

# 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 ECONOMIC GROWTH AND CREDIT FORMATION OF THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

FEBRUARY 23, 1993

Printed for the use of the Committee on Banking, Finance and Urban Affairs

**Serial No. 103-10**



U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON : 1993

64740=

---

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

ISBN 0-16-040771-0

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HENRY B. GONZALEZ, Texas, *Chairman*

STEPHEN L. NEAL, North Carolina	JAMES A. LEACH, Iowa
JOHN J. LaFALCE, New York	BILL McCOLLUM, Florida
BRUCE F. VENTO, Minnesota	MARGE ROUKEMA, New Jersey
CHARLES E. SCHUMER, New York	DOUG BEREUTER, Nebraska
BARNEY FRANK, Massachusetts	THOMAS J. RIDGE, Pennsylvania
PAUL E. KANJORSKI, Pennsylvania	TOBY ROTH, Wisconsin
JOSEPH P. KENNEDY II, Massachusetts	ALFRED A. (AL) McCANDLESS, California
FLOYD H. FLAKE, New York	RICHARD H. BAKER, Louisiana
KWEISI MFUME, Maryland	JIM NUSSLE, Iowa
MAXINE WATERS, California	CRAIG THOMAS, Wyoming
LARRY LaROCCO, Idaho	SAM JOHNSON, Texas
BILL ORTON, Utah	DEBORAH PRYCE, Ohio
JIM BACCHUS, Florida	JOHN LINDER, Georgia
HERBERT C. KLEIN, New Jersey	JOE KNOLLENBERG, Michigan
CAROLYN B. MALONEY, New York	RICK LAZIO, New York
PETER DEUTSCH, Florida	ROD GRAMS, Minnesota
LUIS V. GUTIERREZ, Illinois	SPENCER BACHUS, Alabama
BOBBY L. RUSH, Illinois	MIKE HUFFINGTON, California
LUCILLE ROYBAL-ALLARD, California	MICHAEL CASTLE, Delaware
THOMAS M. BARRETT, Wisconsin	PETER KING, New York
ELIZABETH FURSE, Oregon	
NYDIA M. VELAZQUEZ, New York	BERNARD SANDERS, Vermont
ALBERT R. WYNN, Maryland	
CLEO FIELDS, Louisiana	
MELVIN WATT, North Carolina	
MAURICE HINCHEY, New York	
CALVIN M. DOOLEY, California	
RON KLINK, Pennsylvania	
ERIC FINGERHUT, Ohio	

---

SUBCOMMITTEE ON ECONOMIC GROWTH AND CREDIT FORMATION

PAUL E. KANJORSKI, Pennsylvania, *Chairman*

STEPHEN L. NEAL, North Carolina	THOMAS J. RIDGE, Pennsylvania
JOHN J. LaFALCE, New York	BILL McCOLLUM, Florida
BILL ORTON, Utah	TOBY ROTH, Wisconsin
HERBERT C. KLEIN, New Jersey	JIM NUSSLE, Iowa
NYDIA M. VELAZQUEZ, New York	MARGE ROUKEMA, New Jersey
CALVIN M. DOOLEY, California	PETER KING, New York
RON KLINK, Pennsylvania	
ERIC FINGERHUT, Ohio	

# CONTENTS

---

Hearing held on:	Page
February 23, 1993 .....	1
Appendix:	
February 23, 1993 .....	45

## WITNESS

TUESDAY, FEBRUARY 23, 1993

Greenspan, Hon. Alan, Chairman of the Federal Reserve Board .....

## APPENDIX

Prepared statements:	
Kanjorski, Hon. Paul E. ....	46
Ridge, Hon. Thomas J. ....	3
Greenspan, Hon. Alan .....	48

## ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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" .....	75
Greenspan, Hon. Alan, supplemental statement .....	72



# SEMI-ANNUAL HEARING ON THE CONDUCT OF MONETARY POLICY

TUESDAY, FEBRUARY 23, 1993

HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON ECONOMIC GROWTH AND  
CREDIT FORMATION,  
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,  
*Washington, DC.*

The subcommittee met, pursuant to notice, at 10:10 a.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman] presiding.

Present: Chairman Kanjorski, Representatives Neal of North Carolina, LaFalce, Klink, Fingerhut, Ridge, McCollum, Nussle, Roukema, and King.

Also present: Representatives Schumer, Bachus, Klein, Watt, McCandless, Pryce, Knollenberg, and Grams.

Chairman KANJORSKI. The subcommittee will come to order.

The subcommittee meets today to receive the Semi-Annual Report of the Board of Governors of the Federal Reserve System on Economic and Monetary Policy as mandated under the Full Employment and Balanced Growth Act of 1978, popularly known as the Humphrey-Hawkins Act.

Under the act, the Federal Reserve is required to set forth a review and analysis of recent developments affecting economic trends in the Nation, including changes in the exchange rate; the objectives and plans of the Federal Reserve Board of Governors and the Federal Open Market Committee with respect to the ranges of growth and diminution of money supply, taking into account past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade, and prices; and the relationship between the Federal Reserve's plans and short-term goals set forth in the most recent Economic Report of the President, and any goals set by the Congress.

As the new chairman of this subcommittee, I want to welcome Chairman Greenspan. I look forward to working with the Chairman, his colleagues at the Federal Reserve, and my colleagues on both sides of the aisle, to achieve the overall goals of the Humphrey-Hawkins Act—full employment and balanced growth.

As we sit here today, the single most significant development in economic policy since the last time the Chairman testified before the House Banking Committee comes not as a result of any action by the Federal Reserve, the Federal Open Market Committee, or

this subcommittee. The single most significant development is that the American people have delivered a mandate for change.

In the election of 1992, the American people told the executive branch, the legislative branch, and independent agencies like the Federal Reserve, that this is not the time for politics as usual, that the time for gridlock and divided government is over.

I am extremely encouraged by Chairman Greenspan's statements that President Clinton's deficit reduction proposal is both "serious" and "credible." The Chairman's statements indicate that not only is the President heading in the right direction, but also that cooperation is possible between a President from one party and a Board of Governors appointed by Presidents from the other party. For my own part, I can only hope that this bipartisan spirit of cooperation will spill over to the legislative branch. I will certainly do my best to encourage it in this subcommittee.

The Chairman's appearance today comes at a time when short-term interest rates are at relatively historical lows. Few Americans today are complaining about the price of money. Low interest rates usually mean an ample supply of money—"easy money."

The anomaly we find ourselves in today is that while interest rates are low, many Americans still cannot find access to it at any price. This continuing "credit crunch" is particularly acute for small- and medium-sized businesses which are the lifeblood of our economy, and which have historically created the majority of new jobs in our economy. It is the inability of small- and medium-sized businesses to obtain access to credit which has undoubtedly caused unemployment to remain unacceptably high.

Our inner cities, our second and third tier cities, and our minority communities have been particularly hard hit by the inability to obtain access to credit. Small communities in northeastern Pennsylvania, and the riot-torn sections of Los Angeles may be thousands of miles apart and have vastly different social and cultural backgrounds, but they share one important thing in common: Both feel that their economic recovery has been blocked by inadequate access to capital for business expansion and job creation.

In our economy today, big businesses have avenues other than commercial banks through which they can obtain credit. They can go directly to the capital markets. They can obtain loans from pension funds and insurance companies. Individuals who seek home loans and credit for consumer loans benefit from the secondary market which has been created to increase the flow of funds for these purposes.

Virtually alone among borrowers, small- and medium-sized businesses have little or no alternatives other than borrowing from commercial banks. Yet, banks are too often reluctant to make loans, claiming they are struggling under the weight of increased capital requirements and regulations. Where are these businesses to turn at a time when short-term interest rates are low, and there are capital requirements and regulators who make it easier and more profitable for a bank to invest in government securities than in small- and medium-sized commercial loans?

I hope the Chairman will address the question of how we can ensure that small- and medium-sized businesses obtain access to credit they need to make our economic recovery complete and to

ensure that we meet the goals of full employment, which is an integral part of the Humphrey-Hawkins Act.

If artificial restrictions imposed by either regulators or the Congress are impeding bank lending to small- and medium-sized businesses, please tell us how we can remove these impediments. If new incentives or a secondary market for commercial loans need to be created, tell us the most effective way to create them.

If nothing we can do will convince banks to make commercial loans, then who can we find or create who will make them, and why are we in the business of chartering and insuring commercial banks?

Mr. Chairman, I welcome you to today's hearing and I look forward to hearing your testimony and to working with you in the months and years ahead to revitalize our economy.

Mr. Ridge's plane is delayed. With unanimous consent, I will enter into the record at this time, Mr. Ridge's opening statement. [The opening statement of Hon. Thomas Ridge follows:]

**OPENING STATEMENT OF HON. THOMAS RIDGE, MEMBER OF  
THE SUBCOMMITTEE ON ECONOMIC GROWTH AND CREDIT  
FORMATION**

Thank you, Mr. Chairman. I want to welcome Mr. Greenspan to our new subcommittee today. Traditionally, we have not had jurisdiction over Federal Reserve policy and operations, so we're on a learning curve here. I want to say, however, that those of us who entered Congress not long after the days of double-digit inflation, when all Americans were clear losers, are behind you in your efforts to spur steady long-term growth and, indeed, have an abiding interest in maintaining a healthy, independent Federal Reserve.

I must comment on the package proposed by our new President. Certainly all Americans wish to see him succeed. We cannot wish for him to fail, since we would be, in effect, wishing for our home States and our country to fail. And I agree with Mr. Clinton that the status quo cannot be maintained without jeopardizing our children's future. It will be no easy job to ensure the recession's end (and stimulate the job-producing sector) while also closing a stubborn deficit.

And so while I applaud the hard work he has done, and support the general thrust of the spending cuts he advocates, I must say I do not believe the voters had \$160 billion in new spending in mind when they sent him to the White House. And I say without reservation that they did not want to see the deficit problem tackled primarily through higher taxes. Over the last 14 years, government revenue has averaged between 18 and 20 percent of GNP, while government spending has grown to 25 percent of GNP. We have a spending problem, nothing else.

But look at what will happen under this plan: According to an analysis presented by the American Enterprise Institute, in fiscal year 1994 the Clinton plan will raise \$36 billion in new taxes while cutting just \$3.6 billion, for a 10-to-1 ratio of new taxes to reduced spending. The spending cuts come later, we're told. And the deficit reduction comes later. Pennsylvanians are willing to share in the sacrifice, but government needs to share in the pain.

Of course, dissenters will have to be specific. I think we need to go back and enact precise spending cuts before we enact any tax increases. I think we need to make real distinctions—distinctions not made in the Clinton plan—between spending for infrastructure and children, which are truly investment, and the many other types of spending which must be considered only for what they are: Private sector funds taken for less efficient public spending.

In the end, I don't think a ratio of \$2.5 to \$3 in tax hikes for every dollar of spending cut will do the country justice, and most voter will not accept this balance. I wish Mr. Panetta, who is very knowledgeable in budget matters, could have prevailed with his view of \$2 in spending cuts for every dollar of new taxes. Maybe he will yet prevail.

Finally, I suspect Mr. Greenspan will tell us that he can manage monetary policy just fine if we control the deficit. He will tell us that long-term bond rates will fall if we close the deficit. I think he's right. But if we start down the wrong path and interest rates fall, we may get surprised. Interest rates, particularly short-term rates, fell all through this recession and still, today, small business is not creating the jobs we would expect at the end of a recession. If long-run rates fall but employers have no expectation of future growth, if government regulatory and taxation policy indicate a distinct bias against business, then the lowest bond rates in the world will not be enough to start the research, investment, marketing, and production functions that we need to put everyone back to work and keep them there.

The deficit is an elusive target indeed. We must bring it down. But in the woods of northeastern Pennsylvania, where every year the older generation teaches the younger one how to hunt, they say there's two ways to bring down the deer. You can bring the deer down with patience and planning and a good, clean shot and have yourself a feast afterward. Or you can bring it down with wild, erratic shots that only leave you with a stinking mess on your hands.

I'm hoping that when we get out of the woods, we'll have a feast instead of a mess.

Mr. Chairman, I look forward to our time spent together today.

Chairman KANJORSKI. Mr. King, if you have an opening statement you would like to make.

Mr. KING. Thank you, Mr. Chairman. I certainly did not expect to acquire this much seniority so quickly. Very seriously, I look forward to the testimony of Chairman Greenspan, not only as it relates to the narrow issue of Humphrey-Hawkins, but also, of course, as it relates to the overall economy; specifically, President Clinton's economic proposals, and the impact that those proposals are going to have on the recovery, which is just now beginning, the extent to which the increased taxes could impair that recovery, the extent to which it could have an impact on business expansion, and on the creation of jobs.

As the chairman indicated, I think this subcommittee has very significant questions regarding the impact of regulations on the banking industry, the extent to which banks are precluded from providing credit so that businesses can expand so that jobs can be created, and also whether or not there is a need for secondary markets.



I look forward to your testimony. Thank you, Mr. Greenspan.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Mr. Neal.

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

I want to first say that I am delighted that you are chairman of this subcommittee. I know you will do an outstanding job. I had the privilege of chairing the committee that had part of your jurisdiction for several years, and I was on that committee for many years. This jurisdiction dealing with the Fed is most fascinating and most important.

The Fed does have an even larger impact on our economy than the fiscal policy that we all deal with. I want to say to Mr. Greenspan, and to my colleagues, Paul is a good friend of mine. He is an outstanding Congressman. He is a very thoughtful, intelligent man, and will do an outstanding job with this subcommittee.

I also want to say to Mr. Greenspan, I appreciate the job you have done over recent years. You know, a lot of people say you cannot bring inflation down in light of or in the face of a big deficit. Mr. Volker and Mr. Greenspan did just that. They did a most difficult job.

While the Federal deficit was being quadrupled, the rate of inflation was lowered dramatically, largely under the leadership of Mr. Greenspan. If you understand that there is a way to accomplish all of the sometimes seemingly conflicting goals of the Humphrey-Hawkins mandate—that is, for maximum employment, maximum growth, the lowest possible interest rates, and so on—there is a way of doing that. That way is to bring inflation to as close to zero as possible and to keep it there.

By doing that, we create the essential condition for maximum sustained economic growth, maximum sustained job creation, maximum savings and, therefore, investment productivity growth, competitiveness—everything we want for our economy. We create the condition for the lowest possible sustained interest rates.

So, Mr. Chairman, I appreciate your continuing this effort to bring down inflation. I hope you will let nothing stand in your way. There is no sensible tradeoff, as you know. There is no benefit to be gained from higher inflation.

I have been very heartened by the comments that President Clinton has made on this subject. He has made several major statements on this during the campaign and since then. In every case, he has supported the idea of low inflation. Not once has he suggested that we ought to politically manipulate the Fed or go to high inflation.

So I thank you for the job well done and hope you will keep it up. Thank you.

Chairman KANJORSKI. Thank you very much, Mr. Neal.

Mr. Nussle.

Mr. NUSSLE. Thank you, Mr. Chairman. Welcome, Chairman Greenspan.

I spent this last weekend talking to real budget cutters, back in Iowa—people who cut budgets on the farm, and cut budgets at home, and cut budgets in their small business on Main Street. They are the real budget cutters. I have not met too many budget cutters around here since I have been in Congress my first 2 years.

So I went and talked to the real budget cutters. They told me their impression of the plan that the President has put forth. They are glad he is serious. They think he is serious about it. What strikes them is that instead of saying, let us tighten our belt, what the President is saying is, let us buy a bigger belt. Then let us tighten it, maybe on down the line.

Your testimony to the Senate, to me, was intriguing, and sounded a little bit more like the budget cutters I had met back in Iowa during my weekend home, where you said, I think—and I am paraphrasing, and I am sure we can go into this in the questions—I think you were suggesting that cutting or reducing spending is the most effective way to deal with budget deficits, as opposed to raising taxes. Obviously, those are alternatives, both of them, but I think you suggested that cutting spending was the most effective way.

That is what my people back home are telling me as well. They are saying before you send any more money out to Washington, particularly mine, out of my pocket, my business, my farm, my household, I want to see you do what I have to do, and that is, cut spending.

So those budget cutters are going to be keeping an eye on us as budget cutters during this next round. I would be interested in going into a little bit more detail on some of the testimony that you gave in the Senate.

I appreciate your attendance here. Thank you.

Chairman KANJORSKI. I trust there are operating rooms in Iowa, and not butcher shops, Mr. Nussle.

Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Mr. Chairman. I am delighted to be on this subcommittee, under your leadership.

As Mr. Neal has indicated that he was chairman of one of the predecessor subcommittees, the Domestic Monetary Polices, so, too, I had the pleasure of being on one of the predecessor subcommittees that was merged into this, the Subcommittee on Economic Stabilization, from 1983 to 1986, where we worked so arduously with you as a member, especially on the whole issue of industrial competitiveness. I am glad to see that issue is finally coming to the forefront.

Mr. Greenspan, it is always a pleasure to have you. I have been—well, thrilled is probably an appropriate word—to see that there appears to have been, if not an explicit compact, but at least an implicit compact that, given the fact that you consider the proposals of President Clinton to be both serious and credible, it will enable you to adopt a monetary policy that accommodates such a fiscal policy in order to help continue economic growth and even accelerate it.

Of course, the devil is in the details, as everyone wants to say, both with respect to implementation of the fiscal end of the monetary policy, and of the timing, too.

During the course of your testimony, I hope that you will come to grips with the comments, however, of some of those who are critical of the approach that the President has embarked on. I am certainly not one of them; but there are some individuals who say you

just cannot stimulate the economy if you ever have any kind of tax cuts.

Others, such as Professor Feldstein, former Chairman of the Economic Advisors—did you have an opportunity to read his piece in this morning's *Wall Street Journal*? Well, I would appreciate your shared thoughts on his perspective, because he is an individual whose credentials are too impressive to dismiss. I know we must consider them and account for them.

Thank you.

Chairman KANJORSKI. Mr. Knollenberg.

Mr. KNOLLENBERG. Thank you, Mr. Chairman.

Chairman Greenspan, I want to welcome you here this morning. I look forward to your monetary policy report, as well as your thoughts on the economy and, of course, the Clinton economic plan.

I may not be quite as embracing of the plan as my colleague who just spoke. I am strongly opposed to the direction that I see the Clinton economic plan taking this country.

The Congress has been presented with a package that contains nearly three times as much in tax increases as spending cuts. One of the most alarming aspects of the proposal is the fact that in 1997, Federal spending under the plan will probably approach something like \$203 billion above what it is this year. I know that most Americans would have a lot of difficulty calling that a budget cut.

The attraction of this plan to some is that it will allegedly reduce the deficit. A recent history tells the story. You will only have to remember the 1990 budget summit, with which I know you are very familiar. The cornerstone of that agreement was \$165 billion in new taxes. The deficit was supposed to go down.

As a result of that agreement, it has skyrocketed. When you look at 1993 under the budget agreement, the 1993 deficit was supposed to have been reduced to \$75 billion. Instead, it appears to be going to \$332 billion.

It seems to me that the reason is clear. The tax increases hampered the economy, and spending continued through the roof. The history of these budget deals, it seems, is clear, that they do raise taxes, they raise spending, and they raise the deficit.

I would be very interested in hearing from you as to how you might propose a challenge to that. I look forward to your testimony.

Thank you.

Chairman KANJORSKI. Mr. Klein.

Mr. KLEIN. Thank you, Mr. Chairman.

I am delighted to participate in the work of this subcommittee, which I consider to be among the most vital of all of the work that we, in Congress, are performing this year. I am particularly happy to hear Chairman Greenspan, who, of course, has a great reputation. We look forward to his testimony.

I was particularly glad, Chairman Greenspan, to hear of your reference in your Senate testimony to the President's economic plan as—if I heard you correctly—a very positive force for the American economy. Certainly, our economy needs that kind of direction. I look forward to your testimony and your comments on that subject.

Thank you very much.

Chairman KANJORSKI. Mr. McCandless.

Mr. MCCANDLESS. Thank you, Mr. Chairman.

I appreciate the opportunity to attend today. I do not have an opening statement. I look forward to Chairman Greenspan's testimony.

Chairman KANJORSKI. Thank you very much, Mr. McCandless.

Mr. Klink.

Mr. KLINK. Thank you, Mr. Chairman.

I will be very brief, because I want to hear Chairman Greenspan. I am very honored that he is here with us today.

I am also honored that I have two chairmen here today. Chairman Kanjorski, I think, has shown great leadership on this subcommittee. He and I, both coming from Pennsylvania, realize that particularly in our State, that everything that this subcommittee stands for is what we must accomplish. That is why, Mr. Chairman, we look forward to the words of wisdom that we, hopefully, will hear from you today.

Also, Chairman LeFalce being here is particularly enlightening for me, because the way we see the economy in western Pennsylvania turning around, as well as in the entire Nation, is the strength of small business. I know that, again, it gets back to the Fed and the policies that you will recommend to us.

I am also interested in what I have heard from the other side of the table. Like my colleague from Iowa, we have got some great budget cutters in Pennsylvania, too, so we are going to have to keep our eye on the ball and make sure that we can keep up with them. I hope that we will be able to see—since the President has chosen to use CBO assumptions—that we will all be able to say, well, we are comparing apples with apples, and maybe we will take the lead and come up with some additional cuts.

There is no doubt, we are at a crossroads. That is why I think that you being here today can tell us, as Yogi Berra once said, "When you come to a crossroads, take it." We hope that you can tell us which one to take, or at least give us some indication as to where the sign points.

Thank you for being here.

Chairman KANJORSKI. Thank you, Mr. Klink.

Mr. Grams.

Mr. GRAMS. Thank you very much, Mr. Chairman. I want to thank you for the opportunity and the invitation to be a part of the hearing here this morning. I want to thank Mr. Greenspan for taking the time, and I look forward to the comments that you will be making this morning.

As you know, last November, the American people sent the message that they were sick and tired of business as usual in Washington; that they had had enough of the skyrocketing deficits, runaway spending, and government that no longer represented the true needs of the American people. As a result, this year, we have a new President, and we have 110 new Members of Congress, which is really the recipe for change here in Washington.

Last Wednesday, President Clinton had a tremendous opportunity to show the American people that their votes counted; that the time for reckless government spending had come to an end, and

that we were finally going to get serious about making a debt-free future for our children and grandchildren.

Unfortunately, I do not think that was the case. Instead of proposing any serious cuts in government spending and tax incentives to stimulate our economy, Mr. Clinton gave us just the opposite: \$273 billion in new taxes, \$108 billion in new Federal spending, and enough smoke and mirrors to make even David Copperfield jealous.

President Clinton was right about one thing. It is time for a change, but not the kind of illusionary change he spoke of Wednesday night. We have to reduce the deficit, but through spending cuts, not higher taxes. We have got to reduce the national debt, but not on the backs of middle-income class taxpayers. The time has come for sacrifice, but the sacrifices must begin here, in Congress.

Chairman Greenspan, I look forward to hearing your report today on the national economy. I know, like the rest of the people on the panel, the people back home are asking for spending cuts and real deficit reduction. I hope we can depend on you for your honest and candid remarks.

I want to thank you, and I yield back my time.

Chairman KANJORSKI. Thank you, Mr. Grams.

Mr. Fingerhut.

Mr. FINGERHUT. Thank you, Mr. Chairman.

Chairman Greenspan, it is an honor for me to have the opportunity to hear from you and to speak with you as a new Member of this Congress and this subcommittee.

While I understand that it is preeminent on everyone's mind to talk about the subject of the President's economic plan and what response may come from Congress, I hope we will not lose sight in this hearing this morning of Chairman Kanjorski's opening statement, with respect to the role of the availability and the cost of credit to businesses throughout this country. That is the primary function of this subcommittee and, obviously, the primary function of the Federal Reserve.

It is, without question, the number one issue on the minds of the business people back home that I have talked to. Every time I have the opportunity to ask them, on a scale of 1 to 10, what would do the most to permit their businesses to grow and for them to hire additional people in my district, number one is always the availability or the cost of credit.

So I look forward to your remarks in that regard. I do not think we should lose sight of the chairman's opening remarks, which I think were on point and insightful.

I have one comment of my own on the subject of the President's economic plan, that I hope you will address. Obviously, the preeminent subject on everyone's mind is that which you alluded to when you testified before the Senate. That is the subject of cuts in spending versus taxes.

I note with a certain degree of irony and, I guess, a little bit of partisanship that none of the speakers who have called for more cuts here this morning have taken up the President's challenge and specified where they would make those cuts.

I am wondering if it is possible for you in your comments to help us, to the extent that it can be done in a nonpartisan way, on this subject of cuts versus taxes. It is clear that additional taxes in an

indirect way, are not a boon to the economy, certainly. To the extent that they impact on areas such as energy and other costs of business, they can possibly be a negative.

What we do not hear nearly enough about is the impact that cuts in government spending can potentially have on our economy. I come from the school of thought that believes that a lot of the economic growth that we saw in the 1980's and the early 1990's, to the extent that we saw growth in any of those years, was attributable to government spending in a classic sense, particularly in the defense industry.

It is no secret that the areas that are experiencing the toughest economic problems in our country are those areas that had received the bulk of the government's largess through the defense and other sectors.

Every one of the President's 150 spending cut proposals that I have seen will have some impact on employment in those areas of the country, and will have some impact on the purchasing of contracts and services by the government through private businesses that will then impact unemployment in a secondary nature.

So as you discuss, and I am sure you will find it impossible to avoid, the subject of the deficit reduction course we are on, and the relative credibility of cuts versus taxes, if you could, in your best nonpartisan way—and you are very good at it, and we are not quite so good at it on this side of the table—share with us how taxes impact on the economy, but also how cuts impact on the economy. It might broaden and enlighten the discussion.

Again, I thank you for the opportunity. I look forward to your testimony.

Chairman KANJORSKI. Thank you very much, Mr. Fingerhut.

Mrs. Roukema.

Mrs. ROUKEMA. I have no introductory comments, Mr. Chairman.

Chairman KANJORSKI. Thank you, Ms. Roukema.

Ms. Pryce.

Ms. PRYCE. Thank you, Mr. Chairman. I would also like to express my appreciation for being invited to share the benefits of Mr. Greenspan's testimony this morning.

Mr. Chairman, I am very grateful to you for taking the time to be here with us today. You are one who has worked through different administrations and across party lines. It is essential that we all listen very carefully to your wisdom on this subject. I am very happy to be a part of it, and look forward to your comments.

Thank you, sir.

Chairman KANJORSKI. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman.

First, let me congratulate you on your ascending to the chairmanship of this very important subcommittee, and thank you for inviting the members of the Banking Committee to attend.

I would like to make two quick points. First, Chairman Greenspan, I noticed throughout your testimony, there are all sorts of new problems in terms of the relationship of money supply to the economy, and why things are going up and down at the same time.

The only thing I would say to that is, I do want to tell you that I part water with many of my colleagues on this side of the aisle in

thinking that we need to put more political interference on the Fed.

You have a lot of missions, but your greatest is to wipe out the fear of inflation in this economy. As the world economy expands, as money flows out of banks and into money market funds, you may have actually less to do with that than most people think.

However, what most people think is very, very important. Any idea that Congress or any others of us who are sort of motivated by more short-term goals—and that is what the political system does—to then tinker with the Fed, I think would be a serious mistake. I want you to know that. I do not think you should be afraid about standing up to that to anybody.

On the other point, I just reiterate what Mr. Fingerhut said to my colleagues, particularly, the two gentlemen from Minnesota and Michigan. It is very easy to get up there and say, “Cut, cut, cut.” Ronald Reagan did it, and George Bush did it. They could not get cuts through.

I would like to hear specific cuts that 90 percent of the Republican caucus would vote for. Then they might find 20 percent of the Democratic caucus joining with them. I, for one, would love to cut the space station. Are all you folks going to vote for that? I do not know. I see some are shaking their heads.

There are a number of other cuts that many of us on this side of the aisle might make. Defense spending—I think the cut did not go deep enough. Where are the specific cuts? As President Clinton said yesterday, “Put up or shut up.” It is easy to talk about cuts—

Mr. NUSSLE. Would the gentleman yield?

Mr. SCHUMER. Not until I am finished, and only with the chairman’s permission.

It is easy to talk about cuts in the abstract. It is also easy for each of us to put out a list of the cuts that we would make that do not affect our own communities or our own districts. It is very hard to put together a list of cuts that are going to pass this place.

So that would be my concern about getting the deficit down. Because even if you prefer cuts, it is my view—and I believe the Chairman said this before the Senate—it is better to reduce the deficit in a balanced package of taxes and cuts, than not do it at all.

I do not know if the chairman wants to entertain a discussion; if he does, I would welcome it.

Chairman KANJORSKI. That would be out of order, Mr. Schumer, during the opening statements.

Mr. SCHUMER. Thank you.

Chairman KANJORSKI. Mr. McCollum, do you have an opening statement?

Mr. MCCOLLUM. I do not have much to say in the way of an opening statement, except it is certainly good to see you, again, Mr. Chairman, up here. We all look forward to your appearances. You are more insightful than most are about our economy, and it is certainly timely that you are here today. I look forward to hearing you.

Thank you.

Chairman KANJORSKI. Mr. Watt, do you have a statement you would like to make?

Mr. WATT. Thank you, Mr. Chairman, for the opportunity to be here. I just came to hear Chairman Greenspan. I will reserve an opening statement.

Thank you.

Chairman KANJORSKI. Mr. Bachus.

