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

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THE CONDUCT OF MONETARY POLICY

TUESDAY, JULY 20, 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 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Present: Chairman Kanjorski, Representatives Neal, LaFalce, Orton, Klein, Velazquez, Dooley, Fingerhut, McCollum, Roth, Nussle, and Roukema.

Also present: Representatives Charles E. Schumer and Joe Knollenberg.

Chairman KANJORSKI. The subcommittee will come to order.

We meet today to receive the semiannual report of the Federal Reserve on the economy and monetary policy, mandated by the Full Employment Balanced Growth Act of 1978. Much of the economic news of the last 6 months has been relatively good, and encouraging.

Inflation remains low, as we saw in May, one-tenth of 1 percent. The interest rate remains low, a 30-year low on the Treasury rate at 6.5 percent, thus freeing up billions of dollars for payment of private debt and for reorganization of businesses and other such encouraging areas of our economy.

We have had a refinancing pace second to none in the Nation's history, and a great deal of it not going to consumption, but to pay off debt and to put our financial houses in order. As we view the banking profits and the thrift plans for the S&L cleanup, we notice that the end is in sight.

The BIF fund is in the black for the first time since 1985, and by those successes, we are certainly encouraged. We anticipate, however, that there are problems that still remain. Some of those problems, of course, unemployment remains relatively stuck at 7 percent. We have certainly a stagnant commercial industrial lending program of $600 billion going on.

This subcommittee has held hearings in western Pennsylvania and Ohio and in eastern Pennsylvania, and one of the strong currents of those hearings is that the credit crunch still remains, and it is strangling small- and medium-sized businesses. To that end, we look forward to hearing from the Chairman as to what plans the Federal Reserve has for that.

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We have, since we have last met, introduced legislation, H.R. 2600, the Secondary Market bill introduced on July 1, and we plan hearings in September. The Secondary Market bill, of course, is an attempt to bring Fannie Mae or Freddie Mac to business loans, community development loans, and free up the needed capital to provide the money necessary for the Clinton system laws programs of the next decade.

With all that comes from massive rains in the Middle West of the country and the floods that we have all witnessed over the last several weeks with some farms and with great sympathy, we hope that this will not materially destroy the economic conditions of the Middle West and we trust that the Federal Government will come to the rescue with sufficient funds to stimulate the farm economy and the business economy of that section of the country.

Our hearts go out to the people in the flood zone of the United States because I myself have had experience with the Agnes flood in 1972. The district I represent suffered over $2 billion damage during that flood. And that would be equivalent today of one district suffering about $6 billion in economic damage, which was horrendous and took us more than 15 years to recover from.

Whatever this Congress can do, and I am sure whatever the President can do, and we hope the Federal Reserve will help to bring the flood conditions as back to—area as back to normal as possible.

We look forward to hearing from Chairman Greenspan today as to whether or not the inflationary fears that have been experienced and commented on in our last hearing are less important in the Federal Reserve mind, and that the concentration may be had on assisting in removal of the credit crunch.

We think that certainly the activities of the Federal Reserve have been remarkably successful in keeping down inflation. We hope they haven't been too successful. We hope that the activities of the Open Market Committee and their concern with inflation will not go to the extent of impinging the economic expansion the country needs.

We hope to hear from the Chairman today as to what the future course and recommendations of that committee will be and how they can cooperate with the Congress, with the President, in bringing about a reasonable recovery to the American economy.

And with that, I welcome the Chairman, and in addition, we have with us several additional members of the Banking Committee. First of all, I should recognize Mr. Ridge, who is still on an airplane at this time, but will be here shortly, we understand.

For an opening statement, if I may, have Mr. Roth.

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

Mr. ROTH. Thank you, Mr. Chairman.

Mr. Chairman, I have an opening statement, but in the interest of time, I would ask that my statement be introduced into the record so that we could get to the Chairman's testimony and then have more time for questions.

Chairman KANJORSKI. Without objection, so ordered.

Mr. ROTH. I appreciate your positive review of the economy this morning, Mr. Chairman. I would just say that among the key

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issues facing us here on Capitol Hill are the largest tax increase in history and taxing Social Security, the middle class, and small business. I hope we could get some illumination on some of these issues this morning, Mr. Chairman.

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

The ranking Member present today and chairman of the Small Business Committee, Mr. LaFalce.

Mr. LAFALCE. I am anxious to hear Chairman Greenspan so I will not have any opening statements. Thank you.

Chairman KANJORSKI. The gentlelady from New Jersey.

Mrs. ROUKEMA. Well, what can I say, Mr. Chairman? I did not have a formal statement, but I will observe that a lot has happened and yet nothing has happened since the Chairman was here in February.

It will be—I will observe that much of what you predicted in February has come to pass, but I am looking forward to hearing your evaluation and assessment regarding the Reconciliation Program, the budget and tax proposal as it is presently before Congress, and other indications of economic recovery. Certainly, somebody has been successful at keeping inflation low, and we appreciate that.

We are ready to hear your testimony, Mr. Chairman. Thank you.

Chairman KANJORSKI. Thank you.

The gentleman from Utah, Mr. Orton.

Mr. ORTON. Thank you. I will follow the trend of everyone else and yield any time I have back for the Chairman's testimony.

Chairman KANJORSKI. Thank you very much, Mr. Orton. And the gentleman from New Jersey, Mr. Klein.

Mr. KLEIN. Yes, thank you, Mr. Chairman. I too am most anxious to hear what the Chairman has to say and I will therefore refrain from my opening remarks.

Chairman KANJORSKI. Thank you very much, Mr. Klein. The gentlelady from New York, Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman, and welcome to Chairman Greenspan.

As we meet today, we see and hear signs of the low but continued economic recovery. However, some of the data coming to us indicates that although we see recovery and job creation, employment in some of the areas hardest hit by the recession such as New York State have not yet reached prerecession levels.

I cannot help but wonder whether we will ever reach those levels again. Did we as a region fully recover in terms of job growth or did the recession leave us with a permanent shrinkage of the job base in certain regions? These are difficult questions, but important ones which I hope your words today may shed some light on. I look forward to your testimony.

Thank you, Mr. Chairman.

Chairman KANJORSKI. I thank the lady from New York.

The gentleman from California, Mr. Dooley.

Mr. DOOLEY. I have no statement, Mr. Chairman. Thank you.

Chairman KANJORSKI. One additional member of the subcommittee has just arrived, Mr. McCollum from Florida.

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Mr. McCollum. I just want to welcome Chairman Greenspan, look forward to these hearings with you. We look forward to what you have to say.

Chairman Kanjorski. And we have the gentleman from Michigan, Mr. Knollenberg.

Mr. Knollenberg. Mr. Chairman, thank you very much, and welcome, Mr. Greenspan. The only point I will make is the one I have been making for quite some time—and the evidence continues to be, I think, somewhat dramatic to me—that our economy really is somewhat weak, even though we had a glowing report here.

And the thing I point to is the fact that early in the year, the Fed forecast that the GDP growth was estimated to be somewhere in the neighborhood of 3 and 3.75 percent. I notice by the figures that have been released here very recently that for the first quarter of 1993, that we are sitting at 0.7 percent. That concerns me. That doesn't show growth.

In fact, it indicates there may be a warning that this massive tax increase that Congress proposed may be enough to drown us. We are getting drowned in some other areas, but this is perhaps a financial drowning. I don't want us to repeat the mistakes that were made in 1990 with the tax increase, and I think that raising taxes will further slow the economy, destroy the job situation, make things difficult.

So those are my concerns and I look forward as well to your testimony. Thank you.

Thank you, Mr. Chairman.

Chairman Kanjorski. Thank you. And now I believe we have heard from everyone on the subcommittee, with a great deal of speed, if you'll note, Mr. Chairman, less than 9 minutes. And now we are looking forward to hearing from the Federal Reserve.

Mr. Greenspan.

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

Mr. Greenspan. Thank you very much, Mr. Chairman. I request that the full record of my remarks be included and I will excerpt from them.

Chairman Kanjorski. Without objection, so ordered.

Mr. Greenspan. It is always a pleasure to appear before this subcommittee to discuss the Federal Reserve's semiannual monetary policy report. My remarks this morning will cover the current monetary policy and economic settings, as well as the Federal Reserve's longer term strategy for contributing, to the best of our abilities, to the Nation's economic well-being.

As the economic expansion has progressed somewhat fitfully, our earlier characterization of the economy as facing stiff headwinds has appeared increasingly appropriate. Doubtless, the major headwind in this regard has been the combined efforts of households, businesses, and financial institutions to repair and to rebuild their balance sheets following the damage inflicted in recent years as weakening asset values exposed excessive debt burdens.

But there have been other headwinds as well. The builddown of national defense has cast a shadow over particular industries and

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regions of the country. Spending on nonresidential real estate dropped dramatically in the face of overbuilding and high vacancy rates, and has remained in the doldrums. At the same time, corporations across a wide range of industries have been making efforts to pare employment and expenses in order to improve productivity and their competitive positions.

In the past several years, as these influences have restrained the economy, they have been balanced in part by the accommodative stance of monetary policy and, more recently, by declines in longer term interest rates as the prospects for credible Federal deficit cuts improved. From the time monetary policy began to move toward ease in 1989 to now, short-term interest rates have dropped by more than two-thirds and long-term rates have declined substantially, too. All along the maturity spectrum, interest rates have come down to their lowest levels in 20 or 30 years, aiding the repair of balance sheets, bolstering the cash-flow of borrowers, and providing support for interest sensitive spending.

The process of easing monetary policy, however, had to be closely controlled and generally gradual, because of the constraint imposed by the marketplace's acute sensitivity to inflation. As I pointed out in my February testimony to the Congress, this is a constraint that did not exist in an earlier time. Monetary policy in recent years has had to remain alert to the possibility that an ill-timed easing could be undone by a flareup of inflation expectations, pushing long-term interest rates higher, and short-circuiting essential balance sheet repair.

The cumulative monetary easing over the last 4 years has been very substantial. Since last September, however, no further steps have been taken, as the stance of policy has appeared broadly appropriate to the evolving economic circumstances.

That stance has been quite accommodative, especially judging by the level of real short-term interest rates in the context of, on average, moderate economic growth. Short-term real interest rates have been in the neighborhood of zero over the last three-quarters. In maintaining this accommodative stance, we have been persuaded by the evidence of persistent slack in labor and product markets, increasing international competitiveness, and the decided absence of excessive credit and monetary expansion. The forces that engendered past inflationary episodes appear to have been lacking to date.

Yet, some of the readings on inflation earlier this year were disturbing. It appeared that prices might be accelerating despite product market slack and an unemployment rate noticeably above estimates of the so-called natural rate of unemployment—that is, the rate at which price pressures remain roughly constant. In the past, the existing degree of slack in the economy had been consistent with continuing disinflation.

However, the inflation outcome, history tells us, depends not only on the amount of slack remaining in labor and product markets, but on other factors as well, including the rate at which that slack is changing. Near the end of last year, about the time many firms probably were finalizing their plans for 1993, sales and capacity utilization were moving up markedly and there was a surge of optimism about future economic activity. This may well have set in

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motion a wave of price increases, which showed through to broad measures of prices earlier this year.

Moreover, inflation expectations, at least by some measures, appear to have tilted upward this year, possibly contributing to price pressures. The University of Michigan survey of consumer attitudes, for example, reported an increase in the inflation rate expected to prevail over the next 12 months from about 3¾ percent in the fourth quarter of last year, to nearly 4½ percent in the second quarter. Preliminary data imply some easing of such expectations earlier this month, but the sample from which those data are derived is too small to be persuasive. Moreover, the price of gold, which can be broadly reflective of inflationary expectations, has risen sharply in recent months. And at times this spring, bond yields spiked higher when incoming news about inflation was most discouraging.

The role of expectations in the inflation process is crucial. Even expectations not validated by economic fundamentals can themselves add appreciably to wage and price pressures for a considerable period.

The Federal Open Market Committee became concerned that inflation expectations and price pressures, unless contained, could raise long-term interest rates and stall economic expansion. Consequently, at its meeting in May, while affirming the more accommodative policy stance in place since last September, the FOMC also deemed it appropriate to initiate a so-called asymmetric directive. Such a directive, with its bias in the direction of a possible firming of policy over the intermeeting period, does not prejudge that action will be taken—and indeed none occurred. But it did indicate that further signs of a potential deterioration of the inflation outlook would merit serious consideration of whether short-term rates needed to be raised slightly from their relatively low levels to ensure that financial conditions remained conducive to sustained growth.

Certainly, the May and June price figures have helped assuage concerns that new inflationary pressures had taken hold. Nonetheless, on balance, the news on inflation this year must be characterized as disappointing.

In assessing the stance of monetary policy and the likelihood of persistent inflationary pressures, the FOMC took account of the downshift in the pace of economic expansion earlier this year.

While a slowdown from the unsustainably rapid growth in the latter part of last year had been anticipated, the deceleration was greater than expected. Smoothing through the quarterly pattern, however, the economy appears to have accelerated gradually over the past 2 years, to maintain a pace of growth that should yield further reductions in the unemployment rate.

Consequently, the evidence remains consistent with our diagnosis that the underlying forces at work are keeping the economy generally on a moderate upward track. However, as I have often emphasized, not all the old economic and financial verities have held in the current expansion, and changes in fiscal policy will have uncertain effects going forward. Thus caution in assessing the path for the economy remains appropriate.

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Financial conditions have improved considerably, lessening the need for balance sheet restructuring that has been damping economic activity for several years now. By no means is the process over, but good progress has obviously been made. On the other hand, the economies of a number of our major trading partners have been quite weak, constraining the growth of the demand for our exports.

Although expectations of a significant, credible decline in the budget deficit have induced lower long-term interest rates and favorably affected the economy, the positive influence thus far is apparently being at least partly offset by some business spending reductions as a consequence of concerns about the effects of pending tax increases.

It seems that the prospective cuts in the deficit are having a variety of substantial economic effects, well in advance of any actual change in taxes or in projected outlays. Moreover, uncertainty about the final shape of the package may itself be injecting a note of caution into private spending plans.

To be sure, the conventional wisdom is that budget deficit reductions restrain economic growth for a time, and I suspect that that probably is correct. However, over the long run, such wisdom points in the opposite direction. In fact, one can infer that the recent declines in long-term interest rates are bringing forward some of these anticipated long-term gains.

As a consequence, the timing and magnitude of any net restraint from deficit reduction is uncertain. Patently, the overall economic effect of fiscal policy, especially when combined with the uncertainties of the forthcoming health reform package, has imparted a number of unconventional unknowns to the economic outlook.

Assuming, however, we constructively resolve over time the major questions about Federal budget and health care policies, with the further waning of earlier restraints on growth, the U.S. economy should eventually emerge healthier and more vibrant than in decades.

Over the last 2 years, the forces of restraint on the economy have changed, but real growth has continued, with one sector of the economy after another taking the lead. Against this background, Federal Reserve Board of Governors and Reserve bank presidents project that the U.S. economy will remain on the moderate growth path it has been following as the expansion has progressed, and inflation will come in at or just above 3 percent this year and next.

In addition to focusing on the outlook for the economy at its July meeting, the FOMC, as required by the Humphrey-Hawkins Act, set ranges for the growth of money and debt for this year and, on a preliminary basis, for 1994. One premise of the discussion of the ranges was that the uncharacteristically slow growth of the broad monetary aggregates in the last couple of years—and the atypical increases in their velocities—would persist for a while longer. To an important degree, the behavior of M2 has reflected structural changes in the financial sector. Depository credit has been weak, necessitating little bidding for deposits. And depositors, in any case, have been drawn to the higher returns on capital market instruments, including bond and stock mutual funds.

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In this context, the FOMC lowered the 1993 ranges for M2 and M3—to 1 to 5 percent and zero to 4 percent, respectively. This represents a reduction of 1 percentage point in the M2 range and one-half percentage point for M3. Even with these reductions, we would not be surprised to see the monetary aggregates finish the year near the lower ends of their ranges.

As I emphasized in a similar context in February, the lowering of the ranges is purely a technical matter. It does not indicate, nor should it be perceived as, a shift of monetary policy in the direction of restraint.

In reading the longer run intentions of the FOMC, the specific ranges need to be interpreted cautiously. The historical relationships between money and income, and between money and the price level, have largely broken down, depriving the aggregates of much of their usefulness as guides to policy. At least for the time being, M2 has been downgraded as a reliable indicator of financial conditions in the economy, and no single variable has yet been identified to take its place.

In these circumstances, it is especially prudent to focus on longer term policy guides. One important guidepost is real interest rates, which have a key bearing on longer run spending decisions and inflation prospects.

In assessing real rates, the central issue is their relationship to an equilibrium interest rate, specifically, the real rate level that, if maintained, would keep the economy at its production potential over time. Rates persisting above that level, history tells us, tend to be associated with slack, disinflation, and economic stagnation—below that level with eventual resource bottlenecks and rising inflation, which ultimately engenders economic contraction. Maintaining the real rate around its equilibrium level should have a stabilizing effect on the economy, directing production toward its long-term potential.

The level of the equilibrium real rate—or more appropriately the equilibrium term structure of real rates—cannot be estimated with great confidence, though with enough to be useful for monetary policy. Real rates, of course, are not directly observable, but must be inferred from nominal interest rates and estimates of inflation expectations. The most important real rates for private spending decisions almost surely are the longer maturities. Moreover, the equilibrium rate structure responds to the ebb and flow of underlying forces affecting spending. So, for example, in recent years, the appropriate real rate structure doubtless has been depressed by the headwinds of balance sheet restructuring and fiscal retrenchment. Despite the uncertainties about the levels of equilibrium and actual real rates, rough judgments about these variables can be made and used in conjunction with other indicators in the monetary policy process. Currently, short-term real rates, most directly affected by the Federal Reserve, are not far from zero; long-term rates, set primarily by the market, are appreciably higher, judging from the steep slope of the yield curve and reasonable suppositions about inflation expectations. This configuration indicates that market participants anticipate that short-term real rates will have to rise as the headwinds diminish, if substantial inflationary imbalances are to be avoided.

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While the guides we have for policy may have changed recently, our goals have not. As I have indicated many times to this subcommittee, the Federal Reserve seeks to foster maximum sustainable economic growth and rising standards of living. And in that endeavor, the most productive function the central bank can perform is to achieve and maintain price stability.

Inflation is counterproductive in many ways. Of particular importance, increased inflation has been found to be associated with reduced growth of productivity, apparently in part because it confounds relative price movements and obscures price signals. Compounding this negative effect, under the current Tax Code, inflation raises the effective taxation of savings and investment, discouraging the process of capital formation. Since productivity growth is the only source of lasting increases in real incomes and because even small changes in growth rates of productivity can accumulate over time to large differences in living standards, its association with inflation is of key importance to policymakers.

The link between the control of inflation and the growth of productivity underscores the importance of providing a stable backdrop for the economy. Such an environment is especially important for an increasingly dynamic market economy, such as ours, where technology and telecommunications are making rapid advances. New firms, new products, new jobs, new industries, and new markets are continually being created, and they are unceremoniously displacing older ones. The U.S. economy is a dynamic system, always renewing itself. Central planning of the type that prevailed in postwar Eastern Europe and the Soviet Union represented one attempt to fashion an economic system that eliminated this competitive churning and its presumed wastefulness. But when that system eliminated the risk of failure, it also stifled the incentive to innovate and to prosper.

Risk taking is crucial in the process that leads to a vital and progressive economy. Indeed, it is a necessary condition for wealth creation. In a market economy, competition and innovation interact; those firms that are slow to innovate or to anticipate the demands of the consumer are soon left behind. The pace of churning differs by industry, but it is present in all. At one extreme, firms in the most high-tech areas must remain constantly on the cutting edge, as products and knowledge become rapidly obsolete. Many products that were at technology's leading edge, say 5 years ago, are virtually unsalable in today's markets. In high-tech fields, leadership can shift rapidly. In some markets where American firms were losing share just a few years ago, we have regained considerable dominance.

More generally, it appears that the pace of dynamism has been accelerating. The possibility of failure has productive side effects, encouraging economic agents to do their best to succeed. But there are nonproductive and unnecessary risks as well. There is no way to avoid risk altogether, given the inherently uncertain outcomes of all business and household decisions. But many uncertainties and risks do not foster economic progress, and where feasible should be suppressed. A crucial risk in this category is that induced by inflation. To allow a market economy to attain its poten-

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tial, the unnecessary instability engendered by inflation must be quieted.

A monetary policy that aims at price stability permits low long-term interest rates and helps provide a stable setting to foster the investment and innovation by the private sector that are key to longrun economic growth.

Clearly, the behavior of many of the forces acting on the economy over the course of the last business cycle have been different from what had gone before. The sensitivity of inflation expectations has been heightened, and, as recent evidence suggests, business and households may be becoming more forward-looking with respect to fiscal policies as well.

Mr. Chairman, I believe we are on our way toward reestablishing the trust in the purchasing power of the dollar that is crucial to maximizing and fulfilling the productive capacity of this Nation. The public, however, clearly remains to be convinced. Survey responses and financial market prices embody expectations that the current lower level of inflation not only will not be bettered, it will not even persist. But there are glimmers of hope that trust is reemerging. For example, issuers have found receptive markets in recent months for 50-year bonds. This had not happened in decades. The reopening of that market may be read as one indication that some investors once again believe that inflationary pressures will remain subdued.

It is my firm belief that, with fiscal consolidation and with the monetary policy path that we have charted, the United States is well positioned to remain at the forefront of the world economy well into the next century.

Thank you, Mr. Chairman. I am available to answer whatever questions you would like to proffer.

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

Chairman KANJORSKI. Thank you very much, Mr. Chairman. The questions for those members present will first be in the order of seniority of the subcommittee, and then at the end of the subcommittee's questioning, any nonsubcommittee members or members of the full committee.

Mr. Chairman, I take it that at the Federal Reserve, you sought full commitment to address the question of long-term inflation rates. And that certainly is an admirable course. But the impact this might have on that success or failure will be reflective here, what happens in Congress before the August recess.

We will be facing an important vote on the Deficit Reduction bill. And my question to you would be, one, is it important that the Deficit Reduction bill pass? And what will the consequences for the economy be if it does not?

Mr. GREENSPAN. Mr. Chairman, I think it is important that some major, credible Deficit Reduction bill be passed, because I believe that, as I indicated in my prepared testimony, there is an expectation in the market that a credible initiative will eventually emerge from the process which has been going on for the last 6 months or so. I fear, should that expectation be thwarted, that the markets would respond in a negative fashion.

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Chairman KANJORSKI. Do you have an opinion of just how negative this will be, Mr. Chairman?

Mr. GREENSPAN. It is extraordinarily difficult to tell. But remember that when we moved into this period of inflation concerns several years ago, the major problem that confronted the markets was the growing awareness that after defense expenditure reductions came to an end in the latter part of the 1990's, the underlying thrust of expenditures and revenues would create a deficit which was growing as a percent of the Gross Domestic Product, and that results in fundamentally an unstable financial condition as we get to the turn of the century.

As a consequence, what we observed was an extraordinary inflation premium embodied in longer term interest rates and indeed, as you may remember, we got to a very extraordinary slope in the so-called term structure of interest rates, where despite the fact that short-term interest rates were coming down, long-term interest rates, even though they did come down, remained stubbornly high.

The market's belief that something of a credible nature would emerge out of the debates that have been going on is what has tilted long-term rates down in the last several months. And that expectation, is clearly related to a credible budget deficit reduction outcome of this whole process.

Chairman KANJORSKI. Well, there are forces in the conference, some of the issues in the conference—and I am going to direct myself one further question—that indicate that a reduction of $400 billion as opposed to $500 billion over 5 years is just as acceptable.

Do you have an opinion on that?

Mr. GREENSPAN. Yes. I think not. The problem that we have is a very substantial one. Even the legislative initiatives which have been put on the table from both sides of the aisle in this debate do not complete the requirement of removing that upward bias in the deficit toward the end of the century.

I realize, of course, that health care reform is an obvious major issue in this. But it is also clear that we are going to have to take another shot at the deficit. In other words, we need more than one tranche in budget deficit reduction to get it flattened out. If the markets perceive that we are backing off the size of the commitment in this first tranche, I think that they will react appropriately negatively. The role of the Congress and the administration to finally bring the process to success, requires a fairly large commitment, indeed something not very different from what is contemplated in the current variety of bills.

And my view is that—even though I have not commented and will not comment on the details of the particular program—that the $500 billion program is probably about the right size for the first tranche of what I view as a two-tranche or maybe a multitranche endeavor to finally bring this budget problem under control.

