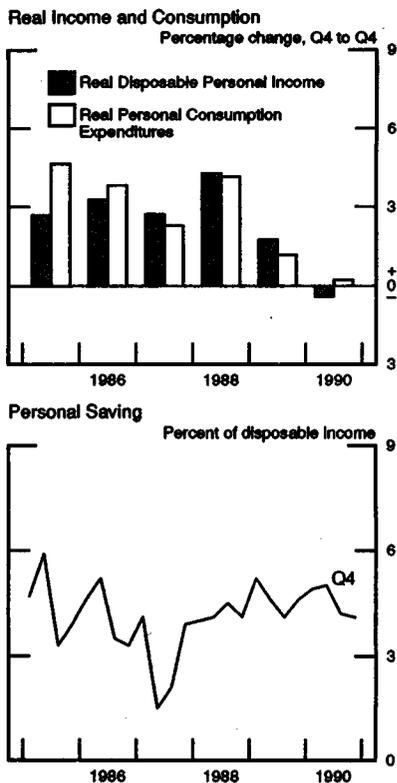
of many locales with heavy concentrations of manufacturing—especially capital goods manufacturing—held up fairly well until the oil shock; activity in those areas was supported by the continued growth of exports. The farm economy was relatively strong again in 1990, although some indications of softening did show up in the second half. Energy producers benefitted from the climb in oil prices; exploration and drilling activity was restrained, however, by the great uncertainty regarding the future course of oil prices.

The Household Sector

In mid-summer, consumer spending still was on an uptrend, and it edged up a little further after the oil shock, peaking in September. But with real incomes being dragged down by slumping employment and soaring energy prices, the rise in spending eventually ran out of steam. Real outlays fell at an annual rate of 3 percent in the fourth quarter; the quarterly drop likely would have been greater but for tax changes that caused some households to make purchases in advance of the turn of the year.

The declines in real income and spending in the latter part of the year essentially reversed the moderate gains made earlier. Over the year, after-tax income was down about ½ percent in real terms; real consumption spending was up over the four quarters of 1990, but only fractionally. The personal saving rate rose over the first half of the year, but then dropped about 1 percentage point in the last two quarters. This drop in the saving rate after mid-year was a little surprising from one perspective, in that an unprecedented plunge in consumer attitudes between July and October might have been expected to generate some increase in precautionary saving. Moreover, many households had suffered losses of wealth because of decreases in house prices or in the value of securities they held; these developments would seem to have called for a shift toward reduced consumption out of current income. But, while such forces may well have been at work, they apparently were outweighed by a tendency of households to dip into savings in the short run when faced with a sudden surge in expenses for energy.

Patterns of change in the various categories of consumer spending were mixed in 1990. Real outlays for services continued to trend up over the year, but at a slower pace than during most years of the expansion; on a quarterly basis, growth in these outlays was quite erratic, owing largely to weather-related volatility in gas and electric bills. Real outlays for nondurables fell 2¼ percent over the course of the year, an unusually



large decline by historical standards. The drop presumably was brought on in large part by the downturn in real income over the four quarters of 1990, the first such decline since 1974.

The real outlays for consumer durables fell ¾ percent over the four quarters of 1990; they had fallen about 1½ percent in 1989. The drop in 1990 was accounted for by a second year of decline in the purchases of motor vehicles. Outlays for the other durables—furniture, household equipment, and the like—were up about ½ percent on net over the four quarters of 1990, after having grown at a moderate pace in 1989. These patterns of change in spending seemed to reflect both macroeconomic forces, notably the slower pace of real income growth after the start of 1989, and the normal workings of household

investment cycles. With regard to the latter, household spending for cars, trucks, and other consumer durables over the 1983-88 period were almost 50 percent above the average for the six best years of the 1970s. By 1989 many households may have reached a point where they were in effect "stocked up" and therefore well-positioned to delay making new purchases if the timing currently did not seem right.

Spending for residential construction got a transitory boost from good weather in the first quarter of 1990, but then fell sharply in each of the three subsequent quarters. Over the year as a whole, residential investment outlays declined 8½ percent in real terms; they had dropped 7 percent in 1989.

This slump in homebuilding reflected a variety of influences, most of which appeared to enter on the demand side of the equation. The downshifting of real income growth after the start of 1989 may have led households to view their longer-run prospects in a more cautious light and to hold back from housing investments that they might otherwise have undertaken. In addition, the unwinding in some regions of the country of real estate booms seen in the 1980s tarnished the attractiveness of housing as a longer-term investment. These negative developments came at a time when housing demand already was being restrained by a much slower rate of growth of the adult population than was seen in the 1970s and early 1980s.

Builders cut back sharply on new construction in 1990. The annual starts of single-family units fell 11 percent from their 1989 level, and starts of multifamily units declined about 20 percent, from an already low level. However, these reductions in starts still

were not large enough to balance the market. The supply of unsold new homes, measured relative to the pace of sales, jumped sharply in the first part of 1990 and then remained high over the rest of the year; the vacancy rate on multifamily rental units dipped temporarily in the spring, but later bounced back up to the high levels seen over most of the period after 1986.

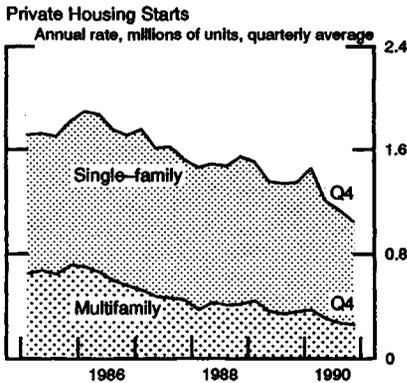
In some instances, new construction activity was deterred in 1990 by the difficulty that prospective builders had in obtaining credit. Failures of thrift institutions severed established credit relationships for some builders, and the thrifts that survived moved toward more conservative lending policies, either out of choice or in response to the more stringent capital requirements and lending limits mandated by the Financial Institutions Reform, Recovery, and Enforcement Act. Banks also were cautious about extending credit to builders; with large volumes of problem loans already on their books, banks were very sensitive to the poor conditions in many local housing markets.

In contrast to builders, potential homebuyers did not seem to have serious problems in obtaining financing in 1990; mortgage credit remained readily available, and the spreads between mortgage rates and the rates on other long-term loans actually narrowed. For the most part, consumer credit also appeared to be readily available, as lenders exhibited only a mild tendency to tighten standards on this generally profitable line of business.

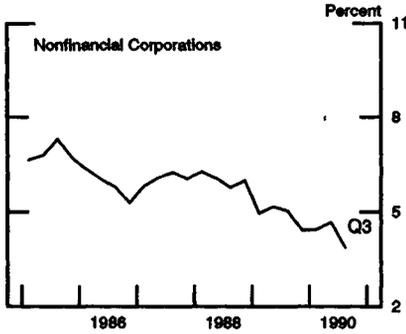
The Business Sector

The business sector began 1990 on a rather shaky note. Profits had declined during 1989, and overhangs of business inventories had developed in the second half of that year in some markets, notably autos. In manufacturing, production growth had been restrained late in 1989, and output dropped sharply in January of 1990, led by a steep cutback in auto assemblies. But conditions improved over the next few months. Industrial production rose fairly briskly, in fact, from January into mid-summer, and the drop in business profits was halted for a time.

From August on, the business climate was dominated by the oil shock and its attendant uncertainties. After peaking in September, industrial production plummeted over the last three months of 1990, and it closed out the year about 1½ percent below the level of a year earlier. The operating rate in industry also fell sharply over the latter part of the year, back to where it had been in early 1987, before capacity pressures

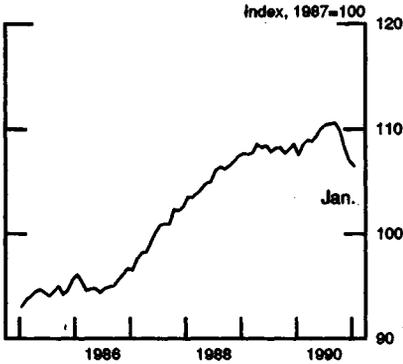


After-Tax Profit Share of Gross Domestic Product *



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

Industrial Production



started developing in that year. With volume declining and costs on the rise, corporate profits undoubtedly went into renewed decline in the fourth quarter (the official data are not yet available); for 1990 as a whole, the share of profits in total GNP was the lowest of any year since 1982.

