

CONDUCT OF MONETARY POLICY

HEARING
BEFORE THE
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FINANCIAL SERVICES
HOUSE OF REPRESENTATIVES
ONE HUNDRED FIFTH CONGRESS
FIRST SESSION

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CONDUCT OF MONETARY POLICY

WEDNESDAY, JULY 23, 1997

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to call, at 10:10 a.m., in room 2128, Rayburn House Office Building, Hon. James A. Leach, [chairman of the committee], presiding.

Present: Chairman Leach; Representatives McCollum, Roukema, Baker, Lazio, Castle, Snowbarger, Foley, LaFalce, Vento, Frank, Gutierrez, Roybal-Allard, Barrett, Velázquez, Watt, Hinchey, Bentsen, Jackson, Kilpatrick, Maloney of Connecticut, Hooley, Carson, and Sanders.

Chairman LEACH. The hearing will come to order.

On behalf of the committee, I would like to welcome our distinguished first panel of witnesses. I would particularly like to extend my appreciation to Vice Chairman Rivlin and Governor Meyer for adjusting their vacation plans in order to testify before us this morning.

By way of background, the committee has not traditionally held two days of hearings in conjunction with the requirement of the semiannual reports to Congress under the Humphrey-Hawkins Act. Rather, we have held one day of hearings in which Chairman Greenspan has testified before the Subcommittee on Domestic and International Monetary Policy, so ably led by Representatives Mike Castle and Floyd Flake.

But, as Members are aware, April 17, I received a letter from the Minority requesting that the committee convene an oversight hearing before the next Federal Open Market Committee meeting scheduled for May 20. The purpose of the requested hearing was to examine the rationale and economic assumptions of the Federal Reserve's decision to raise the Federal funds target by 25 basis points from 5.25 to 5.5 percent.

As I wrote in my April 17 response—and I ask the indulgence of my colleagues while I quote—“Congress has, by statute, set the goals of monetary policy to be pursuit of maximum employment and stable prices. And through the Humphrey-Hawkins mechanism, the Federal Reserve reports semiannually to the committee on the state of the Nation's economy. The precedent of holding a hearing on every quarter-point shift in interest rates is troubling, particularly given that U.S. economic expansion is entering its seventh consecutive year with high levels of employment and relatively low inflation. Whatever one's view of the threat of inflation at this time, the case for political second-guessing must be viewed

against the backdrop of rather impressive Fed monetary policy stewardship developed over the past decade within the constraints of a deficit-ridden fiscal policy.”

The letter went on to note that there is a tradition of independence at the Fed that has protected the economy; nevertheless, the Fed is accountable to Congress and ultimately the American people. Fed policy should never be immune from criticism. In this overall context, my sense is that it would be ill-advised to rush to judgment, and that the most appropriate time to express its perspective on monetary policy is the next regularly scheduled Humphrey-Hawkins hearing.

The letter concluded in agreement with the Minority's suggestion that outside experts from business, labor, and academia be invited to present their views on monetary policy, and pledged on behalf of the Majority that we would be happy to work with them on developing a witness list.

This hearing fulfills that commitment. We have consulted closely with the Minority in selecting witnesses for this hearing. In addition to representatives from the Federal Reserve, we will be hearing from two additional panels of distinguished witnesses representing a wide diversity of views.

In thinking through the issue of alternative perspectives, I want the Minority to know that I think Mr. Frank is absolutely correct in suggesting that other views ought to be heard from, especially when a change in Fed policy appears to be underway. I also think that periodically, perhaps every two years, other perspectives should be placed on the table, even when no significant change in monetary policy is contemplated.

As for the quarter-point bump-up in the Federal funds rate that took place in March, it is interesting to note that, as reflected in Treasury issuances, 10-year note rates have decreased 43 basis points and 30-year bond rates have decreased 49 basis points since the March decision of the Federal Open Market Committee. In other words, the most meaningful rates in the economy have declined significantly as the Fed has made clear that its attention to inflation concerns is vigilant.

As for the economy at large, the current economic expansion has been extraordinarily steady, albeit unspectacular. The unemployment rate is down to 5 percent, while inflation is running at an annual rate of 1.5 percent in the first 6 months of this year. If the Consumer Price Index does, in fact, overstate inflation by as much as 1 percent, then the United States may well be close to achieving functional price stability, an extraordinary achievement and vindication of almost two decades of restraint of monetary policy.

Although short-term interest rates are high in real terms, long-term rates, which affect particularly industries like housing, have fallen from a peak of just over 7 percent to approximately 6.5 percent. At the same time, U.S. equity markets are enjoying one of the greatest bull runs in history, with a Dow Jones Industrial Average at a peak of over 8,000, up nearly 25 percent since Chairman Greenspan cautioned about “irrational exuberance” late last year.

More broadly, the pessimistic predictions of American economic decline, so much in vogue in the 1980's, have proven to be without merit. Our climate of macroeconomic stability, corporate competi-

tiveness, worker productivity, modern financial markets, and the culture of entrepreneurship make the U.S. economy the envy of the world.

Why has the United States enjoyed such steady growth and low inflation at levels of relatively high employment—what appears to be becoming near full employment? My own sense is, the Fed enjoys such credibility in financial markets that its commitment to an anti-inflation policy is not in doubt. Likewise, the recent congressional emphasis on fiscal prudence and deficit reduction may be helping to raise the long-term growth of output in the economy.

Nevertheless, Members and, more importantly, the public, have many legitimate questions about the conduct of monetary policy. How long can we maintain the current expansion? Is expansion best maintained through a modest dose of monetary restraint or loosening of the reins of the economy? Can the United States grow faster without jeopardizing stable prices? What is the relationship between employment and inflation? Can the Fed accountability be increased without undermining its independence? And what is the appropriate policy and oversight role of Congress regarding the Fed's conduct of monetary policy? I hope our distinguished witnesses can answer those questions and more.

[The prepared statement of Hon. James A. Leach can be found on page 114 in the appendix.]

Chairman LEACH. At this point, I would like to turn to Mr. LaFalce.

Mr. LAFALCE. I thank the Chairman very much.

Last April, Representative Frank and I initiated a request to you from the committee Democrats for a hearing to examine the rationale and economic assumptions behind the Federal Reserve's decision on March 25 to raise the Federal funds target rate. You responded that such an examination was unnecessary at that time and should wait until the regularly-scheduled Humphrey-Hawkins hearings in July. I am very, very pleased that you have scheduled today's hearing with the full range of economic observers.

For those most directly affected by interest rate hikes, the Federal Open Market Committee did not see a need to raise rates when it met in May and earlier this month. Nonetheless, the basis for our request was, and remains, sound. It is critical that components of the economy and their interrelationship be understood and considered when judgments about interest rate bubbles are rendered.

Yesterday, Chairman Greenspan testified that our economy's recent performance has truly been exceptional, and that the reasons for the performance may well lie much deeper than the preemptive actions of the Fed, deregulation of certain industries, and congressional and Administration budget-cutting efforts. Chairman Greenspan proceeded to list a number of influences that have contributed to the economy's unusually good performance.

Nonetheless, he did warn that caution and alertness to inflationary pressures are always warranted. Inevitably he said that a change at some point in the tools of monetary policy—and that is the Federal funds rate—will be required to foster sustainable growth and low inflation, and that is exactly why the hearing this morning is important, to understand both the impact of Federal

Reserve policy and the range of considerations that must be part of the analysis that defines monetary policy.

It is my personal view that any interest rate increase should be preceded by a fairly clear set of consistent indicators that inflation is about to ignite. Despite arguments about lead time and preemptive necessity, I do not think it is too late to take effective anti-inflationary action when there are clear indications that inflation is on the horizon rather than seeing some possible signs of inflation in the distant future. I believe it is important to allow economic growth benefits to reach workers. Choking off economic growth just when small wage increases are beginning to help low-wage workers will not begin to correct the decline in real wages that for many workers are still below the 1989 peak.

We should be very reluctant to take actions that will slow the economy, the economy where people live and work in neighborhoods and factories, especially if we are motivated to do so because of our concerns about irrationally high stock market valuations. What is or is not irrational is a subject of considerable debate.

Historically, wage increases have not led inflation. The notion that wages should be a proxy for inflationary pressures, I don't think is grounded in experience of the inflation spikes we have witnessed since World War II. If one graphs the sharp peaks of inflation, one learns they have occurred either during periods of war or serious supply shortages: The Korean War, Vietnam, the Gulf War, the OPEC oil crisis of the mid-1970's.

Mr. Chairman, the witnesses appearing today undoubtedly will provide us with a wide range of views and experience on what is moving today's economy and the appropriate role of monetary policy as a lever of control and adjustment, and I look forward to their testimony and, again, thank you for accommodating our concerns and requests.

Chairman LEACH. Thank you.

Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman. I want to welcome the panel and thank you for holding the hearing today.

I think that sometimes we get a little complacent when we think about the situation with regard to monetary policy because it has been nearly 20 years since we had a roaring inflation rate that required truly heavy brakes by the central bank of the United States and the Federal Reserve. But you look around the world, and you see what happens in countries that don't have a central bank that has the kind of options that our bank is given, or at least doesn't have the freedom to exercise those options, like in Thailand and some other countries we could name. And we then, I think, can more fully appreciate the fact that we have a stable force at work to try to make certain that we don't encounter those rough spots to the degree that some of the rest of the world has.

In fact, I believe that some of the great problems of the economies of our allies and friends such as Israel—and I could name a couple more; Argentina in recent years—have been as strongly difficult as they have been because they don't have the kind of flexibility and freedom for their central banks and independence that we have given to ours.

I think these hearings today are very important, not only to look at the mechanisms that we use, but to reinforce the fact that we need a very viable central bank and we should be thankful that our economy is as strong as it is. And while I might not agree with every move and vote that the Open Market Committee makes—I don't know how anybody could—overall, the track record speaks very well for itself.

I, too, share concerns over some of the issues that will be raised today. I know one of the top questions to be asked is whether or not we should be continuing to focus as much as the Humphrey-Hawkins law has on the dual track of maximum employment and stable prices. That is a very grave question. I suspect it is a good academic one. It is also one of policy that many Members are raising in recent weeks.

But the hearings can not only explore that issue but give us a better, firm understanding of the rationale that individual Members and those who may be influencing indirectly, if not directly, the votes of the Open Market Committee, the rationales that they use to achieve the balanced approach that has gotten us to the point where we are now, and that may give us some insight into what changes need to be made, if any, in law to help guide future Fed policies down the road.

I thank you for holding this hearing today, Mr. Chairman. I think it is a very positive one, and I look forward to hearing the witnesses.

Chairman LEACH. Thank you.

Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman, for responding to the requests for an expanded hearing with regard to monetary policy.

I think most of us have come to realize that the importance of monetary policy and setting it is enormously important in terms of our economy. It has been a point of stability in the latter part of the 1980's and the early part of the 1990's, but I think one which needs to be refocused on at this point, because there seems to be, within the Federal Open Market Committee, a timidity with regard to, in fact, exercising the options that are available given the circumstances in the economy in terms of the low inflation, a timidity which is often reflected in a tendency to move toward higher rates, notwithstanding that the inflation and other indexes would indicate the justification for yet lower Fed discount rates. And of course the Fed discount rate is just one of many of the indexes that need to be examined in terms of others that from time to time have been held up as the benchmark mechanism for, in fact, establishing or trying to set policy.

Of course, I would hasten to note that, going back in my experience here, most of the Fed governors and chairmen have indicated that they are not setting it at all, they are just responding to what is taking place in the market. But I think most of us today recognize that monetary policy, along with fiscal policy, is an integral part of what happens in our mixed economy. And I think that the condition of that economy, while better than it has been, could be improved with a more aggressive type of monetary policy activity in terms of moving closer to what the actual inflation and other rates are in terms of the discount rate. It would be a great benefit

in terms of the fiscal policy that we need to deal with and, more importantly, in the marketplace in terms of providing greater business opportunity and employment.

I think today that while we have indices that we use in terms of employment, they don't reflect accurately the underemployment and unemployment of individuals that do not show up in those statistics, and I think that as we look at the rates, the benchmark rates of the Fed, that as they get multiplied into other credit lines, they are much more expensive and prohibitive to the type of growth and innovation that we need. I think so much so, that much of that has moved in ways to seek different efficiencies, in terms of bonds and other bases outside of the primary financial institution role, that historically has been a stronger source of credit.

I look forward to hearing the diverse views of these governors and others that are welding this important policy role in 1997 and hope that we can establish a type of rapport and dialogue which could, in fact, provide for a greater latitude and a greater responsiveness with regard to monetary policy to build the type of stability and confidence.

I realize it is more of an art than a science at this point, but I hope to see that monetary policy could be reengaged in terms of moving in a positive direction in terms of steering this great economy in this global environment to an unprecedented type of benefit.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you very much, Mr. Vento.

Mrs. Roukema.

Mrs. ROUKEMA. Mr. Chairman, I simply want to congratulate you and thank you for complying with the request of the Minority in setting up this very timely hearing. I am most appreciative, particularly timely following Mr. Greenspan's testimony. I think we saw what Wall Street thought of it in terms of the actions yesterday.

But I also want to particularly observe that you have selected panels here, and the range of analysis that we are going to have here today is particularly instructive. You have picked the most highly professional and objective people to testify, and I would expect there would be a minimum of partisan prejudices expressed here today. But I think we have exceptionally qualified people on all three panels, and I want to thank you for that and look forward to the testimony. It is very instructive and timely.

Thank you.

Chairman LEACH. Thank you, Marge.

I want to give particular credit to Mr. Frank for suggesting that maybe we ought to move the hearing from more than simply the Fed Chairman on these issues.

Mr. FRANK. Thank you, Mr. Chairman.

I would like to say I have distressed my colleague, Mrs. Roukema, from time to time by agreeing with her too much.

I have to do it again, Marge. I agree with everything you said. I am sorry.

Mrs. ROUKEMA. I accept your apology.

Mr. FRANK. Thank you, Mr. Chairman, not just for being willing to have the hearing, but there was great cooperation between us

and among all of us in selecting, I think, a very balanced panel, and I appreciate that. And I really think this is Congress doing its job in the best way. We are not talking about anything partisan, we are not squabbling, we are talking about areas where there are very legitimate and profound differences of opinion on one of the most important questions that confronts the country, and I think that it is important that we are doing that.

I should note that because we are dealing here with a serious, intellectually challenging subject of great importance in which there are no good guys or bad girls or corrupt people or honest people but simply well-intentioned people grappling with an issue of great public policy, it will almost certainly get very little attention in the media, but we will not, I hope, allow that to deter us.

The question that we are dealing with is central. And I do have one minor quibble, Mr. Chairman. You said that when Mr. LaFalce and I asked for a hearing, it was to examine a rate increase in March. To be honest, it was more to try to deter one in May. But they are not unrelated. And we had no hearing and no increase, so it was a pretty good wash for us.

The question does, as you correctly say, go beyond this or that quarter-point or even half-point. We are talking about, I think, the most fundamental economic question before us, because as yesterday's hearing showed, it implicates questions of social equity. It implicates, in my judgment, what international trade policy will be. And the question is, there is clearly a great deal of dissatisfaction on the part of a lot of people in the middle-income brackets and lower, people who didn't used to think of themselves as being in the lower- and middle-income brackets but have found themselves there.

There is dissatisfaction because they have seen a recent period in which they have read a lot of good news while they are getting bad news. It is one thing to be laid off because the company has gone bankrupt or there is a recession, but it is another thing to be laid off when the company is declaring record profits and you are reading that the economy is in a period of extended growth. We have, many of us believe, a very difficult problem now of greater inequality at a time of wealth. Technological change, international trade, all of those factors are there.

Clearly, as difficult as those issues are, they are greatly exacerbated in an environment of slow growth. Relatively rapid growth, better growth, doesn't solve all of these problems, but it gives us the wherewithal to solve them in terms of revenues.

Obviously, just one example: Mr. Eisner will testify later that if we could keep growth at a higher level than we have had by a half-percent or so, the Social Security crisis greatly attenuates as a crisis because of that revenue stream. Clearly, it makes no sense to talk about assimilating welfare recipients into the job market unless you substantially can reduce the unemployment travesty. So we have to be able to do not just as well as we have been doing in overall growth, but somewhat better if we are to resolve problems.

The last point I would make on this, I will quote again what John Kennedy said about Franklin Roosevelt when Kennedy launched the Alliance for Progress. Referring back to the Good

Neighbor policy of Roosevelt, he said Franklin Roosevelt could be a good neighbor abroad because he was a good neighbor at home. It is not an accident that Roosevelt gave us the minimum wage law during the Roosevelt Administration, and there are varying degrees of enthusiasm about some of these things, but we got the National Labor Relations Act, a blessed memory since it was silently assassinated about 10 years ago. We got the National Labor Relations Act, we got the Fair Labor Standards Act and Social Security, and we also got reciprocal trade because you could not have gotten one without the other.

And I have to say to people now who are supportive of an expansion of the international economic cooperation which I believe is ultimately in our own overall interest, if we do not alleviate the sense of anger and unfairness that is prevalent among so many working and middle-class people, and with good reason; this is not just some perceptual problem they have—

I would ask for an additional 45 seconds.

Chairman LEACH. Without objection.

Mr. FRANK. Thank you.—Then you are going to continue to see resistance.

I thought the Mexico loan approach of 2 years ago made sense. The Chairman worked very valiantly to put it together. I had some conditions I wanted to see on it. I think it worked well, but, you know, it is still wildly unpopular with a majority of Americans because they see it as a product of a national economic establishment that is indifferent, at best, to their interests.

The centrality of the point is this: There is good reason to believe that we are now able to get faster growth without having inflationary problems than before. I have to be honest; I very much want that to be true, because I think if it is not true, we see an exacerbation of all these other social problems, of the Social Security crisis, of Medicare, of welfare, of all of these issues. And what troubles me is the notion that for institutional reasons, for cultural reasons, for a whole range of reasons, there are people on the Federal Reserve System who are resistant to the good news, who approach it with the notion of a prosecutor cross-examining a defense witness.

Obviously, we cannot be sure that this is all there. It does seem to me that anyone who approached the economic facts of the last couple of years without preconception would be somewhat more optimistic of our ability to grow with low inflation than appears to me to be prevalent among many of the monetary policymakers.

And that is why I think this hearing deals with the central question of our time. We have to figure out whether we can do this, because I have to say this in closing—I appreciate the indulgence, Mr. Chairman—if, in fact, the pessimists are right and we have been growing these past 2 years greater than our capacity, then woe is us, because if we are not able to grow at at least this rate and better, we are a Nation with very serious internal difficulties that will frustrate what many in the financial community think ought to be the best policies.

Chairman LEACH. Thank you very much, Mr. Frank.

Yes, first, is Mr. Castle here? I wanted to go to him as a subcommittee Chairman, and then I will come back.

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

We did have a rather interesting hearing—it has been alluded to—at the Subcommittee on Domestic and International Monetary Policy yesterday, and we appreciate the Chairman and his long staying-power to answer questions from the breadth of the political spectrum, and every question possible, I think, was brought to his attention. I think that hearing and our meeting today are very important and the actions of Congress and the Administration are basic to creating prosperity now and in the future.

The arcane practices of monetary policy are a proper subject of interest to almost every citizen, although almost none of them are cognizant of those practices, but they really are important to all of us. To borrow an expression from Dr. DiClemente, a witness later today, “The Fed is the guardian of the lifeblood of the market economy.” When the Fed does its job well and this is reinforced by responsible legislation and policy, we all prosper.

Today, we will be reminded of the difficult job that is involved in the production of good economic analysis. We will also see demonstrations that strongly contrasting conclusions can be drawn from the same data by different experts. This shouldn't be viewed simply as an esoteric exercise in arguing statistics and growth cycles. What concerns us today on both sides of the aisle are the personal consequences of these analyses. The prospect of planning for a secure and comfortable retirement as a result of a life of hard work and careful savings should not be undercut by Government action. Taxes and inflation should not steal the fruits of that labor and saving. The broadest possible opportunity should be offered to every citizen, and this especially includes the opportunity for young people to get an education that will equip them to advance as far as personal application and ambition can take them.

Chairman Greenspan touched on this theme, which was of great personal interest. That is, we are all diminished because we are not yet successfully equipping our youth to take advantage of the opportunities available in the information-intensive, computer-driven economy that is upon us.

I also believe that the good work of the Federal Reserve and this Congress to date only prepares the foundation for us to take up the major challenge of making the balanced budget the normal state of affairs. We accomplished this in Delaware some number of years ago, and it has enhanced our general prosperity. We will also be called upon to reform our retirement system and our educational system. None of this will be possible without good monetary policy, and if we keep these goals in sight, all the charts and graphs we will see today will come alive with meaning.

[The prepared statement of Hon. Michael N. Castle can be found on page 117 in the appendix.]

Chairman LEACH. Thank you, Mr. Castle.

Mr. Sanders.

Mr. SANDERS. Thank you very much, Mr. Chairman. And thank you for holding this hearing.

I would hope—and I am going to be running in and out, but I would hope that our distinguished guests today would comment perhaps on Mr. Greenspan's view that the economy is performing “exceptionally.” You see, I have a hard time understanding that. I

think the confusion lies in that for the people on top, the economy is performing exceptionally. Perhaps never before in American history have the rich been doing quite as well as they are doing now. As you are familiar and know, last year the CEOs of large American corporations saw a 54 percent increase in their compensation. That is pretty good. That is exceptional.

But what about tens of millions of middle-class and working families? They got a 3 percent increase in their compensation. That is not so exceptional. That, in fact, means, looking at inflation, that tens of millions of American workers saw a continuation of the process by which their standard of living declines, by which they work longer hours for lower wages.

Now, maybe I am missing something; OK? But it seems to me that only within the Beltway, only within a climate heavily influenced by corporate interests, could anyone say that the economy is "exceptional" when tens of millions of people over the last 20 years have seen a significant decline in their standard of living and continue to see a decline in their standard of living. Can somebody say that the economy is "exceptional"?

I would hope that you would comment about the new jobs that are being created and talk about the fact, as I understand it, that low-wage American workers are now the lowest paid workers in the industrialized world. I hope that you would comment about the growing gap between the rich and the poor and maybe talk about the morality or the propriety of Bill Gates. What is he up to? I am sure he made another billion dollars yesterday. He is up to about \$35 billion. A proliferation of millionaires and billionaires, and guess what? The United States has the highest rate of childhood poverty in the industrialized world by far. We have people sleeping out on the street. We have 40 million Americans without health insurance.

Maybe I spend too much time back home talking to Vermonters who are working 50-, 60-, 70-hours a week, talking to women who would rather stay home with the kids but are forced to work in order to bring in an extra paycheck. Maybe I am missing how the economy is performing in an exceptional way.

Mr. Frank talked about his concern about what it means socially if we do not address the needs of low-income and working families, and I absolutely agree with him. Also, touch on that point and touch on the morality of an economy which is making the people on the top so fabulously wealthy.

Do you have anything to say about one person being worth \$35 billion while so many other people are seeing a decline in their standard of living? What does that say about our tax policy? Should we have a tax on wealth and do what some of the European countries are doing? Is that proper?

Should we raise the minimum wage so that low-income workers earn wages that are above the poverty level? What about a tax package that is now floating through Congress, 55 percent of which gives tax breaks to the upper 5 percent? Will you comment on that? Will you comment on a two-party system that seems not to reflect the needs of ordinary Americans?

I get a little bit confused when I hear about how wonderful this economy is going. It does not reflect the economy that I see back

home, nor does it reflect the economy that exists anywhere in America.

Mr. Chairman, thank you very much. I appreciate this hearing. I will be running in and out.

Chairman LEACH. Thank you.

Mr. Lazio.

Mr. LAZIO. I just wanted to welcome a good friend of mine who is going to be testifying here, Bill McDonough, who is an outstanding public servant and is doing a wonderful job in the Fed in the New York area. And also the two other panelists. Good to see you again, Vice Chairman Rivlin. We worked together on the budget.

I would want to comment on the fact, obviously the Fed has limited ability to impact on stagnant wages. Those are policy decisions that we need to make here in Congress and obviously the President needs to show some leadership on. And in terms of having or achieving the long-term goal of low inflation in a sustained way, I have to compliment the Federal Reserve, that, in fact, speculative inflation does deprive low-income people and does disproportionately hurt low-income people in their capacity to make ends meet, and so it is an important goal, and one that I share, to restrain inflation.

In fact, our economy, I think, is doing remarkably well internationally. A few years ago, we were envious of the Saudis and the Japanese, and now the attention has turned to America and people are looking to this economy. Billions are pouring into this country; IPOs creating new jobs, increasingly good jobs; higher-skilled, good paying jobs. This is exactly the goal that we need for America, not to look back at the past and say that we need to recreate jobs that there is no market for, but to look to create jobs by correctly funding investment here in America that will enable us to be competitive and to pay the kind of wages that you need to have in order to meet some of the social goals that we have here in this country.

I look forward to this hearing and compliment you, Mr. Chairman, and certainly the subcommittee Chairman, Mike Castle, for your work on this.

Chairman LEACH. Thank you very much.

Mr. Gutierrez.

Mr. GUTIERREZ. Thank you very much, Mr. Chairman. And I would like to welcome the witnesses to this hearing here this morning.

And just to kind of follow up a little bit on what Mr. Lazio spoke about, indeed it is our responsibility here in Congress to make sure that working men and women receive an equitable share of the distribution of the wealth that is created here in this Nation. Certainly we need to intervene, and maybe it is correct that the Fed doesn't have any ability, not that I believe that, but that is what some people said, that they do not have the ability. But they do have the ability, when Mr. Greenspan comes here, to make the stock market go up 65 points while he spoke here. So apparently they do have an impact on the economy just by coming and stating what their opinion happens to be.

And while it may rest with us as a legislative body to take certain action, they can certainly opine on what they think the House of Representatives might do or not do in order to foster greater eq-

uity in the distribution of this great wealth that we are seeing created here in the United States of America so that we can all rise together, so that all working men and women can gain some added self-respect and self-esteem and pride and a sense of accomplishment. I think that this is one of the fundamental issues that we are going to have to address as a Nation. If millions of people feel as though they are not part of this great process of progress in this Nation, and they feel alienated from that process, are we truly doing everything we can to make this a greater and better Nation for all of us?

I think that while you are here, we are certainly interested in hearing your opinions, because I, for one, do not believe that the participants in today's hearing just don't have an opinion on this. I mean, working men and women who make minimum wage certainly have an opinion, because they watch the news and they see the S&P and they see the stock market. They read there are jobs, and they read their papers on the way to work, and they are certainly involved in the economy and see what is going on. I just don't believe that the kinds of well-versed and certainly articulate spokespeople that we are going to have here don't have an opinion.

One last comment, Mr. Chairman. There is this great conference in Chicago. The National Conference of La Raza has a great conference in Chicago, and Vice President Al Gore went out there yesterday. And there is something interesting, an interesting point that our witnesses might care to comment on later on.

Latinos in the United States of America have been at a record pace in the creation of jobs. There is this burgeoning middle class, entrepreneurial middle class. And the number of Latinos who today are part of the middle class have grown over the last 10 years. And that is good; right? There is incorporation and integration. The problem is that the median income for Latinos has decreased in the United States of America.

How do you take a group of people and say on the one hand some people are prospering and doing better—and obviously it is through their entrepreneurial skills—right?—and contributions. And yet as a group, their wages are lower. Something is wrong.

Last, we are all going to be in this boat together, and the boat is going to sail smoothly to the extent that everyone feels that the boat is taking them to a harbor in which they can all eat well, dress well, live well, educate their children well. Otherwise, I think there is going to be a Nation of haves and have-nots that is going to seriously erode the possibility for progress, for success, for all of us. For all of us.

I don't think we want to reach that, but I see this continuing concentration of wealth on the one hand. I want the rich to be wealthy; I have absolutely no problem with that, none whatsoever. I am not speaking about a Nation in which there are not wealthy people; I just want to make sure that working men and women get to partake in this great progress.

Thank you so much for coming here this morning.

Chairman LEACH. Thank you very much, Mr. Gutierrez.

Ms. Roybal-Allard.

Ms. ROYBAL-ALLARD. Thank you, Mr. Chairman.

I, too, would like to express my gratitude to my colleague, Mr. Frank, who has been so diligent in his efforts to make this hearing possible. As has been stated, this hearing is critical because the decisions of the Federal Reserve regarding the conduct of monetary policy have a serious and direct impact on the financial well-being of all Americans. And I think you have heard that over and over again, the emphasis on the word "all."

As a result, I believe that the Members of this committee have an obligation to consider this issue very closely and to hear differing viewpoints. And for that, I would like to thank the Chairman for providing us with this opportunity.

As you know, the economy is currently doing better than most expected. The unemployment rate reached its lowest level in 24 years when it fell to 4.8 percent in April. Currently, unemployment nationally is at a low 5 percent. Prices have been stable, and the Consumer Price Index rose just .1 percent in June, bringing the year-to-date annual rate to 1.4 percent, the lowest rate for the first 6 months of any year since 1986. The question of whether the Federal Reserve needs to take further action to slow this growth to prevent the possibility of inflation is the critical question that must be answered because of the financial impact any action will have on every American.

I, too, am particularly concerned about the impact that such a policy would have on low- and middle-income Americans. The Los Angeles area, where my district is located, has only recently begun to emerge from the last recession. The unemployment rate in Los Angeles is still 2 percent higher than the national average. The per capita income in my congressional district is just under \$7,000 last count, the lowest in the country. Almost 30 percent of all adults and over 34 percent of the children in my district live below the poverty level.

The low-income residents of inner cities and areas like Los Angeles are only just beginning to see the benefits of these seven consecutive years of economic growth. If the Federal Reserve raises interest rates to prevent what many consider to be phantom inflation, low-income individuals may find that they are finally arriving at the party only to have the door slammed in their faces.

I look forward to hearing your comments and to have you each address this issue of how we are going to protect middle- and low-income families or, rather, how are we going to give them also opportunities to improve the quality of their lives?

Thank you, Mr. Chairman.

Chairman LEACH. Thank you very much.

Mr. Hinchey.

Mr. HINCHEY. Mr. Chairman, thank you very much. Thank you again for holding these hearings. I think that they are very helpful to the Members and also for the general public.

Ms. Rivlin, I welcome you. It is very good to see Mr. McDonough and Mr. Meyer. Thank you very much for being here with us. Yesterday we had the chairman here, and he talked about his view of monetary policy, as he always does, somewhat enigmatically, as I understand it.

But what we are seeing in the economy generally is that the supply-side economics that were practiced under a previous adminis-

tration have managed to supply a great deal to those that have much, and very little to the struggling many. The trickle-down theory of economics just does not work, no matter how you try to re-fashion it. And the question is, how do we get more of the benefits of this booming economy to more of the American people?

I think, frankly, that the Clinton Administration has answered that question in large measure, because it was unquestionably the budget resolution of 1993 which brought the annual Federal budget deficit down from a record high of more than \$290 billion a year to where it is today; somewhere in the neighborhood of \$50 billion, as I understand it, and still falling as we meet.

There is some question as to whether the budget would actually come into balance in the very near future absent any additional action from the Congress or the Administration. Simply by leaving the policies of the 1993 Clinton budget proposal in place, we may, in fact, get into surplus by virtue of those policies. Unquestionably, that is what has brought us to this particular point when this economy is doing so very well.

We have even seen in recent years, under the economic policies of President Clinton and Vice President Gore, some improvement in the economic situation of the average working American. The great disparity in wealth and income which plagued this economy beginning back in the mid 1970's through the early 1990's now shows signs of reversal, and working people are beginning to get a modicum of the benefits of this growing economy.

That was a Herculean effort, and it was a determined effort, on the part of the President. I was here in January 1993, and I remember how that bill passed with only one vote in the House of Representatives and a tie in the Senate broken only by the vote of the Vice President of the United States. He said to me and some others yesterday that every time he votes, we win. And I guess it actually works that way.

That budget bill passed so narrowly, but the benefits of it are becoming clearer and clearer. And now we are struggling here with another budget, and the Majority party in this House wants to create tax cuts which are going to blow the deficit out again in the outyears and provide the major benefits of that tax cut to the people who need it the least.

Their attitude seems to be that you should tax the benefits of capital gains at half the level that you tax the benefits of people who make their living by working the ways people work in this country, either with their minds, or their hands, or some combination of the two. That is wrong, in my estimation.

What concerned me about the chairman's testimony yesterday, however, was the hint that it may be necessary to raise interest rates again next year. I hope that that is not the case.

I remember what happened in 1994 when the economy began to grow again as a result of the budget resolution of 1993. The Fed stepped in and raised interest rates, and raised interest rates, and raised interest rates, and raised interest rates over and over and over again in 1994, and interest rates doubled during that year and the expansion of the economy was choked off. It wasn't given the opportunity to succeed in a way that it would have absent those increases in interest rates. I hope that that does not happen again.

Some might argue that those interest rate increases even had a bearing on the complexion of the congressional elections in November 1994. Whether they did or not, the important thing is that people in this economy, the vast majority of American people generally, are beginning to experience some of the benefits of this economy.

It would be a serious mistake indeed, in my opinion, to raise interest rates, absent any firm, solid, irrefutable evidence that inflation exists, and I don't see any anywhere around. There is a lot of talk about it in the papers, even on the front page of the *New York Times*, about the specter of inflation, but no one points to any material evidence. It is all illusory, all a figment of the imagination of bankers and writers.

Let's make sure that we know what we are doing here, because this economy is beginning to show signs of goodness and greatness for the majority of the American people, and we want to make sure that that continues.

Thank you very much.

Chairman LEACH. Thank you very much.

Mr. Snowbarger.

Mr. SNOWBARGER. Mr. Chairman, thank you; and thank you to the witnesses for appearing today in the hope that you may have some minimal amount of time to answer all of these statements.

I don't have any opening statement.

Chairman LEACH. Thank you, Mr. Snowbarger.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman; and let me just say on the one hand, first of all, let me just thank the witnesses for being here and the other panelists that will testify later, and thank the Chairman for calling this hearing.

This hearing dealing with the conduct of monetary policy requires us to look at a number of issues in the abstract, in particular whether or not the business cycle has been repealed or extended; whether or not the Phillips Curve has been denied; whether or not we can increase growth beyond current levels and still maintain a stable economy; whether or not we are in a transitory period, as the chairman of the Fed testified yesterday, and as I know some of you all have in your statements as well.

Like the chairman's testimony yesterday, there are still more questions than there are answers; and there may never be some of the answers. But I think we also have to be aware that we have probably the best general economy in this country that we have had in the last 20 or more years. The President is certainly capable of saying it is morning in America, again from his period in office, like we saw from another President not too many years ago.

But be that as it may, with low unemployment, stable growth, low inflation, there are gaping holes within the economy. Whether or not those are a result of monetary policy is yet to be answered, and I am not sure whether it will be answered in today's hearing or not.

There are many questions related to fiscal policy, including the Nation's tax policy, as well as our regulatory policy and labor policy, trade policy and the impact that they have on income distribu-

tion, which I think is the concern of a great number of the Members of this committee, particularly on my side of the aisle.

I welcome the panelists. I appreciate the Chairman calling this hearing. I would encourage our Members to listen carefully, but let's not have any illusions that we walk away today with any of the answers because I am not sure any of the panelists have the answers, either.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Bentsen.

It has been suggested that there should be a second round of opening statements, but we won't do that.

Let me just very briefly introduce our first panel. It is composed of the Vice Chair of the Federal Reserve Board of the United States, Ms. Alice Rivlin, a recent appointee to the Board; Lawrence H. Meyer; and the President of the New York Federal Reserve Bank, Mr. Bill McDonough.

Mr. LAFALCE. Mr. Chairman.

Chairman LEACH. Yes, sir.

Mr. LAFALCE. Before we proceed, could I ask unanimous consent to have Mr. Gonzalez' opening statement included in the record immediately following your opening remarks?

[The prepared statement of Hon. Henry B. Gonzalez can be found on page 116 in the appendix.]

Chairman LEACH. Without objection, so ordered.

Each of these individuals has extraordinary resumes and backgrounds, and I would simply say on behalf of the party that is not the same as the Executive branch, I think the President has done an extraordinary job in his choice of Federal Reserve Board members. Ms. Rivlin and Mr. Meyer were designated by President Clinton and they are first-class appointees.

I would also say that sometimes when you think of the New York Federal Reserve Board and the Fed here in Washington, you think of coastal institutions, which they are, but these three individuals have ties to the Midwest, which I think is very important to all three. Mr. Meyer was recently in St. Louis. Mr. McDonough was recently in Chicago. Ms. Rivlin comes from the Midwest and is married to an Iowan. In fact, of the seven members of the Federal Reserve Board, one is from Iowa City, Iowa. Ms. Rivlin is married to a gentleman from Iowa City, Iowa.

So, the center of power, of monetary policy, I think, can correctly be defined as in the State of Iowa.

Mr. LAFALCE. Mr. Chairman, as I recall the law, it requires a geographical diversification and a balance. Are you suggesting a coup d'etat based upon this concentration geographically?

Chairman LEACH. What we have done is sneakily put people in other parts of the country to make the appointments, but the real ties are—

Mr. FRANK. Mr. Chairman, I did want to note Mr. Sanders is out of the room and if we do want to go back through the failed routine, you might want to wait until he comes back so he can do it.

Chairman LEACH. Good enough.

But I think it is appropriate to begin with the Vice Chair of the Federal Reserve Board. Ms. Rivlin probably has as much respect on Capitol Hill from her prior work as anyone I know. Ms. Rivlin.

**STATEMENT OF HON. ALICE M. RIVLIN, VICE CHAIR, BOARD
OF GOVERNORS, FEDERAL RESERVE SYSTEM**

Ms. RIVLIN. Thank you very much, Mr. Chairman. I think we all feel considerably welcomed here this morning.

I am very glad to be here and I am glad you are having this hearing at this particular moment. Monetary policy, as several of you have observed, is not only important, it is also often mysterious; Mr. Castle said "arcane." It is good to get a wide range of views and to discuss it frequently, and I think it is especially good right now, when the economy in general is going well, but when there is a great deal of uncertainty about what is happening.

I would like very briefly to discuss three questions. One is, why is the economy doing so well? Especially, why do we have such low inflation at a time when we also have low unemployment?

Second, why is it so important right now, and I believe it is, to keep this good news flowing?

And third, what policies, monetary and other, are needed to keep the performance of the economy strong and sustained?

At the moment, we have the most positive set of aggregate economic statistics in many, many years, indeed, decades.

It is true, as several Members have emphasized, that not everybody is doing well.

People with less skill and education have been falling behind for some time, and that is a very serious situation. But what is good about the overall situation and why the chairman, I think, described it as exceptional, is that it gives us the ability—if the economy can continue with this low inflation and low unemployment—to solve some of the major problems that still do face us. This includes, in particular, raising the overall standard of living and providing opportunities for those with less skill and lower wages to move up in the income scale.

It has been a surprise to most economists that we do have such tight labor markets with so little inflation. It is important to understand why it is happening, as well as we can, if we want to make it last. Some of the factors leading to this situation are clearly temporary. Some may be more permanent. At the moment, it is too soon to tell.

Some of the surprise that has greeted economists has been that wages and other forms of compensation have not moved up faster in the face of very low unemployment. Why haven't they? In part, we have had an increase in the labor force, with more people coming into work, which has taken the pressure off.

Without these new entrants, unemployment would have been even lower. It is likely that access to new entrants can't continue for too much longer. Some have proposed that worker insecurity is part of the answer, or that less membership in labor unions has mandated wage pressures. It is also possible that employers are bargaining harder to keep wages from rising faster, because they perceive themselves to be in a more competitive situation than they have ever been in before at home and abroad.

We have certainly had lower increases in health costs than had been plaguing us for a very long time, and that has helped keep the cost of total compensation down. And lower inflation expectations themselves mean that wages don't move up as rapidly.

Many of these factors may be temporary. One hopes that many of them are not temporary. Indeed, we are seeing wage increases now and as several people have pointed out, that is good for workers. That is what this is all about, a good economy should produce income increases for everybody.

The bigger mystery is why prices have been so subdued. Overall, they have not been accelerating. Indeed, producer prices are still falling and that is very good, indeed.

Again, some of the reasons may be temporary and some may be permanent and we aren't quite sure yet. Temporary things include the influence of the strong dollar. The dollar may not get much stronger, but it has certainly helped to keep down import prices. Energy prices have been falling. They won't continue to fall forever. But the really important question is whether we are on the verge of a sustained increase in the growth of productivity. Productivity increases are what we really need to move to a higher sustained growth track and to have a higher standard of living for everyone.

There are some reasons to think that we really are in a new situation. Many of them were detailed in the chairman's statement yesterday. We may be moving to a higher productivity track, though we can't be sure, because it hasn't shown up very clearly in the aggregate statistics yet.

I think it is always important to keep the economy growing on the highest possible growth track and reduce the chances of sliding into recession, but there are at least three reasons why it is particularly important right now. Several of them have been mentioned already.

First, we need to make welfare reform work. That will not be possible if we slide into recession. Only if we keep the unemployment rates low can we have a chance of finding jobs for people who are currently on welfare.

Also, there is an enormous movement across the country to develop communities. Partnerships between private and public institutions are producing good things in central cities and smaller towns and in rural areas. Unless we can keep this economy growing, those efforts will not succeed. Finally, as has also been mentioned, we need to prepare our economy for having more retirees, and unless we can keep the economy growing and moving on to a higher track, that will be hard. It will be much easier if we are growing faster and if we don't slide into recession.

What kind of monetary policies do we need? I think we need a central bank that is continuously balancing the risks. We don't want—you don't want us to be slowing down the economy unnecessarily. On the other hand, I don't think you want a central bank that is taking significant risk of the economy overheating, largely because we might then have to rein in harder later and because we might be getting the kind of imbalances in the economy that have in the past precipitated recessions.

The perception now that I think all of us share on the Open Market Committee is that the economy is growing strongly and that there is not much risk, in the near-term, of it sliding into a recession. There is a somewhat greater risk of the economy overheating. That is why we tapped the brakes a little bit in March, and we

have to watch and see whether it will be necessary to do that again.

I think the chances of keeping a continued low inflation are enhanced by having a Federal Reserve that is known to be cautious and that is sounding cautious. Unless the Federal Reserve is concerned about inflation, we will have inflationary expectations which tend to be self-fulfilling prophecy.

But monetary policy, though very important, is not the only policy game in town. Besides a wise monetary policy, we clearly need a much greater emphasis on training and skills and providing people with the ability to earn more wages. Those kinds of programs are more likely to work in an environment where we have low unemployment.

We also need investment. We need it in research and development and technology. That takes saving, it takes both public and private saving. That is why I take such particular pleasure, as I worked on the 1993 budget bill, in seeing the Federal deficit coming down so much more rapidly than any of us thought it could, because that means we have less public dissaving.

We need to assure people that they will have an adequate retirement and that the resources they need will be there. That means we need to address the long-run question of dealing with the retirement of the Baby Boom generation, and we need to do it in a way that increases overall saving and investment for the economy.

I can't promise you that the Fed will call everything right. I can, however, promise you that we will try to do our part to keep the good news flowing and to keep inflation down and unemployment down.

I look forward to an exchange of views with the committee.

[The prepared statement of Hon. Alice M. Rivlin can be found on page 119 in the appendix.]

Chairman LEACH. Thank you very much, and I must say to Mr. Frank, we have seen something here that vindicates any request for another hearing for him, because the Vice Chair under the Fed has inaugurated a group policy that has never been brought before this committee in my memory, and that is that she has read from yellow pages which have not been cleared by Fed staff. That, in and of itself, is worthy of some interest.

Mr. McDonough.

**STATEMENT OF WILLIAM J. McDONOUGH, PRESIDENT,
FEDERAL RESERVE BANK OF NEW YORK**

Mr. McDONOUGH. Thank you, Mr. Chairman. My pages are white, but also uncleared.

The ultimate goal of monetary policy in the United States today must be to achieve the highest level of sustainable economic growth, which in turn will promote the highest possible standard of living for all our citizens and the greatest number of jobs.

In saying this, however, I want to be clear as to what we can expect monetary policy to do and what we know it cannot do.

What monetary policy cannot do in and of itself is produce economic growth. Economic growth stems from increases in the supply of capital and labor, and from the productivity with which labor

and capital are used, neither of which is directly influenced by monetary policy.

But what monetary policy can do is to help foster economic growth by ensuring a stable price environment. The pursuit of price stability involves anchoring inflation at low levels over the long-term, and thereby locking in inflation expectations. In addition, monetary policy can help offset the effects of financial crises, as well as prevent severe downturns of the economy.

Now, let me make myself clear. Price stability, to me, is the absolutely essential means to produce sustained economic growth. Moreover, there need be no inconsistency between seeking long-run price stability and leaning against short-run business cycles. Indeed, a stable price environment that the public expects to persist almost certainly will enhance the capacity of monetary policy to fight occasions of cyclical weakness in the economy.

In my view, a goal of price stability requires that monetary policy be oriented beyond the horizon of its immediate impact on inflation and the economy. This horizon is on the order of 2 to 3 years and is important for setting the stage for what comes later. The longer-run purpose of today's policy actions should be to lay the foundation for price stability and sound economic growth over the coming decade. This orientation properly puts the focus of a forward-looking policy on the time horizon most important to household and business planning. This is the horizon that is relevant for the definition of price stability articulated by Chairman Greenspan: that price stability exists when inflation is not a consideration in household and business decisions.

But we may well ask, why is price stability so important? Price stability is important because a rising price level, inflation, even at moderate rates, imposes substantial costs on society. These costs are both economic and social. The economic ones are much discussed. Let me concentrate on the social.

The avoidance of unnecessary boom-bust cycles limits the serious social costs that inflation can impose, costs that all too often are underestimated in economists' typical calculations. Inflation may strain a country's social fabric, pitting different groups in a society against each other as each group seeks to make certain its wages keep up with the rising level of prices. Moreover, inflation tends to fall particularly hard on the less fortunate in society. These people do not possess the economic clout to keep their real income streams steady, or even buy necessities when a bout of inflation leads to an increase in the prices they must pay. When the bust comes, they also suffer disproportionately, by being among the first to lose their jobs. They also are not users of sophisticated financial instruments that might help protect their modest savings from confiscation by inflation.

I am convinced that the less fortunate in our society benefit particularly from an environment of price stability and the economic growth that stability fosters, as we currently are seeing in our economy. Sustained economic growth brings a lower level of unemployment, higher labor force participation and greater availability of jobs to those who are not easily hired because they need more training and more help from their employers.

Unless all parts of society share in—and therefore have a stake in—economic growth, we cannot have the social and political cohesion that is essential to the continuation of growth.

From a personal perspective, I believe that much of the success the Federal Reserve has had in containing inflation in recent years reflects monetary policy actions that preempted inflationary pressures before they actually showed up in general prices.

The main reason we need a preemptive approach is because monetary policy works with uncertain and long-term lags. Because of its long and variable lags, monetary policy requires of Federal Reserve officials the experience and the courage to deal with what will always be a level of uncertainty. The FOMC has been willing to deal with the uncertainty caused by the overestimation of inflation and the underestimation of growth in most economic models in the last year or so.

The committee's monetary policy has been an important ingredient in the excellent economic performance we have been enjoying.

And so, Mr. Chairman, I believe that the American people, whom we serve, have benefited from a monetary policy aimed at maximizing economic growth through the tool of price stability. That is the approach that should continue to guide the Federal Reserve in carrying out the responsibilities given us by the Congress.

Thank you.

[The prepared statement of William J. McDonough can be found on page 132 in the appendix.]

Chairman LEACH. Thank you, Mr. McDonough.

Mr. Meyer.

STATEMENT OF HON. LAURENCE H. MEYER, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. MEYER. Mr. Chairman and Members of the committee, I am pleased to have this opportunity to meet with you this morning to discuss my views on monetary policy. I am well aware that despite the recent good performance of the economy, some Members of this committee have reservations about the conduct of monetary policy, specifically the decision to raise the federal funds rate target one-quarter percentage point on March 25th.

I am also aware that there has been a particular interest by some Members, particularly Congressman Frank, in my views, specifically my views about the relevance of the NAIRU concept to understanding recent performance and risks to the outlook. I welcome the chance to discuss these issues with you this morning.

Achieving price stability in the long-run and preventing an increase in inflation in the short-run are not ends in themselves. They are a means to an end, important because they are the best way that the Federal Reserve can contribute to achieving the highest sustainable level of production and the maximum sustainable rate of growth for the American people. This is a key point. While there may be, from time to time, differences about how to reach these common goals—indeed, it would be amazing if there were not—there is no disagreement about the goals.

The history of business cycles has repeatedly taught us that the greatest risk to an expansion comes from failing to prevent an overheated economy. The best way to ensure the durability of this

expansion is, therefore, to be vigilant that we do not allow the economy to overheat and produce the inevitable rise in inflation. Failure to heed this lesson of history would result not only in higher inflation, but also in cyclical instability and higher unemployment rates.

Recent aggregate economic performance has been extraordinarily favorable. I have noted on several occasions that U.S. policymakers, including the Federal Reserve, would probably be inclined to accept more credit for this performance if they had forecast it or even could explain how it was possible. Herein lie the challenges. First, how do we explain such favorable performance? And specifically, what accounts for the favorable combination of low inflation and low unemployment? Second, what can monetary policy do to extend the good performance? Specifically, how should monetary policy be positioned, in light of the uncertainties in the current economic environment, so as to balance what I call "regularities and possibilities." Regularities that suggest that there are limits to the economy's productive capacity, at any point in time, and to the growth of capacity over time, and possibilities that suggest that these limits may have become more flexible in recent years.

In recent years, monetary policy has not simply been guided by historical regularities about the relationship between inflation and unemployment inherited from the 1980's and early 1990's. Rather, monetary policy has been adaptive, pragmatic and flexible in response to evolving economic circumstances. Such an adaptive approach does not throw out the framework that has successfully guided forecasting and policymaking in the past, but attempts, in real time, to adjust that approach based on the current data.

There are, in my judgment, two key issues in the outlook related to monetary policy and these focus on the interaction among growth, utilization rates and inflation. First, will growth rebound to an above-trend rate, raising utilization rates still further? Second, are prevailing utilization rates already so high that inflation will begin to rise, even if growth remains at trend? These are the same questions I raised in my first speech after coming to the board in September, 1996. They are the key questions that have affected my judgment about the appropriate posture of monetary policy over the last year and they remain relevant today.

I have covered in my written testimony my views on the relationship between inflation and unemployment and on how fast the economy can grow, along with a discussion of what factors might explain the recent surprisingly favorable performance of inflation and unemployment. I look forward to expanding upon these topics in response to your questions. Let me conclude with a brief discussion of the March 25th policy move.

The policy action on March 25th was clearly a preemptive one, not based on inflation pressures evident at the time, but on inflation pressures likely to emerge in the absence of policy action. As the chairman has repeatedly emphasized, lags in the response to monetary policy make it imperative that monetary policy be forward-looking and anticipatory, not backward-looking and reactive.

One of the principles of such a forward-looking monetary policy, in my judgment, is to lean gently against the cyclical winds. This means that when growth is above trend and utilization rates are

increasing, it is often prudent to allow short-term rates to rise. Monetary policy should not sit on interest rates and wait until the economy blows by capacity and inflation takes off. To do so would be to risk a serious boom-bust cycle and would require abrupt and decisive increases in interest rates later to regain control of inflation.

A small, cautious step early is the recipe for avoiding the necessity of a sharp and destabilizing move later on. This is why I believe the March 25th move was prudent. I voted in favor of it because I thought it would help prolong the expansion and contribute to the goals of maximum sustainable employment and maximum sustainable growth.

Thank you.

[The prepared statement of Hon. Laurence H. Meyer can be found on page 142 in the appendix.]

Chairman LEACH. Thank you very much, Mr. Meyer. Since it is now part of the public record, let me just make it clear Mr. Meyer voted for the increase in March.

Ms. Rivlin, you also did; is that correct?

Ms. RIVLIN. Yes, I did.

Chairman LEACH. And you are both appointees of this Administration; is that correct?

Ms. RIVLIN. That's correct.

Mr. MEYER. Yes.

Chairman LEACH. First, let me return to a theme of the chairman yesterday, and that was the question of growth. Some Members have suggested, and some in the public, that the Fed is biased against growth. Could you respond to that? Is this a valid observation or is it not?

And second, a kind of a subtlety here. Mr. Meyer said you want to preempt a little bit early, which I think is a very thoughtful observation. But in theory, if you had the option of 2 years in which you had 3 percent growth, or the option in which you have in 1 year, 1 percent growth, and the next year, 7 percent growth, which is a better deal? I mean, is steadiness the goal or is the goal the highest rate of growth at the end of a given period of time? Let me first ask Mr. Meyer.

Mr. MEYER. Well, steadiness has its value, to be sure. It is much more difficult to make economic decisions when growth rates are fluctuating all over the place.

But in terms of preemptive policy, it is important to understand the relationship between growth, utilization rates and inflation.

I make the distinction between trend growth and the actual growth rate of the economy. Trend growth is a rate of growth that is possible based on the growth of productive capacity due to increases in labor force and increases in productivity over the long-run. The higher the trend growth rate, the better, as the chairman said in his last testimony.

I don't think we would really ever make the mistake of suppressing trend growth for the following reason: Let's say that we were at an unemployment rate of 5 percent. If growth was at trend, the unemployment rate would stay the same. That is how we would know if growth was at trend.

I would like the growth rate to be higher; if it is 4, that is better than 3; 5 is better than 4; 6 is better than 5. As long as utilization rates aren't changing, the higher the growth, the better.

High utilization rates are often good, but after some point they signal potentially excess demand. When utilization rates get so high that they result in excess demand, that is when strains come into the economy and that is when there are very dangerous signs that we may be getting to the end of the expansion.

Chairman LEACH. Thank you.

Ms. Rivlin.

Ms. RIVLIN. In answer to your question, "are we biased against growth?" Absolutely not. We are biased in favor of growth. That is what we think we are aiming for. The highest sustainable rate of growth is what the Fed really is trying to achieve.

There are a couple of problems. One is, we don't know what that sustainable rate is. And there are indications that it may be higher than was thought. That depends primarily on whether we are getting more productivity increase and can look forward to more productivity increase than we have had in the past. And I think the jury is still out on that.

Is steady growth better than unsteady growth? Yes, I think clearly so. And the thing to be avoided, the real risk when you are in the kind of situation we are in now, is that growth might be so high that it did touch off inflation and other kinds of imbalances and tipped us eventually into recession.

The thing we really want to avoid, if we can possibly do it, is a recession in the near-term. Forever.

Chairman LEACH. Thank you.

Let me just quickly ask Mr. McDonough to comment on this: It has been argued that there are real or perceived tradeoffs between inflation and unemployment. In fact, when I was a student of economics, it wasn't quite with the popular wisdom, but it was fairly common almost, that there were "3-5 principles"—3 percent inflation meant 5 percent unemployment and 5 percent meant 3—but, I am exaggerating and putting in different numbers.

It is my impression that today any real or perceived tradeoff is no longer academic wisdom and that there is a growing consensus in the academic community that low levels of inflation are more likely to create higher levels of employment, and that that is what the Fed is oriented to.

So my question, as you look at Open Market decisions—of which, as Chairman of the New York Fed you are part—that is your primary driving assumption. Is that valid or not?

Mr. MCDONOUGH. Well, we assume, Mr. Chairman, that in the economics jargon of your days as a student that the long-term Phillips Curve doesn't exist; that there is no tradeoff. You don't buy long-term economic growth through inflation.

