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

ONE HUNDRED FOURTH CONGRESS

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CONDUCT OF MONETARY POLICY

WEDNESDAY, JULY 19, 1995

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

The subcommittee met, pursuant to notice, at 10:03 a.m. in room 2128, Rayburn House Office Building, Hon. Michael N. Castle [chairman of the subcommittee] presiding.

Present: Chairman Castle, Representatives Royce, Lucas, Metcalf, Chrysler, LoBiondo, Watts, Kelly, Ney, Fox, Flake, Frank, Kennedy, Maloney, Barrett, Fields, and Watt.

Also present: Representatives Leach, Roth, LaFalce, and Bentsen.

Chairman CASTLE. The subcommittee will come to order.

The subcommittee meets today to receive the semiannual 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, welcome back to the House Committee on Banking and Financial Services Subcommittee on Domestic and International Monetary Policy, probably the longest named committee you appear before.

Today we will have 5-minute opening statements by the members of the subcommittee who are present. In addition, some members of the Full Committee will sit with us this morning and they will be permitted to ask questions if they wish. As always, any prepared remarks presented will be accepted for the record.

As you know, Mr. Chairman, we are in legislative session even as we speak and we may have to occasionally break for votes. We will try to do that around the 10 minute mark and resume as quickly thereafter as the votes end over on the floor. I think you have been through this before. It's a necessary interruption that we have to sometimes live with.

By several definitions it might well be claimed that the projected soft landing has been achieved by the national economy. In the buildup to this point we have seen the Federal funds rate double from 3 percent to 6 percent in seven steps over the 13 month period from February 1994 to February 1995. Nearly 2 weeks ago a signal was sent to the markets via the lowering of the Federal funds rate by one quarter percent.

Pundits divide on whether the soft landing to slower growth has been achieved or the economy is being pushed back into recession.

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Reading the indicators at these junctures is at best a chancy business, so we will welcome any comments you care to make on what you see ahead with regard to inflationary pressures, the international value of the dollar and the future of interest rates, to name a couple of items.

In addition to the normal complaints from editorial writers regarding the policies of the Fed we are beginning to see arguments that the Federal Reserve may no longer be relevant as an institution. This argument is the opposite of those who fear your power to pump up or choke off economic expansions. Indeed, with the emerging market technologies and the ability to trade and transmit enormous sums around the world nearly instantaneously, this school asserts that the Fed is a toothless tiger that no longer influences a large enough part of the economy to matter.

This subcommittee will be inviting you back after the recess as we continue our exploration of the future of money and the payment system in the dawn of the age of electronic cash and stored value cards. We will open this investigation next week with testimony by private sector innovators and entrepreneurs in the field. This will be followed with another hearing involving the views of the Federal Reserve System, the IRS, the Financial Crimes Enforcement Network, the Secret Service, the Mint, and others concerned with the public policy questions raised by these new facts and technologies.

Since our last Humphrey-Hawkins hearing, this Congress has altered the expectation of the marketplace by largely enacting the Contract with America. This has reshaped economic realities by providing the prospect of a genuinely balanced Federal budget. Significant change also is underway with regulatory reform and major cuts in domestic and foreign spending that all must affect the Federal Reserve System calculus. Meanwhile the dollar appears to have bottomed out overseas and may even be demonstrating additional signs of strength relative to most foreign currencies. We would welcome any insight into how these new factors have shaped your perceptions or altered your models.

Your chairmanship of the Federal Reserve continues to be marked by unprecedented openness both with Congress and the public. This is most appreciated on this side, especially since I know that changing the culture at the Fed makes your life more difficult.

That concludes my opening statement. I will turn to Mr. Flake, the ranking minority Member for his opening statement.

[The prepared opening statement of Hon. Michael Castle can be found in the appendix.]

Mr. FLAKE. Thank you very much. Mr. Chairman, it is certainly my pleasure to welcome Chairman Greenspan to this Humphrey-Hawkins Act subcommittee hearing to discuss the Federal Reserve's conduct of monetary policy.

I also want to commend you, Mr. Chairman, for your leadership on the various issues of this subcommittee, those which we tackle today and those which we will tackle in the near future.

Some issues, like the Federal Government's role in minting and issuing currency, will directly affect the Federal Reserve's ability to manage and influence the Nation's economy. So I look forward to

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seeing the result of our next hearings as we move to discuss those issues.

Chairman Castle, I will be very brief in my comments, as I want ample time for Chairman Greenspan's testimony and questions from the subcommittee.

When we last welcomed Chairman Greenspan there had been a tremendous amount of concern about the impact of seven interest rate increases over the past year. My particular concern was the impact of these increases reflected in the housing market and the effect that these increases would have on affordable housing markets.

Although interest rates have decreased, I remain concerned about the availability of affordable housing units and note indicators for leasing and sales of existing housing along the eastern seaboard. Recent reports suggest that Boston, New York, and the District of Columbia have sagging residential rental markets. I hope to hear Mr. Greenspan's comment on housing availability and affordability.

Moreover, I would like to hear comments on the future projections on the average American's ability to find an affordable home.

Mr. Chairman, I have other questions for Chairman Greenspan, but for now I thank him in advance for his contribution and comments to the Committee and await the hearing of his testimony. I yield back the balance of my time.

Chairman CASTLE. Thank you, Mr. Flake.

Now we will go, alternating from side to side, through the various members who might wish to make opening statements.

Mr. Lucas.

Mr. LUCAS. No statement.

Chairman CASTLE. Mr. Metcalf.

Mr. METCALF. No opening statement.

Chairman CASTLE. Mr. LoBiondo.

Mr. LOBIONDO. Thank you, Mr. Chairman.

I would like to welcome Chairman Greenspan to the subcommittee. I am sure that we are all very anxious to hear what you have to say. I want to commend you, Chairman Greenspan, and the other members of the Federal Open Market Committee for your decision earlier this month to lower the Federal funds interest rate by 25 basis points.

While I am sure that Chairman Greenspan will not be able to give a clear indication of what is likely to come from the Fed in the future, I would hope that it would stick with its tradition of lowering rates by at least 75 basis points in an easing cycle. Given that the mortgage lending in my area does not appear to be increasing, I believe that lower rates could help those people who want to fulfill the American dream of owning a home while at the same time providing much needed jobs in the construction industry.

While lower rates may help our economy in the short run, they are not a long-term answer. They can only remain low so long as the economy does not show signs of inflation. I believe the long-term answer is a significant reduction in our Nation's crippling debt.

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I am particularly interested in hearing Mr. Greenspan's opinion of our efforts to reduce the Federal budget deficit. In the last Humphrey-Hawkins report I was pleased to read the Board's recommendation that both Congress and the Administration make further progress in reducing the Federal budget deficit.

As we work through the remaining appropriations bills this summer I believe that we must keep in mind that it is through reductions in government spending that we will see a reduction in long-term interest rates, which will then lead to increased productivity and higher standards of living for our children and grandchildren.

According to data from the Federal Reserve Bank of Philadelphia, important business sectors such as the fabricated metals industry are growing only slightly in my district as well as in your State of Delaware, Chairman Castle, while more significant growth is occurring in other parts of the Nation.

We are also seeing declines in other sectors such as industrial machinery, food, apparel and chemicals. Such information shows the crucial need for higher levels of productivity that come from lowering long-term interest rates as a result of the reduction of the budget deficit.

I would urge my colleagues to examine this and similar information that shows the necessity of acting today to rein in deficit spending before it is too late.

Thank you, Mr. Chairman, and I yield back the balance of my time.

Chairman CASTLE. Thank you very much, Mr. LoBiondo.

Mr. Kennedy.

Mr. KENNEDY. Thank you, Mr. Chairman.

Welcome, Mr. Chairman. It's nice to see you this morning. As you may recall, although it is probably hard to keep everybody up here straight, I have often felt in the past that the continuous raises that you have advocated in our interest rates were perhaps too much, too fast and too quick.

We have seen a number of economic indicators lately that have indicated that the interest rate increases that the Fed has pursued have in fact precipitated a real decline in the growth of the economy. The employment rate has fallen significantly since last fall. The number of workers filing new claims for unemployment compensation has increased. The blue chip economic forecast for real economic growth for 1995 fell to 2.9 percent. Housing starts have been declining since the fall. And there is, I think, still a very strong concern, although the stock market seems to continue to rise, that the underlying economy is not keeping pace with that kind of investment.

I would like you, and I am sure you will this morning, to address your ideas about the fact that while lowering interest rates by a quarter of 1 percent sends a signal, that perhaps at this point we need more than a signal, that what we need is a real lowering of the interest rates to get this economy moving.

I think there is enough sense that we are in sort of economic doldrums and that the overall economy has not had the kind of energy that had taken place in the previous couple of years, and that people are very, very concerned. Even last night on the news there

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were a number of people that were analyzing the market, saying that it has risen so quickly that it could decline very, very quickly.

It seems to me if you had a real drop in the stock market because people decided they wanted to take profits because the companies' performances couldn't actually keep up with the raises in stock value that you could end up in a very, very serious recession in a very short period of time.

I guess my basic point to you is that I think it was an important step to send a signal of reducing interest rates, but my feeling is that there should be very serious consideration given toward a real lowering of interest rates beyond a quarter of 1 percent.

Thank you for coming. I look forward to hearing your statement.

Chairman CASTLE. Thank you very much, Mr. Kennedy. We appreciate your comments.

Mrs. Kelly.

Mrs. KELLY. I have no statement at this time but reserve my right to add one to the record later.

Chairman CASTLE. Thank you.

Mr. Royce has just arrived. Do you wish to make an opening statement, Mr. Royce?

Mr. ROYCE. Yes. Thank you, Mr. Chairman. I just want to welcome Chairman Greenspan. I look forward to hearing his comments today.

What I would like to do is encourage you, Mr. Chairman, to speak to the issue of what we here in Congress are doing or should be doing to help achieve a stable growing economy without inflation. My own view is that the most important contribution that we could make to that objective would be to balance the budget.

As you know, the House has taken a major step in that direction by passing a budget resolution which puts us on a glide path to a balanced budget by 2002. I would be interested to hear whether you feel that that does in fact put us on the right path.

I believe that balancing the budget and then starting to pay down the enormous national debt would make your job easier just as it would ours. Balancing the budget will take pressure off interest rates, free up capital for private investment, improve the competitive position of American industry in the global marketplace, and reduce the economic pressure on ordinary American families.

For example, I noted recently that at present more than half the credit generated in the United States in loans go to Federal, state and local government. That obviously limits the availability of credit to the private sector. In fact, the same source indicated that only 6 percent of credit goes to private business expansion. Surely balancing the budget will improve this credit drought and give American businesses the capital they need to expand and create jobs.

Thank you again for joining us today, Chairman Greenspan, and thank you, Mr. Chairman, for allowing me to make that opening statement.

Chairman CASTLE. Thank you very much, Mr. Royce.

Mrs. Maloney.

Mrs. MALONEY. Thank you very much, Mr. Chairman. I would like to submit my opening statement for the record. I just would like to welcome the Chairman. I look forward to your comments, particularly any ideas that you have about what the Fed can do to

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improve the wage prospects of the average working American. They have not been improving. I look forward to any ideas that you have of how we can improve the prospects of the average working American family.

Thank you.

Chairman CASTLE. Mr. Leach, would you like to make any kind of a statement at this time?

Mr. LEACH. Mr. Chairman, no, but I do want to welcome Chairman Greenspan and say that a quick review of your testimony makes this the most understated optimistic statement of my time from a Federal Reserve Board Chairman. We welcome your testimony in that light.

Thank you.

Chairman CASTLE. We have two members with us who are not on the subcommittee, but in light of the fact some of the members are not here, if they want to make a brief opening statement, I think it might be appropriate. We will start with Mr. LaFalce and then we will go over to Mr. Roth.

Mr. LAFALCE. Thank you, Mr. Chairman.

Dr. Greenspan, it is always a pleasure. I hope at some time during your testimony you will address an issue of deep concern to me. I think the economy and the mix between fiscal and monetary policy is moving in the right direction. I think we have bottomed out of the decline of our dollar as opposed to other currencies, and so forth. So what is on the horizon that we should be concerned about?

While this is not directly within the jurisdiction of the Fed, you do have a strong voice as Chairman of the Fed to help affect it. That is a dynamic that is taking place right now in the Congress and a future dynamic that will take place with the President. Appropriations bills are being passed. It seems to me that these appropriations bills are so confrontational with what would be possibly acceptable to the President that if the bills are presented individually there is going to be a series of vetoes.

Come the end of September, beginning of October, I'm fearful that we will have very few appropriations bills passed and we might have to have continuing resolution of whatever duration. But also there will be an absolute imperative to increase the debt ceiling, and if we do not increase the debt ceiling, government will cease to function. Not only will government cease to function, but the bottom could drop out of the markets under those circumstances.

Also the new majority has a great many reforms of tremendous controversy, not only between parties but within parties, whether it's Medicare or Medicaid or welfare reform, and so forth. My big concern is that we could develop a crescendo here where all these bills are put in one package, a reconciliation package that will be totally unacceptable to the President, and he will be forced to veto it, but it will also contain an increase in the debt ceiling. This could produce a bit of a crisis in government which could have a very unsettling impact on not only domestic but international markets.

Therefore it is imperative that we proceed on these items individually, welfare reform individually, Medicaid, Medicare, whatever it might be, individually. The increase in the debt ceiling individ-

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ually. The appropriations bills or the continuing resolutions absent any other substantive changes individually, so as not to precipitate this crisis which in my judgment is probably the most serious thing on the horizon over the next several months.

I hope you will comment on that.

Chairman CASTLE. Thank you very much, Mr. LaFalce.

Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman. Mr. Chairman, I'm not a member of this subcommittee. I wish I was. I am interested in what the Chairman has to say and I want to thank you for allowing me to be here today. I have to run back and forth. International Relations Committee is marking up three bills. Thank you, Mr. Chairman. It's good to have the Chairman with us.

Chairman CASTLE. I know the feeling about running back and forth. I've done that too on a few committees in this building.

I believe that completes the opening statements of those present. If anyone else comes at a later time and wishes to submit an opening statement, it will be accepted unanimously for the record.

At this time, Mr. Chairman, we will turn off the clocks and we will turn to you, sir, for your statement following which I'm sure the various members will have questions. We do welcome you. We do appreciate the very difficult job that you have and the openness with which you do it, and we look forward to your testimony and thank you for being here today.

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

Mr. GREENSPAN. Thank you, Mr. Chairman. I very much appreciate those remarks. It's a pleasure, as always, to appear before this subcommittee to present the Federal Reserves' semiannual report on monetary policy.

In February, when I was last here for this purpose, I reported that the U.S. economy had turned in a remarkable performance in 1994. Growth had been quite rapid, reaching a torrid pace by the final quarter of the year, when real gross domestic product rose at a 5 percent annual rate and final sales increased at a 5¾ percent rate. Inflation had remained subdued through year-end, although productive resources were stretched. The unemployment rate had fallen to its lowest level in years, while manufacturing capacity utilization had been pushed up to a historically high level.

As I indicated in February, a slowing of economic growth to a more sustainable pace with resource use settling in around its long-term potential was required to avoid inflationary instabilities and the adverse consequences for economic activity that would invariably follow.

After posting three straight years of consumer price increases of less than 3 percent for the first time in decades, inflation seemed poised to move upward. Reflecting market pressures, prices of raw materials and intermediate goods had already risen considerably, and a surge in the prices of a variety of imported goods could be expected to follow the weakening in the dollar through early 1995.

Monetary policy tightenings over the previous year had been designed to foster the type of moderation in final demand that would help damp inflation pressures going forward and sustain the eco-

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nomic expansion. When we began the policy tightening process, we knew the previous drags on the economy stemming from balance sheet stresses and restraints on lending were largely behind us. But that still did not make it a simple matter to gauge just what degree of firming in reserve market conditions would be necessary to produce a financial environment consistent with sustainable economic growth. In the event, the Federal funds rate was raised to 6 percent as the surprising strength in the economy and associated pressures on resources required a degree of monetary policy restraint to ensure that inflation would be contained.

Fortunately, we started the tightening process early enough and advanced it far enough that monetary restraint began to bite before some potential problems could assume major proportions. With inadequate monetary restraint, aggregate demand could have significantly overshot the economy's long-run supply potential and created serious inflationary instabilities.

Moreover, the perceived capacity constraints and lengthening delivery times that come with an overheated economy could have fostered the development of more serious inventory over-accumulation. In such circumstances, the longer the moderation in output growth is delayed, the larger will be the inventory overhang and the more severe will be the subsequent production correction.

As hoped, final sales slowed appreciably in the first quarter of this year, but inventory investment didn't match that slowing and overall inventory-sales ratios increased slightly. Although the aggregate level of inventories remained modest, a few major industries, such as motor vehicles and home goods, found themselves with substantial excesses. Attempts to control inventory levels triggered cutbacks in orders and output that inevitably put a damper on employment and income.

How the ongoing pattern of inventory investment unfolds is a crucial element in the near-term outlook for the economy. Production adjustments could fairly quickly shut off unintended inventory accumulation without a prolonged period of slack output—one that could adversely affect personal incomes and business profitability, which in turn could undermine confidence and depress spending plans.

Under these conditions, final sales should continue to grow through and beyond the inventory correction, leading to sustained moderate economic expansion. But a less favorable scenario certainly cannot be ruled out. The inventory adjustment could be extended and severe enough to drive down incomes, disrupt final demand, and set in motion a period of weak growth or even a recession.

Useful insights into how an inventory correction is proceeding often can be gained by evaluating developments in industries that supply producers of final durable products with key primary inputs, such as steel, aluminum, and capital equipment components and parts. This is because inventory adjustments often are larger in durable goods and they become magnified at progressively earlier stages in the production process. Typically, when purchasing managers for durable-goods producing firms find their inventories at excessive levels, they reduce orders for materials and also for

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components of capital goods, and as a consequence suppliers shorten promised delivery times and cut back on production.

In the current instance domestic orders for steel and aluminum and for some capital equipment components have weakened, but not enough to have had more than modest effects on production. Prices of key inputs also suggest that demand so far is holding up and the inventory correction is contained. The price of steel scrap, for example, has not fallen, and spot prices of nonferrous metals on average have stabilized recently after considerable weakness in the first part of the year. Though still lethargic, the behavior of durable goods materials and supplies markets scarcely evidences the type of broader inventory liquidation that usually has been at the forefront of the major inventory recessions of the past.

At the finished goods level, we experienced significant inventory liquidation in both cars and trucks in May and June. We do not have comprehensive, up-to-date inventory evaluations for recent months as yet, but inferring what we can from scattered and partial data, the prospects seem reasonably good for a reduction in inventory investment that moves us a considerable way toward eliminating unwanted stocks.

That process and the longer run outlook for the economy depend ultimately on the behavior of final sales. In that regard, the slowing of the growth of final sales that began in the first quarter seems to have continued a little further in the second quarter. Combining final sales and the likely reduced second quarter pace of inventory investment, the level of overall domestic production of final goods and services, or real gross domestic product, evidently changed little last quarter.

Going forward, of the several credible outlooks, the most probable is for an upturn in the growth rate of final sales and real gross domestic product over the rest of this year and a moderate pace of expansion next year with the economy operating in the neighborhood of its potential.

One area of improvement should be our external sector. A significant downside risk when I testified in February related to the situation in Mexico. The economic contraction in that country and the depreciation of the peso did act to depress our net exports in the first half of the year. But with the external adjustment of the Mexican economy apparently near completion, this drag should be largely behind us. Moreover, our trade with the rest of the world should begin to impart a positive impetus to our economic activity, partly because of the strong competitive position of U.S. goods in world markets.

Regarding domestic final demand, financial developments so far this year should provide important support over coming quarters. Interest rates, especially on intermediate- and long-term instruments, have fallen a great deal since last fall in reaction to the improved fiscal outlook, the effects on inflation expectations of our earlier monetary tightening, and, of course, recently, the slowed economy. Lower interest rates have helped to buoy stock prices, which have soared ever higher.

The positive implications of the rally in financial markets for household debt-service burdens and wealth and for the cost of capital to business augur well for spending on consumer durables, on

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housing, and on plant and equipment. These influences should be reinforced by the generally strong financial condition and the willingness to lend of depository institutions as well as the receptiveness of capital markets to offerings of debt and equity.

Early signs of a little firming in consumer durable spending are already visible in the stabilization of the motor vehicle sector. Residential construction also has started to revive, judging by recent data on home sales and mortgage applications. Unfilled orders are sizable in the capital goods area, suggesting business investment in equipment will continue growing, albeit perhaps more slowly than in the recent past. Finally, rising permits suggest expansion in nonresidential construction.

An outlook embodying a resumption of moderate economic growth is conveyed by the central tendencies of the expectations of the Federal Reserve Governors and Reserve Bank Presidents for real gross domestic product. After the second quarter pause, a projected pickup in activity in the second half would put output growth over the 4 quarters of the year in the neighborhood of 1½ to 2 percent. For next year, projections of real GDP growth center on 2½ percent.

The inflation picture is less worrisome than when I testified 6 months ago, just after our last policy tightening. Demands on productive resources should press less heavily on available capacity in the future than we envisioned in February. This prospect is evident in the central tendency of the expectations of the Governors and Presidents for the unemployment rate in the fourth quarter of this year, which has been revised up from about 5½ percent in February to a range of 5¾ to 6⅛ percent. This outlook for unemployment has been extended through next year as well. Increases in employment costs to date have been modest, and labor compensation evinces few signs of exacerbating inflation pressures, although the recent unusually favorable behavior of benefit costs is unlikely to continue.

Declines in industrial output over recent months have already eased factory utilization rates closer to their long-term averages. Reflecting a slowing in foreign industrial economies as well as in the United States, the earlier surge in prices of materials and supplies has tapered off. Moreover, the stability of the exchange value of the dollar in recent months bodes well for an abatement of the recent faster increases in import prices.

Against this background, most Governors and Presidents see lower inflation over coming quarters than experienced in earlier months of 1995. The central tendency for this year's 4 quarter rise in the CPI is 3⅛ to 3⅜ percent. And for next year the central tendency suggests that CPI inflation will be shaved to 2⅞ to 3¼ percent.

The success of our previous policy tightenings in damping prospective inflation pressures set the stage for our recent modest policy easing. Because the risks of inflation apparently have receded, the previous degree of restriction in policy no longer seemed needed, and we were able at the last meeting of the Federal Open Market Committee to reduce the Federal funds rate by ¼ percentage point to around 5¾ percent.

