CONDUCT OF MONETARY POLICY

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

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

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FEDERAL RESERVE REPORT ON MONETARY POLICY

TUESDAY, JULY 16, 1991

U.S. 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 a.m., in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal [chairman of the subcommittee] presiding.

Present: Chairman Neal of North Carolina, Representatives Neal of Massachusetts, Roth, and Duncan.

Also present: Representatives Kennedy, Hoagland, and Leach.

Chairman Neal of North Carolina. I would like to call this meeting of the subcommittee to order at this time. Today, we are delighted to welcome the Chairman of the Federal Reserve to present the Fed's report to Congress on monetary policy. I would like to begin by congratulating him on his nomination for new terms as Governor and as Chairman. He has certainly earned the respect and confidence of the public for his stewardship of monetary policy.

He certainly deserves another 4 years at the head of the Federal Reserve System. Mr. Chairman, congratulations.

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

Chairman Neal of North Carolina. And some condolences, too, it is a tough job.

There is, in addition, a very specific reason he deserves another term at the helm. The primary objective of his conduct of monetary policy, as he had reaffirmed again and again before this subcommittee, has been and must be the gradual but inexorable elimination of inflation.

In his first term, the Federal Open Market Committee launched monetary policy on a path that should, overtime, reduce measured inflation to insignificant levels. Despite some ups and downs, the longer term growth rates of M2 have been dramatically reduced over the past 4 years.

As Chairman Greenspan emphasized in previous testimony, that decline in monetary growth has been no accident. It has been a necessary condition for reducing, and eventually eliminating inflation.

Though a necessary condition, I must note that it has not been, as yet, a sufficient condition. Measured inflation has yet to register any significant break from its 4 percent to 5 percent plateau. I will

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want to question the Chairman about the prospects for progress in reducing inflation in the near term.

At present, I will only call attention to several factors which have been impeding this effort. In the first instance, we must remember that monetary policy operates with lags, possibly very long lags.

The major impact of reduced money growth over the past few years may still lie ahead of us. Moreover, the fact that measured inflation has not fallen over the past 4 years—it has, in fact, risen slightly—does not prove that the Fed's strategy has lacked any bite whatsoever.

One must recall that monetary growth had been very rapid in the mid-1980's. The decompression that began about 1987 served, in part, to offset the rapid expansion of previous years. Though I cannot prove the point, I suspect that monetary policy, since about the 1987-1988 period has had a very significant impact on inflation. But that impact is not only observable, since it just stymied an inflationary explosion that would have otherwise occurred.

The first 4 years of Chairman Greenspan's tenure served to arrest an accumulating inflationary momentum. Actually reducing measured inflation to trivial levels remains the objective of the next 4 years.

I would like to conclude by calling attention to the major political impediment that threatens to undermine that objective at every turn. To put it bluntly, this administration consistently refuses to support a monetary policy aimed at eliminating inflation.

Despite what it says, its actions speak loudly to the financial markets. And those actions have been clear.

First, the President dawdled until the last possible moment in reappointing Mr. Greenspan. That could only signal to the markets an ongoing campaign to bulldoze the Fed into reinflating the economy in time for the next election.

Second, the Secretary of the Treasury seems to spend most of his time trying to browbeat all the major countries to reinflate, along with us, if not ahead of us.

It is very maladroit and potentially ruinous financial diplomacy. How do financial markets react to these episodes?

They read in them a persistent pattern of political pressure on the Fed to cave in to inflation. The credibility of a long-term commitment to eliminating inflation is undermined. The markets simply do not believe, yet, that inflation can or will be eradicated. Thus, inflationary expectations change very little, even in the midst of a recession.

As a consequence, long-term interest rates remain high, even when short rates fall considerably. The economy remains weaker, inflation more stubbornly resistant than it should be, and primarily because the administration simply refuses to accept the basic point about the purpose of monetary policy.

Anti-inflation is the best policy for economic growth and prosperity. Their estimates and actions, no matter what they say, even though they say they are for lower interest rates, in fact, keep them higher than they would otherwise be.

By spurning zero inflation, the administration turns its back on the benefits that would surely follow. Long-term government inter-

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est rates would fall to the 30- or 40-percent range, mortgage rates much lower than they are now, consumer and business rates about half of what we pay today.

The budget deficit would drop, as the Treasury issued debt more cheaply. Savings and investment would be stimulated. Savers would no longer fear the corroding effect of inflation. Inflation would no longer undermine the long-term planning needed for productive investment.

Productivity would rise, driven by new savings and new investment. Unemployment would fall, on average, to the lowest levels possible, since the economy would become more efficient, more productive, and less prone to recession.

Since most recessions are by-products of the periodic need to regain control over inflation, they would be minimized by a monetary policy resolutely targeted on zero inflation.

Our major competitors have learned this lesson. Japan's prosperity and competitiveness are, in large part, a consequence of its success in stabilizing prices. The same for Germany and the same will hold true for a new European currency, if it is managed by the commitment to price stability that will likely be mandated for a new European central bank.

If for no other reason, we must achieve zero inflation to remain competitive in the world economy. Without it, we will face periodic recessions, stagnating productivity, the constant erosion of competitiveness—in short, economic decline.

There is a right policy for monetary policy. It is zero inflation. Only by achieving and maintaining zero inflation can we achieve all of the other economic goals which will keep America number one.

[The prepared statement of Mr. Neal of North Carolina can be found in the appendix.]

Chairman NEAL OF NORTH CAROLINA. Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman.

Mr. Greenspan, I join the chairman in welcoming you to our subcommittee here this morning because what you have to say means a great deal, not only to us here in Congress, but it has tremendous impact on our entire economy. With our global economy, the world hangs on what you have to say.

Now, I have to respond somewhat to the chairman's comments here because I am from the other side of the aisle. The Presidential candidates may not be out campaigning, but I notice from my good friend, the chairman, here, who is a very influential Member of Congress, that the Democrats are not at a lack for a philosophy for this coming Presidential campaign.

Let me say that the next 4 years with you at the helm of the Federal Reserve are very welcome, I think, to all of us because we have trust and confidence in you and because we do hold you in high regard.

Mr. GREENSPAN. Thank you.

Mr. ROTH. I wonder, however, with no disrespect for you, in all deference to you, whether the President wasn't sending a message to you and your colleagues at the Fed by waiting until only recently to announce your reappointment, even though you were clearly the best choice for the job.

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Maybe the delay, simply put, in the light of the current state of our economy, is that the Fed shouldn't become too preoccupied with further lowering inflation, particularly if it would be at the expense of the entire economic recovery.

I think we have to be somewhat dubious about keeping inflation down, if our economy suffers because, Mr. Brown, head of the Democratic Party, said good news for the economy is not good news for us, that is, the Democratic Party.

We should try to bring politics out of our financial policymaking. It would be to the betterment of our entire economy and our country. I would assert that worrying about inflation at this point in our country's economic recovery is like a good fussing over the dessert, while letting the main course burn.

The *Wall Street Journal* recently pointed out that the lower inflation is not an issue with the American people right now, as they are perfectly happy seeing inflation chug along at its current 3, 4 percent pace.

However, seeing this country rebound from its current economic situation is of vital concern to every American. When I go back home and go around the country and talk to people, people never say, hey, we have got to do something about inflation. But people do say, we have got to do something about interest rates. We have got to do something about more jobs. We have got to do something about our economy.

Focusing on lower inflation helps keep interest rates high. It means higher unemployment, and it retards our country's economic recovery. These are costs which are clearly too high for the benefits we gain. Thus I am anxiously awaiting, Mr. Chairman, your disclosure and discussion on the Fed's proposed money market targets, and I sincerely hope that the news is that the Fed is going to put its worries about inflation on the back burner for now and let the Nation get on with the recovery.

I also look forward to hearing Chairman Greenspan's thoughts on other important issues that may affect our monetary policy, such as the effects of the House's proposed banking reform bill, as well as its effects and any of our other issues; for example, trust and confidence because of the savings and loan banks; problems in banking and all of our financial institutions; how can we rebuild the public's trust and confidence in our lending institutions.

So I look forward, Mr. Chairman, to hearing your views on these and other important issues, and, again, I welcome the news that you will be with us for 4 more years, and again we have trust and confidence in you. I know that trust and confidence will not be misplaced.

Mr. GREENSPAN. Thank you, Mr. Roth.

Chairman NEAL OF NORTH CAROLINA. Mr. Neal.

Mr. NEAL OF MASSACHUSETTS. I don't have an opening statement, but I want to congratulate you for the long-standing feeling you have had on the Fed, one of the most complicated agencies, one that the public has very little interest in, but the fact that you have continued to schedule hearings of this sort to keep interest high among subcommittee members, I think, is testimony to the role you have served here as chairman of this subcommittee.

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I intend during the question and answer period to revisit the issue again, Mr. Greenspan. I have already congratulated you last week about reappointment, but I intend to revisit the issue of the New England economy vigorously with you when you are able to conclude your testimony.

I have to say once again that I have not witnessed any relief across New England, and I intend to question you about it vigorously at the conclusion of your remarks.

Chairman NEAL OF NORTH CAROLINA. Thank you, sir. Mr. Leach.

Mr. LEACH. Mr. Chairman, I am not a member of this subcommittee, but I did want to come by just for 30 seconds to your subcommittee.

Chairman NEAL. You are always welcome.

Mr. LEACH. Fine. The reappointment of Mr. Greenspan truly symbolizes the vindication of integrity in that Mr. Greenspan was reappointed even though some of his policies did not meet the approval of the administration during his tenure. I think it is very significant that despite an independent and vigorous Fed, who has policies we all disagree with, Mr. Greenspan was reappointed. I want to congratulate Mr. Greenspan not only on being reappointed, but also on the vigor of his integrity and not kowtowing on monetary policy.

Thank you.

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

Chairman NEAL OF NORTH CAROLINA. Mr. Chairman, again, welcome. We would like to hear from you if we can at this time.

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

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I have a rather extended prepared statement, and even though my oral remarks will be somewhat extended, they will be significantly shorter than my written statement. I request, however, that the full statement be included in the record.

Chairman NEAL OF NORTH CAROLINA. Yes, without objection, it will be done at this point in the record.

Mr. GREENSPAN. Mr. Chairman, members of the subcommittee, I am pleased to be here today, as always, to present the midyear Monetary Policy Report to the Congress. My prepared remarks this morning will take their cue from that report by focusing on current economic and financial conditions, as well as on the outlook for the economy and monetary policy over the coming 1½ years. These topics merit particularly close attention at the current time, when the economy appears to be poised at a cyclical turning point, moving from recession to expansion. In addition, I plan to devote some time to discussing the importance of the changes that we have been seeing in patterns of credit usage and in the flows of money and credit through the financial system. There are signs of what could be significant departures from the trends prevalent in the 1980, with potential implications for the interpretation of financial data and economic developments.

At the time of our last report in February, the economy had been declining for several months. Today, however, there are compelling

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signs that the recession is behind us. Although the turning point has not yet been given a precise date, a variety of cyclical indicators bottomed out by early spring, and some have moved noticeably higher in recent months. Such data strongly suggest that the economy is moving into the expansion phase of the cycle. Nevertheless, convincing evidence of a dynamic expansion is still rather limited, and we must remain alert to the chance that the recovery could be muted or could even falter.

In recent months, there also have been promising signs of a slowing in inflation. A bunching of price increases and excise tax hikes at the beginning of the year boosted so-called core inflation measures for a time. But in their wake, an underlying softening trend has become evident with consumer prices outside of the food and energy sectors rising quite modestly. In an environment of slack demand, businesses have worked especially hard to control costs by keeping their operations as lean and productive as possible.

With the threat of an oil-related inflation surge largely behind us, and output evidently declining, the Federal Reserve took a series of easing steps in quick succession over the latter part of last year and into the spring. These actions, aimed at ensuring a satisfactory upturn in the economy, brought the Federal funds rate more than 2 percentage points below its pre-recession level and 4 percentage points below its peak of about 2 years ago. Other short-term interest rates dropped more or less commensurately. Despite the progressive easing of monetary policy, the foreign exchange value of the dollar is up substantially since the beginning of the year, in part, owing to the brightening outlook in the United States for economic recovery without added inflation. Anticipations of economic expansion also were reflected in rising stock prices, and in long-term interest rates, which have changed relatively little on balance so far this year, even as short-term rates have declined.

With the cumulative drop in short-term interest rates making monetary assets more attractive to the public, M2 growth picked up noticeably in the first half of 1991. Its growth probably was restrained to a degree, however, by the firmness in returns on capital market instruments. Money growth also continued to be held down by the ongoing restructuring of credit flows away from depository institutions. As the thrift industry has contracted and banks have remained quite cautious about expanding their balance sheets, there has been less need for depositories to issue liabilities which constitute the vast bulk of the monetary aggregates. Currently, M2 and M3 are somewhat below the midpoints of their respective target ranges.

In the last several months, monetary policy has adopted a posture of watchful waiting as economic indicators have pointed increasingly toward recovery. With an eye to the usual lags in policy effects, this stance has been viewed as prudent to guard against the risk of adding excessive monetary stimulus to an economy that might already be solidly into recovery. Monetary policy during the first half of the year has had two jobs: first, to help bring the economy out of recession and, second, to avoid setting the stage for the next recession, which would follow if we allowed inflationary imbalances to develop in the economy.

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The progress against inflation that has been set in motion must not be lost. Moreover, by consolidating and building upon the gains against inflation, we come that much closer to our longer-term goal of price stability. Inflation and uncertainty about inflation keep interest rates higher than they need be, distort saving and investment, and impede the ability of our economy to operate at its peak efficiency and to generate higher standards of living.

It is this strategy that has been guiding monetary policy recently, and the effects of the strategy are reflected in the economic projections of the Federal Open Market Committee members and other Reserve Bank presidents. On the whole, their outlook is for underlying inflation to continue to slacken as the economy first recovers and then expands at a moderate rate through the end of next year. Their forecasts for real GNP growth over the 4 quarters of 1991 center on 1 percent or a shade below, implying growth over the remainder of this year that not only offsets the first quarter decline in GNP, but also lifts output above its prerecession peak by yearend.

Two fundamental questions must be posed with regard to this outlook for the rest of the year. The first is an inquiry into the potential sources of strength in the recovery—those forces that will be at work to pull the economy out of the recession in a lasting fashion. We see a number of factors as having set the stage for the recovery: In particular, the reversal of the spike in world oil prices and the favorable effects of that reversal on real incomes; the conclusion of the Gulf War and the consequent rebound in consumer and business confidence; and, finally, the decline in short-term interest rates following our policy easings and the narrowing of risk premiums in financial markets. Against this backdrop, consumer expenditure growth seems to have turned positive again, along with real income; home building has bottomed out and is providing some lift to overall growth; and orders for capital goods are pointing to a firming in demand that should be reflected in production and shipments in coming months.

The strongest force behind output growth in the near term, however, probably will be the behavior of inventories. Business inventories have been drawn down aggressively in recent quarters and with inventories now quite lean, sales increasingly will have to be satisfied out of new production. The inherent dynamics of an inventory cycle, as the draw down ceases and eventually turns to rebuilding, likely will engender the bulk of the initial set-up in output. But there may be additional areas of demand that will impel the recovery; it is quite common at this point in the cycle for forecasts both to underestimate the strength of the recovery and to miss the forces that end up driving the expansion.

In fact, recessions typically have been followed by periods of appreciably stronger growth than that foreseen here. This raises the second question about the near-term forecasts; that is, whether they are optimistic enough. A number of considerations come to mind on that side of the issue. First is the simple notion which is lent some support by history, that relatively mild recessions beget relatively mild recoveries. And this recession, assuming it came to an end in the spring, seems to have been mild. Not only does it appear to have been marked by a considerably smaller contraction

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in real GNP and industrial production than the average postwar recession, it also was a bit shorter.

Arguing against a rapid rebound in the economy are several other factors as well, including the lack of impetus from some sectors that contributed in earlier cycles. First, it has not been unusual to see some fiscal stimulus in the early stages of expansion in the past; this time, however, the Congress and the administration have worked long and hard to make sure that genuine progress will be made in righting the structural imbalance in the budget, putting Federal spending in real terms on a downward path. Nor is fiscal stimulus likely to emerge from the State and local sector, where deepening budget problems are constraining spending. A portion of the financial distress of localities can be traced to the softness in real estate markets feeding through to property tax receipts. The condition of the real estate market also is certain to restrain the pickup in construction that usually accompanies a recovery, with overbuilding in commercial real estate likely to damp activity in this area for some time to come. Finally, in the consumer area, expenditures are unlikely to grow more rapidly than personal income, as households avoid reducing their saving rate further from its already low level.

The expansion is seen as becoming more securely established next year, with real GNP growth strong enough to bring the unemployment rate down a half a percentage point or more from its current level. Should the recovery unfold about as we expect, price pressures will remain muted and progress on inflation is likely. The expectations of the FOMC members and other Reserve Bank presidents for inflation this year, are centered in the neighborhood of 3.5 percent, well down from the 6.25 percent rate of inflation experienced last year. Although the slowdown in this area is exaggerated by the retreat in oil prices, a clear deceleration should be evident even abstracting from energy prices. That deceleration in the underlying trend is expected to continue next year, as well. However, the unwinding of the oil shock this year matches the improvement, so that the projection for the increase in overall consumer prices is about the same for 1992 as for 1991.

The FOMC viewed the near-term outlook for output and prices as generally favorable and consistent with growth in money and debt within the ranges that had been specified earlier in the year. Consequently, at its meeting earlier this month, the FOMC reaffirmed the 1991 ranges for money and debt growth. In addition, it was felt that the money ranges retained enough scope for policy to be responsive should the economy stray substantially from its expected path over the remainder of the year.

Unlike the monetary aggregates, our latest reading on debt of the domestic nonfinancial sectors places it right at the bottom edge of its 1991 range. Its growth has been unusually low, and its position within the range is indicative both of the reduced demands for credit associated with the weak economy and of the restraint, on the part of borrowers and lenders, that has been evident in recent quarters. In these circumstances the FOMC felt that lowering the monitoring ranges would be inappropriate and might falsely suggest a complacency on the part of the policy makers about weakness in credit growth. Instead, maintaining the debt range un-

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changed underlines the implications that a further slowdown in this aggregate would warrant close scrutiny.

On a provisional basis, the FOMC extended the 1991 ranges for money and debt growth to 1992, with the understanding that there will be opportunities to reevaluate the appropriateness of these ranges before they come fully into play next year. The ranges were viewed as consistent with additional progress against inflation and with sustained economic expansion. Moreover, the path of no change appeared most sensible to the subcommittee at the current time of some uncertainty about the vigor and even the durability of the economic recovery, as well as about developments affecting the future of the thrift and banking industries.

This uncertainty about the credit intermediation process is one of the factors that could probably make movements in M2 somewhat difficult to interpret in the short run, but I would emphasize that we expect the aggregate to remain a stable guide for policy over the longer run. The relationship between M2 and nominal income has been one of the most enduring in our financial system. Presumably, this reflects an underlying demand for liquidity on the part of businesses and consumers that is associated with a given level of spending and wealth. This demand is likely to persist, though the financial structures that supply the liquidity may change.

Recently, patterns of financial intermediation have been changing, and there are signs that patterns of credit usage in general have been changing as well. It is difficult to know which of these developments will show some permanence and which will prove ephemeral. But some of the recent changes have been striking and have affected a number of the financial variables that the Federal Reserve routinely monitors in an effort to glean information about the health of the economy, the soundness of the financial system, and the appropriateness of current monetary policy. I would like to address several aspects of these recent developments in the remainder of my remarks today, Mr. Chairman.

First, at the most aggregate level, the ratio of domestic nonfinancial sector debt to nominal GNP, which soared in the 1980's, is beginning to show signs of flattening out. With the Federal Government's borrowing lifted by the effects of the recession and payments related to deposit insurance, these signs have been evident so far only in other sectors. While the changes in behavior may, in part, reflect cyclical factors at work, a longer-term trend also may be emerging. This trend, if it fully develops, would represent a return to the pattern evident in earlier postwar decades.

The deregulation, technological advances, and financial innovations that came at an accelerated pace in the 1980's, lowered the cost of borrowing for many and probably raised the equilibrium ratio of debt to net worth for a wide range of economic entities. A temporary surge in borrowing was implied in the course of this transition from one equilibrium to another. A tapering off of that surge would then be expected as the new equilibrium was approached, and this may be what we are currently witnessing. If these sorts of adjustments were in train, the slow debt growth associated with them should not be read as implying that credit was insufficient to support satisfactory economic performance.

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On the supply side of the credit market, perhaps the major factor at work in creating a break with the behavior of the 1980's has been the adverse consequences of that behavior. It is clear that a significant fraction of the credit extended during those years should not have been extended. Now financial institutions, regulators, and taxpayers are facing the wrenching unwinding of those lending decisions. A key lesson to be learned is how important it is to avoid these costly adjustments in the future and that this can only be done by avoiding a return to such financial laxity. A more prudent approach to capitalization and lending decisions is overwhelmingly a healthy development that ultimately will result in strengthened balance sheets for the Nation's financial institutions and more assurance of stability of the financial system.

In certain areas, however, the credit retrenchment appears to have gone beyond a point of sensible balance. In some cases, lender attitudes and actions have been characterized by excessive caution. As a result, there doubtless are creditworthy borrowers that are unable to access credit on reasonable terms. Even in the obviously troubled real estate area, new loans are arguably too scarce, in some cases, intensifying the illiquidity of the market for existing properties. To some extent, the scarcity of some types of loans may reflect the efforts of individual financial institutions to reduce the share of their assets in a particular category such as commercial mortgages. While a single bank may be able to do this without too much trouble, when the entire industry is trying to make the same balance sheet adjustment, it simply cannot be done without massive, untoward effects. Instead, it may be in the banks' self-interest to make the adjustment in an orderly manner over time. Regulatory efforts to address credit availability concerns continue.

Not only the behavior of the debt aggregate itself, but also the avenues through which the debt flows represent something of a break with the past. The recent decline in the importance of depository institutions as intermediaries, when measured by the credit they book, is quite striking. While this predominantly reflects the contraction of the thrift industry, banks, too, have contributed by growing only slowly. Over time, other financial institutions have provided more close substitutes for banking services, and the profitability of the banking industry suffered over the last decade or so from a decline in loan quality.

As banks make further strides in bolstering their capital positions, however, they will become better able to take advantage of opportunities to add profitable loans to their balance sheets. While the role of the banking industry has been changing, its importance in the financial system and the economy remains assured.

In summary, Mr. Chairman, the financial system in this country is changing, and it is changing rapidly. Technology, regulatory initiatives, and market innovations are changing many dimensions of the financial system. The relationships between borrowers and lenders, between risk and balance sheet-exposure, and between credit and money are being altered in profound ways. In response, we must understand the nature of these changes, their permanence, their limitations, and their possible implications for the economy and monetary policy. And we must assure that the stability of the financial system is protected as changes occur, for a sound

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financial system is an essential ingredient of an effective monetary policy and a vital economy.

Thank you very much.

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

Chairman NEAL OF NORTH CAROLINA. Thank you, sir, Chairman Greenspan.

First, before we get into the main thrust of your testimony, just a little housekeeping matter, if I may.

Last week, on Tuesday, July 9, the *Wall Street Journal* ran a story which said that after considerable discussion your Open Market Committee agreed to leave the committee growth target for the monetary measure known as M2 at 2.5 percent to 6 percent for next year, the same as this year's target range.

It is a long story, and it goes into some great detail about your meeting, the results of which you report to the Congress and the world at the semi-annual hearings.

Now, as I read this story, in light of today's testimony, the story is essentially accurate, suggesting to me that somehow there is a leak within the Fed there that is troubling. It is troubling because if it is not important that this data be made public at the times called for by law, then it should be made public the day you do it, and if it is important.

It suggests a certain problem with competence, that somehow information is getting out that shouldn't. So could you talk about this a little and tell us what happened.

Mr. GREENSPAN. I read that article, Mr. Chairman, and I must tell you, I was most distressed. I, however, think I know how that information got out, and unless I am mistaken, that opening, if I may put it that way, is now currently closed.

Whether or not I am correct in my evaluation, only time will tell. But I can certainly agree with the thrust of your remarks that that is something which we should be chagrined at seeing occur.

Chairman NEAL OF NORTH CAROLINA. Are you saying that you have corrected it so we won't see it occur?

Mr. GREENSPAN. I think I understand how that information was obtained, and I trust I have taken steps which will avoid that in the future.

Chairman NEAL OF NORTH CAROLINA. Thank you. While we are on the subject, how about commenting a little bit on this question.

Others from time-to-time have suggested that there is no reason for waiting even a minute in terms of letting your decisions be known. I personally think that the more sunshine we have in government activity the better; the more that we can do in the open and full public view, the less suspicion there is of our institutions; the more accountable they are to the public, the better the policy that is likely to develop.

Is there some good reason for not making public the conclusions of your deliberations coincidental with arriving at them? Is there some reason for delay?

Mr. GREENSPAN. First of all, Mr. Chairman, let me say that I certainly agree with your view that for public institutions, short of the issue of the efficiency of the operation which we are required to im-

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plement, full public disclosure should be forthcoming in all respects.

The only reason that one can argue for the failure to do so is that it impedes the purposes assigned by the Congress to the Federal Reserve. The reason why we are quite cautious in releasing market-sensitive information is that how the information is released, affects markets and affects the actual implementation of policy itself.

As I think I have mentioned to this subcommittee on previous occasions, we view our specific monetary actions in terms of either those in which we wish to be very visible, in a sense make an announcement, and those in which we believe that a smooth continuum of policy without disruption to the market actually contributes best to the overall policy thrust of the Federal Reserve.

To the extent that we would be required to make all actions immediately available, which in a sense is an announcement, we lose part of what I consider an important element in the structure of policy capabilities. Even though in many instances the issue is marginal, there are enough occasions, especially when markets are particularly disrupted by events outside of monetary policy, or caused by external events even outside the country, that it is important for us to be able to have as many tools as we can in an endeavor to stabilize the system.

Finally, let me say, Mr. Chairman, that it is very difficult for us to release the minutes of our meetings very quickly in that they must be compiled and edited and checked so, there will always be a delay in that respect, and I am not certain that we would ever be able to be in a position, even were we desirous of doing so, of communicating completely all of the actions in a real time sense.

In summary, I would just say to you, Mr. Chairman, that while I very much appreciate and fully subscribe to the notion of the necessity of a public institution such as ours being completely open, there are times when so doing conflicts with what the Congress itself encourages us to do in the most efficient manner.

Chairman NEAL OF NORTH CAROLINA. I understand this. I am wondering if it wouldn't be useful for you all to do a little brief on this subject, using some examples from recent history, maybe the aftermath of the 1987 crash, or some other time when you think it has been useful to have available to you something other than what you call the announcement effect.

Mr. GREENSPAN. I will be glad to do so, Mr. Chairman.

Chairman NEAL OF NORTH CAROLINA. I believe that would help us in keeping available to you a tool that I agree is useful to you. My time has expired.

Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman.

Chairman Greenspan, I am going to follow up on the chairman's line of questioning.

The Fed is shrouded in secrecy, and within the Fed's Open Market Committee disagreement over policy has been a long tradition. But it seems recently there has been an unusual amount of bickering, is there dissension among the committee members as to how we should deal with inflation?

