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 FIFTH CONGRESS

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CONDUCT OF MONETARY POLICY

WEDNESDAY, MARCH 5, 1997

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

The subcommittee met, pursuant to notice, at 2:03 p.m., in room 2128, Rayburn House Office Building, Hon. Michael N. Castle [chairman of the subcommittee] presiding.

Present: Chairman Castle, Representatives Leach, Fox, Lucas, Metcalf, Paul, Weldon, Roukema, Flake, Frank, Kennedy, Sanders, Kanjorski, Maloney, Hinchey, Bentsen, and Jackson.

Chairman CASTLE. The hearing 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. You will note that this subcommittee has done its best to accommodate the Fed while meeting the schedule required by the Humphrey-Hawkins Act. We have followed your appearance before our Senate colleagues as closely as we could, so that the same testimony can serve for both hearings. I trust that in turn, you will be as candid as possible in addressing issues raised over the past week.

Today, we will have 5-minute opening statements by the Members present. In addition, some Members of the full Committee may sit with us today and participate in the questioning. As always, any prepared remarks presented by a Member will be accepted for the record.

Today the U.S. economy continues to be healthy with inflation apparently in check. We welcome the continued sound performance of the economy which evidently has been assisted by the Fed's monetary policy. Having witnessed what even one of your carefully-calibrated characterizations of the stock market can accomplish, it is clear that what you say can have a significant impact on the market, at least over the short term.

Following your testimony last week, many analysts have argued both that the current prices of common stocks are justified and that external factors are also somewhat responsible in making this market the investment vehicle of choice. Others dispute the actual

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amount of influence the Fed is able to exercise using the traditional mechanisms of monetary policy.

If you believe that any of your earlier remarks were misinterpreted or unfairly taken out of context, today's hearing offers the opportunity to correct such misreading. Certainly, several percentage points of exuberance have been wrung out of the stock markets, and we can hope that some seeds of inflation have been destroyed as well.

I am also interested in your assessment of whether the run-up in relative value of the dollar is becoming a limiting factor in the conduct of monetary policy by the Federal Reserve.

Your chairmanship of the Federal Reserve System Board of Governors continues to be successful as judged by results. Nevertheless, aside from monetary policy there are other aspects of Federal Reserve operations that merit review by Congress. This subcommittee is planning oversight hearings on the Federal Reserve System that will review Fed activity, including the transition from physical to electronic forms of money as the digital age looms in our future. Of particular concern to me, it seems that with the current level of technology available, the Fed's proposal to add an additional day to the current check-clearing process seems to be going in the wrong direction, especially from the point of view of the consumer needing access to his or her money.

We also hope to review the role of the central bank as a competitor with private sector clearing facilities. We look forward to hearing how the Fed is planning for the potential of new technology to affect systemic security, safety, soundness, and consumer privacy as well as the future conduct of monetary policy.

In this future hearing, we hope to engage in a discussion of the various ways that the approaching digital revolution in money will affect the operations of the Federal Reserve System. I am increasingly persuaded that dramatic change in how we define and employ money may soon be upon us. This in turn, must affect the payment system and institutions charged with its stewardship. Thus, we should be prepared for the threshold at which this impending change becomes significant in your models of the economy.

As always, we are delighted to have you with us and look forward to a lively discussion.

Before recognizing Mr. Frank for his statement, I want to recognize and welcome the participation of Members of the Banking Committee not appointed to the Monetary Policy Subcommittee and ask unanimous consent that to the extent they wish to participate and ask questions of the witness they may be permitted to do so.

[The prepared statement of Chairman Castle can be found on page 44 in the appendix.]

Hearing no objection, it is ordered. At this time I will turn to Mr. Frank for his opening statement.

Mr. FRANK. Thank you, Mr. Chairman. I welcome this in part as a chance to, I hope, demonstrate my commitment to the value of civility which we talk about a lot. I say that because civility is something that is most important when we have profound disagreements. Mr. Greenspan, you are the perfect subject for this because I cannot think of many people now in Government for whom I have

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greater respect or with whom I have greater disagreement. I think it is important for us to be able to show that personal respect and very profound disagreement can exist side-by-side.

The disagreement is that I believe through the performance of your role, given how you have interpreted it, the Federal Reserve System under your governance, with the support of those who work with you, has become an engine for inequality in our society. I think that has terribly negative consequences.

A lot of people have talked recently about a poll of the Republican Party done by Mr. Fabrizio in which he talks about various segments of the Republican Party. He found five segments. What I found very interesting was that all five segments, when asked, were negative as to whether or not we should expand NAFTA. There is, I think, almost a certainty that a poll of Democrats would show an even heavier negative. All five of the sectors of the Republican Party which differ on a lot of things were opposed to, according to this poll, to expanding NAFTA.

We have an increasing degree of resistance on the part of the American people to the kinds of international economic cooperation that you believe are very important to the prosperity of this country and the world, and I agree with you to a great extent. But the problem we have is, I think illustrated by a comment John Kennedy made when he initiated the Alliance for Progress. He said Franklin Roosevelt, who was the model here with the Good Neighbor policy, was able to be a good neighbor abroad because he was seen as a good neighbor at home.

Increasingly, a lot of Americans do not see this Government, the Federal Reserve System, Congress, the Executive Branch as a good neighbor at home. They see increased inequality. You talk about job insecurity. It is, as you know, a terrible thing to live with. I realize you understand the anguishing factor of it, but most of your statement is about the centrality of job insecurity as a factor in America. Living with job insecurity, which means uncertainty as to whether or not you are going to be able to feed and clothe and educate and care for your children, is a terribly anguishing thing.

Recently, you have come out very strongly in favor of what, I understand your technical justification for, but what is in fact one of the most regressive policies being proposed: telling old women who live on $7,000 and $8,000-a-year in America that they are getting too much compensation for inflation and that we ought to cut them $100 or $200 every so often. I cannot think of a more regressive policy.

Wage increases are, as you see the world, a problem. The lower the rate of wage increases, the better. Meanwhile, of course, there are elements in the economy where things go up that are not a problem.

It also has to do with tax policy, and I am going to ask you to address this, if not in my 5 minutes, at some later point in writing. We passed a tax bill in 1993 that increased taxes on upper-income people. I thought that helped promote equity and helped reduce the deficit. You said in testimony that you and I discussed that you were committed to the view that this was going to cause problems for the economy. I remember in 1994 you said that this would

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reduce the growth in the economy, when you raise taxes on upper-income people, or taxes on anybody.

I asked you this about 1994 or 1995 and you said it was too early for those effects to show. Well, I would have to ask you. We passed that tax increase nearly 4 years ago. In the intervening years since we passed the tax increase your view has been that the economy was growing, if anything, more rapidly than it should. You have leaned more toward restraint. Your policy has been caution.

So I have to ask, if we damaged the economy by raising taxes, why then has your view been that the economy was, if anything, a little bit too exuberant, to use a word? Does that not mean if we had not raised taxes, presumably you would have shown us less restraint?

I understand this is not your goal, but it does seem to me, in closing, as you add up the specific policy positions you have taken: let us cut the cost-of-living increase for Social Security recipients which will have its major social impact on the elderly poor; let us worry if wages go up too much; let us worry if unemployment goes down too much; let us oppose a tax increase on the wealthy.

The consequence of this is, we pay for lower inflation, if that is in fact what we had to do to get it, with an increase in inequality or, at best, an absence of any measures to fight the inequality that the market inevitably sets forward. That is, as I said, not just a problem of equity. But I have never seen America in a more anti-internationalist mood, and I think that that is one of the consequences of this set of policies.

Chairman CASTLE. Thank you, Mr. Frank.

Mr. Lucas is recognized for his opening statement.

Mr. LUCAS. I do not have one, Mr. Chairman.

Chairman CASTLE. Thank you.

Now we recognize the distinguished Ranking Member of this subcommittee, and a pleasure to have him back. Mr. Flake.

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

I would like to welcome Mr. Greenspan to our biennial Humphrey-Hawkins hearings to discuss the Federal Reserve's conduct of monetary policy and its opinion on the current state of this economy. Given last week's reactionary activity on the stock market and the persistent political commentary of our Nation's economic health, I certainly look forward to hearing your statements today, Mr. Greenspan.

I will be brief in these comments, but I do wish to express to you one area of specific concern for me. This concern is the continued neglect of our Nation's poorer communities. The Federal Reserve appears to focus its efforts on macro-economic issues that in general have been good for the overall economic health of our Nation. But in its zeal to control inflation and to stave off economic downturns, the Federal Reserve seems to have forgotten that there are communities in America that are in a persistent cycle of poverty and stagnation.

These communities are not hearing policies from the Fed that speak directly to their needs. The question thus becomes, does the Federal Reserve focus on all participants in the economy, or does it need to improve its communications process with respect to its concern and compassion for all of society?

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Whichever conclusion we come to, I do believe that these hearings tend to focus too much on macro-economic issues that do not speak very well to Mr. and Mrs. America. I recognize the old saying that a rising tide lifts all boats, and to an extent that your macro-economic decisions are prudent for the Nation as a whole, I do commend you.

But let us not forget that the rising tide also has the real potential to set the small boat adrift without direction. Mr. Chairman, there are many communities in America adrift in a sea of unemployment, poor education, deteriorated commercial areas, overall hopelessness. Inside the Beltway, economic and political discourse, unfortunately is often detached from these realities of everyday life.

So I invite you, Mr. Chairman, to join with us in trying to participate in a means by which we bring about the necessary change that lifts all of our communities so that we might have the kind of civilization that we dare to dream about. I would encourage you to speak directly to those of us who represent these types of communities, give illustrations and ideas of policies that you and your colleagues believe will directly benefit what I have come to call America's Third World nation.

Chairman Greenspan, I come here today not to single out the Federal Reserve, but with the belief that all of us here in Washington need to become better stewards of the people's Government. Democrats need to come to the realization that social programs to help the poor are not the exclusive answer for social ills, and Republicans should not blindly enact slash-and-burn policies in the name of a balanced budget. Entrenchment of these partisan positions is not good government and only leads to pessimistic opinions about Washington's ability to govern in a responsible manner.

Obviously, the solution is somewhere in the middle, and thus is the result of compromise between Democrats and Republicans. It is a solution defined by cooperation between Government and the private sector, and is a solution that has Government and the private sector working together in an effort to uplift the poorer communities. This partnership I believe includes improving job growth, education, and the moral fiber of our Nation.

Therefore, in the coming months I intend to work with all Members in a bipartisan effort to encourage the Federal Reserve to communicate its thoughts on possible efforts for the revitalization of these often neglected and overlooked communities.

With that, Mr. Chairman, I close. I will listen intensely to the testimony and I thank you, Mr. Greenspan, for coming to share with us this afternoon.

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

[The prepared statement of Hon. Floyd H. Flake can be found on page 48 in the appendix.]

Dr. Paul is recognized for an opening statement if he wishes to make one.

Mr. PAUL. No statement, Mr. Chairman.

[The prepared statement of Hon. Ron Paul can be found on page 53 in the appendix.]

Chairman CASTLE. Thank you.

Mr. Kennedy.

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

Chairman Greenspan, welcome once again to the Banking Committee. I, first and foremost, want to say that I think that despite some of my pessimism about your policies in the past, I think the record that has been established in terms of the continued economic growth as well as the decline in the unemployment rate indicates that there have been times in the past when you perhaps have proven more correct in terms of your analysis of how the economy should be handled than some of the rest of us, myself included.

But having said that and having reviewed your testimony for today, I think that there are certain issues that need to be addressed more completely in terms of how you actually feel certain issues are going to be resolved. I notice that you talk a lot about stagnant wages. But when it gets to the actual corrective actions that you feel are going to be taken you say, in other words, that the relatively modest wage gains we have experienced are temporary, rather than a lasting phenomenon, because there is a limit to the value of additional job security people are willing to acquire in exchange for lesser increases in living standards.

I am not sure that the notion of simple supply-and-demand is going to necessarily take care of those stagnant wages. I think that when you see the kind of wage increases that have occurred, particularly at the top end of many of the corporations that are holding these wages down, that just as you are willing to jawbone the advancements in the stock market, that there is a necessity for you as the leader of this country's economy to take on more actively the issues of justice in terms of the economy as well.

I think the issue of the CPI is one where it is very difficult to argue the technical issue of the COLA increase. Take for example my neighbor in Brighton who earns around $8,000. When I first moved there she had a husband and two sons. Her husband died. One son moved to New Jersey. The other son became a fireman on Cape Cod. She lives by herself. Even though she worked most of her life, her total income is Social Security benefits, because she never earned a pension. That woman has to tape blankets across her doorways in order to stay warm enough in the wintertime.

The ultimate result of not granting a full COLA increase is to say that she should remain cold in the winter because there is a technical glitch in how the CPI is treated. I just think that underneath the CPI issue we need to hear from you not on just those technical questions, but as to whether or not the amount of money that Social Security pays the lowest wage earners in this country enables people to have what Social Security promised.

What I am asking for is a sense of your weighing in on some of the issues pertaining to not just the growth of the economy but who wins and who loses. I firmly believe that is well within your jurisdiction and you can have an important impact.

Then finally, just very briefly, my concern is that simply because the unemployment rate drops to a certain number, an automatic result of that will be to increase the interest rates of this country. I would like to hear you address that directly. I think, again, that this is an issue that pertains to justice and to whether or not people who are unemployed can ever expect, particularly with the

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changes that have taken place in the welfare laws, whether they can ever actually expect to be employed in our workforce.

Thank you very much, Mr. Chairman.

Chairman CASTLE. Thank you, Mr. Kennedy.

Mr. Sanders.

Mr. SANDERS. Thank you, Mr. Chairman, and welcome, Mr. Greenspan. Thank you for joining us today.

Like Mr. Frank, I have respect for you personally. I have very, very strong disagreements with your policy. It is incomprehensible to me that President Clinton would have reappointed you in fact.

Mr. Greenspan, like every American, you are entitled to your political views. According to newspaper reports, over the years you have made political contributions to Jesse Helms, to George Bush, to Bob Dole. You have served on the Committee to Reelect or Elect President Reagan, as I understand it. And of course, you worked as a key economic advisor for President Nixon and President Ford. I respect that. There is nothing wrong. We are all entitled to our points of view.

In 1985, as I understand it, you served as a consultant to many in the savings and loan industry. According to *Time Magazine*, you suffered your "greatest embarrassment in 1985 when as a private economist you wrote letters to regulators and Congress endorsing Charles Keating and his Lincoln Savings and Loan. Lincoln subsequently collapsed at a cost to taxpayers of $2.6 billion and Keating landed in jail." That was from *Time Magazine*. You also served as a consultant for 15 other savings and loans, 14 of whom eventually failed.

In your confirmation hearings 1 year ago, despite the fact that the minimum wage of $4.25 is at its lowest point in 40 years—millions of people working for $4.25-an-hour—you noted your opposition to raising the minimum wage. This January, you told the Senate Budget Committee that "the appropriate capital gains tax rate is zero." Currently, many Senate Republicans are calling for a capital gains tax cut. According to the Center on Budget and Policy Priorities, 70 percent of the benefits of that tax cut will go to households earning over $100,000-a-year, and their proposal is far more limited than your proposal suggests.

Mr. Greenspan, I will grant you consistency in your support for trickle-down economics. In your career up to today, it is clear that you have advocated tax and monetary policies which have benefited the very richest Americans, while at the same time your views reflect policies that come down very heavy on the middle class, the working class, and low-income people.

In 1983, you were appointed to chair, as I understand it, the Social Security Commission. Under your leadership, the highly regressive payroll tax was increased by about $200 billion. You chose to solve the Social Security crisis by raising the payroll tax on working Americans, while at the same time as an economic advisor you advocated huge tax decreases for the richest people in America.

Now currently, as others have suggested, you are a proponent of reducing the Consumer Price Index. Like Mr. Kennedy, I have neighbors and friends, elderly people, who are trying to survive on $7,000- or $8,000-a-year, and I regard it as horrendous and vulgar, to be frank with you, that there are people in Government who

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want to balance the budget on the weakest and most vulnerable people in this society, and then advocate huge tax breaks for the richest people in this country as you continuously do.

Now I would like to ask you—and later on maybe you can respond to that. I do not know where you get your information from. I go, and as I am sure many of my colleagues do, we talk to elderly people who are trying to make it. They cannot afford their prescription drugs. In my State it gets 20 below zero. Elderly people cannot afford to heat their homes. Maybe you will tell this subcommittee the last time you have sat in a room with low-income senior citizens and asked them how they are going to survive if they lose $100-a-year in their Social Security benefits, what kind of pain they go through now trying to survive on $7,000- or $8,000-a-year.

Mr. Greenspan, the United States of America today, not alone through your work but through the help of a lot of other people, both parties, has the most unfair distribution of wealth and income in the industrialized world. The richest 1 percent of the population own 42 percent of the wealth, more than the bottom 90 percent. And the last 20 years, that unfair distribution of wealth has become even worse. I would ask you in your comments to tell us what we can do to equalize wealth in this country so that we do not have such an unfair distribution of wealth.

You would about economic growth. Between 1983 and 1989, 62 percent of the increased wealth in this country went to the richest 1 percent. You can have all the growth that you want, but the middle class continues to shrink. People in my State are working two and three jobs just to survive because their wages have not kept pace with inflation. I want to ask you what your policies are doing for the middle class, for the working class, for low-income people rather than the wealthy people who I think you end up representing?

Thank you, Mr. Chairman.

[The prepared statement of Hon. Bernard Sanders can be found on page 61 in the appendix.]

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

Mr. Kanjorski, do you wish to follow that, sir?

Mr. KANJORSKI. Yes. I have to apologize for my colleague's inability to be direct.

[Laughter.]

Mr. KANJORSKI. Mr. Chairman, I too however, following this line, am very much interested in what the policy of the Administration and the Congress and the Federal Reserve will be in regard to the Consumer Price Index. I have previously introduced into Congress, and most recently went over the numbers with the Bureau of Labor Statistics, that the Consumer Price Index if geared to senior citizens in America actually are 4/10ths of 1 percent understated in that application of people over 62 years of age.

I know we are attempting to use that mechanism for two purposes really. I hope the first purpose is to have a legitimate Consumer Price Index that we can all rely on without being driven by politics. But the second purpose, obviously, is a very quick fix to the budget deficit and imbalance that would occur out in the next century.

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However, I join my colleagues, Mr. Frank, Mr. Kennedy, and Mr. Sanders in asking the question of where fairness is. If in reality, the Consumer Price Index today is understated by 4/10ths of 1 percent if it is applied to people over 62, why do we see there will be any major savings? I understand that about 82 percent of the programs that use the Consumer Price Index for automatic COLAs are senior programs in the budget. So if we were to change that and give the reflection, it does not really give us a great deal of latitude to save any money, if indeed it may cost the Government more money and drive us further into debt.

But this casual addressing of this issue that I see that is being driven by budgetary considerations as opposed to humanitarian considerations. And it is one thing if we are going to affect the index to reflect truth. I certainly do favor that. And if we need to have an application of a formula of adjustment to help in the budget, I can understand that. But it does not mean that it should apply across the board.

I think if you went into areas like mine where the average Social Security recipient receives $480 a month, that is hardly in this day and age a sufficient amount to survive on. And 92 percent of the people who receive that, that is their major source of income for sustenance.

So I would hope that you would exercise the influence of your office in this total debate in seeing that fairness prevail, looking at the means-testing nature of how it applies across the board. Maybe there ought to be people that are exempt from a change. Maybe some people should get more at the lower end of the scale than some that are in more beneficiary positions as a result of their earning capacity where they may not have the need. Call it a means-test, if we will, but we should look at that.

Certainly, I hope this all is not driven from the harsh accounting position of merely budgetary means and easy political decisions, whether it be here in the Congress or in the Administration. This is too important an issue for the American people, and senior citizens of today and in the future, for us to be callous about it. So I would appreciate anything you can address yourself on that issue.

Thank you, sir.

Chairman CASTLE. Thank you, Mr. Kanjorski.

Mr. Hinchey.

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

Mr. Greenspan, welcome. It is very nice to see you again. We are happy to have the opportunity to discuss with you once again the provisions of the Humphrey-Hawkins Bill. I was just looking at the purpose of that bill. It says, to maintain long-run growth of monetary and credit aggregates commensurate with the economy's long-run potential to increase production so as to promote the goals of maximum employment, stable prices, and moderate long-term interest rates.

Now I know that you have quarreled with the language of that law, and as a matter of fact at one point you were advocating that the law be changed so that the imperative to focus attention on economy growth and increased employment be excised, taken out of the law and that the focus of the Federal Reserve be exclusively on maintaining stable prices. Nevertheless, that has not occurred

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and the charge of the Federal Reserve is to promote economic growth as well as to stabilize prices.

It is disturbing to those of us who believe that the economy can grow at a rate much faster than 2 percent and still not suffer the adverse consequences of inflation, to see the Federal Reserve continually holding back economic growth. Historically, we have experienced economic growth far beyond 2 percent. In the 1960's, this economy was growing at the rate of about 5 percent a year. In the 1970's, we were growing at the rate of about 4 percent a year. In the 1980's, we were growing appreciably faster than we are at the present time.

Nevertheless, the attitude of the Fed seems to be that anything beyond a 2 percent rate of growth, and any unemployment—it used to be 6 percent. Now I guess you have accepted 5.5 percent. Any unemployment level that goes lower than that is going to produce inflation.

Now when you add to that some of the things that you have said recently in your admonitions, apparently to Wall Street, with regard to their stock market, talking about the kind of exuberance, or excess exuberance that exists in the market, people are very fearful that when the Federal Open Market Committee meets later this month on the 25th of March that you will be advocating before that committee and that the Federal Reserve will in fact raise interest rates above the level where they are presently. We are fearful of that because we believe that if that happens, that will have the consequence of reducing economic growth even further.

It may be that you are justified in being concerned about some of the aspects of Wall Street and the rise in prices on the stock market and the fact that the market has gone up above 7,000, although it has settled back a little bit below that now. I do not want to argue that with you. You may be justified in that. You may not be.

I would argue with you, sir, though that if you advocate raising interest rates to deal with that phenomenon, if it is a problem, that the use of raised interest rates to deal with that situation is a blunt instrument which will have broad-ranging consequences throughout the economy, far beyond Wall Street and on every Main Street all across this country.

People, as you note in your testimony, are struggling to make a living. Every American family is struggling in one way or another, with this low economic growth that we have been experiencing. You note stagnant wages. I would say to you that those stagnant wages are a consequence of long-term economic policies that have existed for a long-term, one of them being the trade legislation that we are living with currently.

The other is a situation that has to do with the oversupply globally of both production and labor at the moment, and the fact that American workers are forced increasingly to compete with labor in other parts of the world because of the multinational corporations, transnational corporations. These are the problems that we are deeply concerned about.

So I would urge you, sir, to perhaps continue to be concerned about the stock market. But do not attempt to use the blunt instrument of interest rates to deal with any perceived problems in the

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stock market because that act will have broad-ranging consequences far beyond Wall Street on every Main Street across the country.

Chairman CASTLE. Thank you, Mr. Hinchey.

Let me go next to Mr. Jackson, who gets a gold star. He has been in his seat since 2:00. Then if Mr. Bentsen wishes to make a statement, we will come back to him.

Mr. JACKSON. Thank you, Chairman Castle, Ranking Member Flake. I would first like to express how pleased I am to have the opportunity to join the Subcommittee on Domestic and International Monetary Policy for my first hearing with this subcommittee. I have just been recently, Mr. Greenspan, granted the honor of serving on this distinguished panel. I very much look forward to learning from your leadership, Chairman Castle, and Mr. Flake, and working with you during this Congress as we address the critical matters which fall in the purview of this subcommittee's jurisdiction.

There is no better illustration of the significance of this subcommittee's role than the subject matter of the present hearing and the distinguished witness who is before us to testify today. Chairman Greenspan, it is with great pleasure and admiration that I welcome you here today to apprise us of the status of the American economy and your judgments as to the activities of the Federal Reserve System in fulfilling its duty, among others, of conducting monetary policy in pursuit of the objectives of price stability and full employment.

To that end, Mr. Chairman, in your semi-annual report to Congress, first delivered to the Senate last week, you clearly hailed the strength of the economy, highlighting a 2 percent increase in gross domestic product as evidence of expanding economic opportunities. Relative to previous decades, however, we know that 2 percent is less than the 1980's, 1970's, and the 1960's. You tempered your optimism however with a call for caution when you stated that history is strewn with visions of new eras that in the end have proven to be a mirage.

I agree completely with your assessment, and today while conventional economic wisdom speaks to expansion and growth, my view deviates just slightly from this conclusion. For the Second District of Illinois, I have devised a vigorous and a stringent economic test. I call it the eyeball test. In order to assess the relevant economic indicators, I merely open my eyes and look around to determine whether my constituents on the south side of Chicago and in the south suburbs are experiencing this relative economic growth. Sadly, Mr. Chairman, my results do not render the same optimistic projections. In my district, things have never been good and they are now getting worse.

Nationally, the unemployment rate is 5.4 percent, which means that 7.3-million people who receive unemployment compensation have no job. The actual number of unemployed and underemployed people is closer to 15- to 20-million Americans. These numbers include those who are unemployed, underemployed, working part-time when they want to be working full-time, they have never had a job or they have given up looking for one. These numbers are compounded by those who are faced by corporate and Government

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downsizing, are on the brink of or worried about the reality that they may fall into one of these categories.