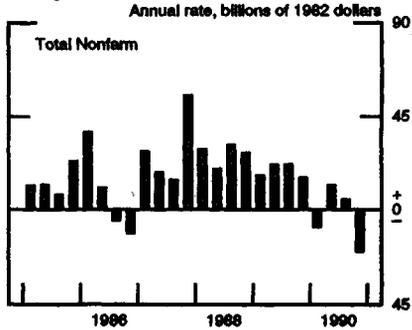
Serious overhangs of business inventories were not apparent when the oil shock hit in August, and prompt production adjustments that followed the shock forestalled stockbuilding in the ensuing months. Indeed, real manufacturing and trade inventories fell slightly on net between the end of July and the end of November. Under the circumstances, however, these reductions clearly were not great enough to get actual stocks down to desired levels. In wholesale and retail trade,

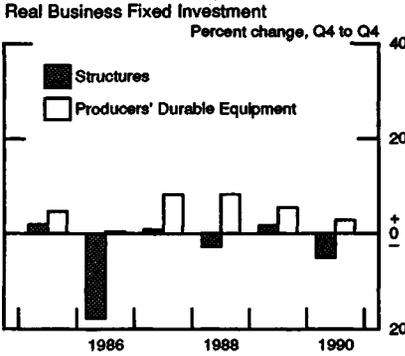
sales declined sharply from July to November, and the constant-dollar ratios of inventories to sales in these sectors moved up to levels that were around the upper end of the ranges seen over the past two or three years. The inventory-sales ratio in manufacturing also edged up on net between July and November, and manufacturers continued to cut output through the end of 1990 and into early 1991. Over 1990 as a whole, the level of real business inventories declined about \$3 billion, according to preliminary estimates. The rapid reductions of nonfarm inventories that were seen in the fourth quarter of 1990 accounted for all of that quarter's drop in real GNP.

After registering relatively strong gains in each year from 1987 to 1989, business outlays for fixed investment rose only 1 percent in real terms over the four quarters of 1990. Spending was affected by the squeeze on profits, the easing of pressures on capacity, and the heightened uncertainties regarding the business outlook. These influences showed through most clearly in the outlays for equipment. Real spending for computers and other information processing equipment rose 3 percent on net over the four quarters of 1990; growth had averaged 15 percent per year over the first seven years of the expansion. In addition, outlays for industrial equipment turned down in 1990, as the deterioration of profits and the falloff in operating rates took their toll. Business purchases of motor vehicles bounced around from quarter to quarter, but held in essentially the same range that they have been in for the past several years. By contrast, business outlays for aircraft, which have been very strong in recent years, rose further in 1990.

Nonresidential construction declined 5 percent over the four quarters of 1990. Weakness was concentrated mainly in the outlays for offices and other commer-

Changes in Real Business Inventories





cial structures (which together account for about one-third of the total). An excess supply of these structures developed in many cities during the building boom of the mid-1980s, and despite sharp cutbacks in construction after 1985, vacancy rates remained high through 1990. Reflecting this continued imbalance—and the reluctance of creditors to finance new projects in this troubled sector of the economy—the indicators of future activity, such as the data on new contracts and building permits, continued to have a decidedly negative cast through the second half of 1990. Spending for industrial structures rose over the first three quarters of 1990, but fell sharply in the fourth quarter, and the indicators of future construction continued to weaken. As noted previously, investment in oil drilling remained subdued in the second half of 1990, despite the rise in oil prices; in some instances, drillers may have been hampered by shortages of experienced crews, but, more important, the uncertainty whether prices would remain high enough to justify stepped-up investment prompted a cautious response.

The Government Sector

In the government sector, budgetary pressures intensified in 1990. At the federal level, the rate of growth of receipts slowed to 4.1 percent in fiscal year 1990, less than half the rate of increase in the previous fiscal year and more than a percentage point below the rate of growth in nominal GNP. Meanwhile, spending jumped 9.4 percent in fiscal 1990, and the federal budget deficit increased to \$220 billion, up \$67 billion from the 1989 fiscal year and well above the target for 1990 that had been laid out in the Gramm-Rudman-Hollings legislation. Finding a way to get back on track toward deficit reduction occupied Congress and the Administration through much of 1990; an agreement that was reached

in October prescribed new targets and new procedures for the five-year period starting in the 1991 fiscal year.

Part of the slowing of receipts in the 1990 fiscal year stemmed from the weakness in corporate profits; collections from that source fell almost \$10 billion. In addition, the growth of tax receipts drawn from the incomes of individuals slowed appreciably, from 11 percent in 1989 to a bit less than 5 percent in 1990; this slowdown mainly reflected the absence in 1990 of transitory factors that had led to the big jump in these receipts in 1989. On the expenditure side of the ledger, about one-third of the \$108 billion increase in nominal federal outlays in fiscal 1990 was attributable to federal deposit insurance programs; the main portion of these outlays went to honor obligations to holders of deposits in failed thrift institutions. Spending also moved up rapidly in 1990 for entitlements. The outlays for medicare rose 15 percent, pushed up by continued rapid inflation in health costs and an expansion in the number of beneficiaries. Outlays for social security and other income security programs, which together account for close to one-third of total federal spending, rose about 7½ percent in fiscal 1990, a pickup from the pace of recent years. Net interest outlays, which now account for almost 15 percent of total spending, also continued to climb rapidly.

Federal purchases of goods and services, the portion of federal spending that is included directly in GNP, increased 5.5 percent in real terms over the four quarters of 1990. Excluding changes in the inventories owned or financed by the Commodity Credit Corporation, which tend to be very volatile, federal purchases of goods and services increased 4.4 percent, on net, over the year; nondefense purchases were up 3.6 percent and defense purchases, which had registered moderate declines in each of the three previous years, increased 4.7 percent in 1990. The rise in defense purchases came mainly in the fourth quarter of the year and apparently reflected, in part, outlays associated with Operation Desert Shield.

The deficit in the combined operating and capital accounts of state and local governments (excluding social insurance funds) averaged \$30 billion at an annual rate over the first three quarters of 1990, and it appears to have widened considerably further in the fourth quarter as the recession cut into tax receipts. State and local budgets first moved into deficit in late 1986, and they have slipped further into the red in each succeeding year. At the same time, concerns have intensified about the repayment abilities of some state and local governing units; as evidence of this, the downgradings of state and local credit ratings outnumbered upgradings by a wide margin in 1990.

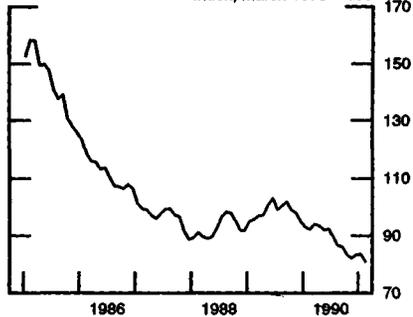
In an effort to strengthen their finances, many state and local governments have raised taxes in recent years. Reflecting those increases, total state and local receipts moved up faster than nominal GNP both in 1989 and through the first three quarters of 1990. In addition, spending has been scaled back from planned levels in many cases. Overall, however, the efforts to control spending have collided with the growing demands for services that state and local government traditionally have provided for such things as education, public protection, and health and income support. Thus, while the growth of state and local outlays has slowed from the rate of rise seen earlier in the expansion, it nonetheless has been running above that of total GNP. The nominal rise in state and local purchases of goods and services over the four quarters of 1990 was 7.9 percent; in real terms, purchases grew 2.5 percent over the year.

The External Sector

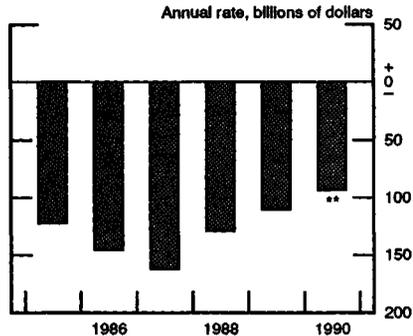
The merchandise trade deficit narrowed from \$115 billion in 1989 to a bit less than \$110 billion in 1990, a degree of improvement that was smaller than seen in either of the two preceding years. A surge in the price of oil imports in the second half of the year led to a jump in the value of imports. In addition, trade flows during the year were influenced to some extent by lagged effects of the firming of dollar exchange rates that had taken place in the first half of 1989. The current account balance averaged \$93 billion, at an annual rate, during the first three quarters of 1990, down from a total of \$110 billion in 1989; the improvement in this account was greater than that in the trade account owing to a strengthening of net receipts from service transactions, those involving such things as travel, education, and finance.