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Mr. GREENSPAN. Well, Mr. Roth, I don't agree with the premise that there is an unusual amount of bickering. On the contrary, the thinking which has impressed me more than most anything else about my first term as Fed Chairman is the collegiality of the operation.

I do think there may be more open discussion than usual, but I would argue strenuously that bickering is a most inappropriate term to describe what is going on, and I would say that the overall philosophy of the FOMC and the current nonmember presidents is remarkable, I would say——

Mr. ROTH. It could be, Mr. Chairman, that we just have people with stronger opinions on the board now than we have had before, more free-thinking people, and, of course, that would be healthy, wouldn't it?

Mr. GREENSPAN. Well, I am not even sure that that is the case because my impression of the past is that the Board has always been peopled by fairly significant forward-thinking and strong personality members.

I think that is good, not bad, and frankly, the extent to which these discussions induce people to change their minds is a suggestion that substantive things are being discussed.

Mr. ROTH. Mr. Chairman, I wasn't going to go down this line of questioning, but I just want to tell you what people in the Cloakroom are saying, and then you can respond. I am going to ask you in a letter to respond to some of these things.

In the cloakroom, I hear a lot of Congressmen saying they are concerned about what the Fed is doing, although they do have confidence in you. But they say what we should have the Comptroller General look the Federal Open Market Committee, and all the Federal Reserve Banks and their branches so that there is a lot of openness so that we don't have the shroud of secrecy. Do you think such a thing would be a good idea? Is that a good concept?

Mr. GREENSPAN. Mr. Roth, as I have indicated to you previously, I think it is not a good concept, will not achieve what it is endeavoring to do, and what I would like to do is to spell out for you in detail in a written response precisely why.

Mr. ROTH. OK. I appreciate that. We were told yesterday that the deficit is going to be increasing by some $60 billion. This, of course, is something that I am very much concerned about, and I know others are.

What is your advice to the Congress on the deficit?

Mr. GREENSPAN. First of all, the budget agreement which was hammered together last October was an agreement which I suspect very few people like in total. Nonetheless—and I might add I would certainly subscribe to that view myself—but nonetheless, the basic structure that was put in place is clearly one which will lead to a very significant reduction in the deficit over time.

It is the apparent first successful structure of procedures which will enable spending to be restrained in a manner which is consistent with the long-term necessity of a balanced fiscal system.

Mr. ROTH. Mr. Greenspan, this is very important, however, because we were told that our deficit is going to be $280 billion. Now, it is a $60 billion increase. That would be $340 billion. There is no way we can live with a $340-billion deficit.

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Yes, you are right, there was a hard hammered out agreement last fall, but golly, that is not going to get us to a balanced budget, is it?

Mr. GREENSPAN. Remember that a very substantial part of the deficit which is projected for next year of necessity, by its nature, is temporary. That is, a goodly part is deposit insurance costs, the thrift bailout, and specifically, there are some accelerations of defense expenditures caused by the need to replenish some of the inventory reductions during the Gulf War.

But most importantly, there has been a major change in the presumed relationship between the levels of income that are related to the Gross National Product and the presumed tax receipts that are coming off that income. I am not sure whether or not that revision is right or wrong, but it is something which we will be looking at to make sure that those estimates make sense.

But even under the extreme conditions of the most pessimistic relationships, there is a very dramatic decline in the deficit over time. But there is no question that I certainly agree with you, were we to have to live with $350 billion deficits, the budget would be in very serious shape. I don't anticipate that, and I believe that we will be seeing marked progress on the deficit over time.

Mr. ROTH. My time has expired. I thank you, Mr. Chairman, for answering my questions.

Chairman NEAL OF NORTH CAROLINA. Mr. Neal.

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

Mr. Greenspan, I don't profess to know more about monetary policy than you do, and certainly it is not my intention to trespass into your realm of competence, but I do know this. In New England, there are more vacant storefronts, longer unemployment lines, and more and more responsible businessmen and businesswomen who cannot get routine credit.

Would you concede this morning that the Fed was slow in coming to acknowledge the problems of the New England economy?

Mr. GREENSPAN. No, I don't think so, Mr. Neal, largely because we were acutely aware of the extent of the problems emerging there. My recollection is that concern about the nature of the New England economy arose quite early in the game at the Federal Reserve.

Mr. NEAL OF MASSACHUSETTS. For months, including forums similar to this, I questioned you about the credit crunch. The initial reaction from you and from the Fed was that there was not a credit crunch in New England.

Mr. GREENSPAN. That is correct, and I am going to distinguish between the early stages of moving from what was very evident lending laxity to patterns which appeared to have more of the characteristics of a credit crunch. This early stage was indeed, something which was healthy, not something which was deleterious. And it is only as we began to perceive that the initial move from laxity to balance began to continue in an adverse direction toward excessive caution, and indeed actions which we perceived to be unnecessary, that we began to define what was occurring as a crunch.

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There has never been a problem in understanding what the processes were. We were fully cognizant of the pulling back in lending standards, of pulling back in the general evaluation processes that banks and supervisors tend to make, but that was something which was essential, and in my judgment, healthy to the economy.

And as a consequence of that, I would not define that this economy, or for that matter any aspect of it, began to move into a meaningful credit crunch until it had moved over that line, and that, in my judgment, was well into the process.

Mr. NEAL OF MASSACHUSETTS. I think the term you used in your testimony was that we moved beyond a sensible balance.

Mr. GREENSPAN. That is correct.

Mr. NEAL OF MASSACHUSETTS. OK. Well, the truth of the matter is, it hasn't gotten any better months after we acknowledged the problem. We have heard a number of times witnesses before the full Banking Committee and this panel indicate that they were going to address the issue in New England, and there isn't any plausible evidence at this time that that process has begun.

Mr. GREENSPAN. Well, I wouldn't want to agree with that, Mr. Neal. I think that we have been spending a good deal of time on the issue of credit crunch, have been fully aware of what is going on in New England, and the President of the Federal Reserve Bank of Boston, Richard Syron, whom you know, has been in fairly consistent contact with those of us at the Federal Reserve Board in Washington, both at the Board and at the staff level.

And we have been, in conjunction with other regulators, endeavoring to find means to bring the credit crunch to a halt and to turn it around. I grant you that it has not turned around, but I do think there is increasing evidence that it is no longer getting worse, and that is at least the first step.

You asked me would I prefer that it were much better. I certainly would. Do we intend to pursue this issue until we can say that it is better? The answer is yes.

Mr. NEAL OF MASSACHUSETTS. The point I would simply like to make, and I would like to move on to another question, is that you more or less declared this morning that there are a number of indicators that would suggest that the recession is behind us. I just want to tell you firmly and emphatically this morning that is not the case in New England or I certainly haven't witnessed those indicators that I think that the layman might come to acknowledge or recognize as supporting the evidence that you have offered this morning in your testimony.

Mr. GREENSPAN. I think it is definitely the case that New England is dragging behind the rest of the economy, and the evidence there of an upturn is far more muted that in other areas in the country.

Mr. NEAL OF MASSACHUSETTS. Let me speak to the issue of the national savings rate which you have eloquently addressed. Incidentally, I have great confidence in your decisionmaking except in this particular instance.

Let me speak to the issue of the national savings rate. There are a number of proposals floating around Capitol Hill, one of which I have sponsored, that would support the idea of returning the IRA. If we are not going to move in the direction of returning the IRA

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or some sensible vector upping the national savings rate, what do you suggest to us this morning?

We have run around this issue a number of times now, and yet we don't seem to be any closer to taking the kind of vigorous action here on Capitol Hill that would, in fact, offer some incentive to encourage people to save.

Mr. GREENSPAN. I testified before the Ways and Means Committee a number of weeks ago, Mr. Neal, and gave similar testimony before Senate Finance. The general thrust of the way I came out, confronted with the same dilemma that you are raising, was that even though the evidence on the IRA is not by any means conclusive as to whether it will improve the national saving rate, the issue of national saving is so crucial to this economy that we probably ought to take risks in that direction and endeavor to try to move toward a form of renewed, expanded IRA, fully aware that we may end up with very little in the way of net additional saving.

But on the other hand, it might be a definite plus, so I think it is worthwhile at least taking a shot at.

Mr. NEAL OF MASSACHUSETTS. Mr. Chairman, may I ask for 30 more seconds.

So you are willing to state again today that the number one economic problem that faces America is the low national savings rate?

Mr. GREENSPAN. Yes, most definitely, but it is a long-term problem.

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

Chairman NEAL OF NORTH CAROLINA. I would like to welcome—there are several Members of the full Banking Committee here this morning who are not members of the subcommittee, but we also welcome other members of the committee to our subcommittee hearings. We think it is valuable to hear their thoughts and points of view, and it is a way of getting those out to the public.

Mr. Leach, I would like to call on you at this time.

Mr. LEACH. Thank you. I would defer to any member of the subcommittee first.

Well, I just had one issue I wanted to raise with you, Mr. Chairman, and that is obviously the news of the day relates to the major banking merger in New York. And from a congressional perspective, it seems impressive that a consolidation has occurred without infusion of public monies.

Can you reveal to us the role of the Fed or the attitude of the Fed or both in relationship to this merger?

Mr. GREENSPAN. Well, Mr. Leach, as you know or are aware, the Federal Reserve Board will be required to review and express early approval or denial of this merger. I think, under those conditions, I am restrained at this stage from preliminarily discussing views which will be part of an adjudication process at some later time.

Mr. LEACH. OK. Thank you, Mr. Chairman.

Chairman NEAL OF NORTH CAROLINA. Mr. Kennedy.

Mr. KENNEDY. First of all, Mr. Chairman, I am glad to see you are here this morning and looking healthy. I just wish the committee was looking as healthy as you are, at least in my region of the country, but I want to congratulate you on your reappointment and also just hope that you are feeling as well as you look.

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

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Mr. KENNEDY. I am worried, as Rich Neal was speaking with you, about the New England region, and the general state of the economy. It seems to me that we are hearing talk this morning about the fact that there has been some success in keeping the inflation rate under control, which I think that there is no question you have been able to do a reasonable job on.

On the other hand, we have got unemployment rates that are going into double digits in New England, and it is not just in New England. There are other parts of the country that are stumbling along at best. It just seems that if you look at what Mr. Roth was talking about, you have got a deficit that was announced in the paper this morning of being $348 billion. You have got a situation where the credit in New England has been stifled.

It is very difficult for small businesses, medium-sized businesses to gain access to the credit markets. You have got a general feeling, I think, on everybody in the United States that at least I come in contact with, with maybe the exception of Wall Street, which I never quite understood why when everybody else thinks it has gone down, these guys send the DOW over 3,000 points.

It just doesn't seem to make sense. Maybe you could explain that to me as well. But what I am really driving at is the fact that I think people get a sense in the pit of their gut that somehow the United States is not really making the kinds of innovations, not really being able to get itself prepared to deal with the 21st century in a way that makes us truly competitive with our counterparts abroad; that the savings rates of the Japanese are down, the investments by the Germans in terms of taking an aggressive stand and going into the Soviet Union, addressing the concerns of Eastern Europe and the like indicate kind of a vibrancy that has been lost by the U.S. economy, and that we sort of consider all these minute little measurements that you have to come up with in your day-today work.

I don't mean to diminish the importance of them, but in terms of whether or not the United States is going to be able to seriously get out and compete with the rest of the world in the 21st century, I have got some real concerns. I just wondered if you might address generally where you see the U.S. economy going and how we are going to get out of this sort of creeping along, 1 percent growth, and maybe it goes up 1 percent this year and it goes back down one-half percent next year.

But other than an overstimulation that we perhaps saw in the 1980's, how do we begin to get this country moving again?

Mr. GREENSPAN. You are raising the crucial question about long-term economic policy which actually interrelates with the issue of national saving which your colleague from New England raised earlier.

The total labor force which is currently in place is determined by—I should say the labor force which will be in place, say, 10 years from now—is pretty much determined at this stage in the sense that the number of people who will be in that labor force are already born, are already becoming educated, and we can forecast with some degree of accuracy what the labor force will be.

That essentially leaves the growth in the GNP or the economy overall as being determined by output per worker, and that funda-

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mentally, as best we can judge, relates to the level of investment, or more specifically, investment per worker, which in turn gets to the question of an adequate level of saving to engender that level of investment.

The saving rate is unquestionably too low, and we are going to need to raise it, but it is important for us to focus very clearly on the issue of productivity, technology, and education, all the elements which are involved specifically with how to improve output per worker, because we are not going to change in any measurable form how many people are in the labor force or how many people are working over the years ahead. We have got to get an upswing in productivity, which I must say has improved some in the 1980's, but we have got to enhance it even faster if we are going to get the type of growth that you are suggesting, Mr. Kennedy.

Mr. KENNEDY. So, then, doesn't that, in fact, raise two questions: First, that in the short-term—I would rather hear you talk about the long-term, but in the short-term if you take the money that would normally be invested in some sort of durable good or just the measurements that you use to determine whether or not the economy is being stimulated and is working, in fact, lowers the savings rates because it takes money out of people's pockets to go out and buy the washing machine. And what you really want is the banks to have the money so that they can make the loans to the innovative entrepreneur who can go out and come up with a breakthrough on technology.

Aren't those two really at opposite ends of the equation?

Mr. GREENSPAN. It appears that way in the short run, but if you think in terms of the way the economy evolves, what tends to happen is both saving and investment rise proportionately or equally, in effect, depending on how one defines it, and that in turn raises the level of aggregated economic activity so that consumption, whether it is for durable goods or others, rises as well. One is not confronted with the issue of trading off one good versus another.

What we are trying to achieve is a much larger overall level of economic activity which would enable increased production for all types of goods.

Mr. KENNEDY. My time is up, but I just wanted to conclude, Mr. Chairman, briefly by maybe asking the Chairman if it would be possible to get even in writing or if you ever have a few minutes to get some ideas about what you can actually do to stimulate the savings rate in this country, particularly as it seems that we are going to be spending so much of our dollars just paying off the deficit, anyway, even the interest on the debt, so I think that there has been sort of a dearth of ideas.

We have got these gimmicks of the IRA's and things like that, but as to whether or not you actually get people to put money into the long-term investments that are necessary to get these increases in productivity, I just haven't really seen, and I think that you can ask the American people to make those investments. But I don't see any political leadership.

I certainly don't see the President or anybody else talking in those terms to the American people about what the real challenge, the fundamental economic challenge to the economy are. You hear

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a lot of platitudes about no new taxes and this and that and the other thing, but what you don't hear is what the people of the country are supposed to actually do in order to achieve the goals that you are talking about.

Anyway, thank you, Mr. Chairman, for having us here this morning.

Chairman NEAL OF NORTH CAROLINA. Thank you. Well, I think you are on to the key point, myself. For a prosperous future, we need a greater level of savings. It is the single, I think, most important issue for our economy.

Is that true, would you say?

Mr. GREENSPAN. It is the toughest public policy problem we have in the economic area.

Chairman NEAL OF NORTH CAROLINA. Now, there is something that the Fed can do and I think is trying to do that will help, and that is, you know, just sort of looking at human nature, if you think that the value of savings is going to be maintained, I think it is human nature to save.

I remember years ago, if you will forgive me this little sideline here, being amazed, I was in China back in the late 1970's. It was before the so-called normalization, and the Chinese were very proud of the fact that they maintained the value of their currency.

It was one of the very keys, they saw, to the success of their economy such as it was. It was not a very successful economy, I will have to say, but it was one thing that they did, and that is that the Chinese, as little as they made—they made almost nothing in terms of a living wage, and yet they felt confident in saving their money because they knew that the government would not allow the money to lose its value. And so actually, you know, the working people in China making—we couldn't possibly live on what they were making, but they put some of it aside.

They would save it for their old age because they would not allow inflation in their country. Again, back to my pet project, there is just—the one thing that the Fed can do on the fiscal side, the thing that we could do that would be the most help would be to reduce the deficit.

That is the major dissavings in the economy. It is the major enemy of savings. On the monetary side, the most valuable thing the Fed can do is to, in a reasonable way, over some period of time so that we don't disrupt the economy, bring inflation to zero and keep it there.

That will do more toward inspiring savings than any other single action the Fed can take, I believe. Is that true, would you say?

Mr. GREENSPAN. I have said that many times, Mr. Chairman, so I could say nothing more than——

Chairman NEAL OF NORTH CAROLINA. We talk about the gimmicks, Mr. Kennedy is right, you are right. There is no real evidence that IRA's and so on really increase the overall level of savings. You want to take a shot with them, fine.

I am not against it. I think I am a cosponsor of a bill that would do that. It might help a little bit, but does it really get to the core problem?

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No, it doesn't. You want to get to the core problem, and we have to really go at the basics, balance the Federal budget or get closer to it, and on the monetary side, reduce and keep inflation low.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman. You have touched a little bit on what I want to ask about. Mr. Greenspan, Mr. Kennedy mentioned that there is a report today that says the administration has had to revise upward its estimate of the deficit for next year to $348 billion, and some people think it may even go higher than that.

To some of us who really don't understand these things, we aren't economists, loss of a billion dollars a day at the Federal level and of national debt of well over $4 trillion are scary things, and they cause great concern, to put it lightly.

Does all of this Federal debt and do all of these huge deficits, do they have—do they cause you great concern, and what effect are they having on our economic posture in this country today, and can we have any sustained long-term recovery unless we get the Federal Government under control from a fiscal standpoint?

Mr. GREENSPAN. I am very concerned about the level of the deficit and have been for quite a while. I have argued before the Congress on innumerable occasions the importance of getting the drain on private saving down, which is, of course, what the Federal deficit does.

It drains away some of the private saving which would otherwise go into productive investment. I was quite chagrined at the state of affairs that was emerging with our inability to come to grips with this in years past, but even though, as I have indicated earlier, I, like everyone else, had troubles with the particular elements with the budget agreement that took place last October, I suspect that we may finally be seeing a mechanism which will put this huge, burgeoning problem under control.

I did not like nor did I feel comfortable with the revisions that I saw, as you saw, yesterday. However, knowing how the process is functioning, I still have confidence that we will see a significant reduction in that process and very specifically on the size of the borrowing which the Federal Government has taken which, needless to say, has created fairly significant pressure in the financial markets.

I don't think there is any question that at least some of the problems that we are having with long-term interest rates higher than we would like is that the supply coming on the markets is continuously very large.

I am hopeful that we will soon see that change, and certainly if the Congress adheres to the various procedures that are implicit in that budget agreement and enacted into law, I am hopeful that we will see a significant reversal in this process.

Mr. DUNCAN. So you think we are seeing some light at the end of the tunnel, so to speak?

Mr. GREENSPAN. I should hope so.

Mr. DUNCAN. Let me go in another direction. You say in your testimony that the credit retrenchment appears to have gone beyond the point of sensible balance, and we have heard other testimony in this subcommittee about how more and more lending is

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being done by nonbank lenders who are not subject to all of the rules, regulations, and red tape that the banks are put under, and you say that regulatory efforts to address this credit crunch and these credit concerns continue.

How do we walk that thin line or what do we do to walk the line between the public's demand for tight regulations on the banks to get the crooks, so to speak, and yet allow some flexibility or leeway for the bankers.

We had a banker from Ohio who testified one day in front of the Financial Institutions Subcommittee, and he said, you know, every loan, even the best loan, has some risk to it. He said the bank regulators won't let us take into consideration things like future earnings prospects and character and good will and things that we used to be able to take into consideration.

They want to know only about cash-flow. How do we tighten up on one hand and loosen up on the other?

Mr. GREENSPAN. Congressman, you are raising the basic dilemma of bank regulation. The best way to do it is to recognize that there is a tendency both on the part of the lending officers of the commercial banks and the examiners who come into those banks to be unnecessarily lax in periods when the economy is surging forward, when appraisals for various different types of properties are going straight up, and where loans that are being made look inordinately safe. You get an attitude during that period which turns very dramatically when the economy changes, and we get what we are seeing today, mainly, in many respects almost the mirror image in reverse of the attitudes of all the participants of what was occurring at the top of the cycle.

I don't know whether we are going to be able to succeed, but I should certainly hope that a number of regulators are beginning to try to find ways in which we can take that cycle and smooth it down so that we are neither overly lax in periods of expansion nor unduly constrictive during periods of decline.

My impression is that were we able to do that, we would find that this continuous dilemma of whether you are being too tight or too lenient would disappear, but you have stated the dilemma relatively clear, and that is to a large extent the way we look at it, as well.

Mr. DUNCAN. Thank you.

Chairman NEAL OF NORTH CAROLINA. Mr. Hoagland.

Mr. HOAGLAND. Well, thank you, Mr. Chairman, for allowing us nonmembers of the subcommittee to participate in this hearing.

Chairman Greenspan, our Banking Committee here in the House completed its work last June, and as you know, we reported out a comprehensive bill changing Federal banking statutes and regulations, and immediately the bill ran into some entrepreneurial differences in the House, which will no doubt continue.

I wanted to ask you, in light of your report, when the bill must pass in terms of granting the borrowing authority to the BIF that the bill contains?

Mr. GREENSPAN. Well, that issue has been examined in some detail by Chairman Seidman, Treasury Secretary Brady, and others with respect to when BIF really needs replenishment, and it has been the conclusion that there is ample time at this stage to

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bring the bill, the broad bill which this subcommittee overall approved, to the floor in time to get those provisions passed and to get proper BIF recapitalization.

It would be really most unfortunate if this process were stretched out in a manner which required the House to break apart the BIF recapitalization from the rest of the bill and deal with them separately because I do think that it is an integrated process, and a very sensible bill overall, which this subcommittee voted out, and I should certainly hope that it will make significant headway rather quickly on the floor.

Mr. HOAGLAND. Is it your opinion that it needs to pass this session of Congress?

In other words, it needs to pass the House in 1991 and should not be held over until January?

Mr. GREENSPAN. Mr. Hoagland, I am certainly of the opinion it should not be held over. I think that reform is long overdue, and I would say the sooner the better. And so I should certainly hope that the House of Representatives would see fit to complete this legislation as quickly as feasible.

Mr. HOAGLAND. Let me ask you about two specific policy decisions made in the bill that, as I understand it, are coming under assault over in the Energy and Commerce Committee, and ask your opinion of those. The first is the commercial ownership of banks. The second are the provisions as written in our bill that amends Glass-Steagall. I wonder if you might indicate to us whether you support or oppose the position that this subcommittee took on those two issues.

Mr. GREENSPAN. Well, as I testified before this subcommittee in full session, the Federal Reserve supports the principle of joining Commerce and Banking, although we thought that owing to the complexity of the problems associated with it, that it probably should be an issue that is delayed.

With respect to repeal of Glass-Steagall, we are fully in support of its repeal and subscribe to all aspects of the administration's recommendations, which as I understand it, were embodied in the committee print and in the committee vote that will eventually send this bill to the floor.

Mr. HOAGLAND. The bill is very complex, other than the commercial ownership issue which you have just addressed, do you have any reservations about any other aspects of the legislation?

Mr. GREENSPAN. Mr. Hoagland, the one area that we at the Federal Reserve feel somewhat uncomfortable with is the extent of the firewalls that are implicit in the bill which is part of the increase in powers.

In our judgment, the firewall recommendations in the administration's bill are sounder than those which are in the committee print. And that having reviewed this issue in some detail, looking at the pros and cons, while we subscribe several years ago to a higher level, or I should say, a thicker level of firewalls than we would today, we have subsequently reviewed what evidence we have with respect to that and have concluded that we could very well get along, perhaps, beneficially get along with somewhat thinner walls than those walls which are currently implicit in the bill today.

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Mr. HOAGLAND. And you are talking in the securities area?

Mr. GREENSPAN. Yes, very specifically in the securities area.

Mr. HOAGLAND. Thank you, Mr. Chairman.

Thank you, Chairman Neal.

Chairman NEAL OF NORTH CAROLINA. Thanks, Mr. Hoagland.

Mr. Chairman, you said in your testimony that you thought the recession was—that we pretty well bottomed out and heading out of this, maybe slowly. Some commentators predicting what I think has been called by some a "double dip," suggesting that we might be coming out of the recession, but then we might—that might be followed later this year, or early next year some time, with another little dip. Do you see any evidence, anything to suggest to you that that might be the case?

Mr. GREENSPAN. Mr. Chairman, we have great difficulty in forecasting one turn at any time. To try to forecast too far in advance, I think, is straining the capabilities of forecasting techniques.

I must say to you, I don't see the elements of a double dip. I recognize the possibility, but then there are all sorts of possibilities that could emerge. With the various elements that are evolving, it might well turn out that way, and we might see evidence at a later time that that is occurring. But I must say to you at this particular point, I find no credible evidence that would suggest that is the most likely outcome.

Chairman NEAL OF NORTH CAROLINA. During your testimony you placed considerable emphasis on M2. What range for M2 will be needed to achieve and maintain zero inflation, and when do you think that we could expect to see such an M2 growth rate?

Mr. GREENSPAN. Well, first of all, going back to our earlier discussion on this question, on what we really mean by noninflationary environment, it is an environment in which what price changes do occur, do not have any significant effect on business decisions or, in your terms, on saving or investment, or in any of the other areas of concern.

It is apparent from looking at the details of our actual published price indexes that we do not fully capture the improvement in quality that goes on year-by-year, and a truly zero price change probably is consistent with some modest positive inflation rate as measured by the Consumer Price Index.

I suppose, incidentally, that one of the reasons why we were misled about the state of economic well-being behind the Iron Curtain at the height of the cold war, is we did not fully understand that there was no quality change in most of the goods that were produced in a central planned economy and that when we were measuring real GNP in the West, we were measuring it in terms of applying price increases which probably overestimated the degree of the real price increase, and as a result had a lower relative GNP; that was apparently not occurring behind the Iron Curtain.

In other words, that Trabant, the cars that the East Germans produced, was probably the same car in the 1950's as it was before they shut the lines down, and the price may or may not have changed, but the quality certainly changed insignificantly.

Even though we endeavor to try to adjust for price in our cars, and that is part of BLS's procedure in estimating the price index in

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the CPI, we don't really fully do that, and the cars that we have today are significantly better than they were 20 or 30 years ago.

Even after making these various different adjustments and trying to capture the change in quality, we don't fully capture it, which is another way of saying that when we look at a noninflationary, or in your terms, a zero inflation economy, I think it is probably closer to 1 to 1½ percent, or one-half to 1½ percent inflation rate, which is consistent with that noninflationary goal, so that if you then apply that inflation rate to the expectation of real economic growth, that specifies over the long run where the central tendency for M2 should be to be a noninflationary economy.

I would think that that would suggest that somewhere down the line we probably would want to take another notch down in our targets, but I don't think that we need to have a firm view of doing that at any specific period of time.

I am more inclined myself to watch the inflation rate, the measured-inflation rate come down in line with the monetary patterns that are already in place before we seek to make what you would term, I guess, the ultimate adjustment, which brings us to a noninflationary environment.

I don't think we are very far from that, and we have the capability and the necessity of viewing the sustainability of economic growth concurrently with achieving that ultimate goal.

At this stage we are well on the path of actually achieving the type of goals which we have set out to achieve, the solid economic recovery, with the unemployment rate moving down to its lowest sustainable long-term rate, with growth at or close to its maximum long-term sustainable pace, with inflation wholly under control.

I wish also to subscribe to the point you made in your opening remarks that the experience of Germany and Japan in recent years is suggestive that low inflation did really contribute to growth, and it should be a lesson that we must focus upon.

