CONDUCT OF MONETARY POLICY

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

HEARING

BEFORE THE

SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY

OF THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

HOUSE OF REPRESENTATIVES

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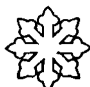

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CONDUCT OF MONETARY POLICY

Thursday, February 23, 1995.

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL
MONETARY POLICY,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Michael N. Castle, [chairman of the subcommittee] presiding.

Present: Chairman Castle, Representatives Lucas, Metcalf, Chrysler, LoBiondo, Watts, Kelly, Ney, Flake, Frank, Kennedy, Maloney, Roybal-Allard, Fields, and Watt.

Also present: Chairman Leach, Representatives LaFalce, Schumer, Sanders, Wynn, Hinchey, and DeFazio.

Chairman CASTLE. The subcommittee will come to order. I wanted to start on time, for various reasons. There are so many meetings going on today and Mr. Greenspan is not feeling at 100 percent, suffering from a cold, and we want to give everybody a fair chance to ask questions.

At this particular subcommittee meeting, I will make an opening statement. Mr. Flake, who should be here shortly, is the ranking minority Member and he will make an opening statement. Mr. Greenspan will testify and each member will be able to ask questions under the 5-minute rule.

I will have to repeat this several times as we go along, but I'm going to ask that any questions be finished before the red light goes on and, Mr. Greenspan, that you would take maybe a minute or so after that to finish up the last question, so that the whole question and answer period does not take more than, at the most, 6 minutes, so we can continue to move along.

This subcommittee meets today for the first time to receive the semi-annual report of the Board of Governors of the Federal Reserve System on the conduct of monetary policy and the state of the economy, as mandated in the Full Employment and Balanced Growth Act of 1978.

Chairman Greenspan, we welcome you to the Subcommittee on Domestic and International Monetary Policy, a newly organized subcommittee that combines the areas of concern of several previous banking subcommittees. Some of the members are well known to you from past hearings, but we also have a number of newly elected members on the majority who may be unfamiliar to you. Today we have three minority members, Representatives Wynn, Hinchey and DeFazio, who will be sitting in. Mr. Leach is

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here as well, of course, our distinguished Chairman of the Banking Committee. They've all requested the opportunity to sit with the subcommittee and present questions to you.

We have acceded to their requests, but ask your indulgence and that of the subcommittee membership that following the ranking minority Member's introductory comments, we dispense with opening statements by the Members. Any prepared remarks presented will be accepted for the record. This should permit us to listen attentively to your presentation, have ample time for questions, and still vacate, which we must do, in time for the markup on the Mexico resolution scheduled for 2:00 p.m. this afternoon in this room.

A report in the January 17 edition of my hometown newspaper, the *Wilmington News Journal*, cites the Federal Reserve Bank of Philadelphia to the effect that future economic indicators suggest the outlook for business conditions in the Philadelphia-Wilmington-Trenton region has fallen to its lowest level in more than 4 years. While the index for current general economic activity in the region rose slightly from January to February, the report said that future economic indicators suggest that manufacturers there expect some slowing of growth over the next 6 months.

Similar indications from other members' districts would seem to suggest that the long awaited "soft landing" may be in view. Along with my colleagues today, I am eager to hear your views as to how seven interest rate adjustments in the past 12 months and other actions taken by the Board have prepared the ground for this result.

In addition, I look forward to learning your impressions of how this new Congress and the Contract with America will reshape economic reality. Significant change is underway in regulatory reforms, prospects for a balanced budget, major cuts in domestic and foreign spending, all will affect the Federal Reserve System calculus. Your chairmanship of the Federal Reserve has been marked by unprecedented openness both with Congress and the public. Such candor, of course, invites pressure for even more transparency in areas previously kept confidential, such as minutes of the meeting of the Federal Open Market Committee or foreign exchange dealings.

Any comments you may care to make regarding this policy of drawing aside the veil over Central Bank operations will find an interested audience with this subcommittee.

You will have come prepared for questions regarding why we have experienced seven interest rate raises in the past 12 months when the Producer Price Index for January again advanced only three-tenths of 1 percent for finished goods and a remarkable two-tenths of 1 percent in the core of PPI, excluding food and energy components. During that same 12-month period, finished producer good prices have risen by only 1.5 percent.

This is producing much skepticism about whether the inflation bogeyman still threatens our economy. We have also noted your speculation to the effect that the Consumer Price Index perhaps overstates inflation, increasing government outlays via items in the economy that are indexed to the CPI. I appreciate that this is a complicated problem to fix without invoking the law of unintended

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consequences. I hope this is a subject that we can address during these Humphrey-Hawkins hearings.

The Humphrey-Hawkins bill mandates goals for the Federal Reserve System to pursue that are often inconsistent or conflicting. Most of the bill's mandates have been more honored in the breach, especially those that apply to the Executive. To the extent that these inconsistent goals actually hamper the Fed's ability to optimize its operations, we may have an opportunity to revisit this legislative charter by the time we gather here next in July, and I suggest that we might then consider improvements or adjustments to your mandate that would make monetary operations more effective.

With that, let me turn to our very distinguished ranking minority Member, who has joined us now, we're delighted to have him here, Mr. Floyd Flake, for his opening statement.

Mr. FLAKE. Thank you very much, Mr. Chairman, and certainly my compliments to you at this first hearing of the Subcommittee on Domestic and International Monetary Policy. I look forward to working with you and I think we share many of the same ideas in terms of the direction of this subcommittee and I think we'll be able to do some wonderful things together.

Let me again welcome Mr. Greenspan. It's my ninth year. It seems we've been seeing each other for a long time now and I'm happy to welcome you again. As always, it's a refreshing moment to have you to be before us. You're always filled with candor and truthfulness and openness, and I certainly appreciate that.

I'd like to welcome also those who are new members of this new subcommittee. Since we deal with monetary policy issues, obviously, it has an impact on everybody's life. I think our interest has certainly reached a high point in light of recent changes that have taken place, particularly in interest rates and their impact both as it relates to our domestic and international positions.

As everyone has read, there's been a tremendous amount of concern about the impact of these interest rate changes over the past year. Of course, my concern, because my interest is largely in areas of housing and community development, is how these interest rate increases have reflected on our housing market.

While I clearly understand the operation of the Fed to keep well ahead with the nation's economic developments and take the necessary steps to stabilize the economy through monetary policy, I feel that once again we may directly hurt those who cannot afford the kind of changes that more economic blows, such as increases in interest rates, cause.

I must say that I have been encouraged over the last several days and today in particular in reading the newspapers and realize that you're doing your best to try to make sure that the best is done in regards to meeting the interests of stabilizing the economy here in this nation. I hope that the newspapers have correctly interpreted your statements and that, as we hear from you today, we will get clarifications from them.

Toward that end, I look forward to hearing from you again and will yield back, Mr. Chairman, so that we might use this time wisely in using Mr. Greenspan. Thank you.

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Chairman CASTLE. I thank the ranking minority Member a great deal. I've just been informed we have 10 minutes left in a Journal vote. So we have to hurry over to vote. I do apologize for this. I know what it does to the schedule. We will resume as rapidly as we can, hopefully no later than 15 minutes from now, maybe even 10 minutes from now, to hear your testimony, Mr. Greenspan, and to go on with the questioning at that point, our opening statements having reached their conclusion at this point.

Mr. KENNEDY. I would like to make an opening statement either now or when we get back.

Chairman CASTLE. We have agreed before—I have ruled that we will not have opening statements by members other than Mr. Flake and myself. You are more than welcome to give that as part of your questioning period, if you wish, Mr. Kennedy. Sorry, sir. If there's no one here, we might waive it. We stand adjourned temporarily.

[Recess.]

Chairman CASTLE. The subcommittee will come to order. I apologize for the delays. It's something we can't control. We have completed our opening statements and, Mr. Greenspan, we will now turn to you.

Let me point out to the members here that we have all received the Monetary Policy Report to the Congress, pursuant to the Full Employment and Balanced Growth Act of 1978, Humphrey-Hawkins as we know it. We also have your testimony, which came in after that. If anyone here has had the time to read all this in the last couple of days, I would be shocked. So we probably will depend more on what you say than we do anything else that you've already submitted to us, but we do appreciate the fact that this was submitted in a timely fashion and we look forward to hearing your testimony, sir.

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

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I have excerpted from the detailed presentation I have in my formal testimony and request, however, that the full testimony be included for the record.

Chairman CASTLE. Without objection, so ordered.

Mr. GREENSPAN. Mr. Chairman and other members of the subcommittee, as always, I appreciate this opportunity to discuss the Federal Reserve's conduct of monetary policy. Nineteen ninety-four was a good year for the American economy. We now have enjoyed over 3 years of relatively brisk advance in the nation's output of goods and services and this economic progress has been shared by many Americans. Payrolls swelled $3.5 million last year and the unemployment rate closed 1994 at 5.5 percent, more than a percentage point below its level 1 year ago.

The data that have been published in the first weeks of 1995 have offered some indications that the expansion may finally be slowing from its torrid and unsustainable pace of late 1994. While hours of work lengthened in January, employment growth slowed from its average of recent quarters and the unemployment rate rose. Moreover, recent readings on retail sales suggest a more moderate rate of increase, and housing activity has shown some soft-

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ness. Nonetheless, the economy has continued to grow without seeming to develop the types of imbalances that in the past have undermined ongoing expansion.

Of crucial importance to the sustainability of the gains over the last few years, they have been achieved without a deterioration in the overall inflation rate. Inflation at the retail level, as measured by the CPI, has been a bit less than 3 percent for 3 years running now, the first time that has occurred since the early 1960's. This is a signal accomplishment for it marks a move toward a more stable economic environment in which households, businesses and governmental units can plan with greater confidence and operate with greater efficiency.

As I have stated many times in congressional testimony, I believe firmly that a key ingredient in achieving the highest possible levels of productivity, real incomes and living standards is the achievement of price stability. Thus, I see it as crucial that we extend the period of low inflation, hopefully returning to a downward trend in the years ahead. The prospects in this regard are fundamentally good, but there are reasons for some concern at least with respect to the nearer term. These concerns relate primarily to the fact that resource utilization rates have already risen to high levels by recent historical standards. History tells us that economies that strain labor force and capital stock limits tend to engender inflation instabilities that undermine growth.

It is true, however, that in modern economies, output levels may not be so rigidly constrained in the short run as they used to be. Aggregative indicators, such as the unemployment rate and capacity utilization, may be suggestive of emerging inflation and asset price instabilities, but they cannot be determinative. Policy makers must monitor developments on an ongoing basis to gauge when economic potential actually is beginning to become strained, irrespective of where current unemployment rates or capacity utilization rates may lie.

If we are endeavoring to fend off instability before it becomes debilitating to economic growth, direct evidence of the emerging process is essential. In this context, aggregate measures of pressure in labor and product markets do seem to be validated by finer statistical and anecdotal indications of tensions.

In the manufacturing sector, for example, purchasing managers have been reporting slower supplier deliveries and increasing shortages of materials. Pressures have been mirrored in a sharp rise over the past year in the prices of raw materials and intermediate components. There are increasing reports that firms are considering marking up the prices of final goods to offset those increased costs.

In that regard, January's core CPI posted its largest gain since October 1992, perhaps sounding a cautionary note. In the labor market, anecdotal reports of shortages of workers have become more common.

It was to preserve and to extend the gains associated with low and declining inflation and to avoid the instabilities and imbalances attendant to rising inflation that we began the process of tightening 1 year ago. Our view at the time was that the accommodative policy stance we had adopted in earlier years to contain

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the effects of financial strains on borrowers and lenders was no longer appropriate once their balance sheets had been greatly strengthened.

In these changed circumstances, absent policy action, pressures on capital and labor resources could build to the point where imbalances would emerge and costs and prices would begin to accelerate, jeopardizing the durability of the current expansion.

In the event, the strength in demand and the potential for intensification of pressures on prices were even more substantial than envisaged when we started down that road. As we thought might be possible at this time last year, a significant upturn in inventory investment induced a stronger economy than was generally anticipated. Additional strains on capacity became increasingly evident in higher prices at early stages of production processes.

Moreover, in financial markets, the effects of the policy firmings were muted to an extent by an easing of terms and conditions on bank loans and by a drop in the foreign exchange value of the dollar. In these circumstances, the Federal Reserve needed to take further steps to head off potential instabilities that would threaten the economic expansion.

Looking ahead to the prospects for the U.S. economy, we must remember that the Nation has entered 1995 with its resources stretched. We do not now have the substantial unused capacity that made possible the especially favorable macroeconomic outcomes of 1993 and 1994. As a result, the likely performance of the economy in 1995 almost surely will pale in comparison with that of the previous 2 years.

The growth in output arguably must slow to a more sustainable pace and resource utilization settle in at its long-run potential to avoid inflationary instabilities. Inflation itself is unlikely to moderate further and may even pick up temporarily, but, overall, the performance of the economy still should be good. We expect growth to continue and inflation to be contained.

The Federal Reserve, for its part, will be attempting to foster financial conditions that will extend that good performance through 1995 and beyond. Our policy actions will depend on an ongoing assessment of a number of forces acting on the economy. One is the effects on spending of the rise in interest rates that has occurred over the past year. Our reading of the historical record is that the cumulative effect of higher interest rates should lead to a significant deceleration in spending, but, to date, the jury remains out on whether the slowing that is in train will be sufficient to contain inflation pressures.

That judgment also rests importantly on a reading of business cycle developments more generally, cycles which often relate to the interaction of physical stocks and flows. These dynamics are most clearly seen in inventory investment, which has always been an important swing factor in the post-World War II era. In 1994, the increase in inventory investment in real terms added almost 1 percentage point to GDP growth. It appears most unlikely that business people will wish to build their stocks at the pace they did in 1994. But whether their actions with respect to inventories will turn that plus for growth last year into a significant minus in 1995

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remains to be seen. However, incoming information does not suggest that a substantial inventory correction is imminent.

In another area, actions of this Congress regarding the Federal budget deficit will have important consequences for the economic outlook. A credible program of fiscal restraint that moves the government's finances to a sounder footing almost surely will find a favorable reception in financial markets. That market reaction by itself should serve as a source of stimulus that would help to offset in whole or in part the drag on spending that otherwise would be associated with reductions in Federal outlays and transfers over time.

It is also important to remember that a larger issue is at stake during these deliberations on the Federal budget. Too much of the small pool of national saving goes toward funding the government to the detriment of capital formation. By trimming the deficit, those resources will likely be put to more productive uses, leading to benefits in the form of improved living standards.

I and my colleagues appreciate the time and the attention that members of this subcommittee devote to oversight of monetary policy. Our shared goal, the largest possible advance in living standards in the United States over time, can be best achieved if our actions ultimately allow concerns about the variability of the purchasing power of money to recede into the background.

Price stability enables households and firms to have the greatest freedom possible to do what they do best—to produce, invest and consume efficiently. But the best path to that long-run goal is not now and probably never will be obvious. Policymaking is an uncertain enterprise. Monetary policy actions work slowly and incrementally by effecting the decisions of millions of households and businesses, and we adjust policy step-by-step as new information becomes available on the effects of previous actions and on the economic background against which policy will be operating.

No individual step is ever likely to be decisive in pushing the economy or prices one way or the other. There is, so to speak, no monetary policy "straw that broke the camel's back." The cumulative effects of many policy actions may be substantial, but the historical record suggests that any given change in rates will have about the same effect as a previous change of the same size.

Because the effects of monetary policy are felt only slowly and with a lag, policy will have a better chance of contributing to meeting the nation's macroeconomic objectives if we look forward as we act, however indistinct our view of the road ahead. Thus, over the past year, we have firmed policy to head off inflation pressures not yet evident in the data. Similarly, there may come a time when we hold our policy stance unchanged or even eased, despite adverse price data, should we see signs that underlying forces are acting ultimately to reduce inflation pressures. Events will rarely unfold exactly as we foresee them and we need to be flexible, to be willing to adjust our stance as the weight of new information suggests it is no longer appropriate.

That flexibility, Mr. Chairman, applies to the particular stance of policy, not its objectives. We vary short-term interest rates in order to further the goals set for us in the Federal Reserve Act,

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namely, promoting over time, as the Act states, "maximum employment, stable prices, and moderate long-term interest rates."

Achieving these goals has become increasingly more complex in the nearly 2 decades since they were put into the Federal Reserve Act, as a consequence of technology-driven changes in financial markets in the United States and around the world. Suppressing inflationary instability, a necessary condition of achieving our shared goals, requires not only containing prevalent price pressures, but also diffusing unsustainable asset price perturbations before they become systemic.

These are formidable challenges which will confront policy, both fiscal and monetary, in the years ahead. It is of course, unrealistic to assume that we can eliminate the business cycle, human nature being what it is. But containing inflation and thereby damping economic fluctuations is a reasonable goal.

We at the Federal Reserve look forward to working with the Administration and the Congress in meeting our common challenges. Thank you, Mr. Chairman.

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

Chairman CASTLE. Thank you very much, Mr. Chairman. I will start the questioning process now, if I may. Let me just remind the Members who have arrived a little bit later that we are going to go through a series of questions. I will do questions in the order of seniority as to who is here. I would ask that you finish your question before the red light comes on. Otherwise, there will be no answer to the question.

If you ask during the yellow light, we'll try to wrap it up in 1 minute or so, so that we can keep moving. We have a time limit on this room, for one thing, but it's very important that everybody has a chance to ask questions. So I will go quickly into this.

My initial question that I have, Mr. Chairman, it's sort of a catch-22, I guess, in running the Federal Reserve, because it is absolutely necessary that in some very important way that you operate—secretly is sometimes the word used—but obviously in a way not subject to public scrutiny because of the importance of the information at hand.

Sometimes the product of that, particularly as we deal with interest rates, is a significant issue to the public. That's how the public often, as you know, sees the Federal Reserve.

I am concerned and would ask for an explanation. You've touched on it before and you and I have talked about it, about the increases in interest rates in 1994. I believe there were seven and they happened with a degree of rapidity, which I think was somewhat surprising to the public, certainly a little surprising to me.

I just can't tell from that if the interest rate hike from the time before has had a chance to trickle down through the economy. Now, clearly, in the money markets and in the big banks, the monetary policies, there may be an instant effect. But in terms of inventory and business decisions and some of the longer-range things, I wonder sometimes how we can judge that this has worked or not worked or whether we're reacting too rapidly.

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I would be interested in your explanation of the speed with which some of this happens. And both going up and going down, I might add.

Mr. GREENSPAN. Yes. That's a terribly important question, Mr. Chairman, because it gets at the core of basically how we implement monetary policy. In many instances, when there is a change in circumstances—as indeed existed at the end of 1993 and into early 1994, which was really quite significant, sharp and very perceptible—if we basically had our druthers, we probably would take our interest rates from where they were and move them right up to where we thought they should be or at least close enough and make that adjustment very quickly, because the circumstances had changed and they sometimes do not change incrementally, but quickly.

However, were we to do that, in my judgment and the judgment of my colleagues, we would so destabilize the financial markets as to actually be counterproductive to the policies which we're trying to implement. Indeed, we had a large debate in early February 1994 as to whether our first move should be 25 basis points or 50. We argued that 25 was enough of a shock to the system and, indeed, even though I was out there waving flags as best I could, indicating that we were going to do that, when we did it, the stock market went down almost 100 points that day.

What that required us to do was to move in adjustment processes until we felt comfortable that the financial markets had readjusted, reestablished themselves, and were not at risk to a substantial, sharp, discontinuous rise in rates. Therefore, we picked up our pace and our extent of changes toward the end of the year.

Chairman CASTLE. I wasn't going to ask this, but something you said just triggered a question, in my mind. I thought you said the change in rates will have the same effect as previous changes of the same size, or words to that effect.

Mr. GREENSPAN. Yes.

Chairman CASTLE. Is that a documented history and something that you look to when you make your decisions on interest rates?

Mr. GREENSPAN. Yes. It's obviously a critical issue to us. There are two potential regimes out there. It could be that we could be moving rates up and that doesn't have a significant effect and then all of a sudden you hit a certain rate and you break the economy. That's sort of the straw that breaks the camel's back routine. It was very important for us to know whether the historical data confirmed that or not.

And granted all the difficulties that we have in making evaluations in a very complex economy, it was the conclusion of our statistical analysis that one could not find that type of phenomenon; that, indeed, a 25 or a 50 basis point increase in one period has the same effect as in a much earlier period and that phenomenon, apparently, while it is a possibility, apparently does not exist.

Chairman CASTLE. Let me change subjects for 1½ minutes, which is not going to be enough for this. I'm very interested in your statements that the Consumer Price Index may overstate inflation. I know that's a very complex subject because so many of our government outlays and, actually, our tax revenues are indexed to all this, as we know.

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First of all, is that your belief, if you could reaffirm it, and, second, what is the process for dealing with that? What role should Congress play, the Fed play, if, indeed, it is to be dealt with? I'm not suggesting it should be, but how could it come out?

Mr. GREENSPAN. First of all, it's important to recognize that those economists who have looked at the process generally agree that there is an upward bias in the CPI. Part of it is built into the way the price index is itself structured and unless you change the structure, the bias will be in there. That is a bias resulting from the fixed weight base, with long periods of time before when you change the base.

There are a number of technical issues that are involved, many of which are now being addressed and hopefully will be removed by the Bureau of Labor Statistics in the years to come. They're working hard at that. There are certain aspects to the bias which I don't think they're ever going to be able to remove. It is very difficult technically to get a true cost of living.

But my judgment is since it is the intent of the Congress that beneficiaries from government expenditures should be held whole from changes in the cost of living, we should endeavor to try to get a measure of the cost of living which adjusts appropriately to that. And the suggestion that I have made to other committees of this Congress is instead of trying to adjust the CPI by going into the basics of it and trying to alter it, as the BLS is trying to do, is to recognize that there is a bias, and all we need to know is roughly what that bias is. And if we get a group of experts each year to sit down and say that, in their judgment, the bias is such, then I think what should be done is that the Consumer Price Index, for purposes of indexing programs and taxes, should be the published Consumer Price Index minus what the professional group of analysts would indicate is the most likely bias.

Chairman CASTLE. Thank you, sir. I appreciate your answers. Let me turn to Congressman Flake.

Mr. FLAKE. Thank you very much. Mr. Chairman, as you know, in some housing markets, like New York and Austin, California and others, there's a great deal of high cost. The high cost of homebuying is of such a nature that you can hardly find a home for less than $100,000 and when you do assume a mortgage and you consider the interest rate increases that we've had over the last year, which, according to a recent letter from the National Association of Homebuilders, indicates that the current levels are approximately close to 9 percent.

In these places where one's primary asset is generally a home, can you say to this subcommittee, as it relates particularly to these markets, but to all markets, given the relationship between increases in interest and home purchasing, what kind of impact do you anticipate long-term as it relates to the ability of the average person in these kind of markets to buy homes if the interest rate does not stabilize?

Mr. GREENSPAN. Well, first of all, Congressman, the level of interest rates for both adjustable rate mortgages and fixed rate mortgages are still quite low relative to where they have been in the last couple of decades. Affordability, as we measure it on the part of homebuyers, is still pretty good.

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The issue is it's not as good as it was, say, in the fall or spring of 1993, which is clearly the case. The trouble, unfortunately, is you could not maintain that pace. Remember, we had this huge amount of refinancing that was going on, which is sort of an interesting measure of the fact that we had the lowest mortgage rates in a very long period of time.

The trouble with maintaining that is that implicit in that regime is a rate of economic growth which is ultimately unsustainable and one which would throw the economy off the tracks and create really significant economic disruptions. So that those rates were there only temporarily and can only be maintained for a modest period of time.

Had we waited significantly before we moved, in my judgment, the fixed rate mortgages, not to mention the adjustable rate mortgages, at this stage would have had to have gone significantly higher than they ultimately went.

While I certainly recognize and I agree with your evaluation, it's really an issue in comparison to what, and in that regard, I would suspect that the actions that we have taken, which will keep inflation down, hopefully, will also over the long run make affordability far greater for the average American and keep the cost of new construction at levels which don't price those houses out of the market for the average homebuyer.

Mr. FLAKE. Mr. Chairman, I'd like to submit for the record the letter from the Association of Homebuilders, by unanimous consent.

Chairman CASTLE. So ordered.

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

Mr. FLAKE. My second question has to do with a very serious concern, and that is the disparity that is anticipated between the BIF/SAIF Fund. My concern obviously has to do with if there is a major disparity, institutions that have been able to or that have retained a presence in certain communities, for the most part, represent the SAIF institutions. If those institutions are not there, it means that the probability of being able to get loans for many of the properties will not be available.

I'd like to ask you if you can respond as quickly as possible, first of all, whether you're concerned about the disparity, your projections as it relates to what happens if we allow that disparity to happen, and if you have any potential solutions that we in the Congress might be able to move toward at some resolution before December 1995 comes upon us.

Mr. GREENSPAN. We are talking about the BIF/SAIF authority——

Mr. FLAKE. Exactly.

Mr. GREENSPAN. And the fact that the Bank Insurance Fund institutions, having this very dramatic drop in their insurance premiums, versus still quite significantly high insurance premiums for the savings associated institutions. The answer is yes, I do think there's a problem here. I've said so before and I would reiterate that.

It's not easy to know what the difference is, but if you're dealing with 15 or 20 basis points, which could be more or less, that's not an insignificant competitive disadvantage in those types of institutions. The issue is not whether it's a problem which has to be re-

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solved in one form or another, but it's what, in fact, can the Congress do.

This is, frankly, going to be the most difficult issue which is going to confront the Banking Committee of the House. I would suspect that we at the Fed will be called up to try to give our recommendations and I must say to you that if I appear to be avoiding an answer, I am because it's——

Mr. FLAKE. Well, Barney Frank was just telling me that.

Mr. GREENSPAN. It is a very tough no-win situation. However, we will be glad at that point to find out what we feel least uncomfortable with in recommending to this subcommittee.

Mr. FLAKE. But I'd appreciate continued discussions on it because I think it will have deleterious impact on certain communities even more so than others.

Mr. GREENSPAN. I agree with that.

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

Chairman CASTLE. Thank you, Mr. Flake. Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman. Mr. Chairman, a brief observation and a question. I just completed eight town meetings back in my district this last week, and Oklahoma being, by its nature, a traditionally capital starved area, your name came up several times at several of those town meetings.

And while I reminded my constituents that I did not have a direct impact on the decisions made, I would pass along their observations that, be it agriculture or homeowners or small business people, their attention has been achieved out there. It's been gotten.

My direct question, Mr. Chairman, coming from a district that's so close to the international border to the south and at a period of time when—of course, not only is the President proposing to raise the minimum wage, which has some impact on these things, but also at a time when the Mexicans, in effect, have gone through, what, an approximately 40 percent devaluation in their peso.

Coming from a region that is so close to our southern border, I worry about the effect of the differences between wage costs and the impact that that will have on manufacturing on both sides of the border up and down the line. I wonder if you can make a comment on the effect that these incentives, intended or otherwise, will have on the potential for manufacturing to go south of the border from my region perhaps.

And I hope that our neighbors to the south, everything works out well and they have a prosperous and stable environment, but what the potential is for a stampede down there. After all, I'm only just a few hundred miles from the border.