Chairman KANJORSKI. I want to comment on your answer, because I agree with you, Mr. Greenspan. And I think that it is essential that the Congress and the administration show the nerve to the American people to take this necessary first hit. And what most Americans don't seem to understand, I learn from my town

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meetings, is that they think we are reducing the debt, as opposed to the deficit.

After all the pain and anguish that we seem to be going through here in town, when it is all said and done, the debt is still going to be $1 trillion higher after this administration than it is right now. We are actually trying to reduce the increase in the debt by a half a trillion dollars. This is a hard-sell issue out there. The American people don't seem to understand that.

But as I understand your last answer, once we get the first half trillion in, that the Congress and the President, after a period of time allowing for the economy to further stabilize, will have to go back to contribute more to deficit reduction in order to turn down the increasing rate of the deficit.

Mr. GREENSPAN. Yes, sir.

Chairman KANJORSKI. And do you think that the President's timing, in terms of reduction per period of time to control the deficit, is about right, or would you progress at a faster speed? Some of our colleagues, particularly on the other side, have been struck with the idea that we can contain the deficit overnight and it can be done magically, we can cut it right out.

Mr. GREENSPAN. I can't comment on other people's characterization, but I can indicate to you that whereas we may have had some time slack several years ago to come to grips with it, as I indicated in February to this subcommittee, I think time is running out.

It is a very long-term project. It is not something which is going to be completed overnight, but unless we come to grips with it fairly quickly, I don't see how we are going to get it done in a manner which will reach successful conclusion without ultimate disruption to economic processes.

Chairman KANJORSKI. And in discussions that we have had, not on the public record, I seemed to gain the impression that your feeling is that the best we can do is show the way toward deficit reduction, and that will reduce the long-term interest rates in such a manner that it would infuse a great deal of capital into our system to allow for the economic growth and productivity that you talked about in your testimony; is that correct?

Mr. GREENSPAN. Yes, indeed. I would say that while obviously there are other factors involved in the recent declines in long-term interest rates, in my judgment, the issue of expected credible deficit reduction at the end of this process is the major factor which is inducing the decline in rates and is a major factor in the support of economic activity which, although quite subdued in the first quarter, is clearly accelerated in the second quarter. The outlook is one which seems moderately favorable and I would attribute the decline in long-term interest rates as a major factor in that process.

Chairman KANJORSKI. Thank you very much, Mr. Chairman. I would now like to go to my colleague, Mr. McCollum of Florida.

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

Chairman Greenspan, last February you predicted or the Federal Reserve predicted a Gross Domestic Product growth in the range of 3 to 3.75 percent for this year we are in now. And up to this point, it has been less than 1 percent.

I noticed in your testimony today, you say that the Federal Reserve predicts for the quarters from last—the end of 1992 fourth

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quarter through the fourth quarter of 1993, an average growth in GDP of about 2.5 percent.

Does that mean that you are looking at upward of 4 percent GDP growth rate the second half of this year to compensate for this very slow start, or what is it—what does it translate to?

Mr. GREENSPAN. It is still too early to make a really firm estimate of the second quarter GDP. But it is clearly somewhat in excess of 2.5 percent growth. And depending on how the data for the month of June in certain key areas come down, there is a fairly large range of where the basic growth rate in the second quarter will have turned out. But we are clearly somewhere running about 3 percent, if one uses all the various measures we are trying to focus on.

Now, that clearly is not something which I would consider to be adequate, but in the context of the balance sheet restraints that we still have and the difficulties of our export markets resulting from the weakness abroad, it is not a bad performance.

Would we like to see better? Obviously, we would like to see better.

Mr. MCCOLLUM. Do you see better? I guess that was the question. In other words, you are saying the second quarter—the first quarter was less than 1 percent. You think the second quarter is closer to 3 percent, and therefore you are expecting it to stay at that level or higher for the balance of the year in order to get you that 2.5 percent average?

Mr. GREENSPAN. Yes, well, roughly. I don't want to characterize the specific estimates for the second half, but remember that the first quarter was abnormally low for a number of short-term reasons. First of all, even though there has been a decline in defense expenditures programmed by the various authorizations and appropriations of the Congress, there was a particular deceleration that occurred in the first quarter, which had a major impact on the GDP number. That, I might add, is stabilized in the second quarter.

And, obviously, we had some extraordinary bad weather conditions in the first quarter. So in that sense, the first quarter was clearly far underrepresenting what basically has been the thrust of this recovery, which, while not very powerful, has been reasonably supportive of cumulative recovery.

Mr. MCCOLLUM. We have got some bad weather conditions right now that are going to have an impact on the GDP, aren't we, with the flooding in the Midwest and the drought in the East, and all of that in the agricultural community?

Mr. GREENSPAN. We will have some, but not as great as those that occurred in the first quarter by a significant order of magnitude.

Mr. MCCOLLUM. Let me ask you a different type of question relative to your comments about the impact of the tax or anticipated tax increases on business and business decisions. I know in the past, on numerous occasions, you have stated your personal preference for reducing the spending side of the equation to tax increases in the deficit battle, although you have always emphasized your overall commitment to basic deficit reduction.

Is this tax plan that now is being debated in the format that seems to be most likely to go ahead of having the tax increases up

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front and any spending reductions out 3 or 4 years, is that going to have a significant impact on business in a negative way that would be better if we had the tax—I should say, spending cuts balanced up front? Would it not, in your opinion, be better if we could balance them?

Mr. GREENSPAN. Congressman, I am going to repeat what I said here 6 months ago when the original budget proposals were put on the table. As central bankers, our basic concern is getting the Federal borrowing requirement down because of its destabilizing effects on economic activity.

I also said that I favored significant emphasis on the expenditure side for a very important statistical reason or numerical reason. Namely, that if you take a look at the current services spending trend, as we move into the latter part of the 1990's, the growth in expenditures is greater than the growth in the tax base or the Gross Domestic Product, in nominal dollars.

And even though a significant part of that is in health care, the major principle involved is that unless that path of growth in outlays is slowed down, there is no tax increase which will effectively reduce the long-term budget deficit problem.

So my central point is that if you have to increase taxes to support the ever-rising percentage increase in spending as a percent of the GDP, you ultimately cannot succeed because as tax rates or the tax base continuously rise to support that spending, the economy at some point will run into some difficulty.

So irrespective of how one looks at this question, there is no alternative to slowing the rate of expenditure, bringing it back in line to the percentage increase in the tax base or nominal Gross Domestic Product.

Mr. McCOLLUM. And may I assume then that it does concern you that the spending reductions and the slowing of that spending growth are delayed in what has been proposed up here by the Senate and the House this year?

Mr. GREENSPAN. I am sorry, would you repeat that?

Mr. McCOLLUM. Well, does it bother you that the spending reduction side of deficit reduction has been delayed, I think in the neighborhood of 2, 3, 4 years, in the proposals currently pending out of the Senate and the House as opposed to——

Mr. GREENSPAN. I can't respond to that without specifically commenting on the proposals that are before the Congress. I will let it stand as I said it, as best I can.

Mr. McCOLLUM. Thank you, Mr. Chairman. You are being very diplomatic.

Chairman KANJORSKI. The gentleman from New York, Mr. LaFalce.

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

Chairman Greenspan, I welcome your warm endorsement of the basic budget plan submitted by President Clinton, which is now in conference. And I think you pointed out quite clearly how that is only one-half the battle when you pointed out that the huge increased——

Mr. GREENSPAN. I know you are being a little facetious, but let's put it on the table, I was endorsing nothing.

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Mr. LaFalce. It was a good try. But it seems to me that you were certainly calling for the control of health care costs, because that is the largest single component of the spending increases that are projected over the future years that you expressed concern about.

And so imperative of not only dealing with this budget proposal of the President in a successful manner, but also dealing with health care reform, the largest component being costs, health cost controls. I am going to ask you to respond to three comments that some constituents of mine have made to me and see how you would handle them. And all of them want me to oppose the President's basic budget initiative.

First, they argue, you can't tax your way to prosperity, and that is basically what you are doing. And you attempted that, you being the Congress, in 1990, and look what happened to the economy in 1990.

So I am curious how you would distinguish between what was done between President Bush and bipartisan Congress in 1990 and what happened then, and what we are doing today.

And second, some of them would argue that the whole effort for the President's budget proposal was based upon his assertion that there has been a change in the budget deficit figures from precampaign to postcampaign, but now it would appear that the budget deficit for this fiscal year, and perhaps next fiscal year, might be lower than the revised estimate that gave rise to these specific budget proposals, and therefore perhaps it is not as important to come in with as much of a deficit reduction measure in the early years, as long as we are consistent with the outer years.

And the third point, so much concern has been raised about this being a jobless recovery, that it appears that this clearly was true when the President was inaugurated in late January, but the recent figures with respect to new jobs are somewhat encouraging, and therefore perhaps we don't need the type of action that is being called for now.

How would you respond to those three charges, statements, arguments?

Mr. Greenspan. First of all, Congressman, the debate on the outcome of the 1990 Budget bill is under extraordinary dispute. My own impression is that a number of the elements that were in that 1990 compromise to restrain expenditures by putting different restraints and caps on various programs, have indeed worked, and that there is no question that a substantially lower level of outlays has occurred as a consequence of the 1990 budget agreement.

What was fundamentally wrong in that period was a very extraordinary underestimate of what the long-term budget outlook was. It was indeed in my judgment, especially in retrospect, far worse than the data that was evolved at that time and used to evaluate how the budget deficit would proceed. The problem of the deficit back then clearly was substantially underestimated.

As a consequence of that, we are seeing, as the Congressional Budget Office appropriately indicated, a major reduction from what it otherwise would have been as a consequence of that act. Clearly, what was expected then has not evolved. And part of that, but only

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part and perhaps significantly less than half, resulted from lower economic estimates than in fact were the case.

It is my judgment that there is an additional level of outlays which must be added to the current services budget, which would take into account the fact that there are administrative and judicial actions that are taken coupled with add-ons which occur as a consequence of congressional action, which are biased toward increased spending. And that number is not added to the basic long-term budget projection.

That is part of the reason why the 1990 agreement looked to be so badly off. A goodly part was that they failed to recognize how bad the outlook at that point basically was.

With respect to your second point, the problem, long term, is very substantial. The changes that are involved in the fiscal budget deficits for fiscal 1993 and 1994 are really quite small and essentially irrelevant to the long-term problems that confront us. And I would say they are not something which should induce us to pull back our endeavor to trim the deficit.

Finally, there has been a better job outlook. We went back and revised the data and found that the employment shortfalls that we thought existed were not fully there and that the employment outlook has indeed been better than we have expected. In fact, since the end of 1991, there have been an increase of 2 million jobs. But that is again a short-term phenomenon.

The problem we are dealing with in the longer run is not affected by these conditions. And it is the longer run to which the budget deficit issue has to be addressed.

Mr. LaFalce. Thank you very much.

Chairman Kanjorski. Thank you very much, Mr. LaFalce. We now go to Mr. Roth, the gentleman from Wisconsin.

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

Chairman Greenspan, in your testimony this morning you point to—and I think very appropriately—the rapidity of change. Technology 5 years ago would be virtually unsalable today. And that would lead us, I suppose, to the conclusion that we have got to do whatever we can to encourage our entrepreneurs and risk-takers to provide the jobs our people need.

Wouldn't you say that would be correct?

Mr. Greenspan. Most certainly.

Mr. Roth. Now, in this bill that is before us, this Tax bill that some of my colleagues were referring to, we have capital gains tax increase, we have individual tax increase, we have energy tax increase, we have increase of all kinds, yet at no time in our previous history where we have had these increases have we strengthened our economy. And certainly this wouldn't give incentive to our risk-takers and our entrepreneurs.

So wouldn't you say that this bill is going to have a wet blanket effect on our economy?

Mr. Greenspan. I can't comment on the specific aspects.

Mr. Roth. Sure you can.

Mr. Greenspan. I can, but I won't. But, Mr. Roth, I think that I have indicated, before this subcommittee, that the capital gains tax should either be indexed retroactively, lowered, or preferably eliminated.

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And the basic reason why I have argued before this subcommittee in the past on that question, well in advance of these budget initiatives, is that the underlying nature of this economy is, as I describe it in my prepared remarks, an extraordinarily dynamic continuously renewing economy, which requires incentives for people to take the types of risks that create wealth and increase standards of living. So that is a position that I have held over the years and clearly continue to hold.

When we are beyond this question of the budget issues, I trust that a more appropriate evaluation of the issues of capital gains and the question of how they should be handled with respect to maximum wealth creation will be addressed.

Mr. ROTH. Well, I appreciate that comment. And yes, you have been consistent in your statements over the years as far as capital gains tax is concerned. You know, we had TIFRA, where we are going to get $3 in spending cuts for every dollar in tax increases, we had that $99 billion tax increase, you remember. Then, of course, we had other increases. And then 1990, as has been pointed to before here, we had another tax increase.

And basically what concerns me about the legislation before us is, in your testimony, you talk about a long-range view. And I agree with that, I can see that. But even with this Tax bill, and even with the best estimates, we are going to have a $6 trillion deficit after it is all said and done by 1996, 1997.

Aren't you concerned about that?

Mr. GREENSPAN. The level of the debt?

Mr. ROTH. The level of the debt, yes.

Mr. GREENSPAN. Certainly, I am. There are two aspects to the concerns one should have about the budget deficit. One, obviously, is the deficit, per se, as a percent of the Gross Domestic Product and its impact on financial markets. But the level of the debt from which the service costs emerge is also critical in evaluating precisely what type of deficit reduction we need.

Because what is evident by very simple arithmetical relationships, as we project what is going on indefinitely into the future, is that the system breaks down.

Mr. ROTH. Yes, I take an opportunity to tour a lot of our small businesses that we have in our home State and other parts of the country. And I am always impressed; that is why I was impressed with your testimony here on page 14 talking about the entrepreneurs and rapidity of change. This rapidity of change is something I don't think we focus on enough, we are not sensitive to enough. Because it is such a dynamic economy.

Therefore, I would like to ask you, what one thing could we do on Capitol Hill to help our entrepreneurs and our risk takers? What advice would you give us in this subcommittee and as a Congress?

Mr. GREENSPAN. I would say what I indicated previously; namely, to review the incentives that we create for the creation of new wealth and risk taking, and remember that this is a—as I say in my written text—that this economy is churning at a very rapid rate, there is a great deal of risk that is being taken and a great deal of it which creates losses. But all of the wealth that we create occurs as a consequence of risk taking. Every action that any indi-

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vidual householder or businessman takes which is a commitment to the future is of necessity at risk because we cannot know for sure how various actions we will take will come out.

If we can induce people to be willing to take those risks, to create wealth—if we can induce an acceleration of that process—we will induce the acceleration of economic growth and standards of living.

Mr. ROTH. Thank you, Mr. Chairman.

Chairman KANJORSKI. The gentleman from Utah, Mr. Orton.

Mr. ORTON. Thank you, Mr. Chairman, and welcome, Chairman Greenspan. I appreciate your testimony with regard to the importance of deficit reduction, and would like to follow up briefly with a couple of questions on that subject.

You indicated you would not recommend that we lower our target from $500 billion to $400 billion or less in deficit reduction. Would there be a negative result on the economy if we increased our target and actually increased the deficit reduction beyond $500 billion in 5 years, to, say, $600 or $650 billion in deficit reduction?

Is $500 billion about the right target or do we risk having negative impact if we go higher than that?

Mr. GREENSPAN. I must say that were you to put more in, I would not be terribly concerned. One of the reasons is that history tells us that there is always considerable slippage after the fact. And if one buttressed it in part with an add-on, it probably would not be bad policy.

My suspicion is that it would be extraordinarily difficult to do and the pressures are clearly on the other side. The content of my testimony is mainly to reinforce where we are, but if the Congress in its wisdom decided to increase it, I should certainly find that not discomforting.

Mr. ORTON. It is an uphill task, politically, but there are those of us here who are attempting to do that. I also would have a question about the way in which we achieve deficit reduction. We either have to do it by reducing spending or increasing taxes.

I am wondering if there is a quantifiable difference between those two methods on the economy in the way that we pull money out of the economy through deficit reduction. Is there a more negative impact as a result of reducing Federal spending or as a result of pulling more money out of the system through increasing taxes?

Mr. GREENSPAN. Congressman, this is a highly debatable issue amongst economists. You can get views on both sides. The conventional wisdom is that if you leave out the question of expectations and the sort of advance effect I have described, then you basically impact the economy more by lowering spending than in raising taxes.

I must say, I am not overly persuaded by the evidence on that myself, and I do think that the anticipatory aspects of tax increases, for example, create an expectation of permanent tax levels which will impact on business spending over a much longer period of time.

Now, it is true that the same phenomenon holds when you reduce expenditures as well. So it works in both directions. So it is very difficult in any specific instance to prove conclusively one way or the other. If you bring five or six economists here and you ask

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them, I can guarantee you will get 10 different answers on this subject.

Mr. ORTON. We can hedge our bets by doing some of each, apparently.

Mr. GREENSPAN. My inclination, as I indicated to an earlier question, is that the problem that we have over the long run is that there is an expenditure increase projected by current law which is in excess of the increase in the tax base, which means that first and foremost, we have to make certain that the expenditure growth slows down or we will not solve this problem. The tax question is really secondary, because we have got to get the expenditure path reduced first.

Mr. ORTON. And I think that is critical. I would like to shift to just one other point before my time expires, and that has to do with the availability of capital and credit. In order to have an expanding economy, we must have access to capital and credit.

This subcommittee has been holding hearings regarding the credit crunch as it is called, the lack of availability of credit. Obviously, the policy of the Fed has been to keep inflation low and keep interest rates down.

I am wondering if you have any opinion upon the credit crunch. First of all, do you think it does exist? if it does exist, what is driving that credit crunch? Is it a lack of demand for credit from the private sector? Is it some policy that the Federal Reserve has that is keeping tight credit? Or is it the process, the banking regulatory process, the need to increase capital and the RTC collapse? Or is it a combination of all or something different?

And if you don't have time, I would be happy to receive a written comment from you on it as well.

Mr. GREENSPAN. Let me just say very quickly, it is not reasonable to assume that Federal Reserve monetary policy is involved here. And the reason I say that is that not only have interest rates come down extraordinarily, but in the many instances where individual banks have endeavored to increase their market share by lowering their interest rates, they failed.

In other words, it does not appear as though this credit problem that we have, and indeed I think we have one, is a function in any material sense of the level of interest rates, because the market in that sense has been tested quite considerably. I think the real problem is, as I have indicated to this subcommittee on many occasions, the result of a period of extraordinary rise in debt to financing rising assets.

After the value of the assets fell, mainly in commercial real estate collateral, you ended up with commercial banks with very strained balance sheets themselves and fearful of the state of their capital, which has led many of them to hold back and to tighten their lending policies, which only very recently have shown evidence of easing.

But there has also been this extraordinary holding back on the part of borrowers who, having overborrowed, have been very reluctant to get back into the market. We at the Federal Reserve have done a number of things in conjunction with the other regulators, and some of it, I think, is helpful.

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But, fundamentally, this is a psychological problem. People have been frightened and it takes a while for it to wear off. It is in the process of wearing off, but I would scarcely argue that the so-called credit crunch phenomenon is over. It is not.

Mr. ORTON. Thank you, Mr. Chairman.

Chairman KANJORSKI. Next, the gentlelady from New Jersey, Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman.

Chairman Greenspan, Mr. Orton and, to some extent Mr. McCollum, have asked the questions that I wanted to ask. I was particularly interested in your response on the credit crunch and I would hope that we could work along. I do believe it is psychological and I think there is time that is needed to work this out.

But there may be some suggestions you can make for congressional action and Fed action. And if there are followups that you are going to be directing to this subcommittee, to Mr. Orton, I would hope that you would share that with the whole committee. I think it is an extremely important issue for all of us.

The other question really on my mind was this question of the ratio of spending to—spending to tax reductions in the budget. And that was the center of my concern. I would like to make a couple of observations and perhaps you will respond. I think you made a very coherent and excellent presentation on the interest rate question, and its relationship to, using your words, the credible deficit reduction, and if we don't have credible deficit reduction, we are going to see all kinds of negative effects and particularly on interest rates.

But I would like to observe, although you have been cautious in being—not wanting to be too specific on the questions of spending versus tax increases, and I am not one of those Republicans that say "read my lips, no new taxes," but I do feel and I wish that we had had more support from the business community and other economists, that the voices haven't been loud and clear enough on constraint on spending.

In fact, I would like to have seen strong statements calling for moratoriums on any new spending. I find that this budget proposal is remarkably weak on the spending side in the fact that with the exception of Medicare—which is what I am going to get to—with the exception of Medicare, there has been no real restraint on spending as far as I can tell. They haven't cut out any real big projects, nothing that costs any real money.

They nibbled away here and there a little bit, and worse than that, they have actually proposed some new spending programs that have the potential of growing into capped entitlements, which I find extraordinary, when we are facing the kind of debt and deficit reduction needs that we are facing.

To that extent, the ratio is not good in my opinion and to that extent there is too much of a reliance on new taxes rather than on spending restraint first and then looking at the capital side. But you have made a very accurate statement and I am afraid none of us really want to accept it, that the current services growth over time will be greater than the growth of the tax base.

And I guess we will find that out, what, in 1996 or 1997 or whatever that date is. It is not too far in the future. What disturbs me

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is, and you referred to the health plan, what disturbs me is people are too easily talking about capping health care costs almost as though that is going to be an elixir.

It may be the sine qua non, but I don't think it is the elixir to our problems. But I have got to say, nobody seems to acknowledge that no matter what we do in reforming health care, and I do think there are some cost controls, that the population is getting older and this is going to be not only draconian, but an unfair share of the burden if we look to that elixir despite the growth in the aging population in this country.

And I don't know whether I have asked you a question or want you to comment. I would love to have you comment on it. But I think we are fooling ourselves if we believe that we are going to find great savings at that point in time. And I wish we would all come to the reality of cutting costs now in this budget reconciliation, but I don't see much hope for that.

Mr. Chairman.

Mr. GREENSPAN. Let me just comment that arithmetically, one finds that the excess of growth in spending under current services is all over the medical care area. The——

Mrs. ROUKEMA. All in the medical care area?

Mr. GREENSPAN. Yes. In other words, by excess over the rate of growth of——

Mrs. ROUKEMA. Yes, I see.

Mr. GREENSPAN. Of gross domestic product in nominal terms. If, and this is the important if, if you could stabilize the proportion of health care that is in the budget as a percent of the growth domestic product, then effectively you would slow down the rate of spending enough.

But as you point out, the underlying thrust of health care is suggestive of an outcome which is more likely to be that it is still increasing as a share, even though it may be increasing less fast than it is today. Should that occur, and it is a hypothetical, obviously, it then means arithmetically that you have to reduce the remainder of expenditures to a rate of increase less than the increase in the tax base.

And if on top of this—I raise the issue that I raised earlier—the current services expenditure projections tend to exclude these add-ons which occur. Indeed, the most appropriate projection of budget outlays is not the current services projection, because that stipulates what would happen under current law and under current regulations.

What history tells us is that that assumption never prevails. There are always changes, either judicial or administrative, in the way programs are administered, and the bias of those judgments and rulings is always higher. The presumption that the Congress does not add anything is also an inappropriate assumption.

So all in all, my concerns and the reason why I raise these issues is a major concern about the longer term, and one of the reasons I raise the question about the 1990 agreement is I think we are underestimating the longer term pattern of spending. Therefore, there is all the more reason why we have to come to grips with the spending question and why, irrespective of what is done on the tax

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side, coming to grips with spending is an essential ingredient to resolving the long-term budget problem.

Mrs. ROUKEMA. Well, thank you, Mr. Chairman. I appreciate what you just said and I didn't want any of my questions to be interpreted as feeling that you have been less than forward thinking and less than articulate in stating again exactly what you do mean about the spending restraint.

I only made the point because I feel that there are too few in the business community and among economists who are speaking as forthrightly on the spending side, and I think we have lost a unique opportunity at this point in time, in this particular budget, to set the path finally. The Medicare question is another issue.

Thank you, Mr. Chairman.

Chairman KANJORSKI. We will now hear from the gentleman from California, Mr. Dooley.

Mr. DOOLEY. Thank you, Mr. Chairman, and Chairman Greenspan.

To follow up on the comments of Congressman Orton, both the Republican proposal and President Clinton's budget proposal will not ever take us to what would be.

If I interpreted your statement correctly, until we make balancing the budget a fundamental objective, we drive the deficit to zero and start to make attempts to reduce the national debt and the servicing of that debt, we are still going to be facing some underlying problems that will affect how rapidly our economy can improve. Is that correct?