Mr. Chairman, I believe that those in my district and these particular explanations explain the widespread levels of economic anxiety currently plaguing the American people. In light of the foregoing, Chairman Greenspan, I will listening intently to your testimony, particularly your views on how the Fed can encourage and guide the economy toward attaining true levels of full employment. I have been most concerned, Mr. Chairman, most recently with the reality that whenever unemployment dips beneath a certain percentage point, the Federal Reserve turns off the spigot. It shuts opportunity down and slows down job growth and creation.

In light of the reality that we most recently passed a welfare reform bill in this Congress, I am very concerned that we could slow the economy down at a time when our Nation's most-vulnerable can no longer turn to the Government for assistance.

Once again, thank you, Mr. Greenspan, for joining us today and I look forward to hearing your testimony.

Thank you, Chairman Castle.

[The prepared statement of Hon. Jesse L. Jackson Jr. can be found on page 55 in the appendix.]

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

We will now call on Mr. Bentsen.

Mr. BENTSEN. No statement, Mr. Chairman.

Chairman CASTLE. Mr. Bentsen has no opening statement. I think that concludes our opening statements at last, Mr. Chairman. We turn to you now for your statement, sir. We appreciate your patience.

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

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I want to say, I certainly appreciate the opportunity, as always, to appear before this subcommittee to present the Federal Reserve's Semiannual Report on Monetary Policy.

The performance of the American economy over the past year has been quite favorable. The growth of real gross domestic product picked up to more than 3 percent over the four quarters of 1996, as the economy progressed through its 6th year of expansion. Employers added more than 2.5-million workers to their payrolls in 1996, and the unemployment rate fell further. Nominal wages and salaries have increased faster than prices, meaning workers have gained ground in real terms, reflecting the benefits of rising productivity. Outside the food and energy sectors, increases in consumer prices actually have continued to edge lower, with core CPI inflation only 2.5 percent over the past 12 months.

Looking ahead, the members of the FOMC expect inflation to remain low and the economy to grow appreciably further. However, as I shall be discussing, the unusually good inflation performance of recent years seems to owe in large part to some temporary factors of uncertain longevity. Thus, the FOMC continues to see the distribution of inflation risks skewed to the upside, and must remain especially alert to the possible emergence of imbalances in financial and product markets that ultimately could endanger the

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maintenance of the low-inflation environment. Sustainable economic expansion for 1997 and beyond depends on it.

For some, the benign inflation outcome of 1996 might be considered surprising, as resource utilization rates, particularly of labor, were in the neighborhood of those that historically have been associated with building inflation pressures. To be sure, an acceleration in nominal labor compensation, especially its wage component, became evident over the past year. But the rate of pay increase still was markedly less than historical relationships with labor market conditions would have predicted.

Atypical restraint on compensation increases has been evident for a few years now and appears to be mainly the consequence of greater worker insecurity, possibly owing to the rapid evolution of technologies in use in the workplace. Technological change almost surely has been an important impetus behind corporate restructuring and downsizing. Also, it contributes to the concern of workers that their job skills may become inadequate.

Certainly, other factors have contributed to the softness in compensation growth in the past few years. The sharp deceleration in health care costs, of course, is cited frequently. Another is the heightened pressure on firms and their workers in industries that compete internationally. Domestic deregulation has had similar effects on the intensity of competitive forces in some industries. In any event, although I do not doubt that all of these factors are relevant, I would be surprised if they were nearly as important as job insecurity.

If heightened job insecurity is the most significant explanation of the break with the past in recent years, then it is important to recognize that suppressed wage cost growth as a consequence of job insecurity can be carried only so far. At some point, the tradeoff of subdued wage growth for job security has to come to an end. In other words, the relatively modest wage gains we have experienced are a temporary rather than a lasting phenomenon. The unknown is when this transition period will end.

Indeed, some recent evidence suggests that the labor markets bear especially careful watching for signs that the return to more normal patterns may be in process. The Bureau of Labor Statistics reports that people were somewhat more willing to quit their jobs to seek other employment in January than previously. The possibility that this reflects greater confidence by workers accords with a recent further rise in the percent of households responding to a Conference Board survey who perceive that job availability is plentiful. Wages rose faster in 1996 than in 1995 by most measures, perhaps also raising questions about whether the transitional period of unusually slow wage gains may be drawing to a close.

To be sure, the pickup in wage gains has not shown through in underlying price inflation. Increases in the core CPI, as well as in broader measures of prices, have stayed subdued or even edged off further in recent months. As best we can judge, faster productivity growth last year meant that rising compensation gains did not cause labor costs per unit of output to increase any more rapidly. Non-labor costs, which are roughly a quarter of total consolidated costs of the non-financial corporate sector, were little changed in 1996.

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Owing in part to this subdued behavior of unit costs, profits and rates of return on capital have risen to high levels. As a consequence, businesses believe that, were they to raise prices to boost profits further, competitors with already ample profit margins would not follow suit. Instead, they would use the occasion to capture a greater market share. This interplay is doubtless a significant factor in the evident loss of pricing power in American business.

Intensifying global competition also may be further restraining domestic firms' ability to hike prices as well as wages. Clearly, the appreciation of the dollar on balance over the past 18 months or so, together with low inflation in many of our trading partners, has resulted in a marked decline in non-oil import prices that has helped to damp domestic inflation pressures. Yet it is important to emphasize that these influences, too, would be holding down inflation only temporarily. They represent a transition to a lower price level than would otherwise prevail, not to a permanently lower rate of inflation, as distinct from levels.

Against the background of all of these considerations, the FOMC has recognized the need to remain vigilant for signs of potentially inflationary imbalances that might, if not corrected promptly, undermine our economic expansion. The FOMC in fact has signaled a state of heightened alert for possible policy tightening since last July in its policy directives. But, we have also taken care not to act prematurely. The FOMC refrained from changing policy last summer. In the event, inflation has remained quiescent since then.

Given the lags with which monetary policy affects the economy, however, we cannot rule out a situation in which a preemptive policy tightening may become appropriate before any sign of actual higher inflation becomes evident. If the FOMC were to implement such an action, it would be judging that the risks to the economic expansion of waiting longer had increased unduly and had begun to outweigh the advantages of waiting for uncertainties to be reduced by the accumulation of more information about economic trends.

I wish it were possible, Mr. Chairman, to lay out in advance exactly what conditions have to prevail to portend a buildup of inflation pressures or inflationary psychology. However, the circumstances that have been associated with increasing inflation in the past have not followed a single pattern.

In general, our analysis will need to encompass all potentially relevant information, from financial markets as well as the economy, especially when some signals, like those in the labor market, have not been following their established patterns.

This year overall inflation is anticipated to stay restrained. The central tendency of the forecasts made by the Board members and Reserve Bank presidents has the increase in the total CPI slipping back into a range of 2.75 to 3 percent over the four quarters of the year.

The unemployment rate, according to Board members and bank presidents, should stay around 5.25 to 5.5 percent through the fourth quarter, consistent with their projections of measured real GDP growth of 2 to 2.25 percent over the four quarters of the year.

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The Federal Reserve will be endeavoring to help extend the current period of sustained growth. Participants in financial markets seem to believe that in the current benign environment the FOMC will succeed indefinitely. There is no evidence, however, that the business cycle has been repealed. Another recession will doubtless occur some day owing to circumstances that could not be, or at least were not, perceived by policymakers and financial market participants alike.

History demonstrates that participants in financial markets are susceptible to waves of optimism, which can in turn foster a general process of asset-price inflation that can feed through into markets for goods and services. When unwarranted expectations ultimately are not realized, the unwinding of these financial excesses can act to amplify a downturn in economic activity, much as they can amplify the upswing. As you know, last December I put the question this way: "How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions?"

We have not been able, as yet, to provide a satisfying answer to this question, but there are reasons in the current environment to keep this question on the table. Clearly, when people are exposed to long periods of relative economic tranquility, they seem inevitably prone to complacency about the future. This is understandable.

We have had 15 years of economic expansion interrupted by only one recession, and that was 6 years ago. As the memory of such past events fades, it naturally seems ever less sensible to keep up one's guard against an adverse event in the future. Thus, it should come as no surprise that, after such a long period of balanced expansion, risk premiums for advancing funds to businesses in virtually all financial markets have declined to near record lows.

Is it possible that there is something fundamentally new about this current period that would warrant such complacency? Yes, it is possible. Markets may have become more efficient, competition is more global, and information technology has doubtless enhanced the stability of business operations. But, regrettably, as has been commented, history is strewn with visions of such new eras that in the end have proven to be a mirage. In short, history counsels caution.

Such caution seems especially warranted with regard to the sharp rise in equity prices during the past 2 years. These gains have obviously raised questions of sustainability. Caution also seems warranted by the narrow yield spreads that suggest perceptions of low risk, possibly unrealistically low risk, not just in the stock market but throughout the financial system.

Why should the central bank be concerned about the possibility that financial markets may be overestimating returns or mispricing risk? It is not that we have a firm view that equity prices are necessarily excessive right now or risk spreads patently too low. Our goal is to contribute as best we can to the highest possible growth of income and wealth over time, and we would be pleased if the favorable economic environment projected in markets actually comes to pass. Rather, the FOMC has to be sensitive to indications of even slowly building imbalances, whatever their source, that, by

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fostering the emergence of inflation pressures, would ultimately threaten healthy economic expansion.

Mr. Chairman, I will conclude on the same upbeat note about the U.S. economy with which I began. Although a central banker's occupational responsibility is to stay on the lookout for trouble, even I must admit that our economic prospects in general are quite favorable. The flexibility of our market system and the vibrancy of our private sector remain examples for the whole world to emulate. The Federal Reserve will endeavor to do its part by continuing to foster a monetary framework under which our citizens can prosper to the fullest possible extent.

Thank you, Mr. Chairman. I am available for questions.

[The prepared statement of Mr. Greenspan can be found on page 63 in the appendix.]

Chairman CASTLE. Thank you, Mr. Chairman.

Mr. GREENSPAN. May I ask, incidentally, that the full testimony be included for the record?

Chairman CASTLE. Without objection, it will be included in the record and we do appreciate that, Mr. Chairman.

Mr. GREENSPAN. Thank you.

Chairman CASTLE. We appreciate your testimony and we appreciate your commitment to being here for this process. As you know, we now enter into a period in which we each have 5 minutes in which to ask you questions and get your answers in, which is always a little bit difficult for each Member, so we will try to go as efficiently as we can. I will take the Chairman's prerogative and start the process.

You said yesterday that there was 100 percent probability that the CPI overstates inflation. As I understand it, you have proposed a two-track approach toward improving the accuracy of the CPI by urging the Bureau of Labor Statistics to accelerate its efforts to correct some errors in the creation of a rotating expert advisory committee that would periodically select the inflation adjustment factor that in its judgment best represents the modification of the CPI rise needed to measure the increase in the cost-of-living. Is this correct? Did I state it correctly, and how do you envision this two-pronged approach would work in practice?

Finally, is it your feeling, based on what you know, read, have seen, discussions with the White House, that the time has come that this or some similar mechanism may be put into place at some time in the near future? I know that is conjecture and you may not wish to, but I wanted to ask you the question.

Mr. GREENSPAN. No, I cannot answer that, largely because I really do not know. You probably have more insight in that than I.

Chairman CASTLE. I doubt that, but it is kind of you to say so.

Mr. GREENSPAN. The issue is clearly on the table. It is fairly clear that Senator Moynihan has considered it a very high priority over in the Senate. Let me, if I might, address the questions that your other colleagues on your right have been raising with respect to this issue as I respond to your question.

There has been an extraordinary amount of analysis of the Consumer Price Index which the BLS stipulates, and I think quite correctly, is not a cost-of-living index. It was the intent of the

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Congress, as best I can judge, in 1972 to endeavor to insulate Social Security recipients from increases in the cost-of-living and in, I believe it was 1980, to insulate taxpayers similarly from bracket creep as a consequence of cost-of-living increases. In both instances, there was a general view that what was involved was adjustment for the cost-of-living increases only.

I fully recognize that in removing the bias from the CPI—and indeed the evidence in my judgment is just overwhelming, and I can go into it in detail, that that is in fact the case—if the Congress decides that it wants to do more than the cost-of-living, then I think it is perfectly appropriate as a third track to bring forward legislation to increase the real benefits. I think it is inappropriate for the Government of the United States to be using an index as a proxy for the cost-of-living, which clearly does not reflect cost-of-living.

I regret that this issue is in the context of the budget, and it does have significant momentum because of the budget issue. But my main concern is that the index is a very crucial statistic for policy purposes and a lot of other purposes, and I think to improve it in a significant manner would be very useful to this country.

What I had in mind is that there are a number of technical adjustments which the BLS can implement, and indeed, are in the process of doing so. They are moving forward at a fairly pronounced clip at this stage. As I understand it, the Administration has put additional funds for the BLS in this year's budget.

Nonetheless, as hard as they may endeavor to move, there are certain things that are going to take quite a number of years to adjust, and I am referring mainly to the biases very obviously in the quality area of the statistics and in so-called new products. That is, the statistics are not picking up the very dramatic improvements in quality in a number of major areas.

I suggested, in line with the Boskin Commission and in earlier comments that I made with respect to this issue a couple of years ago, that there be a second track in which an additional adjustment would be made on the basis of the evaluation of professionals in this area, appointed by the President and confirmed by the Senate, to make judgments on the basis of what studies have been made about what the remaining bias is. And say every October, that commission would meet to define in its judgment what the appropriate estimate should be. In my belief, Mr. Chairman, that would address this issue in the most reasonable way.

As I indicated before, should the Congress decide that there are many recipients who would be unduly affected by correcting what is an incorrect measure, then I think a third track would be perfectly appropriate to address those issues.

I might say with respect to the question of changing the cost-of-living index to reflect the expenditures of the population over age 65, the BLS does have an index of that nature at this stage. The spread incidentally is less than .4. Last year it was only .1. But it is true, Mr. Kanjorski, the index is somewhat higher. And if the Congress chooses to make that sort of adjustment, I think that is a perfectly appropriate thing for you to be examining.

Chairman LEACH. [presiding]. Thank you, Chairman.

Mr. Flake.

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Mr. FLAKE. Thank you very much.

Mr. Chairman, going back to my statement and the concerns that I raised earlier, I would like to just ask, as you consider where the Nation is going now, I think most of us agree that you have to make changes in welfare. That is not a big issue.

The question becomes, as you talk about moving toward workfare, and the people who are most affected are living in certain communities where there has been devastation and deterioration to the degree that it is impossible to attract industry. It is impossible in many instances even to attract the small sector jobs from franchisors. It is impossible to get banks to see these communities as necessary places for making investment. Corporate entities really do not even look at them as a potential place for opportunities for building businesses.

Yet, those same corporate entities will go abroad where the environment is much worse than it is in many of these urban and poor rural communities, will make the investments, will take the risk, and in many instances take a loss. I would just like to know if within the scope of your analysis, has there been or will there be some means of looking at what might be done over the next 5 years or so in trying to determine what kind of industries can go into these communities, and how we might be able to assure that the same corporations that look abroad in these Third World countries will look at these communities as places of opportunity?

Is that something that you think you can influence? If so, what kind of direction would you suggest we might go in trying to assure that it happens?

Mr. GREENSPAN. Mr. Flake, you are raising one of the most difficult but important problems that this country has. I know our colleague Jack Kemp has addressed this with his enterprise zones in an endeavor to find a means to go in there to enhance economic development. We have so far made very little progress in the area of our knowledge of how to induce companies to go into areas to expand plants and to gain profitable opportunities. I have been dealing with this issue for many, many years and I must tell you, I feel very frustrated by the terribly small amount of results that have been achieved.

Monetary policy itself cannot do anything. We only have one single instrument and that can only affect the economy as a whole. But I do think all of us who are involved in trying to observe what the various forces engendering growth in this economy are doing are also trying to understand better what is causing the locational differences among various areas and see whether we can alter them. There has probably been some progress, but I would suspect that you would argue, and with some reason, that the results have been far inferior to what you would like to see happen.

Mr. FLAKE. I think on the question from a monetary side, obviously corporations do not see these as the fertile fields of opportunity that I would see. I think on the other side though, the level of your influence as primary spokesperson as it relates to the monetary policy of this Nation can probably influence in a much more positive and meaningful way. We created a way abroad with NAFTA, and we create other means through taxing capability, or changing tax law.

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It would seem to me to suggest that if we indeed want a Nation that is strong enough to be able to absorb these individuals without having to make the kind of expenditures, capital expenditures for what is a growing industry, which is the penal system, that somehow the transference of even those dollars would make a major difference and a major impact in helping to solve problems, not only unemployment problems, but clearly, I think give an advantage to many of those corporations who were looking for a marketplace where there is a labor base, but a labor base that has nowhere to work.

So that long-term, I think it represents a drain on the Nation. If you have all of those persons unemployed in jail, either way, the long-term benefits are not in the best interest of developing positive kind of monetary policy for the Nation.

Mr. GREENSPAN. I must say I agree with you, Mr. Flake.

Mr. FLAKE. And that is it?

Mr. GREENSPAN. I agree that we all should be endeavoring to do something. We, as you know, have been trying through the Community Reinvestment Act indirectly to come at this issue. It does not, as you know, work directly because it only refers to lending, and to a very large extent to mortgage lending. But there has been some general awareness, growing awareness, that there are foregone loan opportunities, profitable loan opportunities, in small business in a number of our urban communities which are not being exploited.

I think that the one thing we can do is to try to find the ways in which that can be expanded. Because it is true, if you bring a large corporation in, that helps a lot. If you cannot bring a large corporation in, at least have a lot of small ones because they can grow. They may, in fact, be a better investment than the larger ones.

Mr. FLAKE. Thank you, sir.

Yield back, Mr. Chairman.

Chairman CASTLE. [presiding]. Thank you, Mr. Flake.

Mr. Chairman, I apologize for departing in the middle of your answering my question. My mother would not have been happy about that, but I am on the Education and Workplace Committee which is 179 running steps away, and if I get a phone call I can go vote in our markup over there. So that is why I had to go. It may happen again.

Mr. FRANK. If the gentleman would yield?

Chairman CASTLE. I yield.

Mr. FRANK. If you guys would reinstate proxies, you would not have to run around like a nut.

[Laughter.]

Chairman CASTLE. If you think I have enough influence to reinstate or not reinstate proxies, you are wrong. You are sadly mistaken.

Chairman Leach.

Mr. LEACH. Thank you, Mr. Chairman.

As I listened to several of the comments in the opening statements, I must say I think as Chairman of the Federal Reserve you see a distinction between this body and the other body. We are the people's House. We have a little bit broader perspectives sometimes

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than the other body. We are represented by socialists, libertarians, Republicans, Democrats, and combinations of those.

I consider myself a little bit toward the center right in American politics, but I must say that not infrequently those at the outer edges describe problems better than the rest of us. When Congress' only socialist defined the problem of income inequality, I think he was speaking very profoundly about an American issue.

As I am sitting here thinking of the problems of wage stagnation, which may or may not be now on the move a bit, I am wondering if as Chairman of the Federal Reserve Board you would care to comment on what I consider to be an ethical umbrage in corporate governance. This whole precept that not only do we have wage stagnation at certain levels, but we also have incredible compensation escalation at other levels. The notion in the last month that a head of a given company received a $771-million compensation package describes to me a problem in our system. I am wondering, as Chairman of the Federal Reserve Board if this is an issue that you would wish to jawbone on?

Mr. GREENSPAN. No, but I must say that when I was in the private sector, when I actually had some capability as a member of a number of boards, I argued that stock options should not be priced directly but priced as a ratio to the overall stock price level. If one is doing something in corporate governance which is competitively superior to everyone else, one should be rewarded. But one should not be rewarded if the stock market overall goes up, which drags up all prices irrespective of whether a company is doing well or not well.

I would suggest to you that if that type of view had prevailed—which it clearly has not—many of these outsized compensation packages which you are looking at would not at this stage exist.

Mr. LEACH. I appreciate your decision not to totally bite on that bone. Turning a little bit differently, in a historical sense, in Humphrey-Hawkins hearings the Chairman of the Federal Reserve Board speaks to levels of interest rates, levels of unemployment, now increasingly, levels of the Dow Jones Industrial Average. Would you care to comment, and perhaps with the historical perspective of, for example, the 1987 downturn and the role of the Federal Reserve Board in terms of being a liquidity-supplying institution, of the rationale for commenting on the market itself? How appropriate or inappropriate is that?

Mr. GREENSPAN. It has become ever clearer in recent years that as the economy has become more complex, internationalized, and as balance sheets, both household and corporate have increasingly become factors in the economic outlook, and in the production of goods and services, we have had to broaden our view of the particular range of issues which we cover in the context of developing monetary policy.

It is probably inevitable as our standards of living overall rise that the assets that individuals have become an increasing part of their decisions to spend or not spend. Therefore, because of that fact, and because of the lag that monetary policy invariably has with respect to the economy, we have to forecast what we think is developing in the economy. Were we not to be looking at balance sheets and asset spillovers as I like to call it, I do not think we

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would be getting a full, comprehensive understanding of what the forces driving the economy are.

I decided that we cannot be making changes up or down in the Federal funds rate without a fairly extensive explanation to the Congress and the American people of what the factors are we that are looking at. Years ago, we looked mainly at the money supply in a fairly restricted range and we communicated that as best we could. As a consequence of that, it was pretty easy to communicate why we were moving policy one way or the other.

Since the money supply has grown in recent years in a manner which has been inconsistent with economic events, and only recently has seemed to get closer to its historical norm, we have been forced to broaden the whole area of indicators to make judgments as to how the economy functions. We therefore concluded that it was necessary for us to express the fact that we were doing that, and to evaluate various changes in balance sheets and markets in much the same way we do home building, personal consumption expenditures, consumer debt, and export markets.

I recognized that as soon as we raised the issue in my speech back in December about the nature of the stock market that it would probably have some effect. I, however, did not speculate as to which direction I thought the market was going. I was merely raising a broad question. Today, in my prepared remarks you will find that I take a look at the various factors affecting the stock market and conclude that if profit margins continue to rise as analysts on Wall Street expect them to, then the market is properly priced, as best we can judge on the basis of the level of interest rates.

If, however, profit margins, which are quite high but below where they were in the 1960's, fail to rise further, then the market will run into some difficulty. I think in the process of evaluating that, we do not know what is likely to happen. Is it possible for margins to rise further? It certainly is. At this rate of inflation back in the 1960's, margins were indeed higher from where they are now. So that despite the fact that they have come up a considerable ways since 1991, they could very well continue further as analysts expect them to.

Our basic judgment is that we need to look at all of these various things, and we have to communicate our views to the Congress if we are going to give you an essential view of the types of things we are going to look at.

The one thing I was not endeavoring to do, because I do not think it is possible to do, was to jawbone the stock market. Stock markets in this world, especially in the United States, are extremely sophisticated, complex, very liquid markets with millions of investors. You cannot talk those markets up or down. Anyone who thinks they can has just not looked at the evidence.

What we will inevitably be required to do as the years go on, and as this economy becomes increasingly more complex, and especially as an ever-increasing proportion of American households own all sorts of assets, is evaluate how they will respond to price changes, whether it is in real estate, whether it is in residences, whether it is in any of a variety of other things which appear on the balance sheets.

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What I was endeavoring to do, and I have hopefully effectively tried to communicate today and to your Senate colleagues last week, is to say that is what has evolved as a natural consequence of the increased complexity of the economic system with which we are dealing. It is not any longer, if it ever was, a simple thing with which to deal. And we use a number of different techniques for evaluating where we are with respect to what our fundamental objective is; namely, we believe that our goal is maximum sustainable economic growth. But that, in our judgment, requires low inflation, or more appropriately, stable prices.

Our evaluation of that process, whether we look at the supply and demand forces which are driving the economy, or direct measures of inflationary expectations such as the gold price or money supply, if it ever gets back into place, and the newly issued index bonds, these are all elements involved in how we endeavor to determine what is going on, as best we can, and to make a judgment as to what as a consequence is the most appropriate policy stance.

So it is not a stock market issue we are involved with, and to answer Congressman Hinchey, who has left, specifically, we do not view monetary policy as a tool to—I do not know how he put it—prick the stock market bubble, or something like that. What we do is look at a wide variety of things, income and consumption, assets and liabilities, combining them all to make judgments as to what it is that one should be doing with respect to our policy stance.

Mr. LEACH. Thank you.

Chairman CASTLE. Thank you, Chairman Leach.

Mr. Frank.

Mr. FRANK. Mr. Chairman, I take you at your word that you were not trying to jawbone the stock market. But when you say that it is impossible, looking at what happened, I guess I am not sure whether I am supposed to believe you or my own eyes, to quote Marx. But let me get on to a couple—let me just ask you——

Mr. GREENSPAN. Can I just answer very quickly?

Mr. FRANK. Yes. The stock market does not seem to know that.

Mr. GREENSPAN. I ask the Chairman to put this on my time, not his.

Mr. FRANK. I thank you.

Mr. GREENSPAN. There is a lot of volatility in the market, and markets will move on rumors. They will move on statements by myself or my colleagues. But what you cannot do is affect the underlying forces. You can do it on a day-by-day basis. If you try to do it more than that, you will fail.

Mr. FRANK. That I would accept.

I was also pleased to actually hear your articulation that your concern on the CPI is with its role as a measure for use in the economy. By the way, I note parenthetically, because you refer for instance to the generally steady performance of the CPI and no great increases, in fact I gather the news is even better than the number might look. Because to the extent that the CPI overstates inflation, that means there has been even less inflation in the economy than that low number shows, and that is an encouraging sign.

Mr. GREENSPAN. That is correct. But it has been that way for a very long time.