Mr. GREENSPAN. Congressman, there are two extreme possibilities here. One is that the Mexicans will fully succeed in reestablishing the type of stability which they had and which, in my judgment, would imply a significant improvement in the value of the peso and probably not a huge change in unit labor costs between, say, Oklahoma and States immediately south of the Rio Grande. In that case I would say that we're back to where we were at an earlier time, which I thought was quite competitive for the United States and certainly for American workers vis-a-vis those in Mexico.

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Alternatively, the current turmoil does not get substantially reduced. In that event, it seems to me that the risks involved in the Mexican situation would be of an order of magnitude which would make it very difficult to move investments south of the border and create significant competitive structures for the United States.

So I doubt very much that we are going to see a major change from where we are, because the implications of a major change don't seem to fall into any of the reasonable probablistic outcomes that seem likely at this time.

Mr. LUCAS. And when you say over a period of time to reach that equilibrium again, any speculation on that?

Mr. GREENSPAN. On time? Well, it's not easy to make judgments with respect to time, but we're not talking about several years because the Mexican economy made some extraordinarily important structural changes through the latter part of the 1980's and the early part of the 1990's, and that has not been reversed. So that, if they can restore essentially what is a tremendous lack of confidence in the monetary unit, they should not have a long period of time to find that the real assets within the system are back in line and everything is functioning.

What they have got is a crisis of confidence in the currency and that is not an easy thing to very quickly restore, but they are not dealing both with a crisis of confidence and a very moribund economic structure. At least the latter is not what it was, say, a decade ago when they were struggling with very much the same sorts of problems.

This is a different type of problem. In one respect it's more severe because it's in an international environment which is far more unforgiving, if I may put it that way.

Mr. LUCAS. Thank you.

Chairman CASTLE. Thank you very much, Mr. Lucas. Mr. Frank.

Mr. FRANK. Mr. Greenspan, in your review of 1994, you talked about what a good year it was, in your review. We had talked previously about this. We raised taxes in 1993 on upper income people and they went into effect and were in effect for all of 1994 and as of now.

Have you seen any negative effect on the economy from that tax increase yet?

Mr. GREENSPAN. No, Congressman, I haven't, but I never expected to because my view of the impact of that, which I did think, in my judgment, was negative, was very unlikely to be evident for quite a long period of time, but, nonetheless, still negative.

Mr. FRANK. In my last conversation with you, I thought you were expecting a negative result earlier, but you didn't. When do you expect it to be negative, the income tax increase?

Mr. GREENSPAN. I would say it's hard to say, but within a period of years.

Mr. FRANK. Would we be able to measure it somehow?

Mr. GREENSPAN. I'm sorry.

Mr. FRANK. How will it be measured?

Mr. GREENSPAN. Negative in the sense of reducing incentives for types of capital investment which won't show up for periods of years.

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Mr. FRANK. Well, why wouldn't they show up? If the incentives have already been reduced, why would they have not shown up about 1½ years after they were passed?

Mr. GREENSPAN. Well, basically because it takes a long time for the type of changes in capital structure to occur. While it may make incremental effects, it doesn't show up for a while. But the point of issue is I don't recall saying that I expected it to be——

Mr. FRANK. We'll go back. I thought you said that it would.

Mr. GREENSPAN. I always thought that 1994 was going to be a good year.

Mr. FRANK. Let me ask with regard to your view that we should reduce the cost of living increase for older people, which would, of course, be the case if we adopted your position on the CPI matters.

Should there be, in your view, any offset because older people, for instance, pay a much higher percentage of their income for health care? Under your proposal, elderly people who got a 2.7 percent increase, I believe, last year in social security would have gotten maybe 2.2 or 2.3, whatever the panel of experts said they should get.

I must say I think that would be horrible social policy for older people for whom that's a major part of their income. Would it not be fair with regard—if we're going to get that—if we're going to try and tighten it up, try and look at what the actual cost of living is, particularly for such a large segment of the population?

Mr. GREENSPAN. Yes, I do. I think that's a bias factor in the other direction, which is probably about .2.

Mr. FRANK. But you would, with regard to the elderly, have an offset.

Mr. GREENSPAN. Yes, indeed, I would.

Mr. FRANK. But you still believe that as a result of your calculations, the elderly would get less of a cost of living increase each year.

Mr. GREENSPAN. That is correct. Well, they would get the cost of living increase, not the——

Mr. FRANK. They would get less than they had been getting.

Mr. GREENSPAN. Less than they would——

Mr. FRANK. Well, that works out well because for my friends who have the balanced budget amendment in the form that they do, they could then, having paid the elderly less in terms of a cost of living each year, claim that as part of the surplus in social security, which would help them meet the balanced budget total the way they have it. So there's some synergy there that they, unlike some of us, would find attractive.

The last question I have. I was pleased to see you talk about new openness, and so forth. My recollection, maybe it's wrong, is that some of the things that you're now doing, previously members of the Federal Reserve Board had refused to do on the grounds that they would be deleterious.

Has it been that the Federal Reserve Board has changed its position and it turns out that more openness was, in fact, possible than you thought without damaging things?

Mr. GREENSPAN. Yes. I must say to you, Congressman, that I thought that certain types of changes that we would make would create some problems in the effectiveness of the deliberations of the

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Federal Open Market Committee. I was quite pleased to see that I was wrong in that regard.

Mr. FRANK. I thank you. I think we ought to pay tribute to former Chairman Gonzalez, who had argued for that last point. Given your view that we can't really substantially increase the rate of job creation in the near term, what does that mean for welfare reform, in which we would go to those people on AFDC, many of whom are the least employable, by traditional standards?

What is the likelihood that we would be able to absorb, given a certain unemployment rate and given your view that we're above the limit—I mean, you believe that we have been at a job creation limit beyond what was sustainable over the long term, whether that's right or wrong.

If that's right, what are the implications of that for welfare reform which seeks to substantially increase the rate of job absorption for people on AFDC?

Mr. GREENSPAN. Well, remember, Congressman, that the labor force increases, as I recall, something in the area of 1 percent a year. It varies one way or another. And there's a tremendous amount of churning that goes on in the labor market, that is, the gross new job creation is very large, the gross loss in jobs is very large, the net change tends to be very small.

I have not looked in any detail at the implications of what is possible in the job markets to the various different——

Mr. FRANK. But you do think the recent rate is unsustainable.

Mr. GREENSPAN. I'm sorry. The what?

Mr. FRANK. You have felt that the recent rate is unsustainably high.

Mr. GREENSPAN. That's correct—the net increase in jobs.

Mr. FRANK. If the net increase has been unsustainably high over the last year, I just wonder what the implications are for absorbing people who are hard to employ on AFDC.

Mr. GREENSPAN. First of all, let me say that I have not looked in any detail at the various different welfare initiatives. The problem basically is that what we don't know is to what extent——

Mr. FRANK. The problem appears to be his handwriting.

Mr. GREENSPAN. What?

Mr. FRANK. The problem appears to be his handwriting.

Mr. GREENSPAN. No, it's not the handwriting. It's the concept.

Chairman CASTLE. Thank you very much, Mr. Frank. Mr. Leach, you are the Chairman of the Committee, sir. Would you like to ask questions at this time? We can take you, sir.

Mr. LEACH. Mr. Chairman, I just have two questions. One relates to the interrelationship of Congress with Fed policy, fiscal and monetary policy. It's the belief of many on the Republican side that there is going to be a reduction for the first time since the end of World War II in the size of government in relationship to the economy. That is the major meaning of the new Congress.

Given that some fiscal stimulus will be taken out of the economy, in terms of how that inter-reacts with monetary policy, it implies to many of us that the Fed is going to have to pick up some of the burden, particularly to ensure job growth in areas of the country that perhaps are going to be disadvantaged by some of the reduction of Federal spending.

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Recognizing you can't target with monetary policy very well, is this going to play a major role in terms of Fed consideration of monetary policy?

Mr. GREENSPAN. Mr. Chairman, this is a very tricky issue largely because it is difficult to know the extent to which the so-called fiscal drag, which occurs as a consequence of a very sharp reduction in the structural budget deficit, will effect long-term interest rates.

My impression, as I stated in my longer remarks, is that this drag will be offset, in whole or in part, by a reduction in long-term rates as inflation expectations and the risk premiums associated with inflation expectations are taken out of the long-term rate. That's going to mean that mortgage rates are lower, long-term capital costs are lower, and that basically the market value of assets, generally, as a consequence of the lower cost of capital will tend to be higher.

It is very likely, and probably in the long run unquestionable, that the effect overall is positive on long-term economic growth and does not impact the level of employment over the long run. It may, and I use the word may, have a short-term effect and if that occurs and that affects the markets, it affects the economy, and it affects the things that the Federal Reserve looks at in order to formulate policy. We obviously will respond to that.

But what we will not be responding to is the mere fact of the budget deficit reduction. It's only if, through its workings in the marketplace, it has a far more deflationary effect than I personally think is likely to happen.

Mr. LEACH. I appreciate that. The only point I would make is that I have some optimism the deficit is going to go down a bit, but I have great certitude that the size of government will go down. I think the reduction in size of government is a bigger macroeconomic phenomenon than the size of the deficit.

To the degree that the size of government goes down, it strikes me that that becomes a factor militating toward a little lower interest rate environment rather than a higher interest rate environment. If that occurs, I think that's one of the things the Fed should take into consideration.

But, anyway, let me very quickly state my second question. Many of us are sympathetic with the dilemma that our government faced vis-a-vis Mexico, but we have some questions about whether or not our government should be pressing specific interest rate targets in another country. I personally believe that's more the role of the IMF than the United States, but even interest rates themselves is a dicey circumstance.

Are you comfortable in Mexican interest rates going to 50 percent?

Mr. GREENSPAN. Well, when you're dealing with an inflationary bubble, which is clearly what is in the process of emerging in Mexico as a consequence of the devaluation, the question is how do you respond to that. And the way that you respond to it basically is to remove liquidity from the system in a manner which tries to improve the exchange rate and which causes, as a consequence, a rise in interest rates, both real and nominal.

The real interest rates that now exist in Mexico are still relatively low to where they were, say, just 5 or 6 years ago. But,

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nonetheless, I agree with the premise of your remarks that these rates, if maintained indefinitely, will have detrimental effects on economic structure. And I view them, as best I understand what the Mexicans are trying to do, as transitional issues, aimed toward solely implementing a phase-in from this inflation to reduce the secondary effects of the inflationary bubble, so they can restore a level of non-inflationary type of economic growth at a later point. It's a temporary phenomenon, assuredly.

Mr. LEACH. Thank you.

Chairman CASTLE. Thank you, Chairman Leach. Mr. Kennedy.

Mr. KENNEDY. Thank you, Mr. Chairman. Welcome, Mr. Chairman.

Mr. GREENSPAN. Thank you.

Mr. KENNEDY. I guess at least when this hearing started, you were here on Wall Street this morning. So if that's consolation, congratulations.

Obviously, the concern that I think many people have these days is that by the pursuit of this anti-inflation policy that the Fed has so diligently stayed after, we've seen economic growth drop from 4 or 5 percent, as you indicated in your testimony yesterday in the Senate, down to—I don't know—you said 2½ percent or something like that.

The fact is that——

Mr. GREENSPAN. Excuse me, Congressman. The only numbers I used were basically a forecast of the members of the FOMC for the year as a whole.

Mr. KENNEDY. OK. Well, wherever the numbers came from, the fact of the matter is that what I think people are genuinely concerned about is that in pursuit of that policy of anti-inflation, that the Fed might have gone too far in terms of the drop in economic growth of the country.

It seems to me that the Administration has done its job, cut $500 billion out of the budget deficit, has created a policy that, even with the criticisms that have been generated as a result of these continuing $200 billion deficits into the future as a percentage of gross national product, that it seems to me that the overall deficit has been reduced.

So the question is whether or not you feel that there will be under—and I guess it really under what circumstances could you foresee a reduction in interest rates in the coming year. Are there circumstances where you would take as quick a reduction as you have as quick an increase in interest rates in order to, I hope, end up providing some relief and actually getting the economy moving again, if there really is no direct concern about inflation?

Mr. GREENSPAN. Well, I certainly wouldn't say there is no direct concern about inflation.

Mr. KENNEDY. I said if.

Mr. GREENSPAN. But the whole problem is that if inflation stabilizes and if the economy seems to have gone to a less frenetic level, that will not affect interest rate policy in the same way as a continuation of frenetic activity would affect it. But I can't tell you in advance what interest rate policy actually will be in place, largely because when we actually get to a point in time where we

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have to make a decision, there are far more complex issues that are involved than we can possibly anticipate in advance.

And as a consequence of that, I don't refrain from trying to forecast where we're going to be to be coy or anything like that. I don't think we really know until we get to look at data, look at what's happening, and understand the process. And as I said in my prepared remarks, the only thing we see at this particular stage is that the frenetic pace, the torrid pace that we saw in economic activity, which we knew was unsustainable, is fortunately simmering down.

What the full implication of that is as yet is what we don't know.

Mr. KENNEDY. And all I'm trying to suggest is that while you have pursued a policy that has kept inflation obviously very, very low, it has done so at a tremendous price. It seems to me that if we go back to what the purposes of the organization are, the Federal Reserve is an attempt by the Federal Government to try to keep the overall standard of living for the American people moving forward.

So by just looking at the inflation rate and having that be sort of the determinant factor as to whether or not that is occurring, whether or not the standard of living of the American people is increasing, we're kind of missing the boat here.

Let me just make a point, Mr. Chairman, which is that if you look at pensions, pensions have not changed for the American people in 20 years. There are no more people on pensions that are going to have pensions today than occurred 20 years ago.

Every newspaper in America covers stories of the biggest companies in this country laying off literally tens of thousands of workers. Your unemployment numbers demonstrate that somehow the unemployment rate has dropped. But ordinary citizens feel that they're working longer, their wives are out working, and they don't feel that their standard of living is increasing.

Now, you can direct all of that to inflation, but the fact is that that's not where people feel it is. People feel that their standard of living is not increasing.

My real question is what can you do, what can this country do to begin to increase that overall standard of living. It seems to me that the control that you have in your power is to allow interest rates to go down in order to get some money into this economy that will create good jobs.

Mr. GREENSPAN. I don't agree with that, Congressman, and let me tell you why.

Mr. KENNEDY. Thanks.

Mr. GREENSPAN. You're welcome. What monetary policy can do is relatively limited. It can create an environment in which maximum economic growth is possible. And from all of the evidence that we have been able to marshal, the reason why we think that it is important to keep inflation low is because we think of all the alternatives that are available, that create the environment which can enable productivity and, therefore, living standards to grow appreciably.

I don't think, however, that we, from the point of view of the central bank, can basically convert that stable environment into in-

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creasing productivity. That requires whole other modes of activity, part of which is government, part of which is not.

But it's important to know what we can do and what we can't do. And the point is if we were just merely to pump money into the system, which we have done in the past, history tells us that what we do is engender inflationary instabilities, undercut productivity, undercut standards of living, and at the end of the day are far worse off, and indeed everyone is far worse off, than they would be if we were successful in creating a stable environment.

Mr. KENNEDY. Well, all I would say is that there don't appear to be a lot of Americans that feel that they are better off as a result of the policies that are being pursued.

Mr. GREENSPAN. I don't disagree with that statement, Congressman. That is true and it's unfortunate that it is true. I would agree with you that we ought to try to do whatever is feasible to make that less true. And part of the problem, as we have discussed in the past, is there is an increasing dispersion of income which has not been helpful in this regard.

And, unfortunately, monetary policy can't address that at all. It can do so only indirectly as it affects the platform from which the economy can move.

Chairman CASTLE. Mr. Kennedy.

Mr. KENNEDY. I hope that's an endorsement of CRA, Mr. Chairman.

Chairman CASTLE. Mr. Metcalf.

Mr. METCALF. Thank you, Mr. Chairman. Chairman Greenspan, I'm particularly concerned about possible international commitments that our nation may have. Could you please explain to the subcommittee the financial obligations of the Federal Reserve to the Bank of International Settlements, in general and in connection with the proposed $10 billion short-term credit facility for Mexico?

Mr. GREENSPAN. Congressman, we are not involved in that directly or indirectly in the sense that while, in the past, we have been associated with certain Bank for International Settlements joint swap loans to a number of different countries, we have not participated in this one and it's strictly a function of the other central banks associated with that organization which are involved, excluding the United States.

We did join the board of the Bank for International Settlements last year, as we had contemplated doing when certain conditions eventually arose. But that did not entail any financial obligation on our part. So in that regard, we, other than on occasion investing in some BIS instruments, are not in any way obligated or have any financial commitment to that particular facility or any facility, and especially in the context of the $10 billion facility which is currently being structured.

Mr. METCALF. Thank you. As an amateur observer, sort of, of the system, I used to believe that money supply or monetary expansion was the thing that dealt with interest rates. So in the mid-1980's, as monetary expansion seemed to me to be overwhelming, a great growth there, I went around to my friends in the State Senate in Washington State and confidently predicted a lot of inflation. It didn't happen.

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From that experience, I have come to believe that there must be a number of other factors or let's say deep in the bowels of the Federal Reserve, there are big power levers that can influence this that we may not be aware of. I'd like to ask aren't there other factors, other than interest rates, that can be used to compensate or put the brakes on inflation? There must be other things, other than interest rates.

Mr. GREENSPAN. We do a number of indirect things. Actually, even though we've endeavored to seek a certain rate in the Federal funds market, the way we do that is basically by affecting liquidity in the banking system, the reserves of the banking system. And we can also affect those reserves by changing reserve requirements, which is done very rarely.

The third vehicle to change reserves is the discount window of the Federal Reserve, which has fallen into some disuse in recent years compared to what it used to be as a major focus in years past. So, effectively, even though there are different instruments that we can use, they all ultimately impact the relationship between required bank reserves of all commercial banks and depository institutions which are involved in this and actual reserves, to the extent that the required reserves rise. Relative to what reserves there are in the system, it puts pressure on the markets.

Outside of that, there are no levers that we have or at least none that we've been able to find, and I can assure you that if there were, we'd probably use them.

Mr. METCALF. Thank you.

Chairman CASTLE. Thank you very much, Mr. Metcalf. Mr. Sanders.

Mr. SANDERS. Thank you, Mr. Chairman, and thank you, Mr. Greenspan, for joining us this morning.

Mr. GREENSPAN. Thank you.

Mr. SANDERS. If I might, I would like to pick up a little bit on Mr. Kennedy's line of questioning. I get a little bit confused when people tell us that the economy is doing well, we have a whole lot of growth, 1994 was a good year. The way I look at it, and the people that I talk to, they're concerned about the growing gap between the rich and the poor, which I think is now the widest of any industrialized nation on earth.

They're concerned about the decline in the middle class and the fact that the younger generation for the first time in the modern history of America will have a lower standard of living than their parents did and the profound drop in manufacturing wages that has gone on in this country in the last 20 years, the growth of poverty in America, the fact that we have by far the highest rate of childhood poverty in the industrialized world—22 percent of our kids in poverty, the fact that the new jobs that are being created are low wage jobs, that the minimum wage today is 25 percent lower than it was in purchasing power 20 years ago, family farmers are being driven off their land. Please help me out.

How come the economy is doing well? People in Vermont don't see that. Maybe the Wall Street folks and the heads of corporations think it's doing well, but not the folks in Vermont that I talk to. Can you help me out on that one?

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Mr. GREENSPAN. Sure. At least on the statistics I can, Congressman. All of the data that we have, on average, suggest that the economy in the last 2 or 3 years has done very well relative to what the patterns have been in recent years. Productivity has accelerated, employment growth has accelerated, unemployment——

Mr. SANDERS. But, you see, all of those things mean nothing.

Mr. GREENSPAN. No. I will get to your point. I don't disagree with what you're saying. I just want to try to reconcile what the evidence is. The evidence is in all of the macro data which ultimately is what is involved when you say the economy is doing well. There is no other way to use that term except as an average or as a total.

It is true, nonetheless, in fact, as I indicated to Congressman Kennedy, that the dispersion of incomes have increased since the late 1970's and that has meant, by definition, that there are certain groups within our society who have done significantly less well than the average. That is an arithmetical necessity.

And what we are observing is that there is tremendous frustration that numbers of people are having difficulty improving as they had seen their parents improve on their grandparents. We're seeing now, for example, that homeownership is running, on a cohort basis, lower that the last generation. In other words, children now at the same age levels have lower homeownership than their parents did. That's a factually correct statement.

Mr. SANDERS. Mr. Greenspan, wouldn't you agree with me that the problem with averages is that if you have a million dollars and I'm broke, on average, we have a half a million dollars, which is not too bad, but you're doing OK and I'm doing terrible. Isn't that the problem when we talk about averages?

Mr. GREENSPAN. Sure. I think that averages are very useful for the purpose of making a specific point and summarizing the point, but that's not all there is to the real world.

Mr. SANDERS. Let me just change gear. Some would argue, as you have undoubtedly heard, that you have enormous power; that by your ability to raise interest rates and effect the lives of millions of Americans who own homes and are paying their mortgages—in fact, you alone exercise more power than the U.S. Congress and, in some instances, more than the President.

The concern that I have is not about you personally, but about the institution of the Federal Reserve. We have to go back to our districts every weekend. We have to hear from the people and sometimes we get reelected, sometimes we don't. Are you too isolated from the American people? When is the last time you went to a union hall to talk to workers, to a low income community and talked to people who are facing homelessness or who are on food stamps, the last time you talked to middle—do you get out and talk to people?

Mr. GREENSPAN. I try on occasion to do that, when I can. It's not easy to do because it takes a good deal of time.

Mr. SANDERS. No, I understand that. That's not a personal criticism.

Mr. GREENSPAN. No. I try. I understand what you're saying and I think it's important that we do, because it's easy to get isolated.

Mr. SANDERS. Am I correct in understanding that you meet basically behind closed doors, that the results, the discussions that take

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place in your meetings are closed to the media? And the fear that I have is that on issues like NAFTA, I think you were dead wrong. I'm not the only person around here. Dead wrong.

And I have problems with an institution which is so, it seems to me, isolated from the needs of ordinary American people. I think the policy that ends up coming out—and this is not a personal criticism, it's an institutional criticism—ends up reflecting the interest of very wealthy and powerful people on Wall Street.

Do you think there's any validity in that concern?

Mr. GREENSPAN. I hope that's not true. The one constituency that we have, and if one sort of listens and one can see it in the older transcripts which we have released, the basic focus of the Federal Open Market Committee, the basic constituency, if you may want to put it that way, is the economy overall.

As I indicated earlier, we cannot affect the distribution of income. We can't affect things like productivity and the like. What we can do is to create an environment for the economy overall, if it is capable of doing so, to make maximum progress.

I hope that the focus of what we do is for the American people as a whole, because that issue does come up. And while I fully recognize that there are innumerable accusations that we're an elitist group and all of that sort of criticism, part of that is something which we probably have difficulty fending off because we are required, if we're not going to affect markets inordinately, to meet in secret and basically not disclose or discuss what we're doing in the open.

If we were to do that, we would create a very major problem of financial instability. All I would just say——

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

Chairman CASTLE. Thank you, Mr. Sanders. I'm sorry, but we really do have to move on to the others. Mr. Chrysler.

Mr. CHRYSLER. I don't have any questions.

Chairman CASTLE. OK. Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. Mr. Greenspan, a few weeks ago, in testimony before the Senate Banking Committee, you said "As the central bank of the United States, our focus has to be the soundness of the American economy and the soundness of the American currency." The dollar has been falling against other major currencies for quite some time and it weakened further yesterday.

What can you and the Fed do about the weakness in the dollar?

Mr. GREENSPAN. As I've said before this subcommittee and others, the dollar is a very important issue, both as an issue with respect to the financial structure of our system and as an indication of what inflationary forces might be extant in the world which is affecting us.

The dollar is effectively the reserve currency of the world and it is incumbent upon us, as the central bank and as, indeed, the central bank which is the ultimate supplier of the reserve currency, to make certain that it is a stable, non-inflation-ridden, solid currency.

As a consequence of that, we are obviously very acutely aware of when the currency gets weak or when the currency gets strong. I cannot tell you in advance what we will or what we may or may

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not do relative to concerns that may or may not arise when the markets are running in one direction or the other, but I can assure you that it is our concern that the American dollar be a viable, solid, strong basic currency because if it is not, we will find that because of our reserve currency status, a weak currency in that context creates very significant problems for us domestically.

We will, as I have indicated on many occasions in the past, be focused on preventing that from happening.

Mr. WATT. One other question. Given the magnitude of exchange stabilization funds committed to the Mexican peso rescue, will the Fed be hampered in near-term exchange market activities on behalf of the dollar or other major currencies?

Mr. GREENSPAN. You mean with——

Mr. WATT. Will the Fed be—due to the magnitude of the exchange stabilization funds committed to the Mexican peso rescue, will the Fed be hampered in near-term exchange activities on behalf of the dollar or other major currencies?

Mr. GREENSPAN. The answer to that, Mr. Watt, is no, it will not be hampered, because we at the Federal Reserve have substantial quantities of marks and yen and so does the Exchange Stabilization Fund. The probability of any substantial reduction that in any way undercuts our ability to engage in operations that we would otherwise have been engaged in with respect to either the Deutsche mark or the yen, the probability of our in any way reducing our capabilities is non-existent by the way we have structured this system. So I'm not concerned with that in the slightest.

Mr. WATT. What is your outlook for the nation's savings rate over the next 3 to 5 years and do you believe this rate will be favorably affected by the enactment of the Contract with America legislation?

Mr. GREENSPAN. The saving rate is one of the most difficult things to forecast and economists have done very poorly in trying to do that over the years. The only thing I would say to you is that since what evidence we have suggests that it is very difficult to change the rate of private saving materially, the one chance we've got to get domestic saving up, which includes both private saving and Federal Government saving or government saving generally, is to reduce the deficit.

The fallout from reducing the deficit on domestic saving is very close to one-to-one, as best we can judge. As a consequence of that, I would say that the importance of reducing the budget deficit in that regard is crucial.

Mr. WATT. Thank you.

Chairman CASTLE. Thank you very much, Mr. Watt. Ms. Roybal-Allard.

Ms. ROYBAL-ALLARD. Mr. Greenspan, in your testimony yesterday before the Senate Banking Committee, you indicated that you were not supportive of the balanced budget amendment. Could you elaborate a little bit on why and what the consequences of the balanced budget amendment would be on the economy?

Mr. GREENSPAN. Congresswoman, the issue that I would raise with respect to that goes back to testimony which I first gave before the Judiciary Committee of the House back in 1979, and I really haven't changed my view since then.

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The problem that I find with the amendment is not its underlying premise. Those who are concerned about the underlying bias in our system toward excessive Federal Government spending are correct. As I see it, the basic motive for those who are endeavoring to create a balanced budget amendment is basically that we've tried everything else, nothing else has worked, and that a balanced budget amendment will finally get the spending in check.

My concern is that it is a very difficult type of amendment to enforce. Secondarily, I dislike the idea of trying to do fiscal policy in the Constitution, which has to be there 50 and 100 years from now. It's very difficult to do.