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Indeed, inflation pressures were damped somewhat more quickly than we might have expected. This experience underlies the uncertainties and risks in any forecasting exercise. The projections of the Governors and Presidents are for a rather benign outlook, as are the views of many private sector forecasters. But these expectations cannot convey the risks and subtleties in the developing economic situation.

A month or so ago I noted publicly that a moderation in growth was both inevitable and desirable, but that the process could not reasonably be expected to be entirely smooth, and that accordingly the risks of a near term inventory-led recession, though small, had increased. More recent evidence suggests that we may have passed the point of maximum risk, but we have certainly not yet reached the point at which no risk of undue economic weakness remains.

We do not as yet fully understand all the reasons for the degree of slowing in economic activity in the first half of the year, so we need to be somewhat tentative in our projections of a rebound. Imbalances seem to be limited, financial conditions should be supportive of spending, and businesses and consumers are largely optimistic about the future. Nonetheless, questions do remain about the strength of demand for goods and services, not only in the United States but abroad as well.

Upside risks to the forecast also can be readily identified, particularly if the inventory correction is masking a much stronger underlying economy than appears from other evidence to be the case. If so, spending could strengthen appreciably, especially in light of the very substantial increases in financial market values so far this year.

In a transition period to sustainable growth such as this, reactions to unexpected events may be especially pronounced. This is not a time for the Federal Reserve to relax its surveillance of and efforts to analyze the evolving situation. The Federal Reserve must do its best to understand developing economic trends. While we cannot expect to eliminate cyclical booms and busts, human nature being what it is, we should nonetheless try where possible to reduce their amplitude.

Some observers have viewed prospective year-by-year budget deficit reduction as constituting an important downside risk to the economy. I do not share this concern. In response to fiscal consolidation, financial markets provide an important shock absorber for the economy. Declines in long-term rates help stimulate private, interest-sensitive spending when government spending and transfers are reduced.

Clearly the Federal Reserve will have to watch this process carefully and take the likely effects of fiscal policy into account in considering the appropriate stance in monetary policy. But there is no doubt, in my judgment, that the net result of moving to budget balance will be a more efficient, more productive U.S. economy.

In summary, Mr. Chairman, the economic outlook on balance is encouraging despite the inevitable risks. The American economy rests on a solid foundation of entrepreneurial initiative and competitive markets. With the cyclical expansion more than likely to persist in the period ahead, the circumstances are particularly opportune for pressing forward with plans to institute further signifi-

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cant deficit reduction. For such actions, by raising the share of national saving available to the private sector, should foster declines in real interest rates and spur capital accumulation. Higher levels of capital investment in turn will raise the growth in productivity and living standards well into the next century.

The Federal Reserve believes that the main contribution it can make to enhancing the long-run health of the American economy is to promote stability over time. Our short-run policy adjustments, while necessarily undertaken against the background of the current condition of the U.S. economy, must be consistent with moving toward the long-run goal of price stability. Our recent policy action to reduce the Federal funds rate 25 basis points was made in this context. As I noted in my February testimony, easing would be appropriate if underlying forces were clearly pointing toward reduced inflation pressures in the future. Considerable progress toward price stability has occurred across successive business cycles in the last 15 years. We at the Federal Reserve are committed to further progress in this direction.

Thank you very much, Mr. Chairman. I request that my full transcript be included for the record.

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

Chairman CASTLE. Thank you very much, Mr. Chairman. Without objection, your full transcript will be included for the record. We appreciate that. We know those words are meaningful, and when spoken by you they come together very neatly.

We will now proceed with questioning. We will resume the clocks. Each of us will have 5 minutes. The general rules are that you can say what you wish in those 5 minutes, at which point we are quiet, and if you still need to respond, you can, or we go on to the next person. I will start with the first question.

I want to relate back to when you were here last February. You painted a picture of an economy whose growth was slowing from the fast pace of the fourth quarter of 1994, but you reassured us that "nevertheless, the economy has continued to grow without seeming to develop the types of imbalances that in the past have undermined ongoing expansion."

Later in your testimony, in reference to your forecast for 1995, you said, "but overall the performance of the economy still should be good."

By my observation, over the past 3 months total employment in the United States has fallen by nearly 600,000, industrial production has fallen 3 of the last 4 months, and GDP growth for the second quarter will either be very weak or, using your words, marginally negative. What happened between February and July to produce an outcome that at least seems so drastically different from your reassuring forecast?

Mr. GREENSPAN. Mr. Chairman, when you are dealing with a very rapidly moving economy as we experienced in the latter months of 1994, and you are putting pressure on it to slow it down to get it back on track so that the expansion can continue, it is not easy to make judgments as to precisely how that is going to come out. It's very much like trying to brake a car when you are coming up to a particular stop. Sometimes you move from side to side, and

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you can't predict that in advance. As I said in my prepared testimony, I think that the economy slowed faster than we expected, considering the way we had imposed a degree of monetary tightening and the balance of forces that we were looking at.

As a consequence of that, we got a quicker response than we had expected, but it is certainly by no means outside the relative areas of response that we had anticipated, and it certainly was not a difference in response qualitatively; it was just faster, not different.

Chairman CASTLE. I referenced this in my opening statement. One of the fascinating developments of the last few years, indeed the last few months or even weeks or days, has been the rapidity with which large amounts of money can be transferred from country to country. This has been complemented by the development of many new financing media which serve as substitutes for the more traditional financing media furnished by banks.

Have these two developments complicated or diminished in any way the conduct or effectiveness of monetary policy, or will they in the future? I am sure it is something that is the subject of a lot of discussion. If so, how?

Mr. GREENSPAN. Mr. Chairman, we are acutely aware of the very rapidly changing payment system, both in international finance and in the internal structure which has evolved in the United States. We exercise monetary policy by having a certain leverage on the system. We are the lender of last resort. The Federal Government is the only entity which can create legal tender. As a consequence of that, there are a variety of different means by which the central bank can create an effective monetary policy.

Over the decades and even in recent years, we have gradually changed the procedures we employed to exercise that monetary authority as the structure of the financial system changes. I suspect that we will do so in the future, and it will be dependent upon the nature of the changes that will be evolving over time. But I see no reasonably contemplatable notion that somehow or by some means our leverage will be reduced or eliminated.

Chairman CASTLE. Thank you, sir.

On a different subject, my final question. As you well know, there have been several competing tax reform programs introduced in the 104th Congress. Does the Federal Reserve or do you individually favor significant changes to the income tax systems? Do you support any of the following specific proposals?

A 17 percent flat tax on earned income and the elimination of all deductions and credits.

A national sales tax on goods and services.

A 10 percent tax rate for families earning up to about $60,000 with families earning more paying progressively higher rates, topping out at 34 percent. This plan would eliminate all deductions except for mortgage interest and would tax money spent on charitable contributions and state and local taxes. Sort of a progressive simplified tax, I guess.

Mr. GREENSPAN. Mr. Chairman, we at the Federal Reserve do not, as you might suspect, have any policy position with respect to any of these initiatives. Nonetheless, we obviously examine them in some detail, especially if we perceive that they may well be enacted at some point, because clearly our monetary posture must take into

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consideration all various aspects of how the economy is behaving in addition to the issues I raised in the answer to the previous question.

I can't give you an answer with respect to how any of us view personally these various different tax initiatives, but I will tell you we are watching the process quite closely.

Chairman CASTLE. Thank you, Mr. Chairman. The answer seems to be you can't give me an answer. I'd love to know what your answer would be if you could give us an answer, but I know you can't, sir.

Mr. Flake.

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

You probably noted or received information regarding the home loan mortgages to minorities which surged in 1994, which has been revealed today in the *American Banker*. There are suggestions that one reason for this increase of loans has much to do with approaches to CRA. You as the Fed Chair, joined with other regulators, have done an extensive bit of work over the last several years. Larry Lindsey, who represented the Fed in the community reinvestment area, and others have traveled the country, and have made some determinations in terms of the direction that CRA ought to go. Yet there are many, even in this body, who have fought to repeal community reinvestment as we know it.

Mr. Chairman, given these statistics, which are very good and glowing statistics, would you suggest that this is not the time to repeal CRA, but rather to let the process that you and others have been working with over these last several years run its course, and see if that will indeed get an even greater and glowing report in the future?

Mr. GREENSPAN. Congressman, let me say that I clearly found the results that were published quite encouraging. They do show a significant change. The numbers that we are looking at, as my colleague Governor Lindsey has said, are startling economic statistics. The orders of magnitude are quite substantial. I must say I concur in his view.

In my judgment, it clearly indicates that the banking community is reaching out beyond its normal historic areas of interest in making loans. As you know, under the very extensive restructuring that we regulators have been implementing in the last year or so we have come up with a new approach to trying to implement CRA in an effective manner. And we are doing that because that is what the Congress stipulates in the law we should be doing, and we will continue to do that.

We as an organization, as I indicated before with respect to the question that the Chairman raised about taxes, have tended not to focus specifically on congressional initiatives. Our job is to fulfill the legal statutes as promulgated.

If you are asking me, do I think that we are making progress in this whole area, for a wide variety of reasons, I would say most certainly, yes. I am quite pleased with the progress that is being made. It is slow; it is not in some cases the way I would like it; but we are dealing with a very turgid, difficult problem.

I would suggest to you that one of the consequences of the public discussions on these issues in recent years has been to make the

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banking community, more importantly, the depository institution system, quite sensitive to the issue that they are really obligated to make loans throughout their communities and that they should avoid the deleterious effects on society as a whole of the forms of discrimination, covert or otherwise, which were undercutting the financial system.

As I have stated many times in the past, I think it is a crucial aspect of a free market capitalist institution that discrimination not be involved in the marketplace because it undercuts the efficacy of that.

I think the banking and other depository institutions are beginning to understand that process and are working in that direction. Without commenting specifically on any legislative initiative, I have a suspicion that that thrust is going to continue forward, because everyone is beginning to realize it's in the Nation's interest and indeed in the interest of the financial community as well.

Mr. FLAKE. I wholeheartedly agree. I guess my concern becomes one of, if you do not have the benefit of legal statutes, that might well be reversed. Will the banks continue to perform as they have? I'm certain from the relationship I've had with you and with the other regulators that you will continue to try to assure that discrimination does not apply to lending practices.

Mr. GREENSPAN. That's the law of the land, Congressman, as you well know, and as far as we are concerned we move in every way that we can to make certain that the discriminatory practices, especially the more subtle ones which are not necessarily conscious, do not prevail.

Mr. FLAKE. Thank you. My time has expired. I will have other questions if we get a second round. I yield back, Mr. Chairman.

Chairman CASTLE. Thank you very much, Mr. Flake.

Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman. I too appreciate the opportunity to be here to listen to this report on the state of the economy.

Chairman Greenspan, most Members of Congress have concerns that are tied closely to their district, and certainly I am no different. In my case, even though 40 percent of my constituency is urban in nature, I represent otherwise a very predominantly rural and agricultural district.

I also have the privilege of serving as a member of the Agriculture Committee where we are in the process of drafting the 1995 farm bill.

In light of the potential impact that this public policy could have on rural economies, I can't help but think back to my days as an undergraduate student in agricultural economics at Oklahoma State. I well remember my old ag econ policy professor. He was a very young man now that I think back, but I think of the gentleman's lectures about how in his perspective the Great Depression began first perhaps in 1927 in rural America, and it was his view that the economic conditions that severely impacted my grandparents began with a general decline in farm commodity prices at that time, and consequently rural America went through a very, very difficult period long before it made it to the rest of America in 1929 and 1930.

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With all of that in mind, I would like to refer to the Fed's June report on the current economic conditions where it indicated that crop yields were expected to be below normal and that bankers had reported an increase in farm loan refinancing requirements. Of course, with lower crop yields come higher prices, but you have to have a commodity to sell whatever the price may be.

I can't help but think about the potentially dramatic cuts in the farm bill reauthorization we are working on. Those potential cuts come from both sides of the aisle. That's not a partisan issue.

My personal concern is that if this safety net is removed, it will perhaps not only jeopardize our Nation's food supplies but the economy of rural America also. I suppose more directly, what are the implications of substantial, maybe even dramatic cuts in the farm bill reauthorization, and what would the effect be on this Nation as a whole if through our actions on Capitol Hill we produce, heaven forbid, a dramatic downturn in the rural economies in this country?

Mr. GREENSPAN. Congressman, I don't want to be a continuous unanswering witness here, but as I indicated to the Chairman and then to Mr. Flake, we should not as an institution get involved in commenting on specific pieces of legislation unless we are directly involved in the process of implementing that legislation as a primary responsibility of the Federal Reserve.

I grant you it is a very narrow line and it's not an easily sharply definable issue, because we, as the central bank, are involved in a lot of different things. Hopefully we are going to try to succeed in that through what is going to be a very major debate in this country on all various different pieces of legislation that arise as a consequence of the very laudable endeavor to reduce the budget deficit, and hopefully get it to zero.

That is important to us because we are involved in the financing of the Treasury debt. To that extent, it's the size of the financing that is crucial to us, not the issue of what tax receipts are, what expenditures are, and what the various programs are.

I would be delighted at some point to get involved in discussing the farm economic outlook and the various different aspects of it, but what I don't want to do is get involved in any way or come out on one side or the other of what will be an extraordinarily interesting debate on a number of the programs which this government is involved with.

The one thing I think we are very clear on is that if we have all of these programs in place, which is currently the case, the American people are supportive of them, all of them, because indeed if they were not, since we have a very effective democracy, they wouldn't be in the budget. The problem is not the lack of support of the programs that are in the budget, it's the fact that when you add all of the programs up and look at the resources that we have to finance, we have an arithmetical problem.

All I say to you, without obviously addressing your specific question very purposely, Congressman, is that I hope we come to grips with this basic issue and resolve the budget problem. While I'm convinced that every person in the Congress has got certain things they would hope will not be touched, if we all kept to that view, the laws of arithmetic would have to be violated if we are going to

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get to a balanced budget. So I beseech you to recognize that the issues you are raising are very legitimate questions, but the problem is a much larger one that we have to deal with.

Mr. LUCAS. Thank you, Chairman Greenspan. If there is a second round, I would love to have an opportunity to ask a different question.

Mr. GREENSPAN. I'll be glad to discuss the price of wheat, corn or soybeans, anything you want, up to a point.

Chairman CASTLE. Thank you, Mr. Lucas. I will let you guys discuss all those prices.

Mr. Frank.

Mr. FRANK. Thank you.

Mr. Greenspan, first, relevant to your discussion with Mr. Flake, I want to express my appreciation for the testimony and letter Governor Lindsey sent us in which he talked about the interaction between things like community reinvestment and safety and soundness and reassured us that there was no evidence that the legislation undercuts it. That was very helpful. I assume we are now talking about some legislation where you do have some responsibility, and I take your answer to Mr. Flake to mean that you believe that the statutes ought to stay in place in terms of nondiscrimination.

Mr. GREENSPAN. The issue that I want to emphasize is that the efforts that we, the Federal Reserve and the other agencies, are involved with in reducing discrimination have got to move forward under any set of circumstances, and they will. But I don't want to comment on any specific pending legislation before this body.

Mr. FRANK. You have perfected the one-way ratchet. You are not able to comment on anything you don't want to talk about but you do manage to get into things that you want to, and that's fine. [Laughter.]

Mr. GREENSPAN. That's why I said it's a very fuzzy line.

Mr. FRANK. There are statutes that you administer. I assume it's OK for you to comment. Do you think that we should leave those statutes in place that give you that mandate on anti-discrimination? Absent those statutes, you wouldn't have an anti-discrimination mandate.

Mr. GREENSPAN. No. I'm not sure that I agree with that.

Mr. FRANK. Where would you get it?

Mr. GREENSPAN. The point is that we have a number of various different statutes that exist for anti-discrimination and the like which enable us to do a lot of things.

Mr. FRANK. I would like you to tell me in writing which ones you think should be maintained and which ones repealed.

Mr. GREENSPAN. Are you asking the Federal Reserve Board?

Mr. FRANK. Right. I would ask you to tell me in writing, of the statues that mandate you to do various anti-discrimination enforcement, if there are any you think should be repealed and which ones should be maintained.

Mr. GREENSPAN. I'll be glad to do that.

Mr. FRANK. Beyond that, you talk about our democracy. I think it does work very well in most areas, but unfortunately, I think you and your predecessors out of the best of motives have impaired democracy in one of the most important parts of our life, and that's

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the economy. The Federal Reserve has become quite strong. It has survived a lot better than a lot of other political institutions.

You, like most previous Federal Reserve leaders, see inflation as the major problem. As I read your testimony, for instance, we have a problem with the standard of living, the wages of workers, but the wages of workers here appears negative. For instance, on page 8, it is a good thing that "labor compensation evinces few signs of exacerbating inflation pressures," that is, it's a good thing wages aren't going up very far.

Mr. GREENSPAN. That's nominal wages. That is not real wages. That is a very important distinction.

Mr. FRANK. It is an important distinction, but the fact is that real wages have been suffering for a lot or workers, and that is a positive in the Fed's overall approach, and the problem we have is this. You have managed to create a situation in which——

Mr. GREENSPAN. The fact that real wages in certain segments of our society have not moved forward is not a positive.

Mr. FRANK. I read everything I got here today. I don't see any concern about that. The fact is that the only reference to wages is to talk about it's a good thing if they don't go up. It may be that personally and individually you regret that. You are here under the Humphrey-Hawkins Act, which deals with employment, but there is nothing in here about employment. There is nothing in here about saying we have a problem. The fact that unemployment is going to be in a higher range in context appears to be a positive thing. There is nothing in here which addresses that problem. Not a word in the testimony and not a word in the report.

The problem is this. With the power the Federal Reserve has garnered you have become a very powerful force for holding things down. You are saying that we grew too fast, we created too many jobs on a net basis over the past couple of years. Unfortunately, there is nothing in here that talks about the negative social consequences of that. I think we are on the way where you have the strength that you have as an inflation fighter and don't have any institutional concern about these other factors.

I understand you believe in the long run we will be better off. In the long run we will all be dead, and the fact is that the negative social consequences of that kind of erosion which goes unremarked in your testimony and which your policies in the short term exacerbate are very negative for this country.

Mr. GREENSPAN. I can't disagree with you more, Congressman. It has been our experience over the years that if our purpose is to get a stable, growing economy in which we can achieve increasingly higher standards of living for not only ourselves—we will all be dead eventually, I grant you—but for our children and generations thereafter, if that is our purpose, it is very clear that maintaining a stable currency, and maintaining a stable non-inflationary environment is a necessary condition for achieving that. It is only the central bank which has the ultimate capability of making certain that the degree of inflationary excess engendered by financial conditions can be contained.

So if you are saying to me that we are strongly focused on holding down the inflation rate, I grant you that, and that is basically what we are all about, but I would disagree with you if you pre-

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sume that the ultimate focus is not, as I have stated many times in the past, the maintenance of sustainable long-term economic growth at the greatest potential that we can have.

Mr. FRANK. What I am saying is that operationally I think your means have eaten your ends and that given the role that you play in the economy, that has been the effect. I hope we will have a second round to pursue it.

Chairman CASTLE. Thank you very much, Mr. Frank. Let me just say, Mr. Chairman, referring to your earlier comments and Mr. Frank's response, if you perfected that you can't talk about anything you don't want to but can if you do want to talk about it, you should consider running for Congress. It would work well here.

Mr. Metcalf.

Mr. GREENSPAN. The opening statement, I will say I partly agreed with the Congressman. He's partly right on that. It was the rest of his discussion.

Mr. FRANK. Besides, I don't think he wants to step down that much in power and run for Congress. [Laughter.]

Chairman CASTLE. I can understand that.

Mr. Metcalf.

Mr. METCALF. Thank you.

Chairman Greenspan, in your opening statement you mention Mexico. About 6 months ago you and I discussed the proposed $20 billion bailout or backing for Mexico. You might remember that I was pretty vigorously opposed or had deep reservations about that. About how much of the $20 billion that was finally allotted from the exchange stabilization fund has been expended and might there be more?

Mr. GREENSPAN. Out of the ESF it's $11.5 billion and an additional $1 billion in swap arrangements with Mexico. You'll have to ask the Secretary of the Treasury the second part of the question.

Mr. METCALF. Thank you.

From the view of hindsight, how do you view what we did relative to Mexico? Good? Bad? Indifferent? How would you rate it?

Mr. GREENSPAN. Congressman, as I described it at the time, I thought it was the least worst of the various alternatives that confronted us. In the event, it has turned out somewhat better than I would have anticipated. It has by no means completed the task. There are a lot of gyrations and various other things which inevitably will occur as Mexico works its way back to full stability. But I don't think there is any question that to date it has gone well and indeed probably somewhat better than I would have anticipated.

Mr. METCALF. Better than I had hoped too, frankly.

You mentioned the lower inflation. I think you mentioned CPI of about 2⅞ to 3¾ percent. As I mentioned to you in our discussion in February, I felt that encouraging foreign entities to help in the financing of U.S. debt was a pretty big factor along with fighting inflation. I would like to know, in light of the lowering of the CPI, and so forth, if lowering interest rates would be a possibility.

Mr. GREENSPAN. I'm sorry. In the context of what?

Mr. METCALF. Of the lowering of the CPI. In other words, right now inflation is not churning, and maybe we could look forward to lower interest rates.

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Mr. GREENSPAN. What the evidence very clearly suggests is that the expectation of inflation over the maturity of a debt instrument is a very important factor in determining what the nominal interest rate is. If we continue to get improvements in the inflation outlook, that will be continuously reflected in lower long-term nominal interest rates. It's a process which works back and forth, as you well know, Congressman, and it's not a smooth operation.

To the extent that the markets and businesses no longer perceive inflation as something which they have to take into consideration in making long-term economic judgments, then there is a tendency for the inflation premium, so to speak, to be expunged from the nominal long-term rates, and the rates accordingly turn out to be lower.

Mr. METCALF. Let's put it this way. At the time that the rates were very low we were having trouble selling the debt and getting help on financing the debt. It seems to me that that is pretty agreed. Can you assure us that that won't be a factor in considering the lowering of the interest rates? I'm in favor of lower interest rates, obviously.

Mr. GREENSPAN. Congressman, I'm not aware that we have very many difficulties in selling the Federal debt at lower interest rates. Indeed, if we did, rates would move up, because essentially what the Treasury does is to offer Treasury bills, notes and bonds in the marketplace. It determines the amount that it is offering basically as a consequence of the difference between receipts and expenditures, and it can't really control that amount of financing. So the interest rates are set at those levels at which the purchasers of debt instruments, not only Treasury instruments but all debt instruments, are willing to pay for the instruments. It's the market which sets those rates.