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Mr. FRANK. I understand. But people do not often talk about that side of it as much as they talk about the other. But I also take it, what you are saying then is that you express no opinion then on whether or not we should be reducing the cost-of-living adjustment, or whatever adjustment we give—let us forget cost-of-living. You are not expressing any opinion that we are overcompensating Social Security recipients as a matter of policy.

If we were to decide that low-income recipients should be treated separately and that the CPI calculation should be separate, that is not a problem for you?

Mr. GREENSPAN. Correct.

Mr. FRANK. Thank you, because I think that helps remove some of what people have been arguing as a driver of Social Security. As a statistical, that is a separate issue.

Two other points. One, you conclude by saying you are going to conclude on an upbeat note. It is partly professional and partly the style that you think appropriate, but you upbeat is most peoples' depressed, you realize.

[Laughter.]

Mr. GREENSPAN. I fully understand that.

Mr. FRANK. What you say is, in your upbeat phase, Mr. Greenspan, you say, even I must admit that our economic prospects are quite favorable. This is not what most of us would consider to be the source of an admission.

What I am concerned about is this, it does seem to me over the years that you have been somewhat pleasantly surprised by the fact that we have had as steady a growth and as great a reduction in unemployment as we have had with so little inflation. Am I correct in inferring that you have been somewhat pleasantly surprised; that your expectations were somewhat more pessimistic over the past say 4- or 5-years?

Mr. GREENSPAN. That is correct, Congressman.

Mr. FRANK. I think that is a fact. Because I think what some of us are worried about when you talk about preemptive strikes is, that you might be a little bit too preemptive because there has been this historic mis-estimate. A lot of people missed it, and you did as well as anyone could. But that is part of our problem, where you have a history of a little bit more pessimism than turned out. We just hope that that correction gets factored in.

I do want to talk specifically then about the question I asked you before. I recall when I was on the Budget Committee I think it was, asking you your view of the effect of the tax increases of 1993, and you did say to me in either late 1994 or 1995, you believed they would have a negative effect on the economy but it was too early for that to happen. They are now over 3 years.

I guess the question is, do you still believe that the tax increases of 1993 had a negative effect on growth? Then the second part of the question is, if they did and growth would have been even higher, would that not have simply meant you would have been more restrictive?

Mr. GREENSPAN. Let me put it this way. It is certainly the case, as you point out quite correctly, that the economy is doing exceptionally well from our point of view. It is almost certainly the case

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that there is no direct evidence that you can see at this stage that capital investment or other things have slowed down.

Nonetheless, it is very hard for me to believe that when you increase marginal tax rates it has no effect. But there are so many other things going on in the economy that it is hard to disentangle them. So all I can say to you is that the hypothesis that it has had a demonstrable negative effect is not capable of being proved.

Mr. FRANK. That is a very comfortable——

Mr. GREENSPAN. That is as much as I can say.

Mr. FRANK. We just voted on that. That could be the 11th Commandment. It is OK to invoke faith, because that is all we voted on this week was religion, and we were in favor of it by two-thirds. But I do think it was relevant to note that this is not an assertion that you believe provable.

But I do have to say the second part, to the second extent that your ideological view, your view was correct that the tax increases of 1993 did slow the economy down, is it not the case that had that not happened you would have then been more restrictive?

Mr. GREENSPAN. Not necessarily. It is hard to know what would have happened in the context of inflation, because it is not growth, *per se*, that we respond to. It is evidences of imbalances, inflationary imbalances which upend the economy. But it is not growth, *per se*.

Mr. FRANK. I appreciate that. If I can just have my last 30 seconds. That I am particularly glad to hear, because what you are saying, and I am pleased to hear this is, that the fact that unemployment could drop further and growth would continue, in and of itself is no reason for people to get nervous or to make preemptive, absent some specific—I think that is something that you reassure me when you say that. Because there has been this view that your position might be that too much good news, even absent specific indications of imbalances, might lead to that preemptive strike.

Mr. GREENSPAN. I want you to understand that a very substantial part of the academic community does believe that. I am very skeptical about that relationship myself.

Mr. FRANK. That growth necessarily leads to that.

Mr. GREENSPAN. Yes.

Chairman CASTLE. Thank you, Mr. Frank.

Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman.

Chairman Greenspan, I certainly want to reiterate, in a sense, the words of our Committee Chairman, Mr. Leach, when he described the differences of economic philosophy on this subcommittee. We are certainly very diverse in our views. Could you reassure me for just a moment, after listening to a number of my distinguished colleagues that I respect intensely about the nature of these things. I sometimes get the feel that there are those who have the goals of maybe affecting how we allocate the income and resources in this country.

On page 15 of your testimony you state that the goal is the highest possible growth of income and wealth over time. Just reassure me a little bit that that is indeed the goal of the Fed.

Mr. GREENSPAN. It is. Indeed, you have to remember that prices, employment and the like, are all intermediary goals. The ultimate

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goal has got to be the physical well-being of the American people, meaning maximum sustainable economic growth. The financial relationships are only important as they contribute to those goals. We function in the financial market and therefore must deal with them. But we deal with them in the context, as we see the relationships over the years develop, which in our judgment contributes to maximum growth.

Mr. LUCAS. So as we would say in Oklahoma, our goal is to make the economic pie of this country larger?

Mr. GREENSPAN. Yes.

Mr. LUCAS. Thank you. One other question I have and an issue close to my own heart. I am a proponent of either eliminating, or at the very least, providing substantial decreases in the capital gains tax rate. It is my view that such action would encourage a more productive use of our investment resources. Could you elaborate whatever point of view you might have on that subject for a moment?

Mr. GREENSPAN. I have always argued, since I came out of graduate school I guess, that the capital gains tax is an inappropriate tax for purposes of raising revenue. All taxes suppress economic growth one way or another. This, because it focuses very directly on entrepreneurial activity, in my judgment, has the most restrained effect on economic growth. If you are going to raise revenue, I think it is far better to do it with a different form of taxation.

Mr. LUCAS. I share that view completely. On that note, thank you, Mr. Greenspan.

Mr. Chairman, I yield back my time.

Chairman LEACH. [presiding]. Thank you.

Mr. Kennedy.

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

Mr. Chairman, I want to go back to the issues that I tried to bring up in my opening statement, which were your quote on this issue of wage stagnation where you explain why the suppressed wages have been caused by worker anxiety about job security. But then you seem to conclude that there will be an end to that, because there is a limit to the value of additional job security people are willing to acquire in exchange for lesser increases in standards of living.

I wonder what your thoughts are on the idea that in 1974, as I understand it, statistically, the typical CEO earned 34 times the pay of the lowest worker. Today, that has risen to about 173 times.

It just seems to me that there is perverse equality going on where we end up seeing the stock market having these huge run-ups for companies that lay off more and more workers, sending a very strange message to the American worker in general. As a result of those stock run-ups, we see the salaries of the top CEOs skyrocketing, and there does not seem to be anywhere near a comparable rise in wages.

I wonder if you might just comment on the phenomenon, and whether or not you feel that you could in fact take a more aggressive role in this phenomenon of these huge corporate wages versus the average wage to the average worker?

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Mr. GREENSPAN. First of all, let me just say that there are two reasons of which I am aware which are engendering this type of opening up of the gap. One is the stock option issue and the way that is paid is tied to the stock market. The stock market goes up for everybody. In other words, the underlying key evaluation process affects all individual stocks. Once the average has been set in that regard, then differences between companies emerge largely as a result of differences in overall outlooks.

Were you here when I was mentioning to Chairman Leach about the stock option question?

Mr. KENNEDY. No, I do not think I was.

Mr. GREENSPAN. What I was mentioning is that when I was in the private sector I was a very strong advocate of tying stock options not to the price of a stock, but to the ratio of the price of a stock to some overall price index, so that the general change in stock prices does not accrue to the benefit of individuals who really had nothing to do with it.

Second, however, there has been, as we know and discussed over the years, a significant opening up of income spreads, largely as a function of technology and of education with the increased premium of college education over high school, and high school over high school dropouts becoming stronger. That whole spread goes right through the basic system. It is a development which I feel uncomfortable with. There is nothing monetary policy can do to address that, and it is outside the scope, as far as I am concerned, of the issues with which we deal.

Mr. KENNEDY. But, Mr. Chairman, excuse me. I think the problem with that is that somebody else could make the same argument about your statements about the stock market.

Mr. GREENSPAN. They have and I think they are wrong. And I think they are wrong because I think that is part of the bailiwick of the overall financial system and affects what it is we do.

Mr. KENNEDY. But do you now think that the idea that we are having a greater and greater disparity between the incomes of working families and the poor as well as the very, very rich—do you not think ultimately that this will have an effect on the economy of this country?

Mr. GREENSPAN. The answer is yes, in the very broadest sense that all things have an effect. But that is very indirectly related to our particular portfolio. It is there only to the extent that as private citizens we obviously are concerned about the status of our society, and I am concerned when I see very significant changes in income distribution. I cannot demonstrate to you that it has a significant effect on the way in which we implement monetary policy. If I saw that way, then I would say I would have to agree with you. There would have to be some way we could address it, if we could figure out what we could do to change it.

Mr. KENNEDY. I would have some ideas on that.

Mr. Chairman, if I could just ask one very brief question that would require a one-word answer.

Is there an unemployment rate number at which the unemployment rate falls to where you automatically feel interest rates have to rise?

Mr. GREENSPAN. No.

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Mr. KENNEDY. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Kennedy.

Mr. Metcalf.

Mr. METCALF. Thank you, Mr. Chairman. I have three questions so I will hurry.

As is Chairman Leach, I am deeply concerned about wage stagnation. In your speech you highlighted the fact that workers are becoming more and more concerned about job security. As you know, we talk a lot about modernization; specifically in this subcommittee, financial modernization. Do you see any indication that with the growing concentration of economic power that that could exacerbate unemployment and also heighten job security? Should this not be a major concern of this subcommittee as we move forward on financial modernization?

Mr. GREENSPAN. It is a very difficult question to answer because we know very little as to the impacts that are likely to arise as we move into a very complex and evolving state of technology in the 21st Century. It is a complex issue which I do not think I can add terribly much to, unless you want me to be very specific to a specific question.

Mr. METCALF. That is OK, I just have that concern and want to register it.

Mr. GREENSPAN. I understand it and it is the right type of question that should be on the table when you are discussing the modernization issue.

Mr. METCALF. Thank you. Last week in the Senate hearings, the issue of paying interest on sterile reserves was brought up. I authored a bill last year and I will reintroduce it shortly, to allow sterile reserves to gain interest, and also allow small businesses to earn interest on their demand deposits, which they cannot do now under Regulation D and Regulation Q. There are significant budget implications; specifically, the way CBO scores this issue.

Do you see the benefits of this action outweighing the budget scoring process, and would the Fed support such action?

Mr. GREENSPAN. Congressman, we have supported the payment of interest on required reserve balances for a very long period of time, and indeed, the elimination of the prohibition on the payment of interest on overall demand deposits as well. We continue to do so. There is no question that there would be a not insignificant loss to the Treasury as a consequence of that; somewhere between $300-million and $500-million annually.

Mr. METCALF. Thank you. The Fed's open market intervention procedures were changed as of the first of the year. Could you briefly outline to us what the changes were and why they were needed? And also, any impact the changes might have on the ability of the Fed to execute monetary policy.

Mr. GREENSPAN. I am sorry, I am not familiar with what particular changes you are referring to.

Mr. METCALF. I heard or read that the Fed's open market intervention procedures were changed as of the first of the year.

Mr. GREENSPAN. I am sorry. We, for a long period of time, used to enter into the market, which we do daily, later in the morning than the period where maximum transactions were occurring.

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What we have done is speed up our process of evaluating the various needs for reserves during the day that might accrue over the so-called maintenance period. What we have been able to do is to enter the market at an earlier part of the day and engage a thicker part of the market, the part where more transactions are going on. I do not consider this an important issue and I do not think it has been creating a particular problem for us, Congressman.

Mr. METCALF. Thank you very much. I read about it and I just wanted to ask about it in case it was something more than——

Mr. GREENSPAN. No, it is an interesting issue. I am just, quite frankly, surprised that anyone noticed.

Mr. METCALF. Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Metcalf.

Mrs. Maloney? Excuse me, I am sorry, the gentleman from Vermont. I apologize.

Mr. SANDERS. I may be an independent, Mr. Chairman, but geez. Thank you, Mr. Chairman.

Mr. Greenspan, the wealthiest 1 percent of Americans now own 42 percent of the Nation's wealth; more than the bottom 90 percent. In 1976, the wealthiest 1 percent owned 19 percent of the wealth. So we have seen the upper 1 percent more than double the percentage of the wealth in this country that they own.

Does this concern you, the fact that we today have, by far, the most unequal distribution of wealth and income in the industrialized world? A, does it concern you? And B, what do you intend to do about it? And I have a number of questions to ask you, so I would appreciate if your answers could be brief.

Mr. GREENSPAN. Yes, the answer is, it does concern me. It is not clear to me what monetary policy can do to alter that in any material way.

Mr. SANDERS. Mr. Greenspan, from what I just heard a moment ago you talked that from your point of view the economy is doing "very well." Did I hear you correctly?

Mr. GREENSPAN. That is correct.

Mr. SANDERS. I would love to take you to the State of Vermont where you can talk to working families where workers are working two or three jobs trying to pay their bills; where women who would prefer to stay home with the kids are now being forced to work; where jobs in our economy which used to pay $15-an-hour in manufacturing are now paying $5-an-hour working for McDonald's.

But more importantly, during the past 20 years we have seen a decline in wages, or stagnation, for 80 percent of all American families while the people on top have never had it so good. Twenty years ago, American workers were the best compensated in the world. Today, we rank 13th in the world. In 1973, the average American worker earned $445 a week, and 20 years later in 1993, that worker was making $373 a week. Please tell the working people of Vermont and the working people of this country how the economy is doing so good for them as opposed to the very rich who have never had it so good.

Mr. GREENSPAN. Congressman, at any time throughout our history there have always been areas in our economy which are doing far less well than others. All we can measure is the average changes. I can suggest to you that in terms of the average changes,

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the economy by any measure which we have available to us, is doing well.

Mr. SANDERS. But Mr. Greenspan, is not the concept average change totally meaningless? If you make $1-million-a-year and I make $10,000-a-year, on average we are making a little bit less than $500,000-a-year. You are doing very well. I am dead broke. Does not this whole on average concept perpetuate a fraud when the vast majority of the people in this country have seen a decline in their wages, working longer hours; when the new jobs that are being created are terribly low wage jobs? So what are we talking about average? If the rich are getting richer, that distorts the whole figure.

Mr. GREENSPAN. First of all, let me question your data. It is not true that the vast majority of people have lower wages at this stage.

Mr. SANDERS. You question the statistic that I gave you?

Mr. GREENSPAN. I do. I do indeed.

Mr. SANDERS. What do you believe? You believe that the working people of this country have seen higher wages?

Mr. GREENSPAN. No, I am just saying, you said the vast majority.

Mr. SANDERS. That is right.

Mr. GREENSPAN. So that is a number which means 60, 70 percent?

Mr. SANDERS. I have said that in 1973, the average American worker earned $445 a week. Twenty years later that worker was making $373. That 80 percent of our working people have seen a significant decline.

Mr. GREENSPAN. You are using BLS' payroll employment figure, and the average weekly earnings that is associated with that. That figure is questionable, I must tell you that.

Mr. SANDERS. Why do you think it is questionable, sir?

Mr. GREENSPAN. It is questionable basically because of the fact that those data are not produced in an appropriate sample. The employment figures are, but not the wages and they are not revised. Let me just say this, the Bureau of Census has alternate data which they do on a more scientific basis which are far less pessimistic than that.

Mr. SANDERS. I believe it was the Labor Department came out recently with statistics which says that for high school graduates who are entering the labor market, for young men the wages are 30 percent less than they were 15 years ago; for women I believe it was 27 percent less. Significant drop in wages for high school graduates. Is that also not a good figure?

Mr. GREENSPAN. I can believe that figure.

Mr. SANDERS. Given that reality, what about the figure that the inflation-adjusted median income for young people are doing worse than older families, with children? Young families with children headed by persons younger than 30 plunged 32 percent between 1973 and 1990. Meanwhile, we have seen a proliferation of billionaires going from 12 to 135 from 1982 to today. Do you really deny that while the wealthiest people of this country have never had it so good, the vast majority of the people have seen a decline in their standard of living?

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Mr. GREENSPAN. The Consumer Price Index, which is employed to deflate those data is precisely the index which I have been arguing is mis-specified. If you make the appropriate adjustments, that declining trend disappears. Nonetheless, I grant you that it is pretty stagnant.

Mr. SANDERS. I would simply say, I would welcome you. Please give me a ring. You come to the State of Vermont with me and I will take you around our State, and I would love to hear the response when you tell the working families of our State that the economy is doing very well. It is not doing well for the middle class, for the working class. It may be doing well for upper-income people, but not for the vast majority of the people.

Mr. Chairman, thank you very much.

Thank you, Mr. Greenspan.

Chairman CASTLE. [presiding]. Thank you very much.

Dr. Paul.

Mr. PAUL. Thank you, Mr. Chairman.

Mr. Chairman, I want to bring up the subject again about the CPI. We have talked a lot about the CPI and an effort to calculate our cost-of-living in this country, and specifically here, to measure how much we are going to increase the benefits that we are responsible for. But in reality, is not this attempt to measure a CPI or a cost-of-living nothing more than an indirect method or an effort to measure the depreciation of a currency? And that we are looking at prices, but we are also dealing with a currency problem.

When we debase or depreciate a currency we do get higher prices, but we also have malinvestment. We have distorted interest rates. We contribute to deficits. And also, we might not always be looking at the right prices. We have commodity prices, which is the usual conceded figure that everybody talks about as far as measuring inflation. But we might at times have inflated prices in the financial instruments.

So to say that inflation is under control and we are doing very well, I would suggest that we look at these other areas too, if indeed we recognize that we are talking about the depreciation of a currency.

One other thing that I would like to suggest, and it might be of interest to my colleagues, is that one of the characteristics of a currency of a country that depreciates its currency systematically is that the victims are not always equal. Some suffer more than others. Some benefit from inflation of the currency and the debasement of the currency. So indeed, I would expect the complaints that I hear. I would suggest that maybe this is related to monetary policy in a very serious manner.

The consensus now in Washington, all the important people have conceded that we should have a commission. But when we designate a commission, this usually means everybody knows what the results are. I mean, nobody complains that the CPI might undercalculate inflation or the cost-of-living for some individuals, which might be the case. So we have this commission.

But is it conceivable that this is nothing more than a vehicle to raise taxes? the *New York Times* just this week editorialized in favor of this because it raised taxes, and also it cuts benefits, and they are concerned about cutting benefits. But would it not be

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much more honest for Congress to deal with tax increases in an above-board fashion, especially if we think the CPI is not calculable? I think it is very difficult.

Also, I think that if it is a currency problem as well, we cannot concentrate only on prices. There have been some famous economists in our history who say, look to the people who talk about prices because they do not want to discuss the root cause of our problem, and that has to do with the inflation of the monetary system or the depreciation of the currency.

Mr. GREENSPAN. Dr. Paul, the concept of price increase is conceptually identical, but the inverse of the depreciation of the value of the currency. The best way to get a judgment of the value of the currency as such, if one could literally do it, is to separate the two components of long-term nominal interest rates into an inflation premium component and a real interest rate component. The former would be the true measure of the expected depreciation in the value of the currency.

We endeavor to capture that in these new index bonds that have been issued in which the Consumer Price Index, for good or ill, is used to approximate that. It does not exactly, and I think that is what I have been arguing with respect to the commission is to take the statistical bias out of the CPI and get a true cost-of-living index.

It is certainly the case that that is a measure of inflation. There are lots of different measures of inflation. I would argue that commodities, *per se*, steel, copper, aluminum, hides, whatever, used to be a very good indicator of overall inflation in the economy when we were heavily industrialized. Now they represent a very small part of the economy and services are far more relevant to the purchasing power of the currency than at any time, so that broader measures of price, in my judgment, are more relevant to determining what the true rate of inflation is.

Mr. PAUL. Can the inflated prices in the financial instruments not be a reflection of this same problem?

Mr. GREENSPAN. They are. This is a very important question and one which I was implicitly raising: do asset price changes affect the economy? And the answer is clearly, "yes." What you call it, whether it is inflation or not inflation, that is a nomenclature question. But the economics of it clearly means that if one is evaluating the stability of the system, you have to look at product prices, that is, prices of goods and services, and asset prices, meaning prices on items generally which have rates of return associated with them.

Mr. PAUL. Thank you.

Chairman CASTLE. Thank you very much, Dr. Paul.

Mrs. Maloney.

Mrs. MALONEY. Thank you very much, Mr. Chairman. First, may I request that my opening statement be submitted in the record as read?

Chairman CASTLE. Without objection, so done.

[The prepared statement of Mrs. Maloney can be found on page 59 in the appendix.]

Mrs. MALONEY. Second, I would like to welcome a former constituent from the great city of New York, Mr. Greenspan. It is always good to see you.

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First of all, I would like to know, why are you as a central banker commenting on the stock market? I have never heard of other central bankers doing that. I thought that the law, the 1946 Employment Act intended the Fed to stabilize the price of goods and services.

Mr. GREENSPAN. That is correct, Congresswoman. As I mentioned to your colleagues earlier today, the reason why we are moving our analysis to a far broader plane than merely what we used to do is because it is becoming increasingly evident in this increasingly complex economy that asset prices generally are having an important impact on the production and consumption of goods and services and on the general state of inflation. As a consequence, what we are doing and have been doing in recent years, is to gradually broaden what we are evaluating in the economy as the economy becomes more complex.

While it is certainly the case that our mandate, as you put it, is on goods and services, if we are to appropriately fulfill that mandate, it is required that we evaluate and endeavor to look at asset price changes in the same manner we look at changes in residential construction, exports, consumption, or various other elements of demand.

Mrs. MALONEY. But your statement on irrational exuberance rolled the stock market by 100 points, and it is a concern to me because it may have been a move potentially designed to impact on Wall Street, but it had a far further impact on every Main Street in our country. It seemed to me like a tremendous broadening of your mandate.

Mr. GREENSPAN. Let me say this——

Mrs. MALONEY. And the fact that it was a broadening, maybe there was an over-reaction to your statement.

Mr. GREENSPAN. I was fully aware, as were my colleagues, that just merely mentioning the word stock market or something of that nature would create a price reaction. We are also aware of the fact that we are dealing with very sophisticated markets which are international in scope, have millions of investors.

While, to be sure, you can, as rumors do, as statements by myself and my colleagues do periodically, induce short term changes, you cannot fundamentally affect the broad trend in market prices. That requires real economic changes, and I do not care what any central banker endeavors to do, we will never succeed in altering the path of major economic markets.

Mrs. MALONEY. But you rolled it 100 points. Let us go on to your statement on page seven. In your opening statement you said, "We cannot rule out a situation in which a preemptive policy tightening may become appropriate before any sign of actual higher inflation becomes evident." Yet in the other materials that you submitted, it showed that the real economic growth that you predicted is 2 percent to 2.25 percent. The Clinton Administration predicts it at 2 percent. This is not great growth. This is a very limited growth.

Then when you talked about inflation, some people say that in 1996 it was at 3.2 percent, the rate of inflation represented by the CPI which many people today have said are overstated. In your former statements you said that you thought inflation may be

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overstated by 1.5 percent, which means that inflation really could be 1.7 percent, which is low. The economic growth is low.

Why are you talking about a preemptive policy with numbers like that?

Mr. GREENSPAN. It is not the expected forecasts which drive policy, it is the various distribution of risks on that policy, meaning what happens if we make a projection and we are wrong? What we try to do is to evaluate the consequence of mistakes in judgment. The reason we have to do that is that monetary policy, by all of our measures, has a very delayed effect on the economy. So, we are forced to make projections pretty far out—a year or more. As a consequence of that, we have to recognize that inflationary pressures can start to mount well before they become evident in any of the published statistics.

We have made judgments in the past that the economy was weakening well before it became evident and we started to ease monetary conditions. In that sense, it was preemptive in the other direction. There is no alternative—and I really wish it were otherwise—to acting preemptively because of that long lag between what we do and what happens.

Mrs. MALONEY. I do not believe ever in my lifetime there has been a preemptive action with a 1.7 percent inflation and a 2 percent growth.

Mr. GREENSPAN. Yes, but remember that the inflation rate has been biased upward for a very long period of time. So you cannot compare it with earlier data. In short, if you took the inflation bias out of the Consumer Price Index going all the way back, the inflation rate data at a very earlier period would have been much lower than they are now.

It is the type of situation in which you are doing more than making an average expectation. In other words, if we were assured that inflation would stay down, that is a forecast which in my judgment would mean we would do nothing.

Mrs. MALONEY. But we have no indication that it is going up.

Mr. GREENSPAN. I am not saying we——

Chairman CASTLE. Mrs. Maloney, we are going to have on. I am sorry.

Mrs. MALONEY. Mr. Chairman, may I do one brief follow-up question that really feeds on——

Chairman CASTLE. Let us try to come back to you. We are trying to be—several of us have other subcommittee problems today, so we are trying to run through the questions, if you will excuse us. I am sorry, we are without relief here at this point. We will try to come back if we go quickly.

Mr. Bentsen, please.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Greenspan, it is good to see you again since I guess yesterday morning in the Budget Committee. I want to follow up on a couple things we talked about yesterday and then I have some other questions for you.