Chairman NEAL OF NORTH CAROLINA. Yes, I think that is a misunderstanding that has been costly to the economy, that somehow low inflation or price stability, zero inflation is inconsistent with growth, and it is simply wrong. It is the way to maximize sustainable growth.

Mr. GREENSPAN. I certainly agree with that, Mr. Chairman.

Chairman NEAL OF NORTH CAROLINA. I appreciate your comments.

Certainly, I take that as certainly good news that we are in the range, that we are close to seeing that accomplishment.

By the way, for whatever it is worth, I want to say I couldn't agree with you more about the definition. When I say zero inflation, I am talking about exactly the same thing you are when you have used the term, which I am sure is more precise, the economic professional's term of price stability.

It just seems to me that zero inflation is more readily understood and is found more acceptable, but they mean the same thing.

Mr. GREENSPAN. The reason I raise the issue is that it becomes a relevant issue when you are beginning to talk specific numbers about target ranges because of what it is we are endeavoring to measure; in other words, you better be certain that the true measure that we are dealing with reflects the way of the world.

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Chairman NEAL OF NORTH CAROLINA. I guess it is a fairly technical point, though. If prices are stable, they are not rising.

Mr. GREENSPAN. Yes.

Chairman NEAL OF NORTH CAROLINA. The idea of rising prices and stable prices are incompatible.

Mr. GREENSPAN. What I am saying is the inflation rate, if the actual measured inflation rate is growing at a very small number, for all practical purposes, it is probably a reflection of the fact that were we able to truly capture the quality changes, it would be zero.

Chairman NEAL OF NORTH CAROLINA. I understand, and I agree. I see the point. I take the point.

I must say I don't fully understand how you expect to achieve that, though, with M2 growth somewhere in the ranges that you are talking about now, I think we are—what was it, 2½, 3½ to 6, something like that? What are the ranges that we have now?

Mr. GREENSPAN. We are now 2½ to 6½.

Chairman NEAL OF NORTH CAROLINA. Two and a half to six and a half.

It seemed to me that an M2 growth rate of 6½ percent would be totally incompatible with price stability.

Mr. GREENSPAN. Over the long run, that is correct.

Chairman NEAL OF NORTH CAROLINA. So there is going to have to be some adjustment downward in M2 growth.

Mr. GREENSPAN. As I indicated in my earlier remarks, at some point, I don't think it is important necessarily to say when, but there is probably a final downward notch, a small one, to create target ranges which are consistent with what you say is price stability.

Chairman NEAL OF NORTH CAROLINA. Well, my time has expired. I want to return to this in just a minute if I can, but I have to abide by the rules here.

Mr. Roth.

Mr. ROTH. Thank you.

Mr. Chairman, I read all these things about Chairman Greenspan, he is the second most influential man in the country and all these things.

I am curious, 25 years from now when young people in the colleges open their textbooks, when the *Wall Street Journal* looks back on the Greenspan legacy, what is the legacy going to be; or what do you want it to be?

Mr. GREENSPAN. Well, I should certainly hope that it will say that we succeeded in achieving the types of goals which I have spelled out many times before this subcommittee, which are essentially to achieve maximum, long-term economic growth in the context of a noninflationary environment, which we perceive as a necessary condition to achieving that long-term economic growth.

Mr. ROTH. Of course, that long-term economic growth, as you have mentioned here, primarily or one of the main reasons that we have long-term growth is our savings rate, right?

The savings rate, one of the key provisions, pillars of that is going to be the savings rate?

Mr. GREENSPAN. Yes. I am not saying that, obviously, monetary policy can achieve all of those elements, but what we can do is put in place a policy in which whatever monetary policy can do to

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achieve that, we have done, but you are clearly quite correct, there are other elements in economic policy, certainly budget policy, regulatory policy, among other things, which will be factors clearly related to whether we can achieve what maximum growth is possible in this country.

Mr. ROTH. Well, in this question of legacies, I am not asking this question lightly, because it tells you what a man is focused on, if you ask him what is your goal, you can see pretty well where he is going to be coming from. You have listed a number of items, of course, that you are working toward.

Now, if you had to prioritize them in these Greenspan legacies, what is the most important, is it going to be to keep inflation under 4 percent, is it going to be to keep lower interest rates? What was the top priority?

Mr. GREENSPAN. Mr. Roth, I don't view it as priorities, because I think there is, essentially, a single standard out there which is a balance of policy in which we achieve all of these simultaneously. If we fail to do that, I would say we have come up short.

Mr. ROTH. OK. Thank you very much.

Chairman NEAL OF NORTH CAROLINA. Mr. Neal.

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

Mr. Greenspan, are you in favor of a gradual recovery? I mean, you did declare the recession to be over.

Mr. GREENSPAN. Well, I am not in a position to declare anything in that respect.

Mr. NEAL OF MASSACHUSETTS. Well, Mr. Roth said you were the second most powerful person in America, so we would subscribe to your thought processes on it.

Mr. GREENSPAN. He may perceive that, but I don't.

Mr. NEAL OF MASSACHUSETTS. At least you came very close to declaring it over this morning. Did the Fed favor, or do you favor a gradual recovery?

There has been ample publicity generated suggesting that because of the condition of American banks today——

Mr. GREENSPAN. I don't think we look at it that way. I think that we would like to see the recovery fairly robust.

Obviously, the more the better in the context of not running off the tracks. I think there is ample room for a fairly significant recovery without that happening.

Mr. NEAL OF MASSACHUSETTS. A follow-up question to that, is you touched upon it in your testimony this morning, how do you relate the problems of local governments and State governments across the country to the overall economic problems that we have, I guess, as it relates to consumer confidence as well?

Mr. GREENSPAN. Well, I think that it is a relatively severe problem.

Mr. NEAL OF MASSACHUSETTS. We keep saying things that makes people dash to the door. I suppose it comes from you, being the second most powerful person in the government, not from my line of questioning.

Mr. GREENSPAN. You leave me speechless. The State and local problem is a very severe one. It doesn't require much to take a look at the individual accounts of the various States and a number of

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municipalities to know there are some real difficulties and hardships there.

I do think, however, that as the economy starts to turn up, receipts will move since, obviously, there is a very close relationship between the receipts, nonproperty receipts, and a number of these State and local units.

Mr. NEAL OF MASSACHUSETTS. You mean the growth taxes?

Mr. GREENSPAN. Yes; in other words, taxes. If we leave the property taxes aside, which are another problem, there is a very substantial part of the tax receipts of State and local governments which are highly sensitive to the economy, and I think that that is going to make a major change. Nonetheless, I do think that there probably is going to have to be, and, indeed, there is, some fairly significant belt tightening that is in the process of occurring, and as we see it, there is a substantial fiscal drag on the economy that is occurring from this issue of State and local governments pulling in.

Since a substantial amount of the revenues which accrue to State and local governments come from property and since property values have, obviously, been in some difficulty, a goodly part of the recovery in State and local governments is going to rest upon the stabilization and recovery of the real estate industry.

Mr. NEAL OF MASSACHUSETTS. Thank you.

Mr. Chairman, I found this very helpful this morning, very helpful.

Chairman NEAL OF NORTH CAROLINA. Thank you. Glad you are here.

Thanks for coming.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. Greenspan, one last question.

The President is presently at a summit meeting designed, at least in part, or as one of its goals it is intended to encourage Russia and, perhaps, other countries to put more free enterprise into their systems and have less government control of economy, and yet I recall reading last summer where the chairman emeritus or the head of Sony made some comments about our own economy that angered some Americans, but one of his main points was he said that the major problem with the American economy today was that American business was overregulated or subject to too much regulation.

We have talked in recent years about deregulation of certain industries, and yet to most of the lawyers in those industries they laugh about that because they know that the airlines and certain other industries that supposedly have been deregulated, are subject to more laws, rules, and regulations today than probably ever before. Do you feel, sir, that our economy is overregulated, and do you think that our economy would grow stronger if we could work some more free enterprise into our own system or is that not a problem in your mind?

Mr. GREENSPAN. No, I do think in the very broadest sense that there is more regulation in our system than is desirable or necessary. Obviously, in certain specific areas, specifically, regrettably, where I am actually a regulator, it has become clear that certain

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increases in regulations, such as the various initiatives on international banking that we brought to this subcommittee a short while ago, are required. But having said that, I certainly was fully supportive and continue to be supportive of the general thrust toward increasing deregulation because I think it is very obvious that it is helpful to economic growth and long-term gains in standards of living.

Mr. DUNCAN. Thank you.

Chairman NEAL OF NORTH CAROLINA. Thank you, sir.

Mr. Chairman, back to this question that we were discussing a moment ago.

Wouldn't part of our success on achieving price stability, zero inflation be dependent on the credibility of that effort, people believing that, in fact, we are serious, that we are going to achieve it and we are going to maintain it?

It seems to me that a lack of credibility is the explanation for the wide spread between short and long rates that is just not believed. I am not sure of that, but since we have not maintained zero inflation as a matter of policy, a matter of practice over many years, I think it is going to take some effort to convince investors, the public, that we are serious.

So maybe I am wrong about that, but I would love for you to comment on that. And if that is the case, wouldn't it be useful to ratchet down these target ranges in a visible sense.

I am just wondering about the benefit of mystery here, what benefit do we enjoy from not being clear about this?

I guess the only thing I can think of that might explain their reluctance would be changes in velocity, that if there were changes from time to time, that that might then run up the growth and then that might reduce credibility. But anyway, would you comment on this?

Mr. GREENSPAN. First of all, credibility is a very difficult thing to measure. I mean, clearly, there is no analytical technique that we have which says this is increasing or decreasing, we really don't know. We can make judgments, we can make guesses, we can get market opinions.

However, while I don't dismiss the importance of credibility, far more important is not what you say but what you do.

Chairman NEAL OF NORTH CAROLINA. Well, then in that light, comment on the target.

Mr. GREENSPAN. I basically will. Were we not in a position at this stage where we are dealing with a still fragile, although significantly less fragile financial structure than we had 6 months or 9 months ago, or if we were beyond the credit crunch and the financial structure was back in balance in all respects, I think one could make a stronger argument for moving targets down at this particular stage.

Were we in a position where inflation was rampant, and we had very high targets and we had to move them down pretty quickly because you can't create a gradualist view of getting inflation out of your system when you are dealing with double-digit inflation and instability; if you say you are going to take it out of the system in 10 years, it means you are not going to take it out of the system ever. But we are now at a point where we are close enough where

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we have the luxury, if I may put it that way, to decide how we make these adjustments. And I think that we do and should take into consideration the fact that we are still in a fragile system and that we believe that the actual measured rate of inflation will continue to come down in the context of the targets we are discussing this morning.

They will not come down, as best we can judge, to, as you put it, zero or the zero equivalent, and I don't think that we need to do that right away, but I do think ultimately it would be certainly helpful for all of the reasons which you suggest. But I see no need at this point, there is no urgency to initiate that, and I should think that so long as we maintain an overall policy which remains consistent with economic growth and the context of declining inflation, we can adjust sometime in the future as we see fit to get, as you would put it, the ultimate target range from which one would assume a noninflationary policy would continue to come forth.

Chairman NEAL OF NORTH CAROLINA. Well, ultimately isn't that going to be in the range of 4 percent, something like that? I mean, if we assume growth to be 2, 2½ percent, if zero, in fact, 1 or 1½, or something like that, it seems to me that that suggests that 4 percent M2 growth is about what it is going to take to make——

Mr. GREENSPAN. I don't want to give you a specific number, but, obviously, it is somewhat not terribly far from that. If you say 1 percent growth, or something of that nature, that is not very far from where we are at the particular time. And remember, Mr. Chairman, as I said in the prepared remarks, we continuously review these targets every 6 months, and the purpose of it basically is to make judgments as to whether or not they should or should not be changed.

Chairman NEAL OF NORTH CAROLINA. Well, anyway, I commend you for it. I think you are on the right track. I think that because I think that the only way we can accomplish our other economic objectives of lower interest rate, maximum growth, maximum employment, maximum productivity, maximum savings, maximum competitiveness, and so on, is, in fact, to achieve zero inflation.

So I certainly commend you for your efforts. I think we are on the right path. It is hard, frankly, to argue about the timing of it.

We are probably making all the progress we can, given everything else that is going on in the economy. It would be disturbing if we were moving in any other direction, frankly.

I just have one other question, and then I will yield one more time.

Earlier, last year, the Fed and the Treasury were intervening heavily in foreign exchange markets, buying foreign currencies to try to manipulate the value of the dollar. As a result of that your holdings in foreign currency increased substantially.

Now the dollar is going up again in value on foreign exchange markets, and that would suggest that the Fed and Treasury have suffered losses in their currency holdings as a result of that. That is true, I assume it must be true, doesn't that suggest that the earlier intervention was a mistake?

Mr. GREENSPAN. First of all, I think you have to look at the other side of the issue as far as the books are concerned. The early stages of that intervention led to very substantial potential gains which

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have now been offset to a large extent, but not fully by losses. Although this has not been our purpose, my recollection is it is that the total net is plus rather than minus so that there has not been a loss here, as I recall the data.

Nonetheless, I don't think we should be viewing this type of intervention as endeavoring to make profits for the monetary authorities. It is done for purposes of stabilizing the currency which has broader macroeconomic advantages.

Clearly a stable dollar will reduce risk premiums and make economic performance both here and abroad to the extent that others do it, superior to what it would otherwise be. So what we are trying to do is to create an economic value, the order of magnitude of which is very difficult to measure, and while it may be that in the process there are some foreign exchange losses, the cost probably is very small relative to the economic advantages that accrue to the Nation.

But having said that, my recollection of the accounts, and this will be defined in considerably more detail in the report that we make in early September, is that on balance we have come out OK with respect to the gains and losses on exchange trade.

Chairman NEAL OF NORTH CAROLINA. I know you are not in the business of speculating on foreign exchange, but it is hard for me to see also the gains from that intervention.

Mr. GREENSPAN. You are raising the question that obviously we discuss at great length ourselves within the Fed, at the Treasury, and specifically in the various fora in which central bankers tend to meet, and the general conclusion basically that seems to be fairly prevalent is that intervention cannot significantly alter the major trends in currencies, but it has some capability of success in keeping instabilities down, disruptions at a minimum, and creating a more balanced market which has advantages for trade and capital movements.

Chairman NEAL OF NORTH CAROLINA Thank you.

Mr. Roth.

Mr. ROTH. Thank you. I just have one short question, but before I do that, I was going to say I was hoping, Mr. Greenspan, that you would tell the Congress that we have got to do something about these deficits more than just last fall's agreement.

I don't like to disagree with you, but I must disagree. I don't think that last fall's agreement, budget agreement is going to bring these deficits under control, and I think we have got to do much more, but having said that, there is a very historic meeting taking place in London, as you know, today.

I don't think we realize how historic this meeting is until we read history books 25, 30 years from now. That is Gorbachev coming to the Western leaders in London today. What should the President do when Gorbachev asks for aid? Should we give U.S. aid?

What should the Western World do? Should they give aid to Gorbachev? What is your analysis?

Mr. GREENSPAN. Well, Mr. Roth, I think, as many of the members of the G-7 have indicated in recent weeks, that the most important thing that the Soviet Union could do is to set in place a structure of reforms, specifically in the area of setting up a free

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market infrastructure, a body of laws, a culture which essentially would enable the centrally planned economy to wither away and a market economy to emerge.

As best I can judge, listening to the remarks of Mr. Gorbachev, he understands that, and what he is essentially endeavoring to do is to communicate to the G-7 that he understands. And the conversations, hopefully, will be about the general recognition that the solution to the Soviets' economic difficulties is to move as quickly as is feasible to a market structure and away from what has been an extraordinarily deleterious, uneconomic, centrally planned system.

Mr. ROTH. But that is not really answering my question. What should the President do? Should he give him aid? Should the West give him aid?

Mr. GREENSPAN. Mr. Roth, I have communicated my views to the President on that issue, and I should like to leave it there, if I may.

Mr. ROTH. Well, I see that again, we go back to this shroud of secrecy around the Fed. I sure would like to know what you told the President.

Mr. GREENSPAN. That has to do with the shroud of secrecy which I think is most appropriate when one communicates views to the President. That is, I think, desirable. It is a long tradition in this country which I subscribe to that if the President wishes to stipulate to what he heard, that is his judgment, but I don't like writing open letters to the President of the United States.

Mr. ROTH. OK. Thank you, Mr. Chairman.

Chairman NEAL OF NORTH CAROLINA. Mr. Duncan.

Mr. DUNCAN. I have no other questions.

Chairman NEAL OF NORTH CAROLINA. Thank you. On that score, the President, I read a quote somewhere about his willingness to help the Soviets develop a fully convertible currency. What would that mean?

Mr. GREENSPAN. What would it mean?

Chairman NEAL OF NORTH CAROLINA. Yes, sir.

Mr. GREENSPAN. You have to define convertibility with respect to the ruble in two senses. First, they have to achieve what economists call internal convertibility, meaning that in a sense the currency has value and is legal tender for the purchase of goods and services within that economy, even were it closed. It is fairly apparent that with the extraordinary queues that still characterize the Soviet system, they do not yet have what we would term full internal convertibility.

Once that is achieved, then the question is attaining convertibility relative to currencies outside of the Soviet Union. I think that is basically what he is referring to. The analogy, I suspect, that is involved here refers to what was done for Poland when they devalued and went to convertibility. There was a large fund that was contributed to by a number of countries in hard currencies to support the Polish currency against the Western currencies, which has to a substantial extent succeeded.

But in order to make that succeed in the Soviet Union, in my judgment, it will have to be a major reduction, hopefully, and in fact probably necessarily an elimination of their huge budget deficit which currently gets funding mainly, if not wholly, by the printing of money. And unless and until they can shut off the spigot

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which is creating excess money, which obviously means that the ruble is declining in the black market and in fact in the financial markets, until that is done, and the monetary overhang that is the excess amount of currency which is creating these queues in the Soviet Union, until that is done, it will be very difficult to get a stabilized currency for the ruble in the international markets.

So that they have got a lot of very important major macroeconomic adjustments to make, not to mention the extraordinary, huge number of microeconomic adjustments to move from the centrally planned rigid structure which they have to a market system.

Chairman NEAL OF NORTH CAROLINA. Supporting—somehow supporting their currency which is inflated internally would just amount to a subsidy through another door.

Mr. GREENSPAN. I don't think anybody would recommend that international convertibility for currency is feasible in the context of very large currency creation of the type that is currently going on.

Chairman NEAL OF NORTH CAROLINA. They are a long way from any kind of international convertibility.

Mr. GREENSPAN. I would think that is the case.

Chairman NEAL OF NORTH CAROLINA. Why was it necessary to support—you mentioned the Polish situation. Why was it necessary to support that? Why couldn't the value be established in a free market?

Mr. GREENSPAN. Well, because they were concerned, and I think rightfully, that unless they stabilized their currency, that is the Poles, that they would be visited by massive inflation potential if the currency began to weaken dramatically because import prices would then rise substantially, which would work its way through the price structure in Poland, and unquestionably disrupt the endeavors that they were currently involved with.

Chairman NEAL OF NORTH CAROLINA. But wouldn't that just signal that they have priced it improperly to begin with?

Mr. GREENSPAN. Well, the answer is, yes, it would, but the point being that there is a vicious circle which would begin to emerge. If your currency begins to collapse, it creates a significant amount of internal inflation, which in turn weakens the currency still further.

Chairman NEAL OF NORTH CAROLINA. I see.

Mr. GREENSPAN. So that the advantage of a stabilization procedure with external assistance is to try to break the circle.

Chairman NEAL OF NORTH CAROLINA. So it is only necessary during a transition period, during a relatively brief transition period?

Mr. GREENSPAN. Yes. Ultimately you would want a country to have adequate reserves to maintain its position after a while, and you would certainly want a situation in which you could stabilize the currency so that the markets would basically then perceive that it would continue to stay stable, and you would soon begin to get individuals willing to invest in longer term claims against that currency.

The reason we have 30-year bonds, for example, in this country and elsewhere is that the holders believe that even though there may be some inflation over the next 30 years, that the major part

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of the value of that currency will be maintained, and people are willing to make long-term investments, so that what you are substantially endeavoring to do is to create a sense of security about the value of the currency over the longer term, which tends to create a virtuous cycle, if I may put it that way.

Chairman NEAL OF NORTH CAROLINA. I don't mean to—this is not the subject of our hearing. I am just curious, though. It does seem to me that a real benefit to the Soviets—to our central bank, you and your folks could be a big help to the Soviets in terms of setting up a system to establish some credibility in their currency and a healthy economy.

Do they call on you?

Mr. GREENSPAN. Oh, yes, we have spoken to them on many occasions over the last 2 or 3 years.

Chairman NEAL OF NORTH CAROLINA. Well, that is great. Are there other questions?

Mr. ROTH. I don't have any other questions. I was just wondering, however, when you mentioned to the President, gave him your views on what was going to be happening today, did he wink at you or did he nod or smile? What kind of body language did he have?

Mr. GREENSPAN. You have put me in an impossible position, Mr. Roth. I don't, frankly, remember, but if I did, if I believe what I said before, which I do, I would not want to comment. The one thing I will say about the President of the United States is he is very knowledgeable about these issues, and I must tell you that a lot of the times you think you are giving him new information, and he has heard it 10 times before. And he often knows a good deal more about certain issues than I do, so I don't want to suggest that the way the President gets his ideas is that somebody sits there and tells him and he absorbs it.

That is not my impression. I think he is somebody who has been around the horn many times.

Mr. ROTH. Thank you, Mr. Chairman.

Chairman NEAL OF NORTH CAROLINA. Thank you, sir.

Well, Mr. Chairman, thank you again for being with us today. It was a very useful hearing.

Mr. GREENSPAN. Thank you, Mr. Chairman.

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

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A P P E N D I X

July 16, 1991

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OPENING STATEMENT

The Honorable Stephen L. Neal, Chairman

Subcommittee on Domestic Monetary Policy

July 16, 1991

Today we are delighted to welcome the Chairman of the Federal Reserve to present the Fed's Report to Congress on Monetary Policy. I would like to begin by congratulating him on his nomination for new terms as Governor and as Chairman. He has richly earned the respect and confidence of the public for his stewardship of monetary policy. He certainly deserves another four years at the head of the Federal Reserve System.

There is, in addition, a very specific reason he deserves another term at the helm. The primary objective of his conduct of monetary policy, as he has reaffirmed again and again before this Committee, must be the gradual but inexorable elimination of inflation. In his first term the Federal Open Market Committee launched monetary policy on a path that should, over time, reduce measured inflation to insignificant levels. Despite some ups and downs, the longer-term growth rates of M2 have been dramatically reduced over the past four years. As Chairman Greenspan emphasized in previous testimony, that decline in monetary growth has been no accident. It has been a necessary condition for reducing, and eventually eliminating, inflation.

Though a necessary condition, I must note that it has not been, as yet, a sufficient condition. Measured inflation has yet to register any significant break from its 4-5% plateau. I will want to question the Chairman about the prospects for progress in reducing inflation in the near term. At present I will only call attention to several factors which have been impeding this effort.

In the first instance, we must remember that monetary policy operates with lags, possibly very long lags. The major impact of reduced money growth over the past few years may still lie ahead of us. Moreover, the fact that measured inflation has not fallen over the past four years -- it has, in fact, risen slightly -- does not prove that the Fed's strategy has lacked any bite whatsoever. One must recall that monetary growth had been very rapid in the mid-80's. The decompression that began about 1987 served, in part, to offset the rapid expansion of previous years. Though I cannot prove the point, I suspect that monetary policy since about 1987-88 has had a very significant impact on inflation. But that impact is not observable, since it just stymied an inflationary explosion that would have otherwise occurred. The first four years of Chairman Greenspan's tenure served to arrest an accumulating inflationary momentum. Actually reducing measured inflation to trivial levels remains the objective of the next four years.

I will conclude by calling attention to the major political impediment that threatens to undermine that objective at every turn. To put it bluntly, this Administration consistently refuses to support a monetary policy aimed at eliminating inflation. Despite what it says, its actions speak loudly to the financial markets. And those actions have been very clear. First, the President dawdled until the last possible moment in reappointing Mr. Greenspan. That could only signal to the markets an ongoing campaign to bulldoze the Fed into re-inflating the economy in time for the next election.

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Secondly, the Secretary of the Treasury seems to spend most of his time trying to browbeat all the major countries to re-inflate right along with us, if not ahead of us. It is positively embarrassing to witness such maladroit, and potentially ruinous, financial diplomacy.

How do financial markets react to these episodes? They read in them a persistent pattern of political pressure on the Fed to cave in to inflation. The credibility of a long-term commitment to eliminating inflation is undermined. The markets simply do not believe, yet, that inflation can or will be eradicated. Thus, inflationary expectations change very little, even in the midst of a recession. As a consequence, long-term interest rates remain high, even when short rates fall considerably. The economy remains weaker, inflation more stubbornly resistant than they should be. And primarily because the Administration simply refuses to accept the basic point about the purpose of monetary policy: anti-inflation is the best policy for economic growth and prosperity.

By spurning zero inflation the Administration turns its back on the benefits that would surely follow: long-term government interest rates would fall to the 3-4% range, with mortgage rates not much higher. The budget deficit would drop, as the Treasury issued debt more cheaply. Savings and investment would be stimulated. Savers would no longer fear the corroding effect of inflation. Inflation would no longer undermine the long-term planning needed for productive investment. Productivity would rise, driven by new savings and new investment. Unemployment would fall, on average, to the lowest levels possible, as the economy became more efficient, more productive, and less prone to recession. Since most recessions are by-products of the periodic need to regain control over inflation, they would be minimized by a policy resolutely targeted on zero inflation.

Our major competitors have learned this lesson. Japan's competitiveness is, in part, a consequence of its success in stabilizing prices. The same for Germany. And the same will be true of a new European currency, if it is managed to achieve the price stability that will likely be mandated for a new European central bank. We would then need our own zero inflation just to remain competitive in the world economy. Otherwise, we would face periodic recessions, stagnating productivity, the constant erosion of competitiveness -- in short, unabated economic decline.

Debate on this issue tends to emphasize the short-term costs of attaining zero inflation. It fails to recognize the long-term costs of <u>not</u> eliminating inflation. Those costs are severe, because they burden our economy year after year, with no relief in sight. But the benefits of zero inflation, once achieved, are also exponential: they grow and compound year after year, paving the way for the strongest possible growth our economy can achieve.

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July 16, 1991

Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

July 16, 1991

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Mr. Chairman and members of the Committee, I am pleased to be here today to present the midyear Monetary Policy Report to the Congress. My prepared remarks this morning will take their cue from that Report by focusing on current economic and financial conditions, as well as on the outlook for the economy and monetary policy over the coming year and a half. These topics merit particularly close attention at the current time, when the economy appears to be poised at a cyclical turning point--moving from recession to expansion. In addition, I plan to devote some time to discussing the importance of the changes that we have been seeing in patterns of credit usage and in the flows of money and credit through the financial system. There are signs of what could be significant departures from the trends prevalent in the 1980s, with potential implications for the interpretation of financial data and economic developments.

Economic and Financial Developments in the First Half of 1991

At the time of our last Report in February, the economy had been declining for several months. The considerable uncertainty and higher oil prices that followed the invasion of Kuwait had depressed confidence and real incomes, discouraging spending by consumers and businesses and pulling down output and employment. However, even by February, the first seeds of an economic recovery appeared to have been sown: The initial coalition successes in the Gulf War, the reversal of much of the runup in oil prices, and the significant easing of monetary policy all pointed in the direction of a resumption of growth.