Mr. BACHUS. I have no opening statement, Mr. Chairman.

Chairman KANJORSKI. Well, I think we have gone through our opening statements, as usual, in our fast order.

Mr. Chairman, if you will proceed.

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

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

I appreciate this opportunity to appear before you and your subcommittee members to discuss the developments in the economy and the conduct of monetary policy.

Nineteen hundred and ninety-two saw an improved performance of our economy. It is clear now that the expansion firmed and inflation moderated. Nevertheless, the expansion seemed to exhibit little momentum through much of the year, unemployment remained high, and money and credit growth was sluggish.

In response, the Federal Reserve took steps to increase the availability of bank reserves on several occasions. These actions brought short-term interest rates to their lowest levels in 30 years. Long-term interest rates also fell in 1992 and early 1993 as inflation expectations gradually moderated and optimism developed about a potential for genuine progress in reducing Federal budget deficits.

In the view of the vast majority of business analysts, as well as our Federal Reserve policymakers, prospects appear reasonable for continued economic expansion and further declines in the unemployment rate. Before discussing the outlook in more detail, however, I would like to reflect on how monetary policy has interacted with the forces that have shaped developments over recent years.

I have often noted before this subcommittee the distinctly different nature of the current business cycle. A number of extraordinary factors contributed to the earlier weakening in the economy and have worked against a brisk and normal rebound from the recession.

These factors have included balance sheet restructuring in response to record debt burdens, overbuilding in commercial real estate, business restructuring, and a substantial cutback in defense spending.

Balance sheet restructuring has been, perhaps, the most important of these factors. In the 1980's, debt growth, hand in hand with rising asset prices, considerably exceeded that of income, and debt burdens rose to record levels. Debt-financed construction in the commercial real estate market was an extreme manifestation of this development. It was apparent as well in the other sectors of the economy.

The difficulties faced by borrowers in servicing their debts as the expansion slowed and the leveling out or decline in asset prices



prompted many to cut back expenditures and divert abnormal proportions of their cash-flows to debt repayment. This, in turn, fed back into slower economic growth.

In addition, financial institutions were faced with impaired equity positions, owing to sizable loan losses as well as more stringent supervision and regulation and demands by investors and regulators for better capital ratios. In response, they limited the availability of credit, with particular effects on smaller businesses.

Intensive business restructuring has been another important characteristic of the evolving economic situation. In an environment of weak demand and intense competition here and abroad, many firms have found it necessary to take aggressive measures to reduce costs.

The contraction in defense spending has been an additional development restraining the expansion. Real Federal defense expenditures dropped about 6 percent in 1992, and are down 9 percent from their 1987 peak.

Another less discussed factor that contributed to the formulation of our recent monetary policy dates not from the 1980's, but rather from the 1970's—inflation and inflation expectations. Over the past decade or so, the importance of the interactions of monetary policy with these expectations has become increasingly apparent. Through the first two decades of the post-World War II period, this interaction was less important. Savers and investors, firms and households made economic and financial decisions based on an implicit assumption that inflation over the long run would remain low enough to be inconsequential.

There was a sense that our institutional structure and culture, unlike those of many other nations of the world, were alien to inflation. As a consequence, inflation premiums embodied in long-term interest rates were low and effectively capped.

Even during the rise in inflation of the late 1960's and 1970's, there was a clear reluctance to believe that the inflation being experienced was other than transitory. It was presumed that inflation would eventually retreat to the 1- to 2-percent area that prevailed during the 1950's and the first half of the 1960's. Consequently, long-term interest rates remained contained.

But the dam eventually broke, and the huge losses suffered by bondholders during the 1970's and early 1980's sensitized them to the slightest sign, real or imagined, of rising inflation. At the first indication of an inflationary policy, monetary or fiscal, investors dumped bonds, driving up long-term interest rates.

This heightened sensitivity affects the way monetary policy interacts with the economy. An overly expansionary monetary policy, or even its anticipation, is imbedded fairly soon in higher inflation expectations and nominal bond yields. A stimulative monetary policy can prompt a shortrun acceleration of economic activity. But the experience of the 1970's provided convincing evidence that there is no lasting tradeoff between inflation and unemployment. In the long run, higher inflation buys no increase in employment.

This view of the capabilities of monetary policy is entirely consistent with the Humphrey-Hawkins Act. As you know, the act requires the Federal Reserve to “maintain long-run growth of the

monetary and credit aggregates, commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

The goal of moderate long-term interest rates is particularly relevant in the current circumstances in which balance sheet constraints have been a major—if not the major—drag on the expansion. The halting but substantial declines in intermediate and long-run interest rates that have occurred over the past few years have been the single most important factor encouraging balance sheet restructuring by households and firms and fostering the very significant reductions in debt service burdens.

Although the easing actions over the past few years have been purposefully gradual, cumulatively they have been quite large. Short-term interest rates have been reduced since their 1989 peak by nearly 7 percentage points.

Some have argued that monetary policy has been too cautious, that rates should have been lowered more sharply, or in larger increments.

In my view, these arguments miss the crucial features of our current experience: the sensitivity of inflation expectations and the necessity to work through structural imbalances in order to establish a basis for sustained growth. In these circumstances, monetary policy clearly has a role to play in helping the economy to grow. The process by which monetary policy can contribute, however, has been different in some respects than in past business cycles. Lower intermediate- and long-term interest rates and inflation are essential to the structural adjustments in our economy. Monetary policy, thus, has given considerable weight to helping these rates move lower.

Some have suggested that the decline in inflation permitted more aggressive moves, and had the downward trajectory of short-term interest rates been a bit steeper, that aggregate demand would have been appreciably stronger. I question that as well. Basing this argument on the lower inflation that has occurred is a non sequitur. The disinflation very likely would not have occurred in the context of an appreciably more stimulative policy, and such a policy could have led to higher inflation in the next few years. Moreover, such a policy would not have dealt fundamentally with the very real imbalances in our economy that needed to be resolved before sustainable growth could resume. The credibility of noninflationary policies would have been strained, and longer term interest rates likely would be higher, inhibiting the restructuring of balance sheets, and reducing the odds on sustainable growth.

Recent evidence suggests that our approach to monetary policy in recent years has been appropriate and productive. Even by last July, when I presented our midyear report to the Congress, some straws in the wind suggested that the easing of monetary policy to that date and the various financial adjustments underway in the economy were proving successful in paving the way for better economic performance.

It is now apparent that our July expectation of a firmer trajectory of output has been borne out. Gross domestic product growth is estimated to have picked up to a 3½-percent rate during the

second half of 1992, following a more modest increase in the first half. Indications are that the expansion is continuing in the early months of 1993. The news on inflation in 1992, likewise, was quite encouraging.

These favorable outcomes occurred despite slow growth of the money and credit aggregates. Both of the monetary aggregates, M2 and M3, finished the year about one-half percentage point below their ranges, and debt was just at its lower bound.

Interpreting this slow growth was one of the major challenges faced by the Federal Reserve last year. You may recall that, in establishing the ranges in February and reviewing them in July, the committee took note of the substantial uncertainties regarding the relationships between income and money in 1992. As we moved into 1992, there appeared to be an appreciable likelihood that unusual weakness in M2 growth relative to spending that had been experienced in 1991 would continue.

In the event, the nominal gross domestic product was even stronger, relative to the broad monetary aggregates in 1992 seemed likely when their ranges were established.

What accounts for this unusual behavior? Why is it that our financial system was able to support 5½ percent growth in nominal GDP, with only 2 percent growth in M2, and one-half percent growth in M3? We cannot be entirely certain we have all of the answers, but certain elements of our evolving financial picture, which are detailed in the full testimony, clearly have played a major role. A number of factors inducing savers to place funds outside M2, and borrowers to concentrate demands in long-term markets, have accelerated a longstanding process of channeling credit flows outside of depository institutions. With reduced needs to fund asset growth, banks and thrifts have bid less vigorously for deposits.

As a result of these developments, the relationship between money and the economy may be undergoing a significant transformation. If this is true, the liabilities of depository institutions will not be as good a gauge of financial conditions as they once were.

This is not to argue that money growth can be ignored in formulating monetary policy. The Federal Reserve in 1992 paid substantial attention to developments in the money supply, and we will continue to do so in 1993 and beyond. Selecting ranges for monetary growth over the coming year consistent with desired economic performance, however, is especially difficult when the relationship between money and income has become uncertain.

Eventually, the monetary aggregates may resume a more stable relationship with the economy, or experience may suggest useful new definitions for the aggregates. In the meantime, the Federal Open Market Committee necessarily has given less weight to monetary aggregates in the conduct of policy, and has relied on a broad range of indicators of future financial and economic developments and price pressures. In particular, the FOMC judged in 1992 that more determined efforts to push the aggregates into their ranges would not have been consistent with achieving the Nation's longer term objectives of maximum sustainable economic growth.

This use of a broad range of indicators is appropriate because achievement of the ranges of growth of particular measures of

money and credit is not, and should not be, the objective of monetary policy. Rather, the ranges are a means to an end. The Humphrey-Hawkins Act, incorporating this view, does not require that the ranges be obtained in circumstances in which doing so would not be consistent with achieving the more fundamental economic objectives.

Mr. Chairman, in establishing the ranges for the monetary and credit aggregates for the current year, the FOMC took into account the likelihood that many of the factors that have acted in recent years to restrain money and credit growth relative to income, would continue, though perhaps with somewhat diminishing intensity.

The Federal Open Market Committee has elected to reduce the ranges for M2 and M3 for 1993 by one-half percentage point. The FOMC does not view the reductions in the monetary ranges as signaling a change in the stance of monetary policy. Most emphatically, these reductions do not indicate a desire on the part of the Federal Reserve to thwart the expansion. The Federal Reserve, to the contrary, is endeavoring to conduct monetary policy in a way that promotes sustainable economic expansion. The lowering of these ranges does not imply any change in our fundamental objectives. The necessity for a reduction in the monetary ranges at this time is wholly technical in nature, and is the result of forces that are altering the money income relationship.

Several of the forces affecting relationships between money and income also complicate the task of assessing the economic outcome itself. For example, the prospects for an easing of supply restrictions on credit from banks and other intermediaries are difficult to assess; but any major change in this situation could have important implications for the economy.

While uncertainties remain, the economy appears to have entered the year with noticeable momentum to spending. In addition, inventories are at relatively low levels, and factory orders have been rising. Consumer confidence has recovered, and spending on durables and homes appears to be moving at a brisker pace. Recent surveys suggest an appreciable increase in business investment this year.

Against this background, members of the Board and Federal Reserve Bank Presidents project a further gain in economic activity in 1993, and inflation is expected to remain low.

As I have often emphasized, monetary policy, by achieving and maintaining price stability, can foster a stable economic and financial environment that is conducive to private economic planning, savings, investment, and economic growth.

The contributions that monetary policy can make to maximum sustainable economic growth would be complemented by a fiscal policy focused on long-term deficit reduction.

Mr. Chairman, as I indicated last week, the President is to be commended for placing on the table a serious proposal that is activating debate on our burgeoning structural budget deficit.

Unless addressed, the deficit will increasingly threaten the stability of our economic system. Time is no longer on our side. After declining through 1996, the current services deficit starts on an inexorable upward path again. The deficit and the mounting Federal

debt as a percent of gross domestic product are corrosive forces slowly undermining the vitality of our free market system.

If we fail to resolve our structural deficit at this time, the next opportunity will undoubtedly confront us with still more difficult choices. How the deficit is reduced is very important, but that it be done, is crucial.

With current services outlays from 1997 and beyond rising faster than the tax base, stabilizing the deficit as a percent of nominal gross domestic product, not to mention a reduction, would require ever-increasing tax rates. This could undercut incentives for risk taking, and inevitably dampen the long-term growth potential of our economy.

Hence, there is no alternative to achieving much slower growth of outlays. This implies not only the need to make cuts now, but to control future spending impulses. I trust the President's endeavor to rein in medical costs will contribute importantly to this goal.

The hope that we can possibly inflate or grow our way out of the structural deficit is fanciful. Certainly, greater inflation is not the answer. Aside from its serious debilitating effects on our economic system, higher inflation, given the explicit and implicit indexing of receipts and expenditures, would not reduce the deficit.

As I indicated in testimony last month to the Joint Economic Committee, there is a possibility that productivity growth may be moving into a faster long-term channel, boosting real growth over time. Even if that turns out to be the case, it would not, by itself, resolve the basic long-term imbalance in our budgetary accounts.

Finally, I find misplaced the fears that some have expressed that significant reductions in structural deficits will exert an insurmountable drag on the economy.

The Federal Reserve recognizes that it has an important role to play in this regard. In formulating monetary policy, we certainly need to take into account fiscal policy developments. However, it is not possible for the Federal Reserve to specify, in advance, what actions might be taken in the presence of particular fiscal policy strategy.

Clearly, the course of interest rates and financial market conditions more generally will depend importantly on a host of forces, in addition to fiscal policy, affecting the economy and prices. In any event, I can assure you of our shared goal for the American economy: The greatest possible increase in living standards for our citizens over time.

Thank you very much. I would appreciate my full statement being included for the record, Mr. Chairman.

Chairman KANJORSKI. Without objection, it is so ordered.

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

If I understand what you said, Mr. Greenspan, I think that you are indicating that this administration finally is coming to grips with the structural problems of our economy; that speed is of the essence, however, that we put the plan in place. That is not necessarily that it be identical to what the President has suggested, but along those lines, as long as we make the long-term commitment. Is that, substantially, your position?

Mr. GREENSPAN. That is correct, Mr. Chairman. As I have indicated to your colleagues in the Senate Banking Committee, we at the Federal Reserve, in our role as central bankers, have a fundamental interest in the financial stability of our system. As a necessary condition for that, the structural budget deficit must be brought down.

Obviously, the process which you are currently going through is extraordinarily difficult. It is fairly clear that this is quintessentially political in the best sense of the word. Because of that fact, we at the Federal Reserve will, of course, step back and not be involved, and should not be involved, in the decisions of how the budget deficit is brought down.

I did indicate in my remarks a number of general economic principles which I have enunciated before this subcommittee over the years. They, in that sense, suggest certain limits of how the process has to occur. It is more an arithmetical, technical evaluation.

Fundamentally, the choices are political. These are very difficult choices which must be made because the budget will restructure how the governmental resources of this country are distributed. Obviously, how they are distributed, and to whom, have very important economic and political implications.

Chairman KANJORSKI. Mr. Greenspan, we, of course, have jurisdiction, on this subcommittee, over other areas. One of the areas that we will be addressing early this year will be the Community Development Bank concept, which I do not really look to go into with you today.

The second area we will be addressing in the near future is the creation of a secondary market for commercial business loans to help protect business slumps. I am particularly struck with the lack of credit in our system today. Some people call it the credit crunch. I am not quite certain why it exists.

I talk to bankers all over the country, and they are awash with money. Their answer, generally, is they want to lend money out, but they cannot find responsible borrowers. Then, I run into businessmen that are saying they are being choked off, that they are not being given the type of credit that is necessary to even sustain their operations, let alone expand them.

I would like your opinion, on this apparent contradiction. If there is fault to be had, is it with the regulators, is it with the bankers; or is it possible that with the lack of a secondary market in business slumps, that it is less advantageous for the commercial banking community to engage in business lending today, than it is for residential lending, or school lending, or anywhere else that there is a secondary market?

Mr. GREENSPAN. As I think I may have—and probably have—indicated before this subcommittee over the last 2 or 3 years, what we are confronted with is an extraordinary circumstance which is a consequence of the very heavy lending that was engaged in by bankers in the 1980's and, very obviously, owing to lax underwriting standards, we ended up with a very large amount of nonperforming loans. This cut very severely into the capital positions of commercial banks, threatened the franchise of the institutions, and, frankly, frightened an awful lot of lending officers who had

not been aware of the extent of what could happen when they lent in the manner in which they lent for a goodly part of the 1980's.

As a consequence of that, it should not be surprising that they have pulled back and, in my judgment, overly so, in that they exaggerated in one direction and now they have exaggerated in the other. So what has occurred is that we have seen a very stringent set of conditions for lending, which has been characterized as fairly tight.

We run a number of surveys, periodically. While we have picked up some very mild degree of easing of some of the standards by the bank, there is no question that they are still fairly rigid, and the term "credit crunch" is, in my judgment, still appropriately applicable to the process.

An element which has clearly been a problem has been the dramatic decline in commercial real estate values, which were the collateral of a substantial part of the loan expansion of commercial banks in recent years.

It would not be the type of problem it is today if the value of real estate had come down dramatically, but the transactions had continued and the markets had been liquid, and as a consequence of that, the average banker, even though he knew he had considerable loss on his real estate collateral, would nonetheless know that if he had to he could sell at a known price expeditiously in the market. Therefore he, or she, would know what the value of the loan that he had made is to the bank.

Regrettably, we have not yet reached that stage. What I mean by that is, while the values have clearly declined in the commercial real estate market, we still do not have the liquidity or the turnover and the transactions that are required to give confidence to lending officers about the values of the collateral that now exists in their banks. As a result of that, there is a very great deal of uncertainty about whether they have really solid resources. They, therefore, are being extremely conservative.

There is no question in my mind that if we could find a way to expedite the secondary market in small business loans, it would be very helpful because, as I think you pointed out in your opening remarks, it is the small businesses who have no alternative to credit financing.

As a consequence of that, the credit crunch that we have perceived is disproportionately impacting on small businesses. Since they, historically, are the source of employment growth, it has been one of the key factors as to why we have had a sluggish recovery in employment.

The feasibility of creating a secondary market in small business loans is something which I think we ought to be looking into. There is a bill that is being offered in the Senate to change some of the legal impediments to the securitization of small business loans. If we could find a way to make them homogeneous the way, for example, one- to four-family mortgages are, that would clearly facilitate the expansion of the securitization and the secondary market in small business loans.

You are quite correct. It is easier to make a mortgage loan, because you can securitize it and sell it, than a small business loan,

which is, by its nature, different. This is because each business loan has a certain characteristic reflecting the individuals.

So I certainly subscribe to anything that we can do that would improve the homogeneity of the small business loan, and it is securitization, because there is no question that that would be a major contribution to the financial vitality of this country.

Chairman KANJORSKI. That sounds very good, Mr. Chairman. That is our major goal of this subcommittee this year. We look forward to working with you and the Federal Reserve. Getting your assistance and help, we can create that secondary market.

Mr. Nussle.

Mr. NUSSLE. Thank you, Mr. Chairman.

First of all, I would like to respond, very briefly, to some of the opening comments that were made.

As far as the "put up or shut up" on the specific cuts, the Republicans have put up 12 years of specific cuts, and now it is your turn. I still have not seen the specific cuts from the President. Until we do that, I do not think it is responsible to say, "Put up or shut up."

My understanding is, those specific cuts that are now in just vague generalities are not going to be available now until March 23. So until those specifics come down, I do not think it is responsible to say, "Put up or shut up."

As far as the spending cuts that are in the plan that we know of, the generalities that are available to the press and to those of us that are Members who have to try and work through the plan, we understand that there may be some double counting; in other words, that there were \$123 billion worth of cuts that were actually in the 1990 budget agreement, and have been double counted for purposes of this new proposal. That was what came out in testimony at the Senate.

We understand that part of the cuts—maybe as many as half—are really increases in user fees, and have nothing to do with actual cuts in spending, or actual reductions in program baselines. We understand that many of these cuts that have been made are really illusory, and really not available to actually reduce the size of the budget deficit.

This concerns me. It also concerns me that as such, the *New York Times* would state—and I think it is putting words in your mouth—in a headline last week, February 20, "Clinton's program gets endorsement of the Fed Chairman."

Now I listened to your testimony, and I have read this news article. I never once heard you, Mr. Chairman, use the word "endorsement." I have heard you say, "It is serious." I have heard you say, "It is credible."

I never once heard you come out and say, "This is the plan that I would have introduced if I had the opportunity;" or, "I fully put my stamp of approval behind this plan. This is my full endorsement as the Fed Chairman." I did not get that at all.

I got that—as I am—you are concerned about the budget deficit, and concerned about trying to bring down spending. You are happy that at least we have a start. That was the impression I got. However, fully endorsing this plan, saying that you have gone through it, and this is the best thing we can have at this time—I did not get that impression.



So I would like to give you the opportunity to maybe rewrite the headline. [Laughter.]

I know that is not your job. However, I would like to find out exactly what your position is on this plan. Do you fully endorse this plan? Is everything in there exactly what this economy needs right now in its history?

Mr. GREENSPAN. Congressman, as I said just a few moments ago, we at the Federal Reserve, myself and my colleagues, are not going to enter into the discussions on the specific details of how the budget deficit is reduced. It is our purpose to indicate to the Congress how important the activity is, and that there is time urgency about this.

Up to, say, maybe a year or two ago, we used to look at the longer term budget projections, and they invariably went down to zero, as far as the deficit is concerned, and even into surplus. What is different about the current period is owing to the change in the structure of the longer term deficit, it no longer does that.

As the defense decline comes to an end, and as the savings and loan monies unwind, then what we find is an inexorable rise in the deficit which is engendered by the laws which currently exist. One may even go further and say that that problem exists with the expectation that the Congress and the administration will add nothing to that. Now, I would say to you that history suggests that that assumption has some difficulties with it. I would want to impress upon you that where our interests lie is in the total borrowing requirements of the Treasury. It is inappropriate for us to get involved into the specific details of the budget document because, as I said earlier, that is the appropriate political decisionmaking of the representatives of the American people.

Mr. NUSSLE. Well, Mr. Chairman, if you had a plan before you, or if a plan was presented to you similar to—and I am not sure if you are familiar with this plan or not—Gramm-Armev, which is a plan that was introduced just this last week, which proposes not to raise taxes, but, in fact, to cut spending and to have strict enforcement mechanisms within the plan; one that allows or actually demands the reauthorization of programs and policies. I think it is a triannual basis. It actually goes into permanent changes of the budgeting process.

If you had a plan before you that did the same thing, or actually projected out and could demonstrate to you, through just cuts and spending—not increases in taxes, but cuts and spending—that it could do the same thing or better, would it receive the same kind of headline as possibly being endorsed, or being serious or credible?

Mr. GREENSPAN. That is the important issue. The question is, to be serious and credible, it has got to be very specific, line by line. General goals, as we know, do not work.

Mr. NUSSLE. I just want to make sure. You do not have to raise taxes, in your mind, to be serious and credible?

Mr. GREENSPAN. As I have said to a question raised by Senator Kerry at the Senate Banking Committee, who asked me whether, in fact, the reduction in the deficit required taxes, I said, "It did not."

Mr. NUSSLE. Thank you, Mr. Chairman. I appreciate that.

Chairman KANJORSKI. The headline should read, "Greenspan declares specificity of Clinton plan, above all others."

Mr. NUSSLE. You may have a new career, Mr. Chairman. That is pretty good. [Laughter.]

Chairman KANJORSKI. Well, it is always tempting to write headlines. I hope that the subcommittee does not engage in writing any more headlines, and that we take the benefit of the Chairman's testimony here to get serious testimony and make the atmosphere less politicized, if we can.

Mr. McCollum, I apologize. I should have recognized you next, but I am going to take you out of order.

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

I certainly thought Mr. Nussle's questions were very appropriate, with respect to the question of clarifying, perhaps, for the headline writers.

I have one area of question in relationship to that, and then I want to ask you some very serious monetary policy questions.

In looking at this Clinton proposal, Mr. Chairman, it appears that most analysts are concluding that the amount of taxes that are being raised in this proposal over the 4- or 5-year period versus spending cuts is a ratio of about 5 to 1—5 times as much taxes as spending cuts. It depends upon, again, your interpretation, but it certainly looks like this is the largest tax increase in history in dollars—the \$328 billion.

Is there a point—and, again, I am not asking you to criticize or critique Mr. Clinton's proposal—but is there a point where we can go, as a body, on the fiscal side, too heavily on the tax increase proportion in relation to spending reductions where it will damage the economy and hurt your job? I do not know whether this is true in this case or not; but in principle, is there a point where we could be imbalanced by overemphasizing the tax increase side as a body?

Mr. GREENSPAN. In principle, the argument is, yes, one can. The trouble is that we do not know where that number is; but, obviously, as I think most everyone has acknowledged, nobody likes taxes. They are, of necessity, types of instruments which do dampen economic activity. I mean, there is no way in which I can conceive of a tax, except in certain very extraordinary circumstances, where it does not, by itself, have a negative effect.

The question that the Congress has to confront at this stage is the issue of getting the structural budget deficit down. What one very clearly senses by the debate that is emerging at this stage is that there are very great differences on this issue.

If I knew that there was very strong evidence that says at a certain point of taxation, you do considerable damage to the economy, I would certainly cite the reference.

The trouble is, we economists have not been able to come to a specific conclusion although there is a very general belief that if you undercut incentives, and if you put too much taxation on the system, it is bound to dampen growth, and, at the extreme, create very destabilizing forces.

Mr. McCOLLUM. I believe I have heard you say in the past, and I think you were quoted last week as saying, in response to a Senate question, if you had your personal preference, you would prefer spending reductions to tax increases.

Mr. GREENSPAN. Well, no, I did not put it as a personal issue. I put it as an issue of how one should look at the process, analytically if our fundamental purpose is to get the budget deficit down. What I said to the Senate was that it is easier to do that from the expenditure side than from the tax side. What I was saying then was that expenditure cuts tend to have a more permanent impact on the deficit than increases on the revenue side; but, as I also said, the composition is partly an economic question but more fundamentally a political question with respect to how resources are distributed through the budget process.

Mr. McCOLLUM. I understand, and I appreciate that. Rather than torture you with those type of questions, I want to ask you a monetary policy-specific question. Should we include in the monetary aggregates the stock and bond mutual funds that are not now counted? Is that something you are considering?

Mr. GREENSPAN. Mr. McCollum, we have looked at that in some detail, obviously, in endeavoring to understand what has happened to M2 and it is very obvious that one can trace funds basically held in so-called M2 deposits, moving directly into mutual funds. However, it is not just a simple question of looking at what has happened recently. There is a question of how do those data or those indicators behave over history, as an indication of economic activity and spending. We are looking at that, as we are looking at a number of other things. It is by no means obvious that that is something which we would grab onto and say this is a much better indicator than other elements in the economic system.

Mr. McCOLLUM. It is too early to tell right now?

Mr. GREENSPAN. I would think it is, yes.

Mr. McCOLLUM. Well, to wrap up—my time is running out very rapidly already. It probably technically has. I would like to know what those other range of indicators are, if you would just one, two, three, summarize them, that you look at. You have alluded to them. I have heard you say some of them in the past, but I think they should be on the record here. They are not specifically in your testimony that I see.

Mr. GREENSPAN. What are the other indicators we would look at?

Mr. McCOLLUM. Yes. Besides the aggregates, right.

Mr. GREENSPAN. Yes, let me be more general, Congressman. We, as you know, have a number of econometric models which, through complex mathematical relations, try to infer what the economy is going to do in the future under certain circumstances, depending on what it has done in the past. The problem we have is that, in recent years, the economy—its structure, that set of relationships which drive it—is clearly changing, and hence to rely on the past solely has not been a useful indicator of what is going on.

Nonetheless, in order to formulate monetary policy, it is essential that we have a concept of what causes what to happen. My discussions, over the last 2 or 3 years about how the balance sheet effects have impacted on economic activity, the allusion that I have often made to much earlier periods in American history where we saw asset values rise, followed by debt financing, followed then by a decline in assets and balance sheet restraints, is the type of evaluation we make. As a consequence of that, and as I have mentioned before this subcommittee in the past, we now think in this

particular environment, that the major driving force of a positive nature is lower intermediate- and long-term interest rates because, very specifically, of the nature of the real estate markets, the nature of the balance sheets, and the like. As a consequence, we would look at that very closely, as well as the credit aggregates, and all of the other elements in the system which drive this type of phenomenon.

Mr. McCOLLUM. Thank you, Mr. Chairman. Thank you.

Chairman KANJORSKI. Mr. Neal.

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

Along those lines, Mr. Chairman, since we know that we can maximize sustainable employment and growth through lower inflation, and lower interest rates, and, since we know that the only way to get long-term rates down, in a sustainable way, is to get inflation down, my question is, why wouldn't you want then to bring down your target range for money growth? I believe you said that even that one-half a percent drop that you have set as your target range is really—I think you called it a technical change, as opposed to a policy shift.

Mr. GREENSPAN. That's correct.

Mr. NEAL OF NORTH CAROLINA. I am just wondering why you would not want to make a little bit of a policy shift and help us achieve these great benefits a little bit sooner. May I ask you to do me a favor? I have one other question I want to ask you before the time runs out. So, if you would give me not the complete answer, but a summary of the complete answer.

Mr. GREENSPAN. The basic reasons why we moved the targets down for technical reasons is largely that, obviously, M2 has veered off its course, and we are trying to capture it. The reason we would not do it for policy reasons at this stage is that we are not sure what the proper relationships are. It is also clear that because of the fact that a noninflationary environment, or one of stable prices if you want to put it that way, basically is probably consistent with a measured inflation rate of the Consumer Price Index higher than zero. For reasons we have discussed in the past, we tend to mismeasure the degree of inflation. In a certain sense, as the inflation rate has come down, we are not now all that far from our ultimate goal where we think price stability is; but, until we have a much better sense of what it is that is happening in M2, and what it is that is happening in the other aggregates, I do not think that other than technical changes at this particular point are called for. We may find when all of the data work their way through that we are pleased with the stance of credit policy. I do not know that to be the case. I am saying that will require us to have a much better sense of how M2 is evolving, whether its behavior is going to be a real long-term problem, and the like.