Measured in terms of the other Group of Ten (G-10) currencies, the foreign exchange value of the U.S. dollar depreciated about 12 percent from December 1989 to December 1990. This depreciation extended a decline that began in mid-1989 and more than reversed the earlier appreciation. Adjusted for movements in relative consumer price levels, the dollar's decline in 1990 was slightly less than it was in nominal terms, as inflation in the United States exceeded somewhat the weighted average of inflation rates in the other G-10 countries. In real terms, the weighted-average dollar in December 1990 was at about its low of 1980; the huge appreciation in average exchange rates in the first half of the 1980s thus has been reversed.

Foreign Exchange Value of the U.S. Dollar*
Index, March 1973 = 100

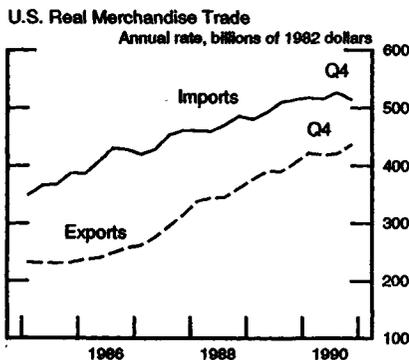


U.S. Current Account



* Index of weighted average foreign exchange value of U.S. dollar in terms of currencies of the other G-10 countries. Weights are 1972-76 global trade of each of the 10 countries.
** Average of first three quarters of 1990, at an annual rate.

The decline in the dollar in 1990 was broadly based against the Japanese yen, the German mark, and other European currencies. The dollar also declined about 10 percent against the Singapore dollar, but it appreciated about 5 percent against the currencies of South Korea and Taiwan, partially reversing declines of the preceding few years. The weakness in the dollar against the G-10 currencies over the past year reflected primarily the influence of different trends in interest rates in the United States and other major industrial countries. Whereas U.S. short-term interest rates trended down through the year and long-term rates were about unchanged over the year as a whole, foreign short-term rates rose by an average of about ½ percentage point, and foreign long-term rates rose by an average of about 1 point. Official intervention in foreign exchange markets was small in 1990.



U.S. merchandise exports grew 7½ percent in real terms over the four quarters of 1990, after rising about 12 percent in 1989. Merchandise exports grew rapidly in the first quarter, boosted in part by a strong recovery of exports of aircraft after the Boeing strike of late 1989 ended. Over the next two quarters, real exports changed little on net. Growth of activity in the major U.S. export markets slowed noticeably in the middle of the year; outright recessions developed in Canada and the United Kingdom. In the fourth quarter, export growth picked up again, probably largely in response to the gains in U.S. price competitiveness that took place during the year. Export prices rose moderately during the year.

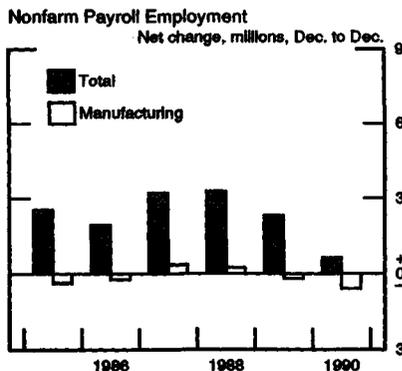
Merchandise imports excluding oil grew only 2 percent in real terms during 1990, less than half the pace recorded in 1989. The deceleration in imports reflected the net decline in total domestic demand in the United States during the year. The quantity of oil imports fluctuated during the year, but was up only slightly for the year as a whole. At an average rate of about 8.3 million barrels per day, oil imports accounted for roughly half of total domestic consumption of oil in 1990. The price of imported oil surged to an average level of nearly \$30 per barrel in the fourth quarter, after having fluctuated in a range of \$15 to \$20 per barrel for nearly two years.

The current account deficit of \$93 billion at an annual rate over the first three quarters of 1990 was matched by a recorded net capital inflow of \$26 billion and a large positive statistical discrepancy in the international accounts. Part of the statistical discrepancy may have reflected increased holdings of U.S. currency by foreigners responding to the unsettled political conditions in many parts of the world.

The recorded net inflow of capital was more than accounted for in net transactions reported by banks, which were mainly for the banks' own accounts. Transactions in securities showed a net outflow, as foreigners reduced their rate of net purchases of U.S. corporate and Treasury bonds and actually made net sales of U.S. corporate stocks, while the rate of U.S. net purchases of foreign securities increased. The recorded inflow of direct investment from abroad dropped sharply from the rates recorded in 1988 and 1989; foreign acquisitions in the United States remained strong, but a much greater portion were being financed here rather than abroad. The flow of U.S. direct investment abroad picked up, in part reflecting strong U.S. acquisitions abroad. Foreign official assets in the United States increased \$11 billion over the first three quarters of 1990, and U.S. official holdings of assets abroad declined slightly.

Labor Markets

Payroll employment increased in each month in the first half of 1990 and fell in each month of the second half. The declines of July and August, however, reflected layoffs of federal workers who had been hired temporarily to conduct the 1990 Census. In the private nonfarm sector, employment continued to edge up into August and did not turn down decisively until October. More than half a million jobs were lost over the final three months of the year. Over the year as a whole (December to December), the number of jobs in the private nonfarm sector increased about 250,000 on net, but much of that small gain was wiped out by the further drop in employment in January of this year.

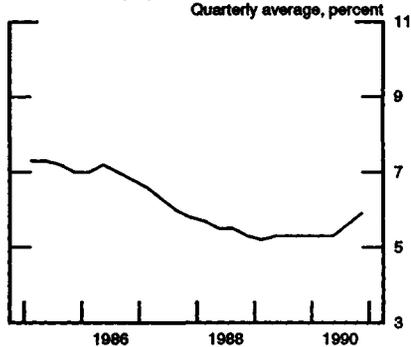


Sectoral patterns of employment change varied considerably in 1990. Employment in manufacturing fell about 585,000 from December of 1989 to December of 1990; losses of factory jobs proceeded at a slow and fairly steady pace through the first half, but then accelerated after the onset of the oil shock. The troubled construction sector shed roughly a quarter-million jobs over the course of the year; after a weather-related jump early in the year, the declines went on almost without interruption through December. Employment in retail and wholesale trade was down slightly on net over the course of 1990, as small gains through the first seven months of the year were more than offset by sharp declines in the fourth quarter. The number of jobs in the services industries increased in each month of 1990, but the rate of gain slowed progressively over the year; health services was the only major area in which hiring was going on with much vigor at year-end.

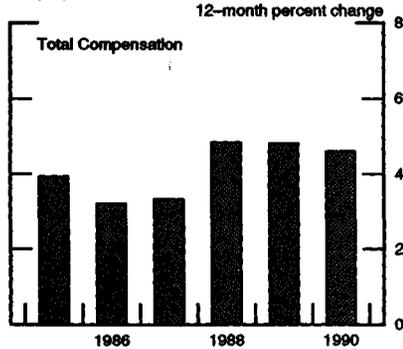
Growth in the supply of labor was quite subdued in 1990. The civilian labor force increased only 0.5 percent on a December-to-December basis, the smallest annual gain in almost thirty years. Part of the explanation for this slow labor force growth is that the working-age population has not been growing very rapidly in recent years. In addition, the share of the working-age population that chose to participate in the work force declined in 1990, by enough to cut labor force growth to about half of what it would have been had the participation rate remained unchanged. The sluggishness of the labor markets in 1990 no doubt discouraged some potential entrants from seeking jobs, as typically happens during cyclical slowdowns in the economy. Still, the drop in participation in 1990 left some questions regarding the future trend in the growth of labor supply. A down-shifting in the growth of labor supply, to the extent that it is not due solely to cyclical factors, would tend to translate one-for-one into slower growth of potential output over time unless there were at the same time an offsetting pickup in labor productivity, of which there has been little, if any, evidence of late.

The flatness of the unemployment rate through the first half of 1990 brought to seven quarters the length of time during which the rate had held tightly around the 5½ percent mark and extended to nearly 3 years the length of time during which the rate had been below 6 percent. Not since the first half of the 1970s had the unemployment rate been at such low levels for so long. This period of low unemployment, unfortunately, also was a period of sharply increased wage inflation. After rising about 3¼ percent in both 1986 and 1987, the employment cost index for compensation (which

Civilian Unemployment Rate



Employment Cost Index *



* Employment Cost Index for private industry, excluding farm and household workers.

includes the cost of workers' benefits, as well as wages and salaries) moved up about 4¼ percent in both 1988 and 1989; and in the first half of 1990, the year-to-year rate of increase in this measure of compensation rose still further, to 5¼ percent.