Today, there are compelling signs that the recession is behind us. Although the turning point has not yet been given a precise date, a

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variety of cyclical indicators bottomed out by early spring, and some have moved noticeably higher in recent months. Such data strongly suggest that the economy is moving into the expansion phase of the cycle. Nevertheless, convincing evidence of a dynamic expansion is still rather limited, and we must remain alert to the chance that the recovery could be muted or could even falter.

In recent months, there also have been promising signs of a slowing in inflation. The price figures themselves have bounced around from month to month, partly in response to the gyrations in oil prices and the partial embedding of those swings in the underlying cost structure of the economy. A bunching of price increases and excise tax hikes at the beginning of the year also boosted "core" inflation measures for a time. But in their wake, an underlying softening trend has become evident, with consumer prices outside of the food and energy sectors rising quite modestly. In an environment of slack demand, businesses have worked especially hard to control costs by keeping their operations as lean and productive as possible.

With the threat of an oil-related inflation surge largely behind us and output evidently declining, the Federal Reserve took a series of easing steps in quick succession over the latter part of last year and into the spring. These actions, aimed at ensuring a satisfactory upturn in the economy, brought the federal funds rate more than 2 percentage points below its pre-recession level and 4 percentage points below its peak of about two years ago. Other short-term interest rates dropped more or less commensurately. Despite the progressive easing of monetary policy, the foreign exchange value of the dollar is

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up substantially since the beginning of the year, in part owing to the brightening outlook in the United States for economic recovery without added inflation. Anticipations of economic expansion also were reflected in rising stock prices and in long-term interest rates, which have changed relatively little on balance so far this year even as short-term rates have declined.

With the cumulative drop in short-term interest rates making monetary assets more attractive to the public, M2 growth picked up noticeably in the first half of 1991. Its growth probably was restrained to a degree, however, by the firmness in returns on capital market instruments. And, as had been anticipated at the beginning of the year, growth of M2 remained below what would have been predicted solely on the basis of historical relationships with interest rates and income. Money growth also continued to be held down by the ongoing restructuring of credit flows away from depository institutions. As the thrift industry has contracted and banks have remained quite cautious about expanding their balance sheets, there has been less need for depositories to issue liabilities--which constitute the vast bulk of the monetary aggregates. Currently, M2 and M3 are somewhat below the midpoints of their respective target ranges.

In the last several months, monetary policy has adopted a posture of watchful waiting as economic indicators have pointed increasingly toward recovery. With an eye to the usual lags in policy effects, this stance has been viewed as prudent to guard against the risk of adding excessive monetary stimulus to an economy that might already be solidly into recovery. Monetary policy during the first half

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of the year has had two jobs: first, to help bring the economy out of recession and, second, to avoid setting the stage for the next recession, which would follow if we allowed inflationary imbalances to develop in the economy.

The progress against inflation that has been set in motion must not be lost. Moreover, by consolidating and building upon the gains against inflation, we come that much closer to our longer-run goal of price stability. Inflation and uncertainty about inflation keep interest rates higher than they need be, distort saving and investment, and impede the ability of our economy to operate at its peak efficiency and to generate higher standards of living.

The Economic Outlook

It is this strategy that has been guiding monetary policy recently, and the effects of the strategy are reflected in the economic projections of the Federal Open Market Committee members and other Reserve Bank presidents. On the whole, their outlook is for underlying inflation to continue to slacken as the economy first recovers and then expands at a moderate rate through the end of next year.

For this year, while there remain--without question--frailties in the economy, economic activity appears on balance to be picking up in a fairly broad-based manner. The expectation that the turnaround in output is occurring, and that it will persist, is evident in the economic projections of the FOMC members and other Reserve Bank presidents. Their forecasts for real GNP growth over the four quarters of 1991 center on 1 percent or a shade below, implying growth over the

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remainder of this year that not only offsets the first-quarter decline in GNP, but also lifts output above its pre-recession peak by year-end.

Two fundamental questions may be posed with regard to this outlook for the rest of the year. The first is an inquiry into the potential sources of strength in the recovery--those forces that will be at work to pull the economy out of recession in a lasting fashion. We see a number of factors as having set the stage for the recovery: in particular, the reversal of the spike in world oil prices and the favorable effects of that reversal on real incomes; the conclusion of the Gulf War and the consequent rebound in consumer and business confidence; and, finally, the decline in short-term interest rates following our policy easings and the narrowing of risk premiums in financial markets. Against this backdrop, consumer expenditure growth seems to have turned positive again, along with real income; homebuilding has bottomed out and is providing some lift to overall growth; and orders for capital goods are pointing to a firming in demand that should be reflected in production and shipments in coming months.

The strongest force behind output growth in the near term, though, probably will be the behavior of inventories. Business inventories have been drawn down aggressively in recent quarters, and, with inventories now quite lean, sales increasingly will have to be satisfied out of new production. The inherent dynamics of an inventory cycle, as the drawdown ceases and eventually turns to rebuilding, likely will engender the bulk of the initial step-up in output. But there may be additional areas of demand that will impel the recovery; it is quite common at this point in the cycle for forecasts both to underestimate

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the strength of the recovery and to miss the forces that end up driving the expansion.

In fact, recessions typically have been followed by periods of appreciably stronger growth than that foreseen here. This raises the second question about the near-term forecasts, that is, whether they are optimistic enough. A number of considerations come to mind on that side of the issue. First, and in some sense most appealing, is the simple notion, which is lent some support by history, that relatively mild recessions beget relatively mild recoveries. And this recession, assuming it came to an end in the spring, seems to have been mild. Not only does it appear to have been marked by a considerably smaller contraction in real GNP and industrial production than the average postwar recession, it also was a bit shorter. In at least one respect, however, this recession was close to average, and that was in job losses, as firms cut payrolls fairly aggressively. Nevertheless, the unemployment rate did not rise as much or as high as was typical in the past.

Arguing against a rapid rebound in the economy are several other factors as well, including the lack of impetus from some sectors that contributed in earlier cycles. First, it has not been unusual to see some fiscal stimulus in the early stages of expansion in the past; this time, however, the Congress and the Administration have worked long and hard to make sure that genuine progress will be made in righting the structural imbalance in the budget, putting federal spending in real terms on a downward path. Nor is fiscal stimulus likely to emerge from the state and local sector, where deepening budget problems are

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constraining spending. A portion of the financial distress of localities can be traced to the softness in real estate markets feeding through to property tax receipts. The condition of the real estate market also is certain to restrain the pickup in construction that usually accompanies a recovery, with overbuilding in commercial real estate likely to damp activity in this area for some time to come. Finally, in the consumer area, expenditures are unlikely to grow more rapidly than personal income, as households avoid reducing their saving rate further from its already low level.

The expansion is seen as becoming more securely established next year, with real GNP growth strong enough to bring the unemployment rate down 1/2 percentage point or more from its current level. Should the recovery unfold about as we expect, price pressures will remain muted and progress on inflation is likely. The expectations of FOMC members and other Reserve Bank presidents for inflation this year are centered in the neighborhood of 3-1/2 percent, well down from the 6-1/4 percent rate of inflation experienced last year. Although the slowdown this year is exaggerated by the retreat in oil prices, a clear deceleration should be evident even abstracting from energy prices. That deceleration in the underlying trend is expected to continue next year, as well. However, the unwinding of the oil shock this year masks the improvement, so that the projection for the increase in overall consumer prices is about the same for 1992 as for 1991.

Ranges for Money and Debt Growth for 1991 and 1992

The FOMC viewed the near-term outlook for output and prices as generally favorable and consistent with growth of money and debt within

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the ranges that had been specified earlier in the year. Consequently, at its meeting earlier this month, the FOMC reaffirmed the 1991 ranges for money and debt growth. In addition, it was felt that the money ranges retained enough scope for policy to be responsive, should the economy stray substantially from its expected path over the remainder of the year. With M2 and M3 now well within their ranges, there remains ample room for money growth to change in the event policy needs either to ease in support of a faltering recovery or to tighten in reaction to an unexpected resurgence of inflation pressures.

Unlike the monetary aggregates, our latest reading on debt of the domestic nonfinancial sectors places it right at the bottom edge of its 1991 range. Its growth has been unusually low, and its position within the range is indicative both of the reduced demands for credit associated with the weak economy and of the restraint, on the part of borrowers and lenders, that has been evident in recent quarters. In these circumstances, the FOMC felt that lowering the monitoring range would be inappropriate and might falsely suggest a complacency on the part of policymakers about weakness in credit growth. Instead, maintaining the debt range unchanged underlines the implication that a further slowdown in this aggregate would warrant close scrutiny.

On a provisional basis, the FOMC extended the 1991 ranges for money and debt growth to 1992, with the understanding that there will be opportunities to reevaluate the appropriateness of these ranges before they come fully into play next year. The ranges were viewed as consistent with additional progress against inflation and with sustained economic expansion. Moreover, the path of no change appeared most

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sensible to the Committee at the current time of some uncertainty about the vigor and even the durability of the economic recovery, as well as about developments affecting the future of the thrift and banking industries.

This uncertainty about the credit intermediation process is one of the factors that could possibly make movements in M2 somewhat difficult to interpret in the short run, but I would emphasize that we expect the aggregate to remain a stable guide for policy over the longer term. The relationship between M2 and nominal income has been one of the more enduring in our financial system. Since the founding of the Federal Reserve, nominal GNP and M2 have grown, on average, at almost precisely the same rate. Presumably, this parity reflects an underlying demand for liquidity on the part of businesses and consumers that is associated with a given level of spending and wealth. This demand is likely to persist, though the financial structures that supply the liquidity may change.

Changing Patterns of Financial Intermediation and Debt Accumulation

Recently, patterns of financial intermediation have been changing, and there are signs that patterns of credit usage in general have been changing as well. It is difficult to know which of these developments will show some permanence and which will prove ephemeral. But some of the recent changes have been striking and have affected a number of the financial variables that the Federal Reserve routinely monitors in an effort to glean information about the health of the economy, the soundness of the financial system, and the appropriateness

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of current monetary policy. I would like to address several aspects of these recent developments in the remainder of my remarks today.

First, at the most aggregate level, the ratio of domestic nonfinancial sector debt to nominal GNP, which soared in the 1980s, is beginning to show signs of flattening out. With the federal government's borrowing lifted by the effects of the recession and payments related to deposit insurance, these signs have been evident so far only in the other sectors. While the changes in behavior may, in part, reflect cyclical factors at work, a longer-term trend also may be emerging. And this trend, if it develops fully, would represent a return to the pattern evident in earlier postwar decades. In that case, it would be the 1980s, with their burgeoning federal deficits and massive corporate restructurings, that would appear the aberration. The deregulation, technological advances, and financial innovations that came at an accelerated pace in the 1980s lowered the cost of borrowing for many and probably raised the equilibrium ratio of debt to net worth for a wide range of economic entities. A temporary surge in borrowing was implied in the course of this transition from one equilibrium to another.

A tapering-off of that surge would then be expected as the new equilibrium was approached, and this may be what we currently are witnessing. The new equilibrium debt-to-income ratio may even be below the current level, implying the possibility of sluggish debt growth for some time. If these sorts of adjustments were in train, the slow debt growth associated with them should not be read as implying that credit was insufficient to support satisfactory economic performance.

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A number of considerations point in the direction of restructuring of balance sheets. The forces that appear to be restraining the demand for credit can be generally categorized as less "grossing up" of balance sheets and less substitution of debt for equity. During the 1980s, there was a great deal of this "grossing up" of balance sheets, as credit financed more purchases both of physical assets and of financial assets. As far as physical assets are concerned, the 1980s saw some strong spending on consumer durables and nonresidential structures; spending on physical assets, such as these, appears more often to be financed with debt than is spending on most other types of goods and services. Now, with stocks of those assets already built up and with tax law changes that have made it less attractive in many cases to borrow to finance their purchase, credit demands are likely to remain relatively damped.

The high interest rates of the late 1970s and early 1980s spurred increased financial innovation and extensive deregulation, helping to bring businesses and consumers increasingly into more complex financial dealings. The state and local sector built up a large stock of financial assets, and the household sector acquired assets from the wider array of instruments available. Moreover, household borrowing behavior was shaped importantly by the rising capital gains available on residential real estate over this period. As house prices escalated, mortgage debt on existing homes increased, both as capital gains were realized in home sales and as unrealized gains were tapped through the use of second mortgages and, more recently, home equity lines. In this

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process, home owners were able to redirect a portion of these capital gains toward other assets or current consumption.

Over the decade, the financial services industry grew at an extraordinary rate, in part by creating debt instruments seemingly tailored to every need and financial assets for any portfolio. While households took advantage of a number of these new instruments, the bulk of them were directed toward business. Mergers and acquisitions took off, financed essentially by debt, resulting in net retirements of equity that averaged nearly $100 billion annually between 1984 and 1989.

More recently, with debt levels relatively high and lenders less eager to extend credit, markets have changed. One aspect of this change shows up dramatically in data for the second quarter, where equity issuance by nonfinancial corporations is estimated to have exceeded equity retirements for the first time in eight years, removing this element behind the buildup of debt. While much of the weakness in credit demand at present reflects cyclical influences, borrowers likely will continue to shy away from the heavy expansion of debt seen in the 1980s.

On the supply side of the credit market, perhaps the major factor at work in creating a break with the behavior of the 1980s has been the adverse consequences of that behavior. It is now clear that a significant fraction of the credit extended during those years should not have been extended. We need merely look at the recent string of defaults and bankruptcies, and the condition of many of our financial intermediaries to confirm this impression.

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In a sense, this process may have been very nearly inevitable. With the financial system groping toward a new equilibrium, the likelihood of mistakes was high. Laxity by lenders abetted the spiral of debt, and we regulators were too often slow to intervene. Now, financial institutions, regulators, and taxpayers are facing the wrenching unwinding of those lending decisions. A key lesson to be learned is how important it is to avoid these costly adjustments in the future and that this can only be done by avoiding a return to such financial laxity.

Going forward, we likely will see a continuation of the "credit correction" now under way. One aspect of this correction is the increased attention paid by regulators and the financial markets to the capital positions of financial intermediaries. The more prudent approach to capitalization and lending decisions is overwhelmingly a healthy development that ultimately will result in strengthened balance sheets for the nation's financial institutions and more assurance of stability of the financial system.

In certain areas, however, the credit retrenchment appears to have gone beyond a point of sensible balance. In some cases, lender attitudes and actions have been characterized by excessive caution. As a result, there doubtless are creditworthy borrowers that are unable to access credit on reasonable terms. Even in the obviously troubled real estate area, new loans are arguably too scarce, in some cases intensifying the illiquidity of the market for existing properties. To an extent, the scarcity of some types of loans may reflect the efforts of individual financial institutions to reduce the share of their assets

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in a particular category, such as commercial mortgages. While a single bank may be able to do this without too much trouble, when the entire industry is trying to make the same balance sheet adjustment, it simply cannot be done without massive untoward effects. Instead, it may be in the banks' self-interest to make the adjustment in an orderly manner over time. Regulatory efforts to address credit availability concerns continue.

Credit conditions remain tight is some sectors, but in others the situation appears to have improved considerably since our last Report in February. To chronicle briefly what we know about credit supply conditions at present: In financial markets generally, risk premiums and spreads between yields on different types of debt have declined substantially this year as investor attitudes have improved. In part reflecting this narrowing, corporate bond offerings surged over the first half of the year. Banking firms, too, gained increased access to capital markets, leaving them in a better position to lend as credit demands begin to pick up in the recovery. Indexes of bank stock prices rose much more rapidly than the stock market as a whole, bringing the average market value of shares in the top fifty bank holding companies back up to around their book value. Yield spreads on bank-related debt obligations narrowed sharply over the first half of the year, prompting considerable issuance. Thus far, however, lending by commercial banks has remained quite weak. To the extent we can judge, this appears primarily to reflect weak credit demand, as is typical at this point in the business cycle. Nonetheless, supply restrictions remain a problem. This so-called "credit crunch" owes importantly to financial

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institutions' efforts to build capital to meet the demands of both the market and the regulators. Information on lending terms, however, suggested little further tightening over the spring.

Not only the behavior of the debt aggregate itself, but also the avenues through which the debt flows, represent something of a break with the past. The recent decline in the importance of depository institutions as intermediaries, when measured by the credit they book, is quite striking. While this predominantly reflects the contraction of the thrift industry, banks, too, have contributed by growing only slowly. Over time, other financial institutions have provided more close substitutes for banking services, and the profitability of the banking industry suffered over the last decade or so from a decline in loan quality. Moreover, recent emphasis on higher capital ratios and higher deposit insurance premiums should affect this trend as well.

Even as the economy has firmed, financial flows through depository institutions have remained weak. Some lag is typical. Indeed, in the case of business loans, there is enough of a regularity that they are included in the Department of Commerce's Index of Lagging Economic Indicators. But lending to businesses has been unusually weak for some time now and the outlook is for a rather modest upturn when it comes. At the same time that decisions to purchase goods and services are made, decisions about the financing of those purchases are usually being made. Increasingly, it appears that those decisions are not being reflected in credit on the books of depository institutions. Banks still may be involved, however. They may, for example, provide letters of credit or arrange financing through a special-purpose

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corporation. Mortgage and consumer debt may pass through the balance sheets of these intermediaries only briefly, as it is increasingly being securitized and sold into capital markets. As banks make further strides in bolstering their capital positions, however, they will become better able to take advantage of opportunities to add profitable loans to their balance sheets. While the role of the banking industry has been changing, its importance in the financial system and the economy remains assured.

In sum, the financial system in this country is changing, and it is changing rapidly. Technology, regulatory initiatives, and market innovations are changing many dimensions of the financial system. The relationships between borrowers and lenders, between risk and balance-sheet exposure, and between credit and money are being altered in profound ways. In response, we must understand the nature of these changes, their permanence, their limitations, and their possible implications for the economy and monetary policy. And we must ensure that the stability of the financial system is protected as changes occur, for a sound financial system is an essential ingredient of an effective monetary policy and a vital economy.

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For use at 10:00 a.m., E.D.T.
Tuesday
July 16, 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

July 16, 1991

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Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 16, 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 and 1992

When the Federal Reserve presented its last monetary policy report to the Congress, in February of this year, the economy was still in a downswing that had been precipitated by Iraq's invasion of Kuwait in August 1990 and the associated spike in oil prices. To be sure, several developments early in the year had created conditions that promised to help foster a turnaround in the economy: Not only had oil prices reversed most of their earlier runup, but monetary policy had been eased substantially in the final months of 1990 and the early part of this year. However, the economy continued to weaken for a time, and policy was eased further into the spring, with the objective of ensuring a satisfactory recovery.

Recent evidence suggests that a pickup in activity probably is now under way. Much of the uncertainty that had depressed business and consumer sentiment was removed by the successful end of hostilities in the Persian Gulf. The resulting improvement in confidence, combined with the boost to real purchasing power provided by the retreat in oil prices, raised consumer spending on balance over the late winter and spring. These same factors, as well as lower mortgage rates, also have spurred a gradual recovery in the housing sector. Reflecting the stimulus from housing and consumer demand, along with the continued growth in U.S. exports, industrial production turned up in April and has advanced appreciably since then; in addition, labor demand showed signs of stabilizing during the spring.

As anticipated earlier this year, inflation has slowed from its pace in 1990. Retail energy prices came down substantially during the first half of the year, and the rise in consumer food prices moderated after several years of relatively large increases. More generally, the softness of labor and product markets has attenuated price pressures for a range of goods and services. This downdrift in "core" inflation was difficult to discern earlier in the year because of a bunching of price increases in January and February; however, most of the significant increases in those months either did not continue or were reversed.

The Federal Reserve's easing moves over the first part of the year were taken not only in light of the contraction of economic activity and the progress in reducing inflationary pressures, but also were prompted by the continued slow growth of the monetary aggregates early in the year and continuing credit restraint by banks and other intermediaries. Reserve market conditions were held steady after April, however, as evidence began to accumulate that the economy was on track toward recovery. Reflecting the Federal Reserve's policy actions and generally weak credit demands, short-term interest rates declined appreciably during the first half. Longer-term rates, which had moved down markedly in the final months of 1990, were mixed over the first half; with bond market participants focusing on signs of an emerging recovery, Treasury bond yields rose a bit, while rates on bonds issued by businesses fell as risk premiums narrowed sharply. In the stock market, share prices have registered sizable increases since January, and broad indexes remain within a few percent of the all-time highs set in the spring. Meanwhile, the value of the dollar has climbed substantially on foreign exchange markets, supported by the successful conclusion of military operations in the Gulf, expectations of a recovery in the U.S. economy, and by economic developments in Germany and political difficulties in the Soviet Union.

In response to Federal Reserve easings and associated declines in short-term interest rates, growth of both M2 and M3 strengthened somewhat in the first half relative to the slow pace of the second half of 1990. The expansion of M2 exceeded that of nominal GNP and its velocity thus fell, although not as much as might have been expected given the decline in short-term interest rates. The continued muted response of M2 to the easings in short-term rates probably reflected the ongoing rerouting of credit outside of depositories and an effort on the part of savers to maintain yields on their assets by turning to the stock and bond markets, sometimes via mutual funds. Growth of M3 was boosted early in the year by strong issuance of large time deposits by U.S. branches and agencies of foreign banks in response to a reduction in reserve requirements around the end of the year. In the second quarter, however, the expansion of M3 slowed as issuance of time deposits at foreign banks waned, and depository credit and associated funding needs contracted. Through June, both M2 and M3 had grown at rates somewhat below the midpoint of their annual growth ranges.

Credit growth was slow in the first half of the year. The federal government's borrowing requirements were held down by reduced levels of activity by the Resolution Trust Corporation (RTC) and by contributions from foreign countries to cover the costs of Operation Desert Storm. Growth of the debt of private sectors was restrained by slack demand associated with the

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weakness of the economy and by a reduced appetite for leveraging. On the latter score, a lasting shift toward more conservative patterns of credit use would be a fundamentally healthy development; the excesses of the 1980s clearly left us with problems in our financial sector that will take some time to resolve. In part reflecting earlier credit losses, banks continued to be cautious lenders through the first half. However, private borrowers who turned to securities markets found readier access to capital as the economic outlook brightened and risk premiums narrowed dramatically; financial intermediaries as well as nonfinancial firms issued large volumes of equity and longer-term debt, making significant progress in strengthening their balance sheets.

Monetary Objectives for 1991 and 1992

At its meeting earlier this month, the FOMC reaffirmed its previously established ranges for money and credit for 1991. The target range for M2 had been lowered in February to 2½ to 6½ percent from the 3 to 7 percent range that had been in place for 1990. To date this year, M2 has grown at an annual rate of a little less than 4 percent, placing it well within the target range for 1991 as a whole. This, in effect, leaves the Committee some room to maneuver as events unfold in the coming months, while remaining within the annual range. The potential need for such room arises in part in connection with the significant uncertainties attending the prospects for the velocity of M2. If, for example, the public's demand for M2 balances should be damped by moves among depository institutions to lower deposit rates (in response to earlier declines in market yields and to higher insurance premiums), then velocity might tend to be stronger than otherwise would be the case and less M2 growth would be required to support a given rate of GNP increase. If, on the other hand, institutions were to become more aggressive in bidding for loanable funds in the retail deposit market, and thus the public began to shift its portfolio back in favor of M2 assets, then velocity could weaken and faster M2 growth might be required. The Committee expects that the current annual growth range will permit it to deal with such velocity-altering disturbances in money supply and demand while it fosters financial conditions conducive to moderate economic growth and further progress toward price stability.

The 1 to 5 percent range for M3 adopted in February took account of the expected continued contraction in the thrift industry and associated redirection of credit flows away from depository institutions. The assets of thrift institutions are expected to shrink further in the second half, owing in large part to closures by the RTC. Issuance of large time deposits by branches and agencies of foreign banks has moderated, but domestic banks may have a greater appetite for funds in the second half as sound lending opportunities increase with the projected improvement in the economy.

Even though growth of the aggregate debt of domestic nonfinancial sectors at midyear was at the lower end of its current 4½ to 8½ percent monitoring range, the Committee anticipates that the debt measure will end the year well within that range. Stronger private credit demands are expected to arise as the economy grows, and federal borrowing will increase to finance stepped-up RTC activity. However, debt growth is likely to continue to be damped by the shift in attitudes about leveraging.

In setting provisional ranges for 1992, the Committee chose to carry forward the 1991 ranges for the monetary aggregates and for debt. Recognizing that the ranges had been reduced significantly over the past few years, the Committee at this time believes that expansion of money and debt in 1992 within the current ranges probably would be consistent with consolidating and extending the gains that have been made to date toward lower inflation, while providing sufficient liquidity to support a sustainable expansion of economic

Ranges for Growth of Monetary and Credit Aggregates

Percent change, fourth quarter to fourth quarter	1990	1991	Provisional for 1992
M2	3 to 7	2½ to 6½	2½ to 6½
M3	1 to 5	1 to 5	1 to 5
Debt	5 to 9	4½ to 8½	4½ to 8½

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Economic Projections for 1991 and 1992

	FOMC Members and Other FRB Presidents		Administration
	Range	Central Tendency	
1991			
Percent change, fourth quarter to fourth quarter			
Nominal GNP	3¾ to 5¾	4½ to 5¼	5.3
Real GNP	½ to 1½	¾ to 1	0.9
Consumer price index	3 to 4½	3¼ to 3¾	4.3[1]
Average level in the fourth quarter, percent			
Civilian unemployment rate	6½ to 7	6¾ to 7	6.6[2]
1992			
Percent change, fourth quarter to fourth quarter			
Nominal GNP	4 to 6¾	5½ to 6½	7.5
Real GNP	2 to 3½	2¼ to 3	3.6
Consumer price index	2½ to 4¼	3 to 4	3.9[1]
Average level in the fourth quarter, percent			
Civilian unemployment rate	6 to 6¾	6¼ to 6½	6.5[2]

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

activity. The ranges will, of course, be reevaluated next February in light of intervening economic and financial events. The Committee will want to update its assessment of the underlying tendencies in the economy as well as in the relations between money and debt expansion and economic performance. Although the initial indications of money and credit ranges that are given in July always are tentative, flexibility seems all the more warranted in the current circumstances, with the economy apparently at a cyclical turning point and the financial system being buffeted by fundamental change.

Economic Projections for 1991 and 1992

The target ranges for the monetary aggregates and debt have been selected with the objective of supporting a sound economic expansion accompanied by declining inflation – a pattern the Board members and Reserve Bank presidents generally expect to prevail over the coming year and a half. Most forecast that real GNP will grow ¾ to 1 percent over the four quarters of 1991; given the decline during the first quarter, this central tendency range for 1991 as a whole implies an appreciable pickup in activity over the remainder of the year. The projections of growth in real GNP over the four quarters of 1992 have a central tendency of 2¼ to 3 percent.

In appraising the near-term outlook, the FOMC participants have placed considerable weight on the apparent absence of inventory overhangs in most sectors. Accordingly, the recent firming of aggregate final demand is expected to bring a halt soon to the inventory drawdowns that persisted into the second quarter. The resulting swing in the pace of inventory investment is expected to boost domestic production considerably over the rest of 1991. As typically occurs in the initial stage of a recovery, much of this rise in output is expected to reflect gains in the productivity of existing workers, rather than a marked pickup in employment. Thus, the Board members and the Bank presidents

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project only modest progress in reducing unemployment over the second half of the year; the central tendency for the civilian jobless rate in the fourth quarter is 6¾ to 7 percent.