I don't envisage any conditions, other than very technical issues with respect to certain types of instruments, of the Treasury experiencing any problems whatever, in the short run, at least, in financing its debt. I do think that the issue that I've raised in previous testimonies, that is if we allow the budget deficit to maintain the path that is implicit in the current service budget well into the 21st century, I do think that interest rates that the Treasury will have to pay in order to sell those instruments would go up very significantly.

Mr. METCALF. I very much agree with you. Thank you.

Chairman CASTLE. Thank you, Mr. Metcalf.

Mrs. Maloney has just returned, but perhaps we should go to Mr. Watt and then come to Mrs. Maloney.

Mr. WATT. Thank you, Mr. Chairman.

Chairman Greenspan, I apologize for being in and out during the course of your testimony. I'm trying to participate in the Waco hearings at the same time I'm doing this. I did, however, have a couple of areas that I wanted to make inquiry about.

Most of your testimony, probably reflective of your position, deals with a long-term perspective. I want to deal with a couple of short-term impacts of the policies that may, as you represent, be positive long term but in the short term we represent a number of people who are suffering some of the consequences of those policies.

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As I recall, at a prior time when you testified before this Committee or another committee, you indicated that it was in effect desirable to have unemployment in our country in the range of 5 percent. Today your testimony suggests that it is clearly desirable long term to have a balanced budget and that that will yield long-term positive consequences.

What I want to ask you about is how we deal with the short-term impact of those policies if those are in fact our long-term government policies. How can we in the interest of implementing those long-term policies soften the blow for those 5 percent who turn out to be unemployed, those poor people who turn out to lose substantial expenditures in the process of getting to a balanced budget?

Does your office have a role to play in that process, and if so, what is that role and how should we be translating what you are saying to people who in the short term are suffering the consequences of what I may well concede is a long-term good policy?

Mr. GREENSPAN. That is a very important question, Congressman. First of all, let me say I don't recall saying, because I don't believe it, that any particular unemployment rate, 5 percent or 5½, or whatever numbers we are dealing with, is something desirable in and of itself. I don't believe that.

I do think, however, that when you are dealing with maintaining the lowest possible rate of unemployment that we can engender in this country and maintain a stable system, we are talking not about monetary policy, we are talking about employment policies. This gets to the question of how do we reduce the actual rate of unemployment over the longer term to what economists normally call frictional unemployment, which is essentially voluntary unemployment that occurs as a consequence of people just changing jobs and the mere fact that they don't immediately get a job.

Mr. WATT. At what rate would you think that frictional unemployment would be?

Mr. GREENSPAN. We haven't really examined this in a number of years, but I guess it's somewhere between 2 to 3 percent, depending on whatever one determines is frictional. It has not been a subject which, as I recall, has involved considerable efforts in recent years.

I do recall several decades ago that there was an official policy in this government to get the unemployment rate down to 3 percent, which was then perceived to be the frictional rate.

The point that I wish to make is that I do think we ought to engage in various different types of programs, whether it is in the private sector or in the public sector, to try to bring the elements of unemployment down, and this is an issue of education, training and a variety of other issues of which we are all aware.

But it is not, regrettably, an issue which we as central bankers can do very much about, because we have one single set of instruments which affects the interest rates for the economy as a whole. We cannot differentiate. We don't have the means to differentiate between various different segments of the society or different regions of the country. So that our central focus has got to be where we can actually function, namely, in areas of the total financial system, the total economy, where hopefully our policies will maintain

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maximum economic growth through maintaining a stable financial system, and specifically, a stable price level.

If we can do that, what we hope to be able to do as a consequence is raise the overall level, but that does not, as you point out I think very importantly, say that all individual strata of the economy are moving together. Indeed, the evidence suggests in recent years that income is being dispersed rather than contracted, and as I have commented many times before this subcommittee and on numerous occasions, it is something which I personally think does not lead to the stability of the society. That is not a Federal Reserve view; it's my own personal view on what has to be done in this area.

What I am saying is that it's not something which is related to monetary policy; it's related to a wide variety of other policies which we will try to support as part of the interaction that monetary policy has with all other policies to a greater or lesser extent, but it is not something that actions at the central bank as such can materially affect.

Chairman CASTLE. Thank you very much, Mr. Watt.

Mr. Royce.

Mr. ROYCE. Chairman Greenspan, I apologize for ducking out to vote on a markup.

About 4 months ago you testified before the House Budget Committee, and at that time you said that the dollar's weakness was connected to the Federal budget deficit. As a matter of fact, at that time you linked a 4-day plunge in the value of the dollar with the Senate's failure to pass a balanced budget amendment. Today in your testimony you added that a balanced budget amendment would lead to a more efficient, more productive economy, in your words.

Mr. GREENSPAN. Actually, I don't think I said balanced budget amendment. I said a balanced budget.

Mr. ROYCE. A balanced budget. So on that note, since the House and the Senate have both now put together a plan to lead to a balanced budget within 7 years, my question would be, what would be the ramifications of such government spending reductions on the economy, and how would these plans influence the formation and execution of monetary policy over the short and long run given that we are moving to just completely zero out that budget deficit?

Mr. GREENSPAN. Congressman, as I've said previously and I hope reiterated in today's testimony, whatever the effect of stretching out the form of the budget deficit reduction over a number of years as contemplated by both the Congress and the President, neither one of those time horizons is sufficiently short that its impact on the economy is very abrupt. All of the various programs that I have observed are stretched out enough that one would be hard pressed to argue that there is a short-term major up-front so-called fiscal drag.

One of the reasons why it is not something which is crucially a concern is that to the extent that long-term interest rates adjust to the fact that there is a credible expectation of the budget deficit coming down significantly, that has an immediate offset on any fiscal drag.

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As I said further in my testimony, should it turn out that indeed there is more fiscal drag than we realize, and that the economy slows down even though long-term interest rates come down, the central bank has a role in responding to that. I've said that many times in the past and I merely repeat it today.

All in all, I don't think that there is any reason to be concerned that the contemplated reduction in the budget deficit, or more exactly, the timeframe in which all of the various programs have been put forward, is in the range where, in my judgment, there should be any significant macroeconomic effects. There need not be, if I may put it that way.

Mr. ROYCE. Thank you, Chairman.

Chairman CASTLE. Thank you, Mr. Royce.

Mr. Kennedy.

Mr. KENNEDY. Thank you, Mr. Chairman.

Chairman Greenspan, I was listening to your testimony and you mentioned this issue of final sales a number of times in your testimony as sort of being ultimately what has to happen in order to get the economy moving despite all these other sort of hopeful developments. If the economy is dependent on those final sales increasing, doesn't that mean that you are hoping that we continue a system which tends to stimulate consumption versus investment?

Mr. GREENSPAN. I'm sorry. I meant by final sales to include in that investment as well as consumption. The way the term is generally used is it is the gross domestic product less any inventory investment. Unfortunately, a lot of these terms are sort of economist-type terms and they are not often terribly clear, but that term as I used it does include investment.

Mr. KENNEDY. In other words, if you put money into your checking account or your savings account or an IRA or something like that, that would go into your notion of final sales?

Mr. GREENSPAN. No. It's actually the extent to which that is invested. What we would measure is not the IRA or the saving per se, but what it is invested in—in other words, if you build a machine or you build a factory or you build an automobile.

Mr. KENNEDY. Is a T–bill considered that?

Mr. GREENSPAN. No. It's only an endeavor to capture the amount of economic activity, final consolidated sales, excluding only the change in inventory. So it's really a measure of output of goods and services.

Mr. KENNEDY. I appreciate the lesson in economic terminology, Mr. Chairman. I guess what I want to try to understand here a little bit is, you've given a lot of what I'm sure even in your own assessment would be fairly dry testimony about all these kind of terminologies. Even the guys behind you are smiling a little bit. I'm sure that wouldn't be a technique on your part to lull us all into a false sense of security.

Mr. GREENSPAN. I wasn't aware that that was possible, Congressman.

Mr. KENNEDY. In any event, I think ordinary people are concerned about the fact that they have seen their wages really stagnate for a long period of time.

You see almost every major company in the country through this sort of productivity increase measurement end up laying off lit-

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erally tens of thousands of the best jobs that America had to offer. The notion of sort of the "Leave it to Beaver" or "Ozzie and Harriet" lifestyle seems to be evaporating before ordinary citizen's eyes, and they have had a very deep concern that over the course of the last decade or two that they are just not able to make it.

They can't keep up with the costs—I don't mean to be putting you to sleep, Mr. Chairman—but they don't seem to be able to keep up with the costs of education. What happens is they generally sense that they are now on a downward competitive path toward competing with foreigners that are willing to work for much cheaper wages and have much cheaper costs. So for ordinary citizens their structure and their lives are in decline where they look at the stock market and they see these stocks gaining each and every month, the stock market gaining new heights, and they feel this terrible disconnect. So it no longer feels that what is good for General Motors is good for them. They just feel that all these institutions that are supposed to be protecting them are in fact abandoning them and they are left to try to kind of swim on their own with absolutely no one really caring about them.

I'm wondering whether or not you can take some of these dry statistics and put it into the hopes and dreams of ordinary citizens about the kind of struggles they are trying to face and how they should be reacting to this message that you are giving.

Mr. GREENSPAN. First of all, the concerns that you exhibit are quite real. I agree with you in the sense, as I indicated before, that there has been a regrettable dispersion of incomes which goes back to the late 1970's and as best I can judge is still occurring. What that means is that even though we have average real growth in the society, if there is a dispersion, there has got to be significant segments of the society which are not growing at all or indeed are going down in real terms.

I think this is a very considerable concern. As a citizen, as I said before, if you asked me what is the major threat to our society, and if I were to list a number of different things, I would list this as a crucial issue, because I think if it divides the society, if it creates the type of concerns that you are suggesting, I do not think that is good for any democracy of which I'm aware.

It is true that the rise in stock prices does indirectly benefit vast majorities of people, because a lot of that stock is held by pension funds and other types of institutions which are where the savings of the society are held. But there are people without pension funds, there are people who are scraping to make ends meet where maybe their parents were doing rather well. Really, for the first time in the history of this country you have significant evidence that people's major concern is that their children will not live at the level of standard of living that they themselves have. I find that a very disturbing fact.

Does it concern the people who work at the Federal Reserve? It does. Do we think about it? Yes. Do we study that? Yes, we do. In fact, a lot of the information I get comes out of trying to understand this process.

As I said before, central banks can only do so much. Our job has to be to essentially try to maintain a stable financial system which enables the economy as a whole to function in an effective way.

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If there were vehicles that we could employ which would essentially come to grips with the types of problems that you suggest, Congressman, I would think we would implement them, but we don't have that sort of means. What is required to resolve those types of problems are issues of education, training, and a whole variety of other types of programs both in the private sector and the public sector. I would not eliminate the private sector from responsibility in maintaining this particular area.

I think it is terribly important not to get monetary policy involved in areas where we cannot effectively help, because if you dilute the process of monetary policy, I think at the end of the day we will all be most chagrined at the consequences.

Mr. KENNEDY. Mr. Chairman, could I have 30 seconds to respond?

Chairman CASTLE. Thirty seconds, please, Mr. Kennedy. Then we need to move on.

Mr. KENNEDY. I appreciate very much your response, Mr. Chairman. I would just point out that in fact through your monetary policy you do in fact affect the fiscal policy of the country and you have been outspoken on that. It seems to me that there is a necessary consequence of that to also show the kind of leadership that I think you implied this morning when you talked about the necessity of our investing in education and job training and those kinds of issues that are necessary to be able to get our wages up so that we can get the high wage and competitive jobs that are going to be available to the world, perhaps not to this country, unless we make those investments in our own people.

Mr. GREENSPAN. A country's standard of living is ultimately a function of the individuals in the society. People build machines. They don't happen by themselves. In a sense we talk about human capital and in a sense real capital, meaning physical machines and the like, but it is human beings who build the latter. So ultimately it is the degree of intelligence, insight, ideas, initiative, entrepreneurship in the population of a society which determines its standard of living.

Mr. KENNEDY. Thank you, Mr. Chairman.

Chairman CASTLE. Thank you, Mr. Kennedy.

Mr. Ney.

Mr. NEY. Thank you, Mr. Chairman.

I have a question on the dollar, but I just want to ask for a brief response based on a question asked earlier by our colleague Mr. Watt. He asked you to comment on the unemployment factor which, I understand your answer is a difficult thing to do. On the other hand, there are multiple reasons for unemployment and we'll continue to arrive at that real figure of who is unemployed and factor in if you offered everybody in the country a job some people would not take a job, but there are a lot of people out there that want a job. I understand it's a complicated puzzle of why we have the unemployment and actions by Congress down the road on how we help or hinder people, and that will be decisions made by Congress.

Looking fiscally, can you comment on the other end of this, that if in fact the $4.8 trillion would continue over the next 7 years or

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10 years? Have you ever looked at what that does to create unemployment? Do you have any hard statistics on that?

Mr. GREENSPAN. When economists look out 7, 8, 9, 15 years there is a tendency to try to judge what the state of the structural labor market would be out in the forward period independent of how we get there. It's an endeavor to, for example, beg the question in part by saying what would the economy's unemployment rate be if certain programs were in place and the system had degrees of mobility and a variety of other elements that are involved in it. So it's not that we try to forecast the economy and say that the unemployment rate will therefore be X. We usually do it in the other direction. We say at that unemployment rate with the change in the labor force and the growth in productivity that we expect over that period of time, what, under those conditions, will be the level of economic activity or the gross domestic product.

When you go out longer term, the means by which you forecast change differs from the way we do it short term. I was describing the process of inventory adjustments and pricing and all of the variety of other elements that get into the short-term forecast, which tries to balance supply demand incentives and a variety of other things. When we forecast longer term, we cannot do it that way because we don't have the tools to do it, and we come around it in a different way.

There is very little that economic forecasting per se in the usual sense can add to the judgment as to where the unemployment rate can be unless we are saying that the economy is going to be operating at levels which for some reason or somehow creates a level of unemployment which is different from what we could achieve. Very rarely is that done to any extent that I'm aware of.

Mr. NEY. There are also factors out of your control, disasters, technology breakthroughs, and I understand that. In general, from what I have read of your statement, you are recognizing that the deficit as it stands adds money on to someone and that creates a system where somebody has to pay for that deficit, and it comes out of people, and it would be better to have less of a deficit, obviously.

Mr. GREENSPAN. Yes, but I would say that the argument would be because lowering the deficit increases domestic saving and therefore domestic investment, the more likely effect of reducing the deficit is to raise standards of living, because productivity would be higher, and levels of real income would be higher.

It's not clear to me that the level of the deficit in the structural sense tells us terribly much about the issue of unemployment except if it engenders an inflationary, unstable society which creates a higher level of unemployment because the system is inefficient. But that's a special case, and I don't think that really relates to the type of issue that you are addressing, Congressman.

Mr. NEY. Thank you. Since I am running out of time, I just want to add this last question real quick. Since 1945, as you are well aware, the dollar has remained the principal reserve currency in international finance. In that context, would you agree or disagree that the dollar's current status as the world's preeminent reserve currency is under threat from any changes of its status?

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Mr. GREENSPAN. There have been a lot of people who have argued that our reserve currency status is in significant difficulty. The evidence of that is unconvincing.

What we do see is that if you look at the structure of who is holding what type of currencies as a store of value, which is really what a reserve currency is all about, it is true that the ratio of U.S. dollars to other currencies has gone down, but that is more a reflection of the fact that the other currencies' countries have made very major changes since 1945. Indeed, both Germany and Japan were in very serious condition.

You still get the wide predominance of the desire in the world to store value in U.S. dollars. Despite the problems that we have had over the years, in my judgment there is no significant evidence that we have lost an important amount of status. However, I do state that we should nonetheless be quite careful to preserve our reserve currency status, because if we were to lose it, it would have some very significant effects on U.S. interest rates, economic growth, and a wide variety of related issues.

I must say to you that I find that a number of the people who are wringing their hands about the decline in the American currency is not something which I think is based in any way on evidence which I find persuasive.

Mr. NEY. Thank you. Thank you, Mr. Chairman.

Chairman CASTLE. Thank you, Mr. Ney.

Mrs. Maloney.

Mrs. MALONEY. Thank you very much. Following up on my colleague's statement, the dollar has declined this year, roughly 10 to 15 percent to the yen since the first of the year. Do you see this as continuing? Will the dollar continue to decline? Do you see that it will rise in value, or will it continue to decline?

Mr. GREENSPAN. Congresswoman, there are two things that I try not to comment on at all. One is a forecast of interest rates and the other is a forecast of the exchange rate. I don't think I could do it without becoming so utterly unintelligible that it's probably a waste of your time. [Laughter.]

Mrs. MALONEY. Combined with the decline of the dollar, this past month we had a record trade deficit of over $11 billion despite the fact that the dollar had declined. Some people were saying that if the dollar declined, then our trade deficit would not grow. Certainly the combination of an increased trade deficit and a declining dollar is not good. Can you comment on that?

Mr. GREENSPAN. I do think that there are numerous things which engender trade balances. Remember that a significant part of the higher than expected deficit in last month's figures was a fairly marked rise in petroleum imports. Clearly that reflects inventory adjustments in the United States with respect to oil requirements; it reflects price changes which are sometimes quite significant.

While I'm not saying if you strip out the oil data that things look particularly benign, I do think that, as I indicated in my prepared remarks, we are likely to see a shift in the other direction, that the net exports of goods and services, which of course is negative at this stage, is likely to narrow some as the year goes on. I think that clearly the competitive position of the United States, all things

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considered, is obviously one that is much better than it was a number of years ago.

So while I am not particularly pleased with the large trade deficits or current account deficits because they add to the net debtor position of the United States, I can't say that I think that we are in a trend now which is likely to worsen particularly. But we will see whether our internal forecast that I indicated does in fact work out.

Mrs. MALONEY. If the trend continues of increased trade deficits and the value of the dollar declining, what would that do to the American economy?

Mr. GREENSPAN. We cannot be unaware of the consequences of what a currency decline would have on domestic economic events. As I've said many times in the past, while we don't focus monetary policy exclusively on our external exchange rate, we do take into consideration changes in the exchange rate which have domestic economic effects to which we respond. I find it most unlikely that one can project continued rises in the trade deficit, because I think that the various events that we are looking at at this particular stage suggest that we should start to improve the trade balance at some point.

Mrs. MALONEY. Earlier, my colleague Mr. Kennedy was very concerned about the American wages, the American dream. Many people are writing about the fact that Americans don't believe that they will have a better life for their children, and wage statistics are showing that wages are declining. Can monetary policy have a direct impact on wages, and if so, what can the Fed do to encourage businesses to raise wages?

Mr. GREENSPAN. I think the crucial issue is the issue of real wages. It's the purchasing power of the wages that we should be focusing on. That relates directly over the longer term to the productivity of the economy. If we are asking how do we get the average real wage up, the answer to that is to get greater growth in productivity, which in turn implies greater investment in the society, which in turn implies greater saving, and is one of the reasons why I think that getting the budget deficit down, increasing saving matters a great deal.

The other issue is the issue that we discussed, which is that even though the averages are rising in real terms, there is a big dispersion that is going on and there are significant numbers of our society who are not experiencing growth, and indeed some of them are experiencing declines. That requires a different set of policies generally to address that.

If we don't have growing average real incomes, then the issue of dispersion becomes a particularly crucial one. If you have a significant growth in real productivity, then one can tolerate a modest degree of dispersion, because everyone is going up but at somewhat different degrees. So it is crucial that we focus first on trying to get real economic growth at as rapid a sustainable rate by the implementation of effective policies in the area of investment and incentives.

Mrs. MALONEY. Thank you very much.

Chairman CASTLE. Thank you, Mrs. Maloney.

Chairman Leach, do you have any questions, sir?

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Mr. LEACH. Thank you, Mr. Chairman.

Mr. Chairman, in your opening statement and in response to Representative Metcalf you commented on Mexico and noted what appears to be a near-term stabilizing result of our policies. As you know, in response to the decisionmaking this January and February of our government, or what was, more precisely, on the Hill a lack of decisionmaking, I became very concerned that what we had inaugurated was a major war for financial stability without the capacity to wage two or three other substantial wars at the same time, that the international community is quite capable of being involved in many skirmishes but perhaps not two wars or three wars at once.

One of the questions that emerged in reviewing the Mexican situation was, what do we have to do to bolster the crisis prevention and crisis management capacity to the international community?

At the recent G–7 meeting consideration was given to expanding the surveillance capacity of the IMF, expanding the General Arrangements to Borrow, and also looking at new approaches potentially to enhancing international law. As you know, I'm an advocate of structuring a Chapter 11 for the world. I'm wondering if you would care to comment either on the appropriateness of these new approaches and the need for looking at additional mechanisms as well as the timing of such.

Mr. GREENSPAN. Mr. Chairman, you outlined the problem rather well. The difficulty is, as we all are aware, that with the extraordinary changes that have occurred in the international financial system, the huge expansion of cross-border capital movements, on the beneficent side, has been quite helpful to economic growth worldwide, but on the negative side, creates the potential for significant types of disruptions. The Mexican situation is probably the first major case which the new finance, if we may put it that way, has experienced.

If you look at the arithmetic, as we all are aware, and indeed I think I made this point several months ago before your Committee, the potential for the types of financing vehicles are extraordinarily large, in my judgment, perhaps outside the realistic range where governments could get together and continuously make available unlimited amounts of finance to solve particular problems of liquidity or even insolvency on the part of sovereign nations. Which leads to the question, are there other mechanisms such as advance surveillance and other types of things which can be put in place which would ameliorate the effects of a significant problem within a country or make it far less likely to happen? I think there are numerous instances where progress can be made in that direction.

Nonetheless, at the end of the day one must look at the question as to whether in fact there is the potential of creating a mechanism which would be in effect a workout of a form of default or state of illiquidity or whatever. I think that the international community, the finance ministers on the one hand, the central bankers on the other hand, and combined, are exerting considerable efforts in trying to find a means which can come to grips with this issue in an effective way.

I would say to you only that one of the difficulties that does emerge, which is something that we have to recognize and see if

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we can address, is that the culture of individual sovereign nations is really quite different. Bankruptcy statutes in an international fora are not simple legalisms. They reflect the culture of the society in the sense that we have had considerable difficulty, for example, in trying to coordinate private bankruptcy statutes around the world.

The reason is that it's not just a question of being unable to bring the legal codification together. It's the fact that, for example, in Europe debtors are considered to be something which should be reined in more than in the United States. That is, our culture evolved through our problems with large debt in the 19th century and major changes in our society, and events of populism have removed the debtor prisons and essentially tried to make the debtor some way capable of restoring himself.

That has created the details of our Chapter 11 or our Chapter 9 and a variety of other things in ways which are culturally balanced for our society between debtor and creditor. There are different balances in other countries.