There is a short-term Phillips Curve, which is one of the reasons we can make monetary policy effective and had a great deal to do with Governor Meyer's discussion.

To go back to your question. If you had 1 and 7 coming out of a recession, that is better than 3 and 3, because 8 is better than 6. However, at the very good growth rate we are at now, what we want to avoid doing is getting into a boom-bust cycle, because we

are all convinced that after adding up the pluses and minuses of the boom-bust cycle, it will be a lower algebraic total than would be the case if we had sustained economic growth.

Now, what we want is the highest possible level of sustained economic growth. That involves, in our view, a monetary policy which avoids the evils of inflation, especially the social costs of inflation, which I tried to describe.

What we really need in our society, which is not done by monetary policy—although facilitated by monetary policy—is a higher sustained level of investment, taking advantage of the fact that Americans use investment much more efficiently than do other countries around the world, so that we can constantly increase productivity. That is what makes a better life for the American people.

Chairman LEACH. Thank you very much.

Mr. LaFalce.

Mr. LAFALCE. Thank you. Rather than ask you one specific question, I will try to describe to the three of you some of the, what I refer to as "felt difficulties" that I have in dealing with economic issues in general—but monetary policy issues in particular—to see how you respond to them.

One of the difficulties I have is, for a while I thought I had a handle on what might be guiding monetary policy, and I thought it might be a basket of commodities, including gold, and Chairman Greenspan did give some testimony to that effect. Then I was concerned that what might be driving monetary policy might be the Dow Jones, because—at least in part, and that was at the time of the "irrational expectations" speech when the Dow Jones was approximately, as I recall, 6300—today it is almost 8100, a 25 percent increase. I am wondering if the judgment with respect to possible irrational expectations that existed then still exist today, and to what extent is that, if at all, a factor?

Another difficulty is dealing with this whole question of inflation. On the one hand, inflation is a problem. On the other hand, inflation is overstated by perhaps 1 percent, at least for the purposes of benefits, most particularly Social Security benefits. How accurate are our measures of inflation? How accurate are our measures of unemployment?

We do an awful lot of extrapolation, an awful lot of guesswork. People stop looking for employment because they can't find a job. They are no longer considered unemployed. That is one way of dealing with the problem, the way George Bernard Shaw suggested that we deal with the problem of the poor. "Exterminate them." We deal with the problems of the unemployed by telling them to stop looking for work.

I remember once when Chairman Greenspan came in and said that we had been wrong in looking back on the growth in GNP. The Fed was off by about 100 percent. Then, 3 months later he said, "No, we were off by almost 200 percent." And that is even looking back.

Therefore, it would seem to me that before we would do anything like increasing the Federal funds raised, there would have to be a pretty compelling reason. It would seem to me that we should be extremely reluctant to increase interest rates through the raise of

the Federal funds rate. And I am wondering what your perspective is on some of the points I have made?

Ms. RIVLIN. Can I start off on that?

The question, "What is guiding monetary policy?" has a very clear answer. It is the desire to keep the economy growing at the highest sustainable growth rate. We have all said that several times, but it is really true. It can't be emphasized enough.

So that the other things that you have talked about, baskets of currencies or other measures—

Mr. LAFALCE. Commodities.

Ms. RIVLIN. —Or commodities. Once you establish that we are aiming at the highest sustainable growth rate, then one also has to say, as we have said several times, that a low level of inflation, we believe, is one of the ingredients of higher growth in the long-term.

Now, there are lots of ways to measure inflation. The thing that most of us keep our eye on most of the time is the Consumer Price Index because that reflects as closely as possible what most people have to buy and are exposed to.

That is not a perfect index, however. There has been a lot of discussion about that recently. Most of us think that the CPI is somewhat overestimated; that inflation may actually be even lower by maybe half a percent, maybe more, than the Consumer Price Index says it is.

But that, in a sense, is a different issue, because if that is true, it has been true for a long time. And the index that is published and the right index are pretty much parallel.

It is important to get it right, but it isn't what is significant for monetary policy.

There are also various ways of measuring unemployment, and they tend to move together and there is no perfect way to measure.

Mr. LAFALCE. Does anybody else have any comments on some of the difficulties I have expressed?

Mr. MCDONOUGH. Well, I could perhaps make a short comment. There is no single indicator—or two or three indicators—that we can look at to tell us exactly where the economy is and where it is likely to be 2 years from now.

The monetary aggregates are not working. The forecasting models are working in fits and starts, and so I think we have to look at everything possible in the employment area, in production costs and especially—in the case of a Reserve bank president like me—you have to get out of your office and spend a lot of time with real people. Which is why you see me wandering around Buffalo and why I know the Hudson Valley rather well. You have to get out and see real people in order to understand what is happening in the economy and to figure out where it is likely to go.

Mr. LAFALCE. Let me ask you a specific question. If we were to have as a policy a 3.5 percent increase in the GNP per year for the next 5 years, what would you think of that?

Mr. MCDONOUGH. I would think it is a great idea. I think I would rather have a larger number, but we as a society would have to invest more in order to crank up our capability of producing that kind of growth level without unleashing the evils of inflation.

Mr. LAFALCE. Mr. Rivlin, could you respond to that specific 3.5 percent?

Ms. RIVLIN. 3.5 is better than 2.5, as Mr. McDonough says. I hope we can grow that fast. I think there are some indications that we can—that we are looking at a higher level of productivity increase than we have had in the past. But realize what this means. Our economy can grow approximately as fast as our labor force—our working labor force is growing, plus productivity. The labor force is growing at about 1 percent per year. Maybe we could rev that up to 1.1 or 1.2, but not much more.

To get to 3.5 percent growth, you would have to have a productivity increase of about 2.5 percent per year. That's terrific, but we haven't had that level in years. It would be more than doubling the rate of productivity increase of the last couple of decades, and I don't know whether we can do that. There is some indication that productivity is moving up, but is it doubling? I doubt it.

Mr. MEYER. Could I respond to those?

Mr. LAFALCE. Yes.

Mr. MEYER. I want to respond, first, to your question about what guides monetary policy, and then I want to come back and deal with your question about how fast the economy can grow.

As to what guides monetary policy, I think the kind of issues that you were looking at seem to be pretty easy to deal with. We have a certain set of ultimate objectives of monetary policy. We didn't pick those ultimate objectives. You picked them. Congress wrote them into the Federal Reserve Act. You told us that maximum sustainable employment and price stability were the objectives and that is what guides me in terms of monetary policy. I took an oath of office to uphold that Act, and I certainly intend to do so.

Now, I want to pull us back to reality, shall we say, in terms of thinking about economic growth. As an economist, it is my job to set out a disciplined sense of what the possibilities are; that is very, very important. We don't want to get into a dream world and think that we don't have tough choices to make because the economy can grow 3½-, 4½-, or 5-percent; that there could be such bounty that all social problems would go away; and that we don't have tough decisions to make. That is not the case.

I presented in my written testimony a table which I think is very important. It gave outside estimates, including those from the Council of Economic Advisors, the Congressional Budget Office, and leading economic forecasting firms, of what trend growth is, that is, what the possibilities are. These estimates are in a pretty narrow range. I don't want to say that they are the last word, but they run from 2.1- to 2.3-percent.

When you look for private sector estimates of trend growth, they range from 2- to 2½-percent. Would we like to be at 3½ percent? Absolutely. Can monetary policy get us to 3½ percent if the current trend is 2¼? Absolutely not.

Can Congress get us there? Well, honestly, no. But you, Congress, have the tools to make a difference. We have no effect on the long-run trend rate of growth, absolutely none. Congress has an influence through a variety of policies, through the budget deficit policy, through tax policy, and through the composition of spending.

You keep asking me to opine on fiscal policy, but I have to tell you, you are the experts on those policies.

I feel like you are putting me into a very unusual position that I should come here and tell you how to set education policy, what to do about the deficit, what to do about tax reform.

My plate is pretty full. I worry day-after-day about monetary policy and about the economic outlook. But it is my job to present a real sense of discipline about what the possibilities are for monetary policy, and I hope my written testimony was a contribution to that end.

Mr. LAFALCE. I thank you.

Chairman LEACH. Thank you.

Mrs. Roukema, could I ask for 30 seconds, if I could, of your time?

Mrs. ROUKEMA. Absolutely.

Chairman LEACH. You have been generous with your time.

Mrs. ROUKEMA. You are the Chairman.

Chairman LEACH. Let me just say very quickly I thought that last statement was very profound, but you took an oath to the Constitution not to a particular law, but that particular law, as Chairman of this committee, I strongly support and I think the majority of the Members do. And I raise this because there is a theory that that law should be changed dramatically only to look at a numerical number rather than at the effect on the economy. And all three of you today made it very clear that your concerns are with the effect on the economy.

And I think that is a very important precept and something I am very appreciative of. I am sorry.

Mrs. ROUKEMA. Mr. Chairman, I have two questions and one question follows directly on what you just asked or just commented upon. And the other one follows on what Mr. Meyer just said. Hopefully, I can get it in before a vote comes.

Mr. McDonough, I am not sure that I interpreted some of your comments accurately, but with respect to the Humphrey-Hawkins Act, I think there were some implicit implications in your testimony that you indicate that stabilization of price supports might be more important than achieving maximum sustainable growth, or maybe both together. But the reason I am asking you is could you clarify what you meant? And do you see any reason to amend or modify Humphrey-Hawkins? Please.

Mr. MCDONOUGH. I think the Humphrey-Hawkins Act does set out a variety of goals that are supposed to be accomplished. I think a reasonable interpretation is that the primary goal is maximum sustained economic growth. It is a growth bill. The Federal Reserve, as I interpret it, as I carry out my responsibilities, is in the business of maximizing growth.

I am convinced that growth is maximized through the tool of price stability. Price stability is a means to an end. The end, which is always more important than the means, is maximum sustained economic growth.

Mrs. ROUKEMA. Yes. Now, do you see any area, either related to that or another area, where you believe that the Act should be amended or modified?

Mr. MCDONOUGH. To tell you the truth, Mrs. Roukema, I am——

Mrs. ROUKEMA. Please tell me the truth. That is why I am asking the question. I want the truth.

Mr. MCDONOUGH.—I don't claim to know enough about it. All I know is that the Humphrey-Hawkins Act, as it exists today, gives me all the clarity I need.

Mrs. ROUKEMA. OK. Good.

Mr. MCDONOUGH. So, if the Congress would like to change the emphasis of it so that our marching orders are somewhat different—

Mrs. ROUKEMA. I am not proposing that, but I heard some inferences in the opening statements of Members where the question might be raised and I wanted to hear your reaction.

Now, to get to my other question, I was interested in Ms. Rivlin saying that monetary policy is not the only game in town, and Mr. Meyer in some way anticipated my question.

I appreciate what you are doing on monetary policy; I do. But it is not the only game in town. The Congress has an obligation here. And that obligation is currently working its way through what is called a budget bill and a tax bill.

Can you evaluate how you feel—particularly with all of you making such a stress on higher sustained levels of investment, how you think we are doing in terms of the priorities that we have set in the budget agreement and the tax bill? Ms. Rivlin, or Mr. Meyer, whoever would like to go first.

Ms. RIVLIN. I think one of the best things about the tax bill is that it isn't terribly large, because I think it is more important to get the budget deficit down right now than it is to reduce taxes. The bill presently provides some relief to some of the people who need it most, I think young families with children. That is good. Some of the problems that have been alluded to about income distribution I think could be made better by making sure that the working poor get major benefit from this bill.

I am less enthusiastic about cutting capital gains, because largely it will not have much impact on the economy, and it does tend to reinforce the widening of the distribution of income.

Mrs. ROUKEMA. That last statement surprises me. But Mr. Meyer.

Mr. MEYER. I will briefly opine on fiscal policy, but cautiously so. I agree with the Vice Chair that reducing the deficit is the most important contribution in terms of promoting higher national saving, lowering interest rates, and increasing investment. Number two, with respect to the tax policy—

Mrs. ROUKEMA. Do you think we are doing a good job on that in this budget?

Mr. MEYER. I think that, in terms of achieving a balance by 2002, I think it is OK. But, I think there is just way too much emphasis on 2002. It doesn't really matter where we are in 2002 relative to where we are today. Where we are today is about as good as we are going to be in 2002.

The issue of the changes that you are considering today has nothing to do with where we go in 2002. It is setting a foundation for the more difficult problems that come later, and I think there is inadequate attention to that groundwork. That is what we

should be doing and focusing on, and I don't think we have done quite enough in this bill.

Mrs. ROUKEMA. Thank you very much. Mr. McDonough, do you wish to comment on that aspect?

Mr. McDONOUGH. If you will permit me not to comment, I would be delighted not to comment.

Mrs. ROUKEMA. I would permit you not to comment.

Thank you, Mr. Chairman, I appreciate it.

Chairman LEACH. Also do you want to be—

Mrs. ROUKEMA. No. They have answered my questions. I think we get a pretty positive—if not an A-plus, we get something like a B-plus maybe, or maybe even an A. Thank you. I am opining. I am opining. Thank you.

Chairman LEACH. Mr. Vento.

Mr. VENTO. Thanks, Mr. Chairman. One of the witnesses that is going to appear later today is going to comment about the fact that technological advances achieved in the private sector can permit faster growth with continued low inflation. There are a number of factors, I thought, about that one.

That is probably a dissertation for most of you, but another factor is, of course, the globalization of our economy. What is happening with that? I have also reflected on our monetary policy during times of problems, and I think this is a more stable time. I think there are still some real challenges here and I think that is why it is good to discuss this today, and I appreciate your being here; but that the globalization issue, in terms of what other central banks are doing, I noticed that for a long time we were kind of being led and now they are following in terms of the value of the dollar and so forth.

Can you comment on those two aspects and technological changes that would permit—I guess this would say we are moving away from the one model or the one theory that has been used here. I will leave that to my colleague, Mr. Frank.

Mr. Meyer.

Mr. MEYER. The model of the economy that we use to explain growth gives a very prominent role to technological change in raising productivity over time. Now the question that you are asking, however, is whether we are on the verge of some dramatic increase in the rate of productivity growth, because of the innovations that have taken place recently. And the answer is, I hope so. But I don't know. I don't make policy on the basis of hope. I make policy on the basis of what I know.

I look very carefully at these things. I try to look at the data, because there is a qualitative story that would tell us that there is a possibility that the trend growth may be higher. But, again, in terms of monetary policy, it is not that critical, because there is just no way policy is going to suppress a high rate of growth. If trend growth increased and we were suppressing actual growth, the unemployment rate would be rising, and rising, and rising forever. That is not going to happen, I am quite sure.

Mr. VENTO. I think the real issue here is whether you are leading or following.

Mr. MEYER. The question is—yes, I am—I am following the data very closely, very closely.

Mr. VENTO. OK.

Mr. MEYER. And that is what I think is prudent to do.

Mr. VENTO. As you point out, it is an art and a science combined. I guess it is a question of emphasizing the art part of it.

Mr. McDonough, do you want to try to respond? He didn't touch globalization.

Mr. MCDONOUGH. I think technology and globalization go very much hand-in-glove. One of the reasons that the American economy is doing well is that we are the world's leaders in technology. We were worried 10 years ago that the Japanese were going to take over the world in information technology. We have clearly surpassed everybody. That creates great opportunities for the American people.

It may be possible—as Governor Meyer says, we don't know yet—that there may have been an accumulation of investment in computer power and information technology which will kick in and make it possible for us to grow productivity faster and therefore grow the economy better. We do not know that yet. It is a very interesting question, and one has to hope and pray that the answer is yes.

Globalization also helps the United States, because world trade, especially for a country that is as good and competitive in exports as we are, makes it possible for us to create jobs through these export industries.

Now unfortunately, like most things in life, there is another side of the technology-cum-globalization coin, and that is that it puts an enormous amount of additional benefit on those who are technologically skilled and better educated. It is the single biggest driver behind the disparity of income which a number of you discussed in your opening statements and about which monetary policy can do very little but, in my view, is the major structural problem in our economy.

We don't want to solve the problem by killing technology, but we have to recognize that this greater reward to people who are better educated and better skilled creates a problem for those who are not making it, which we as a society need to focus on.

Mr. VENTO. The education institution itself might be worried.

Governor Rivlin, did you want to respond?

Ms. RIVLIN. I am not sure I have anything to add. I think those are the important points.

Mr. VENTO. Well, you know, we had participated, some of us, in rewriting the legislation in 1978, and we strongly believe in the social goals that are embraced in it, because we think monetary policy—notwithstanding the tendency to be modest about what the impact was by then-Chairman Arthur Burns or his predecessors—that it does have an important role, and in fact we think it is on a par with fiscal policy. And of course the relationship is—1 percent here or there, in a \$5 trillion debt, does have an impact on fiscal policy.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Vento.

Mr. McCollum.

Mr. MCCOLLUM. Thank you.

Mr. McDonough, in answering the questions a minute ago that Mrs. Roukema asked you, I don't think you got to the point that I would like for you to have. Governor Rivlin and Governor Meyer too.

Senator Mack and Congressman Saxton have been toying with the idea of legislation, I think, introduced at least a couple of times to eliminate the maximum employment consideration for the Open Market Committee and to focus on price stability. If that were done, if we were to take that out of the legislation as a part of the criteria legislatively, would it make any difference, in your judgment, to how Open Market decisions were made? And if so, would that be positive or negative?

Mr. MCDONOUGH. I think that it would make very little difference now, because I believe that the FOMC, in its entirety, its entire membership, believes that price stability is a means to achieve sustained economic growth. So in a way it would say, rather than look at price stability as a means, that is the goal, and we as the Congress of the United States will worry about everything else.

Mr. MCCOLLUM. And so maximum economic growth would net maximum employment; that is your view?

Governor Rivlin, what do you think?

Ms. RIVLIN. I have a stronger view. I think it would be a mistake to change the law. I think the drafters of Humphrey-Hawkins got it about right. You could reword it, but I don't think it would be sensible to single out price stability or a target inflation rate as the only goal of the Federal Reserve.

Mr. MCCOLLUM. It would make a difference?

Ms. RIVLIN. I think at the margin it might make some difference. But my point is that the Federal Reserve should have as its goal what other economic policymakers have, and I believe that is maximum sustainable growth. And if you go beyond that and say that the only goal is price stability, I don't know that it would make a big difference, but I think it would tip the balance toward—

Mr. MCCOLLUM. Governor, I wouldn't argue with maximum sustainable growth, but "maximum employment," those are words that are used in the Act, and those are the words I understand they want to strike, as opposed to "maximum sustainable growth." There is quite a bit in there, of course.

Ms. RIVLIN. I think that would be a mistake. I think all of those things are important and should be weighed by the FOMC in its review of the economy.

Mr. MCCOLLUM. Mr. Meyer, what is your view?

Mr. MEYER. Well, I had an interesting discussion with Senator Mack before my confirmation hearings, and I respect his thoughtful views on this subject.

My view is that I am a dual objective person. I said so in my opening statement of my confirmation hearings. I believe that we have an influence on employment in the short-run. We don't have an influence in the long-run on the rate of growth, but we do have an influence on employment in the short-run. And I think it is reasonable, therefore, to make us sensitive to the importance of maximum sustainable employment as well as price stability. These are both our goals.

Mr. McCOLLUM. Let me ask you a question related to this. The price of gold has dropped to something like \$322 an ounce, I think in part because of the foreign banks, like Australia, selling gold, and there have been some indications this has been encouraged by our Federal Reserve.

What price pressures do you see, Governor Meyer, on the commodities markets in general? And do you think that commodity prices; A, are a good signal of inflation or disinflation?; and, B, is the selling of this gold now making this less a usable tool for the Open Market Committee?

Mr. MEYER. I think it is a perfect example why I have never focused on gold in my own analysis as a particularly useful signal or forecaster of inflation.

What has happened to gold now is a result of political decisions being made about what the composition of international reserves of central banks around the world. It has nothing to do with inflation expectations.

Mr. McCOLLUM. But if that were not happening, would it not be more likely?

Mr. MEYER. But there are always assorted other influences on the gold market, and, again, I don't view that as very useful.

The broader commodity markets are a different story. The broader commodity markets have some value, because they tend to be very sensitive early warnings of aggregate demand pressures in the world economy. These are set in world markets.

Mr. McCOLLUM. And broader commodity markets being what?

Mr. MEYER. I am talking industrial raw materials rather than food and oil, because those are very volatile. Industrial raw materials can be of some value, but they have a very small weight in the determination of overall prices, and therefore they are almost always overweighted in people's forecasts about what inflation is going to be. They are not unimportant, but there are many, many factors that are much more important in the determination of prices than commodity prices.

Mr. McCOLLUM. Could I, with the indulgence of the Chairman, get Governor Rivlin and Mr. McDonough to respond?

Chairman LEACH. I think this is important.

Mr. McCOLLUM. I would appreciate their views.

Ms. RIVLIN. Mine are similar. I have never had a great focus on gold, and I think the current situation simply justified that.

High gold prices sometimes are an indicator of high inflationary expectations. People hold gold because they think the price of everything else is going up. We don't have that at the moment, and that is good. But I think Governor Meyer has put the argument about commodity prices just about right.

Mr. McCOLLUM. But if you saw the price of gold going up steeply or sharply, that might be some signal that inflation might be on the horizon because of the psychological result of the marketplace? Is that your thinking?

Ms. RIVLIN. I think that is possible, but I wouldn't give it enormous weight.

Mr. McCOLLUM. Mr. McDonough.

Mr. McDONOUGH. Let me just clarify a fact issue, since because of the distribution of responsibility among senior central bankers,

if anybody had been encouraging the foreign central banks to sell gold, I would have been the person. That is part of my job. I can assure you, no such encouragement was given. We don't tell them what to do with their gold—buy, sell, or keep it.

As regards the gold price, I think if you saw the gold price move up, first of all, you would want to know why. If all of a sudden everybody in India decided to get married 6 months from now—which is a big main source of demand for jewelry gold, then you would say that romance is in, in India. On the other hand, if it were sort of a generalized approach to the gold price going up, you would have to ask yourself a question about whether inflationary expectations internationally were increasing. That should be something one should be concerned about. That is about the only signal it would give you.

Mr. MCCOLLUM. And the commodity basket?

Mr. McDONOUGH. I think the commodity basket—I agree exactly with what Governor Meyer said about it.

Mr. MCCOLLUM. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Mr. Frank.

Mr. FRANK. Thank you.

At one level of formulation, I think we all agree, but clearly there are differences. Let me try to summarize what I think the differences are. You say price stability is very important and therefore you must act to protect price stability. The problem I have is that we have had price stability for some time and you are—some of you, acting as if we didn't. That is the problem.

I agree, Governor Meyer, you should not act out of hope, but I think you have to some extent been acting out of fear, and I think that is an equally bad idea. Some do say we should always err on the side of caution, but that means more unemployment. And I appreciate your saying maybe in the long-run it doesn't affect employment, but it does in the short-run. Everybody I know is employed in the short-run. I don't know anyone that has a job 11 years from now. Keynes was right; in the long-run, we will all be dead. Obviously, we are talking about this short-run.

My problem is this. I believe you Governor Meyer, cited train lines, estimates for various people in the NAIRU, but the problem I have is this. If you had been here 2 years ago citing all of those experts and all of those authorities, they would have been wrong. They would have been significantly wrong on the pessimistic side. And so I now feel that I have to quote Marx—Chico—"Who am I supposed to believe, you or my allies?" The fact is that you are citing a set of statistics and a set of indicators that I think have been proven inaccurate over 2 years.

I agree, we have an open question. Is that a one-time inaccuracy or not? You address that, and I think that it is probably a one-time inaccuracy. But at the very least, it seems that you are not entitled to simply cite those things. That is my problem. Of course, long-term price stability is a good thing.

And, Mr. McDonough, you are one of the few from the Fed who are willing to make the CPI a two-way ratchet. Usually we have people from the Fed telling us inflation is a problem, and they cite the CPI with no adjustment, but then they tell us we are giving

the poor old people too much money in Social Security, and they tell us the CPI always overstates inflation. If it overstates inflation for the poor old people, it overstates inflation for the economy. And I appreciate you taking that into account.

Here is my problem. On that account—by the way, I believe, by the Fed's own acknowledgment, the March increase was wholly unnecessary. I hope it wasn't damaging, but it was clearly based on assumptions about growth which turned out not to be true. Mr. Greenspan acknowledged that. You voted for the March increase, and I think it clearly was proven to be unnecessary. Things began to drop in the second quarter, and nobody thinks that the March increase caused that.

Here is the problem. Yes, price stability is a good thing. There is a lot of the empirical evidence of the last couple of years is that we can sustain more growth than we thought without endangering price stability. And you are acting to some extent as if that didn't happen and wasn't true, and you are telling us that you have to err on the side of caution.

Well, Mr. Meyer, let me ask you: You say Professor Gordon is saying the NAIRU is 5.4 to 5.9. How long have we been under the NAIRU then, by your estimate, and what negative consequences have happened? And are you convinced that there are going to be negative consequences?

For how long have we been under the NAIRU, and by how much? And why have we seen no negative consequences of it yet, and when do you think we will?

Mr. MEYER. Your point is well taken. You ought to have less confidence in this model, less confidence in the estimate of NAIRU, because of everything that has gone on. You are absolutely right. I agree with you. I have less confidence in it, too. But I believe, because of the extraordinary value and reliability of this concept and estimate earlier—

Mr. FRANK. How long have we been under it?

Mr. MEYER. I have said since I came to the board that I thought NAIRU might be 5.5 percent. We averaged 5.4 percent in 1996. We have been significantly under the estimate of NAIRU, in my judgment, for about 3 months.

The lags involved in monetary policy are very long. We will not have a test of whether we are below NAIRU until about the middle of 1998. That is the whole point.

Mr. FRANK. First, I am pleased to get your estimate at 5.5, because you had a range of 5.4 to 5.9 here.

Mr. MEYER. Those were outside estimates.

Mr. FRANK. Right. But you think 5.5. We have been under it, I thought, for more than 3 months.

Mr. MEYER. Well, 5.4 was the average in 1996.

Mr. FRANK. But now we are into the seventh month. You don't have to apologize to me for saying that we are only slightly under it. I am glad. I am not worried. You are worried. You don't have to reassure me. If your message is we are not sufficiently under what you think the NAIRU is to worry about, then we have a happier time than I anticipated, and I am glad.

Mr. MEYER. Let me make it a little bit more interesting for you. You say that we should certainly not have made the move in

March, because what we worried about didn't happen, because growth slowed down. I completely disagree with that. I have called that monetary policy action "just-in-time monetary policy." I believe it was worthwhile.

When we were making that decision, the unemployment rate was 5.3 percent. My judgment was that the momentum in growth was so strong that I believed that the unemployment rate was going to move down to or below 5 percent over the next 6 months. It moved down to 4.8 percent. Now it is up to 5 percent, but the point is, it did move down. It was utilization rates that were the issue here. In my judgment, monetary policy should result in interest rates being pro-cyclical. When the economy is growing above trend and utilization rates—

Mr. FRANK. First of all, what I am saying is that I think you are disregarding evidence that the trend is better than it has been, and specifically when you talk about the slowdown. But it did slow down. You are now telling me that we are not significantly below the NAIRU. Do you think that the March increase is the reason that we didn't grow faster?

Mr. MEYER. No. Monetary policy—

Mr. FRANK. Let me say two things. It is one thing to say, "at the time I made the right decision," but I think in retrospect the explanations given for it were simply wrong, that the growth rate didn't continue at the high level that it was at then and it didn't stop the growth rate.

Further, if you knew in March what unemployment and inflation and growth rate figures were going to be for the succeeding months, you still would have voted for the increase?

Mr. MEYER. That is correct.

Mr. FRANK. Why?

Mr. MEYER. Because the issue wasn't the growth rate. The fact of the matter is, the growth rate in the first half of the year was stronger than I anticipated when the decision was made in March.

Mr. FRANK. But if the issue wasn't the growth rate, why did you raise interest rates?

Mr. MEYER. You are absolutely right. The issue was the expectation that utilization rates would rise further from already high levels. The expectation, by the way, was realized immediately. It was done in anticipation of an increase in utilization rates which, indeed, happened immediately.

Mr. FRANK. Are utilization rates, and have they been in this quarter, at an unsustainable high level?

Mr. MEYER. What?

Mr. FRANK. Are the utilization rates at an unsustainable high level now?

Mr. MEYER. We will only know that over time.

Mr. FRANK. You don't have an opinion on that?

Mr. MEYER. I have given my opinion on it.

Mr. FRANK. I missed it. Give it to me again—slower.

Mr. MEYER. I am concerned that the utilization rates may already be so high—

Mr. FRANK. My problem is that this is a confirmation of what I thought. We are not significantly below the NAIRU, but now you—

Mr. MEYER. By my estimate, half a percentage point.

Mr. FRANK. I am just quoting you.

Mr. MEYER. But, Mr. Frank—

Mr. FRANK. Excuse me. You said we are not significantly below. What I am saying is, there seems to be a kind of, "let's find a reason to justify putting on the brakes," and I think that this can translate that this is an unfortunate pessimism that is there.

I reject the notion that you are supposed to err on the side of caution, because all the errors are on the side of slowing down. Nobody ever thinks about erring on the side of maybe avoiding some unemployment, and I think that adds up to a bias that is unfortunate.

I am not saying that you are biased against growth. Obviously, you are not. You are biased against, in my judgment, the interpretation of the most recent set of statistics that suggest that we can sustain more growth than we have been. I think it is cultural lag, rather than bias that is our problem.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you. The time of the gentleman, who has implicitly acknowledged that he speaks faster than he listens, has expired.

Mr. FRANK. I find it much more interesting when I speak than when I listen, Mr. Chairman.

Chairman LEACH. So do the rest of us.

Mr. Sanders.

Mr. SANDERS. Thank you, Mr. Chairman.

I will try to speak slower. "Fat chance," says Mr. Frank.

One of the concerns that I have in terms of what is going on in American society, is that we have the lowest voter turnout in the industrialized world. The next congressional election, I am guessing 65 percent of the American people don't vote. They don't really care much about what you say. They don't care much about what I say, what Congress does. They think Congress and the United States Government is largely irrelevant to their lives.

And one of the reasons, I think, that they feel that is when they hear statements from people in governmental policy such as Alan Greenspan, and many others, who say that the economy today is performing in an exceptional way.

Now, in 1994, earnings for production workers were \$389 compared to \$444 in 1979, in 1994 dollars. What we have experienced over the last 20 years is a precipitous drop—decline—in the wages and the standard of living of tens of millions of American workers. In 1995, according to *Business Week*, the average compensation for corporate CEOs increased by 54 percent.

See, I think that is where Mr. Greenspan got the idea of an exceptional economy. He forgot that most people weren't corporate CEOs. But for average workers during that year, there was a 3 percent increase.

The last statistics that I have seen from the Bureau of Labor Statistics suggest that last year, compensation went up by 2.9 percent, which indicates that if we understand the people at the very bottom got a bump, because of a rise in the minimum wage, the average American worker's standard of living continues to go down. People are working longer hours for lower wages, and in my State

you find people working two jobs, three jobs, begging for overtime. Women who would prefer to stay home with their kids are now forced to work.

CEOs are now earning 200 times what their workers are making. We have the largest gap between the rich and the poor in the industrialized world. I don't hear so many people talking about that issue.

If we are here to represent the middle class and the working class of this country—and I know the word “working class” offends people. Maybe I am the only one who feels that we do not live in a classless society. When you have CEOs making 200 times the workers, we have the most unfair distribution of wealth.

I want to ask you some pointed questions. Am I the only person who thinks that the economy is not exceptional when tens of millions of workers have seen a decline in their standard of living? And when we have the largest gap between the rich and the poor in the industrialized world? Who wants to tell me that you all think that the economy is just exceptional? Please come to Vermont and help me explain that.

Mr. McDONOUGH. I would be happy to try on that.

Alice, you want to go?

Ms. RIVLIN. I would be happy to.

“Exceptional” doesn't mean “perfect.” What it does mean is that we have lower unemployment and lower inflation than we have had in several decades, and that gives us the chance to correct some of the problems you are talking about.

I share your view that CEOs and quarterbacks and lots of other people probably make more money than they are worth. That is not a problem I can solve. The bottom end of the income distribution is much more important. We have the chance now, with low unemployment, to move people up in the income distribution.

Mr. SANDERS. Other brief comments? Do you all agree with Ms. Rivlin?

Mr. McDONOUGH. I would like to add something to it. The fact that we think that the economy has been behaving unusually well does not mean that there are not some problems in society. I think there are some serious problems in society in regard to the ability of people in the bottom, say, quintile of our society, to make it out of the situation in which they find themselves. I am very sensitive to that. I was an orphan, who was on relief, who got to where I am today because in the United States of America that was possible.

Now you, above all else, but also the Federal Reserve operating in its capacity, have to address those problems in our society which are very serious and need looking at, but there is absolutely nothing that lowering interest rates will do to solve those problems.

Mr. SANDERS. You used the words, Mr. McDonough, “exceptionally well” What I am suggesting to you, is that if people work longer hours for lower wages, if their standard of living is in decline, the economy is not working “exceptionally well.”

You can tell me, and I will accept, unemployment is low. True. Inflation is low. True. But you know what is more important for tens of millions of Americans? How they are doing. And if people are going out working 50-, 60-, 70-hours a week to pay the bills,

if at one time in our economy one breadwinner could provide for one family and now you need two, how can you, with a straight face, tell the people that the economy is doing "exceptionally well"?

You can say truthfully that inflation is low. No argument. You can say truthfully unemployment is low. No argument. But come up with new criteria. Say those things, but don't say that the economy is doing exceptionally well.

My next question—we don't have a whole lot of time. The United States has the most unfair distribution of wealth in the industrialized world. The richest 1 percent own 42 percent of the wealth, more than the bottom 90 percent. Mr. Gates makes a billion dollars more every day, and people down below are having a hard time surviving.

What are you going to do about the unfair distribution of wealth, so that we do not have that dubious distinction of, on the one hand, having a proliferation of millionaires and billionaires and, on the other hand, having the highest rate of child poverty in the industrialized world? Twenty-two percent of our kids are in poverty; proliferation of millionaires and billionaires. What are you going to do about that?

Mr. MEYER. I would like to answer that question, and I don't mean to be disrespectful, and I hope this will not seem too sharp, but I am going to give you a very simple answer. What am I going to do as a member of the Board of Governors of the Federal Reserve System voting on monetary policy? What am I going to do about income inequality? The answer is—nothing.

One of the most important things that you have to understand as a policymaker is what you are capable of achieving and what you are not capable of achieving. I envy you the position that you have as a Member of this body and as a Member of Congress, because these are the very issues, the heart of the problems, that we are facing today.

And you are absolutely right. I think you are right on in your comments. And I apologize for focusing on some of the issues that macroeconomists focus on—inflation and the low unemployment rate—and not giving attention to the slow rate of growth in productivity, the slow average rate of increase in the standard of living, and the fact that, in that context many people are falling behind. You are absolutely right, we do need to focus public policy on that. It is the most important thing we can do.

The only thing I want to do is throw it back to you. Monetary policy has one instrument and two goals. Some people think that we have too many goals already, and you want us to do something about the income distribution. Frankly, I don't know how to do that.

Mr. SANDERS. Let me see if I can help you. Let me ask you: Some of us—I introduced legislation to raise the minimum wage to \$6.50 an hour, so that low-wage workers might get a boost; people making \$6 or \$7 an hour might make a little bit more money. We have to make that decision, not you. Are you going to be supportive of those efforts?

Mr. MEYER. that is not my favorite way of handling it. I prefer what I call "opportunity legislation."

The problem in the United States is that we have the vision that we are supposed to be the land of opportunity, but it isn't working like it is supposed to work. We need opportunity legislation so that people can be assured that they will have equal opportunity. That means education; that means training.

Mr. SANDERS. Will you then suggest that we should raise taxes on upper-income people to put more money in education to make college affordable for everybody? How is that?

Mr. MEYER. I am not saying that we have to raise it. It is a question of spending priorities.

Mr. SANDERS. But some people, both in the Clinton Administration and Republicans, are supporting huge tax breaks for the rich. What do you think about doing away with those and putting more money into education, so that we can have opportunity? Do you support that?

Mr. MEYER. I am not going to make a judgment at this point about where that money should come from, and, of course, education is a very complicated subject in terms of where the education dollars get spent. But education and training are the kinds of things that are absolutely important. I think the earned income tax credit is extremely important. It seems to me that that is a much better way of helping working families.

Mr. SANDERS. Will you support us in expanding the earned income tax credit? You just told us it was a good idea.

Mr. MEYER. I am simply not going to take positions on every single matter of fiscal policy.

Mr. SANDERS. Let me conclude, Mr. Chairman—

Mr. MEYER. I don't go around the country and give speeches about fiscal policy, about education, about these things. I go around the country talking about what I spend every single day focusing on, and that is economic outlook, monetary policy, bank regulation, financial modernization, consumer protection, and so forth.

Mr. SANDERS. Thank you very much.

I would simply conclude by saying this. I conclude by how I began. Most Americans could care less what you think, and what I think. They have given up on the political process. You should be ashamed and concerned about that. We should be ashamed. We have the lowest voter turnout in the industrialized world, and if somebody does not start paying attention to middle-class workers, and lower-middle-class workers who are falling further and further behind, rather than talking about the "exceptional" economy, we are not going to live in a democracy.

Mr. MEYER. I disagree.

Chairman LEACH. In case anybody doesn't think our committee has diversity, they are wrong. And in case anyone doesn't think that people of diverse views don't have fundamental truth in some of the things they say, they are also wrong.

Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman.

I think Ms. Velázquez had asked to have some questions submitted, so I ask unanimous consent that I could submit some questions on her behalf for the panel, if that is all right with the Chairman.

Chairman LEACH. Without objection.

Mr. BARRETT. Thank you, Mr. Chairman.

I would like to follow down the road maybe that Mr. Sanders was going down. And I viewed the news yesterday—I was, frankly, happy to hear Mr. Greenspan be very upbeat on the economy, and I agree that this is—at least in my adult life—sort of an unprecedented time in some quarters of our economy, with low unemployment, with low inflation, with the stock market doing very well.

And as I was reading some of the news reports, one of the things that struck me was one of the factors, or actually two of the factors that were cited by some observers as to why we are in this unusual situation. The first factor was insecurity among workers, and the second factor was the lack of aggressiveness, in particular, by organized labor, or maybe lack of effectiveness by organized labor, to help push up wages.

Mr. Meyer, I understand where your role is not to do anything, and I don't want to restate whatever you said. I concur with it. But I am wondering. I was sitting here thinking, "I wonder what they think about or what they talk about when they are in that room? Like most Americans have this sort of "Wizard of Oz" view of what goes on behind the closed doors.

Does the insecurity of American workers ever come into play in this discussion of what you do, Mr. Meyer?

Mr. MCDONOUGH. Do you want me to answer that? I have been there longer than any of these people.

Mr. BARRETT. I will ask all three of you.

Mr. MCDONOUGH. Chairman Greenspan brought up the possible theory that people have decided that they are more concerned about job security than they are about getting a pay raise. If that is so, we are not saying that is a good thing or a bad thing, but if it exists, then it is a partial explanation of why wage pressures have been so low. Again, we are not saying it is a good thing or it is a bad thing, but if you observe it, then you should decide whether to take it into consideration.

I think what you find at the table of the Federal Open Market Committee is a bunch of people who are trying to do their jobs very well. Some of us, like Governor Meyer, are trained economists. I, thank God, stopped studying economics in 1962 with an MA, and therefore I tend to look at things much more as a banker, which I did all of my life, but somebody who, because of historical accident, is terribly interested in the social well-being of the less well off. So I kind of bring that to the table.

And then we all talk and share views. And in the process of the meeting, a consensus is formed. And the consensus is that this is what we need to do to sustain economic growth in order to sustain the greatest number of jobs.

As Vice Chair Rivlin said earlier, can we guarantee you that we will always be right? Of course not. You have got 12 voting human beings, and therefore it is possible that sometimes we will be right; I hope most of the time. And occasionally we will be wrong.

Now, another thing—the reason I volunteered to head off—that the 12 Reserve Bank presidents can do is that we have an unbelievably good bully pulpit from which to try to influence the people in our community to attack problems that don't have anything to

do with monetary policy but have a lot to do with people being better off.

Let me just tell you a tale of something we did recently at the New York Fed. I am a great, great believer in the community development corporations, because the leadership of the community form them. They go into a community, and they know what their problems are and how to solve them infinitely better than I do.

The kickoff speaker at this event was the Reverend Calvin Butts, a superb human being who is the pastor of the Abyssinian Baptist Church in Harlem. He knows more about Harlem than I ever can. But, what I can do is to bring the leaders of the business community together with the real leaders of the community—the real people, as I call them—bring them together so that they can accomplish something.

One of the things that was accomplished was that Frank Newman, the head of the Bankers Trust Corporation, formed a group of financial leaders and they created a multimillion dollar pool to make grants to community development corporations, because frequently you have got the leadership, you have got the ideas, but you don't have any money. So we have got to start it. That is the kind of thing that we can do that has very little to do with monetary policy, but can help solve real problems.

Mr. BARRETT. I appreciate that.

Ms. Rivlin, do you want to comment?

I guess I can't accept the notion—and I think you both stated it very honestly—that there is a sort of morally neutral element here. I don't think it is good for society to have the masses insecure about their jobs, and I think to the extent that you have a bully pulpit, I think that bully pulpit should be used.

And I recognize that you don't have the tools to perform three or four different things, but to accept the notion that one of the reasons that we have low unemployment and low inflation is that everybody is terrified about losing their job next Friday I don't think is really a great thing for the masses in this country, and it seems as though no one at the Federal Reserve cares about that at all.

Mr. McDONOUGH. There is a big difference between observing something and not caring about it. I wouldn't spend my time thrashing about the Second Federal Reserve District trying to create more development and get more jobs if I were indifferent to the situation.

Mr. BARRETT. But I don't hear anybody speaking out in an atmosphere where there are massive layoffs—and I agree that every one of you wants to see more jobs created. What I am talking about is that the people who have the jobs, who are told that, "Your jobs are going to be moved to Mexico if you try to have a wage increase. We are going to downsize you and move your jobs to another part of the country." I think that there is a moral element here that I hear nothing about.

Ms. RIVLIN. I agree with that. I think that there is a moral element, and it comes into play very strongly in the board room at the Federal Reserve.

You asked the question of whether we talk about it. We talk about a lot of the things that we have been talking about here. I

didn't make any point in my statement that I haven't made to my colleagues. The most important thing right now is to keep this economy growing at the highest sustainable rate and keep labor markets tight.

It is good to have tight labor markets. And the reasons for that—some of the ones I enumerated in my statement—are that that is the way we raise the living standards for the least fortunate. That is way you make welfare reform work. That is the way we make community development work. Those are very important things to be doing, and we may disagree on how to do it, but that is what we all want to do.

Mr. FRANK. Would you yield?

I would ask for 10 seconds, Mr. Chairman, to make a point.

Chairman LEACH. Without objection.

Mr. FRANK. Thank you.

Governor Rivlin, I am delighted to hear you say that you think we should keep labor markets tight, but that is not what the Fed is doing. As a matter of fact, tight labor markets—for example lower unemployment—is a bad thing. At this point, we are being told that they are too tight, that we are too much below the NAIRU, and I think that is, unfortunately, the opposite end.

Mr. Barrett's point has particular poignancy. Not only do the workers now have this insecurity, but as long as we are told growth is going to have to be limited in the short-run, they don't even get the benefit of that insecurity. They don't even get the benefit. But I simply cannot accept that you are in favor of tight labor markets as a board when, in fact, it is tightness in the labor market that led you to raise interest rates.

Ms. RIVLIN. The tightness in the labor market is a very beneficial thing to the economy now. We are getting millions of people who have jobs—

Mr. FRANK. Was it beneficial in March when you raised rates?

Ms. RIVLIN. We have millions of people who have jobs and job experience that they would not have had. The Chairman made a major point of that in his statement. I happen to believe that one of the things that will enable us to keep the unemployment rate coming down is exactly that, that as people with less job experience who would have been unemployed get trained and job experience—

Mr. FRANK. The fact is, for the majority of your board, if the unemployment rate came down significantly, they would be advocating raising the interest rates right now. That is what this hearing is all about, and that is my problem.

Ms. RIVLIN. But I don't think that is right.

Mr. MCDONOUGH. That is not the way the Federal Open Market Committee has been behaving.

Mr. FRANK. Mr. Meyer, wouldn't you feel that if we were too far below the NAIRU, they would be obligated to move rates?

Mr. MEYER. I would argue that since there is uncertainty about where that particular point is. I don't put emphasis so much on that particular point. When you are close to it, then as utilization rates increase, you have to—

Mr. FRANK. Can you answer in 10 seconds?

Mr. MEYER. That is what I have consistently said.

Mr. FRANK. I want to declare a partial victory. If I am told I am wrong to think that a reduction in the unemployment rate would cause you to raise rates, I am delighted to be wrong, never happier to be wrong.

Chairman LEACH. Mr. Barrett.

Mr. BARRETT. I think my time has expired.

Chairman LEACH. Mr. Hinchey.

Mr. HINCHEY. Thank you very much, Mr. Chairman. And let me thank our three guests for their obvious sincerity and the candor of their answers to these questions. I think this has been a very helpful discussion.

At least by inference, perhaps more directly by Mr. Meyer, there have been a number of suggestions that the Fed does not deal with fiscal policy and to a large extent the problems that we are talking about are problems that can only be dealt with by fiscal policy or a combination of fiscal and monetary policy.

There is a role for fiscal policy that is not being met. It has been the failure of this Congress and previous Congresses going back under both parties for more than a decade, in my opinion, that have abjectly failed to deal with their responsibilities with regard to fiscal policy. Those reasons, along with the tight monetary policy of the Federal Reserve, is causing the great disparity of wealth and income that we have seen recently. Civilian compensation under the latest measurement has risen at 2.9 percent, inflation at 2.3 percent, creating a .6 point difference on the positive side for the American workers. That is one of the first times in recent months that we have seen that kind of progress in years, which is great, but it is still not enough.

My question is, what can we do, what can you do, to get that .6 of a percent up to where it ought to be so that a majority of people in our economy can begin to feel the benefits of this economic growth that we are experiencing?

Mr. McDONOUGH. We can reduce inflationary expectations, which is what well-sustained monetary policy can do. And in the process of reducing inflationary expectations, we can make the economy grow better. That is, in my view, the only thing we can do directly to attack it.

You are absolutely right that what we really need to do to solve the major problem in society is a combination of good fiscal policy and good monetary policy. If you get the two together, we can do a lot of good for the people.

Ms. RIVLIN. I would put it a little differently. I think we can have, to the extent that we know how to do it, a monetary policy that will keep the economy growing as fast as it can and keep the unemployment rates down. I think we are in a good spot now. Things are beginning to move at the bottom of the wage distribution particularly, and we need to keep this going.

Mr. HINCHEY. Let me attempt to posit a theory as to why we have low inflation at the same time we have this strong economic growth, and it is simply this: We have broken the economic contract, or the social contract. The social contract in this country has been broken as a result of a variety of phenomena that have occurred in recent years. One is that you have about one-third as many people engaged in organized collective bargaining than you

had several decades ago; 30 percent of the workforce as opposed to 11 percent of the workforce today. That weakens the bargaining position of the working men and women of this country and weakens their ability to achieve greater economic justice in the marketplace.

Also, we have had an extraordinary level of technological advancement, which is not adequately factored into the decisionmaking process yet, in my opinion.

Also, you have had trade agreements, such as NAFTA and GATT. You can today, if you are an American manufacturer or if you are selling manufactured goods in the United States, no matter what your nationality might be, go to Kwandong, hire a factory worker for \$30 a month. He will work for you for 14 hours a day, 6 days a week, for \$30 a month. That puts pressure on the American worker, and that keeps inflation down, and that keeps wages down.

The end of the Cold War. One of the things that the Soviet Union did was to educate their people, and they now have an extraordinary surplus of educated people. So if you are an engineering firm in the United States, you can contract for scientists in St. Petersburg, Russia, to work for you for \$150 a month, and you can get first-class science for \$150 a month from that worker, that scientist, that engineer in St. Petersburg. That puts pressure on the American work force. That holds wages down. And none of these events are adequately factored into the decisionmaking process that goes on in this town either by the Federal Reserve Board or by the Congress of the United States.

And the people who are suffering are the American working man and woman, because they have not been permitted to participate anywhere near the level that they expect to participate in this strong economic growth that we are experiencing, and, consequently, all of the money is going to a handful of people in our society.

The Clinton Administration has started to reverse that, but not enough yet. And holding down the deficit is not enough. We have got to have, as you have suggested, a fiscal policy which promotes growth and a better economic condition for workers. But we have also got to have a different psychology, in my view, respectfully, at the Federal Reserve Board which recognizes that the ball game has changed. We are playing today by a whole new set of rules. The old set of rules is out the window. We haven't adjusted to the new set of rules.

Mr. McDonough, you said something I thought was very profound and interesting. "Price stability is the best means to achieve maximum economic growth and maximum employment."

That is an interesting statement in a sense that it already has done what some of our colleagues want to do with Humphrey-Hawkins. It already has said that price stability is paramount, and the way to achieve the other requirement of the charter of the Federal Reserve and the Humphrey-Hawkins Act is simply by focusing your attention on one side of the equation, on the price stability side, and not on the maximum growth side and not on the maximum employment side.

It is a psychological barrier that we need to cross. And if we can cross that psychological barrier, both you, the Fed, and we, the

Congress, we can begin to achieve the kind of economic growth that the people in this country really deserve.

Mr. McDONOUGH. I think we may not have a psychological barrier but a communications barrier. My view—and I believe it is the collective view of the FOMC—is that the goal is sustained economic growth. Within our powers, the best contribution we can make to that is through price stability, because if we have that, then the other things—such as fiscal policy—can be better applied. Moreover, it is likely that you will have an atmosphere in which both businesses and households will be willing to invest, and the economy will grow more.

What it does not get at well at all, which you are very concerned about and I am very concerned about, is the disparity of income problem.

Now, if an economy is creating wealth, there is more to spread around. There is a very clear issue of how it is being spread. Since quarterbacks don't hit small women—but might hit tall men, I am not going to say quarterbacks are overpaid, but clearly there is a distribution of income problem in our society which we need to look at.

As a citizen, I am going to be batting the drums to have you ladies and gentlemen working on that. But in our business of monetary policy, the best thing we can do to contribute to the overall success of public policy is to achieve maximum economic growth by stabilizing prices. That we firmly believe in, and some of us—I think all of us—firmly believe that there are other problems in our society that need to be solved. But if we start trying to solve them by bad monetary policy, we just make it worse, we don't make it better.

Ms. RIVLIN. I agree with that. The one thing we want to avoid, in the interest of a strong economy, is making some of the mistakes that other countries have made. If you spend any time in France and Germany these days, you realize that in the interest of protecting workers, in part, they now have found themselves in a situation with 12- and 13-percent unemployment and they don't know how to get out of it, and that is self-perpetuating, too. They are raising a whole generation of young people who have very little opportunity ever to have a job or job experience.

We really need to remember that the benefit of having job growth and low unemployment is that we are doing exactly the opposite. We are making it possible for more people to learn and to move up.

Mr. HINCHEY. I am not suggesting, if I may, Mr. Chairman, with your forbearance, that we ought to be following or imitating what is going on in France or Germany. What I am saying is that we ought to have a monetary policy that allows for stronger economic growth.

The Philips Curve, in effect, has shifted as a result of those phenomena that I mentioned. This is a changed circumstance, and we ought to have a Federal Reserve policy that allows for economic growth, that encourages economic growth.

I would agree with you more, Mr. McDonough, if I did not know that the Congress of the United States has, in effect, tied its hands and eviscerated any ability to have a pro-growth fiscal policy.

There is no pro-growth fiscal policy in the Congress of the United States these days, as a result of the binds that this Congress has constructed for itself—not just this particular one, but this and previous ones—which make it virtually impossible for the Congress to adopt a fiscal policy that is growth-oriented.

Mr. MCDONOUGH. I think it is difficult to make it growth-oriented in the Keynesian sense, but let me use my own town as an example. New York City spends plenty of money on the public school system, but the public school system isn't very good. What the mayor and the school authorities wisely did is, they brought in a terrific school chancellor. The State legislature in Albany changed the law and gave the chancellor the power so he could do something.

A lot of us in the private sector are working very, very closely with him in order to bring the private sector in. He was sitting with me at lunch one day, and he said, "I would like to create an internship program for a thousand 16-year-olds so that they can get work experience." And I said, "Terrific. We will take the first 25." And we now hope we can get this going next summer.

If we have great fiscal restraint, which we certainly do, I think what we have to concentrate on is using the money wisely. And in this New York City example, I can tell you, the way things are going, we are going to be producing a lot better educated kids in the next few years than was the case in the past, with no additional expenditures, just using the money smarter.

Chairman LEACH. The time of Mr. Hinchey has expired.

Let me make an announcement. It is the Chair's intent to go straight through. We have been fortunate to not have votes on the floor, and I am very apprehensive that that process will start, and so the next panel will proceed immediately after this panel. For panelists, there is a carryout shop on the floor below us.

Mr. FRANK. Mr. Chairman, we can waive the rule against testifying with your mouth full.

Chairman LEACH. Well, in the oldest extant book of etiquette in the United States written by George Washington at the age of 16, one of his admonitions is: Speak not with your mouth full.

Mr. FRANK. That is if you have wooden teeth, Mr. Chairman.

Chairman LEACH. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

And I apologize for having to leave. I had to pick up my children and deposit them somewhere else. But I did have some questions that I really did want to ask you. Then I have to leave to go to another thing, so I apologize for that in advance.

First of all, Mr. Meyer, in reading your testimony, I have a couple of questions. One, you seem to be stating that you think that the lower unemployment rate, low inflation is not a result, necessarily, of temporary factors but is a transition within the economy. In part, worker insecurity, which I think we all would agree is probably a bad labor policy for this country; but in addition, you seem to be stating that somewhere productivity is increasing, maybe in the product side more than the labor side.

Yesterday, Mr. Greenspan testified that unit labor cost had been flat over the recent period. One thing that we have always been told, those of us who are concerned about income distribution and

wage stagnation, at least at the middle and lower ends, has been that to get away from wage stagnation, you have to increase productivity commensurate with increasing output.

If that is going on, or if you think that is going on, why have we not seen an increase then in wages at the middle and lower end?

Mr. MEYER. Let me clarify what is in the written testimony. I did break up the explanations of the low-inflation, low-unemployment environment into what I called "temporary" factors, and somewhat longer-lasting, if not permanent, structural changes. Of those, I would say there is no speculation about the role of temporary factors; they are clearly important. They are the single most important factor explaining the recent performance.

Some—quite a number of—economists believe that you can explain most of the surprise by this confluence of temporary events. The appreciation of the dollar, the decline in import prices, lower rate of increase in employee benefit costs because of what is going on in the health care industry, the faster rate of decline in computer prices, and most recently, the decline in energy prices and the slow increase in food prices, all of these are important. We can document them, and we can have some ability to parse out how important they are.

Now, it is my judgment that when you take all of these things into account, there is still something more going on, that the explanation is not just these temporary events, but also some longer-lasting changes. That is why I am saying that I think the critical unemployment rate threshold is not 6 percent as it was—and I thought it was, as we entered this decade—but something that might be lower. So I do think that there might be some fundamental factors at work.