First of all, I appreciate in your testimony today you made some comments regarding education. That issue was raised yesterday at the Budget Committee. Today, you did underscore I think the importance of enhancing our education, trying to invest in human

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capital potential. I think that is correct as well and I am glad that you have gone on the record in doing so, regardless of whether it is through tax credits or whatever form we might take. I realize that you do not want to get into taking a position on that.

I do want to follow up very briefly on the CPI question which I did not get to ask yesterday. This may be more of a political question, but you state you believe there is a 100 percent probability that we are understating——

Mr. GREENSPAN. Virtually.

Mr. BENTSEN.——Virtually a 100 percent probability that we are understating CPI; that we should form a commission. Now a commission quite possibly might not come to a 100 percent perfect solution as to what real CPI is, but they would presumably try and get as close as they could. But there would obviously be some error and they would be working on an average.

Do you think in that case that it would be better, if Congress were to take that route, for us to enact some sort of flat CPI or flat COLA or dollar-average COLA? In effect, means-test the COLA to make up for the inexactness of what a commission might come up with?

Mr. GREENSPAN. So you mean like CPI minus X; is that what you mean?

Mr. BENTSEN. Something along those lines.

Mr. GREENSPAN. That is surely an alternative approach.

Mr. BENTSEN. But also to say, perhaps those that may be at the mean or at the median would be held harmless, those above might get less, those below might get more?

Mr. GREENSPAN. Yes, the Congress can certainly do that.

Mr. BENTSEN. Let me ask you also with respect to CPI, you stated yesterday that if we are understating CPI, we are probably understating productivity because we are looking at companies that continue to have increasing earnings; therefore, we must be understating productivity. Therefore, would that mean that a 5 percent to 5.5 percent unemployment rate is not necessarily as dangerous from an inflationary standpoint as we once thought it might be?

Mr. GREENSPAN. Congressman, I think you are raising the question of so-called "NAIRU" that is the unemployment rate in which the rate of inflation, by hypothesis, neither rises nor falls. I have been quite skeptical about that as a stable notion. In other words, I think that there is a reasonable concept of a NAIRU for a metropolitan area, for example, where there is competition in the labor market and people can go from one part of the area to another part and take another job.

I am very skeptical that that concept can be globalized for the United States as a whole, implying that the demand and supply for labor can somehow operate between Portland, Maine and Portland, Oregon, for example.

Implicit in a national NAIRU is that somehow all of these metropolitan area NAIRUs average out in a fixed way. I think the evidence is very questionable on that, and I think that the concept itself is so unstable that I would be very careful in employing it as a means for any form of monetary policy. I do not deny that it is useful to give you a hint as to the way things are going, but

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certainly not something which in any way is sufficiently stable to give one confidence that it works.

Mr. BENTSEN. Let me ask you this, your comments before the Senate Banking Committee a week ago set off fear within the markets that there will be a rate hike sometime in the near future. Yet when I look at your testimony, I look at the report that you all have provided to the Congress, I am not sure I see where that is coming from.

There is a little pressure in the employment cost index. Are you looking at the monetary aggregates? You have some that are at the top of the span, some that are near the top of the span. Interest rates, in your report you talk briefly about the last time you took action in early 1994, and yet you look at interest rates today compared to where they were in late 1993, early 1994 and rates are higher today.

So I am curious as to where—is this all based on price-earning ratios and concern about the market? How does that now play into the Fed's calculations?

Mr. GREENSPAN. The market does not know anything more than you read. They get the same information. So what we try to do is detail as fully as we can what it is we tend to look at. As I indicated in my formal remarks, it is not easy to give you a road map because we do not have one at this stage of exactly the types of things which are likely to emerge which could create a destabilizing of the expansion.

As a result of that, the only point that I wanted to make, which is an important point, is that we have to recognize that monetary policy acts with a lag. And if it acts with a lag, it is conceivable that we will, on certain occasions, be required to move policy in either direction in advance of particular events becoming clearly evident. The economy at this particular stage in time, as we have indicated in previous comments, is clearly running very close to any measure of capacity. As I have said in my prepared remarks, it is not indicating one that is clearly overheated; one in which inflation is clearly accelerating. That is not the case at this particular point as I have suggested.

But the question that is on the table for all of us, in fact really since July, is that when you are in this particular zone the risks are on the upside. But we monitor it very closely, and as I indicated, we chose not to move through all of the second half of last year even though we were in that zone because the evidence of inflation acceleration was clearly lacking.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman CASTLE. Thank you, Mr. Bentsen.

Mr. Jackson has earned his second star because he got here on time and he stayed through the whole proceedings and we appreciate that. Mr. Jackson?

Mr. JACKSON. Thank you, Mr. Chairman. I just have two questions of the Chairman.

In the past when the economy slowed and millions of our country's workers lost their jobs, people knew there was a safety net that would allow them to scrape by even if they exhausted their unemployment benefits. Under the new welfare reform law the

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Federal floor under the poor has been removed because welfare benefits have been terminated after 2 continuous years on welfare. The new rules then dictate that the poor find a job or join the homeless or beg for food.

I would like your assessment of the need for full employment policy in light of the new welfare reform law, and whether or not you think that the Federal Reserve has a role to play in accomplishing full employment, particularly as those of us on Capitol Hill keep dictating and mandating that the poor beyond their public assistance find some work.

Mr. GREENSPAN. Did you say full employment law?

Mr. JACKSON. Full employment policy as a goal.

Mr. GREENSPAN. What I trying to get at is, where is the incidence of the policy? Because as far as the Fed is concerned, we agree with you in the sense that we should think there should be maximum sustainable economic growth, and that translates into the lowest sustainable rate of unemployment implicitly.

Mr. JACKSON. Let me comment on that quickly, Mr. Chairman. In 1972, respectfully, sir, that was 3 percent. In 1997, it is about 5.3 percent, 5.4 percent. So that is 7.5-million Americans, not counting the underemployed or the unemployed. So we move people off of public benefits, welfare to work, that is the policy we passed in the 104th Congress, my question is does the Federal Reserve have a role to play in making sure that an expanded economy remains expansive so that it reaches those who have been unemployed or underemployed?

Mr. GREENSPAN. As I said before, our goal is maximum sustainable economic growth. That is about as strong a commitment as I think one could make toward maintaining the job creation and sustainable income levels. With respect to the structural problems which are clearly there as you point out, there is very little that monetary policy can do. That is an issue for other forms of policy. That is the reason why I raised the question about where is the locus of the policy as such, because it has got to be broader than just mainly monetary policy.

Mr. JACKSON. That may be a source of concern, respectfully, Mr. Chairman, for all of us. I know the President most recently in his State of the Union Address congratulated several companies for hiring people and expanding their hiring programs to reach out to welfare recipients.

But if in fact there is a rate hike, it slows the economy down. It obviously slows down job creation at a time where we are operating here on Capitol Hill under the assumptions that an expanded economy is going to employ people that we are going to move off of public assistance. Any effort to slow the economy down really runs contrary to many of the assumptions that we have been functioning with here on Capitol Hill.

I am interested in your comments, sir.

Mr. GREENSPAN. First of all, we do not raise rates for the purpose of slowing the economy. When we raise rates it usually is for the purpose of stabilizing elements which threaten the growth of the economy. So all I can say to you is that we do not believe that the purpose of the Federal Reserve is to restrain growth, as is often the comment and indeed some of your colleagues have made that

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statement. I will tell you, that is not the purpose of monetary policy, and it should not be.

Mr. JACKSON. I appreciate your answer. Let me move on to my second question, if I can. You said in your testimony that wages are not rising rapidly because of workers' job insecurity. That was on page four and global competition on page six. And on page six of your written testimony you said that these influences would be holding down inflation only temporarily. Then you go on to say on page seven that preemptive policy tightening may become appropriate before any sign of actual tightening becomes evident.

Mr. Chairman, there are many hard-working people in my district who have not seen a significant wage increase in many years. Their wages corrected for inflation have, quite frankly, been stagnant. I wanted to know, do you really want to slow down the economy if these workers receive a raise even if the prices of goods and services rise at the present levels of inflation?

Mr. GREENSPAN. All I can say to you, Congressman, is that one must measure, from the point of view of monetary policy, what we call unit labor costs, meaning the change in compensation adjusted by productivity. So to the extent over the long-run that wages go up on average with the rate of growth in productivity, there is no inflationary bias that is perceivable.

If inflation begins to take hold and as a consequence, as it invariably has in the past, unbalances the economy, what then happens is that economic growth comes to a halt and more often than not we move into a recession. I scarcely want to see that happen, and it strikes me as an outcome which is one which would create far more difficult problems for everybody. I think that a little inflation may sound like it is harmless. A little leads to more, and more leads to slower economic growth.

Chairman CASTLE. Mr. Jackson wants to ask a follow-up and we will allow it. Then Dr. Paul had one or two brief other questions he wanted to ask, and Mr. Bentsen has one brief question. I want to try to wrap it up, but I do not want to cut anybody off. So let us go in that order. We will start with Mr. Jackson.

Mr. JACKSON. Thank you, Mr. Castle.

Very quickly, in the last 3 years I did a little analysis of the salaries of senior staff at the Fed and I have also noticed that they have been rising somewhat rapidly. In 1993, there were 35 employees at the Board of Governors earning $125,000-per-year with the highest at about $174,100. I was really wondering, were these inflationary wage increases, and what could my constituents and workers throughout the country come to understand about salaries at the Fed seeing as though they are being paid for by their taxes? That is my follow-up.

Thank you, Mr. Chairman.

Mr. GREENSPAN. We observed a few years that we were having very considerable difficulty hiring the types of people that we needed to accomplish the particular responsibilities that the Congress has given to us. What we then did at that point is to come up to both the leadership of the House Banking Committee and the Senate Banking Committee and indicated that since we were not required by law to stipulate any particular level of wages that we decided that it would be wise for us to move up the whole structure,

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which is what we have done. Since then, the average increase has slowed very dramatically.

Mr. JACKSON. Thank you, Mr. Chairman.

Chairman CASTLE. Thank you very much.

Dr. Paul.

Mr. PAUL. Thank you, Mr. Chairman.

Much has been said about your statements regarding the stock market and I wanted to address that for just 1 minute. In December when you stated this, of course, the market went down and this past week there was as sudden drop. The implication being that if you are unhappy with it, they assume that you will purposefully push up interest rates. But really since the first time you made that statement it seems that almost the opposite has occurred. M3 actually has accelerated, to my best estimate in the last 2 months it has gone up at a 10 percent rate. The base actually has perked up a little bit. Prior to this time it was rising at less than a 5 percent rate and now it is rising a little over 8 percent.

But then too we have another factor which is not easy to calculate, and that is what our friends in the foreign central banks do. During this short period of time they bought $23 billion worth of our debt. We do know that Secretary Rubin talks to them and that maybe there is an agreement that they help you out; they buy some of these Treasury bills so you do not have to buy quite so many.

Mr. GREENSPAN. There is no such agreement, Dr. Paul.

Mr. PAUL. You read about that though.

Mr. GREENSPAN. Sometimes what you read is not true.

Mr. PAUL. OK, we will get your comments on that. But anyway, they are accommodating us, whether it is policy or not. Their rate of increase on holding our bills are rising at over 20 percent, and even these 2 months at maybe 22 percent.

My suggestion here and the question is, instead of the sudden policy change where you may increase interest rates, it seems like to me that you may be working to maintain interest rates from not rising. Certainly, you would have a bigger job if we had a perfect balance of trade. I mean, they are accumulating a lot of our dollars and they are helping us out. So if we had a perfect balance of trade or if their policies change, all of a sudden would this not put a tremendous pressure on interest rates?

Mr. GREENSPAN. We have examined the issue to some extent on the question of what foreign holdings of U.S. Treasuries have done to U.S. interest rates. I think the best way of describing it is that you probably have got some small effect in the short run when very large changes in purchases occur. There is no evidence over a long run that interest rates are in any material way affected by purchases.

The reason, incidentally, is that they usually reflect shifts—in other words, some people buy, some people sell. Interest rates will only change if one party or the other is pressuring the market. There is no evidence which we can find which suggests that that is any consistent issue, so that the accumulation of U.S. Treasury assets, for example, is also reflected in the decumulation by other parties. We apparently cannot find any relationship which suggests to us that that particular process is significantly affecting——

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Mr. PAUL. For the past 2 years, the accumulation has been much greater.

Mr. GREENSPAN. That is correct, it has been.

Mr. PAUL. Thank you.

Chairman LEACH. [presiding]. Thank you, Dr. Paul.

We are going to have two more questions, one coming from Mr. Bentsen. But I think it is fair to place in the record at this moment in time that when the Chairman of the Federal Reserve Board of the United States speaks with confident exuberance, the market goes up, as it just has 90 points.

Mr. Bentsen.

Mr. BENTSEN. Now it is too late to do anything about it.

[Laughter.]

Mr. BENTSEN. Mr. Chairman, first of all, last year in your response to my previous question we talked a little bit about capacity utilization; I think it was last year or the year prior. At that time—and my numbers are probably incorrect—we were seeing somewhere around 81 percent, 82 percent, I think. It was near the level where in the past we had said, or economists had said, you are about to breach the wall of capacity utilization which will cause bottlenecks and price increases. You said, I think at that time, that has probably changed because of new efficiencies and production and all.

I guess it is coming down, and what your response was to that question in trying to look at that, monetary aggregates and other things is the old rules of determining or foreseeing inflation have changed and now it is almost, you know what it is when you see it.

But let me move to a question. I would be remiss if I did not ask a question regarding the oil economy, since it is important to my State. Your report states that you expect oil prices, which have declined quite dramatically in recent years, to stay relatively flat and not be a pressure point on the price index.

There was an article in yesterday's *Wall Street Journal*, however, where some are speculating that oil prices in fact may rise, for a couple of reasons. But one of the points they made was that worldwide oil production is now at about 95 percent of capacity, which seems quite high. I would like your comments on that.

And I would also like your comments on the fact that the article goes on to say, some argue that a potential price increase in oil might be tempered by the fact that North Sea and other world markets could flood the oil market and drive prices back down.

But it comes back to the fact that in the United States, the capacity of the oilfield services industry has declined so much as we have seen imports continue to rise, and now we may be seeing the effect of that on domestic prices. It is good for Houston. It is good for the oilfield services economy that is still around, but perhaps that is bad for the general economy of the United States. I would appreciate your comments on that.

Mr. GREENSPAN. We have a fairly broad set of data, some of which are good, some of which are less good on oil production around the world. What I was saying in my prepared remarks was essentially, that analysts are projecting or something of that nature. What they are saying effectively, and we have no direct

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verification on this, is that projections of increases in the North Sea and in the Gulf are more than adequate to meet the expected worldwide demand for crude, and in addition build some inventories back into the system.

As a consequence, what we observe is a fairly significant decline recently in West Texas intermediate crude prices. They had gotten as high as $28 a barrel. Now I guess they are down to a little over $20. Forward markets are projecting a price a little lower, as you know.

It is true, nonetheless, that the oil services industry is very tight, and the drilling rig availability, especially offshore, is very tight. There are people, and this was expressed in that article to which you refer, who think that the exploration and development requirements to keep the oil flowing in an adequate way is being constrained by service industry capacity. I am not aware that that is a general view.

I am aware that there is difficulty in getting equipment, but I am not aware that there is a significant concern that crude availability will be foreshortened in a manner which could induce significant acceleration of prices. That can happen, obviously, in the sense that there are many things we have seen in the past which have induced major increases in crude prices, and I would certainly not rule that out. But the evidence at this particular stage seems to be more consistent, as the forward markets are pricing, that increases in supply in the next year should be marginally larger than increases in consumption.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman CASTLE. [presiding]. Thank you very much, Mr. Bentsen.

For our final question we will turn to Chairman Leach.

Mr. LEACH. To skip issues slightly, one of the responsibilities of this subcommittee this year is going to relate to a whole spectrum of issues related to the IMF, including possible increases in quotas, and so forth. As Chairman of the Federal Reserve Board would you give us your opinion on the wisdom of Congress moving in this direction or not?

Mr. GREENSPAN. We work, as you know, with the Secretary of the Treasury and his colleagues on this issue and we give them our advice on various things and then support them, because so far as international affairs are concerned, monetary authorities should be one. We have supported directly the new borrowing facility, which we think is wise, and we have communicated that to the Secretary.

In general, we think that our international responsibilities are such that it is important that we make certain that we maintain the effectiveness within those institutions that we have had over the years. In that regard, we are supportive of the Secretary of the Treasury in his initiatives.

Mr. LEACH. Thank you, Mr. Chairman.

Chairman CASTLE. Thank you, everybody, particularly those who were able to stay with us. We thank you, Chairman Greenspan. Chairman Leach has already announced that the Dow Jones average is up 93-some-points today, which is good, which indicates to us that you should always testify before the House and not the

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Senate because the results are better. But I should warn you that gold was down $6 today. So there may be some repercussions on that side of it for you to worry about.

But again, we thank you. You are always very patient with all of us, and we thank all of our Members who participated.

We stand adjourned.

[Whereupon, at 4:28 p.m., the hearing was adjourned.]

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APPENDIX

March 5, 1997

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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,
2:00 p.m., March 5, 1997
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. You will note that this subcommittee has done its best to accommodate the Fed while meeting the schedule required by the Humphrey - Hawkins Act. We have followed your testimony before our Senate colleagues as closely as we could, so that the same testimony can serve for both hearings. I trust that in turn, you will be as candid as possible in addressing issues raised over the past week.

Today, we will have five minute opening statements by the members present. In addition, some members of the full Committee may sit with us today and participate in the questioning. As always, any prepared remarks

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presented by a member will be accepted for the record.

Today the US economy continues to be healthy with inflation apparently in check. We welcome the continued sound performance of the economy which evidently has been assisted by the Fed's monetary policy. Having witnessed what even one of your carefully calibrated characterizations of the stock market can accomplish, it is clear that what you say can have a significant impact on the market, at least over the short term.

Following your testimony last week, many analysts have argued both that the current prices of common stocks are justified and that external factors are also somewhat responsible in making this market the investment vehicle of choice. Others dispute the actual amount of influence the Fed is able to exercise using the traditional mechanisms of monetary policy.

If you believe that any of your earlier remarks were misinterpreted or unfairly taken out of context, today's hearing offers the opportunity to correct such misreading. Certainly, several percentage points of exuberance have been wrung out of the stock markets, and we can hope that some seeds of inflation have been destroyed as well.

I am also interested in your assessment of whether the run up in relative value of the dollar is becoming a limiting factor in the conduct of

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monetary policy by the Federal Reserve.

Your Chairmanship of the Federal Reserve System Board of Governors continues to be successful as judged by results. Nevertheless, aside from monetary policy there are other aspects of Federal Reserve operations that merit review by Congress. This subcommittee is planning oversight hearings on the Federal Reserve System that will review Fed activity including the the transition from physical to electronic forms of money as the digital age looms in our future. Of particular concern to me -- it seems that with the current level of technology available, the Fed's proposal to add an additional day to the current check clearing process seems to be going in the wrong direction, especially from the point of view of the consumer needing access to his money. We also hope to review the role of the central bank as a competitor with private sector clearing facilities. We look forward to hearing how the Fed is planning for potential of new technology to affect systemic security, safety, soundness, consumer privacy as well as the future conduct of monetary policy. In this future hearing, we hope to engage in a discussion of the various ways that the approaching digital revolution in money will affect the operations of the Federal Reserve System. I am increasingly persuaded that dramatic change in how we define and employ money may soon be upon us. This in turn, must affect the payment system and institutions charged with its stewardship. Thus, we should be prepared for the threshold at which this

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impending change becomes significant in your models of the economy.

As always, we are delighted to have you with us and look forward to a lively discussion.

Before recognizing the distinguished Ranking Member, I want to recognize and welcome the participation of Members of the Banking Committee, not appointed to the Monetary Policy Subcommittee, and ask unanimous consent that to the extent they wish to participate and ask questions of the witness, they may be permitted to do so.

Hearing no objection, so ordered. Mr. Flake ……..

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STATEMENT OF FLOYD H. FLAKE
HUMPHREY-HAWKINS HEARING BEFORE
THE COMMITTEE ON BANKING AND
FINANCIAL SERVICES
MARCH 5, 1997

I WOULD LIKE TO WELCOME CHAIRMAN GREENSPAN FOR OUR BIENNIAL HUMPHREY HAWKINS HEARING TO DISCUSS THE FEDERAL RESERVE'S CONDUCT OF MONETARY POLICY, AND ITS OPINION OF THE CURRENT STATE OF THE ECONOMY. GIVEN LAST WEEK'S REACTIONARY ACTIVITY IN THE STOCK MARKET, AND THE PERSISTENT POLITICAL COMMENTARY ON OUR NATION'S ECONOMIC HEALTH, I LOOK FORWARD TO HEARING CHAIRMAN GREENSPAN'S COMMENTS.

I WILL BE BRIEF IN MY COMMENTS, BUT I WISH TO EXPRESS TO MR. GREENSPAN ONE SPECIFIC CONCERN. THIS CONCERN IS THE CONTINUED NEGLECT OF OUR NATION'S POOR COMMUNITIES. THE FEDERAL RESERVE APPEARS TO FOCUS ITS EFFORTS ON MACRO-ECONOMIC ISSUES THAT, IN

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GENERAL, HAVE BEEN GOOD FOR THE OVERALL FINANCIAL HEALTH OF OUR NATION. BUT IN ITS ZEAL TO CONTROL INFLATION, AND TO STAVE OFF ECONOMIC DOWNTURNS, THE FEDERAL RESERVE SEEMS TO HAVE FORGOTTEN THAT THERE ARE COMMUNITIES IN AMERICA THAT ARE IN A PERSISTENT CYCLE OF POVERTY AND STAGNATION. THESE COMMUNITIES ARE NOT HEARING POLICIES FROM THE FEDERAL RESERVE THAT SPEAK DIRECTLY TO THEIR NEEDS. THE QUESTION THUS BECOMES; DOES THE FEDERAL RESERVE FOCUS ON ALL PARTICIPANTS IN THE ECONOMY, OR DOES IT NEED TO IMPROVE ITS COMMUNICATION PROCESS WITH RESPECT TO ITS CONCERN AND COMPASSION FOR ALL SOCIETY? WHICHEVER CONCLUSION WE COME TO, I DO BELIEVE THAT THESE HEARINGS TEND TO FOCUS TOO MUCH ON MACRO-ECONOMIC ISSUES THAT DON'T SPEAK VERY WELL TO THE MR. & MRS. SMITHS OF AMERICA.

I RECOGNIZE THE OLD SAYING THAT "A RISING TIDE

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LIFTS ALL BOATS," AND TO THE EXTENT THAT YOUR MACRO-ECONOMIC DECISIONS ARE PRUDENT FOR THE NATION AS A WHOLE, I COMMEND YOU. BUT LET US NOT FORGET THAT THE RISING TIDE ALSO HAS THE REAL POTENTIAL TO SET THE SMALL BOAT ADRIFT WITHOUT DIRECTION. MR. CHAIRMAN, THERE ARE MANY COMMUNITIES IN AMERICA ADRIFT IN A SEA OF UNEMPLOYMENT, POOR EDUCATION, AND OVERALL HOPELESSNESS. INSIDE THE BELTWAY ECONOMIC AND POLITICAL DISCOURSE, UNFORTUNATELY, IS OFTEN DETACHED FROM THESE REALITIES OF EVERYDAY LIFE. SO CHAIRMAN GREENSPAN, I WOULD ENCOURAGE YOU TO SPEAK DIRECTLY TO THOSE OF US WHO REPRESENT THESE COMMUNITIES, AND ILLUSTRATE IDEAS AND POLICIES THAT YOU AND YOUR COLLEAGUES BELIEVE WILL DIRECTLY BENEFIT WHAT I HAVE COME TO CALL AMERICA'S THIRD WORLD COMMUNITIES.

CHAIRMAN GREENSPAN, I COME HERE TODAY NOT TO

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SINGLE OUT THE FEDERAL RESERVE, BUT WITH THE BELIEF THAT ALL OF US HERE IN WASHINGTON NEED TO BE BETTER STEWARDS OF THE PEOPLE'S GOVERNMENT. DEMOCRATS NEED TO COME TO THE REALIZATION THAT SOCIAL PROGRAMS TO HELP THE POOR ARE NOT THE EXCLUSIVE ANSWER TO SOCIETY'S ILLS, AND REPUBLICANS SHOULD NOT BLINDLY ENACT SLASH AND BURN POLICIES IN THE NAME OF A BALANCED BUDGET. ENTRENCHMENT IN THESE PARTISAN POSITION IS NOT GOOD GOVERNMENT, AND ONLY LEADS TO PESSIMISTIC OPINIONS ABOUT WASHINGTON'S ABILITY TO GOVERN IN A RESPONSIBLE MANNER.

OBVIOUSLY THE SOLUTION IS SOMEWHERE IN THE MIDDLE, AND THUS IS THE RESULT OF COMPROMISE BETWEEN BOTH DEMOCRATS AND REPUBLICANS. IT IS A SOLUTION DEFINED BY COOPERATION BETWEEN GOVERNMENT AND THE PRIVATE SECTOR, AND IS A SOLUTION THAT HAS THE GOVERNMENT AND THE PRIVATE

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SECTOR WORKING TOGETHER IN AN EFFORT TO UPLIFT POOR COMMUNITIES. THIS PARTNERSHIP, I BELIEVE, INCLUDES IMPROVING JOB GROWTH, EDUCATION, AND THE MORAL FIBER OF OUR NATION. THEREFORE IN THE COMING MONTHS, I INTEND TO WORK WITH ALL MEMBERS IN A BIPARTISAN EFFORT, AND ENCOURAGE THE FEDERAL RESERVE TO COMMUNICATE ITS THOUGHTS ON POSSIBLE EFFORTS TO REVITALIZE POOR COMMUNITIES.