Mr. NEAL OF NORTH CAROLINA. Thanks. I know we have had these changes that we do not fully understand. I thank you.

The other question really has to do with what you think about the strength of our economy now. I know, over the last several years, there have been several of what appeared to be spurts, maybe brief spurts in the economy that proved to be short lived. It seems to me, and just looking at what other experts are saying and so on, that now we might be on a course that is fairly sustainable—

a healthy recovery that, even though not booming, in fact, it is probably good it is not booming—that we are on a course that could be sustainable over a long period of time—of healthy growth, job-creating growth. If that were the case, then that might be an argument for not spending some of the money that has been considered to be necessary for stimulus. If that were possible, there would be an opportunity to save a little money.

Now, the question obviously would be, are we on that kind of path with the economy, in your opinion? We certainly would not want to do something that is going to cost more in the long haul. I think the argument of the administration here is that by giving a little stimulus, that we ward off the possibility of a dip in the economy later that will end up costing us more—that this is a cost-benefit ratio—the stimulus now would be positive. What would you say about that?

Mr. GREENSPAN. It is clear that if you look at the last two quarters of 1992 the data show important improvements. The third quarter, as I recall, was up 3.4 percent at an annual rate, and the fourth quarter, I assume, will be revised up from its 3.8 percent rate. The data will be available I believe at the end of this week. Is that right? Yes.

The first quarter level is running at a somewhat slower pace, as best we can judge, from the upward revised—I would say assumedly upward revised—fourth quarter number, but it is moving at a reasonably good pace.

The problem, however, in saying that this is a sustainable recovery and all of the wheels are running correctly, is that it would require that the problems that the chairman raised at the beginning have been resolved. So long as we have the process of balance sheet restructuring continuing, so long as we have a continuation of the problems that exist within the commercial banks, especially with respect to small business loans, and so long as we have the continued downward adjustment of the defense industries, which has very significant impact across the country, it is too soon to say that we are, in a sense, moving forward in a self-perpetuating recovery.

Having said that, Congressman, there is no question that the improvement in productivity which has been quite extraordinary and which I suspect is probably related to the low level of inflation we are looking at, is very important to this outlook.

Chairman KANJORSKI. Mr. LaFalce.

Mr. LAFALCE. Chairman Greenspan, I always find your testimony stimulating and insightful, and today certainly was no exception. I think it would also be instructive and insightful for us to listen to another wise individual, Pogo, who has said “we have met the enemy and it is us.”

I think that so many of the problems that we are visiting today have been self-induced. I am thinking of the credit crunch, for example. I remember when I started predicting the credit crunch in 1989, saying we were beginning to experience it in 1990. I had difficulty getting either the Federal Reserve or the administration to recognize that reality. I go back to the 1989 law, FIRREA, which was quite a spectacle in 1989, where you had an administration and a Congress each trying to work with the media to prove which

was tougher. Reason was thrown out the window. There was one purpose and mission in life, you know, prove that you are tough.

I remember when the administration came in with a 10-year amortization period for good will, despite the fact you might have had an agreement for 20, 30, 40 years. I called representatives from the administration in. I said that is too tough. That is too precipitous of a change. They said, you know, we think you are right. We might have to ease up on that a bit. Of course, then the administration and the Congress chipped in to go down to a 5-year period. That was just one small example. The application that we made of the Basel accords, not just to commercial institutions, but to thrift institutions, when you had a decidedly different history of our institutions, the underemphasis in the early and mid-1980's on capital, and then an appropriate emphasis, but not to the exclusion of all other factors on capital precipitously in 1989, especially since we were using risk-based capital, and the definition of risk-based capital, under the Basel standards, did not consider interest rate sensitivity, helped to create an incentive to go to government securities, as opposed to commercial loans as a means of satisfying these requirements.

The hearings that we held where we excoriated regulators and examiners, we indicted them, we tried them, we convicted, we sentenced them, and then we asked them to come in to testify, after all that had taken place, the chilling effect that that had. Not only the creation of the RTC to buy as many commercial assets that you conceivably could, the largest financial institution in the world; but the hearings we had, constantly asking the regulators how many institutions have you closed today? That became the watchword—the number of institutions you closed, as opposed to the number that you were helping to resolve, to make better, to heal.

I hope we understand certain lessons, rather than just think that there are a bunch of bad guys out there—that the Congress and the administration itself, and the regulators may have contributed to this.

I was very pleased—working for years—I was very pleased when President Clinton at least put a sentence or two dealing with the possibility of excessive regulation, how necessary it is to have regulation, and solid regulation; but it can go too far, too. We had 1 million applause lines. That was not an applause line. I think I was about the only one applauding at that one. We need tough regulations, but not too tough, not too tough. We can frighten the examiners, frighten the financial institutions, the loan officers, and so forth. We have to have safety and soundness of institutions, but we have to also spur the economy. We have to strike a balance. We could have the safest and soundest banks in the world, we just will not make any loans. We would make a lot of money to put it into government securities.

I am curious too. This is an argument. Are they putting too much into government securities? I tend to think they are. They come back and they say, oh no, they are not, if you look at it historically 20 years ago; but 20 years ago, all of the money was in banks, it was not in the Merrill Lynchs, and the Dean Whitters of this world, and so forth. That is one question I have for you.

Another question I have is on the Basel accords. Do we need some change in the standards we use for determining risk-based capital? How do we take into consideration interest rate sensitivity? Is there a problem in getting from here to there, because of the extent to which we rely upon this high percentage of monies in government securities as a means of financing our deficit? Is there a transition period that will be needed if we are going to make any change in those standards?

Mr. GREENSPAN. Well, let me say, first, I generally agree with most of what you said, as I am sure you know.

Mr. LAFALCE. OK.

Mr. GREENSPAN. I will stipulate that.

Mr. LAFALCE. OK.

Mr. GREENSPAN. I think, perhaps, I should have mentioned it with respect to Chairman Kanjorski's question earlier. There is a problem of regulatory cost that is involved in this process which is inhibiting small business loans, very specifically what we used to call character loans, where you could basically make a loan to an individual of a modest amount on your knowledge of the individual, with full expectation of it being repaid, without going through a number of formal documents, without collateral, without appraisals, without various different things which now make a number of those loans prohibitively costly. As a consequence, we do not see them anymore. This is the direction of the excess that you are mentioning.

We have looked into the question of the securities holdings of commercial banks in some considerable detail to see if we can infer what the various motives are. While there is a small amount of evidence to suggest that the Basel accord differences do make some slight difference, the overwhelming reason that we can infer as to why they are holding these securities is basically that they have no loans that they feel they can make in a manner which is profitable to them, for reasons which I mentioned earlier. In that regard, I would suspect that the availability of this extraordinary amount of liquidity which exists in the system is reason to believe that when finally the dam is broken, and they no longer are concerned about the losses and they are more worried about competitive positions as bankers, that they have more than adequate liquidity to essentially service the loan community. I hope, under those conditions, we will see this psychological problem unwinding.

Mr. LAFALCE. You mentioned tremendous liquidity, and yet you also posited, at the beginning of your testimony, a real credit crunch, a slight easing, but, still, a real credit crunch despite this liquidity. So, obviously, you have a quarrel with the simple explanation that there are good loans out there, otherwise you would not posit a credit crunch. Reconciling those two competing arguments is sometimes difficult.

My last question. Go to the secondary market. I have introduced legislation for 10 years now, to help facilitate the development of a secondary market, first, as chairman of this subcommittee, and then as chairman of the Small Business Committee. There is a debate on a number of issues I should say. Can we do it simply by changing laws to facilitate securitization of small business loans, or will the needed homogenization of small business loans, a very dif-

difficult thing, require some government jump-start, through either the creation of a new government-sponsored enterprise, or, as I have introduced, or as I know Paul is thinking, the amendment of the charter of an existing governmental-sponsored enterprise, to enable them to do not only residential mortgages, but small business loans?

I tend to think some jump-start is necessary—that you cannot do it, given the tremendous disparity that exists amongst commercial loans, without that governmental involvement.

I am also curious though—I do not think it is going to bring additional liquidity. We do not seem to need additional liquidity. I mean, that will bring it, but that is not our big need. One of the biggest values of the small business community is that it will avail him of long-term loans, something that is not now available to the small business community; but it also has some downsides too. The standardization of the loans might make character loans when this dam does break a little more difficult, too. I would want to develop a secondary market, but I do not want to develop a secondary market that is going to have a perverse, unintended consequence. That is a trick, if it can be accomplished. I would seek your insights on these issues that I have raised.

Mr. GREENSPAN. Congressman, we want to be a little careful about extending the federally sponsored credit agency type of organization because there is this never-never land as to whether or not they are federally insured or not federally insured. That is a problem which we ought to be backing away from. As a consequence, when and if you look at solutions, increasing the contingent liabilities of the Federal Government is something I think we have to be very careful to avoid.

There are lots of problems in the construction of securitization of small business loans, which I suspect appropriate legislative vehicles can possibly eliminate. I do not know enough about some of the detailed legal aspects at this particular stage, but I am aware that we did facilitate the secondary markets in mortgages by certain legal changes which inhibited the form in which these securities could be issued. So, as a minimum, we want to make certain that the legal playing field, if I may put it that way, is clearly in this direction.

When you get to the other issues, then we have to get to the far more detailed question of how small business is financed, where the bottlenecks are, and whether those bottlenecks are temporary or of a more permanent nature. If they are temporary, which is what I suspect they are, if we could get the character loan back into the mix, then I do not suspect we will need to go for any long-term solution. But, if we have essentially eliminated a significant part of small business lending through the regulatory area, which I think in part we have done, then some additional avenues will have to be explored.

Mr. LAFALCE. Thank you.

Chairman KANJORSKI. Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman. I welcome you here today.

Mr. GREENSPAN. Thank you.



Mrs. ROUKEMA. I want to associate myself with the remarks made earlier by our colleague, Mr. Schumer, when he pointed out that he was opposed to any attempts to politicize or compromise the positions, or restrict the position of the Fed, vis-a-vis either political parties or the Congress, and I stand with him on that.

However, without compromising your position, I do want to press you a little bit further, not to the point of writing a headline, but I do want to press you a little further here on this subject of the package that we are facing, this so-called deficit reduction share of pain, share of the sacrifice program. I am pressing you because I think it is the obligation of people in your position, and certainly the business community, and other economists to give us an assessment in the best possible way, because we are going to have extraordinary decisions to make here. It is not a question of whether you reduce spending, or increase taxes, it is the package that we have put together. Another element that I find that has not been really focused upon is the relative position of what I call capital investment incentives in this package, which I think are woefully lacking.

I would like to ask you, if you would, please give us a relative value scale here as to the position of the tax increases; evaluate the capital investment, whether it be the ITC or the capital gains approach, because I think it is woefully lacking, and maybe I am wrong. I would just like to know your opinion on that. Most specifically, I find it very disturbing that the President would be leading off with new spending programs when we have not gotten the ability to pay for what we have, and when you are even speaking about reining in medical costs. I mean, that would be the most extraordinary thing that we would be able to do without being accused of balancing the budget on the backs of the sick elderly.

There are human capital and social spending proposals here that I think should be put on hold, unless and until we get some evidence of structural deficit reduction. I am not talking about the infrastructure, or the waste water treatment programs, that part of the stimulus, I am talking about what are clearly new social entitlement programs that are being recommended, and the human capital investment which I think, proportionately speaking, is much too great in this package.

Mr. GREENSPAN. Congresswoman, the only response I can give is that, if I were a private economist, a private citizen, I would unquestionably be giving you the answers that you request, as indeed I did when I was a private citizen and appeared before this subcommittee.

Mrs. ROUKEMA. Yes, you certainly did. We did not listen to you, did we, Mr. Chairman, unfortunately?

Mr. GREENSPAN. All I can say to you is that I do not think it is appropriate for the central bank to be involved in this particular set of decisions. I would regrettably request that you seek responses from private economists who can be of considerable assistance. As I have said in the past to the Ways and Means Committee, and other committees of the Congress, I personally think that the capital gains tax ought to be lowered, but that is not relevant to this. Indeed, I went even further. I said I do not think the capital gains tax is a desirable tax instrument to raise revenue, because I do not

think the negative effects that it has is something that I would consider to be—in a cost-benefit analysis—something that should be on the table.

This is something which really is not quite related to this whole package. That is independent of the budget deficit reduction question which is a much broader and much more complex issue, as far as I see it.

Mrs. ROUKEMA. Mr. Chairman, are you suggesting that, as part of this—well, let me put it this way. I believe that one of our goals, our primary goal in reducing the deficit was to develop more facility for capital investment—make capital more available. You are suggesting that we should do that, absent a package that has a corollary to it, which is tax programs that would develop capital investment as a corollary to deficit reduction?

Mr. GREENSPAN. What I am basically saying is I do not want to comment on the specific elements of the package that I am very hopeful this Congress develops to finally confront an issue which has been simmering for a very long period of time. There are a number of other elements involved in tax policy which do not relate to the budget deficit question.

Mrs. ROUKEMA. Well, all right. If you do not want to go further than that, would you be free to give a relative value to the concept of no new spending programs, unless and until there is progress on the structural deficit demonstrated?

Mr. GREENSPAN. That is getting involved in this detail, and I personally regret I cannot be responsible—I would love to be involved in this debate, but I just do not think it is appropriate for the Federal Reserve to be involved in it.

Mrs. ROUKEMA. Well, I am sorry for that, because I am fearful, and I hope I am wrong. I have been here 12 years, and I have never yet seen a deficit package proposal, including the well-intended Gramm-Rudman enforcement mechanism ever yet result in reductions here. I am fearful that Congress is going to work itself into a lather over this, maybe come up with the same gridlock, or a simplistic or a symbolic deficit reduction that we find in a few years is not doing the job. Unless we have strong leadership from some independent sources, particularly the business community and the economics community, and since you were willing to talk about reining in medical costs, I thought you might be willing to go out a little further on some of the other areas. I respect your decision, Mr. Chairman.

Mr. GREENSPAN. Thank you.

Chairman KANJORSKI. Mr. Klein.

Mr. KLEIN. Thank you, Mr. Chairman. First of all, Chairman Greenspan, I wanted to tell you that I share with you your feeling that it is absolutely critical that we make real, meaningful, serious cuts in the budget deficit. To you, my colleague from New Jersey, on the other side of the aisle, you have been here 12 years, I have only been here 6 or 7 weeks, but I can tell you there are 65 new Members on this side of the aisle who really mean business, and are going to do something in a very serious way about structural budget deficit reduction.

I would like to turn to the question of credit—the credit crunch. I think that your efforts, Chairman Greenspan, with respect to

monetary policy, have been commendable, and indeed have been extremely helpful. It does seem to me that the monetary policy alone does not ease completely the credit crunch. I was wondering if you have any thoughts as to whether incentives to the banking community are an appropriate way of stimulating lending? I hear so often from members of the banking community that one of the big reasons that they are not lending is because they can make a very handsome profit simply by investing in government securities and, therefore, there is not a great deal of incentive for them to go out and make loans that are of a marginal nature, or the character loans that you have talked about. Can we provide them with some incentives so that they will once again get into this market?

Mr. GREENSPAN. Mr. Klein, we at the Federal Reserve are in discussions with our colleagues at the Treasury Department in trying to confront precisely this question, and to review the experience we have had in recent years. Remember, we have tried a number of different vehicles which have not been very successful. We want to see whether we now are in a position to find newer ways to break the back of this credit crunch which I certainly agree with you is a crucial element. I hope that we will have something useful forthcoming reasonably soon.

Mr. KLEIN. Second, you commented about the regulatory problems affecting the credit crunch. Do you have any specific suggestions as to how we might ease the regulatory situation so as to make it easier to make the kind of character loans that you have talked about?

Mr. GREENSPAN. Yes. That is the type of thing we are discussing with the Treasury. It obviously would require, in certain instances, changed statutes as well as changed regulations. We have not decided which is which at this particular stage. There is no question that the costs of making a loan have risen very dramatically. That, to a large extent, is partly the regulatory burden which has increased so substantially in recent years. Nonetheless, we do recognize that there is a need to maintain a degree of supervision and regulation to maintain the safety and soundness of the institutions. I believe it was Congressman LaFalce who talked about the issue of appropriate balance—and it is in that context that we are coming at this issue.

Mr. KLEIN. Thank you very much.

Chairman KANJORSKI. Mr. King.

Mr. KING. Thank you, Mr. Chairman.

Chairman Greenspan, just to put it on the record, I want to associate myself with the remarks of Mr. Schumer and Mrs. Roukema; regarding any attempt to politicize the Fed, I am totally opposed to any attempt of that nature.

Second, I also want to endorse your remarks about the need for deregulation in the banking industry. I think it is very important.

Now, having said that, in your statement, you say that it would be fanciful to say that we could grow our way out of a deficit. On the other hand, I believe, to achieve real long-term deficit reduction, we have to ensure some element of long-term solid growth.

Now, if I could just make this point which may seem somewhat parochial, but hopefully, is pertinent to the Nation. My district on Long Island is in Nassau County. Nassau and Suffolk Counties

comprise almost 3 million people. Over the past 5 years, both of those counties, under both democratic and republican administrations, have been devastated by the economy. One reason was the loss of jobs due to the cutback at Grumman; second, a tremendous loss of jobs because of the 1987 Wall Street crash. As a result of that, both counties went literally to the verge of bankruptcy, almost reaching junk bond status by Moody's and Standard and Poors. I should emphasize, that was not so much because of government spending at the local level, it is because sales tax revenues were just not coming in because of the tremendous business reverses on Long Island.

Now, from talking to the county executives, from talking to the banking industry, from speaking to the business community, it appears that businesses on Long Island are very much the way you describe the national economy on page 20 of your testimony. There has been a recent momentum in spending. Christmas sales were almost at record heights, inventories are at very low levels. Consumer confidence is recovering. They are anticipating a steady growth over the next 2 to 3 years.

I am asking what impact are these new taxes going to have on these businesses that are just on the verge or recovering? Specifically, we are talking about increasing the marginal rates drastically. We are talking about increasing corporate rates. Also, the energy tax is going to be particularly damaging on Long Island. I understand the estimates are it is going to cost families more than \$300 a year. That has to affect sales. That has to affect consumer spending. It has to have an effect on business.

So, I would just really ask you a series of questions with that as the backdrop. One, Chairman Greenspan, has there ever been an instance in our history where tax increases have brought us out of business downturn, or out of a faltering economy? Specifically, whether it is Hoover in 1931 or Bush in 1990, it appears raising taxes at critical stages has just caused a further downturn.

Second, in your testimony, you referred to—that tax increases at a certain level could bring about considerable damage. I am asking, are we at a stage now where we can afford any damage to the business cycle? Would any damage, no matter how small, also be considerable? I would just ask you that, Mr. Chairman.

Mr. GREENSPAN. What the Congress is confronted with, Congressman, is the extraordinary dilemma, as I indicated in my comments, that how the budget deficit is brought down matters a good deal, but that it be brought down is crucial.

The problem that one confronts in this sort of environment of trying to come to a political decision is that, if no conclusions are reached that can achieve a majority in both Houses, and we fall back on not solving this problem, that is the worst of all possible outcomes. If you are asking me, in the process of trying to solve this, whether taxes can be put on with impunity, the answer is, I do not know of any economist who would say that. Clearly, taxes, by their very nature, do restrain. The issue, however, is a more general one as to how does one sort out this whole question? How does one put it all together in a manner in which we can get the budget deficit down in a way which does not undercut the underlying efficacy of the incentive structure of our economy and the basic

recovery that is underway? That is a very difficult problem that if we continue to procrastinate and not confront is only going to get worse.

So, my major focus in this morning's testimony is to try to emphasize how crucially important it is, and how significant it is to the long-term outlook of this economy that this deficit issue be confronted very quickly. We no longer have the luxury to stretch out the discussions and various different policy initiatives. We have to come to grips with this issue because the arithmetic is just overwhelming—with the inexorable turn of the calendar, we are going to be confronted with some very serious financial difficulties, as a consequence of a budget deficit which begins to accelerate.

Mr. KING. Can I have just one followup question, Mr. Chairman?

Chairman KANJORSKI. We have a vote on.

Mr. KING. OK.

Chairman KANJORSKI. I wanted to get Mr. Fingerhut though.

Mr. KING. OK. That is fine. Thank you.

Chairman KANJORSKI. Mr. Fingerhut.

Mr. FINGERHUT. Thank you, Mr. Chairman. I will try and be brief. I, being the first one to speak after your last answer, Chairman Greenspan, I just have to say how much I agree with you that the principal objective here has got to be to do something, and that the worst thing that we could do about the budget deficit is to do nothing. One cannot help but sit here and listen, and think what the public is thinking back home when they listen to the back and forth between the opposite sides of the aisle that there is a growing fear and a growing sense that we may indeed gridlock and do nothing.

We have a President who has put his plan out. He has been duly elected by the American people. Clearly, his preferences are known. That sets the terms of the debate. I just feel very strongly that your statement is right, that we must do something.

Let me ask a couple of brief questions to follow up on some earlier points you made, if I can. A couple of times, in response to the subject of the credit crunch, which you have said has impacts on small business disproportionately, you referenced the subject of character loans. One of the things I am concerned about is that the ability to give character loans is not only related to the regulatory structure of the banking system, but also to the ability of a banker to know the individuals on a personal basis. What we are increasingly seeing is the decline in local banks, and small community-based banks, and the increase in these decisions being made at centralized locations, hundreds of miles away from our communities. Would you care to comment on what we could do, not only through the regulatory structure, but through other ways to make sure that our bankers know my small businessmen in my community?

Mr. GREENSPAN. Congressman, if we change the regulatory structure so that character loans can again be made, it then gives an incentive to those individuals who know the people in the business community to either form smaller banks, or to take branches of other banks and literally make them profitable. In other words, what we have done by removing the character loan is we have removed the economic franchise of the small bank which had a very strong competitive advantage over the larger banks and over those

from other areas who did not know the people in the particular community. So that, if we are interested in community banking, which I certainly am, the way to make sure that the appropriate incentives are there is to ensure that the people who are bankers in the small community and have the assets of knowing all of the various players in this community, be allowed to function as banks in a profitable way. If we require somebody who knows everybody in the community to sit and write out a long series of loan documents and various different forms of appraisal requirements, the cost of doing that is more than the profit that the loan could conceivably engender. As a consequence of that, I would say that what we are doing is undercutting our small community banks by essentially taking their franchise away from them in that respect.

Mr. FINGERHUT. It is your opinion, Mr. Chairman, that undoing that regulatory element alone is sufficient to overcome the other dynamics in the regulatory and financial structures that have been leading to the banking consolidations and the decline in community banking?

Mr. GREENSPAN. No. I do not think so. There is more to this in the sense that there is still a fear on the part of bankers, there is still a concern with respect to commercial real estate markets and their liquidity, and there are a number of other general aspects to this problem which will keep it festering for a while. Having said that, there is no question that moving in the character loan area would be a major factor contributing to easing this problem.

Mr. FINGERHUT. Mr. Chairman, if I could ask one other quick question? I know we have to go vote very quickly. In my opening remarks, I asked you about the subject of the impact of spending cuts on the economy. We have had any number of questions about taxes, and I think we all understand the parameters of that debate. Just as a perfect example, my colleague, Mr. Schumer, to my right, in his aggressive remarks about the subject of spending cuts, said he is against the space station. Well, that decision alone takes 2,000 jobs out of my district overnight.

What you have said is—and that does not mean I am not willing to consider that—what you have said in your prepared testimony is that you cannot comment specifically on the actions that the Federal Reserve could take, but, in general, you felt that you could take ameliorative actions to make up for whatever we would do to the deficit, because reducing the deficit is so important. Can you comment specifically on the spending cuts side, and whether indeed you think you can take ameliorative actions? I am sure the chairman would appreciate it if you did that in 30 seconds or less, so we could go vote.

Chairman KANJORSKI. I suggest maybe we hold that answer. I think it is a great question. Can we take a break now, Mr. Greenspan? We will be right back as soon as we vote, and we will take your answer.

Mr. GREENSPAN. Certainly.

Chairman KANJORSKI. Thank you.

[Recess.]

Chairman KANJORSKI. We have a question pending I understand.

Mr. FINGERHUT. I assume that we all remember the question.

Chairman KANJORSKI. In detail? I was just wondering if it would help Mr. Greenspan if we had the stenographer reread the question?

Mr. FINGERHUT. Mr. Chairman, I could save time. I will just maybe rephrase it very quickly. The question was that we have had a lot of discussion about the subject of the impact of potential tax increases on the economy. We all know that subject very well. In my opening remarks, and again in my question, I posed to you the question of the impact on spending cuts, particularly program cuts that resulted in unemployment. I cited the example of the space station which would, if cut, take a couple of thousand jobs out of my district. In your testimony you said, well, you could not be specific, which I understand—that you did feel that we should not be afraid of deficit reduction through either mechanism because of the ability of the Fed to take ameliorative measures. I wanted to ask you specifically your feeling about the impact of cuts that result in job losses on the economy and what, in general terms, measures you think will be taken to help areas that will be hard hit by the cuts.

Mr. GREENSPAN. Congressman, let me say that, to the extent that expenditure cuts change the long-term expected direction of the structural Federal budget, then one could expect long-term interest rates, and intermediate-term interest rates, and, most specifically, mortgage interest rates to fall. What that will do is engender a degree of economic activity, unassociated obviously with the expenditure cuts, but, nonetheless, of an order of magnitude which will probably either closely offset or maybe somewhat fall short. One can expect a significant impact from declining real long-term interest rates, as a consequence of expenditure cuts.

What I was indicating in my prepared remarks is that monetary policy obviously is focusing on the economy as a whole. While we would not respond to anything specific because we do not know what the consequences are, to the extent that various different fiscal policies have an impact upon the overall economy, on the structure of the economy, obviously we respond to that, but to say in advance how we might or might not respond would require us to have a judgment and knowledge about a huge number of individual events that may or may not transpire. So, all I can say is that the basic purpose of monetary policy is long-term stability, and to foster the elements in the financial system which would contribute to long-term sustainable economic growth. To the extent that various elements of fiscal policy impact the environment in which that was occurring, obviously we would respond to that.

Mr. FINGERHUT. Is there—Mr. Chairman, if I could just follow up—I know that, by virtue of this break, I have gotten more than my share of time—but, is there an issue of timing? You indicated, in your response just now, Mr. Greenspan, that we would expect, as we cut spending, even if it has an impact on jobs that were previously government-sponsored jobs, that the reduction in interest rates, the private sector would make up the slack. You also indicated that it may not be a one for one—

Mr. GREENSPAN. It may not be one for one.

Mr. FINGERHUT. Or a direct relationship. One of the real concerns, frankly, is not that it would be a one-to-one relationship na-

tionwide, but that it will be far from a one-to-one relationship in certain regions. In other words, we will have regionally impacted development.

I guess the question is, do you have a sense on the timing of this? Should we be phasing in things at a certain rate, such that the private sector would be able to pick that up at a certain rate, or are you not at all concerned about that question?

Mr. GREENSPAN. I am frankly not concerned. I am not concerned in the sense that if we give reasons not to do something—if we give reasons not to cut expenditures—we will procrastinate. That would be most unfortunate. My judgment is that the amount of cutting that is likely to be done to be effective is extremely unlikely to go to the extreme where it will cause great economic hardship. I do not believe that there is a consensus within the Congress, for example, to actually do that. Even if it was the inclination of a number of the Members, it would not happen that way. I am saying, even were it to happen, there are vehicles that one could expect to occur as countervailing forces which would very significantly ameliorate the problem.

I suspect that on the interest rate issue, more specifically the mortgage rate, the one thing that every community in this economy has is residential building. In that respect, the one thing we are certain of is that when mortgage rates come down, building goes up. That is true everywhere in the country.

Mr. FINGERHUT. Thank you. Thank you for waiting for 15 minutes to answer the question. I appreciate it.

Chairman KANJORSKI. Mr. Bachus.

Mr. BACHUS. Chairman Greenspan, as a member of the RTC Board, what advice—

Mr. GREENSPAN. Oversight Board. We are not actually members of the Board, per se, but we are the members of the Board which oversees—

Mr. BACHUS. I see.

Mr. GREENSPAN. The RTC, itself.

Mr. BACHUS. Well, in your capacity as—on that Board of Oversight, what would you suggest to this subcommittee on how we get a handle on the RTC? Now, I will give you the backdrop, which you know, but which concerns us about the fact that this agency may be losing \$6 million a day, by their own testimony. They have been making procurement decisions, including the 67-cent-a-page cost of copying. We are very disturbed about that.

We just received an estimate that the costs of resolving the remaining failed institutions may be less than we expected because of the return we are getting from asset sales. I will say this specifically, just two questions within that general question. Are you concerned that RTC funding has not been included in the President's package, number one; and what has been the effect of Congress in withholding the RTC bill?

Mr. GREENSPAN. The answer to your first question is yes, I am. I think that it is something which is not a question of funding the RTC, it is a question of the obligation of the Federal Government to support the deposits that are being insured. To the extent we are not doing that, we are, in effect, losing, as you point out, \$6 million a month.



Mr. BACHUS. A month?

Mr. GREENSPAN. A day.

Mr. BACHUS. A day.