Labor market tightness was not the only factor putting pressure on wages and compensation between the end of 1987 and the middle of 1990. The updrift in inflation caused workers to press for nominal increases in wages and benefits that were big enough to keep real incomes on a reasonably even keel, and with labor in short supply, businesses found it necessary to accede to hefty increases in order to attract and keep workers. The actions of government also added to cost pressures: A further rise in social security taxes in 1990 added 0.2 percent to total compensation, and a boost

in the minimum wage may have added another 0.1 percent.

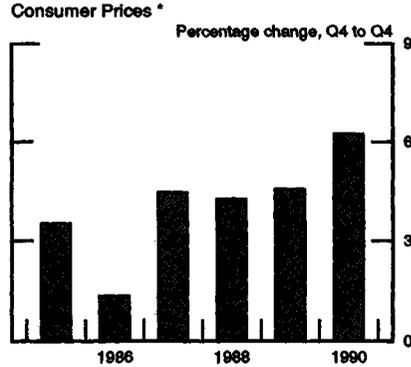
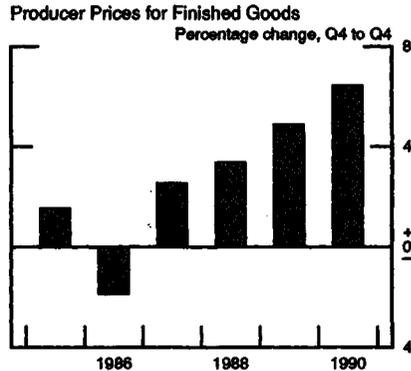
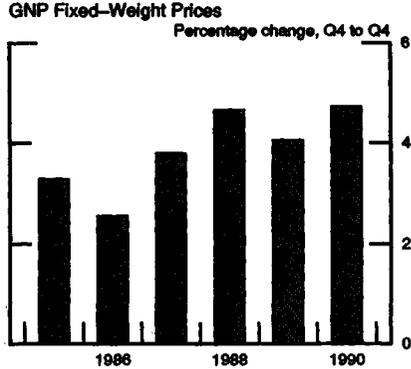
A marked slowing of wage pressures emerged in the second half of 1990, and the year-to-year rate of increase in the employment cost index for compensation dropped back to 4.6 percent by the end of the year. Although workers' real incomes were battered by the surge in energy prices during this period, attempts to regain those income losses appear to have been overwhelmed by the increase in labor market slack and associated concerns about job security. The efforts of management to contain costs in a time of declining profits probably also were a factor helping to limit wage increases during this period.

The performance of productivity was sub-par for a second successive year in 1990. Output per hour in the nonfarm business sector edged down 0.1 percent over the four quarters of the year, after having dropped 1.6 percent in 1989. More than likely, the behavior of productivity over this two-year period mainly reflected typical cyclical influences, namely the tendency of firms to adjust output faster than hours in response to a slowing of demand. Unit labor costs increased about 4½ percent over the four quarters of 1990, the largest annual rise since 1982.

Price Developments

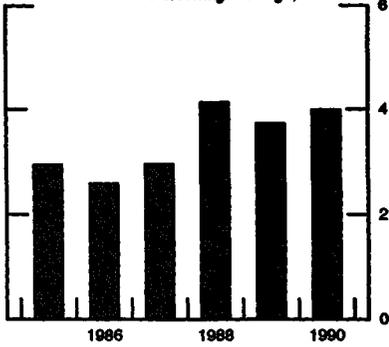
All of the major price indexes—the consumer price index, the producer price index, and the GNP price indexes—rose faster in 1990 than they had in 1989. In general, the increases seen in 1990 also were the largest since those of the early 1980s. In all of the measures, the pickup in the rate of price increase in 1990 basically reflected the effects of the oil shock in a situation in which underlying inflation pressures already were well entrenched. Acceleration was especially pronounced in those indexes, such as the CPI, that measure price change for goods and services purchased by domestic buyers, as the surge in oil import prices had a particularly strong effect on these measures. By contrast, the GNP price measures, which cover goods and services produced domestically, exhibited a less pronounced degree of acceleration this past year.

The CPI for energy rose 18 percent from December of 1989 to December of 1990. Although the bulk of the 1990 rise came after the start of August, intermittent pressures had surfaced earlier in the year. A severe bout of cold weather at the end of 1989 cut into the inventories of heating oil, disrupted operations at several refineries, and caused the prices of fuel oil and gasoline to soar. After January, fuel oil prices fell back,



* Consumer Price Index for all urban consumers.

Implicit Deflator for GNP
Percentage change, Q4 to Q4



but gasoline prices remained relatively firm into the summer as still more supply interruptions prevented a rebuilding of stocks.

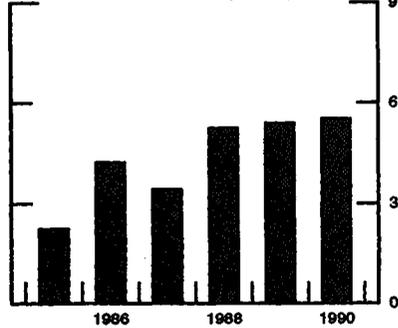
The August invasion of Kuwait set off another round of steep price increases. World oil production dropped temporarily after the invasion, and the uncertainties associated with the tensions in the Persian Gulf set off a scramble for inventories by refiners and others seeking to guard against a possible further disruption in supplies. The price of oil fluctuated widely in this period, but generally maintained an upward trend into early October. By then, however, the losses of oil from Iraq and Kuwait were being fully offset by increased production from other countries, and demand was weakening. As a result, oil prices turned down and held on a

choppy downward pattern through the end of the year, retracing about half of the runup that had occurred between August and early October. A further steep drop came in mid-January of 1991, when initial successes of the coalition forces in the Gulf war seemed to signal a greatly diminished potential for disruption of world supplies.

The CPI for fuel oil also turned down over the last two months of the year, but gasoline prices again held firm, supported this time by a five cent per gallon rise in the federal excise tax that took effect on December 1. Over the year, fuel oil prices increased about 30 percent at the consumer level, and gasoline prices were up almost 37 percent. By contrast, increases over the year in the prices of the service fuels (natural gas and electricity) were quite small—in the range of 1½ to 2 percent; reaction of these prices to the oil shock apparently was damped by ample supplies of natural gas and coal, as well as the customary lags in adjusting rate structures at retail.

Consumer Food Prices *

Percentage change, Q4 to Q4

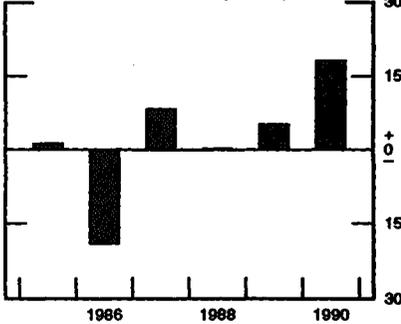


* Consumer Price Index for all urban consumers.

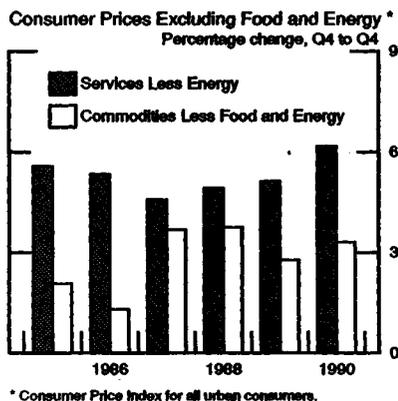
The consumer price index for food rose 5.3 percent in 1990; this increase was about the same as those seen in 1988 and 1989. Over the preceding few years, food price increases had tended to run more in the 3 to 4 percent range. To a considerable degree, the continued sharp increases in food prices in 1990 seemed to reflect underlying inflation processes similar to those at work in other sectors of the economy. In addition, prices were affected by the changing supply conditions in agriculture. Production of beef and pork declined in 1990, and their prices at retail increased 9 percent and 17 percent, respectively, over the course of the year. Dairy production, which had fallen in 1989, turned up

Consumer Energy Prices *

Percentage change, Q4 to Q4



* Consumer Price Index for all urban consumers.



in 1990; but with stocks initially at low levels, the rise in production did not have a damping effect on prices at retail until relatively late in the year. The spell of cold weather late in 1989 led to a surge in the prices of orange juice and fresh vegetables early in 1990; toward the end of 1990, another cold snap destroyed citrus crops in California and boosted citrus prices. By contrast, big wheat crops here and abroad in 1990 caused wheat prices to plunge and led to some rebuilding of stocks; at retail, the CPI for cereals and bakery products slowed from an increase of 7½ percent in 1989 to one of 4½ percent in 1990.