WITH THAT I WILL CLOSE, AND I WILL LISTEN INTENTLY TO THE TESTIMONY. THANK YOU CHAIRMAN CASTLE, AND AGAIN WELCOME CHAIRMAN GREENSPAN.

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Opening remarks of Dr. Paul before the Humphrey-Hawkins testimony of Alan Greenspan March 5, 1997

The Consumer Price Index (CPI) is a bad indicator of inflation and makes no pretense of being an index of the cost of living. Mr. Greenspan has made clear that he believes that the current CPI does not do a very accurate job of measuring increases in prices. The Fed Chairman has endorsed the idea of a commission to review the "bias" of the CPI which he believes overstates the nation's inflation rate.

Adopting the recommendations of a so-called bipartisan commission would in fact be a backdoor way to reduce the deficit by cutting the benefits of many Americans who receive a government benefit check and also a way to increase the taxes that these people pay to the government. The recommendations of these bipartisan commissions are almost always preordained and are merely attempts to provide cover for politicians to take more of the people's money. Government will just grow larger as a result.

Since even the Federal Reserve does not trust the ability of the government to measure accurately the changes, and by changes we always mean increases, in prices for all urban consumers, it is even less relevant to rural Americans for whom the CPI does not even pretend to consider. Yet Mr. Greenspan is urging the federal government to use a quick fix with this index to increase their taxes.

Rises in prices are just the symptom of an ailment that the CPI tries to quantify. Fudging the numbers does not address the cause of the symptom. The problem with inflation is that it represents a loss of value of the unit that it uses, in this case the dollar. Consumer prices fell gently by roughly one-third from 1800 to 1912 (in 1912 dollars). Since 1912, the year before the Fed was created, prices have risen to a level 15 times higher than they were when the Fed was established. Thus, we should address the cause of the problem not play games with the symptoms.

The value of the dollar, Americans' purchasing power, has since fallen to only one-fifteenth what it was when the Fed was created. Mr. Greenspan himself wrote one of the most persuasive articles warning against the use of fiat money and the tendency of government to grow under its use. Inflation, the destruction of the value of the currency, is a natural by-product of this paper tiger.

Before another banking subcommittee last week, Paul Volcker acknowledged a quote attributed to him in The Central Banks by Marjorie Deane and Robert Pringle. Mr. Volcker said, "It is a sobering fact that the prominence of central banks in this century has coincided with a general tendency towards more inflation, not less. By and large, if the overriding objective is price stability, we did better with the nineteenth-century gold standard and passive central banks, with currency boards, or even with 'free banking'...The truly unique power of a central bank, after all, is the power to create money, and ultimately the power to create is the power to destroy."

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There is a great concern now that the present increase in the money supply (M3), currently running at an annual rate of approximately 15%, is creating a speculative boom in financial investments planting the seeds for the coming bust. The easy credit scheme that the Fed is pursuing to keep the market from moving interest rates higher is facilitating a nominal appreciation in the value of speculative assets that by some measures is comparable to the bubble that existed before the stock market crash of 1929. The Fed's power, the power to create money, may be used to destroy the value of these speculative investments.

Dollar purchases by foreign central banks in Asia and Europe (primarily the Bank of Japan) have augmented the Fed-created speculative bubble. This additional fueling of the US credit markets into the US equity market adds to the size of the bubble and the likelihood of a severe correction or worse.

Efforts of the Fed Chairman to warn against the ill effects of the Fed's own policies does not exonerate Fed policy from the responsibility they must assume for their own culpability.

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JESSE L. JACKSON, JR.
2D DISTRICT, ILLINOIS

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Congress of the United States
House of Representatives
Washington, DC 20515–1302

STATEMENT BY CONGRESSMAN JESSE L. JACKSON, JR.
COMMITTEE ON BANKING AND FINANCIAL SERVICES
SUBCOMMITTEE ON DOMESTIC AND
INTERNATIONAL MONETARY POLICY
HUMPHREY HAWKINS HEARING
THE STATE OF THE U.S. ECONOMY
MARCH 5, 1997

Chairman Castle, Ranking Member Flake, I would first like to express how pleased I am to have the opportunity to join the Subcommittee on Domestic and International Monetary Policy for my first hearing with this Subcommittee. I have just recently been granted the honor of serving on this distinguished panel. I very much look forward to learning from your leadership and working with you during this Congress as we address the critical matters which fall under the purview of this committee's jurisdiction.

There is no better illustration of the significance of this Subcommittee's role than the subject matter of the present hearing and the distinguished witness who is here to testify before us today. Chairman Greenspan, it is with great pleasure and admiration that I welcome you today to apprise us of the status of the American economy and your judgments as to the activities of the Federal Reserve System in fulfilling its duty, among others, of conducting national monetary policy in pursuit of the objectives of price stability and full employment.

To that end, Mr. Chairman, in your semiannual report to Congress first delivered to the Senate last week, you hailed the strength of the economy, highlighting a two percent increase in the Gross Domestic Product as evidence of expanding economic opportunities. Relative to previous decades, however, we know that 2 percent is less than the 1980s, the 1970s, and the 1960s. You tempered your optimism, however, with a call for caution when you stated that "History is strewn with visions of new eras that in the end have proven to be a mirage." I agree completely with your assessment. Today, while conventional economic wisdom speaks to expansion and growth, my view deviates from this

313 CANNON BUILDING
WASHINGTON, DC 20515–1302
(202) 225–0773

17926 SOUTH HALSTED
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(708) 798–6000

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conclusion. For the Second Congressional District of Illinois, I have devised a very rigorous and stringent economic test -- a test that I call the "eyeball test." In order to assess the relevant economic indicators, I merely open my eyes and look around to determine whether my constituents on the South Side of Chicago and in the South Suburbs are experiencing this relative economic growth. Sadly, Mr. Chairman, my test results do not render the same optimistic projections. In my district, things have never been good and they are now getting worse.

Nationally, the official unemployment rate is 5.4 percent, which means that 7.3 million people who receive unemployment compensation have no job. The actual number of unemployed (and underemployed) people is closer to 15 to 20 million Americans. These numbers include those who are unemployed, underemployed, working part-time when they want to be working full-time, have never had a job or gave up looking for one (so that they are not even counted among the unemployed). These numbers are compounded by those who are faced with corporate and government downsizing, and are on the brink of and worried that they may soon fall into one of those categories. Mr. Chairman, I believe that this is a more accurate picture of the economic conditions of communities like those in my district and explains the widespread levels of economic anxiety currently plaguing the American people.

In light of the foregoing, Chairman Greenspan, I will be listening intently to your testimony and particularly with respect to your views on how the Fed can encourage and guide the economy towards attaining true levels of full employment. Once again, thank you Chairman Greenspan for joining us today. I look forward to hearing your testimony. Thank you, Mr. Chairman.

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COMMITTEE ON BANKING AND FINANCIAL SERVICES
SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY

Statement of

REP. JOHN J. LaFALCE

Humphrey-Hawkins Hearing
March 5, 1997

Chairman Greenspan, it is always a pleasure to welcome you to the Committee and benefit from the insights and observations that you provide on the state of the U.S. economy.

From my perspective, it appears that we are doing quite well--with the exception of our irrationally exuberant stock market, of course, and the ballooning of our trade deficit.

Annual GDP growth in 1996 was 2.4 percent, and most economists believe this steady growth will continue for another two years. Inflation rate remained "quiet" at 3 percent growth in 1996. Business productivity increased at an annual 0.8 percent in 1996, making it the best annual performance since 1992. Real hourly wage earnings rose a mere 0.1 percent, and the Labor Department reported in January that wage pressures were non-existent.

On the other hand, we have a real problem with our growing trade deficit. For 1996, the deficit registered $114.23 billion, the highest deficit in eight years. Economists are predicting a stronger import surge in the months ahead, partly because of the dollar's strength and because of weakened export demand from our industrial trading partners.

For this reason, I believe we need to continue the path of moderate to strong growth, growth that allows for job creation and

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wage enhancement. The trade deficit not only indicates that our economy is importing to enhance productive capacity relative to our trading partners; but it also indicates that we are consuming beyond our means. Inevitably, a trade deficit the magnitude of that which we reached last year will weaken our economic strength and growth. The deficit cannot go on indefinitely without negative repercussions.

I am concerned, too, about international currency relationships, and the trend of the dollar. We seem never to hit a level of dollar strength or weakness that is the "right" level for everyone. We hear criticism and concern from our trading partners whether the dollar is rising or sinking against the yen, mark or other currencies.

I also question why we in the U.S. are giving scant attention to the impact of the Eurpean Union's path toward monetary union with the single currency, the Euro. We have heard little about the potential impact of the Euro on the dollar and U.S. trade with the EU. This line of inquiry is not meddling in EU affairs; it is anticipating a major change in international monetary relationships and how it will affect our own currency and economic transactions.

So, Mr. Chairman, in addition to your usual observations on inflation and employment, I would welcome your comments on the prospects for controlling the U.S. trade deficit, as well as currency relationships with the yen and future Euro--in addition to any stock market insights, of course.

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Opening Statement of
Rep. Carolyn Maloney (D-NY)
March 5, 1997 Humphrey-Hawkins Hearings

Thank you, Chairman Castle.

I welcome Chairman Greenspan to this important Humphrey-Hawkins hearing where Federal Reserve policies can be openly discussed so that the public can better understand the nation's central bank.

I want to thank you, Chairman Greenspan, for your March 3 response to questions I had asked about the Alliance bill and the Fed's request to change the Expedited Funds Availability Act of 1987 so that banks could lengthen from two to three days the holding period for local checks before consumers could access their funds.

About the Alliance bill -- I sought your comments on the process and scope of granting exceptions to Sections 23A and 23B of the Federal Reserve Act -- I gather you and I share a similar conclusion that the bill's provisions as written do not provide adequate safety and soundness protections for consumers. I look forward to working on these provisions to improve them during the Committee's deliberations, and I am glad we agree on this point.

On the Federal Reserve's request to extend the hold period on local checks by one day, we still differ. However, I think we can reach agreement on the shorter hold period for three-quarters of the banks in the United States. In your letter you state:

> "The Board's study indicated that 75 percent of banks provide better funds availability than required for local checks."

Banks are doing a fantastic job of clearing checks and providing prompt credit to depositors. Many banks are promoting electronic banking where customers can use their home computers to initiate funds transfers that are cleared electronically. Since 1993 many banks have been offering SWEEP accounts that allow business customers to use deposited funds in less than one day.

(more)

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So I would suggest that the central bank encourage the remaining 25 percent of banks to utilize new and faster check clearing methods. This cannot be done as rapidly as possible if the central bank continues to heavily subsidize the use of paper checks. I have received information that the Federal Reserve heavily subsidizes its Interdistrict Transportation System which supervises 47 airplanes the Fed uses each night to clear paper checks. These subsidies slow down the process of utilizing the latest technology in transferring funds and prevent private banks from fully competing with the Fed on a level playing field to provide check clearing services.

Chairman Greenspan, I look forward to working with you in resolving these issues.

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BERNARD SANDERS
MEMBER OF CONGRESS
VERMONT, AT LARGE

2202 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515–4501
TELEPHONE: (202) 225–4115
FAX: (202) 225–6790

Congress of the United States
House of Representatives
Washington, DC 20515–4501

COMMITTEES:
BANKING AND FINANCIAL SERVICES
GOVERNMENT REFORM AND OVERSIGHT

1 CHURCH STREET, SECOND FLOOR
BURLINGTON, VT 05401–4417
TELEPHONE: (802) 862–0697
TOLL FREE: (800) 339–9834
FAX: (802) 860–6370

Statement of the Honorable Bernard Sanders
March 5, 1997 Hearing on Monetary Policy
of the Subcommittee on Domestic and International Monetary Policy

Mr. Greenspan:

Thank you very much for joining us today and for your presentation.

Mr. Greenspan. Like every other American, you have a political ideology and political beliefs. According to newspaper reports, you have made campaign contributions to the political campaigns of Jesse Helms, George Bush and Bob Dole, served on the committee to elect President Reagan, and of course, worked as a key economic adviser for Presidents Nixon and Ford. While I respect you for participating in the political process, I strongly disagree with your views.

In 1985, as I understand it, you served as a consultant to many in the Savings and Loan industry. According to Time magazine, you suffered your "greatest embarrassment in 1985 when, as a private economist, [you] wrote letters to regulators and Congress endorsing Charles Keating and his Lincoln Savings and Loan. Lincoln subsequently collapsed at a cost to taxpayers of $2.6 billion, and Keating landed in jail." You issued similar endorsements for 15 other S&Ls, 14 of which eventually failed.

In your confirmation hearings one year ago, despite the fact that the minimum wage of $4.25 had reached its lowest point in 40 years, you noted your opposition to raising the minimum wage.

This January, you told the Senate Budget Committee that "the appropriate capital gains tax rate is zero." Currently, many Senate Republicans are calling for a capital gains tax cut. According to the Center on Budget and Policy Priorities, 70% of the benefits of that tax cut would go to households earning over $100,000 a year. And that proposal is much more limited than what you have suggested.

Mr. Greenspan, I will grant you consistency in your support for trickle-down economics. In your career up to today, it is clear that you have advocated tax and monetary policies which benefit the richest Americans while, at the same time, your views reflect policies that come down very hard on middle-income families, senior citizens, and the poor.

In 1983, you were appointed to chair the Social Security Commission. Under your leadership, the highly regressive payroll tax was increased by about $200 billion a year. In inflation-adjusted terms, this is often referred to as the largest tax increase in history, falling

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disproportionately on working people because of the payroll tax ceiling which excludes most income of the rich. At the same time, you strongly supported President Reagan's income tax cuts, which reduced the contributions made by the wealthiest Americans.

Currently, you are a proponent of reducing the Consumer Price Index. As you know, the CPI determines the cost of living increases upon which millions of senior citizens and others depend. Yesterday, you told the Budget Committee that "The best available evidence suggests that there is almost a 100 percent probability that we are overcompensating the average Social Security recipient for increases in the cost of living."

Mr Greenspan, I am holding in my hand a study conducted over several years by economists at the Bureau of Labor Statistics. This study suggests that, for our senior citizens who spend disproportionately high amounts on health care, the CPI we use today may in fact be too **low** an index, not too high. Given the controversy over the CPI among prominent economists, I am surprised to hear you talk of "100 percent" clarity on the question.

Mr. Greenspan, as a public official, I talk to many senior citizens who live on seven or eight thousand dollars a year. They tell me that a cut in the CPI would make it even harder than today to pay for their health care needs, their heat, their food, and their housing.

What I would like to know from you, who throughout your career has advocated tax breaks for the rich, is: Can you tell this committee the last time you sat in a public meeting with low-income senior citizens and talked to them about how they are surviving on seven or eight thousand dollars a year, and what a cut in the CPI of 100 dollars a year might mean?

And, my second question is: At a time when the richest people in this country are becoming much richer, and we have seen a proliferation of millionaires and billionaires, why do you think we should balance the budget on some of the most vulnerable people in this country - low-income senior citizens - rather than asking the wealthy to pay their fair share of taxes.

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Statement 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

U.S. House of Representatives

March 5, 1997

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I appreciate the opportunity to appear before this Committee to present the Federal Reserve's semiannual report on monetary policy.

The performance of the U.S. economy over the past year has been quite favorable. Real GDP growth picked up to more than three percent over the four quarters of 1996, as the economy progressed through its sixth year of expansion. Employers added more than two-and-a-half million workers to their payrolls in 1996, and the unemployment rate fell further. Nominal wages and salaries have increased faster than prices, meaning workers have gained ground in real terms, reflecting the benefits of rising productivity. Outside the food and energy sectors, increases in consumer prices actually have continued to edge lower, with core CPI inflation only 2-1/2 percent over the past twelve months.

Low inflation last year was both a symptom and a cause of the good economy. It was symptomatic of the balance and solidity of the expansion and the evident absence of major strains on resources. At the same time, continued low levels of inflation and inflation expectations have been a key support for healthy economic performance. They have helped to create a financial and economic environment conducive to strong capital spending and longer-range planning generally, and so to sustained economic expansion. Consequently, the Federal Open Market Committee (FOMC) believes it is crucial to keep inflation contained in the near term and ultimately to move toward price stability.

Looking ahead, the members of the FOMC expect inflation to remain low and the economy to grow appreciably further. However,

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as I shall be discussing, the unusually good inflation performance of recent years seems to owe in large part to some temporary factors, of uncertain longevity. Thus, the FOMC continues to see the distribution of inflation risks skewed to the upside and must remain especially alert to the possible emergence of imbalances in financial and product markets that ultimately could endanger the maintenance of the low-inflation environment. Sustainable economic expansion for 1997 and beyond depends on it.

For some, the benign inflation outcome of 1996 might be considered surprising, as resource utilization rates--particularly of labor--were in the neighborhood of those that historically have been associated with building inflation pressures. To be sure, an acceleration in nominal labor compensation, especially its wage component, became evident over the past year. But the rate of pay increase still was markedly less than historical relationships with labor market conditions would have predicted. Atypical restraint on compensation increases has been evident for a few years now and appears to be mainly the consequence of greater worker insecurity. In 1991, at the bottom of the recession, a survey of workers at large firms by International Survey Research Corporation indicated that 25 percent feared being laid off. In 1996, despite the sharply lower unemployment rate and the tighter labor market, the same survey organization found that 46 percent were fearful of a job layoff.

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The reluctance of workers to leave their jobs to seek other employment as the labor market tightened has provided further evidence of such concern, as has the tendency toward longer labor union contracts. For many decades, contracts rarely exceeded three years. Today, one can point to five- and six-year contracts--contracts that are commonly characterized by an emphasis on job security and that involve only modest wage increases. The low level of work stoppages of recent years also attests to concern about job security.

Thus, the willingness of workers in recent years to trade off smaller increases in wages for greater job security seems to be reasonably well documented. The unanswered question is why this insecurity persisted even as the labor market, by all objective measures, tightened considerably. One possibility may lie in the rapid evolution of technologies in use in the work place. Technological change almost surely has been an important impetus behind corporate restructuring and downsizing. Also, it contributes to the concern of workers that their job skills may become inadequate. No longer can one expect to obtain all of one's lifetime job skills with a high-school or college diploma. Indeed, continuing education is perceived to be increasingly necessary to retain a job. The more pressing need to update job skills is doubtless also a factor in the marked expansion of on-the-job training programs, especially in technical areas, in many of the nation's corporations.

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Certainly, other factors have contributed to the softness in compensation growth in the past few years. The sharp deceleration in health care costs, of course, is cited frequently. Another is the heightened pressure on firms and their workers in industries that compete internationally. Domestic deregulation has had similar effects on the intensity of competitive forces in some industries. In any event, although I do not doubt that all these factors are relevant, I would be surprised if they were nearly as important as job insecurity.

If heightened job insecurity is the most significant explanation of the break with the past in recent years, then it is important to recognize that, as I indicated in last February's Humphrey-Hawkins testimony, suppressed wage cost growth as a consequence of job insecurity can be carried only so far. At some point, the tradeoff of subdued wage growth for job security has to come to an end. In other words, the relatively modest wage gains we have experienced are a temporary rather than a lasting phenomenon because there is a limit to the value of additional job security people are willing to acquire in exchange for lesser increases in living standards. Even if real wages were to remain permanently on a lower upward track than otherwise as a result of the greater sense of insecurity, the rate of change of wages would revert at some point to a normal relationship with inflation. The unknown is when this transition period will end.

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Indeed, some recent evidence suggests that the labor markets bear especially careful watching for signs that the return to more normal patterns may be in process. The Bureau of Labor Statistics reports that people were somewhat more willing to quit their jobs to seek other employment in January than previously. The possibility that this reflects greater confidence by workers accords with a recent further rise in the percent of households responding to a Conference Board survey who perceive that job availability is plentiful. Of course, the job market has continued to be quite good recently; employment in January registered robust growth and initial claims for unemployment insurance have been at a relatively low level of late. Wages rose faster in 1996 than in 1995 by most measures, perhaps also raising questions about whether the transitional period of unusually slow wage gains may be drawing to a close.

To be sure, the pickup in wage gains has not shown through to underlying price inflation. Increases in the core CPI, as well as in several broader measures of prices, have stayed subdued or even edged off further in recent months. As best we can judge, faster productivity growth last year meant that rising compensation gains did not cause labor costs per unit of output to increase any more rapidly. Non-labor costs, which are roughly a quarter of total consolidated costs of the nonfinancial corporate sector, were little changed in 1996.

Owing in part to this subdued behavior of unit costs, profits and rates of return on capital have risen to high levels.

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As a consequence, businesses believe that, were they to raise prices to boost profits further, competitors with already ample profit margins would not follow suit; instead, they would use the occasion to capture a greater market share. This interplay is doubtless a significant factor in the evident loss of pricing power in American business.

Intensifying global competition also may be further restraining domestic firms' ability to hike prices as well as wages. Clearly, the appreciation of the dollar on balance over the past eighteen months or so, together with low inflation in many of our trading partners, has resulted in a marked decline in non-oil import prices that has helped to damp domestic inflation pressures. Yet it is important to emphasize that these influences, too, would be holding down inflation only temporarily; they represent a transition to a lower price level than would otherwise prevail, not to a permanently lower rate of inflation.

Against the background of all these considerations, the FOMC has recognized the need to remain vigilant for signs of potentially inflationary imbalances that might, if not corrected promptly, undermine our economic expansion. The FOMC in fact has signaled a state of heightened alert for possible policy tightening since last July in its policy directives. But, we have also taken care not to act prematurely. The FOMC refrained from changing policy last summer, despite expectations of a near-term policy firming by many financial market participants.

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In light of the developments I've just discussed affecting wages and prices, we thought inflation might well remain damped, and in any case was unlikely to pick up very rapidly, in part because the economic expansion appeared likely to slow to a more sustainable pace. In the event, inflation has remained quiescent since then.

Given the lags with which monetary policy affects the economy, however, we cannot rule out a situation in which a preemptive policy tightening may become appropriate before any sign of actual higher inflation becomes evident. If the FOMC were to implement such an action, it would be judging that the risks to the economic expansion of waiting longer had increased unduly and had begun to outweigh the advantages of waiting for uncertainties to be reduced by the accumulation of more information about economic trends. Indeed, the hallmark of a successful policy to foster sustainable economic growth is that inflation does not rise. I find it ironic that our actions in 1994-95 were criticized by some because inflation did not turn upward. That outcome, of course, was the intent of the tightening, and I am satisfied that our actions then were both necessary and effective, and helped to foster the continued economic expansion.

To be sure, 1997 is not 1994. The real federal funds rate today is significantly higher than it was three years ago. Then we had just completed an extended period of monetary ease which addressed the credit stringencies of the early 1990s, and with

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the abatement of the credit crunch, the low real funds rate of early 1994 was clearly incompatible with containing inflation and sustaining growth going forward. In February 1997, in contrast, our concern is a matter of relative risks rather than of expected outcomes. The real funds rate, judging by core inflation, is only slightly below its early 1995 peak for this cycle and might be at a level that will promote continued non-inflationary growth, especially considering the recent rise in the exchange value of the dollar. Nonetheless, we cannot be sure. And the risks of being wrong are clearly tilted to the upside.

I wish it were possible to lay out in advance exactly what conditions have to prevail to portend a buildup of inflation pressures or inflationary psychology. However, the circumstances that have been associated with increasing inflation in the past have not followed a single pattern. The processes have differed from cycle to cycle, and what may have been a useful leading indicator in one instance has given off misleading signals in another.

I have already discussed the key role of labor market developments in restraining inflation in the current cycle and our careful monitoring of signs that the transition phase of trading off lower real wages for greater job security might be coming to a close. As always, with resource utilization rates high, we would need to watch closely a situation in which demand was clearly unsustainable because it was producing escalating pressures on resources, which could destabilize the economy. And

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we would need to be watchful that the progress we have made in keeping inflation expectations damped was not eroding. In general, though, our analysis will need to encompass all potentially relevant information, from financial markets as well as the economy, especially when some signals, like those in the labor market, have not been following their established patterns.

The ongoing economic expansion to date has reinforced our conviction about the importance of low inflation--and the public's confidence in continued low inflation. The economic expansion almost surely would not have lasted nearly so long had monetary policy supported an unsustainable acceleration of spending that induced a buildup of inflationary imbalances. The Federal Reserve must not acquiesce in an upcreep in inflation, for acceding to higher inflation would countenance an insidious weakening of our chances for sustaining long-run economic growth. Inflation interferes with the efficient allocation of resources by confusing price signals, undercutting a focus on the longer run, and distorting incentives.

This year overall inflation is anticipated to stay restrained. The central tendency of the forecasts made by the Board members and Reserve Bank presidents has the increase in the total CPI slipping back into a range of 2-3/4 to 3 percent over the four quarters of the year. This slight falloff from last year's pace is expected to owe in part to a slower rise in food prices as some of last year's supply limitations ease. More importantly, world oil supplies are projected by most analysts to

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increase relative to world oil demand, and futures markets project a further decline in prices, at least in the near term. The recent and prospective declines in crude oil prices not only should affect retail gasoline and home heating oil prices but also should relieve inflation pressures through lower prices for other petroleum products, which are imbedded in the economy's underlying cost structure. Nonetheless, the trend in inflation rates in the core CPI and in broader price measures may be somewhat less favorable than in recent years. A continued tight labor market, whose influence on costs would be augmented by the scheduled increase in the minimum wage later in the year and perhaps by higher growth of benefits now that considerable health-care savings already have been realized, could put upward pressure on core inflation. Moreover, the effects of the sharp rise in the dollar over the last eighteen months in pushing down import prices are likely to ebb over coming quarters.