I do think that if we are going to do something in the Constitution which inhibits spending, my judgment is that we ought to have an amendment which requires super majorities on all authorizations, appropriations and outlays, which would be immediately enforcing in the sense that one would not have to go to court to get that enforced, and one doesn't have to make any estimates. If you can't get the number of votes, a bill will not pass.

If there is a bias, which I do believe is the case, in spending running ahead of taxable revenues, it is most effectively handled in a non-balanced budget amendment form, the type which I would suggest, because I do have concerns about throwing this issue, fiscal policy, into the courts of the United States, which, in my judgment, would have very great difficulty being able to handle it.

Ms. ROYBAL-ALLARD. Do you see the balanced budget amendment complicating the use of monetary and fiscal policy? For example, if our economy were to fall into a recession, what would the consequences of the balanced budget amendment be in such a scenario?

Mr. GREENSPAN. I haven't raised that issue because I think there is a solution to that, if there is a balanced budget amendment. If that, in fact, is the case, then the optimum level of where one endeavors to get the budget is not at balance, but in a modest surplus, because then it gives you flexibility in the event that we run into a recession and revenues fall, that we are not confronted with the problem of having to raise taxes or lower spending as the economy is shrinking.

If we start off or are in surplus at the time the economy softens and we have a balanced budget amendment in the Constitution, then we needn't be concerned because to be sure, the surplus will fall, but it will still be in surplus and will not be subject to the amendment.

But that is, in fact, a requirement. If you do get a balanced budget amendment, the optimum equilibrium—if I may put it that way—the focus of fiscal policy, should appropriately be for a modest surplus.

Ms. ROYBAL-ALLARD. So, if I understand you correctly, there would be a problem if we had a balanced budget amendment now, given the tremendous deficit our economy faces. However, there would not be a problem when we are in a surplus situation.

Mr. GREENSPAN. Well, the question basically is how soon we get to a balanced budget with an amendment in place. All I'm saying is that over the long run, there are two issues. One is short-term transition to effectuating actual budgetary actions to fulfill a bal-

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anced budget amendment, which is a very technical problem which I don't think I could properly address, because I'm not sure I understand it.

Ms. ROYBAL-ALLARD. But what I'm getting at is that when we have a deficit, there are dangers to having the balanced budget amendment. When we are in a surplus, then we have the mechanisms with which to——

Mr. GREENSPAN. That is correct. But I would say that if we have a balanced budget amendment in the Constitution, appropriate fiscal policy should start as a norm with the surplus.

Chairman CASTLE. Thank you very much. Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman. Mr. Greenspan, I've heard you say this morning that you feel your purpose is to effect the economy, the environment for the economy overall in the nation. Yet, from what I'm hearing from the questions, the way they're being posed by people up here, indicates that there is a regional concern for the way these policies are affecting the United States. They aren't affecting us equally overall.

And I'm wondering if you have the potential to address our regional concerns. Are there mechanisms that you have where you can perhaps fine tune, do it with a little finer brush than a broad brush approach?

Mr. GREENSPAN. Mrs. Kelly, at the beginning of the Federal Reserve, after the Act was passed in 1913, we believed that that was going to be possible. And, indeed, in the early years, the discount rate, which was the crucial rate set by the 12 Federal Reserve Banks with Board approval, often differed. But it soon became fairly clear that we were dealing with an increasingly national financial system and it became impossible for different discount rates—in fact, different interest rates—to exist from one section of the country to the other.

As recently as, I recall, the 1950's and maybe the early 1960's, we did have differential mortgage rates between, say, the west coast and the east, with the west coast rates being higher. As the markets have become increasingly sophisticated and homogenized, we have been dealing with a national financial system, which means you can only have a national monetary policy.

So even though, for example in recent years, we have seen that California and New England, for example, sagging relative to the middle west, we did not have the capability, we do not have the capability, of making differentiations. That has to be done, to the extent that it is done, through various fiscal policy measures where one tries, by grants to states and local governments, to differentiate in a manner which tries to address that particular subject.

But, regrettably, monetary policy no longer has that capability. The good part is that we have a very efficient national financial system. The bad part is it doesn't allow us to address individual differences sector by sector within society.

Mrs. KELLY. When you say you no longer have the capability, has something changed with regard to the Congressional charge or to the Executive charge to what you're doing? The capability is there, but it's a perceptual idea that the monetary policy must be geared to the nation as a whole. Is that correct?

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Mr. GREENSPAN. Well, no. It's not a political issue. It's not a policy issue. It's an issue which is driven by the markets. For example, if we were to have different interest rates enforced by the Federal Reserve, say, in Cleveland versus Mobile, what would happen is that monies would move quickly from one place to the other to quickly equalize the rates.

We don't have that capability to offset that type of move. So it's not political, it's not statutory. It's the fact that the markets have become so efficient that we no longer have the capability which we thought we had. Now, it is conceivable we were wrong back in 1914 when we started, and that we didn't have it then either. We thought we did and it just didn't work, but we surely don't have it today. And that is a market phenomenon. It's not a political or statutory matter which could be changed by law.

Mrs. KELLY. Thank you very much.

Chairman CASTLE. Thank you very much. Mr. Fields.

Mr. FIELDS. Thank you, Mr. Chairman. Let me thank you, Mr. Greenspan, for appearing before the subcommittee this morning. Mr. Greenspan, about 11 million people wake up every morning, two-thirds of which are adults and about 60 percent of them are women. They wake up every morning, they go to work and they work a full work day and they come home and at the end of the day they're still poor. And it's not because they're lazy, but simply because they make minimum wage.

I've been through your remarks and I saw no mention of the minimum wage or the possible minimum wage increase and what effects it would have on this economy. So my question to you, sir, is what effects, in your opinion, would a raise in the minimum wage have on the economy.

Mr. GREENSPAN. I don't think it would have very much effect on the economy. What I am concerned about is it would have an effect on so-called minimum wage jobs. As I said before your colleagues in the Senate Banking Committee yesterday in response to very much the same question, up until very recently, it was the general belief of most people who examined the issue that a rise in the minimum wage would cause an increase in unemployment of those who were getting the minimum wage.

It's clear that a number of people, maybe a majority, would still have their jobs, but a significant number, from all of the evidence that was adduced, would lose their jobs. And as economists would like to say, is it better to have a higher minimum wage and no job than a lower minimum wage and still be employed, and that's what the real crucial issue is.

There has been some recent studies by some economists which suggest that the effect on the level of employment of minimum wage workers is not materially affected by raising the minimum wage. From what I understand of the people who look at these data, that is still a significant minority view of economists and people who evaluate this.

Mr. FIELDS. So it's your opinion, sir——

Mr. GREENSPAN. The question is really whether, in fact, it destroys jobs of those who are at the minimum wage and whether or not that is a desirable social policy to implement, not to mention——

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Mr. FIELDS. Well, I find it hard to separate jobs from the economy, but it's your opinion, according to your testimony, that the minimum wage increase would have no effect on the economy, but there's a possible effect that it may have on jobs.

Mr. GREENSPAN. On jobs of minimum wage workers, that is correct.

Mr. FIELDS. Minimum wage workers. If that is your opinion, sir, then let me ask you what statistics you have to support that statement? The minimum wage has been increased 17 times in this country and I have no real data and have not seen any real data or evidence to suggest that people have lost jobs as a result of a raise in the minimum wage.

Mr. GREENSPAN. Congressman, it's true that the minimum wage has been raised quite significantly, but in real terms, which is really the determinant of it, if you look at a chart of the minimum wage, it sort of kicks back and forth and doesn't go anywhere. So it's not been materially changed.

Those economists who have examined the issue and tried to observe what happens when the minimum wage goes up or goes down, and, in real terms, it does go down on occasion, they have concluded from looking at what's happening to employment within those areas that job loss is very clear.

And the question basically is more an issue of how much as distinct from what's the sign of the relationship, is it plus or minus.

Mr. FIELDS. Sir, let me ask you. Are you in support of a minimum wage increase? Do you think this Congress should raise the minimum wage for the 11 million hard-working people in America?

Mr. GREENSPAN. No, I don't. And the reason I don't is I'm terribly concerned about those who will lose jobs as a consequence.

Mr. FIELDS. How can you sit here today and raise interest rates and then sit here and say that a poor person who is making $680 a month does not deserve a cost of living increase?

Mr. GREENSPAN. I'm not saying that they don't deserve it. I'm worried that if you try to artificially increase the rate of wages above what a small businessman can pay, that the job will disappear. I am more concerned about the issue of people losing jobs, especially minimum wage earners who——

Mr. FIELDS. And I respectfully disagree with you because even today, in your testimony, you have not been able to give any clear statistics in terms of those individuals in the past losing jobs. I think that's only a scare tactic. You have already stated very clearly and adequately——

Mr. GREENSPAN. Congressman, it is not a scare tactic.

Mr. FIELDS. If I may conclude, because my time is running out, if it's not already out. Let me just close in saying, sir, that you have stated emphatically clear that there would be no effect on the economy if the minimum wage——

Mr. GREENSPAN. No measurable effect, that is correct.

Mr. FIELDS. No measurable effect, which means you can't measure the effect, on the economy if the minimum wage is increased in this session of Congress.

Mr. GREENSPAN. Of the type that is being advocated, that is correct.

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Mr. FIELDS. If I may conclude, sir. You are going to have a lot of time.

Mr. GREENSPAN. Yes, sir.

Mr. FIELDS. And if that is the case, I just can't see why you would sit here today and say you're not for raising the minimum wage, it has no effects on the economy, and, in the same breath, sit here and raise the interest rates, where poor people won't be able to benefit from realizing the true American dream.

I find that to be quite contradictory, sir.

Chairman CASTLE. Mr. Fields, let me give Chairman Greenspan just a moment to answer your question, and then we'll go on to the next questioner.

Mr. GREENSPAN. Congressman, there are two separate issues here. One is the question of creating a stable economic environment in which all elements of our society and economy can move forward. The issue of the minimum wage relates directly to the question of what evidence exists as to what happens to people who are getting the minimum wage and are confronted with an increase in the minimum wage and lose their jobs as a consequence.

That is a separate question. My argument against raising the minimum wage is based on the evidence that a lot of people lose their jobs as a consequence and I think that that's wrong.

Chairman CASTLE. Mr. Wynn is a member of the committee but not of the subcommittee. We previously agreed that he could participate. We're delighted to have him here. If you would like to ask questions, this is your opportunity.

Mr. WYNN. Thank you very much, Mr. Chairman, and thank you, Mr. Greenspan. First, Mr. Greenspan, it appears that we don't have state-run economy, but we do have a central bank-run economy. My question is this. Would further deficit reduction based on budget cuts result in the kind of growth that would then in turn trigger higher interest rates, which is what happened the last cycle when we reduced the deficit?

Mr. GREENSPAN. If deficit reduction were induced by cuts in the budget? Do I understand you correctly?

Mr. WYNN. Yes.

Mr. GREENSPAN. If deficit reduction is induced by cuts in expenditures, what the evidence historically indicates is, as indeed occurred in 1993, a significant reduction in long-term interest rates, which has a positive effect on the economy.

Mr. WYNN. But would that trigger growth? Because we had the reduction in long-term interest rates following the 1993 reduction of the deficit and then the Fed proceeded to seven times in 1 year increase the interest rates. So I'm asking are we about to start the same cycle again.

Mr. GREENSPAN. I understand what you're saying. The reason we move rates up is an endeavor to stretch out growth in economic activity. What we are trying to avoid is a situation in which the economy overheats and runs off the track.

Mr. WYNN. Because of the deficit reduction.

Mr. GREENSPAN. Well, for any reason. And the point——

Mr. WYNN. Well, I'm specifically linking it to deficit reduction. Was it caused by the deficit reduction?

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Mr. GREENSPAN. Deficit reduction is not likely in and of itself to necessarily be an expansionary force. It's the interest rate decline in the long end of the market which would do it. If the interest rates do not come down appreciably, deficit reduction, other things equal, actually suppresses economic growth. It's the interest rate effect that is stimulative.

What happened, in my judgment, in 1993 was that the extraordinary effect of interest rate reduction which came upon the deficit reduction was the driving force. Now, it may be—indeed, I stipulate in my prepared remarks—that it doesn't necessarily follow that the so-called fiscal drag that occurs from deficit reduction will be fully offset by lower long-term rates.

Mr. WYNN. Let me go on to another question. You're quoted in the *Wall Street Journal* as saying that one of the reasons apparently that you had to continue these rate increases was because of an easing of terms and conditions on bank loans.

Now, as a member of the Banking Committee, we have worked to reduce the paperwork burden on banks in hopes of encouraging them to make more loans. We have CRA to encourage more loans, small business people, minority business people, all arguing more loans. Apparently that happened.

And am I correct, based on your statement in the *Wall Street Journal*, that if that continues, if we have an easing of credit, we're going to have more interest, higher interest rates?

Mr. GREENSPAN. No. The issue that we were focusing on from our studies is that termed commercial and industrial loans, to both small and large businesses, have eased. One of the reasons they eased is they had gotten so tight and as a consequence, the amount of loans that were being made were really subnormal.

Mr. WYNN. If I could just jump. You were quoted as saying that the rate increases would have slowed the economy more if not for an easing of terms and conditions on bank loans. Did you not say that?

Mr. GREENSPAN. Yes, I did.

Mr. WYNN. So, therefore, is it fair to conclude that the reason we're having these interest rate increases is because we're making more loans to small businesses?

Mr. GREENSPAN. No. What I said, and I said it in my prepared remarks, is that the fact that the commercial banks were in the process of easing their terms had a partial offset to the effect of rising rates. It by no means was a major offset. It was very marginal. But, nonetheless for example, if you got a situation in which rates go up, but terms get easier, the net effect on the borrower is not as though the only thing that happened was that rates went up.

Mr. WYNN. One last question, because my time is running out. You are also quoted as saying that you think we ought to be on the gold standard. Could you explain why you feel that way?

Mr. GREENSPAN. Yes. I also said that I thought I was an extraordinary minority within the Federal Reserve on that issue, but the point being is that to the extent that stability and noninflationary environments increasingly appear to be a crucial factor in a stable long-term economic environment, reducing inflationary expectations becomes a crucial issue for long-term economic growth.

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The best way I know to do that is something like a gold standard, but I would hasten to add that there are lots of important consequences which relate not to monetary policy necessarily, but fiscal policy and a variety of other things that would occur as a consequence of that.

And I'm not saying that all you've got to do is switch and you go to a gold standard and everything is fine.

Mr. WYNN. Would that enable us to avoid these sequential interest rate increases?

Mr. GREENSPAN. Yes, I think it would. You would get interest rate fluctuations, but I think they would be a much lower level, on average.

Mr. WYNN. You wouldn't have to do seven in 1 year is what you're saying.

Mr. GREENSPAN. Well, you might, but they'd be from a much lower level.

Mr. WYNN. Thank you.

Chairman CASTLE. Thank you, Mr. Wynn, very much. Mr. Hinchey, likewise, is on the committee, not on the subcommittee, but we're delighted to have him here with us and welcome his questions.

Mr. HINCHEY. Thank you very much, Mr. Chairman. I want to remind us that we're here today fulfilling our obligations under the Humphrey-Hawkins Act, which sets forth certain economic targets, one of which is to stabilize prices and to keep the CPI at 3 percent or below, but also to maximize employment. It's a very ambitious goal set forth in that law, seeking to minimize unemployment at 2 percent for adults 20 years of age or older and at 3 percent for teenagers.

It would seem that we have been very successful over the last couple of years particularly in meeting the second half of that requirement set forth in Humphrey-Hawkins in that the CPI has been, if I'm not mistaken, 2.7 percent over the course of the last 2 years.

You have been reported to suggest that the CPI, in fact, overestimates inflation, the CPI as it is currently constructed, overestimates inflation by anywhere from ½- to 1½ percent.

Mr. GREENSPAN. That's the staff estimate of the Federal Reserve.

Mr. HINCHEY. Staff estimate. Do you buy into that estimate?

Mr. GREENSPAN. Yes, I do.

Mr. HINCHEY. You do. In that case, I would conclude, and correct me if I am mistaken, that the CPI, adjusted in the way that the staff and you suggest, would not, in fact, be 2.7 percent over the course of the last 2 years, but would be 2.2 to perhaps as low as 1.2 percent. So it would seem that you have really been an enormous success on half of the requirements for Humphrey-Hawkins, but not so much on the other half because unemployment remains quite high and, in fact, right now is going up.

What are we doing about dealing with the second half of that requirement?

Mr. GREENSPAN. Well, the Federal Reserve itself is not required to affect these levels of unemployment, which is in the original act. Unless I am mistaken, I think that there are no longer in the act—are those specific numbers still there?

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Mr. HINCHEY. Those numbers are in the act and they——

Mr. GREENSPAN. There were certain parts of——

Mr. HINCHEY. They simply—the idea goes back to 1946.

Mr. GREENSPAN. Yes.

Mr. HINCHEY. To be able to maximize employment and then Humphrey-Hawkins came along, finally passed in 1987, which said that we ought to try to achieve those goals in order to keep as many people in the economy working.

Mr. GREENSPAN. Ninety seventy-eight.

Mr. HINCHEY. Ninety seventy-eight, yes, thank you. That's correct.

Mr. GREENSPAN. What is required there is that the Administration implement policies which will achieve the ends of Humphrey-Hawkins and we're required under the Act to indicate what policies we will take——

Mr. HINCHEY. Respectfully, sir, yes. The act does lay out some requirements for the Administration, unquestionably. But the act also sets forth certain objectives that the Federal Reserve is designed to achieve, and those objectives are stable prices and maximum employment.

I'm questioning the Federal Reserves actions with regard to trying to maximize employment, because, in fact, it seems to me that what you've been doing is achieving the direct opposite results.

One of the things that—well, let me just draw attention to something that struck me in your testimony. You said "In the past year, we have firmed policy to head off inflation pressures not yet evident in the data." That strikes me as a very interesting remark, almost Orwellian in its construct. And I must certainly, however, agree with you that what you have done to head off inflation, inflation for which you admit there is no evidence, has really run contrary to the other responsibility under Humphrey-Hawkins.

We are seeing, in fact, that there is no wage push effects in the inflation whatsoever. Labor costs are very, very low. In fact, in the fourth quarter of last year, they rose only seven-tenths of 1 percent and we're told that that matched the record low for a single quarter.

So here we have no evidence of any inflationary pressures in the economy. You admit in your testimony that there's no indication anywhere in the data that you're aware of that inflation is pushing this. That's what you said in your testimony.

Mr. GREENSPAN. No. I'm just saying it hasn't appeared in the price indexes. But what——

Mr. HINCHEY. No, no. You said "We have firm policy to head off inflation pressures not yet evident in the data."

Mr. GREENSPAN. That's what we started to do, but the inflation pressures had been building up all through 1994 in the sense that you could begin to see the process which historically has created significant inflationary breakouts to occur. And what we have endeavored to do, and hopefully have succeeded in doing, is to suppress that process so it does not break out into an unstable inflationary and debilitating outcome for the economy.

What is true and what I said in my remarks is that the actual final price data have not broken out yet, but the process is clearly there and it's been working in a direction that if we did not re-

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spond to it, we would have had a very important breakout of inflation, which would have had very disastrous effects.

Mr. HINCHEY. Let's say, respectfully, sir, finally, that I've seen no evidence of any indication on your part that you have been able to delineate any specific inflationary pressures in the economy.

Mr. GREENSPAN. The evidence that we have is very clear that the resources that are available have been significantly under strain. We see it in a significant slow-down in the ability of suppliers to deliver goods to their customers. We see it in the significantly rising increase in shortages of goods. We see it in the prices of intermediate materials, which, as a consequence of those shortages, have gone sky high.

We have seen a process, which historically we've seen many times in the past, that if not contained, will ultimately break out in a very broad inflationary pattern. It's that which we've addressed and that which we've hopefully succeeded in containing.

Mr. LUCAS [presiding]. The gentleman's time has expired.

Mr. HINCHEY. I'm reminded of the military phrase "The generals always fight the last war." It seems to me that the Fed generals are fighting the last war. You're fighting the inflation of the 1970's.

Mr. GREENSPAN. No. We're fighting the inflation process which is visible today.

Mr. LUCAS. Thank you. In a little bit, we will go vote. I think we probably have time for Mr. DeFazio, who is not a member of the subcommittee, but graciously we've agreed to have a question or two.

Mr. DEFAZIO. I thank the chairman for his generous grant of time. I am not on the subcommittee, but do have a concern. Mr. Greenspan, I'd like to know if the Fed subscribes to the NAHRU theory, the natural rate of unemployment, and, if so, what is your target for unemployment? I know that it generally impacts the economy and, therefore, the economy adjusts itself to a rate of unemployment.

But what rate of unemployment do you consider optimal?

Mr. GREENSPAN. I would say there are differences of opinion within the Fed on that question. On the Federal Open Market Committee, there are those who strongly view the so-called NAHRU as a crucial element involved in monetary policy. I personally am uncomfortable with the notion that there is a single unemployment rate which describes a process of supply pressures on labor markets which can be appropriately characterized for the country as a whole.

So if you're asking me, I'm saying I feel uncomfortable with that notion. I don't think there is a specific number which is stable. What we derive statistically is a number which kicks around a great deal. You will find that the Council of Economic Advisors and a lot of private economists throughout the country who estimate this think that the number is somewhere between 5½ and 6 percent.

Mr. DEFAZIO. So would you say, then, that it's a majority opinion on the FOMC that NAHRU targets should be somewhere around 6 percent?

Mr. GREENSPAN. No. I don't know the answer to that. We've never actually gotten to a point where I could describe that process,

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because it's not discussed at length, nor is it an issue which I've in any way sensed I can respond to easily.

Mr. DEFAZIO. The most recent computations for labor costs show that employment costs, which we've been measuring with a certain quantifiable measure since 1981, have been declining since 1989 and we had the lowest increase since 1981. So I guess you would agree that there does not seem to be upward pressure on wages or benefits at this point in time.

Mr. GREENSPAN. Not yet. I agree with that.

Mr. DEFAZIO. Do you see that coming or are you worried about upward pressure on wages and benefits?

Mr. GREENSPAN. No. As I said in my prepared remarks, Congressman, from what I can judge as the reason why we have had very well behaved, as economists like to say, indexes of wages is that there is still a deep-seated sense of job insecurity out there, which has had a material effect on the process of wage adjustments in this country.

And with the very strong productivity increases that we've had, unit labor cost increases have been really quite modest.

Mr. DEFAZIO. Given the job insecurity, and I would certainly support you on that observation, I think that we should be endeavoring to lower that level of insecurity on the part of the American people, given NAFTA, given the possibility of firms relocating to seek drastically lower wages, particularly given the recent devaluation of the peso, downsizing, productivity gains and GATT, wouldn't you say that the picture has changed rather dramatically in terms of the potential for upward pressure on inflation because of wages, because companies can threaten to go to Mexico or companies can threaten to move offshore or because they can threaten to downsize?

Isn't there a dramatic change which goes to this job insecurity you talked about?

Mr. GREENSPAN. I think that the job insecurity goes back a long way with respect to a long period of very sluggish job growth and the very significant downsizing which has created fairly extensive job insecurity throughout a number of companies.

However, if you look at the surveys recently, there has clearly been some improvement in the sense of security in the short run; that is, the number of people who are saying jobs are easier to get has come up quite appreciably in the last couple of years. So that the level of job insecurity is assuredly less. It's just not at the levels one would ordinarily expect when aggregate employment and the levels of unemployment are where they are in this particular economy.

Mr. DEFAZIO. Of course, the way we measure unemployment, there may well be a fair number of discouraged workers out there and others who aren't quantified.

Mr. GREENSPAN. Sure. I agree with that, but even if we'd add the discouraged workers back into the data, it still doesn't explain the extent of the level of job insecurity that I could infer from the data.

Mr. DEFAZIO. I thank the chair for the generous grant of time.

Chairman CASTLE [presiding]. Thank you. We just have a few minutes left in this vote, for those of us who have not voted. Mr. Chairman, we have had a request to come back for one or two peo-

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ple. I know they're not here now. Would it be possible for you to stay for 10 or 20 more minutes?

Mr. GREENSPAN. Yes, I think so. Sure.

Chairman CASTLE. And we know we have to be done as soon as possible. We realize that you're suffering from a cold.

Mr. GREENSPAN. My voice is holding up better than I expected.

Chairman CASTLE. You're doing very well, sir. We'll resume in 10 minutes right here. Thank you.

[Recess.]

Chairman CASTLE. The meeting will return to order. When we left, there were one or two requests for possible further questioning. They are not presently here. They may come. While we're waiting to see if anyone is going to come, I would like to ask one question along sort of a follow-up to things that were already asked.

There was discussion here concerning the balanced budget amendment and government spending in general. I would like to get your views with respect to the deficit spending that we presently have, be it approximately $200 billion a year, that the debt, in general, and the need, as I perceive it at least, to reduce our deficit spending and eventually get if not to a balance of the budget, at least closer to it, and to deal with this whole problem of the structural debt and continuing deficit that we have in the country.

Mr. GREENSPAN. Well, Mr. Chairman, the crucial issue that confronts us when we look at where both receipts and expenditures are going to be under current law, the one thing that strikes you immediately is the fact that there is a rise, under current law, in expenditures which is driven, to a substantial extent, by the entitlements, which is in excess of the rise in the tax base at existing tax rates. That basically means that you cannot have a situation where that exists if the starting point of outlays is above receipts. In other words, the situation continues to worsen.

It therefore follows that you either have to raise the tax base or tax rates or lower the thrust of outlays. You cannot indefinitely raise tax rates because eventually you will bring the economy down and overall revenues will come down. So whatever one does with taxes, in my judgment, is the less the better and ideally nothing.

The issue of bringing the long-term rate of growth in outlays down is mandatory for financial stability and, therefore, if there is anything at all in the Kerrey-Danforth Entitlement Commission data, which, as far as I can judge, looks pretty solid to me, they show that there is a fundamental problem which has to be addressed here and there is no way to get around it.

We can wait, it will get worse, or you can attack it early on, which means that you change the law now, but its effect is the year 2010 or something of that nature. That is far easier to do than it is to wait until you get to a couple of years before the problem arises and try to politically handle that type of issue.

Chairman CASTLE. Which was essentially the findings of the Entitlement Commission.

Mr. GREENSPAN. Yes.

Chairman CASTLE. To deal with it now as opposed to having it become a huge problem later on.

Mr. GREENSPAN. Yes, exactly.

Chairman CASTLE. Mr. Watt is here.

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Mr. WATT. I don't have any questions.

Chairman CASTLE. He doesn't have any questions. OK. Does anyone have any report on anyone else?

[No response.]

Chairman CASTLE. If not, I think it's unfair to hold the Chairman. We have reconvened at the time that we stated we would. Everyone did have a chance to ask some questions, at least. So it would only be in addition to whatever they asked before.

We thank you very much, Mr. Chairman, for being here. I think we'll have even more fun when you come here first as opposed to the Senate first, which is next time around. You've been a very patient witness. We realize your job is difficult. Obviously, not everybody here is going to agree with you all the time, but you do it well and we appreciate that and we look forward to continuing to work with you. Thank you, sir.