It is very difficult to test worker insecurity precisely, but it has the right feel to it. There are lots of labor market phenomena that seem consistent with this story, although it is not entirely a positive story. I am using it to explain this environment, but it has got a pessimistic tone as to why things are the way they are.

In terms of productivity, I always say "may." It really hasn't shown up in any clear-cut way in the data yet. There are a variety of reports that we hear from businesspeople, that I talk about in my testimony, that they are seeing significant increases in the efficiency of the production process because of corporate reorganization and the application of new technology, but it hasn't really shown in the data. We can hope that that will occur, but to me it is still one of the possibilities, but something that I cannot confirm at this time.

Mr. BENTSEN. If I could, Mr. McDonough has mentioned this, the issue of globalization, and this is probably beyond monetary policy, but it would appear that globalization, the world market that we deal with now, has put us, in some instances, at a competitive disadvantage as it relates to environmental policy, worker health and safety policy, and still some remaining labor policy.

How do we handle that, absent rolling back environmental protection, which I certainly don't agree with and I don't think the majority of Americans agree with, rolling back worker health and safety policies and wage policies, for that matter? What is the pre-

scription for dealing with that competitive disadvantage, if in fact there is one?

Mr. MEYER. I just don't believe there is a competitive disadvantage at all. I think American producers are doing an extraordinary job of competing in the world marketplace. I think we are very, very competitive. That seems to be at conflict—

Mr. BENTSEN. Could I interrupt you for a second, because I would like to follow up on that, because every Member of this committee will tell you that we have people who come in our offices every day representing industry, telling us that: "You have to unshackle us from regulation; we cannot compete with low wages in the Philippines, or in the Asian Pacific, or in Mexico; if you do not reduce regulation or give us some more leeway under environmental regulation, we are going to have no choice but to move our plants overseas."

I am a free trader, and I get very nervous when we get into those types of arguments. But what you are saying seems to conflict with what we hear from a lot of industry.

Mr. MEYER. Fine.

Mr. BENTSEN. I mean—

Mr. MEYER. No, I believe that the efforts that really began in the late 1980's, when we were suffering some serious competitive problems and made great efforts to cut costs to make U.S. goods more competitive in world markets, have paid off very significantly. We see that.

If you look at exports, they are one of the fastest growing components of aggregate demand. Exports are growing very rapidly. The trade balance has continued to increase, partly because of the great strength of the U.S. economy, and also because of an extraordinary appetite for imports on the part of the American people.

But our export growth has been excellent. It has shown a lot of strength, and I think American firms have demonstrated their capability. We are a world class competitor. There is no question about it, in my judgment.

Mr. MCDONOUGH. We sure shouldn't shift to dirty air in the United States in order to compete. I think that the efforts that have been made under the previous administration and under this one to insist, in our trade discussions, in our trade negotiations, that we shouldn't be competing with clean-air American steel against dirty-air other people's steel is a tack we should continue to take. There are those who think that is inappropriate as a matter of foreign policy or trade policy; I don't agree.

Mr. BENTSEN. But do you believe there is any need for any sort of compensation? Mr. Meyer says that we really are not at a disadvantage there; we have found other efficiencies in order it make up for great regulation. Is that your opinion?

Mr. MCDONOUGH. That is certainly true at the macro level. At the micro level, which is the level of the people who come to see you, they are not interested in the whole economy, they are interested in their business. I don't know whether they have a case or not. As you well know, because they want you to help them, there are mechanisms within our Government structure to hear those complaints.

Mr. BENTSEN. Thank you.

Chairman LEACH. Let me modify an earlier Chair announcement before turning to Mr. Jackson to conclude. I am informed that in a minute or two there is going to be a vote—probably two votes, possibly just one vote on the floor, and so what I would like to do, with the conclusion of Mr. Jackson's remarks, is bring this panel to an end and then to reconvene a half-an-hour after we conclude.

Mr. Jackson.

Mr. JACKSON. Thank you.

Let me ask unanimous consent that my opening remarks be entered in the record.

Chairman LEACH. Without objection.

[The prepared statement of Hon. Jesse L. Jackson Jr. can be found on page 118 in the appendix.]

Mr. JACKSON. Governor Rivlin, Governor Meyer, President McDonough, welcome.

Yesterday, Chairman Greenspan acknowledged that the true unemployment rate and underemployment rate is actually much higher than that which is officially reported. For example, he said that the official unemployment rate is 5 percent, which means 7 million Americans are unemployed. He also acknowledged that there were an additional 5 million people who were actually unemployed, who are actively looking for work, who cannot find jobs but are not reported in the official numbers. That means in reality there are 12 million people who are unemployed.

Mr. Greenspan further acknowledged that while the exact numbers were harder to come by, there were additional millions who had never been employed, who were working part-time, who would like to be working full-time, or who were underemployed; that is, working at jobs in terms of pay scales and pay levels which were clearly below their qualifications. I suggested that the total number is somewhere between 15 to 20 million Americans who are either unemployed or underemployed, and he did not—I repeat—he did not challenge my figures.

Then I asked him if the actual number of people who are unemployed or underemployed was reported each month as 15 to 20 million Americans, whether such accurate reports would have Fed policy implications. He said—and I quote—“No.” I said, “Let's say 9 percent,” and then he said—in essence, he said—and I quote—“Reality is reality, and simply reporting the reality differently would have no effect on policy.” At least he said he hoped it wouldn't have an effect on policy.

Ms. Rivlin said a few moments ago that unemployment in Europe was 12 to 13 percent. It might be because the Europeans are reporting their numbers a little differently than we are. I will give you an opportunity to respond.

My question is, do each of you agree that if the Labor Department each month reported to the American people that 15 and 20 million able-bodied Americans were unemployed or underemployed, that it would have no effect on Fed policy whatsoever?

I would encourage you to be brief, because I want the American people to understand your answers.

Ms. RIVLIN. I think the way we measure unemployment, looking at the people who have jobs or the people who don't have jobs relative to those who are actively seeking work is a very useful way

to do it. There are also people who are not actively seeking work who either might want more hours or who would like a better job or a job if they could get one. It is useful to know how many of those—

Mr. JACKSON. Let me ask a quick question. Let's say that there are 19 million people—that is an official number—19 million people are working part-time jobs. It doesn't suggest that they are looking for full-time work. Would that be incorporated in your thinking in terms of official unemployment numbers?

Ms. RIVLIN. If I could get to the end of my sentence, I think that all of these figures are important and useful and should be incorporated in the thinking. But they move together; they move up and down together.

The chart that I happen to have in front of me is of unemployment levels, and if you reconfigured it to include people who are not actively looking for jobs, that total number has come down, and it has come down very fast, and it is now about at the level that it was in the 1970's.

Most of these statistics move together, and therefore focusing on one rather than the other wouldn't change policy discussions.

Mr. JACKSON. Consistent with what the Chairman had to say yesterday, if the number were more accurate, 15 to 20 million Americans—I am interested—again, my specific question is what impact on Fed policy of that number, the actual number, would have, from your perspective?

Ms. RIVLIN. The Fed, as I said, ought to look at all of these unemployment rates, but I don't think that they move separately and I don't think that that particular number should have an independent impact.

Mr. JACKSON. Mr. McDonough.

Mr. MCDONOUGH. Mr. Jackson, looking at your concern about the American people who are unemployed or looking for jobs or part-timers who would like to have jobs, clearly all of those people are a matter of public policy interest and Federal Reserve interest. The question that the Chairman was answering was, would policy be different if, instead of looking at the official unemployment rate of 5 percent, we looked at all of these other incrementals.

Mr. JACKSON. And they were included in that number; is that right?

Mr. MCDONOUGH. Right. I think the answer is, at the present time the policy would not change.

Part of the session, while you were out, we spent a fair amount of time talking about things that we really could do through using spending better, through the private sector working harder with the public sector in joint ventures to do things. I think it puts an even greater degree of intensity on that.

Frankly, that is why I spend so much time working on those issues. To me, whether somebody is officially unemployed or is a person who would like to have a job but doesn't come under the statistics, is the same kind of problem. We ought have the same compassion for those people, and public policy in general ought to be trying to help them.

Now we think that the Federal Reserve policy, as it is presently shaped, is doing the best that monetary policy can to make a con-

tribution to the solution to that problem. Does that solve the problem? No, it doesn't. But it is the most we think we can do to help solve the problem.

Mr. JACKSON. Let me ask a question of Mr. McDonough.

In light of public policy in terms of what we can do, Members of Congress, if the numbers were accurate and suggested that there were 15 to 20 million people who were unemployed, as an official statistic, it certainly suggests that the priorities of the Federal Government in terms of its spending priorities should then begin to reflect ways to tackle unemployment in ways that probably it presently doesn't contemplate. I think that is a political reality that we would all, as Members, have to deal with. Let me ask Mr. Meyer.

Mr. McDONOUGH. As I mentioned earlier, the most important thing is what you are spending the money on.

Mr. MEYER. I think it is very instructive to look at these broader measures. Part of the issue is, what is the nature of the problems in the society, and I think these measures give us a better feel for that. But I have to tell you that they do, to the best of our knowledge, move together with the other rates of unemployment.

We are trying to achieve the maximum sustainable level of employment, and looking at these numbers doesn't change my view about what that maximum sustainable level of employment is. It doesn't change my view of what monetary policy should be. But, on the other hand, it does set forth a little more clearly what the challenge is that faces us as a society.

And I would certainly commend any efforts in Congress to deal with these issues, although these are particularly difficult ones to deal with. The average level of unemployment might be brought down through a variety of means—including education and training.

Mr. JACKSON. Mr. Chairman, I have a couple of other questions that I would like to submit for the record in view of the time. However, Mr. Chairman, I do have one question that I do want to ask. My questions I will submit for the record—

Chairman LEACH. The Chair is lenient on his time. Without objection, your question will be submitted for the record, and then proceed as you wish.

Mr. JACKSON. Thanks. My questions for the record will be on Fed policy and welfare reform and the impact of wage increases and indications of inflationary threat. But I want to ask a question that almost never gets addressed in these hearings, because I raised it a couple of weeks ago and the Chairman of the committee—when we talked about Export-Import Bank and the implications for putting taxpayers' money at risk, the Chairman of the full committee indicated that he felt that the American taxpayers' money as it relates to overseas investments was truly only at risk in the event of some global economic depression.

I shared with the Chairman that historically the cost of human rights in any country has had some tremendous economic implications in our own country, the United States, certainly in India. Certainly in South Africa before they could have a Truth and Reconciliation Committee, Mr. Mandela had to start building homes

and repairing Soweto, which has budget implications, which obviously has monetary policy implications.

I talked with Moskow, your contemporary at the Chicago Fed, who indicated that we are seeing the same thing in Europe, with their move toward one central bank and one currency, their human rights considerations.

I am interested, however, in this one point. The day that China—let's say there are 1,200,000,000 people in China. The day that 700 million of them decide that they want the same quality of life as people who live in Hong Kong, they want the same education system, let's say they all want something basic that is very American, a minimum wage. Say that civil rights marches like in Tiananmen Square are breaking out all over China.

I am interested in what the impact on Fed policy will be when, let's say, one-fourth, maybe one-fifth, of the world's population decides that they want to be paid and receive the same kind of quality of life that we have, what its implications will be on our economy?

Ms. Rivlin.

Ms. RIVLIN. Basically, I think it can only be good. If they want to—and I think they do—grow faster and raise their standard of living, that is a vast market for us, and we will be better off with a more prosperous China than a less prosperous China.

Mr. JACKSON. Would you want to make the argument, Ms. Rivlin, that therefore we should be on the side of those forces that are fighting for human rights within their country and therefore it may raise some questions about our present policy with respect to China?

Ms. RIVLIN. Well, I am not sure this is the moment to get into exactly what our China policy should be, but we—

Mr. JACKSON. In terms of long-term risk and putting the taxpayers' money at risk in terms of overseas investments, certainly that would have some impact on the economy in the globalized economy.

Ms. RIVLIN. In the long-run, what we want is a prosperous China, and strong human rights, and there are judgment calls on how you get there. Clearly, we benefit from their doing better and their being much more democratic and more conscious of their own need for human rights.

Mr. MCDONOUGH. I share those views in their entirety.

Mr. MEYER. I share those views, and you are overtaxing what I know about in terms of trying to figure out what is the best way of getting from where we are to where we want to go. But I share those goals.

Mr. JACKSON. Thank you very much.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Jackson.

Does Mrs. Roukema want to add anything to this panel?

Mr. Frank.

Mr. FRANK. I wanted to thank them and you for the indulgence in terms of time and their patience.

Chairman LEACH. Let me just say, we thank you. And I also think the President ought to be thanked for appointments of two of the three before you, the third coming in a different fashion.

And I also believe that the Federal Reserve Board has done a remarkable job, given the constraints of fiscal policy, and that it is simply self-evident, that if you have a larger deficit, it is harder to operate in a constrained monetary policy so both our fiscal and monetary policy work together.

In addition, I think it should be emphasized that monetary policy has different effects on different industries, but it cannot differentiate in itself from those effects. Fiscal policy can target, and so, for example, fiscal policy can spend more money in one kind of problem, one kind of region, over another, whereas monetary policy is consistent, although the effects on one industry or another can be different.

Mr. JACKSON. Would the Chairman yield?

Chairman LEACH. Yes, of course.

Mr. JACKSON. Would the Chairman acknowledge that if there were more accurate numbers with respect to unemployment, that it could fundamentally shift the nature and line of our questioning to the Fed with respect to each of us had 9 percent unemployment, or that were the national figure, that the political reality in our districts would subsequently shift and force maybe a different line of questioning?

Chairman LEACH. Well, the definitions are always very important, and I think it is imperative that people have consistent definitions, and then if there are other definitions, that they be consistent too.

And we have a slightly different definitional approach than Europe, and we changed our definitions at several points over the last several generations, but I think it is key that people bear in mind that there are other ways of looking at unemployment, and you have raised a very significant one, and I think we are all obligated to understand that the single definitional approach is not the only definitional approach.

At any regard, let me thank you all. You are serving your country as I think the law has prescribed. Thank you.

Ms. RIVLIN. Thank you, Mr. Chairman.

Chairman LEACH. Given the prior announcement of the Chair, and it is my understanding that the vote that was expected about 1:05 is now expected after 1:20 or 1:25. The Chair would recess until 2:10. The hearing is in recess.

[Whereupon, at 1:16 p.m., the hearing was recessed, to reconvene at 1:50 p.m., the same day.]

Chairman LEACH. The hearing will reconvene. Panel Two is composed of Mr. Gordon Richards, who is the Chief Economist for the National Association of Manufacturers, and who, I understand, has a distinguished background in economics; and Mr. David Smith, who is Director of Public Policy for the AFL-CIO, and since 1994, he has also been a Senior Fellow at the 20th Century Fund. As a board member and vice chair of that organization, I can attest to the distinction of that assignment. Unless there has been a prior arrangement between the two, I think we will begin with Mr. Richards. Is that appropriate, or would you prefer the other way around?

Mr. SMITH. Fine with me.

Chairman LEACH. Mr. Richards, please.

**STATEMENT OF GORDON R. RICHARDS, CHIEF ECONOMIST,
NATIONAL ASSOCIATION OF MANUFACTURERS**

Mr. RICHARDS. Thank you, Mr. Chairman. I would like to address two issues in my testimony today. The first is that there have been structural changes in labor and product markets that make it possible to achieve lower inflation rates; and the second is that there has been an increase in the rate of technological advance which makes it possible to achieve higher productivity, and therefore higher growth rates. The basic conclusion here is that monetary policy should accommodate the potential for higher growth.

The NAM has repeatedly urged the Federal Open Market Committee to leave interest rates unchanged and, in some instances, to lower them. We have never argued that the Federal Reserve should actively reflate, as it did during the 1960's and 1970's. Rather, we argue that monetary policy should be loosened, or certainly not tightened, mainly in order to allow the economy to reach its potential.

The most important changes that we have seen in the economy of the early 1990's consists of a whole series of technological advances, which have taken place in the private sector and particularly in private industry. To see this, consider the standard model of economic growth which has been widely known for more than four decades. This model holds that the long-term trend in output per person is determined primarily by the rate of technological advance. But of course, technological advance is not a fixed number; rather, the rate of technological advance depends on real world events, such as the advent of microcomputers or scientific breakthroughs.

Some of this credit for technological advances certainly lies with the way in which industry has used the best available computer technologies to achieve process improvements, such as statistical quality control, just-in-time inventory control, and CAD-CAM, which enables scientists and engineers to design new products on the computer more rapidly. Evidence for an acceleration in the rate of technological advance is provided by a substantial pickup in manufacturing productivity, which has achieved robust gains, about 4 percent last year. The upshot is that as a result of these technological improvements, overall productivity is now picking up. I will get to the evidence shortly, but the key implication is both lower inflation and higher potential output.

One item of evidence supporting the idea of faster productivity is that the inflation rate has declined consistently through this business cycle. In 1992, the inflation rate, as measured by the GDP deflator, was 2.8 percent. In 1996, it was 2.1 percent, and as of early this year, it had dipped below 2 percent.

It should be noted that the actual inflation rate is lower than sometimes reported. The Consumer Price Index is frequently used, but it is widely recognized that this overstates the inflation rate by perhaps half a percentage point and, in some instances, more so.

The low inflation has coincided with the fact that the unemployment rate has also continued to drop, and in this respect, I would

like to address the issue of the natural rate of unemployment, or NAIRU.

The natural rate of unemployment declined very sharply in the early 1990's. One problem in the analysis of the NAIRU is that many economists have interpreted this as a fixed number, whereas, in fact, the NAIRU is likely to vary through time as conditions in the labor markets change. There are several reasons why the NAIRU should have declined. As some of the witnesses this morning were discussing, during the 1990 to 1991 recession and the slow recovery in 1992 to 1993, rational workers would keep wage increases moderate simply in order to preserve job security. At the same time, this wouldn't explain why a lower NAIRU would tend to persist. In my mind, this reflects two basic causes. The first is, of course, that labor markets are now much more competitive; and second—and I think this point is more important—there has been a shift in the structure of compensation. Workers are now compensated less through hourly wages and more through performance schemes, such as commissions, productivity bonuses and stock options. And what this means, of course, is that the total compensation to labor becomes less dependent on rigid wage contracts and more dependent on the profitability of firms, so that even with labor markets much tighter now than in the past, the inflation rate is less apt to accelerate.

One should mention, of course, in many instances, that this is actually a good deal for workers and better than an increase in the hourly wage. The stock market has risen so fast that when workers took stock options instead of wages, they did, on average, better than they would have otherwise.

To return to the issue of the natural rate of unemployment, this clearly is not a fixed number. Structural changes in the labor market can cause the natural rate to decline, and in this respect, we did an econometric analysis. We concluded that in the late 1980's, the natural rate was as high as 5.7 percent, but in the early 1990's, it dropped to about 5 percent and has shown no tendency to increase since that time.

Furthermore, it is entirely possible that the natural rate could be lowered below 5 percent. For instance, the more the existing unemployed workers are given education and training, the more skills they have; as a result, it would be entirely possible to get the NAIRU down well below 5 percent, and as a result, the actual unemployment rate could be kept even lower than it is today.

A related concept of the NAIRU is what we call "potential output." Governor Meyer used the term "trend growth." Potential output is, of course, the long-term growth rate that is consistent with stable inflation. The intuition behind this concept is that if demand grows faster than the ability of the economy to produce, labor and product markets would tighten, causing inflation to rise.

The usual measure of potential output is to add the growth rate of the labor force to the trend in productivity. First, let's look at productivity. The official BLS measure of productivity in non-farm business shows an average growth rate of just over 1 percent per year, and in 1996, the BLS estimate was a productivity gain of only .7 percent, which is pretty anemic. These very low productivity

numbers have led some analysts to arrive at very low estimates for potential output.

Several items of evidence demonstrate that the productivity numbers are seriously understated. In 1996, the income side of national income and product accounts—NIPA—rose much more rapidly than the product side. The statistical discrepancy between the two came to \$74 billion, and if you raise the product side to account for the additional income, then productivity in the nonfarm business sector would work out to something like 1.8 percent, which is a good deal higher than the .7 estimated by the Bureau of Labor Statistics.

A second reason why the official productivity numbers are too low is that they are just impossible to reconcile with declining inflation. For instance, in 1996, the employment cost index rose by 3.3 percent, whereas the inflation rate, taking out the energy component, rose by only 1.9 percent, so the discrepancy between the two suggests that the productivity must have been at least 1.5 percent in 1996.

A third way to approach this issue is to look at measures of technological advance. Productivity is, of course, not a direct measure of technology, but it encompasses the effect of both capital and technology. So we built a production function—we built a model of the economy in which we look at empirical measures of technology. In it, we use measures such as research and development; we use the quality of computers; we use measures of the education of the labor force. We theorize in a relationship between computers and capital, so that when you have capital equipment that is computer-controlled, you can produce much more efficiently. We also theorize that computers increase the efficiency of R&D, because scientists and engineers can use them to do more sophisticated calculations.

Looking at all these measures, we then compute the implied rate of productivity growth and the implied rate of growth of potential output and find that in 1996, the productivity growth rate we come up with is about 1.8 percent, very similar to what you get if you simply look at the difference between the income and the product side of national income accounts. And for the early 1990's, we find that potential output was much higher than any of the major models are indicating; we find a potential output growth of slightly over 3 percent in 1993 to 1996. Forecasting this model for the late 1990's, we find the potential output is just shy of 3 percent per year; my preferred estimate would be around 2.9 to 2.8 percent up until the year 2000.

The implication of all this is that we are actually in a very favorable economic situation. We achieved low unemployment, low inflation, and we can sustain a stable growth rate at a higher rate of growth than some of the other economists have suggested. The Federal Reserve deserves some credit for having contributed to this stable environment. We are not indifferent to the fact that on prior occasions, the Federal Reserve reflatd too actively, and this caused a whole series of cycles of inflation, followed by booms and busts in the 1960's and 1970's. We certainly don't want to repeat that kind of experience.

We also give the Federal Reserve high marks for having kept interest rates low in the early 1990's, especially in 1993 when the re-

covery was having trouble getting started and the Fed left the funds rate at 3 percent.

Where we fault the Federal Reserve is that they were much too cautious in 1994 and 1995, where they raised the Federal funds rate from 3 percent to about 6 percent. Then of course they had to backtrack; they lowered the Federal funds rate by 75 basis points later on in 1995 because it was becoming apparent that the economy is slowing down.

Finally, we have argued that the increase in interest rates on March 25 was unnecessary, and that this, to some extent, indicates the Fed is still erring on the side of caution.

In conclusion, what should the Federal Reserve do now? So far, the year 1997 is shaping up to be a pretty good one. The growth rate for the year will come in at about 3 percent or above. The strong first quarter was of course not sustainable; it was just the result of a whole series of one-time factors. We currently project that the economy is slowing to a growth rate of about 2.5 to 3 percent in the second half and will probably maintain a pace like this through next year. And as we have indicated, some people might consider this to be above potential. We consider this to be slightly below potential, so we are not concerned about any increase in inflation; instead, we predict the inflation rate is going to continue at around 2 percent.

In sum, the best course of action for the Federal Reserve is simply to leave interest rates where they are. If so, the economy will converge to a path of stable growth near its potential; the inflation rate will remain in the range of 2 percent.

Thank you, Mr. Chairman. I would be happy to answer your questions.

[The prepared statement of Gordon R. Richards can be found on page 169 in the appendix.]

Chairman LEACH. Well, thank you very much, Mr. Richards.
Mr. Smith.

STATEMENT OF DAVID A. SMITH, DIRECTOR OF PUBLIC POLICY, AFL-CIO

Mr. SMITH. Thank you, Mr. Chairman. I want to thank you for holding these hearings. There are few subjects that are more important than the one you are wrestling with today, and deciding to have a second day of hearings is an important service.

I also want to thank you for giving NAM and the AFL-CIO a chance to sing out of the same song book. We don't very often get to do that, and we welcome that chance.

With unemployment near its lowest official rate in almost a quarter of a century and inflation lower than it has been in 30 years, these ought to be good times for working Americans and their families. Instead, as many of you noted in talking with the earlier panel, the prosperity that is reflected in the stock market and in skyrocketing CIO salaries in the productivity numbers has seemed to bypass—

Chairman LEACH. Excuse me. You meant CEO, not CIO.

Mr. SMITH.—I did mean CEO, I am sorry—has seemed to bypass a large majority of workers.

The employment situation has improved since the early 1990's, but downsizing in both the public and private sectors has kept layoffs and economic insecurity at high levels.

Rising productivity hasn't shown up in paychecks. Average hourly wages remain 12 percent below their 1973 levels. There is room here. Rising productivity, rising corporate profits give corporate America ample room to pay long-overdue wage increases. And against this backdrop, it is especially troubling that the Federal Reserve continues to be concerned about the slight evidence of wage increases that we have seen during the past year.

They send an unfortunate message to working Americans. "Economic expansion is acceptable so long as only the CEO paychecks and corporate profits are its beneficiaries, but when working Americans begin to take home a little bit more, it is time to slam on the brakes." This logic puts the Federal Reserve Bank, which is the central reserve bank for all of us, in the position of using the power of monetary policy to promote and defend the most unequal distribution of income and wealth we have seen in this country since the early 1920's.

We are especially troubled by the Fed's apparent increased interest in targeting the Employment Cost Index. That turns out to be—because it ignores productivity—a *de facto* income policy applied only to working Americans. If we were to try to target zero growth in the ECI, we would in effect say, "No wage increases, never again." Not only is this bad policy, but it violates the spirit of the legal mandate under which the Fed is supposed to operate. The Employment Act of 1946 and the Full Employment and Balanced Growth Act of 1978 instruct the Fed to pursue policies that produce full employment as well as stable prices.

We are pleased at the current unemployment situation, but would note that it is still a full point above the Humphrey-Hawkins target. If unemployment were a point lower, income would be roughly 3 percent, or \$225 billion higher—almost \$2,250 for each household in the country.

I want to comment on something which several of you inquired about earlier. It is increasingly apparent that labor markets aren't as tight as the official numbers would lead us to believe. The official rate of 5 percent in June needs to be compared to their broader measure. The U-6 series would suggest that 9.2 percent of the labor force was still unemployed out of—not seeking work or working part-time involuntarily. This broader measure, we need to pay attention to it.

We also need to pay attention to the growing evidence that increased opportunity increases supply in the labor markets. We have seen sharp increases in labor force participation, as the economy has continued to grow and as job opportunities have become more available. That elasticity needs to be considered as we think about just how tight these markets are.

I think we are seeing a lot of older people, who may have been laid off or downsized, finding their way into the market; and young people, who had never previously entered it, are finding this period of relatively strong job growth an inducement to come back in. This elasticity of supply, of course, is going to be expanded as we continue to implement welfare reform and add a couple million addi-

tional workers to the low end of the market, so we ought not to overstate the extent to which this market is tight or that we don't have any more room to go.

I want to comment briefly on the question of price stability as a goal. We are convinced that, if one were to follow the advice of Governor Meyer this morning, and target zero price inflation or stable prices, that that would be a deeply misguided course. There are solid economic grounds for believing that steady, low inflation can help reduce the long-run rate of unemployment by greasing the wheels of adjustment in labor markets. Nobel laureate Jim Tobin has argued this throughout his distinguished career and just last year, three former colleagues of Governor Rivlin published an important paper in the *Brookings Review of Economic Activity*, suggesting that steady, low rates of inflation were a lubricant for the economy.

By contrast, high rates of unemployment create permanent losses that can never be regained; the production, the output, the consumption that is associated with full employment is not possible to recover when employment is discouraged.

Today, as actually Governor Rivlin noted, we have the best opportunity in a generation to recognize the full employment promise of the Humphrey-Hawkins Act. We certainly ought not squander that opportunity because we fear that somewhere, some worker might be getting a raise.

Thank you.

[The prepared statement of David A. Smith can be found on page 178 in the appendix.]

Chairman LEACH. Thank you very much, Mr. Smith.

I had two questions. One, taking off on a theme that was raised earlier by the gentleman from Vermont, this issue of inequality of standards of living and in pay, some have ascribed this to the increasing technical nature of the economy, where people that are technically literate are getting premiums; others have suggested it relates to international competition, that we are in an international labor market.

Are there things that the AFL-CIO thinks that the Federal Reserve can do that would have a direct impact on this inequality issue?

Mr. SMITH. Yes, and most importantly, encourage tight labor markets. There is simply no better device that we know of to encourage reductions in income inequality than tight labor markets, where opportunities at the bottom grow, where pressure to provide the kinds of training that allow working people to upgrade their skills grow. There is nothing better for reduction of income inequality than tight labor markets. Tighter labor markets than we have now would be that much better. I think later this afternoon, my former colleague, Professor Galbraith, will elaborate on the argument, New York Fed—President McDonough—said a couple of times this morning that the Fed can't do much about social inequity. That is simply not true. He is right that there are many things that the Fed cannot do in this area, and that there are many responsibilities Congress has to address inequality; but, the Fed can ensure we run tight labor markets, that full employment does remain a goal and that the upward effect of competition in

those labor markets finds its way into paychecks and into living standards for working people.

Chairman LEACH. There were somewhat oblique references in the earlier panel to the Humphrey-Hawkins Act and the Humphrey-Hawkins Act basically establishes for the Federal Reserve kind of a twin charter of concern for sustained economic growth and labor markets, and then the second charter relates to restrained monetary policy and the need for a strong dollar.

Now, many of us believe that those two goals are consistent, but in any regard, there has been a movement in the last decade to suggest that the only charter for the Fed should relate exclusively to the management of the money supply. How does the AFL-CIO see that?

Mr. SMITH. Actually, I thought in your intervention this morning, Mr. Chairman, you expressed the AFL's position quite well. We would severely and strongly resist any change in that mandate. Economic policy is about the management of factors which affect the everyday life of all 230 million of us; it is not about a single thing. Managing the economy so that prices are stable, if the cost of that is substantial unemployment, forgone output, falling investment, and technological advance, is an absurd tradeoff. To think that there is a single indicator for economic policy would, in our judgment, be an enormous mistake, and we share your views on that.

Chairman LEACH. Thank you very much.

Mr. LaFalce.

Mr. LAFALCE. Thank you, Mr. Chairman.

Mr. Smith, it is always good seeing alumni of the United States Congress, and Professor Galbraith, it is good seeing you again, and we look forward to your testimony.

You are the Director of Public Policy for the AFL-CIO. When did you assume that position?

Mr. SMITH. Just before the first of the year.

Mr. LAFALCE. Is there a separate chief economist?

Mr. SMITH. There isn't a chief economist with that position, Congressman. Several economists work on my staff and other places in the Federation.

Mr. LAFALCE. OK. I was curious about that.

The hearings are ostensibly about monetary policy, extremely important. You are responsible for overall public policy, but monetary policy is one component. I am just going to take this opportunity to ask you some other questions on some other areas.

Is there some strategic public policy initiative that the AFL-CIO is involved in, with respect to the achievements of worker rights internationally? We have been given an explanation for some of the market and economic dynamics today, including technology, international trade, and so forth. I honestly don't think that we are going to be able to cope with so many of the problems our domestic workers are having without expanding worker rights internationally. I just see an exacerbation of the tensions that exist in international trade until we can come to grips with that issue, and I am wondering what the AFL-CIO is doing in that effort?

Mr. SMITH. You point to an important topic, Congressman. We have consistently argued that as the United States contemplates

extending trading arrangements and moving toward more open markets that those efforts must be linked to an explicit effort to ensure that worker rights and environmental protections aren't degraded. The result of an absence of attention to those questions is a race to the bottom, when we create a perfectly rational incentive for capital and employers to seek the most degradable environment or the most exploitable worker. That is clearly not in the interest of American workers, nor is it in the interest of workers around the world.

We have argued, and will continue to, as you consider the President's upcoming request for Fast-Track authority, that as we extend trade agreements, there ought to be explicit attention paid to enforceable worker and environmental rights questions, and that that ought to be on the agenda. In fairness to the Administration, Ambassador Barshefsky worked very hard in Singapore at the last WTO ministerial meeting to convince the WTO to make this part of the WTO charter. She failed in that effort; but we will encourage the Administration—and you—to keep these issues on the table as you consider the upcoming trade debate.

Mr. LAFALCE. What is the AFL-CIO, or labor in general, doing to create advisory bodies to our negotiators in the international trade negotiations, similar to the advisors that the owners of capital have, the corporations have? And second, what is AFL-CIO doing to effectuate the provisions of the 1994 appropriations bill, commonly referred to as the Frank-Sanders amendment, which calls upon the international financial institutions, or at least upon the United States executive directors, to attempt to achieve, within contracts awarded by the international financial institutions, contractual provisions dealing with worker rights?

Mr. SMITH. Let me start at the end of your question.

We have been working most recently with the Inter-American Development Bank and the other regional banks, as well as the World Bank, to urge them and encourage them and assist them, where they are willing to accept our assistance, at doing precisely what the amendment of Congressman Sanders and Congressman Frank calls for.

We are engaged in a series of ongoing conversations with officials at all four regional development banks, as well as with Jim Wolfensohn and his staff.

On the advisory question, we worked very hard to convince the Western Hemisphere trade ministers, who recently held their ministerial meeting in Bela Horizonte, Brazil, to take such a step. We joined with trade unionists throughout the hemisphere in urging that they accept a labor advisory panel on a similar footing to the business advisory panel. That request was rejected. The American Government supported us. We will renew that request, and mirror it in our continuing conversations about other trade advisory panels.

Mr. LAFALCE. Thank you.

Mr. SMITH. Thank you.

Chairman LEACH. Thank you.

Mrs. Roukema.

Mrs. ROUKEMA. I apologize to Mr. Richards. I came in toward the end of his presentation, but I would like to give him the oppor-

tunity to respond to a couple of things that I heard Mr. Smith comment about; and one of those was that there is room here for paying long-overdue wage increases.

I would like your reaction to that statement in speaking about the general improvement in the economy and the business profits, I think it was, in that context that Mr. Smith made it. And, also, does that have a direct relationship, in your opinion, to Fed policy?

That is the first question I have. Then I have a follow-up.

Mr. RICHARDS. What the Federal Reserve can do is simply to ensure a stable environment in which the economy is allowed to reach its full potential. The Federal Reserve has less power over the distribution of income than is sometimes alleged. As long as the Federal Reserve allows the economy to grow at potential, we will eventually get to something like full employment, which one can think of as the unemployment rate declining to its natural rate or NAIRU. At that point, wages should reflect market forces, which is to say workers total compensation would rise roughly at the rate of productivity growth in real terms.

The reason that hasn't happened—that is the reason wages have lagged behind productivity in the early 1990's is, of course, the actual unemployment rate was much higher than the natural rate; or to put it another way, there was a lot of slack in labor markets holding wages down.

Now that we are at a situation which is near to full employment, I think we are reasonably close to the NAIRU, then market forces ought to ensure that workers compensation goes up roughly at the rate of productivity growth; and as I indicated in my testimony, we estimate that the productivity growth rate picked up starting in 1996 and will probably continue to do fairly well in the late 1990's.

Mrs. ROUKEMA. And that has been reflected in the board's documentation?

Mr. RICHARDS. Yes, that is right. And in our view, this implies a much more favorable path for wages in the late 1990's than the early 1990's, when you had a combination of low productivity growth and high unemployment, both of which were keeping wages down.

Mrs. ROUKEMA. The second question and perhaps Mr. Smith may want to come back as well, but first Mr. Richards.

Mr. Smith said the Fed—and I didn't quite know what he meant by this; maybe I wasn't listening carefully enough—but that the Fed should encourage tight labor markets. I don't know how the Fed can do that? What is your interpretation of that goal, and do you understand the Fed's relationship to the tight labor markets?

Mr. SMITH. Gordon, go ahead.

Mr. RICHARDS. Thank you.

I think this is really just a matter of phraseology. The way I prefer to think about it is that Federal Reserve accommodates the economy's potential for growth, and market forces will ensure the unemployment rate eventually falls to its natural rate. In the short-term, you can go a little above potential and get unemployment down faster, and I think we should have done that in the early 1990's, but once the unemployment rate is down to its natural rate or something like it, then the Fed should adopt the stance

of simply allowing the economy to grow along its potential or its long-term trends, and that, in and of itself—

Mrs. ROUKEMA. In terms of growth of money and the interest rates—

Mr. RICHARDS. In other words, the Federal Reserve—

Mrs. ROUKEMA. In other words, the inflation factor.

Mr. RICHARDS. The Federal Reserve should set interest rates at a level that is consistent with the economy growing along its potential trends, and in that instance, you would not have the sort of tightening in labor markets that would cause inflation to overheat. Rather, labor markets would be pretty much in equilibrium, which is to say that new workers would be able to find jobs because the economy's growth rate would be sufficient to accommodate the gains in the labor force.

Mrs. ROUKEMA. So you are agreeing with Mr. Smith?

Mr. RICHARDS. Yes.

Mrs. ROUKEMA. Mr. Smith, did you want to comment further?

Mr. SMITH. I would be happy to accept my colleague's view here. I think the simple point here is, Congresswoman, the Fed can encourage tighter labor markets by refusing to put its foot on the brake to restrain increases in employment and increases in growth, and we believe it should do that. At some point, presumably, we will have soaked up the labor that is available, but we are clearly not at that point yet.

Mrs. ROUKEMA. Of course, the Fed has to weigh that requirement against the inflation spiral, and that is—go ahead.

Mr. SMITH. We need to be careful with this presumed trade-off. Much of the discussion this morning, for instance, is of the preemptive strike. The preemptive strike suggests that perhaps something bad will happen in the future, so we will do something bad now. We will restrain the opportunity of men and women to work, because we are afraid that—Governor Meyer said sometime in 1998—something bad might happen. We think that is an unwise basis on which to make policy.

Mrs. ROUKEMA. Thank you very much.

Chairman LEACH. Thank you, Mrs. Roukema.

Mr. Vento.

Mr. VENTO. Well, thank you, Mr. Chairman, and I appreciate the testimony of the witnesses and their written statements.

Mr. Smith, we raised the question this morning about—what really your colleague on this panel, Mr. Richards raised, with regard to technology and the nature of the—he didn't say this, but the interrelated nature of the global markets and technology have created a sort of different environment in which monetary policy is now exercised. I think all of us recognize these relationships, especially with the Western European counterparts and the related nature of our economies in terms of managing monetary policy. We are doing pretty well now in terms of the value of the dollar, compared to the deutschemark and some of the other currencies.

And he goes on to point out—and Mr. Richards may want to elaborate on this, but I want you to respond as well—on a technology getting a better ability on the part of a monetary policy, or those that exercise it, to in fact have more information and do a better job with this issue, given the goals which I agree with under

the Humphrey-Hawkins Act, as you know from my comments this morning.

Did you want to comment?

Mr. SMITH. I think, Congressman Vento, that there are really two answers to your question. The broad question of the introduction of additional technology into the economy is certainly something that we ought to encourage; we ought to encourage additional investment, we ought to encourage substantial purchase of productivity-increasing equipment, and, again, the Fed being more—rather than less—accommodating will encourage that.

The second part of your question suggests that technology has allowed us in some fashion to understand the economy better and, therefore, to manage the business of monetary policy more efficiently. I don't know if that is true.

I was struck by Congressman Frank's colloquy this morning with Governor Meyer. Technology has allowed a bunch of economists to regularly recalculate NAIRU, but all that has meant is that they can do calculations that chase a chimera ever more rapidly, so they can adjust this construct to changing information with greater speed. I am not sure that is a policymaking advance.

Mr. VENTO. Dr. Richards.

Mr. RICHARDS. I would like to return to one of the themes in my testimony, and that is the tremendous importance of technical advance for the long-term growth of the economy. More than 40 years ago, the model developed by Robert Solow argued that the long-term trend in output per person has to do with the rate of technological advance primarily and, secondarily, with increases in capital stock. Productivity is pretty much that same phenomenon, it is mainly determined by technological advances, and second, by increased investments.

Again, let's look—

Mr. VENTO. I would feel a lot better if you would have added investment and human resources in the third, which is the one that usually is lagging, incidentally.

Mr. RICHARDS. That certainly is true also. Improvements in the skills of the labor force are—

Mr. VENTO. But you are telling me a theory of that?

Mr. RICHARDS. Yes. The question then becomes what sort of growth rate can the economy sustain? I was surprised in Governor Meyer's testimony at the extent to which many of the models and some of the forecasters, such as the CBO, are saying the sustainable growth rate or potential output is only around 2.1 or 2.2 percent a year. When we take into account the new technological innovations, we arrive at a much higher figure for this. My preferred estimate is around 2.9 to 2.8 percent, which is sustainable out to the year 2000. The only reason I don't know whether or not it is sustainable beyond that is because I haven't done the calculations beyond the year 2000.

The result is that if the Federal Reserve were to recalculate potential output along the lines we have suggested, they could afford to pursue a looser monetary policy, and we would achieve higher growth rates at the same rate of inflation, which is to say an inflation rate of less than 2 percent. In this sense, the crux of whether

or not the economy can grow more rapidly at a stable rate of inflation is intimately bound up with the rate of technological advance.

Mr. VENTO. The international central banks probably should be the subject of another hearing, in terms of how that dictates or limits or adjusts, because I am certain that the witnesses this morning in here probably would have come back and argued it does or doesn't affect them. I think it does; I think there is a degree of transparency.

Furthermore, Mr. Chairman, in my view, there is a timidity with regard to the action of the Federal Reserve Board in recent years, all undergirded by the general, what we think of as positive help to the economy, and certainly not the instability that occurred in the late 1960's, or the late 1960's—the late 1970's, pardon me—and early 1980's that I was familiar with; and that has made almost anything look good.

But, I think the question is whether monetary policy is being used to the extent it should, based on the type of—really of burdens that fiscal policy labors under, both because of a deficient monetary policy and because of limits in terms of the growth of our economy generally, that are hampered by this type of monetary policy; whereas indeed I think it becomes a self-fulfilling prophecy in terms of what is going on and whether you think 2 or 2.5 is the inflation rate and that a 5 percent unemployment rate is appropriate.

I find the same concern that my colleague apparently identified this morning, with when they try to use a simple index or even a complex index because seldom do they mesh. I mean, I think this is a case of not being pure science and being a lot more art in terms of what goes on. As such, I agree with the comments that Mr. Smith made with regard to the responsibilities and the power of the Federal Reserve Board. I mean, I even at one time had proposed an Office of Congressional Monetary Policy, but we all know, this gets back to who has the power and who hasn't, and I think all of it is influenced too by who serves on the Federal Reserve Board. They come out of banks; they have an interest in interest rates.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman, I appreciate the witnesses sticking with us.

I do have to comment, I welcome C-SPAN being here. I know they are going to need us in the long days of recess in August, so there is a supply and demand problem there that we are filling; but I do have to note the absence of most of the press. No one is going to be murdered, impeached, accused or challenged, and they stay away, and that is unfortunate because we are dealing with the single, I think, most significant economic policy question we have, which is what is the rate of growth which this economy is capable of in a noninflationary way, and how can we help it; and I welcome both of the witnesses.

Mr. Smith noted, the National Association of Manufacturers finds themselves on the same side; and I think we would also find—Mr. Richards would know this—many of the other represent-

atives of producers in the economy would take the same position. And I think it is somewhat significant that we have both representatives of the workers and representatives of various aspects of the productive sector of the economy, the direct producers, and I do not mean productive in a nonpejorative or pejorative way, but direct producers convinced of this.

And I think that is very important because I really believe we have a situation where, if they listen to Mr. Meyer and Mr. McDonough in particular, and as I interpret what the Federal Reserve Board of Governors and the regional bank presidents do, I do get the sense that they are complying with the notion that, "Well, it may work in practice, but it is no good in theory, and so much the worse for practice."

The point is, and I would like to ask both of you, who follow this closely, if you took the assumptions that Mr. Meyer operates on, if you took the notion of a nonaccelerating inflation rate of unemployment, of 5.5 to 5.9 percent, if you took their views of the rates of growth—in other words, if you took as accurate the census statistics on what is tolerable employment and what is the trend rate of growth for the economy, and if you had those views two years ago, and if I went to one of the economists two years ago who had those views and said, "Look, here is what is going to happen in the intervening two years." What would they have expected to happen?

Mr. Richards.

Mr. RICHARDS. I think that the entire economics profession overestimated the NAIRU or the natural rate of unemployment for quite some time. Our own analysis indicates that the NAIRU fell very sharply in the early 1990's, in fact, my preferred estimate is that it was 5.7 in the late 1980's and it fell to about 5 percent in the early 1990's, and it stayed down there; and in some sense, what went wrong was that the forecasters assumed that the NAIRU was a fixed number.

Mr. FRANK. In other words, Mr. Richards, what went wrong is what some people think went right, but to the economists, given their forecasting models, that was wrong?

Mr. RICHARDS. A poor choice of words on my part Mr. Frank. Rather, what went right was, of course, the natural rate declined; but what went wrong was a lot of economists failed to perceive it.

Mr. FRANK. Mr. Smith.

Mr. SMITH. Gordon is kinder than I am inclined to be.

Mr. FRANK. That has generally been my experience.

Mr. SMITH. The natural rate of unemployment, we have not found it. We have theorized about it, we have posited it, we have chased it, and, as Gordon has said, it continues to move around. I think it is time to entertain the notion that no such beast exists. Governor Meyer this morning cited some new work by Professor Gordon at Northwestern. Professor Gordon's work hasn't even quite caught up with the existing rate of unemployment, which appears to be sustainable at a noninflationary rate. I would urge the profession, and some of my current and former colleagues, to pay attention to something they are likely to find, rather than chase this illusion.

Mr. FRANK. If I could, Mr. Chairman, I am going to ask for a couple of additional minutes. I want to take a minute out; we need to deal with the confusion.

As the Fed people used the term, it is the nonaccelerating inflation rate of employment, Mr. Meyer kindly even underlined the first letter of each word for us. I do have to say he pronounces it "NAIRU," maybe to make it clear.

Mr. SMITH. That is because he is from Iowa, Congressman.

Mr. FRANK. We don't knock Iowa in this committee. I have never heard "A-I" pronounced as "I" in English; it is usually the other way around. But, the point I would make is this. Actually, you note Professor Gordon hasn't quite caught up. We may discover a new economic statistic here; that is, NAIRU as the lagging indicator, that the NAIRU will lag the actual unemployment rate by half a percent to three-quarters of a percent, and that might be a way to calculate in the future.

But, the point I would like to get at subsequently here is this. And it does seem to be clear, if you had used the statistics Mr. Meyer used—and I think he is a representative here of the Open Market Committee in general—then you would have anticipated a lot more inflation than we have had over the last couple of years.

The question then is, how did we have so little inflation? Why the surprising good news?

My problem is, too many people on the Fed seem to me inclined to explain that away to some aberration and to continue to use the models that were, in fact, proven inaccurate. And I think, Mr. Richards, you hit on the key point, the most rational explanation is there has been an increase in our productivity. I mean, you look at the fact that the labor petition made and the labor market has gone up only a certain amount, and we have had much more growth, not just for a month or two months, but for a significant period now, we have done better than their models predicted.

The logical answer is, we have had an increase in productivity, and they resist that because they can't measure productivity well, they say, well their current measures don't do it. Well, people who are quite ready to criticize the current measure of consumer price inflation, I wish they would apply the same skepticism to the measures of productivity, because it seems to me you have given the obvious answer, that in fact we have done better in productivity. And they then get back to, we are supposed to believe them and not our own eyes, and it just can't be that good.

Is it your experience, representing the major manufacturers of the country, that productivity has in fact gone up and there is reality to this explanation?

Mr. RICHARDS. Yes, my testimony details three reasons why we believe that productivity has increased. One is, of course, it is showing up on the income side of the national income accounts, and if you add that to product, you find a much higher productivity growth rate. We also look at the decline in inflation, which has to be caused by an increase in the productivity growth rate. We look at various measures of technology, ranging from R&D to computers, and again we find that the implied rate of productivity growth is much faster.

So, we have three separate ways to calculate productivity here, and in each case, they yield a much higher estimate.

Mr. FRANK. Mr. Smith.

Mr. SMITH. If I might, I agree with much of what my colleague has said, and there is another explanation, which is, labor markets aren't as tight as we believe they are.

Mr. FRANK. Can I make one very real point? We talk about the labor market; as a matter of national policy rates, we added to the labor force a group of people previously not counted, welfare recipients who number in the hundreds of thousands. If you take the number of welfare recipients we expect to get jobs, whom we have legally ordered, in effect, to get jobs if they are going to survive, you add significantly to the labor force, you add a couple tenths of a percentage to the labor force, in terms of the unemployment rate. You are talking about two-tenths of a percent, three-tenths of a percent, significant figures in what we are talking about in the unemployment rate; so there have been some changes. I guess it clarified for me today.

I will say, in summary, and I appreciate the indulgence, Mr. Chairman, the situation is this. Clearly, the economy performed much better with much less inflation at a given level of unemployment and growth than most of the prevailing economic models predicted, especially those in use at the Fed; and instead of taking what I think would be the likeliest answer for someone who approached this without preconceptions—mainly, among other things, productivity has done better and the labor market was not as tight as we thought. They are resisting that. And we still had today, it seemed to me, Mr. Meyer and Mr. McDonough suggesting that they think we ought to be tightening at some point in the future.

Let me say, in closing, their argument for tightening, that somewhere, somehow, something is going to cause inflation; they can't point to it now and they can't explain where it is going to come from, but it is just, things can't be this good.

I remember when I was a kid reading a biography of Ty Cobb, and it said the last time he got thrown out of a game for hitting an umpire, he was about 40, and his hitting skills had slowed down a little bit. He hit what everybody thought was a home run; but the umpire ruled after it went out of everybody's sight line, it had curved foul and called it a foul. And Cobb got quite angry.

And it seems to me that is what they are telling us, outside anybody's sight line, outside of anything measurable, outside of our experience in the last couple of years, this economy is curving it to high inflation, and they are going to stop it. And I wish we had Ty Cobb back to remonstrate with them.

Chairman LEACH. If the gentleman will yield, at the age of 41, he hit .323.

Mr. FRANK. But, for him, that was the decline because his lifetime batting average was .367.

Chairman LEACH. Including a number of .400-plus years.

Mr. Sanders.

Mr. SANDERS. Thank you very much, Mr. Chairman, and my apologies for running back and forth. Just a couple of questions I would like to ask our panelists.

Last year, according to *Business Week Magazine* a couple of months ago, the CEOs of major corporations earned a 54 percent increase in their compensation, workers earned a 3 percent increase in their compensation; CEOs of major corporations now make over 200 times what their workers earn. I would ask both of the gentlemen, what is your assessment of that situation? Is that a good situation for the United States of America? If it is not, what should we do about it?

Mr. SMITH. Congressman, I think we share both your outrage and your puzzlement at those numbers. The growth of inequality in this country during the last 20 years has been shameful. It is partly accounted for by a lack of opportunities, a lack of investments in human beings who find themselves at the bottom of the labor market; but it is partly accounted for by outrageous salaries and associated perquisites. As a moral issue, as a question of what kind of society do we want to be, how do we share the fruits of our productivity, it is suggestive of some quite ugly things.

I would point out however, that we cannot fix what ails the bottom of the labor market. We cannot address the problems that low-income workers face simply by somehow appropriating or extracting more the compensation of the very wealthy. We need a fast-growing economy. We need tighter labor markets, we need policies that invest in those men and women. We ought not simply think there is a one-for-one tradeoff here. But the pattern that you described is one that we deplore.

Mr. SANDERS. The gentleman from the National Association of Manufacturers.

Mr. RICHARDS. You raise two issues, one of them being inequality and incomes, which has to do with the fact that wages were depressed in the early 1990's—I indicated earlier, I think that a large part of the problem is simply the fact we had too much slack in labor markets. We had an unemployment rate briefly over 7 percent and a natural rate of unemployment, probably less than 5. As a result, it was not until the last couple of years that you have gotten back to a situation of near full employment. As a result, the result for wages and wage increases in particular is going to be much better in the late 1990's than it was in the early 1990's.

Another dimension of inequality has to do with ownership of wealth. In fact, most CEOs are not paid huge salaries; they are paid in stock options, and one of the reasons their total compensation has gone up is the appreciation of the stock market.

This brings up an interesting issue from my point of view. That is, what is the best way to rectify the inequality of wealth in this country? This is not a NAM position; it is my personal view as an economist. I think workers should own more stock, and we have seen some movement in that direction. Many companies are paying their workers more stock options. Quite a few of us as small investors have gotten into the market and done well. There is an opportunity for workers, as long as they are employed and are able to save and invest their income, to actually raise their wealth by investing in the stock market; and I think that the best way to reduce inequality in this society is, in fact, to get workers more into the stock market so that they own more national wealth.

Mr. SANDERS. Thank you for your thoughts. After—all of a sudden, last year, the CEOs were earning 200 times what their workers were making, Mr. Richards, as I understand it, including all forms of compensation. And you are right about stock options, but you also have to acknowledge that there are some very fabulous salaries out there for CEOs as well.

Do you want to comment on the fact that the spread is \$200-to-\$1, the largest in the world; we have the most unfair distribution of wealth? You talked about distribution of wealth, the richest 1 percent own more wealth than the bottom 90 percent. What do you think about that?

Mr. RICHARDS. Supposing back in 1989 workers had been offered large stock options in the old wages. In other words, companies had gone to workers and said, "All right, we will give you stock options instead of the current compensation you are currently getting, and these stock options will be tax favored, you can put them into IRAs and so on." In the event that had been done, given the appreciation of the stock market we have seen in the early 1990's, then workers would be much better off today than they are. To some extent, the reason we have so much inequality is workers were not given the opportunity of getting in the stock market.

Mr. SANDERS. You are still not quite answering my question, because stock options are important, but they are not the only thing. There are areas of companies all over America cutting back on health insurance for workers today, companies that are—probably the National Association of Manufacturers wants to create a situation where workers today who receive benefits are now going to be what are called "independent contractors," which will mean a continued lowering in their standard of living.

I am asking you, very simply, does the NAM have any concern that we have the most unfair distribution of wealth and the most unfair distribution of income, that CEOs today make 200 times of their workers? Is that on your radar screen as a near area of concern?

Mr. RICHARDS. It is on our radar screen and I have suggested a possible solution, and I stand by that solution. I think workers have to be given stock, because that way they will be able to share in national wealth, and if they are given stock, the problem of inequality in future years will be reduced.

Mr. SANDERS. We have heard—last year, as you know, there was a big fight over here about whether or not we could raise the minimum wage more than \$4.25. And some of us thought that was virtually a starvation wage, the lowest minimum wage this country had had for 40 years, and we raised it up to \$5.15. And there were terrible predictions that the economy would collapse and no one would have any jobs and all that stuff, none of which has in fact taken place.

Now some of us think, given the fact our low-wage workers are the lowest paid workers in the industrial world—we are behind the Italian low-wage workers and German low-wage workers—and maybe we want to raise the minimum wage again to make sure that everybody that works 40 hours in America does not live in poverty.

How do you gentlemen stand on the need to raise the minimum wage again, say to \$6.50 an hour? I think Senator Kennedy has proposed something along those lines, and I have something in the House.

Mr. Smith, do you want to comment on that?

Mr. SMITH. Congressman, for most of the postwar era, the minimum wage was roughly 50 percent of the average manufacturing wage. It is still short of that target; it has been short of that target, I believe, since 1979.

It is certainly appropriate to restore the purchasing power of the minimum wage at a minimum to that level, and then to index it so that we don't go through these disgraceful battles every few years, where some American citizens argue that their brothers and sisters don't deserve a wage sufficient to raise their family.