The unemployment rate, according to Board members and Bank presidents, should stay around 5-1/4 to 5-1/2 percent through the fourth quarter, consistent with their projections of measured real GDP growth of 2 to 2-1/4 percent over the four quarters of the year. Such a growth rate would represent some downshifting in output expansion from that of last year. The projected moderation of growth likely would reflect several influences: (1) declines in real federal government purchases should be exerting a modest degree of restraint on overall demand; (2) the lagged effects of the increase in the exchange value of the dollar in

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recent months likely will damp U.S. net exports somewhat this year; and (3) residential construction is unlikely to repeat the gains of 1996. On the other hand, we do not see evidence of widespread imbalances either in business inventories or in stocks of equipment and consumer durables that would lead to a substantial cutback in spending. And financial conditions overall remain supportive; real interest rates are not high by historical standards and credit is readily available from intermediaries and in the market.

The usual uncertainties in the overall outlook are especially focused on the behavior of consumers. Consumption should rise roughly in line with the projected moderate expansion of disposable income, but both upside and downside risks are present. According to various surveys, sentiment is decidedly upbeat. Consumers have enjoyed healthy gains in their real incomes along with the extraordinary stock-market driven rise in their financial wealth over the last couple of years. Indeed, econometric models suggest that the more than $4 trillion rise in equity values since late 1994 should have had a larger positive influence on consumer spending than seems to have actually occurred.

It is possible, however, that households have been reluctant to spend much of their added wealth because they see a greater need to keep it to support spending in retirement. Many households have expressed heightened concern about their financial security in old age, which reportedly has led to

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increased provision for retirement. The results of a survey conducted annually by the Roper Organization, which asks individuals about their confidence in the Social Security system, shows that between 1992 and 1996 the percent of respondents expressing little or no confidence in the system jumped from about 45 percent to more than 60 percent.

Moreover, consumer debt burdens are near historical highs, while credit card delinquencies and personal bankruptcies have risen sharply over the past year. These circumstances may make both borrowers and lenders a bit more cautious, damping spending.

In fact, we may be seeing both wealth and debt effects already at work for different segments of the population, to an approximately offsetting extent. Saving out of current income by households in the upper income quintile, who own nearly three-fourths of all non-pension equities held by households, evidently has declined in recent years. At the same time, the use of credit for purchases appears to have leveled off after a sharp runup from 1993 to 1996, perhaps because some households are becoming debt constrained and, as a result, are curtailing their spending.

The Federal Reserve will be weighing these influences as it endeavors to help extend the current period of sustained growth. Participants in financial markets seem to believe that in the current benign environment the FOMC will succeed indefinitely. There is no evidence, however, that the business cycle has been repealed. Another recession will doubtless occur some day owing

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to circumstances that could not be, or at least were not, perceived by policymakers and financial market participants alike. History demonstrates that participants in financial markets are susceptible to waves of optimism, which can in turn foster a general process of asset-price inflation that can feed through into markets for goods and services. Excessive optimism sows the seeds of its own reversal in the form of imbalances that tend to grow over time. When unwarranted expectations ultimately are not realized, the unwinding of these financial excesses can act to amplify a downturn in economic activity, much as they can amplify the upswing. As you know, last December I put the question this way: "...how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions ...?"

We have not been able, as yet, to provide a satisfying answer to this question, but there are reasons in the current environment to keep this question on the table. Clearly, when people are exposed to long periods of relative economic tranquility, they seem inevitably prone to complacency about the future. This is understandable. We have had fifteen years of economic expansion interrupted by only one recession--and that was six years ago. As the memory of such past events fades, it naturally seems ever less sensible to keep up one's guard against an adverse event in the future. Thus, it should come as no surprise that, after such a long period of balanced expansion,

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risk premiums for advancing funds to businesses in virtually all financial markets have declined to near-record lows.

Is it possible that there is something fundamentally new about this current period that would warrant such complacency? Yes, it is possible. Markets may have become more efficient, competition is more global, and information technology has doubtless enhanced the stability of business operations. But, regrettably, history is strewn with visions of such "new eras" that, in the end, have proven to be a mirage. In short, history counsels caution.

Such caution seems especially warranted with regard to the sharp rise in equity prices during the past two years. These gains have obviously raised questions of sustainability. Analytically, current stock-price valuations at prevailing long-term interest rates could be justified by very strong earnings growth expectations. In fact, the long-term earnings projections of financial analysts have been marked up noticeably over the last year and seem to imply very high earnings growth and continued rising profit margins, at a time when such margins are already up appreciably from their depressed levels of five years ago. It could be argued that, although margins are the highest in a generation, they are still below those that prevailed in the 1960s. Nonetheless, further increases in these margins would evidently require continued restraint on costs: labor compensation continuing to grow at its current pace and productivity growth picking up. Neither, of course, can be ruled out. But we

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should keep in mind that, at these relatively low long-term interest rates, small changes in long-term earnings expectations could have outsized impacts on equity prices.

Caution also seems warranted by the narrow yield spreads that suggest perceptions of low risk, possibly unrealistically low risk. Considerable optimism about the ability of businesses to sustain this current healthy financial condition seems, as I indicated earlier, to be influencing the setting of risk premiums, not just in the stock market but throughout the financial system. This optimistic attitude has become especially evident in quality spreads on high-yield corporate bonds--what we used to call "junk bonds." In addition, banks have continued to ease terms and standards on business loans, and margins on many of these loans are now quite thin. Many banks are pulling back a little from consumer credit card lending as losses exceed expectations. Nonetheless, some bank and nonbank lenders have been expanding aggressively into the home equity loan market and so-called "subprime" auto lending, although recent problems in the latter may already be introducing a sense of caution.

Why should the central bank be concerned about the possibility that financial markets may be overestimating returns or mispricing risk? It is not that we have a firm view that equity prices are necessarily excessive right now or risk spreads patently too low. Our goal is to contribute as best we can to the highest possible growth of income and wealth over time, and we would be pleased if the favorable economic environment

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projected in markets actually comes to pass. Rather, the FOMC has to be sensitive to indications of even slowly building imbalances, whatever their source, that, by fostering the emergence of inflation pressures, would ultimately threaten healthy economic expansion.

Unfortunately, because the monetary aggregates were subject to an episode of aberrant behavioral patterns in the early 1990s, they are likely to be of only limited help in making this judgment. For three decades starting in the early 1960s, the public's demand for the broader monetary aggregates, especially M2, was reasonably predictable. In the intermediate term, M2 velocity--nominal income divided by the stock of M2--tended to vary directly with the difference between money market yields and the return on M2 assets--that is, with its short-term opportunity cost. In the long run, as adjustments in deposit rates caused the opportunity cost to revert to an equilibrium, M2 velocity also tended to return to an associated stable equilibrium level. For several years in the early 1990s, however, the velocities of M2 and M3 exhibited persisting upward shifts that departed markedly from these historical patterns.

In the last two to three years, velocity patterns seem to have returned to those historical relationships, after allowing for a presumed permanent upward shift in the levels of velocity. Even so, given the abnormal velocity behavior during the early 1990s, FOMC members continue to see considerable uncertainty in the relationship of broad money to opportunity costs and nominal

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income. Concern about the possibility of aberrant behavior has made the FOMC hesitant to upgrade the role of these measures in monetary policy.

Against this background, at its February meeting, the FOMC reaffirmed the provisional ranges set last July for money and debt growth this year: 1 to 5 percent for M2, 2 to 6 percent for M3, and 3 to 7 percent for the debt of domestic nonfinancial sectors. The M2 and M3 ranges again are designed to be consistent with the FOMC's long-run goal of price stability: For, if the velocities of the broader monetary aggregates were to continue behaving as they did before 1990, then money growth around the middle portions of the ranges would be consistent with noninflationary, sustainable economic expansion. But, even with such velocity behavior this year, when inflation is expected to still be higher than is consistent with our long-run objective of reasonable price stability, the broader aggregates could well grow around the upper bounds of these ranges. The debt aggregate probably will expand around the middle of its range this year.

I will conclude on the same upbeat note about the U.S. economy with which I began. Although a central banker's occupational responsibility is to stay on the lookout for trouble, even I must admit that our economic prospects in general are quite favorable. The flexibility of our market system and the vibrancy of our private sector remain examples for the whole world to emulate. The Federal Reserve will endeavor to do its part by continuing to foster a monetary framework under which our citizens can prosper to the fullest possible extent.

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For use at 10:00 a.m., E.S.T.
Wednesday
February 26, 1997

Board of Governors of the Federal Reserve System

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

February 26, 1997

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Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 26, 1997

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

The economy performed impressively this past year, and members of the Board of Governors and Reserve Bank presidents anticipate that 1997 will bring further appreciable economic expansion with relatively low inflation. In 1996, solid advances in the real expenditures of households and businesses led to sizable gains in output. Employment rose briskly, and the unemployment rate edged down to its lowest level of the current expansion. Consumer price inflation increased owing to the likely temporary effects of firmness in food and energy markets, but some broader price measures showed inflation holding steady or even declining. With the economy strengthening, intermediate- and long-term interest rates rose on net, but credit continued to be amply available to businesses and most households, and equity prices soared.

Several factors helped to restrain price increases this past year in the face of high levels of resource utilization. With workers still concerned to some degree about job security, acceleration in hourly compensation was not so pronounced as in comparable periods in the past; wage increases picked up relatively moderately, and further success in controlling health care costs helped to temper the rise in benefits. Moreover, significant declines in the prices of U.S. imports, owing to low inflation abroad and appreciation of the dollar on foreign exchange markets, tended to hold down domestic prices. Damped inflation expectations probably contributed as well to the favorable price performance: A lengthening run of years during which inflation has been in a more moderate range, together with an understanding of the Federal Reserve's commitment to maintaining progress toward price stability, may have discouraged aggressive pricing behavior. Business firms continued to rely on cost control and gains in productivity, rather than on price increases, as the primary channels for achieving profit growth.

Still, the Federal Open Market Committee (FOMC) recognized the danger that pressures emanating from the tight labor market might trigger an acceleration of prices, which could eventually undermine the ongoing economic expansion. Consequently, although conditions last year were not deemed to warrant immediate policy action, the Committee's policy directives starting in mid-1996 reflected a perception that the most likely direction of any policy action would be toward greater restraint in the provision of reserves to the banking system. Forestalling a disruptive buildup of inflationary pressures in the near term and moving toward price stability over time remain central to the System's mission of promoting maximum sustainable growth of employment and production.

Monetary Policy, Financial Markets, and the Economy in 1996

The FOMC eased the stance of monetary policy twice around the beginning of last year—in December 1995 and in January—lowering the federal funds rate ½ percentage point in total, to 5¼ percent. These actions were taken to offset the effect on the level of the real federal funds rate of declines in inflation and inflation expectations in the second half of 1995 and thereby to help ensure the resumption of moderate economic growth after the marked slowdown and inventory correction in late 1995. By the spring, economic growth had become more vigorous than either the Committee or financial markets had foreseen. In response, intermediate- and longer-term interest rates as of mid-May were up around a full percentage point from the two-year lows reached early in the year. In combination with some softening of economic activity abroad and declines in interest rates in major foreign industrial countries, these developments contributed to a further appreciation of the dollar, building on the rise that had started in mid-1995. The Committee anticipated that the increase in the cost of credit, along with the higher exchange value of the dollar, would be sufficient to foster a downshift in economic expansion to a more sustainable pace and contain price pressures; thus, it left its policy stance unchanged at its spring meetings.

By early summer, however, the continued momentum in demand and pressures on labor resources that were being reflected in faster growth in wages were seen as posing a threat of increased inflation. Core inflation remained moderate, but in light of the heightened risk that it would turn upward, the Committee in its early July directive to the Manager of the Open Market Account indicated its view that near-term economic developments were more likely to lead to a tightening of policy than to an easing. Labor markets continued to be taut over the balance of the year, and this bias toward restraint was included in directives adopted at all of the Committee's remaining meetings in 1996.

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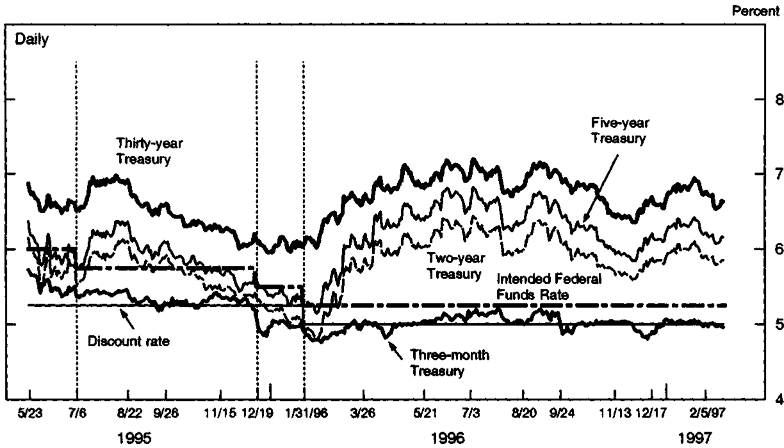
Selected Interest Rates



Note. Dotted vertical lines indicate days on which the Federal Open Market Committee (FOMC) announced a monetary policy action. The dates on the horizontal axis are those on which the FOMC held scheduled meetings.

After peaking during mid-summer, interest rates moved down on balance through the fall, as expansion of consumer spending and economic activity in general appeared to be moderating and markets saw less likelihood of a need for Federal Reserve firming action. Equity prices fell back for a time during the summer, reversing some of the substantial increase registered over the first half of the year, but by autumn they had reached new highs. Interest rates and dollar exchange rates turned back up late in the year when signs of rapid growth and more intense use of the economy's resources reemerged. Since year-end, interest rates have changed little, on net. The foreign exchange value of the dollar has posted further gains, in part reflecting greater-than-expected weakness in Europe and renewed pessimism about economic and financial prospects in Japan. Equity prices have registered new highs since the start of the year. As of mid-February, intermediate- and long-term interest rates were up about ½ to ¾ percentage point, on balance, since early 1996, and the value of the dollar was up around 9 percent against an average of other G-10 currencies.

For the nonfinancial business sector, the effect of the higher intermediate- and long-term interest rates on the overall cost of funds last year was offset to some degree by an easing of lending terms at banks and a narrowing of yield spreads on corporate bonds over Treasuries, as well as by declines in the cost of capital in the equity market. Encouraged, perhaps, by the prospects of sustained economic expansion and low inflation, banks, market lenders, and equity investors displayed a strong appetite for business obligations and seemed willing to require less compensation for the possible risks entailed. Some households, by contrast, faced a tightening of standards and terms with respect to credit card debt and some other types of consumer debt last year, as banks reacted to a rising volume of delinquencies and charge-offs on these instruments. However, credit availability under home equity lines increased, particularly from finance companies but also from banks. Overall debt growth slowed slightly but remained near the midpoint of its 3 percent to 7 percent monitoring range. The growth rates of M2 and M3 edged up last year and, as was anticipated in the monetary policy reports to the Congress last February and July, both aggregates ended 1996 near or above the upper end of their growth ranges. Again last year, the growth of M2 relative to nominal income and interest rates was generally in line with historical relationships, in contrast to its behavior during the early years of the decade.

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Economic Projections for 1997
Percent

Indicator	Federal Reserve governors and Reserve Bank presidents: Range	Federal Reserve governors and Reserve Bank presidents: Central tendency	Administration
Change, fourth quarter to fourth quarter[1]			
Nominal GDP	4¼ to 5¼	4½ to 4¾	4.6
Real GDP[2]	2 to 2½	2 to 2¼	2.0
Consumer price index[3]	2¾ to 3½	2¾ to 3	2.6
Average level, fourth quarter			
Civilian unemployment rate	5¼ to 5½	5¼ to 5½	5.4

1. Change from average for fourth quarter of 1996 to average for fourth quarter of 1997.
2. Chain-weighted.
3. All urban consumers.

Economic Projections for 1997

With the economy free of serious imbalances, prospects appear favorable for further growth of activity and expansion of job opportunities in the coming year, although resource constraints seem likely to keep the pace of growth below that of 1996. The central tendency of the GDP growth forecasts put forth by members of the Board of Governors and the Reserve Bank presidents is from 2 percent to 2¼ percent, measured as the change in real output between the final quarter of 1996 and the final quarter of 1997. Output growth of this magnitude is expected to result in little change in the civilian unemployment rate, which is projected to be between 5¼ percent and 5½ percent in the fourth quarter of this year. These forecasts of GDP growth and unemployment are similar to those of the Administration. The central tendency of the policymakers' CPI forecasts for 1997 spans the relatively narrow interval of 2¾ percent to 3 percent, with the lower bound near the inflation forecast of the Administration.

Consumer spending, which accounts for about two-thirds of total GDP, should be supported in coming quarters by further gains in income and the substantial increase in household net worth that has occurred over the past two years; debt problems, although rising of late, do not seem to be so widespread as to threaten the ongoing expansion of household expenditures in the aggregate. In the business sector, balance sheets are strong, profits have been rising, and efforts to bolster efficiency through the use of technologically advanced equipment are continuing at an intense pace. In the commercial real estate market, the supply–demand balance has shifted in many locales to a point at which interest in office building projects has picked up noticeably. These conditions, together with the ready access to a wide variety of sources of finance that businesses currently are enjoying, should keep investment spending on an upward trajectory. Foreign demand for U.S. products should continue to rise with growth of the world economy, even in the wake of the significant appreciation of the dollar since the first half of 1995; however, imports also seem likely to remain on a clear upward trend, given the prospects for continued expansion of the U.S. economy. Government expenditures for consumption and investment probably will follow recent trends, with further cutbacks in real outlays at the federal level and moderate increases in the combined purchases of state and local governments.

Although the risk of increased inflation pressures is significant, especially in view of the tightness of the labor market and the strength in activity that has been evident recently, Federal Reserve policymakers expect this year's rise in the consumer price index to be somewhat smaller than that of 1996. The major reason for expecting a smaller CPI increase this year is a more favorable outlook for food and energy prices. Prices of farm products have dropped back from the highs of last summer, and, barring further

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Ranges for Growth of Monetary and Debt Aggregates
Percent

Aggregate	1995	1996	1997
M2	1 to 5	1 to 5	1 to 5
M3	2 to 6	2 to 6	2 to 6
Debt	3 to 7	3 to 7	3 to 7

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

weather problems, this year's rise in food prices at retail should be considerably smaller than that of 1996. Oil prices have recently declined and seem likely to ease further in coming months as world production and consumption come back into better balance; this price relief is important not only because of the direct effects on the price of gasoline and other consumer energy items but also because petroleum is a major element in the cost of producing and distributing many other goods. By contrast to the favorable outlook for food and energy prices, some risk exists that core inflation could turn up during the coming year. The minimum wage will be moving up further in 1997, compounding whatever cost pressures might be in train as a result of labor market tightness, and the degree to which businesses can continue to absorb stepped-up increases in labor costs without raising prices more rapidly is not certain.

As noted in the July 1996 monetary policy report, the CPI forecasts of the governors and Reserve Bank presidents incorporate allowances for the technical improvements to this index that have been made by the Bureau of Labor Statistics. These technical changes are estimated to have trimmed the reported rate of CPI inflation slightly in each of the past two years, and additional changes will be affecting the rise in the index in 1997. In view of the remaining difficulties of accurately measuring price change in a highly complex and rapidly changing economy, alternative price indexes will continue to be given substantial weight, along with the CPI, in monitoring progress toward the long-run goal of price stability. Some of the broad measures of inflation derived from the GDP accounts slowed in 1996; the Committee is concerned that, even if the CPI decelerates as expected in 1997, other indexes—with different scope and weights—may pick up in reflection of the pressures on productive resources.

Money and Debt Ranges for 1997

Again in 1997, the Committee has set ranges for M2 and M3 that would encompass monetary growth expected to be consistent with approximate price stability and a sustainable rate of real economic growth, assuming that the behavior of velocity is in line with historical norms. These ranges are unchanged from those for 1996: 1 to 5 percent for M2 and 2 to 6 percent for M3.

As has been the case for several years, the 1997 ranges for M2 and M3 were set against a backdrop of uncertainty about the stability and predictability of their velocities. A long-run pattern of reasonably stable velocity behavior broke down in the early 1990s when the public's holdings of monetary assets were depressed by several factors: the contraction of the thrift industry; a tightening of credit supplies and deleveraging by businesses and households; an extremely wide spread between short- and intermediate-term interest rates that heightened the attractiveness of capital market instruments relative to bank deposits; and the expanding availability and growing acceptance of stock and bond mutual funds as household investments.

With the waning of all but the last of these influences, movements in velocity have become more predictable over the past couple of years. This recent evidence of stability, however, covers only a relatively brief period, and its durability remains uncertain. In these circumstances, the Committee has opted to continue treating the ranges as benchmarks for the trends of money growth consistent with price stability rather than as short-run targets for policy. Meanwhile, the actual behavior of the monetary measures will be monitored for such information as it may convey about underlying economic developments.

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The central tendency of the Committee's expectations for nominal GDP growth in 1997 is slightly below that registered in 1996. Thus, if velocity behaves as it did last year, M2 and M3 might decelerate a bit but even so would again expand around the upper ends of their growth ranges. Debt of the nonfinancial sectors is anticipated to increase this year at around the pace of last year, remaining near the midpoint of its unchanged 3 to 7 percent range.

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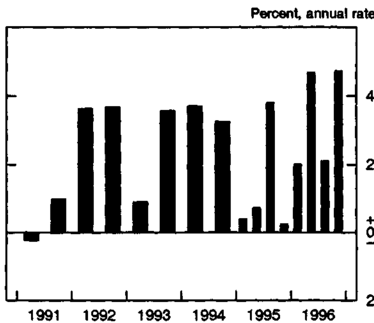
Section 2: Economic and Financial Developments in 1996 and Early 1997

The economy turned in a remarkably favorable performance this past year. Preliminary estimates indicate that real GDP rose more than 3 percent over the four quarters of 1996, one of the larger gains of the past several years and appreciably more than the FOMC was expecting a year ago. Although intermediate- and long-term interest rates moved up, credit remained readily available to most borrowers, and equity prices rose substantially. Expansion of the debt of nonfinancial sectors continued at about the 5 percent rate it has maintained over the past several years, and growth of the stock of money picked up a little to its most rapid pace this decade. These financial developments provided support for strong advances in the real expenditures of households and businesses, and the growth of exports held up well in the face of an appreciating dollar. Tightness of the labor market led to a moderate pickup in wage increases in 1996. However, acceleration of prices was confined largely to the food and energy sectors; prices for other consumer products decelerated, as did prices paid by businesses for capital goods and materials. Economic data for early 1997 show the unemployment rate holding in a low range with the inflation trend still subdued.

Change in Real GDP

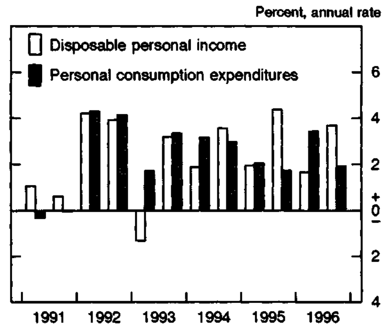


Economic Developments

The Household Sector

After rising less than 2 percent in 1995, real personal consumption expenditures moved up 2¾ percent in 1996. Although debt problems arose with greater frequency this past year, households benefited from healthy increases in real income and another year of sizable gains in wealth. Consumers were relatively optimistic about prospects for the economy at the start of 1996, and they became more so as the year progressed.

Change in Real Income and Consumption



Real outlays for consumer durables rose more than 5 percent in 1996 after a gain of only 1¼ percent during 1995. As has been true for many years, real expenditures on computers and electronic equipment outpaced the growth of other household outlays by a wide margin in 1996. Sizable increases were also reported for most other types of consumer durables. However, real expenditures on vehicles changed little on net over the year, as gains achieved during the first half were reversed after mid-year. Late in 1996, sales of light vehicles may have been constrained to some degree by supply shortages that arose during strikes in the United States and Canada; early in 1997, vehicle sales strengthened. Consumer purchases of nondurables rose 1¾ percent in 1996 after increasing 1 percent during 1995. Spending for services rose 2½ percent last year, about the same as the average gain in previous years of the expansion.

After-tax personal income increased 5 percent in nominal terms over the four quarters of last year. Wages and salaries rose briskly, and the income of farm proprietors surged. Other types of income generally exhibited moderate gains. Given the low level of

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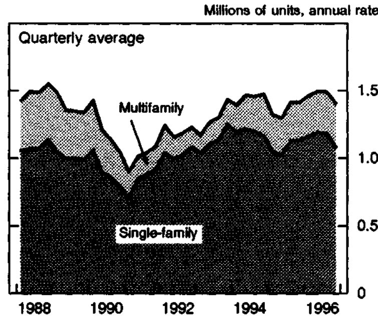
price inflation, the rise in nominal income translated into another significant advance in real disposable income—about 2¾ percent over the year.

As in 1995, strong cross-currents continued to shape individual households' willingness—and ability—to spend from current income. Huge increases in stock market wealth provided some households the wherewithal to boost spending at a pace considerably faster than the growth of disposable income. But a number of households were likely held back by the need to divert income to the servicing of debt, and according to some survey evidence, households have become more concerned about saving for retirement. Responding to these influences, the annual average of the personal saving rate was up slightly from that of 1995; however, it remained relatively low compared with its longer-run average.