The CPI for nonenergy services (which accounts for more than half of the total CPI) rose 6 percent during 1990, after an increase of 5.3 percent in 1989. The prices of medical services, which have been rising rapidly for many years, were up 9.9 percent in 1990; they had increased 8.6 percent in the previous year. The cost of tuition, another category where pressures have been evident in the CPI for some time, rose more than 8 percent in 1990, about the same as in 1989. Elsewhere in the services sector, prices soared for public transportation and lodging. Airlines, which were hit hard by the surge in energy costs, raised their

fares almost 23 percent over the year. Price increases for other forms of public transportation were in the 6 to 7 percent range, and the CPI for out-of-town lodging advanced nearly 16 percent over the year. Increases in the costs of many publicly provided services—such as water and sewerage maintenance and refuse collection—also were large in 1990; these increases probably reflected the needs of municipalities to raise revenue, as well as environmental imperatives in some instances.

The CPI for commodities excluding food and energy rose 3.4 percent in 1990, after increasing 2.7 percent in 1989. Within this category, tobacco prices again registered a particularly large increase, about 11 percent over the course of the year. This increase partly reflected the pass-through to consumers of a jump in manufacturers' prices; in addition, governments continued to view excise taxes on tobacco products as an attractive way to boost revenues. The CPI for apparel was up 5 percent in 1990; apparel prices had changed little over the course of 1989, and the 1990 rise may therefore have been, in part, an effort to restore margins. New car prices continued to rise, even as sales declined; by contrast, the prices of used cars were down a bit for a second year. The prices of many household appliances fell in 1990, extending the gradual downward trends seen in previous years.

Apart from energy, increases in producer prices were comparatively moderate in 1990. The producer price index for finished goods excluding food and energy rose 3.5 percent over the year, about ¾ percentage point less than in either of the preceding two years. In manufacturing, the pressures from rising wages and soaring energy costs were partly damped by continued rapid gains in productivity and softening demand. The prices of intermediate materials excluding food and energy rose 1.9 percent during 1990, the second year in a row in which increases for that category have been small; materials prices had increased sharply in 1987 and 1988. The spot prices of raw industrial commodities moved up on net in the first half of 1990, held firm through September, and then fell rapidly in the fourth quarter as the economy weakened; further declines in these prices have been evident in the early part of 1991.

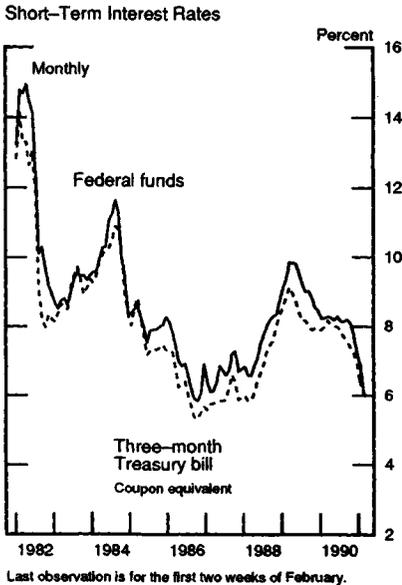
Section 3: Monetary and Financial Developments During 1990

Monetary policy has been progressively eased since mid-1990, resuming the trend begun in 1989. The Federal Reserve has acted against the backdrop of a weakening economy, sluggish money growth, improved inflation prospects, greater fiscal restraint, and indications of tightening credit to private borrowers. In response to the System's actions and to developments in economic activity and prices, short-term interest rates, as of mid-February, were nearly 2 percentage points below those prevailing at the time of the Board's July report to Congress, and long-term rates were down about a half percentage point.

After an initial small cut in money market rates in July, policy was held stable for a brief period, in light of the sharp jump in world oil prices that occurred in the wake of the Iraqi invasion of Kuwait. This shock implied an uncertain combination of increased prices and reduced economic activity. The magnitude of the impact would depend on the extent of the disruption in world oil markets, which could not be forecast with precision. As it became clear in the autumn that the risks of increased inflation were fading relative to the risks of a downturn in economic activity, the Federal

Reserve moved aggressively, using a variety of instruments. Open market operations and a 1 percentage point reduction in the discount rate, taken in two steps, have brought overnight rates down 1½ percentage points since late October; in addition, reserve requirements were reduced in early December to foster easier credit conditions.

In the formulation of policy in 1990, the Federal Reserve continued to examine a variety of information bearing on developments relating to economic activity and prices. Over the year, certain developments in financial markets took on special significance for the economy and monetary policy. The cost and availability of credit was monitored in light of indications that tightening credit supplies were constraining output to a greater degree than was desirable. In addition, considerable attention was paid to money stock movements, especially in the latter part of 1990 and into 1991, when money growth virtually stalled. The Federal Reserve recognized that the relation of the monetary aggregates to broad measures of economic performance remained subject to considerable uncertainty, but the marked sluggishness of money growth was seen as suggesting both weak contemporaneous growth of income and spending and the existence of constraints on the availability of credit through depository institutions that could adversely affect spending in the future.



The Implementation of Monetary Policy

During the first half of 1990, the Federal Reserve took no actions in reserve markets designed to produce changes in money market interest rates. Federal funds—overnight interbank loans of immediately available funds—traded around the 8¼ percent level that had been established in December 1989, and other short-term rates were little changed as well. Throughout this period economic activity continued to grow, the unemployment rate held steady, and there were no clear signs of abatement in inflation.

Yields on longer-term debt instruments rose considerably during the early months of the year, restoring the yield curve's usual upward tilt, which had been absent for much of 1989. This rise in long-term rates reflected a stronger economy than some had expected, increased concerns about inflation, and higher foreign interest rates. As the second quarter progressed, however, bond rates began to recede, responding to a shift in sentiment about the strength of the economy and the likely path of monetary policy.

Around that time, growth of the broader monetary aggregates began to slow appreciably. To a large extent, the weakness in the aggregates was associated with a redirection of credit flows away from depository institutions, related mainly to the ongoing restructuring of the thrift industry but also to an apparent decrease in the willingness or ability of banks to lend. For the most part, the decline in depository credit was expected to be taken up by other lenders, with minimal impact on the overall cost and availability of credit. M3 velocity in particular was expected to be boosted substantially in the process, and the FOMC at its July meeting reduced the annual target range for this aggregate by 1½ percentage points. By mid-July, it was increasingly apparent that the pullback by depositories was constricting credit supplies to some classes of borrowers, and the Committee eased reserve conditions to bring down interest rates slightly in order to offset the effects this tightening of credit conditions on an already soft economy.

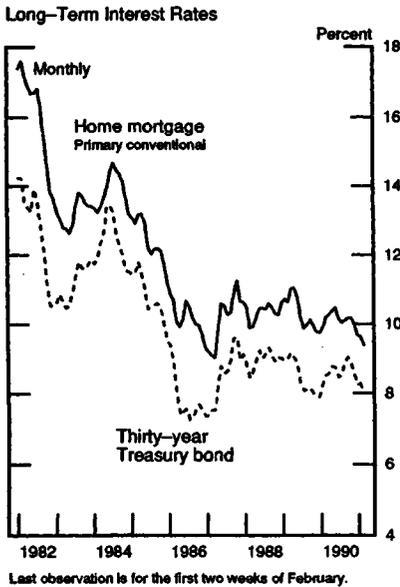
The invasion of Kuwait at the beginning of August fundamentally altered the environment for monetary policy. World oil prices soared, and a considerable measure of uncertainty was added to the outlook for the economy, complicating the formulation of monetary policy. Business and consumer confidence plummeted,

and the adverse effects of high oil prices on the public's spending plans, domestic economic activity, and inflation soon became apparent. As volatility in financial markets increased, heightened investor preference for liquidity and safety was evident: Treasury bill rates fell over August and September while private short-term rates changed little; money market mutual funds experienced large inflows, boosting growth of the monetary aggregates late in the summer as investors apparently fled stock and bond markets; and the ongoing decline in the foreign exchange value of the dollar was halted for a while by safe-haven demands.

In these circumstances, the benefits of any easing action taken to cushion the possible effects on output in the near term needed to be weighed against the potential for embedding higher energy prices in the price level and, more importantly, into inflationary expectations, a reaction that ultimately would undercut sustainable economic growth. Policy decisions were further complicated by the fact that the military and political situation underlying the oil price shock was so fluid; in fact, it clearly was a war-risk premium rather than a current shortage of supply that was maintaining a higher price of crude oil. The possibility existed that any substantial moves in monetary policy might prove ill-advised as circumstances changed, and it appeared that the most constructive role monetary policy might play, until the balance of risks was clarified, would be to foster a sense of stability in the very nervous financial markets.