Mr. SANDERS. Mr. Richards, what do you think? Can we do better than \$5.15 an hour?

Mr. RICHARDS. At the current time, market events have really gotten ahead of the minimum wage; and in many cases, even the less skilled workers are making a good deal more than the minimum wage.

Mr. SANDERS. In some cases.

Mr. RICHARDS. Some less skilled workers are. The issue you have to consider, whenever you consider raising the minimum wage, is if you raise it beyond a given threshold, you end up pushing people out of work because you are raising costs on the kind of businesses that employ low-wage workers, which are typically not manufacturing firms; they are typically places like grocery stores and restaurants with very constrained liquidity. In many cases, these firms are not paying their CEOs much.

Mr. SANDERS. McDonald's and Burger King, I suspect, compensate them.

Mr. RICHARDS. In other words, the danger that you face in raising the minimum wage is that you could end up throwing low-wage workers out of work if you raise it too high?

Mr. SMITH. If I might, Gordon's argument ought to sound familiar to you. It is what you heard last year. The facts are in. We raised the minimum wage, it goes up again in about 6 weeks, and there has been not a ripple in the economy, but more people are taking home more money; it is hard to argue with that.

Gordon's argument strikes me as disingenuous. I suppose at some level the minimum wage could be a job eater, but to argue because that might happen if we raise the minimum wage to \$16, we shouldn't raise it to \$6 is not correct.

Mr. SANDERS. One of the issues we don't talk about, and it is amazing how little we do talk about in the Congress, but what has always amazed me is, with all of the booming economy and new technology, it turns out American workers are working many longer hours than either 15 or 20 years ago. I think the figure I recall is about 160 hours a year more than was the case 20 years ago, because lower wages have forced people to work overtime and two and three jobs, as is the case in the State of Vermont.

In Germany, I think workers get 6 weeks paid vacation, throughout Europe, Sweden, France, and so on. In this country it is not uncommon for workers to be getting 1 week, 2 weeks paid vacation.

What about extending developing legislation which basically gives people more time off, without cuts in pay, so that we can create more decent-paying jobs and give people an opportunity to experience family values, rather than having to work all the time?

Does anyone want to comment on the overworked American?

Mr. SMITH. Congressman, I think what we have seen in the last 2 decades is families using almost any means to keep up. First, they supplied more workers to the labor force, two adult households become two-worker households. Workers have added hours. This has allowed their standard of living not to fall as rapidly as their hourly compensation has fallen.

This has become not simply an economic problem, but a social problem as well, and addressing it both statutorily and in the collective bargaining process is certainly appropriately on the agenda.

Mr. SANDERS. Sir.

Mr. RICHARDS. As a market economist, I still think decisions of that nature should be made between individuals and their employers, and the private agents should be able to arrive at employment contracts that are favorable to themselves. Many families have a second wage earner for the simple reason that women want to participate in the labor force and earn more money. I think this is in some ways a very favorable development.

Mr. SANDERS. That is certainly true, but on the other hand, as Mr. Smith indicated, I think what is obviously true is, the millions of women who would prefer to stay home with the kids who have now got to work in order to compensate for the decline in wages that the male has made.

Is this not a concern that people have? Why are our workers—a figure that I saw is that our people are working 200 hours a year more than they are in Europe. The National Association of Manufacturers is concerned about that?

Mr. RICHARDS. We are concerned, but we think much of the downward pressure on real wages had to do with specific developments over the 1960's and 1970's. Specifically, we had the entry of the Baby Boomers into the labor force, which meant you had a temporary surplus of labor; you had events like the OPEC price shocks, which, of course, lowered wages very sharply; and you also had deep recessions, which put downward pressure on wages.

Now, under the circumstances, clearly some families were forced to have a second wage earner because their real wages were going down. At the same time, one development in the Baby Boom generation was that more people wanted to participate in the labor force and have careers, and I view that as a completely positive development.

As we now enter into a situation in which we are reaching a very low rate of unemployment, we should also be able to sustain a higher growth rate for a long period of time. Chances are wages will begin to catch up and people can then make whatever decision they choose regarding their participation in the labor force.

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

Chairman LEACH. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. First of all, I know my colleague from Massachusetts had talked about the fact that productivity may be understated, and I think Mr. Richards does make

that fairly clear—in your testimony, that you think productivity probably is—in the last year is probably around 1.8 percent, rather than .7 percent, something like that.

Barney mentioned, where are the people who said CPI is understated when it comes to productivity? There was a study the Fed put out, I think the Boston Fed, one of their researchers put out, that in fact said we may not only be understating CPI, but may also be understating productivity as well as GDP. That is not hashed out, but it is probably something to take a look at.

Additionally, it would appear that there is slack in the labor market in some degrees. In other degrees, obviously there is not. There is an article in today's *Houston Chronicle* where there is a great demand for geophysicists. That demand ebbs and flows, and obviously ebbed in earlier years, and the geophysicist market is not that big to begin with.

But in the lower levels, there is still a problem, and I think both industry as well as labor agrees with that. Whether or not that is a tool or something that monetary policy can cure, I think probably not. I think that is a labor policy issue or a fiscal policy issue for us in terms of education.

Mr. Richards, I read in your testimony that you seem to indicate—and I don't know if this NAM speaking, but perhaps we do need to be making more investments in the education area. But what I want to ask is a question that I brought up earlier for both of you, and this comes in the case of trade negotiations as well as regulatory policy.

I have people from the labor groups, as well as from manufacturers, who come to my office and say, "We need more regulation in trade," or more specifically, "We need less regulation in environmental policy. We need more freedom in labor policy as it relates to work rules or health and safety rules."

Are we at a competitive disadvantage with the rest of the world?

Mr. RICHARDS. There are several dimensions to competitiveness, but there are two highly important factors. One is labor cost less productivity, and the other is the exchange rate.

You mentioned several dimensions of cost. Of course, the labor cost is the main cost faced by other businesses, which other costs include regulation, compliance with regulation and, for instance, input prices.

If we look at the cost situation in American industry, the rising productivity growth has put us in a very good competitive situation. The rising productivity has been sufficiently strong as to make American products quite competitive in world markets.

Despite the fact that the dollar has been going up, we have seen reasonably good export growth through the 1990's. Exports are still likely to grow around 6 to 7 percent per year, and the only thing really holding us back from achieving an export growth rate of perhaps 10 to 11 percent a year is the dollar has appreciated in the last couple of years. If the dollar were back at its level of, say, 2 years ago, mid-1995, chances are we would be seeing even faster export growth.

But the United States is certainly not at a comparative disadvantage in international markets. I think the United States actually enjoys a competitive advantage in the world markets at the present

time. There are two reasons. One is, of course, the strengthened productivity in manufacturing, because manufacturing does a lot of the trade; and the other is the fact, we got the exchange rates down from the overvalued levels of the mid-1980's.

Mr. BENTSEN. If I might, I don't want to pick on NAM, for instance, but let's say other business groups, for instance, why do they want, or why in the last Congress did they want such dramatic changes? I guess my confusion is, I have people that come to my office and say, "You have to roll back the clean air and water acts, you have to give us more work rule flexibility in order for us to maintain competitiveness; otherwise, we will have to move our plant overseas or our new expansion will be overseas."

One industry group which told me that, which has a very large presence in my district, the same year they were telling me that they exceeded every other country in the level of exports of their product. So, on the one hand—and at the same time, at least on an average, their stock values continued to rise and their price-to-earnings ratios have risen dramatically.

I guess my confusion is, why on the one hand do we hear we are doing so well and then on the other hand we are being asked to make changes in the rules that would affect the employees who maybe are not doing quite as well?

Mr. SMITH. Can I take a crack at that?

I think we ought not to be surprised when owners of capital act like owners of capital. Reduced regulatory constraints, reduced obligations to pay workers, easier opportunities to degrade the environment, produce higher returns. Your job is to constrain that behavior in appropriate ways consistent with allowing the economy to grow and increase the goods and services that we all get to divvy up.

But, it certainly should not surprise you, I think, Congressman, that the business owners will continue to wish to pay their workers less, to pollute more, and to invest less in health and safety. It is not a surprise. It is not right or wrong, it is simply the nature of the transaction that we are engaged in.

It is your job to measure those competing claims and to ensure that we don't degrade environments or workers or health and safety when we can avoid it.

Mr. RICHARDS. I would like to answer that question. You raised the issue of which perspective is correct—are we very competitive, or are we facing a competitive disadvantage? In my opinion, the correct perspective is, we are now very competitive.

One of the problems is that corporate lobbyists—of course, not my own employers—often use the term "competitiveness" in a very irresponsible way. When they want a particular policy changed, they throw around "competitiveness" as though it were a buzzword.

In fact, competitiveness is determined mainly by the exchange rate and, secondarily, by way of productivity growth. If you look at the effect of something like environmental regulation—and I have run this through econometric models—I cannot find any evidence that it has ever affected our trade balance. I can, however, find evidence it has lowered the growth rate of the U.S. economy.

There are some estimates by Dale Jordanson of Harvard that I think are very good in this respect. Just to take environmental reg-

ulation as an example, what happens is that more capital spending gets diverted to pollution abatement. As a result, over an average business cycle, the capital stock ends up lower; as a result of that, GDP ends up somewhat lower and that, in turn, implies lower employment and lower wages.

So the ultimate costs of environmental regulation are borne in the form of lower domestic GDP and perhaps somewhat lower wages, but not in the form of a loss of trade competitiveness.

Mr. BENTSEN. With the Chairman's indulgence, if I might—

Chairman LEACH. If I could just say, we have got another very long panel.

Mr. BENTSEN. A very short question.

Chairman LEACH. Please, go ahead.

Mr. BENTSEN. I appreciate the Chairman.

I am not picking on you, Mr. Richards. Actually, I think you raised a very interesting point.

You said in your testimony that labor structure has changed, structural change in the labor markets, and you talk about the fact no longer are there rigid wage contracts, but instead you have pay for performance schemes, commission stock options, and so forth, which I don't disagree with.

You also mention that this is an exceptionally good deal for workers and a better deal than an increase in the hourly wage.

You talk some about stock options. I guess my question is, do you have any data that indicates how prevalent that is in the labor markets? I actually think stock options for most employees is an excellent idea, because I think that probably adds to productivity. It gives them a piece of the profit margin. But is that really prevalent throughout the labor markets at this point in time, or is that something that we ought to be encouraging as a Federal tax policy or fiscal policy?

Mr. RICHARDS. I think that it is still the exception rather than the rule, but it is becoming much more pervasive. It is being adopted in particular by a lot of newer manufacturing outfits. We had a couple of companies recently who indicated that they give their workers a base wage of \$9 an hour, but that the workers in many cases are achieving a take-home pay of something like \$50,000 a year, and most of that consists of productivity bonuses or stock options or other forms of compensation. Unfortunately, we don't have any national data.

The only thing I can say is that this is something which, in my judgment, should be encouraged. It is a way of, one, making the workers more productive, and two, more importantly, rectifying income inequality, because it is a way of sharing national wealth.

Mr. BENTSEN. Would it be efficient or inefficient to provide some form of a tax concession in return for providing such options at certain levels of income?

Mr. RICHARDS. It would be extremely efficient. In fact, I would encourage Congress to draft such legislation.

Mr. SMITH. Congressman, I would just observe that you can't eat a stock option, and the phenomenon that Gordon is discussing is a phenomenon that occurs in a fairly small and very particular part of the labor market. It is not something that most wage earners have an opportunity to do, and I would venture that very few

of the people in America who work for an hourly wage would trade in the opportunity to take home a little bit more for a stock option.

Mr. BENTSEN. But, I know our time is up, but would it be, from labor's perspective, in a supplemental way an added benefit?

Mr. SMITH. Well, an added benefit is an added benefit. But the substitute of a stock option for take-home pay would strike us as not much of a benefit.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Let me turn to Mr. Kennedy, but first make the observation, Mr. Smith, and it is the only point today I have a slight difference of opinion on.

Mr. SMITH. I knew that might happen if I stayed up here long enough, Mr. Chairman.

Chairman LEACH. An economist has won a Nobel Prize for one precept, and that precept is, the major reason people want to save in America is for retirement. The precept of stock options is tied to retirement, and it is in most of the programs we have, whether it be 401Ks or whatever, these are extraordinarily popular with the average working person who has an exceptionally sophisticated understanding of the meaning of that retirement program to him.

My own view is, to the degree that can be encouraged, that is another way of expanding real worker take-home pay, which just means it is in a saved circumstance. That doesn't mean it is a substitute for higher income, but as an augment, and it is a very sophisticated augment, because the tax policy frequently means more than take-home pay. I don't think what Mr. Bentsen was getting at is the least bit irrational.

Mr. SMITH. If I might, just for a minute, we may disagree less than you had thought. Certainly compensation in the form of increased resources for retirement security is something that we support, but Mr. Richards was suggesting trading hourly compensation for some kind of incentive compensation, some kind of contingent compensation. I think that is quite a different matter than encouraging more employers to contribute to the retirement security of their employees.

Mr. BENTSEN. If I might, though, wouldn't you agree to the extent that in addition to—and obviously you are for anything in addition—but in trying to deal with income distribution, that expanding the reach of stock options is a favorable policy, that it just doesn't go to the top, as Mr. Sanders would mention; with you, it also goes to the middle and the bottom as well, that those workers enjoy in the fruits of their labor as well.

Mr. SMITH. We certainly agree with you, Congressman, that workers ought to enjoy the fruits of their labor, and we would start with higher paychecks.

Chairman LEACH. Mr. Kennedy.

Mr. KENNEDY. Thank you, Mr. Chairman. I want to welcome Mr. Richards, and I also very much want to welcome David Smith, whom I have known for many years and whose work I think has done a large part to help many, many working families. I am delighted to see him before the committee.

And thank you, Mr. Chairman, for inviting all of the panels that are part of this process today.

I was somewhat frustrated and wanted to get your opinion, David, on the line of questions that actually the three of us—Barney, myself and Bernie Sanders—pursued with Chairman Greenspan yesterday, as well as the last time he was before the committee.

It seemed, in effect, at the end of the series of questions that the three of us posed, that he doesn't necessarily—although we probably disagree on some of the specification—that he would say when he is sitting there that he does think there is a big problem between—the disparity between the rich and the poor in the United States, and that this is a serious problem that needs to be addressed.

But his basic conclusion, after you get through all of the words, is that this is not really within the purview of the Federal Reserve, and that he really has to deal with macroeconomics policy pertaining to monetary policy, and that all he can do is kind of look at the figures, and if the figures show there is an overall economic growth without inflation, then he is not going to raise interest rates. If inflation sticks up its head, he is going to raise interest rates.

I suppose the converse of that is, if the markets were all gummed up and not moving forward, that he would probably lower interest rates or something like that.

But I don't know whether you feel the position of the Federal Reserve Chairman offers opportunities beyond simply raising and lowering rates to achieve some of the goals that I think both of you have spoken about here today, and certainly in times past.

David.

Mr. SMITH. Briefly, Congressman, the Chairman surely is right that the Fed doesn't have the same sort of stewardship of social policy, for instance, that Congress does. But he is also a bit disingenuous.

The most important thing we can do to move toward a reduction in income inequality in this society is ensure that we keep labor markets tight. Tight labor markets encourage the kinds of investments in workers and investments in capital which allow the economy to grow, allow us to produce more and allow us to distribute more.

They also allow people who have been locked out of the labor force or left out of the labor force to rejoin it. No policy is more important in determining how tight our labor markets are than what the Federal Reserve Bank does. So the Chairman does have a role.

He certainly is correct that in some social policies there is not much the Fed can do. But to suggest that the Fed therefore has no capacity to affect income distribution, I think is incorrect.

Mr. FRANK. If the gentleman will yield to me, I am struck by that, and it occurs to me some of my free market friends seem to lose their faith in the free market when it comes to labor. Essentially what you are saying is, the way to increase the price that labor gets is to increase demand for it, and that seems to be a perfectly acceptable application of free market economics to which a lot of our free market friends take exception. It is one of those things, like agriculture, where there was apparently a footnote in

all of the conservative texts which said, this doesn't apply to wages, or whatever.

Mr. KENNEDY. I also want to come back to this issue. Yesterday on page 14 he says, as I noted, "The recent performance of the labor markets suggests the economy was on an unsustainable track. Unless aggregate demand increases more slowly than it has in recent years, more in line with the trends of supply of labor and productivity, imbalances will emerge."

Essentially what he is pointing at there is the notion that we have too much employment. Effectively, he is trying to suggest that we are hitting a stage in terms of the economic policy where there is—at one point, I can't remember exactly where in his testimony, he was saying we have too many unskilled workers in the labor force, which is going to create some sort of inflationary cycle. At a certain stage, there is kind of a bizarre quality to the way he is structuring the question.

I am sure there is an economic theory that would suggest that because we have more unskilled laborers in the work force, therefore you are going to create inefficiencies. But the truth of the matter is, I think we come at it from a perspective that the more people you have working in the society, the better off the society is, the more people are able to purchase more goods and services and, effectively, everybody can gain.

I think our great frustration is this notion that somehow there is either a number out there of unemployed people or a percentage of unemployment, or there is a growth of actual wages that might occur that, therefore, would automatically trigger a rise in the interest rates.

I wonder if you could just comment whether or not you think that those are legitimate concerns, or whether or not you think that there is an alternative view?

Mr. SMITH. Congressman, I have been struck, as this debate has unfolded over the last couple of years, by the appropriateness of a couple of chapters from "Grapes of Wrath." Steinbeck describes "Oakies" moving to the West Coast and being denied employment in the cannery factories south of San Francisco because they were simply not up to the arduous and difficult task of canning sardines.

A decade later, these same people were arming democracy and preparing for the Second World War, building the bomber fleets and advanced weaponry in L.A.

We have enormous capacity with tight labor markets to train and develop workers who currently may not be as productive, but they will stay unproductive if they stay unemployed.

Mr. KENNEDY. Exactly. I know we are out of time.

Mr. Richards, if you wanted to offer any comments.

Mr. RICHARDS. Thank you. I think you should really approach these issues on a two-pronged basis. What the Federal Reserve can do is ensure that you have sufficient economic growth so that we don't grow below potential, that unemployment doesn't increase, that the unemployment rate gradually declines to something like its structural rate or natural rate, sometimes called NAIRU. This, I think, was the concept Mr. Greenspan was dealing with.

The issue for Congress, of course, is what can be done legislatively to ensure the natural rate of unemployment declines. Here,

education of the work force, greater training of workers, any efforts to make labor markets function more efficiently will encourage those workers to get jobs, as a result of which the natural rate of unemployment will tend to decline, probably to well below the level we currently see.

Currently the level of unemployment is around 5 percent. I think it would be entirely conceivable to get the actual unemployment rate and natural rate down below 5 percent, probably closer to 4, if you would adopt some structural policies, such as additional education and training, and at the same time the Federal Reserve keeps monetary policy sufficiently loose that the economy grows along potential.

Mr. KENNEDY. Well, Mr. Richardson, I would point out, while I very much agree with your perspective on this in terms of the goals, in any event, the truth is that the Chairman yesterday also indicated that he didn't believe that the kinds of programs that we had—and even though we were voting on the House floor just yesterday on revamping the vo-tech bill, were in fact successful in getting people the kind of job training and educational opportunities that they need.

Now, there might be some areas we need to revamp even more. But, nevertheless, it seems to me what we need at this point, in addition to all of the rest of the economic policy, is someone who is showing at least some sensitivity in talking about some of these concerns in terms of the differentials between rich and poor, and the fact we can have more people working in the work force and through that work actually encouraging people to gain new skills and move up the economic ladder, which I believe is what I ultimately believe is the fundamental and most important building block of the economy of this country.

Mr. Chairman, I thank you for the time.

Chairman LEACH. Thank you for those thoughtful perspectives. I want to thank both of you.

One of the symbolisms of the National Association of Manufacturers and the AFL-CIO is that we are all in the same boat together. I think it is impressive that there are differentiations of judgment, but also a lot of similarity. I thank you both for your quality testimony. Thank you.

On our next panel is Mr. John Lipsky, the Chief Economist of the Chase Manhattan Bank. Prior to that, he served as Chief Economist at Salomon Brothers and was an economist with the International Monetary Fund. Prior to that, he received his real education in the public school system of Cedar Rapids, Iowa.

Our second witness is Dr. Robert Eisner, who is a Professor at Northwestern University. He was also a Senior Research Associate at the National Bureau of Economic Research and was an economist and statistician for the United States Government in the Office of Price Administration.

Our third panelist is Dr. William Brown, Managing Director and Chief Economist at the J.P. Morgan Company. He is a graduate of Harvard University.

Our fourth witness is Dr. Lawrence Chimerine. Dr. Chimerine is the Managing Director and Chief Economist at the Economic Strategy Institute in Washington, DC., for more than 16 years has been

a consultant to hundreds of major corporations, and was once Manager of Research and Forecasting for the IBM Corporation.

Our fifth panelist is Dr. Robert B. DiClemente who is Director and head of the United States Economic and Market Analyst Group at Salomon Brothers.

Our last panelist is Dr. James K. Galbraith, who is a Professor at the Lyndon Johnson School of Public Affairs at the University of Texas. He holds a large number of establishment degrees from Harvard, Yale and Cambridge, but is best known for challenging establishment theories.

If there is no objection, we will begin as introduced, unless there has been a prior arrangement. If not, we will begin with John Lipsky.

Mr. Lipsky.

**STATEMENT OF JOHN LIPSKY, CHIEF ECONOMIST AND
DIRECTOR OF RESEARCH, CHASE MANHATTAN BANK**

Mr. LIPSKY. Thank you, Mr. Chairman. It is a pleasure to be here this afternoon to give my views on U.S. monetary policy. I would note that there must be something about an Eastern Iowa upbringing that fosters an interest in finance and economic policy. The earliest discussions on that topic that I recall were at Franklin Junior High School in Cedar Rapids.

But, more generally, I have often wondered about the broader implications of Cedar Rapids economic record. Unemployment there persistently has been below the national average, but without producing the distorting and destabilizing effects that normally are described as inevitable in those circumstances.

Turning to the subject of the committee's invitation, which was to examine the state of the economy and to review the conduct of monetary policy, there are four main points that I would like to make today.

First, the U.S. economy is performing exceptionally well compared both with our own industrial country partners and with our post-World War II experience.

Second, this economic success is not a result of only temporary factors or luck, but rather derives in large part from good policy choices and from favorable structural developments. Of the former factors, sustained anti-inflationary monetary policy has been the most important.

The third point is that the outlook remains free of expansion-threatening imbalances, as near-term growth likely will be somewhat more moderate than is reflected in current consensus views. Thus, inflation risks will remain quiescent and potential pressures for additional tightening of Federal Reserve monetary policy likely will be absent in the coming months.

Fourth, looking beyond near-term issues, Fed officials need to examine possible new guides for setting policy, because the changing structure of the U.S. economy has rendered traditional monetary policy indicators less reliable. The new class of so-called "feedback rules" looks particularly promising in this regard.

The U.S. economy's performance during the past few years has exceeded even the most optimistic forecasts. In particular, growth has strengthened while inflation has remained tame. The improved

price outlook has helped to lower long-term interest rates, thereby boosting investment and improving the economy's long-term growth potential.

Accelerating productivity growth, aided by double-digit growth in investment on capital equipment during the past few years, has permitted both noninflationary wage gains and robust increases in business profits. The rise in U.S. asset prices, including the stunning stock market gains of the past 2 years, no doubt derives in large part from the unexpectedly favorable corporate earnings performance and the prospect that the benign economic environment will be sustained.

The excellent U.S. performance of the 1990's stands in stark contrast with the disappointing recent record of our G-7 partners. Without exception, they have suffered deeper recessions and weaker recoveries than has the United States. Investment growth in these countries generally has been sluggish, and job gains have been paltry or nonexistent for years.

In fact, the recent U.S. economic success in effect represents a new American challenge to other industrial countries. International investors have grown more confident that the U.S. outlook will remain favorable in the future. It is not surprising, therefore, that the dollar has strengthened over the past 2 years and that net long-term private capital inflows have accelerated to a record pace.

This is not to claim that the U.S. economy today represents some theoretical ideal and that all problems have been overcome. Nor is it evident that the business cycle has been rescinded for all time. Nonetheless, to claim that nothing new is going on ignores the obvious: U.S. GDP has grown in every quarter save four since the Fall of 1982. This is the best record of the post-World War II era, and suggests that we need to examine closely the structural shifts currently underway and to rethink traditional notions of the business cycle.

A debate has emerged whether the U.S. economy is being governed by a new paradigm. Analysts, investors and policymakers alike have wondered whether the unexpectedly good U.S. economic performance has resulted from temporary factors and simple good luck, or rather, from improved economic policy decisions and/or favorable structural changes. The answer to these questions is important. If the U.S. performance reflects good decisions, then it likely will be sustainable. Moreover, U.S. policy may represent a prototype for other industrial countries.

In my view, the U.S. economy's low inflation expansion has not resulted from good luck, but derives in large part from four basic factors: one, sustained anti-inflationary monetary policy; two, economic liberalization, including financial market deregulation, the elimination of price controls and reductions of barriers to entry in several key sectors, such as telecommunications; three, declining budget deficits in the context of a medium- and long-term focus for budget policy; and four, improved inventory controls and a trend decline in inventory sales ratios that, together, have reduced troublesome inventory cycles.

Of these factors, the persistent application of serious anti-inflationary monetary policy has been the most important. Since Mr. Paul Volcker became Federal Reserve Chairman in 1979 and, sub-

sequently, under the leadership of Mr. Alan Greenspan, the Fed has pursued price stability as its primary policy goal. As inflation has declined, the Fed's credibility has grown, while inflation fears have waned. Given the focus of this hearing and in the interests of brevity, I will not offer further comments regarding the other factors, beyond noting that the combination of credible monetary policy and significant regulatory reform has been unique to the United States among the G-7 economies in the past two decades.

The fruits of the Fed's anti-inflationary policies have been particularly evident in the past few years. The reason for this apparently delayed impact, is straightforward. The central bank earns credibility the same way that Cal Ripken, Tony Gwynn and Ken Griffey, Jr., have earned their reputations as hitters: That is, by stepping up to the plate and swinging the bat with consistent success. The Fed earns credibility by promoting good economic performance through successfully resisting inflationary pressures. Unlike baseball players, who get to bat hundreds of times each season and whose batting average is calculated anew every year, the Fed faces reputation-setting inflationary challenges very infrequently, but the results accumulate. By resisting inflationary pressures vigorously in the late 1970's, again in the late 1980's, and most recently in 1994-1995, the Fed's reputation has been enhanced progressively and the economy's performance has improved as a result.

By now, the Fed's message is widely understood. There will be no return to higher inflation. The clarity and credibility of the Fed's commitment to price stability has lowered both inflation expectations and long-term interest rates. This has bolstered the prospects for sustained investment-led growth and—in the context of reducing mortgage rates—has bolstered the housing sector.

What economists—and what many others recognized some years ago—that there is no long-term tradeoff between low unemployment and low inflation—increasingly is evident in the historical record. In the post-World War II era, the periods of strongest growth in output and in income per capita and the lowest unemployment rates, have coincided with the lowest inflation.

Many analysts and financial market participants harbor pessimistic views about U.S. prospects. Consensus expectations encompass higher inflation and higher interest rates in the next few quarters, including new Fed rate hikes and the risk of an eventual cyclical downturn. The pessimists maintain that when the U.S. unemployment rate falls below 5.5 to 6 percent—that is, below NAIRU—inflation will accelerate necessarily.

Moreover, with the stock market allegedly levitating on a speculative tidal wave of mutual fund purchases and with second quarter income growth outpacing consumption, a new acceleration of private spending toward an inflationary pace is viewed by many as a foregone conclusion.

I don't find these arguments convincing. Several factors suggest that U.S. economic growth in the coming quarters likely will be somewhat more moderate and inflation risks somewhat less acute than is reflected in the current market consensus.

First, the combination of good productivity growth and strong investment is boosting the economy's productive capacity at a faster pace than has been typical in past decades.

Second, the NAIRU almost certainly has declined in recent years, reflecting increased labor mobility and shifts in demographics, economic expectations and cultural attitudes. Thus, the near-term risk of inflationary wage pressures is less convincing than would have been the case in past decades.

Third, the widely used concept of consumer spending "momentum" is overstated in the consensus view. Current income trends provide powerful explanations of current spending, but offer little guidance about future spending. Yet, the outlook for future income trends is uncertain.

Fourth, the consumer investment cycle and the so-called "wealth effect" on spending of rising equity and other asset prices, appear to be winding down.

Finally, the dollar's continued rise and sluggish growth among our main trading partners will keep imported inflation low.

The prospects are good, therefore, for continued moderate growth and quiescent inflation pressures. In this case, the Fed may not need to tighten policy further in this expansion phase. Indeed, it is conceivable that, in time, the Fed's next policy decision could be an easing.

Looking beyond the near-term policy challenges, a long-run issue remains to be addressed: Whether reliable, objective procedures can be developed for setting monetary policy.

Fed officials can no longer rely on many traditional monetary policy indicators. Money supply rules, for example, have been rendered problematic by structural changes in the financial sector. As has been mentioned already, economic indicators, such as NAIRU, appear to be more useful in explaining the past than in predicting the future.

At the same time, monetary policy techniques in use in several other countries, such as formal inflation targeting, seem more helpful in establishing credibility than in providing operational guidelines.

Finally, pegging the dollar's value to some external anchor, such as gold or a basket of commodities, enjoys limited theoretical or practical support.

In recent years, the Fed has been forced by the absence of a reliable policy rule to operate in a highly pragmatic fashion. This provides one explanation for the heightened attention paid to public speeches by Fed officials. In any case, uncertainty is sufficiently great about whether the current combination of good growth, low unemployment and steady inflation can be maintained.

But, the Fed must remain flexible with regard to upcoming policy decisions. That is, the policy-setting FOMC must sift through myriad data series, as well as qualitative factors, in order to determine as well as possible the appropriate Fed funds rate.

A more systematic approach to setting Fed policy might rely on so-called "feedback monetary policy rules." These rules use readily available and easily understood data to help set Fed policy in a self-correcting framework. The best known is the Taylor Rule, named after its author, Professor John Taylor of Stanford University. This rule relies on both output and inflation data to indicate when Fed policy shifts are needed to meet a specified inflation target.

Regardless of the analytical method used, the basic question that needs to be answered is whether at this time there exists a policy-driven or other imbalance in the economy, and if so, whether Fed action would be an appropriate remedy. At present, it is difficult to develop a strong case for additional Fed tightening. Unless more convincing evidence emerges of growing inflationary pressures, the FOMC can leave policy unchanged.

These remarks have addressed several complicated issues in a highly summarized fashion, and I will be very happy to answer questions later.

Thank you.

[The prepared statement of John Lipsky can be found on page 188 in the appendix.]

Chairman LEACH. Thank you very much.

Professor Eisner.

STATEMENT OF ROBERT EISNER, PROFESSOR, NORTHWESTERN UNIVERSITY

Mr. EISNER. Thank you very much for the opportunity to be here.

Some half a century ago, the policy of Congress was directed in the Employment Act of 1946 to maximum employment, production and purchasing power. There has been very little direct implementation of that goal over the years. In 1978, of course, the Humphrey-Hawkins Act attempted to guide the Congress in policy to a better implementation of specific goals, including 4 percent unemployment; and yet that goal, to be achieved by 1983, has not been achieved and, in fact, there has been little action really directed toward it. To the extent unemployment has gone down, it has not been due to a conscious aim to drive it down, with some very rare exceptions.

I suggest that there is really a lot of opposition to full employment in this country in various circles. I would like to suggest, only half jokingly, that there are many closet Marxists. Karl Marx, some of you may recall, argued there has to be a "reserve army" of the unemployed in order to keep workers from bidding up their wages and thereby driving out profits and destroying the system.

A lot of people in this country seem to believe that you cannot have labor markets too tight, or unemployment too low, or the modern view of that, wages will simply drive up inflation, which will be a disaster.

Now, that view has been reincarnated, this old Marxist view, in the NAIRU, which I consider one of the worst abominations to affect economic policy, and indeed, much of my profession, to my embarrassment. It is a view, a dogma, without a sound basis in economic theory, and supported over the years by econometric estimates, of which I have made many, but which are based on a restricted model. In fact, current modern estimates are showing high standard errors, meaning our ability to estimate where in the world this NAIRU is is very uncertain.

I have been attacking it for a number of years in a number of papers. I submit for the record one which is in *The American Prospect* Spring 1995 issue, an early paper of mine on that entitled "Our NAIRU Limit, the Governing Myth of Economic Policy."

[The material referred to can be found on page 204 in the appendix.]

What I found in my own work on the NAIRU is that if you separate out periods in which unemployment is below the alleged NAIRU and unemployment above the alleged NAIRU, you do find that high unemployment does tend to lower inflation, which should be no surprise. If businesses cannot sell their products and workers can't get jobs, that may begin to lower inflation. But low unemployment has not raised inflation. As I say, I have a number of papers, estimates over about 40 years of data, bringing this out.

I might also point out that the application of NAIRU is closely associated with rates of growth, and the big view of the Fed and many people is if you allow the economy to grow too rapidly, that it will reduce the unemployment rate—God forbid—and put the unemployment rate below the NAIRU and, therefore, cause inflation.

Just one slightly parenthetical remark: I was quickly looking at some numbers while I was sitting here, and I can point out that, in the four quarters from the first quarter of 1996 to the first quarter of 1997, the real GDP growth was about 4.1 percent. Unemployment did, in fact, come down. As for the inflation rate measured by this GDP price deflator, which is the broadest measure of prices in the economy, prices went up all of 1.8 percent. Indeed, you can even question whether they went up that much.

What I have tried to stress over and over again—and I think this should be a critical guide for policy of this body, or the Fed—what counts for the economy? We have been hearing what counts for real people.

What counts is the gross domestic product, the total amount of what we can produce in a year. What counts is the distribution of that product and, therefore, the income that we earn from producing it. What counts is not only the present, but our investment in the future; the more investment of all kinds that we have, both public and private, physical capital and human capital, the greater will be our output in the future. And finally, what counts, not only because it promotes growth and is good for GDP, you have more GDP with more people working, but what counts is employment and unemployment themselves. Because in our world, in our society, a person without a job who needs a job is nothing. That is destructive not only of income, it is destructive of family, it is destructive of human beings, it is destructive of the very fabric of our society.

Those are the targets we have to keep in mind.

Where does inflation come into all this? We keep talking about inflation. In fact I was able to watch Chairman Greenspan on television last night, and I noticed that he indicated that inflation is simply a tool for something else. He, too, is interested in the growth of the economy. We do not want excessive inflation, but you know, if everybody is paying higher prices, slightly higher, sellers as well as buyers, that is not necessarily the end of the world.

Again, I am not arguing for higher inflation, but Alan Greenspan, Chairman Greenspan said, as well, that he wants to keep a stable price situation, low inflation or no inflation, because that promotes the other objectives of growth.

Now, the thing that I think many people seem to forget and I trust the Members of this committee are well aware of, and Chairman Greenspan is well aware of, the Fed has limited tools. The Fed cannot do everything. What it can do is control the cost and the amount of credit, and that is intended to influence the amount that people in the economy spend.

If they spend more, what happens? There is more production, and there may be higher prices in some circumstances. If they spend less, there may be lower prices. There will almost certainly be less production.

The one tool that the Federal Reserve has of raising the discount rate, actually raising the Federal funds rate, choking off credit, has the effect of making people spend less; and if it does anything to lower inflation, that will do it precisely as it lowers output and increases unemployment. There are no two ways about that.

You can slow inflation, if the Fed is doing it, by increasing unemployment, by slowing the rate of growth.

Now, Alan Greenspan spoke of the importance of maintaining a sustainable growth rate. That is an interesting thing to get into. I am not saying the economy can grow at 4 or 5 percent forever. Maybe it could, but nothing can go on forever. The population can't grow for 1 percent a year forever or we will overflow the Earth.

The question is, first, how fast you can grow in the short-run? I just pointed out, it grew more than 4 percent in the last year. As long as there is some slack in the economy, more people that can go to work, then output can grow at a more rapid rate; and we certainly should and can promote policies which mean lower interest rates, as far as monetary policy goes, that would enable the economy to grow as fast as it can until it uses up all the slack.

I am not saying that is sustainable. I know that 4.1 percent is not sustainable indefinitely. I am confident that 3 percent is sustainable, even though the Administration and Congress talk of 2.1 to 2.3 percent rates. Sustainable growth, in the first place, means in the short-run to get yourself up to that capacity limit; in the longer run, to grow as fast as the economy can grow.

I think some things in economic theory and evidence are forgotten. That a lower rate of growth is not necessarily more sustainable than a higher rate of growth. A lower rate of growth, like 1 percent instead of 2 or 3, means less demand for new capital, less investment, and may well bring a collapse of the economy. The faster growth we have had actually brings out more investment and, therefore, keeps the economy profitable, growing and successful.

I might then close in terms of what I would urge and argue. In the first place, clearly, the Federal Reserve should do no harm. That means it should not raise interest rates, not tighten credit. As many of us have suggested now, it should not tighten because it thinks somehow there might be some inflation some time in the future. There is no evidence of that now, and if there were a bit, you might wait until you see the whites of their eyes before you fire anyway.

The second thing I would say is, the Fed has responsibility to do more than do no harm. The Humphrey-Hawkins Act says it should be directing itself to maximum employment, low unemployment, a 4 percent target. That means it should keep trying to lower interest

rates to keep the economy moving forward as rapidly as it can, and that, by the way, will also meet each of the objectives of what I say counts and what I think we must all recognize counts—maximum production now, maximum investment in the future, maximum employment now, and as has been addressed by a number of people, a better distribution of income.

Because a more prosperous economy with lower unemployment will increase the demand for labor and of low-skilled labor, which is generally the first to be unemployed, it will increase that demand for low-paid labor and help the distribution of income as well.

Thank you.

[The prepared statement of Robert Eisner can be found on page 194 in the appendix.]

Chairman LEACH. Thank you.

Dr. Brown.

**STATEMENT OF WILLIAM A. BROWN, MANAGING DIRECTOR
AND CHIEF ECONOMIST, J.P. MORGAN COMPANY**

Dr. BROWN. Thank you very much, Mr. Chairman. The starting point for my comments today is the tremendous surge we have seen over the past 18 months in optimism about current and prospective economic performance. It is evident almost everywhere—in the performance of the stock market, in household attitudes, in business actions as seen in the continued boom in capital spending.

The mood of optimism is particularly striking as it is in such contrast to the pervasive gloom of only several years ago. As someone who spends a lot of time giving presentations on the economy to a wide range of people, I can testify how hard it was only 4 years ago to convince people that things might actually get better. Today, there is a similar resistance to any suggestion that they might not be this good forever.

Let me quickly highlight the economic performance that lies behind this transformation in sentiment and then discuss the implications for monetary policy.

The economy in recent years has featured sustained, although unspectacular, growth and very well-behaved inflation. One explanation for this good performance is that we have entered a new age in which rapid growth and inflation are compatible. I would be very cautious about embracing such notions. It is worth remembering that the 2.8 percent average growth in this expansion is the lowest of all post-World War II expansions and falls well short of the 4 percent achieved as recently as the 1980's expansion and the close to 5 percent of the 1960's expansion.

Inflation, although low and well-behaved, was lower consistently in the 1950's, has been as well-behaved at times in the past, particularly in the cycle of the 1960's, and has benefited from some potentially temporary factors, most importantly, a very favorable external environment. In short, it has been a nice business cycle, but this performance is far from unprecedented and certainly no miracle.

There is one aspect of recent performance, however, that is worth highlighting and is unusually positive. Recent economic and market performances both suggest that the unwinding of the inflation

rise of the late 1960's and 1970's is now complete. The three-decade rise and fall of inflation has been the central economic and financial market event of the post-World War II period. Over the past 15 years, a gradual working down of inflation has been a central focus for monetary policy.

Although critically necessary, disinflation came at a heavy price. Since the Federal Reserve began in earnest to attack the inflation program under Chairman Volcker at the beginning of the 1980's, the unemployment rate has averaged 6.9 percent. In the two decades before inflation rose decisively, the unemployment rate had averaged 4.9 percent.

The completion of the disinflation process holds out the possibility of sustaining substantially lower unemployment rates than we have gotten used to over the past 15 years. How low? I think both the fact that the roughly 5 percent average of the 1950's brought with it a bit of an up-creep in inflation and the fact that wage inflation has accelerated modestly in the past year, suggests that 5 percent is probably at the low end of what will prove possible. But something below 6 percent is a reasonable expectation and would be a substantial improvement over what we have been experiencing on average.

There is some reason, as well, to believe that lower inflation might also contribute to a higher sustainable rate of economic growth, as one major intermediate-term uncertainty for business is removed. The relationship between inflation and sustainable growth, however, is poorly defined; and as I indicated, the low growth rate during the current cycle does not provide much encouragement. Higher sustainable growth thus remains a hope more than something that can be counted on.

Despite this major accomplishment, the magnitude in the swing toward optimism seems disproportionate to the actual and prospective performance of the economy, although it is not out of line with the history of sentiment swings over the business cycle. Just as slow growth in the early 1990's led people to conclude this was the norm, people are now extrapolating recent solid growth. In both cases, what was missed was that economic performance was being significantly influenced by business cycle considerations.

This brings me to the question of the appropriate stance of monetary policy. Over the past 18 months, the Federal Reserve has displayed a relatively relaxed approach to the inflation threat posed by strong growth in an already fully employed economy. The delayed, and so far modest, one-quarter point tightening is in clear contrast, for example, to the aggressive tightening undertaken at a similar point in the last cycle in 1988.

The easier approach is justified by the progress that has been made in the disinflation process and by the apparent recent further fall in longer-term inflation expectations. Both are sound reasons for moving monetary policy away from a focus on reducing inflation, and they justify as well a somewhat more confident approach to managing inflation risks. They do not mean, however, that the Federal Reserve can relax in the important job of managing the business cycle.

One key function of monetary policy is to lean against the swings between gloom and euphoria, whether rational or otherwise, in

order to keep the economy on a reasonably even keel. This is what has been done successfully in the current cycle, either by luck or design; and it is a key reason for the excellent economic performance we have been enjoying. Every time growth threatened to boom, something has knocked it back.

In 1992, growth reached 4 percent, but a severe recession in Europe and Japan and a tax increase at home cooled things for a time. By 1994, growth worked its way back to 4 percent, but Fed tightening, a major setback in global bond markets and a collapse in exports to Mexico cooled growth again.

Over the past year, growth once again has climbed back to 4 percent or a little bit better. What is different this time is that no countervailing forces are emerging. Neither the Fed nor market interest rates have risen appreciably, a modest tax cut is on the way, and growth abroad is accelerating noticeably. In fact, the major reaction to the pickup in growth has been the surge of optimism that has elevated the stock market and produced the largest increase in stock market wealth on record. With no restraint in place, growth will not fall back quickly as it did twice earlier in the cycle and is anticipated to do by most forecasts, including those of the Federal Reserve.

The current growth surge will inevitably come to an end, but the risk is that the slowing will be brought about by a rise in inflation and the market and policy reactions, or by a buildup of cyclical excesses and their inevitable unwinding. In either case, the slowing of growth will likely be sharp and extended, as both an acceleration in inflation and cyclical excesses involve the need for reversal and thus for a period of "payback."

In contrast, slowing due to monetary tightening can be quickly reversed, if appropriate. Ironically, the Federal Reserve's relative inaction over the past year has encouraged people to believe that the current growth surge is sustainable. The resulting upgrades to earnings expectations and demand forecasts are feeding, rather than dampening, the surge in activity.

What is needed now is not another cheerleader for the U.S. economy—it has plenty—but a timely dose of restraint. The need does not reflect any underlying problem in the economy. Just the opposite, it is the basic health of the economy that requires a firmer hand on the monetary reins. It would be a shame if a cyclical misstep at the end of a very well-managed expansion prevented the country from realizing fully the potential benefits of restored low inflation and global competitiveness.

[The prepared statement of William A. Brown can be found on page 213 in the appendix.]

Chairman LEACH. Thank you very much, Dr. Brown.
Dr. Chimerine.

STATEMENT OF LAWRENCE CHIMERINE, MANAGING DIRECTOR AND CHIEF ECONOMIST, ECONOMIC STRATEGY INSTITUTE

Dr. CHIMERINE. Thank you, Mr. Chairman. It is nice to see you and the other Members again. I suspect you are beginning to suffer from monetary policy fatigue with, now, with two days of hearings on the subject. I am going to try to be very brief and, to the extent

possible, avoid too much repetition, focusing primarily on what I believe to be the key issues in the decisions the Fed will be making over the next several months, and presenting my views on those and what the Fed should do in response.

I guess the question that everyone is wrestling with is, is there now something different? There are two reasons why many of us believe there is something different, particularly with respect to inflation.

First, it is very rare to have experienced such benign inflation as late in the business cycle as we are right now, and in fact, I cannot remember another case where all the inflation measures were actually declining in the sixth year of an economic expansion as they are now. In almost every other expansion at this time, inflation would be accelerating.

And second, and I am not sure whether this has been mentioned before, wage increases have not only been modest, but for several years now, at least three, probably four, virtually all of the models that have wage equations in them have been consistently overpredicting wages. That is, the traditional relationships between wages and all the determining factors, levels of corporate profits, unemployment measures and lagged inflation rates, and whatever else they might be, has changed.

Those equations have been sizably and consistently overstating wage increases now for a number of years, so this has been going on for so long now that I think the conclusion that something different is taking place is a legitimate conclusion, even though I realize the phrase "this time is different," is one of the most overused phrases in the English language.

By the way, if I can make one comment on an observation Will Brown made a moment ago, this is a relatively modest expansion by traditional measures, such as real GDP, but it is very difficult to make comparisons between this expansion and those, for example, which occurred in the 1950's and 1960's. There are a number of demographic changes, changes in average education levels, and other factors, which pushed up economic growth very strongly during those years, and don't do it to the same extent now, so the economy has probably been doing better over the last 4 or 5 years than it appears to be based solely on GDP comparisons for economic expansions.

What is different this time? I think there are several key differences. Probably the most significant are a number of factors which have dramatically reduced pricing flexibility and pricing power throughout the United States, in almost every major industry. I think some of these factors have already been discussed. They include the increase in global competition; more intense domestic competition; deregulation across a number of major industries in the United States, now even spreading to telecommunications and electric power and others; an increasing number of industries characterized by learning curves, which forces down prices over time, as these industries grow; huge excess capacity in retailing, resulting from massive building and overbuilding in recent years; and the growth of discount operations, many based largely on economies of scale, in a wide number of industries, especially in parts of retailing and distribution. All of these have created intense

competition and pricing pressures in so many industries that more often than not, price cutting and price discounting is the order of the day, rather than price increases, and there is no sign whatsoever, in my opinion, that any of this is changing in any way.

Almost all of the companies I talk to tell me it is still extraordinarily intense out there, and it is difficult, if not impossible, for them to raise prices. In fact, in virtually every case, all the companies I talked to tell me they essentially start their business planning process with the assumption that they will not be able to raise prices, and then work backward to find ways to keep costs under control, so they can continue to show improved profitability, despite the inability to raise prices.

They are doing this by holding wages as low as they can; by reducing benefits in many cases; by increasingly outsourcing high cost activities to someone on the outside who can do it more cost-effectively; by using more and more cost-saving technologies, more of which is probably available now than might have been the case 10 or 20 years ago; by pressuring suppliers, in some cases unmercifully telling them on a regular basis what kind of price cuts they expect from them each year, and so on down the list.

And while it is true that if market conditions change, it is possible some of these companies may be able to push through some price increases where they haven't in recent years, the fact is that they are putting in place many changes which are holding down costs, reducing the risk of inflation as we move ahead.

On the labor side, I think there have been many changes as well, which have reduced increases in wages for any given rate of unemployment, some of which have been discussed extensively already. These include the decline in union power; the decline in the real minimum wage over the last 10 or 12 years—even with the increase last year, the minimum wage in real terms is still relatively low—widespread job insecurity, a legacy of corporate downsizing; increased competition coming from low-wage countries; and a number of other factors that clearly appear to have dampened wage increases in recent years. In line with the comment made earlier, they are lagging behind what the traditional relationships have been predicting.

By the way, these factors reinforce each other. Small wage increases, being held down by corporate efforts to keep costs under control, only reinforce the factors that have probably reduced wage increases on the labor side. In my opinion, these are intense factors that are still in place and suggest that the favorable inflation climate is likely to continue.

Some would take the opposite view. They point to the modest acceleration in wages over the last 12 or 18 months as a sure sign of coming inflation. This is the first step, they argue, in cost increases, which will ultimately push prices up. I think this is a misguided conclusion. The increase in wages has been very slow and gradual and very spotty.

Second, it is probably more of a catch-up than a precursor or a leading indicator of inflation. As many people have discussed already, wages have been lagging for years. And in fact, in this expansion period, a larger share of the increase in national income has gone into corporate profits and a smaller share into employee

compensation by far, than in any recent expansion, so these wage increases are not leading indicators of inflation. Furthermore, they are being offset by productivity increases in almost every single industry and with a high level of profit margins can easily be absorbed within current levels of profits. I don't view this modest, gradual pickup in wages as a sign of inflation.

Notwithstanding, given the fact that there is no automatic pass-through, with the intense competition in product markets and end markets, even the increases in wages that have taken place, even if they are not offset completely by productivity growth, probably won't be passed on given current market conditions.

Then you hear the argument that the economy is growing too fast, or is going to start growing too fast again, which is sure to create inflationary pressures. I think the real story is that the first quarter growth rate was an aberration. It was caused in great part by temporary and erratic factors, such as very mild winter weather, early tax refunds, and probably, inaccurate seasonal adjustment factors. It overstated the underlying growth rate in the economy. The economy has slowed in the second quarter. And whatever bits of information we have for July suggest that things might be picking up a little bit again, but not by a lot, and certainly there is no evidence of any overheating or a rapid surge in economic growth taking place at the current time.

Third, I think there is still room to grow in the economy. When you take into account the expansion of global capacity in many industries, the investment boom we have had in the United States, which is the real story of this business expansion—we have had the best 3- or 4-year growth in business equipment spending since the 1970's—which is increasing productivity and increasing capacity in many industries, all of which have created significant capacity to accommodate additional economic growth. Even on the labor side, with the increase in the labor force coming from former welfare recipients and former discouraged workers entering the labor market, and prior victims of downsizing, and with a shift of people from part-time to full time work, the labor market is probably not as tight as some people think it might be.

Then, there is the argument that Will made a moment ago that maybe the economy is not booming now, but it is sure to boom as we move forward because of all the wealth that has been created by the stock market boom. The relationship between wealth and spending is very weak at best. Not only that, many families are now spending less and putting more of their income into mutual funds and other retirement funds. We are still seeing a high level of inflows into these funds, probably reflecting higher savings, not lower savings, as you would expect from the wealth effect. As others have mentioned, the trade deficit is rising, holding down growth. Finally, given our inability to forecast accurately at present, I would be reluctant to base any recommendation to the Fed on a forecast of more rapid economic growth as we move forward.

And finally there is the issue of NAIRU. The truth of the matter is, NAIRU has been nowhere near as reliable as a predictive tool in the past as some people have suggested. We can't measure it. We probably can't even accurately measure the actual unemploy-

ment rate anymore, given all the changes taking place in labor markets. It is a weak concept, it is too unstable, and in my opinion should not be used as the basis for monetary policy. Again, even if it does suggest some acceleration in wages, in the current environment that does not necessarily mean more inflation any more than the pickup in commodity prices 2 or 3 years ago did, after years in which commodity prices were depressed.

This is an increase in relative prices at most, not an early sign of future inflation. And if you look at other leading indicators of inflation, like gold prices, commodity prices and the value of the dollar, you certainly don't see anything there either. There is absolutely no reason to believe that the favorable inflation environment is going to change at any time in the near future.

What should the Fed do in response? Number one, stand pat right now. Number two, ease when they can, to a minimum, reverse the unnecessary tightening move at the March meeting. I think the entire discussion of what the Fed should do has to start with the point that real interest rates are already extraordinarily high and, in fact, with the more favorable inflation numbers recently they have increased further. This is not an extremely loose monetary policy, based on the aggregates of money or based on real interest rates.

Third, I think the Fed should scrap preempting. The environment is different now. We have very few cost-of-living adjustments in union contracts or in business-to-business contracts, unlike the situation 15 to 20 years ago. There is no longer an inflation psychology in this country like there was at that time. Nonunion companies no longer use the cost of living as a factor determining their compensation programs.

The risk of a wage-price spiral triggered by some event that pushes inflation up, then feeding into wages, and prices and wages spiraling upward out of control, thus no longer exists. The Fed has ample time to watch and to see what happens to inflation. If it picks up, it will have plenty of time to tighten, if it is necessary, but in this environment, given the uncertain outlook, given the already favorable inflation performance and given the structural changes that have reduced the risk of a wage-price spiral, in my opinion, there is absolutely no need to preempt.

And finally, I think it would be a terrible mistake to reform or repeal Humphrey-Hawkins, or to change it in any way that would reduce economic growth and low unemployment as a priority for the Federal Reserve System.

Thank you, Mr. Chairman.

[The prepared statement of Lawrence Chimerine can be found on page 222 in the appendix.]

Chairman LEACH. Thank you, Dr. Chimerine. I just want to stress, we suffer less from MPF—monetary policy fatigue, than we do from PVB—which is pre-voting bells.

Let me now turn to Dr. DiClemente. Please go ahead.

**STATEMENT OF ROBERT V. DiCLEMENTE, DIRECTOR, U.S.
ECONOMIC RESEARCH, SALOMON BROTHERS, INC.**

Dr. DiCLEMENTE. My prepared testimony is in four parts, covering the Fed's track record, the economic outlook, the so-called Phil-

lips Curve debate and finally central bank independence. I will only summarize them here briefly.

After 7 years of sustained growth, the current economic expansion continues to post impressive results. The percentage of the population employed is the highest ever, and inflation is at 30-year lows. I believe the Federal Reserve has played a key role in this outcome. Although economists once argued that the effort to squeeze out inflation would make the economy less stable, in fact, the volatility of GDP has been reduced by half in the past 15 years. At the same time, when we compare the Fed's track record to the experience of other countries, the so-called "misery index," which combines inflation and joblessness, is now at 7½ percent, 5 points below, or 5 points better than the OECD standard.

One of the useful tools for assessing the Fed's track record entails the application of operational guides for policy. One such guide, the Taylor Rule, you have heard about earlier, is a very helpful way of demonstrating that policy has, indeed, been appropriate. Fed funds rates prescribed by the Taylor formula demonstrate that the forces motivating policy in recent years are quite transparent.

One often hears the criticism that the Fed is, quote, "flying by the seat of its pants" or "chasing ghosts." Nothing could be further from the truth. The path of the actual funds rate tracks very closely the prescribed Taylor rate over most of the past decade. Of course, we need to be mindful that these policy decisions affect the economy with a lag.

In this sense, today's inflation statistics tell us about the appropriateness of decisions made 2 years ago. Stable underlying inflation in 1997 provides the ultimate verdict that the Fed's shift in 1994 and 1995 was both timely and needed. Without those actions, I believe we would have higher interest rates today and a more troubled economic setting.

Despite this record, the risk of greater inflationary pressures is rising slightly. A similar perception justified the minor adjustment that the Fed made in March, and I believe that they will need to take further modest actions in the year ahead. In this context, we must avoid the temptation to believe that globalization and technological advance have removed the limits on our capacity to grow.