Mr. GREENSPAN. The reasons for the losses, obviously, is we are keeping institutions open which shouldn't be kept open. The sooner that that issue gets resolved, the sooner the job is completed the cheaper it is going to be for the American taxpayer. It has been a horrendous amount of money. It has been a horrendous problem, but I do think we are getting close to where we can see the end of the tunnel. I hope, in using that term, I do not create a jinx on the system. There is no question that very significant progress has been made. We are fairly close to getting this very unpleasant incident behind us.

Mr. BACHUS. Well, I appreciate your straightforward advice, and I think that is basically to fund RTC, and let them resolve—

Mr. GREENSPAN. Yes.

Mr. BACHUS. The remaining—

Mr. GREENSPAN. Remember, it is not the RTC that is getting the money—

Mr. BACHUS. Right.

Mr. GREENSPAN. It is basically the depositor who has been insured.

Mr. BACHUS. Thank you very much.

Chairman KANJORSKI. We have finally rescued our friend from Pennsylvania whose plane just arrived. I reached him on the floor and advised him that we had not concluded. It is my pleasure to recognize Mr. Ridge, my distinguished ranking Member.

Mr. RIDGE. Thank you very much, Mr. Chairman, and thank you, Chairman Greenspan. I apologize to both of you for being late. Transportation got a little messed up this morning. I am happy to be here with you. I am sorry I did not get the opportunity to listen to your entire testimony. I do have a few questions for you, if I might.

I thought that President Clinton made a very succinct and probably the best statement concerning the deficit and its impact on the American taxpayer in his State of the Union, or his economic address, which I thought was long overdue. I thought it, as I said before, was a good, succinct, and appropriate statement.

Having said that, when I take a look at some of the projections for—within the administration with regard to new taxes, and compared with spending reductions, there is an analysis that we have seen that says in the first year taxes will go up \$36 billion, and we are going to cut government about \$3.6 billion. That is a 10 to 1 ratio. We in the Congress are supposed to anticipate that the spending cuts will come later. In my 11 years here, normally, when this entity has had access to more revenue, expenditures just seem to grow, and we never seem to get around to cutting that deficit. One of the advantages that the President pointed out, and you have talked about a long, long time with reducing the deficit, is the impact on interest rates. I am just wondering, if we fail to do our share of reducing the deficit by spending cuts, will the interest rate reduction that the President has suggested we could anticipate, and that you have suggested we might, if we do the right thing, antici-

pate, will it ever really materialize if we do not actually reduce the size of government?

Mr. GREENSPAN. Mr. Ridge, as I said in my prepared remarks, or more exactly in the supplementary remarks, we are dealing with a current services expenditure path which, when projected indefinitely out into the future, creates an increasing growth in the deficit which becomes destabilizing at the end of the day, if I may put it that way. It is clear that one cannot resolve that longer term deficit solely from the tax side, because what that would imply is ever-increasing tax rates and, at some point, that becomes debilitating to economic growth, and hence revenues fall and the deficit starts back up.

So, you are led to the conclusion, inexorably, that a necessary condition for resolving the long-term budget deficit problem is to restrain the growth in spending to a point which is not in excess of the tax base that we would project indefinitely into the future, and be related to some level of economic growth. Obviously, the greater the economic growth, the more that the current services level of expenditures could be tolerated. As I also indicated in my testimony, I do not find it credible that growth, per se, is going to resolve that issue, and I, therefore, concluded that expenditure growth had to be suppressed over the long run, if the structural deficit is to be brought down and if, as a consequence, long-term and intermediate interest rates are to come down.

Mr. RIDGE. When you look at that though—let's assume the best-case scenario, with the government trying to tighten its belt, at the same time we are trying to lighten taxpayers' wallets. It remains to be seen whether or not we are going to do that. What would you anticipate would be the response, in terms of interest rate reduction, and how do you think, given the fact that we had short-term interest rates down fairly low, even during 2-3 years ago, the small business community still seemed to lack the credit opportunities that many of them felt continued—exacerbated the recession and retarded their growth? What is it about this package of spending cuts, if we do our job on the Hill, tax revenue that will reduce the rates even less than they have been in the past couple of years, and will make capital accessible to smaller business, which seems to be the engine of growth down the road for the entire country?

Mr. GREENSPAN. Yes. As I have discussed in previous testimonies and here this morning, interest rates as such are not the major inhibitor in small business lending. It has basically been an extraordinary concern, on the part of lending officers and bank officers generally, following on their very unhappy experiences of the 1980's when lax underwriting standards led to very significant increases in nonperforming loans which threatened a number of institutions, and essentially traumatized a big segment of the commercial banking industry which, as a consequence, have been extraordinarily restrained, slightly less so recently, but still extraordinarily restrained in lending. When you say that, what we really mean is lending to small business because, to a large extent, it is they who are feeling the brunt of this because their alternate sources of credit are extraordinarily limited and, as a consequence of that, expansion in the small business area has clearly been suppressed.

So, it is more an issue of several things. One, as I indicated earlier, improving liquidity in commercial real estate assets would enhance the ability to liquidate collateral, and assure the degree of capital that one actually really has in your bank, except other than an accounting judgment as to what might happen under certain hypothetical values for commercial real estate. Then there is the question of the regulatory issues, which we discussed at length, and I very specifically argued that we have eliminated the character loan in small business lending and, in my judgment, that probably has been a really strong force undercutting the availability of credit for a lot of businesses.

Mr. RIDGE. Should it be restored?

Mr. GREENSPAN. I think we should, most certainly.

Mr. RIDGE. I appreciate that. I have just seen, over the past couple of years, the relationships between small business and their credit market—their lending institution with whom they had dealt for 10, 15, and 20 years, with whom they had a mutually profitable relationship, with whom they worked, and never had—businesses that had never had a default payment, were always on time, and did historically what businesses had done, got a line of credit, continued to pay on the interest for a long period of time, and either refinanced it, paid it off, or went back again. Yet, sadly, for a lot of reasons in the past 3 or 4 years, this avenue has been cut off, and there has been no alternative to them. So, your recommendation that we restore those character loans is—

Mr. GREENSPAN. I would say, Congressman, at a minimum, allowing well capitalized banks to get back into the business of character loans strikes me as no threat to the safety and soundness of the banking system.

Mr. RIDGE. Good. Thank you.

One final question with regard to small business. I know my time has elapsed. There are those who have taken a look, and you perhaps have answered this question before, but there are those who have taken a look at President Clinton's tax package. At the top end, although the suggestion is that these are the affluent and the wealthy, as a matter of fact, the burden will fall heavily upon individuals who file as subchapter S, who are in the business of creating wealth and opportunity through their small businesses. If you increase the tax on small business, we still have an unfriendly regulatory environment, or at least unfriendly credit environment, the two do not seem to provide the kind of incentive that I would think that this administration or all of us, Republicans and Democrats, would like for a small business. Have I misstated the impact of the tax burden on small business? Will it be a deterrent to growth?

Mr. GREENSPAN. In my earlier testimony this morning, I had indicated that I did not think it was appropriate for the Federal Reserve to be involved in the programmatic detail of the discussions—

Mr. RIDGE. Right.

Mr. GREENSPAN. Which are involved here. So, I would like to just remain mute on that subject if I may.

Mr. RIDGE. All right.

I very much appreciate the fact that whenever you are before this subcommittee or others, that it is rare that you remain mute. I

certainly appreciate your thought on that regard. Thank you for testifying.

Mr. GREENSPAN. Thank you.

Chairman KANJORSKI. One quick question, Mr. Greenspan. What do you think is the window of opportunity for the Congress and the President to cooperate on this deficit reduction package?

Mr. GREENSPAN. I would certainly think that it is obviously within this year. The problem is that the longer we procrastinate in resolving this issue, the more difficult it is going to become to really come to grips with it. While it is not something where one can say, as of August 31 or what have you, the window comes down, and all problems are unsolvable—I certainly would not want to say that and clearly, no one should—the time element here is not what it used to be.

When we discussed these issues 3 or 4 years ago, as indeed I recall I am repeating myself almost verbatim in what I have said this morning, the difference was that we looked at the deficit problem as a slow, corrosive deterioration in the system which did not really create a major concern that a crisis was on the other side of the horizon. What is happening, however, is the data are becoming increasingly persuasive that this problem is beginning to move closer and closer to a destabilizing type of environment, and I should think we should not be taking the risks that are implicit in waiting indefinitely to get this issue resolved. Time is no longer on our side.

Chairman KANJORSKI. You have indicated that, if we are successful, we can anticipate the long-term interest rates falling. Have your economists or you yourself come up with where you see that eventual leveling out—what is the most optimum level?

Mr. GREENSPAN. It depends, in large respect, on those issues I raised in my prepared testimony, when I discussed the attitudes that existed in the 1960's, and most of the 1970's, about this country being essentially inflation-resistant and in that environment long-term interest rates never got particularly high, I mean, higher than 4 or 5 percent. When the dam broke, as I put it, and all of a sudden the inflationary potentials of this economy became evident, of course, we got interest rates rising very sharply.

The key question is, can we put the genie back in the box, so to speak? Can we go back to the judgments and values, and institutional insights that occurred say in the 1960's? My suspicion is probably not—not fully. It will take a very long while before people really have a serious view that inflation is no longer a crucial force in this economy. Nonetheless, if we resolve the long-term structural budget deficit, and put into place hard-wired budgetary actions, which, instead of having the long-term budget go down through 1996 and 1997 and start back up, if we have programmatic changes, which are in the law that bring it down, and credibly bring it down, then we have still further to go on the downside for long-term interest rates and mortgage rates. Indeed, it is the expectation that the resolution of this debate, which is now in the process of emerging within the Congress, will be successful that has already lowered long-term rates not insignificantly. We have essentially pierced the 7-percent long-term 30-year bond rate which no one really expected would occur at this particular stage. That is es-

entially attributable, as best I can judge, to the expectation that by the end of this debate major progress will be made and long-term budget issues will be resolved. If that occurs, I think that is a very important event in American economic history.

Chairman KANJORSKI. If the long-term interest rate falls by 1 percentage point, that would alleviate the Federal Government of about \$40 billion in interest on the debt, assuming we had long-term funding of the debt. You give a figure that there would be an injection into the system of, I think, for every point, \$50 billion or \$100 billion, I am not sure into the private—

Mr. GREENSPAN. It is a very tricky calculation; but it is between the two numbers. It is fairly apparent that in this particular environment the sensitivity of economic activity to the intermediate interest rate, mainly the mortgage rate, is very high, and that, as we have observed in recent quarters, whenever the mortgage rate goes down, there is an acceleration of economic activity. It is the far most potent stimulus that I can imagine that we can get.

Chairman KANJORSKI. Mr. Greenspan, you have heard the political bickering that has occurred today. Actually, that surprises me, although I am aware that this is a very political institution.

I see this as a once-a-lifetime opportunity. If we do not do something about the deficit now, we will never get another opportunity quite like this. To see the contentious political activity that has even appeared here at the subcommittee today is a little bit disappointing for me, so that I am moving now to the next phase. If we cannot get a singular comprehensive program approved, if the minority and the majority talk ourselves to death, and refuse to cut, as we have to cut across the board, or increase taxes, if we have to increase taxes, is this problem so severe, in your estimation, that it would warrant us passing extraordinary emergency powers constitutionally to provide what the President—with extraordinary powers to cut the budget at will, or line item at will?

Mr. GREENSPAN. No, Mr. Chairman. I am very conscious of the constitutional structure that we have imposed on this country, and I just cannot imagine that this issue cannot be resolved through constitutional means. If we cannot do that, then I think we will find some very significant debilitating forces affecting our economy and our society. I have enough confidence in this country in watching the way our political system functions to remember that when we do confront crises, we eventually come out OK. The presumption that there should be extra constitutional powers is, in my judgment, wholly misplaced.

Chairman KANJORSKI. Finally—and I will give my fellow members an opportunity to ask final questions—is there some point where we will cut too much? I think, when we finally get used to cutting things around here, we will find a stampede of who can outdo each other. I think one of the fellow members talked about a similar stampede when we set capital standards in FIRREA. We amazed ourselves that we went so far we destroyed ourselves in a way. I think we may do the same thing in cutting. Is there some point where we could cut too fast and injure the economy?

Mr. GREENSPAN. I find that politically noncredible, meaning it just—

Chairman KANJORSKI. Would not be beyond the political boundary?

Mr. GREENSPAN. It is hard to believe that there could be sufficient agreement. I am arguing that there should be adequate agreement to cut the budget, but that it should be far greater than that, I just find difficulty contemplating.

Chairman KANJORSKI. I am just suggesting there may be schizophrenia at work here. I am not sure—once we tend to start in a direction, the correction may exceed even our best expectations. You mean, you do not see that some of our friends may say well, the space station—we will raise you one with the super collider, and then somebody comes back and says, well, we will do a real job on defense and do away with the B-2, and raise you on the tanks, or whatever? You do not see that type of bidding war occurring? You just see that it is a hard knock, if we can get anything out of the system, we are going to—

Mr. GREENSPAN. I would appreciate observing that phenomenon, Mr. Chairman.

Chairman KANJORSKI. I think, from an outside observer, maybe I have been here too long, Mr. Greenspan.

Mr. Bachus. Did you have any further questions?

Mr. BACHUS. No.

Chairman KANJORSKI. No. OK.

Mr. Ridge.

Mr. RIDGE. Just one. I agree, Mr. Chairman, sometimes it is better to be a spectator than a participant. It remains to be seen whether or not we will have a comity that I think—and not comedy—comity that I think the Chairman is talking about.

I guess when I take a look at, not only the actual day-to-day working of the marketplace, but also the psychological impact of what we do on the marketplace, which is very real, it is troubling to me to see that the ratio between spending cuts, and revenue increases—let's not just talk necessarily this administration, but the discussion has always started at a fair level that we were going to be \$2 or \$3 of spending cuts for \$1 of increased expenditure. As the process worked, as administrations assessed and reassessed what they were able to do on the Hill, it would go from three to one, to two to one, to one to one. Now I guess, what is it? Fifty-nine cents? Depending on the analyst.

The bottom line is that it seemed to me that the most significant factor in the degree to which this entire scheme will affect short- and long-term interest rates and affect the economy is the degree to which we not only increase revenues, but we also downsize government in projected years. I just do not get a sense, from some of the initial discussions that we are going to get that. Without getting you into commenting about specific programmatic changes, and those kind of political decisions that we have to make, could you say that the positive impact on the market, on financial institutions, on interest rates, on the economy generally would be better or worse, the higher the ratio was between spending cuts and increased revenue?

Mr. GREENSPAN. Well, Mr. Ridge, I have said many times before this subcommittee in years past, and indeed I repeated it this morning, if one's purpose is to get the budget deficit down, it is

more efficiently done from the expenditure side than from the tax side. If that is true then, clearly, the market's anticipation of the decline in the budget deficit is likely to give more credence to the expenditure cuts, which are perceived to be permanent, than the tax increases. It is also clear that the markets will react as they indeed have to expectations that the deficit is coming down. It is only an issue of the relative weighting of what they think the probabilities are of effectively achieving that on expenditures on one side, or taxes on the other.

It is essentially a question of what is the probability of long-term success for equal amounts of a dollar of taxes and a dollar of expenditures? I would say, as best I can judge the evidence, that there is a higher probability on the expenditures side. Clearly, the tax side is not zero. Ultimately, the judgment that has to be made by the Congress is a political one, and, as I said, political in the best sense of the word. It is the way our Constitution functions and the way our elected representatives bring to bear the various value judgments of the electorate hopefully to a solution to this problem which, as I indicated to the chairman, is one for which time is not infinitely available.

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

Chairman KANJORSKI. Well, thank you very much, Mr. Greenspan. We certainly do appreciate it. I know some subcommittee members have not had an opportunity to ask questions, and they would like to do so in writing. So, if we could have your cooperation, we would appreciate it. Further, we have asked your assistance on resolving this question of whether there is in fact a use of the open window to acquire funds for purchasing securities or some other abuses out there by banks. Ahead of time, I would like to thank you for the indicated cooperation of the Federal Reserve with the Congress on that issue. We look forward to further conversations.

Thank you very much for your statement. I congratulate you for taking the position that you will not allow the Federal Reserve to become politicized in the highly political question of what we do on the deficit reduction issue.

Thank you very much, Mr. Chairman.

Mr. GREENSPAN. Thank you, Mr. Chairman.

[Whereupon, at 1:09 p.m., the hearing was recessed, to reconvene at the call of the Chair.]





# A P P E N D I X

February 23, 1993

**Opening Statement**  
**The Honorable Paul E. Kanjorski, Chairman**  
**Subcommittee on Economic Growth & Credit Formation**  
**Semi-Annual Hearing on the Conduct of Monetary Policy**  
**February 23, 1993**

The Subcommittee meets today to receive the semi-annual report of the Board of Governors of the Federal Reserve System on economic and monetary policy as mandated under the Full Employment and Balanced Growth Act of 1978, popularly known as the Humphrey-Hawkins Act.

Under the Humphrey-Hawkins Act, the Federal Reserve is required to set forth:

1. A review and analysis of recent developments affecting economic trends in the Nation, including changes in the exchange rate;
2. The objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or diminution of the money supply, taking into account past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade, and prices; and
3. The relationship between the Federal Reserve's plans and the short-term goals set forth in the most recent Economic Report of the President, and any goals set by the Congress.

As the new chairman of this subcommittee, I want to welcome Chairman Greenspan. I look forward to working with the Chairman, his colleagues at the Federal Reserve, and my colleagues on both sides of the aisle, to achieve the overall goals of the Humphrey-Hawkins Act – full employment and balanced growth.

As we sit here today, the single most significant development in economic policy since the last time the Chairman testified before the House Banking Committee, comes not as a result of any action taken by the Federal Reserve, the Federal Open Market Committee, or this Committee. The single most significant development is that the American people have delivered a mandate for change.

In the election of 1992 the American people told the Executive Branch, the Legislative Branch, and independent agencies like the Federal Reserve, that this is not a time for politics as usual, that the time for gridlock and divided government is over.

I am extremely encouraged by Chairman Greenspan's statements that President Clinton's deficit reduction proposal is both "serious" and "credible." The Chairman's statements indicate that

not only is the President heading in the right direction, but also that cooperation is possible between a president from one party and a Board of Governors appointed by presidents from the other party. For my own part, I can only hope that this bipartisan spirit of cooperation will spill over to the Legislative Branch. I will certainly do my best to encourage it in this subcommittee.

The Chairman's appearance today comes at a time when short-term interest rates are at relatively historical lows. Few Americans today are complaining about the price of money. Low interest rates usually mean an ample supply of money – "easy money."

The anomaly we find ourselves in today is that while interest rates are low, many Americans still cannot find access to it at any price. This continuing "credit crunch" is particularly acute for the small and medium-sized businesses which are the lifeblood of our economy and which have historically created the majority of new jobs in our economy. It is the inability of small and medium-sized businesses to obtain access to credit which has undoubtedly caused unemployment to remain unacceptably high. Our inner cities, our second and third tier cities, and our minority communities have been particularly hard hit by the inability to obtain access to credit. Small communities in Northeastern Pennsylvania, and the riot-torn sections of Los Angeles may be thousands of miles apart and have vastly different social and cultural backgrounds, but they share one important thing in common: both feel that their economic recovery has been blocked by inadequate access to capital for business expansion and job creation.

In our economy today, big businesses have avenues other than commercial banks through which they can obtain credit. They can go directly to the capital markets. They can obtain loans from pension funds and insurance companies. Individuals who seek home loans and credit for consumer loans benefit from the secondary markets which have been created to increase the flow of funds for these purposes.

Virtually alone among borrowers, small and medium-sized businesses have little or no alternatives than borrowing from commercial banks. Yet banks are all too often reluctant to make loans, claiming they are strangling under the weight of increased capital requirements and regulation. Where are these businesses to turn at a time when short-term interest rates are low, and capital requirements and regulators who make it easier and more profitable for a bank to invest in government securities than in small and medium-sized commercial loans?

I hope the Chairman will address the question of how we ensure that small and medium sized businesses obtain access to the credit they need to make our economic recovery complete and to ensure that we meet the goal of full employment which is an integral part of the Humphrey-Hawkins Act. If artificial restrictions imposed by either the regulators or the Congress are impeding bank lending to small and medium-sized businesses, please tell us how we can remove those impediments. If new incentives or a secondary market for commercial loans need to be created, tell us the most effective way to create them. If nothing we can do will convince banks to make commercial loans then who can we find or create who will make them, and why are we in the business of chartering and insuring commercial banks?

Mr. Chairman, I welcome you to today's hearing and I look forward to hearing your testimony and to working with you in the months and years ahead to revitalize our economy.

Testimony by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Economic Growth and Credit Formation

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

February 23, 1993

Mr. Chairman and members of the Committee, I appreciate this opportunity to discuss with you developments in the economy and the conduct of monetary policy. Nineteen ninety-two saw an improved performance of our economy. The expansion firmed, and inflation moderated. Some of the structural impediments to growth seemed to diminish. In particular, the financial condition of households, firms, and financial institutions improved. In addition, confidence rebounded late in the year.

Nevertheless, the expansion seemed to exhibit little momentum through much of 1992, unemployment remained high, and money and credit growth was sluggish. In response, the Federal Reserve took steps to increase the availability of bank reserves on several occasions. These actions brought short-term interest rates to their lowest levels in thirty years. Long-term interest rates also fell in 1992 and early 1993 as inflation expectations gradually moderated and optimism developed about a potential for genuine progress in reducing federal budget deficits.

Mr. Chairman, in the last few years our economy has been held back by a variety of structural factors that have not been typical of post-World War II business cycles--certainly not occurring all at once. These factors have included record debt burdens, overbuilding in commercial real estate, and a substantial cutback in defense spending. In this we have not been alone: Other major industrial countries also have been experiencing unusual impediments to growth, and by comparison the recent performance of the U.S. economy has been relatively good. Our monetary policy actions have been directed at facilitating adjustments to these developments and have in the process improved our economy's prospects for long-run sustainable growth.

Significant hurdles, of course, still remain to be overcome in the short run. Nonetheless, in the view of the vast majority of business analysts, prospects appear reasonable for continued economic expansion and further declines in the unemployment rate. The tasks of the monetary and fiscal authorities alike will be not only to support this prospective growth but also to set policies to enhance the capacity of our economy to produce rising living standards over time. Before discussing the outlook in more detail, I would like to reflect on how monetary policy has interacted with the forces that have shaped developments over recent years.

Recent Economic Developments and Monetary Policy in Perspective

I have often noted before this Committee the distinctly different nature of the current business cycle. A number of extraordinary factors contributed to the earlier weakening in the economy and have worked against a brisk and normal rebound from the recession.

Balance sheet restructuring has been, perhaps, the most important of these factors. In the 1980s, debt growth, hand in hand with rising asset prices, considerably exceeded that of income, and debt burdens rose to record levels. Debt-financed construction in the commercial real estate market was an extreme manifestation of this development, but it was apparent as well in other sectors of the economy.

That these imbalances developed should not be entirely surprising. The economy grew continuously for nearly eight years-- from late 1982 through mid-1990, the longest peacetime expansion on record. In this unusual period of uninterrupted growth, unrealistic expectations of what the economy could deliver seem to have developed. In addition, households and businesses apparently were skeptical that

inflation would continue to decline and, based on their experience during the 1970s, may even have expected it to rebound. As a consequence, many may have shaped their investment decisions importantly on expectations of inflation-induced appreciation of asset prices, rather than on more fundamental economic considerations. In the commercial real estate sector, assessments of profit potential formed during the first half of the 1980s simply went too far, leading to an unavoidable period of retrenchment.

The difficulties faced by borrowers in servicing their debts as the expansion slowed and the levelling out or decline in asset prices prompted many to cut back expenditures and divert abnormal proportions of their cash flows to debt repayment. This in turn fed back into slower economic growth. In addition, financial institutions were faced with impaired equity positions owing to sizable loan losses as well as more stringent supervision and regulation and demands by investors and regulators for better capital ratios. In response, they limited the availability of credit, with particular effects on smaller businesses. Over the last year or so, however, considerable progress has been made in strengthening balance sheets in both the nonfinancial and financial sectors. Moreover, by some measures the rate of deterioration of the commercial real-estate industry might be slowing and prices in this sector may soon begin to stabilize. Such developments should contribute to the sustainability of the expansion in the period ahead.

Intensive business restructuring has been another important characteristic of the evolving economic situation. In an environment of weak demand and intense competition here and abroad, many firms have found it necessary to take aggressive measures to reduce costs. These actions have included selling or closing down unprofitable units

and reducing their workforce. The process of restructuring has been given added momentum by the availability of new computing and communication technologies. Although these changes involve difficult adjustments in the short run, they are producing important gains in productivity, which will boost real wages and living standards over time.

The contraction in defense spending has been a third development restraining the expansion. Real federal defense expenditures dropped about 6 percent in 1992, and are down 9 percent from their 1987 peak. Those regions of the country with substantial defense-related activity have been among the areas whose economies have performed especially poorly. Although this development is having a contractionary influence on the economy in the short run, over a longer period the productive resources freed in this process will find employment in the private sector, contributing to capital formation and the growth potential of the economy.

Another, less-discussed factor that contributed to the formulation of our recent monetary policy dates not from the 1980s but rather from the 1970s--inflation and inflation expectations. Over the past decade or so, the importance of the interactions of monetary policy with these expectations has become increasingly apparent. The effects of policy on the economy depend critically on how market participants react to actions taken by the Federal Reserve, as well as on expectations of our future actions. These expectations--and thus the credibility of monetary policy--are influenced not only by the statements and behavior of the Federal Reserve, but by those of the Congress and the Administration as well.

Through the first two decades of the post World War II period, this interaction was patently less important. Savers and



investors, firms and households made economic and financial decisions based on an implicit assumption that inflation over the long run would remain low enough to be inconsequential. There was a sense that our institutional structure and culture, unlike those of many other nations of the world, were alien to inflation. As a consequence, inflation premiums embodied in long-term interest rates were low and effectively capped. Inflation expectations were reasonably impervious to unexpected shifts in aggregate demand or supply. In those circumstances, monetary policy had far more room to maneuver; monetary policy, for example, could ease aggressively without igniting inflation expectations.

Even during the rise in inflation of the late 1960s and 1970s there was a clear reluctance to believe that the inflation being experienced was other than transitory; it was presumed that inflation would eventually retreat to the 1 to 2 percent area that prevailed during the 1950s and the first half of the 1960s. Consequently, long-term interest rates remained contained.

But the dam eventually broke, and the huge losses suffered by bondholders during the 1970s and early 1980s sensitized them to the slightest sign, real or imagined, of rising inflation. At the first indication of an inflationary policy--monetary or fiscal--investors dump bonds, driving up long-term interest rates. To guard against unexpected losses, investors now demand a considerable premium in bond yields--a premium that seems out of proportion to the likely future path of inflation, but one that nevertheless conditions the environment of monetary policy today. The steep slope of the yield curve and the expectations about future interest rates that it implies suggest that investors remain quite concerned about the possibility of

higher inflation over the longer run, even as they appear less concerned about that possibility for the next year or two.

This heightened sensitivity affects the way monetary policy interacts with the economy. An overly expansionary monetary policy, or even its anticipation, is embedded fairly soon in higher inflation expectations and nominal bond yields. Producers incorporate expected cost increases quickly into their own prices, and eventually any increase in output disappears as inflation rises and any initial decline in long-term nominal interest rates is more than retraced. To be sure, a stimulative monetary policy can prompt a short-run acceleration of economic activity. But the experience of the 1970s provided convincing evidence that there is no lasting tradeoff between inflation and unemployment: in the long run, higher inflation buys no increase in employment.

This view of the capabilities of monetary policy is entirely consistent with the Humphrey-Hawkins Act. As you know, the Act requires the Federal Reserve to "maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

The goal of moderate long-term interest rates is particularly relevant in the current circumstances, in which balance sheet constraints have been a major--if not the major--drag on the expansion. The halting, but substantial, declines in intermediate- and long-term interest rates that have occurred over the past few years have been the single most important factor encouraging balance-sheet restructuring by households and firms and fostering the very significant reductions in debt service burdens. And monetary policy

has played a crucial role in facilitating balance sheet adjustments-- and thus enhancing the sustainability of the expansion--by easing in measured steps, gradually convincing investors that inflation was likely to remain subdued and fostering the decline in longer-term interest rates.

That is the background against which we have conducted monetary policy for the last several years. Through this period, Federal Reserve policy was directed at fostering sustainable growth in the economy. Recognizing tendencies for the economy to slow, the Federal Reserve began to ease monetary policy in the spring of 1989. In response to the downturn that began in August 1990, we accelerated the reduction in short-term interest rates. Last year, we extended our earlier reductions in interest rates by lowering the federal funds rate another percentage point through another cut in the discount rate and injections of a large volume of reserves. In addition to reducing interest rates, the Federal Reserve lowered reserve requirements last year for the second time in eighteen months to help reduce depository institutions' costs and encourage lending.

Although the easing actions over the past few years have been purposely gradual, cumulatively they have been quite large. Short-term interest rates have been reduced since their 1989 peak by nearly 7 percentage points; looked at differently, short rates have been lowered by two-thirds. Some have argued that monetary policy has been too cautious, that rates should have been lowered more sharply or in larger increments.