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

[Whereupon, at 12:33 p.m., the hearing was recessed, to reconvene at the call of the Chair.]

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APPENDIX

February 23, 1995

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House Committee on Banking and Financial Services

Subcommittee on Domestic and International Monetary policy

Humphrey-Hawkins Hearing with testimony from Alan Greenspan, Chairman of the Federal Reserve Board, February 23, 1995, Room 2128 Rayburn House Office Building

Chairman Michael N. Castle's Opening Remarks:

The Subcommittee will come to order.

This subcommittee meets today for the first time, to receive the semi-annual report of the Board of Governors of the Federal Reserve System on the conduct of monetary policy and the state of the economy as mandated in the Full Employment and Balanced Growth Act of 1978.

Chairman Greenspan, we welcome you to the Subcommittee on Domestic and International Monetary Policy, a newly organized subcommittee that combines the areas of concern of several previous Banking subcommittees. Some of the members are well known to you from past hearings but we also have a number of newly elected members on the majority who may be unfamiliar to you. Today we have three minority members (Wynn, Hinchey and DeFazio) who have requested the opportunity to sit with the subcommittee and present questions to you. We have acceded to their requests but ask your indulgence and that of the subcommittee membership that following the ranking minority member's introductory comments, we dispense with opening statements by the members. Any prepared remarks presented, will

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be accepted for the record. This should permit us to listen attentively to your presentation, have ample time for questions and still vacate this hearing room by 1:00 p.m., in time for the mark-up on the Mexico resolution scheduled for 2:00 p.m. this afternoon.

A report in the February 17 edition of my hometown paper, the *Wilmington News Journal,* cites the Federal Reserve Bank of Philadelphia to the effect that future economic indicators suggest the outlook for business conditions in the Philadelphia-Wilmington-Trenton region has fallen to its lowest level in more than four years. While the index for current general economic activity in the region rose slightly from January to February, the report said that future economic indicators suggest that manufacturers there expect some slowing of growth over the next six months.

Similar indications from other member's districts would seem to suggest that the long awaited "soft landing" may be in view. Along with my colleagues today I am eager to hear your views as to how seven interest rate adjustments in the past twelve months and other actions taken by the Board have prepared the ground for this result. In addition, I look forward to learning your impressions of how this new Congress and the Contract with America will reshape economic reality. Significant change is underway and regulatory reform, prospects for a balanced budget, major cuts in domestic and foreign spending, all will affect the

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Federal Reserve System calculus. Your Chairmanship of the Federal Reserve has been marked by unprecedented openness both with Congress and the public. Such candor of course, invites pressure for even more transparency in areas previously kept confidential such as minutes of the meetings of the Federal Open Market Committee or foreign exchange dealings. Any comments you may care to make regarding this policy of drawing aside the veil over Central Bank operations will find an interested audience with this subcommittee.

You will have come prepared for questions regarding why we have experienced seven interest rate raises in the past twelve months when the Producer Price Index for January again advanced only 0.3% for finished goods and a remarkable 0.2% in the core PPI (excluding food and energy components). During that same twelve month period, finished producer goods prices have risen by only 1.5%. This is producing much skepticism about whether the inflation bogeyman still threatens our economy. We have also noted your speculation to the effect that the Consumer Price Index perhaps overstates inflation, increasing government outlays via items in the economy that are indexed to the CPI. I appreciate that this is a complicated problem to "fix" without invoking the law of unintended consequences. I hope this is a subject that we can address during these Humphrey-Hawkins hearings.

The Humphrey-Hawkins bill mandates goals for the Federal

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Reserve System to pursue that often are inconsistent or conflicting. Most of the bill's mandates have been more honored in the breach, especially those that apply to the Executive. To the extent that these inconsistent goals actually hamper the Fed's ability to optimize its operations, we may have an opportunity to revisit this legislative charter by the time we next gather here in July and I suggest that we might then consider improvements or adjustments to your mandate that would make monetary operations more effective.

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Statement of Congressman Cleo Fields
Humphrey-Hawkins Hearing
Subcommittee on Domestic and International Monetary Policy
February 23, 1995

Today we come to this hearing after many of our constituents have strongly voiced their concerns about the interest rate hikes you have recommended and implemented. I tend to agree with my constituents. Yet, Mr. Greenspan, you continue to take direct action to raise our interest rates, again and again, regardless of the direction it seems to be taking middle and low income Americans. Over the past year, you have continually placed home buyers out of the market. Over the past year, interest rates have been increased seven individual times amounting to an upward climb of more than 2

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percentage points since January a year ago. Seven times in one year is clearly not giving the economy a chance to adjust. I challenge you to first give your interest rate hikes a chance to take affect before you again take action against our first time home buyers.

With that said, I look forward to hearing your testimony.

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Testimony by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic and International Monetary Policy

of the

Committee on Banking and Financial Services

U.S. House of Representatives

February 23, 1995

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Mr. Chairman and other members of the Committee, I appreciate this opportunity to discuss the Federal Reserve's conduct of monetary policy. As required by law, we have already delivered to the Congress our formal report detailing the performance of the economy and the implementation of policy. In my remarks this morning, I will summarize that discussion and expand further on some of the key factors bearing on monetary policy.

Recent Developments

Nineteen-ninety-four was a good year for the American economy. Economic growth quickened, with real gross domestic product expanding 4 percent over the four quarters of the year. In manufacturing, industrial production advanced nearly 6 percent. We now have enjoyed over three years of relatively brisk advance in the nation's output of goods and services, and this economic progress has been shared by many Americans. Payrolls swelled 3-1/2 million last year, and the unemployment rate closed 1994 at 5-1/2 percent, more than a percentage point below its level one year ago. And workers were producing more on average: Output per hour in the nonfarm sector increased about 1-1/2 percent over the four quarters of last year, suggesting some tilting up to the underlying trend of labor productivity that promises sustained and substantial benefits in the coming years.

The data that have been published in the first weeks of 1995 have offered some indications that the expansion may finally be slowing from its torrid and unsustainable pace of late 1994. While hours of work lengthened in January, employment growth slowed from its average of recent quarters and the unemployment rate rose. Moreover, recent readings on retail sales suggest a more moderate rate of increase, and housing activity has shown some softness. Nonetheless,

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the economy has continued to grow, without seeming to develop the types of imbalances that in the past have undermined ongoing expansion.

Of crucial importance to the sustainability of the gains over the last few years, they have been achieved without a deterioration in the overall inflation rate. The Consumer Price Index rose 2.7 percent last year, the same as in 1993. Inflation at the retail level, as measured by the CPI, has been a bit less than 3 percent for three years running now--the first time that has occurred since the early 1960s. This is a signal accomplishment, for it marks a move toward a more stable economic environment in which households, businesses, and governmental units can plan with greater confidence and operate with greater efficiency.

As I have stated many times in Congressional testimony, I believe firmly that a key ingredient in achieving the highest possible levels of productivity, real incomes, and living standards is the achievement of price stability. Thus, I see it as crucial that we extend the period of low inflation, hopefully returning it to a downward trend in the years ahead. The prospects in this regard are fundamentally good, but there are reasons for some concern, at least with respect to the nearer term. Those concerns relate primarily to the fact that resource utilization rates have already risen to high levels by recent historical standards. The current unemployment rate, for example, is only a bit above the average of the late 1980s, when wages and prices accelerated appreciably. The same holds true of the capacity utilization rate in the industrial sector.

Clearly, one factor in judging the inflationary risks in the economy is the potential for expansion of our productive capacity. If "potential GDP" is growing rapidly, actual output can also continue to

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grow rapidly without intensifying pressures on resources. In this regard, many commentators, myself included, have remarked that there might well be something of a more-than-cyclical character to the evident improvement of America's competitive capabilities in recent years. Our dominance in computer software, for example, has moved us back to a position of clear leadership in advanced technology after some faltering in the 1970s. But, while most analysts have increased their estimates of America's long-term productivity growth, it is still too soon to judge whether that improvement is a few tenths of a percentage point annually, or even more, perhaps moving us closer to the more vibrant pace that characterized the early post-World War II period. It is fair to note, however, that the fact that labor and factory utilization rates have risen as much as they have in the past year or so does argue that the rate of increase in potential is appreciably below the 4 percent growth rate of 1994.

Knowing in advance our true growth potential obviously would be useful in setting policy, because history tells us that economies that strain labor force and capital stock limits tend to engender inflation instabilities that undermine growth. It is true, however, that, in modern economies, output levels may not be so rigidly constrained in the short run as they used to be when large segments of output were governed by facilities such as the old open-hearth steel furnaces that had rated capacities that could not be exceeded for long without breakdown. Rather, the appropriate analogy is a flexible ceiling that can be stretched when pressed; but, as the degree of pressure increases, the extent of flexibility diminishes. It is possible for the economy to exceed "potential" for a time without adverse consequences by extending workhours, by deferring maintenance, and by forgoing longer-term improvements. Moreover, as world trade

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expands, access to foreign sources of supply augments, to a degree, the flexibility of domestic productive facilities for goods and some services.

Aggregative indicators, such as the unemployment rate and capacity utilization, may be suggestive of emerging inflation and asset price instabilities. But, they cannot be determinative. Policy makers must monitor developments on an ongoing basis to gauge when economic potential actually is beginning to become strained--irrespective of where current unemployment rates or capacity utilization rates may lie. If we are endeavoring to fend off instability before it becomes debilitating to economic growth, direct evidence of the emerging process is essential. Consequently, one must look beyond broad indicators to assess the inflationary tendencies in the economy.

In this context, aggregate measures of pressure in labor and product markets do seem to be validated by finer statistical and anecdotal indications of tensions. In the manufacturing sector, for example, purchasing managers have been reporting slower supplier deliveries and increasing shortages of materials. Indeed, firms appear to have been building their inventories of materials in recent months so as to ensure that they will have adequate supplies on hand to meet their production schedules. These pressures have been mirrored in a sharp rise over the past year in the prices of raw materials and intermediate components. There are increasing reports that firms are considering marking up the prices of final goods to offset those increased costs. In that regard, January's core CPI posted its largest gain since October 1992, perhaps sounding a cautionary note. In the labor market, anecdotal reports of "shortages" of workers have become more common. To be sure, increased

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wages are a good thing if they can be achieved without commensurate acceleration in prices, but they are not beneficial if they are merely a part of a general pickup in inflation. A hopeful sign in this regard, however, is that to date the trends in the expansion of money have remained subdued, and aggregate credit is growing moderately. These developments do not suggest that the financial tinder needed to support the ongoing inflation process is in place.

That kind of ongoing process also would be expected to involve a different expectational climate than seems to prevail today. Despite the marked improvement in consumer confidence overall, the survey readings on consumers' views of whether jobs are easy to get fall far short of the previous cyclical peak in 1989. Moreover, there is some evidence that the number of people voluntarily leaving their jobs is subnormal currently. This suggests that deep-seated job insecurity has not fully dissipated despite strong job growth recently.

Some analysts attribute this phenomenon to workers' concerns about losing health insurance and, for some, pension coverage if they change jobs. Whatever the cause, the lingering sense of insecurity doubtless has been a factor damping wage growth and overall labor costs. Since the latter, on a consolidated basis, accounts for roughly two-thirds of overall costs in our economy, slower wage growth combined with strong cyclical productivity growth has restrained increases in unit labor costs and hence in prices of final goods and services.

However, as overall output growth of necessity slows in an environment of high resource utilization, so will cyclical productivity growth. Moreover, if labor market tightness assuages job insecurity, pressures to raise wages might well intensify and unit

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labor costs could accelerate. In the later stages of previous business cycles, declines in profit margins absorbed some of the increases in unit labor cost, but some were passed through into final goods prices and inflation picked up. Thus far in the current cycle, price increases have been muted, not only by subdued unit labor costs, but also by a prevailing concern among firms that, despite capacity pressures, enough slack remains in the system to foster competitive inroads on those who try to price above the market. But this form of discipline may also become less effective if pressures on resources persist. Consequently, it may be that these pressures will lead to some deterioration in the price picture in the near term; but any such deterioration should be contained if the Federal Reserve remains vigilant.

Policy Action and Financial Markets

It was to preserve and to extend the gains associated with low and declining inflation--and to avoid the instabilities and imbalances attendant to rising inflation--that we began the process of tightening one year ago. Our view at the time was that the accommodative policy stance we had adopted in earlier years to contain the effects of financial strains on borrowers and lenders was no longer appropriate once their balance sheets had been greatly strengthened. In these changed circumstances, absent policy action, pressures on capital and labor resources could build to the point where imbalances would emerge and costs and prices would begin to accelerate, jeopardizing the durability of the current expansion. In the event, the strength in demand and the potential for intensification of pressures on prices were even more substantial than envisioned when we started down that road. As we thought might be possible at this time last year, a significant upturn in inventory

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investment induced a stronger economy than was generally anticipated. Additional strains on capacity became increasingly evident in higher prices at early stages of production processes.

Moreover, in financial markets, the effects of the policy firmings were muted to an extent by an easing of terms and conditions on bank loans and by a drop in the foreign exchange value of the dollar. In these circumstances, the Federal Reserve needed to take further steps to head off potential instabilities that would threaten the economic expansion. Over the past year, including our most recent action, we have raised money-market interest rates seven times, pulling the federal funds rate up 3 percentage points, to 6 percent. Four of these actions were associated with increases in the discount rate. The discount rate now stands at 5-1/4 percent, or 2-1/4 percentage points higher than it was at the onset of tightening.

A stronger track for economic activity, higher credit demands, and a revival of inflation fears pushed up yields on securities with intermediate- to longer-term maturities from 1-1/2 to 3 percentage points over the past year. Most of that rise was posted in the first three quarters of 1994. As Federal Reserve action--particularly the 3/4 percentage point move in November--came to convince most market participants that policy would sufficiently restrain excess aggregate demand, those inflation fears and uncertainty premiums subsided a bit. This change in attitude, reinforced by signs of moderating demand, has helped to trim interest rates on long-term Treasuries and fixed-rate mortgages more than one-half of a percentage point from their peaks in November.

The adjustment in financial markets to rising interest rates was not, by any means, smooth. At the beginning of this process of tightening, many members of the Federal Open Market Committee (FOMC)

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shared a concern that some market participants, made complacent by the relatively high and stable returns on long-term assets that had prevailed for a considerable stretch of time, had taken on substantial risk in their portfolios as they reached for yield--in some instances leveraging heavily. Taking account of this, our first three steps were small--with each translating into a 1/4 percentage point rise in the federal funds rate--to allow market participants an extended opportunity to readjust their portfolios in light of rising short-term rates. As markets became accustomed to the new direction of short rates, the FOMC picked up the pace of firming. Measures of bond-price volatility, both actual and those inferred from options prices, moved higher when monetary policy first began to firm, but rolled back much of that run-up as the year progressed.

While securities markets were turbulent from time to time, in general, they remained quite resilient and performed their economic function of allocating credit quite well. Indeed, in some respects, credit has apparently been easier to get, likely in reflection of the improved assessment of financial prospects for borrowers and the larger capital cushions of many lenders. In many securities markets, quality spreads, when measured by the difference between rates on private and Treasury instruments of comparable maturities, have been quite thin. Commercial banks trimmed their own lending margins--effectively absorbing some of the rise in market interest rates before they got to borrowers--and exhibited a renewed aggressiveness in competing for loans. Bankers themselves reported to us further easing of terms and standards on business loans over the course of 1994 and into 1995. The pickup in total borrowing by nonfinancial businesses was focused primarily on bank loans and other shorter-term sources of funding. This shift toward shorter maturities, no doubt, importantly

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resulted from the substantial run-up in longer-term interest rates over the year, but there probably was some role played by banks' efforts to make more loans and interest income, especially as trading income declined.

Households also increased the pace of their borrowing. Double-digit annual growth of consumer credit helped to fund considerable outlays for durable goods, especially autos. This, too, may have been related, in part, to the eagerness of commercial banks to make consumer loans. And a wide menu of mortgage instruments gave home buyers some flexibility in coping with the rise in interest rates. The increasing share of mortgage originations at flexible rates--often involving concessionary initial terms--and, perhaps, some easing of loan qualification standards permitted some buyers who otherwise would not have been able to obtain financing to go ahead with their home purchases. All told, improved access to credit provided important support to spending.

Some Recent Lessons

Events of the past two months have taught us once again that the global nature of trade in goods, services, and financial instruments exerts an exacting discipline on the behavior of central banks. Technology has defeated distance by slashing the costs of gathering information and of transacting. Advances in computing and financial engineering during the past ten or fifteen years have enabled investors and speculators to choose among a wide array of investment instruments, allowing them to manage risks better and, when they chose, to exert their notions about future market movements forcefully through the use of leverage. The former, improved risk management, has done much to make markets more resilient, while the

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latter, easier recourse to leverage, may add to the volatility of financial prices at times.

These developments have freed up the flow of international capital, thus potentially improving the efficiency of the allocation of the world's resources and raising world living standards. They have also permitted markets to respond more quickly and with greater force to a country's macroeconomic policies. This puts a special burden on the Federal Reserve, because the U.S. dollar is effectively the key reserve currency of the world trading system. In that role, we enjoy an increased demand for our financial instruments. However, this role also heightens the share of the demand for dollar assets that is related to more volatile portfolio motives. The new world of financial trading can punish policy misalignments with amazing alacrity. This is a lesson repeated time and again, taught most recently by the breakdown of the European Exchange Rate Mechanism in 1992 and the plunge in the exchange value of the peso over the past two months. In the process of pursuing their domestic objectives, central banks cannot be indifferent to the signals coming from international financial markets. Although markets can be harsh teachers at times, the constraints that they impose discipline our policy choices and remind us every day of our longer-run responsibilities.

While there are many policy considerations that arise as a consequence of the rapidly expanding global financial system, the most important is the necessity of maintaining stability in the prices of goods and services and confidence in domestic financial markets. Failure to do so is apt to exact far greater consequences as a result of cross-border capital movements than might have prevailed a generation ago.

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The Economic Outlook

Looking ahead to the prospects for the U.S. economy, we must remember that the nation has entered 1995 with its resources stretched. We do not now have the substantial unused capacity that made possible the especially favorable macroeconomic outcomes of 1993 and 1994--rapid real growth and stable or declining inflation. As a result, the likely performance of the economy in 1995 almost surely will pale in comparison with that of the previous two years. The growth in output arguably must slow to a more sustainable pace and resource utilization settle in at its long-run potential to avoid inflationary instabilities. Inflation, itself, is unlikely to moderate further and may even tick up temporarily. But overall, the performance of the economy still should be good. We expect growth to continue and inflation to be contained.

The Federal Reserve for its part will be attempting to foster financial conditions that will extend that good performance through 1995 and beyond. Our policy actions will depend on an ongoing assessment of a number of forces acting on the economy. One is the effects of the rise in interest rates that have occurred over the past year. The effects of higher interest rates on spending are difficult to pinpoint with any precision, because they occur with a lag and have a diffuse influence on the behavior of households and firms throughout the economy. Data rarely point in one direction, and the available information on spending fits this rule. As yet, the performance of the economy suggests a slowing in interest-sensitive spending, but mostly concentrated in housing activity. Our reading of the historical record is that the cumulative effect of higher interest rates should lead to a significant deceleration in spending. But, to

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date, the jury remains out on whether the slowing that is in train will be sufficient to contain inflation pressures.

That judgment also rests importantly on a reading of business cycle developments more generally--cycles which often relate to the interaction of physical stocks and flows. These dynamics are most clearly seen in inventory investment, which has always been an important swing factor in the post-war era. In 1994, the increase in inventory investment in real terms added almost one percentage point to GDP growth. It appears most unlikely that business people will wish to build their stocks at the pace they did in 1994. But whether their actions with respect to inventories will turn that plus for growth last year into a significant minus in 1995 remains to be seen.

Incoming information does not suggest that a substantial inventory correction is imminent. Standard inventory-sales ratios remain on the low side of historical experience; those ratios look even lower compared with historical experience if one subtracts wholesale and retail markups from the published inventory investment figures to get a better handle on the underlying physical units of stocks. Moreover, even if there were a swing in inventory investment, it would have a more muted effect on domestic production than the inventory cycles of just a few years ago. Rough estimates suggest that, currently, perhaps a quarter of the nominal value of all wholesale and retail stocks are imported, whereas the share was substantially less as recently as the late 1970s.

Similar stock-flow interactions should be at work in spending for consumer durables. Large increases in real outlays for consumer durables over the past three years, partly financed in recent quarters by unsustainably rapid growth in the volume of credit, may well have

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exhausted most of the pent-up demand that had accumulated when the economy was sluggish in the early 1990s.

In another area, actions of this Congress regarding the federal budget deficit will have important consequences for the economic outlook. A credible program of fiscal restraint that moves the government's finances to a sounder footing almost surely will find a favorable reception in financial markets. That market reaction, by itself, should serve as a source of stimulus that would help to offset in whole or in part the drag on spending that otherwise would be associated with reductions in federal outlays and transfers over time. It is also important to remember that a larger issue is at stake during these deliberations on the federal budget. Too much of the small pool of national saving goes toward funding the government, to the detriment of capital formation. By trimming the deficit, those resources will likely be put to more productive uses, leading to benefits in the form of improved living standards.

Federal Reserve policy makers had to weigh these factors and more in determining their individual forecasts. As is detailed in the semiannual Monetary Policy Report, the central tendency of the forecasts of the Board members and the Reserve Bank presidents was that real GDP would grow at a rate of 2 to 3 percent over the four quarters of 1995. This slowing from last year's unsustainable pace was viewed as sufficient to bring output growth more in line with that of its potential, helping to stabilize the unemployment rate in the range of the past few months, near 5-1/2 percent. The governors and the Reserve Bank presidents forecast some edging up of consumer price inflation in 1995, with the central tendency of their forecasts bracketed by 3 and 3-1/2 percent. If we are to do our part in helping the economy operate at its fullest potential over time, we need to

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remain watchful to ensure that this cyclical upswing in the inflation rate expected for 1995 does not become firmly entrenched.

Monetary and Credit Aggregates

In discussing these matters at its meeting earlier this month, the FOMC determined that the provisional ranges it had chosen for the monetary aggregates and domestic nonfinancial debt in July 1994 remained consistent with its current outlook for economic activity and prices. Moreover, these ranges conform to the projected deceleration in nominal income that is associated with our efforts to contain inflation and keep the economy on a sustainable path. The 1-to-5 percent range for M2 provides a reasonable benchmark for longer-run growth of this aggregate that could be expected if the behavior of its velocity was to return to its historical pattern under conditions of price stability. This would not be true for M3, however, which historically has grown faster than M2, but which has been depressed in recent years by a number of factors, including the difficult financial adjustment of banks and thrifts. If the broader aggregate M3 returns to its previous alignment, its range of 0 to 4 percent would have to be adjusted upward. At 3 to 7 percent, the monitoring range for the growth of total domestic nonfinancial debt is centered on the actual growth of that aggregate over the past three years, but is one percentage point lower than the monitoring range in 1994. While the performance of the monetary and debt aggregates compared with these ranges will continue to inform the FOMC's deliberations, the uncertainties about the behavior of their velocities will necessitate careful interpretation of their behavior and a watchful eye toward a wide variety of other financial and nonfinancial indicators.

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Information Release

One final point: To make our policy intent as transparent as possible to market participants without losing our flexibility or undermining our deliberative process, at its latest meeting, the FOMC decided to preserve the greater openness of its policy making that it established last year. To that end, all decisions to change reserve market conditions will be announced in a press release on the same day that the decision is made.

The debate surrounding each policy decision will be reported, as is currently the practice, in comprehensive minutes of the meeting that are released on the Friday following the next regularly scheduled meeting of the FOMC. For students of monetary policy making, those minutes will be supplemented by lightly edited transcripts of the discussion at each FOMC meeting. Transcripts for an entire year will be released with a five-year lag. Continuing our current practice, the raw transcripts will be circulated to each participant shortly after an FOMC meeting to verify his or her comments, and only changes that clarify meaning, say to correct grammar or transcription errors, will be permitted. A limited amount of material will be redacted from these transcripts before they are released, primarily to protect the confidentiality of foreign and domestic sources of intelligence that would dry up if their information were made public. A complete, unredacted version of the transcripts of each FOMC meeting will be turned over to the National Archives after thirty years have elapsed, as required by law.

After careful consideration, the FOMC believed that these steps, which essentially formalize the procedures that we have been using over the past year, strike the appropriate balance between making our decisions and deliberations accessible as soon as feasible

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and retaining flexibility in policy making, while preserving an unfettered deliberative process.

Challenges Ahead

I and my colleagues appreciate the time and the attention that the members of this Committee devote to oversight of monetary policy. Our shared goal--the largest possible advance in living standards in the United States over time--can be best achieved if our actions ultimately allow concerns about the variability of the purchasing power of money to recede into the background. Price stability enables households and firms to have the greatest freedom possible to do what they do best--to produce, invest, and consume efficiently.

But the best path to that long-run goal is not now, and probably never will be, obvious. Policy making is an uncertain enterprise. Monetary policy actions work slowly and incrementally by affecting the decisions of millions of households and businesses. And we adjust policy step by step as new information becomes available on the effects of previous actions and on the economic background against which policy will be operating. No individual step is ever likely to be decisive in pushing the economy or prices one way or another--there is no monetary policy "straw that broke the camel's back." The cumulative effects of many policy actions may be substantial, but the historical record suggests that any given change in rates will have about the same effect as a previous change of the same size.

Because the effects of monetary policy are felt only slowly and with a lag, policy will have a better chance of contributing to meeting the nation's macroeconomic objectives if we look forward as we act--however indistinct our view of the road ahead. Thus, over the

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past year we have firmed policy to head off inflation pressures not yet evident in the data. Similarly, there may come a time when we hold our policy stance unchanged, or even ease, despite adverse price data, should we see signs that underlying forces are acting ultimately to reduce inflation pressures. Events will rarely unfold exactly as we foresee them, and we need to be flexible--to be willing to adjust our stance as the weight of new information suggests it is no longer appropriate. That flexibility, Mr. Chairman, applies to the particular stance of policy--not its objectives. We vary short-term interest rates in order to further the goals set for us in the Federal Reserve Act, namely promoting over time "maximum employment, stable prices, and moderate long-term interest rates."

Achieving those goals has become increasingly more complex in the nearly two decades since they were put into the Federal Reserve Act, as a consequence of technology-driven changes in financial markets in the United States and around the world. Suppressing inflationary instabilities--a necessary condition of achieving our shared goals--requires not only containing prevalent price pressures, but also diffusing unsustainable asset price perturbations before they become systemic. These are formidable challenges, which will confront policy--both fiscal and monetary--in the years ahead. It is, of course, unrealistic to assume that we can eliminate the business cycle, human nature being what it is. But containing inflation and thereby damping economic fluctuations is a reasonable goal. We at the Federal Reserve look forward to working with the Administration and Congress in meeting our common challenges.