Mr. GREENSPAN. What we want to do is at least stabilize the ratio of debt to gross domestic product. But remember, that would presuppose a deficit, because the debt is nonetheless growing.

Ideally, I would like to see either the budget in balance or, as I have indicated in earlier testimony before the Banking Committee it would be useful if this country could run a surplus because of our low savings rate.

While I have not surfaced this idea in recent testimony on the ground that it seemed sort of not exactly appropriate, it should be our goal. That would mean obviously that we bring the total debt down.

Mr. DOOLEY. So if that is our goal, then you wouldn't subscribe that it would be an appropriate policy that we can live with a deficit that is 2 percent of GDP?

Mr. GREENSPAN. If you want to put it in those terms, yes, we could live with it. I mean it would not create a great problem for the economy, we would be operating at much lower levels of efficiency, because 2 percent of the GDP put in private productive capital assets rather than in financing the deficit is not a choice I have great difficulty in making.

I don't want to say that we would run into a real major problem, but we obviously would be functioning far less efficiently than we would if we had the budget in balance or in surplus.

Mr. DOOLEY. What would be your anticipation of the impact on the interest rates, 30-year bond, if Congress in the next year or two did make the commitment to get to a balanced budget in a decade, or by the end of this century?

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Mr. GREENSPAN. As the markets have demonstrated, if they sense that there is true credible action about to occur in the Congress, then the markets will move in advance of that.

I don't want to forecast where interest rates can or would go, but it should be obvious that from the extraordinary improvements in corporate and household balance sheets that have occurred as a consequence of the lower long-term interest rates, that more of the same would clearly be most helpful to the American economy.

Mr. DOOLEY. I think certainly a great deal of credit for the reduction in interest rates has to be attributed to some of the commitment or the perceived commitment of Congress and the administration to reduce the deficit. But would not the financial community also respond if they felt that the economy was not going to be improving to expectations, that interest rates would also be a bit lower?

Mr. GREENSPAN. Yes. There is obviously a question that if the markets presume that the economy was weakening, obviously you would get, other things equal, lower long-term interest rates.

And there is no question that some of the reduction that we have seen in recent months does reflect that. But remember that when the economy was far weaker, you know, 18 months, 2 years ago, long-term rates were much higher than they are now.

So you can't argue that that could be a really very substantial determinant. But I don't deny it is part of the fairly extraordinary decline that we have had in long-term rates.

Mr. DOOLEY. Thank you very much.

Chairman KANJORSKI. We will now go to the final member of the subcommittee present, Mr. Neal, and then Mr. Knollenberg, we will go to you.

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

Chairman Greenspan, I noticed in your testimony that you had lowered the target range for M2, and I imagine that that will attract some attention and some comment. And I am just thinking back, I am remembering when we originally put into law the requirement that you focus on the Ms.

I think most economists thought then that the growth rates of the monetary aggregates were very good predictors of inflation. In fact they had been for a long time, but in recent years those relationships have broken down considerably.

And although they may be good over long periods of time and so on, as short-term predictors those relationships have broken down. And I am just wondering if it wouldn't be much better for us to simply focus on inflation as a target, as opposed to these other indicators.

I know you touched on the great benefits of price stability in your testimony, but we know now that we can get the greatest sustained economic growth and the greatest sustained job creation, the lowest sustainable interest rates, the highest sustained levels of savings and investment and productivity and so on, by low inflation.

And since we know that and we know that if we think the goal of monetary policy ought to be to sustain economic growth and sustain job creation, we know the goal ought to be low inflation, I am just wondering if we wouldn't be better targeting that. It just

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seems to me that we run the risk of there being a lot of discussion about something that is in today's environment essentially irrelevant.

Anyway, that is one question. And I would just like for you to comment briefly on it. And I would like to ask you another question before my time goes away. And that has to do with the RTC legislation. As you know, we are probably pretty close to trying to get that past the House. It has passed our subcommittee, passed the full committee, with very good support.

But I would like to ask you to comment on what you think would happen if we didn't pass RTC legislation. I, personally, think it would be quite negative for the economy at large in terms of reduced confidence, and especially bad for the financial system. But I would ask you please to comment on both of these.

Mr. GREENSPAN. Congressman, let me start with the RTC and then go back to the issue of inflation and M2. The current estimates with respect to the costs to the American taxpayer as a consequence of not resolving the institutions that the RTC would be scheduled to resolve is, as I believe the Secretary of the Treasury indicated yesterday, $3 million a day, or roughly $1 billion a year. And the reason for that is that it costs more to fund the liability of these institutions than it would if Treasury bill rates, for example, were employed.

The basic issue here is that the deposits have been guaranteed in these institutions. These are liabilities of the American Government, now. It is nothing that is going to happen in the future. They are already the liabilities of the government. The form of the legislation to allow funding for the RTC is essentially to move those liabilities from a high cost area to a lower cost area.

So in that sense, the failure to fund the RTC is just adding to the costs of something which the American Government, that is the American people, are already obligated for. So it strikes me that it is very poor public policy to be paying more to fund these liabilities which are liabilities of the government by the present means, when we have it in our capability of funding them at a cheaper level.

Mr. NEAL. Isn't there a long-term cost, the potential for longer term cost also? That is, if people thought we weren't going to make good on this promise that we made for almost 60 years to guarantee their deposits, in other words, if we weren't paying someone who——

Mr. GREENSPAN. I don't think that anyone believes and I don't think that it is probably even conceivable that we are not going to pay the deposits or in fact the interest on the deposits, because that is not an issue as far as I can judge.

The question is whether we do it in a sensible manner or in a nonsensible manner and at the moment the lack of funding of the RTC strikes me as most inappropriate government policy.

Mr. NEAL. I notice my red light is on. Would the chairman allow an answer to that other question about the——

Chairman KANJORSKI. Yes, absolutely.

Mr. GREENSPAN. As I have indicated many times to you and in this subcommittee and in other committees, Congressman, we perceive that if our fundamental goal of monetary policy is to create sustained economic growth, the evidence is becoming increasingly

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persuasive that a necessary condition to achieve that is low inflation or stable prices.

And the reason, as I indicated in my prepared text, is that clearly productivity is involved here and living standards and growth are crucial. So we are acutely aware of the inflationary pressures that could emerge and could do great damage to the economy, as indeed it did as we all remember back in the 1970's.

I trust we are not going to allow that to happen again. The purpose of the monetary aggregates has been historically to try to create a set of data which signals when those inflationary pressures are beginning to emerge. And the various measures that we have employed, including this model we call P-star, which relates the general price level over the longer run to the M2 trend values, has broken down. If it were working, it would give us a longer term view of the posture of monetary policy relative to the rate of increase in the price level.

I should hope that when these balance sheet strains and other forces which are so disturbing our financial system are removed, that M2 or something close to it will reemerge as a useful tool and the P-star model will again be a functioning tool for monetary policy.

So while I certainly agree that inflation is a crucial variable, it is a lagging variable as economists like to say. And we need something well in advance to suggest when these processes are emerging so that the actions we take to suppress incipient inflation can be very modest, and not have any disruptive effects, because we do them in a manner which is gradual, we don't allow the type of surging inflationary instabilities that occurred in the past which required draconian action to bring them under control.

Mr. NEAL. Thank you.

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

We now go to the gentleman from Michigan, Mr. Knollenberg.

Mr. KNOLLENBERG. Thank you, Mr. Chairman.

Chairman Greenspan, thank you for testifying here this morning. I particularly enjoyed some of your comments. I know some that you were particularly cautious on. And I guess I would like to go back to one of those items that you were somewhat cautious on.

I know it is a followup to some questions that were raised here already, but being last on the pole here, I have the advantage of having some of my questions answered and then perhaps one or two that aren't, or weren't.

Now, you seem to imply that you were skeptical, that there was much distinction between reducing the deficit via taxes or through cutting spending.

Mr. GREENSPAN. No, I think I was raising the question of the impact on the economy.

Mr. KNOLLENBERG. Impact on the economy, all right.

Mr. GREENSPAN. My predilections, as I have indicated before the committee before and especially in the context of my hearings 6 months ago, was that I would prefer expenditure reduction because over the long run that is a more effective way of restraining the deficit.

I was merely responding to the question relevant to the impact on economic activity and the difficulties economists have in

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making the judgment as to the tradeoffs of the impact of spending reductions on economic activity and tax increases on economic activity.

Mr. KNOLLENBERG. Well, one of the things that—and I appreciate the correction on that. I didn't mean to imply differently. But would you not agree that when it comes to the entrepreneur, to the job creator, to small business, and, for example, in my district in the 1980's, in fact through all of Michigan and particularly in my district, all of the net new jobs were created by small business?

Mr. GREENSPAN. That is true all over the country.

Mr. KNOLLENBERG. That is true all over. I don't suggest it is a unique situation in my State. But it would seem to me, and I would hope that I would get your agreement on this, that taxes are more of a negative, they hazard the small business person much more than the matter of spending cuts.

And, for example, you know, if we are going to see any economic growth, I know that one of the reasons that we are here this morning is to talk about that and we also made reference, and I did in my opening comment, to the fact that the predictions have fallen short by some margin. I think 3 to 3.25 predicted, it is actually less than 1 percent.

And I might even suggest to you that perhaps one of the reasons that the growth hasn't been that great, at least from my perspective in my district, is that people are weary, they are reticent, they are holding back, they are concerned about the future.

And it would seem to me that if we are going to see economic growth, that we have to be particularly sensitive to taxes and taxes on the small business person because they are the ones that have created the jobs. And frankly, right now, they are not. And I just ask your comments, if you would agree in part.

Mr. GREENSPAN. I certainly indicated in my written testimony that there is evidence to suggest that a number of capital projects, small and large, are on hold because of the uncertainty with respect to the tax possibilities. The reason I raise the issue as being not all that easy to answer is that while I have no doubt that expected increasing taxation of small business is a negative—indeed one finds by any survey that that clearly is the case—it is also the indication that respective reductions in expenditures have been negative. For example, the reduction in defense expenditures has had an extraordinarily strong negative impact in southern California.

As I have indicated in past testimony before this subcommittee, all taxation is negative. In other words, it reduces levels of economic activity one way or another. I don't deny that there are secondary effects and a number of people will argue that environmental effects are improved or a variety of other things, but as a general first proposition, I would say that any taxation suppresses economic activity. And to the extent that you impose taxation on risk taking, you do it in spades as far as I am concerned.

Mr. KNOLLENBERG. That is what we are doing.

Mr. GREENSPAN. But what we have as a result of any deficit reduction, to the extent that it reduces interest rates, specifically long-term rates and mortgage market rates, it has a very obvious offsetting effect.

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The reason this is a very complex issue is that we have anticipations having a major impact on economic activity in advance of the first dollar of tax increase or first dollar of expenditure reduction. And what we are observing is how extraordinary markets are and people are in responding to these expectations. I think we have to take those issues in consideration.

Mr. KNOLLENBERG. Thank you, Chairman Greenspan. Mr. Chairman, thank you. Appreciate your comments.

Chairman KANJORSKI. Thank you, Mr. Knollenberg.

The gentleman from New Jersey, Mr. Klein.

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

Chairman Greenspan, I certainly welcome you and admire your leadership in this area. The low interest rates which we have been experiencing during the past several years have certainly been designed, or I shouldn't say designed, but should normally have had the effect of stimulating business activity.

There has not been as much responsiveness to those low interest rates as one might expect. Is there any reason to believe that perhaps other measures should be taken in order to stimulate business activity? Is there some question about the correctness of the low interest rate policy or is it a matter of a continuation of the low interest rate policy along with other stimuli?

But how do we get a more significant increase in the economic activity?

Mr. GREENSPAN. Congressman, as I indicated in my prepared testimony, indeed as I have argued before this subcommittee on innumerable occasions in the past, it is the requirement of households and businesses to restore some balance to their balance sheets, if I may put it that way, which got so badly strained as a consequence of the rise in debt which was used to finance assets whose value subsequently declined.

That has had a remarkably consistent continuing repressive effect on economic growth. I have used the term "50-mile-an-hour headwinds," which is what we are running up against. Clearly, one of the issues that is involved here is that as a consequence of this, the historical response of the economy to lower interest rates has not been clearly replicated. We have seen far less in the way of economic expansion as a consequence of lower rates than would historically have been the case.

Having said that, it is also true that the decline that has occurred in intermediate and longer term rates, especially mortgage rates, has had a very pronounced effect in giving us the growth that we actually see, which while not as strong as we would like, is stronger than anyplace in the industrialized world at this point.

The problem is to try to get the balance sheets repaired as quickly as possible. That is going to take time, but it is working. And it is working in a very steady pace. Debt service burdens are down. This has increased the cash-flow of consumers.

We see some definite improvement in the equity debt ratios of corporations as they finance very heavily in the market for increased equity. So things are clearly gradually coming back into place. We are trying to accelerate the process by trying to see if we can free lending at a faster pace than it would normally occur as a consequence of these balance sheet repairs.

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And we have, in conjunction with the other regulators, instituted what I like to call a character loan, a vehicle or basket which has enabled a number of banks to start to lend with less in the way of required documentation. We can go through, and indeed we have and will, go through a number of initiatives in conjunction with the other regulators to try to ease what is still a very obvious credit crunch.

And we will continue to do that until the issue is finally and fundamentally resolved. But in my judgment, what is at the core of the economic problem in this country, short-term, is the strained balance sheets, the unwillingness to borrow on the part of households and businesses, to in fact create increased economic growth.

All of this means that there is something fundamentally askew in the system, which requires repair. But what is clear is that low intermediate mortgage rates, long-term rates, are the most important in the short run to get the economy back on a solid footing.

Therefore, we are endeavoring to focus on those areas of the economy which enhance the improvement of the balance sheets of the system, which is the most important thing to get the economy back on a much more solid footing.

Mr. KLEIN. I am told that my time is expired, but Chairman Kanjorski has generously given me permission to ask one additional followup question.

And I would just ask you this: I noticed that there are many, many businesses that are seeking credit that had difficulty obtaining credit. I am not talking about those that are the targets of our community banking legislation that was announced last week. I am talking about small- and medium-size businesses that are really the best hope for generating new jobs for the economy.

How do we deal with the credit crunch as it affects those people?

Mr. GREENSPAN. I certainly agree that that is a problem, and indeed it is an issue which has bedeviled us for quite a long while. We are trying to take what regulatory initiatives we can. And we have been endeavoring to create an environment in which lending can start to take hold.

Some progress is clearly obvious. Even though the total commercial and industrial loans have been remarkably flat with maybe just a slight up tilt, that is a net figure. From what we can judge, there has been a significant reduction in business loans to larger businesses which leads us to suspect that the loans to small businesses are finally beginning to show a little bit of buoyancy, but nowhere near enough to suggest that the credit crunch that has been our concern for so long is behind us.

But there is evidence that there is progress being made. In other words, we are not just pushing and pushing and nothing is happening. We have been pushing and pushing and finally getting modest trends occurring. It is clearly subnormal so far as credit growth is concerned.

Credit availability is still, judging from the anecdotal evidence we pick up, less than we would like. So it is just going to be a continuous process by which we will push as much as we can and hope that as the balance sheets finally improve, that we will get a restored financial system. We don't at this point have that as yet.

Mr. KLEIN. Thank you very much.

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Chairman KANJORSKI. Now, we will go to Mr. Schumer from New York.

Mr. SCHUMER. Well, thank you, Mr. Chairman. I certainly appreciate your invitation to the members of the full committee who don't sit on this subcommittee to be here. And thank you, Mr. Chairman. I think that you, as always, are walking this very delicate tightrope with grace and success, I guess.

Let me first talk a little bit again about the deficit and the budget plan. I understand that my colleagues were basically engaged in the debate, is it better to do tax increases or cuts. To me, that is beside the point. It reminds me, I think, of Winston Churchill, once talking about two pachyderms in a natural act, it is not how they do it, but any wonder they do it at all. And here we have come closer than ever before to getting some real deficit reduction.

I ask you to comment just on this in a minute. But that there are real numbers there, this is the first time I have seen that the numbers are not faked, that they made honest and even conservative guesses. So many people are jaundiced by all the other attempts to reduce the budget, but when we sat here when we saw the numbers come down, saw that the numbers weren't really accurate. They were stretched to the optimistic side, that never happened. That is not true in this budget, and I think if we do it one way or another we will get some real deficit reduction.

But my concern relates to the question of the fact that the economy is softer and squishier than maybe we thought even 3 or 4 months ago, that even your own estimates evidently have come down in terms of growth from 3 to 2½.

The question is not whether we should do deficit reduction, but many people have come to me, particularly in the last month or two, and said, yes, we should do deficit reduction, but the timing is bad, that because the economy is soft or because the recovery is less robust than what everyone thought, to do the deficit reduction now, whether January 1 of last year or July 1 of this year, is wrong.

And so my question to you is this, could you comment on that generally, and what would you think of an idea proposed by some that says we should enact the deficit plan this year, but then change its enactment date, move the enactment date a year up, give the economy time to grow before cuts—before the cuts and the taxes bite, but at the same time give people the assurance that on the books there are real laws that will affect deficit reduction?

So your comments on those two things, first the accuracy of the numbers compared to previous times, and their more conservative nature, and second, this proposal for some kind of not change in the budget plan, but delay in its—enacting it now, but delaying its effective date.

Mr. GREENSPAN. As I indicated 6 months ago when the President's program came up, I said in effect that I thought his economic assumptions were credible, that they are within a range of judgments which subsequently proved to be what more optimistic than——

Mr. SCHUMER. Are they more credible than previous ones that this Congress——

Mr. GREENSPAN. I would say probably yes. I mean it——

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Mr. SCHUMER. That is a strong statement for you.

Mr. GREENSPAN. The reason I say probably, yes, is that there has been an inclination in recent years to move in a better direction. I thought that some of the estimates in, you know——

Mr. SCHUMER. Previous years?

Mr. GREENSPAN. Well, I was about to say maybe 10 years ago, were really a little bit more difficult to swallow than some of those in recent years. But I thought that some of the estimates made by the Council of Economic Advisers in the Bush administration were also far more credible than had been previously the case.

I don't think that we have got a problem now of what we used to call rosy scenarios. That is not our problem. Our problems are the real fundamental spending difficulties that exist. I would not agree, incidentally, that the economic outlook is worse now than it was 3 months ago. I think that we have been going in fits and starts. The expansion accelerates, decelerates.

The first quarter data were extraordinarily weak because we had a surprisingly sharp drop in defense expenditures and awful weather. The second quarter is clearly accelerated significantly from that level. It is not running at a fast pace, but at a reasonably moderate pace. If one waits for the "ideal time" to balance the budget, it will never occur.

Unless you come to grips with the issue now—if we seriously believe that we are going to confront this issue but not now, always later—that process will just continue indefinitely. I think we have run out of time. I said that here 6 months ago.

I didn't mean it in the context of weeks or months, but in this particular timeframe. And if we don't come to grips with this issue realistically now, we will always find reasons not to do it.

Mr. SCHUMER. You are not, to paraphrase, you are not worried that taking money out of the economy at this point in time will inhibit whatever—or inhibit sufficiently to not do it, whatever recovery is going on now?

Mr. GREENSPAN. Mr. Schumer, what the evidence indicates, which is really quite different from what a lot of us would have expected, is that we are getting a very substantial positive effect from the expectation of credible budget deficits, which is offsetting a goodly part of the so-called fiscal drag.

Now, there are other aspects which I indicated in my prepared testimony which offset that as well, but looking at the full balance of all of this, the economy is not running at a particularly fast pace, the unemployment rate is too high, it is coming down too slowly, this is not a vibrant economy by any means.

But it is clearly not one that is about to tilt over into a significant state of weakness or contraction, and it certainly is not an economy that one would hesitate to maintain a long-term budget deficit reduction. It is an economy which would not inhibit long-term deficit reduction in my judgment.

Mr. SCHUMER. OK. Just one final question. The chairman has again been nice enough to allow me that, even though the time is up.

You mentioned this a minute ago. I guess the great fear that not only many of us have but out there in the public, too, is the jobs question. No one has laid out a scenario to me, left, right, center.

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Our companies are getting leaner and meaner and that is good in an international economy, they are more productive, we all agree with that.

The cost of that is laying off millions of people in relatively good jobs. Where are the new jobs going to come from?

Mr. GREENSPAN. Well——

Mr. SCHUMER. No one has given a very good answer about that that is reassuring that me.

Mr. GREENSPAN. Let me say this, first of all, we have had a net increase in jobs of about 2 million since the end of 1991. One of the reasons why I took some time in my written testimony to emphasize the extent to which the dynamism of the American economy is, if anything, accelerating, is to try to stress the fact that this system is continuously renewing itself, and that basically jobs are being created all over the place in new areas where history says you could find none.

The data indicate that we create new job openings of about 400,000 a week. That is the obverse of initial claims which are roughly the same order of magnitude. This system is churning at an extraordinarily rapid pace and what history tells us is that basically if you have a stable economic environment, investments will rise to the point that the unemployment rate will come down to what we call the natural rate.

In a sense, people will become employed. We cannot say in advance where it will occur, in other words, in which industries or in what levels, but that it will occur is undeniable if history is any guide. And one of the problems that we have in this type of question is we cannot say what types of goods are going to be produced 5 years from now.

In fact, if we tried to forecast 5 years ago what we would be producing today, we would have been off in remarkable orders of magnitude. Similarly, we cannot say exactly where all the jobs will be in some detail, except that if the environment is stable, that they will be there.

It is too costly to an economy to have people unemployed. It is profitable to somebody to hire somebody who is unemployed. And that is the way the system works.

Mr. SCHUMER. Thank you, Mr. Chairman.

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

The subcommittee has been so nice to you today, Mr. Chairman, that I have got to throw in another question. You have done something unique at the Fed. You have succeeded in unifying Dr. Samuelson and Dr. Friedman, in both charging the Fed with overly restricting monetary policy.

I think Dr. Friedman says that you are only paying lip service to meeting the monetary policy targets. We want to give you an opportunity to respond to economists on both sides of the spectrum.

Mr. GREENSPAN. I must say that these are very prominent economists who have done great service to the profession and to the American economy and they are both very good friends of mine. And the arguments we may have are technical and economic.

I do think they are wrong, nonetheless. I say so largely because in many instances their view of the state of monetary restriction, in my judgment, and I must say in the judgment of my colleagues,

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is one that fundamentally differs from the points of view that we have taken.

It really gets to how one evaluates the problems we had with the monetary aggregates and how to evaluate them and what their role has been in the system. So I will leave it at that.

Chairman KANJORSKI. Thank you, Mr. Chairman. Mr. Greenspan, we have heard some today, even some of my colleagues, interchange the word "deficit" for debt. This is not uncommon, as we travel to and from our constituencies.

Most people have difficulty comprehending some of the terminology used to describe the situation that our economy is in. And I have heard people even here on the panel today saying that the largest tax increase in history is being proposed. These exaggerated statements seem to go unanswered, but perhaps haven't we created a false impression in the country as a whole, and perhaps even in the world, that since we seem to have no base for comparison, we are leaving people with the opportunity to speak hyperbole that really is not accurate?

To compare a tax increase in dollar terms today to dollar terms of 1982 is of little relevancy. Obviously, there are more people today, the dollar is worth less today, the gross domestic product is greater today than it was. And I want to run through a few things by you and then give you a question.

I often hear how terrible the economy is today relative to the end of the Second World War, and yet as I look back on the Second World War, we had a $350 billion debt and gross domestic product of roughly $350 billion, so we had a one to one ratio.

Whereas today we have a $4.2 trillion debt, but we have a $6.2 trillion gross domestic product, which is a two-thirds to one ratio, significantly different. Adding to that the end of World War II, we only had 120 million Americans, today we have 250 million Americans, a decidedly larger and more complicated country.

What it really is drawing me to is why hasn't the Federal Reserve, or have you and we just missed your voice, or why haven't the more enlightened parts of the business community commanded that the Federal Government go to a more representative budgeting style, truly reflective of the difference between a capital budget and an operating budget?

So many of us, when we agree with the President that there are advantages to making investments that are reflected in the capital budget, we do so because we believe that long-term net investment creates wealth for the country and creates just a better quality of life for everyone, as opposed to operating with difficulty or imbalances which may be using tomorrow's wealth to satisfy needs of today. Why isn't there a greater hue and cry from the Federal Reserve and others to separate these economic distinctions?

Obviously, the purchase or the implementation of a highway system is something that should not be charged off in 1 year. And how are we ever going to get away from the excessive misstatements of people using wrong comparisons if we do not get a more plausible budgetary strategy in this country?