In my view, these arguments miss the crucial features of our current experience: the sensitivity of inflation expectations and the necessity to work through structural imbalances in order establish a basis for sustained growth. In these circumstances, monetary policy

clearly has a role to play in helping the economy to grow; the process by which monetary policy can contribute, however, has been different in some respects than in past business cycles. Lower intermediate- and long-term interest rates and inflation are essential to the structural adjustments in our economy, and monetary policy thus has given considerable weight to helping such rates move lower.

Some have suggested that the decline in inflation permitted more aggressive moves and, had the downward trajectory of short-term interest rates been a bit steeper, that aggregate demand would have been appreciably stronger. I question that as well. Basing this argument on the lower inflation that has occurred is a *non sequitur*; the disinflation very likely would not have occurred in the context of an appreciably more stimulative policy, and such a policy could have led to higher inflation in the next few years. Moreover, such a policy would not have dealt fundamentally with the very real imbalances in our economy that needed to be resolved before sustainable growth could resume. And it would have run the risk of aborting the process of balance sheet adjustment before it was completed. The credibility of noninflationary policies would have been strained, and longer-term interest rates likely would be higher, inhibiting the restructuring of balance sheets and reducing the odds on sustainable growth.

Recent evidence suggests that our approach to monetary policy in recent years has been appropriate and productive. Even by last July, when I presented our midyear report to the Congress, some straws in the wind suggested that the easing of monetary policy to that date and the various financial adjustments underway in the economy were proving successful in paving the way for better economic performance. Households and businesses appeared to have made significant progress

in shoring up their balance sheets; considerable reductions in debt servicing requirements had been achieved, equity had risen, and liquidity was higher. In the financial sector, bank profitability had improved, and a brisker flow of bank earnings as well as issuance of new equity shares and subordinated debt had bolstered capital ratios, helping to arrest the tightening of lending terms and standards. The lower level of interest rates, both short- and long-term, helped to limit the decline in real estate values and boost the profitability of thrift institutions, as a byproduct reducing the losses that would have been borne by the Resolution Trust Corporation and, ultimately, the taxpayer.

It is now apparent that our July expectation of a firmer trajectory of output has been borne out. GDP growth is estimated to have picked up to a 3-1/2 percent rate during the second half of 1992, following a more modest increase in the first half. Beginning in the late summer, some quickening in the pace of auto sales could be detected, and spending on other consumer durables strengthened as well. Single-family housing starts rebounded. Industrial orders, production, and shipments all rose. In association with this stronger trend, payroll employment growth has picked up and the unemployment rate has dropped back to 7.1 percent by early this year--certainly too high, but well below the level at mid-year. For 1992 as a whole, real gross domestic product is currently estimated to have increased at about a 3 percent rate. And indications are that the expansion is continuing in the early months of 1993, though perhaps at a slightly reduced rate.

The news on inflation in 1992 likewise was quite encouraging. The consumer price index rose just 3 percent in 1992, at the lower end of the central tendency of our July projections. Excluding volatile

food and energy prices, inflation last year was the lowest in two decades. Although the January CPI was surprisingly high, judging from survey evidence and the behavior of long-term interest rates, inflation expectations appear to be gradually diminishing, as market participants gain more confidence that inflation is being contained.

#### Money and Credit in 1992

These favorable outcomes occurred despite slow growth of the money and credit aggregates. The Federal Open Market Committee had established ranges of 2-1/2 to 6-1/2 percent for M2, 1 to 5 percent for M3, and 4-1/2 to 8-1/2 percent for domestic nonfinancial sector debt. Over the year, M2 actually rose 2 percent, M3 1/2 percent, and debt 4-1/2 percent. Thus, both of the monetary aggregates finished the year about 1/2 percentage point below their ranges, and debt just at its lower bound.

Interpreting this slow growth was one of the major challenges faced by the Federal Reserve last year. You may recall that, in establishing the ranges in February and reviewing them in July, the Committee took note of the substantial uncertainties regarding the relationships between income and money in 1992. Although the velocity of the broad monetary aggregates--the ratio of nominal GDP to the quantity of money--had not changed much in 1991, that result itself was surprising. In the past, when market interest rates declined, as they had in 1991, savers shifted funds into M2, since deposit rates usually did not fall as much as market rates, and this produced a decline in velocity, in contrast to what occurred in 1991. As we moved into 1992, there appeared to be an appreciable likelihood that unusual weakness in M2 growth relative to spending would continue. But, in the absence of convincing evidence for increases in velocity, the FOMC elected to leave the ranges unchanged from the previous year.

noting that it would need to be flexible in assessing the implications of monetary growth relative to the ranges.

In the event, nominal GDP was even stronger relative to the broad aggregates in 1992 than seemed likely when their ranges were established. Income increased 3-1/2 percent faster than M2 over the year and 4-3/4 percent faster than M3. The unusual nature of these increases in velocity can be illustrated by noting that, prior to 1992, the velocity of M3 had risen more than 3 percent in a year only once; the historical increases in M2 velocity comparable to last year's occurred solely in the context of sizable increases in market interest rates, in contrast to last year's declines.

What accounts for this unusual behavior? Why is it that our financial system was able to support 5-1/2 percent growth in nominal GDP with only 2 percent growth in M2 and 1/2 percent growth in M3? We can't be entirely certain we have all the answers, but certain elements of our evolving financial picture clearly have played a major role. The most important, perhaps, was that savers believed they could earn considerably more on their funds if they were invested in something other than the deposits and money market mutual funds that make up M2. The unprecedented steepness of the yield curve was one factor contributing to the apparent rate disadvantage of M2 assets. The high level of long-term yields relative to shorter-term rates--rates on deposits, in particular--has attracted funds from bank and thrift deposits into alternative, longer-term investments. For example, bond and stock mutual funds, which are not included in our standard monetary measures, flourished in 1992. Assets in those funds, excluding institutional holdings and IRA and Keogh accounts, increased \$125 billion. In the absence of such growth, a sizable proportion of the additional shares doubtless would have resided in

deposits. Shifts from deposits to mutual funds have been abetted by the spread of facilities in banks and thrifts to sell mutual funds directly to their customers.

In addition, the high relative cost of consumer debt, which has resulted partly from the elimination of the tax deductibility of consumer interest expenses, no doubt has prompted households to use funds that otherwise would be held in M2 to pay off, or avoid taking on, consumer debt. Mortgage interest rates also are high compared with interest rates on deposits, reflecting the steep yield curve. This relationship has led some households to repay mortgage debt with funds that might otherwise be held in deposits.

Of course, if banks and thrifts had been expanding their loan portfolios, they would have had to bid more vigorously for deposits. But a number of developments damped growth of bank and thrift credit, and depositories consequently have been prompt to reduce rates on deposits. In the business sector, the higher levels of stock and bond prices have encouraged many corporations to pay down bank debt with the proceeds of a large volume of bond and stock offerings. More generally, the attitudes of households and firms toward debt and leverage appear to have changed considerably in recent years, perhaps in part mirroring revised expectations about prospects for inflation to ease debt burdens or reward leverage.

The supplies of credit by depositories also have been constrained. Incentives to lend have been damped by market and regulatory pressures for depository institutions to increase capital ratios, as well as by other factors raising their costs of intermediating credit, such as higher deposit insurance premiums, rising regulatory costs, and more stringent supervisory oversight. As



a result, banking and thrift institutions have sought to limit balance-sheet growth or actually to shrink.

Together, these supply and demand factors have accelerated a long-standing process of rechanneling credit flows outside of depository institutions. With reduced needs to fund asset growth, banks and thrifts have bid less vigorously for deposits, as can be observed in the very low returns on such instruments. These low yields, as I have noted, provide incentives for depositors to redirect cash toward alternative investments and repayment of debt. In addition, the proceeds of banking firms' offerings of equity shares and subordinated debt have substituted for banks' deposit funding and have thus reduced monetary growth.

The adjustments in our depository sector have significant implications for the overall operation of the financial system and the performance of the economy. Historically, banking institutions have played a critical role in financing small and medium-sized businesses--firms that in the past have been a key source of growth in the economy. Some of the factors leading to the relative shrinkage of our banking industry, by limiting the availability of credit to smaller firms, have restrained aggregate demand and thus have significantly hindered the economic expansion.

Nevertheless, the financial markets have shown a remarkable capacity to adjust to the contraction of the depository sector in a way that mutes the impact on the overall economy. For instance, despite a massive contraction in the thrift industry since 1988, housing credit has remained readily available and, in fact, relatively inexpensive as a result of the further exploitation of financial innovations such as mortgage-related securities. Similarly, open market sources of funds have flourished in recent years, allowing many

firms to tap the stock or bond markets to restructure their balance sheets.

As a result of such adaptations, the relationship between money and the economy may be undergoing a significant transformation. In contrast to earlier work that suggested a stable long-run relationship between M2 growth and inflation, recent developments may indicate that the velocities of the broader monetary aggregates are moving toward higher trend levels. It may be that the opening of securities markets to increasing numbers of borrowers and lenders--in part through securitization of loans by depositories as well as their offerings of mutual funds to deposit customers--is permanently shunting financing around depository institutions. If this is true, the liabilities of these institutions will not be as good a gauge of financial conditions as they once were.

This is not to argue that money growth can be ignored in formulating monetary policy. The Federal Reserve in 1992 paid substantial attention to developments in the money supply, and we will continue to do so in 1993 and beyond. Selecting ranges for monetary growth over the coming year consistent with desired economic performance, however, is especially difficult when the relationship between money and income has become uncertain. Recent experience suggests that, at least for a time, measuring money against such ranges may lead to erroneous conclusions regarding the stance of monetary policy.

The shortfall of the aggregates from their ranges and suggestions that the Federal Reserve should have been more vigorous in preventing the shortfall have raised the general question of the role of the ranges in conducting monetary policy. The annual ranges for money and credit growth can be useful in communicating to the Congress

and the public the Federal Reserve's plans for monetary policy and their relationship to the country's broader economic objectives. Lowering the ranges during the 1980s, for instance, served as an important signal of the anti-inflationary commitment of the Federal Reserve.

In some circumstances, the monetary aggregates can also be of value by serving as indicators of the thrust of monetary policy. Deviations of money growth from expectations may well signal that policy is not having its intended effect, and that adjustments should be considered. Over much of our nation's financial history a number of measures of the money supply had reasonably predictable relationships with aggregate income. The period of rapid financial change had not yet begun, and measuring money was more straightforward. Recognition of these predictable money-income relationships was the basis for the Federal Reserve's increased emphasis on money in the 1970s and the subsequent Humphrey-Hawkins legislation. And at the beginning of the 1980s, the Congress passed the Monetary Control Act and the Federal Reserve adopted procedures to provide greater assurance that targets for M1 could be achieved.

But, even by the mid-1970s, the relationship of the monetary aggregates to the economy was becoming more complex. Financial innovation and deregulation significantly altered the spectrum of available transaction and saving instruments. In the mid-1970s, advances in corporate cash management techniques, such as sweep accounts, reduced the need for business demand deposit balances for any given level of transactions. And in the early 1980s, the widespread availability of NOW accounts--transactions accounts that pay interest--led households to treat their checking accounts to some degree as savings instruments and to shift funds in and out of such

accounts mainly on the basis of interest rate relationships. Such developments primarily affected M1. The FOMC made repeated adjustments to its M1 range to take account of changing velocity and soon after the mid-1980s had eliminated its target for this aggregate. Many of the shifts were captured within the broader aggregates, but adjustments to their ranges also had to be made from time to time.

In the last few years, the broader aggregates in turn have become much less reliable guides for the conduct of policy. Eventually, these measures may resume a more stable relationship with the economy, or experience may suggest useful new definitions for the aggregates. We are currently investigating several possible alternative measures. But, in the meanwhile, the FOMC necessarily has given less weight to monetary aggregates in the conduct of policy and has relied on a broad range of indicators of future financial and economic developments and price pressures. And, in particular, the FOMC judged in 1992 that more determined efforts to push the aggregates into their ranges would not have been consistent with achieving the nation's longer-term objective of maximum sustainable economic growth. Indeed, had there been an attempt to force M2 and M3 toward the middle of their ranges, intermediate- and long-term rates by now might have been significantly higher than they are currently, threatening the durability of the expansion.

This use of a broad range of indicators is appropriate because achievement of the ranges for growth of particular measures of money and credit is not, and should not be, the objective of monetary policy. Rather, the ranges are a means to an end. The Humphrey-Hawkins Act, incorporating this view, does not require that the ranges be attained in circumstances in which doing so would not be consistent with achieving the more fundamental economic objectives.

Ranges for Money and Credit for 1993

In establishing ranges for the monetary and credit aggregates in the current year, the FOMC took into account the likelihood that many of the factors that have acted in recent years to restrain money and credit growth relative to income would continue, though perhaps with somewhat diminishing intensity. The yield curve could well remain steep, absent very marked progress in deficit reduction or a distinct break in long-term inflation expectations, which would tend to lower long-term interest rates. Banking and thrift institutions are unlikely to step up the pace of balance-sheet expansion sharply, and the large volume of securities they have accumulated in recent years will allow them to fund a pickup in loan growth without as marked an acceleration of deposit growth. And households and firms are expected to continue to be relatively cautious in their use of credit. Other factors may add to tendencies for money to expand more slowly than income. For example, a resumption of resolutions by the Resolution Trust Corporation, which has been inactive for nearly a year, by shifting assets from thrifts onto government balance sheets, would tend to substitute federal liabilities for those of thrift institutions, reducing monetary growth.

Reflecting the expectation that sluggish monetary growth will be associated with sustainable expansion in the economy, the Federal Open Market Committee has elected to reduce the ranges for M2 and M3 for 1993 by one-half percentage point. For M2, a range of 2 to 6 percent, measured as usual on a fourth-quarter-to-fourth-quarter basis, was established. A range of 1/2 to 4-1/2 percent was specified for M3.

As I have indicated in correspondence with members of the Congress, the FOMC does not view the reductions in the monetary ranges

as signalling a change in the stance of monetary policy. And most emphatically, these reductions do not indicate a desire on the part of the Federal Reserve to thwart the expansion. The Federal Reserve, to the contrary, is endeavoring to conduct monetary policy in a way that promotes sustainable economic expansion. The lowering of these ranges does not imply any change in our fundamental objectives. The necessity for a reduction in the monetary ranges at this time is wholly technical in nature, and is a result of the forces that are altering the money-income relationship. Consistent with this view, the FOMC decided to maintain a range of 4-1/2 to 8-1/2 percent for domestic nonfinancial sector debt, an aggregate whose relationship with nominal GDP has been less distorted in the last few years than that of the monetary aggregates.

Significant uncertainties regarding the appropriate ranges for monetary growth remain. While we have made some progress in understanding the behavior of the money and credit aggregates over the past year, to a degree this increased understanding has reinforced our appreciation of the complexity--and limited predictability--of the economic and financial relationships that affect money growth and its linkages with the economy.

These uncertainties imply that the relationship between money and GDP growth could turn out significantly different from what currently seems likely. Accordingly, the Federal Reserve again will interpret the growth of money and credit relative to their ranges in the context of other indicators of the financial system, the performance of the economy, and prices. Should recent trends affecting the money-income relationship continue, growth of the monetary aggregates in the lower portions of their ranges might be expected. On the other hand, the upper ends of the ranges provide

ample room for adequate monetary growth should demands for money relative to income come more into line with historical patterns. In any event, until the relationship between the monetary aggregates and spending returns to a more reliable basis, flexibility in the interpretation of the aggregates relative to their new ranges is required.

Economic Outlook for 1993

Several of the forces affecting relationships between money and income also complicate the task of assessing the economic outlook itself. For example, the prospects for an easing of supply restrictions on credit from banks and other intermediaries are difficult to assess, but any major change in this situation could have important implications for the economy. While banking institutions have become much more healthy and are well-positioned to meet an increase in loan demand, very few signals of any easing of terms or standards on business loans have been apparent to date.

In addition, other factors that hobbled the economy in the last several years are likely to persist in 1993, though perhaps with diminished intensity. Households and business are likely to remain cautious in using credit--a healthy development for sustained growth, but potentially continuing to constrain spending in the short run. Sizable imbalances in commercial real estate remain, and a significant rebound in this sector is doubtless several years off. Government spending at the federal, state, and local levels is likely to remain constrained. A number of foreign nations are confronting slow economic growth or recession, which is likely to hold back demand for our exports. And it is apparent from recent announcements by several large firms that corporate restructuring, involving significant cutbacks in operations and employment, is continuing.

Another very considerable uncertainty in the economic outlook is fiscal policy. The Congress and the Administration are considering both short-run fiscal stimulus and steps to reduce the deficit in the long run. Obviously, government spending and taxes could be affected by such measures in such a way as to influence directly the overall economy this year, although the bulk of any effect likely would occur in succeeding years. In addition, depending on the timing, dimensions, and credibility of any fiscal measures, market interest rates and stock prices could be affected appreciably, with implications for private expenditures.

While uncertainties thus remain, the economy appears to have entered the year with noticeable momentum to spending. In addition, inventories are at relatively low levels, and factory orders have been rising. Consumer confidence has recovered, and spending on durables and homes appears to be moving at a brisker pace. Recent surveys suggest an appreciable increase in business investment this year.

Against this background, members of the Board and Federal Reserve Bank presidents project a further gain in economic activity in 1993. The central tendency of our projections is for real GDP to increase at a 3 to 3-1/4 percent rate this year. Such an increase should result in a decline in the unemployment rate, which would be expected to finish 1993 at a level of 6-3/4 to 7 percent. Inflation is expected to remain low this year.

Containing, and over time eliminating, inflation is a key element in a strategy to foster maximum sustainable long-run growth of the economy. As I have often emphasized, monetary policy, by achieving and maintaining price stability, can foster a stable economic and financial environment that is conducive to private economic planning, savings, investment, and economic growth. It is no



accident that the periods in our nation's history of low inflation were the times when the economy experienced high rates of private saving, investment, and hence productivity and economic growth. When inflation is low, endeavors to boost profit margins necessarily involve reductions in cost rather than increasing prices; thus, low rates of inflation tend to be associated with relatively high productivity growth. Conversely, periods of high and rising inflation here and abroad have been characterized by financial instability, an excessive amount of resources devoted to protecting financial wealth rather than production of goods and services, and substandard economic growth.

Over the past decade or so, our nation has made very substantial progress toward the achievement of price stability, reversing a dangerous upward trend of inflation and inflationary expectations. Last year's 3-1/4 percent increase in the core CPI was the lowest in twenty years and far lower than the debilitating double-digit rates at the close of the 1970s. As I have indicated to this Committee on numerous occasions, price stability does not require that measured inflation literally be zero, but rather is achieved when inflation is low enough that changes in the general price level are insignificant for economic and financial planning. At current inflation rates, we are thus quite close to attaining this goal.

Going forward, the strategy of monetary policy will be to provide sufficient liquidity to support the economic expansion while containing inflationary pressures. The existing slack implies that the economy can grow more rapidly than potential GDP for a time, permitting further reductions in the unemployment rate even while inflation is contained.

Implementing this strategy, however, will be challenging. Judging the level of potential output and its rate of growth is difficult. Recent increases in productivity have been unusually strong, given the moderate pace of economic growth during much of the expansion, and it is unclear whether these rates of productivity gain can be continued. In addition, the monetary aggregates do not appear to be giving reliable indications of economic developments and price pressures, and numerous other uncertainties cloud the particular features of the outlook. Monetary policy will have to adjust to unexpected developments as they occur, taking into account a variety of economic and financial indicators.

The contributions that monetary policy can make to maximum sustainable economic growth would be complemented by a fiscal policy focused on long-term deficit reduction. In the current environment, reducing the federal government's drain on scarce savings would take pressure off long-term interest rates, facilitating the readjustment of balance sheets and helping to promote capital formation and more robust economic growth over the longer term.

The Federal Reserve, in formulating monetary policy, certainly needs to take into account fiscal policy developments. Of course, it is not possible for the Federal Reserve to specify in advance what actions might be taken in the presence of particular fiscal policy strategies. Clearly, the course of interest rates and financial market conditions more generally will depend importantly on a host of forces--in addition to fiscal policy--affecting the economy and prices. And the effects of fiscal policy on the economy in turn will depend importantly on the credibility of long-run deficit reduction and the market reaction to any package. The lower long-term interest rates that resulted from a credible deficit-reduction plan

would themselves have an immediate positive effect on the economy. In any event, I can assure you of our shared goal for the American economy--the greatest possible increase in living standards for our citizens over time.

The last several years have been difficult, and the economy is still adjusting to structural imbalances that have built up over recent decades. The near-term outlook, as always, is somewhat uncertain. But I believe that in many respects the inevitable painful adjustments have laid the foundation for better performance of our economy over the longer term. Financial positions have been strengthened; inflation is low and should remain subdued; labor productivity is increasing; resources are being shifted from national defense to investment and consumption. Nevertheless, the challenges ahead for policymakers will be considerable. While continuing to be supportive of the expansion of our economy over coming quarters, the monetary and fiscal authorities alike need to structure our policies to enable our economy to reach its full potential over time.

Supplemental statement of Alan Greenspan, Chairman of the Federal Reserve Board:

The President is to be commended for placing on the table for active debate the issue of our burgeoning structural budget deficit, which will increasingly threaten the stability of our economic system if we continue to fail to address it. Leaving aside the specific details, it is a serious proposal, its baseline economic assumptions are plausible, and it is a detailed program-by-program set of recommendations as distinct from general goals.

It is obviously very difficult to get a consensus on deficit cutting. If it were easy it would have been done long ago. The debate among the nation's elected representatives will be profoundly political, in the best sense of the word. As the nation's central bankers, our primary and professional concern is having the structural deficit sharply reduced and soon.

Time is no longer on our side. After declining through 1996, the current services deficit starts on an inexorable upward path again. The deficit and the mounting federal debt as a percent of gross domestic product are corrosive forces slowly undermining the vitality of our free market system.

If we fail to resolve our structural deficit at this time, the next opportunity will doubtless confront us with still more difficult choices. How the deficit is reduced is very important, that it be done, is crucial.

In this regard, there are certain issues that I have discussed with this and other committees of the Congress over the

- 2 -

years, which are worth repeating.

First, with current services outlays from 1997 and beyond rising faster than the tax base, stabilizing the deficit as a percent of nominal gross domestic product, not to mention a reduction, would require ever increasing tax rates. Hence, there is no alternative to achieving much slower growth of outlays. This implies not only the need to make cuts now, but to control future spending impulses. I trust the President's endeavor to reign in medical costs will contribute importantly to this goal.

Second, the hope that we can possibly inflate or grow our way out of the structural deficit is fanciful. Certainly greater inflation is not the answer; aside from its serious debilitating effects on our economic system, higher inflation, given the explicit and implicit indexing of receipts and expenditures, would not reduce the deficit. As I indicated in testimony last month to the Joint Economic Committee, there is a possibility that productivity growth may be moving into a faster long-term channel, boosting real growth over time. But even if that turns out to be the case, it wouldn't by itself resolve the basic long-term imbalance in our budgetary accounts.

Finally, fear that the deficit reduction can be overdone and create a degree of "fiscal drag" that would significantly harm the economy, I find misplaced. In our current political environment, to presume that the Congress and the President would jointly cut too much from the deficit too soon is in the words of my predecessor "nothing I would lose sleep over."

The Federal Reserve recognizes that it has an important role to play in this regard. In formulating monetary policy, we certainly need to take into account fiscal policy developments. But it is not possible for the Federal Reserve to specify in advance what actions might be taken in the presence of particular fiscal policy strategies. Clearly, the course of interest rates and financial market conditions more generally will depend , importantly on a host of forces--in addition to fiscal policy--affecting the economy and prices. In any event, I can assure you of our shared goal for the American economy--the greatest possible increase in living standards for our citizens over time.

February 19, 1993

**For use at 9:45 a.m., E.S.T.  
Friday  
February 19, 1993**

Board of Governors of the Federal Reserve System



---

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

---

February 19, 1993

---

## Letter of Transmittal

---

BOARD OF GOVERNORS OF THE  
FEDERAL RESERVE SYSTEM  
Washington, D.C., February 19, 1993

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,

A handwritten signature in black ink, appearing to read "Alan Greenspan", written in a cursive style.

Alan Greenspan, Chairman



**Table of Contents**

	<i>Page</i>
<b>Section 1:</b> Monetary Policy and the Economic Outlook for 1993	1
<b>Section 2:</b> The Performance of the Economy in 1992	6
<b>Section 3:</b> Monetary and Financial Developments in 1992	19

## Section 1: Monetary Policy and the Economic Outlook for 1993

Last July, when the Federal Reserve Board presented its semiannual monetary policy report to the Congress, there was considerable uncertainty about the prospects for the economy in the second half of 1992. After a promising start at the beginning of the year, growth of the economy had slowed once again in the spring, and various structural adjustments that had been impeding the pace of the expansion retained considerable force. However, with drag from the structural adjustments expected to diminish gradually over time and with the economy continuing to benefit from the substantial easing of money market conditions that the System had implemented over the years, the most likely prospect for the economy was thought to be one of moderate growth in the second half of the year.

In the event, economic growth did indeed proceed at an improved pace in the second half of 1992, although the pickup did not start to become evident in the incoming economic data until well into the autumn. Fueled by strong increases in household and business spending, real gross domestic product rose at an annual rate of 3.6 percent in the second half of the year. The increase over the four quarters of the year amounted to 2.9 percent. This was the largest gain in output since 1988, and, while far from robust by the standards of past cyclical upswings in activity, it was a much stronger performance than many analysts—inside and outside of government—had thought likely, given the extraordinary headwinds with which the economy had to contend. Indeed, the performance of the U.S. economy stands in sharp contrast to that of a number of major foreign industrial economies that appear still to be laboring to regain forward momentum.

Employment has grown since the middle of last year, but at only a gradual pace. Hiring has been damped by the ability of firms to meet their output objectives through hefty increases in productivity. The unemployment rate, which had risen in the first half of 1992 in conjunction with a surge in the share of the working-age population in the labor force, turned down thereafter as labor force participation fell back. The unemployment rate in January of this year was 7.1 percent, more than half a percentage point below the peak rate of last summer.

Price developments remained favorable in the second half of 1992, and the rise in the consumer price index over the four quarters of the year amounted to

3 percent, matching the low rate achieved in the previous year. Consumer energy prices turned back up in 1992, but the prices of other goods and services that enter into the CPI generally rose less rapidly than they had in 1991. Although the CPI spurted  $\frac{1}{2}$  percent this past month, the underlying trends in labor costs and prices remain encouraging. The success to date in keeping inflation in check, while restoring growth, has had highly salutary effects on financial markets and on the process of financial reconstruction, the continuing progress of which is essential to the achievement of renewed and sustainable prosperity.

The hesitant pace of the economy evident in incoming information throughout much of last year, along with notable weakness in the monetary and credit aggregates and steady gains against inflation, prompted the Federal Reserve to ease monetary conditions three times, bringing short-term rates down by another full percentage point over the year. The discount rate was reduced to three percent and short-term rates generally are now at their lowest levels since the early 1960s.

Long-term rates also fell, on balance. Declines were limited at times, however, by concerns about prospective federal budget deficits and about the possibility that inflation might begin to move higher as the expansion proceeded. Notable decreases in long rates were registered in late 1992 and early 1993, as inflation remained subdued and as statements by Administration officials suggested that they would seek only limited near-term fiscal stimulus and that proposals to make substantial cuts in the federal budget deficit over time were under serious consideration. The trade-weighted foreign exchange value of the dollar in terms of the other Group-of-Ten currencies appreciated on balance over the course of 1992 and rose further during the first weeks of 1993. The dollar benefited from the improved performance of the U.S. economy relative to conditions in other industrial countries.

Growth of the monetary aggregates slowed last year despite an acceleration in nominal spending and income. For the year, M2 advanced 1.9 percent, below the  $2\frac{1}{2}$  percent lower end of its target range. M3 also came in under its 1 to 5 percent target range, growing only .5 percent. The Federal Reserve did not make greater efforts to boost growth to within these ranges

because, as the year went on, it became increasingly clear that slow growth of the broad money aggregates did not indicate that financial market conditions were impeding the expansion of spending and income. In fact, growth of nominal GDP exceeded that of M2 by  $3\frac{1}{2}$  percentage points last year and that of M3 by  $4\frac{3}{4}$  percentage points. Not only did data on spending itself show a firming trend over the year, but narrow money (M1) and reserves were expanding rapidly—suggesting to some that liquidity was quite ample—and the growth of debt, while restrained, was considerably in excess of that of the broader monetary aggregates.

Nominal GDP growth last year, which picked up to 5.4 percent from 3.5 percent in 1991, was fueled by spending that was financed largely outside of banks and other depositories, whose liabilities constitute the lion's share of the monetary aggregates. Spurred in part by advances in equity prices and by declines in longer-term interest rates, businesses and households strengthened their balance sheets by raising funds in bond, mortgage, and equity markets, and repaying bank loans and other short-term debt. This shift in the focus of financing efforts toward the capital markets, a process which has been in progress for the last couple of years, has helped to redress financial distortions that accompanied the buildup of debt and the rapid rise in some asset prices in the 1980s.