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For use at 10:00 a.m., E.S.T.
Wednesday
February 22, 1995

Board of Governors of the Federal Reserve System

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

February 21, 1995

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Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 21, 1995

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 1995

The U.S. economy turned in a strong performance in 1994. Real gross domestic product increased 4 percent over the four quarters of the year. The employment gains associated with this rise in production outpaced growth of the labor force by a sizable margin, and the unemployment rate thus declined substantially. Price increases picked up in some sectors of the economy in 1994 as labor and product markets tightened, but broader measures of price change showed inflation holding fairly steady: The consumer price index increased about 2¾ percent over the year, the same as the rise during 1993. Signs that growth is moderating have emerged in the past month or so, but the bulk of the evidence suggests the economy continues to advance at an appreciable pace.

Federal Reserve policy during 1994 and early 1995 was aimed at fostering a financial environment conducive to sustained economic growth. As the economy moved back toward high rates of resource utilization, pursuit of this aim necessitated acting to prevent a buildup of inflationary pressures. Federal Reserve policy had remained very accommodative in 1993 in order to offset factors that had been inhibiting economic growth. By early 1994, however, the expansion clearly had gathered momentum, and maintenance of the prevailing stance of policy would eventually have led to rising inflation that, in turn, would have jeopardized economic and financial stability. Taking account of anticipated lags in the effects of policy changes, the Federal Reserve began to firm money market conditions last February. The Federal Reserve continued to tighten policy over the course of the year and into 1995, as economic growth remained unexpectedly strong, eroding remaining margins of unused resources and intensifying price increases at early stages of production. Developments in financial markets—for example, easier credit availability through banks and a decline in the foreign exchange value of the dollar—may have muted the effects of the tightening of monetary policy.

Short-term interest rates have increased about 3 percentage points since the start of 1994, with the federal funds rate rising from 3 percent to 6 percent. Other market interest rates have risen between 1½ percentage points and 3 percentage points, on net, with the largest increases coming at intermediate maturities. Through much of the year, intermediate- and long-term rates were lifted by more rapid actual and expected economic growth, fears of a pickup in inflation, and market expectations of additional policy moves. However, a further substantial tightening in November and some tentative signs of moderation in economic activity around year-end and in early 1995 appeared to reduce market concerns about increased inflation pressures and additional Federal Reserve policy actions. As a result, long-term rates declined, on net, from mid-November through mid-February.

The foreign exchange value of the dollar in terms of other G-10 currencies declined almost 6½ percent last year, even as the economy picked up and interest rates rose. The positive effects on the dollar that would normally have been expected from higher U.S. interest rates were offset in large part by upward movements in long-term interest rates abroad. Indeed, foreign long-term rates increased as much on average as U.S. rates during 1994, owing to much more rapid than expected growth abroad, especially in Europe. Concerns about U.S inflation may have contributed to the weakness in the dollar in the middle part of last year; late in the year, the dollar rallied for a time, as tighter monetary policy apparently reduced investors' inflation fears. The dollar weakened again, however, in early 1995, perhaps reflecting the emerging indicators of moderating growth in the United States. In addition, financial markets were roiled early this year by severe financial difficulties in Mexico. A sharp depreciation of the peso had adverse effects not only in Mexico but also in a number of other countries, and these developments also may have contributed to the weakness of the dollar.

Despite the rise in U.S. interest rates in 1994, private sector borrowing picked up in support of increased spending, abetted in part by more aggressive lending by intermediaries. The debts of both households and businesses grew at their fastest rates in five years. The step-up in growth of private debt was accompanied by changes in its composition. Businesses shifted toward short-term funding sources as bond yields rose, increasing their bank borrowing and commercial paper issuance, while cutting back on new bond issues. Similarly, households turned increasingly to adjustable-rate mortgages as rates on fixed-rate mortgages increased substantially. Banks encouraged the shift of households and businesses to bank borrowing by easing lending standards and not allowing all of the rise in market rates to show through to loan rates. By contrast, federal borrowing was slowed in 1994 by policies adopted in previous years to narrow the federal deficit, as well as by the effects of the strong economy on tax receipts and

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Ranges for Growth of Monetary and Debt Aggregates[1]
Percent

Aggregate	1993	1994	1995
M2	1–5	1–5	1–5
M3	0–4	0–4	0–4
Debt[2]	4–8	4–8	3–7

1. Change from average for fourth quarter of preceding year to average for fourth quarter of year indicated.

2. Monitoring range for debt of domestic nonfinancial sectors

spending. Taken together, the debt of all nonfinancial sectors expanded 5¼ percent, about the same as the increase of a year earlier and a figure that was in the middle portion of the 1994 monitoring range of 4 percent to 8 percent.

Growth in the broad monetary aggregates remained subdued in 1994. M3 expanded about 1½ percent, well within its 0 percent to 4 percent target range and slightly more than its increase in 1993. M3 was buoyed by growth of more than 7 percent in large time deposits, as banks turned to wholesale markets to fund credit expansion. For the year, M2 rose only 1 percent, an increase that was at the lower bound of its 1 percent to 5 percent target range. In contrast to 1992 and 1993, the slow growth in M2, and the resulting further substantial increase in its velocity (the ratio of nominal GDP to the money stock), was not a consequence of unusually large shifts from M2 deposits to bond and stock mutual funds. Rather, it seemed to reflect behavior similar to that in earlier periods of rising short-term market interest rates. During such periods, changes in the rates available on retail deposits usually lag changes in market rates, providing an incentive to redirect savings from these deposits to market instruments. These shifts tend to have an especially marked effect on M1 because yields on its components either cannot adjust or adjust quite slowly to shifts in market rates. M1 growth last year was 2¼ percent; it had been 10½ percent in 1993. Only continued strong growth in currency, much of which likely reflected increased use abroad, supported M1.

Money and Debt Ranges for 1995

At its most recent meeting, the Federal Open Market Committee (FOMC) reaffirmed the 1995 growth ranges for money and debt that were chosen on a provisional basis last July. The money ranges—1 percent to 5 percent for M2 and 0 percent to 4 percent for M3—are consistent with the Committee members' expectations of a slowing of nominal income growth as the expansion moves to a more sustainable pace, but also rest on the anticipation of further increases in the velocities of these aggregates. The velocity of M2 is likely to be boosted by lagged effects of the increases in short-term interest rates during 1994 and early 1995 and possibly by increased flows from M2 deposits into long-term mutual funds, as investor concerns about capital market volatility recede. The M2 range also provides an indication of the longer-run growth that could be expected under conditions of reasonable price stability if that aggregate's velocity resumes its historical pattern of no long-term trend. M3 velocity has been on a steep upward path in recent years, but the rate of increase might be expected to slow in the near term. Part of the increase in M3 velocity in the early 1990s resulted from weak growth of bank credit, in part reflecting substantial loan losses and consequent capital impairment, and the contraction of the thrift sector as failed institutions were liquidated. However, the recent strength in bank credit and the end of the contraction in thrift sector credit suggest that M3 growth could pick up, perhaps appreciably, and its velocity could begin to level out. The resumption of a more normal relationship between M3 and nominal income might call for a technical adjustment of the target range for M3 at mid-year or in 1996.

The monitoring range for growth in the debt aggregate in 1995 is 3 percent to 7 percent. This range is 1 percentage point lower than the monitoring range in 1994, reflecting the more moderate path anticipated for expansion in nominal spending and borrowing. Private sector debt growth will likely remain fairly strong in the coming year, boosted by substantial

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Economic Projections for 1995
Percent

Indicator	Federal Reserve Governors and Reserve Bank Presidents		Administration
	Range	Central Tendency	
Change, fourth quarter to fourth quarter[1]			
Nominal GDP	4¾–6½	5–6	5.4
Real GDP	2–3¼	2–3	2.4
Consumer price index[2]	2¾–3¾	3–3½	3.2
Average level, fourth quarter			
Civilian unemployment rate	5¼–6	About 5½	5.5–5.8[3]

1. Change from average for fourth quarter of 1994 to average for fourth quarter of 1995.
2. All urban consumers.
3. Annual average.

capital investment as well as merger and acquisition activity. Credit availability is unlikely to constrain private sector borrowing, as banks continue to be eager to lend and as quality spreads in financial markets remain relatively narrow. The outlook for the federal deficit suggests that Treasury borrowing will be comparable to that in 1994.

The monetary and debt aggregates will continue to be among the variables monitored by the Committee to inform its policy deliberations. Given the uncertainties about the behavior of the velocities of the aggregates, however, the Committee will also need to continue assessing a wide variety of other financial and economic indicators.

Economic Projections for 1995

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, expect the economy to settle into a pattern of more moderate expansion in 1995, after a burst of growth that has brought rates of resource utilization to the highest levels since the latter part of the 1980s. Most of the Board members and Reserve Bank presidents expect the rise in real GDP over the four quarters of 1995 to be in a range of 2 percent to 3 percent.

Effects of the past year's increases in interest rates probably will show through more strongly in the coming year, reflecting the typical lags between Federal Reserve policy actions and changes in the pace of economic growth. Residential building, especially of single-family units, is the part of the economy in which those effects are likely to emerge earliest and stand out most clearly, but reactions to the higher rates probably will be showing up in other interest-sensitive sectors as well.

Other influences also will be working to moderate the rate of growth. For example, large increases in real outlays for consumer durables over the past three years, partly financed in recent quarters by unsustainably rapid growth in the volume of consumer credit, probably have exhausted most of the pent-up demand that had accumulated when the economy was sluggish early in the 1990s. Similarly, business investment in new equipment has been rising extremely rapidly for some time and has moved to quite a high level; businesses likely will be shifting to more moderate rates of spending growth before too long. Inventory investment seems likely to moderate as well, as sustained additions to stocks at the pace of recent quarters would almost surely generate an unwanted backup of inventories at some point.

In other areas, however, increased strength may be forthcoming. Nonresidential construction, which often tends to lag other sectors of the economy over the course of the business cycle, now appears to be picking up steam. In addition, net exports may be a less negative factor in coming quarters than they were in 1994. Many foreign industrial economies entered the new year with considerable forward momentum; that

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should keep real exports of goods and services on a solid uptrend, even allowing for lower exports to Mexico as a consequence of the peso's devaluation and the likelihood of little or no growth in that country in 1995. Imports, meanwhile, should begin to slow as growth of demand in this country eases.

The Board members and Reserve Bank presidents expect that output growth of the magnitude they anticipate will be accompanied by moderate increases in employment and little change in the unemployment rate. Forecasts of the unemployment rate for the fourth quarter of 1995 are tightly clustered around 5½ percent.

An especially encouraging development in 1994 was that inflation remained relatively quiescent even as the economy moved to high rates of resource utilization. However, the costs of materials and components have been rising rapidly, squeezing profit margins in some sectors, and anecdotal reports of pressures on wages and finished goods prices have proliferated in recent months; increases in average hourly earnings and consumer prices picked up in January. Assessing the prospects, members of the Board of Governors and the Reserve Bank presidents think the most likely outcome for this year is that inflation will run somewhat higher than in 1994. Such an outcome would be consistent with patterns of price change during earlier periods when the economy was operating at levels of resource utilization like those seen recently. The central tendency of the Federal Reserve officials' CPI forecasts, measured in terms of the change from the final quarter of 1994 to the final quarter of 1995, spans a range of 3 percent to 3½ percent.

The economic prospects anticipated by the governors and Reserve Bank presidents for 1995 appear to be closely in line with those of the Administration. The Administration's forecasts of real GDP growth and inflation are in the middle of the Federal Reserve's central tendency ranges, and the Federal Reserve forecasts of the unemployment rate are centered near the low end of the annual range that was published in the *Economic Report of the President.*

Over the coming year, the Federal Reserve will seek to foster continued economic expansion while avoiding the provision of so much liquidity that the expected near-term step-up in inflation develops sustained momentum. Much progress has been made over the past couple of business cycles in reducing the role that inflation plays in the economic decisions of households and businesses. Moving ahead, the challenge will be to preserve and extend this progress, given that the Federal Reserve can best contribute to long-run prosperity by establishing an environment of effective price stability.

Economic prospects for the long run will be further enhanced if Congress and the Administration succeed in making further progress in reducing the federal budget deficit. An improved outlook for the federal deficit over the remainder of this decade and beyond could have significant favorable effects in financial markets, including a shift in long-term interest rates to a trajectory lower than that which would otherwise prevail. Such a shift in long-term rates would be an essential part of a process in which a larger share of the nation's limited supply of savings would be channeled to productivity-improving investment, thereby boosting growth in output and living standards.

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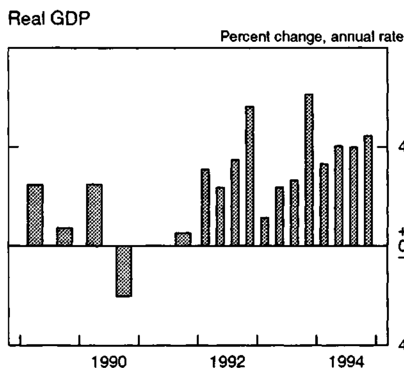
Section 2: The Performance of the Economy

The economy recorded a third year of strong expansion in 1994. Real GDP grew 4 percent over the four quarters of the year, industrial output rose nearly 6 percent, and the number of jobs on nonfarm payrolls increased about 3½ million, the largest gain in ten years. Labor and product markets tightened appreciably. Price pressures intensified in the markets for materials, but broader measures of price change showed inflation holding steady.

Real GDP



As in 1992 and 1993, the economic advance during 1994 was driven mainly by sharp increases in the real expenditures of households and businesses. Consumer purchases of motor vehicles rose further in 1994, and purchases of other consumer durables increased even faster than they had in the two previous years. Residential investment posted a small gain, on net, over the four quarters of the year, despite sharp increases in mortgage interest rates. Business investment in office and computing equipment slowed from the spectacular pace of 1993 but continued to rise rapidly nonetheless, and business investment in other types of equipment accelerated. Real outlays for nonresidential construction, which had been a weak sector of the economy in previous years, picked up in 1994; outlays for office construction ended a long slide that had stretched well back into the 1980s. Business investment in inventories, which had been quite restrained in previous years of the expansion, increased appreciably in 1994. Much of the inventory buildup apparently was intentional and reflected the desires of firms to stock up in anticipation of continued strength in sales or to build stronger buffers against potential delays in supply.

In contrast to the strength in private expenditures, government purchases of goods and services edged down on net over the four quarters of 1994. Federal purchases of goods and services, which had declined sharply in 1993, fell further in 1994 as a consequence of actions taken in recent years to reduce the size of the federal deficit. Meanwhile, the real purchases of state and local governments rose only modestly. Although the expanding economy has provided states and localities with a stronger revenue base, many of these jurisdictions are striving to hold spending in check; a number of states have chosen to cut taxes.

As in the two previous years, a significant portion of the rise in domestic spending in 1994 went for imports of goods and services, which increased about 15 percent in real terms during the year. Meanwhile, growth of real exports of goods and services picked up noticeably, with gains cumulating to about 10 percent over the year. Foreign economies strengthened in 1994, and the price competitiveness of this country's products in world markets was aided by a subdued rate of rise in production costs and a somewhat lower exchange value of the U.S. dollar.

Labor and product markets tightened in 1994. After ticking up in January of last year in conjunction with the introduction of a new labor market survey, the civilian unemployment rate fell sharply over the remainder of the year, to 5.4 percent in December. The level of the unemployment rate in January of this year—5.7 percent—was a full percentage point below that of a year earlier. In manufacturing, gains in production exceeded the growth of capacity by a sizable margin during 1994, and the rate of capacity utilization climbed nearly 3 percentage points. Its level in recent months has been essentially in line with the highest level achieved during the economic expansion of the 1980s.

Inflation pressures picked up in some markets in 1994. Prices of raw industrial commodities rose even more rapidly than in 1993, and price increases for intermediate materials accelerated sharply, especially after midyear. However, the inflation impulse in these markets did not carry through with any visible force to the consumer level, probably because unit labor costs, which make up by far the largest part of value added in production and marketing, continued to rise at a modest rate. The employment cost index of hourly compensation in private nonfarm industries actually slowed noticeably from the pace of 1993, and productivity gains in 1994 held close to the pace of

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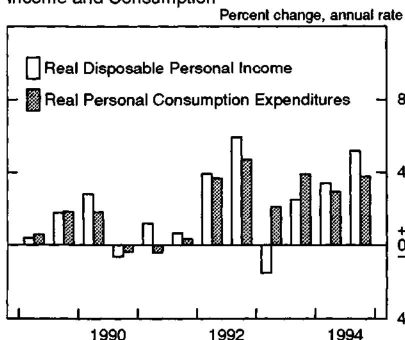
the previous year. As for retail prices, 1994 was the fourth year in a row in which the rise in the total CPI has been around 3 percent. The CPI excluding food and energy rose just 2.8 percent over the four quarters of 1994, after an increase of 3.1 percent in 1993; the rate of rise in this index, which is widely used as an indicator of underlying inflation trends, fell by almost half from 1990 to 1994.

The Household Sector

Real personal consumption expenditures advanced nearly 3½ percent over the four quarters of 1994, about in line with the average pace of the two previous years. Support for the rise in spending came from rapid income growth, and, according to surveys, sharp increases in consumer confidence. Outlays for durable goods continued to rise especially rapidly, seemingly little affected by rising interest rates. Nor did spending appear to be much affected, in the aggregate, by poor performance of the stock and bond markets, which cut into the real value of household assets. Credit generally was readily available during 1994, and growth of consumer installment debt picked up substantially, to a pace comparable with some of the larger increases that were observed during the expansions of the 1970s and 1980s.

Income and Consumption



Real consumer expenditures for durable goods increased about 8 percent in 1994, bringing the cumulative rise in these outlays over the past three years to nearly 30 percent. The stock of durable goods that households wish to hold apparently continued to rise quite rapidly in 1994, and at least some households probably were still making up for purchases that had been put off earlier in the 1990s when the economy was sluggish and concerns about job prospects were widespread. Real expenditures for motor vehicles moved up an additional 3 percent over the four quarters of 1994, after gains of about 9 percent in each of the two preceding years; increases in sales of vehicles in 1994 might have been a bit stronger still but for capacity constraints and various supply disruptions that sometimes limited the availability of certain models. Real outlays for durable goods other than motor vehicles rose about 11½ percent over the four quarters of 1994, a pickup from the already rapid rates of expansion of the two previous years. Purchases of personal computers and other electronic equipment continued to surge in 1994, and spending on furniture and household appliances moved up further.

Consumer expenditures for nondurables and services exhibited mixed patterns of change in 1994. Real outlays for nondurables increased 3 percent over the year, a pickup from the subdued rate of growth recorded in the previous year and, for this category, a larger than average advance by historical standards. By contrast, real expenditures for services increased roughly 2¼ percent, a slightly smaller gain than that of 1993; growth of outlays for services was held down, to some degree, by a decline in real outlays for energy, as warm weather late in 1994 reduced the amount of fuel needed for heating.

Real disposable personal income rose 4¼ percent during 1994. Except for a couple of occasions in previous years when income growth was boosted temporarily by special factors, the rise in real disposable income in 1994 was the largest increase since the 1983–84 period. Growth of wages and salaries accelerated in 1994 in conjunction with the step-up of employment growth. Income from capital also rose: Dividends moved up along with corporate profits, and interest income turned back up after three years of decline. By contrast, transfer payments, the growth of which tends to slow as the economy strengthens, registered the smallest annual increase since 1987. The net income of nonfarm proprietors appears to have about kept pace with the average rate of growth in other types of income. Farm income rose moderately on an annual average basis, as an increase in the volume of output more than offset the effects of sharp declines in farm output prices that developed over the course of the year.

Consumers' perceptions of economic and financial conditions brightened considerably during 1994. By year-end, the composite measures of consumer confidence that are prepared by the Conference Board and

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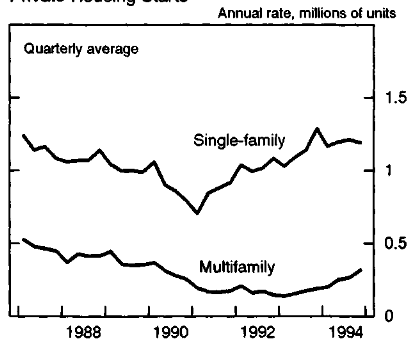
the University of Michigan Survey Research Center had both moved to new highs for the current business expansion. Consumers became more optimistic over the year in regard to both current economic conditions and future economic conditions. Perceptions of employment prospects also improved, with a growing proportion of respondents saying that jobs were plentiful and a reduced proportion saying that jobs were hard to find. Surveys taken early this year indicate that confidence remains high.

In contrast to most other indicators for the household sector of the economy, household balance sheets—which had strengthened appreciably in previous years—showed no further improvement in 1994. According to preliminary data, the aggregate net worth of households appears to have recorded a relatively small increase in nominal terms over the year, and, in real terms, net worth probably declined slightly. Household assets rose only moderately in nominal terms, and the growth of nominal liabilities picked up somewhat, as a result of the sharp increase in use of consumer credit. Early this year, stock and bond prices have risen, on net, giving some renewed lift to household wealth.

With personal income growing faster than net worth during 1994, the ratio of wealth to income fell over the course of the year. In the past, declines in this ratio sometimes have prompted households to boost the proportion of current income that is saved, in an attempt to restore wealth to more desirable levels, and this same tendency may have been at work, to some extent, in 1994. After dipping in the first quarter of the year to the lowest level of the current expansion, the personal saving rate rose a full percentage point over the remainder of the year, to a fourth-quarter level of 4.6 percent. Even then, however, the saving rate remained quite low by historical standards. Rising levels of income and employment and increased confidence in the outlook apparently convinced consumers to push ahead with increases in outlays, most notably those on consumer durables. In addition, although improvement in household balance sheets apparently flagged, signs of outright stress in household financial conditions were not much in evidence: Delinquency rates on mortgages and other household loans generally remained quite low relative to their historical ranges.

Residential investment held up remarkably well in 1994 in the face of sharp increases in mortgage interest rates. Preliminary data indicate that, in real terms, these investment outlays were up about 2 percent, on net, over the four quarters of the year, after gains of 17 percent and 8 percent, respectively, in 1992 and 1993. Although starts and sales of single-family houses fell back from the exceptionally high peaks that were reached briefly in late 1993, they remained at elevated levels. In total, 1.20 million single-family units were started in 1994, topping, very slightly, the highest annual total of the 1980s. Sales of existing homes were about the same as the previous annual peak, set in 1978, and although sales of new homes remained well short of previous highs, their annual total was closely in line with the brisk pace of 1993. Only in the past month or so have indications of a weakening in housing activity started to show up more consistently in the incoming data.

Private Housing Starts



Declines in the starts and sales of single-family houses in early 1994 basically reversed the huge gains of late 1993. Whatever tendency there may have been for these indicators to exhibit at least a temporary setback after a period of unusual strength was probably reinforced by the initial reactions of builders and homebuyers to increases in mortgage interest rates that had begun in the final quarter of 1993. Exceptionally severe winter weather in the Northeast and Midwest early in 1994, coming on the heels of favorable conditions in late 1993, probably also helped to account for the sharpness of the downturn. In any event, starts of single-family homes ticked back up a bit in the second quarter of the year, sales of existing homes flattened out, and the rate of decline in sales of new homes slowed.

In the second half of the year, the signals were mixed: Sales of existing homes trended down at a moderate pace during this period; however, single-family starts and sales of new single-family homes changed little, on net, from the second quarter to the fourth quarter. Sizable gains in employment and

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income and rising optimism about the future of the economy apparently helped to blunt the effects of increases in interest rates during the second half of the year. In addition, the availability of a widening variety of alternative mortgage instruments and, perhaps, some easing of loan qualification standards may have permitted some buyers who otherwise would not have been able to obtain financing to go ahead with their purchases.

Late in 1994 and in early 1995, a softer tone seems to have taken hold in key indicators of single-family housing activity. Sales of new homes tailed off toward the end of last year, and the ratio of the number of unsold homes to the number of sales, which had turned up early in 1994, continued to rise. The ratio in December was slightly to the high side of the long-run average for this series. Starts of new single-family houses, which had increased in November and December, fell sharply in January, to a level noticeably below the lower bound of the range of monthly readings reported during 1994.

Various measures of house prices showed small-to-moderate increases in 1994. The median transactions prices of new and existing homes that were sold in the first half of the year were roughly 3½ percent above the level of a year earlier, and a similar rise was reported during that period in price indexes that adjust for changes in the quality and regional mix of homes that are sold. After mid-year, the four-quarter changes in transactions prices slowed, but the rate of rise in the quality-adjusted indexes picked up somewhat. All told, prices have been firmer in the past couple of years than they were earlier in the 1990s.

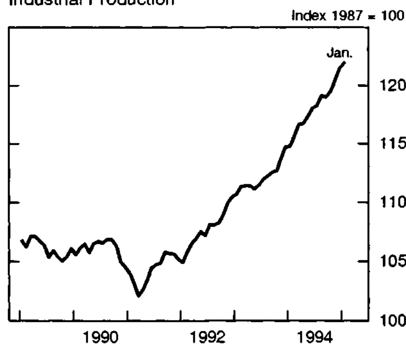
After falling to exceptionally low levels in late 1992 and early 1993, construction of multifamily housing units increased throughout 1994. Although the level of activity in this part of the housing sector was not especially high, gains during the year were large in percentage terms: Starts of these units moved up about 65 percent from the fourth quarter of 1993 to the fourth quarter of 1994, at which point they were more than double the lows of a couple years ago. The national average vacancy rate for multifamily rental units remained relatively high in 1994, but markets in some areas of the country had tightened enough to make construction of new multifamily units economically attractive. Reauthorization in August 1993 of a tax credit on low-income housing units also provided some incentive for new construction. The financing of multifamily projects was facilitated through more ready availability of credit and increased equity investment.

The Business Sector

Robust expansion was evident in 1994 in most of the economic indicators for the business sector of the economy. Real output of nonfarm businesses increased about 4¼ percent over the four quarters of the year, nearly matching the large gain of 1993. For a second year, business investment in fixed capital advanced exceptionally rapidly. Inventory investment also picked up appreciably, spurred by large, sustained increases in sales. Business finances remained on a sound footing: Investment expenditures continued to be financed predominantly with internal funds, and signs of financial stress were largely absent.

Industry entered 1994 with considerable momentum, and expansion was maintained at a rapid pace throughout the year. Industrial production rose nearly 6 percent over the four quarters of 1994, a rate of expansion exceeded in only one of the past ten years. The production of business equipment advanced especially rapidly, buoyed by rising investment in the domestic economy and further large increases in exports of capital goods. Production of intermediate products—which consist mainly of supplies used in business and construction—also moved up substantially during 1994, as did the output of materials, especially those used as inputs in the production of durable goods. The industrial sector also appears to have had a strong start in 1995, as industrial production rose 0.4 percent in January.