There is evidence, which I discussed in my testimony, that our official data are undercounting growth and productivity, but the margin of error is small. We can be optimistic about the longer term implications of these developments, but we must separate secular optimism from cyclical reality. Whether or not productivity growth has improved, capacity has become more flexible, Fed officials know that our resources have been stretched beyond our long-run supply potential in recent years, as evidenced by the decline in unemployment, a lengthening work week, near record overtime, and unprecedented labor force participation.

We have also benefited from developments that are less likely to dampen inflation much further. Among them, I would highlight rapid labor force growth, which has begun to slow quite noticeably, substantial global economic slack, which is now being absorbed by stronger growth, and sizable dollar appreciation. The dollar's 14 percent appreciation over these past 2 years, has knocked a half of

a percentage point off the CPI, according to our model simulations. Benefits from this point on will be more modest.

Back home, our financial conditions remain highly supportive. Money growth, in particular, is now edging above its target and is accelerating. Thus, limited slack with strong demand poses an obvious threat to eventual higher inflation. Unfortunately, the short-term tradeoffs that do exist between inflation and unemployment have led to false characterizations that the Fed worries that unemployment is too low, or that too much growth may cause inflation.

Of course, inflation is not caused by too many people working. Nor is unemployment an inflation cure. But output and employment generated by easy money policies are fleeting. In this context, the aphorism that there is no free lunch might be better rephrased as central banks can print money, but they cannot print savings.

The challenge for the Fed is to discern whether strong demand is being supported by saving and productivity, or by excess credit and artificially low interest rates. The Fed does not and cannot set limits for growth or employment. It is not necessary. If demands are outstripping our capacity to satisfy them, the disparity will cast a shadow in the form of longer delivery times, rising input prices, and increased over time. Rising bond yields and other market signals could also provide evidence that inflation expectations are deteriorating.

It is important in this context that the Fed has the freedom to choose the tactics and the instruments for achieving its goals.

The value of such independence has been recognized increasingly around the world, most recently by the new British Government and in legislatures of 15 countries that approved the Maastricht Treaty. There is a large and growing body of evidence now that economic performance is superior in those countries with a high degree of central bank independence. These countries have experienced lower inflation, with no loss of economic growth. And in the United States, as I mentioned, this has fostered greater stability that in turn has attracted investors everywhere to our markets.

Independence, of course, does not mean that the Fed chooses its own goals to be pursued in a closed fashion. Congress has set those objectives, as maximum employment and stable prices. The law does not say 5 percent unemployment or relatively low inflation, nor should it. The language recognizes the data imperfections and the inexact channels through which inflation works. The avoidance of highly—

Chairman LEACH. If I could interrupt you, sir, we have had second votes and that is what my reference to prevoting bells was about. And I apologize, I am going to have to recess at the moment, pending the vote and we will return in about 15 minutes. Thank you. The hearing is in recess.

[Recess.]

Chairman LEACH. The hearing will reconvene and I apologize to Dr. DiClemente. There is nothing more awkward than to be interrupted in your train of thought, but please proceed.

Dr. DiCLEMENTE. Just virtually at the end, I was extolling the virtues of central bank independence, with the modifier that independence does not mean that the central bank should choose its

own goals to be pursued in some closed fashion. Congress, of course, has set those objectives for the Fed as maximum employment and stable prices. The law, as we know, does not say 5 percent unemployment or relatively low inflation, nor do I think it should.

The language of the Humphrey-Hawkins and Federal Reserve Act, as amended, recognizes there are imperfections in our inflation measures, and the inexact channels through which inflation works. The avoidance of highly specific measures is farsighted, in my view, and assures the public that policy will, indeed, have a long-term focus. Accounting for policy in public, as the Fed has done here, results not only in a better understanding of the Fed's mission, but it offers the Fed the chance to heighten the credibility of its goals.

Although I think the Fed still has work to do, the current generation of leaders has set a standard for commitment to price stability and therefore to maximum employment, and in doing so, they have obeyed the law.

Thanks.

[The prepared statement of Robert V. DiClemente can be found on page 236 in the appendix.]

Chairman LEACH. Thank you, Doctor. You are the first person, by the way, that suggested that they have obeyed the law. Everyone else says they have been successful or unsuccessful. That is a very interesting conclusion.

Dr. Galbraith.

STATEMENT OF JAMES K. GALBRAITH, PROFESSOR, LYNDON B. JOHNSON SCHOOL OF PUBLIC AFFAIRS, UNIVERSITY OF TEXAS AT AUSTIN

Dr. GALBRAITH. Mr. Chairman, let me first state my pleasure at returning as a witness to this committee and to these hearings, both of which I served for years as staff. As an occasional critic of Federal Reserve policy, I am especially pleased to appear on a day when I have few criticisms to offer.

For the past 2 years, the Federal Reserve has mostly refrained from raising interest rates. That was good policy. It represents conceptual progress, I hope, and it certainly should continue. Chairman Greenspan's statement yesterday seemed to indicate that the present policy will continue for the time being and that is also good news. I believe Congress has been an effective part of this success story; that it has been doing its job, partly through these hearings, in keeping the fundamental issues behind monetary policy in public view.

If I may turn first to one of those issues, 2 years ago, the economic profession was in almost unified consensus around the idea that if unemployment were to fall below 6 percent, the then-estimated natural rate of unemployment, or NAIRU, there would be a strong tendency for inflation to accelerate. Of course, no such consensus exists anymore. The debate today is between those who think that the NAIRU has fallen to some undetermined value and for an unknown reason, and those who believe that the concept has been shown to be useless as a guide to economic policy.

I may be going beyond the evidence here, but it seems to me at least possible that the balance of opinion at the Federal Reserve

may now be moving toward the second camp. If so, so much the better.

Doubts about the natural rate of unemployment necessarily imply doubts about the pernicious doctrine of the preemptive strike. Again, if such doubts are coming to the fore, so much the better.

Why and how have we achieved our present condition? Accepting, as a point of departure, the official measures of growth and productivity—and we have had some discussion of those this afternoon—I present, in my written statement, four figures which show how the present economic expansion compares to earlier ones. I have some copies for the other Members of the panel. I won't go over them in detail, they cover growth, productivity, unemployment and wages, and the evidence, as a whole, suggests to me that there is nothing all that remarkable about the present economic expansion. In most respects, it is on a par with the expansion of the 1980's and well below that of the 1960's.

The conclusion I would draw is that we should not allow an overly rosy view of our growth and employment record so far to breed an unwarranted pessimism about inflation. Things could be worse, but they also could be better, and if current policy is continued, there is a chance that they might well get better. Indeed, we face today the tantalizing possibility that the original Humphrey-Hawkins interim targets of 4 percent unemployment with reasonable price stability could be achieved within a year or two from the present date.

If so, that would be a very good thing for the economy, for American living standards, for the progress of average wages, and certainly and not incidentally, for the Federal budget. I do want to spend a minute on another aspect of economic performance that the sustained achievement of full employment would help us to address and that is the problem of high—and in recent years, rising economic inequality.

In Figures Five and Six of my testimony, I share with the committee some of my own work, which extends the measurement of wage inequality back as far as 1920, and compares this measure of inequality in the structure of wages, mostly in manufacturing wages, with the unemployment rate, on a year-to-year basis over that entire 72-year timeframe. The association between the two measures is very strong, and it suggests to me that sustained achievement of full employment would be the single most effective measure that the country could take to begin to bring inequality back down toward the levels that we enjoyed in the 1950's and 1960's, when, as a whole, our economy was much more middle-class, much more, I think, balanced, in its distribution of wage and salary incomes than is the case today.

For more recent years, I might add, I have also identified effects of interest rates, the real exchange rate, inflation, and the minimum wage, in the measure of inequality, and this suggests to me that monetary policy affects inequality in multiple ways; that it is not something which is entirely separate from the effects of Federal Reserve policy, but, rather, intimately, bound up with it and in quite complex fashion. Therefore, one needs to be very attentive to the conduct of monetary policy in the future if we hope to restore

a higher degree of equality in the wage structure. But unemployment is the main thing, particularly over this long sweep of history, and my final chart suggests that rather than speaking of the natural rate of unemployment, we might speak of that rate of unemployment below which inequality tends to decline.

I have estimated that at around 5½ percent. I think we are in a range right now where the tendency is for inequality to decline slightly, and I suggest we might christen that statistical estimate the "Ethical Rate of Unemployment," and set it as a kind of ceiling, since we should be aware that if unemployment does go above that rate, there is a very strong historical tendency for inequality to rise.

There is one point, finally, on which I would differ with what I understand to have been Chairman Greenspan's statement of yesterday. That was his implication—which I must say I only get from reading the newspaper accounts this morning—that ultimately interest rates will have to be increased. It seems to me that it would be more logical to follow the evidence of our recent experience toward the conclusion that interest rates should be gradually lowered.

If we are, in fact, entering a period in which we can set aside the natural rate of unemployment as a guide to macroeconomic policy, if, in fact, we are in a period when inflation has been unwound, then it seems to me there is very little justification for retaining the very high real interest rates that the current nominal rate structure and low rate of inflation together produce. And, particularly, if I am correct in reading Chairman Greenspan's statement as predicting a slowdown in economic growth over the period ahead, then it seems to me that a natural implication of that prediction would be that the Federal Reserve should consider a gradual reduction of interest rates, so as to mitigate the effects of a slowdown in economic growth, to get us toward full employment and to help us stay at full employment. For the benefits of a low unemployment rate will only be realized if it can be sustained over a very substantial period of time.

I will close by, again, saying that the Congress has a role in keeping Chairman Greenspan, and the Federal Reserve, focused on the evidence and the logic of the facts that are developing before us, and in avoiding any actions on the fiscal side that might themselves generate pressure for rising interest rates and the tighter monetary policy. Given the choice, it seems to me that the right course of action is simply to keep the pressure on monetary policy, to keep interest rates stable, and if possible, to bring them down, and to keep progress toward full employment at reasonably stable prices.

Thank you.

[The prepared statement of James K. Galbraith can be found on page 259 in the appendix.]

Chairman LEACH. Thank you, Dr. Galbraith.

Let me first begin with Dr. Lipsky. There appears to be a growing economic consensus that statistics today perhaps overstate inflation and understate productivity. If this is the case, does this have any implications on statistics that relate to real wages and real living standards? That is, would they be higher or lower?

Mr. LIPSKY. Yes, Mr. Chairman. The answer is there is uncertainty about the data that hasn't been, and perhaps won't be resolved. However, the preponderance of evidence suggests that productivity gains have been somewhat greater than portrayed in the official data.

If that is the case, a number of important implications follow. One is that real wage gains probably have been larger than portrayed in the data. Another is that the amount of productive capacity available in the economy is larger than had been portrayed in official figures. Such a conclusion would be consistent with the experience of the last year or year-and-a-half, during which more rapid growth and higher capacity utilization rates have not been accompanied by evidence of accelerating inflation pressures.

Chairman LEACH. Thank you.

Dr. Brown, in your testimony, you placed more emphasis than some of the witnesses today on the international environment, and one of those aspects is obviously the value of the dollar and interest rates relative to other economies, and if that other economies' interest rates increase, there is a tendency to raise our interest rates in order to attract investment and vice versa, and as others come down, unrelated to the internal dynamics of our own economy, there might be a case for bringing ours down. From an external perspective, is the case today for keeping stable, increasing or decreasing interest rates?

Dr. BROWN. As you mentioned, I think the external environment has been a very favorable one for U.S. inflation from a number of points of view. First, relatively weak economies abroad have kept global commodity prices weak. Second, there have been relatively low interest rates abroad, which has allowed the dollar to go up, even though U.S. interest rates have only risen modestly. The stronger dollar has tended to help cap inflation.

I think what we are seeing abroad is a broad-based acceleration in growth, both in Europe and in Japan, that is likely to continue through 1998, so I think as we look forward, we will gradually lose this beneficial effect on inflation, and, therefore, on capping interest rates. Maybe I could make one point relative to interpreting the "surprisingly good inflation performance in the past year or 18 months," whether that indicates that we should be lowering our estimates of NAIRU.

If you take a reasonably standard NAIRU equation, it says that if the unemployment rate is one percentage point below full employment, you should expect the inflation rate to accelerate something like three-tenths of a percentage point in the following year. Over the last year, the unemployment rate has been somewhat less than full employment, below even the high side estimates, so it would point to a quite modest acceleration of inflation.

The standard inflation equation also says that if the dollar goes up 10 percent on a trade-weighted basis, which is what it has done in the last year, you should expect inflation to come down between three- and five-tenths of a percentage point, so the dollar rise in the past year has been enough, on standard theory, to more than offset the upward pressure you would expect from inflation, coming from the low unemployment rate.

Chairman LEACH. Thank you.

Dr. Galbraith, you have disappointed the committee a bit. Your testimony was very reasonable. But several months ago, in the *New York Times*, you had an article in which you suggested that Dr. Greenspan's goals were to repress wages by slowing economic growth, and you also suggested that Dr. Greenspan has hinted that he wants to deflate the stock market. Why, you say, not to protect middle-class families from a bursting bubble, but to scare them out of stocks and back to the banks. Now, is that a valid perspective from your point of view?

Dr. GALBRAITH. At the time that the Federal Reserve raised rates in March, I believe Chairman Greenspan was speaking very explicitly about the stock market, and leaving the impression that the irrational exuberance, I think he said at the time, of stock investors was somehow unsettling to monetary policy and a reason for raising rates. I did criticize that action in March, which I thought was unnecessary. I thought that it also set up a kind of unstable dynamic between the Federal Reserve and the stock market, in which stock investors would basically place their bets from one day to the next on what they thought would happen at the Open Market Committee and the Open Market Committee would be making its decisions on the basis of the actions taken by short-term speculators. This was something which changed a stock market that had been moving up very steadily up to that point into a very unstable market.

Now, in May and more recently, the Federal Open Market Committee has not raised rates again, in spite of continuing very strong gains in the stock market, and Chairman Greenspan said yesterday, if press reports are correct, almost nothing about the stock market. At least nothing that would raise concerns that he would act on the basis of those recent gains, and so—

Chairman LEACH. I think the most recent thing he said, at least in a public context, he was very careful on this: "If earning trends continue to improve as they currently have, the market may not be overvalued," which is a nice conditional. Let me just ask one other question.

As you know, since the March 25 basis points move upward in the Federal funds rates, 10- and 30-year market instruments, at least Government market instruments, have come down significantly. One 39 basis points, the other—or I think one was 37 and one was 49. Do any of you credit the decision to move up short—the Federal funds rates, to bringing down the long-term rates, or is that totally unrelated, or part and parcel? Let me turn to, maybe, Dr. Chimerine.

Dr. CHIMERINE. Mr. Chairman, I think it is two things. First, the Fed has clearly gained credibility by its performance in recent years, and without that credibility, long-term interest rates probably would be higher than they are right now. But what also happened is that Chairman Greenspan began to drop hints late last year, suggesting that the Fed might tighten. The markets responded in advance of the tightening, by discounting it, so that we had a sharp increase in long-term yields, long-term interest rates, early this year in anticipation of that tightening and perhaps even more.

Now, the markets have turned and interest rates are coming down because it is becoming clearer that the Fed is not going to tighten any more, and as a result, some of the additional tightening that has previously been discounted has come out of the market. But I don't think you can really say that the increase in the funds rate, the tightening move in March, is responsible directly for the drop in long-term rates. I think the market just discounted more, thinking the Fed would do more, and now it has reversed course on that.

Chairman LEACH. Mr. Eisner.

Mr. EISNER. Yes. I might just urge that we really should pay attention to the real rate of interest, and that, I think Dr. Chimerine had indicated earlier is quite high by historical standards.

We now have these index bonds for the Treasury which tell us that apparently it is over 3 percent, and that is a high rate. The trick is not to get the nominal long-term rate down by reducing expectations of inflation, which it may do. If the expectations of inflation come down at a greater rate than the nominal rate comes down, your real rate is going up, which depresses investment, and that is bad for the economy.

Chairman LEACH. Dr. DiClemente.

Dr. DICLEMENTE. Two points that I would make in this context. We have seen, for example, in the last 3 months, two important surveys that were conducted regarding long-term inflation expectations. These are direct results of polls of either households or professional forecasters about the 5- or 10-year inflation outlook. These numbers have been very stubbornly stuck at about 3 or 3.25 percent now for the last few years; and for the last few months, both of them have dropped below 3 percent for the very first time. The professional forecasters' survey is about 2.85 and the Michigan survey, which comes out as part of their normal consumer sentiment survey, has dropped to about 2.9 percent.

This has coincided with the phenomenon we have seen in the Treasury market, where the spread between conventional 10-year bonds and the yield on so-called TIPS, The Inflation Protection Securities, that has narrowed from about, again, 3.1 percent, not surprisingly down to below 2.75 percent. Whether or not that is a function of the Fed's actions, there is certainly some evidence, in a very crude way, that there has been another sea change toward lower long-term inflation expectations, and that is very important, because it lowers risk premiums, it lowers interest rates for real borrowers.

Chairman LEACH. Now, the two institutions represented here follow this on a weekly, if not daily, basis, and it is my understanding that large banks often make a prediction each week on whether the trends will be up that week, let alone what they will be a decade from now.

Do you think that this indication of dedication to—and fighting inflation even if the signals aren't present in the economy, but there might be indications that they could become present—is that a beneficial effect on these medium- and long-term interest rates, or are they inconsequential?

Mr. Lipsky.

Mr. LIPSKY. Mr. Chairman, I think they have been quite consequential. The growing credibility of the Fed and its evident willingness to act has persistently reduced inflation expectations over the past few years. The troublesome aspect has been that expectations invariably have lagged behind the reality of relatively low inflation. This has kept the apparent real interest rate, as measured by actual inflation versus actual interest rates, unusually high.

The latest evidence suggests that the 3 percent barrier is being broken on long-term inflation expectations; just as the 4 percent barrier was broken following the Gulf War recession. If the latest breakthrough is confirmed and sustained, it will lower long-term real interest rates, boost investment and improve the long-term economic outlook. The Fed's credibility has been critical in this process.

Chairman LEACH. Dr. Brown, would you concur?

Dr. BROWN. Yes, I would agree. I think long-term inflation expectations are ratcheting down and confidence that inflation will stay lower is rising. It is certainly higher now than it was even 6 or 12 months ago.

Chairman LEACH. Let me just ask one more question and then turn to Mr. Frank.

If we were to ask all of you to advise the Congress on these inflation expectations, would you say it would be wise for Congress to pursue a policy of continuing reduction of deficits, or would it be wise for Congress to back off these constraints and let the deficits come back up? Would a signal of a firmer emphasis on deficits be helpful or harmful to this expectation of inflation issue?

Mr. Eisner.

Mr. EISNER. Well, I have long been suggesting that reducing deficits would certainly bring it into balance, but should not be a high priority, if it has any at all. It is hard to tell what influences expectations in the short-run, but in the real world, we do see that reducing the underlying directly-measured, inflation-adjusted structural deficit will reduce interest rates to the extent it slows the economy.

If it does succeed in slowing the economy, and I don't presume that was its intent, then there will be less demand by business to invest and interest rates will come down. Beyond that, what investors in the short-run will determine is even harder to tell.

Chairman LEACH. Does anyone want to disagree with that?

Dr. CHIMERINE. I will mildly disagree, Mr. Chairman. I think, all other things remaining the same, that bringing the deficit down is helpful over the long-term, but I don't think that is the only priority. I think policies aimed at promoting faster long-term economic growth would help a lot, and I think the things we need to do in the tax system and other in policy areas are primarily to shift the focus away from some of the short-term mentality that exists in the markets now and, in corporate planning, moving more toward building for the future and creating more long-term growth. There may be times you have to choose between that and the deficit and times when that should have a higher priority.

Chairman LEACH. Fair enough.

Let me turn to Mr. Frank at this point, because we have a vote.

Mr. FRANK. Thank you, Mr. Chairman. It is another motion to adjourn. I am not going to make it. If you want to go over, I will just stay here. We are doing warfare, and the motion is to adjourn, and they cannot adjourn without me.

I must say I am a little intrigued at the Fed getting the credit—or potentially getting the credit, for bringing down long-term rates by the short-term increase. The reason they did this short-term increase was presumably to slow down the economy which was growing too fast, and if they wound up instead reducing long-term rates, which could have a stimulative effect, then they should certainly be upset, because they would have had exactly the opposite effect of what they were trying to do.

Dr. Brown, you were the most cautious in terms of policy and you seem to be the most supportive of saying the Fed ought to be thinking about some tightening soon. I assume that is based on the feeling that we are growing above capacity now?

Dr. BROWN. Yes, 4 percent growth in the last year and accelerating.

Mr. FRANK. But 4 percent growth, Mr. Eisner gave the figures that was first quarter 1996 to first quarter 1997; the second and third quarters have been significantly below 4 percent, haven't they?

Dr. BROWN. We don't have the third quarter yet.

Mr. FRANK. But we expect it to be less.

Dr. BROWN. I do not expect it to be below 4 percent.

Mr. FRANK. Do you think the third quarter is going to be 4 percent?

Dr. BROWN. Yes.

Mr. FRANK. Let me ask it this way. We have already had a year, first quarter to first quarter, of 4.1 percent growth, twice what some people believe is the trend, or nearly twice. How come no inflation has shown up yet?

I mean, by the models that people have been using to say above-trend growth means you have to tighten, wouldn't you have told me that if we grew at nearly twice what the consensus is of trend growth that inflation would begin to be showing? You know, we are now several months after the end of that year, we are in the fifth month, fourth month after the end of the year. Doesn't the fact that there has been no inflation at all of any significant kind after a year of 4 percent growth give you pause?

Dr. BROWN. Not very much pause if one takes into consideration the fact that the dollar has risen substantially over this period and, in fact, the reason inflation has done well in the last year is that goods prices, particularly prices of imported goods which are sensitive to the dollar, have decelerated sharply. The domestically-driven components of prices, including wages and services prices, have not decelerated and actually have crept up a little bit when you adjust for changes in BLS procedures.

What I see happening is very modest upward pressure on inflation from domestic forces, in particular, the strong growth and falling unemployment, offset—or even more than offset over the past year—by very favorable external forces.

Mr. FRANK. That would explain maybe the drops in the PPI. But leaving aside the offsets, you talk about creeping up and really quite small effects?

Dr. BROWN. Yes.

Mr. FRANK. If you are correct, we have seen growth nearly twice what it should be, or maybe twice what it should be, and all we get—I mean, that is after one year of growth, twice what the trend is, and now 4 or 5 months after that year is over and we are still only getting creeps in moderate amounts. I thought you just acknowledged you thought, with Mr. Lipsky, that long-term inflation expectations are down; why then the need to tighten?

Dr. BROWN. Well, a couple of points. One, you have to consider lags, as all of the Federal Reserve Board Governors and FOMC members mentioned. Inflation responds to activity in the economy with a lag. The real issue is what inflation does next year and how long growth is sustained above 4 percent.

A second point I would make, completely independently of what inflation does, I think there is an argument for Fed tightening. The Fed's job is not only controlling inflation, it is also balancing the ups and downs of the business cycle. For example, I don't think the Bank of Japan deserves a pat on the back for their managing of the Japanese economy during the 1980's. They allowed a tremendous bubble to occur in financial markets, in investment activity, in the economy tremendous overheating. They never got substantial inflation as a result of that, but they paid a very severe price for this in terms of an extended period of weakness as payback for those excesses. So I think—

Mr. FRANK. I understand that, but I think we should talk about lending practices and other things, and it doesn't seem to me we are suffering from it. I mean, history can sometimes mislead you, when one-to-one analogies from history are always wrong. America today is not Japan in the 1980's. And, in effect, you are conceding that you can't make the case for tightening on inflation. I don't think you can make it by, you know, the bad real estate practices of Japan in the 1980's either.

What is it about today's economy? You say there is a lag, but that is why I thought those figures Dr. Eisner gave were so relevant.

We have had, from beginning in 1996—it is now 18 months after that period of very heavy growth, and all you can point to are very minor pieces of inflation.

Let me just summarize and then ask you to comment. The only justification we get for tightening is preemption, and I have got to say, you know, I remember to some extent from nuclear times, uncertainty is a very poor basis for a preemptive strike. I mean, in the nature of preemption, you ought to be more sure. You cannot argue, it seems to me, simultaneously, logically for caution and for indecisiveness and uncertainty and then justify preemption based on uncertainty.

Dr. BROWN. I wouldn't compare a 25- or 50-basis point increase in the funds rate with nuclear preemption.

Mr. FRANK. I am not talking about March; I am talking about your tightening for the future. If they told me in March that that is all they were going to do and they weren't going to do it in May

or July, I would have taken a week off. I wouldn't have gotten excited.

Dr. BROWN. If monetary policy was up to me, I would have had a funds rate of 50 basis points above current levels.

Mr. FRANK. Justified by what? Justified by what? I mean, the argument is we have been doing well, it seems to me all you have got. It seems to me you say, the Fed's job is to lean toward the cycle. You said in your testimony this has not been such a great expansion. We can't stand prosperity, literally?

Dr. BROWN. No. It is simply that a market economy has a tendency for instability at a fixed interest rate. The Fed needs to adjust.

Mr. FRANK. But there is no sign of it now?

Dr. BROWN. No, there are signs that the enthusiasm, the animal spirits, are moving in the up direction. We have seen a tremendous rise in the stock market; we have seen a clear and quite decisive acceleration in growth; we have seen very sharp increases in confidence levels. Against those developments, which are reality and facts of the past year, a 50- or 75-basis point rise in short-term interest rates is a very modest, measured response.

Mr. FRANK. I have to say it sounds to me like you have a case more for the Psychic Friends Network than for the Open Market Community.

Chairman LEACH. Will the gentleman yield?

Mr. FRANK. Yes.

Chairman LEACH. I understand the phrase "animal spirits" is rooted in Keynes, but it doesn't strike me as immensely relevant, except to Congressional politics.

Mr. FRANK. Or specifically Republican congressional politics right now, Mr. Chairman.

Mr. EISNER. If I could get in a last remark on raising the funds rate, but also on something which I think is fundamentally an issue on policy. It is said that the Fed should be trying to stabilize the economy both ways, in other words, keeping it from being too good as well as keeping it from being too bad.

I remember the Chairman just mentioned Keynes, and Keynes' solution was to stabilize the business cycle, not by lopping off the booms, but by filling in the troughs, and that, I think, is a very fundamental point.

Congressman Frank has repeatedly been questioning people as to why the Fed may be erring, may always be worried about erring in terms of allowing too much inflation. It can also err very seriously by risking a recession; am I not doing enough to combat that?

I would say that the Fed policy should be directed at keeping the economy as prosperous as possible all the time with both as rapid as possible. I don't see why people think we can have too much of a good thing.

Chairman LEACH. Will the gentleman yield here?

Mr. FRANK. Yes, Mr. Chairman.

Chairman LEACH. First, I think your reading of Keynes is modern-day traditional and not deep in this sense: Keynes says—and it has been widely accepted by virtually everybody in economics—that even downturns of the economy, or national emergencies to some extent, can be better dealt with through borrowing; but he

also said that in good times you paid it back. And that flip side of Keynes is precisely lopping off some of the excesses of good times, and it is a principal element of the written Keynes, not the political Keynes; and it is the only thing that makes Keynes, as a body of logic, rather compelling. But if you don't include that and if you don't accept that, then you are into the easiness of economic policy as well as the easiness of political policy that can be pretty counter-productive.

Mr. EISNER. Well, I don't believe that he in any way meant to slow the economy to lop off the booms. Obviously, when things fluctuate, all kinds of things will fluctuate. I mean, one of the reasons so many of us were petrified of the thought of a balanced budget amendment to the Constitution is that it did not recognize that, while in good times, you might well have a deficit going down, maybe a balanced budget—as I think we may shortly have without any action by the Congress—in bad times, the deficit will go up.

Chairman LEACH. Excuse me. Without any action by the Congress?

Mr. FRANK. Yes. I will take back my time to say the best way to achieve deficit reduction right now would be to vote against this budget deal. The budget deal itself scores out as increasing the deficit over the next 2 years—those are CBO figures—so that if you are interested in maximizing short-term deficit reduction, you vote against the budget deal. CBO scores this as increasing the deficit.

Let me say this, that increasing the deficit over what it will be this year—we can't tell you exactly what it will be as opposed—according to trend lines, because the Administration is afraid of the news being too good and won't release the new estimates. So, the Administration is sitting on the projection of what the deficit would be next year, and the year after, absent a budget deal, because they are threatened by good news in this case. Not an uncommon malady apparently in this room today.

Could I just go back? I want to ask my last question, and Dr. Eisner talked about it. I mean, one of the defenses against our criticisms of the Fed has been that there is no long-term relationship between inflation and employment, so don't worry about it; but I guess I would ask whether that works both ways? I mean, if that is the case, if worrying too much about inflation can't be a long-term threat to employment, then maybe high employment can't be a long-term threat to low inflation.

But I also want to ask every member of the panel—Dr. Eisner has just spoken on it, and his ride to the airport is waiting, if he wants to leave now, but I would like to ask everybody else—we have heard a lot about the danger of the Fed not tightening enough and allowing inflation. Is there a danger today and going forward, as a matter of policy, of the Fed tightening excessively and the result being recessions deeper or more frequent than they have to be in a better world?

Mr. Lipsky, let's start with you.

Mr. LIPSKY. Yes, of course, there is no justification for excessive monetary tightness. I think the issue at stake for current monetary policy is whether there are policy-driven imbalances in the economy that will be destabilizing.

Right now, we are all struggling a bit because of the lack of a clear framework for analyzing that question and because the traditional benchmarks don't seem to be providing very clear answers. In any case, there is no reason for excessive tightness of monetary policy or for excessive ease.

Mr. FRANK. I just want to reemphasize one point, because I agree with you that this is a time when there is not clarity. I just want again to stress what seems to me the appropriateness of preemption in a time of lack of clarity. You really need, it seems to me, to have some certainty of what you are doing before you go off and preempt.

Dr. Brown.

Dr. BROWN. I would agree that you make errors in both directions. I think the Fed erred in not moving quickly enough to support an economy that was hurting from the effects of the banking crisis in the late 1980's and early 1990's. I think the risks at this point are quite clearly in the other direction.

What the economy is being faced with is a set of very positive things, and the danger is that those positives in the short-run could get out of hand a bit and drive the economy a little bit too rapidly, creating excesses.

Dr. CHIMERINE. I would take the opposite view. I don't think the risks are heavily weighted toward overheating and more inflationary pressures. We know the economy has slowed over the last 3 or 4 months. There is no evidence that it is surging back up, and I know some believe that we will have 4 percent growth in the third quarter. I don't. But even at this stage it is all hypothetical, it is all forecast. And let's be honest about it, forecast reliability in recent years has not been strong enough to be certain of any outcome. Not only that, there are some factors that will hold down growth as we go forward. For example, the trade deficit is clearly rising.

Second, a pent-up demand for consumer durables, which was very large as we came out of the 1990-1991 recession and the stagnation that preceded it, to some extent has been used up. Real interest rates are already extraordinarily high, so you could easily put out a forecast now of very modest economic growth over the next year or two that is very credible.

The second key point is what I mentioned in my testimony, and you mentioned a minute ago. The need to preempt, in my view, is much less now than it used to be, and as a result, to preempt based upon very iffy forecasts when you don't have to and when there is no sign of inflation doesn't make a lot of sense to me. As a result, I would not tighten, and I think there is some risk that if the Fed overtightens, this economy could slow down too much.

Dr. DICLEMENTE. I think that it is important to remember that credibility does work in both directions. To the extent that many Fed officials have said that their anti-inflation policy is not an anti-growth policy, in fact, it is a profoundly progrowth policy. The credibility of that position would certainly be damaged if they err on the side of tightness and create an unwanted or undesirable slowdown in the economy, that position would be tougher to defend.

But I think—and I thought this is where you were going with this statement—if the Fed errs on the side of too much stimulus,

recognizing that policy does not have long-term effects on the economy's ability to grow or the levels of employment, that is a very small mistake. Similarly, any damage done to the economy in the very short-run by a misstep, a limited misstep, is also going to wash out over time. The economy adjusts to these missteps as long as they are not prolonged or accumulated over time.

Mr. FRANK. I appreciate that; I just want to underline one specific reason I do. Some of those who are strong supporters of the Fed argue that—and Mr. Meyer said this explicitly in his April speech after the March increase; he said, "If it is a pretty cozy decision, better to err on the side of restriction than on no restriction because," he said, in effect, "a little inflation goes a very long way and once the genie is out of the bottle, it is hard to recap it." That is not his metaphor, but it was his thought process.

Because if you look at Mr. Meyer's April speech, he explicitly disagreed with what you just said, that we ought to ask for neutrality, including—and I welcome that, because as I said, Mr. Meyer explicitly said, "When in doubt, err on the side of restriction, because the consequences will be worse."

Dr. DICLEMENTE. But if you—I think that in a situation where, if you are going to make a mistake that is going to actually develop into a serious problem, certainly the first mistake you are likely to make is taking the view that small mistakes are just that. To get ourselves back into a serious inflation problem, I think we would have to begin with things like extreme New Era thinking and overestimating our potential to grow and that sort of thing.

But, I think in this particular situation—and maybe I would take issue with the Fed's position as well—there is an element of flexibility that they have earned as a result of their credibility. They don't need to be as preemptive. In fact, no one has mentioned this, but I suspect one of the reasons we are getting the competitive pricing behavior—or wage-setting behavior—that we are getting, is that it is, in fact, a widely-accepted premise that inflation is not going to get us out of a cost problem, or cover our inefficiencies the way it might have 10 or 20 years ago.

I have to begin my business, as Lawrence was saying before, with the point that I have to find out at what price I can make money, what cost structure will allow me to make money. Begin with the premise of zero inflation. I think the Fed is benefiting from that. We are getting dividends from these years and years of declining inflation expectations, which should translate into a greater flexibility for the Fed to err in the short-run.

Mr. FRANK. You keep suggesting things—I am sorry, but that is your penalty.

That is very important for this reason. It does seem to me if you look at the constriction on the increase in wages, on the growing inequality, that working people in effect are told, "Look, here is the bargain; you are not going to have the kind of social benefits you would get in Europe; you are not going to have a very good rate of wage increase." The compensation is higher employment overall. The tradeoff for the workers, people have been saying, is, you will have higher employment.

If, in fact, when employment begins to rise, that is choked off because we think it is unsustainable, then they are not getting what

was supposed to be the other end of the bargain and the consequence is a lot of social anger that is not helping.

Dr. Galbraith.

Dr. GALBRAITH. I think we have had a substantial experiment in the last 2 years with a stable interest rate policy, and that has paid off, and we are now moving gradually perhaps toward full employment. I am enough of an old Keynesian traditionalist to believe that the very strong upward movement of Federal revenues, which may move us toward a budget deficit of zero or a surplus much sooner than expected, will also have a depressing effect on economic growth. So to the extent that we do need to balance or have a counterweight against any excesses in that direction, the budget has already provided one, provided that that surplus is not given away in the near-term by legislative action.

Given that is the case, it seems to me that it is appropriate for Federal Reserve policy to consider unwinding the very high real interest rates that have been our lot since the early 1980's, and the way to move in that direction as long-term rates decline is to begin a phased and gradual reduction of short-term rates. That seems to me to be the logical step to take, given everything else that is happening in the economy right now, as I see it.

Mr. FRANK. One last question for, particularly, Dr. Brown.

If, in fact, we get no negative—there is no way to be sure one way or another—we might, but if the inflation rate a year from now is about where it has been, what would your thought be about the implications of that for interest rate policy at the Fed?

Dr. BROWN. Well, at the time, you have to look at what other things are doing, but there would be no great argument for moving policy one way or the other for that reason alone a year from now.

Mr. FRANK. Thank you, Mr. Chairman.

Chairman LEACH. Well, thank you, Mr. Frank.

If I were to ask this panel—and I think I know some of the answers, but not all—if you had three options to lower the Federal fund rate slightly, to keep it the same, or to raise it, where would the panel come down?

Dr. Brown is for increasing, Dr. Galbraith is for lowering, I assume. Where do the other three stand?

Mr. Lipsky.

Mr. LIPSKY. Is the question for today?

Chairman LEACH. Today.

Mr. LIPSKY. Steady.

Chairman LEACH. Dr. Chimerine.

Dr. CHIMERINE. Stay right now, but at the first opportunity, lower it.

Chairman LEACH. Dr. DiClemente.

Dr. DICLEMENTE. I would be steady with readiness to act to raise rates.

Mr. FRANK. Let me say, I know Mr. Eisner well enough; let's rank him as leaning over.

Chairman LEACH. Well, then, what we have is a perfectly balanced panel.

Mr. FRANK. Mr. Chairman, could I just say, we do have, though, it seems to me, a kind of 5-to-1 for staying where we are; and I

do think that ought to be part of it, that 5-to-1 for stability as of now into the future.

Chairman LEACH. So, 5-to-1 against your original concerns in March that led to the——

Mr. FRANK. Oh, 5-to-1 for my original concerns, which was to stay where we are. Because if you will remember, the letter you got, Mr. Chairman, was after the March increase.

As I said, I was worried about a May increase that didn't happen, and I was worried about a July increase and about an August increase that I think we just got a 5-to-1 vote against the August increase with the shadow Open Market Committee we have just started here.

Chairman LEACH. Let me just raise one other minor thing, and it is not immensely minor because in monetary policy there are, once in a while, legislative effects that are different from simply the whole fiscal issue; and one is that there is a view—it has been around for, oh, a half a decade or so, and it is particularly increasing in the conservative wing of my political party and particularly on the Senate side—that Humphrey-Hawkins ought to be changing its goals. And today the goals are dual, that is, maximum employment and minimum inflation, in effect, and stable inflation. So one of the arguments is that one should dispense with the maximum inflation and simply go to the minimum—the stable monetary policy.

My own perspective is that that is a very numerical goal without any heart; that is, you measure monetary policy and its effects on the economy and the economy as a people issue, and if you separate people from numbers, I think you lose a lot of support from the Federal Reserve Board and monetary policy in general.

But I just want to ask, is anyone on this panel in favor of taking out of the current Humphrey-Hawkins approach the idea of being concerned with maximum employment?

Dr. DICLEMENTE. Mr. Chairman, I dealt with it at some length in my prepared testimony, and I would come down very strongly in favor of leaving it alone.

Chairman LEACH. Fair enough.

Well, thank you. I appreciate that, because this is an issue that could, with great suddenness, arise at any point in a legislative circumstance; and I obviously agree with you, Dr. DiClemente.

Well, anyway, this has been a very helpful and thoughtful panel. All of you have distinguished yourselves, and I assure you we will make this available to a wider audience than has been the case. I apologize for bringing you here at a time that we are in the middle of major appropriations debates, as well as certain political debates within the various parties.

Thank you very much. The hearing is adjourned.

[Whereupon, at 5:35 p.m., the hearing was adjourned.]

APPENDIX

July 23, 1997

(113)

CURRENCY

**The Committee on Banking and Financial Services
U.S House of Representatives, 105th Congress
James A. Leach, Chairman**

Phone: (202) 226-0471 Fax: (202) 226-6052 Internet: <http://www.house.gov/banking>

For Immediate Release
Wednesday, July 23, 1997

Contact: David Runkel or
Andrew Biggs 226-0471

**Opening Statement
By Representative James A. Leach
Chairman, Committee on Banking and Financial Services
Hearing on the Monetary Policy and Status of the U.S. Economy**

On behalf of the Committee, I would like to welcome our distinguished first panel of witnesses. I would particularly like to extend my appreciation to Vice Chairman Rivlin and Governor Meyer, for adjusting their vacation plans in order to testify before us this morning.

By way of background, the Committee has not traditionally held two days of hearings in conjunction with the requirement of semi-annual reports to Congress under the "Humphrey-Hawkins" Act. Rather we have held one day of hearings in which Chairman Greenspan has testified before the Subcommittee on Domestic and International Monetary Policy, so ably led by Representatives Mike Castle and Floyd Flake.

But as Members are aware, on April 17, 1997, I received a formal letter from the Minority requesting that the Committee "convene an oversight hearing" before the next Federal Open Market Committee (FOMC) meeting scheduled for May 20, 1997. The purpose of the requested hearing was to examine the rationale and economic assumptions behind the Federal Reserve's decision on March 25 to raise the Federal Funds target by twenty-five basis points from 5.25 to 5.5 percent.

As I wrote in my April 17th response, and I would ask the indulgence of my colleagues while I quote: "... Congress has by statute set the goals of monetary policy to be pursuit of maximum employment" and "stable prices." And, through the Humphrey-Hawkins mechanism, the Federal Reserve reports semi-annually to the Committee on the state of the nation's economy..."

"The precedent of holding a hearing on every quarter point shift in interest rates is troubling, particularly given the U.S. economic expansion is entering its seventh consecutive year with high levels of employment and relatively low inflation. Whatever one's view of the threat of inflation at this time, the case for political second-guessing must be viewed against the back drop of rather impressive Fed monetary policy stewardship developed over the past decade within the constraints imposed by a deficit ridden fiscal policy..."

The letter went on to note, "there is a tradition of independence at the Fed, which in the long run has protected the economy...Nevertheless, the Fed is accountable to Congress and ultimately the American people. Fed policy should never be immune from criticism..."

"In this overall context, my sense is that we would be ill-advised to rush to

judgment and that the most appropriate time for the Committee to express its perspective on monetary policy is the next regularly scheduled Humphrey-Hawkins hearing." The letter concluded in agreement with the Minority's suggestion that outside experts from business, labor, and academia be invited to present their views on monetary policy, and pledged on behalf of the Majority that we would be happy to work with them on developing a witness list.

This hearing fulfills that commitment. We have consulted closely with the Minority in selecting witnesses for this hearing. In addition to representatives from the Federal Reserve, we will be hearing from two additional panels of distinguished witnesses representing a wide diversity of views.

In thinking through the issue of alternative perspectives, I want the minority to know that I think Mr. Frank is absolutely correct in suggesting that other views ought to be heard from, especially when a change in Fed policy appears to be underway. I also think periodically, perhaps every couple of years, other perspectives should be placed on the table even when no significant change in monetary policy is contemplated.

As for the quarter point bump up in the federal funds rate that took place in March, it is interesting to note that as reflected in Treasury issuances, 10-year note rates have decreased 43 basis points and 30-year bonds have dropped 49 basis points since then. In other words, the most meaningful rates for the economy have declined significantly as the Fed has made clear that its attention to inflationary concerns is vigilant.

As for the economy at large, the current economic expansion has been extraordinarily steady, albeit unspectacular. The unemployment rate is down to 5%, while inflation is running at an annual rate of 1.5%. If the consumer price index (CPI) does in fact overstate inflation by as much as 1%, then the U.S. may well be close to achieving functional price stability – an extraordinary achievement and vindication of almost two decades of restrained monetary policy.

Although short-term interest rates are high in real terms, long-term rates which affect particularly industries like housing have fallen from a peak of just over 7% to approximately 6.5%. At the same time, U.S. equity markets are enjoying one of the great bull runs in history – with the Dow Jones Industrial Average over 8000, up nearly 25% since Chairman Greenspan cautioned about "irrational exuberance" late last year.

More broadly, the pessimistic predictions of American economic decline – so much in vogue in the 1980s – have proven to be without merit. Our climate of macro-economic stability, corporate competitiveness, worker productivity, modern financial markets, and culture of entrepreneurship makes the United States economy the envy of the world.

Why has the U.S. enjoyed such steady growth with such low inflation at levels of relatively high employment. My own sense is that the Fed enjoys such credibility in financial markets that its commitment to an anti-inflation policy is not in doubt. Likewise, the recent Congressional emphasis on fiscal prudence and deficit reduction may be helping to raise the long-term growth of output in the economy.

Nevertheless, Members and more importantly the public have many legitimate questions about the conduct of monetary policy. How long can we maintain the current expansion? Is the expansion best maintained through a modest dose of monetary restraint or a loosening of the reins on the economy? Can the U.S. grow faster without jeopardizing stable prices? What is the relationship between employment and inflation? Can the Fed accountability be increased without undermining its independence? And what is the appropriate policy and oversight role of Congress regarding the Federal Reserve's conduct of monetary policy? I hope our distinguished witnesses can answer these questions and more.

Statement of Henry B. Gonzalez
Ranking Member
Committee on Banking and Financial Services
for the Humphrey-Hawkins Hearings
July 23, 1997

I welcome the witnesses today and thank the Chairman for accommodating the Minority's request for a second day of hearings to discuss the Federal Reserve's monetary policy. In recent years, the Federal Reserve has made some progress, but it still has a long way to go.

The Federal Reserve first began its routine reporting of monetary policy in March 1975. Those of us who were in the Congress recall how difficult it was to persuade then-Federal Reserve Chairman Arthur Burns and other Fed officials that this would be a good thing.

Now, more than two decades later, the Fed agrees that markets work best with more information rather than a system of secrecy where rumors abound and Fed actions are leaked to a favored few. In 1978 when Congress passed "The Full Employment and Balanced Growth Act of 1978," better known as the "Humphrey Hawkins Act," it formalized the reporting process in establishing goals for monetary policy.

In October 1993, when I served as Chairman of the Banking Committee, we attempted to obtain a better written record of the Fed's meetings where monetary policy is decided. We wanted the record made public and pressed for a more timely announcement of the Fed's monetary policy changes.

During these hearings, after first denying their existence, the Fed Chairman revealed that the Fed had indeed, maintained 17 years of verbatim minutes of the Federal Open Market Committee meetings.

In February 1994, the Fed began making announcements of its monetary policy changes. It also began releasing these verbatim minutes with a five-year lag. That is far too long a lag. The public will not be able to learn in any detail how Fed officials determined the nation's monetary policy until many of these officials are no longer in office. This is not the kind of accountability we should demand from government officials who are determining the economic well-being of every American. I encourage the Fed to adopt the reforms we have suggested and hope each of the witnesses will address this important issue.

House Committee on Banking and Financial Services
Humphrey-Hawkins Hearing II, 10:00 a.m., July 23, 1997
Room 2128 Rayburn House Office Building

The Honorable Michael N. Castle's Opening Statement:

The Monetary Policy Subcommittee met yesterday, 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. I am pleased that the full committee is devoting another day to some of the important issues that were raised during that hearing. Our session yesterday reminded us why Economics often is called the "dismal science". Chairman Greenspan delivered a message that contained a lot of good news and it was met by great dissatisfaction that the glass he described was fully one quarter empty rather than three quarters full.

That hearing and our meeting today are nevertheless very important. The actions of Congress and the administration are basic to creating prosperity now and in the future. The arcane practices of monetary policy are a proper subject of interest for every citizen. To borrow Mr. DiClementi's apt phrase, "the Fed is guardian of the lifeblood of the market economy." When the Fed does its job well and this is reinforced by responsible legislation and policy, we all prosper.

Today we will be reminded of the difficult job that is involved in the production of good economic analysis. We will also see demonstrations that strongly contrasting conclusions can be drawn from the same data by different experts. This should not be viewed simply as an esoteric exercise in arguing statistics and growth cycles. What concerns us today on both sides of the aisle are the personal consequences of these analyses. The prospect of planning for a secure and comfortable retirement as the result of a life of hard work and careful saving should not be undercut by government action. Taxes and inflation should not steal the fruits of that labor and saving. We are also concerned about offering the broadest possible opportunity to every citizen. This especially includes the opportunity for young people to get an education that will equip them to advance as far as personal application and ambition can envision.

Chairman Greenspan touched on this theme which is of great personal interest. That is, that we are all diminished because we are not yet successfully equipping our young to take advantage of the opportunities available in the information intensive, computer driven economy that is upon us.

I believe that the good work of the Federal Reserve and this Congress to date only prepares a foundation for us to take up the major challenge of making a balanced budget the normal state of affairs. We accomplished this in Delaware and it has enhanced our general prosperity. We will also be called upon to reform our retirement system and our educational system. None of this will be possible without good monetary policy and if we keep these goals in sight, all the charts and graphs we will see today will come alive with meaning.

JESSE L. JACKSON, JR.
26 District Area

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

COMMITTEES
BANKING AND FINANCIAL SERVICES
SUBCOMMITTEE ON HOUSING AND
COMMUNITY OPPORTUNITY
SUBCOMMITTEE ON DOMESTIC AND
INTERNATIONAL MONETARY POLICY
SMALL BUSINESS
BANKING MEMBER
SUBCOMMITTEE ON
REGULATORY REFORM AND
PAPERWORK REDUCTION

STATEMENT BY CONGRESSMAN JESSE L. JACKSON, JR.
COMMITTEE ON BANKING AND FINANCIAL SERVICES
CONDUCT OF MONETARY POLICY
JULY 23, 1997

Thank you, Mr. Chairman. I would like to join my colleagues in commending you for holding this very important hearing, and providing this Committee with an additional day of testimony in conjunction with the Humphrey-Hawkins hearing held in the Domestic and International Monetary Policy Subcommittee yesterday. I appreciate the opportunity to welcome our distinguished panelists and look forward to hearing their testimony on the way in which the Federal Reserve System conducts national monetary policy in pursuit of price stability and full employment.

While we are currently experiencing record levels of economic expansion and growth by certain economic indicators -- the stock market has reached record levels, and we are experiencing falling unemployment and rising incomes for some sectors of the population with a concurrent decline in inflation -- wages continue to stagnate for those occupying the lower rungs of the economic ladder.

I, thus, join my colleagues in cautioning against any preventative inflationary Fed action to raise interest rates, based upon my concern that this will no doubt adversely impact job creation and economic growth. As I discussed with Chairman Greenspan yesterday, I am greatly concerned that even the way we define the levels of full employment for the purpose of conducting monetary policy leave behind millions of Americans. In fact, under the current definition of full employment, at least fifteen to twenty million Americans are unemployed or underemployed, have never had a job or gave up looking for one. Coupled with the fears of corporate and governmental downsizing, it is no surprise that widespread levels of economic insecurity persist despite the supposed "exceptional" performance of the current economy.

I am likewise concerned that these unfortunate circumstances can only be compounded for the most vulnerable Americans who are affected by the welfare reform legislation. Welfare reform assumes that we have a true full employment economy, in which former recipients have secure and sustainable jobs through which they can successfully transition from welfare to work as contemplated by the policy. To these ends, I will be listening closely today for the panelists views on how Fed policy can guide the economy towards attaining true levels of full employment.

Thank you, Mr. Chairman.

For release on delivery
10:00 a.m. E.D.T.
July 23, 1997

Statement by

Alice M. Rivlin

Vice Chair

Board of Governors of the Federal Reserve System

before the

Committee on Banking and Financial Services

U.S. House of Representatives

July 23, 1997

Mr. Chairman and Members of the Committee,

I would like to begin by expressing my appreciation to the Committee for holding this hearing to solicit a wide range of views on appropriate monetary policy at this extremely favorable moment in our economic history. All too often congressional hearings are called when something bad is happening. In a deteriorating situation, Congress finds it necessary to survey the damage, assess responsibility and call for better policies in the future.

At the moment, however, the economy as a whole is functioning amazingly well. Employment is high and rising, unemployment is low, incomes are increasing, profits are high, the Federal budget deficit is plummeting, state and local finances are increasingly strong, and inflation is benign. The overriding economic objective -- shared by all participants in the economy -- is to keep the good news flowing. We all want the economy to grow at its highest sustainable rate, to keep unemployment and inflation low, and above all, to avoid recession as long as possible.

Thoughtful people, at the Federal Reserve and elsewhere, have somewhat different views about why the economy is doing so well and how best to keep it going. Your invitation to share those views is timely, constructive and welcome.

I would like briefly to discuss three questions:

(1) Why is the economy performing so well -- and, in particular, why do we have so little inflation with such low unemployment?

(2) Why is it so important, especially right now, to keep the economy growing at its highest sustainable rate and to avoid recession?

(3) What policies -- monetary and other economic policies -- are most likely to keep economic performance high and sustained?

Why is the economy doing so well?

Most economists are frankly surprised that the economy has been able to grow fast enough to push unemployment rates below 5 percent without generating accelerating inflation. Until recently, most students of the economy thought that unemployment rates below 5.5 - 6.0 percent (estimates differed) for an appreciable period would lead to rising labor costs that would be passed on in higher prices and start a self-perpetuating wage-price spiral that would be hard to reverse. True, unemployment had been lower in the 1960s while inflation remained low, but the structure of the economy and the characteristics of the labor force subsequently changed in ways that seemed to make the economy more inflation-prone for given levels of unemployment. The experience of the period since about 1970 appeared to confirm that inflationary pressure emerged at unemployment rates appreciably higher than those of the 1960s.

Five years ago, most economists would have thought the Federal Reserve irresponsible and derelict in its duty if it had not used monetary policy to slow an economy operating at such a high level that unemployment remained under 5.5 percent for more than a short time. The inflation might not appear immediately, but it was thought to be inevitable, and allowing it to get up a head of steam before acting was taking a high risk of having to react more strongly, perhaps strongly enough to bring on a recession.

Nevertheless, the unemployment rate has been below 5.5 percent for over a year and below 5.0 percent in 1997 while inflation has shown no signs of picking up -- indeed, producer prices have actually been falling. The Federal Reserve, except for a quarter point tightening of the federal funds rate in March (after months of inaction), has left the monetary levers alone. Is the Federal Reserve ignoring risks of future inflation?

The answer depends on whether the coexistence of higher growth and lower unemployment with benign inflation is explained by a fundamental improvement in the structure of the economy making it less inflation-prone, or by temporary factors that might return to "normal" and kick-off an inflationary wage-price spiral, or by some combination of the two. The honest answer is: We don't know yet.

One surprise has been that such tight labor markets have not resulted in more

rapid increases in wages and other labor compensation. Part of the explanation, as Chairman Greenspan noted in his testimony on July 22, may lie in less aggressive behavior on the part of workers. Workers may be more reluctant than previously to bargain for higher compensation or to take drastic action, such as striking or quitting to look for a better job. They may be reluctant because they are insecure in the face of rapidly changing technology, for which they fear they may not have the right skills, because they have recent memories of company "downsizing," or because they are less likely than in previous tight labor markets to be members of a union. These explanations of less aggressive worker behavior are plausible, but likely to be temporary. Workers are not likely to get more insecure as low unemployment continues, and union strength is unlikely to ebb further.

Part of the explanation of moderate compensation increases may also lie in more aggressive employer resistance to labor cost increases than in previous cycles. Business owners and managers appear to believe strongly that they are operating in such a competitive environment -- whether domestic or international -- that they cannot pass cost increases on to their customers in higher prices because they would lose those customers to competitors overseas or down the street. Low import prices resulting from growing international competition and the strong dollar reinforce this perception. Domestic markets have also become more fiercely

competitive as the result of deregulation, lower transportation and communication costs, and more competitive business attitudes. These competitive forces, well known to workers, may give employers a plausible reason -- or at least an excuse -- for strong resistance to wage and benefit demands.

The subdued inflation rate itself, moreover, has dampened inflationary expectations. These lower expectations contribute both to diminished compensation demands of workers and stiffer employer resistance to those demands. An important contribution to lower total compensation costs has also come from the slowdown in the rise of health benefit costs associated with the shift to managed care and the general reduction in the rate of health care inflation. It is not yet clear how much of this slowdown is temporary.