We are going to have to work as aggressively as we can to find ways around these differences to recognize that there is an international basis of achieving these ends and an international imperative that we do it, because we are increasingly becoming involved in a very major international trading and financial system which is helping all of us, but we have to recognize that there are shortcomings inevitably to that type of system and we have to find means which address them in a manner which is feasible.

Mr. LEACH. I appreciate your comments. Let me just conclude by saying as possibly the last speaker, the summation of anyone listening to what has occurred today just underscores the imperative need for a professional, competent, independent Federal Reserve System. Without it, I think stability in this country and around the world would be substantially lessened. You symbolize that, and we are appreciative. Thank you.

Mr. GREENSPAN. I thank you very much, Mr. Chairman.

Chairman CASTLE. Unfortunately, Mr. Greenspan, Chairman Leach may not be the last speaker. [Laughter.]

Chairman CASTLE. Mr. Bentsen is with us. He is not a member of this subcommittee, but he is a distinguished member of the Banking Committee. If he wishes to ask questions, we would love to have him participate.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman Greenspan, I appreciated your comments with regard to Mrs. Maloney's questions regarding the trade deficit. It appears that we do have some form of a structural trade deficit that has been a problem for this country for over a decade. You answered some of the questions that I had with respect to that. I have two, though, that I would like to ask you about.

One, in your report you talk about the impact of Mexico. Certainly that has had an impact of declining exports to Mexico. Can you attribute the increase in the trade deficit over the recent months just to Mexico, or are there other problems?

The other question I have is a little bit different. You talked about the increasing oil imports. Heretofore I have been philosophically opposed to any sort of import fee. I think it's inefficient. Do

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you think that we have reached a point in time or do you think we will reach a point in time where the increasing oil imports, resulting in an increase in our debtor status, would outweigh the cost of moving away from a cheap oil policy, that maybe we should look at some price floor, we should look at some sort of import fee?

Mr. GREENSPAN. Let me comment seriatim, if I may. The long-term structural trade deficit is ultimately determined not by trade per se but by the difference between domestic investment and domestic saving. It really gets to the question as to whether in order to finance our domestic investment we have to borrow from abroad.

The major element of the current account deficit, which is our total measure of borrowing from abroad, is reflected in the trade deficit. So that if our purpose is in the long run to resolve the question of the trade deficit, then the most important thing that we can do, in my judgment, is to reduce the budget deficit, which would increase domestic saving and hence narrow the gap between domestic investment on the one hand and total domestic saving on the other, and that will effectively reduce the underlying current account deficit and therefore the trade deficit.

In remarking to Congresswoman Maloney, I was referring to shorter run, competitive pressures in the United States. Over the long run the real crucial issue is the balance with respect to the budget deficit, domestic saving, domestic investment, and the balancing item in that, which is essentially borrowing from abroad, which is the current account deficit, which encompasses mainly the trade deficit.

With respect to the issue of oil, I think we have to recognize that there is an issue here of how much oil and natural gas and other energy imports we need for our system. We have production especially of crude in this country, mainly in Texas, the Southwest, and Kansas and the North Slope, but it is pretty clear that it is very difficult to get crude production rising. Indeed we have had great difficulties in the decade holding up oil production. Natural gas, as you know, is doing better.

It strikes me that unless we can find a way to significantly either reduce crude oil consumption in the country or augment our production, the arithmetic forces the import numbers. The question that I would raise is really an issue of when we are concerned, as a number of us have been over the years, about the security of our oil supplies, I think we've got a whole series of other issues that are related.

I certainly know that your uncle was very much involved with the issue of various questions of fees, quotas, and all those sorts of issues. We haven't discussed that in recent years, largely because imports had not been growing for a while. Technologies have improved quite considerably in both production and especially in keeping down oil consumption. The gas guzzler is hopefully a thing of the past, and that has made a big difference.

I do think we are running into the question now where this issue is re-emerging. I don't have much more to add than we have discussed in past years on that particular issue, but I do think it is interesting that you should raise it, largely because I was looking this morning at the trade figures, and I'm saying, I haven't seen this for a while. And we are beginning to see this same phenome-

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non which inexorably tends to create questions about security of our oil resources.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman CASTLE. Thank you, Mr. Bentsen.

Mr. Fox.

Mr. FOX. Thank you, Mr. Chairman.

Thank you, Chairman Greenspan, for coming today and enlightening us.

You sometimes use the price of gold as an indicator of future inflation. What do you expect to see in the next 3 to 6 months for the price of gold? [Laughter.]

I need to call someone right after you give me the answer, by the way.

Mr. GREENSPAN. When I was indicating before about the types of forecasts I don't make, interest rates, exchange rates, I guess I should have added the price of gold to that.

I don't know. But you are quite correct, Congressman. I do think that there is a considerable amount of information about the nature of a domestic currency from observing its price in terms of gold. It's a longer term issue; it's an issue which I think is relevant; and if you don't believe that, you always have to ask the question, why is it that central banks hold so much gold which earns them no interest and which costs them money to store? The answer is, obviously, they consider of it significant value and indeed they consider it the ultimate means of payment, one which doesn't require any form of endorsement.

So there is something out there that is terribly important which the gold price is telling us, and I think disregarding it is to fail to recognize certain crucial aspects of the values of currencies.

I cannot forecast the price of gold. I can, but I shouldn't. I do think that it is something, which clearly if we fail to keep an eye on it, we do it at our own peril.

Mr. FOX. What rate of growth do you think the economy can achieve in 1995 without generating inflation and an interest rate increase?

Mr. GREENSPAN. There are a lot of economists who have a fixed notion of where a particular rate of growth will be. I think the issue, as I've discussed before the Committee many times, is it's a far more flexible thing than a point estimate. When I use the word "potential" I use it in a very broad sense, not a fixed specific which, if the economy runs up against it, it stops dead.

What does actually happen, though, and we observed this in 1994 particularly, is that as you get up to a certain point you don't stop, but it becomes increasingly more difficult to move. It's as though you are running up against a rubber sheet which in the early stages of pushing it you can move it very readily, but at some point it really begins to grip, and that's when you get tight labor markets, shortages of skilled labor, all sorts of problems which create inflationary pressures and interest rate increases.

It was pretty clear that in the latter stages of 1994 we were pretty much pressing up against that rubber sheet and having all the indications of pressures beginning to emerge—of shortages and lead times on materials delivery stretching out—all the characteris-

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tics which have historically led to a significant inflationary set of instabilities.

When you get to the question of exactly where that potential is, without raising the question of what type of investments you're making, what type of incentives there are in the society, what type of entrepreneurial activity you have, what type of tax structure, I don't think you can basically fix a number very readily, and I would be disinclined to do that, largely because there is more give in this area than I think most of my colleagues in the economic profession would assert.

Mr. FOX. Thank you, Mr. Chairman.

Chairman CASTLE. Thank you, Mr. Fox.

Mr. Chairman, one or two of us have additional questions. We have been very fortunate this morning in not having a call to a vote. We have been a long time sitting here too. These questions might take maybe 10 minutes total or something of that nature. Do you want to continue on at this point without a break?

Mr. GREENSPAN. Sure. That's fine with me.

Chairman CASTLE. I'm going to ask one question sort of unrelated to anything we have heard here. It's conventional wisdom, and I assume you have spoken on it before, although I don't know that, that we need to increase the savings rates by individual Americans. Various government methods are used to show how that could be done, all the way from expanding IRAs to 401(k) expansions. I've even had a chance to study the Chilean pension system, which I'm sure you're familiar with, which is a quasi-private system in that they invest in the private sector of Chile, and in fact are restricted to keeping their investments there for the most part.

I guess my question is, do you agree with the conventional wisdom that we should increase our savings rates, and if so, is it something that we should do individually if we are able to do so, or should there be different government outlets or tax changes that would allow this to happen?

Mr. GREENSPAN. There are several points. First, the evidence clearly suggests that the major way to improve domestic saving in this society is to bring down the budget deficit, because domestic saving is arithmetically defined as total private saving minus the budget deficit, which is a claim on that private saving. So obviously if you reduce the budget deficit, you increase the net domestic saving of the society.

The evidence is more equivocal on the question of whether various different incentives to save in the tax system have produced aggregate increases in saving. There is a big dispute, for example, on whether or not 401(k)'s have added to aggregate saving, and it's a legitimate issue which technicians differ on, and I'm not sure that I could add terribly much to the discussion.

The Chilean experience is an interesting one in the sense that they have instituted an interesting way in which their social security system invests directly in private instruments and as such does increase the private saving of the society. I must say that there was some element of that in the Kerrey-Danforth Commission recommendations of about a year ago in which they raised some elements of approaching Social Security over the very much longer run to have elements in it of private saving. I recall at the

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time that I thought that was an interesting issue that we ought to be looking at.

It's a very tough problem. Anyone who seriously thinks you just can shift from the type of Social Security government system that we have today to a private system has not experienced looking at the details of what that transition implies. But I do think that the issues that were raised by the Kerrey-Danforth Commission are something we ought to at least focus on for the longer term.

Chairman CASTLE. Thank you, Mr. Chairman.

We have about 12 minutes until the vote. I know Mr. Flake has a question and Mr. Frank might have a quick question, and Mr. Leach might. Let's start with Mr. Flake.

Mr. FLAKE. Mine is relatively quick, Mr. Chairman. As you know, beginning last term we engaged in some discussion about the BIF/SAIF question and we've had a number of times to ask you questions on it. Now that it looks as if we have some movement toward the thrift institutions paying a large amount of up front, taking care of bonds, with the banks having some level of participation——

Mr. GREENSPAN. You mean the SAIF institutions.

Mr. FLAKE. SAIF institutions, and ultimately the merger of charters.

Can you just give us an overview of your feeling if this is a good direction or if there are other things we ought to consider in this process?

Mr. GREENSPAN. I must say I too am pleased, Congressman, that there seems to be some movement in this direction, because I do think the situation is inherently unstable, and that basically at some point, in some manner we've got to come to grips and resolve this issue once and for all.

We are in the process ourselves of looking at very different issues which relate to this. It is not in our primary focus, obviously. It relates more to the FDIC and the Treasury Department as the lead elements in this. But hopefully we may be able to add some insights to a potential solution to our colleagues in the lead agencies in this regard.

Chairman CASTLE. The Chairman had a brief comment he wanted to make.

Mr. LEACH. No.

Chairman CASTLE. Mr. Frank, we have a couple of minutes.

Mr. FRANK. Thank you, Mr. Chairman.

I was interested in your discussion about 401(k)'s. I think that is an example of the flexibility with which you can embrace certain subjects when it becomes useful to do that. I wasn't aware that 401(k)'s were at the core of the Fed's statutory mandate.

Mr. GREENSPAN. I was merely repeating, Congressman, what other economists have concluded.

Mr. FRANK. I understand that, but repetition with the right tone of voice is sometimes relevant.

Mr. GREENSPAN. I do not deny that. I grant you your point.

Mr. FRANK. Thank you, Mr. Chairman. Let's see if we can extend that tendency.

I just want to make a statement that obviously we differ here. I understand the importance of a stable monetary situation and

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combatting inflation and your role in it. The problem I think it has come to is this. The Federal Reserve has become by far the strongest institution precisely because you are so insulated from the day-to-day democratic pressures. It is an institution with the staggered terms, where people's appointments go a long time.

What has happened, I think, is this. In my view there are some structural changes going on in the economy, particularly in the area of labor compensation, that have diminished inflationary pressures. What has happened to working people is that they get the negative aspect of that, that is, the lack of wage increases similar to what it has been in the past, some of it real, some of it nominal, but I think both are involved. Particularly people who are the mainstream workers who are not the most skilled. They get the negative of that but they don't get the benefit from it in the Fed's analysis.

While you look at that intellectually in terms of your estimates of inflation—I think this is what has happened over the past couple of years—you err on the side of assuming things are as they were. You are not yet ready to think there might be some real changes. So you then conclude that we had too much employment growth and that the economy was growing too quickly over the last couple of years.

The consequence then is to slow that down so that higher unemployment becomes a positive, a lower rate of wage increase, both real and nominal, is treated, it seems to me, in the statement as positive, and what we get is a terrible exacerbation of social tensions in this country, an inability to deal as much as we would like, and it affects immigration, it affects welfare, it affects views of discrimination, because you do have this tightening.

I would say to you, given the centrality of the Fed making economic policy, it isn't enough simply to say, OK, we will be as tough a we can on inflation; the rest of you figure that out. The consequence of that is terribly destabilizing socially in this country, and I think you are going to have to help us figure out how we can deal with that problem of the dispersion that you discussed and its negative consequences within the framework that you are trying to pursue.

Mr. GREENSPAN. Let me say in response, Congressman, you are making an extraordinarily important conclusion if it is true, namely, that there is some fundamental change in the international structure of our economy such that inflation no longer has any capacity to——

Mr. FRANK. Mr. Greenspan, you know you are overstating me. That's not what I said at all. What I said was, I think the role of labor has changed and that it is less inflationary. I didn't say there was no danger at all.

Mr. GREENSPAN. OK. Let me then readjust to the word "less."

We recognize and indeed I have stated in the past that I do believe that there are elements which have created lesser wage pressures. Mainly, as I put it, there is a sense of insecurity among the large groups of people whose job security has clearly diminished. In fact, I think the last time I was before this Committee, or a previous time, I stated explicitly that I thought that one of the crucial issues holding nominal wages in check was a sense of insecurity on

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the part of a large segment of our job population who essentially were not pressing for higher wages but were far more interested in the security of jobs. That fact will keep nominal wage increases under less pressure than they would have been in the past. That, other things equal, diminishes inflationary pressures in the society.

I submit to you that we do consider that and we do consider that in some detail in making judgments as to what type of monetary policy we think is required. If we did not conclude that, I would suggest to you that a far tighter policy would probably have been required as we came out of 1993 into 1994 than in fact prevailed.

I say to you that, yes, we do consider that. We do think that is important.

When you get to the broader questions of income dispersion, I hope that we intellectually can make a contribution to that, if we could figure out ways of understanding the process better. In that regard, all people who are familiar with the structure of these markets, whether they are in the private sector, in universities, in government or the like, have an obligation if they can make some contribution to this issue to do so.

Chairman CASTLE. Mr. Chairman, we are going to have to run to our vote. We thank you very much for being here today. The meeting of the subcommittee stands adjourned.

[Whereupon at 12:25 p.m. the hearing was adjourned.]

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APPENDIX

July 19, 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, 10:00 a.m., July 19, 1995 Room 2128 Rayburn House Office Building

Chairman Michael N. Castle's Opening Remarks:

The Subcommittee will come to order.

The Subcommittee meets today, to receive the semi-annual report of the Board of Governors of the Federal Reserve System on 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, welcome back to the House Committee on Banking and Financial Services, Subcommittee on Domestic and International Monetary Policy. Today we will have five minute opening statements by the members present. In addition, some members of the full Committee will sit with us this morning and ask questions as well. As always, any prepared remarks presented will be accepted for the record.

By several definitions it might well be claimed that the projected "soft landing" has been achieved by the national economy. In the build up to this point we have seen Federal Funds Rate double from three percent to six percent in seven steps over the thirteen month period from February 1994 to February 1995. Nearly two weeks ago a

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signal was sent to the markets via the lowering of the Federal Funds Rate by one quarter percent. Pundits divide on whether the "soft landing" to slower growth has been achieved or the economy is being pushed back into recession. Reading the indicators at these junctures is at best a chancy business, so we will welcome any comments you care to make on what you see ahead with regard to inflationary pressures, the international value of the dollar and the future of interest rates, to name a couple of items.

In addition to the normal complaints from editorial writers regarding the policies of the Fed we are beginning to see arguments that the Federal Reserve may no longer be relevant as an institution. This argument is the opposite of those who fear your power to pump up or choke off economic expansions. Indeed, with the emerging market technologies and the ability to trade and transmit enormous sums around the world nearly instantaneously, this school asserts that the Fed is a toothless tiger that no longer influences a large enough part of the economy to matter. This Subcommittee will be inviting you back after the recess as we continue our exploration of the future of money and the payment system in the dawn of the age of electronic cash and stored value cards. We will open this investigation next week with testimony by private sector innovators and entrepreneurs in the field. This will be followed with another hearing involving the views of the Federal Reserve System, the IRS, the Financial Crimes Enforcement Network, the Secret Service, the Mint and others concerned with the public policy questions raised by these new facts and technologies.

Since our last Humphrey-Hawkins hearing, this Congress has altered the expectation of the marketplace by largely enacting the Contract With America. This

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has reshaped economic realities by providing the prospect of a genuinely balanced federal budget. Significant change also is underway with regulatory reform and major cuts in domestic and foreign spending, that all must affect the Federal Reserve System calculus. Meanwhile the dollar appears to have bottomed out overseas and may even be demonstrating additional signs of strength relative to most foreign currencies. We would welcome any insight into how these new factors have shaped your perceptions or altered your models.

Your Chairmanship of the Federal Reserve continues to be marked by unprecedented openness both with Congress and the public. This is most appreciated on this side, especially since I know that changing the culture at the Fed makes your life more difficult.

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OPENING STATEMENT
"Humphrey-Hawkins Hearing"
Subcommittee on Domestic & International Monetary Policy

Thank you Mr. Chairman.

One of the great advantages of serving on this important Subcommittee is the fact that twice a year we are fortunate enough to receive the report of the Chairman of the Federal Reserve Board about the likely prospects for the U.S. economy in the coming 18 months.

The last six months have been extremely interesting. After a considerable period of time in which interest rates have risen quickly in order to slow inflation, the Federal Reserve Board recently lowered its discount rate by a quarter of a point.

I look forward to the Chairman's explanation of why the Fed chose to lower its discount rate, and what his reasoning has been as to the timing of that decision.

The economy does not appear to be coming in for the soft landing that we have heard about. There are conflicting indications. I welcome the opportunity to question the Chairman about what the likely impact of these indicators is likely to mean, and his view of the likely prognosis for the future.

Clearly, the Federal Reserve's actions prior to this date have been effective at slowing growth and keeping a tight rein on inflation.

At the same time, we hear a growing sentiment that while the economy continues to grow, and worker productivity is up, wages remain stagnant.

The Fed's policy of working to raise interest rates may have had a beneficial impact on inflation, but it also makes it more difficult for the average American to realize the American dream by buying a new home, or financing the purchase of a car, or putting their children through college.

We know that the Fed practices an inexact science. It has to take action before inflation begins to show up in the economy, and if it fails to act before inflation shows up, by the time it does act, it is already too late. This increases the likelihood that the Fed will act too cautiously, and raise interest rates higher than it needs to, to the detriment of the economy.

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MALONEY STATEMENT/July 19, 1995
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Additionally, I think we have to acknowledge that when we accept an unemployment rate of five and a half or six percent, that means that a significant portion of our population is unemployed, underemployed or discouraged from seeking employment. This continued unemployment acts as a drag on wages, and leads many young people to conclude that they will have to settle for a standard of living that is lower than that enjoyed by their parents.

While I fully support the Federal Reserve Board's efforts to keep inflation under control, I would like to know whether the Chairman has any ideas about what the Fed can do to improve the wage prospects for the average working American. If the average working person is not sharing in the benefits of a growing economy, then there is something seriously wrong.

Our economy should provide Americans with the promise of a better day and a brighter future. And I look forward to the Chairman's suggestions of how the Federal Reserve is going to take us there.

Finally, I think that we should note that in the information age, business is developing new forms of money. Cyberbucks are showing up on the internet. Cash transactions are growing rarer. Many people make payments directly through ATM machines and over the phone, meaning that fewer checks are written. ATM cards make it easier for Americans to get foreign currency abroad, without having to bring travellers checks.

All of these changes in the way transactions are made must be having an impact on the money supply, and the way the Fed does business. I look forward to hearing from the Chairman what he views these changes in the use of money is likely to have on the way the Fed does business.

Thank you Mr. Chairman.

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10:00 A.M. E.D.T.
July 19, 1995

Testimony by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic and International Monetary Policy

Committee on Banking and Financial Services

House of Representatives

July 19, 1995

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Mr. Chairman and members of the Subcommittee, I am pleased to appear today to present the Federal Reserve's semi-annual report on monetary policy. In February, when I was last here for this purpose, I reported that the U.S. economy had turned in a remarkable performance in 1994. Growth had been quite rapid, reaching a torrid pace by the final quarter of the year, when real GDP rose at a 5 percent annual rate and final sales increased at a 5-3/4 percent rate. Inflation had remained subdued through year-end, although productive resources were stretched: The unemployment rate had fallen to its lowest level in years, while manufacturing capacity utilization had been pushed up to a historically high level.

As I indicated in February, a slowing of economic growth to a more sustainable pace, with resource use settling in around its long-run potential, was required to avoid inflationary instabilities and the adverse consequences for economic activity that would invariably follow. After posting three straight years of consumer price increases of less than 3 percent for the first time in decades, inflation seemed poised to move upward. Reflecting market pressures, prices of raw materials and intermediate goods had already risen considerably, and a surge in the prices of a variety of imported goods could be expected to follow the weakening in the dollar through early 1995.

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Monetary policy tightenings over the previous year had been designed to foster the type of moderation in final demand that would help damp inflation pressures going forward and sustain the economic expansion. When we began the policy tightening process, we knew the previous drags on the economy stemming from balance-sheet stresses and restraints on lending were largely behind us. But that still did not make it a simple matter to gauge just what degree of firming in reserve market conditions would be necessary to produce a financial environment consistent with sustainable economic growth. In the event, the federal funds rate was raised to 6 percent, as the surprising strength in the economy and associated pressures on resources required a degree of monetary policy restraint to ensure that inflation would be contained.

Fortunately, we started the tightening process early enough and advanced it far enough that monetary restraint began to bite before some potential problems could assume major proportions. With inadequate monetary restraint, aggregate demand could have significantly overshot the economy's long-run supply potential and created serious inflationary instabilities. Moreover, the perceived capacity constraints and lengthening delivery times that come with an overheated economy could have fostered the development of more serious inventory over-accumulation. In such circumstances, the longer the moderation in output

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growth is delayed, the larger will be the inventory overhang, and the more severe will be the subsequent production correction. As hoped, final sales slowed appreciably in the first quarter of this year, but inventory investment didn't match that slowing, and overall inventory-sales ratios increased slightly. Although the aggregate level of inventories remained modest, a few major industries, such as motor vehicles and home goods, found themselves with substantial excesses. Attempts to control inventory levels triggered cutbacks in orders and output that inevitably put a damper on employment and income.