The pace of expansion may moderate somewhat in 1992, as the initial impetus from the inventory swing subsides and gains in production track the growth in final demand more closely. The advance in real GNP expected for 1992, though subdued relative to that in the early part of most previous expansions, is anticipated to reduce the margin of slack in the economy over the year. The central tendency of the civilian unemployment rate projected for the fourth quarter of 1992 is 6¼ to 6½ percent, roughly ½ percentage point below the level expected in the fourth quarter of this year.

Several factors lie behind the expectation of a relatively mild upswing in economic activity. In real estate markets, the persistent overhang of vacant space for many types of buildings, along with continued caution on the part of lenders, likely will limit the amount of new construction. In addition, fiscal policy will remain moderately restrictive owing to the federal budget agreement reached last fall and efforts by state and local units to correct serious imbalances in their budgets; although this fiscal restraint ultimately will strengthen the U.S. economy by boosting domestic saving and investment, its near-term effect will be to hold down aggregate demand. Further, with the personal saving rate already at a low level and some households saddled with heavy debt burdens, consumer spending is projected to grow at a relatively slow pace. Finally, the appreciation of the dollar this year has offset some of the previous declines in relative prices of U.S. goods in international markets, thus limiting the contribution that can be expected from the external sector.

By adopting policies intended to put the economy on a path of moderate, sustainable growth, the Board members and Reserve Bank presidents believe that it will be possible to achieve meaningful progress in reducing inflation over the remainder of this year and into 1992. The central tendency of the forecasted rise in the total consumer price index is 3¼ to 3¾ percent over the four quarters of 1991 and 3 to 4 percent over 1992, well below the 6¼ percent rise over the four quarters of 1990. In each of the prior three years, 1987–89, the CPI rose about 4½ percent.

The common midpoint of the forecast ranges for CPI increases in 1991 and 1992, 3½ percent, masks the downtrend in core inflation anticipated over the next year and a half. In particular, most of the slowing of inflation observed thus far this year has reflected the sharp drop in energy prices and a move toward smaller increases in food prices; excluding food and energy, the deceleration in the CPI so far has been relatively small. However, with the tempering of labor-cost increases now under way and the reduced pressure on plant utilization, core inflation is expected to recede significantly in coming quarters. As these declines become widely perceived, expectations of inflation should moderate, reinforcing the tendencies toward deceleration. By reducing and ultimately eliminating the distortion to resource allocation stemming from ongoing, generalized price increases, a monetary policy aimed at achieving price stability over time will enhance the economy's potential to grow and thereby raise standards of living.

The Administration's economic projections for 1991, presented in the budget, differ from the projections of Federal Reserve policymakers mainly with respect to expectations for the consumer price index. The Administration forecast, at 4.3 percent, is above the Federal Reserve central tendency; however, recent statements by Administration officials suggest that this number will be lowered in the mid-session update of the budget. As regards 1992, the Administration is somewhat more optimistic about prospects for real GNP growth while it is anticipating an increase in consumer prices near the upper end of the central tendency of Board members' and Bank presidents' forecasts. This combination of output and inflation places the Administration's forecast of nominal GNP growth next year somewhat above the range of projections by the FOMC participants. Given the obvious limitations on anyone's ability to forecast the economic future, these differences certainly cannot be said to be large – and the forecasts do have the important common feature of pointing to a relatively moderate recovery with inflation remaining below the average pace of the past few years. And, in light of the uncertainties attending the behavior of the velocities of money and credit in the present period of flux in patterns of intermediation, there appears to be no necessary inconsistency between the Administration's economic forecast and the FOMC's financial ranges for 1991 and 1992. The FOMC, of course, will be reviewing the prospects for the economy, along with those for velocity, when it reconsiders the 1992 ranges for money and credit next February.

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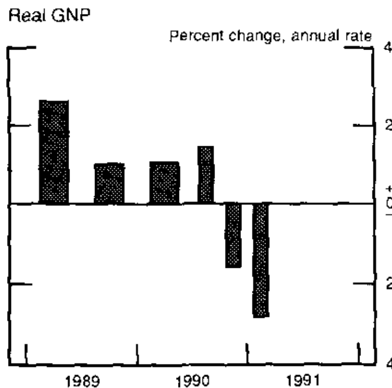
Section 2: The Performance of the Economy During the First Half of 1991

Economic activity contracted appreciably this past fall and winter. Although the economy had been sluggish during the first half of 1990, real gross national product registered a further increase in the third quarter, and a substantial downturn in activity began only after the jump in oil prices that followed Iraq's invasion of Kuwait. With consumer and business confidence badly shaken and real income depressed by the higher oil prices, employment and production declined markedly starting in October; real GNP fell at a 1.6 percent annual rate in the fourth quarter. The civilian unemployment rate, which had held around the relatively low level of 5¼ percent during the first half of last year, rose steadily over the second half, to just over 6 percent at year-end.

The downward momentum in activity carried into the early part of 1991. Industrial production fell through the first quarter, and the shrinkage of private-sector payrolls continued through April, as firms moved aggressively to reduce inventories and to trim labor costs in response to the weakening of final demand. However, much of the negative impetus to activity was reversed by the cumulative drop in oil prices that occurred between October and February and by the boost to confidence that accompanied the swift and successful conclusion of the Persian Gulf war. These events, combined with a considerable easing of monetary policy, set the stage for a recovery, and a few sectors of the economy actually hit bottom quite early in the year. Notably, construction of single-family homes, which in past recessions turned up before the economy as a whole, reached its low point in January, as did real consumer spending and real personal income.

Real GNP



Recently, further evidence has emerged to indicate that economic activity, in the aggregate, stabilized or began to move up in the second quarter. Much of this evidence is to be found in developments in the labor market. Initial claims for unemployment insurance – an indicator of the pace of job loss – have fallen from their high level in March; employment on nonfarm payrolls edged up on balance over May and June, after ten months of decline; and the length of the average workweek increased noticeably in May and June. In addition, industrial production advanced in April, May, and June, with these gains propelled initially by an upturn in the output of motor vehicles and parts. Although these indicators are subject to revision and thus should be read with considerable caution, the weight of the available evidence points in the direction of economic recovery.

The magnitude and length of the recent recession still are not known with certainty, but the decline in real GNP appears to have been considerably smaller than the average decline during the previous post-World War II recessions; for the industrial sector alone, production dropped 5 percent between the peak in September of last year and the low point in March, compared with an average fall-off of nearly 10 percent during previous recessions. The recent contraction also seems to have been relatively short by historical standards. Aggregate job losses, however, were close to the average in previous recessions, suggesting that firms cut payrolls vigorously given the fairly shallow drop in real activity. The resulting rise in the unemployment rate, though, was damped relative to that in earlier contractions, as unusually slow growth of the labor force held down the number of job seekers; the level of the unemployment rate in June of this year, 7 percent, was about ¾ percentage point below the average jobless rate at the end of previous recessions.

Consumer price inflation, which exceeded 6 percent last year, slowed to a 2¾ percent annual rate over the first five months of 1991. Consumer energy prices fell sharply early this year, after soaring during the second half of 1990. In addition, the rate of increase in food prices has retreated this year from the pace registered during the preceding three years.

Apart from food and energy, price increases were large early in the year, but have been more moderate in recent months. In January and February, prices were boosted by hikes in federal excise taxes and postal rates

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and by the passthrough of the energy price increases in 1990 to a wide range of goods and services. With no further increases in these federal charges and the reversal of energy prices beginning to show through to other items, the CPI excluding food and energy rose much more slowly over the three months ended in May. On balance, over the first five months of 1991, this portion of the CPI increased a bit more than 5 percent at an annual rate, about ½ percentage point below the trend rate of increase as of last summer. In part, the recent headway made on inflation reflects the reduction in labor-cost pressures that accompanied the rise in unemployment. As measured by the employment cost index, compensation per hour increased at an average annual rate of 4¼ percent over the second half of 1990 and the first quarter of this year, compared with the 5¼ percent (annual rate) rise over the first half of 1990.

The Household Sector

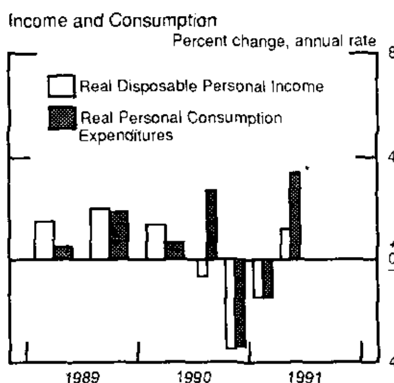
Consumer spending was an area of notable weakness last fall and early this year, largely in response to a substantial decline in real income: purchasing power was cut initially by the jump in oil prices, but it continued to fall even after oil prices were in retreat, reflecting the ongoing declines in employment. Real consumer outlays dropped sharply between September and January, with the monthly pattern of spending distorted to a degree by tax changes that caused some households to shift purchases from early 1991 into late last year. All told, real consumer spending fell at a 1½ percent annual rate in the first quarter, after a 3½ percent (annual rate) decline in the fourth quarter of 1990. However, in February, real income turned up and consumer confidence rebounded late in the month with the end of the Gulf war; both developments bolstered consumer spending. As a result of the spending gains that began in February, the average level of outlays in April and May stood considerably above the first-quarter average.

Among the major components of consumer spending, outlays were cut back sharply for motor vehicles and other durable goods as the recession unfolded. Indeed, between the third quarter of 1990 and the first quarter of this year, real consumer outlays for motor vehicles fell at a 23 percent annual rate; the resulting level of such outlays in the first quarter was the lowest recorded since 1984. Substantial cuts also were made in purchases of nondurable goods. In contrast, consumer outlays for services trended up at a pace only slightly below that registered during the first three quarters of 1990. Since the January trough in total consumer outlays, purchases of both durable and nondurable goods have turned up. In particular, as of May, real consumer purchases of motor vehicles had risen about 8 percent from the depressed January level; separate data on unit sales of new cars and light trucks suggest that further gains were registered in June.

During late 1990 and early this year, total consumer outlays fell more sharply than they had in most previous postwar recessions. The steepness of the drop this time mainly reflects the unusual weakness in several components of income out of which the propensity to consume is high. Most important, nominal wages and salaries fell more in this recession than would have been expected given the magnitude of the decline in nominal GNP, as firms moved aggressively to control costs by trimming payrolls. In addition, because the share of unemployed persons receiving unemployment insurance benefits declined during the 1980s, smaller payments were made to job losers than in earlier downturns. The weakness in these components of nominal income was compounded, in real terms, by the spurt in energy prices.

Although consumers cut back spending, they cushioned some of the effect of weak income by reducing their savings. After averaging about 5 percent over the first half of 1990, the personal saving rate dropped to 4.2 percent in the third quarter and remained at that level through the first quarter of this year. The decline in the saving rate occurred despite some deterioration, on net, in wealth positions during the second half of 1990, which reflected the softening of house prices and losses in the stock market. The average level of the

Income and Consumption



* Percent change from 1991:Q1 to average of April and May 1991, at an annual rate.

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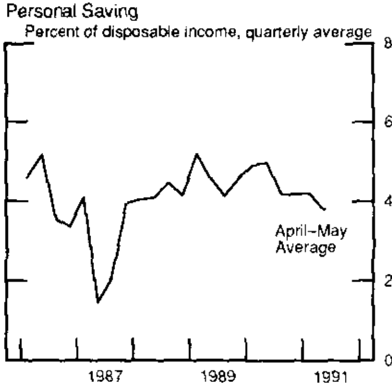
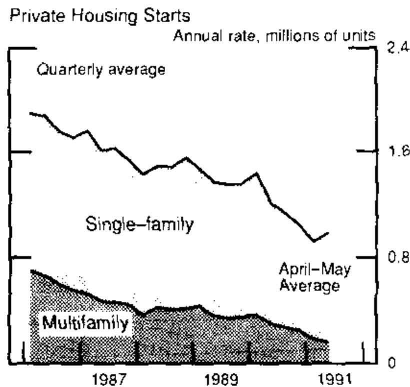


saving rate dropped another notch in the spring, to about 3¾ percent. The bounceback in the stock market and the improvement in confidence may have contributed to this decline, but the explanation also could involve the reduction in personal interest income associated with the lowering of short-term interest rates between last fall and this spring. Historically, consumer spending has been rather insensitive to movements in interest income, so that a decline in such income causes the saving rate to fall in the short run. That said, the saving rate is now at the lowest level since late 1987, and it would not be surprising if gains in consumption lagged behind those for income in the near term as households worked to rebuild net worth through increased saving.

The recession placed some strains on household finances, as indicated by the increase in delinquency rates for all types of consumer loans in the first quarter. By far the sharpest rise occurred for credit card debt, for which the first-quarter delinquency rate was close to the highest on record. This jump partly reflects the relaxation of credit standards by major card issuers in recent years; at the same time, relatively low-risk borrowers with access to home equity lines of credit evidently have reduced their reliance on credit cards. Because of the resulting deterioration in the pool of credit card users, the rise in delinquencies for this type of debt probably overstates the degree of stress in the household sector as a whole. For other types of consumer loans, the first-quarter delinquency rates were not out of line with those typically seen during recessions, despite the currently high level of debt relative to disposable income. Apparently, the rise in asset values during the 1980s left most households with sufficient wherewithal to cover the expanded level of debt. Thus, although the recession has weakened the financial position of the household sector, the situation does not appear worse than that at the end of other downturns.

Residential construction activity, which had been trending lower since 1986, slumped further in the second half of last year. However, the market for single-family homes bottomed out in January and has staged a mild recovery since then, spurred by a firming of demand. Several factors account for the pickup in demand, including the decline in home prices to more affordable levels in a number of markets, improved prospects for employment and income, and some reduction in mortgage rates from those prevailing in the middle of last year. Recent survey results show a more favorable attitude toward homebuying among consumers than at any time since 1988. Reflecting this shift in sentiment, sales of existing homes have risen substantially from their low in January. Although sales of new homes have been less impressive, the higher level prevailing since February has reduced considerably the inventory of unsold new homes relative to sales; in response, home builders have boosted production to satisfy consumer demand. Despite continued caution on the part of lenders in granting land acquisition and construction loans, the quantity of financing available appears sufficient, on balance, to support a further recovery in this sector.

In contrast, the market for multifamily housing has continued to weaken this year. Starts in May were at the lowest monthly level since the 1950s. Moreover, even with the greatly reduced pace of new construction in recent years, the vacancy rate for multifamily units has remained exceptionally high. Given current conditions



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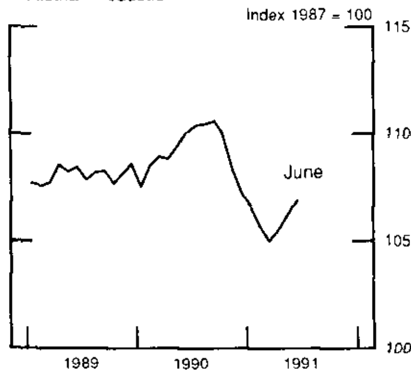
in the market, both lenders and potential investors recognize that the number of viable projects is quite limited.

The Business Sector

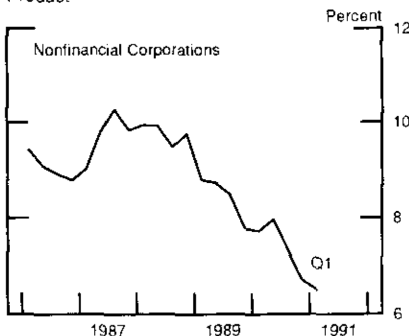
During the latter part of 1990 and the first quarter of this year, the business sector experienced considerable stress. Demand for business output was depressed both by the loss of domestic purchasing power and by the enormous uncertainties created by the situation in the Persian Gulf. In response to the slump in demand, industrial production turned downward last October; it continued to fall through March. The combination of plummeting sales and rising energy prices caused profit margins, which were already slim, to shrink further in most industries during the second half of 1990. In the first quarter, before-tax profits from current operations for U.S. corporations edged down from the low fourth-quarter level.

Industrial Production



An unusual feature of the recent recession was the speed with which producers cut output in order to avoid a buildup of inventories. The promptness of this adjustment likely reflected a combination of factors. The downturn in final demand was widely anticipated, and some producers cut output pre-emptively, rather than risk being saddled with excessive stocks. In addition, improved systems for monitoring and controlling inventories have been installed in recent years, which enabled firms to react quickly to signs of slowing demand. Further, the relatively heavy debt burdens in the corporate sector created substantial financial pressures for many firms and focused attention on the need to cut costs.

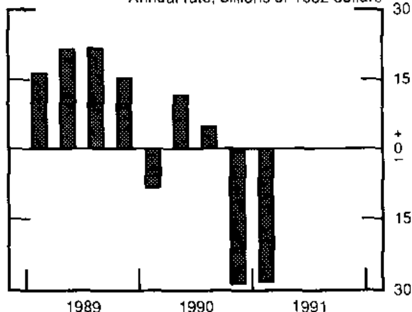
Before–tax Profit Share of Gross Domestic Product *



* Profits from domestic operations with inventory valuation and capital consumption adjustments, divided by gross domestic product of nonfinancial corporate sector

Accordingly, inventories were run off at a rapid clip beginning late last summer. Automakers slashed production and inventories particularly aggressively; domestic output of motor vehicles in the first quarter was nearly 30 percent below that in the third quarter of 1990. The resulting drawdown of inventories at auto dealers accounted for fully one-half of the total liquidation of nonfarm stocks during the fourth quarter and the first quarter. Despite production cutbacks by the automakers and other producers, the inventory-to-sales ratio for total manufacturing and trade moved up through January. However, by May, the ratio had retraced most of the runup that began with the onset of the recession, reflecting the continued liquidation of stocks and an upturn in sales.

Changes in Real Nonfarm Business Inventories



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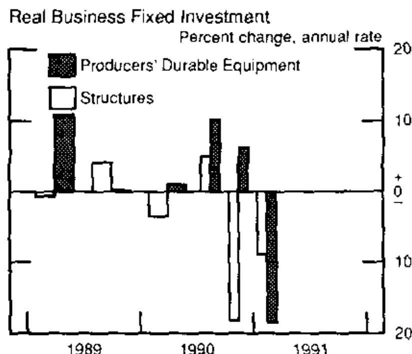
Inventories in most industries appear now to be reasonably well aligned with sales, and output has begun to rise with the expansion of final demand. After reaching a trough in March, industrial production expanded at more than a 7 percent annual rate over the next three months; although stronger output of motor vehicles and parts accounted for most of the increase early in the second quarter, the gains in recent months have been more widespread. Orders for a range of manufactured goods firmed in April and May, pointing to a further pickup in production during the summer.

Business spending for fixed investment was flat in real terms during the fourth quarter of last year and dropped sharply during the first quarter of this year. Several factors worked to reduce outlays, including the easing of pressures on capacity, the diminished level of cash flow, and the general atmosphere of uncertainty related to events in the Persian Gulf. Real spending for equipment plunged in the first quarter; measured in percentage terms, the decline was the sharpest quarterly fall-off recorded in nearly eleven years. Reflecting the difficulties in the manufacturing sector, real spending for industrial equipment dropped at more than a 20 percent annual rate, after smaller declines in the preceding five quarters. Real business outlays for motor vehicles were cut at nearly a 35 percent annual rate in the first quarter, sinking to the lowest level since mid-1983. Purchases of computers and other information-processing equipment also were scaled back in the first quarter, and outlays edged down for aircraft, for which real spending had jumped 60 percent over the four quarters of 1990.

The pace of nonresidential construction fell substantially during the fourth quarter of 1990 and the first quarter of 1991. Although this decline was broadly based, the steepest contraction occurred for office and other commercial buildings. Activity in this sector actually peaked in 1985 and has trended lower since then in response to persistently high vacancy rates and the removal of important tax benefits. In the industrial sector, the rate of plant construction has been damped by the emergence of serious excess capacity in a number of major industries. Petroleum drilling activity, which moved up a bit late last year, retreated in the first quarter with the price declines for crude oil and natural gas; data on drilling rigs in use indicate a further weakening of activity in the second quarter.

Business spending for new equipment typically does not turn up until several months after the end of a recession, and the lag is often substantially longer for construction outlays. As yet, there is little sign of a rebound in spending for either equipment or nonresidential structures. Nonetheless, shipments of industrial equipment and other nondefense capital goods – a coincident indicator of equipment spending – have stabilized in recent months. Similarly, although vacancy rates remain high for commercial buildings, the steepest declines in total nonresidential construction activity may be over; in April and May, the average level of activity was about unchanged from the first-quarter average, and the downtrend in forward-looking indicators, such as construction contracts and permits, has slowed considerably.

Real Business Fixed Investment



The Government Sector

The federal budget deficit over the first eight months of fiscal year 1991 was $175 billion, compared with the $151 billion deficit recorded during the same part of fiscal year 1990. The deficit during the current fiscal year has been boosted considerably by the slowdown in economic activity, and this cyclical increase has masked the fiscal restraint imposed by last autumn's budget agreement. On the revenue side, federal tax receipts have been held down by the anemic growth of nominal income since last fall; indeed, personal income tax payments so far this fiscal year are little changed from the payments made during the same period a year earlier. The slowdown in activity also has raised the deficit by increasing outlays for income-support programs such as unemployment insurance, food stamps, and Medicaid. These effects of the contraction have been offset, to some degree, by the easing of short-term interest rates, which has restrained the growth of interest payments on the federal debt.

Although the deficit has risen during the current fiscal year, the increase has been far smaller than that projected roughly six months ago. At that time, the

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Administration and the Congressional Budget Office both estimated that the deficit for fiscal year 1991 would top $300 billion. Two developments have caused the 1991 deficit to be lower than was expected, though neither one indicates any fundamental improvement in the budget situation. First, cash contributions from our allies in Operation Desert Storm have exceeded the outlays made to date for U.S. involvement in the Persian Gulf. The contributions not yet spent will be used to pay for the replacement of munitions into fiscal 1992 and beyond. Second, federal outlays related to deposit insurance were well below expectations during the first quarter, mainly reflecting the slow pace at which insolvent thrifts were resolved. The activities of the RTC during that period apparently were hindered, in part, by a lack of funding; additional RTC funding was enacted in late March, and the RTC has announced a more rapid schedule of resolutions over the rest of the year.

Federal purchases of goods and services, the part of federal spending that is included directly in GNP, rose 5¼ percent in real terms over the four quarters of 1990. This increase reflected the fourth-quarter rise in defense purchases to support operations in the Persian Gulf, as well as increases over the year in such nondefense programs as law enforcement, space exploration, and health research. In the first quarter of 1991, real defense purchases moved above the already high fourth-quarter level, while nondefense purchases fell somewhat on net, pushed down by sales of oil from the Strategic Petroleum Reserve. Over the rest of 1991, fiscal policy likely will be a restraining influence on the economy, owing to the spending limits and tax increases mandated by last fall's budget agreement.

The fiscal position of state and local governments has remained extremely weak in recent quarters. The deficit in operating and capital accounts (that is, the deficit excluding social insurance funds) stood above $40 billion at an annual rate in both the fourth quarter of 1990 and the first quarter of 1991, after holding at a $30 billion rate for a year. The recent increase in the state and local deficit reflects, for the most part, a cyclical shortfall in tax receipts. However, this cyclical effect overlays structural imbalances that have been growing for some time. Since mid-1986, when the sector's accounts (excluding social insurance) were roughly in balance, outlays have risen from about 13½ percent of nominal GNP to 14½ percent, while revenues have held fairly steady relative to GNP. The rise in the spending share reflects an expansion of services largely related to rapid growth in public school enrollments, prison populations, and Medicaid expenses.

During the past year, state and local governments moved to address their mounting fiscal difficulties. Many governments trimmed outlays relative to earlier trends. Between the first quarter of 1990 and the first quarter of 1991, real purchases by state and local governments rose only about 1 percent, well below the 3½ percent annual rate of increase averaged over 1985-89. Moreover, last year several states instituted broad-based hikes in personal income and sales taxes. Looking ahead, state budgets for fiscal year 1992 – which began on July 1 for all but four states – generally mandate significant further cost-cutting from earlier plans. On balance, these budgets point to a weak picture for real state and local purchases over the current calendar year. Supplementing this restraint on spending, many new budgets include a second wave of major tax increases.

The External Sector

Over the first half of 1991, the foreign exchange value of the dollar appreciated about 15 percent, on balance, in terms of the currencies of the other Group of Ten (G-10) countries. The net appreciation over this period reversed about two-thirds of the decline in the dollar that had occurred between the middle of 1989 and the end of 1990.

In early January, the dollar was boosted by investors seeking a safe haven against the backdrop of growing tensions in the Persian Gulf. However, once the Allied bombing campaign commenced and was perceived as going well, part of the safe-haven demand for dollars evaporated, and the currency resumed its earlier decline. Between mid-January and early February, the dollar fell about 4 percent against the currencies of the other G-10 countries. During this period, the U.S. monetary authorities joined with foreign central banks to support the dollar. Subsequently, the dollar surged through the end of March, largely reflecting the quick end of the war, which fueled widespread expectations of an early rebound in the U.S. economy. The sharp run-up prompted official sales of dollars during March and April, mainly by European authorities. After dropping back a bit, the value of the dollar rose again in June on the accumulation of evidence suggesting that the U.S. recession had ended.

On a bilateral basis, the dollar has appreciated about 20 percent this year against the German mark and by similar amounts against the European currencies associated with the mark. The weakness of these currencies partly reflects economic difficulties in Germany and the spillover effects of the turmoil in the Soviet Union and Yugoslavia. In contrast, the dollar has not appreciated nearly so much against the currencies of most of

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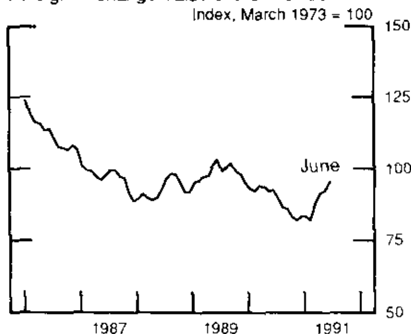
Foreign Exchange Value of the U.S. Dollar*

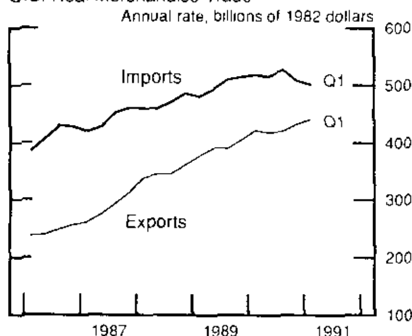


* Index of weighted average foreign exchange value of U.S. dollar in terms of currencies of other G-10 countries. Weights are 1972-76 global trade of each of the 10 countries.

our other major trading partners. So far this year, the dollar has risen less than 5 percent, on balance, against the Japanese yen and has changed even less against the currencies of Canada, Korea, Singapore, and Taiwan.

The overall strengthening of the dollar this year has acted to restrain prices for non-oil imports. Over the first quarter of 1991, these prices rose at a 2½ percent annual rate, less than half the rate of increase recorded between June and December of 1990; non-oil import prices then fell during April and May, more than reversing the entire first-quarter rise. The price of imported oil, which surged between August and October of last year, has since retraced most of the rise induced by the Iraqi invasion of Kuwait. Taken together, these two developments contributed significantly to the restraint on domestic inflation.