Mr. GREENSPAN. Mr. Chairman, there are differences between accounting in the private sector and accounting in the public sector. And indeed we do have estimates in the Federal budget process of

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these various different types of investments. You can look through the appendices of the budget document and find fairly detailed analyses of what parts of government outlays are quasi investment type goods and under various classifications.

But there is a fundamental question here which is important to address. And that is that as far as the financial markets are concerned, as far as the impact on interest rates, as far as the impact on financial stability, there is very little difference between funding a project for capital purposes or for consumption purposes.

The reason basically is that in the private sector a capital project is self-financing, meaning there are revenues which come directly from that project to repay the debt that has been incurred for the purpose of funding that particular project.

To the extent that there are such projects in the Federal Government, that is, those which raise revenue, then there is an argument in favor of a capital budget for those projects. But the vast variety of what we loosely call investment expenditures are very indirect in their impact on the economy, education, and a variety of other related sorts of issues, and do not directly have measurable cash-flows which are usable to repay the debt which was incurred.

As a consequence, the financial markets tend not to make those distinctions, and probably will not unless we fund projects in a manner in which they would be self-financing. The classic case is the toll road, for example, in a State or municipal funding area. So, while I do think there are useful applications for capital budgeting in the Federal Government, I think we have to be very careful to recognize that there are major differences between the private and the public sectors, and be particularly wary of defining items as investment rather than consumption and put them off budget because the markets will not put them off budget, they will count them.

My own counsel here is to be very careful in changing the budgetary system. In my judgment the unified budget accounting system, while clearly having many flaws associated with it, has served us rather well over the years.

Chairman KANJORSKI. But is it not creating internal confusion within the government itself as to whether or not we are going to be making decisions for investment or decisions for consumption?

It is really a field day for the hypocrite to argue that internally a dollar spent is a dollar spent, when in fact if it is a dollar spent for some long-term investment purpose as compared to some immediate consumption purpose, it may be a significant difference as to the long term well-being of the country.

Mr. GREENSPAN. Mr. Chairman, I certainly don't deny that there are significant differences between various items in the budget outlay side of our accounts, depending on what they are used for. I don't question that.

And I think that appropriate budget policy should very clearly make determinations of the appropriate composition of what we spend our resources on. I am only raising the question that so far as the financial markets are concerned, and this is relevant to what the Federal Reserve is interested in, that there appears to be no meaningful distinction being made unless projects are self-fi-

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nancing in a cash sense, not in a long term very difficult to measure sense.

Chairman KANJORSKI. I believe that the gentleman from Florida has another question. Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

Chairman Greenspan, a lot of water has gone under the bridge in terms of words since I last asked you a few questions at the beginning of this hearing, and a lot of it has to do with tax and spend matters more than it has to do with monetary policy, although they are certainly interrelated.

I would note in deference to the Chairman's comments about statistics, one seems to be a pretty sound one that has out there that some of us remain finding useful and cause us to be skeptical about the current proposals in terms of the deficit reduction plan; that is, that since World War II, I think I am right, that for every dollar in tax increases that has occurred, the Congress has enacted, we have increased spending by about $1.57.

And I think the public is concerned about that. It probably is reflected in the business decisions you noted to us today in terms of anticipation of what is going to happen when you are really going to see over the next 3 or 4 years is substantial increase in taxes and whichever version apparently comes out of the House/Senate Conference on this budget deal, and you are going to see no real spending reductions at least planned for during that period of time, until virtually the end of the Clinton administration.

And I just would submit that while there will be a great debate that will go on, I am not going to ask you a further question about this, this has been the heart I think of why you have been asked so many questions today on this subject. It is just a concern, how this reaction is in the business community and in the American public eye, skepticism about really getting deficit reduction, really happening when so much is dependent upon early tax increases as opposed to real spending reductions in the plan.

Now, I do have a question or two, though, for you, that remain unanswered today. One of them has to do with your comment earlier that the price of gold is sharply increased recently and you indicated in your testimony that was one of the concerns that the Federal Reserve had in its monetary policymaking.

My question, and what I want to ask you is, is this in your judgment a reflection of inflationary pressures at the moment? Is it, as some technical analysts say, a technical move that it would actually go over $400 an ounce to some figure, that that is just in the nature of the beast for this cycle of gold to do that? Is it reflective of a contraction in the supply of gold because as we had a few years ago the Russians pulled in their horns on their gold supply?

Do you have any data that could tell us what the forces at play are in this recent rise in the price of gold?

Mr. GREENSPAN. There is considerable dispute amongst analysts about what causes gold prices to move. My own view is that the basic supply of gold in place essentially approximates all the gold that has ever been produced, going back to antiquity.

And that therefore short-term changes in the supply and demand for gold, unlike the effect on other commodities, cannot have a major impact. From which I conclude that the substantial part of

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the price change that occurs in gold is from the demand side, meaning if the supply is fundamentally fixed by the huge stock that exists, then the price changes as a consequence of demand.

I have always interpreted the changes not on a day-by-day basis or even a week-by-week basis, as being a reflection of concerns about inflation because essentially what the gold price reflects is a concern about the purchasing power of currency or money.

And while its ability to forecast changes in inflation is quite open to dispute, there is nonetheless a key question of whether it is a good measure of inflation expectations. And in that regard, it is something which we clearly have to look at because it is a measure which is not replicated in other forms.

We obviously look at a wide variety of issues. But clearly, despite the narrowness of the gold market and even though it tends to be highly volatile and in many respects seems to reflect short-term supply and demand characterizations, over the longer run I think that it tells us something fundamentally about the view of the stability of the currency.

Mr. McCollum. You and I discussed this over the years and I certainly concur that gold is a significant factor in terms of a measure device. It can't be the only one and we even talked about a commodity basket that you have alluded to using from time to time as one of those many other things you look at besides the Ms.

I wanted to ask one other question about a so-called Ron curve theory that you may be familiar with, and I have never been in the presence of your testimony when you addressed that question. And I am curious to know what you think of this theory. I want to state it as succinctly as I know it. It is that as government spending rises as a share of the gross domestic product, its contribution to economic growth slowly diminishes until it reaches a point where it actually retards economic growth.

Are you familiar with this theory?

Mr. Greenspan. I am not familiar with it in that particular form. I have heard of many different versions of that. It is essentially the notion that as the government share of the economy increases, the share that is available to the private sector decreases, and that unless you are to argue that capital productivity in the government sector is superior to the private sector, then clearly you end up with total gross domestic product slowing down.

The classic case is a centrally planned economy where by definition government controls 100 percent of the output. The experiences we have had in recent decades with that type of economic organization clearly, if you want to call this a curve, fixes one point of where that curve is.

But I am sure you will find that there is very great dispute within the economics profession as to where various different changes in government share of the GDP impact on economic activity.

Mr. McCollum. But in principle that basic statement I read you, whatever it is called, I guess it is named after Richard Ron, the former economist down at the Chamber, is not divergent from your general view?

Mr. Greenspan. No. If you are asking whether or not at some point the share of GDP which goes to government can come to the

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point where it slows economic growth, the evidence of that is unquestioned. Sweden, for example, very recently has run into a problem where they have perceived that the size of the government has been a retardation factor in their economic growth pattern.

Mr. McCollum. If the chairman would permit me, I would like just one last question. And it is a followup to what Mr. Neal asked you about on the Resolution Trust Corporation, only to this extent, because I don't want to get into a long discussion. We will go debate that on the floor here in a few days I guess.

But I am curious, since he raised it, if you can switch your hat over there to that field again, is there a rationale that you are familiar with of why the $7 to $10 billion that is sitting there in the cash holdings of the RTC or in the cash holdings available for resolving these institutions has not been used at all in the last few months to resolve any of the 84, 85 of these institutions in conservatorship?

That question has been raised of me several times lately, and I don't have a good answer for it one way or the other.

Mr. Greenspan. I am not familiar with the particular issue, but I do know that they like to keep some spare resources in the event of some unanticipated event which might require action on their part. What the appropriate reserve is, frankly, I don't have a good judgment.

Mr. McCollum. I am just curious if you knew. That is all. I am not going to take more of your time.

You've been very good to be with us today as always and we appreciate your coming up here, reporting to us. It is always fascinating to me, as I said earlier on. I sat in several of these with you and it is a very good appearance, a very positive one I think for the Nation.

Thank you very much.

Thank you, Mr. Chairman.

Chairman Kanjorski. Thank you, Mr. McCollum.

Mr. Chairman, I have just a few more questions and then we will let you get back to work. We have noticed that the activities of the Federal Open Market Committee meeting of May 18 were rather quickly leaked, although the transcript is usually kept from the public eye for some 60 days.

And as you know, there have been suggestions that in order to not give certain people benefits with leaks, that the minutes of that committee be made immediately available so there is no one that gets a decided advantage.

I guess what I would like to ask is whether there has been any determination as to who has had an advantage as a result of those leaks on May 18? And what can we expect the Fed to do to prevent future leaks?

Mr. Greenspan. Obviously, we have been concerned about the problem. Leaks are a very serious matter and there is no question that to the extent that they occur, they are unfair to the public and potentially disruptive of the policymaking process.

And I don't think it helps public confidence in the central bank to have every once in a while something leak out which is inappropriate. We have reaffirmed our concerns and reaffirmed our policies to make certain as best we can that that does not happen.

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The problem that we have in releasing the directive early or the minutes early is that in my judgment, and I think the judgment of my colleagues, is it significantly inhibits the efficiency of policy-making.

The major issue is that in our deliberations, what we try to do is to create alternative paths that policy might take in the intermediate period, depending on certain events that could occur. If we were to publish that immediately, the financial markets would respond and adjust to expectations of how we might or might not behave. That would make it very difficult for us to actually act, because if, for example, we said under conditions A or B we might do something, and the markets interpreted that we might, then there would be an immediate adjustment in market rates.

If we chose not to take action, then the markets would have to come down very sharply. And in our judgment that would create a degree of instability in the system which we find unacceptable. If it turns out that we were required to publish in advance, or I should say immediately, all of the deliberations, we could not use those contingencies. We would find ourselves probably with what we call symmetric directives, meaning on the one hand and on the other hand, and we wouldn't have any various different contingencies spelled out.

We probably would act only after meeting, and we would meet far more often. That would be a far less efficient means of implementing the policies that we are trying to implement. We certainly recognize that in a democratic society it is very important for the central bank to communicate wherever possible not only what we do, but why we are doing it.

And we hope that the minutes, which I think are really quite informative and capture the real essence of what those discussions were, does that. I would hope that we are not required to publish them immediately, because I think they would turn out to be very bland and the process of policy would indeed be undercut in my judgment.

Chairman KANJORSKI. I understand the argument against the publishing of the minutes. But I am unsure that I fully have heard an answer as to what the Fed is doing about closing the leaks.

Am I to understand that maybe this subcommittee could be helpful in examining how those leaks operate? Should we examine that question?

Mr. GREENSPAN. We have focused on this question a great deal recently. Obviously, it is something which we find very disturbing. I hope that we have put into place sufficient controls at this stage to eliminate leaks in the future.

I don't know that for certain, but I suspect we may have. And I would hope that, as the months go by, it will become increasingly clear that we have succeeded in that endeavor.

Chairman KANJORSKI. I am not going to ask you to spell out the controls, because obviously that would allow people to void the controls. But it is going to be my responsibility or the subcommittee to watch very closely, Mr. Chairman, and if there isn't a correction of that, to impose ourselves in some way to either find out what is happening, or to allow everyone to have the leaks simultaneously.

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And I tend to agree with you, that it will make the Federal Reserve meeting its commitment far more difficult, but I don't know that we will have an alternative. Certainly, the pressure along that line is building up, contrary to your position.

Mr. GREENSPAN. I appreciate your concerns, and I certainly appreciate your desires to be of assistance in this regard.

Chairman KANJORSKI. Finally, I guess I am going to close with one last question. I do not know if you or your staff has had the opportunity to study H.R. 2600, the Secondary Market bill, which this subcommittee introduced about 2 weeks ago, establishing a secondary market for business loans, both small, medium, and large, and for community development loans of various types.

I was curious if you have any position on it or whether you have had the opportunity to study it.

Mr. GREENSPAN. Well, earlier in the session, Mr. Chairman, I expressed concerns about the fact that the credit crunch has not been fully resolved, that the financial system has not as yet adjusted to the balance sheet strains, and it is probably going to be a while before we can say we are back in some semblance of equilibrium in this regard.

I must say that the area of greatest concern is in small business lending, because those are the types of establishments that do not have access to the capital markets as large corporations do, and can't finance independently of the banking system.

There is no question in my mind that were we able to create a viable small business secondary market, it would facilitate small business lending. As I think I may have indicated to you before, Mr. Chairman, as I view the general thrust of your initiative, it is to essentially clear away some of the legal impediments that exist in the marketplace in a manner similar to that which was done with respect to the secondary market in home mortgages.

So long as the development of a secondary market is created without direct or indirect government subsidies, either through a federally sponsored agency or through other subsidy means, I think it could be a very useful initiative to assist the financial marketplace.

I would emphasize that we have to be careful not to try to subsidize this market, because to the extent that it is a usable and viable market, as indeed I think it is, it will develop by itself. And if we find that we are creating subsidies, we are not going to be able to get out from under them. Once you get them in, they are very difficult to unwind.

So I would try to emphasize, Mr. Chairman, that it is important that in evolving such legislation, that we be careful that subsidies not be involved and that what the structure of the facilitation is to clear away impediments which do exist in the creation of these markets. Because if that could be done, I think it would be a major contribution to the financial system.

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

I am certainly pleased to hear your position on this issue. I wanted to compliment you in your report today. I felt that it was extremely bipartisan. Presently, we are in a struggle in the Congress which appears, unfortunately, to be very partisan at the time,

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and I think most often that the American people are curious as to whether or not we can ever escape our partisan nature.

But I think your testimony today indicates that although you come from an appointment of a prior administration, at least the Federal Reserve has the capacity to present a bipartisan position on the question of balancing the budget or reducing the deficit.

I compliment you on that. I appreciate your report. I think it has been forthright, and I believe it indicates that the Federal Reserve is going to cooperate with the administration and the Congress in every way it can to move the recovery along, but in an organized, stable way, so that we do not suffer hyperinflation, nor should we experience undue economic trauma in the Nation as a whole.

As a Member of Congress representing a small district in Pennsylvania, I want to thank you for your appropiate position on this and for your report today.

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

Chairman KANJORSKI. The subcommittee stands adjourned.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

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A P P E N D I X

July 20, 1993

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Opening Statement

The Honorable Paul E. Kanjorski, Chairman

Subcommittee on Economic Growth & Credit Formation

Semi-Annual Hearing on the Conduct of Monetary Policy

July 20, 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.

I want to welcome Chairman Greenspan back before the Subcommittee today. Since we last met to discuss monetary policy in February there have been major developments in our nation, the economy, the Congress, and at the Federal Reserve and the Federal Open Market Committee.

Much of the economic news of the last six months has been encouraging:

- **Inflation remains low** – The latest two months' Consumer Price Index numbers, 1/10th of 1% in May and no change in June, are the lowest numbers since the bottom of the 1991 recession.

- **Interest rates remain low** – The 30-year Treasury rates have fallen to almost 6.5% – ***the lowest level since the Treasury began regular sales of 30-year bonds in 1977***. The three-month T-bill rate hovers around 3%. Home mortgage rates are also at twenty year lows, with 30-year fixed rate mortgages at just over 7%.

- **Refinancings continue at an almost unprecedented pace** – saving consumers and businesses tens of billions of dollars in interest costs. This makes it possible for consumers and businesses alike to reduce their debt burden, to increase their savings, and to stimulate the economy by making new purchases. Three-and-one-half million families refinance their mortgages in 1992,

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seven times more refinancings than occurred in 1991, and the refinancing boom is continuing in 1993. The average refinancing saves consumers at least 2% in interest thus reducing the overall debt burdens by $20 to $30 billion a year. Fannie Mae surveys indicate that for home mortgages 45% of this reduced debt burden is going into savings, 35% is being used to pay off other bills, and 10% is being used to increase consumption.

• **Bank and thrift profits are up and the cost of the S&L clean-up is dropping** – The FDIC's Bank Insurance Fund (BIF) is back in the black, and for the first time since 1985 clean-up costs are going down, not up, and the end may actually be in sight. Over the last two years, bank assets and deposits have grown modestly, problem loans have decreased by more than a quarter (from $104 billion to $74.6 billion), the proportion of problems loans exceeding loan loss reserves has been slashed by more than 50% (from $46 billion to $19.8 billion), and capital has increased by almost a quarter (from $239 billion to $292 billion).

• **Both houses of the Congress have passed major deficit reduction legislation** – While the margin may not have been as large or as bi-partisan as we might have liked, the deficit reduction is real, there is no smoke-and-mirrors, the numbers are headed in the right direction, and this will be the largest deficit reduction package in the history of our nation.

While there has been progress on many fronts, storm clouds remain in sight:

• **Unemployment** – remains stuck at 7%. While this is a 10% improvement from a year ago when the rate was 7.7%, there has been virtually no change in recent months.

• **Commercial & industrial lending** – also remains stagnant at just under $600 billion. As the Subcommittee's field hearings in Nanticoke City and Cranberry Township, Pennsylvania, and Ashtabula, Ohio, have indicated, ***small- and medium-sized businesses are still having difficulty securing and retaining lines of credit***. This is particularly troubling because robust economic recovery will continue to be held back unless significant improvements are made in this area.

Despite the assurances we have received from many in the commercial banking industry, there is no question in my mind that ***the business credit crunch is very real and represents a significant impediment to economic recovery***. Hopefully the series of regulatory steps announced by the Clinton Administration will have a positive effect in making more credit available.

I should also note that this Subcommittee is making substantial progress in developing legislation to assist in the creation of an active and broad secondary market for business, commercial, and community development debt and equity investments. On July 1, a number of my colleagues joined me in introducing H.R. 2600. Hearings on this legislation are planned for September, and I look forward to its timely consideration by the Subcommittee.

• Also of particular concern has been the recent **flooding in the midwest and heat waves in the east.** *Billions of dollars of crops, homes and businesses have been destroyed, substantially increasing the need for credit and disaster assistance at a time when collateral has been destroyed and we are trying to reduce the deficit.* Normal supply lines have been cut or disrupted, and transportation costs for products will escalate.

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As Chairman Greenspan is aware, critics of the Federal Reserve contend that its repeated inability to meet even the low-end estimates for monetary growth have contributed to the sluggishness of the economic recovery and the stubborn resistance of the unemployment rate. ***Given the magnitude of the disaster in our nation's heartland, it is imperative that Chairman Greenspan explain today how the Federal Reserve will work with President Clinton and the Congress to ensure the families, farmers, and businessmen in the flood-ravaged midwest that they will have access to the credit they need to rebuild, at rates they can afford.***

Unfortunately, the federal government cannot afford to replace every home and business that has been flooded, and we cannot make farmers whole for the crops they have lost. That makes the availability of affordable credit even more important than it normally is. As the representative of a district which suffered from a similarly devastating flood in 1972, I know how disruptive a flood is and how important credit is to the rebuilding process.

Like all Americans, my heart goes out to those in the flood region. I hope that in his testimony today, Chairman Greenspan will spell out the specific steps that the Federal Reserve and the Federal Open Market Committee are prepared to take to ensure that affordable credit is available to the families, farmers and businesses whose lives and livelihoods have been irreparably damaged by the rising waters of the Mississippi and its tributaries.

Finally, during its May 18 meeting, a majority of the Open Market Committee expressed a probably unwarranted concern that inflation was rising. As a result it also gave what I believe is virtually unprecedented authority to the Chairman to make changes "on the understanding that the Committee would have a chance to discuss any possible policy action." I would appreciate it if Chairman Greenspan would comment on whether or not the inflationary fears expressed at the May 18 meeting have proven warranted; whether he used the extraordinary authority he was given at that meeting, and if so, how; and whether or not we can expect that in the future the Open Market Committee will continue to delegate such broad discretion to the Chairman.

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For use at 9:45 a.m. EDT
Tuesday
July 20, 1993

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

July 20, 1993

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Thank you for this opportunity to discuss the Federal Reserve's semiannual monetary policy report to the Congress. My remarks this morning will cover the current monetary policy and economic settings, as well as the Federal Reserve's longer-term strategy for contributing, to the best of our abilities, to the nation's economic well-being.

As the economic expansion has progressed somewhat fitfully, our earlier characterization of the economy as facing stiff head winds has appeared increasingly appropriate. Doubtless the major head wind in this regard has been the combined efforts of households, businesses, and financial institutions to repair and to rebuild their balance sheets following the damage inflicted in recent years as weakening asset values exposed excessive debt burdens.

But there have been other head winds as well. The build-down of national defense has cast a shadow over particular industries and regions of the country. Spending on nonresidential real estate dropped dramatically in the face of overbuilding and high vacancy rates and has remained in the doldrums. At the same time, corporations across a wide range of industries have been making efforts to pare employment and expenses in order to improve productivity and their competitive positions. These efforts have been prompted in part by innovative technologies, which have been applied to almost every area of economic endeavor, and have boosted investment. However, their effect on jobs and wages through much of the expansion also has made households more cautious spenders.

In the past several years, as these influences have restrained the economy, they have been balanced in part by the accommodative stance of monetary policy and, more recently, by declines in longer-term interest rates as the prospects for credible

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federal deficit cuts improved. From the time monetary policy began to move toward ease in 1989 to now, short-term interest rates have dropped by more than two-thirds and long-term rates have declined substantially, too. All along the maturity spectrum, interest rates have come down to their lowest levels in twenty or thirty years, aiding the repair of balance sheets, bolstering the cash flow of borrowers, and providing support for interest-sensitive spending.

The process of easing monetary policy, however, had to be closely controlled and generally gradual, because of the constraint imposed by the marketplace's acute sensitivity to inflation. As I pointed out in my February testimony to the Congress, this is a constraint that did not exist in an earlier time. Before the late 1970s, financial market participants and others apparently believed that, while inflationary pressures might surface from time to time, the institutional structure of the U.S. economy simply would not permit sustained inflation. But as inflation and, consequently, long-term interest rates soared into the double digits at the end of the 1970s, investors became painfully aware that they had underestimated the economy's potential for inflation. As a result, monetary policy in recent years has had to remain alert to the possibility that an ill-timed easing could be undone by a flare-up of inflation expectations, pushing long-term interest rates higher, and short-circuiting essential balance sheet repair.

The cumulative monetary easing over the last four years has been very substantial. Since last September, however, no further steps have been taken, as the stance of policy has appeared broadly appropriate to the evolving economic circumstances.

That stance has been quite accommodative, especially judging by the level of real short-term interest rates in the context of, on

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average, moderate economic growth. Short-term real interest rates have been in the neighborhood of zero over the last three quarters. In maintaining this accommodative stance, we have been persuaded by the evidence of persistent slack in labor and product markets, increasing international competitiveness, and the decided absence of excessive credit and money expansion. The forces that engendered past inflationary episodes appear to have been lacking to date.

Yet some of the readings on inflation earlier this year were disturbing. It appeared that prices might be accelerating despite product market slack and an unemployment rate noticeably above estimates of the so-called "natural" rate of unemployment--that is, the rate at which price pressures remain roughly constant. In the past, the existing degree of slack in the economy had been consistent with continuing disinflation.

However, the inflation outcome, history tells us, depends not only on the amount of slack remaining in labor and product markets, but on other factors as well, including the rate at which that slack is changing. If the economy is growing rapidly, inflation pressures can arise, even in the face of excess capacity, as temporary bottlenecks emerge and as workers and producers raise wages and prices in anticipation of continued strengthening in demand. Near the end of last year, about the time many firms probably were finalizing their plans for 1993, sales and capacity utilization were moving up markedly and there was a surge of optimism about future economic activity. This may well have set in motion a wave of price increases, which showed through to broad measures of prices earlier this year.

Moreover, inflation expectations, at least by some measures, appear to have tilted upward this year, possibly contributing to price pressures. The University of Michigan survey of consumer attitudes,

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for example, reported an increase in the inflation rate expected to prevail over the next 12 months from about 3-3/4 percent in the fourth quarter of last year to nearly 4-1/2 percent in the latest quarter. Preliminary data imply some easing of such expectations earlier this month, but the sample from which those data are derived is too small to be persuasive. Moreover, the price of gold, which can be broadly reflective of inflationary expectations, has risen sharply in recent months. And at times this spring, bond yields spiked higher when incoming news about inflation was most discouraging.