Residential investment expenditures posted a gain of 4 percent in real terms over the four quarters of 1996, more than reversing a small decline in the previous year. Demand for single-family housing was especially strong. Although interest rates on longer-term fixed-rate mortgage loans moved up considerably in 1996, a substantial number of homebuyers side-stepped at least the initial costs by using adjustable-rate loans that were available at lower rates. The effects of the rate increases on the single-family market were cushioned by other influences as well, most notably the growth of employment and income. Even for fixed-rate loans, mortgage financing costs held at a level that, by historical standards, was low relative to household incomes. All told, sales of new homes surged to the highest annual total of the current expansion, and sales of existing homes established a historical high. New construction of single-family dwellings also rose but not so dramatically as sales, as builders apparently chose to work off some of their inventories of unsold units, which had climbed in 1995. Mild sluggishness in starts toward the end of 1996—which was probably exacerbated by poor weather in December—was followed by more upbeat indicators of new construction in January of this year.

Construction of multifamily units maintained a path of recovery from the extreme lows of the early 1990s, moving up about 13 percent in terms of annual totals. The number of multifamily units started—about 315,000—was double the number started in 1993, when construction of these units was at a low. However, compared with previous peaks, the 1996 total was less impressive—starts were twice as high in some years of the 1970s and 1980s. Although

Private Housing Starts

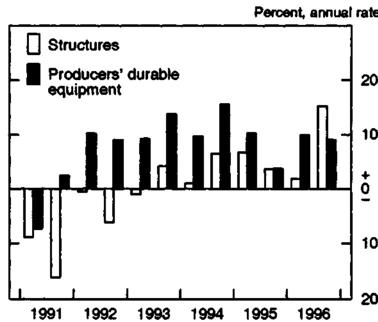


market conditions for multifamily properties varied considerably from city to city in 1996, the national average vacancy rate for multifamily rental units remained relatively high, and demographic influences were probably less supportive of multifamily housing than they were a decade or so ago. Also, manufactured houses have provided an increased number of families with an alternative to rental apartments in recent years.

The Business Sector

Business fixed investment recorded a fifth consecutive year of strong expansion in 1996, rising about 9 percent according to the initial estimate. As in other recent years, investment was driven by rising profits, favorable trends in the cost of capital, and the ongoing efforts of businesses to boost efficiency. Although

Change in Real Business Fixed Investment



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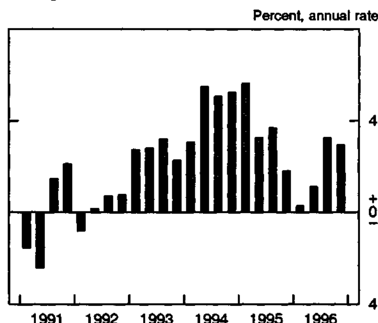
much of the investment spending was to replace depreciated equipment, the net addition to the aggregate capital stock appears to have been substantial. The rate of rise in the stock has picked up over the past two or three years after subpar growth through the latter half of the 1980s and first few years of the 1990s; the resulting rise in the level of capital per worker should enhance labor productivity and potential output.

Equipment outlays moved up almost 9½ percent in real terms in 1996. Business purchases of office and computing equipment once again rose much faster than the outlays for other types of equipment. Computer purchases were propelled by many of the same forces that have been at work in other recent years—most particularly, the expansion of networks and the availability of new models of computers embodying substantially improved computing power at highly attractive prices. Outlays for communications equipment also rose quite rapidly in 1996. Gains for other types of equipment were generally more modest.

Investment in nonresidential structures also rose substantially over the four quarters of 1996, posting the largest advance in several years. Business spending on structures went through an extended contraction in the latter part of the 1980s and early 1990s, and until recently, the subsequent recovery has been relatively slow. That the 1996 gain in nonresidential investment would be so large was not evident until late in the year, when incoming data began to trace out sizable increases in new construction for many types of buildings. Investment in office buildings scored an especially large gain over the year, amid widespread reports of firming market conditions and reduced vacancy rates, and real outlays for other commercial structures moved up for a fifth consecutive year. Financing appears to be in ample supply for commercial construction, and according to reports from the District Reserve Banks, speculative office building projects—that is, those without pre-committed tenants—are becoming more common.

Inventory investment was relatively subdued in 1996. The stock of nonfarm business inventories rose less than 2 percent over the four quarters of the year, the smallest increase since 1992. Businesses had been moving toward a reduced rate of stockpiling over much of 1995, and the rate of accumulation came almost to a halt in early 1996, when stocks of motor vehicles plummeted in conjunction with a strike at two plants that manufacture auto parts. Thereafter, inventory developments were relatively uneventful.

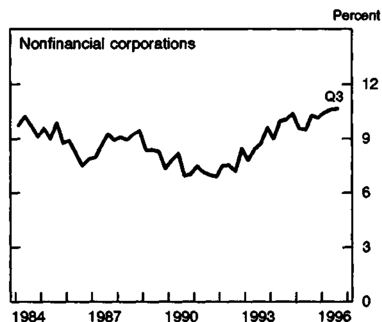
Change in Real Nonfarm Business Inventories



Stocks of vehicles changed little on net over the final three quarters of the year, and accumulation of inventories by other nonfarm businesses was moderate on average. Stocks at year-end generally appeared to be at comfortable levels relative to recent trends in sales.

Business profits turned in another strong performance in 1996. Economic profits of all U.S. corporations rose at an annual rate of more than 10 percent from the final quarter of 1995 to the third quarter of 1996. Profits earned by foreign subsidiaries of U.S. corporations fluctuated from quarter to quarter but remained at high levels, and returns from domestic operations rose substantially, for both financial and nonfinancial firms. Domestic profits of

Before-Tax Profit Share of GDP



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

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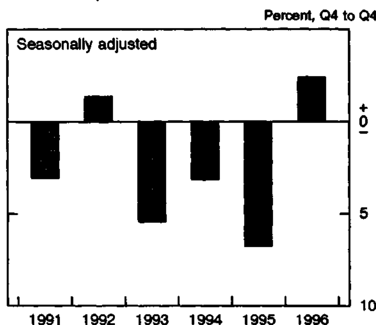
nonfinancial corporations amounted to 10.7 percent of the nominal value of these firms' output in the third quarter, the highest reading of the current expansion.

The Government Sector

Real federal expenditures on consumption and gross investment—the part of federal spending that is included in GDP—rose about 2½ percent, on net, from the fourth quarter of 1995 to the fourth quarter of 1996, but the rise was mostly an artifact of late-1995 real purchases having been pushed to especially low levels by government shutdowns. The underlying trend of federal consumption and investment expenditures probably is better represented by the 2½ percent annual rate of decline from the fourth quarter of 1994 to the final quarter of 1996. Reductions have been apparent over the past two years both in real defense purchases and in real nondefense purchases.

Change in Real Federal Expenditures on Consumption and Investment

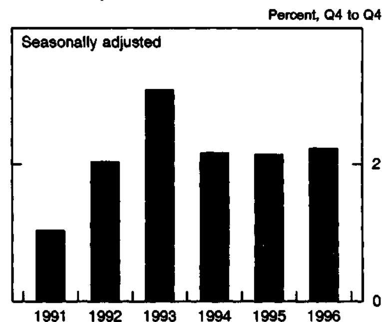


Federal expenditures in the unified budget increased about 3 percent in nominal terms in fiscal 1996 after having increased 3¾ percent in fiscal 1995. Slower growth was recorded across many budgetary categories this past year, and outright declines were reported in some. Combined expenditures on health, social insurance, and income security—items that account for more than half of all federal outlays—moved up 4½ percent, the smallest increase this decade. Defense spending was down about 2¼ percent in nominal terms, and net interest outlays rose much less rapidly than in fiscal 1995. Measured relative to the size of nominal GDP, total outlays in the most recent fiscal year were the smallest since 1979. Legislative restraint has led to cuts in a number of discretionary programs in recent years, and the expanding economy has relieved pressure on those outlays that tend to vary inversely with the strength of activity.

Federal receipts increased about 7½ percent in fiscal 1996, the third year in which growth of receipts outpaced growth of nominal GDP by a significant margin. Receipts from individual income taxes climbed more than 11 percent in the most recent fiscal year, in conjunction with healthy increases in households' taxable earnings from capital and labor. Taxes on corporate profits also continued to rise rapidly, more or less in step with the growth of business earnings. The rapid growth of receipts, coupled with the restrained growth of expenditures, brought the unified budget deficit down to $107 billion in fiscal 1996 from almost $165 billion in fiscal 1995. The deficit as a share of nominal GDP was 1.4 percent, the smallest in more than twenty years.

The aggregate consumption and investment expenditures of state and local governments rose 2¼ percent in real terms over 1996. This gain was about the same as those of the two previous years. Outlays for services, which consist mainly of employee compensation and account for more than two-thirds of all state and local purchases, rose roughly 1¼ percent in real terms last year. Investment expenditures, which make up the next biggest portion of state and local purchases, rose about 4½ percent in real terms. In the aggregate, the budget picture for state and local governments was relatively stable in 1996, as the surplus of nominal receipts over

Change in Real State and Local Expenditures on Consumption and Investment



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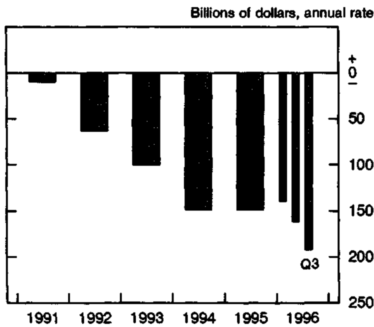
nominal current expenditures changed little from the positive readings of other recent years.

The External Sector

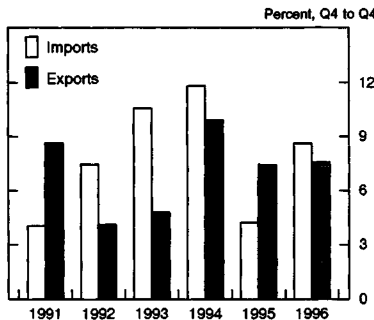
The nominal trade deficit for goods and services widened to $115 billion in 1996 from $105 billion the previous year. For the first three quarters of the year, the current account deficit totaled $165 billion at an annual rate, somewhat greater than the $150 billion deficit recorded in 1995.

U.S. Current Account



The quantity of imports of goods and services rose strongly over the four quarters of 1996—about 8½ percent according to the preliminary estimate—after expanding only 4¼ percent the previous year. The pickup in U.S. real output growth boosted the demand for imported goods, as did the declines in the prices of non-oil imports. Sizable increases in import volume were widespread among most major merchandise trade categories, with the notable exceptions of oil and semiconductors.

Change in Real Imports and Exports of Goods and Services



Very strong export growth in the fourth quarter of 1996 raised the yearly gain in the quantity of exports of goods and services to 7½ percent. Growth in the economies of our major trading partners was only moderate on average but was somewhat faster than in 1995. As a consequence, growth of exports was similar to the 1995 rate despite the appreciation of the dollar. Over the past year, most of the rise in the value of merchandise exports went to Canada and Latin America. Exports to Western Europe and Asia were only marginally higher than they were a year earlier.

In most of the major industrial countries abroad, real economic activity accelerated last year from a relatively weak performance in 1995. In the United Kingdom, real output growth firmed through the year, as growth in consumption spending rebounded from its low 1995 rate. In Germany and France, real GDP growth strengthened but was still too low to prevent a further rise in the unemployment rate in both countries. In Italy, output growth slowed as the rebound in the lira from its previous depreciation sharply reduced the growth of exports and depressed investment spending. For most continental European countries, further fiscal restraint is planned this year as governments hoping to participate in the third stage of European Monetary Union strive to meet the Maastricht Treaty's 1997 reference standard of a budget deficit no larger than 3 percent of GDP. In Japan, fiscal stimulus spurred economic expansion early last year; subsequently, slower private consumption, reduced inventory accumulation, and decreased government investment spending reduced output growth. In contrast, Canada's real output growth rose over 1996 as inventory adjustment was completed during the first half of the year and as exports strengthened.

Except in the United Kingdom, inflation pressures in the foreign industrial countries continued to decline or remained subdued during 1996. Consumer prices in Japan were flat. Consumer price inflation fell sharply in Italy and remained below 2 percent in Germany and France. In the United Kingdom, consumer prices excluding mortgage interest payments accelerated to an annual rate of more than 3 percent.

The Mexican economy continued on a course of recovery that returned GDP to its pre-crisis level

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in the fourth quarter of 1996. Increases in income and a strengthening of the price-adjusted value of the peso contributed to a reduction in the Mexican merchandise trade surplus over 1996. Argentina and Brazil also continued to recover from recessions. In Chile, real GDP growth moderated from the very high rate recorded in 1995 to about 6 percent in 1996. In Venezuela, windfall oil revenues softened the decline in real GDP in 1996 and improved the prospects for 1997.

In our major trading partners in Asia other than Japan, real output growth generally slowed from its 1995 pace, despite a pickup in many countries toward year-end in response to more accommodative monetary policies and a partial recovery in export markets. In China, the slowdown of growth to about 10 percent last year from the 12 to 14 percent annual rates experienced during 1992–94 reflected a substantial deceleration in investment spending, owing to China's efforts to reduce inflation by tightening central bank credit to state-owned enterprises and by restricting investment.

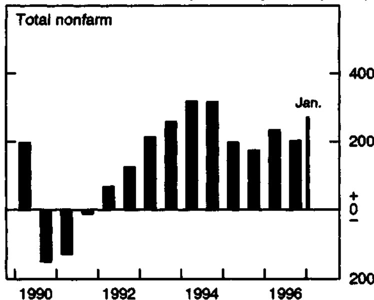
Consumer price inflation in Mexico was around 28 percent in 1996, significantly lower than the 1995 inflation rate of over 50 percent. Venezuela's inflation rate in 1996 exceeded 100 percent, but inflation in most other Latin American countries was at levels well under 10 percent. Inflation rates generally remained low in Asia.

The Labor Market

The number of jobs on nonfarm payrolls rose more than 2½ million from December 1995 to December 1996, an increase of about 2¼ percent. Employment gains were substantial in each quarter last year, and the labor market report for January of this year showed a further sizable expansion of payrolls.

Net Change in Payroll Employment

Thousands of jobs, average monthly change



Employment in the private service-producing sector, in which nearly two-thirds of all nonfarm workers are employed, increased about 3 percent during 1996. Moderate employment gains were posted in retail trade, transportation, and finance, and sizable gains in hiring continued in some other service-producing industries, such as data processing, computer services, and engineering and management. Job growth at suppliers of personnel—a category that includes temporary help agencies—was about 6½ percent, a touch faster than in 1995 but much slower than it had been over 1992–94; with the tightening of labor markets in the past couple of years, longer-lasting commitments in hiring may have come back into greater favor among some employers.

Employment changes among producers of goods were mixed in 1996. In construction, employment climbed about 5½ percent, to a new high that was almost 4 percent above the peak of the last business expansion. In manufacturing, increases in factory jobs through the latter part of 1996 were not sufficient to reverse declines that had taken place earlier in the year. On net, last year's loss of factory jobs amounted to about ½ percent, a shade less than the average rate of decline since 1979, the year in which manufacturing employment peaked. Manufacturers of durable goods boosted employment slightly last year, but many producers of nondurables implemented further job cuts. As in many other recent years, reductions in factory employment were accompanied by strong gains in worker productivity. Consequently, increases in output were sizable—the rise in the Federal Reserve's index of manufacturing production cumulated to 4¼ percent over the year.

Growth of output per hour in the nonfarm business sector as a whole picked up in 1996, rising about 1¼ percent over the year according to preliminary data. However, coming after a three-year period in which output per hour changed little, this rise left the average rate of productivity growth in the 1990s a bit below that of the 1980s and well below the average gains achieved in the first three decades after World War II. The sustained sluggishness in measured productivity growth this decade is difficult to explain, as it has occurred during a period when high levels of investment in new capital and extensive restructuring of business operations should have been boosting the efficiency of workers. Of course, measure-

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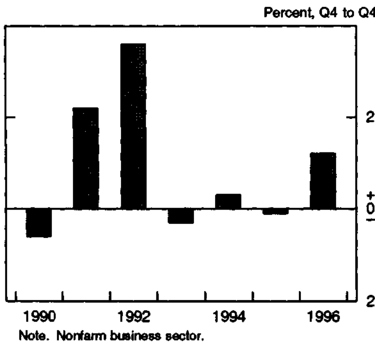
Change in Output per Hour

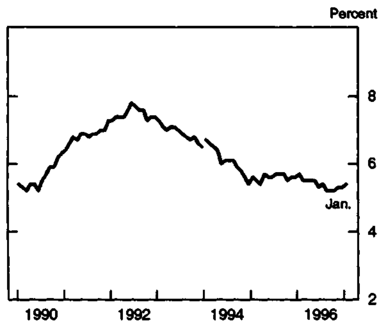


Note. Nonfarm business sector.

ment problems could be distorting the data. As a summary measure that relates aggregate output to aggregate input of labor, the nonfarm productivity index is affected by whatever deficiencies might be present either in adding up the nominal expenditures for goods and services in the economy or adjusting those expenditures for price change. A considerable amount of recent research suggests that growth of output and productivity is in fact understated, but whether the degree of understatement has been increasing over time is less clear.

In contrast to the experience of most other recent years, this past year's rise in employment was accompanied by a sustained pickup in the labor force participation rate. The rise in participation boosted the labor supply and helped to relieve pressures on the labor market. Nonetheless, hiring during 1996 was sufficient to reduce the civilian unemployment rate from a December 1995 rate of 5.6 percent to a December 1996 rate of 5.3 percent. In January of this year, the rate remained low, at 5.4 percent.

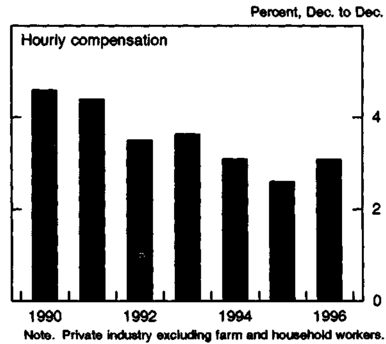
Civilian Unemployment Rate



Note. The break in data at January 1994 marks the introduction of a redesigned survey; data from that point on are not directly comparable with the data of earlier periods.

Tightness of the labor market appears to have exerted some upward pressure on the cost of labor in 1996, even as some workers continued to express anxiety about job security. The employment cost index (ECI) for the private nonfarm sector of the economy showed compensation per hour moving up 3.1 percent over the year. The index had risen 2.6 percent in 1995. The step-up in hourly pay increases was to some extent the result of a hike in the minimum wage that took place at the start of October. More generally, however, businesses probably had to boost hourly compensation either to attract workers or to retain them at a time when alternative employment opportunities were perceived to be more widely available.

Change in Employment Cost Index



Note. Private industry excluding farm and household workers.

As in 1995, increases in hourly compensation in 1996 came more as wage and salary increases than as increases in fringe benefits. According to the ECI, the rise in wage rates for workers in the nonfarm sector amounted to nearly 3½ percent this past year after a rise of 2¾ percent in 1995. By contrast, the ECI measure of the hourly cost of benefits rose only 2 percent, slightly less than it did in 1995 and much less than it rose on average over the past decade. Increases in the cost of benefits have been held down

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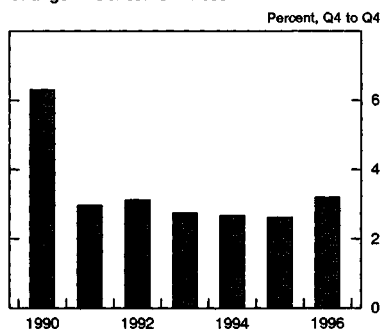
in recent years by reduced inflation for medical services and by the actions that many firms have taken to shift employees into managed care arrangements and to require them to assume a greater portion of the cost of health insurance and other medical benefits.

Prices

The consumer price index rose more rapidly than in 1995, but the step-up was concentrated in the food and energy sectors—areas in which prices were affected by supply limitations that seemed likely to be of temporary duration. The CPI excluding food and energy—often called the "core" CPI—rose just a touch more than 2½ percent after increasing 3 percent during 1995. Both the total CPI and the core CPI have been affected in the past two years by technical improvements implemented by the Bureau of Labor Statistics that are aimed at obtaining more accurate readings of price change; the rise in the CPI in 1996 would have been somewhat greater if procedures used through 1994 had not been altered.

Other price indexes generally rose less rapidly than the CPI. Like the overall CPI, the chain type price index for personal consumption expenditures (PCE) accelerated somewhat in 1996, but its rate of rise, shown in the accompanying table, was significantly lower than that of the CPI. The two measures of consumer prices differ to some degree in their weights and methods of aggregation. They also differ some-

Change in Consumer Prices



Note. Consumer price index for all urban consumers.

what in their selection of price data, with the PCE measure relying on alternative data in some areas in which the accuracy of the CPI has been questioned. The chain type price index for gross domestic purchases, which takes account of the prices paid by businesses and governments as well as those paid by consumers, moved up 2¼ percent during 1996, about the same as the percentage rise during 1995. By contrast, price measures associated with GDP decelerated in 1996 to thirty-year lows of around 2 percent or less. Conceptually, the GDP measures are indica-

Alternative Measures of Price Change

Percent

Price measure	1995	1996
Fixed weight		
Consumer price index	2.7	3.2
Excluding food and energy	3.0	2.6
Chain type		
Personal consumption expenditures	2.1	2.5
Excluding food and energy	2.3	2.0
Gross domestic purchases	2.3	2.2
Gross domestic product	2.5	2.1
Deflator		
Gross domestic product	2.5	1.8

Note. Changes are based on quarterly averages and are measured to the fourth quarter of the year indicated from the fourth quarter of the previous year.

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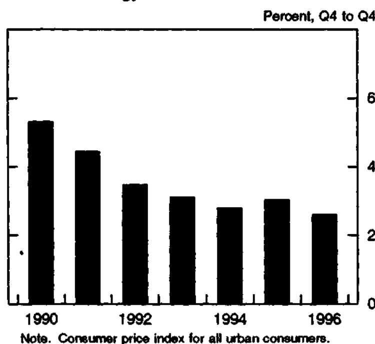
tive of price changes for goods and services that are produced domestically rather than price changes for goods and services purchased domestically—foreign trade accounting for the difference.

The 1996 outcomes for all these measures reflected an economy in which inflation pressures were muted. Sharp declines in non-oil import prices during the year lowered input costs for many domestic firms and likely caused other firms to restrain their product prices for fear of losing market share to foreign competitors. Also important, in all likelihood, were the favorable imprints that several years of moderate and relatively stable rates of inflation have left on inflation expectations. Despite the uptick in hourly compensation and adverse developments in the food and energy sectors, survey data showed little change in consumers' expectations of inflation, and private forecasters' views of the prospects for prices held steady. Businesses commonly described the situation as one in which competitive pressures were intense and the "leverage" for raising prices simply was not present.

Change in Consumer Prices Excluding Food and Energy



Note. Consumer price index for all urban consumers.

Food and energy prices were the exceptions. In the food sector, steep increases in grain prices in 1995 and the first few months of 1996 caused production adjustments among livestock farmers and substantial price increases for some livestock products. Later in the year, grain prices fell back, but livestock production could not recover in time to prevent significant price advances for some retail foods. Consumer prices for pork, poultry, and dairy products registered their largest increases in several years. Retail beef prices also rose but only moderately: Expansion of the cattle herd in previous years had laid the groundwork for a high flow of product to consumers, and herd reductions that occurred in 1996 augmented that flow. Elsewhere in the food sector, acceleration was reported in the price index for food away from home—a category that has a weight of almost 40 percent in the CPI for food; the rise in the minimum wage appears to have been an important factor in the acceleration. All told, the 1996 rise in CPI food prices amounted to 4¼ percent, the largest increase since 1990.

The energy sector was the other major part of the economy in which significant inflation pressures were evident this past year. Crude oil prices, which had started firming in the latter part of 1995, continued on an upward course through much of 1996, rising more than 30 percent in total. Stocks of crude oil and petroleum products were tight during the year, even after allowing for an apparent downward trend in firms' desired inventories. Inventory building was forestalled by production disruptions at refineries, a string of weather problems here and abroad that boosted fuel requirements for heating or cooling, and a reluctance of firms to take on inventories that seemed likely to fall in value once renewed supplies from Iraq became available. Natural gas, too, was in tight supply at times, and its price surged. With retail prices of gasoline, fuel oil, and natural gas all moving up substantially, the CPI for energy rose about 7½ percent over the four quarters of 1996, the largest increase since the Gulf War.

The CPI for goods other than food and energy rose 1 percent during 1996, one of the smallest increases of recent decades. As in 1995, price increases for new vehicles were moderate last year, and prices of used cars turned down after several years of sizable advances. Prices of apparel and house furnishings also fell; these prices, as well as the prices of vehicles, may have been heavily affected by the softness of import prices. Moderate increases were the rule among most other categories of goods in the CPI. In the producer price index, prices of capital equipment rose less than ½ percent over 1996; computer prices continued to plunge, and the prices of other types of equipment rose moderately, on balance. Materials prices were weak: Prices of intermediate materials excluding food and energy declined about 1¼ percent from the fourth quarter of 1995 to the final quarter of 1996, and the producer price index for crude materials excluding food and energy dropped more than 6½ percent over that period. Productive capacity was adequate among domestic producers

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of materials, and supplies of many materials were readily available at competitive prices on the world market.