How the ongoing pattern of inventory investment unfolds is a crucial element in the near-term outlook for the economy. Production adjustments could fairly quickly shut off unintended inventory accumulation without a prolonged period of slack output--one that could adversely affect personal incomes and business profitability, which in turn could undermine confidence and depress spending plans. Under these conditions, final sales should continue to grow through and beyond the inventory correction, leading to sustained moderate economic expansion. But a less favorable scenario certainly cannot be ruled out. The inventory adjustment could be extended and severe enough to drive down incomes, disrupt final demand, and set in motion a period of weak growth, or even a recession.

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Useful insights into how an inventory correction is proceeding often can be gained by evaluating developments in industries that supply producers of final durable products with key primary inputs--such as steel, aluminum, and capital equipment components and parts. This is because inventory adjustments often are larger in durable goods and they become magnified at progressively earlier stages in the production process. Typically, when purchasing managers for durable-goods producing firms find their inventories at excessive levels, they reduce orders for materials and also for components of capital goods, and as a consequence suppliers shorten promised delivery times and cut back on production. In the current instance, domestic orders for steel and aluminum and for some capital equipment components have weakened, but not enough to have had more than modest effects on production. Prices of key inputs also suggest that demand so far is holding up and the inventory correction is contained. The price of steel scrap, for example, has not fallen, and spot prices of nonferrous metals on average have stabilized recently after considerable weakness in the first part of the year. Though still lethargic, the behavior of durable goods materials and supplies markets scarcely evidences the type of broader inventory liquidation that usually has been at the forefront of the major inventory recessions of the past.

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At the finished goods level, we experienced significant inventory liquidation in both cars and trucks in May and June. We do not have comprehensive, up-to-date inventory evaluations for recent months as yet, but inferring what we can from scattered and partial data, the prospects seem reasonably good for a reduction in inventory investment that moves us a considerable way toward eliminating unwanted stocks.

That process and the longer run outlook for the economy depend ultimately on the behavior of final sales. In that regard, the slowing of the growth of final sales that began in the first quarter seems to have continued a little further in the second quarter. Combining final sales and the likely reduced second-quarter pace of inventory investment, the level of overall domestic production of final goods and services, or real GDP, evidently changed little last quarter.

Going forward, of the several credible outlooks, the most probable is for an upturn in the growth rate of final sales and real GDP over the rest of this year and a moderate pace of expansion next year with the economy operating in the neighborhood of its potential. One area of improvement should be our external sector. A significant downside risk when I testified in February related to the situation in Mexico. The economic contraction in that country and the depreciation of the peso did act to depress

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our net exports in the first half of the year. But with the external adjustment of the Mexican economy apparently near completion, this drag should be largely behind us. Moreover, our trade with the rest of the world should begin to impart a positive impetus to our economic activity, partly because of the strong competitive position of U.S. goods in world markets.

Regarding domestic final demand, financial developments so far this year should provide important support over coming quarters. Interest rates, especially on intermediate- and long-term instruments, have fallen a great deal since last fall, in reaction to the improved fiscal outlook, the effects on inflation expectations of our earlier monetary tightening, and, of course, recently, the slowed economy. Lower interest rates have helped to buoy stock prices, which have soared ever higher. The positive implications of the rally in financial markets for household debt-service burdens and wealth and for the cost of capital to businesses augur well for spending on consumer durables, on housing, and on plant and equipment. These influences should be reinforced by the generally strong financial condition and the willingness to lend of depository institutions, as well as the receptiveness of capital markets to offerings of debt and equity.

Early signs of a little firming in consumer durables spending are already visible in the stabilization of

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the motor vehicles sector. Residential construction also has started to revive, judging by the recent data on home sales and mortgage applications. Unfilled orders are sizable in the capital goods area, suggesting business investment in equipment will continue growing, albeit perhaps more slowly than in the recent past. Finally, rising permits suggest expansion in nonresidential construction.

An outlook embodying a resumption of moderate economic growth is conveyed by the central tendencies of the expectations of the Federal Reserve Governors and Reserve Bank Presidents for real GDP. After the second-quarter pause, a projected pickup in activity in the second half would put output growth over the four quarters of the year in the neighborhood of 1-1/2 to 2 percent. For next year, projections of real GDP growth center on 2-1/2 percent.

The inflation picture is less worrisome than when I testified six months ago, just after our last policy tightening. Demands on productive resources should press less heavily on available capacity in the future than we envisioned in February. This prospect is evident in the central tendency of the expectations of the Governors and Presidents for the unemployment rate in the fourth quarter of this year, which has been revised up from about 5-1/2 percent in February to 5-3/4 to 6-1/8 percent. This outlook for unemployment has been extended through next year as well. Increases in employment costs to date have been

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modest, and labor compensation evinces few signs of exacerbating inflation pressures, although the recent unusually favorable behavior of benefit costs is unlikely to continue. Declines in industrial output over recent months have already eased factory utilization rates closer to their long-term averages. Reflecting a slowing in foreign industrial economies as well as in the United States, the earlier surge in prices of materials and supplies has tapered off. Moreover, the stability of the exchange value of the dollar in recent months bodes well for an abatement of the recent faster increase in import prices.

Against this background, most Governors and Presidents see lower inflation over coming quarters than experienced in earlier months of 1995. The central tendency for this year's four-quarter rise in the CPI is 3-1/8 to 3-3/8 percent. And for next year, the central tendency suggests that CPI inflation will be shaved to 2-7/8 to 3-1/4 percent.

The success of our previous policy tightenings in damping prospective inflation pressures set the stage for our recent modest policy easing. Because the risks of inflation apparently have receded, the previous degree of restriction in policy no longer seemed needed, and we were able at the last meeting of the Federal Open Market Committee (FOMC) to reduce the federal funds rate by 1/4 percentage point to around 5-3/4 percent.

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Indeed, inflation pressures were damped somewhat more quickly than we might have expected. This experience underlines the uncertainties and risks in any forecasting exercise. The projections of the Governors and Presidents are for a rather benign outlook, as are the views of many private sector forecasters. But these expectations can't convey the risks and subtleties in the developing economic situation.

A month or so ago, I noted publicly that a moderation in growth was both inevitable and desirable, but that the process could not reasonably be expected to be entirely smooth, and that accordingly the risks of a near term inventory-led recession, though small, had increased. More recent evidence suggests that we may have passed the point of maximum risk. But we have certainly not yet reached the point at which no risk of undue economic weakness remains. We do not as yet fully understand all the reasons for the degree of slowing in economic activity in the first half of the year, so we need to be somewhat tentative in our projections of a rebound. Imbalances seem to be limited, financial conditions should be supportive of spending, and businesses and consumers are largely optimistic about the future. Nonetheless, questions remain about the strength of demand for goods and services, not only in the United States but abroad as well.

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Upside risks to the forecast also can be readily identified, particularly if the inventory correction is masking a much stronger underlying economy than appears from other evidence to be the case. If so, spending could strengthen appreciably, especially in light of the very substantial increases in financial market values so far this year.

In a transition period to sustainable growth such as this, reactions to unexpected events may be especially pronounced. This is not a time for the Federal Reserve to relax its surveillance of, and efforts to analyze, the evolving situation. The Federal Reserve must do its best to understand developing economic trends. While we cannot expect to eliminate cyclical booms and busts--human nature being what it is--we should nonetheless try where possible to reduce their amplitude.

Some observers have viewed prospective year-by-year budget-deficit reduction as constituting an important down-side risk to the economy. I do not share this concern. In response to fiscal consolidation, financial markets provide an important shock absorber for the economy. Declines in long-term rates help stimulate private, interest-sensitive spending when government spending and transfers are reduced. Clearly, the Federal Reserve will have to watch this process carefully, and take the likely effects of fiscal policy into account in considering the appropriate stance in monetary

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policy. But there is no doubt, in my judgment, that the net result of moving to budget balance will be a more efficient, more productive U.S. economy.

With regard to the money and debt ranges chosen by the FOMC for this year, the specifications for M2 and domestic nonfinancial debt were left unchanged, at 1 to 5 percent and 3 to 7 percent, respectively. The FOMC also made a purely technical upward revision to the M3 range. Last February's Humphrey-Hawkins testimony and report had noted the potential need for such a revision to this year's M3 range. Starting in 1989, the restructuring of thrift institutions and the difficulties facing commercial banks depressed their lending and their need for managed liabilities. The FOMC responded by reducing the upper and lower bounds of the range for M3 to below those of the M2 range. This year, M3 growth has begun to outpace that of M2, as it did for several decades prior to 1989. Overall credit flows have picked up some, and a higher proportion has gone through depositories. As a consequence, while M2 and debt remain within their respective annual ranges, M3 has appreciably overshot the upper end of its range. The 2 percentage point increase in the upper and lower bounds of the M3 range to 2 to 6 percent was made in recognition of the evident return this year to a more normal pattern of M3 growth. The ranges specified for M2, M3, and debt this year also were provisionally carried over to 1996. The Committee

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stressed that uncertainties about evolving relationships of these variables to income continued to impair their usefulness in policy.

In summary, the economic outlook, on balance, is encouraging, despite the inevitable risks. The American economy rests on a solid foundation of entrepreneurial initiative and competitive markets. With the cyclical expansion more than likely to persist in the period ahead, the circumstances are particularly opportune for pressing forward with plans to institute further significant deficit reduction. For such actions, by raising the share of national saving available to the private sector, should foster declines in real interest rates and spur capital accumulation. Higher levels of capital investment in turn will raise the growth in productivity and living standards well into the next century.

The Federal Reserve believes that the main contribution it can make to enhancing the long-run health of the American economy is to promote price stability over time. Our short-run policy adjustments, while necessarily undertaken against the background of the current condition of the U.S. economy, must be consistent with moving toward the long-run goal of price stability. Our recent policy action to reduce the federal funds rate 25 basis points was made in this context. As I noted in my February testimony, easing would be appropriate if underlying forces were

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clearly pointing toward reduced inflation pressures in the future. Considerable progress toward price stability has occurred across successive business cycles in the last 15 years. We at the Federal Reserve are committed to further progress in this direction.

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For use at 10:00 a.m., E.D.T.
Wednesday
July 19, 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

July 19, 1995

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Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 19, 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 and 1996

During 1994, spending by U.S. households and businesses grew at an exceptionally rapid pace, and by the end of the year, demands clearly were taxing the productive capacity of the economy. Pressures on resources were particularly intense in sectors of manufacturing that provide inputs for other producers, and sharp increases in the prices of materials and supplies signaled what could have been the first stage of a broader inflationary process. A weakening of the dollar on foreign exchange markets as 1995 began heightened that risk. To damp these inflationary pressures and foster a sustainable economic expansion, the Federal Open Market Committee in February tightened policy somewhat, extending the series of actions undertaken during 1994, and the Board of Governors approved a one-half percentage point increase in the discount rate.

The economy's growth began to moderate in the first quarter of 1995. Among the factors contributing to the slowing were the lagged effects of 1994's increases in interest rates on housing and other rate-sensitive sectors and the impact on U.S. exports of the sharp contraction in Mexico's economy and fall in the foreign exchange value of the peso. As final sales moderated, businesses scaled back their desired inventory accumulation. In some key sectors, the slackening in sales was greater than anticipated, leaving firms with excess inventories. As businesses took steps to trim stocks, aggregate production decelerated further in the second quarter and was probably about flat, as measured by real gross domestic product. The inventory adjustment was especially large in the motor vehicle sector, which accounted for much of the downswing in manufacturing activity in the spring. Homebuilding also showed marked weakness, in part because builders hesitated to start new projects until they could work down stocks of unsold new homes.

While output growth was stalling in the first half of this year, the still high level of resource utilization of the economy, as well as the effects of rapid increases in materials prices, contributed to a pickup in inflation from its 1994 pace. Nonetheless, by July it appeared likely that pressures on resources and hence on prices were in the process of easing. Materials prices were showing signs of softening, and a period of greater stability in the exchange value of the dollar suggested that the rise of import prices might soon slow. With the threat of future inflation thus reduced, the FOMC elected to ease the stance of policy slightly at its meeting in July.

The moderation in economic growth and improvement in inflation prospects over the first half of 1995 sparked a considerable decline in market interest rates. The greater likelihood of significant progress toward a balanced federal budget also seemed to contribute to the decrease in longer-term interest rates. Intermediate- and long-term yields have fallen 1¼ to 1¾ percentage points since year-end 1994, with the decline in 30-year fixed mortgage rates this year reversing most of the increases registered since early 1994. Lower interest rates, solid earnings growth, and prospects for sustained economic expansion helped push most broad stock price indexes to record highs.

The drop in longer-term interest rates in the United States contributed to downward pressure on the foreign exchange value of the dollar in 1995. In terms of the currencies of the other G-10 countries, the dollar has declined 7½ percent on balance. Over the past half-year, foreign long-term interest rates have fallen significantly as growth prospects abroad have weakened, but by less than U.S. long-term interest rates. In addition, the Mexican crisis was seen by market participants as having adverse implications for U.S. growth, especially exports, and contributed to the dollar's decline in terms of currencies other than the peso in early 1995. With the dollar at times under greater downward pressure than seemed justified by fundamentals, the Federal Reserve, acting on behalf of the Treasury and for its own account, joined other central banks in concerted intervention in support of the currency on several occasions in 1995. In recent weeks, the dollar has fluctuated in a range somewhat above the lows reached in the spring.

Despite the slower expansion of nominal spending this year, net borrowing by households and businesses remained substantial. In fact, total private credit flows strengthened, offsetting slower growth of federal debt and an outright decline in state and local government debt; as a result, total domestic nonfinancial debt expanded at a 5½ percent pace from the fourth quarter of 1994 through May, a little faster than in 1994. Credit supply conditions remained quite favorable, with banks continuing to ease terms and conditions of lending and risk spreads in securities markets persisting at quite low levels. Household borrowing this year has been a bit more subdued than in 1994 but still appreciable. Nonfinancial businesses have stepped up their borrowing considerably, reflecting a widening gap between capital expenditures (including inventory investment) and internally generated funds,

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

Aggregate	1994	1995	Provisional for 1996
M2	1 to 5	1 to 5	1 to 5
M3	0 to 4	2 to 6*	2 to 6
Debt[2]	4 to 8	3 to 7	3 to 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.

*Revised at July 1995 FOMC meeting.

along with balance sheet restructuring associated with stock repurchases and a surge in merger and acquisition activity. Although the decline in long-term interest rates this year has spurred a significant pickup in bond issuance and fixed-rate mortgage borrowing very recently, the increase in credit this year has been concentrated in short-term or floating-rate debt.

Depository institutions, as traditional providers of short-term and floating-rate credit, have enjoyed a sharp increase in loan demand. To fund the growth of their loan portfolios, banks and thrifts pulled in more deposits, providing a lift to growth of the broad monetary aggregates. Indeed, M3 expanded at a 6¼ percent pace from the fourth quarter through June, slightly exceeding the upper bound of its revised annual range. In their usual fashion, yields on small time deposits and money market mutual funds have adjusted with a lag to the declines in market interest rates this year. Investors have responded by shifting their portfolios toward these assets, boosting M2 growth from the fourth quarter through June to 3¼ percent at an annual rate. M2 velocity over the first half of 1995 is estimated to have held about steady, in marked contrast to the rise in M2 velocity over the previous five years.

Unlike the broad monetary aggregates, M1 growth has been quite sluggish this year. Low interest returns on transaction deposits have encouraged households and businesses to move excess balances into higher-yielding M2 assets and also into market instruments. This process has been amplified by the expansion of retail sweep accounts offered by a few banks that allow customers to hold a lower average level of transaction balances. Currency growth—although slower than the double-digit pace of the last two years—has remained strong, boosted again by heavy foreign demands.

Money and Debt Ranges for 1995 and 1996

In setting ranges for money and debt in 1995 and 1996, the Committee noted that the velocities of the monetary aggregates have been behaving more in line with historical patterns than was the case earlier in the decade. However, financial innovation, technological change, and deregulation have blurred distinctions among various financial instruments that can serve as savings vehicles and sources of credit. As a consequence, considerable uncertainty remains about the future relationships of money and debt to the fundamental objectives of monetary policy; the Committee will thus continue to rely primarily on a wide range of other information in determining the stance of policy.

The Committee retained its current range of 1 to 5 percent for M2 for 1995 and chose the same range for 1996. If M2 velocity continues on a more normal track, growth of M2 in the upper half of this range in 1995 and near the upper bound of the provisional range in 1996 would be consistent with the Committee's expectations for nominal income growth. The existing range was retained for next year in view of the lingering uncertainties about the money–income relationship and to serve as a benchmark for the rate of growth of M2 that would be expected under conditions of reasonable price stability and historical velocity behavior. The Committee also reaffirmed the 3-to-7 percent range for the debt aggregate and carried this range forward on a provisional basis for 1996, concluding that debt growth within this range would be expected to accompany the moderate economic expansion it was seeking to foster.

With regard to M3, the Committee had noted in its February 1995 report to Congress that the depressed

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Economic Projections for 1995 and 1996

	Federal Reserve Governors and Reserve Bank Presidents		Administration
	Range	Central Tendency	
1995			
Percent change, fourth quarter to fourth quarter[1]			
Nominal GDP	3¾ to 5¼	4¼ to 4¾	5.4
Real GDP	1⅜ to 3	1½ to 2	2.4
Consumer price index[2]	3 to 3½	3⅛ to 3⅜	3.2
Average level in the fourth quarter, percent			
Civilian unemployment rate	5½ to 6¼	5¾ to 6⅛	5.5–5.8[3]
1996			
Percent change, fourth quarter to fourth quarter[1]			
Nominal GDP	4⅝ to 5½	4¾ to 5⅜	5.5
Real GDP	2⅛ to 3	2¼ to 2¾	2.5
Consumer price index[2]	2½ to 3½	2⅞ to 3¼	3.2
Average level in the fourth quarter, percent			
Civilian unemployment rate	5½ to 6¼	5¾ to 6⅛	5.5–5.8[3]

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.
2. All urban consumers.
3. Annual average.

growth of this aggregate in recent years reflected the balance sheet adjustments of banks and thrifts in response to the extraordinary strains they experienced in the early 1990s. The Committee observed that, as these institutions returned to health and intermediation resumed more normal patterns, M3 growth could pick up appreciably and the velocity of M3 might begin to stabilize or even decline, as it had on average over several decades before 1990. In the event, M3 has strengthened considerably so far in 1995, apparently for the reasons noted by the Committee in February. As a consequence, the Committee made a technical adjustment in its M3 range at the July meeting—to 2 to 6 percent for 1995—and carried that range forward on a provisional basis into 1996. The Committee stressed that this change simply recognized the return of historical financing patterns and bore no implications for the underlying thrust of monetary policy.

Economic Projections for 1995 and 1996

The members of the Board of Governors and the Reserve Bank presidents, all of whom participate in the deliberations of the Federal Open Market Committee, generally anticipate that, after a weak second quarter, the economy will experience moderate growth in the second half of 1995 and in 1996. For all of 1995, this would produce growth that was somewhat below forecasts made for the February meeting. In line with these expectations, the unemployment rate in the second half of 1995 may move up somewhat from its recent relatively low level.

A number of factors should contribute to a pick up in demand and production over coming months. Lower interest rates, in particular, likely will directly stimulate spending on housing, motor vehicles and consumer durables, and business investment. More-

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over, increases in the value of bond and stock portfolios that have accompanied the decline in interest rates should strengthen aggregate demand more generally. The strong competitive position of the United States likely will bolster net export growth on balance over the remainder of 1995. To be sure, the level of U.S. exports to Mexico probably will remain depressed for some time, but Mexico's external adjustment has already been substantial and further declines in U.S. export demands from this source are likely to be less severe than in the first half of 1995. Finally, the anticipated pickup in spending will help businesses work off excess inventories more rapidly and reduce the need for further production cutbacks to bring inventories back in line with final sales.

The Board members and the Reserve Bank presidents generally expect the rise in the consumer price index over the four quarters of 1995 to end up around 3¼ percent, the same as in the first half of the year. For 1996, inflation is projected to edge down to the neighborhood of 3 percent. The first-half slowdown in the industrial sector has reduced pressure on materials prices; moreover, wage trends have been stable, suggesting that labor costs are unlikely to provide an impetus to inflation.

The Administration has not released an update of the economic projections contained in the February *Economic Report of the President*. Those earlier forecasts pointed to real GDP growth of 2.4 percent for 1995, well within the central tendency range in the Federal Reserve's February report. Given the slow start this year, that growth pace for the year appears less likely, and the average unemployment rate for the year probably will be around the upper end of the 5.5 to 5.8 percent range in the Administration's February report. The Administration's 3.2 percent CPI forecast is in line with the Federal Reserve's central tendency.

The inflation rates anticipated by the FOMC are marginally above those prevailing in 1993 and 1994 but are considerably below rates of only a few years ago—and lower than many observers seemed to anticipate for the current economic expansion only a few months ago. Nonetheless, they should be regarded as only a milepost along the path toward the long-term goal of price stability. The Federal Reserve recognizes that eliminating the economic distortions associated with inflation is the most important long-run contribution it can make to the economic growth and welfare of the nation.

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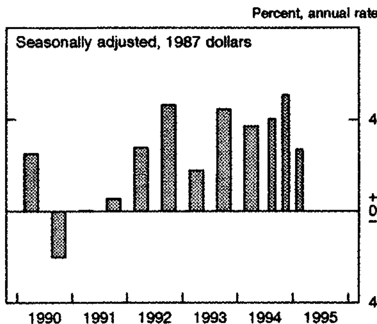
Section 2: The Performance of the Economy

At the end of 1994, resource utilization in the U.S. economy was high: Manufacturing capacity utilization equaled its 1989 peak, and the unemployment rate was close to the low point of the late 1980s. Moreover, economic expansion was still brisk, with real gross domestic product growing at a 5 percent annual rate in the fourth quarter. Although inflation for 1994 as a whole remained moderate, commodity prices, which can signal the onset of inflationary pressures, were rising rapidly at the end of last year.

Change in Real GDP



A deceleration in activity was widely anticipated, and growth in real GDP did moderate to a 2¾ percent annual pace in the first quarter of 1995. But the slowing did not stop there: Spending in several sectors of the economy softened in the spring, industrial production fell, and employment grew relatively little. The level of real GDP appears to have been essentially flat in the second quarter.

A slackening in household demand for big-ticket items was a significant element in the drop-off in economic growth in the first half. After registering sizable gains last year, spending on consumer durables weakened considerably early this year. And residential construction, which continued to grow in the face of rising mortgage rates last year, began to fall this winter and was off sharply in the second quarter. These domestic drags were reinforced by the effects of the plunge in net exports to Mexico, which came in the wake of that nation's financial crisis.