The low level of credit demanded from depositories has meant that these institutions have not needed to seek large volumes of deposits. As a consequence, rates paid on deposits have been adjusted downward rapidly as short-term market rates have declined. Savers, reacting to the lower deposit rates and to attractive returns on bonds and equity, have shifted funds from M2 deposits into the capital markets. One method savers have used to capture these higher capital market yields has been through purchases of bond and stock mutual funds, which are not included in the monetary aggregates, and which together experienced record inflows in 1992. Moreover, consumer loan rates have fallen by less than deposit rates, and households appear to be using M2 assets to repay consumer debt or restrain its growth. The combination of rate incentives, desires to strengthen balance sheets, and the greater availability at low transaction cost of a broadened array of savings vehicles beyond traditional deposits appear to have distorted, at least for a time, the traditional relationship between levels of M2 and M3 assets and given levels of spending.

Although growth of M2 and M3 was very weak last year, M1 accelerated to 14.3 percent, the second fast-

est annual increase recorded in the official series, which begins in 1959. In part, this pickup owed to the expansion of spending, but it mainly reflected the tendency for rates on liquid deposits to adjust downward less rapidly than those on time deposits. In response, savers shifted substantial volumes of funds from maturing time deposits to NOW accounts. In addition, businesses boosted their demand deposits substantially. To support this growth in transactions deposits, the Federal Reserve added substantial volumes of reserves in 1992. Total reserves increased 20 percent last year, and the monetary base, which includes currency outstanding as well as reserves, increased 10.5 percent, the highest rate ever registered in the official series.

Decisions to strengthen balance sheets had a smaller but significant effect on debt growth. The debt of nonfinancial sectors is estimated to have expanded 4.6 percent, only slightly faster than in 1991 and just above the lower end of its monitoring range. With debt growing less rapidly than income and with declines in market interest rates allowing higher cost debt to be rolled over at lower rates, households and businesses made substantial further progress in reducing debt service burdens.

### Monetary Objectives for 1993

The aim of the Federal Open Market Committee in 1993 is to promote financial conditions that will help to maintain the greater momentum that the economy developed in 1992 and to consolidate the trend toward lower inflation. The objectives for the monetary aggregates in 1993 were set with that aim in mind.

At its July 1992 meeting, the Committee had provisionally chosen the same ranges for 1993 as it was confirming for 1992— $2\frac{1}{2}$  to  $6\frac{1}{2}$  percent for M2 and 1 to 5 percent for M3, with a monitoring range for the nonfinancial debt aggregate of  $4\frac{1}{2}$  to  $8\frac{1}{2}$  percent. At that time, the Committee noted that the extent and duration of deviations of money growth from historical relationships remained highly uncertain and that the actual setting, in February, of 1993 ranges consistent with the basic policy objectives would need to be made in light of additional experience and analysis.

At its February meeting, in reviewing the ranges provisionally chosen for 1993, the Committee noted that nominal spending had accelerated considerably in 1992 despite the quite sluggish growth of M2 and M3 throughout the year. The Committee viewed this development as underscoring the importance that

### Ranges for Growth of Monetary and Credit Aggregates

	1991	1992	1993
<i>Percentage change, fourth quarter to fourth quarter</i>			
<b>M2</b>	2½ to 6½	2½ to 6½	2 to 6
<b>M3</b>	1 to 5	1 to 5	½ to 4½
<b>Debt</b>	4½ to 8½	4½ to 8½	4½ to 8½

special, and historically anomalous, forces have had in restraining the growth of broad money relative to spending. While the intensity of some of these forces might diminish in 1993, as borrowers and lenders achieve more comfortable balance sheet positions, they are unlikely to end. For example, the substantial volume of liquid securities on banks' balance sheets suggested that they will not become vigorous bidders for deposits in 1993 even if, as expected, lending picks up. In addition, the yield curve, although it had begun to flatten a bit early in the new year, is likely to continue to provide savers an incentive to shift funds out of monetary assets and into capital markets—a process facilitated by the growing availability of mutual funds at banks and thrifts.

Given that these forces, and others, tending to channel funds around depository institutions and hence to raise velocity—the ratio of nominal GDP to money—seem likely to persist in 1993, a downward adjustment to the money ranges is appropriate to take account of the expected atypical behavior of velocity: Lower money growth than normally expected would be sufficient to support substantial growth in income. With this in mind, the Committee made a technical downward adjustment in the target growth ranges for M2 and M3, reducing the upper and lower ends of each range by ½ percentage point.

The strength of the influences depressing money growth relative to income remains somewhat uncertain, however. If they persist in 1993 to the same extent as in 1992, growth of M2 and M3 in the lower portions of their reduced target ranges would be consistent with substantial further growth of nominal spending. Alternatively, the upper ends of the target ranges would accommodate ample provision of liquidity to support further economic expansion even if the growth of money and income were to begin coming into more normal alignment, and the recent

high rate of increase in velocity were to slow. The Committee will continue to examine money growth as the year unfolds for evidence on developing economic and financial conditions. As in the past, the Federal Reserve will be guided also by a careful assessment of a wide variety of other financial and economic indicators. The Committee's primary concern, as in 1992, will remain that of fostering financial conditions conducive to sustained economic expansion and a noninflationary environment.

For debt growth, which has been less damped by special forces than has the expansion of the broader monetary aggregates, last year's range was retained for 1993. Federal debt growth again is likely to be substantial. Growth of the debt of nonfederal sectors is expected to accelerate somewhat as borrowers' balance sheets continue to improve, as intermediaries become more willing to lend, and as the economy expands. Nevertheless, the growth of nonfederal debt is expected to remain below that of nominal GDP, a development the Committee sees as contributing to building the sound financial foundation crucial to a sustained economic expansion.

#### Economic Projections for 1993

Although the economy and the financial markets continue to face difficult adjustments, the governors and Bank presidents think that the most likely prospect for 1993 is that economic growth will proceed at a moderate pace. The growth of output probably will be supported by further gains in productivity, the ultimate source of increased real income and improved living standards over the long run. In addition, increases in employment are expected to be large enough to bring further gradual declines in the unemployment rate over the course of 1993. Inflation is expected to remain subdued, boding well for sustained expansion in 1993 and beyond.

## Economic Projections for 1993

Measure	Memo: 1992 Actual	FOMC Members and Other FRB Presidents	
		Range	Central Tendency
<i>Percentage change, fourth quarter to fourth quarter</i>			
<b>Nominal GDP</b>	5.4	5¼ to 6¼	5½ to 6
<b>Real GDP</b>	2.9	2½ to 4	3 to 3¼
<b>Consumer price index<sup>1</sup></b>	3.1	2½ to 3	2½ to 2¾
<i>Average level in the fourth quarter, percent<sup>2</sup></i>			
<b>Unemployment rate</b>	7.3	6½ to 7	6¾ to 7

1. CPI for all urban consumers.

2. Percentage of the civilian labor force.

The governors' and Bank presidents' forecasts of real GDP growth over the four quarters of 1993 span a range of 2½ percent to 4 percent, with the central tendency of the forecasts in a range of 3 to 3¼ percent. In considering the possible outcomes for 1993, the governors and Bank presidents cited the degree of momentum that appears to have developed in the economy in the latter part of 1992 and early 1993. The various balance sheet problems that apparently retarded growth of the economy during the early phases of the current expansion, while by no means fully resolved, seem to be receding. In addition, sectors such as residential construction, business investment, and consumer durables clearly are benefiting from the declines that have occurred in interest rates.

However, impediments to more rapid expansion still are present. Government spending for defense appears likely to continue to decline for some time to come. More broadly, balance sheet repair and business restructuring, which have exerted major restraint on economic activity in recent years, still are in process, despite the apparent improvement in business finances in 1992. Indeed, the new year has brought additional announcements of business restructurings in a variety of industries, both defense-related and other. These changes are leading to an economy that is more productive and competitive, but at the cost of some dislocation and disruption in the short run. The magnitude of structural changes like these is a special uncertainty in the economic outlook for the remainder of the year. With regard to the external sector, many foreign industrial countries are experi-

encing prolonged economic weakness. Under the circumstances, the growth of U.S. exports, while remaining positive, may well fall short of the growth of imports again in 1993, exerting a drag on real GDP in contrast with the substantial impetus in the period up to early 1991.

Despite the job cutbacks at some large companies, other firms, especially smaller ones, are adding to payrolls, albeit cautiously, and total employment has been rising modestly. The governors and Bank presidents expect this pattern to persist, with net gains in employment during 1993 likely to be sufficient to bring the unemployment rate down somewhat further over the course of the year. The central tendency of the unemployment rate forecasts for the fourth quarter of 1993 extends from 6¾ percent to 7 percent; the remaining forecasts of the System officials range down to about 6½ percent.

The governors' and Bank presidents' forecasts of the rise in the consumer price index over the four quarters of 1993 extend from a low of 2½ percent to a high of 3 percent. Within that range, a large majority of the forecasts are clustered in the span of 2½ to 2¾ percent. The considerable progress that has been made in bringing down inflation during the past decade is providing one of the essential underpinnings for the sustained growth of real living standards over the long run.

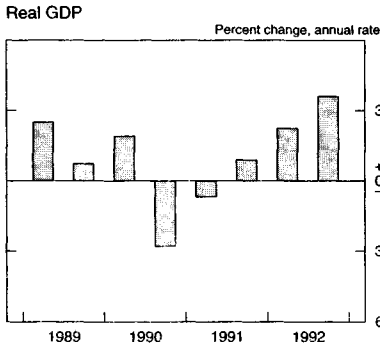
However, achieving a satisfactory economic performance in 1993—and in the years thereafter—will depend on initiatives in many types of policy other

than monetary policy. In coming months, Congress and the new Administration will be grappling with a host of issues, including those related to fiscal policy, regulatory policy and foreign trade policy. Far-sighted approaches are needed in all those areas, if the economy is to perform at its full potential over the long haul. In framing regulatory policy and foreign trade policy, Congress and the Administration will need to keep an eye on potential costs and rigidities that could

sap the vigor of a market economy. With regard to fiscal policy, credible action to reduce the prospective size of future federal budget deficits could yield a very direct and meaningful payoff in the form of lower long-term interest rates than otherwise would prevail. Such action would encourage capital investment and would go far toward relieving anxieties that many of the nation's citizens still have about longer-run economic prospects.

## Section 2: The Performance of the Economy in 1992

The economy began to exhibit renewed firmness in 1992, overcoming a host of impediments that have been working to retard the growth of activity. With the strengthening of growth in the second half, to a 3.6 percent rate, the rise in real GDP over the year cumulated to 2.9 percent, the strongest gain since 1988. Employment also picked up in 1992, but rather slowly; the unemployment rate continued to move up in the first half of the year, but thereafter followed a course of gradual decline. Inflation continued to trend lower in 1992, with most broad price indexes showing increases that were among the smallest since the mid-1960s.



The growth of household and business expenditures picked up appreciably in 1992. Households, for their part, began to spend more freely on motor vehicles and other goods, and their purchases of homes also strengthened, spurring additional gains in residential construction. Businesses began investing more heavily in new equipment; much of that gain went for computers and other electronic equipment embodying new technologies. Business outlays for nonresidential construction declined, on net, over the year, but by a much smaller amount than in 1991. In total, the final purchases of households and businesses rose about 4¼ percent in real terms in 1992, after declining in each of the two previous years; the 1992 gain matched that of 1988 and otherwise was the largest in eight years. By contrast, governments at all levels continued to be burdened by huge budget deficits in 1992, and, for a second year, their combined purchases of

goods and services changed little in real terms. In addition, export growth was slowed by weakness of activity in several foreign industrial economies; despite improvement in the second half, the rise in real exports of goods and services over the year, 3½ percent, was only about half as large as the annual gains in 1990 and 1991. Meanwhile, the faster growth of domestic spending pushed up the growth in imports of goods and services to 9¼ percent in 1992.

Further progress was made in reducing inflation last year. The consumer price index excluding food and energy—a measure widely used in gauging the underlying trend of inflation—increased about 3½ percent over the four quarters of 1992; this was a full percentage point less than the increase during 1991. The total CPI rose about 3 percent over the four quarters of 1992, the same as in the previous year; energy prices, which had fallen sharply in 1991, turned up slightly this past year, while increases in food prices were quite small for the second year in a row. Except for 1986, when the CPI was pulled down by a collapse of world oil prices, the increases of the past two years are the smallest in a quarter century.

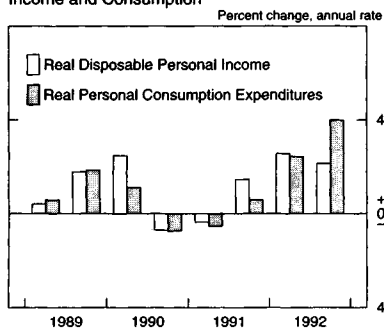
### The Household Sector

The financial condition of households improved in 1992. Income growth picked up a little in the aggregate, the strains on household balance sheets eased a bit, and the spirits of consumers brightened markedly toward year-end. Growth in consumer spending followed a stop-and-go pattern through mid-summer, but the gains thereafter were steadier and fairly sizable overall. Spending for residential investment also advanced over the year, by a considerable amount in total.

The aggregate wealth of households appears to have increased further during 1992. With stock prices increasing, the value of households' financial assets rose moderately, and the value of residential real estate also moved up, on average. On the liability side, households remained cautious in taking on new debt in 1992, and the burden of carrying debt continued to ease, owing both to slow growth in the volume of debt outstanding and to the further reductions in interest rates, which facilitated the ongoing substitution of new, lower-cost debt for old, higher-cost obligations. The incidence of households experiencing loan repayment difficulties diminished over the year.

Income growth picked up moderately in 1992. Wages and salaries rose about 4¼ percent in nominal terms, after a gain of only 2¼ percent in 1991. In addition, proprietors' incomes benefited from the strengthening of economic activity, and, with corporate profits on the rise, the dividends paid to shareholders more than reversed their decline of the previous year. Transfer payments, which had soared as the economy softened in 1990 and 1991, continued to grow rapidly in 1992. By contrast, interest income trended sharply lower, as the rates of return on household deposits and other financial assets fell further. Total after-tax income got a temporary boost in 1992 from an adjustment of federal tax withholdings that took effect at the start of March. With inflation low, real disposable personal income increased nearly 2½ percent over the year—not a large gain by past cyclical standards, but nonetheless the biggest since 1988.

#### Income and Consumption



Real personal consumption expenditures rose about 3¼ percent over the four quarters of 1992, after essentially no gain over the two previous years. For a considerable part of 1992, the increases in spending were interspersed with stretches of sluggishness. A surge in consumer expenditures early in the year was followed by listlessness during the spring, and a second jump in spending around mid-year was followed by still another bout of slow growth during the summer. However, the last few months of the year brought fairly sizable advances, boosting the growth of consumption expenditures to a rate of more than 4 percent in the fourth quarter.

Consumer expenditures for motor vehicles increased about 9 percent over the four quarters of 1992. More than half of that gain came in the fourth

quarter, when sales of new vehicles were boosted by special promotional incentives and, apparently, by a growing perception among consumers that better economic conditions lay ahead. At the start of 1993, after some of the more highly-publicized promotional programs had ended, sales of cars and light trucks fell sharply for a brief time, but they since appear to have regained strength. More than likely, some fundamental support for sales is coming from the replacement needs of persons who had put off buying new vehicles during the recession and the early phases of the recovery.

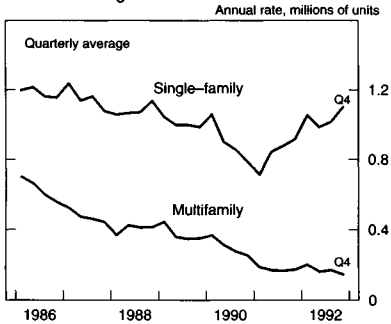
Spending picked up during the second half of 1992 for many items other than motor vehicles, with notable gains in categories in which an element of discretion typically enters into households' purchasing decisions. Real outlays for furniture and household equipment rose at an annual rate of nearly 15 percent in the second half of 1992, and real expenditures for apparel climbed at nearly a 10 percent rate. In total, spending for consumer durables other than motor vehicles grew about 9 percent in real terms over the four quarters of 1992, after declining in each of the two previous years. Real outlays for nondurables, which also had fallen in both 1990 and 1991, rose almost 3 percent in the latest year. Real expenditures for services increased about 2 percent during 1992, slightly faster than in other recent years.

The personal saving rate—the share of disposable income not used for consumption or other outlays—rose moderately in the first half of the year, when concerns of households about the prospects for the economy apparently led them to adopt more cautious attitudes toward spending. The rate then turned down in the second half of the year, as consumers began to spend more freely. The fourth-quarter rate was slightly below the average for 1992, but it was well within the range of quarterly observations seen over the past several years.

Real outlays for residential investment rose 15 percent during 1992, climbing to a fourth-quarter level nearly 25 percent above their recession low of early 1991. Most of the 1992 rise in residential investment came in the form of increased construction of single-family housing units, which benefited from the further net reduction in mortgage interest rates over the course of the year. Outlays for home improvements, which make up about one-fifth of total residential investment, also increased in 1992, after declining in each of the three previous years; repair of the damage caused by Hurricane Andrew accounted for part of that gain. By contrast, multifamily housing remained depressed; high vacancy rates and unfavorable demo-



### Private Housing Starts



graphic trends continued to be big obstacles to new construction activity in that portion of the market.

As with consumer spending, the gains in single-family housing activity tended to come in intermittent bursts through much of 1992. Sales of new homes surged early in the year, weakened in the spring, surged again during the summer, and then fell back just a touch in the fourth quarter; on net, the increase over the year amounted to 12 percent. Mortgage interest rates, while lower than in 1991, exhibited some mild swings during 1992, and these swings appear to have contributed to the fluctuations in home sales. In addition, proposals early in the year for a tax credit for first-time homebuyers may have affected the timing of purchases to some degree.

Construction activity in the single-family sector also had its ups and downs in 1992, influenced by unusual weather patterns as well as by the fluctuations in sales. Nonetheless, the trend over the year as a whole was decidedly upward, and the average level of starts in the fourth quarter was about 20 percent above that of a year earlier. In January, single-family starts fell back somewhat; volatility in the monthly data on starts is not unusual at this time of year, however.

Despite the large gains seen in 1992, starts in the single-family sector have retraced only part of the decline that took place in the late 1980s and early 1990s. Strong impetus for recovery has come from declines in mortgage interest rates, which have been considerably lower this past year than they were in 1986, when single-family starts were at their most recent annual peak. However, a number of other developments have continued to retard the recovery of housing activity. Uncertainties about job prospects

no doubt have deterred some buyers from taking advantage of the lower rates on home mortgages. More broadly, recent demographic trends have been less favorable to growth in the demand for single-family housing than were the trends of the mid-1980s. The declines in house prices that have occurred in a number of regions in recent years—and the more general lack of any real price appreciation to speak of—also may have affected demand to some extent; certainly, housing is no longer viewed by potential buyers as the sure-fire, high-yield investment that it was once thought to be.

Builders, for their part, have remained a little cautious, as have the lenders who finance new construction. In many cases, houses are being started only when a buyer actually is lined up; eagerness to build in anticipation of future sales is not widely apparent.

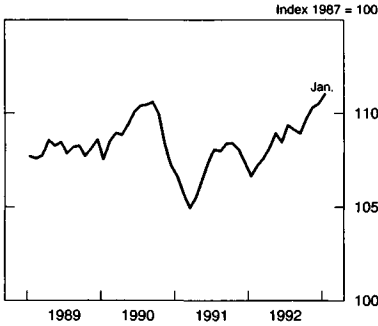
In the multifamily sector, the number of units started in 1992 was about 75 percent below the peak rates of the mid-1980s; the sector accounted for only 6 percent of total residential investment this past year. The overbuilding that occurred in the multifamily sector in the mid-1980s led to high vacancy rates that have stymied activity ever since. In that regard, little progress was made in reducing vacancy rates for multifamily rental units in 1992, despite the greatly diminished level of new construction. The speed at which the excess supply of space can be worked off is being limited by declines in the population of young adults, as well as by the slow rate of depreciation of these long-lived structures.

### The Business Sector

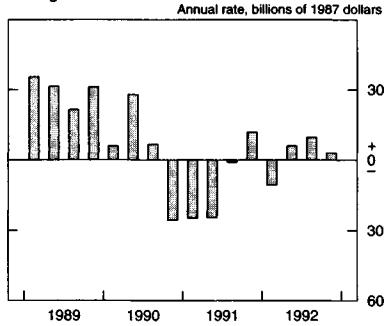
The past year brought moderate increases in activity in the business sector of the economy. Production, sales, and orders rose, on net, over the year, and business profits continued to swing back up from the recession lows of 1991. Many businesses continued to undertake major structural changes designed to cut costs and enhance efficiency. Those changes were manifest both through reorganization of existing operations and through investment in new technologies. Businesses also continued to shore up their finances, trimming away debt and building equity. Financial pressures persisted in the business sector in 1992, but, in general, they seemed to become less acute as the year progressed.

Industrial output rose nearly 3 percent from December of 1991 to December of 1992. Production fell in the first month of 1992, but then picked up, rising about 1/2 percent per month from February through

Industrial Production



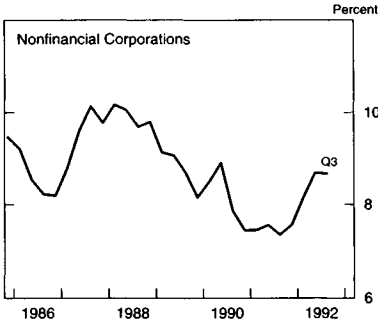
Changes in Real Nonfarm Business Inventories



May. During the summer, the expansion of activity seemed to be losing momentum; orders and shipments fell slightly, on net, from May to August, factory inventories backed up a little, and industrial production essentially flattened out over a four-month stretch. However, orders and shipments began moving up once again in September, and they increased considerably in the fourth quarter. Industrial production also picked up once again in the fourth quarter, and a further gain, amounting to 0.4 percent, was recorded in January of this year.

Business profits, which had taken a turn for the better late in 1991, improved further during 1992. The operating profits earned by nonfinancial corporations from their domestic operations rose 18 percent from the final quarter of 1991 to the third quarter of 1992,

Before-tax Profit Share of Gross Domestic Product\*

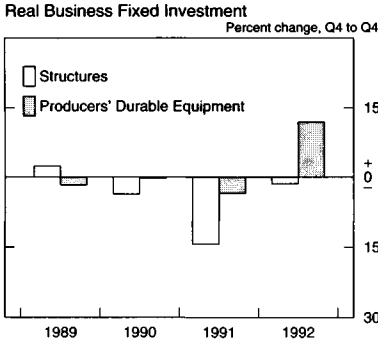


\*Profits from domestic operations with inventory valuation and capital consumption adjustments divided by gross domestic product of nonfinancial corporate sector.

and a further gain seems implicit in the available data for the fourth quarter. (An actual estimate of fourth-quarter profits will not be published by the Commerce Department until late March.) Profits of these firms have been lifted, in part, by increases in the volume of output since the end of the recession. In addition, tight control over costs has led to increases in profits per unit of output. Unit labor costs of nonfinancial corporations have risen only slightly since the start of the current economic expansion, and their net interest costs have declined sharply, owing to lower interest rates and restraint in the use of debt. The domestic profits of financial corporations were strong in the first half of 1992, but were severely depressed in the third quarter by the unprecedented losses that insurance companies suffered in the wake of Hurricane Andrew; in the absence of the hurricane, profits in the financial sector would have increased in the third quarter.

The economic condition of smaller companies also seemed to improve somewhat in 1992. The past year's estimated rise in the profits of nonfarm proprietors was the largest annual gain since the mid-1980s; increases had been relatively small over the three previous years.

The net income of farm proprietors turned back up in 1992, after a moderate decline in 1991. Farm output rose to a record high in 1992, with strong gains for both crops and livestock. Prices, meanwhile, lagged year-earlier levels through much of 1992, but most of that slippage in farm prices already had taken place by the start of the year; the average level of farm prices in December of 1992 actually was about the same as that of a year earlier. Farm production expenses edged down for a second year, as farm



operators, like their nonfarm counterparts, continued to maintain tight control over costs.

Business investment in fixed capital rose about 8 percent in real terms during 1992, more than reversing the decline of the previous year. Spending for equipment increased in each quarter of 1992, and the gains cumulated to nearly 12 percent by the fourth quarter; with spare capacity still extensive in most industries in 1992, much of the gain in equipment spending over the year probably was a result of the desire of businesses to modernize their operations. Meanwhile, nonresidential construction spending, which had plunged 14 percent in 1991, fell by a much smaller amount in 1992—1½ percent according to the estimate in the most recent GDP report.

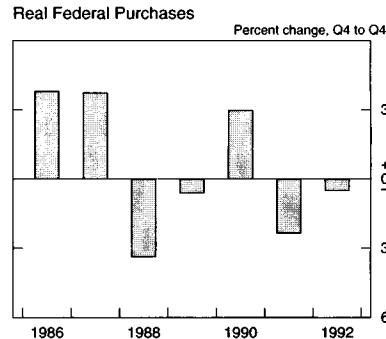
Spending for computers was at the forefront of the rise in equipment outlays in 1992. In terms of annual averages, the nominal outlays for office and computing equipment rose about 17 percent; the gains in real terms were much greater still, as technological advances and competitive market conditions combined to continue driving down the price of real, effective computing power. Businesses also boosted their outlays for telecommunications equipment, especially in the second half of 1992. Spending for motor vehicles strengthened in 1992, and investment in industrial equipment edged up after three years of decline. Spending for aircraft traced out a volatile pattern during 1992 and, for the year as a whole, was down only moderately from the high level of 1991; however, these outlays closed out the year on a weak note, and prospects for 1993 are not encouraging, given the losses that have been experienced by airline companies and the related cancellations and stretch-outs of orders.

The small decline in nonresidential construction outlays during 1992 reflected some widely divergent trends across the various types of construction activity. Spending for new office buildings fell sharply further during the year, to a fourth-quarter level that was about 60 percent below the peak of the mid-1980s. In addition, the real outlays for industrial structures declined in 1992 for the second year in a row, influenced, no doubt, by the current high levels of unused industrial capacity and by the ongoing trend toward tighter control of inventories and concomitant reductions in needed storage space. Annual outlays for oil and gas drilling also fell further in 1992; a rise in drilling in the year's final quarter probably was prompted mainly by a year-end phase-out of certain tax incentives, although some drillers may also have been responding to an upturn in natural gas prices over the year.

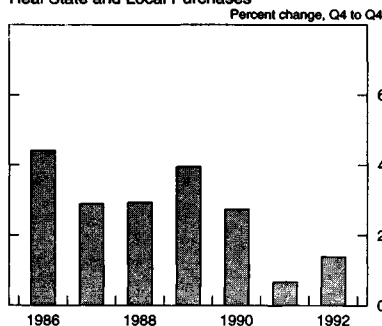
Other types of construction activity fared better in 1992. Spending for commercial structures other than office buildings moved up over the year, after sharp declines in both 1990 and 1991, and the outlays of utilities rose appreciably, boosted by environmental requirements as well as by further moderate additions to capacity. Increases in construction spending also were reported for various types of institutional structures, such as religious facilities and hospitals.

### The Government Sector

Government purchases of goods and services, the portion of government spending that is included in GDP, increased slightly in real terms over the course of 1992, after declining slightly during 1991. Federal purchases fell ½ percent in real terms over the



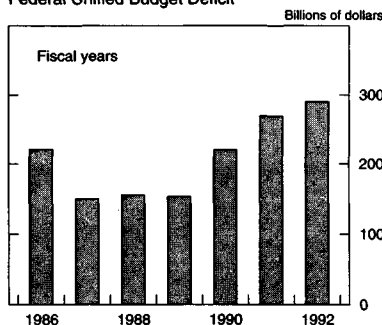
## Real State and Local Purchases



year, as a further decline in real defense purchases more than offset another year of increase in real non-defense purchases. State and local purchases of goods and services increased about 1½ percent during 1992, a slightly larger rise than in 1991, but still well below the rates of increase seen through much of the 1980s.

Governments at all levels continued to be plagued by severe budgetary imbalances in 1992. At the federal level, the unified budget deficit rose about \$20 billion in fiscal year 1992, to a level of \$290 billion. With the economy gradually strengthening, the rate of increase in federal receipts picked up a little, to 3½ percent, from only 2¼ percent in fiscal 1991. However, spending once again rose faster than receipts; total federal outlays were up 4½ percent in fiscal 1992, after a rise of nearly 5¼ percent in the previous fiscal year.

## Federal Unified Budget Deficit



The rates of growth in total spending in 1991 and 1992 may well understate the degree of upward momentum in federal outlays in those years. In 1991, total spending was held down considerably by a convention used in the federal budget to account for the flow of contributions to the United States from its allies in the Gulf War. Those contributions were counted as negative defense outlays, rather than as additions to receipts. Additional contributions from the allied countries were received in fiscal year 1992, but were much smaller than those of 1991. Another important factor at work in 1992, however, was a delay in funding the activities of the Resolution Trust Corporation (RTC), which kept the 1992 outlays for deposit insurance programs much lower than they otherwise would have been.

Excluding the outlays for deposit insurance and the effect of the allied contributions on reported levels of defense spending, federal expenditures rose about 6½ percent in nominal terms in fiscal year 1992, after an increase of nearly 9 percent in fiscal year 1991. Spending for entitlements, especially those related to health care and income support, continued to grow very rapidly in 1992. In the health area, federal outlays for Medicaid increased nearly 30 percent, and spending for Medicare rose 14 percent. Spending for income security was boosted in 1992 by further large increases in unemployment benefits and food stamp disbursements. In dollar terms, the combined rise in outlays for health care and income security amounted to about \$60 billion. Increased expenditures for social security added almost another \$20 billion.