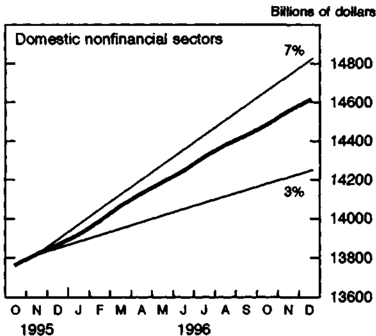
The CPI for non-energy services increased 3¼ percent in 1996. The rise was somewhat smaller than the increases of most other recent years. Prices of medical services decelerated for a sixth consecutive year, and increases in the cost of shelter were held down by another year of moderate advances in residential rent and owners' equivalent rent. Large increases were evident only in scattered categories: Airfares posted a large increase, and educational costs, maintaining a long-established trend, continued to rise quite rapidly relative to prices in general.

Financial Developments

Debt

Growth of the debt of nonfinancial sectors slowed slightly last year, to 5¼ percent. The growth of household sector debt dropped from 8¼ percent to 7½ percent, a deceleration accounted for entirely by a sharp slowing of consumer credit. The expansion of business borrowing was held below its 1995 pace by an increase in internally generated funds, but at 5¼ percent, it was faster than in any other year since 1989. Its strength reflected robust spending, extremely favorable credit conditions, and financing needs associated with a high level of mergers and acquisitions. Federal government debt grew 3¾ percent, the lowest rate in more than two decades. The debt outstanding of the state and local sectors was unchanged.

Debt: Annual Range and Actual Level



The Household Sector. Consumer credit grew 8¼ percent last year, just a bit over half the pace of the preceding two years. The sharp retrenchment likely reflected the burdens associated with a substantial accumulation of outstanding consumer debt over recent years as well as some tightening of lending terms and standards by commercial banks, particularly with respect to credit cards.

The slowing in consumer credit growth also was associated with a shift toward increased use of home equity loans. These loans were marketed vigorously, particularly by finance companies, in part as a vehicle for consolidating credit card and other outstanding consumer debt. Some of the growth in home equity loans reflected moves by finance companies and banks into the sub-prime market—lending either to higher-risk customers or on terms entailing unusually high loan-to-value ratios, or both. The push to expand home equity lending last year offset to some degree the effect of tighter lending standards and terms on credit cards and other forms of consumer credit.

The shift toward home equity loans, along with a strong housing market, led to a pickup in mortgage debt growth last year to a rate of 7½ percent, the largest advance since 1990. Mortgage borrowing for home purchases was restrained surprisingly little by the increase in interest rates over the first half of the year. As noted previously, many borrowers were able to put off, at least for a time, much of the impact of the increase in rates by shifting to adjustable-rate mortgages, the rates on which rose much less last year than those on fixed-rate mortgages.

Although the growth of household sector debt fell off a bit from the pace of recent years, it still exceeded that of disposable income. With loan rates up on average for mortgages and down only a little on consumer loans, debt service burdens continued to rise last year, and some households experienced difficulties servicing certain kinds of debt. Delinquency rates on banks' consumer loans, particularly credit card loans, posted a second year of considerable increase, although they remained below levels in the early 1990s. At finance companies that are subsidiaries of automakers, auto loan delinquency rates rose to very high levels; but this rise apparently resulted in large part from a business strategy to compete in the vehicle market by easing lending standards. Auto loan delinquency rates at commercial banks also rose but remained well within historical ranges. Delinquency rates on residential mortgages remained low.

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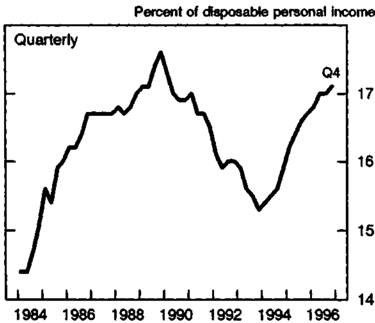
Household Debt Service Burden

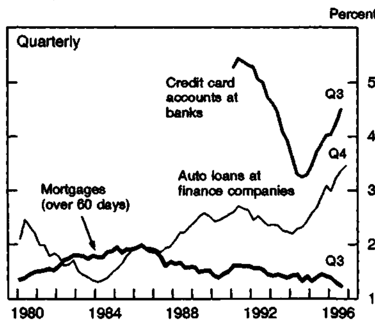


Note. Debt service is the sum of required interest and principal payments on consumer and household-sector mortgage debt.

In the segment of the finance company market that deals in "sub-prime" auto loans, some problems emerged last month. A small firm in this market defaulted on its commercial paper after it restated earlier earnings at lower levels, and another firm filed for bankruptcy. Although the share prices of these and other firms primarily engaged in sub-prime lending declined along with their earnings outlook, this sector constitutes a very small part of the overall auto loan market, and the implications for the availability of credit to the household sector overall appear slight.

Charge-off rates on consumer loans rose at banks in 1996 to around the peak levels of the last recession in 1990–91. According to Federal Reserve surveys of senior loan officers, banks had anticipated some deterioration in the quality of their consumer loan portfolios last year, but they were surprised by its extent. These surveys also showed that banks considered the rate of charge-offs last year to be high relative to the level of delinquencies and that the credit-scoring models most banks use to evaluate consumer lending decisions have tended to be too optimistic. An important reason for the high level of charge-offs and the apparent shortcomings of the credit-scoring models was a 30 percent increase in personal bankruptcies. This surge stemmed in part from changes in the bankruptcy code that became effective at the beginning of last year against a backdrop of an apparently reduced stigma associated with this method of dealing with financial problems. Banks responded to the deterioration in their consumer loan portfolios by tightening standards and terms, especially on credit cards. In contrast, banks eased terms and conditions on home equity loans.

Delinquency Rates on Household Loans



Despite the rise in delinquencies on consumer debt, household balance sheets appear healthy overall, as growth of household assets over the past two years has more than kept pace with the growth of debt. Although year-end balance sheet figures are not yet complete, the net worth of households appears to have risen approximately $5 trillion from the end of 1994 to the end of 1996, an amount that is equal to almost a full year's personal disposable income. Roughly two-thirds of that gain has been accounted for by the surge in the prices of corporate shares, which has lifted the value of a wide range of household investments, not only directly held stocks but also assets held in other forms such as pension plans. The ratio of household net worth to personal disposable income continued to climb this past year, moving to its highest level in recent decades.

The Business Sector. Although many interest rates rose last year, businesses continued to find credit readily available and at favorable terms. This accommodation likely resulted in part from the strong financial condition of this sector, reflected in minimal delinquency rates on bank loans to businesses and very low default rates on corporate bonds, including those of low-rated issuers. With securitization of household debt instruments proceeding apace and with high levels of capital, banks appeared to have ample room on their balance sheets for business loans. This situation encouraged the development of a highly competitive lending environment in which banks further eased a variety of credit terms, such as covenants and markups over base rates. In capital markets, interest rate spreads of private debt instru-

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ments over Treasuries narrowed, particularly in the case of high-yield bonds. Surveys by the National Federation of Independent Business revealed a rising tendency of small businesses to borrow over 1996, with credit availability reported to be in a range more favorable than at any time in the current economic expansion.

On a gross basis, a pickup in bond issuance by nonfinancial firms last year was accounted for mainly by speculative-grade offerings, likely in part a reaction to the improved pricing. In the fourth quarter, however, investment-grade issuance was substantial, responding to the decline in interest rates that began in late summer. Commercial paper declined in the final months of the year, primarily because of paydowns from bond proceeds, but bank lending to businesses was strong, owing in some part to robust merger activity. Despite a marked increase in gross stock issuance—with strong gains both for initial public offerings and for seasoned offerings—equity continued to be retired on net last year, as merger activity remained brisk and businesses used ample cash resources to repurchase their outstanding shares.

The Government Sector. The growth of federal debt was held down in 1996 by legislative constraints on spending and by the boost to tax receipts from both the stronger economy and a booming stock market. Two years of contraction of state and local government debt ended last year. The declines had occurred as issues that were prerefunded earlier in the decade, when interest rates were unusually favorable, matured or became eligible to be called. Pre-refunded debt continued to be called last year, albeit at a reduced pace, but this decline was just offset by gross issuance, which picked up.

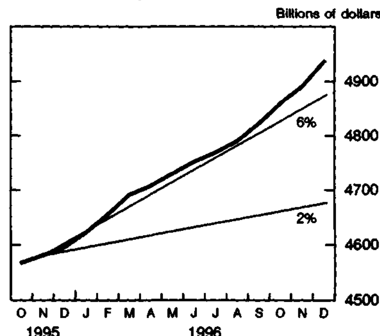
Depository Intermediation. The expansion of depository credit slowed last year, entirely reflecting a slower advance in bank credit. Growth at thrift institutions picked up, benefiting from strong demand for residential mortgages and improved capital positions. Growth of commercial bank loans moderated, as loans to businesses and, especially, consumers decelerated from elevated rates of growth in 1995. Bank portfolio expansion also appears to have been damped somewhat by a faster pace of asset securitization, likely spurred by receptive capital markets. For example, real estate loan growth at banks was a subdued 4 percent last year, despite a robust housing market and a pickup in commercial real estate. At the same time, outstanding securities backed by mortgage pools expanded at a $179 billion annual rate in the first three quarters of last year, well above the pace of 1995. Commercial banks are a major source of securitized mortgages. The outstanding amount of consumer credit that had been securitized by banks also rose at a brisk pace last year, although not so rapidly as in 1995. As a result of the slowing of bank credit, the share of last year's advance in nonfederal debt that ended up on the books of depositories fell to about 38 percent, down from around 44 percent in the preceding two years.

The balance sheets and operating results of depositories remained strong in 1996. Bank profits through the third quarter were at historically high levels for the fourth consecutive year, reflecting the maintenance of relatively wide interest rate margins, further loan growth, and substantial fee income related to sales of mutual funds as well as to securitization and other off-balance-sheet activities. As of the third quarter, almost 99 percent of commercial bank assets were held at banks classified as "well capitalized." Underlying thrift profits were also stronger last year. However, profits at thrift institutions and at banks with deposits insured by the Savings Association Insurance Fund (SAIF) were held down temporarily by a special assessment on deposits to recapitalize SAIF. (Some bank deposits are SAIF-insured because of mergers with thrifts or acquisitions of them.)

The Monetary Aggregates

Despite the slowing of depository credit, growth of the broader monetary aggregates strengthened last year: M3 expanded 7 percent, up 1 percentage point from 1995 and also 1 percentage point above the upper end of its 2 to 6 percent annual range. M2 grew

M3: Annual Range and Actual Level



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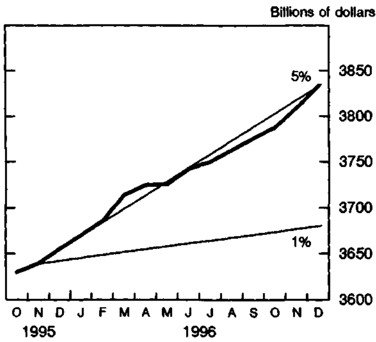
M2: Annual Range and Actual Level

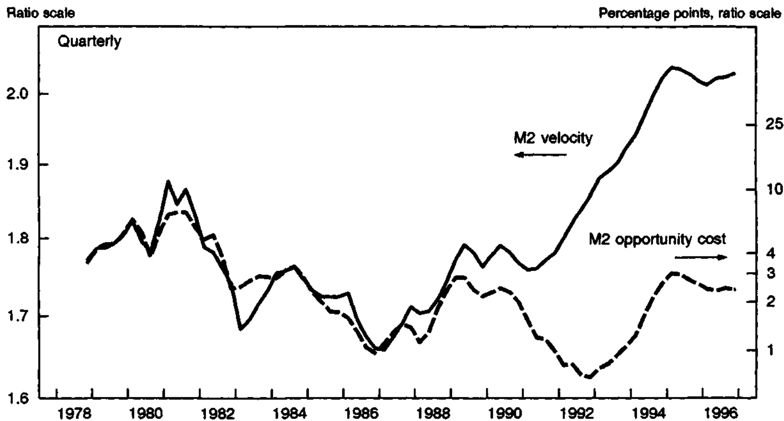


4½ percent, up ½ percentage point and in the upper portion of its 1 to 5 percent range. As noted in Section 1, the ranges for monetary growth last year had been chosen to be consistent with approximate price stability and a sustainable rate of real economic growth, rather than as indicators of the range of money growth rates likely to prevail under expected economic conditions.

The acceleration of M3 was caused partly by a shift in the way banks financed their credit—specifically, substituting issuance of large time deposits for borrowings from offices abroad. Both foreign and domestically chartered banks paid down net borrowing from foreign head offices and branches last year. For domestic banks, this paydown may have been related to the reduction to zero of insurance assessments on deposits, beginning with the last quarter of 1995. In addition, the greater growth of M3 relative to that of M2 reflected the need to fund particularly strong loan growth at U.S. branches and agencies of foreign banks, which do not offer the retail accounts that dominate deposits in M2.

Growth of both M2 and M3 was supported again last year by continuing robust advances in money market mutual funds (MMMFs). Because the yields on these funds are based on the average return earned on their assets, they lag changes in yields on new market instruments; thus, the funds tend to attract additional inflows when market rates are falling. Accordingly, MMMFs advanced most rapidly in the early part of last year, when the monetary easings of December and January pulled down short-term rates, and also later in the year, when short-term rates were again declining. However, these instruments expanded briskly even in the third quarter, when short-term rates were rising, suggesting that part of the attractiveness of MMMFs is the convenience they offer those investors engaged in moving funds in and out of stock and bond mutual funds, which expanded

M2 Velocity and the Opportunity Cost of Holding M2



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

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at a record pace last year. In addition, institution-only funds seem to be having considerable success in marketing cash management programs that capture excess cash of corporations and municipalities. Likely reflecting the attractiveness of money market and capital market mutual funds last year, deposits in M2 actually showed little growth in 1996. Retail deposit growth also may have been damped by a lack of aggressive pricing of deposits on the part of banks, as demand for their loans slipped and they apparently found it cheaper to finance a larger share of loan originations through securitizations and large time deposits.

The behavior of M2 relative to income last year, as summarized by its income velocity, again bore a fairly systematic relationship to M2's opportunity cost—the return on M2 assets relative to yields available on alternative instruments. The relationship of velocity to opportunity costs was reasonably stable historically, but it broke down in the early 1990s, a period characterized by extensive restructuring of balance sheets by households, businesses, and banks. In the process, M2 velocity rose substantially and, apparently, permanently. Since 1993, velocity no longer appears to be shifting higher, and M2 velocity and opportunity costs are moving together about as they did before 1990. However, the recent period of relative stability in this relationship has been too short for the Federal Reserve to place increased reliance on M2 as a guide to policy at this time.

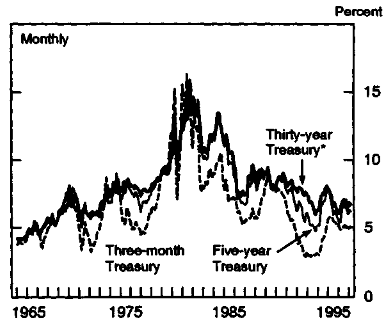
M1 contracted 4½ percent last year, as the pace at which new arrangements were established to sweep reservable retail transactions deposits to nonreservable nontransaction accounts accelerated. The initial amounts removed from transaction accounts by sweep arrangements established last year amounted to $116 billion, compared with $45 billion in 1995. M1 continued to be supported by currency growth last year, when foreign demands, which were depressed earlier in the year partly in anticipation of the new $100 bill, picked up in the second half. Adjusted for the initial amounts removed from transaction accounts by sweep arrangements, M1 grew 5¼ percent last year. The sweeping of transaction deposits contributed to a contraction of almost 12 percent in required reserves—twice the rate of decline of the previous year. The monetary base decelerated only a little, however, as growth of its major component, currency, was little changed between 1995 and 1996.

Continued declines in the levels of required reserves have the potential to impinge on the Federal Reserve's ability to exert close day-to-day control over the federal funds rate—the overnight rate on reserves traded among depository institutions. Depositories hold balances at Reserve Banks to meet daily clearing needs in addition to satisfying statutory reserve requirements. At low enough levels, reserve balances may provide inadequate protection against adverse clearings, and banks' attempts to avoid overdrafts could generate highly variable daily demands for balances at the Federal Reserve and a volatile federal funds rate. To date, however, no serious problems have emerged, in part because the substantial drop in depositories' required reserve balances attributable to sweeps has been partially offset by increases in their holdings of required clearing balances—an arrangement whereby depositories pay for services provided by the Federal Reserve through the holding of specified amounts in reserve account balances. In addition, advances in banks' techniques of monitoring balances at the Federal Reserve and gauging their clearing needs have enabled them to operate efficiently and smoothly at relatively low levels of balances. Sweeps have had an effect on Federal Reserve earnings and the amounts it remits to the Treasury. The decline in reserve balances of around $12 billion owing to sweeps must be matched by an accompanying lower level of Treasury securities on the books of Reserve Banks. The Federal Reserve continues to monitor sweep activity closely.

Interest Rates, Equity Prices, and Exchange Rates

Interest Rates. Declines in interest rates during the second half of last year on evidence that eco-

Selected Treasury Rates



*The twenty-year Treasury bond rate is shown until the first issuance of the thirty-year Treasury bond in February 1977.

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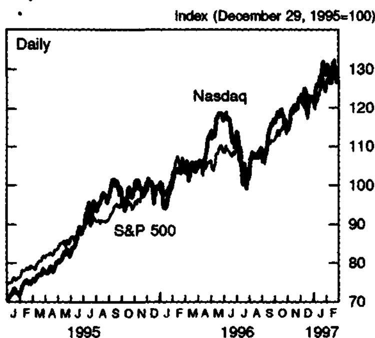
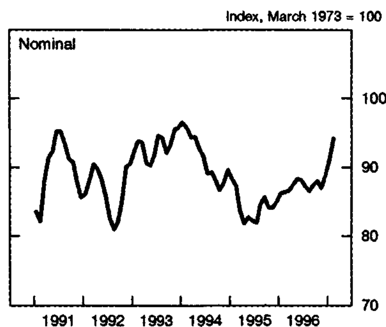
nomic growth had moderated only partially reversed the increases over the first half. Reflecting the surprising strength in economic activity last year, longer-term Treasury rates rose on balance on the order of ½ percentage point over the year, and intermediate rates were up somewhat more. Spreads between most private rates and Treasuries narrowed markedly last year, reflecting the high quality of business balance sheets. Municipal rates moved up comparatively little over the first half of 1996 as earlier relative increases in these yields associated with discussions of fundamental tax reform were reversed when the likelihood of such changes to the tax code diminished. Movements in interest rates over the year appeared to be basically in their real component, as inflation expectations were little changed, according to surveys.

Equity Prices. The substantial rise in equity prices last year was only a bit below that registered in 1995. However, in contrast to 1995, when bond rates declined substantially, the equity gains last year came despite the net rise in bond rates. Corporate earnings were robust last year, but their advance fell short of share price increases, and price-earnings ratios rose to unusually high levels; dividend-price ratios were even more out of line with historical experience. Market participants appear to be anticipating further robust earnings growth, and they also seem to be requiring much less compensation for the extra risk of holding equities compared to, say, Treasury bonds. Such evaluations may be based on a perceived environment of persisting low inflation and balanced economic growth that would lower the odds of disruptions to economic activity. Other asset prices

Major Stock Price Indexes



Weighted Average Exchange Value of the U.S. Dollar



Note. In terms of the currencies of the other G-10 countries. Weights are based on 1972–76 global trade of each of the ten countries.

were generally subdued. Commodity prices were flat to down. Commercial real estate prices, although no longer falling, rose at little more than the rate of inflation. Residential real estate prices increased moderately.

Exchange Rates. The foreign exchange value of the dollar in terms of the currencies of the other G-10 countries rose about 4 percent during 1996. When measured in terms of the currencies of a broader group of U.S. trading partners and adjusted for differences in consumer price inflation, the appreciation of the dollar last year was also about 4 percent. Much of the rise in the exchange value of the dollar occurred during the first half of the year. Indications of greater-than-expected underlying strength in the U.S. economy and signs of weakness in some European economies in the first two quarters reinforced market expectations that U.S. monetary policy was less likely to be eased than was policy in the other industrial countries. These expectations boosted U.S. long-term interest rates relative to those abroad and contributed to upward pressure on the dollar. The dollar fluctuated somewhat from June through December but on balance changed little. Over the course of 1996, the dollar appreciated 12 percent in terms of the yen and 7¾ percent in terms of the mark. During the first weeks of 1997, the dollar's average value against the G-10 currencies has again moved up, appreciating about 7 percent since the end of December, as economic data have suggested additional strength in the U.S. economy and have raised questions about

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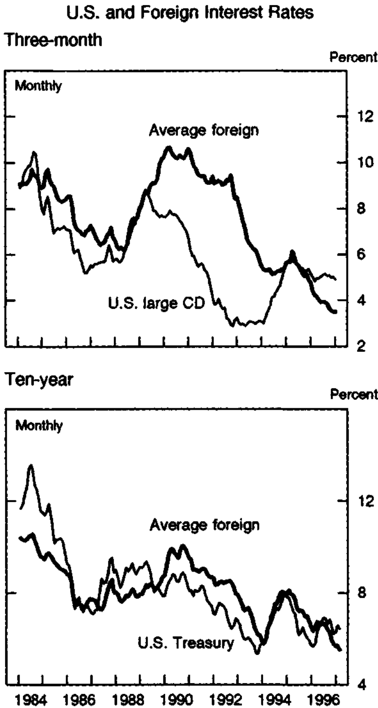

Note. Average foreign rates are the global trade-weighted average, for the other G-10 countries, of yields on instruments comparable to U.S. instruments shown.

the vigor of economic expansions in several foreign industrial countries.

On average, yields on ten-year government securities in the major foreign industrial countries fell about 80 basis points last year, with most of the decline coming in the second half. In Italy, long-term rates declined much more, about 375 basis points, in response to low growth in real output, substantial progress in lowering inflation, and sizable, credible measures to reduce the government deficit. In contrast, long-term rates in the United Kingdom rose slightly as the economy strengthened. Rates in Japan rose early in the year as the economy spurted, but subsequent indicators of a weakening expansion caused rates to turn back down; over the year, they declined about 40 basis points on net. Long-term rates abroad have moved down slightly further so far this year. Short-term market rates in the foreign industrial countries on average declined about 120 basis points during 1996. Except in Japan, official central bank lending rates were lowered in the foreign G-10 countries last year, contributing to the decline in market rates.

Equity prices in most industrial countries rose strongly last year. The major exception was Japan, where prices on balance fell slightly. The general decline in long-term interest rates abroad and moves toward monetary ease were among the factors contributing to the upward movement in stock prices.

The dollar appreciated in nominal terms about 2½ percent on balance against the Mexican peso during 1996, with much of that appreciation coming over a few weeks in October. After fluctuating in a narrow range for most of the year, the Mexican peso depreciated in terms of the dollar when market participants became concerned about the loss of competitiveness of Mexican exports during the year and about the partial nature of the government's planned privatization of the petrochemical industry. Peso interest rates rose in October and November, but have since more than retraced that increase as the peso has stabilized. In January, Mexican officials repaid all remaining outstanding obligations to the Exchange Stabilization Fund of the U.S. Treasury, completing repayment to the United States of all borrowings that were made following the peso crisis in late 1994; a partial early repayment was made to the International Monetary Fund as well.

In the first three quarters of 1996, large increases were reported in both foreign ownership of assets in the United States and U.S. ownership of assets abroad. Over the same period, foreign official assets in the United States increased almost $90 billion. Part of this increase was associated with exchange market intervention by the Japanese authorities to counter a brief strengthening of the exchange value of the yen early in the year, but a larger part reflected the repurchase of reserves by several European countries whose currencies strengthened against the mark. About half reflected increases in reserves of newly industrializing countries.

Private foreigners also added substantially to their assets in the United States in the first three quarters of 1996. Net purchases of U.S. Treasury securities by private foreigners amounted to $85 billion through September, and net purchases of corporate and government agency bonds were equally large. Foreign direct investment in the United States surged to

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a record $71 billion in the first three quarters, reflecting numerous mergers and acquisitions of U.S. companies by foreigners.

U.S. private investors also added rapidly to their holdings of foreign assets in the first three quarters of 1996. In contrast to foreign investors in the United States, U.S. portfolio investors favored foreign stocks over bonds. Net purchases in Japan were particularly large in the first half of the year. In addition, U.S. direct investment abroad remained strong, reflecting acquisitions and continued privatizations of foreign firms.

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Growth of Money and Debt
Percent

Period		M1	M2	M3	Domestic nonfinancial debt
Annual[1]					
1980		7.5	8.7	9.6	9.5
1981		5.4 (2.5)[2]	9.0	12.4	10.2
1982		8.8	8.8	9.7	9.9
1983		10.3	11.8	9.5	11.9
1984		5.4	8.1	10.8	14.5
1985		12.0	8.6	7.7	14.2
1986		15.5	9.1	9.0	13.2
1987		6.3	4.2	5.8	10.0
1988		4.3	5.7	6.3	9.0
1989		0.5	5.2	4.0	7.9
1990		4.1	4.1	1.8	6.9
1991		7.9	3.1	1.2	4.6
1992		14.4	1.8	0.6	4.7
1993		10.6	1.3	1.1	5.1
1994		2.5	0.6	1.7	5.2
1995		-1.6	4.0	6.2	5.5
1996		-4.6	4.6	6.9	5.3
Quarterly (annual rate)[3]					
1996	Q1	-3.5	5.3	6.6	5.0
	Q2	-1.4	4.5	6.3	5.7
	Q3	-6.5	3.4	5.4	5.3
	Q4	-7.4	5.0	8.5	4.9

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

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