The other surprise is that prices have shown no reaction to the moderate compensation increases that have occurred. Increased foreign and domestic competitiveness is certainly part of the answer, but the remarkable fact is that this competition has not generally eroded profit margins. Persistent high profits suggest that, on the average, employers have been able to increase productivity enough to absorb larger compensation increases without comparable price increases. Whether they will be able to continue to do so is the crucial unanswered question facing monetary policy makers at the moment. Measured productivity has grown

slowly for more than two decades and did not accelerate in this expansion as economists hoped it would. Nevertheless, output per hour seems to have picked up a little recently, which is surprising late in an expansion when productivity increase normally slows. If productivity growth were on the verge of sustained acceleration, a possibility discussed in Chairman Greenspan's testimony, it would greatly increase the chances of higher sustained growth without accelerating inflation. There are reasons to be optimistic, but only time will tell if the optimists are right.

Why is sustained growth so important now?

It is always desirable to live in an economy that is growing at a healthy rate. The general standard of living rises and average people are normally better off. Not only do private resources grow, giving consumers more and better choices, but public resources also grow, making it easier to solve public problems and improve national and community infrastructure. Healthy growth has to be sustainable, not bought at the price of environmental degradation or inflationary overheating that turns a boom into a bust.

Nevertheless, there are at least three reasons why it seems especially important for the United States in the next few years to do everything possible to keep the economy growing at a healthy sustainable rate and avoid recession.

Welfare reform. Recent legislation requires extremely ambitious state and

Federal efforts to reduce dependency and channel large portions of the present and future welfare population into self-supporting jobs. For these efforts to be even moderately successful will require effective skill training and job placement, adequate child care and, above all, low unemployment rates and plentiful entry level jobs. If economic expansion continues and labor markets remain tight, there is a good chance that many families who would otherwise have depended on welfare can acquire the job skills and experience that can enable them to live more independent and satisfying lives. If the economy slides into recession before welfare recipients have time to establish new skills, work patterns and eligibility for unemployment benefits, welfare reform is almost certain to be a failure, if not an outright disaster.

Community development. Partnerships for community development are beginning to create new hope for some devastated areas of big cities, smaller towns and rural areas. Partners include business and community groups, financial institutions and governments. With continued economic growth and low unemployment, these efforts could transform many blighted areas into viable communities with decent housing and an economic base. Recession, especially a deep one, would dry up public and private resources and greatly reduce the chances of successful community development.

Preparing for more older people. Perhaps the biggest challenge to the U.S. economy (indeed to all industrial economies) over the next couple of decades is the prospective rise in the ratio of elderly to working age people. Barring a huge increase in working age immigrants or dramatic increases in the length of working life, the number of retirees will rise much faster than the working population beginning early in the next century. No matter what combination of public and private pensions are used to sort out the claims of retirees to a share of the nation's output, the only way to guarantee a rising standard of living for both retirees and workers is to greatly increase the future productivity of that workforce. A high growth economy over the next decade could generate enough saving and investment to make that increased future workforce productivity feasible. Slower growth and repeated recessions could make the burden of an aging population far heavier and policy choices more contentious.

What policies are needed?

These three challenges to the American economy simply reinforce the need to keep the economy on the highest sustainable growth track attainable and to keep recessions as shallow and infrequent as possible. The biggest problem for monetary policy at the moment is that no one knows what growth rate is sustainable. It may be true that the structure of the economy has changed in ways

that make a higher growth rate sustainable without inflation than we thought possible a few years ago -- or it may not be true. The question turns on whether productivity growth has shifted up out of the doldrums of the last couple of decades. It's possible that it has, but by no means certain.

This leaves monetary policymakers with the difficult job of watching all the signs, weighing the risks and making a new judgment call every few weeks. At the moment, there seems to be little risk of the economy slowing down too much in the near term and sliding into recession. Growth has already slowed from its clearly unsustainable pace in the first quarter, but all the current signs point to continued economic expansion for the rest of this year and into the next. The risks seem higher on the other side -- that many of the factors holding down inflationary pressures will prove temporary, that the rebound of productivity necessary for higher sustainable growth will not occur or not prove robust and durable. The Federal Open Market Committee has to weigh the risk of slowing the economy unnecessarily against the risk of waiting too long and having to put the brakes on harder later. Waiting longer may increase the possibility of overheating followed by recession. It's a tough call. I can't promise we will make the right decisions, but I can promise we will try.

It is important not to overestimate the role of monetary policy and the

Federal Reserve. Monetary policy can help keep the economy from falling off the sustainable growth track in either direction -- either by overheating and generating enough inflation to unbalance the economy and threaten growth or by chugging along too slowly with excessive unemployment. But monetary policy cannot do much to determine how high the sustainable growth rate is. How fast the economy can grow is determined by how rapidly the employed labor force is increasing and how fast the productivity of that workforce is growing. There are only two ways to get more output: either more people work or working people produce more (or both).

In the 1960s and 1970s, the American workforce was growing rapidly as the large baby boom generation reached working age and women, especially mothers, moved into the workforce in much larger proportions than previously. But those two trends have run their course. The labor force is likely to grow slowly over the next few years, about 1 percent per year. The main hope for increasing labor force growth, besides encouraging more immigration, is that continued tight labor markets plus increased flexibility in employment hours will gradually begin to reverse the trends to early retirement that has reduced labor force participation among older people. Continued employment opportunities combined with well-designed training programs, especially in computer related skills, could also attract

into the labor force people who are not actively looking for work because they don't think they have the skills to get a "good" job -- principally older workers and young people who have dropped out of school.

Indeed, the shortage of workers with modern technical skills may be the biggest problem facing the American economy at the moment, as well as its biggest opportunity. As long as labor markets stay tight, investment in skill training is likely to pay off handsomely both for individuals and for companies that can retain the trained workers long enough to benefit from their increased productivity. Public investment in training for workers with low skills -- often unsuccessful when jobs are scarce -- also stands a far better chance in tight labor markets of moving workers into jobs in which they can gain increasing skills, experience and higher wages. Continued low unemployment rates, plus public and private investment in skill training are essential, not only for successful welfare reform, but also for modernizing the skills of the portion of the workforce whose real incomes and opportunities have declined both relatively and absolutely in the last couple of decades.

The other key to productivity increase, of course, is continued investment, both public and private, in research and development and the technology and infrastructure needed for continuous modernization of the economy. Stable low

inflation tends to foster long-term planning and investment by businesses and households. A high growth economy should generate more of the saving needed to finance the investment. Reducing the public dissaving inherent in running a deficit in the Federal budget also adds to national saving. Near term reform of social security and Medicare in ways that add to national saving, public and private, could make a significant contribution to future productivity increase and hence to raising the future rate of sustainable economic growth.

In summary, the objective of economic policy -- monetary policy included -- is to keep the economy on the highest sustainable growth path. No one knows exactly what that rate is right now, or what it can be in the future, but a combination of policies, intelligently pursued, can raise it as far as possible. These policies include:

wise monetary policy that helps the economy expand, and keeps labor markets tight, without incurring excessive risk of accelerating inflation; investment in skills by individuals, firms and the public and non-profit sectors;

increased saving (public and private) invested in research, technology and infrastructure.

The Federal Reserve will do its part, in the face of huge uncertainties, to steer an appropriate monetary policy. Fiscal and other policies, both public and private, are needed to take full advantage of the opportunity we have today to keep the American economy operating at a high level in the future.

EMBARGOED: FOR RELEASE UPON DELIVERY
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WEDNESDAY, JULY 23, 1997

STATEMENT OF
WILLIAM J. MCDONOUGH, PRESIDENT
FEDERAL RESERVE BANK OF NEW YORK
BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
OF THE
U.S. HOUSE OF REPRESENTATIVES
JULY 23, 1997

I welcome the opportunity to appear before the Committee on Banking and Financial Services this morning to provide my views on the conduct of monetary policy in conjunction with the semi-annual report to Congress under the Humphrey-Hawkins Act. There can be no doubt that the ultimate goal of monetary policy in the United States today must be to achieve the highest level of sustainable economic growth, which in turn will promote the highest possible standard of living for all our citizens and the greatest number of jobs. But in saying this, I want to be clear as to what we can expect monetary policy to do and what we know it cannot do.

What monetary policy can do is to anchor inflation at low levels over the long term and thereby lock in inflation expectations. In addition, monetary policy can help offset the effects of financial crises as well as prevent severe downturns of the economy.

Over the past twenty years, a widespread consensus has emerged among policymakers and economists that a monetary policy to stimulate output and reduce unemployment beyond its sustainable level leads to higher inflation, but not to lower unemployment or higher output. Moreover, although some countries have managed to experience rapid growth in the presence of high inflation rates, often with the help of extensive indexation, none has been able to do so without encountering severe

difficulties at a later stage. It is thus widely recognized today that there is no long-run trade-off between inflation and unemployment. As a result, we have witnessed a growing commitment among central banks throughout the world to price stability as the primary goal of monetary policy.

One point is worth emphasizing: Allowing even a moderate level of inflation to persist without a commitment to bring that level downward toward price stability permits--and may even encourage--expectations for still sharper price rises in the future.

What monetary policy cannot do, in and of itself, is produce economic growth. Economic growth stems from increases in the supply of capital and labor and from the productivity with which labor and capital are used, neither of which is directly influenced by monetary policy. However, without doubt, monetary policy can help foster economic growth by ensuring a stable price environment.

Some would argue that establishing price stability as the primary goal of monetary policy means that a central bank would no longer be concerned about output or job growth. I would like to make explicit for the record that I believe this view to be simply wrong. Price stability is the absolutely essential means to produce sustained economic growth. Moreover, there need be no inconsistency between seeking long-run price stability and leaning against short-run business cycles. Indeed, a stable price and financial environment that the public expects to

persist almost certainly will enhance the capacity of monetary policy to fight occasions of cyclical weakness in the economy. This is a key point--and is often overlooked.

In my view, a goal of price stability requires that monetary policy be oriented beyond the horizon of its immediate impact on inflation and the economy. This horizon is on the order of two to three years and it is important, in part because it sets the stage for what comes later. But the longer-run purpose of today's policy actions should be to lay the foundation for price stability and sound economic growth over the coming decade.

This orientation properly puts the focus of a forward-looking policy on the time horizon most important to household and business planning. This is the horizon that is relevant for the definition of price stability articulated by Chairman Greenspan: that price stability exists when inflation is not a consideration in household and business decisions.

A central bank's commitment to price stability over the longer term, however, does not mean that the monetary authorities can ignore the short-term impact of economic events. It is important to recognize that, even if we set ourselves successfully on the path to price stability and even if, as a result, price expectations are contained, we still will not have eliminated all sources of potential inflation. The reality is that monetary policy is only one of many influences on the economy.

For example, supply shocks that drive prices up sharply and

suddenly--such as the two oil shocks of the 1970s--are always possible. In such an eventuality, the appropriate monetary policy consistent with a goal of price stability would not be to tighten precipitously, but rather to bring inflation down gradually over time, as the economy adjusts to the shift in relative prices. In the event of a shock to the financial system, the appropriate monetary policy might require a temporary reflation.

As you can see, I believe that monetary policy must be exercised cautiously. Why do I say this? Because the economy is not perfectly flexible and pushing hard in the face of rigidities can cause unnecessary problems. For example, contracts, especially wage contracts, can outlast a good part of, or even exceed the duration of, short-term shocks. In the short term, therefore, monetary policy must accept as given the rigidities in wages and prices that these contracts create. Abrupt shifts in policy, given these rigidities, especially a monetary tightening in the face of wages that are unlikely to be cut, can cause unacceptable rises in unemployment and drops in output.

In my view, therefore, a key principle for monetary policy is that price stability is a long-term goal and a means to an end--to promote sustainable economic growth. But, even if we agree that price stability must be the primary long-term goal of monetary policy, what exactly does price stability mean in practice? We know that, as currently measured, a zero inflation rate is not the same thing as price stability. This is because

of well-known errors in measuring inflation that stem from many factors, including how quality improvements and new products are valued in the consumer price index. Although there is much research on this topic, economists and policymakers cannot agree upon a single number for the magnitude of this measurement error. In most studies, the error has been estimated to range from 0.5 percent to 2.0 percent. Therefore, as a practical matter, price stability may best be thought of as an inflation rate, measured by the CPI, falling somewhere within this range.

But, we may well ask, why is price stability so important and so desirable? Price stability is both important and desirable because a rising price level--inflation--even at moderate rates, imposes substantial costs on society. These costs are both economic and social. The economic costs entail, for example, 1) increased uncertainty about the outcome of business decisions, 2) negative effects on the cost of capital resulting from the interaction of inflation with the tax system, 3) reduced effectiveness of the price and market systems, and, 4) in particular, distortions that create perverse incentives to engage in nonproductive activities.

The costs of inflation-induced nonproductive activities--such as tax code dodges or overinvestment in the financial sector--decrease the resource base available to an economy for growth. A move to price stability gives an economy the necessary incentives to shift resources back to productive uses.

Rapid moves toward price stability from high inflation, however, do have their costs under certain circumstances. I have already described the rigidities caused by contracts. The overdevelopment of a sector for no reason other than the inflation rate is another of those circumstances. The removal of the distortionary incentive--inflation--leads to a rapid transfer of resources out of that sector, causing unemployment and business failures to follow: what was boom, goes bust. Countries which have seen overexpansion of the financial sector have experienced the sharp contraction of that sector when inflation finally was brought down. This implies an additional argument for price stability. Namely, in a low-inflation environment, these boom-bust cycles created by distortionary incentives are less likely to emerge and can be more easily contained when they arise.

The avoidance of such unnecessary boom-bust cycles also limits the serious social costs that inflation can impose. These social costs are all too often underestimated in economists' typical calculations of inflation's costs. For one, inflation may strain a country's social fabric, pitting different groups in a society against each other as each group seeks to make certain its wages keep up with the rising level of prices. Moreover, as we all know, inflation tends to fall particularly hard on the less fortunate in society, often the last to get employment and the first to lose it. These people do not possess the economic clout to keep their income streams steady, or even buy

necessities, when a bout of inflation leads to an increase in prices they must pay. When the bust comes, they also suffer disproportionately by being among the first to lose their jobs. They also are not users of sophisticated financial instruments to protect their modest savings from confiscation by inflation.

There can be no doubt that a stop-go, boom-bust economy significantly reduces the overall economic welfare of its citizens. Such an economy produces serious and dangerous tensions within a society because the benefits and pain of an inflationary environment are unequally distributed. Because of these realities, I am convinced that price stability is important and desirable not simply for purely economic reasons, but for broader public policy reasons as well.

In a word, I believe that the less fortunate in our society particularly benefit from an environment of price stability and the economic growth that it fosters, as we currently are seeing in our economy. Sustained economic growth brings a lower level of unemployment, higher labor force participation, and greater availability of jobs to those who are not easily hired because they need more training and help from their employers. Over the long term, I am convinced strong economic growth can be sustained only if the benefits of the economic pie--more and better jobs, higher incomes, improved housing, and a higher standard of living--are shared by all parts of our society--rich and poor, skilled and less skilled. Unless all parts of society share in--and therefore have a stake in--economic growth, we cannot

have the social and political cohesion that is essential to sustain growth.

From a personal perspective, I am convinced that much of the success the Federal Reserve has had in containing inflation in recent years reflects monetary policy actions that pre-empted inflationary pressures before they actually showed up in general prices. When the Federal Reserve began firming monetary conditions in February 1994, it did so because of the potential it saw for inflation re-emerging. The main reason we need a pre-emptive approach, in my view, is because monetary policy works with uncertain and long time lags. Although most of its effects on output take place within one to two years, its effects on inflation take even longer--over a three-year time frame, which is the appropriate horizon for monetary policymakers.

When one stands back and considers monetary policy over the past several decades, the case is strengthened for a pre-emptive approach to squeeze off incipient inflation before it shows through in broader price increases. Economic analysis has shown not only that an overheating economy has a strong effect in raising inflation but also that reducing inflation is a very painful process. We learned these lessons during the long and costly disinflation of the early 1980s, following the explosion of inflation in the 1970s. Thus, both analysis and experience reinforce the need for pre-emptive monetary policy actions. Failure to contain inflationary pressures at an early stage makes it much costlier to deal with inflation later.

Because of its long and variable lags, monetary policy also requires of Federal Reserve officials the experience and courage to deal with what will always be a level of uncertainty. The FOMC has been willing to deal with the uncertainty caused by the overestimation of inflation and the underestimation of growth of most economic models in the last year or more. In my view, the Committee's policy has been an important ingredient in the excellent economic performance we have been enjoying.

I believe that there is broad support within the United States today for a rigorous and consistent anti-inflation policy. Moreover, I am pleased by the credibility the Federal Reserve appears to have earned in controlling inflation over the past several years, while encouraging both growth of the real economy and financial system stability.

Finally, I am convinced that no central bank can maintain price stability over the longer term without public support for the necessary policies. Only with the confidence of the public in their policies and their own vigilance in implementing these policies can central banks in democracies ultimately succeed in achieving price stability to maximize economic growth. This is the goal we at the Federal Reserve work toward each day.

Thank you.

**For Release on Delivery
10:00 a.m. EDT
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Statement by

Laurence H. Meyer

Member, Board of Governors of the Federal Reserve System

before the

Committee on Banking and Financial Services

U.S. House of Representatives

July 23, 1997

Mr. Chairman and members of the committee, I am pleased to have this opportunity to meet with you this morning to discuss my views on the conduct of monetary policy. I am well aware that, despite the recent good performance of the economy, some members of this committee have reservations about the conduct of monetary policy, specifically the decision to raise the federal funds rate 1/4 percentage point on March 25. I am also aware that there has been interest by some members, particularly Congressman Frank, in my views, specifically my views about the relevance of the NAIRU concept to understanding recent economic performance and risks to the outlook. I welcome the chance to discuss these issues with you this morning.

Achieving price stability in the long run and preventing an increase in inflation in the short run are not ends in themselves. They are a means to the end, important because they are the best way that the Federal Reserve can contribute to achieving the highest sustainable level of production and the maximum sustainable rate of growth for the American people. This is a key point. While there may be, from time to time, differences about how to

reach these common goals -- indeed, it would be amazing if there were not -- there is no disagreement about the goals.

The history of business cycles has repeatedly taught us that the greatest risk to an expansion comes from failing to prevent an overheated economy. The best way to insure the durability of this expansion is, therefore, to be vigilant that we do not allow the economy to overheat and produce the inevitable rise in inflation. Failure to heed this lesson of history would result not only in higher inflation, but also in cyclical instability and higher unemployment rates.

One way of explaining the recent good performance in the economy is that policymakers have created a favorable environment for the private sector and then gotten out of the way, allowing the natural dynamism of our economy to operate to its potential. Monetary policy has laid the groundwork of stable, low inflation -- an environment conducive to long-term planning by households and businesses. Fiscal policy has helped lower the deficit and thus has increased national saving and reduced its competition for funds with the private sector. Trade policy has opened

markets and increased competition, allowing consumers access to the wider variety of goods and increasing the pressure on producers to raise efficiency and quality. Regulatory policy subjects more and more markets to the discipline of competition. The star of this show is the private sector. Our job is not to mess it up. We can mess it up either by inappropriate action or by the failure to take appropriate action.

Challenges in the Good News Economy

Recent economic performance has been extraordinarily favorable. Growth over the last year has been among the strongest in the past decade. The unemployment rate has declined to the lowest level in a quarter century. Inflation is the lowest in more than 30 years. Equity prices have soared. Consumer confidence is at record levels. The performance of this “good news” economy is enough to make you want to cheer.

I have noted on several occasions that U.S. policymakers, including the Federal Reserve, would probably be inclined to accept more credit for this performance if they had forecast it or even could explain how it was possible. Herein lie the challenges: First, how do we explain such

favorable performance, and specifically what accounts for the favorable combination of low inflation and low unemployment? Second, what can monetary policy do to help extend the good performance; specifically, how should monetary policy be positioned in light of the uncertainties in the current environment so as to balance what I call regularities and possibilities – regularities that suggest there are limits to the economy's productive capacity, at any point in time, and to the growth of capacity over time and possibilities that suggest these limits may have become more flexible in recent years.

The art and science of forecasting and policymaking

When I won awards for economic forecasting while in the private sector, I was always asked about my recipe for forecasting. My response was: take one part science and mix it with one part art and one part luck. The science refers to the model that guided the forecast, to the historical regularities that the model uses to help predict future performance. The art refers to the forecaster's judgment. I never made a forecast by standing back and letting the model do all the work. Judgment was equally important to the end product. We constantly had to consider what parts of the model could be

trusted better than others and what to do when some parts of the model got off track. That is where a forecaster earns his living and makes his reputation. Finally, I never ignored the contribution of good fortune to my forecasting success.

It is not very different for policymakers. Models and historical regularities are important underpinnings of any preemptive policy. Such a policy depends on forecasts because you are attempting to avoid problems that would occur if you failed to act. But judgment is essential too, and more so when historical regularities are called into question, as is the case today. A policymaker, like a forecaster, has to adjust on the fly, before there is time to even determine, with certainty, why the models are off track and certainly before they can be corrected. Historians may put this all in perspective in due time. Perhaps. But policy is made in real time.

In recent years monetary policy has not simply been guided by historical regularities about the relationship between inflation and unemployment inherited from the 1980s and early 1990s. Rather, monetary policy has been adaptive, pragmatic and flexible in response to evolving economic

circumstances. Such an adaptive approach does not throw out the framework that has successfully guided forecasting and policymaking in the past, but attempts, in real time, to adjust that approach based on the current data.

Key Issues in the Economic Outlook

The economy appears to have slowed to near a trend rate in the second quarter, after surprisingly robust growth in the previous quarter. The underlying fundamentals of the expansion continue to look quite positive. There is solid momentum in employment and income, financial conditions are highly supporting, and consumer confidence has soared to record levels. I do not see any obstacles to the continuation of the expansion, with growth near trend, through 1998.

There are in my judgment two key issues in the outlook related to monetary policy and these focus on the interaction among growth, utilization rates and inflation. First, will growth rebound to an above-trend rate, raising utilization rates still further? Second, are prevailing utilization rates already so high that inflation will begin to rise, even if growth remains at trend?

These are the same questions I raised in my first speech after coming to the Board, in September 1996. They are the key questions that affected my judgment about the appropriate posture of monetary policy over the last year, and they remain relevant today.

Answers to your questions

Let me briefly now turn to some specific questions that you raised in your letter of invitation or that were the subject of Congressman Frank's comments on my April 24 speech.

What do I think of the NAIRU concept and its usefulness today?

NAIRU stands for Non-Accelerating Inflation Rate of Unemployment. The relationship between inflation and unemployment, based on NAIRU, is called the Phillips Curve.

According to this concept, there is some threshold level of the unemployment rate (NAIRU) at which supply and demand are balanced in the labor market (and perhaps in the product market as well). This balance yields a constant inflation rate. You asked what the relationship was

between full employment and inflation. In this model, there is no relationship between full employment and inflation. At full employment, defined as the rate of unemployment equal to NAIRU, inflation is constant, but any constant level of inflation is possible at full employment. The rate of inflation in the long run is therefore not determined by the unemployment rate at all. It is determined by the rate of growth of the money supply. This of course gives monetary policy unique responsibility for inflation in the long run.

If the unemployment rate falls below this threshold, inflation rises over time, indefinitely, progressively, and without limit. It is a process that feeds upon itself, because once inflation begins to rise, further price increases feed into wage increases. The basic framework is based on supply and demand. At NAIRU, supply and demand are balanced, so inflation is stable, matched by expected inflation. The trigger for increases in inflation is excess demand for labor and goods. The unemployment rate is a proxy for the balance between supply and demand in the labor market, for the degree of excess demand. Historically the balance between supply and demand in the product market -- that is, for final goods and services -- has closely

paralleled the balance in the labor market, so that the unemployment rate has effectively summarized the relationship between supply and demand in both the product market and the labor market.

It has always been the case that the application of the NAIRU concept has been more difficult in practice than in theory. Sometimes, the Phillips Curve has made large errors; occasionally the equation has over or underpredicted for a considerable period of time. The value of NAIRU has also varied over time, for example, in response to changes in the composition of the labor force. Of course, if NAIRU moves frequently without explanation, the concept would not be very useful, either for forecasting or for policymaking. But the fact is that, relative to other equations used to forecast macroeconomic performance, the Phillips Curve was one of the most reliable, if not the most reliable equation, during the 15 years prior to 1994. During this period NAIRU either appeared to be relatively constant or moved predictably with changing labor force composition. More recently, there has been a run of over-predictions, beginning in late 1994 for wages and the last year or so for prices. These errors are the very heart of the challenge of explaining the recent

surprisingly favorable performance and of the challenge of setting monetary policy today. I will turn to the possible sources of these errors below.

The accompanying table provides some outside estimates of NAIRU. The sources include the Congressional Budget Office (CBO), the President's Council of Economic Advisers (CEA), which develops, along with OMB and Treasury, the economic assumptions underlying the Administration's budget projections; two leading model-based forecasting firms – DRI and Macroeconomic Advisors; and estimates from Professor Robert Gordon of Northwestern University, who I consider the leading academic authority on NAIRU. All those represented in the table view NAIRU as a central and important concept for forecasting inflation and identifying long-run values to which the actual unemployment rate will gravitate. The range of estimates is from 5.4% to 5.9%. Professor Gordon's work suggests that, after falling for a couple of years, NAIRU has stabilized, remaining unchanged over the past year.

Obviously, I am not alone in using this concept in important policy work. For example, in its budget projections, CBO is very disciplined in assuming

that the unemployment rate gradually gravitates to NAIRU. If we begin with an unemployment rate below their estimate of NAIRU, CBO assumes a period of below-trend growth to allow the unemployment rate to return to their estimate of NAIRU and to prevent an ongoing increase in the rate of inflation. This is the model and forecast upon which your budget deal is based.

Outside Estimates of the current NAIRU and Trend GDP Growth (percent)		
Organization	NAIRU	Trend GDP Growth
Macro Advisers	5.9	2.2
DRI	5 3/4	2.3
CEA	5.5	2.1
CBO	5.8	2.1
Gordon ¹	5.4-5.5	2.2

¹ NAIRU using CPI. Current NAIRUs for PCE deflator and GDP deflator are 5.3 and 5.55 percent, respectively.

In the conduct of monetary policy, the process of analysis is more decentralized. There is no single model or forecast, no single measure of NAIRU (not everyone on the FOMC even believes that the concept is useful), no single measure of trend growth. But each of us is dedicated to making disciplined judgments about the economy.

I have said on several occasions that (1) I continue to believe NAIRU is an important and useful concept; and (2) I believe that NAIRU is lower recently than it had been in the 1980s. I believe NAIRU has declined from about 6% at the end of the 1980s to about 5 1/2% currently. However, as has always been the case and is certainly true today, there is uncertainty about the precise estimate of NAIRU. Clearly, many believe it is higher, as reflected in this table. Some also believe it is lower. I constantly re-evaluate my own estimate of NAIRU in light of the recent data.

How fast can the economy grow?

The next question you asked is how fast the economy can grow. Over the short run, that depends on the amount of slack in the economy. Once the economy has moved to capacity, the maximum sustainable growth rate is limited by the rate at which productive capacity expands over time. This limit is generally referred to as trend growth. Productive capacity expands both because of increases in physical inputs (labor and capital) and because of improvements in technology – more people working with more and better equipment. Once full employment is reached, the labor force expands with increases in the working age population, augmented by any trend in the

labor force participation rate. The contribution of growth in capital stock and of technological improvements is summarized in the growth in labor productivity.

The accompanying table also provides outside estimates of trend growth. Note they all fall within a very narrow range, just above 2% per year. There has been very little change in these estimates in recent years. About half of the increase in trend GDP is attributable to the long-term trend in labor force growth and about half to the long-term trend in productivity growth. The narrowness of the range of estimates in this table should not suggest the absence of an important degree of uncertainty about trend growth and I will consider in the next section some reasons why trend growth could turn out to be higher.

If output grows at the trend rate, resource utilization rates will generally be constant. If output grows faster than the trend rate, demand increases relative to supply and resource utilization rates will rise. At some point, above-trend growth will raise utilization rates to a point where excess demand puts upward pressure on inflation.

Note that trend growth does not cause inflation. The higher the trend rate of growth, the better, as Chairman Greenspan noted yesterday in his testimony. And while above-trend growth itself does not raise inflation, it does raise utilization rates which, after some point, will result in higher inflation. I will come back to this thought when I answer your question about the rationale for the March 25 policy action.

How do you explain the recent favorable performance of inflation and unemployment?

The answer here, unfortunately, is not as well as I would like. It is important, as a forecaster and policymaker, to understand how much you know and how little you know. In this spirit, I believe that the recent performance of the economy is to some degree a puzzle. I cannot solve that puzzle completely, but I am quite sure of some of the factors that have been important and I can speculate about some other factors that might be important. In the final analysis, we have to make monetary policy before we have all the answers, though we can and do constantly review our models in light of new data to refine our thinking.

The clearest and perhaps the most important factor is the temporary confluence of favorable supply shocks over the last couple of years; by favorable supply shocks, I refer to developments that have recently lowered the prices or slowed the rate of increase in the prices of specific goods, unrelated to the overall balance between supply and demand in U.S. labor and product markets. The list of favorable shocks is well known and generally widely appreciated. First, non-oil import prices have declined, due in large measure to the appreciation of the dollar from mid 1995 through early 1997. This has both lowered the price of imported goods and constrained the pricing power of domestic firms that compete with imports. Second, the cost of employee benefits has risen more slowly, especially the cost of employer-provided health care, tempering the rise in compensation per hour. Third, most recently, energy prices have declined sharply this year and food prices are increasing less rapidly. Fourth, the price of computers is falling even faster, reflecting, in part, the rapid pace of technical change.

Some believe the collection of these temporary factors fully accounts for the recent favorable performance of inflation and such a view is not entirely implausible. But I do not hold this view. I believe that other longer lasting factors may also be contributing. One possibility is an intriguing anomaly of the current expansion. I noted above that the change in utilization rates in the labor and goods markets (the unemployment rate and the capacity utilization rate) usually mirror one another over the cycle. In the current episode, these two measures have diverged to a greater degree than has been typical in the past. This divergence is likely related to another defining feature of this expansion, the investment boom which has raised the level of net investment to the point where the capital stock is expanding rapidly, raising capacity and preventing the increase in demand from overtaking supply. The unemployment rate is signaling that the labor market is tight; but the capacity utilization rate indicates that supply and demand are well balanced, at least in the industrial sector of the economy. As a result, there has been some upward pressure on wages, but no pass-through to higher price inflation. Firms report an absence of pricing leverage because nothing gives a firm pricing power like excess demand and there is no apparent

excess demand for U.S. firms, especially in the global market place where there is plenty of slack abroad.

The most intriguing explanations of the recent favorable performance are structural changes which may have expanded the limits to productive capacity and trend growth. These possibilities come in two forms: structural change in the labor market which lowers NAIRU and structural change in the product market, specifically higher productivity growth, which, at least temporarily also lowers the NAIRU, and which pushes out the limit of trend growth.

One explanation for why we can sustain stable inflation with lower unemployment is the worker insecurity hypothesis. According to this theory, corporate restructuring, globalization, and technological change have increased workers' insecurity about their jobs. As a result, workers have been willing to accept some restraint on their real wages in order to increase their prospects of remaining employed, leading to a more moderate rate of increase in wages than would otherwise have occurred at any given rate of unemployment. While this is consistent with a decline in the

NAIRU, we cannot very precisely test the worker insecurity hypothesis itself. But it does fit some of the facts of the current labor market experience. My conclusion is that NAIRU has declined, even taking into account the role of temporary factors, though I cannot pin down definitely the source of the decline. I am simply adjusting my estimate to the data. The worker insecurity hypothesis is a possible explanation.

An example of a product market structural change would be an increase in trend productivity growth. This is clearly the most intriguing of all the potential explanations, because it ties together so many puzzles. It can explain why we are in a midst of an investment boom, why the profit share of income has been rising, why inflation is so well contained, and why stock prices have soared. The only problem is the data. It is true that productivity has increased more rapidly recently. This is not clear-cut evidence of a shift in the productivity trend, however, because productivity normally accelerates when output growth rises, as it has over the last year. There is, however, some support for the view that we are experiencing a speed-up in the trend rate of productivity growth. For example, if we measure productivity from the income side rather than the product side of the

national accounts, we do observe a sharper acceleration in productivity. This income-side measure of productivity provides at least a tantalizing hint of an increase in trend productivity growth. This would also be consistent with a considerable number of reports by businesses that they are realizing new efficiencies in production, both through corporate reorganization and through the application of new technology.

What was the rationale for the March 25 tightening?

The discussion of the rationale for the March 25 policy move to follow is my personal view. During the period from June 1996, when I joined the Board, through February 1997, utilization rates had remained in a very narrow range, in the case of the unemployment rate only a shade below my estimate of NAIRU. Recall that the unemployment rate averaged 5.4% in 1996. There was some risk that utilization rates were already so high that inflation might increase over time, but this risk was not clear enough, in my judgment, to justify action. I viewed growth as either close to trend already or about to slow to trend, implying that there was negligible risk that utilization rates would rise further. So, before March 25, the Federal Reserve's posture was one of "watchful waiting," but with an asymmetric

directive, based on the judgment that the risks were weighted toward higher inflation.

In March, my view was that there was sufficient momentum in growth to justify a forecast that utilization rates would rise materially further, in the absence of a change in policy. The policy action was clearly a preemptive one, not based on inflation pressures evident at the time, but on inflation pressures likely to emerge in the absence of policy action. As the Chairman has repeatedly emphasized, lags in the response to monetary policy make it imperative that monetary policy be forward looking and anticipatory, not backward looking and reactive.

One of the principles of prudent monetary policy management, in my judgment, is to lean gently against the cyclical winds. This means that when growth is above trend and utilization rates are increasing, it is often prudent to allow short-term rates to rise. Monetary policy should not sit on interest rates and wait until the economy blows by capacity and inflation takes off. To do so would risk a serious boom-bust cycle, and would require abrupt and decisive increases in interest rates later to regain control

of inflation. A small, cautious step early is the recipe for avoiding the necessity of a sharper destabilizing move later on.

What does the record show? Growth was much stronger in the first quarter than I had anticipated and appears to have slowed to trend in the second quarter. The legacy of the robust first-quarter growth was a decline in the unemployment rate to below 5% in the second quarter. I call the March 25 move, as a result, “just-in-time” monetary policy. I believe it was prudent. I voted in favor of it because I thought it would help to prolong the expansion and contribute to the goal of maximum sustainable employment and maximum sustainable growth.

QUESTIONS FOR PANELS II & III

FED POLICY AND WELFARE REFORM ON A COLLISION COURSE

I have spoken publicly and published articles outlining my concern that we have two separate spheres of national policy which, in their implementation, may effectively be on a collision course. I am speaking of both federal monetary and federal welfare reform policies. In the past, when the economy slowed and millions of the nation's workers lost their jobs, people knew that there was a safety net below which they could not fall, even if they exhausted their unemployment compensation. With the new welfare reform law, the federal floor under the poor has been removed, and thus, workers who are unable for whatever reason to find secure employment lack the protection that welfare benefits provided in past economies.

Thus, the federal welfare policy assumes a full employment economy. Yet, we know that calculations of full employment in fact leave out as many as 20 million Americans. I would be interested in hearing your assessment of the need for a full employment policy and plan in light of this apparent conflict in policy.

IMPACT OF WAGE INCREASES

While experts profess that the economy is booming by all indicators, there are many people in the Second Congressional District of Illinois and in like communities across the nation who have not received a wage increase in many years. Their wages, corrected for inflation, have been stagnant. I would like to hear your responses to statements that giving these workers much deserved and necessary wage increases poses an inflationary threat under present economic conditions?

QUESTION FOR PANEL III

IS THERE ANY INDICATION OF AN INFLATIONARY THREAT?

Traditionally, in its stated policy, the Fed has been concerned about economic climates in which rising growth and falling unemployment coincide, that these factors pose an inflationary threat. Yet, we are now experiencing rapid growth, and rising incomes for some sectors of our population while concurrently experiencing declining inflation, and stagnant wages for the least well-off and the least well-educated. How do you explain this new relationship between economic growth and inflation? Is it your belief that changes in the current national and global marketplaces are affecting what the Fed has always considered to be indicators of impending inflation?



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

LAURENCE H. MEYER
MEMBER OF THE BOARD

August 14, 1997

Honorable Jesse L. Jackson, Jr.
House of Representatives
Washington DC 20515-1302

Dear Congressman Jackson:

It was a pleasure to meet you at the oversight hearings on monetary policy before the House Banking Committee. This letter is in response to your follow-up question about the accuracy, interpretation, and policy implications of the unemployment data.

We should, of course, be concerned about the accuracy of the unemployment data. But as I interpret your first question, it is more about the interpretation of the data and its policy implications than about its accuracy.

The unemployment rate, as officially defined, measures the difference between the labor force and employment. To be counted in the labor force, you have to be an adult (16 years or older) and either be working or have actively looked for work over the last four weeks (with a few qualifications). This is a useful definition. I believe we measure unemployment, as officially defined, quite accurately. In July, there were 6.6 million workers officially classified as unemployed.

But I believe your point is that these figures do not tell the whole story – and certainly they do not. The official unemployment rate is not the only meaningful measure of the “underutilization” of labor and, for some purposes, is not the most revealing measure.

The monthly employment report, in fact, reports a series of alternative measures of the underutilization of labor in Table A-7. The broadest

measure, U-6, includes, in addition to the official unemployment rate, all those not in the labor force who report they would like to have a job, were available for work, and looked for work in the past 12 months (referred to as "marginally attached workers") and those employed part time for economic reasons.

In July, for example, there were 4.3 million workers employed part time for economic reasons (workers who worked part time but reported that they would prefer full-time work) and 1.3 million who were characterized as "marginally attached." As a result, the broader measure of labor underutilization totaled 12.5 million workers; this translates into a 9% rate, compared to the official unemployment rate of 5.0%. (All the data reported in this paragraph are not seasonally adjusted, because the BLS only applies seasonal adjustment to the official measure, not to the components or total of the alternative measures. The seasonally adjusted figure for the official unemployment rate in July is 4.8%.) But the broader rate is not more accurate than the official rate. It is a different measure. Nonetheless, I do appreciate and share your concern about the magnitude of the broader measure of labor underutilization, because it is relevant to an assessment of how far we are from satisfying the labor market aspirations -- and, in many cases, the economic needs of our people.

The second question you asked is whether the definition of full employment should be something quite objective, specifically, that every able-bodied American willing to work is employed doing socially useful and necessary jobs while earning a living wage?

Full employment, from the perspective of stabilization policy, has never been defined as zero unemployment. The definition of full employment recognizes that there will always be some vacancies (jobs in search of workers) and unemployment/underutilization (workers in search of jobs). I believe I can explain the concept of full employment best by distinguishing three types of unemployment: demand-deficient, frictional, and structural unemployment.

At full employment, unemployment is as low as it can be driven by monetary policy, without resulting in rising inflation. This threshold for the unemployment rate is often referred to as the "non-accelerating inflation

rate of unemployment," or NAIRU, the concept I discussed in greater length in my written testimony. Lowering the unemployment rate to this threshold (by raising the overall demand for goods) is the most stabilization policy can deliver on a sustainable basis. Given the limits of stabilization policy to fine tune the economy, we cannot even consistently deliver this rate of unemployment. But we can try.

But there is still a lot of unemployment at full employment and even a larger amount of underutilization of labor. The source of this unemployment/underutilization is frictional and structural. In the case of frictional unemployment, there is, in principle, a vacancy for each unemployed worker; the problem is matching one to the other. The better the information available, the better the access to the information, and the better the job search skills of the unemployed, the faster this matching process will occur. Frictional unemployment, nevertheless, is not a serious social problem, because the time involved in the search is usually quite brief.

The more serious problem is structural unemployment. It arises because of a mismatch between the skills and/or location of the vacant jobs and the skills and/or location of the unemployed. Structural unemployment is often of long duration, disproportionately affects low-skilled workers, and therefore represents a serious social problem. Structural unemployment is related to the problem of the American underclass, a group characterized by limited education and skills and therefore limited opportunities for employment. The solution to structural unemployment and the underclass is not monetary policy, but rather policies that deal directly with the sources of this unemployment, for example, by helping the unemployed to acquire useful skills and by reducing barriers to work by increasing access to transportation and child care. It has proved extremely difficult to remedy such problems for those who have dropped out of high school, have little education and limited skills, and have remained in this state for a long period of time. One of the most important directions for policy is to reduce the prospects that the same problem will arise in the next generation. In this light, programs like Head Start that prepare the young for school, enrichment programs that supplement education in the school and empower parents to work with and encourage the education of their children, and

efforts to improve educational opportunities for children from low-income families would seem to be of particularly high priority.

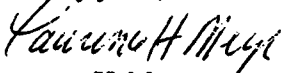
Let me conclude by addressing the question you asked at the hearings. I interpret this question as follows. If the employment report was redesigned to make the broader U-6 definition the headline number, would this change in emphasis change monetary policy?. The answer is no.

Because the broader measures of labor market utilization move together with the official unemployment rate, we can translate NAIRU into a non-accelerating inflation rate of labor market underutilization, corresponding to the U-6 measure of the labor underutilization rate. Lowering the broader measure by monetary policy would also lower the narrower measure and, beyond some point, would result in rising inflation.

Is it more depressing to look at a 9.0% labor underutilization rate than a 5.0% unemployment rate? Most definitely. Does observation of the broader rate reinforce the urgency of efforts to lower structural unemployment? Absolutely. Can monetary policy accomplish this? No. What we can do is foster a noninflationary environment that is conducive to economic and financial stability, thereby providing the foundation for the sound investments in human and physical capital that elevate living standards.

I hope this response is useful. I look forward to other opportunities for dialogue with you on important issues, particularly those related to monetary policy, but also on other policies better targeted to important social problems.

Sincerely yours,



Laurence H. Meyer

Laurence H. Meyer

**TESTIMONY OF
GORDON R. RICHARDS, ECONOMIST
NATIONAL ASSOCIATION OF MANUFACTURERS
ON MONETARY POLICY
BEFORE THE
SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY
HOUSE COMMITTEE ON BANKING AND FINANCIAL SERVICES**

JULY 23, 1997

1. Introduction

I am Gordon Richards, economist of the National Association of Manufacturers. I would like to address two main issues in my testimony today. The first is that there have been structural changes in labor and product markets that make it possible to achieve consistently low inflation rates. The second is that there has been an increase in the rate of technological advance which makes it possible to achieve higher productivity, and therefore higher growth rates.

The basic conclusion here is that monetary policy should accommodate this potential for higher growth. The NAM has repeatedly urged the Federal Open Market Committee to leave interest rates unchanged, or lower them. We have never argued that the Federal Reserve should actively reflate, as it did during the late 1960s and 1970s. Rather, we argue that monetary policy should be loosened only in order to allow the economy to reach its potential.

2. Structural Changes and Economic Potential

Our basic thesis is that a series of structural changes in the 1990s have raised the economy's potential. The most important changes consist of technological advances which have taken place in the private sector, and in particular in industry. To see this, consider the standard model of

economic growth, which has been widely known for more than four decades. This model holds that the long-term trend in output per person is determined primarily by the rate of technological advance. But technological advance is not a fixed number. Rather, the rate of technological advance depends on real world events, such as the advent of microcomputers. If a scientific breakthrough occurs, which later translates into a product that can be used to raise efficiency, this implies an increase in the rate of technological advance.

Much of the credit for new technologies lies with the manufacturing sector. In the 1990s, firms aggressively restructured their operations by using the best available computer technologies to raise productive efficiency. Examples of computer-based process improvements are statistical quality control, just-in-time inventory management, and CAD-CAM. The use of microcomputers has also raised the efficiency of R&D: scientists and engineers can do more, in less time. In this respect, it should be noted that the bulk of the nation's R&D -- about 70 percent -- is performed in industry.

Evidence for an acceleration in the rate of technological advance is provided by the substantial pickup in manufacturing productivity, which achieved robust gains of about 4 percent last year. The upshot is that as a result of technological improvements spearheaded by the manufacturing sector, overall productivity is picking up. This implies both lower inflation -- since prices are marked up over labor costs less productivity -- and higher potential output.

3. The Decline in Inflation

One of these implications -- low inflation -- has been conclusively borne out by the numbers. In 1992, the inflation rate, as measured by the GDP deflator, was 2.8 percent. In 1996 it was 2.1

percent, and as of early 1997, it dipped below 2 percent. We currently forecast about 2 percent inflation in 1997-99.

It should be noted that the actual inflation rate is lower than sometimes reported. While the consumer price index (CPI) is frequently used, for instance in indexing Federal transfer payments, it is also widely recognized to overstate the inflation rate. For instance, in 1996, the CPI rose by 3 percent, nearly a point higher than the GDP deflator, and even the "core" CPI (which nets out the volatile food and energy components) rose by 2.7 percent.

Overstatement of inflation by the CPI will not be a problem in 1997, but only because of the decline in world oil prices, which have fallen by nearly \$6 a barrel since last December. Thus the CPI is running at only 1.3 percent for the first six months of this year. However, the core CPI has been running at 2.6 percent. We estimate that net of energy, the GDP deflator will come in at 2.0 percent in the first half, so that the core CPI is overstating inflation by at least six tenths of a percent.

To its credit, the Federal Reserve recognizes this. In his statements to Congress, Alan Greenspan has repeatedly noted the overstatement of inflation by the CPI. However, advocates of tighter money continue to use the CPI as a measure of inflation.

The reasons for the overstatement are well-known. The CPI uses fixed weights, based on expenditure patterns in 1982-84. But as relative prices change, consumers change their spending in response. If the weights were updated to take account of spending changes, even the core CPI would come in considerably lower. The new chain-weighted deflators produced by the Commerce Department largely correct this problem.

In sum, the actual inflation rate is under 2 percent. While this is not total price stability, it is

close to it. The inflation rate is sufficiently low that inflationary expectations now play very little role in the setting of wages and prices. In this sense, one of the Federal Reserve's goals has been achieved: inflationary expectations have been permanently reduced.

4. Structural Changes in Labor Markets

The inflation rate has remained low despite the fact that the unemployment rate has now been quite low for several years. In December 1994, the unemployment rate declined to 5.4 percent, and has been in a narrow range since then. Unemployment now stands at 5 percent, but there has been little sign of pressure on labor costs.

As a general indicator of labor costs, the employment cost index (ECI) is preferable to hourly wages. Last year, the ECI rose by 3.3 percent. In the first quarter of 1997, the ECI rose by only 0.6 percent, which works out to 2.6 percent compounded. It is likely that the ECI will pick up a bit later in the year, so that an increase of over 3 percent can be projected. On this basis, we can forecast that the inflation rate will also remain stable, or even decline a bit in 1997.

Some analysts have expressed concern over the fact that the wage component of the ECI has been picking up. For instance, in the first quarter, the wage and salary component increased by 0.9 percent. However, this was offset by a much smaller increase in the cost of benefits, which rose by only 0.1 percent. In general, wages and benefits are substitutes for each other. When benefit costs slow down, wages are apt to pick up, and vice-versa. One of the reasons for slow wage growth in the early 1990s was the sharp rise in medical costs at the time. As medical benefit costs have been brought under control, there has been more room for wages to rise. Nevertheless, overall labor costs remain in check.

The fact that low unemployment has not led to an acceleration in labor costs is significant. This implies that the unemployment rate consistent with stable inflation has declined. This is often called the *natural rate of unemployment*, or NAIRU, for non-accelerating inflation rate of unemployment. In the early 1990s, some economists continued to argue that the natural rate was high (for instance, close to 6 percent) and that low unemployment rates would cause inflation to accelerate. Events have proven this view to be incorrect.

There are several reasons why the unemployment rate consistent with stable inflation should have declined. As Federal Reserve Chairman Alan Greenspan has repeatedly noted in his statements to this committee, during the 1990-91 recession and slow recovery in 1992-93, workers kept wage increases moderate in order to preserve job security. But while Greenspan suggested that this might not persist, in our view, the natural rate will remain permanently lower. Our econometric analysis finds that the natural rate dropped sharply starting in 1990, and has shown no tendency to increase since then. This reflects two basic causes.

The first is that labor markets are more competitive. Under these conditions, workers have to take competitive market wages. Second, as noted above, there has been a shift in compensation. Workers are now compensated less through hourly wages, and more through pay-for-performance schemes, commissions, stock options, etc. What this means of course is that compensation to labor becomes less dependent on rigid wage contracts, and more dependent on the profitability of firms. So even with labor markets tighter now than in the past, inflation is less apt to accelerate.

One should mention that in many instances, this is an exceptionally good deal for workers, and a better deal than an increase in the hourly wage. The stock market has risen so fast in the

1990s that workers who received stock options did better on average than workers who received hourly wages.

To return to the issue of the natural rate, this is not a fixed number. Structural changes in labor markets can cause the natural rate to decline. In addition to the changes that have already taken place, greater education of the workforce, especially the working poor, can lower the natural rate even further. It would mean that those who are unable to get jobs because they don't have the right skills would be able to find employment. In other words, if the 5 percent of workers who are unemployed were given additional skill training, it would be possible to get unemployment below 5 percent and still not risk rising inflation.

5. Potential Output

A related concept is *potential output* -- the long-term growth rate that is consistent with stable inflation. The intuition behind potential output is that if demand grows faster than the ability of the economy to produce, product and labor markets would tighten, causing inflation to rise.

The usual way to measure potential output is to add the growth of the labor force to the trend in productivity. First, let's look at productivity. The official (BLS) measure of productivity in nonfarm business shows an average growth rate of just over 1 percent per year. In 1996, the BLS estimate was a productivity gain of only 0.7 percent. These low productivity numbers have led some analysts to arrive at very low estimates for potential output.

Several items of evidence demonstrate that the productivity numbers are seriously understated. In 1996, the income side of the national income and product accounts (NIPA) rose

more rapidly than the product side. The statistical discrepancy between GDP and net national income came to \$74.6 billion (\$67.8 billion in constant dollars). If the product side is revised upward to account for this additional income, then productivity in nonfarm business works out to 1.8 percent.

A second reason why the official productivity numbers are too low is that they are impossible to reconcile with declining inflation. For instance, in 1996, the employment cost index for civilian workers rose by 3.3 percent, while the deflator for gross domestic purchases rose by 1.9 percent. If productivity had risen by only 0.7 percent, the inflation rate would have been seven tenths of a percent higher. Instead, simply by comparing labor costs to inflation, it is clear that productivity must have been higher -- at minimum, it must have increased by 1.4 percent, and probably more.

Productivity is not a direct measure of technology. Rather, it encompasses the effects of both capital and technology. Another way to get at this issue is to use a production function. In production theory, the supply side of the economy can be modeled as the combined effect of labor inputs, the capital stock, and technological advances. So to estimate potential output, we ran estimates for several direct measures of technology. These include research and development (R&D). They also include the quality of computers and the education of the workforce. When we use these measures to estimate potential output in the 1990s, we find much higher values.

In 1993-96, the growth rate of potential output was 3.2 percent per year. In 1996 productivity was 1.8 percent. This figure is very close to the estimate for productivity that you get from the income side of the national income accounts. Forecasting for the late 1990s, we find that potential output is just shy of 3 percent per year.

6. Implications for Policy

All in all, we are now in a very favorable economic situation. We have achieved low unemployment, low inflation and can sustain a stable growth rate. Our forecasts indicate that the current expansion can easily continue for several years to come, without any risk of inflation.

The Federal Reserve deserves some of the credit for having contributed to this very stable environment. We are not indifferent to the fact that on several occasions, the Federal Reserve was too loose, and allowed the economy to overheat. For instance, in the early 1960s, the economy also enjoyed low inflation and high productivity. But as history records, by accommodating the Vietnam War deficits, monetary policy contributed to a buildup in inflation by the end of the decade. Since the 1980s, the Fed has not made the mistake of accommodating fiscal deficits. Rather, it has kept monetary policy independent from fiscal policy, and this has made the economy much more stable. But some of the credit should be given to the private sector. In the final analysis, technological advances are generated by industry.

We also give the Federal Reserve high marks for having kept rates low in 1993. The FOMC correctly recognized that the growth rate was being held back by structural problems such as high debt loads, and left the funds rate at 3 percent. This enabled the recovery to get underway. If the Federal Reserve can be faulted, it is for having been overly cautious, particularly in 1994-95. For instance, the Federal funds rate was raised from 3 percent in late 1993 to 6 percent in mid-1995, before being lowered by 75 basis points later that year. Some of these increases could have been avoided. We also argued that the increase in rates on March 25 was unnecessary.

So what should the Federal Reserve do now? So far, the year 1997 is shaping up to be pretty

good. The growth rate for the year will probably come in at 3 percent or above. The strong first quarter was of course not sustainable. It was the result of a whole series of one-time factors. We currently project that the economy will slow to a growth rate of about 2.5 to 3 percent in the second half. In our view, this is close to potential, but not above it.

The best course of action for the Federal Reserve should simply leave interest rates where they are. If so, the economy will converge to a path of stable growth near potential, with the inflation rate still in the range of under 2 percent.

Thank you, Mr. Chairman. I will be happy to answer any questions.

**TESTIMONY OF DAVID A. SMITH, DIRECTOR
PUBLIC POLICY DEPARTMENT, AMERICAN FEDERATION OF
LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS
BEFORE THE COMMITTEE ON BANKING
AND FINANCIAL SERVICES OF THE
U.S. HOUSE OF REPRESENTATIVES
ON THE CONDUCT OF MONETARY POLICY**

July 23, 1997

Chairman Leach, Congressman Gonzalez and members of the committee, I appreciate this opportunity to testify on behalf of the working men and women of the AFL-CIO, and I commend you for scheduling this extra day of Humphrey-Hawkins hearings. Few topics are more important to the economic well-being of American workers and their families than the ones being discussed today.

With unemployment near its lowest official level in almost a quarter century and inflation lower than it has been in more than 30 years, these should be good economic times for working Americans and their families. Instead, the prosperity that is reflected so dramatically in record corporate profits, previously unheard-of levels of CEO compensation and skyrocketing stock prices has bypassed a large majority of American workers. Despite steadily rising productivity, their real wages remain 12 per cent below the 1973 peak. Their pension and health care coverage have decreased sharply. Downsizing by employers both in the private sector and in the public sector has kept layoffs and economic insecurity at high levels, even in the face of continuing economic expansion. To this mix we must now add the challenge of creating jobs for millions of former and soon to be former welfare recipients.

challenge of creating jobs for millions of former and soon to be former welfare recipients. Meanwhile, inflation has become so tame that the Producer Price Index has registered an unprecedented six straight months of declines in 1997.

Against this backdrop, it is especially troubling that the Federal Reserve continues to be concerned about the modest evidence of wage increases in recent months. In his January 21 testimony before the Senate Banking Committee, Chairman Greenspan noted that "suppressed wage growth as a consequence of job insecurity can be carried only so far. At some point in the future, the trade-off of subdued wage growth for job security has to come to an end...the relatively modest wage gains we've seen are a transitional rather than a lasting phenomenon...the recent pickup in some measures of wages suggests that the transition may already be running its course."

In reality, wage increases for American workers would be a good thing, not something to be avoided or feared. They are economically justified and badly needed. Rising productivity, improved competitiveness and fat profit margins give Corporate America ample non-inflationary room to pay long-overdue wage increases. Yet, with inflation nowhere in sight and the unemployment rate still far above the four per cent Humphrey-Hawkins target, on March 25 the FOMC raised the federal funds rate 25 basis points in order to intentionally slow down the economy. While the full rationale for this decision will not be known publicly till the detailed minutes of their deliberations are released in five years, all indications are that the FOMC based its action on the Chairman's apparent concern that unemployment had dropped so low and had been low for so long that wage increases could not be far behind. While the inflationary concern was purely speculative, the Fed nonetheless chose to send a message that tight labor markets are

to be avoided.