Combined spending for all other programs rose only slightly in fiscal year 1992. Within that broad and diverse grouping, defense outlays fell sharply in nominal terms, once adjustment is made for the allied contributions, but some nondefense functions posted large increases in outlays.

State and local governments saw no relief from budgetary pressures in 1992. The combined deficit in their operating and capital accounts, net of social insurance funds, widened a bit over the first three quarters of the year, reversing the small improvement that had been achieved in the latter part of 1991. As is true at the federal level, a rapidly rising level of mandated transfer payments to individuals for health and income support is at the core of the budget difficulties of many states and localities; in nominal terms, transfer payments in the fourth quarter were about 16 percent above the level of a year earlier.

Construction spending by state and local governments picked up in 1992. According to preliminary

data, the real gain in these outlays amounted to about 3½ percent over the four quarters of the year. Spending for highways increased considerably in 1992, and outlays for buildings other than schools were strong in the first half of the year. Construction of educational facilities, which has been boosted by increases in the school-age population in recent years, rose further in 1992, but the increase was small, both in absolute terms and relative to the gains in most other recent years.

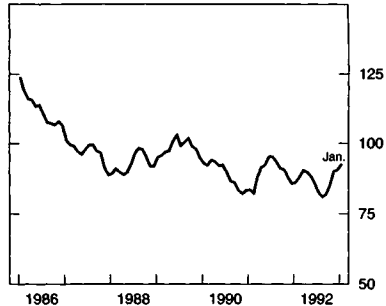
Growth in other major categories of state and local expenditures was restrained. Compensation of employees, which accounts for more than half of total state and local expenditures, increased about 1½ percent in real terms over the four quarters of 1992; in nominal terms, the rise over the year amounted to about 4½ percent, similar to that of 1991 but much less than the nominal increases seen in the years before 1991. Restraint on wage growth was widespread in the state and local sector in 1992, and although total employment in the sector grew a little faster than in 1991, hiring freezes, furloughs, and layoffs continued to be reported in some hard-pressed jurisdictions. State and local purchases of durable and nondurable goods—such things as equipment and supplies—apparently grew little in real terms over the course of 1992. Real purchases of services from outside suppliers apparently edged down for the third year in a row.

Many states and localities have implemented tax increases in recent years in an effort to bolster receipts. In addition, grants-in-aid from the federal government have been rising rapidly, and, in 1992, improvement in the economy helped boost receipts to some degree. In total, state and local receipts rose 7½ percent in annual average terms in 1992, outpacing the growth of nominal GDP by a considerable amount. However, for the third year in a row, the increase in receipts fell short of the annual rise in nominal expenditures, which amounted to 8 percent in 1992.

### The External Sector

The trade-weighted foreign exchange value of the U.S. dollar, measured in terms of the other G-10 currencies, rose nearly 6 percent on balance from December 1991 to December 1992. The dollar increased over the first three months of 1992 amid expectations of strengthening economic recovery in the United States and slowing economic growth abroad. Over the summer, however, the dollar declined to a point below the previous year's low as

Foreign Exchange Value of the U.S. Dollar \*  
Index, March 1973 = 100



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

growth of the U.S. economy was perceived to be more sluggish than expected and as the Federal Reserve eased short-term interest rates further. The dollar reversed direction again in the fall, strengthening sharply in the wake of turmoil in the European Monetary System and, more importantly, on evidence of increased momentum in the U.S. economic expansion and sluggish conditions in foreign industrial economies. The dollar's rise continued into the early weeks of 1993.

On a bilateral basis, the net rise in the weighted-average dollar over 1992 primarily reflected sharp increases in the dollar's value against several European currencies and against the Canadian dollar. Denmark's rejection of the Maastricht Treaty in early June called into question the future of European monetary and political union and led to pressures on the exchange rate mechanism (ERM) of the European Monetary System. In September, those pressures intensified enough to force Italy and the United Kingdom to withdraw from the ERM, and their currencies depreciated sharply. For the year as a whole, the dollar appreciated against those two currencies by 19 percent and 18 percent, respectively. Several other European currencies, including those of Spain, Portugal, and the Scandinavian countries, also depreciated sharply against the dollar in the autumn. The parity of the French franc with the German mark was maintained within the ERM, but at the cost of relatively high French short-term interest rates in the face of a sluggish French economy and rising unemployment.

The dollar fell more than 7 percent against the German mark from December 1991 to August 1992,

as German monetary policy, responding to relatively high German money growth and inflation, remained tight longer than market participants had expected. That decline of the dollar was more than reversed during the fall and winter, however, as it became clear that German economic activity had turned significantly downward and as German monetary policy was eased somewhat. By mid-February 1993, the dollar was about 5 percent higher against the mark than it had been in December 1991.

The dollar depreciated about 6 percent on balance against the Japanese yen during 1992 and early 1993, despite a noticeable decline in Japanese GDP during the second and third quarters and a significant reduction in Japanese interest rates. The net strengthening of the yen probably can be attributed, at least in part, to market reactions to a substantial widening of Japan's external surplus.

The U.S. merchandise trade deficit widened to about \$84 billion in 1992, compared with \$65 billion in 1991 (Census basis). Imports grew about twice as fast as exports as the U.S. economic recovery gained some momentum while economic growth in U.S. markets abroad was sluggish on average. Early in the year, the deficit narrowed somewhat when a drop in oil prices lowered the value of imports. The deficit widened sharply in the second quarter, however, when imports surged and exports remained about unchanged. During the second half of 1992, imports continued to expand somewhat more rapidly than exports, and the deficit increased further.

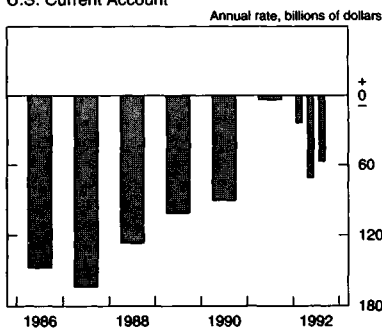
The current account balance worsened substantially more than the trade deficit, moving from near balance in 1991 to a deficit of \$51 billion at an annual rate over the first three quarters of 1992. However,

one-time cash transfers associated with the Gulf War accounted for most of the difference; these transfers had reduced the current account deficit by \$42 billion in 1991, but they reduced it by only about \$2 billion at an annual rate during the first three quarters of 1992. Excluding these transfers, the current account deficit weakened somewhat less than the trade deficit, owing to a strengthening of net service receipts.

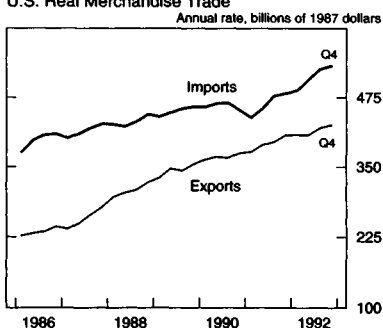
U.S. merchandise exports grew 4½ percent in real terms over the four quarters of 1992. Most of the increase occurred in the second half of the year and consisted largely of stronger shipments of agricultural goods, computers, other machinery, and automotive products. Excluding agricultural products and computers, the quantity of exports grew only 1 percent in 1992 compared with a rise of 6½ percent in 1991; this slowdown was mainly a reflection of sluggish demand in key industrial countries. By region of the world, most of the increase in exports during 1992 went to areas that continued to register moderate to fairly strong rates of economic growth—primarily developing countries in Asia and Latin America. Exports to Japan and to European countries, whose growth rates probably averaged less than 1 percent when weighted by the shares of those countries in U.S. exports, actually declined in 1992.

Merchandise imports grew 10½ percent in real terms during 1992. Two categories—oil and computers, the latter of which includes peripherals and parts—accounted for a significant portion of that rise. Oil imports rose 13 percent over the four quarters of 1992 as U.S. consumption of petroleum products recovered from depressed levels in 1991 and as domestic oil production resumed its long-run downward trend. U.S. domestic sales of computers were very strong beginning in the summer, fueled by price wars

U.S. Current Account



U.S. Real Merchandise Trade



and by a push on the part of U.S. businesses to upgrade PCs and workstations to take advantage of improvements in software. Most of the sales were in the lower end of the spectrum of computer products—items that often are imported. Imports of products other than oil and computers increased 5¼ percent in 1992 as domestic demand in the United States picked up. The strongest increases were in a wide range of consumer goods, especially from China and various other developing countries in Asia. Imports of telecommunications equipment, electric machinery, and other types of machinery also showed significant increases in 1992, for the first time since 1988.

For the first three quarters of 1992, the substantial current account deficit was more than matched by recorded net capital inflows, both official and private. Net official inflows amounted to more than \$30 billion at an annual rate, despite substantial net outflows associated with intervention sales of dollars by major foreign industrial countries. Net private inflows were almost as large, with banks accounting for a large part of these inflows. The agencies and branches of Japanese-based banks used funds from abroad to substitute for a run-off in CDs outstanding in the United States while other foreign-based banks used funds from abroad to help finance asset expansion in the United States. A reduction in the holdings of Euro-deposits by U.S. residents also contributed to the net private capital inflow during the first three quarters of the year, but that reduction was partially reversed in the fourth quarter.

Although securities transactions contributed little to the net inflow of capital in the first three quarters of 1992, the continued impact of the globalization of financial markets was apparent. U.S. net purchases of foreign stocks and bonds were very strong, accompanied by a near record pace of foreign bond issues in the United States. During the same period, foreigners added substantially to their holdings of U.S. government and corporate bonds; however, they made net sales of U.S. equities.

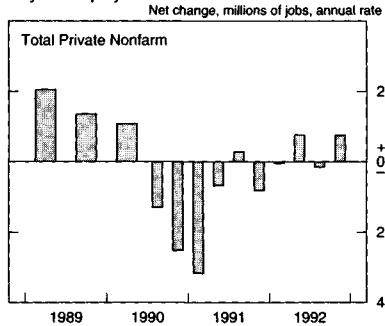
U.S. direct investment abroad was very strong in the first three quarters of 1992. Outflows to Europe remained high, while outflows to Latin America and Asia grew. In contrast, foreign direct investment in the United States fell further, producing a net outflow. The rate of new foreign direct investment in the United States has declined dramatically in recent years from large inflows recorded during the latter part of the 1980s, partly reflecting the sharp drop in mergers and acquisitions in the U.S. business sector. In addition, the very low rates of return reported by

foreign direct investors on their holdings in the United States in recent years may have helped to discourage new investment.

**Labor Market Developments**

The labor market remained relatively sluggish in 1992. Some large companies continued to undergo major restructurings or reorganizations, and these changes led in many cases to permanent workforce reductions at those firms. More generally, businesses remained hesitant to take on new workers, even as the recovery progressed. The still-sluggish pace of output growth in the first half of the year tended to limit labor requirements during that period. Later on, when firms started to expand output more rapidly, they were able to do so without making major long-term hiring commitments. Needs for additional workers were met, in many cases, through use of temporary-help firms, rather than through permanent additions to companies' own payrolls.

**Payroll Employment**



Nonetheless, the tilt of the overall employment trend was positive, rather than negative as it had been in 1990 and 1991. Payroll employment, a measure that is derived from a monthly survey of business establishments, was up about 600,000 during 1992 and an additional 100,000 in January. The number of jobs in manufacturing fell further in 1992, but not as much as in either of the two previous years; small increases in the number of factory jobs were reported toward year-end and in early 1993. In addition, employment in construction changed little in 1992, after two years of sharp decline.

About 900,000 new jobs were created in the service-producing sector of the economy in 1992. The number of jobs in retail trade turned up a little, on net,

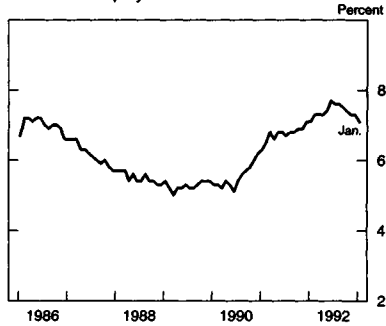
after dropping about one-half million over the two previous years. In addition, firms that provide services to other businesses recorded strong employment growth in 1992; more than likely, these firms were the ones that benefited most from the tendency of businesses to purchase labor and services from other firms, rather than hiring additional workers of their own. Employment in health services, which had remained on a strong upward trend right through the recession, continued to grow rapidly in 1992.

The employment measure that is derived from the monthly survey of households was stronger than the payroll measure in 1992; it showed an increase of about 1½ million in the number of persons holding jobs and, by year-end, had moved back close to the previous cyclical peak of mid-1990. Reasons for the stronger performance of the household series are not entirely clear. Differences in coverage between the household survey and the payroll survey accounted for only a small part of the 1992 gap, and other possible explanations are little more than conjecture at this point. A portion of the gap between the two series was eliminated in January, as the rise in jobs reported in the payroll survey in that month was accompanied by a decline in the household measure of employment.

The number of unemployed persons increased in the first half of 1992, to a peak in June of nearly 9.8 million. Job losses—many of them apparently permanent—continued to mount in the first half of the year, and new job opportunities did not open up fast enough to fully absorb either those workers or others entering the work force for the first time. As a result, the unemployment rate rose more than ½ of a percentage point in the first half of the year, to a June level of 7.7 percent.

The second-half outcome was more favorable. The number of unemployed persons declined about ½ million from June to December, and the unemployment rate moved down over that period, to a level of 7.3 percent at year-end. Some of the workers who had been laid off temporarily were recalled in the second half of the year. In addition, the number of unemployed workers not expecting to be recalled—the so-called permanent job losers—also declined; presumably, these workers either found new jobs elsewhere in the economy or dropped out of the labor force altogether. A similar story also applied to unemployed new entrants, a category of jobless workers whose ranks were a little thinner at the end of 1992 than they had been at mid-year. In January of this year, the number of unemployed persons fell

Civilian Unemployment Rate



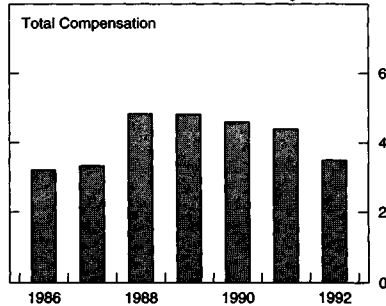
further, and the unemployment rate edged down to 7.1 percent.

In the aggregate, the civilian labor force—the sum of those persons who are employed and those who are looking for work—rose sharply in the first half of 1992, but changed relatively little thereafter. Its level in January of 1993 was up about 1 million from that of a year earlier. The labor force participation rate—the proportion of the working-age population that is in the labor force—fell over the second half of the year and into January of 1993, leaving it about where it had been at the end of 1991.

Against a backdrop of slack in labor markets and in the context of reduced inflation, the rate of rise in workers' hourly compensation continued to slow in 1992. The employment cost index for private industry—a measure of labor cost that includes both

Employment Cost Index \*

Percent change, Dec. to Dec.



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



wages and benefits and that covers the entire nonfarm business sector—increased 3½ percent from December of 1991 to December of 1992. The index had risen nearly 4½ percent in the previous twelve-month period, and, as recently as mid-1990, its twelve-month rate of change had exceeded 5 percent. The employment cost index for wages and salaries increased only 2.6 percent during 1992; this was the smallest annual rise ever reported in this measure, which dates back to 1975. The rate of rise in the cost of benefits provided by firms to their employees also slowed in 1992, but the size of the increase—5¼ percent—was still relatively large. Many firms, both large and small, continued to be pressured by the rising cost of medical care for their employees and by the increased cost of workers' compensation insurance; the difficulty of bringing these costs under control may well have been a serious deterrent to increased hiring in 1992.

Despite the further slowdown in nominal compensation per hour in 1992, the purchasing power of an hour's labor would appear to have risen in real terms, as the nominal increase in hourly wages and benefits, as measured by the employment cost index, outpaced the rise in consumer prices for the second year in a row. Real compensation, computed in this manner, had declined sharply in 1990, and the increase in 1989 had been barely positive.

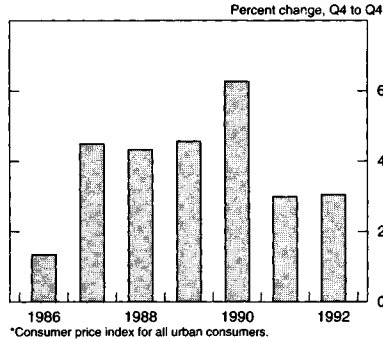
Sustained increases in real living standards depend ultimately on achieving advances in the productivity of the workforce, and on that score, the economy performed well in 1992. Output per hour worked in the nonfarm business sector jumped 3 percent over the year, the largest annual gain since 1975. While a portion of this large rise is no doubt a reflection of

normal cyclical tendencies, longer-range improvement in productivity growth also may be in progress. The jump in output per hour in 1992, combined with the slowing of compensation gains, held the annual increase in unit labor costs to just 0.7 percent.

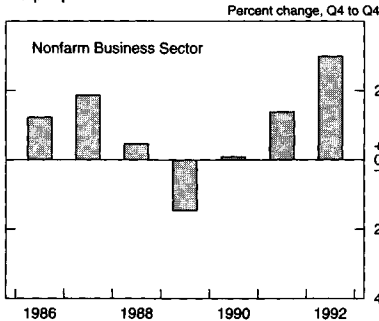
**Price Developments**

The consumer price index rose 3 percent over the four quarters of 1992, the same as in the previous year. Energy prices, which had fallen in 1991, turned up a little in 1992, but price increases elsewhere in the economy were generally smaller than those of the previous year. The limited rise in labor costs in 1992 was one important factor exerting restraint on the rate of price increase. In addition, the cost of materials used in production rose only moderately over the year, as did the prices of goods imported from abroad.

Consumer Prices\*



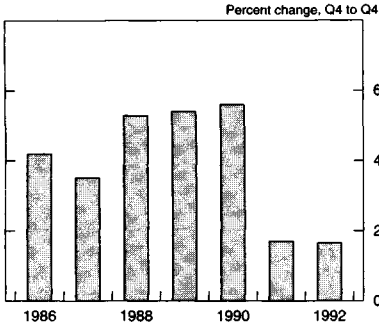
Output per Hour



Although inflation expectations, as reported in various surveys of consumers and business officials, have remained a step or so above actual inflation rates, they too appear to have moved lower over time. On average, their recent levels are about in line with—or, according to some surveys, less than—the lower bound of the range of inflation expectations reported during the 1980s. In view of these recent trends in prices, labor costs, and inflation expectations, the January rise of 0.5 percent in the CPI would appear to be something of an aberration.

The CPI for food increased a bit less than 1¼ percent in 1992, the same as in 1991. Not since the 1960s has there been a two-year period in which the cumulative increase in food prices was so small. This low rate of food price inflation in 1991 and 1992 was, in part, a reflection of the same factors that were

Consumer Food Prices\*



\*Consumer price index for all urban consumers.

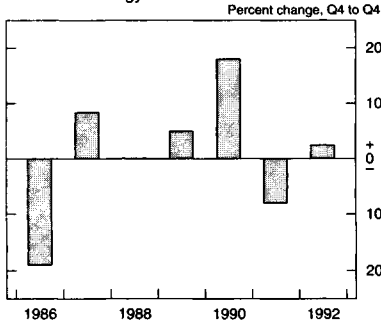
working to pull inflation down in other parts of the economy. In addition, food prices have been restrained by favorable supply conditions in the farm sector. Meat production rose further in 1992, and the output of crops soared. Dryness in some regions imparted temporary volatility to crop prices in late spring. Thereafter, growing conditions turned exceptionally favorable and remained so through the summer and into early autumn. Unusually wet conditions in some regions later on in the autumn apparently made only a small dent in the eventual size of the harvest.

The rise in consumer energy prices over the four quarters of 1992 amounted to about 2½ percent. The previous year, energy prices had fallen 8 percent. With no major supply or demand shocks springing up

in world oil markets in 1992, the price of West Texas Intermediate stayed in the relatively narrow trading range of about \$18 to \$23 per barrel; the price has remained in that range in the early part of 1993. At the retail level, price changes for petroleum products were mixed in 1992; the price of gasoline rose about 3 percent, while fuel oil prices declined moderately. The CPI for natural gas rose about 5 percent in 1992, considerably more than in other recent years. Although much of that rise in gas prices came in the second half of the year in the wake of supply disruptions caused by Hurricane Andrew, prices of gas at the wellhead had already moved up considerably before the hurricane hit, in response to a somewhat tighter supply-demand balance than had existed over the previous year or so.

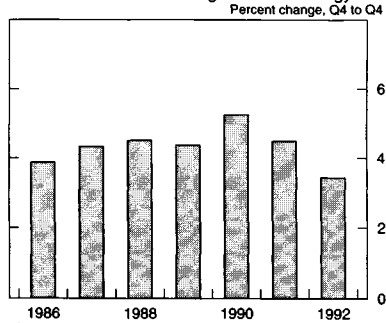
The CPI excluding food and energy rose 3.4 percent over the four quarters of 1992, a percentage point less than it had risen in 1991. The slowdown was widespread among the various categories of goods and services that are included in this measure of core inflation. The rate of rise in the cost of shelter—the single most important category in the CPI, with a weight equal to more than one-fourth of the total—slowed further in 1992; rents for both apartments and houses apparently were damped by the large amount of vacant housing that was available in many parts of the country. The prices of other services that are included in the CPI—which collectively make up another one-fourth of the total index—also slowed appreciably in 1992. Nonetheless, their overall rate of increase remained relatively high. The costs of medical care services and tuition continued to rise much faster than prices in general in 1992, and air

Consumer Energy Prices\*



\*Consumer price index for all urban consumers.

Consumer Prices Excluding Food and Energy\*



\*Consumer price index for all urban consumers.

fares rebounded from their 1991 decline. The CPI for commodities other than food and energy rose 2½ percent during 1992, after an increase of more than 4 percent over the four quarters of 1991. Price increases for this broad category of goods were restrained by the cost and price developments in manufacturing: Unit labor costs in manufacturing actually declined in 1992, and the producer price index for finished goods rose less than 2 percent.

After falling sharply from mid-1990 to the end of 1991, the prices of industrial commodities generally changed little, on balance, during 1992. By the end of 1992, however, prices had begun to tilt up for some industrial metals, consistent with the pickup in the pace of industrial expansion toward year-end, and additional price increases have been reported in some of these markets in early 1993. The prices of lumber and plywood—following a path considerably different from that of most other commodities—rose substantially during 1992, and further steep increases have been evident in early 1993. The surge in prices of these products appears to be a reflection of the

uptrend in single-family housing construction, weather-related supply disturbances in some timber regions, and adjustment of the logging industry to environmental restrictions that have been implemented in some areas of the country. Prices of some other wood products, such as pulp, also rose sharply at the producer level in 1992.

The recent increases in prices of these raw materials have shown through to some extent to broader measures of producer prices. For example, the producer price index for intermediate materials excluding food and energy—a price index that encompasses a wide range of production materials—rose 1 percent during 1992, after declining about ¾ of a percentage point during 1991, and the past couple of months have seen some further pickup in that measure of price change. From an economy-wide perspective, however, that pickup in materials prices has not been sufficient to dominate the deceleration in labor costs, which account for a far greater share of total production costs.

### Section 3: Monetary and Financial Developments in 1992

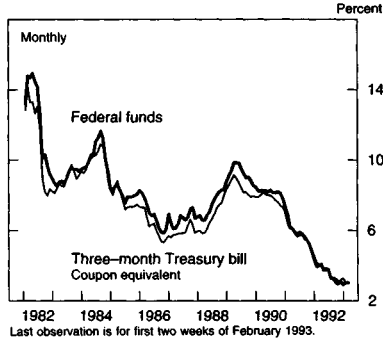
Federal Reserve policy in 1992 was directed at promoting and extending the recovery from the 1990–91 recession, in the context of continued progress toward price stability. The difficulty of designing and implementing constructive monetary policies has been exceptional in this period. In 1992, as earlier, economic activity was held back to an unusual degree by the efforts of households, nonfinancial businesses, and some key providers of credit to the economy, including commercial banks, to strengthen their balance sheets. These forces have tended to alter the normal relations between financial flows—particularly those reflected in movements in M2 and M3—and the behavior of the economy. Under the circumstances, the Federal Reserve has had to take a flexible approach to the use of money and credit aggregates as intermediate policy targets; specifically, in light of evidence that expansion in economic activity was being financed to an unusual extent in capital markets rather than through banks and other depositories, the System tolerated shortfalls of M2 and M3 from their target ranges.

The Federal Reserve judged it appropriate to ease reserve conditions on three occasions in 1992, when financial and economic data suggested that the economy might be losing momentum. The extent of the easings last year was considerably less than in 1991, however, as the underlying trend of the economy overall was more positive. Partly as a result of the cumulative effect of the monetary easings of recent years, economic activity accelerated in 1992 to its fastest pace since 1988. This pickup was achieved even as various measures of inflation evidenced further slowing, with the “core” inflation rate falling to levels last seen in the early 1970s. Thus, 1992 was a year not only of financial repair, but also of improved aggregate economic performance in the United States.

#### The Implementation of Monetary Policy

Nineteen ninety-two began with short-term interest rates at their lowest levels in over a quarter of a century, following a series of actions by the Federal Reserve in the latter part of 1991 that reduced the discount rate and the level around which the federal funds rate was expected to trade to 3½ and 4 percent respectively. Long-term rates were also at lower levels, reflecting the policy actions and a weakening of economic activity in the final quarter of 1991.

Short-Term Interest Rates



Evidently in the expectation that these rate cuts would revive the recovery, the stock market began the year with strong upward momentum, and the dollar appreciated. However, other evidence that the economy was picking up remained scanty in the initial part of the year, despite the significant monetary stimulus already in place and the positive developments in equity and capital markets. Apart from rising housing starts, a phenomenon in part related to special weather and tax factors, the economy appeared sluggish and confidence levels were low. Spending by households and businesses seemed to be restrained by efforts to strengthen financial positions, and banks had done little to reverse the substantial tightening of lending standards that occurred in 1990 and 1991. In view of the still tentative nature of the recovery and the solid progress that had been made to that point against inflation, the Federal Open Market Committee (FOMC) at its first meeting of the new year instructed the Manager of the Open Market Account at the Federal Reserve Bank of New York to remain especially alert to evidence that money market conditions might need to be eased before the next scheduled meeting of the Committee. Such a policy stance biased toward ease had prevailed over much of 1991.

M2 and M3, which had posted moderate gains in January, surged in February, owing partly to stronger income and earlier sharp declines in short-term interest rates, and partly to special factors—above-average tax refunds and a jump in mortgage refinancing, which results in funds being held temporarily in demand deposits. Underlying money growth remained very weak, however, and well below that consistent

with expectations based on the historical relationship of money with income, deposit rates and market interest rates. In March, as the influence of the special factors abated, M2 was about flat and M3 contracted.

The economy seemed to be improving during much of the first quarter: retail sales and housing starts were strong, industrial production turned up, and confidence levels of the business and household sectors were rising as was the quality of their balance sheets. The signs of recovery and the market view that the prospects for further near-term monetary ease had faded caused long-term interest rates to increase, and the dollar rose on foreign exchange markets as well. Increases in private interest rates were less than those on Treasuries, likely reflecting perceived reductions in the riskiness of private debt as the economy strengthened coupled with concerns about enlarged Treasury demands on credit markets stemming from discussions of possible fiscal stimulus. Areas of weakness in the economy remained, however—some attributable to the substantially overbuilt commercial real estate sector and some to the transition to a smaller defense sector. In addition, the backup in long-term interest rates threatened to slow the pace of balance sheet adjustment and could damp housing and its related industries as well as business investment spending, and the outlook for exports clouded.

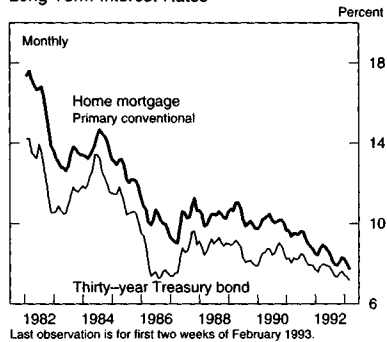
In early April, the System eased reserve conditions again. This action was taken on indications that the monetary aggregates, already at the bottom of their target ranges following their flat performance in March, were beginning to contract, that the balance of evidence was beginning to suggest a slowing in the economic expansion, and that inflation was continuing to recede. Short-term interest rates fell more than the  $\frac{1}{4}$  point drop in the trading level of the federal funds rate, as market participants judged the economy sufficiently weak to make further near-term monetary easing moves likely. The easing buoyed the stock market, but long-term rates showed a limited response and remained well above year-end levels.

In the weeks following the easing, the economy appeared to improve a bit but the evidence continued to be mixed. Single-family housing starts, which had contracted in March, fell considerably further in April and retail sales were little changed on balance between February and April. On the other hand, nonfarm payroll employment and industrial production continued to expand. Weakness in the monetary aggregates persisted into April, but concerns on this front were allayed to some degree by evidence that this was importantly related to the ongoing

re-channeling of credit away from depository institutions and into capital markets, and by expectations that this re-channeling and other financial restructuring would continue to damp money growth considerably more than economic activity. Moreover, what restraint balance sheet restructuring was exerting on spending was seen as likely to abate in view of the considerable progress that by then had been made in this area, both by the borrowing sectors and by depository institutions, as banks added rapidly to capital. At its mid-May meeting, the Committee determined that its bias towards ease in assessing possible intermeeting policy changes was no longer appropriate.