U.S. Real Merchandise Trade



Real merchandise imports declined in the first quarter to a level about 5 percent below that in the third quarter of 1990, with the drop largely reflecting the weakness in domestic demand. Import volumes fell in the first quarter for a wide range of non-oil products, including consumer goods, motor vehicles, and industrial supplies. Preliminary data for April show some increase in non-oil imports, a pattern that is likely to continue with the apparent firming of domestic activity. The quantity of oil imports—which plunged after the spurt in oil prices last summer and remained relatively low early this year—has moved back up in recent months, reflecting efforts to rebuild U.S. petroleum inventories.

Merchandise exports continued to move higher through the spring, a factor that clearly tempered the output loss in manufacturing after the oil shock last year. In real terms, merchandise exports rose at a 10 percent annual rate between the third quarter of 1990 and the first quarter of this year, led by increased sales of computers, other capital goods, and industrial materials. Preliminary data indicate that merchandise exports rose again in April. The competitive position of U.S. companies has benefitted, at least until quite recently, from the substantial drop in the dollar over 1990 and the latter part of 1989. However, recessions in the economies of some of our major trading partners, especially Canada and the United Kingdom, have offset part of the stimulus to U.S. exports provided by the rapid growth in such countries as Germany, Japan, and Mexico.

The merchandise trade deficit narrowed to $74 billion (at an annual rate) in the first quarter of 1991, compared with the $111 billion deficit in the fourth quarter of 1990; the first-quarter deficit was the smallest since mid-1983. The current account actually recorded a $41 billion (annual rate) surplus in the first quarter, a sharp improvement from the $94 billion deficit in the fourth quarter of 1990. Most of this improvement reflected unilateral transfers associated with Operation Desert Storm: The fourth-quarter deficit was boosted by a grant from the U.S. government to Egypt for the purpose of repaying outstanding loans, while cash payments to the United States from our coalition partners surged in the first quarter. Excluding these cash contributions and the special grant to Egypt, the current account moved from a deficit of $83 billion in the fourth quarter to a deficit of $50 billion in the first quarter.

A small net capital inflow was recorded in the first quarter of 1991, as an increase in foreign official holdings of reserve assets in the United States more

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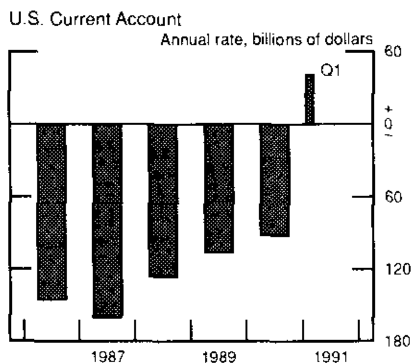
U.S. Current Account



than offset a net outflow of private capital. Within the the private-sector accounts, there was a substantial capital outflow in the first quarter associated with U.S. direct investment abroad, the bulk of which was in the countries of the European Community; at the same time, capital inflows related to foreign direct investment in the United States fell to a low level. Increasingly, multinational firms have raised funds in the United States to finance direct investment here and elsewhere, taking advantage of the relatively low level of U.S. interest rates vis-à-vis those in other industrial nations. With regard to other private transactions, banks reported a small net capital inflow in the first quarter, and net purchases of U.S. securities by private foreigners about matched U.S. net purchases of foreign securities.

The net capital inflow during the first quarter, when combined with the surplus on current account, implies a large negative statistical discrepancy in the international accounts. Nearly as large a discrepancy in the opposite direction was registered in the fourth quarter of last year. These wide swings in the statistical discrepancy, along with the huge size of the discrepancy for 1990 as a whole, cast doubt on the accuracy of both the capital account and the current account data used in the U.S. international accounts and highlight the need to improve these data.

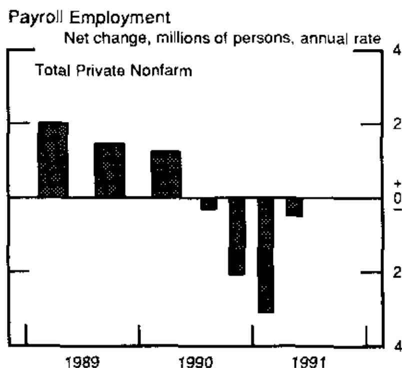
Labor Markets

Labor demand appears to have stabilized after contracting sharply during the latter part of 1990 and the early part of this year. Employment on private nonfarm payrolls peaked last June, edged lower through September, and then fell substantially in each month from October through April. However, the most recent data show that payrolls expanded slightly on balance over May and June, and survey results suggest that firms intend to increase employment further in the third quarter.

The cumulative decline in private nonfarm employment through April was slightly more than 1½ million jobs, roughly a 1.7 percent drop. Although that percentage decline is close to the average experienced in the other recessions after World War II, three industries had abnormally large job losses: construction; retail and wholesale trade; and finance, insurance, and real estate. The steep decline in construction employment likely reflected the unusually sharp fall-off in office and other commercial construction, which compounded the normal cyclical contraction in residential building. In the trade sector, employment was depressed by the sizable decline in consumer spending and the high degree of financial distress among retailers, some of whom were burdened with heavy debt servicing costs as a result of leveraged buyouts. Employment in finance, insurance, and real estate – which continued to rise during past recessions – edged lower this time, reflecting the shakeout in the financial sector and spillovers from the slump in real estate markets. In contrast, the decline in manufacturing payrolls was somewhat smaller than in previous contractions, largely because the drop in industrial production was relatively shallow. Employment in the services industries continued to trend up during late 1990 and early 1991, as it had in previous recessions, supported entirely by gains in health services.

Although the size of the drop in private nonfarm payroll employment was similar to that in previous

Payroll Employment



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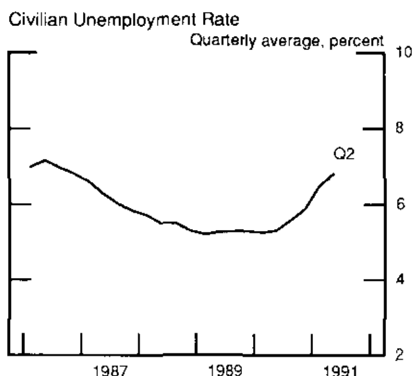
Civilian Unemployment Rate

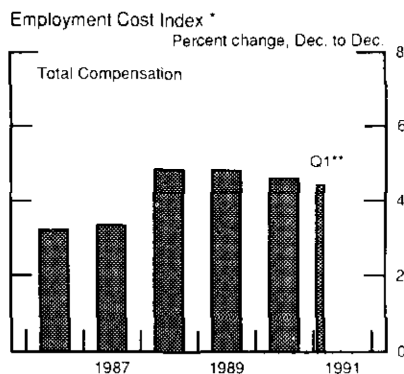


contractions, the decline in real GNP during the current episode was relatively small. This contrast confirms the widespread impression that firms shed workers to an unusual degree during the recent downturn. At the same time, the rise in the civilian unemployment rate from 5.5 percent in July 1990 to 7 percent this June was not particularly large relative to the decline in real GNP. Apparently, an unusual proportion of people who lost jobs subsequently dropped out of the labor force and thus were no longer counted as unemployed. *In addition, the muted rise in unemployment and the* labor force in recent quarters may be part of a longer-term deceleration in the rate at which women – especially younger women – have entered the labor market. For this latter group, there has been a shift toward additional school attendance and toward staying at home to care for young children. By reducing the number of new job seekers at a time when jobs were quite hard to find, this shift held down the rate of unemployment.

A variety of indicators suggest that labor demand has stabilized in recent months. Perhaps the earliest signal of this improvement was provided by the data on initial claims, which peaked at a weekly rate of 535,000 in March and then dropped back to about 470,000 in April; the pace of weekly claims has since moved considerably lower. Employment on private nonfarm payrolls rose in May, the first increase since the middle of 1990. Although part of this gain was reversed in June, firms continued to lengthen the average workweek of their employees. This pattern of cautious hiring combined with an extension of the workweek is common in the early stage of a recovery; given the expenses associated with hiring and firing, such a strategy is a natural response to uncertainty about the strength and duration of the pickup in demand. A separate measure of employment, derived from a survey of households, also suggests that labor demand has stabilized; the number of persons reporting themselves as employed was about flat on balance over the second quarter, after falling sharply over the three preceding quarters. Although the civilian unemployment rate continued to inch up over the second quarter, increases in the jobless rate often occur during the first several months of a recovery. With the brightening of employment prospects, job seekers enter the labor force at an increasing rate, raising unemployment until hiring accelerates enough to outstrip the growth in labor supply.

The slack opened up in labor markets since last summer has helped damp increases in labor costs, which had trended higher between the end of 1987 and the middle of 1990. As indicated by the employment cost index (ECI), increases in compensation per hour for private industry workers accelerated from 3¼ percent during 1987 to about a 5¼ percent annual rate during the first half of 1990; this measure of labor costs covers both wages and payments for worker benefits. The most recent ECI data show that compensation costs rose at an average annual rate of 4¼ percent over the second half of 1990 and the first quarter of 1991, a full percentage point below the peak rate recorded early last year. Although this slowing of labor-cost inflation was apparent in both wages and benefits, the latter component of compensation decelerated the most sharply, reflecting declines in nonproduction bonuses and pension contributions per hour of work. However, employer costs for insurance, which consist mainly of health insurance premiums, continued to rise at close to double-digit rates.

Employment Cost Index *



* Employment Cost Index for private industry, excluding farm and household workers

** Percent change from March 1990 to March 1991

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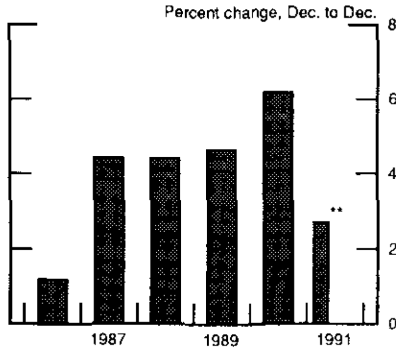
Output per hour in the *nonfarm business sector* was essentially flat, on balance, over the year ended in the first quarter of 1991, after declining during 1989 and the early part of 1990. This pattern differed somewhat from the usual cyclical experience. Typically, productivity continues to rise until shortly before the business-cycle peak, then turns down and falls sharply through the early part of the ensuing recession. Productivity in this episode declined well before the cyclical peak last summer, as output growth slowed and firms continued to hire at a relatively rapid pace. However, as demand softened at the peak, firms began to trim payrolls, and this pruning continued in an aggressive fashion through the recession; as a result, output per hour was better maintained during the 1990-91 contraction than during previous downturns. In *manufacturing*, where competitive pressures have been particularly intense, the process of cutting payrolls began well before the onset of recession, which allowed productivity gains to remain robust over the year leading up to the contraction. Athough productivity in manufacturing turned down during the recession, the continued cutting of factory jobs kept the drop in output per hour relatively small by historical standards.

Price Developments

Inflation pressures have eased somewhat this year. The bulk of last year's spike in energy prices has been retraced, and the rate of increase in food prices has slowed. In addition, the margin of slack in labor and product markets that emerged during the recession is placing downward pressure on price increases for other goods and services; this trend toward slower "core" inflation, however, was obscured early in the year by a number of price increases that either were one-time events or have since been reversed.

The Iraqi invasion of Kuwait last August precipitated a sharp rise in oil prices that carried through to early October. At that point, the posted price of West Texas Intermediate oil, the benchmark for U.S. crude prices, reached nearly $40 per barrel, more than double the $16 price prevailing just three months earlier. Then, between October and February, virtually all of this price spike unwound, chiefly as a result of two developments. Saudi Arabia and other oil producers boosted output to offset the embargo on Iraq and Kuwait, and the Allied forces demonstrated that they could prevent significant disruptions to supply. In addition, prices were damped by the slowdown in economic activity in the United States and other industrial nations. After the end of hostilities in February, OPEC sought to bolster prices by trimming production. This effort proved to be largely successful: The posted price of West Texas Intermediate firmed to $20 per barrel in April and has changed little on balance since then.

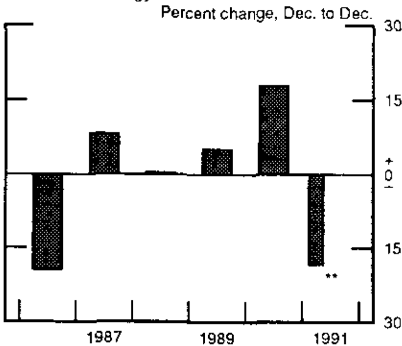
*Consumer Prices**



* Consumer Price Index for all urban consumers.
** Percent change from Dec. 1990 to May 1991, annual rate.

Energy prices for consumers have followed the movements in world oil prices since last summer. The CPI for energy peaked in November 1990 at a level 15 percent above that in July, and then fell sharply through the first quarter of this year. By April, the decline in crude oil prices had been fully passed through to energy prices at the retail level. In May, consumer energy prices edged back up, mainly reflecting price increases for gasoline, the largest component of the CPI for energy. Gasoline demand this spring appar-

Consumer Energy Prices *



* Consumer Price Index for all urban consumers.
** Percent change from Dec. 1990 to May 1991, annual rate.

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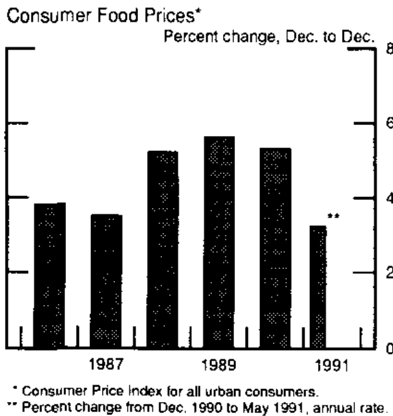
ently was stronger than refiners had expected, and inventories fell to exceptionally low levels. Along with the tight inventory situation, retail gasoline prices may have been boosted by the mandatory switch to cleaner—and more expensive—gasoline before the summer driving season. However, as of early June, gasoline inventories had moved back into the normal seasonal range, and survey data suggest that pump prices softened during the second half of June and into early July.

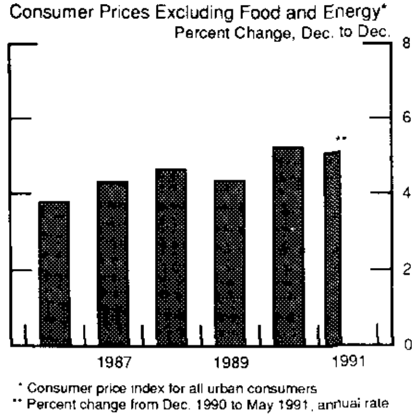
Increases in consumer food prices this year have slowed from the 5¼ to 5½ percent range that prevailed over the preceding three years. During the first five months of 1991, the CPI for food rose at only a 3¼ percent annual rate, held down in large part by price declines for dairy products and by roughly stable prices on balance for meat, poultry, and eggs. Following the typical pattern in agricultural cycles, prices for these livestock products have been damped by an expansion of supply that was itself spurred by the relatively high prices of recent years. In addition, price increases have been muted for many foods for which labor and other nonfarm inputs represent a large share of total cost. For example, the prices of food consumed away from home rose at a 3¼ percent annual rate over the first five months of 1991, down from the 4½ percent increases over 1989 and 1990. The deceleration in food prices this year would have been somewhat greater but for a series of adverse weather developments that have raised prices for fresh fruits and vegetables; given the short production cycles for many of these products, the recent price increases should be reversed, at least in part, in coming months.

Consumer Food Prices*



* Consumer Price Index for all urban consumers.
** Percent change from Dec. 1990 to May 1991, annual rate.

Consumer Prices Excluding Food and Energy*



* Consumer price index for all urban consumers
** Percent change from Dec. 1990 to May 1991, annual rate

The consumer price index for items other than food and energy rose sharply during January and February, but the jumps in those months reflected a number of one-time or transitory increases. Higher federal excise taxes went into effect on cigarettes and alcoholic beverages, raising consumer prices for both items; these tax hikes supplemented the increases in sales and excise taxes that a number of states have imposed over the past year. Postal rates also were raised 16 percent in February. Apparel prices climbed at double-digit annual rates in both January and February, mainly owing to the earlier-than-usual introduction of spring clothing lines, which was not anticipated by the seasonal adjustment factors employed by the Bureau of Labor Statistics. More generally, the spurt in oil prices last fall spilled over through early 1991 to prices for a wide range of non-energy goods and services; this passthrough occurred via higher shipping costs and price hikes for petroleum-based components. However, each of these factors boosting inflation proved to be short-lived. After the large increases in January and February, the CPI excluding food and energy rose at just a 2¼ percent annual rate between February and May. Apparel prices declined over this period, and airfares—which are quite sensitive to changes in oil prices—fell 10 percent (not an annual rate).

The uneven pace of inflation this year has tended to obscure trends in the general level of retail prices. Nonetheless, there is little doubt that the underlying pace of inflation has moderated since last year. The twelve-month change in the CPI excluding food and energy—which held around 4½ percent throughout 1988, 1989, and the early part of 1990—moved up to about 5½ percent in August 1990. By May of this year,

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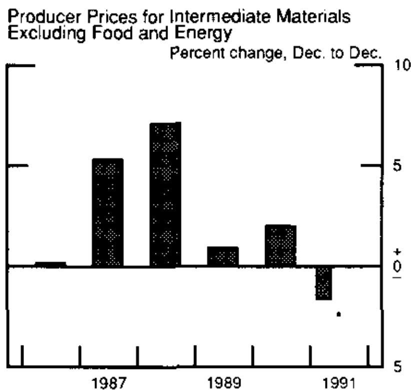
the twelve-month change in this index had fallen back to 5.1 percent. This figure slightly overstates the trend rate of inflation because it includes the increases in federal excise taxes and postal rates earlier this year; in addition, the passthrough of lower energy prices to non-energy items probably was not complete as of May. Adjusting for both of these factors would put the twelve-month change in the CPI excluding food and energy a bit below 5 percent.

Price developments at earlier stages of processing have been favorable this year, reflecting the easing of capacity pressures and price declines for petrochemical products. The producer price index for finished goods excluding food and energy rose at a 3¼ percent annual rate over the first six months of 1991, a bit below the pace in 1990. Prices for intermediate materials excluding food and energy fell about 1½ percent at an annual rate between December and June. Spot prices of raw industrial commodities plunged late last year with the downturn in economic activity, and these prices moved down somewhat further on balance over the first half of 1991.



* Percent change from Dec. 1990 to June 1991, annual rate.

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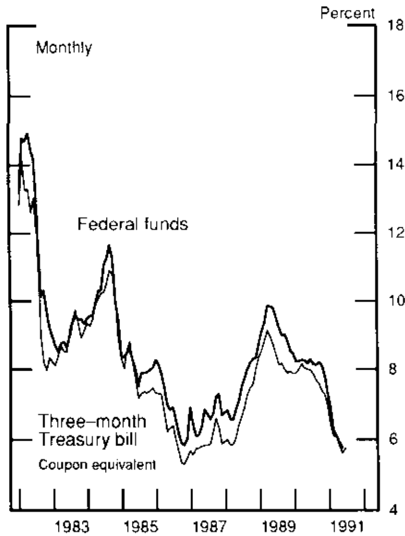
Section 3: Monetary and Financial Developments During the First Half of 1991

The progressive easing of money market conditions initiated last fall as the economy weakened continued through much of the first half of 1991. Since the end of last year, open market operations, in combination with two cuts of one-half percentage point in the discount rate, have reduced the federal funds rate from 7 percent to 5¾ percent – the lowest level in well over a decade. These moves followed a number of easings in the final months of 1990, including a one-half point reduction in the discount rate in December, that already had brought the federal funds rate down about a percentage point. As a consequence of these and earlier actions, the federal funds rate has declined 4 percentage points from its most recent peak in the spring of 1989.

The policy easings this year were undertaken to foster a turnaround in the economy and to help ensure a satisfactory expansion. They were prompted by evidence that the economy was declining further and that inflationary pressures were abating; early in the year, continuing weakness in the monetary aggregates and further restraint on credit availability, especially at banks, also were important indications of the need for additional policy easing. Policy actions led to a strengthening of money growth over the first half from the slow pace of earlier quarters, and both M2 and M3 in June were in the middle portions of their annual ranges. The debt aggregate, by contrast, expanded at the lower end of its monitoring range throughout the first half, held down by sluggish spending and also by a cautious attitude toward additional debt by both borrowers and lenders. As the monetary aggregates accelerated and signs accumulated that the economy was bottoming out, the pace of policy easings slowed and the last such move was made at the end of April.

Short–term Interest Rates



Last observation is for June 1991

Despite the drop in short-term interest rates, long-term rates were mixed on balance over the first half of the year. In the wake of the rapid conclusion of the Gulf war, expectations became widespread that there would be a strengthening in aggregate demand and this tended to push yields on Treasury bonds a little higher and contributed to an increase in the foreign exchange value of the dollar. With the brighter outlook for the economy, however, the risk entailed in holding private obligations was seen as considerably reduced and yields on corporate bonds fell and stock prices rose. However, substantial loan losses continued to afflict many financial intermediaries, and these institutions maintained cautious attitudes toward extending new loans, which were reflected in wide spreads of lending over borrowing rates and more stringent nonprice terms on credit.

The Implementation of Monetary Policy

The Federal Reserve adjusted policy in three separate steps in the first quarter of the year, extending the series of moves initiated in the final months of 1990. Amid signs of continuing steep declines in economic activity and abating inflation pressures, the Federal Reserve eased reserve provision through open market operations in January and again in early March, leading to a decline in the federal funds rate of a quarter point each time, and reduced the discount rate one-half percentage point on February 1, resulting in a similar-sized decline in the federal funds rate.[1] The monetary

1. The federal funds rate came under some upward pressure during much of January, as reduced levels of required reserve balances at Federal Reserve Banks complicated commercial banks' reserve management. Required reserves were low partly owing to the effects of the cut in reserve requirements on nonpersonal deposits in December and partly for seasonal reasons. For some banks, balances held in accounts at Reserve Banks threatened to fall below prudent clearing levels. To avoid overnight overdrafts, banks markedly raised holdings of excess reserves and borrowed sporadically at the discount window. But with maintained balances still low relative to clearing needs, the volatility of the federal funds rate increased. As banks became more accustomed to operating with lower levels of required reserves and as these reserves subsequently rose for

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aggregates were very weak in January, and while strengthening considerably in February and early March, remained on a moderate growth track, especially taking into consideration the lack of expansion late in 1990.

Other short-term rates generally fell about a percentage point over this period. The commercial bank prime loan rate was reduced one-half percentage point in early January in lagged response to earlier declines in short-term rates. The drop apparently had been delayed as banks attempted to hold down loan growth as last year drew to a close, bolstering their capital positions in response to market concerns and the initial phase-in of risk-based capital requirements. The prime rate was reduced again after the cut in the discount rate in early February.

Longer-term rates also fell on balance over the first two months of the year, under the influence of monetary easings and prospects for lower inflation, especially when it became clear that the Gulf war would not interrupt oil supplies. Initial success in the Persian Gulf also led briefly to weakness in the dollar in foreign exchange markets, as safe-haven demands that had been boosting its value since late in 1990, in the face of a substantial easing of U.S. monetary policy, evaporated.

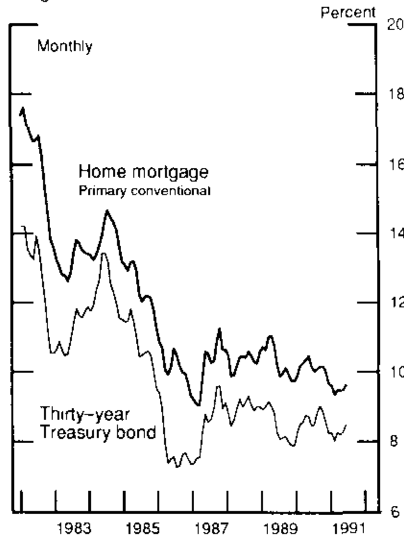
In March, however, long-term market rates began to firm on the rebound in consumer confidence and initial indications of a turnaround in the housing market, which were seen as pointing to a somewhat shorter and milder recession than many had previously feared. Rate increases were muted on private instruments, though, as risk premiums began to shrink in response to brightening prospects for a recovery. These gains extended even to below-investment-grade bonds, and growing optimism was reflected as well in a strong stock market in February and into March. The debt and equity instruments of banks generally outperformed broader indexes over this period, as the market apparently expected their earnings to be bolstered by lower short-term interest rates and the deterioration in the quality of their loan portfolios to be limited as the anticipated economic recovery materialized. Better prospects for a U.S. economic recovery about coincided with a turn toward more pessimism regarding the economic outlook abroad. As a result, the exchange value of the dollar reversed and began to appreciate sharply.

seasonal reasons, reserve management problems eased and the volatility of the federal funds rate diminished. The upward pressures on the funds rate in January did not show through to other short-term rates.

In the wake of the successful Gulf war and in view of initial signs that the System's earlier easing actions had begun to take hold, the FOMC concluded at its meeting in late March that the risks to the economy had become more evenly balanced. Accordingly, the Committee decided to end the formal tilt toward ease that it had adopted in mid-1990, when slowing money growth and tightening credit availability aroused concerns that financial conditions might be placing greater-than-anticipated restraint on economic activity. Under the previous instructions, the FOMC's directive to the domestic trading desk at the Federal Reserve Bank of New York had stipulated that possible adjustments to reserve pressures between Committee meetings would be more responsive to unanticipated signs of economic weakness and abating price pressures than to unexpected evidence of strength. The directive issued at the March meeting restored symmetry to these instructions concerning intermeeting adjustments.

Interest rates generally declined during April, mainly at the short end, reflecting market participants' disappointment that the response they had expected to earlier monetary easings and to the rebound in consumer confidence had yet to show through in measures of economic activity. At the same time, with evidence also continuing to point to a further abatement of inflation, particularly as reflected in wage behavior.

Long–term Interest Rates



Last observation is for June 1991.

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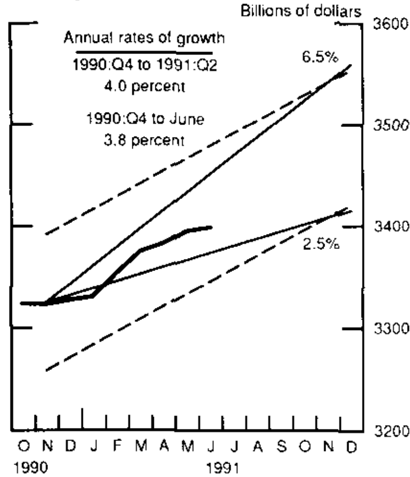
the Federal Reserve at the end of April reduced the discount rate another one-half percentage point, allowing about half that amount to show through to money market rates. As was the case in February, this action was followed by a one-half percentage point decline in the bank prime rate. Despite further monetary ease, the dollar continued to rally on foreign exchange markets, in part boosted by political developments abroad, particularly in the Soviet Union, and potential economic difficulties in Germany.

Market interest rates were little changed until early June, when they rose in response to the release of data on employment and retail sales for May that strongly suggested the trough of the recession had been reached or at least was close at hand. The ensuing rise in interest rates was particularly sharp at the long end of the Treasury market. As signs of the recovery grew more distinct and interest rates firmed, the dollar strengthened further, and by June had retraced all of its declines of late 1990 and early 1991. On balance, Treasury bond yields rose almost one-quarter percentage point over the first half, while yields on investment-grade corporates were down close to one-half percentage point.