As it was, financial markets had to contend not only with the Gulf crisis during the late summer and early fall, but also with uncertainties surrounding the timing and extent of a reduction in the federal budget deficit. Yields were buffeted whenever the odds of a meaningful deficit-reduction package appeared to change. For example, Treasury bond rates fell appreciably when an initial budget accord was hammered out and rose when the government was forced to shut down temporarily after the pact failed to win Congressional approval. By the end of October, long-term rates had come down again, and a budget agreement involving a major degree of fiscal restraint over a multi-year horizon was successfully concluded. In light of the budget agreement, which promised greater and more durable fiscal restraint, and with the economy weakening, the Federal Reserve took another step to ease pressures on reserve conditions.

Late in the year, indications accumulated that inflationary pressures, apart from those closely connected to the surge in energy prices, were easing. As the economy softened and wage pressures also



diminished, it seemed more likely that the effects of higher oil prices would not be built into ongoing inflation trends. Market interest rates declined across the maturity spectrum, although these declines were most pronounced for government obligations owing to heightened concerns about credit quality, which drew investors toward high-grade assets.

Financial strains were experienced by more and more lending institutions, as problems emerged in

many real estate portfolios and as a growing number of highly leveraged firms ran into trouble. Efforts by banks and other lenders to protect or improve their capital positions as their loan portfolios deteriorated were reflected in widespread signs of cutbacks in the availability of credit and increases in its cost, especially to less-than-prime borrowers lacking access to securities markets. While much of the tightening of lending standards was welcome from the standpoint

Growth of Money and Debt (Percentage Change)

		M1	M2	M3	Debt of domestic nonfinancial sectors
<i>Fourth quarter to fourth quarter</i>					
	1980	7.4	8.9	9.5	9.4
	1981	5.4 (2.5)*	9.3	12.3	10.1
	1982	8.8	9.1	9.9	9.1
	1983	10.4	12.2	9.8	11.1
	1984	5.4	8.0	10.7	14.2
	1985	12.0	8.7	7.6	13.1
	1986	15.5	9.2	9.0	13.2
	1987	6.3	4.3	5.8	9.7
	1988	4.2	5.2	6.3	9.2
	1989	0.6	4.7	3.6	7.7
	1990	4.2	3.9	1.8	6.9
<i>Quarterly growth rates (annual rates)</i>					
1990	Q1	5.2	6.2	2.9	6.1
	Q2	4.2	3.9	1.3	6.9
	Q3	3.7	3.0	1.6	7.4
	Q4	3.4	2.2	1.3	6.4

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

of safety and soundness, it exerted a contractionary influence on the economy and was reflected in the slow growth in bank credit and the broad monetary aggregates.

Against this backdrop, the Federal Reserve undertook additional actions designed to support the economy and to counter the tightening in credit terms. In mid-November, the FOMC moved to lower money market rates through open market operations, and in early December, the Board eliminated the 3 percent reserve requirement on nonpersonal time deposits and net Eurocurrency liabilities. This action was taken in response to the increased restraint on lending by commercial banks; lower reserve requirements reduce funding costs to depository institutions, encouraging them to expand lending. Ultimately, the lower funding costs are passed through as a combination of lower rates for borrowers and higher rates offered to depositors.

Following the reduction in reserve requirements, further actions were taken in reserve markets to bring down short-term interest rates. These actions included additional steps toward a more accommodative supply of nonborrowed reserves through open market operations and two reductions in the discount rate—of a half point in December and of a like amount in January. All of these moves were made in light of further declines in economic activity, sluggish money and credit growth, and evidence of ebbing inflation pressures. In total, the federal funds rate has fallen about 2 percentage points from its mid-1990 level and about 3½ percentage points from its most recent peak in mid-1989.

Under the impetus of the easing of monetary policy and the softening of the economy, other short-term rates also fell significantly below mid-1990 levels by mid-February. The drop in yields on Treasury bills roughly paralleled that in the federal funds rate. Banks reduced their prime rates in two ½ percentage point steps in early 1991, but, as a consequence of the tightening in credit supplies, prime rates remained higher than usual relative to rates on federal funds and other sources of funds. Rates on commercial paper and CDs also fell less than those on federal funds or Treasury bills, dropping about 1¼ percentage points from mid-1990 levels. This widening of yield spreads was additional evidence of investor concern about private credits, though these spreads generally remained narrow relative to those seen in past economic downturns. However, yields on private money market instruments were under substantial upward pressure in the weeks leading up to year-end when the prospect of publishing financial statements led banks to attempt to hold down credit extension in order to bolster capital

ratios and led lenders generally to intensify their focus on asset quality. Spreads soared at times in this period, but the Federal Reserve injected large amounts of reserves, the year-end passed without major dislocation, and yield spreads narrowed substantially in January.

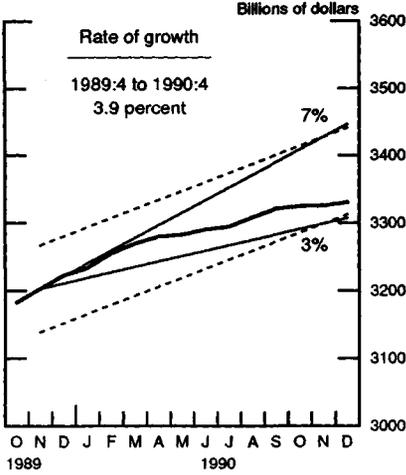
Rates on longer-term securities came down considerably less from their levels in mid-1990 than those on short-term paper. As of mid-February, the yield on the thirty-year Treasury bond had fallen about ½ percentage point since the middle of 1989, and those on private long-term issues were down slightly less. Declines in these yields may have been limited in part by the increased uncertainty and volatility that followed the invasion of Kuwait. Some major stock market indexes had reached record highs in July, but the uncertain outlook both at home and abroad after the invasion of Kuwait and the slump in economic activity pushed stock prices significantly lower in the ensuing months. Since the war broke out in mid-January of this year, however, stock price indexes have moved up sharply, with some indexes reaching new record highs in mid-February. The foreign-exchange value of the dollar declined about 10 percent over the second half of 1990; the dollar turned up early this year, but fell again in February.

Behavior of Money and Credit

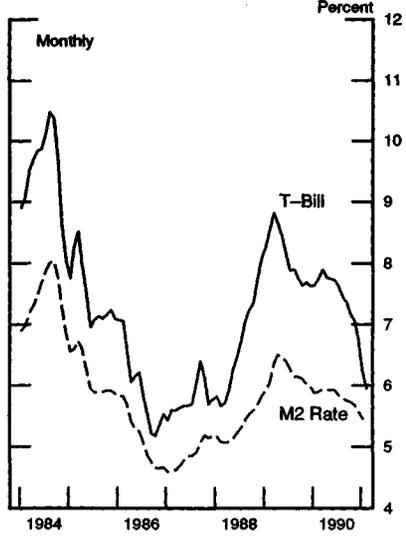
M2 grew unexpectedly slowly in 1990, about 4 percent for the year, well down in the lower half of the FOMC's range. After a robust first-quarter, M2 growth weakened markedly over the balance of the year. The expansion of this aggregate was well below what the historical relationships based on income and interest rates would suggest. The substantial declines in interest rates from their earlier levels would ordinarily be expected to offset to some extent the effects of the slowdown in nominal income in the second half of the year. M2 velocity was fairly stable through 1990, but historical relationships would suggest that velocity should have fallen given the decline in interest rates.