With domestic sales and exports softening, businesses cut orders and production. However, in some cases, the adjustments were not quick enough to avoid an unwanted accumulation of inventories. This was especially true for cars and light trucks, but it extended to other goods as well. Efforts to trim stocks reinforced the contractionary forces in the manufacturing sector of the economy.

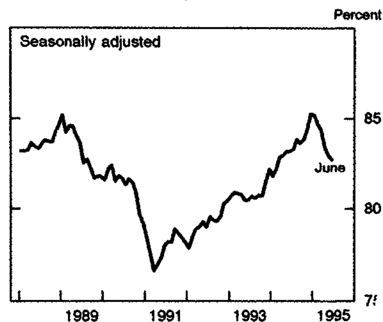
Despite the fall-off in growth in the first half, the unemployment rate edged up only slightly, and while manufacturing capacity utilization fell considerably, it remained above historical averages. Under the circumstances, it is not surprising that the mounting inflationary pressures of the latter part of 1994 carried over into the first part of this year and that materials prices surged further. Rising import prices, related to the depreciation of the dollar, also contributed to domestic inflation. Reflecting these and other factors, the consumer price index increased at a 3¼ percent annual rate in the first half of this year, up from a 2¾ percent increase for 1994 as a whole.

Nonetheless, increases in hourly wages and benefits remained moderate, holding down unit labor costs. Furthermore, the drop in manufacturing activity in the first half of the year contributed to a flattening in industrial commodity prices, suggesting some lessening of inflationary pressures "in the pipeline." These favorable factors were reflected in some moderation of price increases toward midyear.

The Household Sector

After advancing at more than a 4 percent annual rate in the second half of 1994, growth in consumer

Manufacturing Capacity Utilization Rate



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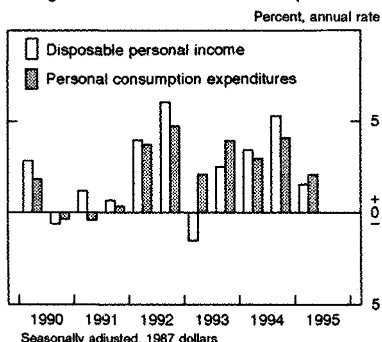
Change in Real Income and Consumption



Seasonally adjusted, 1987 dollars

spending slowed appreciably on average in the first half of this year. Real personal consumption expenditures increased at just a 1½ percent annual rate in the first quarter, before picking up moderately in the second.

Outlays for consumer durables moved up sharply in 1994, and by the end of the year, the level of spending was high relative to income. Many households may have brought their stocks of durables up to desired levels, limiting further purchases this year. In addition, by early this year, the stimulus to consumer spending from the massive mortgage refinancing wave of 1993 and early 1994 likely had been exhausted. The downturn in interest rates this year has led to a comparatively modest rebound in refinancings recently, which may free up some income for additional spending in coming months.

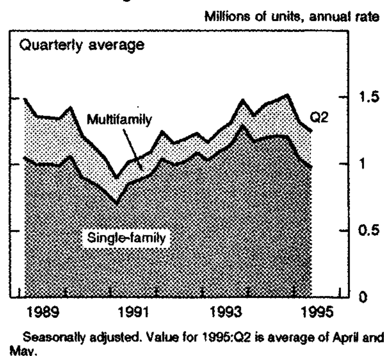
The slackening in consumer demand in the first quarter was concentrated in motor vehicles, where sales fell off after surging in the fourth quarter of 1994. However, real spending on goods other than motor vehicles also grew less rapidly in the first quarter than in the second half of 1994. Some of the deceleration in other consumer durables may have reflected the weakness in home sales, because families often purchase new furnishings and appliances when they change houses. Among nondurable goods, outlays for apparel were especially weak, following rapid growth in spending in the second half of 1994.

The slowing of consumer spending growth so far his year has been about in line with the slowing in ıcome growth. Through the first quarter, wage and ılary income posted solid gains, bolstered by a healthy pace of hiring. But increases in wage and salary income faded in the spring, reflecting slow growth in employment and a drop in the workweek. The deceleration in labor income was only partially offset by rapid growth in interest and dividend income in the first half of 1995. Dividend income benefited from the improvement in corporate profits. Growth in interest income was strong in the first quarter, reflecting the lagged effects of increases in market interest rates in 1994, but began to flag in the second quarter as the decline in market interest rates this year showed through to interest earnings.

Surveys suggest that consumer confidence remained high through the first half of 1995. Movements in both of the major surveys—from the Michigan Survey Research Center and the Conference Board—were similar in in the first half of 1995: Both spent part of the first half of 1995 above their 1994 average values, but by June, both had moved back down to their 1994 averages.

Early this year, residential construction activity weakened significantly and single-family housing starts in the first quarter were 14 percent (not an annual rate) below their fourth-quarter average. Sales of new and existing homes also fell in the first quarter, although not quite so steeply. Single-family starts edged up in April but more than reversed this gain in May; however, building permits, a more reliable indicator, moved up in May. New home sales jumped 20 percent in May, to the highest level since late 1993. Although reported new home sales are volatile, and the initial readings are often revised substantially, other indicators of housing activity also point in a

Private Housing Starts



Seasonally adjusted. Value for 1995:Q2 is average of April and May.

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favorable direction: Applications for mortgages to purchase homes rose sharply in May and remained elevated in June, and attitudes of households and builders toward the housing market became more positive in the second quarter.

Like single-family homebuilding, multifamily construction fell early this year, with starts off 11 percent in the first quarter. The drop this year follows a two-year period of recovery, during which starts doubled from their thirty-five-year low reached at the beginning of 1993. Multifamily starts turned back up in April and May. Prospects for a continued gradual increase in multifamily starts appear good, as newly built apartments were quickly filled last year and vacancy rates for apartments continued to move down in the first quarter of this year. However, continuing overhangs of empty apartments in some markets are likely to keep total multifamily starts well below the levels of the 1980s.

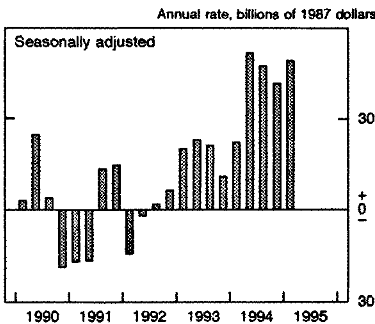
The Business Sector

In the second half of 1994, nonfarm inventories increased nearly 5 percent at an annual rate, about keeping pace with growth in final sales, as firms built stocks to ensure adequate supplies—or, in some instances, to beat anticipated price increases. In the first quarter, inventory growth continued at about its late 1994 pace, but growth in final sales moved down to a 2½ percent annual rate, leaving many firms with stocks they did not want.

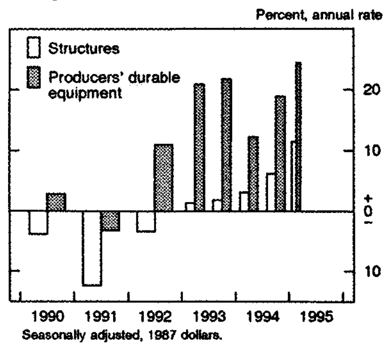
The first-quarter inventory run-up was disproportionately in motor vehicles, as production increased while sales were falling. To bring inventories back in line, manufacturers cut production sharply; between February and May, output dropped 10 percent. The decline in output of motor vehicles, parts, and related inputs was the most important factor in the 1 percent drop in overall industrial production in this period. Motor vehicle inventories accumulated further in April when sales fell sharply, but there was some progress in trimming excess stocks in May and June. Nonetheless, much of the overhang of vehicles that developed earlier this year remains.

The inventory buildup outside the motor-vehicle sector was also quite large in the first quarter, and it continued at a rapid pace in April. The available data for May suggest a somewhat smaller rate of increase. Although stocks of most goods remained in better alignment with sales than in the motor-vehicle sector, inventory accumulation has been running ahead of sales in a few sectors, particularly in apparel, furniture, and appliances. In response, manufacturers have cut production in these areas. The accumulation of furniture and appliances is likely related to the drop-off in home sales in early 1995, and the revival in home sales that appears to be underway should boost sales in these areas, helping to trim inventories further.

Change in Real Nonfarm Business Inventories



Change in Real Business Fixed Investment



Seasonally adjusted, 1987 dollars.

Business fixed investment rose at an extraordinary pace in the first quarter, with strong gains in both the equipment and structures components. Real spendin on equipment increased at a 25 percent annual rat With the exception of motor vehicles, the growth i equipment spending was widespread in the first qua ter. For structures, real outlays increased at a 12 p cent annual rate in the first quarter, followin

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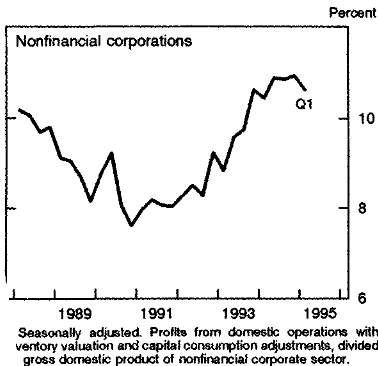
4½ percent gain over the four quarters of 1994. The first-quarter increase in construction was also widespread across components.

Indicators for the second quarter suggest that growth in capital spending continued to be brisk, although not quite so fast as in the first quarter. Shipments of capital goods by domestic manufacturers in April and May were up moderately from their first-quarter average. And permits for nonresidential structures, which tend to lead construction by a few months, indicate that construction should continue to trend upward, although at a slower pace than early this year.

The surge in capital spending in recent years has pushed growth of the capital stock to its fastest pace since the late 1970s. This improvement in the rate of capital accumulation may lead to a pickup in productivity growth, but there is as yet little indication of a significant break with past trends. Indeed, when output is measured using the new chain-type alternative index—which will become the official measure later this year—trends in productivity growth in the nonfarm business sector in the 1990s are little changed from those of the 1970s and 1980s.

Corporate operating profits increased at a 7 percent annual rate in the first quarter, a somewhat faster pace than in the second half of 1994. However, first-quarter profits were boosted by an increase in earnings of U.S. corporations on foreign operations; profits on private domestic operations were about unchanged. The increase in profits on foreign operations resulted in part from the decline in the exchange value of the dollar, which pushed up the value of profits earned abroad. Private domestic financial profits improved in the first quarter, in part because of a surge in bank earnings, which were boosted by strong loan growth. First-quarter earnings on domestic operations of U.S. nonfinancial corporations declined slightly, following solid gains in 1994. Profits were 10.6 percent of the output of nonfinancial corporate businesses in the first quarter, about the same as in 1994 as a whole, when the profit share was the highest since the late 1970s.

Before-Tax Profit Share of GDP



Seasonally adjusted. Profits from domestic operations with ventory valuation and capital consumption adjustments, divided gross domestic product of nonfinancial corporate sector.

In the farm sector, indications are that production will fall well short of last year's exceptionally high levels. Weather conditions have been less favorable than those of 1994, with unusually heavy rains keeping plantings behind schedule across large parts of the Midwest. Also, with stocks relatively high after last year's large harvests, the U.S. Department of Agriculture reduced the amount of acreage that farmers contracting for subsidy payments were allowed to plant. However, livestock production has remained strong so far in 1995, which will help cushion the effects of smaller harvests on total agricultural production. Because of the likelihood that production will fall this year, farm inventory investment will probably be smaller this year than in 1994, and stocks of some crops will likely be drawn down appreciably.

The Government Sector

The federal government deficit has continued to shrink in the current fiscal year. For the first eight months of the 1995 fiscal year, the budget deficit was 19 percent below the same period a year earlier. Nominal expenditures over this period were 4 percent higher than a year earlier, while receipts were up 8½ percent. In addition to the strong economic growth of 1994, receipts were boosted by changes in rules that allowed some individuals to defer until 1995 certain tax payments that would have been due in 1994 under previous rules.

Higher interest outlays contributed to the increase in federal spending in the first part of the 1995 fiscal year. Excluding interest outlays, nominal federal spending in the first eight months of this fiscal year increased about 2 percent, compared with the year-earlier period. Defense expenditures continued to decline in nominal terms; they have been the main factor holding down federal spending in recent years. Spending on income security programs, such as unemployment insurance and welfare benefits, also edged down, mostly reflecting the economic expansion. Spending on Medicare and other health programs was up 9 percent in the first eight months of the

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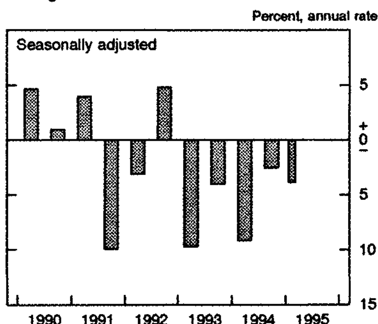
Change in Real Federal Purchases

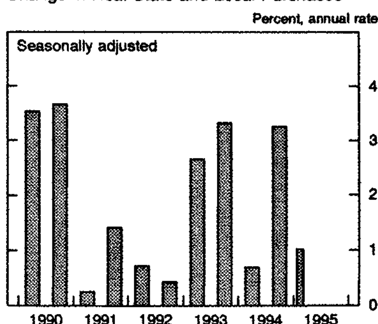


fiscal year; while still quite rapid, this growth is slower than that of the early 1990s, when these expenditures were rising 10 to 20 percent per year. Spending on social security and on other nondefense functions increased less than the recent trend in nominal GDP.

In real terms, federal purchases of goods and services—the part of federal spending included in gross domestic product—fell at an annual rate of 4 percent in the first quarter of 1995. Falling defense spending more than accounted for the decline. As of the first quarter, the level of real federal purchases was 17 percent below the peak reached four years ago.

State and local government deficits on combined capital and operating accounts (that is, excluding

Change in Real State and Local Purchases



social insurance funds) totaled $37 billion in the first quarter of 1995, a small improvement from the deficit a year earlier. Excluding social insurance, tax receipts increased 7 percent between the first quarter of 1994 and the first quarter of 1995 while expenditures were up 6¼ percent. Transfer payments continue to grow faster than other spending, although the rate of increase is well below that earlier in the 1990s.

Real purchases of goods and services by state and local governments have been rising only moderately for some time; in the first quarter of 1995, they were little changed. The slowing in the first quarter was concentrated in construction spending, which fell after three quarters of solid increases. Purchases of other goods and services remained on the gradual uptrend that has been evident over the past few years. State and local employment increased about 14,000 per month, on average, over the first six months of 1995, considerably below the pace of the 1992-to-1994 period.

The small improvement in the budget situation for the state and local sector as a whole masks important differences across levels of government. Available evidence suggests that while state budgets are in relatively good shape, budgets at the local level remain under pressure. State aid to localities, particularly to school districts, has been eroding relative to expenses for several years. Also, local governments rely more heavily than state governments on property taxes, and while sales and incomes have rebounded in the current business cycle expansion, property values have lagged behind, limiting property tax receipts.

The External Sector

The nominal trade deficit on goods and services widened somewhat in the first quarter, to $120 billion at an annual rate. However, net investment income improved in the first quarter, as did net transfers, and as a consequence, there was a narrowing of the current account deficit in the first quarter from its fourth-quarter level, to $162 billion at an annual rate. Nonetheless, the first-quarter current account deficit exceeded 1994's average of $151 billion. In April, the trade deficit increased further from the first-quarter average.

The quantity of U.S. imports of goods and services expanded 10 percent at an annual rate during the first quarter, somewhat less rapidly than in 1994. The slower pace of U.S. income growth contributed to the lower import growth; increased imports from Mexic were a partial offset. In April, real imports continue

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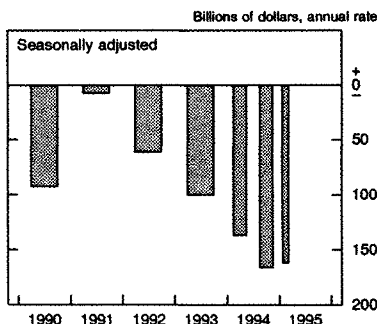
U.S. Current Account

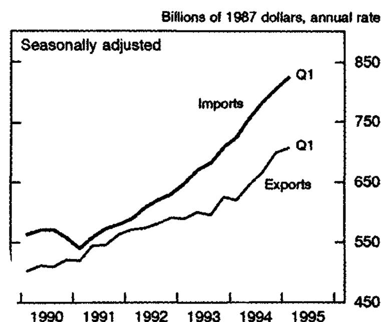


to grow at about the first-quarter pace. The increases in imports in the first four months of the year were widespread across major trade categories.

Non-oil import prices rose at a 3½ percent annual rate in the first quarter, somewhat less than during the second half of 1994, when they were pushed up by large increases in world commodity prices, especially for coffee. In April and May, non-oil import prices rose at a nearly 6 percent annual rate, with increases for most major trade categories. The pickup in price increases for imported goods reflected, in part, the recent dollar depreciation.

The quantity of U.S. exports of goods and services rose at a 5 percent annual rate in the first quarter, more slowly than the double-digit rate of growth over the four quarters of 1994. In large part, the weaker

U.S. Trade in Goods and Services



export performance was the result of the macroeconomic adjustments taking place in Mexico and the reduced Mexican demand for U.S. exports. Preliminary data for April indicated that the quantity of exports expanded a bit further from the first-quarter average. For the first four months of the year, exports to Mexico fell while they increased moderately to most other areas of the world.

Real output in Mexico declined sharply in the first quarter as instability in the financial markets weakened confidence and the government implemented a program of fiscal and monetary restraint. The Mexican economy apparently continued to contract in the second quarter. The crisis and ensuing policy responses induced a dramatic reduction in Mexico's current account deficit during the first quarter of the year. In the wake of the Mexican crisis, the Argentine authorities chose to tighten macroeconomic policies, which has led to a weakening of economic activity in Argentina. In contrast, Brazil experienced very strong real output growth in the first quarter as consumption spending surged; available indicators suggest some slowing of growth in the second quarter.

In Japan, recovery from the recent recession remains tentative. First-quarter real GDP growth was only 0.3 percent at an annual rate; data for the second quarter also suggest that the recovery may be stalling. Asset prices have continued to fall, adding to concerns about the lack of progress in improving banks' balance sheets and limiting the capacity of banks to extend credit in support of the recovery. In May, the Japanese government announced another package of structural reforms and measures to boost domestic demand. The sluggish pace of activity in Japan and the rise in the value of the yen have eliminated inflation: Consumer prices were unchanged over the twelve months through June.

In other industrial countries, the rate of economic expansion appears to have slowed from its rapid 1994 pace. In Canada, real GDP growth slowed to less than 1 percent at an annual rate in the first quarter; second-quarter indicators suggest continued sluggishness. In the United Kingdom, where the expansion has been vigorous over the past three years, real GDP continued to grow strongly in the first quarter, although at less than the 1994 pace. In most continental European countries, the rate of real output growth in the first half of 1995 was somewhat lower than the rapid pace during the second half of 1994. In Canada and several major European countries, measures intended to reduce government deficits as a share of GDP have been announced.

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Inflation rates in the industrial countries generally remain low. However, in the United Kingdom and Italy, currency depreciation has added upward pressure on prices, and consumer prices rose 3½ percent in the twelve months through June in the United Kingdom and nearly 6 percent in Italy. In western Germany, exchange rate appreciation helped offset domestic inflationary pressures, and consumer prices rose only 2¼ percent through June.

Among our Asian trading partners other than Japan, real GDP growth has remained near the rapid 1994 pace, in part because substantial depreciations of those countries' currencies against the Japanese yen and the German mark stimulated exports. However, economic activity decelerated somewhat in China and Singapore, reflecting past tightening of monetary policy and the reduction of spare capacity in these economies.

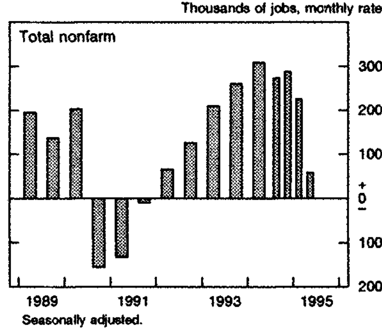
Net capital flows into the United States were large in the first quarter of 1995. Foreign official holdings in the United States rose more than $20 billion, as foreign governments made large intervention purchases of dollars in March in response to strong upward pressure on the foreign exchange value of their currencies. Sizable official inflows continued in April and May. In addition, net private foreign purchases of U.S. securities were considerable in the first quarter, particularly purchases of Treasury bonds and notes and new Eurobond issues by U.S. corporations. Private foreign net purchases of U.S. securities moderated a bit in April and May. In contrast, U.S. net purchases of foreign securities, which had fallen substantially last year from their 1993 peak, continued to decline on balance over the first five months of 1995.

U.S. direct investment abroad was considerable in the first quarter, at $18 billion. Investment in Western Europe was particularly strong. Foreign direct investment in the United States, at $10 billion, remained substantial. On net, there was a large outflow of direct investment in the first quarter, after netting to about zero in 1994.

Labor Markets

Employment grew rapidly in 1994, and labor markets tightened considerably. Although job growth slowed in the first quarter of this year, it was still large enough—at 226,000 per month—to keep the unemployment rate at about the same level as in the fourth quarter of 1994. In the second quarter, nonfarm payroll employment growth slowed to only 60,000 per month and the quarterly average unemployment rate edged up from 5.5 to 5.7 percent.

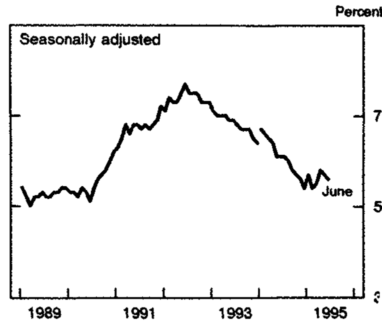
Net Change in Payroll Employment



Seasonally adjusted.

The deceleration in employment was particularly marked in the goods-producing sector, where payrolls fell during the second quarter after posting strong gains in the early months of the year. In construction, payroll growth averaged 30,000 per month in 1994 and through the first quarter of 1995, but employment then fell 8,000 per month in the second quarter. Manufacturing job growth also averaged 30,000 per month in 1994. Factory hiring slowed in the first quarter, and in the second quarter, 35,000 jobs per month were lost. The decline in manufacturing employment was widespread across industries. Employers have also

Civilian Unemployment Rate



A redesigned survey and revised population estimates we introduced in January 1995; data from that point on are r directly comparable with those of earlier periods.

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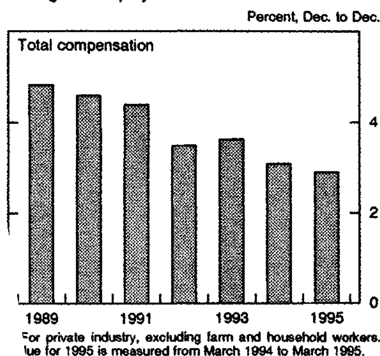
trimmed the factory workweek, which in 1994 had reached the highest level since 1945.