Industrial Production



The rate of capacity utilization in industry increased about 2½ percentage points over the twelve months of 1994. In manufacturing, the operating rate rose about 3 percentage points during the year. By year-end, utilization rates in some industries had

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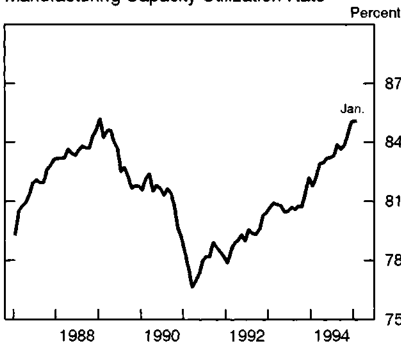
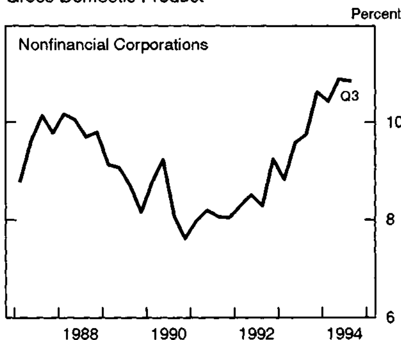
Manufacturing Capacity Utilization Rate



moved to exceptionally high levels. Most notably, the average operating rate among manufacturers engaged in primary processing (basically, the producers of materials) had climbed to the highest level since the end of 1973, surpassing, by small margins, the peaks of the late 1970s and late 1980s.

After rising 23½ percent over the four quarters of 1993, corporate profits increased another 4 percent over the first three quarters of 1994. The profits earned by nonfinancial corporations from their domestic operations increased about 7½ percent over the first three quarters of 1994, after a gain of 21½ percent in 1993. Although the 1994 gain in these profits was partly the result of increased volume,

Before-tax Profit Share of Gross Domestic Product*

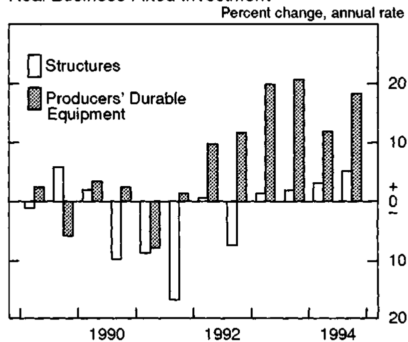


* Profits from domestic operations with inventory valuation and capital consumption adjustments divided by gross domestic product of nonfinancial corporate sector.

profits per unit of output also rose. In the second and third quarters, before-tax profits of nonfinancial corporations amounted to nearly 11 percent of the gross domestic output of those businesses—the highest that this measure of the profit share has been since the late 1970s. A shift in the capital structure of corporations toward reduced reliance on debt, as well as cyclical recovery of the economy, has helped to push the profit share to this high level. In contrast to the experience of nonfinancial corporations, the profits of private financial institutions from their domestic operations fell about 7 percent on net over the first three quarters of the year, as net interest margins narrowed. The decline reversed some of the large rise in profits that these institutions had reported in 1993.

Business fixed investment increased 13 percent in real terms over the four quarters of 1994, after a gain of 16 percent during 1993. Outlays for office and computing equipment, which had registered an astonishing gain in 1993, slowed in 1994, but the rise in these outlays still amounted to nearly 20 percent in real terms. Meanwhile, the growth of real expenditures for most other types of business equipment picked up.

Real Business Fixed Investment



Business investment in motor vehicles rose about 18½ percent over the four quarters of 1994. With the gains of 1994 coming on the heels of big increases in each of the two previous years, annual business outlays for vehicles reached a level about one-third higher than the peak year of the 1980s. Outlays for communications equipment also scored an especially big gain in 1994, more than 25 percent in real terms. Business purchases of industrial equipment advanced about 13 percent during 1994, one of the larger gains of the past two decades. By contrast, commercial

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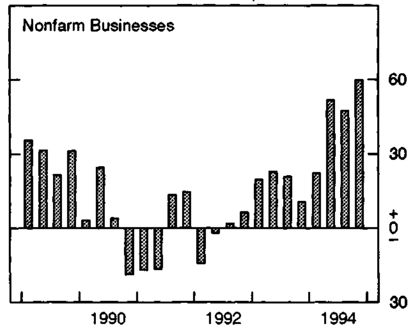
aircraft once again was a notable area of weakness; the investment cycle in that sector has been sharply out of phase with those of most other industries, owing to persistent excess capacity and poor profitability in the airline business.

Business investment in nonresidential structures rose about 4 percent during 1994, after an increase of 1½ percent in 1993 and declines in each of the three years preceding 1993. Investment in industrial structures rose for the first time since 1990, a response, more than likely, to high—and rising—rates of capacity utilization. Investment in office buildings also turned up in 1994, after a long string of declines that, in total, had brought spending on these structures down about 60 percent from the peak of the mid-1980s; declining vacancy rates and a firming of property values provided additional evidence of improvement in this sector of the economy in 1994. The investment data for other types of structures showed a mix of pluses and minuses: Expenditures on commercial structures other than offices moved up further, after large gains in 1992 and 1993; however, outlays for drilling declined for a fourth year, to the lowest level since the early 1970s.

Because a large share of the growth in business fixed investment in recent years has gone for items that depreciate relatively quickly—computers being a prime example—net additions to the stock of productive capital have not been as impressive as the data on gross investment expenditures might seem to indicate. Nonetheless, with the further increase in gross investment in 1994, net additions to the capital stock appear to have become more substantial. Still unclear is the degree to which these increases in the capital stock will ultimately translate into higher rates of increase in output per worker and faster rates of increase in living standards; as discussed in more detail below, the trend of growth in labor productivity, which is affected by the amount and quality of capital that workers have available, seems to have picked up in recent years but by a relatively small amount.

Business investment in inventories picked up sharply in 1994. Earlier in the expansion, firms had refrained from building stocks, even as the economy strengthened. Increased reliance on "just-in-time" systems of inventory control reduced the level of stocks that firms needed to maintain their normal operations, and, with a degree of slack still present in the economy, businesses usually were able to obtain goods quickly from their suppliers and thus were probably reluctant to hold stocks in house. At the end of 1993, the level of real inventories in the nonfarm

Changes in Real Business Inventories
Annual rate, billions of 1987 dollars



business sector was only 2 percent larger than it had been at the start of the recovery in early 1991.

Circumstances changed in 1994, however. Markets tightened as demand continued to surge, and supplies became more difficult to obtain on a timely basis. Anticipation of further growth in demand and increased concern about possible bottlenecks apparently prompted businesses to begin investing more heavily in inventories. Some firms may also have been trying to stock up on materials in advance of anticipated price increases. For the year as a whole, accumulation of nonfarm inventories was more than twice what it had been in 1993. This additional accumulation brought to a halt the previous downtrend in the ratio of nonfarm inventories to business sales, but the ratio remained quite low by the standards of the past quarter-century.

Inventory accumulation in the farm sector of the economy also picked up in 1994. Stocks of farm products had been drawn down in 1993, when farm production fell sharply because of floods in the Midwest and droughts in some other regions of the country. However, crop conditions in 1994 were unusually favorable throughout the year, and the output of some major crops climbed to levels considerably above previous peaks. With the demand for farm output rising much less rapidly than production, inventories of crops increased sharply. Livestock production also rose appreciably in 1994; inventories of livestock, which consist mainly of the cattle and hogs on farms and ranches, continued to expand.

The Government Sector

Federal purchases of goods and services, the part of federal spending that is included in GDP, fell

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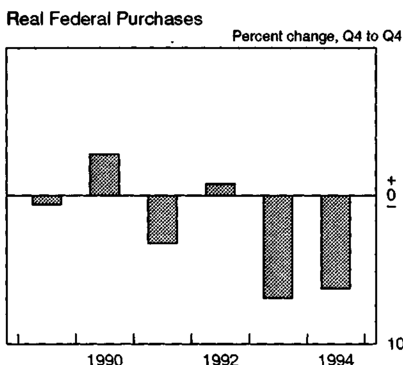
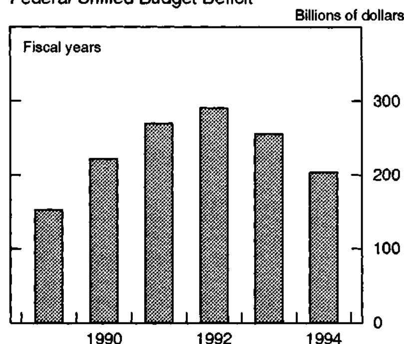


6.2 percent in real terms over the four quarters of 1994. Real outlays for defense remained on a sharp downtrend, and nondefense outlays, which had risen rapidly early in the 1990s, declined moderately for a second year.

Total federal outlays, measured in nominal dollars in the unified budget, increased 3.7 percent in fiscal 1994, after a rise of 2.0 percent the previous fiscal year. These increases are among the smallest of recent decades. Nominal outlays for defense fell again in fiscal 1994. In addition, the growth of outlays for income security (a category that includes the expenditures on unemployment compensation and welfare benefits) slowed further as the economy continued to strengthen. Increases in social security outlays also slowed somewhat in fiscal 1994; the rise was about a percentage point less than that of nominal GDP. Outlays for Medicaid slowed as well, but the rate of rise in those expenditures continued to exceed the growth of nominal GDP by a large margin.

Federal receipts were up 9 percent in fiscal 1994, the largest rise in several years. With rapid expansion of the economy giving a strong boost to almost all types of income, the major categories of federal receipts all showed sizable gains. Combined receipts from individual income taxes and social insurance taxes increased a bit more than 7 percent in fiscal 1994, after moving up 5.4 percent in the previous fiscal year. Receipts from taxes on corporate profits increased nearly 20 percent, slightly more than the gain of 1993.

The federal budget deficit declined to $203 billion in fiscal 1994, an amount that was equal to 3.1 percent of nominal GDP. Earlier in the 1990s, when the economy was sluggish, the federal deficit had climbed to a cyclical peak of 4.9 percent of nominal GDP. The previous cyclical low in the ratio of the deficit to nominal GDP, 2.9 percent, was reached in fiscal 1989. Since fiscal 1989, defense spending as a share of GDP has dropped appreciably, but this source of deficit reduction has been essentially offset by increased outlays for health and social insurance. Thus, the ratio of total federal outlays to GDP has changed little, on net; it was about 22 percent in both fiscal 1989 and fiscal 1994. The ratio of federal receipts to nominal GDP was about 19 percent in both of those fiscal years.



The stronger economy of recent years has provided state and local governments with a growing revenue base and a broadening set of fiscal options. Some governments have responded to these developments by cutting taxes, in most cases by small amounts. Effective tax rates of state and local governments appear to have edged down a bit, on average, over the four quarters of 1994, and nominal receipts apparently rose somewhat less rapidly than nominal GDP over that period.

Many states and localities also have been trying to restrain the growth of expenditures, but success on that score has been difficult to achieve because of increased outlays for entitlements and rising demand for many of the public services that traditionally have been provided by state and local governments. Transfers of income from state and local governments to persons rose about 9 percent in nominal terms over the four quarters of 1994, roughly the same as the rise during 1993 but less than the increases of previous years; from 1988 to 1992, the average compound rate of growth in these transfers was about 15 percent a year. In categories other than transfers, increases in spending have been fairly restrained in recent years;

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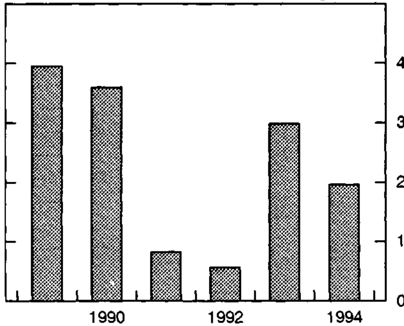
Real State and Local Purchases



nominal purchases of goods and services (which account for about 80 percent of the total expenditures of state and local governments) have been trending up less rapidly than nominal GDP since the early 1990s.

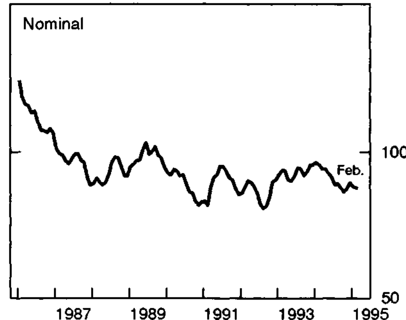
In real terms, the 1994 rise in purchases of goods and services by state and local governments amounted to just 2 percent. Compensation of employees, which accounts for about two-thirds of total state and local purchases, increased 1½ percent in real terms over the four quarters of 1994, a gain that was roughly in line with the growth of state and local employment over that period. Construction outlays declined slightly in real terms during 1994, as gains over the final three quarters of the year were not sufficient to offset a first-quarter plunge. Nonetheless, real outlays for structures remained at high levels; a strong uptrend in construction expenditures over the past ten or twelve years has more than reversed a long contraction that began in the latter half of the 1960s and bottomed out in the first half of the 1980s.

The deficit in the combined operating and capital accounts of all state and local governments (a measure that excludes the surpluses in state and local social insurance funds) amounted to about 0.6 percent of nominal GDP in calendar 1994, little changed from the corresponding figure for 1993 and down only slightly from a cyclical peak of 0.8 percent in 1991. The recent cyclical peak in this measure was larger than the peaks reached in recessions of the 1970s and 1980s, and declines in the deficit during this expansion have not been as large as the declines that occurred during other recent expansions. Historically, the combined operating and capital accounts of state and local governments have been in deficit more often than they have been in surplus; as a share of nominal GDP, the annual surpluses and deficits since World War II have averaged out to a deficit of 0.3 percent.

The External Sector

When adjusted for differing rates of increase in consumer prices, the trade-weighted average foreign exchange value of the U.S. dollar declined 5½ percent against the currencies of the other G-10 countries in 1994. This depreciation was slightly smaller than the almost 6½ percent nominal depreciation of the dollar, as U.S. inflation exceeded foreign inflation by a small amount. An index of exchange rates that also includes the currencies of several of the major U.S. trading partners in Latin America and East Asia showed about the same degree of real depreciation as did the index for the currencies of the G-10 countries. In the first few weeks of 1995, the dollar has weakened, on balance, in nominal terms against the currencies of the G-10 countries, but it has moved up in terms of the Mexican peso.

Foreign Exchange Value of the U.S. Dollar *



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

Growth of real GDP in the major foreign industrial countries rebounded sharply during 1994, significantly exceeding the pace of recovery widely expected at the start of the year. In the United Kingdom and Canada, where recovery was already well established, growth continued to be vigorous. In Germany, France, and other continental European countries, where activity had been sluggish during 1993, strong expansion of real GDP resumed and strengthened as the year progressed. Recovery was evident in Japan as well, but the pace of expansion there remained somewhat subdued relative to that of the other indus-

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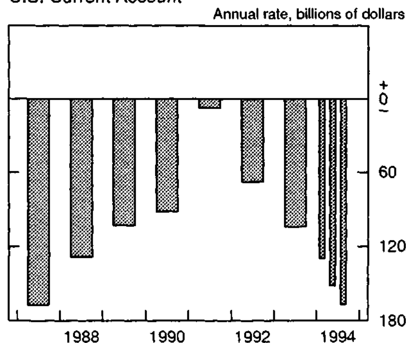
trial countries. Although most of these economies clearly had moved past the troughs of their recessions, considerable slack remained. As a result, consumer price inflation remained low and, in some cases, fell further. On average, in the ten major foreign industrial countries, consumer prices rose 2 percent during the year, even less than the price increase in the United States.

Economic growth in the major developing countries in 1994 continued at about the strong pace of 1993. In Asia, the newly industrializing economies grew rapidly, as external demand was sustained by lagged effects of depreciation of their currencies against the yen and by recovery in the industrial countries. Growth in China, although still quite rapid, was somewhat slower than that in 1992–93, as credit conditions were tightened somewhat further and various controls were imposed to damp demand.

In Mexico, real GDP growth rose markedly during the second and third quarters of 1994 from its near-zero rate in 1993, in part because of fiscal stimulus. However, the economic policy program put in place at the end of the year in response to the peso crisis is likely to restrain growth once again in the coming year. The Mexican macroeconomic stabilization program is designed to maintain wage restraint, reduce government spending and development bank lending, and result in significant improvement in the current account deficit in 1995. The program includes guidelines on increases in wages, guidelines on increases in final energy product prices to consumers and to industry, net cuts in public expenditures, and a reduction of lending by development banks. Mexico has committed to maintain the current floating exchange rate regime, and the Bank of Mexico has agreed to restrain the growth of money. Structural reform measures include continued privatization and lessened restrictions on foreign investment. Further measures could be required if inflation and the exchange rate do not respond as projected.

The nominal U.S. trade deficit in goods and services increased to about $110 billion in 1994, compared with $75 billion in 1993. Imports grew noticeably faster than exports, as U.S. growth about equaled that of U.S. trading partners and as the lagged effects of dollar appreciation during 1993 continued to be felt. The current account deficit averaged about $150 billion at an annual rate over the first three quarters. Net investment income moved from a small positive to a moderately negative figure in 1994, reflecting recovery of foreign earnings on direct investment in the United States and the effects of

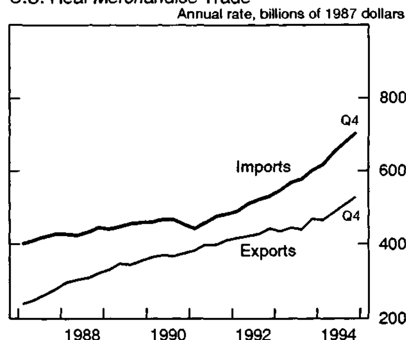
U.S. Current Account



higher interest rates on high and rising U.S. net external indebtedness.

Based on initial estimates for the fourth quarter, exports of goods and services grew 10 percent in real terms during 1994. Computer exports continued to rise rapidly in real terms, about 30 percent for the year; this gain contributed significantly to the double-digit growth in total exports. After declining in 1993, agricultural exports bounced back last year; the much-improved harvest of 1994 eased supply constraints that previously had been limiting shipments of farm products. Other categories of merchandise exports averaged more than 8 percent real growth during the year, as the pace of activity in the economies of U.S. trading partners improved significantly. Geographically, the increase in U.S. merchandise exports was accounted for by increased shipments both to developing countries in Latin America and Asia and to Canada and Japan.

U.S. Real Merchandise Trade



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Imports of goods and services rose about 15 percent in real terms over the four quarters of 1994, reflecting the vigorous growth of U.S. income during the year. Imports of computers continued to expand extremely rapidly in real terms. Of the other import categories, imports of machinery and automotive products were particularly buoyant. Import prices rose about 4 percent in 1994, influenced by depreciation of the U.S. dollar, increases in world commodity prices, and a rebound in oil prices, which had declined in 1993 and early 1994.

In the first three quarters of 1994, recorded net capital inflows were substantially larger than those of 1993, an increase that coincided not only with the growing current account deficit, but also with a sharp swing in unrecorded transactions in the U.S. international accounts, from a positive figure in 1993 to a negative one in the first three quarters of 1994.[1]

Among the recorded capital flows, increases in foreign official assets in the United States were substantial in 1994, but somewhat smaller than in 1993. In particular, the large reserve accumulations in 1993 by certain developing countries in Latin America experiencing massive private capital inflows were not repeated in 1994.

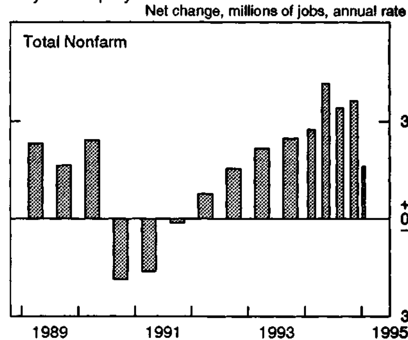
U.S. net purchases of foreign securities, particularly bonds, fell sharply from record 1993 levels. Private foreign net purchases of U.S. securities also fell, but only slightly. Rising interest rates on bonds denominated in dollars and many other major currencies produced capital losses for U.S. holders of long-term bonds and resulted in flows out of U.S. global bond funds. In the first three quarters of 1994, U.S. investors made heavy net purchases of stocks in Japan; Japan alone accounted for more than one-third of all U.S. net foreign stock purchases. In developing countries, those that received the largest net equity inflows from U.S. investors in 1993 (Hong Kong, Mexico, Argentina, Brazil, and Singapore) were less favored by investors in 1994, while interest picked up in a wide assortment of other developing countries, including South Korea, Chile, Indonesia, China, India, and Peru.

The first three quarters of 1994 also witnessed a revival of foreign direct investment in the United States while U.S. direct investment abroad remained at near-record levels. The direct investment inflow was swelled by takeovers of U.S. companies and by the revival of profits and reinvested earnings reported by affiliates of foreign companies in the United States.

Labor Markets

Employment rose substantially in 1994. The total number of jobs in the nonfarm sector of the economy increased 3.5 million over the twelve months ended in December, after a gain of 2.3 million during 1993.[2] About a quarter of a million of the rise in jobs during 1994 was in the government sector, mostly at the local level. Job growth in the private nonfarm sector amounted to 3.2 million, the largest gain since 1984. Increases in employment at nonfarm establishments were sizable in each quarter of 1994. A further gain in payroll employment, smaller than the average increase of the past year, was reported in January of this year; however, total labor input rose considerably faster than employment in January as the workweek lengthened.

Payroll Employment



Producers of goods boosted employment more than half a million in 1994. The job count in construction increased about 300,000 over the year; employment at general building contractors rose briskly for a second year, as did the number of jobs at firms involved in

1. In effect, recorded net capital inflows in the first three quarters of 1994 were larger than necessary to balance the rising current account deficit. Moreover, outflows of currency to foreigners, an item that is not reflected in recorded transactions and, therefore, is a part of unrecorded net inflows in the international accounts, increased substantially in 1994, suggesting that the other unrecorded outflows of capital may have been even larger than the published data on errors and omissions indicate.

2. The Bureau of Labor Statistics has announced that the level of nonfarm payroll employment in March 1994 will be raised 760,000 when revised estimates are released this summer. The revision may lead to larger estimates of job growth in both 1993 and 1994.

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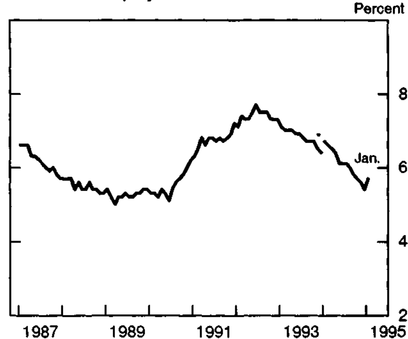
special trades related to construction. The number of jobs in manufacturing increased about 275,000 during 1994, after five years of decline. Producers of durables accounted for most of the rise in manufacturing employment; among these producers, job gains were widespread. Employment at factories that produce nondurables rose slightly in total, as advances in some industries—such as printing and publishing and rubber and plastics—were partly offset by continued secular declines in the number of jobs in industries such as apparel, tobacco, and leather goods. The average workweek in manufacturing, which had stretched out in 1992 and 1993 when factory employment was declining, lengthened further in 1994, rising to new highs for the postwar period. The high fixed costs that are associated with adding new workers probably continued to be an important factor in firms' decisions to rely still more heavily on a longer workweek as a way to boost labor input. Growth of factory output surpassed the rise in labor input by a sizable amount in 1994, a reflection of substantial gains in productivity that were realized in this sector of the economy in the most recent year.

Employment in the private service-producing sector rose nearly 2¾ million during 1994, after a gain of 2 million in 1993. The number of jobs in retail trade increased about 800,000 over the year. Auto dealers, stores that sell building materials, and those that sell general merchandise were among the retail outlets that reported impressive gains. Hiring at eating and drinking places also moved up briskly; after three years of slow growth around the start of the decade, hiring at these establishments has increased substantially in each of the past three years. Employment at firms that supply services to other businesses rose about 710,000 in 1994, even more than in 1993. Once again, job growth within this category was especially rapid at personnel supply firms—those that essentially lease the services of their workers to other employers, often on a temporary basis. Employment at businesses that supply health services increased a quarter of a million in 1994, about the same as the gain in 1993; hiring at hospitals has flattened out over the past couple of years, but elsewhere in the health sector job growth has continued at a rapid clip.

Strength also was evident in 1994 in data from the monthly survey of households. After ticking up in January of 1994, when a redesigned household survey was implemented and new population estimates were introduced, the civilian unemployment rate turned back down in February and declined in most months thereafter. The rate increased last month, to 5.7 percent, but was still a full percentage point below that of a year earlier.[3] Appreciable net declines in unemployment rates have been reported over the past year for nearly all occupational and demographic groups.

Civilian Unemployment Rate*



* A redesigned survey and revised population estimates were introduced in January 1994; data from that point on are not directly comparable with those of earlier periods.

Data on the reasons why individuals are unemployed seem to be tracing out patterns fairly similar to those seen in previous business cycles. Most notably, the number of persons who are unemployed because they lost their last job has declined sharply, on net, over the past year. The number of individuals in this category had soared earlier in the 1990s, when the economy was struggling to gain momentum and many large companies were restructuring their operations. However, with the more recent decline, the number of these "job losers," measured as a percentage of the labor force, has moved back toward the lows of the late 1980s. Much of the decline in the number of job losers this past year has been among workers who were permanently separated from their previous jobs. The number of persons unemployed for reasons other than the loss of a job (that is, the sum of "job leavers" and new entrants or re-entrants unable to find work) also has declined over the past year. As in other business cycles, the number of these individuals, measured relative to the size of the labor force, has been displaying a cyclical pattern considerably more muted than that of job losers.

3. Research undertaken by the Bureau of Labor Statistics suggests that the unemployment rate would have run about two-tenths of a percentage point lower in 1994 but for the changes that were introduced in January of last year. Other series from the household survey also were affected by the introduction of the new survey and the revised population estimates; therefore, data for the period starting in January 1994 are not directly comparable with those for the period ended in December 1993.

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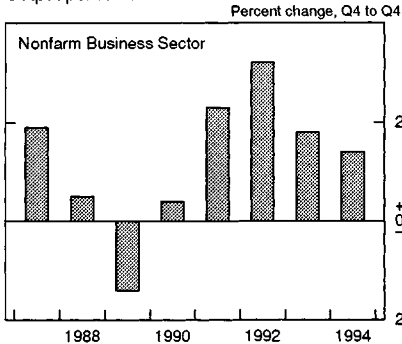
Growth of the civilian labor force—which consists of the individuals who are employed and those who are seeking employment but have not yet found it—picked up a bit in the second half of 1994 and in early 1995. However, even with these increases, the cumulative rise in the labor force in the current business expansion has been relatively small compared with the gains recorded in other recent expansions: growth of the working-age population has been slower this decade than it was in the expansions of the 1970s and 1980s, and the share of the population participating in the labor force, which trended up in earlier expansions, has changed little, on net, during this one.