The role of expectations in the inflation process is crucial. Even expectations not validated by economic fundamentals can themselves add appreciably to wage and price pressures for a considerable period, potentially derailing the economy from its growth track.

Why, for example, despite an above-normal rate of unemployment and permanent layoffs, have uncertainties about job security not led to further moderation in wage increases? The answer appears to lie at least in part in the deep-seated anticipations understandably harbored by workers that inflation is likely to reaccelerate in the near term and undercut their real wages.

The Federal Open Market Committee (FOMC) became concerned that inflation expectations and price pressures, unless contained, could raise long-term interest rates and stall economic expansion. Consequently, at its meeting in May, while affirming the more accommodative policy stance in place since last September, the FOMC also deemed it appropriate to initiate a so-called asymmetric directive. Such a directive, with its bias in the direction of a possible firming of policy over the intermeeting period, does not prejudge that action will be taken--and indeed none occurred. But it

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did indicate that further signs of a potential deterioration of the inflation outlook would merit serious consideration of whether short-term rates needed to be raised slightly from their relatively low levels to ensure that financial conditions remained conducive to sustained growth.

Certainly the May and June price figures have helped assuage concerns that new inflationary pressures had taken hold. Nonetheless, on balance, the news on inflation this year must be characterized as disappointing. Despite disinflationary forces and continued slack, the rate of inflation has at best stabilized, rather than easing further as past relationships would have suggested.

In assessing the stance of monetary policy and the likelihood of persistent inflationary pressures, the FOMC took account of the downshift in the pace of economic expansion earlier this year. This downshift left considerable remaining slack in the economy and promised that the adverse price movements prompted by the acceleration in growth late last year likely would diminish.

While a slowdown from the unsustainably rapid growth in the latter part of last year had been anticipated, the deceleration was greater than expected. A surprisingly precipitous drop in defense spending, a sharp deterioration in net exports, a major blizzard, and some inevitable retrenchment by consumers converged to yield only meager gains in output in the first quarter. But growth apparently picked up in the second quarter, and nearly one million net new jobs were created over the first half. Smoothing through the quarterly pattern, the economy appears to have accelerated gradually over the past two years, to maintain a pace of growth that should yield further reductions in the unemployment rate. Consequently, the evidence remains consistent with our diagnosis that the underlying forces at

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work are keeping the economy generally on a moderate upward track. However, as I have often emphasized, not all the old economic and financial verities have held in the current expansion, and changes in fiscal policy will have uncertain effects going forward. Thus, caution in assessing the path for the economy remains appropriate.

Financial conditions have improved considerably, lessening the need for balance sheet restructuring that has been damping economic activity for several years now. By no means is the process over, but good progress has been made. Debt service burdens, eased by lower interest rates and lower debt-equity ratios, have fallen substantially in both the business and household sectors. On the other hand, the economies of a number of our major trading partners have been quite weak, constraining the growth of demand for our exports.

Although expectations of a significant, credible decline in the budget deficit have induced lower long-term interest rates and favorably affected the economy, the positive influence thus far is apparently being at least partly offset by some business spending reductions as a consequence of concerns about the effects of pending tax increases.

It seems that the _prospective_ cuts in the deficit are having a variety of substantial economic effects, well in advance of any _actual_ change in taxes or in projected outlays. Moreover, uncertainty about the final shape of the package may itself be injecting a note of caution into private spending plans. In addition, uncertainty about the outlook for health care reform may be affecting spending at least by that industry.

To be sure, the conventional wisdom is that budget deficit reduction restrains economic growth for a time, and I suspect that

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probably is correct. However, over the long run, such wisdom points in the opposite direction. In fact, one can infer that recent declines in long-term interest rates are bringing forward some of these anticipated long-term gains. As a consequence, the timing and magnitude of any net restraint from deficit reduction is uncertain. Patently, the overall economic effect of fiscal policy, especially when combined with the uncertainties of the forthcoming health reform package, has imparted a number of unconventional unknowns to the economic outlook.

Assuming, however, we constructively resolve over time the major questions about federal budget and health care policies, with the further waning of earlier restraints on growth, the U.S. economy should eventually emerge healthier and more vibrant than in decades. The balance sheet restructuring of both financial and nonfinancial establishments in recent years should leave the various sectors of the economy in much better shape and better able to weather untoward developments. Similarly, the ongoing efforts by corporations to pare expenses are putting our firms and our industries in a better position to compete both within the U.S. market and globally. And after a period of some dislocation, the contraction in the defense sector ultimately will mean a freeing up of resources for more productive uses. Finally, a credible and effective fiscal package would promise an improved outlook for sustained lower long-term interest rates and a better environment for private sector investment. All told, the productive capacity of the economy will doubtless be higher, and its resilience greater.

Over the last two years, the forces of restraint on the economy have changed, but real growth has continued, with one sector of the economy after another taking the lead. Against this

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background, Federal Reserve Board governors and Reserve Bank presidents project that the U.S. economy will remain on the moderate growth path it has been following as the expansion has progressed. Their forecasts for real GDP average around 2-1/2 percent from the fourth quarter of 1992 to the fourth quarter of 1993, and cluster around 2-1/2 to 3-1/4 percent over the four quarters of 1994. Reflecting this moderate rise and the outlook for labor productivity, unemployment is generally expected to edge lower, to around 6-3/4 percent by the end of this year, and to perhaps a shade lower by the end of next year. For this year as a whole, FOMC participants see inflation at or just above 3 percent, and most of them have about the same forecast for next year.

In addition to focusing on the outlook for the economy at its July meeting, the FOMC, as required by the Humphrey-Hawkins Act, set ranges for the growth of money and debt for this year and, on a preliminary basis, for 1994. One premise of the discussion of the ranges was that the uncharacteristically slow growth of the broad monetary aggregates in the last couple of years--and the atypical increases in their velocities--would persist for a while longer. M2 has been far weaker than income and interest rates would predict. Indeed, if the historical relationships between M2 and nominal income had remained intact, the behavior of M2 in recent years would have been consistent with an economy in severe contraction. To an important degree, the behavior of M2 has reflected structural changes in the financial sector: The thrift industry has downsized by necessity, and commercial banks have pulled back as well, largely reflecting the burgeoning loan losses that followed the lax lending of earlier years. With depository credit weak, there has been little bidding for deposits, and depositors in any case have been drawn to

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the higher returns on capital market instruments. Inflows to bond and stock mutual funds have reached record levels, and, to the extent that these inflows have come at the expense of growth in deposits or money market mutual funds, the broad monetary aggregates have been depressed.

In this context, the FOMC lowered the 1993 ranges for M2 and M3--to 1 to 5 percent and 0 to 4 percent, respectively. This represents a reduction of 1 percentage point in the M2 range and 1/2 percentage point for M3. Even with these reductions, we would not be surprised to see the monetary aggregates finish the year near the lower ends of their ranges.

As I emphasized in a similar context in February, the lowering of the ranges is purely a technical matter; it does not indicate, nor should it be perceived as, a shift of monetary policy in the direction of restraint. It is indicative merely of the state of our knowledge about the factors depressing the growth of the aggregates relative to spending, of the course of the aggregates to date, and of the likelihood of various outcomes through the end of the year. While the lowering of the range reflects our judgment that shifts out of M2 will persist, the upper end of the revised range allows for a resumption of more normal behavior or even some unwinding of M2 shortfalls. The FOMC also lowered the 1993 range for debt of the domestic nonfinancial sectors, by 1/2 percentage point, to 4 to 8 percent. The debt aggregate is likely to come in comfortably within its new range, as it continues growing about in line with nominal GDP. The new ranges for growth of money and debt in 1993 were carried over on a preliminary basis into 1994.

In reading the longer-run intentions of the FOMC, the specific ranges need to be interpreted cautiously. The historical

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relationships between money and income, and between money and the price level have largely broken down, depriving the aggregates of much of their usefulness as guides to policy. At least for the time being, M2 has been downgraded as a reliable indicator of financial conditions in the economy, and no single variable has yet been identified to take its place.

At one time, M2 was useful both to guide Federal Reserve policy and to communicate the thrust of monetary policy to others. Even then, however, a wide range of data was routinely evaluated to assure ourselves that M2 was capturing the important elements in the financial system that would affect the economy. The FOMC never single-mindedly adhered to a narrow path for M2, but persistent and sizable deviations of that aggregate from expectations were a warning sign that policy and the economy might not be interacting in a way that would produce the desired results. The so-called "P-star" model, developed in the late 1980s, embodied a long-run relationship between M2 and prices that could anchor policy over extended periods of time. But that long-run relationship also seems to have broken down with the persistent rise in M2 velocity.

M2 and P-star may reemerge as reliable indicators of income and prices once the yield curve has returned to a more normal configuration, borrowers' balance sheets have been restored and traditional credit demands resume, savers have adjusted to the enhanced availability of alternative investments, and depositories finally reach a comfortable size relative to their capital and earnings. In the meantime, the process of probing a variety of data to ascertain underlying economic and financial conditions has become even more essential to formulating sound monetary policy. This general approach obviously has its weaknesses. When examining many

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indicators, some can always be found that counsel against actions that later appear to have been necessary.

In these circumstances, it is especially prudent to focus on longer-term policy guides. One important guidepost is real interest rates, which have a key bearing on longer-run spending decisions and inflation prospects.

In assessing real rates, the central issue is their relationship to an equilibrium interest rate, specifically the real rate level that, if maintained, would keep the economy at its production potential over time. Rates persisting above that level, history tells us, tend to be associated with slack, disinflation, and economic stagnation--below that level with eventual resource bottlenecks and rising inflation, which ultimately engenders economic contraction. Maintaining the real rate around its equilibrium level should have a stabilizing effect on the economy, directing production toward its long-term potential.

The level of the equilibrium real rate--or more appropriately the equilibrium term structure of real rates--cannot be estimated with a great deal of confidence, though with enough to be useful for monetary policy. Real rates, of course, are not directly observable, but must be inferred from nominal interest rates and estimates of inflation expectations. The most important real rates for private spending decisions almost surely are the longer maturities. Moreover, the equilibrium rate structure responds to the ebb and flow of underlying forces affecting spending. So, for example, in recent years the appropriate real rate structure doubtless has been depressed by the head winds of balance sheet restructuring and fiscal retrenchment. Despite the uncertainties about the levels of equilibrium and actual real interest rates, rough judgments about

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these variables can be made and used in conjunction with other indicators in the monetary policy process. Currently, short-term real rates, most directly affected by the Federal Reserve, are not far from zero; long-term rates, set primarily by the market, are appreciably higher, judging from the steep slope of the yield curve and reasonable suppositions about inflation expectations. This configuration indicates that market participants anticipate that short-term real rates will have to rise as the head winds diminish, if substantial inflationary imbalances are to be avoided.

While the guides we have for policy may have changed recently, our goals have not. As I have indicated many times to this Committee, the Federal Reserve seeks to foster maximum sustainable economic growth and rising standards of living. And in that endeavor, the most productive function the central bank can perform is to achieve and maintain price stability.

Inflation is counterproductive in many ways. Of particular importance, increased inflation has been found to be associated with reduced growth of productivity, apparently in part because it confounds relative price movements and obscures price signals. Compounding this negative effect, under the current tax code, inflation raises the effective taxation of savings and investment, discouraging the process of capital formation. Since productivity growth is the only source of lasting increases in real incomes and because even small changes in growth rates of productivity can accumulate over time to large differences in living standards, its association with inflation is of key importance to policymakers.

The link between the control of inflation and the growth of productivity underscores the importance of providing a stable backdrop for the economy. Such an environment is especially important for an

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increasingly dynamic market economy, such as ours, where technology and telecommunications are making rapid advances. New firms, new products, new jobs, new industries, and new markets are continually being created, and they are unceremoniously displacing the old ones. The U.S. economy is a dynamic system, always renewing itself. It is extraordinary that the system overall is as stable as it is, considering the persistent process of change in the structure of our economy. For example, a frequently cited figure is the two million new jobs that have been created since the end of 1991. This is a net change, however, which masks the many millions who found, lost, and changed jobs over the same period. Currently, people are being hired at a pace of approximately 400,000 per week, with job losses running modestly below that figure. Such vast churning in the nation's labor markets is a normal and ultimately a productive process.

Central planning of the type that prevailed in post-war Eastern Europe and the Soviet Union represented one attempt to fashion an economic system that eliminated this competitive churning and its presumed wastefulness. But when that system eliminated the risk of failure, it also stifled the incentive to innovate and to prosper. Central planning fostered stasis: In many respects, the eastern-bloc economies marched in place for more than four decades.

Risk-taking is crucial in the process that leads to a vital and progressive economy. Indeed, it is a necessary condition for wealth creation. In a market economy, competition and innovation interact; those firms that are slow to innovate or to anticipate the demands of the consumer are soon left behind. The pace of churning differs by industry, but it is present in all. At one extreme, firms in the most high-tech areas must remain constantly on the cutting edge, as products and knowledge become rapidly obsolete. Many

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products that were at technology's leading edge, say five years ago, are virtually unsalable in today's markets. In high-tech fields, leadership can shift rapidly. In some markets where American firms were losing share just a few years ago, we have regained considerable dominance. In one case, U.S. firms have seized a commanding lead in just two years in the new laptop computer market, and now account for more than 60 percent of U.S. sales last year, triple the figure for Japanese firms.

More generally, it appears that the pace of dynamism has been accelerating. As one indication, the average economic life expectancy of new capital equipment has been falling. The average life of equipment purchased in 1982, for example, was 16-1/2 years. By 1992 that figure had declined to 14-1/2 years, a drop more than twice as large as that over the preceding decade. In addition, telecommunications technology is obviously quickening the decision-making process in both financial and product markets.

In such a rapidly changing marketplace, the agile survive by being flexible. One aspect of this flexibility has been the spread of "just-in-time" inventory controls at manufacturing firms. Partly as a result of innovations in inventory control techniques, the variability of inventories relative to total output appears to be on a downtrend.

The possibility of failure has productive side effects, encouraging economic agents to do their best to succeed. But there are nonproductive and unnecessary risks as well. There is no way to avoid risk altogether, given the inherently uncertain outcomes of all business and household decisions. But many uncertainties and risks do not foster economic progress, and where feasible should be suppressed. A crucial risk in this category is that induced by inflation. To

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allow a market economy to attain its potential, the unnecessary instability engendered by inflation must be quieted.

A monetary policy that aims at price stability permits low long-term interest rates and helps provide a stable setting to foster the investment and innovation by the private sector that are key to long-run economic growth. In pursuing our objectives, we must remain acutely aware that the structure of the economy has been changing and growing ever more complex. The relationships between the key variables in the economy are always shifting to a degree, and this evolution presents an ongoing challenge to the business leader, to the econometric modeler, and to those responsible for the conduct of economic policy.

Clearly, the behavior of many of the forces acting on the economy over the course of the last business cycle have been different from what had gone before. The sensitivity of inflation expectations has been heightened, and, as recent evidence suggests, businesses and households may be becoming more forward-looking with respect to fiscal policies as well.

I believe we are on our way toward reestablishing the trust in the purchasing power of the dollar that is crucial to maximizing and fulfilling the productive capacity of this nation. The public, however, clearly remains to be convinced: Survey responses and financial market prices embody expectations that the current lower level of inflation not only will not be bettered, it will not even persist. But there are glimmers of hope that trust is reemerging. For example, issuers have found receptive markets in recent months for fifty-year bonds. This had not happened in decades. The reopening of that market may be read as one indication that some investors once again believe that inflationary pressures will remain subdued.

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It is my firm belief that, with fiscal consolidation and with the monetary policy path that we have charted, the United States is well-positioned to remain at the forefront of the world economy well into the next century.

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For use at 9:45 a.m., E.D.T.
Tuesday
July 20, 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

July 20, 1993

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Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 20, 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,

Alan Greenspan, Chairman

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Section 1: Monetary Policy and the Economic Outlook for 1993 and 1994

In February, when the Federal Reserve prepared its monetary policy plans for 1993, the broad trends in the economy appeared favorable. After a hesitant beginning, the economic expansion had picked up steam in the latter part of 1992, while inflation seemed still to be headed downward. Most members of the Federal Open Market Committee (FOMC) and nonvoting presidents anticipated that 1993 would be a good year for growth and would also see further progress toward price stability.

As the year has unfolded, however, the economy's performance has fallen short of these expectations. Economic growth has slowed appreciably from the pace late last year; in part, this has reflected a retreat in business and consumer confidence and the effects on our trade balance of weakness in a number of other industrial countries. Like most private forecasters, the Board members and Bank presidents generally have trimmed their projections of growth in real gross domestic product (GDP) for the year as a whole, although they continue to foresee increases in output large enough to extend the reduction in the unemployment rate that began last summer. Events on the price side also have been disappointing. The inflation rate in the first part of this year was higher than in late 1992. There is evidence that some of the pickup in the consumer price index (CPI) may have reflected difficulties in seasonal adjustment, and price data for the past couple of months have been much more favorable. Nonetheless, a broad array of indicators points to a leveling out of the underlying inflation trend.

In this circumstance, and with short-term interest rates unusually low, especially when compared with inflation, the Federal Reserve recognized a need to be alert to the possibility that the balance of risks in the economy could shift soon in a direction dictating some firming of policy; failure to act in a timely manner could lead to a buildup of inflationary pressures, to adverse reactions in financial markets, and ultimately to the disruption of the growth process. To this point, however, the moderate thrust of aggregate demand and considerable slack in the economy, taken together with the more subdued price data of late, do not suggest that a sustained upswing in inflation is at hand. Accordingly, the Federal Reserve has not adjusted its monetary policy instruments.

The pace of economic growth in the final quarter of 1992 was not expected to be sustained, but the slowing in the first quarter of 1993 was surprisingly sharp. With the exception of business fixed investment, the slowdown cut across the major categories of final demand. After stepping up their spending in late 1992, consumers became more pessimistic about their economic prospects and more cautious in their spending decisions; the uncertainty surrounding the efforts to reduce the federal deficit may have been a factor in the weakening of household sentiment. Housing activity, which also had been exceptionally strong late last year, hit a lull—even before the March blizzard on the East Coast—and real defense purchases plunged. Moreover, net exports deteriorated sharply, as exports declined and imports surged; the drop in exports was attributable in part to continued weak growth in some other industrial countries and in part was an adjustment to the big increase in late 1992.

The more recent statistical indicators, taken together, point to a resumption of moderate growth in real GDP in the second quarter. Most notably, on the positive side, the increase in aggregate hours worked for the quarter as a whole—a useful indicator of movements in overall output—was the largest of the current expansion. Sales of motor vehicles also exhibited considerable vigor. But other key indicators were less robust. In particular, after allowing for the effects of the blizzard, consumer spending on items other than motor vehicles was lackluster, and housing activity improved only modestly. In the manufacturing sector, orders generally remained soft, and factory output, after having posted solid gains over the preceding seven months, is estimated to have declined somewhat over May and June.

Broad measures of inflation picked up in early 1993, with monthly increases through April in the upper part of the range of the past couple of years. Although readings on consumer and producer prices were much more favorable in May and June, the cumulative price and wage data for the year to date suggest that underlying inflation has flattened out, after trending down over the preceding two years. Excluding the especially volatile food and energy components, the twelve-month change in the CPI has held in the range of 3¼ to 3½ percent since the summer of 1992.

In financial markets, short-term interest rates have changed little so far in 1993, while intermediate- and long-term interest rates have fallen three-quarters to one percentage point to their lowest levels in over twenty years. The decline in longer-term rates seems

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largely to have been a response to the enhanced prospects for credible fiscal restraint, though the slower pace of economic expansion may also have played a role. Falling interest rates have helped stock market indexes set new records. Despite a decline in the dollar versus the yen, the average value of the dollar on a trade-weighted basis relative to G-10 currencies has risen, on balance, since the end of 1992. Although foreign intermediate-term interest rates have been down, on average, about as much as U.S. interest rates, short-term rates abroad have decreased substantially relative to U.S. rates, as foreign monetary authorities have taken steps to bolster weak economies.

Declining U.S. market interest rates contributed to robust growth in narrow measures of money and in reserves over the first half of the year, but broad monetary aggregates were very weak and their velocities continued to show exceptional increases. Credit demands on depositories remained quite subdued relative to spending, considerable depository credit was funded from nonmonetary sources, and savers continued to demonstrate a marked preference for capital market instruments over money stock assets.

In part owing to the drop in bond and stock yields, as well as to the desire to strengthen balance sheets, corporate borrowers have continued to concentrate credit demands on long-term securities markets, using the proceeds in part to repay bank loans; business loans at banks have not grown this year, although there were tentative signs of a pickup over May and June. Total lending and credit growth at banks has risen only slightly from the depressed pace of 1992, and these institutions have therefore not needed to pursue deposits. Thrifts have continued to contract, but at a much slower pace than in recent years.

Banks have eased lending standards for smaller firms for several quarters and recently relaxed standards for medium- and large-sized firms as well. An increased willingness to lend on the part of banks has been associated with considerably more comfortable capital positions. Banks have continued to strengthen their balance sheets by issuing large volumes of equity and subordinated debt, while retaining a substantial amount of earnings. As a result, the portion of the industry that is well-capitalized (taking account of supervisory ratings as well as capital ratios) increased from about one-third at the end of 1991 to more than two-thirds by March 1993.

In turning to equity and other nondeposit funds, banks have reduced the share of depository credit that is financed by monetary liabilities. Depositors, for their part, have continued to shift funds into capital markets, attracted by still-high returns in these markets relative to earnings on deposits. Inflows into bond and equity mutual funds have run at record levels this year, and banks have facilitated investing in mutual fund products by increasingly offering them in their lobbies. As a consequence of these various forces, M2 increased at only a ¾ percent annual rate from its fourth-quarter 1992 average through June, while M3 fell slightly. The sum of M2 and estimated household holdings of long-term mutual funds grew at about a 4¾ percent rate from the fourth quarter through June, little changed from the pace of recent years.

Debt growth has edged up this year, despite a deceleration in nominal spending, perhaps buoyed by improvements in financial positions achieved over the past few years by both borrowers and lenders. Investment outlays are estimated to have exceeded the internal funds of corporations for the first time in two years, while household borrowing has picked up relative to spending. In addition, Treasury financing needs have remained heavy. Nevertheless, nonfinancial debt growth has been running at only a 5 percent rate this year.

Monetary Objectives for 1993 and 1994

In reviewing the annual ranges for the monetary aggregates in 1993, the FOMC noted that the relationship of broadly defined money to income has continued to depart from historical patterns. The annual velocities of these aggregates last fell in 1986, and their prolonged upward movements since then strongly suggest breaks from previous long-run trends of flat velocity for M2 and slowly decreasing velocity for M3. The rise in the velocity measures has been particularly surprising in the last four years, a period of declining interest rates, normally associated with a reduction in velocity.

In February, anticipating that further balance sheet restructuring and portfolio shifts from deposits to mutual funds would result in further increases in velocity, the FOMC lowered the 1993 growth ranges for M2 and M3 by one-half percentage point from the provisional ranges set in July 1992. In fact, velocities of the broad monetary aggregates have been especially strong; in the first quarter of 1993, the velocities of M2 and M3 posted substantial increases of 6¼ percent and 8 percent, respectively, and appear to have recorded additional, but smaller, gains in the second quarter. As a consequence, at its meeting this month, the Committee reduced the 1993 range for M2

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Ranges for Growth of Monetary and Credit Aggregates

	1992	1993 (As of February)	1993 (As of July)	1994
Percentage change, fourth quarter to fourth quarter				
M2	2½ to 6½	2 to 6	1 to 5	1 to 5
M3	1 to 5	½ to 4½	0 to 4	0 to 4
Debt	4½ to 8½	4½ to 8½	4 to 8	4 to 8

by an additional percentage point and the range for M3 by another one-half percentage point, leaving them at 1 to 5 percent for M2 and 0 to 4 percent for M3.

The reductions of these growth ranges represented further technical adjustments in response to actual and anticipated increases in velocity and not a shift in monetary policy, which remains focused on fostering sustainable economic expansion while making continued progress toward price stability. With further substantial increases in velocities, continued sluggish expansion of M2 and M3, which are now at the lower ends of their revised ranges, would be consistent with an acceptable track for the economy. Also at the July meeting, the annual monitoring range for the domestic nonfinancial debt aggregate was reduced by one-half percentage point to 4 to 8 percent; growth in this aggregate is likely to continue to be roughly in line with that of nominal GDP.