The shortfall of money growth, relative to historical patterns, probably reflected the shifting of financial flows associated with the contraction of the thrift industry and the increased reluctance or inability of commercial banks to expand their balance sheets. Indeed, the slowdown of M2 growth emerged at about the time that RTC activity picked up. The drop in depository credit, which had its primary effect on the M3 aggregate, also may have damped M2 by lessening the need of commercial banks and thrifts to bid for retail deposits. One indication is the apparent cutback

M2: Target Range and Actual Growth



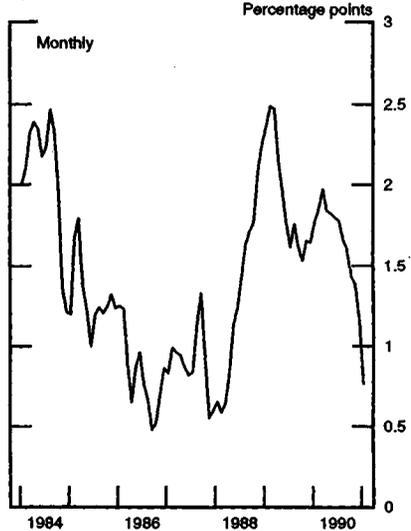
3-Month T-Bill Rate and M2 Own Rate



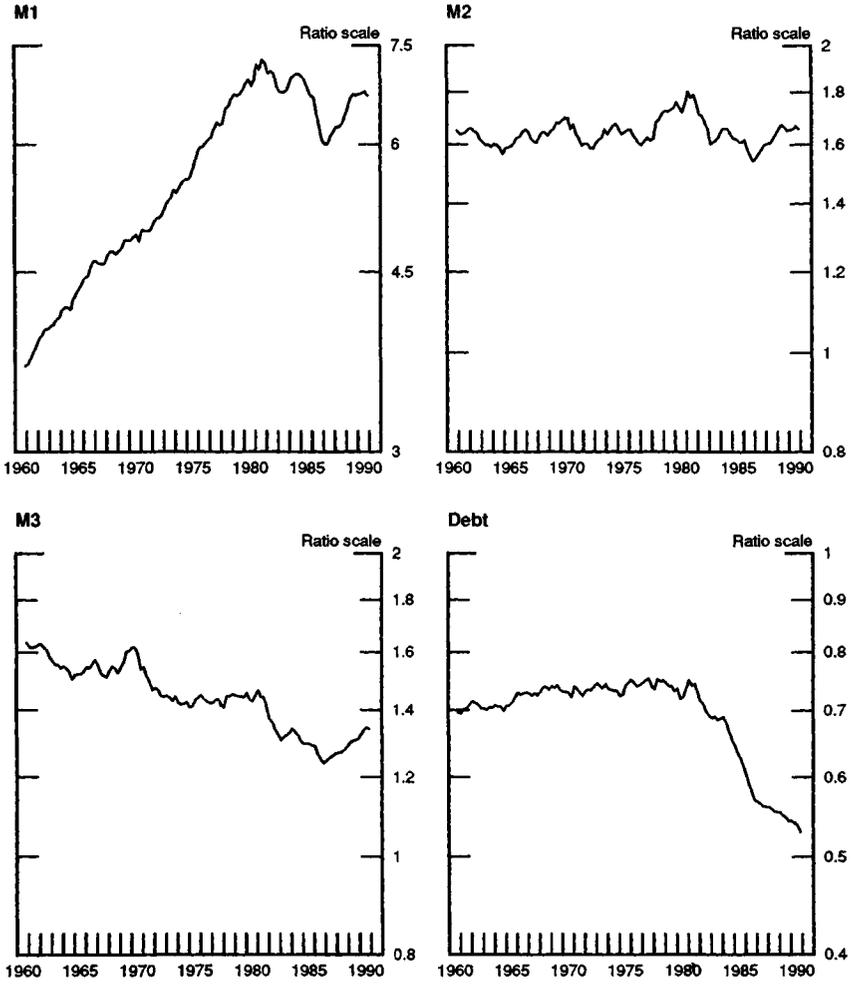
in advertising for these deposits during the year. And, as a result of the diminished need for retail deposits, deposit rates were held down relative to returns available on market instruments. In addition, some high-rate contracts were abrogated in the process of closing failed thrifts, reducing the attractiveness of these deposits; depositors who were dislodged from existing relationships when thrifts were closed may have reallocated their assets in other directions.

Nevertheless, even taking account of these factors affecting the relative attractiveness of yields on M2 assets, M2 growth remains much slower than seems explainable, indicating an underlying reevaluation of, and shift away from, M2 assets. One factor behind such a shift may have been concerns generated by the publicity about S&L failures and about credit quality problems at banks. To the extent that households moved assets to money market funds, which grew rapidly in the second half of the year, M2 would not be affected; however, direct purchases of market instruments would reduce M2. For example, noncompetitive tenders at Treasury auctions have been unusually strong, suggesting a shift toward holding these assets directly. In addition, households may have chosen to deplete liquid assets instead of increasing borrowing to maintain spending in the face of higher prices for energy products and the sudden plunge in real income;

Spread of 3-Month T-Bill and M2 Own Rate



Velocity of Money and Debt
(Quarterly)



consumer credit growth was especially slow in the fourth quarter.

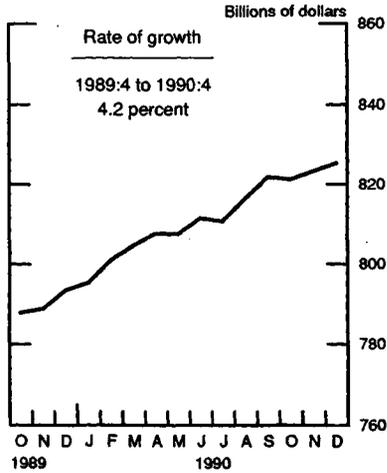
The slowdown in M2 last year would have been even more pronounced had it not been for the rapid expansion of currency. At 11 percent, currency growth was more than twice its 1989 rate and was the most rapid yearly rate of the postwar period. The bulk of the pickup appears attributable to increased demands for U.S. currency outside our borders, however. Information on shipments overseas suggests that demands for U.S. currency were particularly heavy in areas experiencing economic and political turmoil, especially Eastern Europe, Latin America, and, after the Iraqi invasion of Kuwait, the Middle East. The faster growth of currency, along with the effects of lower market interest rates on incentives to hold transactions balances, boosted M1 growth from near zero in 1989 to 4 percent in 1990. The monetary base grew 8½ percent over the year, also propelled by strong currency growth. By contrast, the total reserves portion of the monetary base was about unchanged, reflecting little net growth in reservable liabilities; transactions deposits increased slightly, but declines were registered in non-personal time deposits and net Eurodollar borrowing (abstracting from the effects of the reserve requirement decrease at year-end).

M3 grew 1¾ percent in 1990, somewhat less than had been anticipated early in the year. Roughly similar to the quarterly pattern of M2, M3 growth fell off noticeably after the first quarter and ended the year

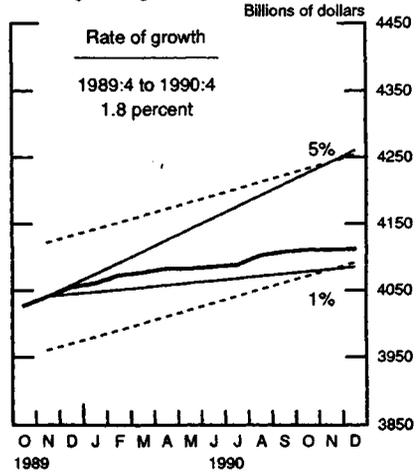
somewhat above the lower bound of its target range. That range itself had been lowered at midyear by 1½ percentage points amid evidence that the drop in thrift assets was proceeding more rapidly than had been expected and that credit flows were being directed away from depository institutions. Banks acquired a substantial amount of deposits from thrifts resolved by the RTC, but, unlike in 1989, they did not use newly acquired deposits to expand their balance sheets. Significant loan losses in 1990 limited the ability of banks to generate capital internally and raised the cost of external capital as investors reevaluated risks. At the same time, banks were facing the prospect of new capital standards. Banks used the deposits they acquired from thrifts to pay down other liabilities, especially large time deposits, with the result that the shift of M2 deposits from thrifts to banks contributed to sharp declines in M3 managed liabilities at banks.

Much of the difficulty in the banking industry can be traced to problems with commercial real estate loans. Before the mid-1980s, developers typically arranged permanent financing for construction and land development projects, usually from institutional investors, prior to obtaining initial bank financing. But during the period of rapidly rising real estate values in the latter 1980s, many banks no longer required such prearranged "takeouts," and when the real estate market cracked, those banks found themselves holding a substantial volume of undercollateralized loans. At about the same time, there was a significant reevaluation of

M1: Actual Growth



M3: Target Range and Actual Growth



the prospects for many of the highly leveraged transactions (HLTs) that had been undertaken in recent years; while bank losses attributable to HLTs have not yet been significant, the virtual disappearance of the market for new low-rated bonds has implied that many HLT loans will not be repaid as promptly as hoped. Growing uneasiness about banks' assets has contributing to increases in their cost of capital and, for some banks, of wholesale funding.