Although employment continued to rise in most service-producing industries in the first half of 1995, the rate of growth slowed by the second quarter. In wholesale and retail trade, where 75,000 jobs per month were added in the second half of 1994, the pace of job gains fell in the first quarter, and only 12,000 jobs per month were added in the second quarter. Similarly, in business services, where 46,000 jobs per month were added in 1994, employment decelerated in the first quarter and was about flat in the second. Among sectors showing employment gains in the first half of this year, entertainment industries posted considerable growth, and increases in employment in the health sector continued to run at about the same pace as in the second half of 1994.

The rate of increase in hourly compensation moved down further early this year. The employment cost index for private industry workers, a measure of hourly labor costs that includes both wages and benefits, rose 2.9 percent over the twelve months ended in March 1995, down from a 3.3 percent increase over the preceding twelve-month period. The increase in wages and salaries was the same in both periods, but the pace of benefits gains declined significantly.

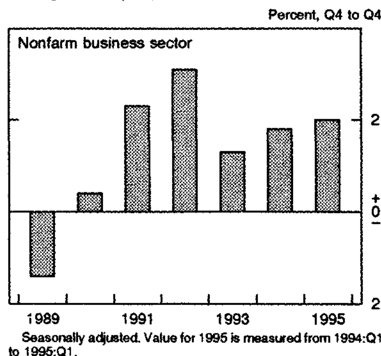
The largest contribution to the deceleration in benefits costs in recent years has come from health insurance. Among the factors restraining the increase in health insurance costs are slower medical-sector inflation, increased use of managed-care plans, and efforts by employers to shift a greater proportion of health care costs to employees. Costs of workers' compensation programs have also contributed to the deceleration in benefits costs; these costs, too, have been affected by lower medical inflation, although regulatory reform has played a role as well. Unemployment insurance costs decelerated sharply over the past two years: firms pay into the unemployment insurance program on the basis of their recent layoff experience, and the improved economy through the first part of this year lowered these payments.

Change in Employment Cost Index



For private industry, excluding farm and household workers. Value for 1995 is measured from March 1994 to March 1995.

Change in Output per Hour



Seasonally adjusted. Value for 1995 is measured from 1994:Q1 to 1995:Q1.

Output per hour in the nonfarm business sector—measured in 1987 dollars—increased at an annual rate of 2.7 percent in the first quarter of 1995. Output per hour increased 2.0 percent over the four quarters ended in the first quarter, down slightly from the rate of growth over the preceding four-quarter period.

Price Developments

The pickup in consumer price inflation so far this year was a bit larger for the index that excludes food and energy than for overall prices: The CPI excluding food and energy increased at a 3.6 percent annual rate over the first six months of 1995, up from a 2.6 percent increase in 1994. The acceleration in the first half was mostly in non-energy services prices, which increased at a 4½ percent annual rate over the first six months of 1995, up from a 3¼ percent increase over the twelve months of 1994. Airfares took off in the first half of 1995, rising at more than a 40 percent annual rate, after falling 10 percent in 1994; this acceleration accounted for two-thirds of the pickup in services inflation in the first half. Auto finance rates also increased rapidly early in 1995—rising at a 38 percent annual rate in the first

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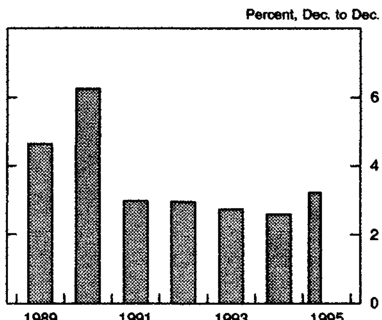
Change in Consumer Prices

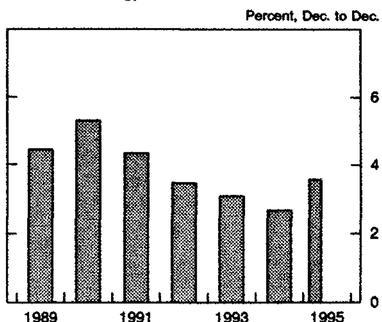


Consumer price index for all urban consumers. Value for 1995 is measured from December 1994 to June 1995, at an annual rate.

four months the year—following a large increase in the second half of 1994. However, the CPI for auto finance declined sharply in May and June, as interest rates on auto loans began to reflect the declines in market rates in the first half of 1995. Price increases for other services were, on balance, roughly in line with their rate of increase in 1994.

As a result of the brisk expansion of the industrial sector in 1994 and the consequent rapid increases in prices of basic manufactured products, the producer price index for intermediate materials other than food and energy increased at a 7½ percent annual rate over

Change in Consumer Prices Excluding Food and Energy



Consumer price index for all urban consumers. Value for 1995 is measured from December 1994 to June 1995, at an annual rate.

the second half of 1994. In the first quarter of this year, these materials prices rose even faster—nearly 10 percent at an annual rate. The rapid increases in materials prices began to affect finished goods prices in early 1995, and the PPI for finished goods other than food and energy, which covers domestically produced consumer goods and capital equipment, increased at a 3 percent annual rate over the first six months of 1995, up from a 1½ percent rate of increase over the twelve months of 1994.

The consumer price index for commodities other than food and energy increased at a 1½ percent annual rate over the first six months of 1995, about the same as in 1994. Prices accelerated at the retail level for some items for which producer prices have been rising rapidly, such as household paper products. But this pickup was partly offset by declines in prices where there have been large inventory buildups. Notably, apparel prices continued to decline in the first half, and prices of appliances, which had increased in 1994, fell in the first half of 1995.

The slowdown in the industrial sector has begun to relieve pressure on materials prices, and the PPI for intermediate materials other than food and energy increased just 0.2 percent per month in May and again in June, suggesting reduced pressures on finished goods prices in the near term.

Consumer food prices increased at a 1¾ percent annual rate over the first six months of 1995, down about a percentage point from 1994. Coffee prices, which had increased 64 percent in 1994, fell 12 percent over the first six months of this year. The swing in coffee prices can more than account for the deceleration in food prices. Prices of meats continued to fall in the first half of 1995, as production remained strong.

Energy prices increased at a 2 percent annual rate in the first half of 1995, about the same as last year. Natural gas prices have continued to decline. Regulatory changes have led to increased competition among suppliers of natural gas; in addition, natural gas prices were depressed early this year by the relatively warm winter, which held down demand. Gasoline prices increased at a 12 percent annual rate in the second quarter, reflecting the run-up in crude oil prices that occurred between December and April. Since April crude oil prices have reversed nearly all of thei earlier run-up, suggesting that gasoline prices wi' move down in coming months.

Survey data suggest that expectations of inflati have changed little since the end of 1994. Accordi

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to the survey of households conducted by the Survey Research Center of the University of Michigan, the mean expected increase in consumer prices over the coming twelve months in the first half of 1995 was the same as in the fourth quarter of 1994. In the Conference Board survey of households, the expected rate of inflation over the coming year remained at 4¼ percent in the first half of 1995, the same as in each of the four quarters of 1994. Expectations of inflation over longer periods also have not changed much on balance this year. In the University of Michigan survey, the expected rate of consumer price inflation over the next five to ten years in the second quarter of 1995 was the same as in the fourth quarter of 1994. Similarly, in the May 1995 survey of professional forecasters conducted by the Federal Reserve Bank of Philadelphia, expectations of inflation over the coming ten years were about 3½ percent, the same as in the survey taken at the end of 1994.

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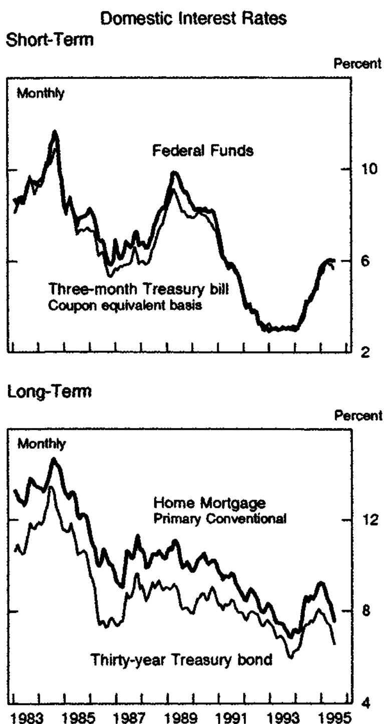
Section 3: Financial, Credit, and Monetary Developments

In charting the course of monetary policy this year, the Federal Reserve has sought to promote sustainable economic growth and continued progress toward price stability. Despite the tightening actions undertaken during 1994, economic data at the beginning of 1995 suggested that the economy was operating beyond its long-run potential and might continue to do so for some time—a situation that would no doubt lead to a significant pickup in inflation if allowed to persist. Against this backdrop, the Federal Open Market Committee (FOMC) voted in February to tighten reserve conditions somewhat further, resulting in a ½ percentage point increase in the federal funds rate. In the months following the February FOMC meeting, economic activity seemedto be leveling out, at least temporarily, considerably reducing pressures on resources. In early July, with the risks of a prolonged upturn in inflation fading, the FOMC decided to ease reserve pressures slightly, resulting in a decline in the federal funds rate of ¼ percentage point.



As incoming data in 1995 increasingly suggested slower economic growth and an attendant relief of inflation pressures, intermediate- and long-term interest rates moved down substantially. Additional downward pressures seemed also to arise from the growing conviction of market participants of the commitment of the Congress and Administration to making progress toward a balanced budget. On balance, most longer-term interest rates have declined 120 to 180 basis points since the end of last year with the sharpest drops at intermediate maturities. The trade-weighted exchange value of the dollar has depreciated about 7½ percent against the other G-10 currencies—in large part reflecting the decline in U.S. long-term interest rates relative to those in the other G-10 countries. In addition, the fall in interest rates, coupled with continued strong corporate earnings, fueled a runup in equity prices; most major stock price indexes have climbed 15 to 35 percent since the beginning of the year.

Despite slower economic expansion this year, growth rates of broad money and credit have picked up, and the decline in intermediate- and long-term interest rates has only recently begun to leave an imprint on the composition of borrowing. Total domestic nonfinancial debt increased 5½ percent from the fourth quarter of 1994 through May—a little above last year's pace—as stronger private sector borrowing more than offset slower growth of the federal debt and a decline in state and local government debt. Borrowing in the nonfinancial business sector has been largely concentrated in short-term or floating-rate debt such as bank loans and commercial paper. Recently, however, declines in longer-term interest rates have stimulated a sharp jump in corporate bond issuance. Household borrowing this year has been considerable, although below the pace of 1994. Tax-exempt debt is estimated to have declinec outright again this year as many state and local unit have called securities that had been advance refundec Federal debt growth has edged down a bit this yea extending the trend toward slower expansion of fe eral debt that began in 1991.

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Depository institutions have been especially important suppliers of credit to both businesses and households this year. Borrowers' demands were concentrated in the types of credit in which depositories are traditional lenders and, on the supply side, commercial banks continued to pursue new lending opportunities aggressively. The health and profitability of depositories have remained solid to date, although federal regulators have cautioned depositories that their lending standards should take account of the potential for deterioration of loan performance in a less favorable economic climate.

The surge in bank lending and the flattening of the yield curve this year have provided a significant impetus for growth of the broad monetary aggregates. M3 advanced 6¼ percent at an annual rate from the fourth quarter of 1994 through June—slightly above the upper bound of its revised 2 to 6 percent annual range set at the July FOMC meeting—as banks pulled in deposits to fund loans. The drop in market interest rates has enhanced the attractiveness of M2, which increased at 3¾ percent rate over the same period—a little above the midpoint of its annual range. In contrast to the broad monetary aggregates, M1 growth has been quite weak, reflecting the low yields on these assets and the implementation by a few banks of retail sweep accounts which move funds out of NOW accounts and into nontransaction balances.

The Course of Policy and Interest Rates

The Federal Reserve entered 1995 having tightened policy appreciably during 1994, boosting short-term rates 2½ percentage points. Nonetheless, data reviewed at the FOMC meeting in December 1994 suggested that pressures on resources were intensifying and that inflation threatened to move higher. Although the Committee took no action to increase rates further at this meeting, it did adopt a directive indicating a bias toward additional tightening in the intermeeting period.

Information reviewed at the February meeting suggested that despite some fragmentary evidence of slowing, the economic expansion remained brisk in an economy already operating at or beyond its long-run potential. The demand for consumer durables and homes was softening, but output and employment had posted substantial gains near year-end, and capacity utilization had moved up from already high levels. In addition, a marked rise in materials prices during the second half of 1994 posed a threat of increased consumer price inflation in coming months. In these circumstances, the Board of Governors approved the pending requests of several Reserve Banks for a ½ percentage point increase in the discount rate, and the Committee agreed to allow this increase to show through fully to the federal funds rate. In light of the tightening of policy called for at this meeting and the anticipated lagged effects of previous tightenings, the Committee viewed the odds of a need for further policy action developing over the intermeeting period as relatively small and evenly balanced, and therefore issued a symmetric directive to guide any intermeeting changes in reserve conditions.

In subsequent weeks, evidence suggested that economic activity was moderating, especially in the interest-sensitive sectors. Financial markets appeared to view these signs as indicating that the previous policy actions of the Federal Reserve had substantially reduced the odds of rising inflation, and thus also the need for additional monetary restraint. Indeed, yields on Treasury securities at maturities ranging from one to ten years fell 60 to 70 basis points between the February and March FOMC meetings.

At its meeting in late March, it was not clear to the Committee whether the deceleration in economic activity was only temporary or was a lasting shift toward a sustainable rate of economic expansion. On balance, the Committee viewed the economy as retaining considerable upward momentum and observed that the decline in longer-term interest rates, the rise in stock prices, and the sharp depreciation of the exchange value of the dollar could be expected to buoy aggregate demand in the months ahead. Moreover, consumer prices, as anticipated, had risen more rapidly in 1995. In these circumstances, the Committee determined that it would be prudent to await further information before taking any additional policy actions, but the Committee's directive included a bias toward additional monetary restraint over the intermeeting period. The asymmetric directive was considered appropriate to emphasize the Committee's commitment to containing and ultimately reducing inflation, in a period when it seemed to be moving higher.

Following the March meeting, incoming data signaled a further deceleration of economic activity. In addition, financial markets appeared to view budget discussions in the Congress as foreshadowing significant fiscal restraint over the balance of the decade. Shorter-term interest rates began to incorporate the possibility of an easing of monetary policy, and yields on longer-term securities—especially those at intermediate maturities—moved down sharply as well.

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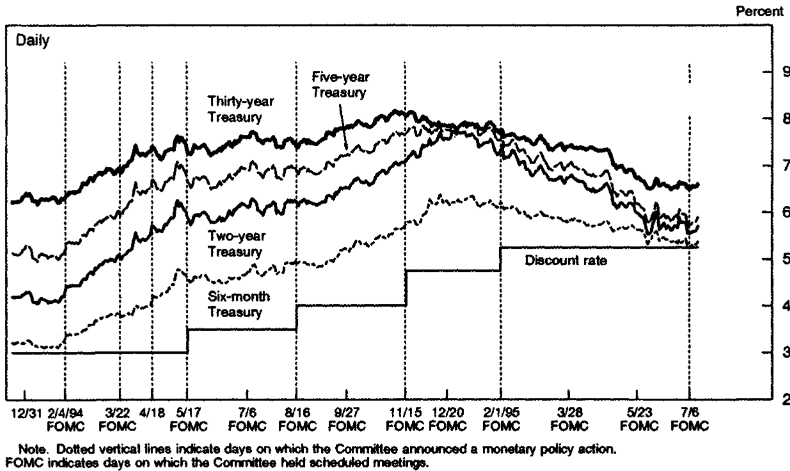
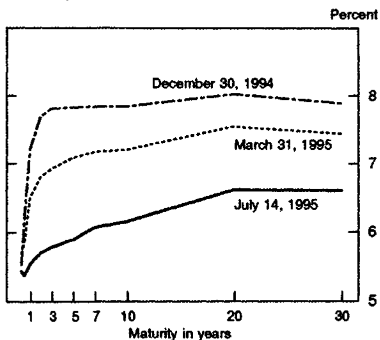
The Discount Rate and Selected Market Interest Rates



Note. Dotted vertical lines indicate days on which the Committee announced a monetary policy action. FOMC indicates days on which the Committee held scheduled meetings.

Information reviewed at the May FOMC meeting provided persuasive evidence that the pace of the economic expansion had slowed, relieving pressures on resources and reducing the threat of a pickup in inflation. The Committee observed that an adjustment to inventory imbalances that had developed earlier in the year was contributing to the slowdown and that the underlying trajectory of final sales was still unclear. The Committee determined that the existing stance of policy was appropriate in these circumstances and adopted a symmetric directive regarding potential policy adjustments during the intermeeting period.

Treasury Yield Curves on Selected Dates



Employment data released shortly after the May FOMC meeting were surprisingly weak, prompting considerable speculation in financial markets of an imminent monetary policy easing. The sharpness of the downward movement in longer-term rates seemed to reflect, in addition to economic fundamentals, trading dynamics associated with the attempts of investors to rebalance their portfolios in light of the substantial change in interest rates. At one point in late June, the spread between the thirty-year Treasury bond yield and the federal funds rate reached a low of 48 basis points but edged higher in subsequent weeks.

From the information reviewed at the July meeting of the FOMC, it appeared that the economy flattened out during the second quarter as businesses sought to pare inventories to desired levels. This pause in the expansion, in turn, had alleviated the inflation pressures that had loomed large earlier in the year. In these circumstances, the Committee voted to ease reserve pressures slightly, resulting in a ¼ percentage point decline in the federal funds rate. Althoug financial markets had anticipated a decline in th

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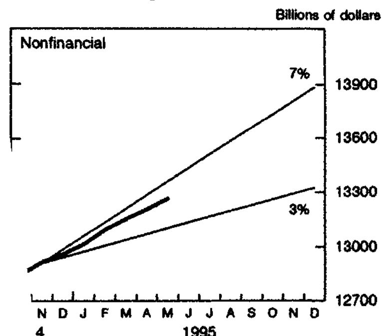
federal funds rate at some point, both bond and equity markets rallied strongly after the change in policy was announced. At the close on July 7, the thirty-year bond rate was down about 165 basis points from its recent high of last November.

Credit and Money Flows

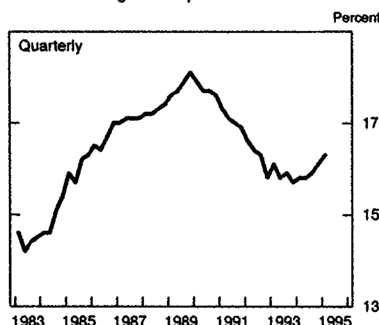
The debt of domestic nonfinancial sectors grew 5½ percent at an annual rate from the fourth quarter of 1994 through May of this year—a modest pickup over the pace of recent years but well within its annual range of 3 to 7 percent. Slower growth of federal debt and a decline in the debt of state and local governments in 1995 were more than offset by strength in business and household borrowing. Although declines in longer-term interest rates and the flattening of the yield curve have stimulated long-term, fixed-rate borrowing of late, during much of the year both households and businesses continued to favor borrowing that was short-term or floating-rate. In part, the reliance on such debt contributed to the larger share of private debt intermediated through the depository sector. In meeting increased credit demands, depositories turned more heavily to time deposits and other liabilities included in M2 and M3. Stronger funding needs and increased reliance on deposits provided a considerable lift to growth of the broad monetary aggregates.

Slower growth of federal debt this year relative to 1994 reflects stronger tax revenues and diminished growth of expenditures, especially defense-related outlays. In the state and local sector, debt outstanding has continued to decline, largely driven by calls of higher-cost debt issued during the 1980s.[1] Yields on municipal bonds relative to Treasuries had moved up considerably after Orange County defaulted on its debt late in 1994 but retraced much of this increase early in 1995. The ratio of municipal yields to Treasury bond yields has climbed again more recently as various budget proposals before the Congress raised the prospect of reduced federal tax advantages for municipal debt. In addition, the recent decision by Orange County voters not to raise taxes to cover the county's losses has tended to boost risk premiums for the obligations of many municipalities in California and, to a lesser extent, for other borrowers in the municipal bond market.

Debt: Annual Range and Actual Level



Household Debt Service Burden as a Percentage of Disposable Income



Note. Debt includes household sector mortgage and consumer debt. Debt service is the sum of required interest and principal payments on mortgage and consumer debt.

Borrowing by households—although off a bit from last year's pace—has generally remained strong this year. Consistent with weaker auto sales this year, a modest deceleration of consumer credit resulted from slower growth of auto loans. Growth of revolving credit—principally credit card debt—trended higher from the already brisk pace recorded last year. The proliferation of incentive programs offered with many credit cards has likely encouraged greater convenience use for transactions in recent quarters.

1. Many state and local units took advantage of historically low long-term interest rates in 1993 to issue bonds that were targeted to replace existing high-cost debt issued during the 1980s as the call dates on those bonds arrived. Calls on previously issued debt likely will continue to depress net state and local borrowing for some time.

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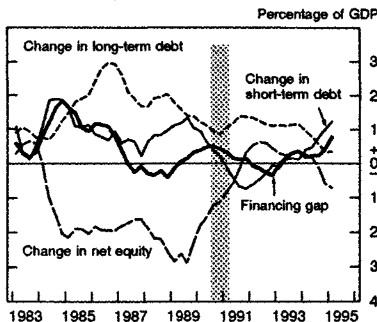
Growth of home mortgage debt moderated somewhat in the first quarter, a pattern consistent with the overall sluggish demand for housing. As long-term rates moved down this year, the pronounced shift toward adjustable rate mortgages (ARMs) evident last year dissipated. As of May, 60 percent of new mortgage originations were fixed-rate mortgages (FRMs). In addition, the decline in long-term rates in recent months has sparked renewed interest in refinancing. Households carrying ARMs with rates that are (or soon will be) above rates offered on FRMs have reportedly begun to refinance with FRMs.

Household debt-service burdens—measured as the ratio of scheduled principal and interest payments on debt relative to income—have risen in 1995 but remain well below levels reached in the late 1980s and early 1990s. Mortgage refinancings undertaken at lower interest rates in recent years have helped to keep the level of debt-service burdens relatively low despite the growth of household debt relative to income. In fact, some measures of delinquency rates on home mortgages have edged down this year to the lowest levels in more than twenty years. The picture for delinquency rates on consumer credit is less clear: Some measures such as the delinquency rates on consumer installment credit remain quite low, while others—especially auto loans booked at finance companies—have moved up considerably.