While the future behavior of the velocities of broad money aggregates was recognized to be difficult to predict with precision at a time of ongoing structural changes in the financial sector, it appears likely that the forces contributing to the unusual strength in velocities will continue for some time, and the FOMC carried forward the revised 1993 ranges for the monetary and debt aggregates to 1994 as well. With considerable uncertainty persisting about the relationship of the monetary aggregates to spending, the behavior of the aggregates relative to their annual ranges will likely be of limited use in guiding policy over the next eighteen months, and the Federal Reserve will continue to utilize a broad range of financial and economic indicators in assessing its policy stance.

Economic Projections for 1993 and 1994

The members of the Board of Governors and the Reserve Bank presidents, all of whom participate in the deliberations of the Federal Open Market Committee, generally anticipate that economic activity will strengthen in the second half of 1993 and continue to expand moderately in 1994. The growth of output is likely to be accompanied by further gains in productivity, but increases in employment are projected to be large enough to keep the unemployment rate moving down. Inflation is not expected to change materially over this period.

The forecasts of the Board members and Reserve Bank presidents for economic growth in 1993 are somewhat weaker than in February, mainly because of the shortfall in real growth in the first quarter. Most expect output gains over the balance of the year to be large enough to result in a four-quarter change in real gross domestic product in the range of 2¼ to 2¾ percent; for 1994, the central tendency of the forecasts spans a range of 2½ to 3¼ percent. The civilian unemployment rate, which averaged 7 percent in the second quarter of 1993, is projected to fall to the area of 6¾ percent by the fourth quarter of this year and to drop slightly further over the course of 1994.

Recent developments in the financial sphere should be conducive to the sustained increases in spending projected for the quarters ahead. The financial positions of many households and businesses have continued to improve, and banks are showing signs of greater willingness to make loans. Short-term interest rates are relatively low, and the appreciable declines in long-term interest rates over the past several months should further the process of balance sheet adjustment and are anticipated to provide considerable impetus to business investment and residential construction. It is likely that business investment also will continue to be bolstered by the ongoing push to improve products and boost efficiency through the use of state-of-the-art equipment. Moreover, with at least a moderate pickup in average growth in foreign

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Economic Projections for 1993 and 1994

	FOMC Members and Other FRB Presidents	
	Range	**Central Tendency**
1993		
Percentage change, fourth quarter to fourth quarter		
Nominal GDP	4¾ to 6¼	5 to 5¾
Real GDP	2 to 3½	2¼ to 2¾
Consumer price index	3 to 3½	3 to 3¼
Average level in the fourth quarter, percent		
Civilian unemployment rate	6½ to 7	
1994		
Percentage change, fourth quarter to fourth quarter		
Nominal GDP	4½ to 6¾	5 to 6½
Real GDP	2 to 3¼	2½ to 3¼
Consumer price index	2 to 4¼	3 to 3½
Average level in the fourth quarter, percent		
Civilian unemployment rate	6¼ to 7	6½ to 6¾

industrial countries, the external sector should be exerting a less negative influence on economic activity in the United States.

Despite the improvement in financial conditions, there are reasons to be cautious about the near-term outlook. Efforts this year to bring the federal budget deficit under control already have helped to ease pressures on long-term interest rates, and a successful agreement to reduce deficits significantly will produce substantial benefits over the longer run. But such actions also are expected to exert some restraint on aggregate demand this year and next. Government outlays for defense will continue to contract, extending the dislocations and disruptions that have been evident for some time in industries and regions that depend heavily on military spending. Prospects for higher taxes may already be influencing the behavior of some households and businesses, and the constraint is likely to intensify in 1994. In addition, uncertainties about prospective federal policies reportedly are weighing on businesses and consumers; although the outcome of the Congressional budget deliberations will be known shortly, uncertainties about health care reform are not anticipated to be resolved fully for some time.

Most Board members and Bank presidents expect the rise in the consumer price index over the four quarters of 1993 to be in the range of 3 to 3¼ percent, about the same as the increase over the four quarters of 1992. At this stage, the food and energy sectors are not expected to have much effect, on balance, on the broad price measures in 1993, but the flooding in the Midwest raises the risk of higher food prices in the quarters ahead. For 1994, the central tendency forecast is for CPI inflation in the range of 3 to 3½ percent, not much different than in 1992 and 1993.

The fundamentals remain consistent with additional disinflation; businesses continue to focus on controlling costs, and slack in labor and product markets is anticipated to decrease only gradually in the period ahead. However, the disappointing price performance in the first half of the year suggests that further progress will not come easily—in part perhaps

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because inflation expectations remain high. Lowering inflation and inflation expectations over time, and achieving sustained reductions in long-term interest rates, will depend importantly on a monetary policy that remains committed to fostering further progress toward price stability. The performance of prices and the economy also will depend on government policies in other areas. Namely, a sound fiscal policy, a judicious approach to foreign trade issues, and regulatory policies that preserve flexibility and minimize the costs they impose are crucial to reestablishing the disinflation trend of the past couple of years and allowing the economy to perform at its full potential.

The Administration has not yet released the mid-year update to its economic and budgetary projections. However, statements by Administration officials suggest that the revised forecasts for real growth and inflation in 1993 and 1994 are not likely to differ significantly from those of the Federal Reserve.

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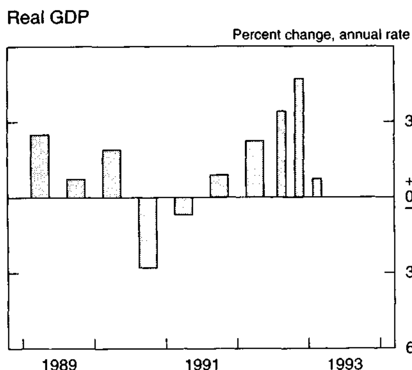
Section 2: The Performance of the Economy in 1993

Economic activity has continued to advance in fits and starts. After posting robust gains in the second half of 1992, real gross domestic product (GDP) rose at an annual rate of less than 1 percent in the first quarter of 1993. The slowing in activity was evident in a broad range of production and spending indicators. The more recent data suggest that the economy expanded at a firmer pace in the second quarter, although growth probably was not as rapid as in the second half of last year.

Real GDP



To some extent, the slackening in economic activity in the first quarter of 1993 can be interpreted as a pay back after two quarters of strong growth. In particular, much of the slowing was in consumer spending, where large gains in the second half of 1992 had outpaced income growth by a substantial margin. In addition, there was a sharp contraction in defense spending; although real defense purchases clearly will remain on a downtrend for some time, the first-quarter plunge followed a spurt in the second half of 1992 and is not likely to be repeated in coming quarters. In the external sector, exports declined in the first quarter after a big increase late last year, while imports rose markedly. Activity was also depressed, especially in the housing sector, by unusually bad weather last winter.

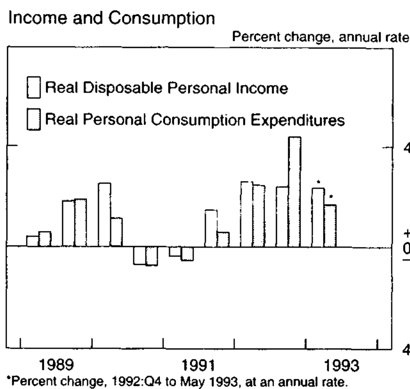
Moderate growth in real GDP appears to have resumed in the second quarter. Nonetheless, experience thus far in 1993 has underscored that the impediments to a more rapid pace of economic expansion over the near term remain sizable. Besides defense cutbacks, the process of balance sheet adjustment goes on, as do the restructuring efforts under way at many large firms. Moreover, the continued disappointing economic performance of some major foreign industrial countries is taking a toll on U.S exports. Finally, uncertainties about prospective federal policies on a variety of fronts, although difficult to measure, are reportedly making some businesses and consumers reluctant to make major hiring and spending commitments.

News on the price side was also worrisome in the first half of the year. Month-to-month movements in prices were on the high side through April, but they moderated in May and June. The more favorable recent data helped to ease concerns that a significant pickup in inflation was under way. Nonetheless, the disinflation process seemingly has stalled, with underlying inflation, as measured by the twelve-month change in the consumer price index (CPI) excluding food and energy, holding in a narrow band between 3¼ and 3½ percent since last summer.

The Household Sector

Growth of consumer spending on goods and services continued in a stop-and-go pattern in early 1993: It hit a lull in the first quarter after surging in the second half of 1992. Averaging through the quarterly data, consumption grew at about a 3 percent annual rate pace over those three quarters, and available data point to a moderate increase in the second quarter. Housing activity appears to have revived in recent months, after sagging earlier in the year.

Income and Consumption



*Percent change, 1992:Q4 to May 1993, at an annual rate.

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Consumer spending increased only about 1 percent at an annual rate in real terms in the first quarter. Outlays for goods were especially weak, down at about a 2 percent annual rate; although a part of the drop was probably attributable to the severe blizzard on the East Coast in March, signs of some retreat in spending had already appeared in January and February. Meanwhile, spending on services remained on the moderate uptrend that had been evident for the past few years.

Spending rose appreciably in April, spurred by a post-blizzard bounce-back in outlays for motor vehicles and other goods. Demand for motor vehicles remained strong through June, resulting in an average sales pace for the quarter of almost 14½ million units (annual rate)—the highest since early 1990. Sales were boosted by the replacement needs of households that put off buying vehicles during the 1990–91 recession and the early recovery period. In addition, price increases—at least for models with domestic nameplates, which have accounted for almost all of the rise in sales this year—have been relatively small, and financing terms favorable. Meanwhile, real spending on goods other than motor vehicles appears to have posted a moderate gain for the quarter as a whole, and outlays for services rose slowly through May.

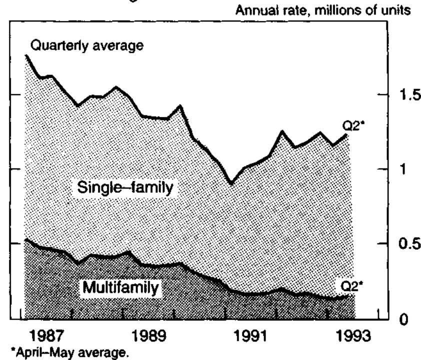
The downshift in overall spending growth this year does not appear to be attributable to any worsening of the current trends in household incomes and financial positions, but it has coincided with a deterioration in consumer confidence. In contrast to the ebullience evident last fall, surveys conducted by the University of Michigan and the Conference Board this year have found respondents more pessimistic about their job and income prospects. Spending may also have been crimped by smaller-than-usual tax refunds—or larger tax bills—this year. Although the change in withholding schedules in March 1992 raised workers' take-home pay, and thus provided the wherewithal to fund additional purchases last year, many households may well have found themselves less liquid than usual in early 1993. More fundamentally, the slowing in spending appears to reflect a return to trend after a surge that outstripped the rise in real disposable income in the second half of last year. Indeed, after having risen somewhat over the preceding couple of years, the personal saving rate dropped from 5¼ percent in the second quarter of 1992 to 4½ percent in the fourth quarter, in the lower part of the range of recent years. The saving rate retraced some of that decline in the first quarter, but it appears to have fallen back in the spring.

Real disposable income has remained on the moderate uptrend that has been evident for the past several quarters: In May, it stood about 2¼ percent above the level of a year earlier. Growth in wages and salaries has stayed relatively sluggish despite the firmer pace of employment growth this year. Meanwhile, transfer payments have continued to expand, although recent increases have been diminished by a drop in unemployment insurance benefits as the number of unemployed has declined. Interest income, which fell appreciably over 1992, has only edged down thus far this year.

Household financial positions have continued to show signs of improvement. The value of household assets has been buoyed by the rising stock market, while debt growth has remained moderate. Moreover, reductions in interest rates have continued to lower debt-servicing burdens; when measured in relation to disposable income, the repayment burden has fallen back to the levels of the mid-1980s. The incidence of financial stress among households also appears to have eased further. Delinquency rates on consumer loans generally dropped again in the first quarter and are down significantly from their recent peaks, and delinquencies on home mortgages are at the low end of the range of the past decade.

Housing activity turned surprisingly soft in the first quarter, after a burst at the end of 1992. However, the most recent monthly indicators suggest that the sector remains on a path of gradual expansion. In the single-family area, both starts and sales of new homes fell back at the beginning of the year and remained below trend through March. Single-family starts rebounded in April and edged up further in May, lifting the

Private Housing Starts



*April–May average.

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average level for the two months about 5 percent above the first-quarter pace; new home sales gyrated in the spring but also were higher, on average, than in the first quarter.

Undoubtedly, some of the recent improvement reflects a reversal of transitory factors that damped homebuilding in the first quarter. The East Coast blizzard delayed both builders and their customers in March; in addition, the weather for the nation as a whole was slightly worse than usual in January and February. Lumber prices ran up sharply between October and March: As measured by the producer price index (PPI), prices rose about one-third over that period, and spot market quotes for some lumber products more than doubled. The jump in lumber costs, which has since been reversed, seems not to have left much of a mark on the prices recorded in sales transactions; indeed, the inability of builders to pass along the cost increases may have accounted for some of the disruption in construction activity.

In any event, low mortgage rates clearly are helping to stimulate housing demand. Interest rates on fixed-rate home mortgages, like most other long-term interest rates, fell to near their twenty-year lows last winter and have since declined further; initial rates on adjustable-rate mortgages have been the lowest since these loans first became widely available at the beginning of the 1980s. Given the trends in house prices, these interest rates have pushed the cost of home purchase—as measured by the share of household income needed to make the mortgage payments on an average home—to the lowest levels since the mid-1970s.

Nonetheless, the trends in house prices this year—small rises in some markets, declines in others—have not been a uniform positive for demand, mainly because they have muted the investment motive for owning a home. Moreover, although most respondents to the Michigan survey in recent months reported that it was a good time to buy a house, only about one-third of those who already owned homes thought it was a good time to sell. In fact, industry reports suggest that first-time homebuyers have accounted for an unusually large share of all home purchases in the past two years, and that sales and prices in many localities have been strongest at the lower end of the market.

Construction of multifamily housing this year has been at its lowest level since the 1950s. These structures—most of which are intended for rental use—now account for less than 5 percent of total residential investment expenditures, compared with a figure of about 15 percent in the mid-1980s. Despite the reduced production in the past several years, vacancy rates and rents have not yet shown clear signs of tightening for the nation overall. By contrast, improvements to all existing housing units have trended up over the past year and now account for nearly one-fourth of total residential construction expenditures.

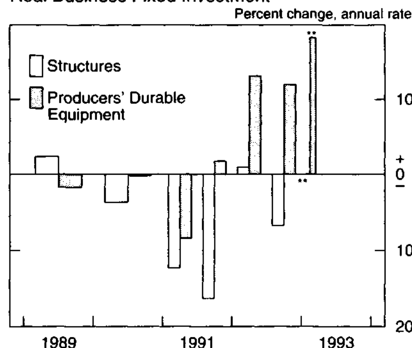
The Business Sector

Developments in the business sector generally were favorable in the first half of 1993. Business fixed investment continued to grow briskly, boosted by ample profits and cash flow, the relatively low cost of capital, and ongoing efforts to improve productivity. Meanwhile, business balance sheets strengthened further as growth of business debt remained relatively slow and many firms continued to take advantage of lower bond yields and high stock prices to enhance liquidity by funding out short-term liabilities.

Real business fixed investment increased at a 13 percent annual rate in the first quarter of 1993. Real outlays for equipment posted another healthy gain, and investment in structures, which had been on a protracted decline for some time, was about unchanged for a second quarter. The indicators in hand suggest that real business fixed investment remained strong in the second quarter.

Equipment spending has continued to be a mainstay of economic growth. It rose at an annual rate of about 18 percent in real terms in the first quarter, after a 12½ percent rise over the course of 1992. Real

Real Business Fixed Investment



**Percent change, 1992:Q4 to 1993:Q1, at an annual rate.

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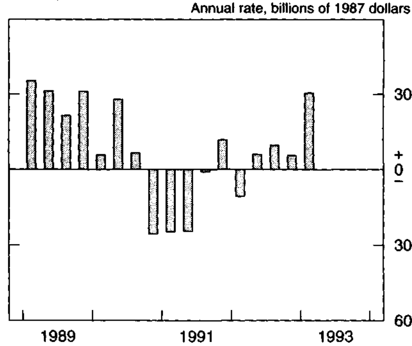
outlays for computers and related devices have continued to soar; since early 1991, they have roughly doubled, boosted by product innovations, extensive price-cutting by computer manufacturers, and the ongoing efforts of businesses to achieve efficiencies through the utilization of new information-processing technologies. However, demand for other, more traditional types of equipment also began to grow around the middle of 1992 and continued to expand in early 1993. Domestic purchases of aircraft spurted in the first quarter; but, given the financial problems besetting the airlines, this increase will likely be reversed in coming quarters.

Investment in nonresidential structures appears to be stabilizing after several years of steep declines. Construction outlays were essentially flat in real terms over the fourth and first quarters, and the advance indicators suggest that the bottom has been reached or is close at hand. Trends within the construction sector have been divergent. In the office sector, the excess of unoccupied space remains huge, and spending continues to contract. However, spending for commercial structures other than office buildings, which also had fallen sharply over the past several years, has apparently turned the corner, because of both the stronger pace of retail sales over the past year and the ongoing shift of retailing activity to large suburban stores. Outlays for industrial construction have not exhibited the normal cyclical rebound—mainly because utilization of existing capacity has tightened only gradually—but they seem, at least, to be leveling out. Meanwhile, activity in the public utilities sector has continued to trend up, mainly because of capacity expansion at electric utilities but also because of the installation of pollution abatement technology, which the Clean Air Act requires be in place by 1995. In contrast, drilling activity remains depressed.

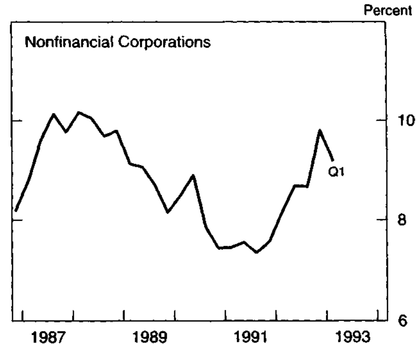
Nonfarm business inventories, which had shown only small changes, on net, since the middle of 1991, rose considerably last winter and spring. Although the buildup early in the year was likely motivated in part by the need to replenish stocks drawn down by surprisingly strong sales in late 1992, some of the recent increase may be attributable to softer-than-expected sales. Notably, the inventory–sales ratio for non-auto retail stores remained in May around the high end of the range of recent years. By contrast, inventories at factories and at wholesale trade establishments generally seem to be reasonably well aligned with sales.

After advancing markedly over the course of 1992, economic profits of U.S. corporations were little changed overall in the first quarter of 1993. The pre-tax profits earned by nonfinancial corporations on their domestic operations weakened after a fourth-quarter surge, but they still stood nearly 35 percent above the cyclical low reached in 1991; the upswing in these profits over the past two years has reflected primarily a combination of restraint in labor costs and reductions in net interest expenses. Domestic profits of financial corporations have been buffeted in recent quarters by the losses that insurance companies sustained from major natural disasters; without such losses, domestic financial profits in the first quarter would have surpassed the high reached in the first quarter of 1992.

Changes in Real Nonfarm Business Inventories



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.

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The farm economy has been beset by numerous weather disruptions so far this year. In the first quarter, severe weather in some regions retarded livestock production and damaged fruit and vegetable crops. In many regions, spring planting was hampered by wet weather, and, in parts of the Midwest, continued heavy rains around mid-year caused major flooding. Because of the planting delays and the floods, uncertainties about acreage and yields are considerably greater than usual for this time of year, and farmers in the flooded regions obviously have suffered financial losses.

Despite the weather-related supply disruptions, farm income and farm financial conditions for the nation as a whole seem to have held up reasonably well in the first half of 1993. On average, farm prices in the first half were slightly above those of a year earlier, with declines for farm crops being offset by higher prices for livestock. Farm subsidies, which have been running well above their 1992 pace, have been lifting farm income and cash flow, and farm investment in new machinery has picked up. The recent jump in crop prices—a consequence of the flooding—will boost the incomes of the many farm producers whose crops are still in good condition.

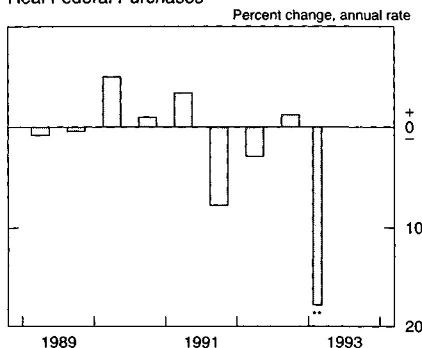
The Government Sector

Governments at all levels continue to struggle with budgetary difficulties. At the federal level, the unified budget deficit over the first eight months of FY1993—the period from October to May—totaled $212 billion, somewhat less than during the comparable period of FY1992. However, excluding deposit insurance and adjusting for the inflow of contributions to the Defense Cooperation Account in FY1992, the eight-month deficit was about $230 billion in both fiscal years. In the main, the underlying deficit has failed to drop because the restraint in discretionary spending that was legislated in 1990 and the deficit-closing effects of stronger economic activity have been offset by continued large increases in spending for entitlement programs.

In total, federal outlays in the first eight months of FY1993 were only about 2 percent higher than during the same eight months of FY1992. Outlay growth was damped significantly by a sharp swing in net outlays for deposit insurance that was attributable largely to the improved health of depository institutions. In fact, so far this year, receipts from insurance premiums and proceeds from sales of assets taken over by the government have exceeded by $18½ billion the gross outlays to resolve troubled institutions. Defense spending was also quite weak in the first eight months of FY1993. Outlays for Medicare and Medicaid continued to rise rapidly; however, the increase so far this year—about 10 percent—was only half as large as the one in the preceding year. The deceleration in health care spending appears to stem, in part, from federal regulations issued in 1992 that limit the states' ability to shift Medicaid costs to the federal government.

Federal purchases of goods and services—the part of federal spending included directly in gross domestic product—declined at an annual rate of 18 percent in real terms in the first quarter of 1993. A sharp decrease in defense spending more than accounted for the drop. Real defense purchases have been falling noticeably since early 1991, but the decline has been erratic; at least part of the first-quarter plunge can be interpreted as a correction after a few quarters of surprisingly strong spending. Meanwhile, real nondefense purchases have been almost flat over the past couple of quarters.

Real Federal Purchases



**Percent change, 1992:Q4 to 1993:Q1, at an annual rate.

Federal receipts in the first eight months of FY1993 were about 5 percent greater than in the same period of a year earlier; the rise was roughly the same as that in nominal GDP. Boosted by the upswing in business profits, corporate taxes rose sharply. However, they account for less than one-tenth of total receipts, and growth in other categories was only moderate in the aggregate.

States and localities continue to face sizable budget deficits: As measured in the National Income and Product Accounts (NIPA), the combined deficit (net of social insurance funds) in the sector's operating

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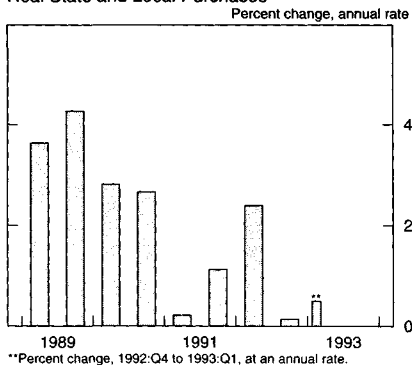


**Percent change, 1992:Q4 to 1993:Q1, at an annual rate.

and capital accounts has been stuck around $40 billion since late 1990. These outsized deficits have persisted despite ongoing efforts by many governments to adjust spending and taxes. As at the federal level, deficit reduction has been complicated by the upsurge in payments to individuals for health and income support; in the first quarter of 1993, state and local transfer payments for Medicaid and Aid to Families with Dependent Children (in nominal terms) were nearly 20 percent above those of a year earlier.

The deficit-reduction efforts of state and local governments in recent quarters have been concentrated on the spending side. Their purchases of goods and services were nearly flat in real terms in the first quarter of 1993 and have changed little, on net, since early 1992. Outlays for construction, which fell at an annual rate of 7 percent, on average, in the fourth and first quarters, have been especially weak. For all major categories except sewer and water, outlays in recent months have been running significantly below year-earlier levels. State and local employment has continued to expand at the somewhat slower pace that has been evident since 1991, while these governments have continued to hold the line on wages and benefits. The approximately 3½ percent increase in state and local compensation rates over the year ended in March was similar to the rise for workers in private industry; by contrast, in the 1980s, state and local workers received increases that, on average, were more than a percentage point per year greater than those in private industry.