Banks by and large are sound and well capitalized, but concerns about the strength of the industry intensified throughout 1990. The General Accounting Office and the Congressional Budget Office issued reports questioning the financial health of some large banks and exploring the implications of possible difficulties with those banks for the Bank Insurance Fund. Banks had to make large provisions for loan losses as delinquency and loss rates rose on most major categories of loans, but especially on real estate loans. By mid-September, rates on the subordinated debt obligations of some major banking institutions had jumped appreciably as investors reevaluated the health of these organizations. Several major bank holding companies chose to redeem portions of their outstanding auction-rate preferred stock rather than pay sharply higher rates. Spreads between bank and Treasury obligations widened significantly, and bank stock prices tumbled. These price movements began to be reversed subsequently. Partly under the influence of lower interest rates, bank stock prices have risen substantially in 1991, reversing much, though not all, of the declines

since the summer; spreads on subordinated and other bank obligations have narrowed over the last few months, but remain well above their levels of last summer.

Other financial institutions also have encountered difficulty. Finance companies and, to a lesser extent, insurance companies took a beating in the securities markets beginning in September, as investors reevaluated the holdings of commercial real estate and HLT loans in light of expectations of a weaker economy. Yield spreads widened significantly. Furthermore, signs of mounting financial stress were not limited to the financial sector last year. The number of corporations reducing, omitting, or deferring dividends in the fourth quarter was the highest in over 30 years. A record dollar amount of corporate bonds defaulted in 1990. Calculated as a percentage of par amount of noninvestment grade bonds outstanding, the default rate of 8.7 percent was the highest in twenty years and more than double the rate in 1989. While the number of downgradings also reached a record high, most of the downgradings were attributable to deteriorating conditions affecting below-investment-grade nonfinancial corporations and, notably, financial institutions.

Not surprisingly, banks tightened standards and raised lending margins in response to the rising cost of funds, capital shortages, and perceptions of greater risk of default. In the wake of HLT disclosure guidelines, banks instituted management-imposed caps on their exposure to HLTs. Banks with low capital have

Senior Loan Officer Opinion Survey

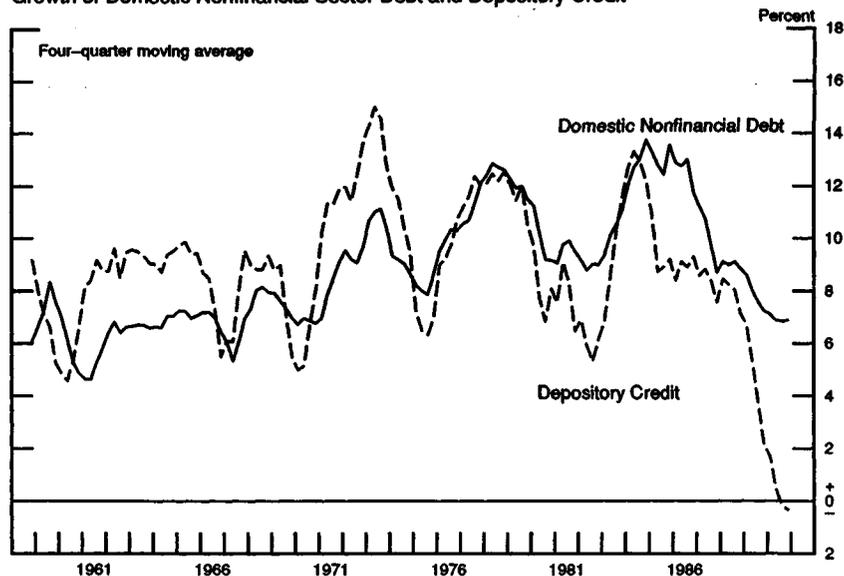
Three months ending with survey date	May	August	October	January
<i>Percent of banks reporting tighter standards for approving business loan applications¹</i>				
Domestic bank lending to				
large firms	n.a.	36	50	35
middle market	58	43	48	37
small businesses	54	34	41	32
U.S. branches and agencies of foreign banks				
	n.a.	61 ²	72	89

n.a. — not available

1. Survey of 60 large domestically chartered banks and 18 U.S. branches and agencies of foreign banks.

2. Refers to tightening in the six-month period from February to August.

Growth of Domestic Nonfinancial Sector Debt and Depository Credit



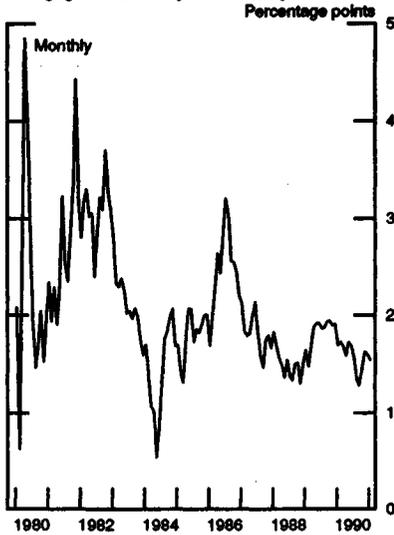
cut back lending, while adequately capitalized banks—though maintaining substantial credit growth—appeared to be unwilling to step into the breach and increase their lending pace. Survey responses and other information on lending terms suggest especially severe constraints on credit for real estate development and commercial mortgages, but also some cutbacks for business lending more generally. Some of these business borrowers have limited alternative sources, and so the restriction of credit by banks probably has reduced their access to funds.

As a result of the tightening of credit standards and lending terms, but also owing importantly to the ebbing of borrowing demand as the economy turned down, the growth of bank assets slowed in 1990, especially in the fourth quarter. Total loan growth fell to roughly half its 1989 rate, with slowing evident in business, real estate, and consumer lending. There was, however, a strong regional disparity in the slowdown of bank lending, a disparity that was visible in total bank loans as well as each loan category. In the Southwest, bank loans continued their pre-1990 decline, while, in New England, bank loans experienced a sharp turnaround at the beginning of 1990 from robust growth to outright decline. New England banks were particularly aggres-

sive in selling loans into securities markets, which contributed to the overall drop, as did loan write-offs. For the rest of the country, loans continued to grow.

The slowdown in bank credit growth in 1990 occurred despite a pickup in bank holdings of government securities early in the year and the large transfers of deposits from failed thrifts. Thrift credit shrank rapidly during the year as the RTC resolved insolvent thrifts, acquiring the bulk of those institutions' assets in the process, and as many viable thrifts shed assets in an effort to meet the new capital guidelines. The credit contraction at depository institutions probably reduced total credit to some extent, but by far less than one for one. Both the secondary market in mortgages and the securitization of consumer loans substituted to a large extent for bank and thrift intermediation in those sectors. Securitization alone is estimated to have removed more than \$40 billion in consumer loans from bank balance sheets during 1990 as banks pared their asset totals to improve capital ratios. Overall, the markets for home mortgages and consumer credit showed little indication that supply conditions were a significant factor restraining growth of these types of credit. Spreads on both asset-backed and mortgage-backed securities did widen a bit in the fourth quarter,

Rate Spread Between Primary Home Mortgages and Ten-year Treasury Bonds



but remained well within historical ranges and appeared to have little impact on the cost of funds to consumers. Sluggish expansion of both consumer credit and residential mortgage borrowing in 1990 seemed to reflect ebbing demands associated with slumping markets for housing and consumer durable goods.

Business borrowing slackened further in 1990, reflecting developments on both the demand and supply sides of the market. Although credit needs to finance corporate restructuring diminished—as indicated by the falloff in net equity retirements to roughly half the pace of the previous two years—the mismatch between corporate capital expenditures and internal funds increased in the second half of the year. A tightening of credit availability for all but investment-grade firms became increasingly evident. The pullback in lending to lower-rated borrowers was not limited to domestic banks; it included U.S. offices of foreign banks, which previously had been aggressive suppliers of funds to

U.S. borrowers, as well as domestic nonbank lenders such as insurance companies. In addition, bond markets remained unresponsive to offerings of below-investment grade issues.

State and local governments reduced new borrowing and retired sizable amounts of debt that had been advance-refunded earlier, as pressures on municipal credit ratings mounted in 1990. A significant number of local housing issues had their ratings downgraded in response to the slipping credit quality of several banks and insurance companies that provide credit enhancements. Also, late in the year, certain municipalities and some states found themselves paying substantially higher rates in light of their own financial difficulties.

Growth of the debt of all domestic nonfinancial sectors was boosted last year by the federal government, which borrowed in part to fund acquisitions of thrift assets by the RTC. Borrowing for the RTC accounted for about 1/2 percentage point of the 7 percent growth of total debt in 1990. The growth of debt has slowed over recent years, but, even abstracting from the effects of RTC activity, remained well in excess of last year's expansion of nominal income.

Debt: Monitoring Range and Actual Growth
Billions of dollars