M2: Target Range and Actual Growth



Monetary and Credit Flows

Despite the continuing weakness in economic activity, expansion of the monetary aggregates in the first half of 1991 picked up from the lackluster pace of late 1990, and M2 and M3 grew at annual rates of 3¾ and 2¼ percent, respectively, from the fourth quarter of last year through June. M2 growth increased as policy actions reduced short-term market interest rates relative to returns that could be earned on assets in this aggregate (a decline in the "opportunity cost" of holding M2). As a consequence, expansion of M2 exceeded the growth of nominal GNP. However, the growth in M2 (and decline in its velocity) was smaller than would have been expected on the basis of past relationships with income, interest rates, and opportunity costs. This shortfall of M2 growth from historical patterns followed an even greater discrepancy in 1990.

The tepid response of M2 to declines in interest rates may partly reflect reduced funding needs at depositories associated with weak credit growth. As discussed below, commercial bank credit expanded sluggishly over the first half, and thrift institution balance sheets continued to contract. In these circumstances, depositories may well have been less aggressive in supplying retail deposits; although rates on these deposits do not appear on the surface to have fallen unusually rapidly, institutions may have acted in other ways to reduce the cost of funds, including adjustments in advertising and marketing strategies. On the demand side, growth in M2 appears to have been held down early in the year by the public's concerns about depository institutions; purchases of Treasury securities through noncompetitive tenders were especially heavy in January. As the turnaround in the economy seemed in prospect, bank access to both deposit and capital markets improved greatly. Later, in the second quarter, a slowdown in M2 growth appeared to be partly related to the developing configuration of returns on assets. Maturing small time deposits could be rolled over only at much lower rates at the same time that the steep upward slope of the yield curve seemed to offer an opportunity to preserve high yields by moving into capital market instruments. For example, expansion of stock and bond mutual funds was quite strong over the second quarter. In addition, with returns on M2 assets falling steeply relative to rates charged on loans, households had a greater incentive to finance spending by holding down the accumulation of M2 assets rather than by taking on new debt.

The decline in market interest rates also promoted a marked shift in the composition of M2 towards its liquid household deposit components—other checkable deposits, money market deposit accounts, and

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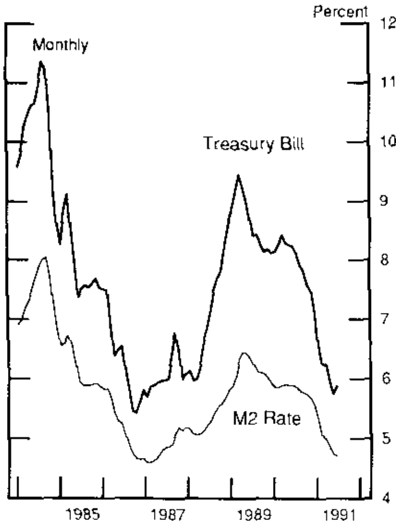
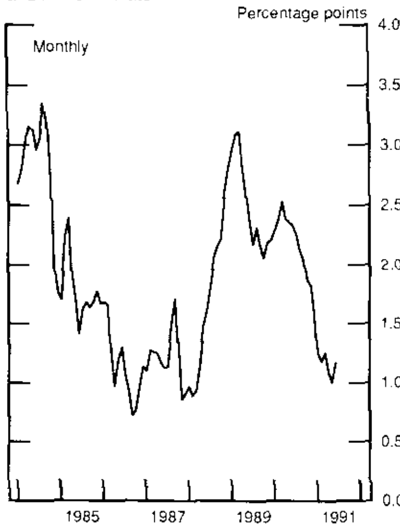
Three–month Treasury Bill Rate
and M2 Own Rate *



Spread of Three-month Treasury Bill
and M2 Own Rate *

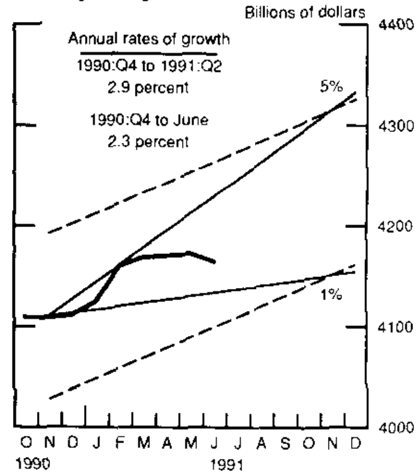


* M2 Own Rate is the weighted average of rates paid on components of M2

savings deposits. As is typically the case, offering rates on these deposits adjusted very slowly to the drop in market rates. As their opportunity costs declined, these deposits accelerated, expanding at double-digit rates over the first half. Small time deposits, by contrast, contracted over the period as some of the proceeds of maturing instruments evidently were shifted into liquid components of M2 and depositors hesitated to commit currently generated savings at available time deposit rates. The strength in other checkable deposits contributed to a strong first-half advance in M1. In the first quarter, this aggregate also was boosted by a surge in currency stemming from rising demand abroad, particularly the Middle East. Reflecting the strength in currency and in other checkable deposits, the monetary base expanded over the first half at an 8½ percent annual rate, more than twice the pace of M2.

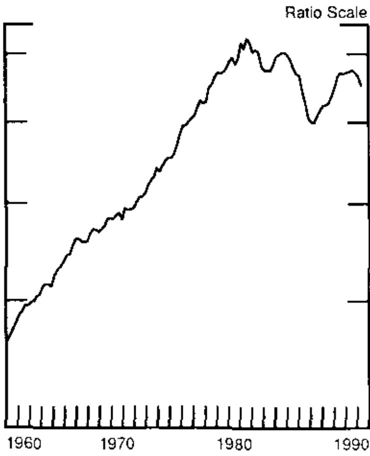
Growth of M3 over the first half was concentrated in the early months of the year, when it received a considerable boost from heavy issuance of large time deposits by U.S. branches and agencies of foreign banks. The issuance of these "Yankee CDs" resulted from the reduction in December of the reserve requirement on nonpersonal time deposits and net Eurocurrency deposits from 3 percent to zero. Previously, branches and agencies had been able to borrow a limited volume of funds from their head offices without incurring reserve requirements. With Yankee CD issuance apparently an inherently cheaper source of funds,

M3: Target Range and Actual Growth

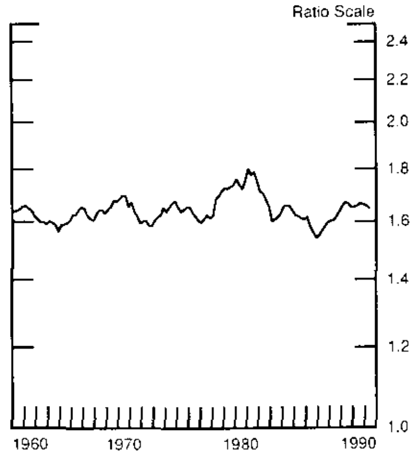


Velocity of Money and Debt
(Quarterly)

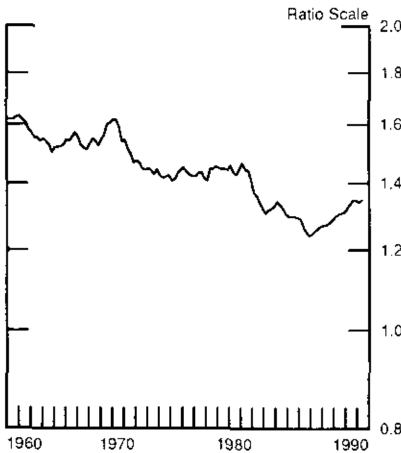
M1



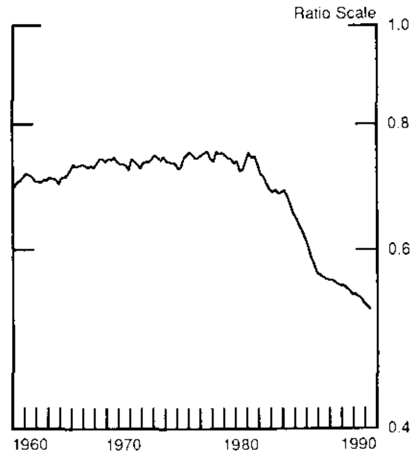
M2



M3



Debt



Note Velocities for 1991:Q2 are based on projected GNP. Debt for 1991:Q2 is partially estimated.

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those institutions that had been able to fund additional asset expansion through reserve-free borrowing from their head offices began to pay down these advances with funds raised in the CD market. Some foreign banks also tapped the CD market to advance funds to affiliates abroad and to pay down other nondeposit liabilities. Domestic banks and thrifts, by contrast, ran off large time deposits in the first quarter as core deposit inflows were more than adequate to fund asset growth. The strength of M3 in the first quarter also reflected strong growth of money market mutual funds. The relative attractiveness of these funds tends to rise when market rates are falling, as fund owners receive returns based on average portfolio yields, which decline only as fund holdings mature and must be replaced with lower-yielding instruments.

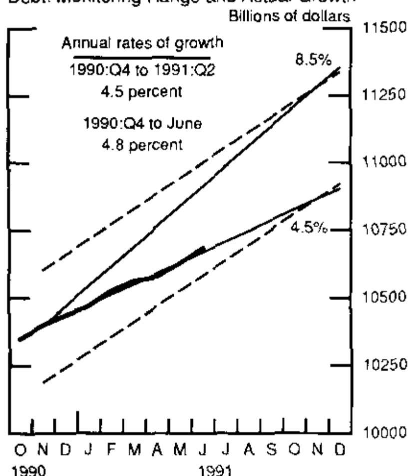
M3 was about flat between March and June. Shifts of foreign bank liabilities toward large time deposits slowed, large time deposits at domestic depositories ran off more rapidly with a contraction of their credit, and money funds decelerated as their yields came into line with market rates.

Bank credit expanded very slowly in the first half of 1991, and was concentrated in acquisitions of securities, particularly those of the Treasury and agencies. As in 1990, the recent strength in acquisitions of these securities owes in part to their favorable treatment under risk-based capital requirements. Mainly, however, it reflects the impact on loan growth of weaker spending by potential borrowers and continued lending restraint by banks. A substantial proportion of bank lending officers, citing heightened uncertainties about the economy and, in many cases, weak capital positions, reported implementing still more restrictive lending policies in a Federal Reserve survey conducted early in 1991. Evidence of tightening continued into May, although the percentage of surveyed banks reporting added tightening declined, perhaps owing in part to the more favorable market environment that had developed from earlier in the year and that had allowed banks to issue large volumes of debt and equity.

The asset quality problems that dogged banks in 1990 continued to crop up in the first half of 1991. Available data on delinquency rates show them climbing further in the first quarter, both for commercial real estate and other business credits and also for consumer loans. At midyear, when a number of large banks announced surprisingly large loan losses and depressed profits, some of the gains that banks had made in debt and equity markets were reversed.

The contraction in depository credit was not fully reflected in the growth of total debt of nonfinancial

Debt: Monitoring Range and Actual Growth



sectors. As occurred last year, credit advanced through securities markets and by other intermediaries met an unusually high proportion of credit needs. Banks themselves continued to sell consumer loans and mortgages into securities markets to hold down asset growth and to bolster capital ratios; through these sales, the cost and availability of funds to households has been largely insulated from the possible effects of bank restraint on credit. In addition, businesses turned to long-term securities markets to meet credit needs and restructure balance sheets, reducing their reliance on banks as well.

Overall, the debt of domestic nonfinancial sectors increased at about a 4½ annual percent rate over the first half. This was likely a bit above the rate of expansion of nominal GNP, though by considerably less than on average over the previous decade, as both borrowers and lenders apparently have been adopting more cautious attitudes toward additional debt. Businesses, for example, stepped up new equity issuance and greatly reduced the retirement of existing equity in corporate restructurings. These activities, together with the decline in financing needs associated with falling inventories and fixed investment, held down growth of business sector debt to a 2 percent annual rate in the first half. With some consumers also attempting to reduce high debt loads, growth of consumer credit was weak as well. Lower mortgage rates and stronger home sales helped maintain growth of residential mortgages. States and municipalities, facing con-

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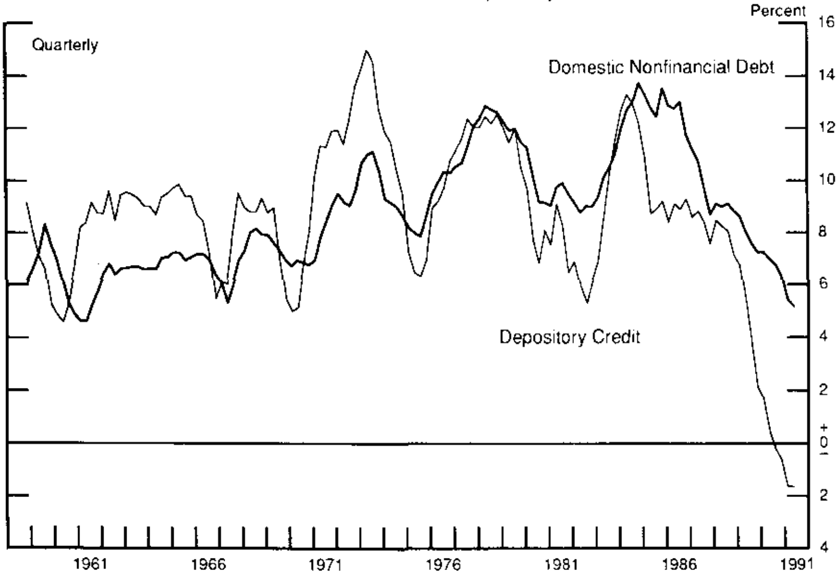
tinuing downgrades and the need to cut back expenditures, put fairly limited net demands on the credit markets in the first half of this year. Federal government debt growth in the first quarter was held down by the slow pace of RTC activity and the receipt of contributions from foreign governments of payments related to the Gulf war; government debt issuance picked up sharply in the second quarter, however.



Growth of Money and Debt *(Percentage change)*

		M1	M2	M3	Debt of domestic nonfinancial sectors
Annually, fourth quarter to fourth quarter					
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	3.8	1.7	6.7
Quarterly (annual rate)					
1991	Q1	5.9	3.4	4.0	4.8
	Q2	7.4	4.6	1.8	4.2
Semiannually, fourth quarter to second quarter (annual rate)					
1991	H1	6.7	4.0	2.9	4.5

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

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ALAN GREENSPAN
CHAIRMAN

September 23, 1991

The Honorable Stephen L. Neal
Chairman
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and
Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

At the Humphrey-Hawkins testimony, you requested a fuller statement of the rationale for delayed disclosure of certain monetary policy decisions. This letter responds in some depth to that request.

In general, monetary policy decisions are made public immediately, expect when doing so could undercut the efficacy of policy or compromise the integrity of policymaking. For example, when we change the discount rate or reserve requirements, those decisions are announced at once. When we establish new ranges for money and credit growth, those ranges are set forth promptly in our reports to Congress. And when Congress requests our views, we testify. Moreover, we publish our balance sheet every week with a 1-day lag. What we do not disclose immediately are the implementing decisions with respect to our open market operations. However, even these are conveyed rather clearly to the markets and to the public at large through the operations themselves. In practice, there is little lag between a change in operating policy and the wide recognition of that change, despite the absence of a formal announcement. Guidance for those operations is given to the account manager at the Federal Reserve Bank of New York as a Directive, which is made public shortly after the next FOMC meeting, 6 to 7 weeks later. At the same time, we publish a lengthy record of the policy deliberations underlying the Committee's decisions. In all these respects, the Federal Reserve compares very favorably with the central banks of other major industrial nations.

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The Honorable Stephen L. Neal
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As you noted, however, suggestions have been made that we announce publicly any change in our operating objectives as it occurs and release the Directive immediately after an FOMC meeting. These suggestions have appeal: surely more information is better than less in promoting efficient financial markets; and the need to infer the Federal Reserve's policy stance from its actions can give rise to mistakes and unnecessary market volatility.

Yet the amount of genuine new information that would be released is small; it is subject to misinterpretations; and its premature announcement could adversely affect the policy process.

Wide movements in bond and stock prices occur when investors receive new information that significantly alters their expectations over a relatively long-term horizon. Normally, changing perceptions about the unannounced *current* operating stance of monetary policy play only a minor role in episodes of financial variability. For example, in the first half of 1990, there was no change in the operating stance of monetary policy and no market uncertainty about that *current* stance, but U.S. bond and stock prices experienced fairly wide swings. To the extent that any of these market movements reflected policy, they must have been related to changes in market expectations about our *prospective* policy stance. But announcements of future changes in operating policy are not possible, since they are contingent upon future economic developments.

Changes in our current operating stance, of course, have the potential to alter anticipations of future conditions, including future policy. At times, monetary policymakers wish to strengthen the market's sense of a more basic change in the thrust of policy through an announcement effect, as well as through a change in the instrument itself. Changes in the discount rate provide good examples.

More often, however, the Federal Reserve judges that policy implementation is better served through small, incremental operating moves that do not connote a significant alteration in policy intent and do not have major implications for financial conditions in the more distant future. Signalling such policy moves through open market operations as opposed to formal announcements usually avoids major and potentially destabilizing movements in bond and stock prices.

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This way of distinguishing the nature of policy intent may well convey information to the financial markets about the future direction of policy better than would a formal, immediate announcement of every policy change.

The immediate disclosure of all changes in our operating targets would take a valuable policy instrument away from us by reducing our flexibility to implement decisions quietly at times to achieve a desired effect while minimizing possible financial market disruptions. With an obligation to announce all changes as they occurred, the distinction between making changes either quite publicly or more subtly, as conditions warrant, would evaporate; all moves would be accompanied by announcement effects. If markets always accurately assessed the implications of such announcements, incorporating them into the structure of prices, then market efficiency might be enhanced by making our open market objectives public immediately. However, prices can, and do, overreact to particular announcements. The loss of flexibility implied by the announcement requirement would be regrettable, especially in view of the inevitable uncertainties surrounding the outlook for financial markets and the economy.

The need for flexibility is especially pressing in times of acute financial unrest. At those times, it is imperative that the Federal Reserve remain able to respond promptly and in whatever manner is most appropriate to the moment. The fluidity of financial crises requires the same kind of fluidity in our response. Some types of announcement could well be helpful in such circumstances--as, for example, the very general statement made at the time of the October 1987 stock market crash appeared to be. However, it would be ill-advised and perhaps virtually impossible to announce short-run targets for reserves or interest rates when markets were in flux. Our open market operations might depend on market conditions at the moment and might not be accurately represented by an announcement of a particular goal for reserves or interest rates. Moreover, the specific instrument settings might themselves be changing as developments unfolded. Markets are often prone to overreact at times when the financial system appears fragile, and under these conditions, the requirement to publicize each change could risk further unsettling markets.

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In the normal course of events, a public-announcement requirement also could impede timely and appropriate adjustments to policy. In recent years, the Federal Reserve has been most successful when it has anticipated pressures on the economy and has moved promptly to counter them. The immediate announcement of changes to our instrument settings could adversely affect the policymaking process that has made this possible and could impart a degree of sluggishness to policy responses. The Federal Reserve might be forced to focus more on the announcement effect associated with its action, than on the ultimate economic impact.

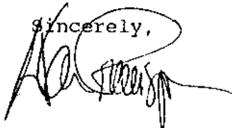
The immediate release of the Directive also would be ill-advised. The Directive itself cannot capture all the considerations that guide Committee policy for the intermeeting period. It needs to be accompanied by the record of the Committee's deliberations, which takes several weeks to prepare properly. Moreover, early release could provoke overreactions in financial markets to contingencies or reserve pressure alternatives mentioned in a Directive that may not occur, or that may be superseded by intermeeting developments and adjustments. To the extent that market participants anticipate contingencies in the Directive that never materialize, the markets would be subjected to unnecessary volatility.

Earlier release of the Directive would, in addition, force the Committee itself to focus on the market impact of the announcement as well as on the ultimate economic impact of its actions. To avoid premature market reaction to mere contingencies, FOMC decisions could well lose their conditional character. Given the uncertainties in economic forecasts and in the links between monetary policy actions and economic outcomes, such an impairment of flexibility in the evolution of policy would be undesirable.

Currently, the basic policy stance of the Federal Reserve is reviewed by Congress and the nation when we present our semiannual report on monetary policy. The longer-run ranges for money and credit, along with other considerations set forth in those reports, constitute the framework within which shorter-run, implementing actions are taken. Should the basic policy objectives change, that would be announced promptly. The current issue concerns only the immediate disclosure of operational decisions connected with carrying out those basic objectives. Our conclusion is that mandating such announcements would yield only marginal rewards, but could significantly reduce the effectiveness of policy.

Clearly, this line of reasoning is undermined by the selective, unauthorized, and premature release of FOMC decisions to the press. As I indicated in response to your question at the Humphrey-Hawkins hearings, I have found these instances extremely distressing. I believe that the appropriate response to this problem is not the abandonment of procedures designed to enhance the effectiveness of policy implementation, but rather the better enforcement of the Committee's rules regarding confidentiality.

Sincerely,



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Committee on Banking, Finance and Urban Affairs

BRIEFING

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Gail Makinen
Specialist in Economic Policy
Economics Division

July 15, 1991

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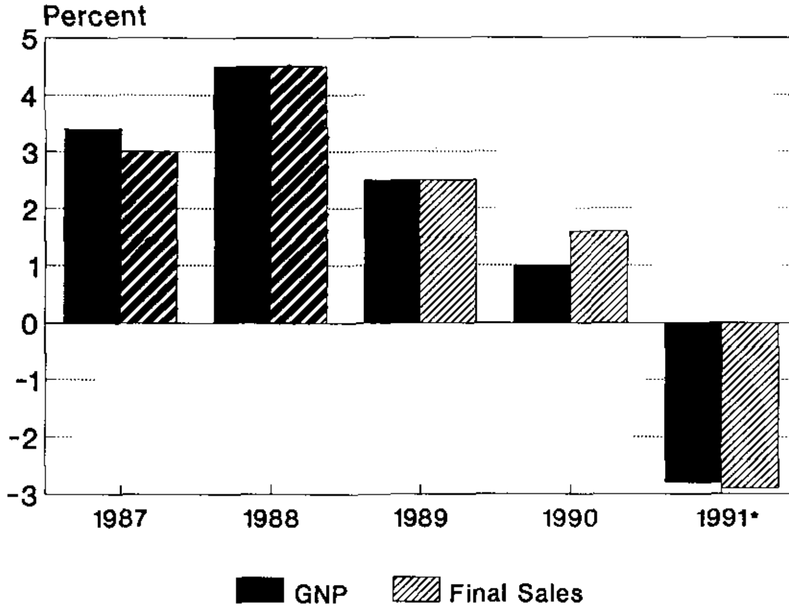
RECENT MACROECONOMIC DEVELOPMENTS

1. While real GNP grew 1 percent during 1990, it contracted at an annual rate of 1.6 percent during the fourth quarter of the year. The rate of contraction accelerated to an annual rate of 2.8 percent during the first quarter of 1991. Final sales, which is GNP less changes in inventories, grew 1.6 percent during 1990. Unlike GNP, final sales growth was positive during the fourth quarter of that year. During the first quarter of 1991, final sales fell at an annual rate of 2.9 percent.

FIGURE 1. GNP vs. Final Sales



* Annualized first quarter rate of change.

Source: U.S. Department of Commerce.

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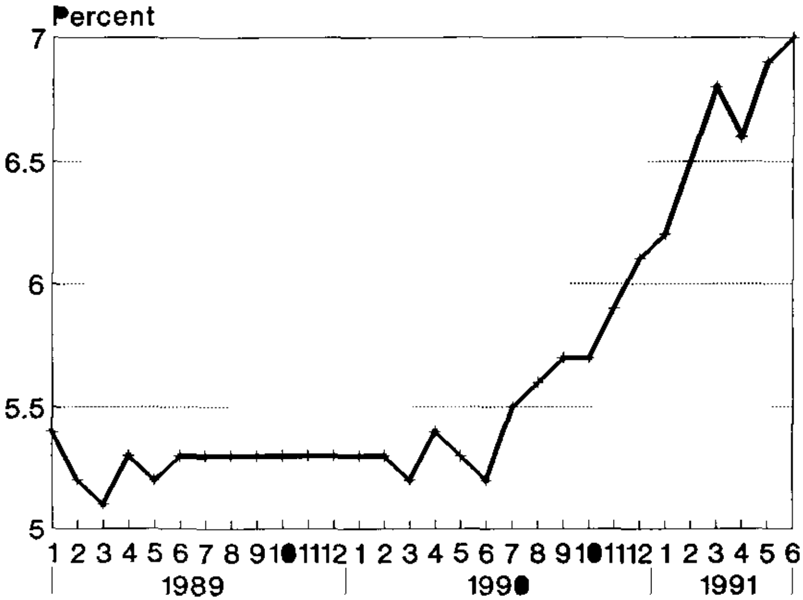
2. For much of 1988 and 1989, the unemployment rate was virtually unchanged, at about 5.3 percent. The magnitude of the slowdown in GNP growth that began early in 1989 and, ultimately, the contraction of GNP, caused unemployment to rise. The rate for June 1991, 7.0 percent, is a high for *the current recession. Rates this high were last seen in 1986. While those* unemployed for short periods of time (14 weeks or less) continue to dominate unemployment, longer term unemployment (15 weeks and over) has been rising.

FIGURE 2. Civilian Unemployment Rate



Source: U.S. Department of Labor.

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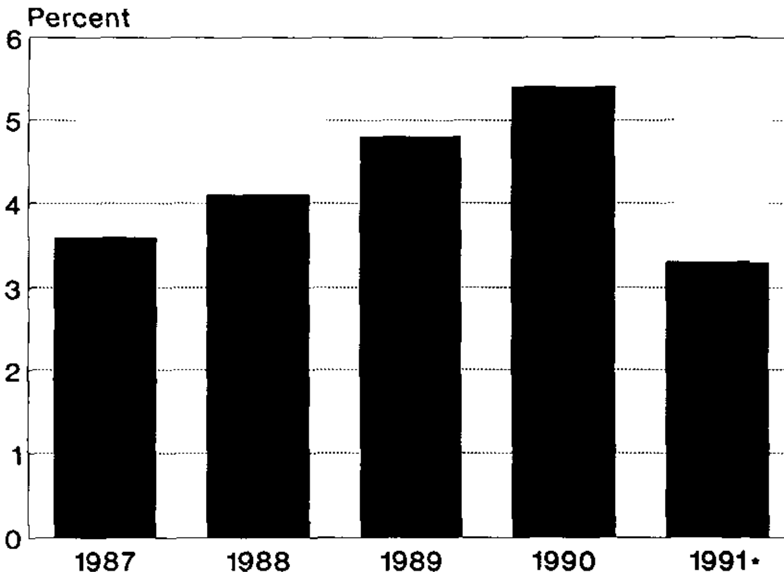
3. The inflation rate, measured by the CPI, rose at an annual rate of 3.3 percent during the first five months of 1991. This compares with 5.4 percent, 4.8 percent, 4.1 percent, and 3.6 percent during 1990, 1989, 1988, and 1987, respectively. Undoubtedly, some of the deceleration in inflation was affected by the fall in energy prices following the successful war against Iraq. The non-energy portion of the CPI rose at an annual rate of 4.8 percent during the first five months of 1991 compared to 5.2 percent during 1990.