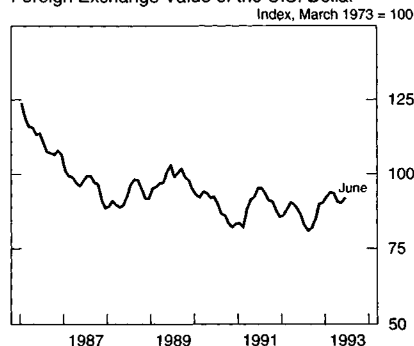
Receipts of state and local governments, restrained by the relatively tepid cyclical upswing in the sector's tax bases, have grown only moderately over the past year. Also, these governments have lately been reluctant to raise taxes, after the sizable hikes they enacted in 1990 and 1991. All told, the sector's own-source general receipts, which comprise income, corporate, and indirect business taxes, rose 5 percent over the four quarters ended in the first quarter of 1993, about the same that nominal GDP increased.

The External Sector

Since December 1992, the trade-weighted foreign exchange value of the dollar has risen about 5 percent, on balance, in terms of the currencies of the other Group of Ten (G-10) countries. This net increase has reflected much larger movements in the dollar's value against individual currencies: In particular, a sharp decline against the Japanese yen was more than offset by substantial increases against major European currencies.

Relative to the monthly average for December 1992, the dollar has declined nearly 15 percent against the yen to record lows, prompting heavy Japanese official purchases of dollars and moderate dollar purchases by U.S. authorities. The strengthening of the yen has occurred despite the weak performance of the Japanese economy and market expectations that Japanese short-term interest rates will remain near historically low levels over the next year; it seems to be based largely on the perception that Japan's external surplus, which has grown rapidly over this period, is not sustainable.

Against the German mark, the dollar has risen almost 10 percent since December, reflecting a sub-



*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.

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stantial easing of German interest rates and the expectation of further declines in light of the sharp contraction in German economic activity. The dollar has also appreciated against other European currencies, and it has remained little changed against the Canadian dollar.

Economic activity in the major foreign industrial countries generally has been sluggish so far this year. The recovery in Canada now seems to be reasonably well established, and real GDP in the United Kingdom has been growing slowly. However, continental Europe remained in recession in the first quarter, with a sizable reduction in real GDP in western Germany; recent indicators point to continued weakness in the second quarter. After falling for much of 1992, Japanese real GDP rose in the first quarter, in large part reflecting the effects of earlier fiscal measures; however, indicators for the second quarter are mixed, and the appreciation of the yen will likely result over time in a drag on net exports.

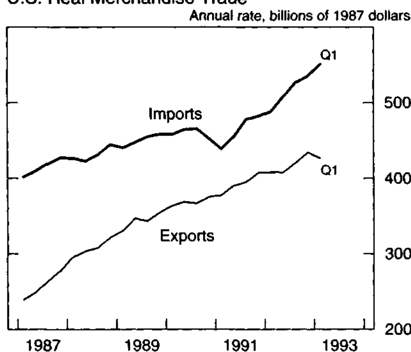
Unemployment rates have continued to rise (into the double-digit range in many instances) in the countries still in recession; even in the countries showing signs of recovery, unemployment has remained high. Partly as a consequence, wage pressures have ebbed, and underlying inflation has continued to decelerate, on average. A notable exception is western Germany, where the CPI rose more than 4 percent over the twelve months ended in June, partly because of an increase in the value-added tax early this year and large increases in the prices of housing services.

In contrast to the overall weakness of activity in foreign industrial countries, real growth so far this year in major developing countries, especially in Asia, appears to have remained at around the strong pace of 1992.

After expanding rapidly at the end of 1992, real merchandise exports declined during the first quarter of 1993, but they bounced back to their fourth-quarter 1992 high in April and May. Shipments to developing countries, which had risen sharply over 1992, dropped back during the January-to-May period. In the aggregate, exports to industrial countries rose somewhat in the first five months of 1993, but Canada and the United Kingdom accounted for most of the increase.

Real merchandise imports, extending the rapid pace of growth recorded over the four quarters of 1992, rose sharply over the first five months of 1993. Trade in computers continued to soar and was responsible for about one-third of the increase in merchandise imports. More broadly, imports were boosted by the rapid growth of U.S. domestic final demand in the second half of 1992 and inventory restocking this year. In addition, the prices of non-oil imports, reflecting the lagged effects of the appreciation of the dollar during the last quarter of 1992, fell somewhat in the first quarter; much of that decline appears to have been reversed in the second quarter. The price of oil imports fluctuated in a relatively narrow range over the first half of 1993. Mild weather and strong OPEC production pushed oil prices down early in the year, but prices subsequently retraced the decline on signs that OPEC would effectively curb production. Recently, oil prices have dropped on Kuwait's decision not to participate in OPEC's quota allocations for the third quarter and speculation that Iraq may be allowed to resume exporting sooner than had been expected.

U.S. Real Merchandise Trade



The merchandise trade deficit widened to $116 billion (at an annual rate) in the first quarter of 1993, nearly $10 billion greater than in the second half of 1992; it increased somewhat further in April and May, on average. With moderate increases in net direct investment income receipts and a slight further widening of the surplus on net service transactions, the current account deficit rose somewhat less than the trade deficit, to $89 billion (annual rate) in the first quarter, compared with $83 billion in the second half of 1992.

Net capital inflows recorded in the first quarter of 1993 were largely attributable to substantial increases in foreign official assets held in the United States, particularly in those of some newly industrializing Asian economies and of certain Latin American countries. Net private capital inflows were relatively small.

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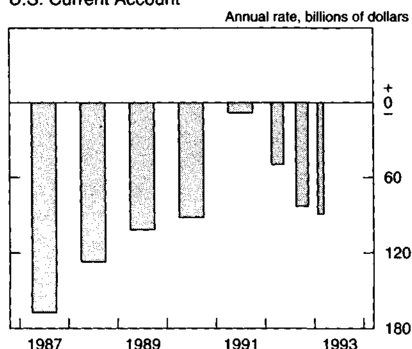
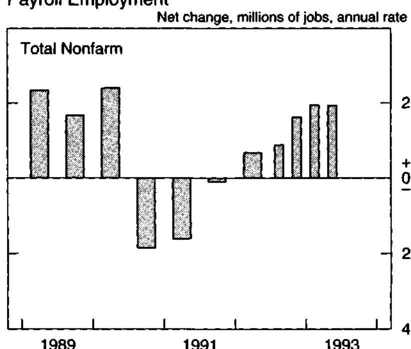
U.S. Current Account



Payroll Employment



Private foreigners added significantly to their holdings of U.S. securities, particularly Treasury bonds. However, U.S. net purchases of foreign bonds reached record levels, and net purchases of foreign stocks, although down from peak levels reached in the last half of 1992, remained heavy. New bond issues by foreigners in the United States also were very strong.

Capital inflows associated with foreign direct investment in the United States recovered substantially in the first quarter but remained far below the peaks reached in 1989. Foreign direct investment in the United States apparently has been deterred by unfavorable returns realized on earlier investments and by financial market conditions less favorable to acquisitions. In contrast, capital outflows associated with U.S. direct investment abroad remained strong.

Labor Market Developments

The labor market showed signs of improvement in the first half of 1993. According to the payroll survey, employment increased about 1 million; this number compares with a rise about 600,000 over the second half of last year and brings the total increase since the cyclical low in 1991 to about 2 million.

Nonetheless, job gains have continued to fall far short of the norms set by earlier business cycle expansions. For example, only in May did payroll employment return to its pre-recession peak, two years after the cyclical trough; by contrast, recessionary job losses typically have been reversed within the first year of the expansion. Job growth has continued to be restrained by the temperate pace of economic activity and employers' ongoing efforts to improve productivity. In addition, firms are confronting cost pressures associated with sizable increases in health insurance premiums and in other fringe benefits; uncertainties about the future course of government policies may also be contributing to the reluctance of some firms to expand their permanent full-time work forces.

Moreover, firms are relying increasingly on temporary workers, in part because doing so affords them greater flexibility in responding to fluctuations in demand for their products. Indeed, employment at personnel supply firms, which consist largely of temporary-help agencies, rose more than 150,000 between December and June. Over the past two years, the increase has been about 500,000; thus, although these firms currently account for less than 2 percent of total payroll employment, they are responsible for one-quarter of the increase in total employment over this period.

Job gains in the first half of 1993 also reflected a continuation of the steady uptrend in employment in health services. In addition, gains occurred at trade establishments, construction payrolls improved with the recent stronger housing activity, and there were scattered increases in services other than health and personnel supply.

Meanwhile, manufacturing employment declined further, on balance, over the first six months of the year. Although factory output increased steadily through April, firms relied mainly on a combination of productivity improvements and longer workweeks to meet their output objectives; in May and June, output decreased somewhat. Job losses in the first half were concentrated in the durable goods sector, with particular weakness at producers of aircraft and motor vehicles. Since its last peak in January 1989, manu-

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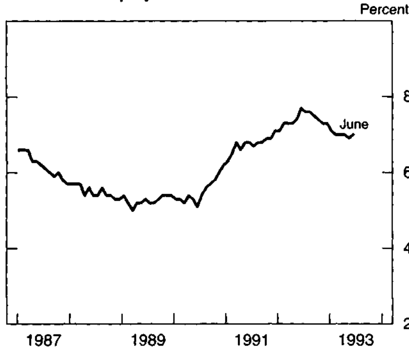
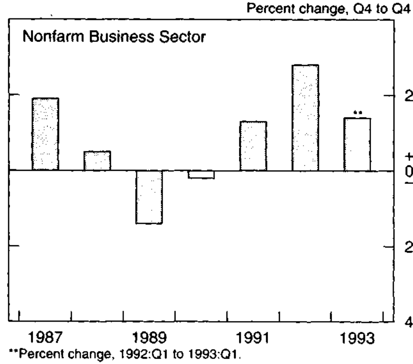




**Percent change, 1992:Q1 to 1993:Q1.

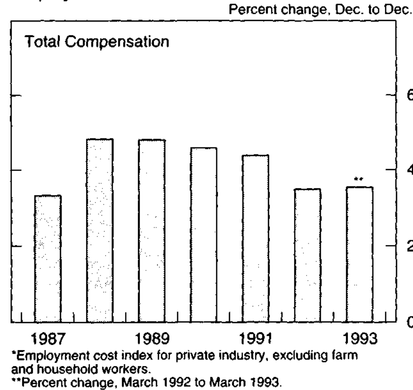
facturing employment has fallen about 1¾ million; layoffs in defense-related industries (those industries that depend on defense expenditures for at least 50 percent of their output) have accounted for about one-fifth of the decrease in total factory payrolls.

Employment as measured by the monthly survey of households rose about 900,000 over the first six months of the year—essentially the same as in the payroll series. The number of unemployed fell appreciably at the beginning of the year, and the civilian unemployment rate dropped from 7.3 percent in December to 7.0 percent in February; it has shown little change since that time.

The civilian labor force expanded only modestly over the first six months of 1993—less than 1 percent at an annual rate. Labor force growth continued to be damped by the relatively small increase in the working-age population. In addition, perceptions of meager employment opportunities evidently continued to deter many potential job seekers. The labor force participation rate, which measures the percentage of the working age population that is either employed or looking for work, spurted in late spring; however, this spurt followed a sharp decline earlier in the year, and the level at mid-year was about the same as that in late 1992.

Output-per-hour in the nonfarm business sector declined at an annual rate of 1½ percent in the first quarter, echoing the sharp deceleration in output. Nonetheless, the first-quarter drop followed a string of sizable increases; all told, the rise in productivity over the year ending in the first quarter of 1993 amounted to 1½ percent—smaller than the gains recorded earlier in the economic expansion, but still noticeably larger than the norms for the past decade. Productivity growth in the manufacturing sector, where downsizing and restructuring efforts have been under way for some time, has continued to be especially impressive, totaling more than 5 percent over the past year.

Labor compensation has tilted up of late. The employment cost index for private industry—a measure that includes wages and benefits—rose at an annual rate of 4¼ percent over the first three months of the year. Even so, the data are volatile, and the total increase since March 1992 amounted to only 3½ percent; by contrast, this index had risen 4¼ percent over the preceding twelve months, and, as recently as early



*Employment cost index for private industry, excluding farm and household workers.
**Percent change, March 1992 to March 1993.

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1990, the twelve-month change had exceeded 5 percent. The increase in wages over the past year was less than 3 percent, whereas the cost of fringe benefits, pushed up by the steep rise in the cost of medical insurance and by higher payments for workers' compensation, rose more rapidly. Primarily because of the drop in productivity, unit labor costs deteriorated markedly in the first quarter, but they still were up less than 2 percent over the past year.

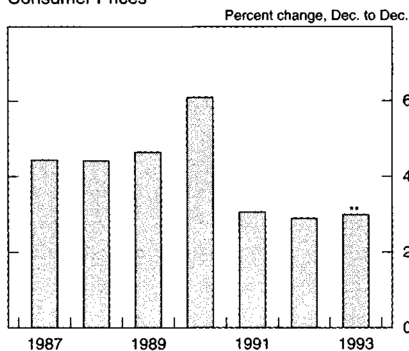
Price Developments

Inflation exhibited considerable month-to-month volatility in the first half of the year. Broad measures of inflation picked up somewhat in early 1993, with monthly readings through April in the upper part of the range of the past couple of years. However, price changes at the consumer and the producer levels were small in May and June. Cutting through the monthly data, the disinflation process evident in 1991 and 1992 seems to have stalled, with underlying inflation, as measured by the twelve-month change in the CPI excluding food and energy, holding in the range of 3¼ to 3½ percent that has prevailed since last summer. The total CPI, held down by essentially flat energy prices, has risen 3 percent over the past twelve months.

The CPI for food increased at an annual rate of 2 percent in the first half of 1993, a shade above the rate of increase during 1992. Meat prices jumped sharply during the first few months of the year as production fell short of year-earlier levels. In addition, the prices of fresh vegetables were boosted during the spring by weather-related production setbacks in several regions of the country. By late spring, these supply problems had abated, and the June CPI brought price declines in food categories where the sharpest upward pressures previously had been evident. Since the end of June, however, farm crop prices have moved up in response to the severe flooding in the Midwest. The increases in crop prices have already been reflected in the form of large advances in some commodity price indexes and have raised the possibility that renewed upward pressures on consumer food prices could soon emerge.

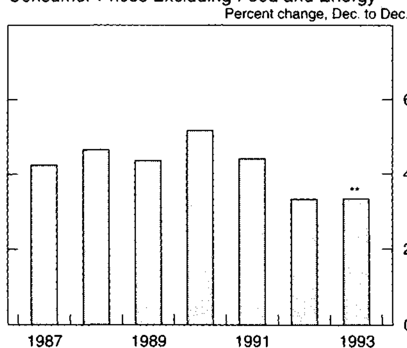
Consumer energy prices changed little, on net, over the first half of the year. With world oil markets remaining relatively quiescent, the price of West-

Consumer Prices*



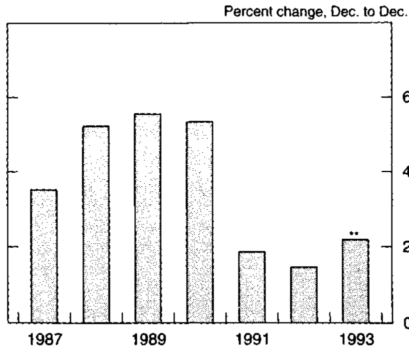
*Consumer price index for all urban consumers.
**Percent change, June 1992 to June 1993.

Consumer Prices Excluding Food and Energy*



*Consumer price index for all urban consumers.
**Percent change, June 1992 to June 1993.

Consumer Food Prices*



*Consumer price index for all urban consumers.
**Percent change, June 1992 to June 1993.

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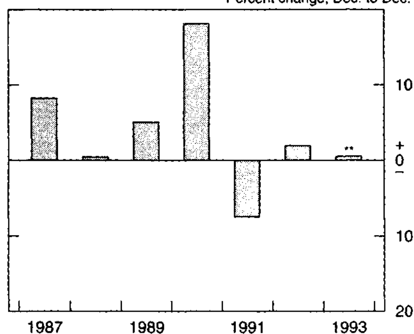
Consumer Energy Prices*



*Consumer price index for all urban consumers.
**Percent change, June 1992 to June 1993.

Texas intermediate generally fluctuated between $18 and $20 per barrel but has weakened recently. Retail prices for refined petroleum products changed fairly little on the whole through April and dropped, on balance, in May and June. Residential natural gas prices rose considerably over the first half, in part because of inventory adjustments associated with last winter's colder-than-usual weather; although recent declines in wellhead prices suggest that some of the increase at the retail level may be retraced in coming months, over the longer haul, natural gas prices are being supported by an ongoing shift toward the use of cleaner-burning fuels.

All told, the CPI excluding food and energy increased at an annual rate of 3½ percent over the first half of the year, after rising 3 percent over the second half of 1992. The CPI for goods soared in January and February, with large increases reported for several items. Apparel prices jumped early in the year, in part because strong sales in late 1992 limited the need for post-Christmas markdowns. Some retailers may also have seen opportunities to widen profit margins on other merchandise; the recent decrease in prices of home furnishings, for example, suggests that not all of these increases stuck.

Increases in prices of non-energy services were steadier but also somewhat larger than in 1992. Part of the step-up was in shelter costs, which account for about half of non-energy services and had posted some unsustainably small increases last summer. However, the substantial deceleration in medical care prices (for both goods and services) that has been in train over the past few years extended into 1993. In fact, the CPI for medical care rose only about 6 percent over the twelve months ended in June; this increase was among the smallest of the past decade.

To some extent, the higher underlying CPI inflation rates in the first half of 1993 may be a statistical phenomenon that will be reversed in the second half: Indeed, over the past several years, price increases early in the year have tended to exceed those for the year as a whole, even after seasonal adjustment by the BLS. But, even allowing for this phenomenon, inflation seems to have leveled out. The lack of further deceleration is puzzling in light of the considerable slack in labor and product markets. One possible explanation is that the pickup in economic activity late last year may have triggered a round of price increases; if so, some deceleration in prices is likely in the wake of the subdued performance of the economy in the first half. Another may be the apparent failure of inflation expectations, as measured by various surveys of consumers and businessmen, to reflect fully the reduction in actual inflation over the past few years; although the survey measures vary considerably, respondents seem to share a sense that inflation has bottomed out.

Prices received by domestic producers have slowed in recent months, after undergoing a pickup earlier in the year. All told, the twelve-month change in the producer price index for finished goods other than food and energy was less than 2 percent in June, down somewhat from a year earlier. At earlier stages of processing, where price movements tend to track cyclical fluctuations in demand, prices of intermediate materials (excluding food and energy) firmed a little early in the year, but they subsequently moderated; although the pattern was exaggerated by the spike in lumber prices, it was evident for some other materials as well. In commodity markets, prices of precious metals have moved up sharply over the past couple of months, and some scattered increases have been evident elsewhere. More broadly, however, industrial commodity prices were down slightly, on net, over the first half of the year.

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Section 3: Monetary and Financial Developments in 1993

Monetary policy in 1993 has been directed toward the goal of sustaining the economic expansion while preserving and extending the progress made toward price stability in recent years. In the first half of the year, economic activity slowed markedly from the very rapid pace of the fourth quarter, while inflation indicators fluctuated widely. Although inflation readings were a source of concern for the Federal Open Market Committee, the intensification of price pressures did not seem likely to be sustained over an extended period, and reserve conditions were kept unchanged. With short-term rates steady, prices of fixed-income securities were buoyed by prospects for significant fiscal restraint and by a slowing of the economic expansion, although fears of a pickup in inflation at times prompted partial reversals in bond rates. Yield spreads on private securities relative to Treasury rates remained historically narrow, and stock price indexes set new records.

The monetary aggregates have been sluggish this year, as both the share of depository institutions in overall debt finance and the proportion of depository credit funded with monetary liabilities have fallen further. The reduced role for depositories largely reflects weak demands for loans and deposits by the public. Corporate borrowers have continued to issue heavy volumes of stocks and bonds in part to pay down bank debt, while households have withdrawn deposits to invest in bond and equity funds that finance *inter alia* corporate issuers. After two years of no growth, bank loans weakened further early this year, but increased fairly vigorously in May and June, posting a modest net gain for the first six months of the year. The growth of nonfinancial sector debt so far this year has edged up from the subdued pace of 1992, despite a deceleration of nominal spending, as investment spending is estimated to have exceeded the internal funds of corporations, household borrowing has picked up relative to spending, and Treasury financing needs have remained heavy.

The Implementation of Monetary Policy

Early in the year, incoming data suggested that the faster pace of economic activity that had emerged in the third quarter of 1992 had been maintained through year-end. Indicators of industrial production, retail sales, business fixed investment, and residential construction activity all posted solid gains. Financial impediments to the expansion appeared to be diminishing as the balance sheets of households, business firms, and financial institutions continued to improve, although money and credit growth remained weak. Wage and price data suggested a continuing trend toward lower inflation. Intermediate- and long-term interest rates had declined somewhat, in part reflecting a view that the new Administration's fiscal stimulus package was likely to be modest and that material reductions in future deficits were in prospect. The economic outlook remained clouded, however, by uncertainties regarding details of fiscal policy plans, continued restructuring and downsizing of large businesses, and lingering restraints on credit supplies. At its early February meeting, the Federal Open Market Committee decided that its directive to the domestic open market desk should retain a symmetric stance regarding possible reactions over the intermeeting period to incoming indicators; such a directive, which implied no presumption in how quickly changes in operations should be made toward tightness or ease, had been instituted in December, following directives that had been biased toward easing over much of the previous two years.

Economic activity appeared to decelerate in the early months of the year, however, in part because of adverse weather conditions, with softness in retail sales, housing starts, and nonresidential construction. Bank credit was failing to expand significantly, while broad money was declining owing both to temporary factors and a weak underlying trend. Although short-term interest rates were little changed, bond markets rallied further on weaker economic activity and improved prospects for fiscal restraint, which would reduce the government's demand for credit. Long-term rates fell to the lowest levels in almost twenty years in early March, before backing up somewhat on reports of a second month of substantial increases in consumer and producer prices. The drop in interest rates buoyed stock markets to record highs and contributed to a small decline in the weighted-average value of the dollar. The dollar depreciated substantially against the yen, as market attention focused on Japan's growing trade surplus.

Signs of price pressures were a concern for the FOMC, but the fundamentals of continued slack in labor and capital utilization, subdued unit labor costs, and protracted weakness in credit and broad money suggested that a higher trend inflation rate was not setting in. With the economy slowing, reserve pressures were kept unchanged and a symmetric policy directive was retained at the meeting in March.

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After pausing in March, producer and consumer prices leaped again in April. Long-term interest rates backed up further in response; the price of gold surged, and the dollar fell more rapidly. With the Japanese authorities buying dollars in foreign exchange markets, the U.S. Treasury and the Federal Reserve also purchased dollars for yen in late April. After extended weakness, the monetary aggregates jumped in early May by more than could be explained by temporary factors.

At its May meeting, the FOMC was confronted with weak output growth and intensified inflation readings. It was difficult to identify reasons for this juxtaposition. Price increases by business firms in early 1993 could have reflected optimism engendered by strong demand conditions in the second half of 1992 or an upward adjustment of inflation expectations. However, considerable slack remained in labor and product markets, and the pace of economic activity had slowed markedly. The Committee concluded that no policy adjustment was needed at its meeting, but the risks of increased inflation and inflation expectations warranted a directive that contemplated a relatively prompt tightening of reserve pressures if signs of intensifying inflation continued to multiply.

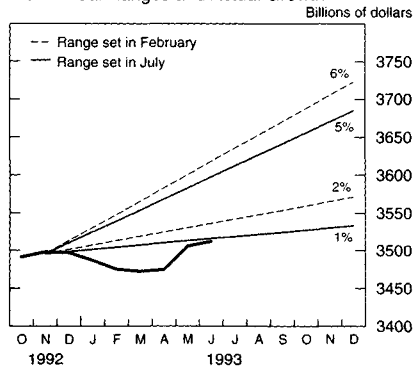
The subsequent readings on inflation for May and June were subdued; moreover, evidence of heightened inflation expectations did not emerge in markets for fixed-income securities. Consequently, the stance of monetary policy was not changed following the May FOMC meeting. The dollar rebounded on foreign exchange markets in June and early July in the wake of the fall of the Japanese government and evidence that economic conditions in Europe had deteriorated further.