The message to working Americans is clear, and devastating. Prosperity is acceptable only so long as corporate profits and CEO compensation are its principal beneficiaries. As soon as it looks as though prosperity may start to flow through to wages, it is time to slam on the brakes. This logic puts the Federal Reserve, the central bank of all Americans including the vast majority who must work for a living, in the position of using the power of monetary policy to promote and defend the most unequal distribution of income and wealth this nation has seen since the 1920s. The Fed's focus on wages and an apparent renewed interest in targeting Employment Cost Index amounts to a de facto incomes policy targeted at those who work for a living.

High real interest rates and sluggish economic growth which accompany them have been redistributing income from borrowers (including most working people) to lenders since the 1970s. The damaging consequences of these trends are stated powerfully in a recent book co-authored by the chief economist of Business Week:

“If the economies of the industrial world should go into permanent decline, history will show that the road to disaster was paved by their great central banks, the Federal Reserve Bank in Washington, the Bundesbank in Frankfurt, the Bank of Japan in Tokyo, and the Bank of England in London. By bowing to the dictates of financial markets, which decree an all-out fight against inflation at any cost, these financial institutions have become the deadly enemies of those who earn their living from work. Instead of seeking an appropriate balance between growth and price stability, the central banks have put the entire world on a course that makes it

painfully difficult for their citizens to make even minimal gains in their standard of living."¹

In the case of the Federal Reserve, this lack of balance violates the spirit of the legal mandate under which our central bank is supposed to operate. The Employment Act of 1946 and the Full Employment and Balanced Growth Act of 1978 (also known as the Humphrey-Hawkins Act) require the Fed to pursue policies that produce full employment as well as stable prices. In addition to fighting inflation, the Fed has a clear legal obligation to "promote maximum employment, production and purchasing power."

While we are pleased that unemployment is low by the standards of the last two decades, it is important to remember that the current official unemployment rate of five per cent is still a full percentage point above the Humphrey-Hawkins four per cent goal. If unemployment were one percentage point lower, national income would be roughly 3 percent or \$225 billion higher-- or \$2,250 more per household-- according to Okun's law, a well-known empirical regularity in economics.

If joblessness were one point lower, an additional 1.3 million persons would now be working. This would be a welcome development for groups in the labor force whose unemployment rate still remains high. For example, the June unemployment rate among African-Americans was 10.4%; among Hispanics, it was 7.6%. Unemployment also remains high in many geographic areas--9.4% in New York City, for example.

Yet instead of taking steps to assure that the Federal Reserve adheres to its full employment mandate, some members of Congress have been seeking to abolish that mandate.

¹ William Wolman and Anne Colamosca, The Judas Economy: The Triumph of Capital and the Betrayal of Work, Addison-Wesley, 1997, pp. 141-142.

They want to narrow the focus of the Fed's legal mission to be solely the promotion of price stability. The AFL-CIO is strongly opposed to any such change in the law. The Fed must be able to lower interest rates aggressively in order to help prevent economic downturns from spiraling into deep recessions or full-fledged depressions – something the central bank might not be able to do if its mission were limited to fighting inflation.

More fundamentally, we are convinced that pursuit of price stability--zero inflation--is a deeply misguided goal. In a paper published last year by the Brookings Institution, economists George Akerlof, George Perry and William Dickens argued persuasively that modest, controlled amounts of inflation act as a necessary lubricant for economic activity by preventing very high, enduring levels of joblessness². After all, mild inflation may redistribute income--causing some pain to those on fixed incomes in the process--but it does not destroy it. By contrast, unemployment permanently and irrevocably reduces the income available to every working American, especially low-paid workers and would-be workers who need it most. For most working Americans, low unemployment and strong economic growth are far more important than totally eliminating inflation. Retirees who depend on fixed incomes can be protected from the dangers of inflation – through inflation-indexed bonds, cost of living adjustments for Social Security – without resorting to tight monetary policy that throws the entire economy into a tailspin.

We are gratified that the FOMC did not tighten further at its two meetings since March, but remain concerned that it may do so, unjustifiably, in the months ahead. We hope this

²George A. Akerlof, William T. Dickens and George L. Perry, *The Macroeconomics of Low Inflation*, *Brookings Papers on Economic Activity*, 1, 1996, p. 1-76

doesn't happen, but if it does that could jeopardize continuation of the current economic expansion and end prematurely the important economic and social benefits which long-lived expansions can bring. We also are concerned that if the current expansion should start to falter, the FOMC will not act quickly enough or aggressively enough to cut the federal funds rate, which at 5.5% -- is historically high in real terms.

Though it is difficult to be certain given the secrecy which still enshrouds the institution, an important reason underlying the FOMC's thinking appears to be the continuing grip of the so-called NAIRU (non-accelerating inflation rate of unemployment) theory. According to this theory, if unemployment drops below the NAIRU, workers simply get too powerful and push up wages beyond the ability of employers to pay. Employers respond by raising prices, and the inflation cat is out of the bag.

How low is the NAIRU? No one knows. For a long time many, if not most, economists thought inflation would start to accelerate if unemployment dipped below 6%, or even 6.5%. The low and declining inflation experience of the last 34 months of below-6% unemployment should have triggered serious re-thinking—not to mention embarrassment--among the economists who held this view. Instead, most of them still cling tenaciously to their faith in the NAIRU. They believe that the NAIRU still exists, but is just somewhat lower than they had previously thought. Surely, some surmise, if unemployment dips below 5%, as it did in April for the first time in 23 years, inflation will be triggered.

Fortunately, not every economist buys the NAIRU concept. The late former American Economic Association (AEA) president and Nobel laureate William Vickrey, in his AEA presidential address, correctly termed NAIRU "one of the most vicious euphemisms ever

coined.” Another past AEA president who you will be hearing from later today, Robert Eisner, has been a cogent critic of NAIRU. The evidence has become so strong that even some economists inside the Fed have begun publicly challenging NAIRU. Recently, an economist at the Federal Reserve Bank of Atlanta wrote that “the concept of a NAIRU is not useful for policy purposes.”³

Yet despite these and other critics and the embarrassment caused by the obvious recent failure of NAIRU to live up to its predictions, the “vicious euphemism” still holds enormous sway. On April 24, for example, Federal Reserve Governor Laurence Meyer gave a widely-reported speech in which he professed his continuing belief in NAIRU, which he offered as the main justification for the Fed’s decision to raise interest rates on March 25.

What, exactly, is wrong with the NAIRU concept? Plenty, it turns out. Most importantly, it contributes to bad policy. The higher interest rates which are used to slow down the economy can actually contribute to inflationary cost pressures. Higher borrowing costs put upward pressure on prices throughout the economy. Higher borrowing costs and a slower economy also choke off business investment in worker training and in new and more efficient production capacity, all of which leads to inflationary capacity bottlenecks in the economy down the road.

Conversely, low unemployment and strong economic growth can lead to a virtuous circle—in which employers hire and train workers they would shun at other times, many of them minorities, youths and women, and invest in new and more productive plant and equipment. Among the many benefits of this kind of virtuous circle is the reduction in future inflationary

³Roberto Chang, “Is Low Unemployment Inflationary,” Federal Reserve Bank of Atlanta Economic Review, 1st Quarter, 1997

pressures.

NAIRU true believers are guilty of a fundamental misreading of recent economic data. While unemployment has indeed come down, millions of Americans are still without a job. Though the official unemployment rate was 5% in June, according to the government's broadest measure fully 9.2% of the labor force was still unemployed, underemployed or marginally attached to the labor force. This broader measure includes the millions of part-time workers who want but cannot find full-time jobs, those who would like to work but are prevented from doing so by transportation or child care problems, and the "discouraged workers" who want jobs but have given up looking for them because they don't believe work is available.

More fundamentally, there is growing evidence of substantial elasticity of labor supply which has been and can continue to provide additional workers if the number of job openings continues to increase. Recent increases in labor market participation suggest that if work is available more workers will respond. The millions of Americans entering the low-wage job market as a result of welfare "reform" will swell the labor pool even more. Even when domestic production capacity constraints are reached, increasing globalization has made the economy far less inflation prone.

We do not mean to suggest that unemployment could be reduced to zero with no up tick in inflation. Clearly, however, there is room for further non-inflationary economic expansion and employment growth. It is this course of continued employment growth which monetary policy should permit and indeed encourage. We do not accept the view that there is a precise point down this road when an increase in inflation will begin to occur. It is clearly contrary to the spirit of the law and the interests of the vast majority of Americans who must work for a living

spirit of the law and the interests of the vast majority of Americans who must work for a living for the Federal Reserve to tighten monetary policy purely on speculation, before any increase in inflation has occurred. Even then, from the standpoint of most Americans, a small increase in inflation would be a modest price for continued economic expansion, long overdue wage increases and employment growth.

There is little evidence to support the view that the economy risks veering off an accelerating inflation cliff if the Federal Reserve were to allow employment growth to continue. In all likelihood, any increase in inflation would be very gradual. By contrast, the human and economic costs and consequences if the Fed were to intentionally slow the economy would, without doubt, be enormous.

Today, we have the best opportunity in a generation to realize the full employment promise of the Humphrey-Hawkins Act. We should not squander that chance because we fear that American workers might be getting the raise that they so rightfully deserve.

Thank you.

FED POLICY AND WELFARE REFORM

Welfare reform will force two million or more Americans to seek employment, mainly in low wage, low skill job markets. This big influx of new entrants into the labor force puts a special responsibility on the Federal Reserve to live up to its legal mandate under the Employment Act of 1946 and the Humphrey-Hawkins Act, which require the Fed to pursue monetary policies that promote full employment. The Federal Reserve should be especially cognizant of the potential adverse impact of higher interest rates and monetary tightening on the needs and aspirations of former and soon-to-be-former welfare recipients who are entering the job market.

It is important to remember that the reduction in the unemployment rate to 4.8% in July, though welcome, still leaves the nation well above the 4.0% unemployment goal set forth in the Humphrey-Hawkins Act. Closing that gap would go a long way toward providing the many jobs that are needed to ease the transition from welfare to work.

Now more than ever, as a result of welfare reform, the nation needs a full employment policy. While other policies in addition to monetary policy will also be needed, the policies of the Federal Reserve must play a crucial role in achieving and maintaining full employment.

IMPACT OF WAGE INCREASES

After adjusting for inflation, the hourly wages of production and non-supervisory workers are 12% below the level of 1973. Meanwhile, productivity has risen 30%. Corporate profits and CEO compensation have skyrocketed.

As a result of these trends--higher productivity and hefty profit margins--corporate America has ample room to pay workers well-deserved wage increases without triggering an increase in inflation.

Recent Economic Developments and Federal Reserve Policy

Testimony Prepared for Delivery to the
Committee on Banking and Financial Services
U.S. House of Representatives
Washington, DC.
July 23, 1997

Introduction

Mr. Chairman and members of the Committee, my name is John Lipaky and I am the Chief Economist and Director of Research for Chase Manhattan Bank. It is a pleasure to be here this afternoon to give my views on U.S. monetary policy.

The Committee's kind invitation to appear at this session indicated that the intent is to "examine the state of the economy and review the conduct of monetary policy." There are four main points that I would like to make today regarding these topics.

1. The U.S. economy is performing exceptionally well, compared both with our industrial country partners, and with our own post-WWII experience.
2. This economic success isn't a result of only temporary factors or luck, but rather derives in large part from good economic policy choices and from favorable structural shifts. Of the former factors, sustained anti-inflationary monetary policy has been the most important.
3. The outlook remains free of expansion-threatening imbalances, as near-term growth likely will be somewhat more moderate than is reflected in current consensus views. Thus, inflation risks will remain quiescent, and potential pressures for additional tightening of Federal Reserve monetary policy likely will be absent in the coming months.
4. Looking beyond near-term issues, Fed officials need to examine possible new guides for setting policy, because the changing structure of the U.S. economy has rendered traditional monetary policy indicators less reliable. A new class of so-called feedback rules look particularly promising.

Unexpected U.S. Economic Success

The U.S. economy's performance during the past few years has exceeded even the most optimistic forecasts. Following a sluggish initial recovery from the 1990-91 Gulf War recession, growth has quickened, keeping employment gains robust and lowering the unemployment rate to 5% or less. Yet, inflation has remained tame: The year-on-year increase in the core consumer price index dropped to 2.5% in June, the lowest rate in 30 years. The improved price outlook has helped to lower long-term interest rates, thereby boosting investment and improving the economy's long-term growth potential.

Accelerating productivity growth -- aided by double-digit growth in capital investment during the past few years -- has permitted both noninflationary wage gains and robust increases in business profits. The rise in U. S. asset prices -- including the stunning stock market rise of past the two years -- no doubt derives in large part from unexpectedly favorable corporate earnings, and the prospect that the benign economic environment will be sustained.

The excellent U.S. performance of the 1990's stands in stark contrast with the disappointing recent record of our G-7 partners. Without exception, they have suffered deeper recessions and weaker recoveries than has the United States (see Chart 1). Investment growth in these countries generally has been sluggish, and job gains have been paltry or nonexistent for years.

The recent U.S. economic success in effect represents a "New American Challenge" to other industrial countries. International investors have grown more confident that the U.S. outlook will remain favorable in the future. It isn't surprising therefore that the dollar has strengthened over the past two years, and that net long-term private capital inflows have accelerated to a record pace.

This is not to claim that the U.S. economy today represents some theoretical ideal, and that all problems have been overcome. Nor is it evident that the business cycle has been rescinded for all time. Nonetheless, to claim that nothing new is going on ignores the obvious: U.S. GDP has grown in every quarter save four since the Fall of 1982. This is the best record of the post-WWII era, and suggests that we need to examine closely the structural shifts currently underway, and to rethink traditional notions of the business cycle.

Assessing the Sources of the U.S. Expansion

A debate has emerged whether the U.S. economy is being governed by a new paradigm. Analysts, investors and policymakers alike have wondered whether the unexpectedly good U.S. economic performance has resulted from temporary forces and simple good luck, or rather improved economic policy decisions and/or favorable structural changes. The answer is important: If the U.S. performance reflects good decisions, then it likely will be sustainable. Moreover, U.S. policy may represent a prototype for other industrial countries.

In my view, the U.S. economy's low inflation expansion has not resulted from good luck, but derives in large part from four basic factors: 1) Sustained anti-inflationary monetary policy; 2) Economic liberalization, including financial market deregulation, the elimination of price controls and reductions of barriers to entry in several key sectors, such as telecommunications; 3) Declining budget deficits; and, 4) Improved inventory controls, and the trend decline in inventory/sales ratios that, together, have reduced troublesome inventory cycles.

Of these four factors, the persistent application of serious anti-inflationary monetary policy has been the most important. Since Mr. Paul Volcker became Federal Reserve Chairman in 1979, and subsequently under the leadership of Mr. Alan Greenspan, the Fed has pursued price stability as its primary policy goal. As inflation has declined, the Fed's credibility has grown, while inflation fears have waned. Given the focus of this hearing, and in the interest of brevity, I will not offer further comments regarding the other factors, beyond noting that the combination of credible monetary policy and significant regulatory reform has been unique to the United States among the G-7 economies in the past two decades.

The fruits of the Fed's anti-inflationary policies have been evident particularly during the past few years. The reason for this apparently delayed impact is straightforward. A central bank earns credibility the same way that Cal Ripken, Tony Gwynn and Ken Griffey, Jr. have earned their reputations as hitters: That is, by stepping up to the plate and swinging their bat with consistent success. The Fed earns credibility by successfully resisting inflationary pressures. Unlike baseball players -- who get to bat hundreds of times in a season, and whose batting average is calculated anew every year -- the Fed faces reputation-setting inflationary challenges infrequently, but the results cumulate. By resisting inflation pressures vigorously in the late 1970's, again in the late 1980's, and most recently in 1994/95, the Fed's reputation has been enhanced progressively.

By now, the Fed's message is widely understood: There will be no return to higher inflation. The clarity and credibility of the Fed's commitment to price stability has lowered both inflation expectations and long-term interest rates, bolstering the prospects for sustained investment-led growth. Declining mortgage rates have bolstered the housing sector. What economists and many others recognized some years ago -- that there is no long-term tradeoff between low unemployment and low inflation -- is evident increasingly in the historical record. In the post-WWII era, the periods of strongest growth in output and income per capita -- and the lowest unemployment rates -- have coincided with the lowest inflation.

The U.S. Outlook

Many analysts and financial market participants harbor pessimistic views about U.S. prospects. Consensus expectations encompass higher inflation and higher interest rates in the next few quarters -- including new Fed rate hikes and the risk of an eventual cyclical downturn. The pessimists maintain that when the U.S. unemployment rate falls below 5.5% to 6% -- that is, below the pre-existing consensus estimates of the Non-Accelerating Inflation Rate of Unemployment (or NAIRU) -- inflation will accelerate necessarily. Moreover, with the stock market allegedly levitating on a tidal wave of mutual fund purchases, and with second quarter income growth outpacing consumption, a new acceleration of private spending toward an inflationary pace is viewed by many as a foregone conclusion.

I do not find these arguments convincing, however. Several factors suggest that U.S. economic growth in the coming quarters likely will be somewhat weaker -- and inflation risks somewhat less acute -- than is reflected in the current market consensus. First, the combination of good productivity growth and strong investment is boosting the economy's productive capacity at a faster pace than has been typical in past decades. Second, the NAIRU almost certainly has declined in recent years, reflecting increased labor mobility and shifts in demographics, economic expectations, and cultural attitudes. Thus, the near-term risk of inflationary wage pressures is less convincing than would have been the case in the past few decades. Third, the widely-used concept of consumer spending "momentum" is overstated in the consensus view. Current income trends provide powerful explanations of current spending, but offer little guidance about future spending. Yet, the outlook for future income trends is uncertain. Fourth, two related factors -- the consumer investment cycle and the so-called "wealth effect" on spending of rising equity and other asset prices -- appear to be winding down. Finally, the dollar's continued rise and sluggish growth in our main trading partners will keep imported inflation low.

The prospects are good, therefore, for continued moderate growth and quiescent inflation pressures. In this case, the Fed may not need to tighten policy further in this expansion phase. Indeed, it is conceivable that in time the Fed's next policy decision could be an easing.

Setting Federal Reserve Policy

Looking beyond the near-term policy challenges, a long-run issue remains to be addressed: Whether a reliable, objective procedure can be developed for setting monetary policy.

Fed officials can no longer rely on many traditional monetary policy indicators. Money supply rules, for example, have been rendered problematic by structural changes in the financial sector. As has been mentioned already, economic indicators such as NAIRU appear to be more useful in explaining the past than in predicting the future. At the same time, monetary policy techniques in use in several other countries, such as formal inflation targeting, seem more helpful in establishing credibility than in providing operational guidelines. Finally, pegging the dollar's value to some external anchor -- such as gold or a basket of commodities -- enjoys limited theoretical or practical support.

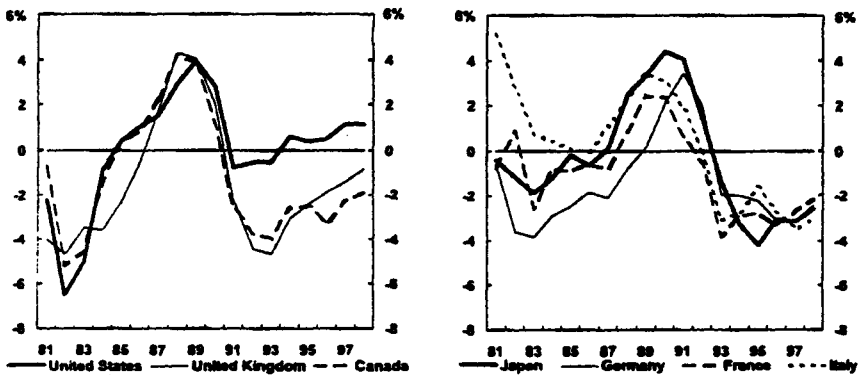
In recent years, the Fed has been forced by the absence of a reliable policy rule to operate in a highly pragmatic fashion. This provides one explanation for the heightened attention paid to public speeches by Fed officials. In any case, uncertainty is sufficiently great about whether the current combination of good growth, low unemployment and steady inflation can be maintained that the Fed must remain flexible with regard to upcoming policy decisions. That is, the policy-setting Federal Open Market Committee (FOMC) must sift through myriad data series as well as qualitative factors in order to determine as best as possible the appropriate Fed funds rate.

A more systematic approach to setting Fed policy might rely on so-called feedback monetary policy rules. These rules use readily available and easily understood data to help set Fed policy in a self-correcting framework. The best-known is the Taylor Rule, named after its author, Professor John Taylor of Stanford University. This rule relies on both output and inflation data to indicate when Fed policy shifts are needed to meet a specified inflation target.

Regardless of the analytical method used, the basic question that needs to be answered is whether there exists a policy-driven or other imbalance in the economy, and if so, whether Fed action would be an appropriate remedy. At present, it is difficult to develop a strong case for additional Fed tightening. Unless more convincing evidence emerges of growing inflationary pressures, the FOMC can leave policy unchanged.

These remarks have addressed several complicated issues in a highly summarized fashion. I would be very happy to respond to any questions you might have.

Chart 1. Major Industrial Countries: Output Gaps.



Note: Deviations of Actual GDP from Potential GDP as a Percent of Potential GDP. 1996 and 1997 estimates and projections.
Source: IMF, World Economic Outlook, May 1997.

John Lipsky
Chief Economist and Director of Research
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Response to Questions Submitted
 by
 Rep. Jesse Jackson, Jr.
 U.S. House of Representatives
 Committee on Banking and Financial Services

Question 1: Fed Policy and Welfare Reform on a Collision Course

The pursuit of proper monetary policy goals – that is, fostering low and stable inflation, protecting the payments system and promoting efficient financial intermediation -- help create the conditions for sustained economic growth and full employment. During the post-World War II era, the periods of strongest growth in per capita income and the lowest unemployment have coincided with low inflation.

In an economic sense, full employment does not imply that everyone who wishes to work will always have a job. Workers who change jobs voluntarily may suffer temporary unemployment. Changes in technology also may shift employment from one sector to another. Moreover, government policies and regulations that distort labor markets can limit the willingness of employers to hire new staff and/or discourage workers from accepting employment at the prevailing wage.

Question 2: Impact of Wage Increases

Wage increases in excess of inflation do not always foreshadow higher future inflation. Indeed, productivity growth should be reflected in higher real wages. Moreover, national income data suggest that the relative share of GNP contributed by labor income is broadly stable; as the economy grows, so too does compensation to workers. Nevertheless, complacency is risky: Accelerating wage gains matched by faster inflation is a reliable signal of impending problems for working Americans.

Question 3: Is There Any Indication of an Inflationary Threat?

The “Phillips Curve” (NAIRU) -- notion of a trade-off between inflation and unemployment is, at best, a rule-of-thumb. It is not an economic law. In practice, the variability of NAIRU over time makes the concept much more useful in explaining the past than in providing a reliable guide to the future.

During the past few years, the enhanced anti-inflation credibility of the Federal Reserve has helped to lower inflation expectations and alter the behavior of businesses and workers. Confident that the present low-inflation environment will be sustained, businesses have increased their investments and hired new workers. In turn, workers have moderated their wage demands, as they are less fearful that they will surrender real income to unanticipated future price increases.

Of course, international competition – and the strengthening of the dollar – also have helped to keep inflation low, especially for many consumer goods. However, U.S.’s the low and relatively stable inflation rate for services suggests that international competition is not the sole explanation for our good inflation performance.

July 14, 1997

U.S. House of Representatives
Committee on Banking and Financial Services
Subcommittee on Domestic and International Monetary Policy
Hearing of July 23, 1997

Statement of Robert Eisner

Full Employment and Inflation:
Where We Stand and Where We Can Go

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July 14, 1997

Full Employment and Inflation: Where We Stand and Where We Can

Go

Robert Eisner

1. Some History

Half a century ago the Employment Act of 1946 committed this nation to the goal of "maximum employment, production and purchasing power." While the compromise wording that was enacted did not specify in so many words "full employment," this was surely what was intended by the law's original sponsors. From 1946 to 1947, unemployment ran at about 3.8 and 3.9 percent. There was allowance for a modest amount of "frictional unemployment," consistent with the absence of involuntary unemployment. Full employment, perhaps in view of what had already been achieved, was then largely taken to imply about 4 percent unemployment.

A mini-recession in 1949-50, which brought unemployment over 5 percent was ended abruptly with the Korean War, with another rise above 5 percent in 1954, after the War's end. Unemployment approached 7 percent in 1958. It was reduced by an unacknowledged acceleration of military expenditures but was still high in 1960. Then Vice-President Nixon was reported to have pressed for stimulatory policies during his campaign for the Presidency, but they were not instituted and the slow economy very likely was decisive in bringing about his defeat.

President Kennedy had pledged to "get this country moving again" and with the advice of his Keynesian Council of Economic Advisors¹ proposed a substantial tax cut in 1962. The cut was finally enacted after his death and helped propel the economy into its longest continuous period of growth on record. I well remember Walter Heller intoning each quarter, "the 15th consecutive quarter of growth," "the 16th consecutive quarter of growth," and on and on. The Viet-Nam War expenditures were undoubtedly a major help, but unemployment was below 4 percent from 1966 to 1969, a record that has not been achieved since. Except for the 4.9 percent rates of 1970 and 1973, unemployment ranged from 5.6 percent to annual

¹ Walter Heller, Chairman, James Tobin and Kermit Gordon.

averages of 9.7 percent and 9.6 percent in the 1982-83 recession. Thereafter, the much maligned Reagan tax cuts contributed to a steady reduction of unemployment to 5.5, 5.3 and 5.5 percent in 1988, 1989 and 1990.

And then came new tax increases and efforts at budget balancing in 1990. Unemployment rose to 7.4 percent by 1992, clearly contributing to the Clinton election victory over Bush. The new President brought forth a modest fiscal stimulus package but could not get it enacted. He then proceeded with a deficit reduction program which led in part to the reduction in the deficit from \$255 billion in fiscal year 1992 to \$107 billion in 1996, with current projections for 1997 running to less than \$50 billion. The deficit decline has stemmed considerably from growth in the economy, however. It has entailed--fortunately, I may add--less reduction in the inflation-adjusted structural deficit during this period and none at all over the last decade.² During the four and one-half years since President Clinton's first term began, with a combination of normal recovery from the 1991-92 slowdown and lower interest rates, unemployment has come down to 5 percent, and in May was at a quarter-century low of 4.8 percent.

2. An Evaluation of Past Policy

What are we to make of employment policy with respect to this record? Sadly, as I view it, except for the acceleration of military expenditures in 1958, the Kennedy-Johnson tax cut of the early 1960s and, possibly, the Reagan tax

² The actual deficit fell from 4.7 percent of GDP in fiscal 1992 to 1.4 percent in 1996 and appears headed for about 0.6 percent in 1997. At 2.8 percent of potential GDP in 1989 and 3.8 percent in 1992, the standardized-employment deficit reported by the Congressional Budget Office, however, declined only to 2.8 percent in 1995, where it was seven years earlier, and to 1.7 percent in 1996. The decline in measured inflation in the last year or two has reduced the inflation tax on outstanding federal debt so that by now the decline in the inflation-adjusted, standardized deficit is some 0.3 percentage points less.

cuts legislated in 1981 (but not fully in place until 1983),³ fiscal policy has not been directed at achieving the Employment Act's goal of maximum employment.

Monetary policy has also not generally been directed at attaining maximum employment. It has rather been dominated by other goals, particularly efforts to combat inflation and at times to pursue fairly arbitrary growth targets for various measures of the money. The easy money policy brought on after World War II by the Federal Reserve policy of pegging interest rates on Treasury securities at low rates was ended by the Fed-Treasury "Accord" of 1951, whatever its possible effect on employment. The real trade-weighted exchange value of the dollar was allowed to increase almost 60 percent from 1979 to 1985, and the United States moved into substantial and persistent import surpluses, which was a drag on domestic employment.

Perhaps the most perverse episode of monetary policy from the standpoint of unemployment was the failure to accommodate adequately, if at all, to the supply shocks to prices in the 1970s. In the fall of 1974, Alan Greenspan, new Chairman of the Council of Economic Advisors, along with other policy-makers, agreed on the "WIN" campaign to "whip inflation now," only to see a major recession, which brought 1975 unemployment to 8.5 percent, become evident within a few months.⁴ And then in 1979, in the face of renewed supply-shock inflation, the Fed undertook a major tightening of credit which helped bring short term interest rates to the neighborhood of 20 percent. Along with misguided tight fiscal policy to reduce a mis-measured budget deficit that did not take into account the high inflation tax, this brought a new increase in unemployment--that incidentally brought down another President, as Carter was defeated by a candidate who asked the voters whether they felt better off than they had felt four years before.

It became fashionable to rationalize the upward drift of unemployment after the 1960s to demographic changes. National rates of unemployment were viewed as a weighted average of unemployment of different groups in the population.

³ The Reagan tax cuts were designed ostensibly as "supply-side" measures to increase business investment and perhaps increase the labor force by inducing more people to seek employment, but not explicitly to reduce unemployment. Murray Weidenbaum, President Reagan's first Chairman of the Council of Economic Advisors, referring to the 1981 tax cut legislation at the time, said prophetically, "What other Administration had its anti-recession program in place before the recession began?" As they became effective in mid-1982 and 1983, the tax cuts, along with the accompanying military buildup, contributed to ending the very severe 1982-83 recession that brought us 10.7 percent unemployment in December 1982.

⁴ At which point they reversed their recommendation, four months earlier, of a tax increase, and advocated a tax cut.

Unemployment was seen as (inevitably?) higher among youths, women and African-Americans. As their proportions in the labor force grew, the national average had to increase.

This always seemed to me a sad and inaccurate explanation. Unemployment does indeed weigh more heavily on marginal workers, whoever they may be. A century and more ago they were immigrants from Ireland and then Italy and Eastern Europe. Who was at the margin changed over time but, at all times, boom-period increases in employment generally were reflected in more than proportional reductions in the high unemployment of the marginal group. God did not determine that women, the young, and ethnic and racial minorities must be unemployed. And in at least one major category, that of women, unemployment rates are no longer higher than elsewhere.

3. The Advent of Humphrey-Hawkins

Those uncomfortable with the lack of implementation of full-employment policies over the years finally succeeded, in the Humphrey-Hawkins Balanced Growth and Full Employment Act of 1978, in putting into law what appeared to be firmer, more specific guidelines. Policies were now to be directed at achieving 4 percent unemployment, to be attained by 1983--and 3 percent adult unemployment--but these goals were bracketed with that of attaining price stability, ignoring the possible contradictions if only aggregative fiscal and monetary tools were to be used. The Council of Economic Advisors and the Federal Reserve were supposed to report on the progress toward achieving these goals but neither showed great enthusiasm, in subsequent years, for actions to implement the achievement of full employment.

Most recently, there has been a significant move to amend the Humphrey-Hawkins Act to end even the nominal commitment of the Fed to reducing unemployment. Senator Connie Mack, Vice Chairman of the Joint Economic Committee, and others have been trying to legislate instructions to the Fed to set as its only goal the elimination of inflation.

4. The Argument Against Full Employment--The Infamous NAIRU

There have always been major political forces, responding to presumed interests in certain financial and business circles, that have rejected the basic premise of the Employment Act, that government policy should be directed at maximum employment. I have only half jokingly accused them of being closet Marxists, wedded to the notion that a "reserve army"

of unemployed is necessary for a private-profit economy to function successfully. Without it, Marx argued, labor would be able to force up its wages and deprive capitalists of the surplus value--or profits--without which they could not stay in business.

But economists over the last several decades have most unfortunately offered modern rationalizations in seemingly rigorous economic theory of this old bit of Marxian dogma. The seeds were planted in the enshrinement of the old Phillips Curve, which fit a negative relation between unemployment and inflation over past data in Britain and then elsewhere, as a substantial obstacle to measures to reduce unemployment. It was interpreted as indicating a trade-off between inflation and unemployment, a trade-off that became increasingly expensive in terms of added inflation as unemployment was reduced.

It had always been assumed or recognized that once full employment were achieved, further increases in nominal aggregate demand--whether brought on by monetary or fiscal policy--could only increase prices and inflation. With no more voluntary labor available, neither employment nor output could be raised. At that point the old classical measures of somehow inducing a greater supply of labor would be the only way of increasing employment and production.

Devices to increase the supply of labor and reduce frictional unemployment would always be in order. But even here, policies to make labor markets more efficient, to increase labor mobility and to offer education, training and re-training to increase employability have been largely underfunded and/or uncoordinated and of limited effectiveness. A "New Jobs Tax Credit" was enacted in 1977, which offered subsidies to employers to hire additional workers. Despite insufficient efforts by the Administration to publicize it and widespread *ex ante* ignorance of its availability, various studies indicated that it had some success in increasing employment of low-wage workers.

After a few years, however, the New Jobs Tax Credit was sharply reduced to a program for a number of highly disadvantaged groups. Perhaps because of the stigmas attached to the categories, studies indicated this employment tax credit to be fairly ineffective. Employers were reluctant to utilize it and workers found themselves better off not indicating their eligibility.

But a large and influential group of economists insisted that only supply-side measures could make any dent in unemployment. The old, sloping Phillips Curve was deemed only a short-run relation. Unemployment was reduced by increasing demand--usually in the new models by increasing the money supply or its rate of growth--only as long as the increased demand generated inflation higher than expected inflation. The economy was viewed implicitly or explicitly at

"equilibrium" or "natural" or full employment, all seen as equivalent. Since there was no involuntary unemployment, higher inflation was seen as temporarily inducing voluntarily idle workers to take jobs because they were tricked initially by inflation into thinking the real wages they were being offered were higher. They could immediately note increases in nominal wages but it took some time for them to sample enough retail stores to recognize that prices had gone up as much or more. When, more or less quickly they did recognize this, they gave up their increased employment.

Unemployment could thus go below its natural rate only as long as inflation remained higher than expected inflation, and to the extent expectations were rational and workers began to understand what was happening that period could be very short. The old short run, downward-sloping Phillips Curve thus became vertical at this natural or non-accelerating-inflation rate of unemployment, dubbed the NAIRU. Unemployment below the NAIRU then brought not only faster inflation but accelerating or increasing inflation. The acceleration could be stopped by allowing unemployment to increase again to the NAIRU, at which point, however, it would remain at whatever new higher, rate it had reached. It could only be brought down again by incurring costly excess unemployment, above the NAIRU.

This doctrine was as unyielding as the old Marxist dogma about the necessity of that reserve army. It offered the terrifying prospect of disaster not only if public policy tried to push unemployment below its natural rate. Disaster could come as well if in some way, unexplained, unemployment drifted by itself below the NAIRU. Monetary policy thus had to be designed to raise interest rates and reduce aggregate demand at any sign that unemployment might drift "too low." With the Fed apparently wedded to the NAIRU, each report of low unemployment jolted bond and stock markets, where investors concluded the Fed was likely as a consequence to tighten.

Employment was hence widely viewed as the equilibrium outcome of the interaction of suppliers and demanders of labor and all unemployment was voluntary or at least structural in the sense that those presumed to be wanting jobs were not qualified. Short of those supply measures that might lower the natural rate of employment, there was then nothing to be done. We were doomed to policy ineffectiveness or impotence on the demand side, except perhaps for the short run effect of "surprises."

I am hopeful that the tide is turning. I have myself been sewing doubts about the existence, location and applicability of the NAIRU,⁵ as have an increasing number of others.⁶ In intensive analysis of U.S. data from 1956 to 1966 I have found that while high unemployment has tended to lower inflation, low unemployment has not increased it.

And events have overtaken the inhibiting dogma. Unemployment has been below the presumed 6 percent NAIRU (many conservatives had put it higher) since September 1994 and far from accelerating, inflation has been coming down; if critics of current measures can be believed, we may have virtually no inflation at all now. The Fed has surprised some tea-leaf (or Greenspan) readers by showing a substantial degree of agnosticism and pragmatism, refusing to raise interest rates as unemployment has gotten lower and lower. There is apparently more thought that unemployment might be allowed to drift still lower, to test the waters or--for those who still believe in it--that "natural" rate.

5. A Policy for the Future--Full Employment and Maximum Growth

What counts in our economy⁷ is: 1) Our total current output of goods and services, usually measured as the GDP but ideally in an expanded measure that would include non-market activity, particularly, in households; 2) The distribution of our income and output; 3) The growth in our output in the future, determined by our rate of saving and investment in all kinds of capital, private and public, physical and human; and 4) The rates of employment and unemployment, related to output, growth and investment, but also in themselves--in a nation such as ours, lack of jobs is destructive of the individuals and families directly affected and of the very fabric of our society as a whole.

Achieving optimum results for what counts requires a fiscal and budget policy which, while sensible and prudent, is not paralyzed by dogmas about balancing a mismeasured budget that takes no proper account of capital investment, inflation taxes or the growth of the economy. And it requires a monetary policy guided not by dogma but by pragmatic regard

⁵ See Eisner (1995a and b, 1996a and b, and 1997a and b and c).

⁶ See, for example, Cross (1995a and 1995b), Fair (1996), Hahn (1995), Staiger, Stock and Watson (1996), Tobin (1995), and several of the papers about to appear in a symposium published in the Winter 1997 issue of *The Journal of Economic Perspectives*.

⁷ Discussed in my book, *The Misunderstood Economy: What Counts and How to Count It*, Boston: Harvard Business School Press, 1994.

for what we can make out about the status of the economy and a healthy skepticism as to the omniscience of Central Bankers as well as the rest of us.

That means, for one thing, doing nothing to slow down our strong, market economy. We cannot have too much of a good thing. A strong economy clearly contributes positively to all of what counts. And I see no evidence that a strong, peacetime economy, undisturbed by the enormous spending and dislocation of a major war such as World War II, engenders meaningful negative effects. As I have observed above, economic analysis is increasingly pointing out that the lower unemployment stemming from a strong economy need not contribute to inflation; the evidence over the past 3 years is that it certainly has not. I may add, with all due respect to the very able Chairman of the Federal Reserve, that none of us can tell when "exuberance" is irrational.

I would go further, however, than advising those controlling monetary policy to do no harm. I do not mean to overstate the Fed's potential impact on an \$8 trillion economy, but it can do good. It can do so by using its control of bank reserves and the federal funds rate to keep credit ample and to keep nudging interest rates down. Inflation expectations, along with current inflation, keep coming down. But that means that real rates of interest, as measured by the difference between nominal rates and inflation or by the new indexed Treasury bonds, remain at historic highs of over 3 percent on even the most secure government securities.

Lower interest rates will encourage more investment and increase current output and its growth in the future, increase employment and improve the distribution of income. They will move us closer to the ostensible major goals of economic policy set forth in the Employment Act of 1946 and the Humphrey-Hawkins Balanced Growth and Full Employment Act of 1978.

We should have and can unemployment down to 4 percent with a growing labor force and a larger labor participation rate. Along with that we should have and can have faster rates of growth. We should hardly be content with the 2.0 to 2.3 percent forecasts of the Administration and Congress, as we should have learned from the better than 4 percent growth achieved over the past year.

I am hopeful that policy will turn back to achieving the lofty goals, enunciated half a century ago, when the Congress made its initial commitment to maximum employment, and restated almost two decades ago in the Act which has occasioned this Hearing.

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OUR NAIRU LIMIT

THE GOVERNING MYTH OF ECONOMIC POLICY

BY ROBERT EISNER

We mustn't have it too good. Too much growth—too little unemployment—is a bad thing. These are not the idle thoughts of economic nail-biters; they are the economic policy of the United States. After real growth of gross domestic product (GDP) hit 4.5 percent in the last quarter of 1994 and unemployment dipped to 5.4 percent in December, the Federal Reserve moved on February 1 to raise interest rates for the seventh time in less than a year. Why? To slow our too rapid rate of growth and stop or reverse the fall in unemployment. Why do that? To fight inflation.

Ordinary people may wonder. Overall inflation, as measured by the GDP implicit price deflator, was down to 2.1 percent, its lowest in three decades. The Consumer Price Index rose only 2.7 percent in 1994 and knowledgeable analysts, including the Fed's chairman, Alan Greenspan, recognize that this measure overstates the rise in consumer costs, perhaps by as much as two percentage points.

Hard-nosed economic analysts and business leaders are also raising questions. They point to technological advances and downsizing in U.S. industry and suggest that productivity and output potential may well be rising more rapidly than the 2.5 percent long-term growth rate that Greenspan and others think marks the outer limit for the economy. Furthermore, as people lose old, high-paying jobs and look desperately even for lower-paying employment, there is slack in the labor force. Perhaps most important, increasing globalization and world competition may limit the ability of American firms to raise prices and workers to push for higher wages.

These heretical observations have so

far failed to dent the dominant dogma haunting economic policy. The central tenet of that dogma is a concept familiarly known among economists as the NAIRU—the “nonaccelerating-inflation-rate of unemployment.” While unknown to the general public, the NAIRU has become one of the most powerful influences on economic policy this century. My recent work, however, shows that even on the basis of a conventional model used to estimate the NAIRU, there is no basis for the conclusion that low unemployment rates threaten permanently accelerating inflation. And, according to an alternative model more consistent with the data, inflation might actually be lower at lower unemployment levels than we are experiencing today.

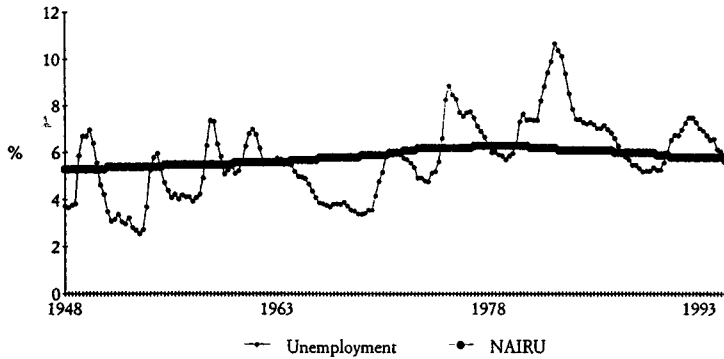
THE NAIRU FRAMEWORK

The basic proposition of the NAIRU is simple: Policymakers cannot use deficit spending or an increase in the money

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UNEMPLOYMENT RATES

Unemployment and NAIRU: Actual unemployment has bounced all around its supposed natural rate in the last half century.



supply to reduce unemployment below some "equilibrium" rate, except at the cost of accelerating inflation. This is a sharp departure from the Keynesian view that inflation poses a danger only when increased spending or demand presses against full or near-full employment.

The concept of the NAIRU, derived from Milton Friedman's notion of a "natural rate of unemployment," rejects the assumed trade-off between unemployment and inflation described by the Phillips Curve, named after A.W. Phillips, an innovative economist from New Zealand. The Phillips Curve suggests that maintaining lower unemployment does produce higher inflation, but the inflation is constant. In the NAIRU view, the Phillips Curve is only a short-run relation. Trying to reduce unemployment by increasing spending or aggregate demand may work for a while, but then the higher inflation will cancel out the effects of the stimulus. Increased actual inflation will raise expectations of future inflation; only the excess of actual inflation over what workers, employers, borrowers, and lenders expect will stimulate the econ-

omy. At each round, higher spending and inflation will be necessary to maintain the original reduction in unemployment.

Thus, according to the NAIRU, fiscal or monetary policies aimed at reducing unemployment would leave us like a dog chasing its tail. If policy were aimed at keeping total spending sufficiently high to keep unemployment below its "natural rate," inflation would rise more and more rapidly. Ultimately, policymakers would give up in the face of runaway prices. Unemployment would then be back at its natural rate and inflation would stop accelerating, but it would stay at its new, higher level until unemployment rose above the natural rate and the process was painfully reversed.

In this view, the only way to reduce unemployment, except possibly in the short run, is to change conditions affecting the supply of labor—for example, by cutting the minimum wage, reducing or eliminating unemployment benefits, or upgrading the skills of workers. If the NAIRU is taken seriously, supply-side measures are the only ways to get unemployment down and keep it down. And if

unemployment is at or close to the NAIRU, the monetary authority must take prompt anti-inflationary action to prevent the economy from "overheating." Otherwise, inflation will not only be higher but will be launched on its accelerating course, from which it can be diverted only by the medicine of excess unemployment—that is, unemployment above the NAIRU.

This is the view that underlies the otherwise inexplicable policy of the Federal Reserve. Most of our central bankers believe that we are at the natural rate of unemployment or below it, and we need more unemployment before it is too late. The main among macroeconomists today is that conservatives tend to put the NAIRU higher, at say 6-plus or 7 percent, while liberals put it at 6 or perhaps 5-plus percent. A few brave souls suggest that since our estimates of the NAIRU are imprecise, we should cautiously try to bring down unemployment until we have signs of inflation. But others say by then it will be too late.

Few economists have challenged the basic concept of the NAIRU. Keynes observed six decades ago that economists could stubbornly stick to their assumptions in the face of crushing reality, as when they argued in the depths of the Great Depression that there could be no involuntary unemployment. Another such episode of professional obstinacy may well be unfolding. Business leaders report, and national statistics confirm, that despite unemployment falling below the conventional NAIRU, accelerating inflation is nowhere in sight. But many economists are unmoved by mere evidence.

The available data do not, in fact, show that the NAIRU has much to do with historical levels of unemployment. In the United States, as shown in the figure on page 59, actual unemployment has bounced all around a NAIRU that was altered only slightly to keep up with it. Why, for example, did unemployment dip well below the NAIRU through most of the 1960s? The theory does not tell us why it was possible then but impossible now.

The conventional model could simply be ignoring many factors affecting inflation or the interaction of unemployment and inflation. These factors may also have a different impact when unemploy-

ment is high and when it is low. When unemployment is high, workers may indeed hesitate to press for higher wages because they are worried about losing their jobs. Still higher unemployment and falling demand may lead to more competition for limited markets, which may further check inflation.

But when unemployment is low, inflation may also be held in check. Low unemployment is usually associated with more efficient use of all resources. Persistent low unemployment rates that might lead to higher wages may encourage the substitution of capital for labor and raise anticipated future productivity, which would curb inflation. And with profits high and overhead costs spread broadly, firms may keep down prices to discourage others from entering their markets. Firms that are flush with profits may consider moving into new areas. Firms already there may well hesitate to raise prices and thus offer greater invitation to would-be interlopers.

This is, of course, just a sketch of why low unemployment and the high profits usually associated with it may inhibit inflation. Thus, the relationship may be different from what is usually assumed. It may be true that high unemployment reduces inflation, while it is false that low unemployment raises inflation.

The premises of the Fed's anti-inflation policy are now in doubt.

THE CONVENTIONAL FORMULATION

Two crucial assumptions are necessary to arrive at the usual concept of the NAIRU. The first is that, left to itself, any given rate of inflation is self-perpetuating; the second, that unemployment is a key factor in changing inflation rates—specifically, that higher unemployment lowers inflation, and lower unemployment raises inflation.

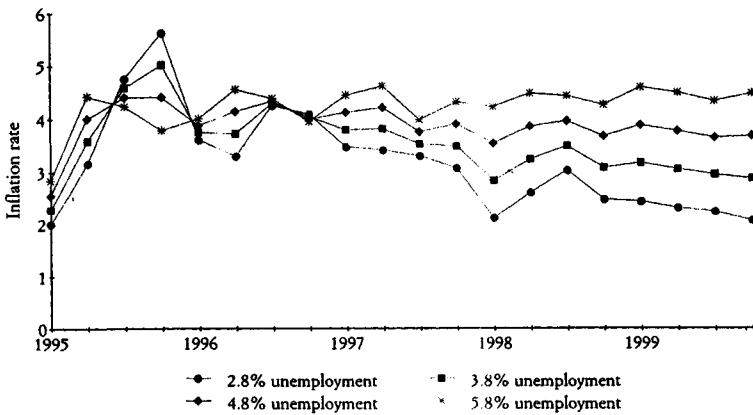
There has been something of a cottage industry in estimating the NAIRU over the years. An exemplary case is the formulation by the Congressional Budget Office (CBO) in its August 1994 *Economic and Budget Outlook: An Update*, which is similar to influential work a decade earlier by Robert Gordon. The general idea is that inflation is a function of a number of variables such as presumably independent food and energy price movements, changes in productivity, the imposition and removal of price controls, and, most important, past inflation and current and past unemployment. The idea that inflation is self-perpetuating is embodied in the assumption that past inflation enters the equations

UNEMPLOYMENT AND INFLATION

High levels of unemployment do cut inflation...



...but low levels do not bring rising inflation; they actually appear to reduce inflation.



with a coefficient of one. The formulation then has an estimated constant term—which is positive, pushing inflation up—and negative coefficients of unemployment to hold inflation down. The size of those negative coefficients determines how much unemployment will be necessary to keep inflation from increasing. The rate of unemployment just sufficient to do this is the NAIRU.

I have replicated the CBO estimates and have confirmed the agency's results using its own model. The sum of the past inflation coefficients is at or above that crucial value of unity necessary for inflation to be self-perpetuating unless stopped. The constant terms are positive and the sums of the unemployment coefficients negative. My estimates yield a NAIRU at just about CBO's figure of 5.8 percent. (The measure of unemployment used by

We have no basis for deliberately raising unemployment.

the CBO is the unemployment rate for married men, which it then adjusts to estimate the general rate of unemployment.)

However, even this model does not support some of the implications usually drawn for policymaking.

Many economists argue that we must never let the genie of inflation out of the bag because even a brief, inflation-accelerating experience of low unemployment will be disastrous and difficult to correct. Testing that proposition, I found that a one percentage point reduction in the married-male unemployment rate to 2.55 percent (one percentage point below the CBO estimate of the married-male NAIRU) generates a sharp increase and fluctuation in CPI inflation for several quarters, which subsides quickly if unemployment goes back up to the NAIRU. Even permanent unemployment of 2.55 percent does not, after five years, get inflation past 7 percent.

These results are based on the conventional formulation, but that is only the beginning of the story. The conventional model constrains the unemployment and inflation parameters in ways that are in fundamental conflict with the data. Freeing the model from those constraints leads to dramatically different conclusions; this calls into question the use of the NAIRU as a justification for blocking fiscal and monetary policies that might bring "full

employment," or distinctly lower unemployment than what is now widely viewed as acceptable.

AN ALTERNATIVE MODEL

My reformulation of the conventional model suggests that the effect of unemployment on inflation is different when unemployment is low compared to when it is high. The key question, then, is what happens to the estimated values of the unemployment coefficients when unemployment is low. Do they differ consistently from the coefficients when unemployment is high?

First, estimates of separate relations for high and low unemployment show that differences between the unemployment coefficients are clearly statistically significant.

Second, the unemployment coefficients in the low-unemployment regressions are generally positive, though usually modest in size. This suggests that, whatever the effect on inflation of unemployment below the NAIRU, once below the NAIRU, lowering unemployment further may reduce inflation.

Third, under low unemployment, the sums of inflation coefficients were below unity, contradicting a critical assumption underlying the NAIRU. Inflation left to itself would not be self-perpetuating, and low unemployment would not cause accelerating inflation. Even if unemployment below the NAIRU did raise inflation, it would raise it by a finite amount—the old Phillips-Curve relation, not permanently accelerating inflation.

SIMULATIONS AND FORECASTS

One way to reveal the effects of the various interacting coefficients is to simulate or forecast ahead. I show results based on a single equation for inflation in the consumer price index. The high-unemployment inflation paths in the figure on page 61 fit the conventional view. Unemployment above the NAIRU drives inflation down, although the implicit NAIRU is closer to 6.8 percent in my simulations based only on high-unemployment observations. It takes still higher unemployment to break the back of inflation. But high enough unemployment does eventually turn inflation negative; that is, it drives prices down.

The low-unemployment paths shown, however, offer quite a different picture. At 5.8 percent unemployment, contrary to Alan Greenspan's fears, there is no accelerating inflation. By the end of the century, inflation settles at about 4.4 percent. Strikingly,

at lower unemployment rates, inflation is no higher. At 4.8 percent unemployment, the simulation shows inflation coming down to 3.6 percent. At 3.8 percent unemployment, inflation comes down to 2.9 percent. At 2.8 percent unemployment, inflation at the end of 1999 is down to 2.1 percent.

NAIRU ESCAPE?

I would not bet the family farm or the nation's economy on any set of econometric estimates, even my own. But promoters, defenders, and practitioners of the conventional NAIRU have done exactly that, with increasingly dogmatic assertion. They have paralyzed macroeconomic policy that should be aimed at the "high" and "full" employment targets set by the Employment Act of 1946 and the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978.

If accelerating inflation is not our fate, some might think a few extra percentage points of constant inflation might offer a pretty good bargain. Lower unemployment would generate large increases in output. According to the robust Okun's Law, named after Arthur Okun, the late Yale economist, each percentage point of unemployment costs at least two percentage points of

output. That would amount to more than \$130 billion of GDP this year.

Those committed to the concept of a NAIRU cannot easily dismiss the evidence of asymmetry that I have presented. I am not proposing a new dogma that lowering unemployment will reduce inflation. Even if my formulation is right, my standard errors are often too high—as, I should add, are those of practitioners of the conventional model—to permit any precise conclusions. There may be no stable, universal relation among unemployment and all the various factors contributing to inflation.

But the results reported here should clearly show the lack of empirical support for the NAIRU and the policies based upon it. They suggest that we have no sound basis for deliberately raising unemployment. On the contrary, we ought to be trying to reduce it, not only by supply-side measures, but by ensuring that the economy is not starved for adequate aggregate demand or productivity-increasing public investment. These measures should aim at reducing both underlying structural unemployment and the unemployment caused by misguided anti-inflation policy. The fight against inflation can then be focused where it should be—on promoting the greatest measure of domestic and international competition. □



Sunday, July 20, 1997
 Home Edition
 Section: Business
 Page: D-4
 TIMES BOARD OF ADVISORS;

Insight;

Budget Nearly Balanced--but Tax Plans Aren't;

By: ROBERT EISNER

Robert Eisner is William R. Kenan professor emeritus of economics at Northwestern University in Evanston, Ill. He is the author of "The Misunderstood Economy: What Counts and How to Count It."

Thanks to a booming U.S. economy, the federal budget may soon be balanced, after all. But how?

Some credible projections indicate that a budget surplus may materialize within a couple of years, well before 2002, even without the fragile deal worked out by the Clinton administration and the Republican leadership in Congress. As the economy and the stock market surge, tax revenue keeps coming in far faster than predicted.

It was only in January that the Congressional Budget Office was projecting the 1997 deficit at \$124 billion. By May, the figure was down to \$67 billion. Widespread current projections are running to \$50 billion and below.

In the face of this, are painful spending cuts--in Medicare, for example--necessary to balance the budget? And if there are to be tax cuts, what should they be and to whom should they go?

There are two possible justifications for tax cuts: 1) that they will help the economy as a whole, creating more jobs and more income and 2) that they will help certain people or households deserving of help. The plans of both the president and the Republicans in Congress would cut taxes \$135 billion--or \$85 billion on a net basis--over five years.

*

So how do the two plans stack up?

First, both would cut capital gains taxes--Congress by reducing the top rate from 28% to 20% and Clinton by excluding 30% of the gains from taxation. The top rate is applicable to the great bulk of gains, received by those in the 39.6% bracket whose taxable income is more than \$263,750. Clinton would lower the top rate only slightly--from 28% to 27.72%.