   The inflation rate measured by the two GNP deflators accelerated during the first quarter of 1991 with both rising at an annualized rate of 5.2 percent. The implicit price deflator for GNP rose 4.1 percent during 1990 compared with 4.1 percent, 3.3 percent, and 3.2 percent, respectively, during 1989, 1988, and 1987. The fixed weight deflator rose 4.5 percent during 1990 compared with 4.5 percent, 4.2 percent, and 3.5 percent, respectively, for 1989, 1988, and 1987.

   Labor costs during the first quarter of 1991 moved at rates similar to those in 1990. Unit labor costs rose at an annual rate of 3.7 percent versus 4.4 percent for 1990. The rise in the Employment Cost Index was identical to its rise during 1990 (4.6 percent) which is similar to its rate of increase during 1988 and 1989.

FIGURE 3A. Consumer Price Index



* Annualized rate based on first five months of 1991.

Source: U.S. Department of Labor.

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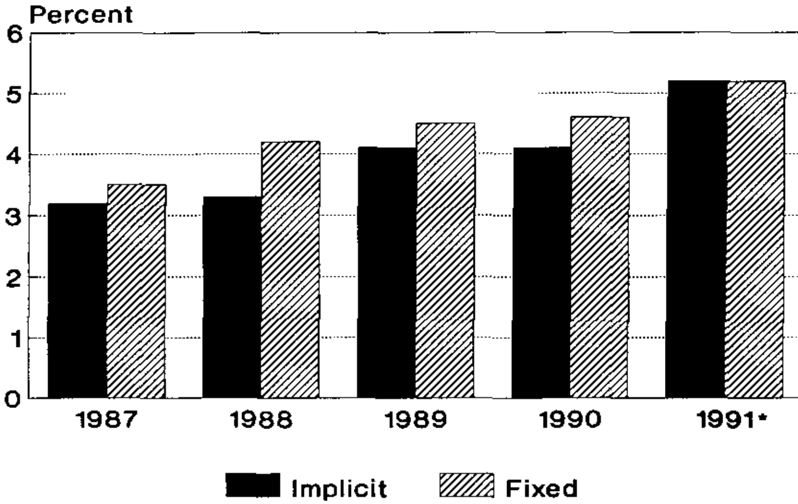
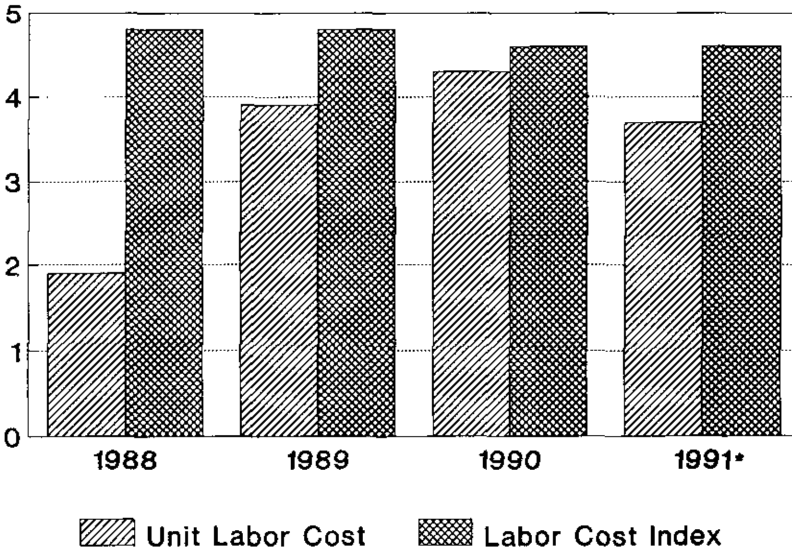
FIGURE 3B. GNP Deflator



* Annualized rate based on first quarter data.

Source: U.S. Department of Commerce

FIGURE 3C. Labor Costs



* Annualized rate based on first quarter data.

Source: U.S. Department of Labor

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4. Monetary policy has eased considerably over the past year. Aggregate reserve growth, the basis for future growth in the monetary aggregates, accelerated noticeably. Only over the past quarter has it been slowed. In response, the growth rates of the monetary aggregates have also accelerated.

TABLE 1. Monetary Aggregates

Period	Aggregate Reserves	Monetary Base	M1	M2	M3
04/87–04/88	3.1%	6.7%	4.3%	5.2%	6.3%
04/88–04/89	-0.5	3.4	0.6	4.7	3.5
04/89–04/90	1.0	8.4	4.2	3.9	1.8
02/90–02/91	5.3	9.4	5.2	3.3	2.1
03/90–02/91	6.9	9.6	5.7	3.4	1.9
04/90–02/91	8.7	9.6	6.8	4.1	2.9
01/90–02/91	5.3	4.2	7.6	4.7	1.8

Source: Board of Governors and the St. Louis Federal Reserve Bank.

TABLE 1A. Growth in the Major Components of the Monetary Aggregates (in percentages)

	Currency	Demand Deposits	Other Checkable Deposits	Money Market Deposit Accts	Money Market Mutual Funds	Saving Deposits	Small Time Deposits	Large Time Deposits
04/87–04/88	8.1	-1.3	7.6	7.7	-4.6	2.9	13.1	11.6
04/88–04/89	4.8	-3.0	0.9	30.0	-4.5	-5.9	11.8	5.0
04/89–04/90	10.9	-0.6	3.5	11.4	5.1	2.0	1.8	-9.5
04/90–02/91*	9.7	0.1	8.6	10.1	6.3	9.5	-2.9	-2.7

* Through May 1991.

Source: Federal Reserve System.

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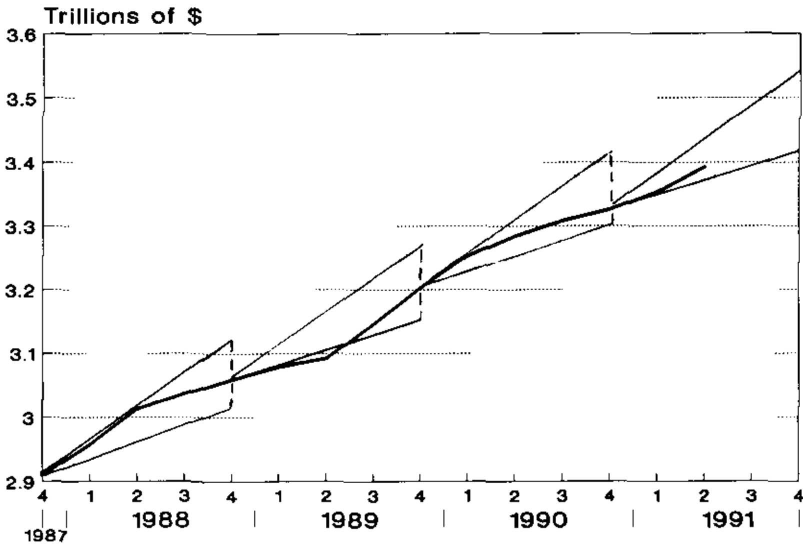
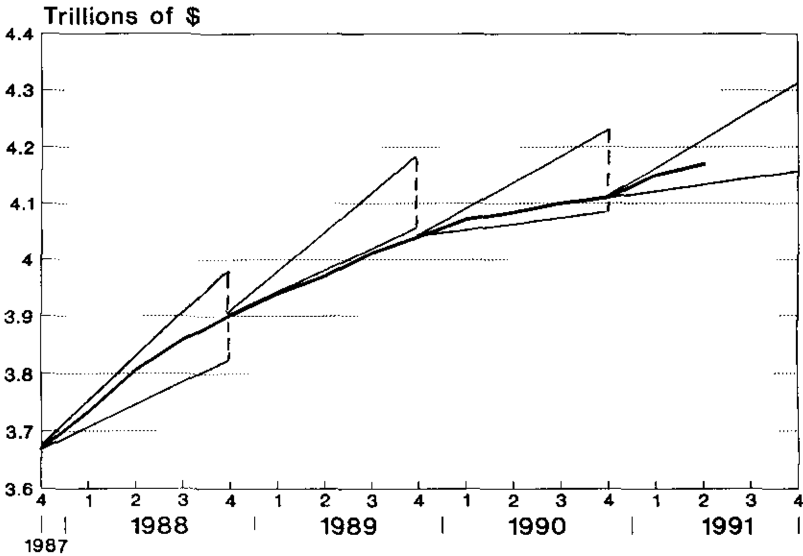
FIGURE 4. M2



Source: Board of Governors of the Federal Reserve.

FIGURE 5. M3



Source: Board of Governors of the Federal Reserve

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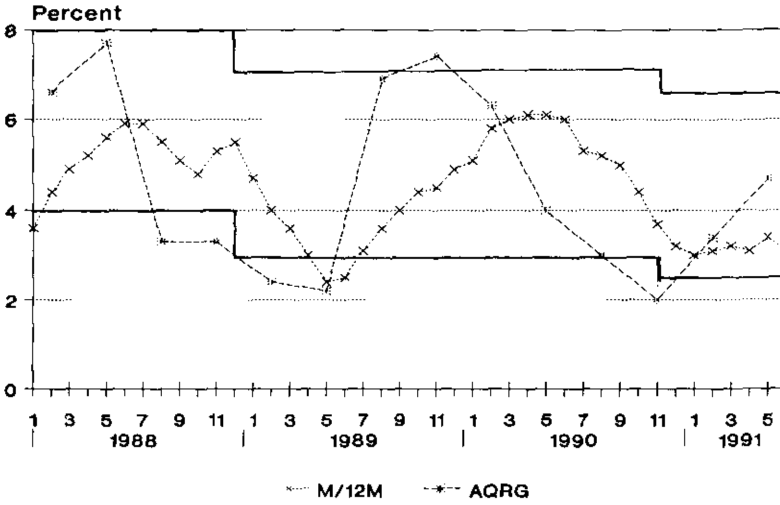
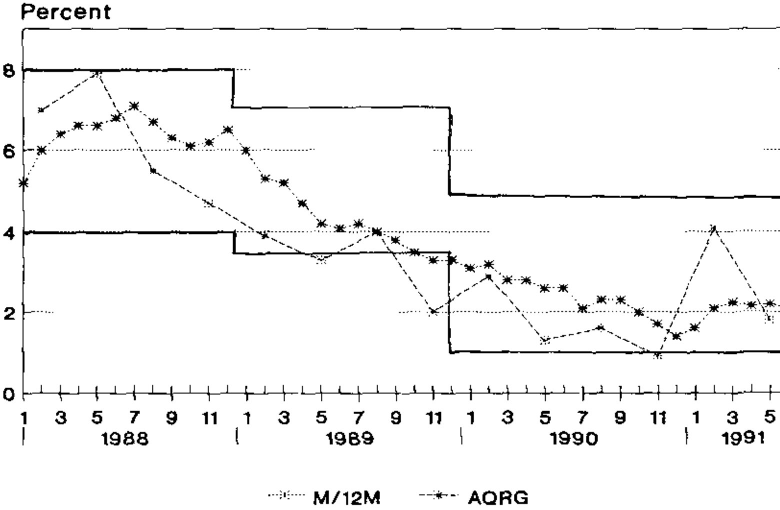
FIGURE 6. M2 Growth Rates



Source: Board of Governors of the Federal Reserve System.

FIGURE 7. M3 Growth Rates



Source: Board of Governors of the Federal Reserve System.

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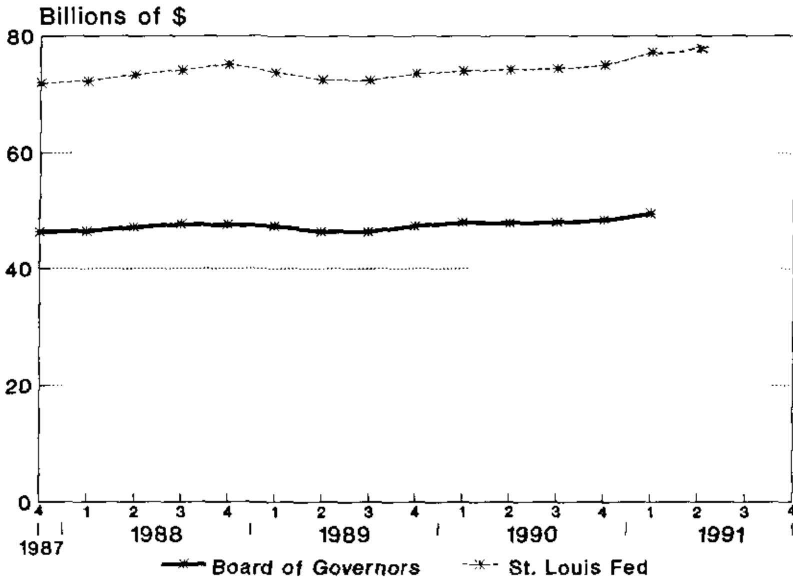
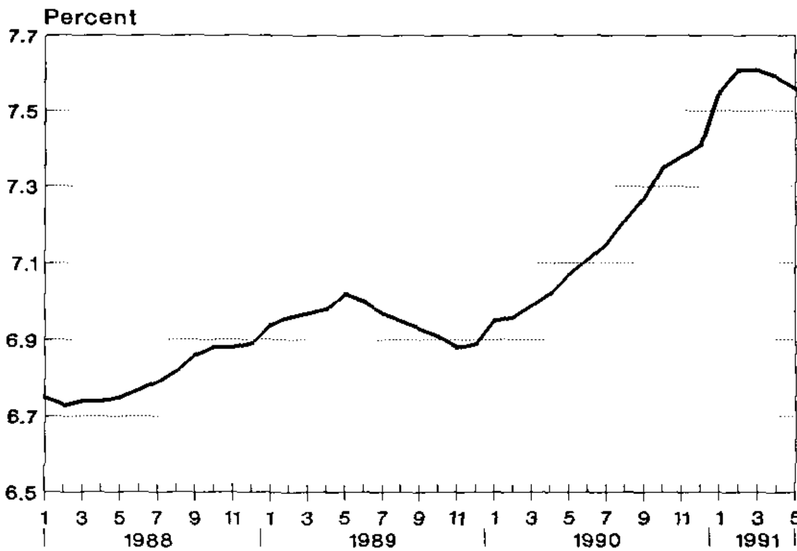
FIGURE 8. Reserve Growth



Source: Board of Governors of the Federal Reserve System.

FIGURE 9. Currency/M2 Ratio



Source: Board of Governors of the Federal Reserve System

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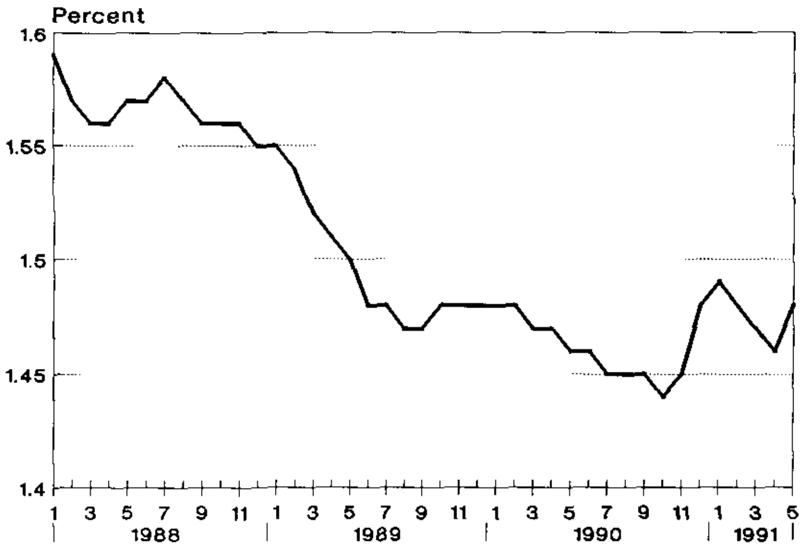
FIGURE 10. Reserve/M2 Ratio



Source: Board of Governors of the Federal Reserve System.

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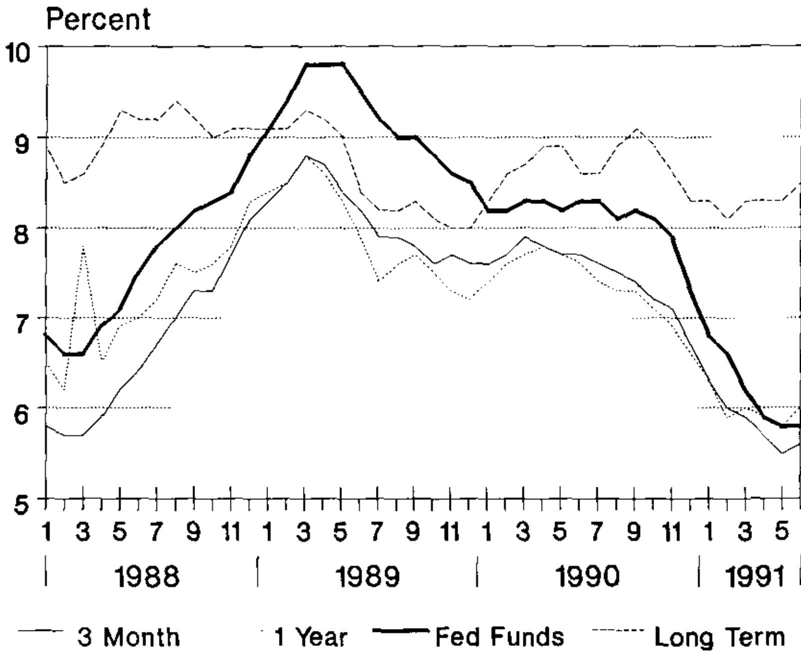
FIGURE 11. Yield on Selected Treasury Securities



Source: Board of Governors of the Federal Reserve System.

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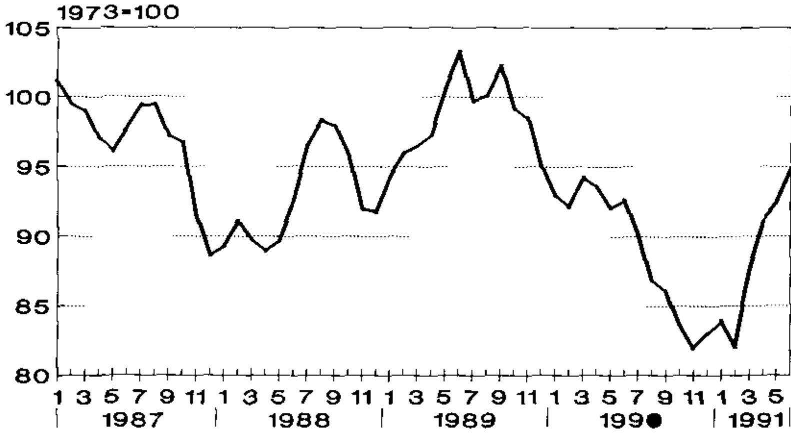
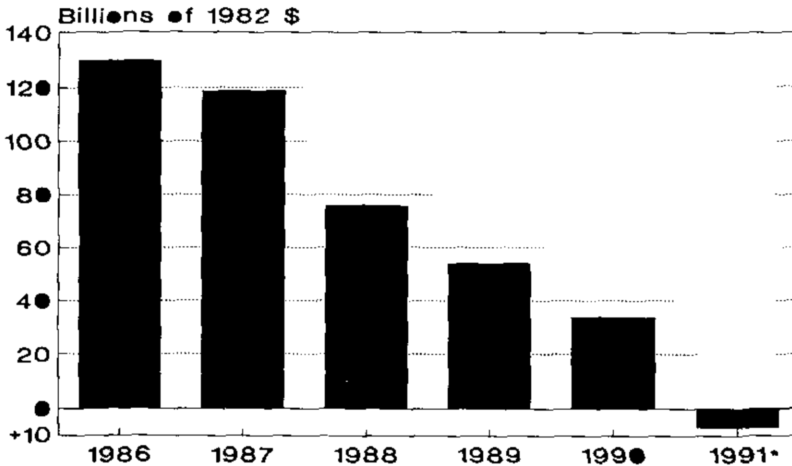
FIGURE 12. Dollar Exchange Rate



Source: Board of Governors of the Federal Reserve System.

5. The foreign exchange value of the dollar has risen steadily since late 1990. It now stands at a level last seen late in 1989. Despite this, the overall downward trend since mid-1989 has contributed to a continued decline in the trade deficit. During the first quarter of 1990, the United States actually ran a trade surplus of $7.1 billion 1982 dollars.

FIGURE 13. U.S. Foreign Trade Deficit



* Based on first quarter data.

Source: U.S. Department of Commerce.

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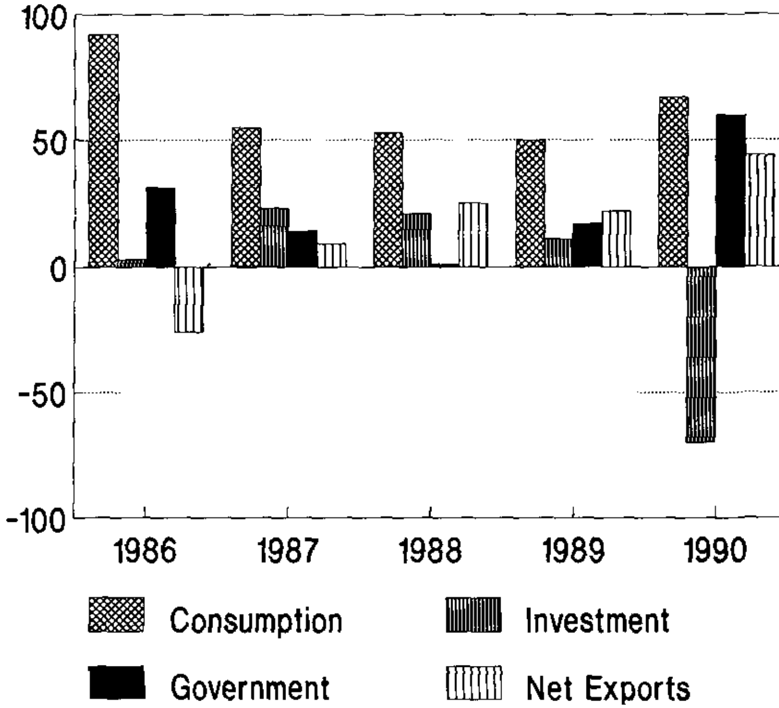
FIGURE 14. Sources of GNP Growth



Source: *U.S. Department of Commerce.*

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TABLE 2. Économic Forecasts, 1991–1992

	1991				1992						
	1	2	3	4	1	2	3	4	1990*	1991	1992
Nominal GNP[a]											
OMB	2.2	4.6	6.3	7.0	7.7	7.5	7.4	7.3	5.1	4.1	7.1
CBO	2.2	5.1	6.2	7.6	8.1	7.2	6.7	6.4	5.1	4.3	7.1
DRI	2.2	4.1	6.6	6.2	6.1	5.7	4.7	4.8	5.1	3.7	5.7
WEFA	2.2	3.8	4.7	5.9	7.5	7.6	7.5	6.6	5.1	3.4	6.6
BC	2.2	4.5	6.4	6.5	6.7	6.5	6.5	6.4	5.1	3.8	6.4
Real GNP[a]											
OMB	-2.8	0.3	2.0	2.8	3.7	3.6	3.6	3.5	1.0	-0.3	3.1
CBO	-2.8	0.8	2.3	3.9	4.0	3.6	3.1	2.8	1.0	0.0	3.3
DRI	-2.8	1.3	3.8	3.3	2.6	2.3	1.8	1.8	1.0	0.1	2.6
WEFA	-2.8	1.5	2.8	3.5	3.9	4.2	4.0	2.9	1.0	0.0	3.6
BC	-2.8	0.8	2.7	2.9	2.9	2.8	2.8	2.7	1.0	-0.1	2.8
Unemployment[b]											
OMB	6.5	6.8*	6.8	6.7	6.7	6.7	6.7	6.6	5.5	6.8	6.7
CBO	6.5	6.8	6.9	6.8	6.6	6.5	6.4	6.3	5.5	6.8	6.4
DRI	6.5	6.8	6.9	6.7	6.6	6.4	6.4	6.4	5.5	6.8	6.5
WEFA	6.5	6.8	7.0	6.8	6.6	6.3	6.2	6.1	5.5	6.8	6.3
BC	6.5	6.8	6.8	6.8	6.7	6.6	6.4	6.3	5.5	6.7	6.5
GNP Deflator[a]											
OMB	5.2	4.3	4.2	4.1	3.9	3.8	3.7	3.7	4.1	4.4	3.9
CBO	5.2	4.3	3.8	3.6	3.9	3.5	3.5	3.5	4.1	4.3	3.7
DRI	5.2	2.7	2.7	2.8	3.3	3.3	2.9	2.9	4.1	3.6	3.0
WEFA	5.2	2.2	1.8	2.3	3.5	3.2	3.4	3.6	4.1	3.3	2.9
BC	5.2	3.7	3.4	3.5	3.7	3.6	3.6	3.6	4.1	3.9	3.5
CPI-U[a]											
OMB	3.5	4.2	4.1	4.0	4.0	3.9	3.9	3.8	5.4	5.2	4.0
CBO	3.5	3.8	3.2	3.6	3.5	3.5	3.5	3.6	5.4	4.9	3.5
DRI	3.5	2.1	2.6	3.5	3.9	3.9	3.8	3.9	5.4	4.2	3.5
WEFA	3.5	2.1	3.4	3.6	4.4	3.5	4.2	5.0	5.4	4.3	3.8
BC	3.5	2.7	3.7	3.9	4.0	4.0	3.9	4.0	5.4	4.4	3.9
T-Bill Rate[b]											
OMB	6.0	5.6*	6.4	6.3	6.2	6.1	6.0	5.8	7.5	6.4	6.0
CBO	6.0	5.6	6.5	6.8	6.9	7.0	7.0	7.0	7.5	6.6	7.0
DRI	6.0	5.6	5.7	6.2	6.6	6.7	6.7	6.4	7.5	5.9	6.6
WEFA	6.0	5.6	5.7	5.8	6.0	6.1	6.2	6.3	7.5	5.8	6.1
BC	6.0	5.6	5.6	5.7	5.9	6.0	6.2	6.2	7.5	5.8	6.1
10-Year Rate[b]											
OMB	8.0	8.1*	7.5	7.4	7.3	7.3	7.2	7.1	8.6	7.5	7.2
CBO	8.0	8.1	7.7	7.7	7.7	7.7	7.7	7.7	8.6	7.9	7.7
DRI	8.0	8.1	8.4	8.7	8.8	8.7	8.6	8.3	8.6	8.3	8.6
WEFA	8.0	8.1	8.3	8.4	8.6	8.6	8.7	8.7	8.6	8.2	8.7
BC	–	–	–	–	–	–	–	–	8.6	NA	NA

* Actual data, subject to revisions.

[a] Annualized quarterly rates of change.

[b] Quarterly average. OMB assumes interest rates follow the course of inflation.

Sources: Data Resources, Inc., *U.S. Forecast Summary*, July 1991; Wharton Econometric Forecasting Associates Group. *U.S. Economic Outlook*, July 3, 1991; *Blue Chip Economic Indicators*, July 10, 1991. Congressional Budget Office. Washington, February 1991; and, the Office of Management and Budget. Feburary 1991. The quarterly detail of the CBO and OMB forecasts are from unpublished data.

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