Data becoming available over subsequent weeks, however, suggested that the forces restraining economic expansion continued to be quite strong. The contraction of consumer credit accelerated, and bank loans more generally began to run off. With the forces that had been constraining money growth intensifying, all three monetary aggregates contracted in June.

#### Long-Term Interest Rates



Nonfinancial data confirmed that the economy remained slack. Although nonfarm payroll employment and industrial production each increased in May for the fourth straight month, the unemployment rate rose sharply, owing to a rising labor force participation rate. Moreover, homebuying and retail sales, other than for automobiles, slowed from the pace earlier in the year, and demand for U.S. exports was held down as growth in some foreign industrial countries slowed or turned negative while other countries struggled to recover from their downturns in 1991 or remained in recession.

With the tenor of incoming economic news having become distinctly negative, long-term Treasury rates,

which had been little changed over most of May and June, turned down around mid-year, although they remained above year-end lows. In light of these developments, and with the downward trend in inflation continuing, the System reinstated its bias towards ease at its mid-year meeting. Immediately following that meeting, on July 2, with evidence of a weakening economy confirmed by a further rise in the unemployment rate, to 7¾ percent in June, the Federal Reserve reduced the discount rate and the federal funds rate each by ½ percentage point, to 3 and 3¼ percent, respectively. Banks lowered their prime rate, also by ½ percentage point, to 6 percent, leaving its unusually wide spread over market rates intact.

Long-term interest rates fell in response to the employment data and the monetary easing and moved down further into early August as the incoming economic news continued to be poor. The drop in yields brought long-term rates to the lowest levels since the early 1970s, and the dollar continued to retreat from its peak levels reached in April.

In early September, with another weak labor report and in the context of contracting industrial production and expansion in the monetary and credit aggregates that, while now positive, was weaker than had been expected, reserve conditions were eased further and the federal funds rate fell to around 3 percent. Shorter-term market rates dropped on this action, bringing them to the neighborhood of zero in real terms. Despite the poor economic news and expectations that further easing moves were in the offing, long-term rates, although they initially declined, drifted back up on renewed concerns that the federal deficit would be enlarged by fiscal actions taken to stimulate the economy.

Throughout the late summer and early fall, policy was conducted against a background of tension in foreign exchange markets; a strong Deutschemark had caused several European countries to raise interest rates sharply to preserve fixed exchange rate relationships with and within the exchange rate mechanism (ERM) of the European Monetary System at a time when aggregate demand in these countries was slowing or sluggish. The dollar continued to decline into early September, but then began to firm. The rise in long-term rates contributed to the reversal, as did actions by several European countries to devalue their currencies, in some cases dropping out of the ERM, and to lower interest rates.

With short-term interest rates in the United States lower, the monetary aggregates continued to expand in September. The implications of the strength of M2

were difficult to assess, however, since it reflected to an uncertain degree the impact of mortgage refinancing on demand deposits as well as strong foreign demands for U.S. currency. Stronger income also appeared to be contributing to money growth, as private employment edged up and the unemployment rate declined in September. Nevertheless, the outlook for the economy remained uncertain. Final demand seemed weak and was being met in part through higher imports, holding down industrial production and employment, and business and consumer sentiment remained relatively depressed.

In these circumstances, the FOMC established a strong bias toward ease at its early October meeting. In the event, however, an improvement in economic indicators immediately following the meeting, along with evidence of some strength in M2 and bank credit, stayed any further easing actions. Since anticipation of further easing had been built into the structure of interest rates, short-term rates backed up following the meeting. Rates also rose at the long end, responding to growing expectations that fiscal stimulus could follow the upcoming presidential election, as well as to the indications of improved economic performance.

Evidence of greater economic strength continued to accumulate in a variety of indicators of production and spending over the fourth quarter. Although this news initially put further upward pressures on longer-term interest rates, these came to be muted and then reversed as the better economic prospects, along with statements and actions of the incoming Administration, began to be viewed as reducing the likelihood of outsized fiscal stimulus. Also helping to lower longer-term rates was continuing good news on inflation. These factors, buttressed by an increasing focus in public discourse on reducing the federal deficit, continued to play an important role as long-term rates fell further into the new year.

With the better economic news, the Federal Reserve kept reserve conditions and short-term interest rates unchanged as the year ended, and the FOMC at its December meeting decided to move back to a symmetric policy stance. Reflecting the improved economic outlook, a stock market rally developed that rivaled in strength that which began the year, and the dollar rose further.

Although the monetary aggregates strengthened a bit in the fourth quarter, the depressing effects of balance sheet restructuring continued to be important, a fact that became clearer once the hard-to-measure temporary boost to deposits deriving from

higher mortgage refinancing abated after October. The velocities of both M2 and M3 rose significantly further in the final quarter of the year, contributing to the exceptional velocity increases posted by both measures for the year as a whole.

### Monetary and Credit Flows

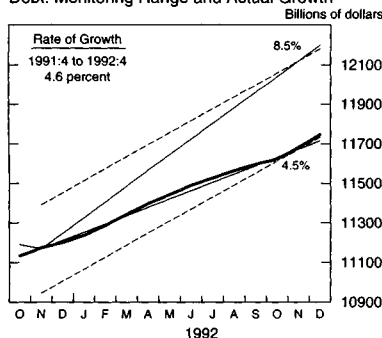
Credit flows again were quite damped in 1992, and money growth was exceptionally weak. Despite an appreciable pickup in nominal GDP growth last year, the broad monetary aggregates decelerated further, and expansion of the nonfinancial debt aggregate edged up only a bit. As had been the case for the last couple of years, considerable efforts by key sectors of the economy to improve balance sheets had a significant restraining effect on credit and, especially, on money growth—a much greater effect than they had on spending itself. Growth of the debt of nonfinancial borrowers other than the federal government edged up by only  $\frac{1}{4}$  percentage point from 1991, to  $2\frac{1}{2}$  percent, as businesses and households restrained borrowing and financed spending out of cash flow and equity issuance and by limiting accumulation of financial assets. The expansion of federal debt slowed slightly to a still rapid  $10\frac{3}{4}$  percent, held down by the lack of activity by the Resolution Trust Corporation (RTC) after April, when it exhausted its legislative authority to fund losses at savings and loans. Reflecting the slowdown in the activities of the RTC and the improving health of depositories, federal outlays attributable to deposit insurance activity fell from the \$50 billion area in 1991 to nil last year. The total nonfinancial debt aggregate expanded about  $4\frac{1}{2}$  percent last year, at the lower end of its monitoring range.

The sluggishness in credit and money growth last year appeared to represent mainly weak demand, rather than any new tightening of credit supply terms. At banks, loan flows were depressed, and, in the absence of appreciable credit demands, bank asset growth mainly took the form of security acquisitions. Some have argued that the shift to government securities over recent years has been motivated by the Basle risk-weighted capital standards, which require capital against loans but not against many government securities. However, the effect of these standards appears to be relatively minor. As in 1990 and 1991, banks that had already achieved adequate capital positions were the major purchasers of U.S. Treasury and agency securities last year, and loan flows were depressed at these banks as well. Moreover, other regulatory factors may be contributing to a reduction in willingness to take deposits and make loans, including rising deposit insurance premiums and the tighter regulations and requirements of new laws governing banks and thrifts in recent years. A similar pattern of asset growth concentrated in government securities occurred at credit unions, which are not subject to the Basle capital standards. Although loan growth at banks remained lackluster, it strengthened in the final quarter of the year as the economy began to expand more rapidly. At the same time, the growth of bank holdings of government securities, which had been very rapid all year, slowed.

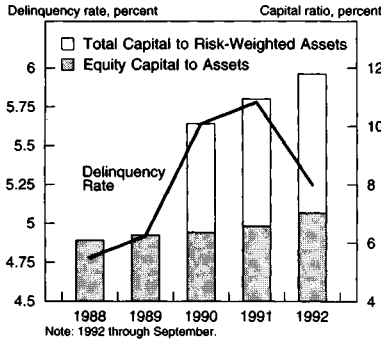
To be sure, the pickup of bank lending toward year-end seemed primarily related to stronger demand—banks gave little indication in Federal Reserve surveys that they had begun to ease the tighter lending standards and terms that they had put in place in 1990 and 1991, and the unusually wide spread of the prime rate over market rates persisted. Banks do seem better positioned to meet increases in demand than they were a few years ago. Not only has their liquidity improved with the acquisitions of government securities, but they have made substantial progress in improving capital positions, including leverage ratios—which are unaffected by asset composition—as both profits and debt and equity issuance reached record levels in 1992. Moreover, the quality of their assets showed some scattered signs of improvement last year; the delinquency rate for bank loans, though still high, began to turn down, as did the rate of charge-offs.

Other financial intermediaries also have taken steps to strengthen balance sheets, and the availability of credit from these lenders also remains somewhat constrained—though probably not more so than in 1991. Life insurance companies, for example, have

Debt: Monitoring Range and Actual Growth



**Commercial Bank Loan Delinquency Rate and Capital Ratios**



suffered from an abundance of bad loans and remain saddled with poor quality commercial real estate loans. Such firms have been limiting acquisitions primarily to high quality, easily marketable assets, meaning that, as in 1991, some medium-sized, below-investment-grade companies found credit from life insurance companies difficult to obtain in 1992. Some business finance companies also have experienced high and rising levels of nonperforming loans, many of which were secured by commercial real estate, with effects on their willingness to make new loans.

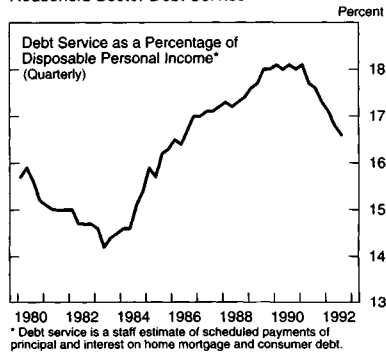
Downgradings of the manufacturing parents of automobile sales finance companies have led to some increases in their funding costs. To date, however, there has been little or no effect on the cost or availability of consumer credit, as these finance companies have increased the volume of loans they have securitized. The availability of credit at thrift institutions likely improved a bit last year. Reflecting the declines in interest rates, profits of private sector savings and loans had reached a record level as of the third quarter, sustained by a wide spread between interest earned on assets and the cost of funds, as well as by a decline in the industry's still high level of troubled assets.

Weak credit demand and constraints on some sources of supply have produced generally sluggish borrowing in each major nonfinancial sector other than the federal government. Overall household borrowing accelerated slightly but continued moderate, as demand was depressed by insecurity about employment as well as by efforts to restructure balance

sheets. Declines in mortgage rates promoted only about a 1/2 percentage point boost to net home mortgage growth, but they spurred a substantial volume of refinancing. Some of the proceeds of mortgage refinancings likely were used to pay down higher-cost consumer credit. Consumer credit also was held down last year as households apparently used funds that otherwise would have been held in low-yielding deposits to reduce high-cost debt.

With the pace of debt accumulation by the household sector damped, and with rates on consumer debt falling and mortgage debt being refinanced at lower rates, the ratio of debt servicing payments to household income declined considerably further last year. Another sign of improving household financial conditions has been recent trends in delinquency rates. Consumer loan delinquency rates mostly fell last year, although they remain at high levels. Home mortgage delinquency rates were little changed on balance last year and still somewhat above their pre-recession levels, but well below those of the mid-1980s.

**Household Sector Debt Service**

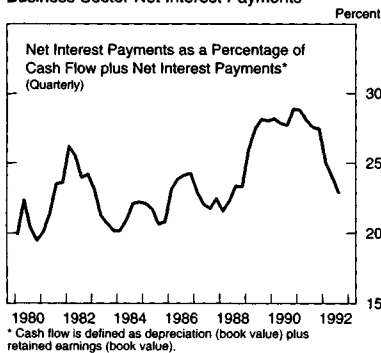


Business debt grew only slightly last year as internally generated funds exceeded investment spending. Taking advantage of the strong stock and bond markets, nonfinancial corporations stepped up their equity issuance and refinanced large volumes of longer-term debt at more favorable rates. In part, the proceeds of these issues were used to pay down short-term debt, particularly bank loans, thereby lengthening liability structures.

The hospitality of the capital markets extended even to lower-graded business borrowers, which



**Business Sector Net Interest Payments**



issued substantially more bonds than in recent years. Overall public gross bond issuance by nonfinancial corporations was well above the 1991 level. Likewise, gross equity issuance by nonfinancial corporations also rose from the already high pace of 1991 and was four times that of the late 1980s and early 1990s. As a result of debt refinancing and sales of equity, corporate net interest payments as a percent of cash flow fell for the second year. As declining interest rates allowed firms to reduce debt burdens, and as the

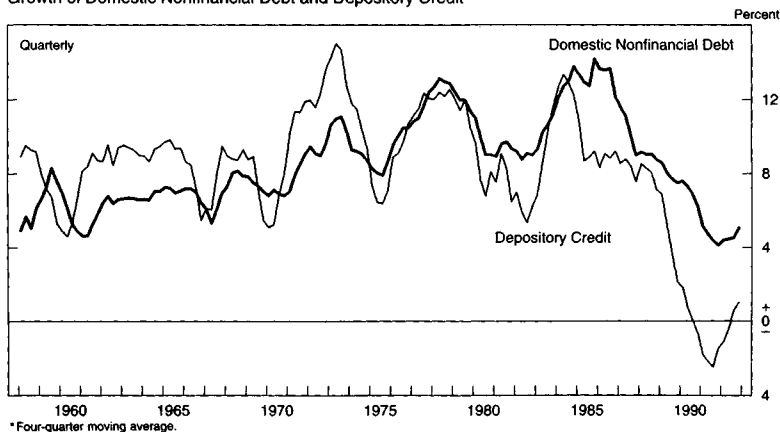
economy advanced, corporate debt ratings began to improve and quality spreads narrowed.

The state and local sector also benefited from the rate declines last year, with large amounts of debt being refinanced, including a large volume that was called. Net debt growth continued to be moderate, however, as this sector's spending remained constrained.

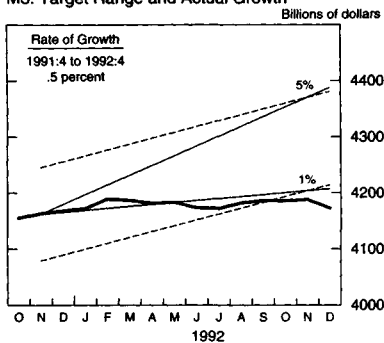
Although balance sheet restructuring has damped credit flows and spending, its greatest impact has been on the monetary aggregates, as an unusually high proportion of spending in recent years has been financed outside the depository system, whose liabilities make up the bulk of the monetary aggregates. Some of this spending has been supported through sources other than borrowing, for example, issuing equity or restraining the accumulation of liquid assets. Depository credit expanded last year, following two years of contraction, but it continued to shrink as a share of nonfinancial debt as borrowers concentrated their credit demands in long-term securities markets—bonds for corporations and fixed-rate mortgages for households.

The sluggish expansion of depository credit was echoed in M3, which comprises most—though not all—of the instruments depositories use to finance their credit extensions. In fact, growth of M3 slowed last year to ½ percent despite the pickup in depository credit, as depositories relied much more on equity

**Growth of Domestic Nonfinancial Debt and Depository Credit\***



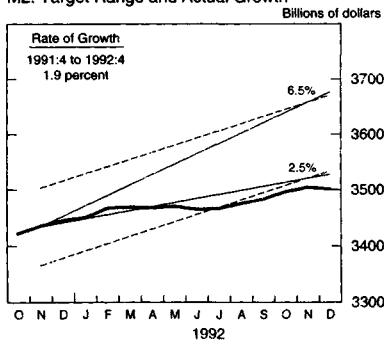
M3: Target Range and Actual Growth



issuance and sales of subordinated debt, which are not in M3. Large time deposits at banks and thrifts fell rapidly. The tendency for spending to be financed outside of depositories, along with the latter's reliance on non-M3 funds, produced a sizable increase in M3 velocity last year—at a rate far above that of recent years. The rise in velocity of M3 would have been even greater had it not been for strong inflows into institution-only money funds over the first three quarters of the year. The attractiveness of these funds increases when short-term interest rates are falling, a phenomenon caused by the fact that the funds do not mark to market, so that their yields tend to exceed market rates when those rates are declining.

M2 increased 2 percent last year, below the 2½ percent lower end of its target range. M2 registered

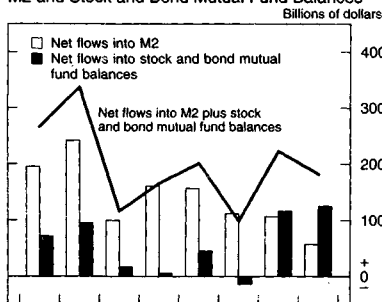
M2: Target Range and Actual Growth



modest growth in the first and last quarters of the year, but was about flat over the middle quarters. The reasons for underlying weak money growth appeared to stem from several important factors, many related to the unattractiveness of holding funds in M2 assets relative to other possible uses of savings.

Contributing to the relative attractiveness of non-monetary assets was the rapidity with which banks adjusted down offering rates on retail deposits as market rates declined last year. Banks' unaggressive pricing of deposits reflected substantial paydowns of bank debt by households and businesses, which kept loan demand low and banks' need for funds to finance them quite limited. In addition, banks and thrifts have been discouraged from going after deposits by the rising cost of issuing deposits to make loans; among the factors accounting for this increase have been increases in deposit insurance rates and higher capital ratios occasioned by market and regulatory forces.

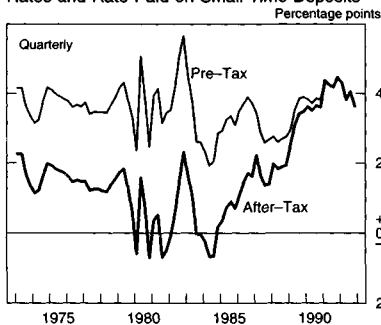
M2 and Stock and Bond Mutual Fund Balances



Note: Mutual fund data exclude IRA and Keogh balances and institutional holdings. IRA and Keogh balances and institutional holdings for 1992 are estimated.

The prompt declines and low level of deposit rates have combined with several other factors to induce savers to cut back on holdings of assets in M2. One important influence was the unprecedented steepness of the yield curve, which was pulling deposit funds into capital markets. An important method for accomplishing this portfolio shift was mutual funds, which experienced record inflows last year. Not only were yields on these funds attractive, but they have become increasingly available through banks and thrifts. Assets in bond and equity mutual funds (apart from those held by institutions and those in IRA and Keogh accounts) increased \$125 billion last year, up from \$117 billion in 1991 and an average of \$30 billion

Spreads between Pre- and After-Tax Auto Loan Rates and Rate Paid on Small Time Deposits



Auto loan rate is the 48-month rate. Small time deposit rate is for maturities of two and a half years and over. Marginal federal tax rates based on John Seater, "On the Construction of Marginal Federal Personal and Social Security Tax Rates in the U.S.," *Journal of Monetary Economics* 15 (1985) pp. 121-35.

over the previous five years. In 1991 and 1992 for the first time, increases in mutual fund assets exceeded increases in M2.

Money growth has also weakened as consumer loan rates have moved downward less rapidly than deposit rates. As a consequence, households face a considerable interest rate incentive, particularly after taking account of changes in the tax deductibility of consumer interest payments, to use funds in deposit accounts to pay down, or limit the accumulation of, debt. In fact, the rise in consumption has been accompanied by an unusually small increase in debt, implying that it has been financed to a large extent by reducing or limiting holdings of financial assets.

The cuts in bank deposit rates were particularly evident for larger (and presumably more interest sensitive) accounts and at longer maturities. Small time deposits ran off throughout the year. Some of these funds appeared to flow into more liquid deposit accounts, as small time deposit rates fell faster than those on savings and checkable deposits. General purpose and broker-dealer money market mutual funds (MMMFs) also contracted over the year, despite the yield advantage these assets offered vis-à-vis other money market rates in an environment of declining yields. This appeared to be another example of the attraction that bond and equity mutual funds and other capital market instruments provided last year to investors. MMMFs grew in October and November, however, perhaps reflecting capital losses in bond funds

resulting from the rise in long-term rates in September and October.

The overall effect of the unusual forces that have been influencing M2 is summed up by the behavior of its velocity, which accelerated for the second year in a row, to a 3½ percent rate, despite the sharp downward trend in short-term interest rates over this period. Over previous decades, the velocity of M2 and short-term rates had moved together in a reasonably predictable way. This occurred because deposit rates lagged market rates. When, for example, short-term rates fell, deposit rates dropped by less, providing an incentive to shift assets from market instruments to deposits and depressing velocity. However, because of the unusual configuration of forces discussed above, these incentives to hold M2 have not followed their usual pattern in the current cycle. As noted, despite the drop in short-term interest rates, a combination of the steep yield curve, sluggish adjustment of loan rates, and other factors has *decreased*, not increased, the incentives to hold M2 in the last year. In other words, the opportunity cost—the earnings given up—in holding M2 actually has widened, rather than narrowed as has happened in the past when market interest rates fell, and this helps to explain why M2 velocity has risen atypically.

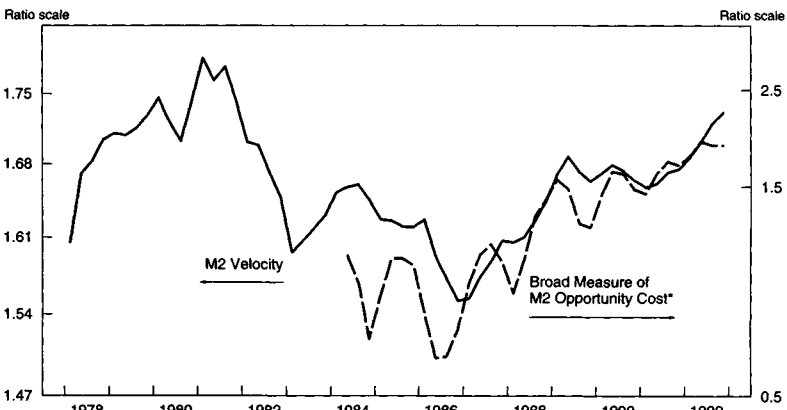
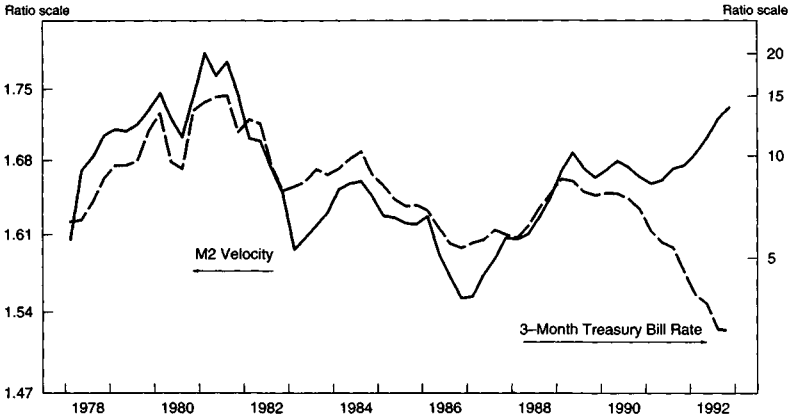
Another indication of the unusual behavior of velocity of M2 is the recent performance of the Board staff's P\* model in predicting inflation. This model is premised on the existence of a reasonably stable behavior of the velocity of M2 over time, and uses this to predict the price level and inflation rates, consistent with M2 growth. If the velocity of M2 is rising atypically, slow growth of M2 would not be associated with the degree of disinflationary pressures that would be predicted by the P\* model, which assumes normal velocity behavior. In fact, consistent with the notion that velocity is behaving abnormally, this model, using actual M2 growth, has underpredicted inflation in 1992.

The growth of M2 over the year was entirely attributable to its currency and transactions deposit components, as M1 growth surged to 14¼ percent in 1992. This performance reflected the advance in income growth, but mainly stemmed from declines in both short- and long-term interest rates. Long-term rate declines prompted large volumes of mortgage rate refinancings, particularly in the first and last quarters. Because a large portion of prepayments are held in demand deposits until the mortgage servicer remits the funds, the level of demand deposits is temporarily boosted by mortgage refinancings. Falling short-term

rates boosted demand deposits by lowering the opportunity cost of holding them and by increasing the amount of deposits businesses needed to hold under compensating balance arrangements. In addition, NOW accounts were boosted by funds shifted from

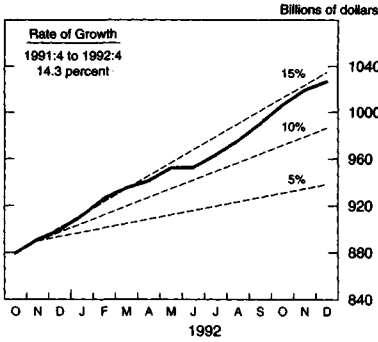
small time deposits, as rates on the latter fell faster than those offered on the former. Growth in NOW accounts last year accelerated from the already brisk pace of 1991, and demand deposits posted the largest increase since at least 1959.

**M2 Velocity and Measures of Opportunity Cost**



Note: Opportunity costs are two-quarter moving averages.  
 \*Estimated difference between a weighted average of competing rates (3-month T-bill, 5-year T-note, after-tax auto loan rate) and a weighted average of rates paid on M2 components.

M1: Actual Growth



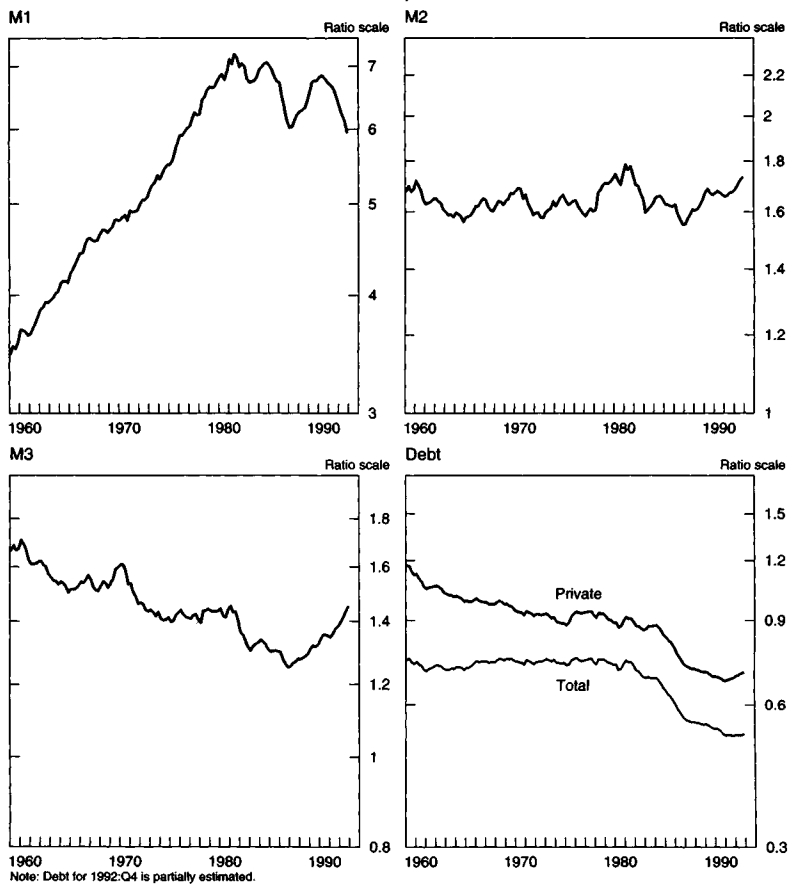
To accommodate the growth in transactions deposits associated with the process of easing reserve conditions, the Federal Reserve supplied large volumes of new reserves in 1992. Total reserves grew at around 20 percent, more than twice the rate of increase in 1991. Currency growth also was rapid, in part owing to shipments abroad, and as a consequence the monetary base increased 10½ percent last year—the highest growth rate in the Board’s official series, which begins in 1959.

Growth of Money and Debt (Percentage Change)

	M1	M2	M3	Debt of domestic nonfinancial sectors
<i>Fourth quarter to fourth quarter</i>				
1980	7.4	8.9	9.5	9.5
1981	5.4 (2.5)*	9.3	12.3	10.0
1982	8.8	9.1	9.9	9.3
1983	10.4	12.2	9.9	11.4
1984	5.5	8.1	10.8	14.3
1985	12.0	8.7	7.6	13.8
1986	15.5	9.3	8.9	14.0
1987	6.3	4.3	5.8	10.1
1988	4.3	5.3	6.4	9.2
1989	0.6	4.7	3.7	8.1
1990	4.3	4.0	1.8	6.9
1991	8.0	2.8	1.1	4.3
1992	14.3	1.9	0.5	4.6
<i>Quarterly (annual rates)</i>				
1992				
Q1	15.5	3.3	2.0	4.3
Q2	10.6	0.6	-0.3	5.4
Q3	11.6	0.8	0.1	4.2
Q4	16.8	2.9	0.2	4.2

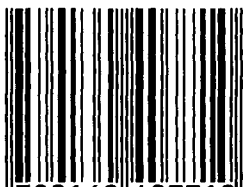
\*Figure in parentheses is adjusted for shifts to NOW accounts in 1981.

Velocity of Money and Debt  
Quarterly





ISBN 0-16-040771-0



90000



9 780160 407710