On balance, since the beginning of the year, short-term interest rates are little changed, while intermediate- and long-term rates have fallen three-quarters to one percentage point to the lowest levels in over twenty years. In particular, the thirty-year Treasury bond has reached a low of 6.54 percent, while the ten-year Treasury note has touched 5.71 percent, its lowest level since 1971. The fixed-rate thirty-year mortgage interest rate has dropped to 7.16 percent, a record low in the 22-year history of the series. The fall in intermediate-term interest rates in the United States was roughly matched on average abroad, and the trade-weighted value of the dollar in terms of G-10 currencies has increased about 5 percent from its December average, as overseas economies weakened and foreign short-term rates declined substantially.

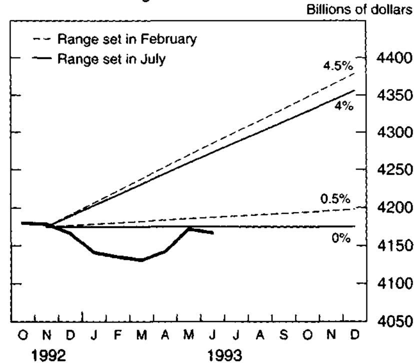
Monetary and Credit Flows

Growth of the broad money measures was quite slow over the first half of 1993, falling below the subdued pace of 1992, and leaving them near the lower arms of the revised growth cones for 1993. This deceleration, however, did not reflect a moderation in overall credit flows or a tightening in financial conditions. Rather, it resulted from a further diversion of credit flows from depository institutions as well as continued financing of depository credit through capital accumulation rather than deposits. Indeed, growth of the debt of all nonfinancial sectors is estimated to have edged up this year—to 5 percent—despite an apparent slowing in nominal GDP. Continued substantial demand for credit by the

M2: Annual Ranges and Actual Growth



M3: Annual Ranges and Actual Growth



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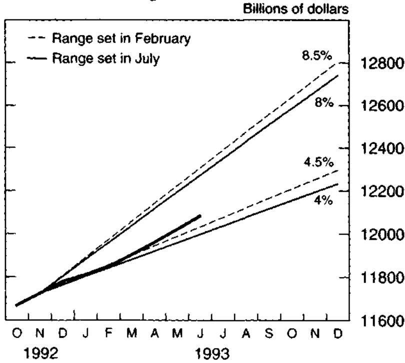
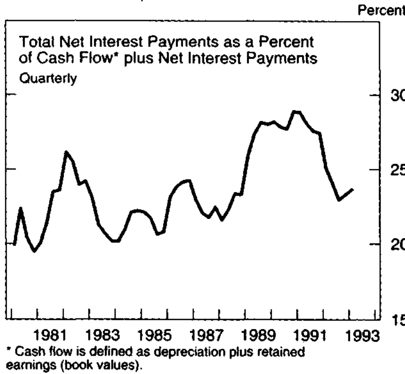
Debt: Annual Ranges and Actual Growth



federal government as well as more comfortable financial positions and consequent signs of a greater willingness to borrow and lend by private sectors likely supported debt expansion. Nevertheless, overall debt growth remains in the lower portion of its revised 4 to 8 percent annual range for 1993. Nonfederal debt growth has expanded at a still modest 3¼ percent pace, after two years of even weaker growth.

Taking advantage of low long-term interest rates and the strong stock market, businesses have issued an exceptionally large volume of bonds and equity; the proceeds have been used mainly to refund other marketable debt and repay bank loans. Stresses associated with the restructuring of the economy and the earlier buildup of debt linger. However, downgradings of corporate debt by rating agencies have dropped well below the peak levels of a few years ago, and a growing number of firms have received upgradings, as corporate cash flows have strengthened substantially relative to interest expenses.

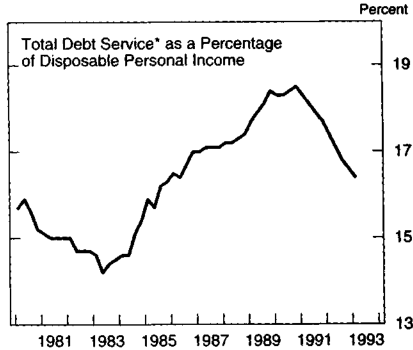
Interest Expense Burden of Nonfinancial Corporations



* Cash flow is defined as depreciation plus retained earnings (book values).

Debt service burdens of households also have continued to decline relative to disposable income, as households have repaid high interest debt or taken advantage of lower rates to refinance. Indeed, the decline in long-term interest rates during the year has brought a new surge of refinancings of mortgages. With balance sheets improved, households have become somewhat more willing to borrow, and consumer credit has begun growing moderately after two years of weakness. Some of that growth, though, may reflect heavy promotion of credit cards carrying special incentives for use in transactions, such as "frequent-flier miles" or merchandise discounts. Net mortgage debt is estimated to have grown only a bit more than the modest rate of 1992.

Debt Service Burden of Households



* Debt service is a Federal Reserve staff estimate of scheduled payments of principal and interest on home mortgage and consumer debt.

Gross issuance of state and local government debt has been particularly robust this year. However, refunding volume has accounted for nearly 70 percent of the offerings, compared with about 45 percent in 1992, a record year for refundings. Net debt of state and local governments has grown only moderately again in 1993. The budgetary situations of some state

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and local governments have improved, as tax receipts have been stronger than expected, but severe financial problems remain in other locales.

With corporate borrowers still relying heavily on financing through capital markets, and depository lending spreads over market rates remaining high, the trend decline in the share of total credit flows provided by depository institutions was extended through the first half of 1993. From the fourth quarter of 1992 to June, bank credit expanded at a 4¼ percent annual rate, only a modest pickup from the sluggish pace of the previous two years. Securities acquisitions accounted for most of the expansion, as loans increased at only a 1¾ percent rate. The growth of bank securities portfolios in part reflects additions to holdings of securitized mortgage and consumer loans; bank financing of consumer spending and real estate transactions is thus stronger than indicated by bookings of loans in those sectors. While commercial and industrial loans have been about flat on balance so far this year, a few signs of easing in bank lending terms and conditions have recently emerged, and business loans rebounded in May and June. Judging by business loan growth at smaller banks so far this year, a pickup has occurred in lending to smaller nonfinancial firms. Thus, the continuing weakness in overall business loan growth does not appear to be driven primarily by restrictive supply conditions, but rather by the preference of larger firms to fund through capital markets.

Lower market interest rates over the past few years have helped strengthen the financial positions of banks and thrifts. The lower rates have resulted in capital gains on securities and improved interest margins—as deposit rates have fallen more than lending rates. Lower rates also have helped bank borrowers by decreasing interest expenses and boosting economic activity, thereby reducing loan loss provisions for banks. Banks posted record earnings in 1992 and remained very profitable in early 1993; prices of their shares on equity markets have risen substantially.

Thrift institutions have continued to contract in 1993, though at a much slower pace than over the last four years. A lack of funding for the Resolution Trust Corporation caused a hiatus in the closure of institutions under its conservatorship. However, privately operated thrifts have not expanded and the industry continues to consolidate.

Slower growth in nominal GDP, moderate demand for credit relative to spending, and the reduced share of credit provided by depositories have all contributed to the lack of significant growth in the broad monetary aggregates this year. Another factor inhibiting money growth has been continued substantial funding of bank and thrift assets with subordinated debt and equity issues, as well as retained earnings—all a byproduct of ongoing efforts to build capital positions. While about a third of the industry (by asset volume) had capital ratios and supervisory ratings high enough at the end of 1991 to be considered well-capitalized, more than two-thirds were so positioned by early 1993. About $10 billion was added to bank equity and subordinated debt during the first quarter, about the same pace as in 1992; data on new debt and equity issues indicate another sizable gain over the second quarter.

Depositories have also recently relied more heavily on other nondeposit sources of funds. Weak economies and credit demand abroad have prompted the U.S. offices of foreign banks to draw more funding

Domestic Bank Assets by Capital Category

Adjusted for overall supervisory ratings[1]

Capital Category	End of Year 1991	End of Year 1992	March 1993
Percent			
Well Capitalized	34	68	70
Adequately Capitalized	45	22	20
Undercapitalized	21	10	10

1. Adjustments to capital categories were made according to the rule of thumb of downgrading a bank by one category for low a examination rating by its supervisory agency (CAMEL 3, 4, or 5).

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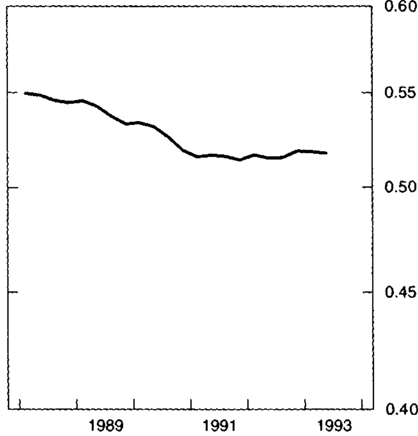
from overseas, and the domestic offices of U.S. banks to reduce foreign lending this year. Overall shifts from deposits to other sources of funding may be driven partly by regulatory inducements—including higher insurance premiums on deposits and incentives to bolster capital. But changes in investor preferences from short-term deposits to longer-term debt and equity may also be playing a role in motivating the restructuring of bank and thrift sources of funds.

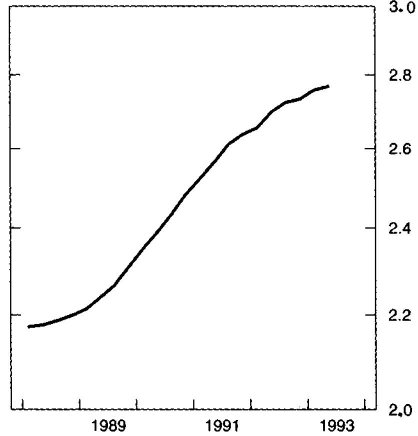
Key elements affecting money growth relative to nominal income may be seen in a decomposition of M3 velocity in the four-panel chart below. The top left panel depicts the moderation in overall borrowing in the economy; after several years of declines, the ratio of nominal GDP to total nonfinancial debt, or debt velocity, has been rather stable since 1990, as debt growth has slowed to about the pace of GDP growth. The top right panel shows the reduced role of

Decomposition of M3 Velocity (Ratio scales)

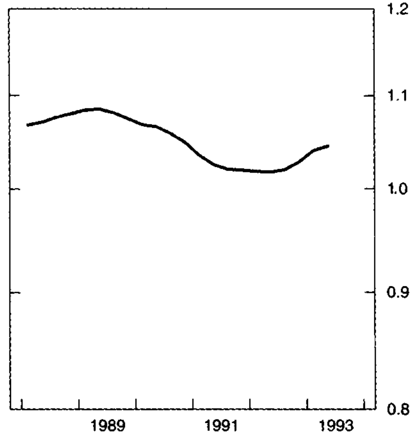
Ratio of Nominal GDP to Total Nonfinancial Debt



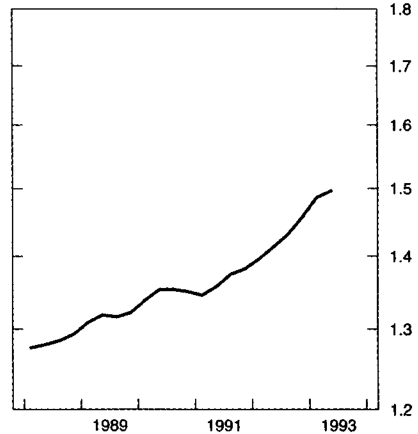
Ratio of Total Nonfinancial Debt to Depository Credit



Ratio of Depository Credit to M3



Velocity of M3



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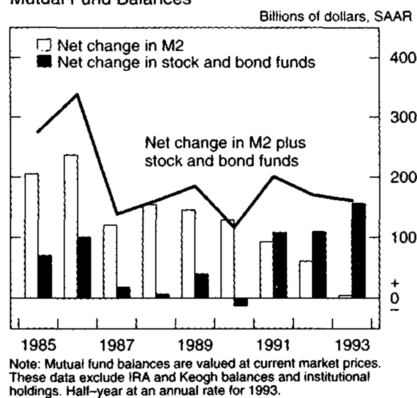
depositories in providing even the more moderate volume of total credit; the ratio of total nonfinancial debt to depository credit has risen sharply over the last three years. Higher costs and attempts to recoup past capital losses led to higher bank loan rates relative to market rates after 1988 and stricter nonprice terms and standards, while declines in long-term interest rates and a strong stock market, along with the impetus to repair balance sheets, induced firms to turn to capital markets for financing. The bottom left panel shows the increased reliance on equity and other nondeposit funding by banks and thrifts, as well as some declines in money market mutual funds; the ratio of depository credit to M3 has been rising since the second quarter of 1992. The velocity of M3 (GDP divided by M3), in the bottom right panel, is the product of the other three ratios. In the late 1980s, M3 velocity departed from its traditional declining trend, increasing at about a 2 percent annual rate as the depository sector began playing a smaller role in financing credit growth. The growth of M3 velocity picked up to 5¼ percent in 1992 and perhaps a somewhat faster rate in the first half of 1993.

Greater reliance by borrowers on capital markets has been facilitated by concurrent shifts in saving preferences away from monetary assets and into capital market investments. Such portfolio realignments are evident in record inflows to bond and stock mutual funds, and money balances were also likely invested directly in stocks and bonds. The incentives for what appears to be an extraordinary adjustment of household portfolios are varied. Interest rates paid on retail time deposits, NOW accounts, and money market deposit accounts (MMDAs) have fallen well below any rate offered since the inception of deregulated deposits in the early 1980s, and savings deposit rates are now the lowest in more than thirty years. The shock effect of historically low deposit interest rates caused many depositors to investigate alternative investments. With the yield curve extraordinarily steep, much higher returns have been available in recent years on longer-term investments. A bond or stock mutual fund offers a chance to earn these higher yields, but still enjoy liquidity features, including in some cases a check-writing facility. However, investment in such a mutual fund carries with it a higher risk of loss as well, because unlike monetary assets, its principal value fluctuates with market prices. Indeed, the higher yield on bonds relative to short-term instruments probably anticipates some capital losses. Whether all households accurately assess relative risks when comparing returns recently earned on mutual funds with those on money balances remains an open question.

Shifts into mutual funds have become much easier and less costly for households, most notably because many banks have begun offering mutual funds for sale in their lobbies. While many banks now offer discount brokerage services, a survey by the Federal Reserve found that larger banks have recently been making special efforts to promote mutual fund investments among their depositors. An increasing number of banks have sponsored their own mutual funds or entered into exclusive sales relationships with nonbank sponsors of funds. Some banks have promoted these products as a defensive measure to retain long-run relationships with valued depositors. In other cases, however, banks have promoted funds as part of a strategy to earn fee income without booking assets, thereby avoiding the need to raise additional capital.

Substitution between money and long-term mutual funds appears to have become evident in the aggregate data in recent years. There was little increase in such funds from 1987 through 1990, but large inflows since then, at the same time that accretions to M2 balances declined. A comparison of the quarterly growth rates of M2 and the sum of M2 and bond and stock funds shows that growth of the sum has not weakened as dramatically as that of M2 over the last two and half years; it has averaged nearly a 5 percent annual rate, compared with less than 2 percent for M2. Although adding mutual funds and M2 together captures some substitution out of M2 in recent years,

Changes in M2 and Stock and Bond Mutual Fund Balances



Note: Mutual fund balances are valued at current market prices. These data exclude IRA and Keogh balances and institutional holdings. Half-year at an annual rate for 1993.

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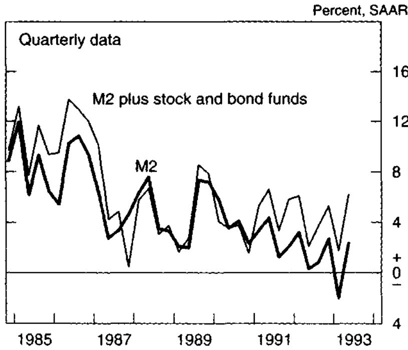
Growth Rates of M2 and M2 plus Stock and Bond Funds



the total remains quite volatile, indicating that other forces have affected both M2 and mutual funds. Partly as a consequence, the relationship of the total to aggregate spending is subject to considerable uncertainty. Investments in bond and stock funds are themselves subject to potentially volatile capital gains and losses. More fundamentally, the responses of the public, now holding vastly expanded mutual funds, to a variety of interest rate and stock price movements has yet to be tested.

Because weakness in the demand for broad money has largely resulted from shifts of portfolio preferences rather than changes in spending intentions, it has not been reflected in comparable weakness in nominal GDP. Furthermore, the effects of a declining share for depositories in overall credit growth have been substantially offset by increased funding through capital markets, where households now invest a larger share of wealth. The velocity of M2 has experienced extraordinary and unpredictable surges, reducing its value as a guide to policy. Traditional models of velocity based on the difference between short-term market interest rates and interest rates on deposits and money market mutual funds, and even broader models that take account of longer-term interest rates and after-tax loan rates faced by households, cannot explain the full 4 percent rise in M2 velocity in 1992, nor what may be a somewhat faster rate of increase in the first half of 1993.

Money growth in the first quarter was depressed in part by the effects of several temporary factors, including distortions of seasonal factors and a lull in mortgage refinancing. A renewed surge of mortgage refinancing began to bolster demand deposits and MMDAs in April, as mortgage servicers increased balances temporarily before making remittances to investors in mortgage-backed securities. The seasonal factor distortions began to reverse that month as well. However, substantial shortfalls in individual nonwithheld tax payments relative to recent years produced an offsetting restraint to money growth in April, as the buildup of balances required to pay taxes was smaller than that incorporated into seasonal factors. Even excluding estimated effects of these special factors, however, underlying growth of money through the first four months of the year was far weaker than historical relationships would suggest.

Despite continued heavy inflows to bond and equity funds in May, the monetary aggregates surged, boosted in part by a reversal of the tax effects and an intensification of mortgage refinancing activity. However, the aggregates decelerated substantially in June, and by more than might be suggested by a waning of tax and mortgage refinancing effects.

In 1993, household portfolio adjustments differed somewhat from their previous pattern. In the past, the realignment of household wealth toward capital market investments had mainly involved shifts from money market mutual funds and small time deposit accounts. At the same time, outflows from those accounts had also gone into NOW and savings deposits, the interest rates on which were falling only slowly as market rates declined. This year, the sum of all these M2 balances has fallen at about the same rate as in 1992, but a slower runoff of small time deposits and money funds has been offset by a sharp deceleration in the growth of NOW and savings deposits. Catch up declines in interest rates on liquid deposits may account for part of their slower growth. Some nontransactions balances held in NOW and MMDA deposits have likely been shifted into bond and equity funds. It may be that some depositors who do not ordinarily shop for small rate advantages have been induced to make basic portfolio adjustments because of the historically low deposit interest rates and the increased ease of making investments in capital market instruments.

Partly as a result, narrow measures of money have decelerated this year, but their expansion has remained rapid. M1 has grown at a 9½ percent rate from the fourth quarter of 1992 through June, compared with 14¼ percent in 1992. Reserves, now held exclusively against transaction deposits, have grown at an 11 percent pace compared with 20 percent in 1992. The monetary base has slowed by much less,

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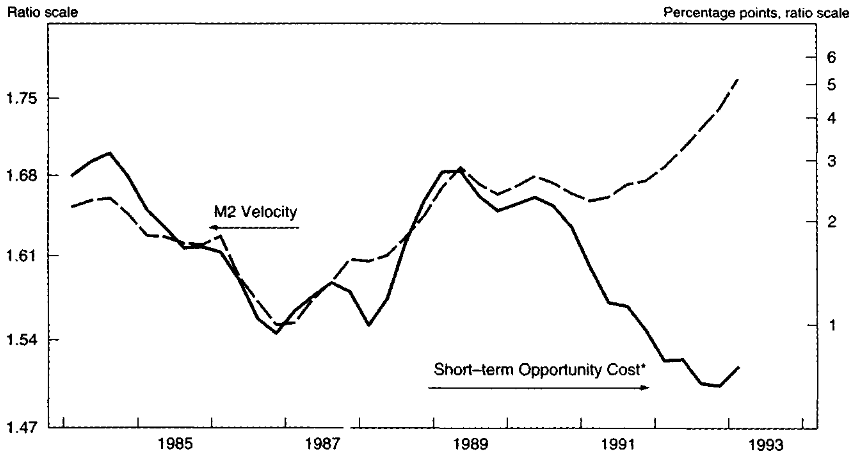
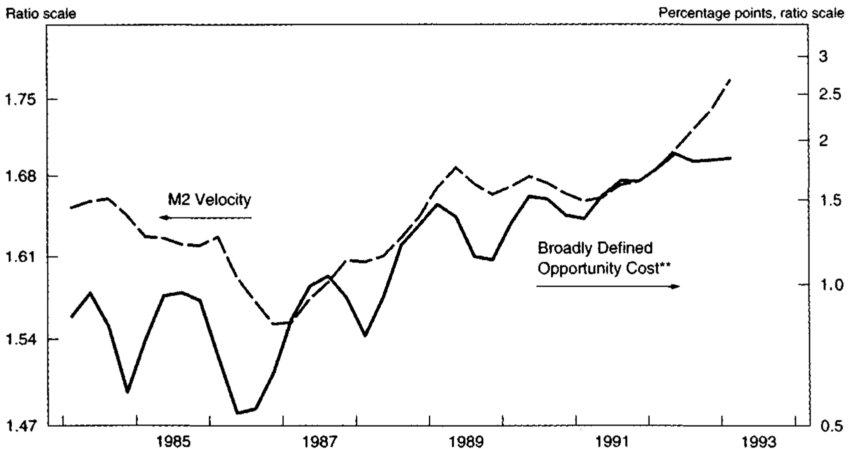
M2 Velocity and Opportunity Cost



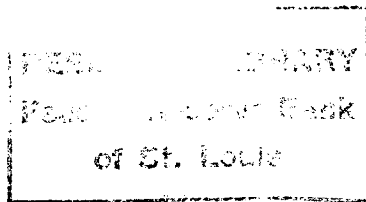


Note: Opportunity costs are two-quarter moving averages.
*3-month T-bill rate less weighted average rate paid on M2.

**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.

because of continued strong foreign demand for currency this year.

With reduced strength in its M1 component, and in savings and MMDAs, as well as continued runoffs of small time deposits and retail money funds, M2 has grown at only a ¾ percent annual rate from the fourth quarter of 1992 through June 1993, well below the lower end of its growth cone set in February. The FOMC monitored the behavior of M2 carefully over the first half of the year, but in light of actual and expected strength of velocity, determined that actions to boost M2 growth were not needed to achieve the Committee's underlying objectives for prices and the



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economy. The aggregate is near the lower arm of the revised annual growth cone established in July, and if velocity continues to increase substantially, M2 may well come in toward the lower end of the revised growth range for the year.

The non-M2 portion of M3 has declined this year at nearly the same pace as the previous two years. Large time deposits have continued to fall, and the halt in reductions in short-term rates has ended the rapid growth of institutional money funds, as their slower-adjusting yields have come down to their usual relationship to market interest rates. From the fourth quarter of 1992 through June, M3 fell at about a ¼ percent annual rate; it lies slightly below its revised annual growth cone.

Growth of Money and Debt

		M1	M2	M3	Total domestic nonfinancial debt	Nonfederal domestic nonfinancial debt
Annually, fourth quarter to fourth quarter				*(Percentage changes)*		
1980		7.4	8.9	9.5	9.5	9.0
1981		5.4 (2.5)[1]	9.3	12.3	10.0	9.7
1982		8.8	9.1	9.9	9.3	7.4
1983		10.4	12.2	9.9	11.4	8.8
1984		5.5	8.1	10.8	14.3	13.9
1985		12.0	8.7	7.6	13.8	13.3
1986		15.5	9.3	8.9	14.0	13.7
1987		6.3	4.3	5.8	10.1	10.4
1988		4.3	5.3	6.4	9.2	9.6
1989		0.6	4.7	3.7	8.2	8.5
1990		4.3	4.0	1.8	6.8	5.9
1991		8.0	2.8	1.1	4.4	2.5
1992		14.3	1.8	0.3	4.8	2.9
Semiannually (annual rate)[2]						
1993	H1					
Quarterly (annual rate)[2]						
1993	Q1	6.6	-2.0	3.8	4.4	3.0
	Q2	10.6	2.2	2.4	5.7	3.6
Fourth quarter 1992 to June 1993 (annual rate)		9.5	0.8	-0.3	5.1[3]	3.3[3]

1. Adjusted for shift to NOW accounts in 1981.
2. From average for preceding quarter to average for quarter indicated.
Second quarter debt aggregates estimated on data through May.
3. 1992:Q4–1993:May for debt aggregates.

70-449 (96)

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