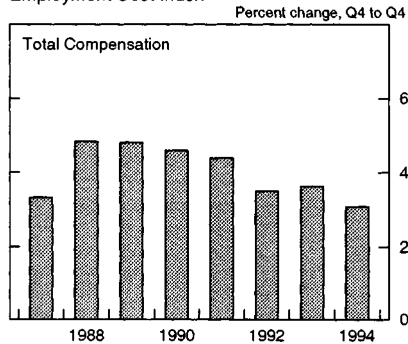
Output per Hour



According to preliminary data, output per hour of labor input in the nonfarm business sector increased 1.4 percent over the four quarters of 1994, after a rise of 1.8 percent in 1993 and still larger gains in 1992 and 1991. Over the business cycle, productivity gains typically are largest in the early years of expansion, and, in that regard, the recent experience does not appear to be unusual. Abstracting from cyclical variation, the trend of productivity growth in recent years seems to have picked up somewhat from the unusually sluggish pace that prevailed through much of the 1970s and 1980s, but, at the same time, the pickup has not been nearly so large as some anecdotal reports might appear to suggest. For example, from late 1988 to late 1994, an interval of time that is long enough to capture all the phases that productivity goes through during the business cycle, the average rate of rise in output per hour in the nonfarm business sector amounted to slightly more than 1¼ percent, up only modestly from an average rate of rise of about ¾ percent during most of the 1970s and 1980s.[4]

The rate of increase in hourly compensation moved down another notch in 1994. The employment cost index for private industry, a measure of hourly labor costs that comprises both wages and benefits, rose 3.1 percent during the twelve months ended in December of 1994, after increases of 3.6 percent in 1993 and 3.5 percent in 1992. The rise in the wage component of compensation was slightly less than that of 1993, and the rate of increase in hourly benefits slowed appreciably. Increases in benefits were restrained, in large part, by another year of deceleration in health care costs and a further slowing in workers' compensation insurance costs. The rise in nominal compensation per hour in 1994 was the smallest yearly increase in the fifteen-year history of the series, the previous low of 3.2 percent having come midway through the expansion of the 1980s. Toward the end of that decade, as bidding for labor resources intensified, increases in compensation moved up for a time to around 5 percent a year.

Employment Cost Index*



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

Unit labor costs in the nonfarm business sector rose 2.0 percent over the four quarters of 1994, after an increase of just 0.6 percent over the four quarters of 1993. In manufacturing, a sector of the economy in

4. Whether even this small degree of improvement in the productivity trend will stand up through future revisions of the data is not clear. For example, among the many difficult issues that are involved in the measurement of productivity is the choice of an appropriate set of prices to be used in valuing the output of goods and services. Currently, aggregate output is tallied using the prices of 1987, but some major changes in relative prices have taken place since then, the most notable of which is a huge decline in the price of office and computing equipment. Using the prices of a more recent year to gauge real output would result in less weight being given to office and computing equipment and, in turn, a smaller contribution from this rapidly growing category to growth of real output. All else equal, the growth of productivity also would be negatively affected by switching to the prices of a more recent year.

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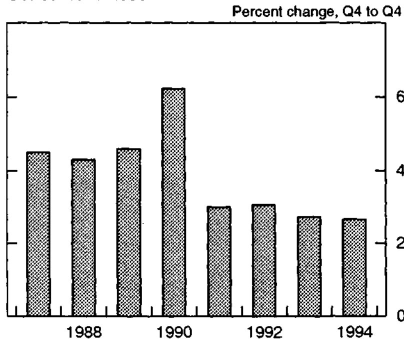
which productivity has advanced quite rapidly in recent years, a rise in output per hour of 4.6 percent during 1994 more than offset a modest increase in hourly compensation, and unit labor costs declined noticeably for a second year.

Price Developments

Although price increases picked up in some parts of the economy in 1994, the broader measures of price change continued to yield readings that were quite favorable. The rise in the total CPI was about 2¾ percent in 1994, the same as the increase during 1993. The CPI excluding food and energy also rose about 2¾ percent over the four quarters of 1994, after increasing slightly more than 3 percent in 1993. The producer price index for finished goods increased 1¼ during 1994, after edging up just ¼ percent during the previous year. As in 1992 and 1993, the past year's increases in all these price indexes were among the lowest readings of the past quarter-century. Measures of inflation expectations held steady in 1994, but continued to show readings that were somewhat higher, on average, than the actual rates of price increase. Price data for January of this year were less favorable than those of 1994: The total CPI moved up 0.3 percent last month, and the CPI excluding food and energy jumped 0.4 percent, the largest monthly rise in that measure since late 1992.

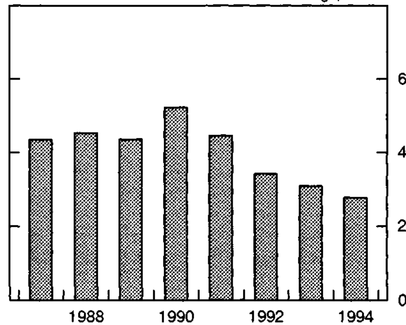
Consumer Prices *



* Consumer price index for all urban consumers.

The pickup of price increases last year was confined largely to markets for materials. Prices of primary industrial inputs, which had moved up sharply during 1993, continued to surge in 1994, and price increases for intermediate materials accelerated as the year progressed. Prices of imports also picked up somewhat, influenced by the depreciation in the exchange value of the dollar; as was true in the domestic economy, the largest price increases for imported goods were those for materials. Gains in productivity apparently enabled manufacturers of finished goods to absorb these increases in the costs of domestically produced and imported materials without raising their own prices very much.

Consumer Prices Excluding Food and Energy *



* Consumer price index for all urban consumers.

Early this year, materials prices continued to surge. The producer price index for crude materials other than food and energy jumped 3 percent in January, to a level about 17½ percent above that of a year earlier. Further along in the production chain, the PPI for intermediate materials other than food and energy rose 1 percent last month; the index has moved up 6 percent during the past twelve months, the largest such rise since the late 1980s, when the twelve-month rate of increase in intermediate materials prices topped out at slightly more than 7 percent. By contrast, the PPI for finished goods other than food and energy again showed only a modest increase in January. Since mid-January, the prices of a number of industrial commodities have backed away from earlier highs, but, given the volatility that these prices sometimes exhibit, the experience of a few weeks may not signal the emergence of a new trend.

In the CPI, the prices of commodities other than food and energy rose 1½ percent over the four quarters of 1994, about the same as the rise of 1993. Prices of new cars and new trucks, responding to strong demand and, at times, shortages in the supply of some models, moved up faster than prices in general; prices of used cars rose especially rapidly for a third year. The prices of tobacco products, which had fallen sharply in 1993 when producers made steep

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one-time price reductions, turned back up in 1994, rising moderately over the four quarters of the year. By contrast, prices of home furnishings changed little over the year, and the CPI for apparel fell noticeably. In January of 1995, the CPI for goods other than food and energy jumped 0.4 percent; this rise followed a string of months in which the index had increased very slowly.

The CPI for non-energy services, a category that accounts for about half of the total CPI, rose slightly less than 3½ percent over the four quarters of 1994, after an increase of about 3¾ percent in 1993. The increase in these prices in 1994 was just a bit more than half the rise that was recorded in 1990, when CPI inflation hit its most recent peak. Prices of medical services continued to slow in 1994, and airline fares, which have been an especially volatile category in the CPI in recent years, fell appreciably after having risen sharply the previous year. However, auto finance charges turned up, and the rate of rise in owners' equivalent rent, a category that has a weight of nearly 20 percent in the total CPI, rose slightly faster over the four quarters of 1994 than it had during the corresponding period of 1993. Like the prices of goods, the CPI for non-energy services accelerated sharply in January of this year.

In 1994, for a fourth year, neither food prices nor energy prices provided much impetus to the inflation process. The consumer price index for food rose a shade more than 2½ percent over the four quarters of 1994, about the same as the rise of 1993. Food prices in 1994 were restrained, in part, by sharp declines in the prices of domestically produced farm products, which, in turn, were pulled down by the huge increases in crop and livestock production noted previously. With beef and pork prices declining over the year, the CPI for meats, poultry, fish, and eggs changed little in total. Retail prices of dairy products rose only a small amount. Prices of foods that are more heavily influenced by the costs of nonfarm inputs also showed only small to moderate advances in 1994: The increase in the CPI for prepared foods amounted to about 2½ percent, slightly less than the previous year's increase, and, for a third year, the rise in the price index for food away from home was less than 2 percent. Coffee was the only item in the CPI for food to show sustained price acceleration; freeze damage to the crop in Brazil caused world prices of raw coffee to surge and led to a price rise of more than 50 percent at retail over the four quarters of 1994. Fresh vegetable prices, which tend to be especially sensitive to short-run supply developments, took a jump toward year-end after Hurricane Gordon had damaged crops in Florida, but the run-up was partly reversed last month.

The CPI for energy rose about 1½ percent during 1994, after edging down ½ percent in 1993. Gasoline prices increased 4½ percent over the four quarters of 1994, reversing the decline of the previous year. Much of the increase in gasoline prices came in the third quarter and followed, with a short lag, a second-quarter rise in crude oil prices, which were moving back up from the low levels of late 1993 and early 1994. Prices of other energy products exhibited brief periods of rapid increase, but sustained upward pressures in these prices did not materialize. Fuel oil prices shot up temporarily early in 1994, when stocks were pulled down for a time by cold weather in the Midwest and the Northeast; later in the year, however, stocks were replenished and the earlier price increases were more than reversed. Natural gas prices followed a pattern similar to the price of fuel oil, rising sharply in the first quarter of the year but falling back thereafter, to a fourth-quarter level that was about 2¼ percent lower than that of a year earlier. Electricity prices rose only slightly during the year. In January of this year, energy prices were up moderately in the CPI.

With the favorable inflation performance of the past year, the average rate of rise in the total CPI since the business cycle trough in early 1991 has been 2.9 percent at an annual rate. Excluding food and energy, the rate of rise has been 3.3 percent at an annual rate. Inflation rates lower than these have not been sustained through the first few years of any business expansion since that of the 1960s, when both the CPI and the CPI excluding food and energy showed average rates of increase of less than 1.5 percent during the first four years after the business cycle trough of early 1961. Average rates of price increase during the current expansion have been much smaller than those reported during the expansion that began in the mid-1970s. They also have been somewhat smaller than those reported during the first few years of the expansion that began in late 1982, a period when price increases were braked in part by unusually steep declines in oil prices. In measuring the progress that has been made toward bringing the economy closer to the goal of long-run price stability, the ratcheting down of the rate of price advance from cycle to cycle since the 1970s is perhaps an even more meaningful indicator than the favorable trends in the annual price data of recent years.

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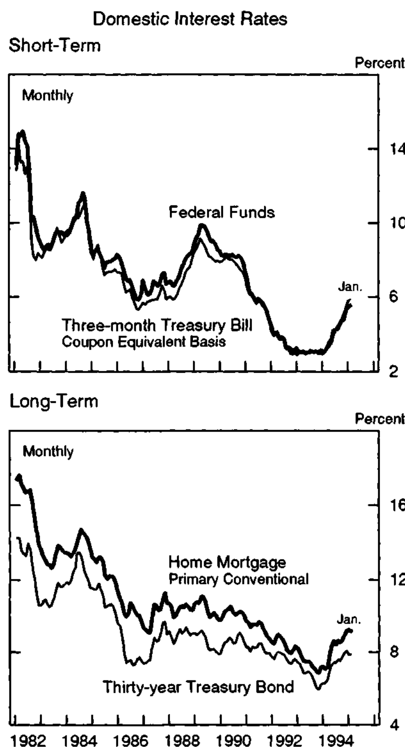
Section 3: Monetary and Financial Developments

With the economy generally strong, financial markets in 1994 and early 1995 have been characterized by somewhat more rapid growth in private debt and by higher interest rates. The increase in interest rates reflected, in part, the policy actions of the Federal Reserve. Concerned about inflationary pressures resulting from rapid economic growth and dwindling margins of available resources, the Federal Reserve firmed policy on seven occasions. These actions were taken to foster a financial environment more likely to be consistent with sustained economic growth and low inflation. In total, the policy tightenings raised the federal funds rate by a cumulative 3 percentage points between early February 1994 and early February 1995. Other short-term rates rose by similar amounts. Over this span, the Board of Governors hiked the discount rate on four occasions by a total of 2¼ percentage points.



Longer-term rates increased 1½ percentage points to 3 percentage points on balance since January of 1994, with the largest increases posted at intermediate maturities. In addition to the policy actions, these rates were boosted through much of 1994 by greater-than-expected underlying strength in the economy and the resulting higher demand for credit, as well as by upward revisions to expectations in financial markets about the policy tightenings that would be required to counter an incipient increase in inflation. Since late last fall, however, the extent of Federal Reserve actions, along with incoming data suggesting some moderation in the pace of expansion, have calmed inflation fears and trimmed estimates of the eventual rise in short-term interest rates. As a consequence, longer-term rates have retraced some of their earlier upward movements.

Increases in intermediate- and long-term rates over the course of the year caused significant capital losses for some investors. Well-publicized losses at a number of investment funds in the first half of the year, along with substantial portfolio reallocations in view of the changed economic and financial outlook, may have contributed to increased financial market volatility at that time. On the whole, however, risk premiums remained modest, and volatility ebbed over the course of the year. Late in the year, the tax-exempt securities market dipped following the bankruptcy of Orange County that resulted from mounting losses in its investment fund, but the effects, beyond those on the fund's investors, proved to be small and short-lived.

One consequence of the higher and more volatile long-term interest rates was a shift in business borrowing away from the capital markets and toward shorter-term sources, such as banks. This shift, which reversed the move toward long-term financing that occurred as bond yields fell in 1992 and 1993, was marked by the first annual increase in bank business loans in several years. Consumer lending also accelerated in 1994, as the improved economic outlook encouraged increased use of consumer credit. Higher interest rates likely held down household mortgage debt growth, in that the resulting decline in refinancing activity limited the ability of households to "cash out" some of the equity in their homes. Higher rates also encouraged households to shift to adjustable-rate mortgages, which offered lower initial interest costs.

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The debt of all nonfinancial sectors increased 5¼ percent in 1994, about the same increase as in 1993, as the pickup in business and household borrowing was offset by lower growth in government debt. The effects of the strong economy on government expenditures and receipts, policy moves to reduce the federal deficit, and retirements of tax-exempt securities that had been advance-refunded all contributed to the slowdown in government borrowing.

Banks funded much of the pickup in their loans with nondeposit funds and, in the second half of the year, with sales of securities. As a result, the doubling of loan growth was not reflected in significantly stronger expansion of the monetary aggregates. M3, which was boosted by relatively heavy issuance of large CDs, rose 1½ percent, a somewhat larger increase than in 1993. With banks pricing savings and small time deposits unaggressively as market interest rates rose, M2 grew 1 percent over the year, somewhat below its 1¾ percent pace in 1993. The increase in market interest rates relative to rates on transaction deposits slowed the growth of M1 to just 2¼ percent from the double-digit increases posted in 1992 and 1993.

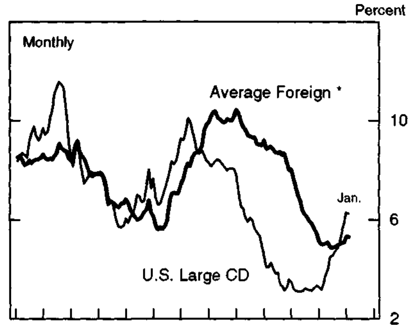
The foreign exchange value of the dollar declined in terms of the other G-10 currencies last year, even as the U.S. economy expanded briskly and interest rates rose. In part, the weakness was the result of unexpectedly strong growth abroad, especially in Europe, where the recovery in many countries was more rapid than had been anticipated. As a result, long-term interest rates in many of the other G-10 countries increased by amounts similar to rates in the United States. Heightened concerns about inflation prospects in the United States may also have contributed to the weakness of the dollar. Indeed, the dollar rebounded late in the fall when tighter monetary policy evidently eased those concerns. The dollar declined, however, in early 1995 amid the signs of slower U.S. growth and concerns about the implications for the United States of turmoil in Mexican financial markets.

The Course of Policy and Interest Rates

In early 1994, short-term interest rates remained at the very low levels reached in late 1992, with the federal funds rate fluctuating around 3 percent—roughly in line with the rate of inflation. The Federal Reserve had maintained an accommodative policy stance throughout 1993. This stance was unusual so far into the expansion phase of a business cycle, but it was believed to be necessary because of a number of extraordinary factors that seemed to be inhibiting growth. These factors included efforts by households, firms, and financial intermediaries to repair strained balance sheets, business restructuring activities, and the fiscal contraction associated, in part, with the downsizing of defense industries.

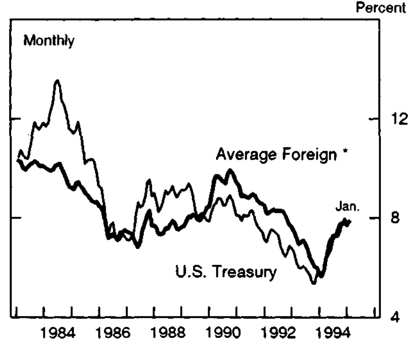
U.S. and Foreign Interest Rates

3-Month



* Trade-weighted average of comparable bank rates in the other G-10 countries.

10-Year



* Trade-weighted average of comparable government bond yields in the other G-10 countries.

During the recovery and expansion, however, considerable progress had been made by households and businesses in decreasing their debt-service burdens, and lending institutions had succeeded in rebuilding their capital positions. By late 1993, the economy was expanding rapidly, and incoming data early last year suggested that much of that momentum had likely carried over into 1994. In the circumstances, continued accommodative policy risked pushing the demands on productive resources to levels that ultimately would be associated with increased inflation.

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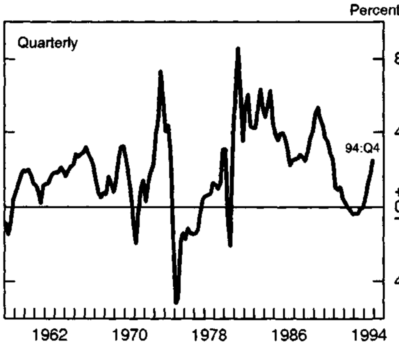
Real Federal Funds Rate *



*Real federal funds rate is the nominal federal funds rate minus the change in the CPI less food and energy over the last four quarters.

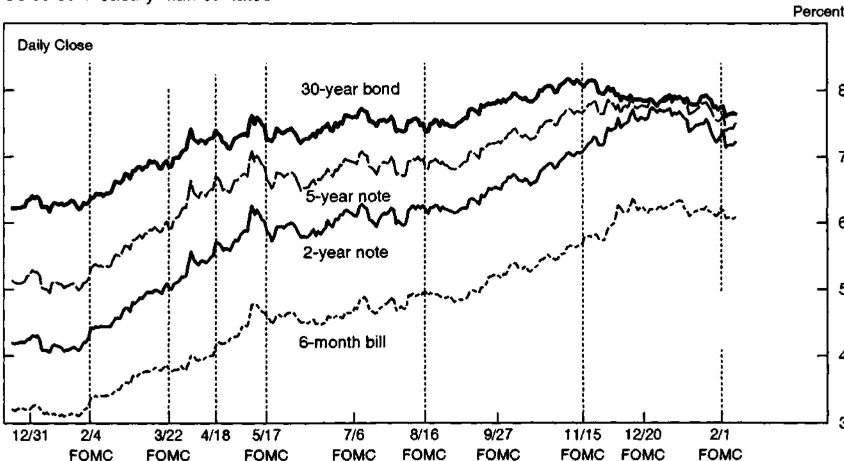
Consequently, the FOMC, at its meeting in early February 1994, agreed that policy should be moved to a less stimulative stance.

The pace at which the adjustment to policy should be made was less clear: A rapid shift in policy stance would minimize the risk of allowing inflation pressures to build, while a more gradual move would allow financial markets time to adjust to the changed environment. Although many market participants seemed to anticipate a firming move fairly soon, it would be the first tightening in many years, and some investors would undoubtedly reconsider their portfolio strategies, possibly causing sharp movements in bond and stock prices. In addition, a slower initial shift would allow more time to assess the strength of the economy and the effects of the change in policy.

In the event, the Committee tightened policy gradually through the winter and early spring. Pressures on reserve positions were increased by relatively small amounts in February, March, and April; once market participants seemed to have made substantial adjustments to the new direction of policy, a larger tightening move was implemented in May. Taken together, the four policy actions raised the federal funds rate about 1¼ percentage points. The May policy action was accompanied by an increase of ½ percentage point in the discount rate, voted by the Board of Governors.

Other interest rates moved up between 1 percentage point and 2 percentage points as a result of these policy moves, with the largest increases coming at intermediate maturities. Besides the effect of the policy actions, longer-term rates were boosted by incoming data suggesting continued robust growth, which heightened market concerns about a pickup in inflation and expectations of further tightening by the Federal Reserve. In addition, uncertainty about the timing and magnitude of future policy actions, as well as the capital losses that followed the tightenings,

Selected Treasury Market Rates



* Dotted vertical lines indicate days on which a monetary policy move was announced.

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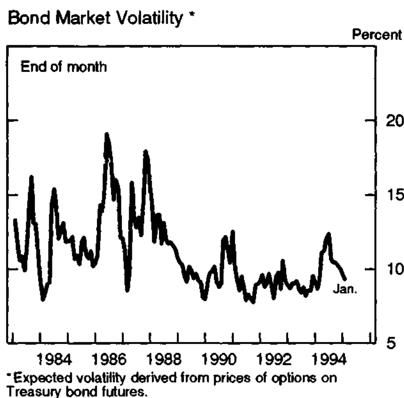
Bond Market Volatility *



*Expected volatility derived from prices of options on Treasury bond futures.

encouraged investors to shorten the maturity of their investments and reduce their degree of leverage. The resulting portfolio adjustments likely contributed to increased market volatility and may have intensified the upward pressure on longer-term interest rates.

Incoming data in the late spring and early summer suggested that the economy continued to expand significantly, led by sales of business equipment, a rebound in nonresidential construction following bad weather earlier in the year, and a pickup in inventory investment. Inflation was of growing concern, as commodity prices increased rapidly, and measures of slack suggested that the economy was entering a range in which pressures on broad price indexes might begin to build. In part reflecting this concern, long-term rates moved up, and the dollar weakened. Given the relatively large policy action in May, however, the Committee decided to take no action at the July meeting and to wait for more information on the performance of the economy. The Committee saw the possible need for tighter policy, however, and issued an asymmetric directive to the Federal Reserve Bank of New York suggesting that policy would respond promptly to evidence of increased inflation pressures.

In the interval between the Committee meetings in early July and mid-August the economy continued to expand robustly, and, coming into the August meeting, it appeared that the markets expected a small further increase in reserve pressures. At its meeting, the Committee agreed that a prompt further tightening move was needed to provide greater assurance that inflationary pressures in the economy would remain subdued, and the members chose a tightening action somewhat larger than had been expected by the markets. A rise of ½ percentage point in the discount rate, voted by the Board of Governors, was allowed to show through fully to the federal funds rate. Short-term market rates rose following the policy move, while long-term yields declined slightly, perhaps as a result of downward revisions to expectations of future tightening.

In advance of the meeting in late September, most market rates increased as incoming economic data were seen in the market as raising the likelihood of higher inflation and the resulting need for tighter reserve conditions. The data suggested that the economy had not yet been greatly affected by the tightening in monetary policy: Employment was growing strongly, and final sales, especially of consumer goods, appeared to have firmed. Manufacturing activity had continued to expand rapidly, boosted in part by an increase in motor vehicle production. Given the uncertain duration of lags between changes in monetary policy and the resulting effects on the economy, however, it was not clear whether the effects of the earlier interest rate increases were smaller than had been expected or were still in train. Another possibility was that the underlying momentum of the expansion was greater than had been evident earlier. Given these uncertainties, the Committee took no immediate tightening action at its September meeting. As in July, however, the Committee agreed to an asymmetric directive suggesting that the likely direction of any move over the intermeeting period was toward additional restraint.

Broad measures of inflation remained moderate through the fall in spite of continued substantial economic growth in an economy that was running close to its estimated potential. Nonetheless, strong economic data and continued upward pressure on prices at earlier stages of production apparently heightened investors' inflation concerns, as well as expectations of future policy tightenings. Consequently, most market interest rates rose appreciably between the September and November meetings, with the largest increases occurring at intermediate maturities. At the November meeting, the Committee members agreed that the stance of policy was not sufficiently restrained given the clear risks of higher inflation. As a result, they chose a sizable firming of monetary policy, tightening reserve conditions in line with the increase of ¾ percentage point in the discount rate approved by the Federal Reserve Board.

The yield curve flattened appreciably in response to the larger-than-expected policy action. The increase in the federal funds rate pushed up most short-term interest rates. Long-term rates increased initially, but

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in late November and early December these rates more than reversed the earlier increases. Evidently, market participants ultimately interpreted the substantial policy tightening as demonstrating the Committee's intention to take the actions necessary to contain inflation at relatively low levels. By contrast, intermediate-term rates increased over the weeks following the November meeting as a variety of incoming data indicated that the economy's growth had accelerated further in the fourth quarter and additional tightenings might be required to slow growth to a more sustainable pace. By the time of the December meeting, rates on two-year Treasury notes were only a little below those on thirty-year Treasury bonds, although both yields remained well above short-term rates.

Financial markets were focused in early December on the failure of an investment fund run by Orange County, California, and the subsequent bankruptcy of the county itself. The municipal securities market bore the brunt of these developments, with rates rising for a time relative to those on comparable Treasury issues. The failure had a substantial effect on the finances of the municipalities that had invested in the fund. In addition, investors had to consider the likelihood of other state and local governments having similar investment difficulties. Over the following days and weeks, however, only a few other problem situations emerged, and they were on a much smaller scale.

In the period leading up to the December meeting, incoming data continued to show robust growth and subdued inflation. The Committee felt that the effect on economic activity of the policy actions during the year, and especially the substantial tightening moves in the second half of the year, were not yet visible, owing to the lags in the effects of monetary policy on the economy. As a result, the Committee decided to take no further policy action at the meeting, and to await additional information on the underlying strength in the economy and the effects of the earlier policy actions. This decision was reinforced by concerns that the financial markets might be somewhat unsettled owing both to the usual year-end adjustments and to uncertainty about the effects and incidence of the sizable market losses sustained by some investors over the year. In view of the substantial strength evident in the incoming data, however, the Committee again chose an asymmetric directive pointing toward further restraint.

In advance of the Committee meeting at the end of January, broad measures of inflation remained modest, although anecdotal reports suggested that some firms intended to raise prices early in the new year. Incoming data on production and employment continued to be upbeat, with healthy growth reported in virtually all industries and regions. Some indicators, however, raised the possibility of a slowing in the pace of the expansion. Nonetheless, output growth in the fourth quarter was the fastest of the year, and the Committee felt that, with output and employment at or even beyond estimates of their sustainable levels, the risks of rising inflation were still considerable. As a result, the Board of Governors voted an increase of ½ percentage point in the discount rate, and the Committee agreed to allow the increase to be fully reflected in the federal funds rate. Because it had been widely anticipated in the financial markets, other interest rates and the foreign exchange value of the dollar were little affected by the policy action. Interest rates turned down subsequently, as additional information on the economy seemed to reinforce the possibility that a slowdown was in process.