Borrowing by nonfinancial businesses has increased in 1995, propelled in large part by a rise in capital expenditures in excess of internal sources of funds and a jump in merger activity. In addition, a number of firms have initiated stock repurchases financed in part with debt. As in 1994, the composition of business borrowing this year has been heavily weighted toward short-term commercial paper and bank loans. Lower long-term interest rates, however, have stimulated a flurry of new bond issues very recently.

Trends in Corporate Finance



Various unsettling developments in financial markets including the Orange County debacle, losses associated with complex derivatives and cash instruments, the failure of Barings Brothers, and the financial crisis in Mexico, have had some limited impacts on the specific companies or sectors involved. However, they have not had a large impact on broad market perceptions of credit risks; spreads of yields on short- and long-term corporate debt over Treasuries have widened only a bit this year, likely reflecting the elevated supply of new corporate debt and perhaps a small uptick in risk premiums.

The gap between the capital expenditures and internal cash flow of nonfinancial corporations (the financing gap) began widening in mid-1994 and has grown even larger in 1995. In part, the bulge in the financing gap is the result of the large buildup of inventories earlier in the year. Most external funding for the purpose of carrying inventories apparently has taken the form of commercial paper or bank loans.

A surge in merger activity beginning in late 1994 has also spurred business borrowing. Many of the largest mergers have been strategic, intra-industry combinations, concentrated especially in areas such as defense, pharmaceuticals, telecommunications, and (most recently) banking. In contrast to the merger and acquisition wave during the late 1980s, the current acquisition boom has not entailed highly leveraged takeovers financed heavily with junk bonds. Indeed, until quite recently, junk bond issuance this year has been anemic. Merger activity in recent quarters has involved substantial use of stock swaps coupled with reductions in financial assets and new investment-grade debt issuance (often in the form of commercial paper). Survey evidence indicates that banks have played only a modest role in directly funding recent mergers, although they have facilitated transactions by providing backup lines for merger-related commercial paper.

Equity retirements associated with mergers ha[ve] accounted for a sizable portion of the decline in equity shares outstanding. In addition, gross issua[nce] of new equity has ebbed as price–earnings ratios h[ave] fallen and many firms have repurchased their s[tock] with both accumulated cash and the proceeds of debt.

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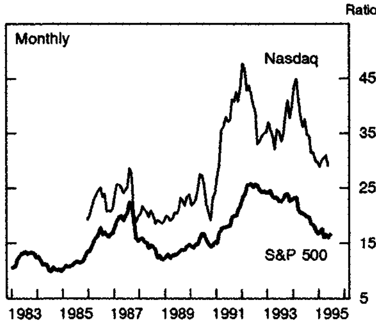
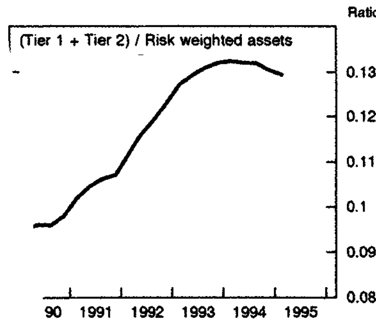
Selected Price–Earnings Ratios



The shift to short-term funding in the business sector has been a boon to intermediaries that tend to specialize in short-term lending. Finance companies and commercial banks, in particular, have enjoyed a prominent role as suppliers of credit over the last year. To date, there are few indications that the health of these institutions has deteriorated. Credit ratings for finance companies have been stable and bank profitability and capital ratios have been solid.

An important factor contributing to the overall strength of depository credit has been the stabilization of the thrift industry, especially savings and loan associations. After several years of sharp contraction, thrift assets expanded slightly over the second half of 1994 and continued a modest recovery in 1995. The number of thrift institutions continues to decline,

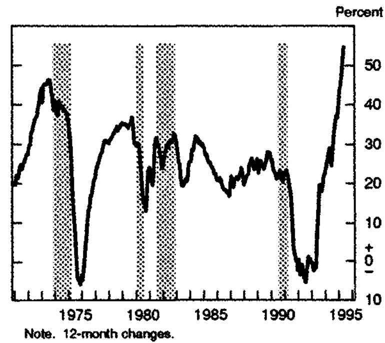
Total Risk-Based Capital Ratio (Domestically Chartered Commercial Banks)



however, with many filing for bank charters or being acquired by banks.

The growth of bank credit picked up appreciably during the first half of 1995, with strength especially evident in bank loans. Indeed, the share of the increase in nonfederal domestic debt over the past twelve months funded by bank loans climbed to record levels. Surveys of bank lending officers have indicated banks' increased willingness to extend consumer credit as well as continued easing of terms and standards applied to business loans. Data from the Federal Reserve's Survey of Terms of Bank Lending to Business show that spreads of loan rates over the federal funds rate for large commercial loans have been about the same as last year but well below those prevailing through much of the late 1980s and early 1990s. Comparable spreads for smaller commercial loans are wider than in the late 1980s but have continued the narrowing trend of recent years. The strength of bank lending has been viewed favorably in financial markets—bank stock prices have risen this year about in line with or faster than the climb in broad stock price indexes, while spreads on bank debt relative to Treasuries have widened only slightly.

Percentage of Change in Domestic Nonfederal Debt Funded with Bank Loans



Note. 12-month changes.

The continued easing of bank lending standards after more than a year of monetary policy restraint has attracted the attention of federal regulators. The Office of the Comptroller of the Currency warned banks against allowing their standards to fall to a point that could expose them to heavy losses in an economic downturn. In the same spirit, the Federal Reserve

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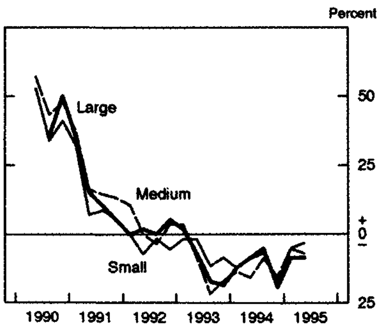
issued a supervisory letter cautioning banks that loan terms and standards should be set with a long-term view that takes loan performance in less favorable economic conditions into account.

Banks have funded the bulge in their loan portfolios this year in part by liquidating a portion of the large holdings of securities they had accumulated earlier in the 1990s.[2] In addition, banks have increasedtheir liabilities. Last year, banks relied heavily on borrowings from their non-U.S. offices to fund growth of their domestic assets. Deposit growth at the foreign offices of U.S. banks has slowed considerably this year. Consistent with this development, borrowing by domestically chartered banks from their foreign offices has increased in 1995 but not at the pace of last year.

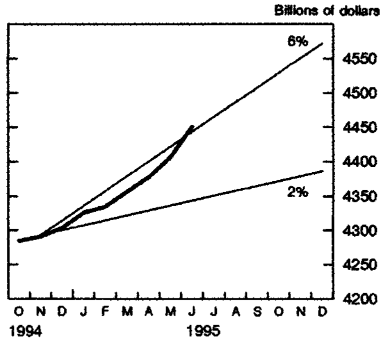
Changes in Bank Lending Standards for Business Loans by Size of Borrower



Note. Percentage of banks tightening standards less percentage easing standards.

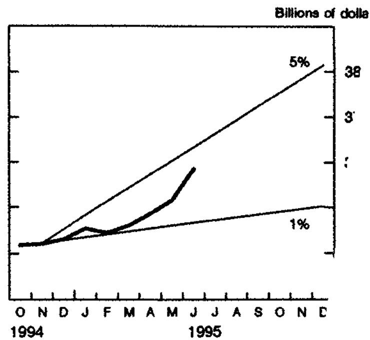
Depositories' shift back into funding with domestic liabilities has helped spur the growth of the broad monetary aggregates this year. From the fourth quarter of 1994 through June, growth of M3 has averaged 6¼ percent, placing the level of M3 above the upper bound of its annual range. Over the same period, M2 growth has averaged 3¾ percent, placing the level of M2 in the upper half of its annual range.

M3: Actual Range and Actual Level



The pickup in M3 growth this year reflects stronger expansion in both its M2 and non-M2 components. The acceleration of "wholesale" funding sources, especially large time deposits, has been quite marked this year. Banks' heavier reliance on wholesale funds is typical during periods in which bank loan portfolios are expanding swiftly. The non-M2 portion of M3 has also been boosted by a sharp jump in institution-only money funds. The yields on these funds tend to lag movements in short-term market interest rates and, as a result, became especially attractive to investors when short-term market interest rates began falling on expectations of a near-term easing of monetary policy.

M2: Actual Range and Actual Level



2. Published data on changes in securities portfolios at banks may not accurately portray funding strategies because recent accounting changes have increased the share of securities and off-balance-sheet contracts that must be marked-to-market on banks' balance sheets. Estimates suggest that changes in the market valuation of securities and off-balance-sheet contracts under these accounting rules have added about 1 percentage point at an annual rate to the growth of bank credit from the fourth quarter of 1994 through June of this year.

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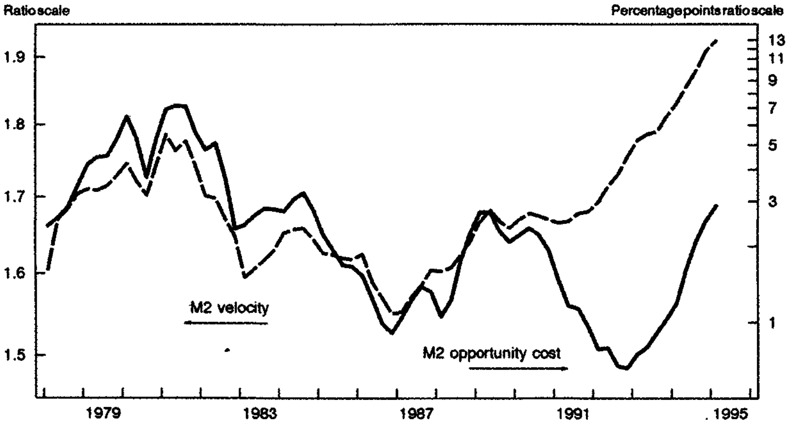
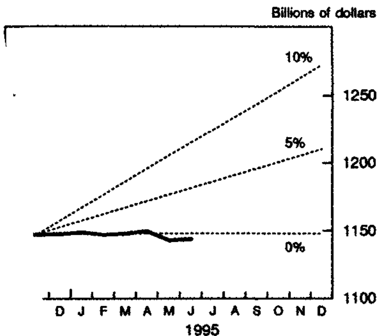
M2 Velocity and M2 Opportunity Cost



Note. M2 opportunity cost is two-quarter moving average of three-month Treasury bill less weighted average rate paid on M2 components.

The acceleration of M2 this year owes chiefly to the waning influence of previous increases in short-term interest rates, and a marked flattening of the yield curve. On balance this year, the returns on assets in M2 have become more attractive relative to both short- and long-term market instruments. Sizable inflows to stock mutual funds have continued, but theflatter yield curve has damped the demand for other long-term investments. Inflows to bond mutual funds—while stronger than during the bond market rout last year—have been much smaller than inflows earlier in the 1990s. Also, judging from noncompetitive tenders at recent Treasury auctions, households' direct investments in Treasury securities have dwindled sharply this year. At least a portion of the flows that previously had been directed to mutual funds and direct investments in securities appears to have boosted M2 growth. Growth of money market mutual funds and small time deposits, in particular, has been especially brisk. Indeed, more than half of the increase in M2 since April is attributable to a steep climb in M2 money funds.

M1: Actual Level



In contrast to the broader aggregates, M1 growth has weakened this year, primarily as a result of wide opportunity costs on transaction deposits and the introduction and expansion of retail sweep accounts at some large banks. Interest rates offered on other checkable deposits (OCDs) have edged up only slightly since the beginning of 1994 despite the sharp rise in short-term market interest rates. Households have responded by reducing balances in these accounts in favor of higher-yielding assets. The development of sweep accounts by a few large banks for their retail customers has facilitated the shift away from transaction balances. Sweep accounts transfer a customer's OCD account balances in excess of a certain threshold into a money market deposit account (MMDA). Automatic transfers from the customer's MMDA account back to the OCD account are initiated as checks and other withdrawals deplete OCD

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balances. Such sweep accounts may allow customers to earn more interest and benefit the bank by reducing its required reserves.[3] Estimates suggest that retail sweep accounts have reduced M1 by about $12 billion so far this year. These programs affect the composition but not the level of M2 because balances are swept from transaction deposits into other accounts included in M2.

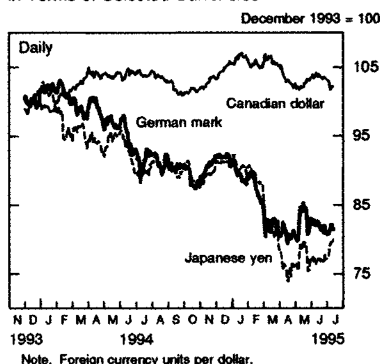
The expansion of retail sweep accounts poses some potential problems for the implementation of monetary policy by the Federal Reserve. To date, such accounts have been offered by large banks that must maintain a balance at a Federal Reserve Bank to meet their reserve requirements. As a result, the reduction in required reserves associated with sweep accounts has implied a nearly equivalent reduction in aggregate required reserve balances; estimates suggest that the $12 billion dollar decline in OCDs this year translates to a reduction in required reserve balances of nearly $1.2 billion.[4] In early 1991, following the cut in reserve requirements at the end of 1990, unusually low levels of aggregate reserve balances were associated with greater variability in the federal funds rate as banks' volatile clearing needs began to dominate the demand for reserves. If many banks begin to offer retail sweep programs in the future, the aggregate level of required reserve balances would likely fall substantially, potentially leading to instability in the aggregate demand for reserves.

The monetary base expanded at a 5½ percent rate from the fourth quarter of 1994 through June. Currency growth this year—at 7¼ percent from 1994:Q4 through June—is off a bit from last year's pace but still quite robust. Foreign demands for U.S. currency have generally remained strong this year. In concert with the decline in transaction deposits, total reserves contracted at a 6 percent rate from 1994:Q4 through June. In the absence of the increase in sweep accounts, the decline in total reserves over this period would have been 2½ percent at an annual rate.

3. Under the current structure of reserve requirements, OCD accounts are subject to a 10 percent reserve requirement at banks with more than $54 million of net transaction deposits. By law, personal MMDAs are exempt from reserve requirements.

4. The reduction in required reserve balances is not necessarily identical to the reduction in required reserves. This is because banks typically use vault cash in addition to reserve balances to satisfy reserve requirements. The level of vault cash held by banks is primarily determined by their customers' needs. Required reserves for some banks are nearly or even completely satisfied by vault cash. In these cases, a reduction in required reserves due to sweeps would not show through to a decline in required reserve balances on a one-for-one basis.

Foreign Exchange Value of the Dollar in Terms of Selected Currencies

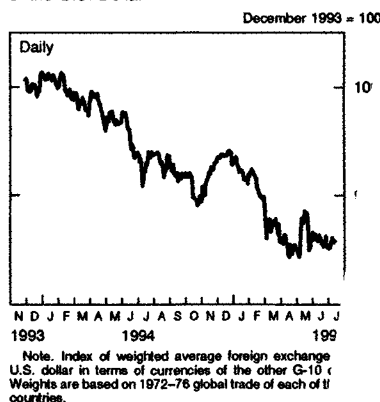


Note. Foreign currency units per dollar.

International Financial Developments

At the turn of the year, the foreign exchange value of the dollar was under downward pressure, and that pressure continued through the first months of 1995. On balance, the multilateral trade-weighted value of the dollar in terms of the other G-10 currencies has depreciated about 7½ percent since the end of December 1994. The dollar declined as economic indicators began to suggest that economic growth in the United States was slowing, lowering the likeli-

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



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

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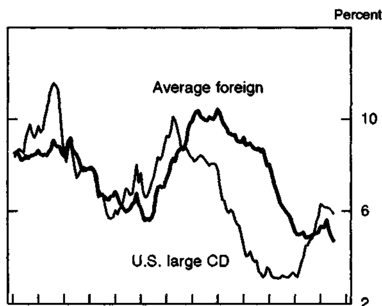
hood of further increases in U.S. market interest rates. In addition, the Mexican crisis appeared to weigh on the dollar in early 1995. External adjustment by Mexico was rightly expected to involve, to an important extent, a corresponding decrease in U.S. net exports. Primarily for that reason, financial turmoil in Mexico and depreciation of the peso were seen as having possible adverse implications for U.S. growth and external accounts and, in general, as negative for dollar-denominated assets.

The dollar was supported only briefly by the increase in the discount rate and the federal funds rateat the February FOMC meeting. With the U.S. economic expansion softening, market participants came to expect that no further increases in these rates were likely in the near term. Downward pressure on the dollar intensified in late February, and on March 2, in somewhat thin and disorderly market conditions, the dollar fell sharply further against the mark and the yen. The foreign exchange Trading Desk at the New York Federal Reserve Bank entered the market, buying both marks and yen on behalf of the Treasury and the Federal Reserve System. The next day several other central banks joined the Desk in concerted intervention in support of the dollar. Intervention by the Desk on behalf of the Treasury and the Federal Reserve System totaled $1.42 billion. In a statement confirming the intervention, Secretary Rubin highlighted official concern about the dollar's exchange value. Downward pressure on the dollar continued, particularly against the yen, and on April 3 and 5 the Desk, acting on behalf of the Treasury and Federal Reserve System, again joined several other central banks in intervention to support the dollar. Secretary Rubin issued a statement that these actions were in response to recent movement on exchange markets and that the Administration was committed to a strong dollar.

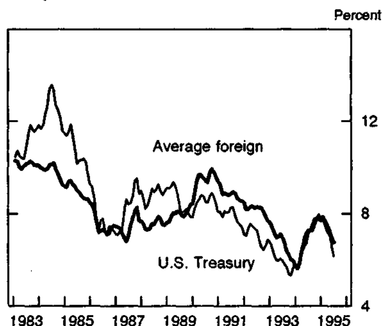
The dollar fell further through mid-April, particularly against the yen, and on April 19 it touched a record low of less than 80 yen per dollar. After recovering slightly and remaining fairly stable through mid-May, the dollar rebounded sharply but subsequently relinquished some of those gains. On May 31, the Desk—on behalf of the Treasury and the Federal Reserve—joined the central banks of the other G-10 countries in intervention purchases of dollars. Secretary Rubin stated that the intervention was in keeping with the objectives of the April 28 communique of the G-7 finance ministers and central bank governors, which endorsed the orderly reversal of the decline in the dollar in terms of other G-7 currencies. Through May and June, the dollar fluctuated in a range somewhat above its lows of mid-April and early May. On July 7, following moves by both the Federal Reserve and the Bank of Japan to ease monetary conditions, the Desk joined the Japanese monetary authorities in intervention purchases of dollars; the dollar moved up a bit in response.

U.S. and Foreign Interest Rates

Three-month



Ten-year



Note. Average foreign rates are the trade-weighted average, for the other G-10 countries, of yields on instruments comparable to U.S. instruments shown. The data are monthly.

Long-term (ten-year) interest rates in the major foreign industrial countries have, on average, have declined about 100 basis points since December, as economic indicators have suggested some slowing of real output growth abroad as well as in the United States. With U.S. long-term rates falling much more, about 170 basis points on balance, the change in the long-term interest differential is consistent with some decline in the exchange value of the dollar. Long-term

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rates have dropped about 150 basis points in Japan, nearly as much as the decline in U.S. long-term rates. Rates in Germany are down about 90 basis points. Three-month market interest rates in these countries have declined about 90 basis points on average since year-end 1994; central bank official lending rates were lowered in 1995 in several countries, including Japan, Germany, and Canada. Following the Federal Reserve easing on July 6, the central banks of Canada and Japan lowered overnight lending rates.

Since December 1994, the dollar has depreciated about 12 percent on balance against the Japanese yen,despite declines in Japanese long-term rates that nearly matched the decline in U.S. rates. The yen fluctuated in response to progress, or lack of progress, in the resolution of trade disputes with the United States. Persistent strength in the yen appears to reflect the large Japanese current account surplus and market perceptions that some adjustment of that surplus, through yen appreciation, is inevitable, especially given the slow growth of the Japanese economy. Japanese financial markets more broadly have reflected the weak state of the Japanese economy. Stock prices have fallen considerably so far this year, with the Nikkei down about 16 percent since the end of December, and land prices have fallen further. These declines in asset prices have added to the perceived risks in the Japanese banking system and concerns that the recovery in economic activity is stalling.

Net depreciation of the dollar in terms of the German mark over this period has been about 10 percent. Some of the upward pressure on the mark over the past several months resulted from shifts within the Exchange Rate Mechanism (ERM) of the European Monetary System, as political uncertainties and fiscal problems in Italy, Sweden, Spain, and later France, led at times to the selling of their respective currencies for marks. Realignment within the ERM on March 5 that lowered the values of the Spanish peseta and the Portuguese escudo contributed to the upward movement of the mark. In contrast to the dollar's movement against the yen and the mark since December, the dollar is down only 3 percent in terms of the Canadian dollar. Early in the year, the U.S. dollar appreciated against the Canadian dollar; uncertainty about whether fiscal problems in Canada would be addressed and spillover from the Mexican crisis caused the Canadian dollar to fall. Since then, the Canadian dollar has regained those losses.

Over the past several months, the Mexican peso has recovered somewhat in terms of the U.S. dollar from the lows reached during the height of the crisis. On balance, the peso has depreciated 40 percent in nominal terms from December 19, 1994, before the crisis broke out. Mexican officials have drawn on the Treasury Department's Exchange Stabilization Fund facility and the Federal Reserve's swap line in addressing addressing Mexico's international liquidity problems. Outstanding net drawings to date total $12.5 billion. The outstanding total of the government's dollar-denominated short-term obligations, tesebonos, has been reduced below $10 billion.

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Growth of Money and Debt
Percentage change

Period		M1	M2	M3	Domestic nonfinancial debt
Annual[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		0.6	4.8	3.8	7.9
1990		4.2	4.0	1.7	6.5
1991		7.9	2.9	1.2	4.6
1992		14.3	2.0	0.5	4.7
1993		10.5	1.7	1.0	5.2
1994		2.3	1.0	1.4	5.1
Quarterly (annual rate)					
1994	Q1	5.5	1.8	0.6	5.2
	Q2	2.7	1.7	1.3	5.4
	Q3	2.4	0.9	2.1	4.2
	Q4	−1.2	−0.3	1.7	5.2
1995	Q1	0.0	1.6	4.3	5.5
	Q2	−0.9	4.2	6.7	5.4

1. From average for fourth quarter of preceding year to average for fourth quarter of year indicated.

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

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