At the same meeting, the Committee also formally adopted two practices that had been followed on a provisional basis during 1994. First, the Committee voted to continue to announce any change in the stance of policy on the day the decision is made. These announcements, which had followed each of the policy tightenings agreed to in 1994, are intended to minimize any confusion and uncertainty about the stance of policy. In addition, a public announcement ensures that all financial market participants have the same access to information regarding changes in monetary policy. Second, the Committee agreed to continue releasing the transcripts of Committee meetings with a five-year delay. The published minutes of Committee meetings, which are available soon after the subsequent meeting, provide a relatively complete summary of the arguments presented and the reasons for a policy choice. The transcripts provide additional information, however, that may be of use to those interested in the details of the policy process. The Committee decided that a five-year delay struck an appropriate balance between the right of interested members of the public to obtain this added detail and the Committee's need to debate policy issues openly and without the sort of restraint that more rapid disclosure might generate.

Credit and Money Flows in 1994

The debt of all nonfinancial sectors grew 5¼ percent in 1994, somewhat below the middle of its monitoring range of 4 percent to 8 percent, and

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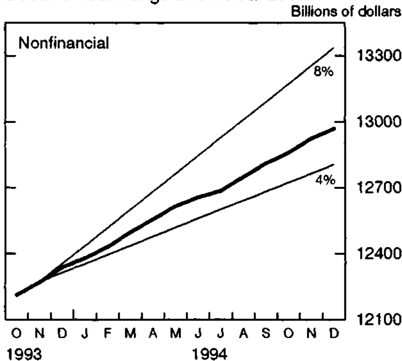
about the same increase as a year earlier. More rapid growth of private sector debt was offset by slower growth of public sector debt. As long-term rates rose well above their late 1993 lows, private sector borrowing shifted toward shorter-term sources of funds. In part as a result of this shift, financial intermediaries supplied a larger share of new debt than they had for several years. Much of the depository credit growth was funded with nondeposit funds, however, and growth in the broad monetary aggregates, which consist primarily of deposits, remained subdued.

Debt: Annual Range and Actual Level



Debt growth both in the federal and in the state and local government sectors slowed last year. Growth of federal government debt was smaller because of the narrowing of the federal budget deficit. The outstanding volume of state and local government debt actually declined as bonds that previously had been refunded in advance of their earliest call date were retired. Much of the bulge in tax-exempt issues in 1993 had been for the advance refunding of higher-cost debt issued in the 1980s. These offerings subsided early in 1994, as the amount of bonds eligible for advance refunding dwindled and borrowing costs rose.

Household debt growth increased modestly in 1994, as an acceleration in consumer credit was partly offset by slower growth in mortgage debt. The pickup in consumer debt reflected, in part, increased demand for consumer durables. In addition, responses to Federal Reserve surveys of banks indicated that many respondents were more willing to extend credit to households last year, which may have led them to ease terms and standards on consumer loans. Indeed, spreads between consumer loan rates and market rates narrowed significantly last year, as increases in loan rates lagged those in market interest rates. Consumer credit may also have been boosted somewhat by the increased use of credit cards offering rebates or other incentives. Rising mortgage rates in 1994 greatly reduced the volume of mortgage refinancings from the very high levels reached in 1993. The refinancings had contributed to an increase in mortgage debt because some households had taken the opportunity afforded by refinancing to cash out a portion of the equity in their properties. Higher rates on fixed-rate mortgages also induced many borrowers to shift to adjustable-rate mortgages that carried much lower initial rates. Concessional starting rates and the growing use of adjustable-rate contracts with initial fixed-rate periods lasting several years also may have contributed to this shift. Over the last few months of the year about half of all new home mortgages were of the adjustable rate variety. The shift to adjustable-rate mortgages and the sluggish adjustment of consumer loan rates mitigated the effect of higher market interest rates on household debt-service burdens.

The debt of nonfinancial businesses expanded in 1994 after three years of stagnation. Earlier efforts to restructure balance sheets by increasing equity capital and refinancing higher-cost credit appeared to leave businesses in a better position to increase debt in 1994, as the sector's debt-service burden had fallen about one-third from its peak five years earlier. A decline in equity issuance, perhaps resulting from the lackluster performance of the stock market, may also have boosted business borrowing. Business financing needs were strengthened by increased spending on capital and inventories, as well as merger and acquisition activity. The total value of mergers and acquisitions increased substantially last year, and the share of such activity requiring cash payments to shareholders—rather than swaps of shares—rose sharply, although it remained below the levels reached in the late 1980s.

Rising and more volatile long-term interest rates encouraged businesses to rely more heavily on short-term debt in 1994. This shift was reinforced by changes in supply conditions in various markets. Capital losses early in the year likely caused some of those supplying long-term funds to become more cautious; for example, some savers backed away from bond mutual funds. At the same time, banks were loosening terms on business loans as well as easing their underwriting standards. Banks attributed the easing of loan terms and standards to increased competition for business customers from other banks and also from nonbank lenders. The competitive posture of banks likely reflected, in part, the high level of profits

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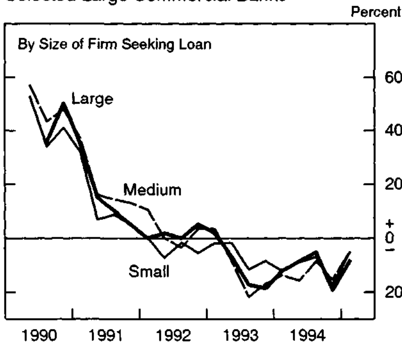
Changes in Business Lending Standards at Selected Large Commercial Banks *



Source. Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices.
* Percentage of domestic respondents reporting tightening standards over the past three months less the percentage reporting easing standards.

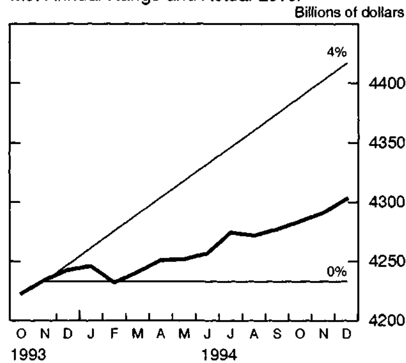
earned by banks in recent years and the resultant strengthening of their balance sheets. As a result of these factors, bank business loans increased more than 9 percent, their first annual increase in several years. Other sources of short-term business finance, including commercial paper and finance company loans, also expanded on the year.

The effect of the pickup in business and consumer loans on bank credit growth was partially offset by slower growth in bank securities holdings. Early in the year, banks purchased a significant volume of government securities, and reported levels of other securities holdings were boosted by an accounting change.[1] Much of this growth was reversed later in the year, however, as banks used sales of securities to fund loan growth. Reported securities growth also was damped by declining securities prices.[2]

In 1994 thrift sector credit expanded for the first time in several years, as the Resolution Trust Corporation virtually completed its liquidation of insolvent thrift institutions. In part, the increase in thrift sector credit also likely reflected the shift by households toward adjustable-rate mortgages. Thrift institutions and banks find holding adjustable-rate mortgages less risky than holding fixed-rate mortgages, and so adjustable-rate loans are less likely to be securitized and sold.

With bank credit growth picking up and thrift sector credit rising, growth of depository credit in 1994 nearly matched that of total nonfinancial debt. Thus, the share of credit provided by these intermediaries stabilized last year after having declined substantially since 1988. Despite the growth in depository credit, the broad monetary aggregates continued to expand sluggishly. Domestic banks funded much of their credit expansion from nondeposit sources, such as borrowings from their foreign offices, that are not included in the monetary aggregates. Funds from these sources are not subject to deposit insurance premiums, which may help account for their recent rise.

M3: Annual Range and Actual Level



The broadest monetary aggregate, M3, did pick up a bit as banks turned, in part, to large time deposits to fund asset growth. M3 expanded about 1½ percent, well above the lower bound of its 0 percent to 4 percent annual range and a somewhat larger increase than in 1993. Growth in large time deposits topped 7 percent for the year, marking the first annual increase in this component since 1989. Much of the increase in large time deposits was in senior bank notes, which are not subject to deposit insurance premiums.

M2 grew 1 percent in 1994—the lower bound of its annual range. The slow growth reflected, in part, relatively sluggish upward adjustment of retail deposit

1. New Financial Accounting Standards Board rules, effective at the start of the year, limited the ability of banks to net off-balance-sheet items for reporting purposes. The new rules affected items such as swaps and options, the cash values of which are reported on balance sheets in the other securities category.

2. A Financial Accounting Standards Board rule implemented at the start of the year required each bank to divide its investment account securities into those that it intended to hold to maturity, which could be reported at book value, and those that were available for sale, which had to be marked to market.

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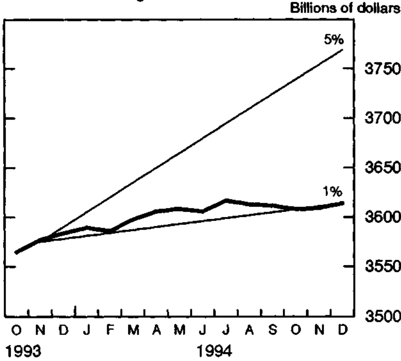
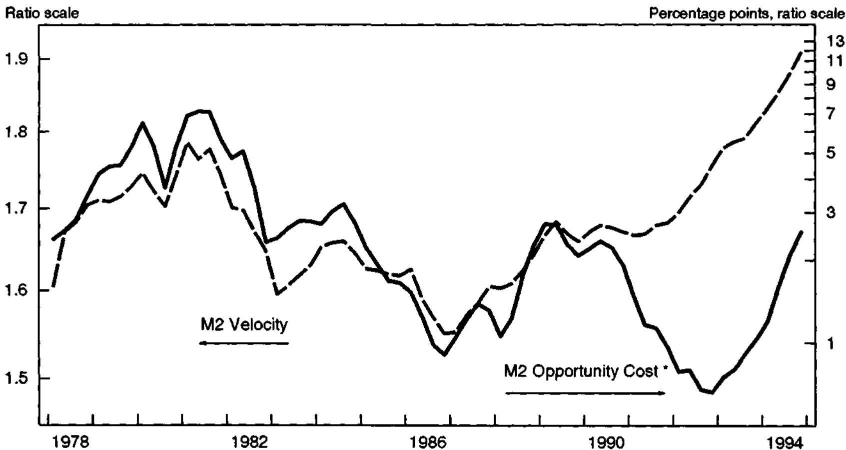
M2: Annual Range and Actual Level



rates. Rates on savings accounts and other checkable deposits (OCDs), including NOW accounts, responded about as slowly as they have in the past to the increase in market rates, while the response of rates on small time deposits was sluggish relative to historical norms. Evidently, banks believed that generating increased retail deposits would be more expensive than raising wholesale funds given that higher retail rates would have to be paid on existing liquid deposits and on time deposits as they were rolled over, as well as on any new deposits. Increasing retail deposits would also require higher advertising, administrative, and deposit insurance costs.

In contrast to the previous several years, M2 behavior in 1994 was roughly consistent with its long-run historical relationship with movements in nominal income and opportunity costs as traditionally defined—that is, the difference between rates on short-term instruments (for example, Treasury bills) and those offered on retail balances. This consistency suggests that, unlike the past few years, the slow growth in M2 last year was not the result of portfolio shifts toward bond and equity mutual funds. Indeed, the growth in M2 plus long-term mutual funds ran slightly below the 1 percent pace of M2 growth. Net sales of equity mutual funds continued at a high level in 1994, although the pace of sales slowed somewhat late in the year. Equity fund sales were partly offset, however, by outflows from bond mutual funds in the last three quarters of the year. Apparently, falling bond prices and greater market uncertainty, and, perhaps, reports of derivatives losses at some funds, led households to scale back their holdings of bond mutual funds in favor of investments that posed less risk of capital loss. With deposit rates lagging, however, these outflows did not translate into faster M2 growth. Some of the withdrawals from bond funds may have been invested directly in Treasury securities. Reflecting such portfolio shifts, net noncompetitive tenders for Treasury bills, which had been negative in 1993,

M2 Velocity and M2 Opportunity Cost



* Two-quarter moving average of 3-month Treasury bill rate less average rate paid on M2 components.

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Net Sales of Shares in Long-Term Mutual Funds*
Millions of dollars (monthly average)

Period	Total	Equity funds	Bond funds
Year			
1991	10,820	3,821	7,000
1992	16,844	7,268	9,576
1993	23,445	11,832	11,634
1994	9,674	11,073	-1,399
Quarter			
1994:Q1	17,438	13,744	3,694
Q2	10,128	10,935	-808
Q3	9,826	11,166	-1,340
Q4	1,306	8,447	-7,141

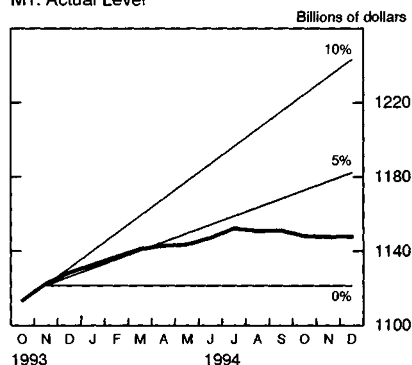
Source. Investment Company Institute.
*Gross sales of shares less redemptions.

totaled more than $16 billion last year, and net noncompetitive tenders for Treasury notes also increased substantially.[3]

Consistent with its historical behavior, M1 growth slowed sharply last year in response to widening differentials between market interest rates and those offered on transaction deposits. M1 expanded only 2¼ percent—down substantially from the double-digit increases recorded the previous two years. Following the typical pattern, demand deposits and OCDs were especially responsive to the rise in short-term interest rates. On balance, demand deposits edged up only ½ percent, compared with growth of 13¼ percent in 1993, as higher market rates encouraged deposit holders to economize on these non-interest-earning assets. In addition, the turnaround reflected the decline in home mortgage refinancing activity last year: Demand deposits had been boosted in 1993 because prepayments of securitized mortgages were held primarily in such deposits for a time before they were distributed. The rates offered on OCD accounts adjusted slowly to higher market rates last year, encouraging households to shift funds into higher-yielding assets. OCD growth also was depressed by the introduction of sweep account programs at some large banks. In these programs, the portion of customers' OCD balances in excess of a predetermined level are swept into money market deposit accounts at the end of each day.

In contrast to transaction deposits, the currency component of M1 continued to register strong growth last year. Currency increased 10¼ percent, the same rise as 1993 and close to the record increase in 1990. As has been the case since 1990, much of the currency growth appeared to reflect rapid expansion in U.S. currency circulating abroad. Informal reports suggest that foreign demand was particularly strong in 1994 in Russia and the other former Soviet republics.

M1: Actual Level



Foreign Exchange Developments

The trade-weighted foreign exchange value of the dollar in terms of the other G-10 currencies declined nearly 6½ percent on balance from December 1993 to December 1994. After displaying some strength at the start of 1994, the weighted-average foreign exchange value of the dollar fell about 10 percent from February through early November. Although U.S. growth continued to be stronger than expected, market perceptions about the strength of economic activity in the other industrial countries were also revised sharply higher as the year progressed. These changed perceptions led market participants to raise their expectations of market interest rates abroad, which, together with increased concerns over potential inflation pressures in the U.S. economy, put downward

3. The Treasury permits noncompetitive bids at its auctions to make it easier for smaller, less sophisticated bidders to participate. Those submitting noncompetitive tenders are assured of receiving the security, and the yield on the security they obtain is the average issue rate established at the auction. The level of net noncompetitive tenders during a period is the dollar volume of securities purchased under noncompetitive tenders less the volume of repayments of maturing securities that had been purchased under noncompetitive tenders.

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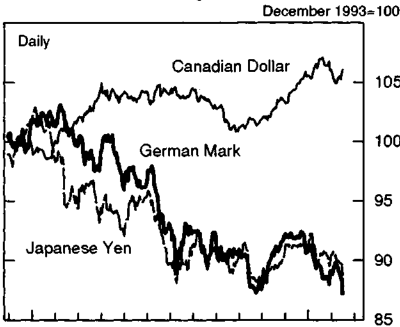
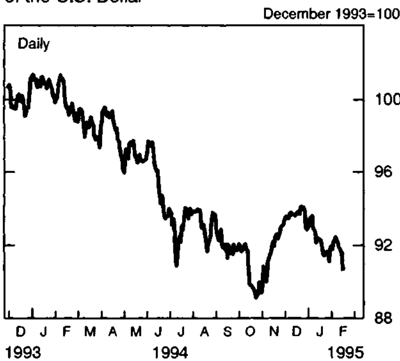
pressure on the dollar against most foreign currencies. The dollar rebounded somewhat at the end of the year as the greater-than-expected tightening action by the Federal Reserve in November reassured market participants that U.S. inflation risks were being addressed. In early 1995, however, with U.S. growth appearing to moderate, and the turmoil in Mexican financial markets raising concerns about possible implications for the United States, the dollar declined on balance, nearly reaching its fall 1994 low.

Selected Dollar Exchange Rates



Weighted Average Foreign Exchange Value of the U.S. Dollar *



*Index of weighted average foreign exchange value of the 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.

Long-term interest rates in major foreign industrial countries generally rose during the year. On average, yields on foreign government issues with maturities of ten years increased 200 basis points in the twelve months to December, about the same as in the United States. In Japan, where the evidence for a buoyant recovery remained somewhat mixed, long-term rates rose less. In contrast to long-term rates, foreign short-term rates were little changed on average and even declined slightly in several countries, including France and Germany. Major exceptions were Canada, where short-term market rates rose about 300 basis points, and the United Kingdom, where they rose 100 basis points. In both countries, official lending rates were increased during the year to contain inflation risks in the face of vigorous economic growth. During the first few weeks of this year, foreign long-term rates on average rose slightly further, but they have since retraced most of that rise.

During 1994, the dollar depreciated 8 percent in terms of the mark and declined by similar amounts in terms of the other currencies in the exchange rate mechanism (ERM) of the European Monetary System. The German economy expanded over the year, and the growth of the targeted monetary aggregate, M3, remained above target until the very end of the year. Market participants trimmed their expectations of further declines in official Bundesbank lending rates, and German long-term interest rates rose. The dollar depreciated by lesser amounts in terms of sterling and the lira, both of which had been withdrawn from the ERM in 1992. The persistent strength of the U.K. recovery raised concerns of renewed inflation pressures there, and the political uncertainties in Italy and, to a lesser extent, in the United Kingdom held back market enthusiasm for the two currencies.

The dollar also depreciated about 8 percent in terms of the yen during the year. At times, the dollar–yen rate fluctuated in response to developments in U.S.–Japanese trade talks. The dollar reached a historic low of 96.11 yen in November and was very weak against the German mark as well, and the Federal Reserve joined the U.S. Treasury in intervention purchases of dollars against yen and marks at that time. Subsequently, the dollar rebounded somewhat in terms of the yen and European currencies. In early 1995 the dollar weakened further, especially against the mark, in part because that currency attracted funds from markets upset by the peso crisis.

In contrast to its experience in terms of the ERM currencies and the yen, the dollar appreciated in terms of the Canadian dollar nearly 4½ percent during 1994. The relative weakness of the Canadian currency appeared to reflect pressures arising from the increases in U.S. short-term rates, concerns over the large fiscal deficits of the central government and the

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provinces and, at times, perceived risks associated with possible secession by Quebec. In the first few weeks of 1995, the Canadian dollar weakened further, as markets apparently became more concerned about the large outstanding Canadian federal and provincial debt and the persistent federal government deficit. As a result, market interest rates have risen further, and the Bank of Canada has moved up overnight rates several times, including an increase to match the upward shift in the U.S. federal funds rate following the most recent FOMC meeting. In response, the Canadian dollar strengthened, but more recently, has given up some of these gains.

The dollar depreciated nearly 5 percent in 1994 against the currencies of major U.S. trading partners in Latin America and East Asia when adjusted for relative changes in consumer prices. The dollar appreciated sharply against the Mexican peso, however, first in March and more significantly during the final two weeks of the year and in early 1995.

In response to continuing downward pressures on the peso and sizable losses of international reserves over the course of 1994, the Bank of Mexico announced on December 20 a 13 percent change in the lower bound of the range that it unilaterally had set for the peso–dollar exchange rate. The peso immediately fell to the new lower limit, from about 3.5 to 4 pesos per dollar, and reserve losses continued. As a consequence, the Bank of Mexico on December 22 permitted the peso to float and activated the North American Swap Facility, which provides up to $6 billion of short-term funds to the Bank of Mexico, evenly split between the Federal Reserve and the Treasury, and an additional C$1 billion from the Bank of Canada.

During the following days the peso remained volatile on exchange markets, fluctuating in a range between 5 and nearly 6 pesos to the dollar. On January 2, a package was announced totaling $18 billion in international financial support for Mexico, including an increase from $6 billion to $9 billion in the swap facilities extended by the United States (again split between the Federal Reserve and the Treasury), an additional C$500 million in the swap facility of the Bank of Canada, $5 billion in credit supported by other central banks acting through the Bank for International Settlements (BIS), and $3 billion in credit from commercial banks. On January 6 the IMF began talks with Mexico on a stand-by arrangement in support of Mexico's economic reform program, and on January 12, against the background of increased turbulence in international capital markets, the Clinton Administration, with the support of the bipartisan leadership of Congress, announced a proposal to provide $40 billion in guarantees on securities to be issued by Mexico in an effort to restore investor confidence.

Subsequently, the peso weakened further as support within the Congress for the guarantee proposal appeared to decline. The Mexican stock market also continued to slide, and short-term peso interest rates rose sharply. In late January the peso reached a new low of 6.55 pesos to the dollar amid signs that problems in Mexico were having effects on financial markets in other countries. In particular, equity markets in Argentina and Brazil had declined in volatile trading. More generally, investors appeared to be retreating from investments in a variety of emerging market economies, some of which have substantial current account deficits, while others maintain fixed exchange rates that pose the risk of becoming overvalued. On January 31 the Administration withdrew the request for approval of the guarantee program and, with the support of the bipartisan leadership of Congress, announced a new plan to provide $20 billion to support financial stabilization in Mexico using the resources of the Exchange Stabilization Fund (ESF) and, in the short run, the Federal Reserve. On February 1, the Federal Reserve's swap line with the Bank of Mexico was increased further to $6 billion as part of this package. The package will consist of short-term swaps, which will be provided by the Federal Reserve and the ESF, and swaps with maturities of three to five years and securities guarantees with maturities of five to ten years provided by the ESF. Repayment will be assured from the proceeds of exports of Mexican oil. Additional multilateral support for Mexico included an increase from $7.8 billion to $17.8 billion in the funds provided by the IMF under a stand-by arrangement that was approved on February 1 and an increase from $5 billion to $10 billion in the short-term credit supported by the central banks of a number of major industrial countries acting through the BIS.

The peso rebounded during the week following the announcement of the January 31 program and, on net, has since held most of that gain in volatile trading. Through mid-February, the dollar on balance has appreciated substantially against the peso since December 19, the day before the peso's devaluation.

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Growth of Money and Debt
Percent

Period	M1	M2	M3	Domestic Nonfinancial Debt
Year[1]				
1980	7.4	8.9	9.6	9.1
1981	5.4 (2.5)[2]	9.3	12.4	9.9
1982	8.8	9.2	9.9	9.6
1983	10.4	12.2	9.9	11.8
1984	5.5	8.1	10.9	14.4
1985	12.0	8.7	7.6	14.1
1986	15.5	9.3	8.9	13.5
1987	6.3	4.3	5.7	10.2
1988	4.3	5.3	6.3	9.0
1989	.6	4.8	3.8	8.0
1990	4.2	4.0	1.7	6.5
1991	7.9	2.9	1.2	4.6
1992	14.3	2.0	.5	4.7
1993	10.5	1.7	1.0	5.2
1994	2.3	1.0	1.4	5.3
Quarter (annual rate)[3]				
1994:Q1	5.5	1.8	.6	5.3
Q2	2.6	1.7	1.3	5.6
Q3	2.4	.8	2.0	4.4
Q4	−1.2	−.4	1.7	5.5

1. From average for fourth quarter of preceding year to average for fourth quarter of year indicated.
2. Adjusted for shifts to NOW accounts in 1981.
3. From average for preceding quarter to average for quarter indicated.

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James R. Irvine
1995 President

February 22, 1995

The Honorable Floyd Flake
Ranking Member
House of Representatives
Committee on Banking and Financial Services
Subcommittee on Domestic and International
Monetary Policy
1035 Longworth House Office Building
Washington, DC 20515

Dear Representative Flake:

I am writing on behalf of the 180,000 member firms of the National Association of Home Builders to express our serious concerns about the Federal Reserve's recent policy adjustments, and to offer our recommendations related to any future monetary policy moves. While we recognize the Federal Reserve's desire to fight inflation, we are also deeply concerned that the rapid rise in interest rates over the past year will prove to be too strong and result in a significant slowdown in the economy -- especially the housing sector -- in 1995 and, possibly 1996 as well.

Instead of letting the full effects of its previous interest rate hikes work their way through the economy, the Fed again bumped up rates on February 1. This was the seventh time the Fed has increased short-term interest rates in the past year, and we believe this move could threaten the overall economy. Since February 1994, the Fed has doubled the federal funds rate target from 3.0 to 6.0 percent. Commercial banks have matched the Fed rate increases and have raised the prime rate from 6.0 to 9.0 percent. This increase has affected the financing costs of builders who typically have floating rate loans tied to the prime rate. Our deepest concerns, however, relate to the impacts of Federal Reserve policies on the ability of Americans to buy homes and on the health of the entire economy.

Mortgage rates have moved up more than two percentage points over the past year to their current level of just under 9 percent. This translates into a $140 increase in the monthly payment on a $100,000 mortgage, an increase that has bumped out of the market thousands of young households trying to buy their first home. Higher interest rates are

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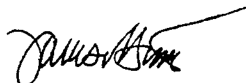
(SAAR) of 1.377 million. The single-family sector -- the most interest-rate sensitive segment of the industry -- is bearing the brunt of this slowdown. In January, single-family starts fell 12.3 percent to a SAAR of 1.072 million. This slowdown is consistent with our surveys of builders which have shown substantial deterioration in the condition of the single-family market since interest rates started to rise early last year. According to our latest monthly survey, builders' expectations of sales in the next six months are down. Just 15 percent of those surveyed in early February expect future sales of single-family homes to be good, down from 19 percent in January.

Moreover, there are other signs that the Fed's rate increases are starting to slow economic activity. The unemployment rate jumped 0.3 percentage point in January to 5.7 percent, and non-farm payrolls rose by only 134,000, about one-half the pace of previous months. Retail sales have slowed significantly over the past few months, and in January increased only 0.2 percent. Since consumer spending comprises nearly two-thirds of the gross domestic product, this could have a significant impact on overall economic activity.

Given the long and variable lags in the impact of monetary policy on the economy, we believe that the danger of policy overkill is substantial at this time. As we look to the future, we strongly urge the Fed to wait until the effects of its past moves are clear before considering any further rate hikes. While we agree that sustainable economic growth is an appropriate objective for the Federal Reserve, we believe that further policy adjustments should occur only when it is clear that the economy is generating genuine inflationary pressures. Unnecessary costs to housing and the economy from an overly aggressive policy clearly would be unacceptable to the American people.

As a demonstration of congressional opposition to further premature interest rate hikes, the National Association of Home Builders urges members of the House of Representatives to support a resolution sponsored by Representative Wynn (D-MD). This resolution expresses opposition to the Federal Reserve Board's continuing interest rate hikes until the effects of its past increases are clear.

Best regards,



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