Most economists who have studied the issue see little theoretical support or evidence for the proposition that any kind of capital gains tax cut will do much for the economy. It has hardly proved necessary in the

stock market's meteoric and sustained rise. And the enormous boom of the information revolution has proceeded very well without cuts in capital gains taxes to further the raising of venture capital.

As for what it does for those who need it, the president's plan is not skewed to the very rich. But hardly any capital gains taxes are paid by the poor or middle class who might deserve some help. By either test, both capital gains tax cut plans should be junked. If taxes are to be cut, there are much better places to cut them.

Similarly, it is hard to see that any general cut in estate taxes, such as the Republicans propose, can be justified, either for the sake of the economy or those who may need help. Even ignoring all the loopholes, there is currently no tax until a couple's estate exceeds \$1.2 million.

Is the Republican proposal to raise this exemption eventually to \$2 million going to help any except the very rich? A sensible reform would be to drop the tax on estates altogether but include gifts and bequests, like other income, in the tax base of those who receive them. But that is apparently too sensible to be under serious consideration.

Then there are the child tax credits. Both plans would eventually offer \$500 per child up to the age of 17. The Republicans' plan would go to families with income of up to \$110,000, Clinton's up to \$75,000.

But the critical difference is that the Republican child credit would not be refundable; it would relate only to income taxes, and the very large proportion of lower-income Americans who pay little or no income taxes--but are in the greatest need of child support--would get little or nothing.

The president is insisting that the credits not entail a loss of the earned income tax credit received by millions of low-paid workers and that it be applicable to payroll taxes. Thus, a worker with two children and annual wages of \$16,129, who would receive nothing in the Republican plan, would save \$1,000 in payroll taxes under Clinton's plan. The extra \$1,000 would also be an important incentive to those hoping to get off welfare and into jobs--if they can find them.

The college education credits in both plans are gravely deficient, the Republican plan somewhat more so. Its formula is 50% for the first \$3,000 of tuition, so that the lower-income student at a community college with, say, \$1,200 of tuition costs, would get only \$600. The Clinton proposal, now put at 100% of the first \$1,000 and 50% of the second \$1,000, would give that student \$1,100. The Republican plan offers full benefits only to the relatively rich who are paying higher tuition at more expensive colleges.

But neither plan addresses our real needs. Income distribution has been getting more and more unequal in this richest economy in the world. Indeed, by all measures, our income distribution is the most unequal, by far, of any of the major industrial nations. The rich continue to get richer--much richer--the poor get poorer, and much of the middle class struggles to stay even. Low incomes at the bottom are clearly associated with lack of education, beginning with nursery school--indeed, beginning at birth with learning in the home.

Tax credits and subsidies--or outright spending, if that word is not too dirty--should be directed at offering all the education and training possible, in day-care centers, kindergarten, elementary and high schools and college. The college aid should go to those really excluded from college because they cannot afford it. It should not be wasted on the relatively rich who are paying tuition of more than \$20,000 at

Stanford, Caltech and Northwestern.

All in all, the president's tax proposals are better from the standpoint of equity and fairness than those coming from Congress. The Republicans may well worry that if they persist in battle with the president, the voters' perceptions that they favor the rich will be sharpened and cost them dearly in the 1998 elections.

But perhaps, with the prosperous economy continuing to eliminate the deficit, we should junk the whole budget deal and put our money where it will really do some good.

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TESTIMONY BEFORE COMMITTEE ON BANKING AND
FINANCIAL SERVICES

U.S. House of Representatives
Washington, D.C.

William A. Brown
Managing Director & Chief Economist
JP Morgan

July 23, 1997

One particularly striking feature of the current economic and market landscape is the tremendous surge in optimism about current and prospective economic performance. It is evident almost everywhere – in the performance of the stock market, in household attitudes as reflected in confidence surveys, and in business actions as seen in the continued boom in capital spending.

The mood of optimism is particularly striking as it is in such sharp contrast to the pervasive gloom of only several years ago. As someone who spends a lot of time giving presentations on the economy to a wide range of people, I can testify to how hard it was only four years ago to convince someone that there was much hope that things might get better. Today there is a similar resistance to any suggestion that things may not look this favorable forever.

What I plan to do today is to highlight the economic backdrop that lies behind this swing in sentiment and then discuss the implications for monetary policy.

Recent economic performance has been characterized by sustained, although unspectacular, growth and very well behaved inflation. Only two other expansions – that of the 1960s and the 1980s – have lasted longer than the current upturn and this one appears as if it could easily match that of the 1980s. The rate of growth has fallen well short of these earlier extended expansions, however. In fact, the current expansion has shown the lowest average growth rate of all the post-W.W.II expansions: 2.8% compared, for example, to 4% in the 1980s and close to 5% in the 1960s.

But even at 2.8%, persistence pays off. Importantly, the unemployment rate has been brought down to a very comfortable 5% average so far this year. This is the lowest level in a generation and the improved job opportunities that it implies are one of the most powerful positives for individuals. Sustained growth has also financed noticeable improvement in the incomes of all sectors: For the government it has all but balanced the budget, for households it has boosted real wages following 15 years of stagnation, and for business it has allowed profit margins to recover from the depressed levels of the 1980s.

Inflation, as I mentioned, has done particularly well: it has drifted a bit lower as the expansion has proceeded and has averaged over a percentage point below the experience of the 1980s. Impressively, inflation is showing no convincing sign that acceleration is imminent. As the unemployment rate approached 5% in the late 1980s, inflation began to creep higher. In the 1960s inflation remained stable for a year after the unemployment rate fell below 5%, in fact until it hit 4%, so current performance is not unprecedented. But it is certainly better than what we have gotten used to in the past 20 years.

The good performance of the economy has generated much discussion of whether a "new age" has arrived in which rapid growth and inflation are compatible. I would be very cautious about embracing such notions. The lowest average growth rate of any post war expansion is a long way from a golden age. It is slow and steady not a miracle that has produced results. And inflation although low and well behaved was lower consistently in the 1950s and has been as well behaved at times in the past. Moreover, there are some less than new age reasons that explain the better performance this cycle than the 1980s. The most important is the difference in the external environment. In the late 1980s the dollar fell

precipitously and economies in Europe and Japan boomed. Both added to inflation here. During this cycle, economies abroad have been abnormally weak and the dollar has been rising. The different external influences combined with better luck with food and energy prices and some help from structural changes in health care can explain the better inflation performance without resort to new-age concepts.

While it may not be a new age, recent good economic performance highlights the fact that the sustained inflation rise of the late 1960s and 1970s and its aftermath have finally been put behind us. This is a hugely positive development. The three decade rise and fall of inflation has been the central economic and financial market event of the post WW-II period. Over the past 15 years, a gradual working down of inflation has been the central focus of monetary policy. The performance of the economy and markets over the past two years suggests that this process may now be essentially complete. Not only has inflation been sustained at a low level, but businesses, investors, and individuals are beginning to behave as if they believe that low inflation is here to stay. In short, they are beginning to behave as they did in the 1950s and 1960s.

Although critically necessary, disinflation came at a price. Since the Federal Reserve began in earnest to attack the inflation problem under Chairman Volcker at the end of the 1970s, the unemployment rate has averaged 6.9%. In the two decades before inflation rose decisively, the unemployment rate had averaged 4.9%. The end of the disinflation process holds out the possibility of sustaining substantially lower unemployment rates than during the past 20 years. How low? The fact that the roughly 5% average of the 1950s brought with it a bit of an upcreep in inflation and the modest rise in wage inflation recently both suggest that 5% is probably at the low end of what will prove

to be possible. But something below 6% would be a reasonable expectation and would be a full point better than what has been realized since 1980.

There is some reason as well to believe that lower inflation might contribute to a somewhat higher sustainable rate of economic growth, as one major intermediate-term uncertainty for business is reduced. The relationship between inflation and sustainable growth, however, is ill defined and, as I indicated, the low growth rate during the current cycle does not provide much encouragement. Higher sustainable growth thus remains a hope more than something that can be counted on.

Despite this sound basis for optimism about future economic performance, the magnitude of the sentiment swing and the degree of current optimism seems disproportionate, although not out of line with the history of sharp sentiment swings over the business cycle. The extended period of slow growth in the early 1990s led people to conclude that this was the norm. The same thing is happening today in reverse. In both cases what was missed was that performance was being significantly influenced by business cycle considerations and thus could not last forever. The weakness of the early 1990s was a mild but drawn-out recession that was the consequence of the mid-1980s real-estate and banking excesses and of the anti-inflationary slant to monetary policy. Similarly, the current good performance reflects a moderate, but sustained, cyclical expansion made possible by slack built up during the early 1990s and the progress made against inflation at that time.

The cyclical nature of growth is indicated by the drop in the unemployment rate as well as the heavy weighting of growth to such cyclically driven components such as investment.

The key to the duration of the current expansion has been its slow and steady pace. Every time growth threatened to boom something knocked it back. In 1992 growth reached a strong 4%, but a severe recession in Europe and Japan hit U.S. exports and the new administration instituted a tax increase that cooled domestic spending for a time. By 1994 growth had again worked its way back to 4%, but Fed tightening, a major set back in global fixed income markets, and a collapse of the Mexican peso (and exports to Mexico) cooled growth.

Over the past year growth once again has climbed back to 4%. What is different this time is that no countervailing force has emerged: neither the Fed nor market interest rates have risen appreciably, a modest tax cut is on the way, and growth abroad (and U.S. exports) are surging. In fact, the major reaction to the pick up in growth this time around has been a surge in optimism that has elevated the stock market, producing the largest increase in wealth, as measured as a percent of GDP, on record. With no restraint forthcoming, growth will not fall back as it did before but will remain strong. The expansion is thus in danger of going from moderate to strong.

This leads me to the question of the appropriate stance of monetary policy. Over the past 18 months the Federal Reserve has displayed a somewhat more relaxed approach to the inflation threat posed by strong growth in an already fully employed economy. The delayed and so far modest 1/4 point tightening is in clear contrast, for example, to the aggressive tightening undertaken at a similar point in the last cycle in 1988. While the easier approach reflects a range of considerations, most important is a recognition of the progress that has been made in the disinflation process and of the apparent recent fall of longer-term inflation expectations. These are both sound reasons for moving policy away

from a focus on reducing inflation and justify a somewhat more confident approach to the control of inflation. It does not, however, mean that the Federal Reserve can relax in the important job of managing the business cycle.

One key function of monetary policy is to lean against the swings between gloom and euphoria – whether rational or otherwise – in order to keep the economy on a reasonably even keel. This is what has been done successfully in the current cycle either by luck or by design, and it is a key reason for the excellent economic performance we have been enjoying. It was also what the Federal Reserve was doing in 1992 and 1993 when it pushed interest rates to exceptionally low levels to counteract the “headwinds” of the banking crisis and the gloom about labor market prospects. And it is what needs to be done today to balance the surging optimism of the private sector and the remarkably favorable domestic and global environment for growth and to keep the economy on a sustainable track.

The current growth surge will inevitably come to an end. The risk is that the slowing will be brought about by an inflation rise, and the undoubted market and policy reactions, or by the buildup of cyclical excesses, and their inevitable unwinding as occurred following the mid-1980s debt binge or, more recently, the “bubble” economy in Japan. In either case, the slowing of growth would likely be sharp and extended as both an acceleration in inflation and cyclical excesses involve a need for reversal and thus a period of “payback,” unlike slowing due to monetary tightening that can be quickly reversed. Ironically, the Federal Reserve’s relative inaction over the past year has encouraged people to believe that the current growth surge is sustainable. The resulting upgrade to earnings expectations and demand forecasts is feeding rather than damping the surge in activity. What is needed now

is not another cheerleader, but a timely dose of restraint. The need does not reflect underlying problems in the economy. Just the opposite. It is the basic health of the economy that requires a firmer hand on the monetary reins. It would be a shame if a cyclical misstep at the end of a very well managed expansion prevented the country from fully realizing the potential benefits of the restoration of low inflation and global competitiveness.

QUESTIONS FOR PANELS II & III**FED POLICY AND WELFARE REFORM ON A COLLISION COURSE**

I see no inconsistency between current monetary and welfare policies. To the extent that inflation is at an acceptable level, the objective of monetary policy will be to maintain full employment. The problem comes if inflation were to rise to an unacceptable level. This is a reminder of why it is critically important for the Federal Reserve to avoid economic overheating and rising inflation.

IMPACT OF WAGE INCREASES

Any wage increase in excess of the national rate of productivity growth -- apparently about 1% -- is inflationary. Price stability can be maintained if some workers receive larger pay increases offset by small increases or declines elsewhere.

QUESTION FOR PANEL III**IS THERE ANY INDICATION OF AN INFLATIONARY THREAT?**

Every business cycle is different, but I do not see convincing evidence that the inflation process has changed substantially from what it was 10 or 20 years ago.

*William A. Brown
Managing Director & Chief Economist
JP Morgan*

September 2, 1997

TESTIMONY TO

COMMITTEE ON BANKING AND FINANCIAL SERVICES

SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL

MONETARY POLICY

LAWRENCE CHIMERINE, Ph.D.

MANAGING DIRECTOR AND CHIEF ECONOMIST

ECONOMIC STRATEGY INSTITUTE

JULY 23, 1997

My name is Lawrence Chimerine. I am currently Managing Director and Chief Economist of the Economic Strategy Institute in Washington, D.C., and Senior Economic Advisor, the WEFA Group, Eddystone, Pennsylvania. I appreciate the opportunity to testify before the Subcommittee on Domestic and International Monetary Policy on current U.S. economic trends and their implication for monetary policy.

In sum, my views are as follows:

1. The economy has slowed sharply from the near 6% rate of GDP growth in the first quarter. This in part reflects the fact that some economic activity was shifted from the second quarter into the first quarter as a result of early tax refunds, mild winter weather, and other temporary and erratic factors.
2. While anecdotal information suggests that the economy may be picking up again, there is no evidence that it is even close to overheating. Growth remains moderate, and largely because of increases in capacity and productivity in many industries, there is still ample room for the U.S. economy to grow.
3. The inflation process has changed dramatically, reflecting intensified competition and other factors which have reduced or eliminated pricing flexibility in most industries, and increased competition in low wage countries and other factors which are holding down wage increases. Most companies now plan their businesses on the assumption

- that they will not be able to raise prices, and then find ways to hold down costs in order to permit profits to continue to rise. This contrasts with previous periods when cost increases were generally passed on in the form of higher prices.
4. There is thus no reason for the Federal Reserve to raise interest rates. The tightening move in March was clearly unnecessary, and it should not only not be repeated, but since real interest rates are very high, the Fed should consider reversing that tightening move at an appropriate time.
 5. The counter-arguments made in support of Fed tightening, namely that the recent up-creep in wages is an early warning sign of accelerating inflation, and that the Fed must preempt in order to stay ahead of the inflation curve, are not consistent with economic trends. The acceleration in wages is slow and gradual, and is coming from depressed levels. It is also being offset by productivity increases. Thus, it is not an inflationary threat. Furthermore, the changed inflation psychology, and the large reduction in the number of cost of living escalator clauses in business and union contracts, have reduced the need for preemptive monetary policy. ¹

THE ECONOMY HAS SLOWED

Those who have regularly argued for a tighter monetary policy in recent years gained support from the unusually large GDP increase in the first quarter of this year. That increase of nearly 6% at an annual rate far exceeds even the highest available estimate of potential economic growth in the United States. However, careful analysis of the economic statistics would have clearly suggested that the first quarter GDP increase was both exaggerated and unsustainable. In particular, a number of temporary factors not

only pushed up economic activity in the first quarter, but did so largely by shifting forward spending that normally would have occurred in the second quarter. These factors included the extremely mild winter, which especially helped housing, other construction, and consumer spending on big ticket items, and the earlier than normal tax refunds, which were spent very quickly (in fact, in today's credit card world, they probably were spent a few weeks before they were paid out). Furthermore, the current expansion has been erratic ever since it began in early 1991 -- there have been several occasions during which the economy spurted for a quarter or two, only to settle back to more sustainable growth thereafter. For all of these reasons, no one should extrapolated the first quarter surge in the economy, nor should it have been a key factor in the policy making process.

As expected , the economy has slowed sharply since that time. Both retail activity and auto sales in particular have trended lower since late winter, after surging earlier. Housing has been on somewhat of a downward trend as well. These and other trends will be reflected in a much smaller increase in GDP for the second quarter -- it now appears that the preliminary estimate of second quarter real GDP growth will be in 1½ percent plus or minus range. Furthermore, early signs indicate that, while activity may be picking up a little bit in July, the upturn is very modest. There is no evidence that the economy is growing at a super fast rate on a sustainable basis.

ECONOMIC GROWTH AND POTENTIAL ARE BEING UNDERSTIMATED

It appears very likely that the economy has been doing better in recent years than the official statistics suggest. This is a key issue with respect to monetary policy -- this suggests that the economy can grow at a faster rate than is now widely believed without triggering an upward spike in inflation. In particular, huge increases in corporate profits and in equity prices, despite little or no price increases, suggest that productivity is growing considerably more rapidly than the modest 1% or so average of recent years which is being indicated by the official statistics. This is further suggested by anecdotal evidence, including information from a large number of companies.

The official statistics are not fully reflecting actual increases in productivity for two reasons. First, the official data may not be capturing all of the revenue increases that are occurring, particularly in many of the new and rapidly growing industries such as software, non-traditional retail outlets, and others. In fact, while revenues for U.S. companies in total are probably lagging behind historical rates, they appear to be growing considerably faster than current dollar GDP. Second, the well known overstatement of the CPI (which, while significant, may be somewhat less than the Boskin Commission estimate), implies that real GDP growth is being underestimated for any given level of current dollar output growth. My back of the envelope estimate suggests that real GDP growth in recent years has been understated by at least a half percent per year, and that if

properly measured, the economy could grow close to 3 percent a year in the future instead of the near 2½ percent that is commonly assumed.

The potential for the economy to grow in the next several years is frequently understated for other reasons as well. First, a substantial part of the growth in the economy in recent years has been accounted for by sharp increases in spending for business machinery and equipment. In fact, in the last several years, real producer durable equipment expenditures have grown more rapidly than at any time since the 1970's. This is raising potential growth in two ways -- it is contributing to the huge increases in measured and unmeasured productivity that are taking place (especially since a lot of the equipment is geared toward efficiency improvements), and it is raising capacity in many industries. Thus, capacity-utilization is now considerably previous peaks, both overall and for many individual industries. Second, there appears to be significant potential for additional productivity gains in the years ahead as the equipment that has been ordered and installed in the last several years becomes fully operational, and given that new orders for state-of-the-art equipment continues to be very strong. Third, there remains substantial excess capacity on a global basis in a large number of major industries, which is preventing the normal bottlenecks and tight capacity situation that might otherwise occur this late in an economic expansion in the United States. Finally, while there are some labor shortages for some occupations in some regions, the use of more overtime, the shifting of part-time workers to full time, new training methods, and other factors are alleviating this problem. Furthermore, labor force growth has accelerated as more welfare recipients, previous

victims of downsizing, discouraged workers, and others are now looking for work now that jobs are more available.

In short, the view that the U.S. economy is now supply-constrained, with little or no slack, so that economic growth even slightly above the assumed 2½ percent increase in potential output will trigger an inflationary spiral, is just not supported by the evidence.

THE INFLATION PROCESS HAS CHANGED.

While the Fed should be vigilant against inflation, it should now be clear to everyone that the excessive concern about inflation in recent years has been misplaced, and that in fact some major changes in inflation dynamics have occurred. These changes are indicated by the fact that the inflation rate has not accelerated -- inflation has actually slowed recently -- despite the fact we are now in the 6th year of an economic expansion. This is unusual -- the rate of inflation did accelerate in the latter stages of virtually every other previous expansion since World War II. Furthermore, wage increases have consistently lagged behind the rates consistent with historical relationships between wages and the CPI, profits, unemployment rates, etc. This has persisted for so long now, and by such a large amount, that it is clear that something fundamental is different.

In my view, the major changes are several factors which have eliminated pricing power in most end markets, and the corporate response to these changes, on the one hand, and other changes affecting labor markets which have dampened wage increases at any given

rate of unemployment. On the former side, inflation is no longer a bottom-ups or cost driven process, but is now determined by forces at the top, forces in the end markets of virtually all goods and services. Those forces, which have severely limited pricing power in most industries, include:

-Intensified domestic competition, in most cases reflecting slower growth that has made existing producers compete more aggressively for market share, and in other cases, new entrants.

-Rising globalization, which has led to new foreign competitors in many industries, and has vastly increased the amount of capacity available to U.S. consumers. The impact of globalization on the United States economy has been exacerbated by the strengthening dollar during the last two years, which in many cases has given foreign competitors a price advantage in U.S. markets, and by excess global capacity in many industries.

-Deregulation in a wide range of industries – including airlines, telecommunications, and now, even electricity – which has resulted in more competition, and an end of cost-based price regulation.

-The huge amount of surplus capacity in retailing, reflecting overbuilding in recent years, which has in effect placed a lid on retail pricing in this country.

-The growth of discount operations, many based on economies of scale, in many segments of retailing, and in auto dealerships, equipment distribution, and the like.

-The rapid growth of industries with steep learning curves which have pushed down prices over time.

The net effect is that most companies are finding it impossible to raise prices: in fact, they now base their business plans on the assumption that they will be unable to raise prices, and then work backwards, in effect, to hold down costs. They accomplish this in part, with ongoing wage restraint – despite the slight acceleration recently, wage increases continue to lag far behind historical rates. In addition, most companies are focusing extensively on productivity enhancement in all parts of the organization, are increasingly outsourcing high cost activities, are regularly pressuring suppliers and vendors to hold the line, and are using more labor displacing, cost-saving technologies to keep costs under control. In effect, inflation is now a top-down process, and the top is so competitive and so price-sensitive that price increases have become the exception, and price discounting and cutting have become the rule.

In addition, increased competition from low wage countries, widespread job insecurity resulting from corporate restructuring, and declining union power, have made it easier to

limit wage increases even in periods of low unemployment. The increased use of performance-based compensation is reinforcing this trend.

The factors discussed above appear to have clearly lowered NAIRU, so much so that there is almost no way of knowing what NAIRU is at the present time. Two years ago, conventional wisdom in the economics profession was that NAIRU was about 6 percent - had this been used as a basis for determining monetary policy at that time, we might now be in recession, instead of enjoying two more years of relatively good growth and even lower unemployment. The truth is that we are probably not even accurately measuring actual unemployment in today's rapidly changing world -- how can we possibly reliably measure a theoretical concept such as NAIRU? In my view, monetary policy should therefore be based on actual inflation and economic trends, not on any estimate of NAIRU.

INFLATION OUTLOOK REMAINS POSITIVE.

There is no indication whatsoever that the changes described above are beginning to be reversed in any way. Quite the contrary, pricing flexibility remains nil in most industries - if anything, there are now even more examples of price cutting and discounting.

Furthermore, the concern that wages are accelerating too rapidly, and will ultimately cause upward pressure on prices, is unfounded. Wage acceleration is modest at best, and very spotty. Average hourly earnings have increased by only 3.5 percent during the last 12 months, hardly a wage explosion. The more-reliable employment-cost index which adjusts for changes in industry mix and overtime, has risen by even less. And surveys

indicate that most major corporations have not significantly increased their budgets for employee compensation over those of recent years.

As mentioned earlier, wage increases continue to remain well below the rate implied by the historical relationship between wages and key determining factors such as the unemployment rate, the cost of living and corporate profits. Clearly, structural changes such as new labor-saving technologies, declining union influence, widespread job-loss fears and increased competition from low wage countries are holding down wages, as discussed earlier. Thus, the increase in profits as a share of the rise in national income has been higher in this expansion than in any previous recovery since World War II.

The gradual acceleration in wages is thus more of a catch-up than a threat of inflation, especially since it can be accommodated by rapid productivity growth and high profit levels. Furthermore, gradually accelerating wages will finally permit workers to experience at least a modest increase in living standards after years of stagnant real wages, especially since it appears to be more heavily concentrated at the low end of the spectrum, among families who have experienced significant economic pressure in recent decades. It might therefore help slow the trend toward growing income and wealth inequality in the United States.

In addition, there is almost no risk that an old-style wage-price spiral will ratchet inflation upward, given that most union and business contracts no longer include cost-of-living

adjustments, and most nonunion companies no longer use the CPI as a key factor in setting wage and salary programs.

And the worry that the more-stable dollar in recent months will limit additional declines in import prices is no reason to tighten. The over-valued dollar is simply not an ideal way to hold down inflation. In particular, it has become increasingly clear that the already huge U.S. trade imbalance is continuing to grow, in part because of the strong dollar. This will slow the economy as its effects spread, and could cause a new round of trade friction between the United States and many of its trading partners. Higher interest rates would aggravate this problem by putting more upward pressure on the dollar. Surely, this is not the best interests of the global trading system and the U.S. economy.

Finally, some of the often used early warning indicators of inflation, such as the price of gold, and various commodity price indexes, are not indicating any near term inflation – quite the opposite, they are probably suggesting even lower inflation in the foreseeable future.

THE FED SHOULD NOT TIGHTEN.

It is thus clear that monetary tightening is unnecessary. Higher interest rates would only aggravate the deceleration in economic growth, and for no reason, given the favorable inflation outlook. The Fed should thus send a strong signal that the already-high level of

real interest rates is a sufficient preemptive strike against future inflation and that rates will be raised again only if there are clear signs that inflation is actually accelerating.

If inflation continues along the low path of recent years, the Fed should stand pat or even gradually ease. On the other hand, if inflation does begin to accelerate, there is ample time for the Fed to tighten in order to prevent it from getting out of hand.

Such an approach would not only be best for the economy, but it would reduce the guesswork in financial markets which has increased market volatility and uncertainty, while benefiting no one, except perhaps a few stock and bond traders.

There are others who continue to advocate more Fed tightening, largely based on their view that economic growth is likely to accelerate again in the months ahead as a result of the rise in household wealth created by the stock market boom. However, most studies show only a small impact of rising equity prices on consumer spending. Furthermore, as mentioned earlier, other factors are affecting the economy in the opposite direction. Finally, it probably doesn't matter -- even if the economy were to pick-up strongly, it is likely that this can be accommodated without a significant acceleration of inflation in view of the changing inflation dynamics discussed earlier.

Responses to Questions from Congressman Jesse Jackson Jr.

From Lawrence Chimerine

Question #1 - Fed Policy & Welfare Reform

I agree that the recently enacted welfare reform legislation is a factor that should be considered in the implementation of monetary policy in the United States. In particular, in my judgment, it further reduces the risk of inflation in the months and years ahead because it is likely to result in an increase in the labor force as more and more individuals are forced off the welfare rolls. This increases the economy's capacity to produce. Furthermore, it is extremely important from a social perspective to make sure that jobs are available for former welfare recipients as they leave the welfare rolls. Thus, it is imperative that the Federal Reserve follow policies designed to maximize economic growth and employment unless there are clear signs that inflation is accelerating in a way that will jeopardize the economic expansion.

Question #2 - Impact if Wage Increases

I completely agree that, despite the overall economic expansion, many Americans have not kept pace. In particular, more workers have not shared in the prosperity because wage increases have continued to be relatively low – in fact, for a large fraction of American workers, wages adjusted for inflation have been stagnant or have risen only slightly in recent years. A gradual acceleration in wages at the present time is not a inflation threat – rather, it would represent a modest catch up for those workers who have been left behind. Furthermore, given the increases in productivity now taking place and the high levels of profits in most industries, it is not a threat to inflation.

Question #3 - Is there any Indication of Inflationary Threat?

In my view, there has been a major change in inflation dynamics in the United States in recent years. In particular, intensified global and domestic competition, deregulation in many industries, excess capacity in retailing and other industries, the growth of discount operations and other factors have dramatically reduced pricing flexibility. This, coupled with the emphasis on productivity growth, has permitted the economy to continue to grow without the normal buildup of inflation pressures. In fact, quite the opposite has occurred – the rate of inflation has actually slowed somewhat recently despite an acceleration in economic growth. Thus, the old guideposts for inflation are no longer relevant. It should be clear to all that additional interest rate increases are not necessary because inflation is not longer a serious threat.

The Conduct of U.S. Monetary Policy

Testimony by
Robert V. DiClemente
Director of U.S. Economic Research
Salomon Brothers Inc
before the
Subcommittee on Domestic and International Monetary Policy
Committee on Banking and Financial Services
House of Representatives
July 23, 1997

Mr. Chairman and members of the committee. Thank you for this opportunity to discuss with you issues surrounding prospective economic developments and the Federal Reserve's recent conduct of monetary policy. Today, I would like to review four interrelated topics: First, the Federal Reserve's long-standing effort to reduce inflation and inflation expectations; second, the immediate economic setting and its implications for policy action in the period ahead; third, the ongoing debate over possible tradeoffs between inflation and unemployment; and fourth, the value of central bank independence and accountability.

The Federal Reserve's Track Record

After seven years of sustained economic expansion, the U.S. economy continues to enjoy relatively low inflation, a vibrant labor market and moderate interest rates. Indeed, with the exception of the brief period of declining output in the aftermath of Iraq's invasion of Kuwait, the U.S. economy has experienced an impressive stretch of almost 15 years of virtually uninterrupted growth and declining inflation expectations. Yet today, despite the understandable concern that such good fortune cannot last indefinitely, we see very few signs that continued economic expansion is threatened.

This enviable performance owes immeasurably to the persistent efforts of Federal Reserve policymakers to reduce inflation and thereby promote the most ideal conditions for maximum sustainable economic growth. In this sense, low inflation has not been an end in itself. A little historical perspective will help us appreciate the extent of policy's success. At present, the percentage of our population employed is the highest ever recorded, yet inflation by almost any measure is the lowest in 30 years. During these past 15 years of committed policy, the volatility of economic growth has declined dramatically as compared to the record of the previous 15 years of very high inflation. In fact, while growth has been slightly stronger in the more recent period, the standard deviation of quarterly changes in real output has fallen by nearly half (from 4.8% to 2.5%) (see Figure 1).

While the Fed's recent track record stands out historically, it also compares favorably to the experience of other countries. The so-called Misery index, which adds the inflation rate to the rate of unemployment as a kind of Everyman's gauge of economic policy, is now at roughly 7 ½%, the lowest since the late-1960s. In that earlier period, the index for the U.S. was worse than the average across all of the OECD countries. Today, the U.S. figure stands five points below the OECD standard (see Figure 2).

I believe that much of this improvement in economic stability reflects the dramatic decline in long-term inflation expectations over this period. At the nadir of our inflation problem, in the fall of 1980 when long-term interest rates were near 15%, a survey of investors and other key professions revealed that these decision makers expected inflation

to average almost 9% over the next ten years. Now, when people are polled about their inflation outlook, the answer coming back in recent months has begun to vary between 2.8% and 3.1%, only slightly higher than the current rate of consumer price inflation.

This progress has a number of favorable implications. First, despite a strong economy, interest rates on mortgages and long-term business borrowing are less than half their previous extremes. We can expect that if the Fed overcomes a possible near-term threat of higher inflation, we will see these rates probe even lower levels over the next several years. Second, these low expectations have begun to yield their own dividends because consumers and businesses do not have to waste time and resources planning ways to protect themselves from inflation. They behave in ways that tend to preserve the gains. Credit usage is running at half the rate of the two previous expansions that lasted as long as the current one (see Figure 3); manufacturers are not hoarding materials; and, businesses faced with rising costs are fearful of raising prices. In short, the customer is king again.

Finally, the enhanced credibility of monetary policy implicit in these low expectations means that the Fed has greater latitude in a difficult environment to be patient, awaiting clearer signs of the appropriate policy direction without inviting the potential second-guessing among investors that can create instability in financial markets. Indeed, the Fed's most recent decisions to forego tightening were viewed by many market participants as a reaffirmation of a favorable inflation outlook.

To be sure, the Fed has gained an important assist from a number of developments including the trend toward freer international trade, the stepped up pace of technological change and most recently, the successful efforts of our political leaders to rein in fiscal expansion. However, the ultimate responsibility for monetary stability rests with the central bank. And, for much of this period, the Fed has had to overcome numerous obstacles, not the least of which were sizable fiscal imbalances and the lack of credibility resulting from earlier monetary policy mistakes.

Keeping Score With Policy Rules

One of the most useful tools for assessing Federal Reserve behavior entails the application of so-called policy rules. Policy rules are operational guides for policy. They use formulas to prescribe policy in a systematic fashion designed to keep short-run decisions consistent with the Fed's long-run mandate to achieve "maximum employment" and "stable prices". For the past several years, we at Salomon Brothers have promoted one such rule, which we dubbed the Taylor rule based on a formulation by Professor John Taylor of Stanford University.¹

From a historical perspective, the Taylor rule is a very helpful way of corroborating the view that policy in recent years has been appropriate. Federal funds rates prescribed by the Taylor formula reveal the sharp change in monetary policy that took place in the early 1980s as the Fed regained control over policy with a strong anti-inflation commitment (see Figure 4). Through most of the period since 1980 the actual fed funds rate has been

at or above the prescribed Taylor rate. In contrast, in the 15 years leading up to that change, the funds rate was generally below prescribed levels. This inflationary bias was true even when the funds rate moved above 10% late in the 1970s. The illusion that rates were high is not borne out by the rule. Thus, inflation continued to mount with devastating consequences for employment and economic stability.

The mirror of this illusion may have been at work in this decade as well. When the Fed moved rates from 3% to 6% in 1994-95, many market participants judged that the 6% funds rate was still too low to arrest the inflationary momentum beginning to surface in the economy. The rule, however, characterized policy as appropriate, and as we saw, an early inflation threat was quashed.

This perspective on policy rules raises a significant point in the debate over policy decision-making. The Taylor rule tells us that the forces motivating policy in recent years are quite transparent, not mysterious. One often hears the criticism that the Fed is “flying by the seat of its pants” or that officials are waving swords at imaginary dragons and “fighting the last war.” Nothing could be further from the truth. The path of the funds rate implied by the Taylor rule tracks the actual funds rate closely over most of the past decade under Chairman Greenspan’s leadership (see Figure 5). This result is not surprising because the rule instructs the Fed to keep inflation trending toward stable prices subject to current economic conditions and the degree of economic slack.

¹ The Taylor rule prescribes a recommended federal funds rate. This Taylor rate is defined as a minimum real rate of 2% plus – on an equal weighted basis – half of any output above potential and half of any excess inflation above a 2% target. Hence, the formula $R = P + 2 + 0.5 \cdot ((Q - Q^*) / Q^*) + 0.5 \cdot (P - 2)$, where R is the target interest rate, P is inflation, Q is output, and Q* is potential output.

I suspect that the rule does a better job of anticipating changes in Fed policy than many financial market participants because officials are forward-looking, while many observers tend to focus on current price statistics. However, policy affects the economy with a lag. Decisions today will begin to affect the economy in a matter of months, but the ultimate effect on inflation will not be felt for more than two years. Therefore, officials must base their decisions in part on uncertain forecasts and assumptions about fundamental relationships in the economy.

To the extent that policy rules can incorporate rough proxies for expected inflation, they can provide a useful check that policy is on track. In this sense, today's inflation statistics tell us about the appropriateness of decisions made two years ago. Stable underlying inflation in 1997 provides the ultimate verdict that the Fed's decisive shift in 1994 was both timely and appropriate. Without those actions, I suspect today we would have an unappetizing combination of higher inflation, much higher interest rates and a more troubled economic backdrop.

The Current Economic Setting

This brings us to the present situation. I believe that the Federal Reserve faces some significant challenges in the months ahead. My colleagues and I are concerned that rapid growth in nominal demand over the past year may be symptomatic of an overly accommodative monetary policy that will need to be repositioned in order to sustain the current expansion. Despite the current benign readings on inflation, the risks of inflationary imbalances developing are rising ever so slightly, barring an unlikely sharp

falloff in nominal demand or the pace of monetary expansion. A similar perception justified the very minor policy adjustment earlier this year; and I suspect we will need further modest tightening in the year ahead.

I recognize that this judgment is not entirely in sync with current market thinking or the present term structure of interest rates; and, it is a minority view among economists who follow the Fed. Indeed, the current euphoria in financial markets increasingly reflects a mistaken, and potentially harmful, view that any limits on the economy's capacity to grow without strain have been repealed by the effects of increased global competition and the rapid pace of technological change. Such "new era" thinking is not new. And, as we have seen in similar episodes historically, there is usually an element of truth in these arguments that is overstated.

However, increased global competition affects neither growth in the labor force nor productivity, the two main forces that govern an economy's ability to grow.

Technological advance has the potential to improve efficiencies, and no doubt has already done so for many *individual* companies. But the advantages to output per worker in the larger macro-economy likely have been small. We suspect that both productivity and output are now being understated slightly. Surging Federal tax revenues and a growing disparity between GDP and its conceptual equivalent, gross domestic income, hint at this shortfall in official statistics.² In addition, the maintenance of high profit margins in the face of rising compensation costs and relatively tame price increases suggests that constraints on our abilities to grow are less rigid than in the past. We can be excited about

² See *Pleasant GDP Arithmetic*, Salomon Brothers Inc, June 6, 1997.

the longer term implications of these developments. But we must separate secular optimism from cyclical reality.

Given the patterns we have observed in overall growth and the incidence of rising resource utilization, it would be highly imprudent for the Fed to assume that the limits to growth have been removed. Whether or not productivity growth has improved or capacity has become more flexible, Federal Reserve officials know that resources have been stretched beyond our long-run potential in recent years as evidenced by falling unemployment, a lengthening workweek, near-record overtime in manufacturing and unprecedented participation in the labor force. Since mid-1992, the economy has grown at an average annual rate of about 2.7%, not very high by new era standards, yet sufficient to pull the unemployment rate down by more than two and a half percentage points. Over a longer span, a simple scatter plot of growth versus changes in unemployment shows that growth barely above 2% has been sufficient to absorb labor slack (see Figure 6).

Apart from the transitory benefits of falling energy prices on headline inflation, there are a number of more fundamental factors that have helped contain price pressures thus far that are not likely to provide much further assistance. These factors include strong labor force growth, declining budget deficits, and substantial world economic slack. We were very fortunate in 1996 that unusually strong hiring demands were accommodated by a surge in the labor force. The numbers of people entering the workforce ballooned by 2%, well beyond the rise in the working-age population. Employment rose by 2 1/4% compared with trend growth in the labor force of little more than 1%. This flexibility among potential job seekers is almost unique in America. But to some extent the rise in

participation reflected a catch up from earlier sluggish growth and may have reflected the impact of welfare reform and the reentry of older "downsized" workers encouraged by a revived job market. But this pattern in all likelihood is not sustainable: In the latest three months, the labor force has stopped growing, perhaps signaling that the burst is over.

Similarly, the decline in the budget deficit has brought our fiscal position into virtual balance, removing an important drain on the country's savings at a critical time in the expansion when private investment needs are high. With the budget deficit now well below 1% of GDP and falling, the additional margin of resources freed up from further restraint will be small.

International developments (not to be confused with global competition) including a strong dollar and subdued global demand for commodities also have played an important part in containing U.S. inflation. Our own model simulations show that the 14% appreciation of the broad real trade-weighted dollar since the spring of 1995 has trimmed as much as ½ percentage point off measured consumer price inflation. Although some further appreciation is likely in the near-term, the dollar is not likely to be as significant a factor in dampening inflation (see Figure 7).

Similarly, sluggish global demand has held the prices of commodities in check, but world growth should become progressively stronger heading into 1998. Moreover, this acceleration is already underway. A proxy for global industrial output based on data from the major industrial countries shows that factory output for the first time since 1994 is beginning to outstrip the rise in capacity (see Figure 8). Symptoms of this rebound are

beginning to surface in the prices of US producer goods in the very early stages of production. The so-called PPI for crude non-energy materials has risen at a 5 1/2% rate in the past six months; not at a pace that makes tightening urgent, but sufficient to justify the Fed's continuing biased stance (see Figure 9).

With little slack and fading help from temporary factors, we must be sure that demand remains on a path consistent with the economy's long-run supply potential. Despite some softening in key components of demand in recent months, the pattern of growth thus far in 1997 seems to have accelerated a bit from an already solid pace in 1996. Moreover, financial conditions are generally supportive of strong demands on resources in the months ahead. Measures of monetary growth are slightly above their desired ranges and accelerating now. Household financial assets relative to income have risen in the range of 10% to 20% over the past two and a half years, presenting a continuing threat that liquidity might surge. Indeed, the rise in household holdings of securities and mutual fund shares that has followed in the wake of declining inflation expectations has increased the stakes for monetary policy. Almost 30% of household net worth is now held in risk-assets, a dramatic increase from about 12% a little over a decade ago (see Figure 10). This increased exposure to risk is a natural outgrowth of the Fed's success but it also increases the underscores the need for monetary stability.

Some analysts reason that monetary policy is well positioned now because real short-term interest rates are above their historic averages. This comparison is misleading. The long-term average of less than 2% includes a period when the financial system was still highly regulated and dominated by banks. Interest rate policy received an important assist from

other regulations that limited the supply of credit. In those earlier days, banks could not compete for savings when market interest rates pierced legal ceilings on deposits. Thus, interest rates did not have to rise very high to choke off all credit to sensitive areas such as housing and autos. Such a system bears no resemblance to today's deregulated, securitized world. Indeed, in the era of deregulation, real short-term rates have averaged roughly 3%, about where they are now. From this perspective, higher than average rates may be needed to promote stability.

To be sure, current financial conditions are not as stimulative as those at the end of 1993 when the Fed was deliberately accommodative. Pent-up demand in some key areas such as motor vehicles has been satisfied. Nonetheless, recent declines in market interest rates have revived housing and spurred new gains in share prices that have reduced the cost of capital to business substantially and buoyed household wealth. Consumer spending on highly discretionary goods and services continues to soar. In this setting, the risks lie decidedly in the direction of excess demand and potential inflationary imbalances.

The Inflation-Unemployment Debate

There is another very common way in which the monetary policy debate is phrased that I believe is unhelpful. It is the Phillips curve framework, which posits a short-run tradeoff between inflation and unemployment when inflation expectations are low. The evidence for this short-run tradeoff is compelling and if we know the so-called natural rate of unemployment, this relationship can be a very useful forecasting tool. But we cannot be certain of the natural rate ahead of time. And in the current circumstance, there is

considerable doubt about what level of unemployment is the lowest consistent with full employment. Moreover, under conditions where inflation expectations are high or rising, any such tradeoff ceases to exist because inflationary policies fail to produce even temporary job gains.

Put differently, there is no long-run tradeoff between inflation and unemployment. Thus, a monetary policy that pursues price stability is also one that produces the maximum gains in employment. As we have seen, bringing inflation expectations down over 15 years has fostered the strongest job market in a generation.

Unfortunately, the short-term tradeoffs have led to false characterizations of policy on both sides of the political aisle. Hence, we hear criticism of the Fed that officials worry that unemployment is too low or that too much growth may cause inflation. Of course, inflation is not caused by too many people working. Nor is unemployment a cure for inflation. Yet output and employment fostered by overly accommodative monetary policy is not growth in a meaningful sense because it is transitory. In this context, an old cliché that “There is no free lunch” may apply; put in policy terms, this might be expressed as “Central banks can print money, but they cannot print savings.”

The challenge for the Federal Reserve is not to discern whether unemployment is too low but whether or not strong demand is being supported by saving and productivity or by excess credit and artificially low interest rates. Is growth the sort that will breed inflationary imbalances or is it sustainable? In the words of Chairman Greenspan, this is “what making monetary policy is all about.”

To its credit, the Fed has not been drawn into the debate on these false terms. There is ample evidence that recent policy decisions have not been driven by Phillips curve logic. For example, in January 1996, the Fed reduced rates with unemployment at 5.6%, below the 6% to 6 ¼% range that many economists reasoned was the threshold for rising inflation. And, of course, the recent decisions to maintain a steady course were taken in the context of the lowest unemployment rate in 24 years and trailing four-quarter growth in GDP of 3 ½%, higher than the long-run trend.

In fact, the Fed does not set limits for economic growth. Nor is it necessary that it have precise estimates of full employment. If economic growth is rising sharply above its underlying potential, the disparity will cast a shadow in the form of lengthening delivery times, rising costs for materials, and increased overtime. Rising bond yields and other market signals could provide evidence that inflation expectations are edging up. Similarly, if hiring is surpassing the numbers of new job seekers such that labor cost pressures begin to outstrip gains in productivity, this could be a sign of excess demand that threatens the durability of the economic expansion. In each case, policymakers would have compelling reason to counter these tendencies before they burst forth in higher inflation.

In recent months, despite impressions that the economy is stretching to meet demand, the urgency for action to head off inflation has been lessened in part because we simply have not seen these symptoms of strain develop with the intensity that historical experience would have suggested. Nonetheless, officials inevitably will want to form some

judgments about what full employment and potential growth might be in the period ahead, particularly if demand remains as strong as we have seen in the past year and a half. Had it not been for the unusual surge in the labor force last year, the rapid pace of hiring would have pushed the unemployment rate down to 4 ½% by now, a rate few, if any, economists would deem sustainable. With respect to growth itself, the Taylor rule's inclusion of the gap between actual and estimated potential output could make this tool a useful first approximation of policy's appropriate stance. At present, the rule is prescribing a funds rate very close to the Fed's current 5 ½% target. An alternative version proposed by Federal Reserve Governor Meyer recommends a somewhat higher rate. Our own economic forecast implies that the prescribed funds rate will rise above 6%.

Central Bank Independence: The Fed As Good Citizen

As citizens, we all have a keen interest in the success of monetary policy. As overseer of the value of money and the stability of the financial system, the Fed is guardian of the lifeblood of the market economy. Success in that effort depends crucially on the independence of the central bank. However, the issue of independence has stirred much controversy because it is viewed by some observers as undemocratic. Therefore, we need to clarify what we mean by central bank independence in a democratic society and why it is so vital to economic stability.

The most important element of independence is that the central bank is free to decide how to achieve the goals set by Congress. In turn, it should be understood that, except in the

most extreme circumstances, those judgments are final and cannot be overruled by Treasury. Independence does not mean that the Fed should be free to set its own goals, pursued in a closed fashion, unaccountable to the public.

However, freedom to set strategy and choose the instruments of policy has clear advantages. First, because policy works with a lag, officials often find that their decisions require a long-term focus, that looks beyond the immediate situation. Such long-horizon planning is difficult to achieve in a political setting. Second, because there may be short-term costs to decisions with larger long-term payoffs, a captive central bank would be biased toward inflationary policy. Third, central bankers should be specialized and technically proficient. Economics is not a laboratory science, and -- subject to rules of accountability--, officials should be thoroughly familiar with the uncertainties and complex interactions of the financial system and the economy.

In practice, there is a large and growing body of evidence that supports the logic of central bank independence. The empirical evidence shows overwhelmingly that economic performance is superior in those countries with a high degree of central bank independence (CBI). Researchers have developed a number of benchmarks (based on various legal provisions) for gauging the extent of independence and have related these to measures of growth and inflation. Countries with more CBI have experienced lower inflation without a loss in economic growth. The evidence fully supports economists' notion that there is no long-run tradeoff between inflation and unemployment. While some have found that economic volatility has increased, the U.S. experience has been quite the opposite as we have shown.

This track record has played a role in the spread of independence. Over the past decade, several countries in all regions of the world have fortified the degree of central bank independence. One of the first acts of the new government in Britain earlier this year was to free the Bank of England from the reins of the Treasury.

Superficially, such independence may appear undemocratic. But the goals for the Federal Reserve and other central banks have been established by the public's elected representatives. In countries such as New Zealand and the United Kingdom, the executive and legislative branches have set a specific inflation target and the central bank must aim to hit it. If it misses, the bank must explain why in public. In the same vein, the proposed European Central Bank's mandate is simply price stability, implying that the price target has been set once and for all as approved by 15 legislatures that ratified the Maastricht Treaty. The Fed's objectives have been set by Congress, and its senior officials are appointed with 14-year terms by the President. As amended, the Federal Reserve Act mandates the Fed to pursue "maximum employment, stable prices, and moderate long-term interest rates." It does not say "5% unemployment" or "relatively small increases in the consumer price index." Nor should it. The avoidance of highly specific measures is far sighted and its so-called "dual mandate" assures the public that policy will have a long-term focus because only stable prices will promote maximum employment.

Moreover, the language of the Fed's mandate recognizes the imperfections in the inflation data as well as the inexact channels through which inflation works. After all, inflation ultimately is a process, not a statistic. We cannot know ahead of time how the

misallocation of resources engendered by inflationary policy will show through in the economy. It may appear in the prices of goods and services, but business expansions in the past have ended because of similar distortions in the prices of housing and real estate and the prices of capital goods and financial assets, all validated by excess money and credit. Put differently, Adam Smith and Henry Thornton never saw a CPI, but they understood inflation as well as any macroeconomist.

These uncertainties and the discretionary powers given to the Fed, increase the importance of open dialogue about the conduct of policy. The Federal Reserve must account for its actions and the underlying rationale in forums such as this. This practice results not only in a better understanding of the importance of the Fed's mission but it offers the Fed the opportunity to enhance the credibility of its stated goals. Recent experience has taught us that when a central bank can "walk the walk" as well as "talk the talk," its power to carry out its task and its flexibility to err without serious consequence are strengthened. Although the Fed still has work to do, the current generation of Fed leaders has set a standard for commitment to price stability. In doing so, they have followed the public's will.

Economic Growth Has Become More Stable

(Quarterly Growth in Real GDP, 1968-1Q 97)

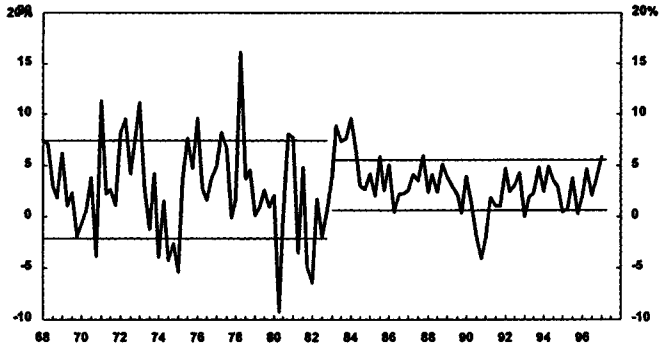


Figure 1 Note: Lines denote average growth for each period plus or minus one standard deviation.

Salomon Brothers

The United States Is Outperforming Other Industrial Countries in the Anti-Inflation Era

(The Sum of Inflation and Unemployment: U.S. vs. OECD)

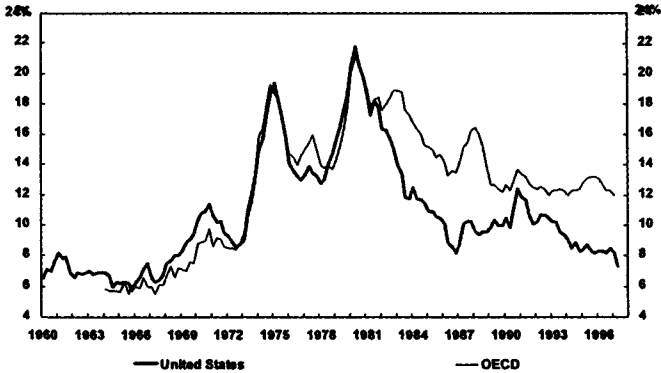


Figure 2

Salomon Brothers

Credit Usage Is Below That of Prior Expansions

Cumulative Percent Change in Domestic Nonfinancial Debt from Trough Month

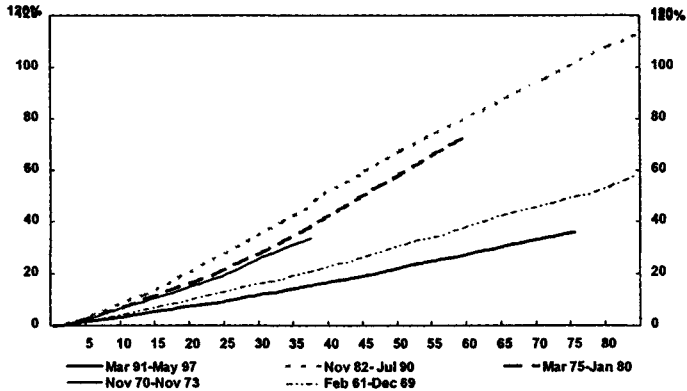


Figure 3
FD-0178

Salomon Brothers

Spread Between Taylor and Actual Fed Funds Rate and Three-Year Core Inflation

Although the Taylor rule cannot be applied mechanically, it has been a good test of policy's general thrust. Inflation has tended to accelerate when interest rates are held below prescribed levels.

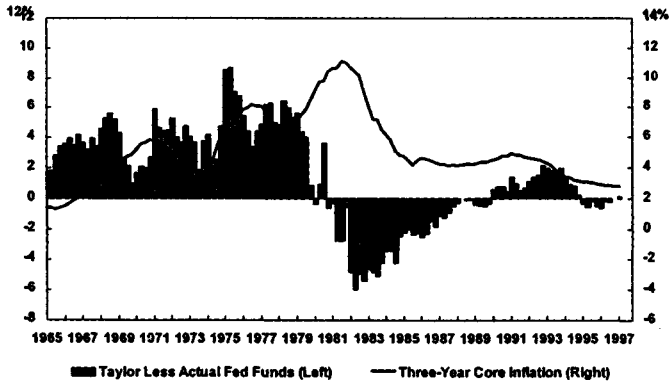


Figure 4
FD-0182

Salomon Brothers

Actual Fed Funds Rate vs. Taylor Rule Prescription

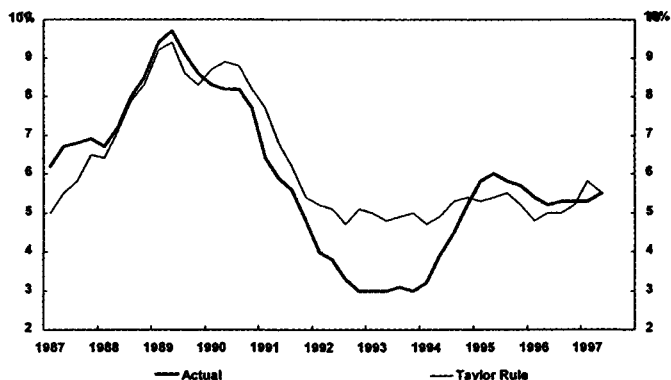


Figure 5
#0226

Salomon Brothers

Real GDP Growth and Changes in Unemployment, 1983-1Q 97

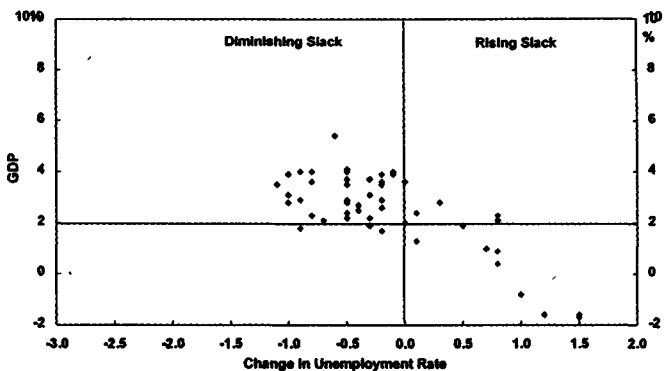


Figure 6
#0227

Salomon Brothers

The Strong Dollar Has Helped to Keep Inflation In Check

(Year-to-Year Inflation With and Without the Rally in the Dollar)

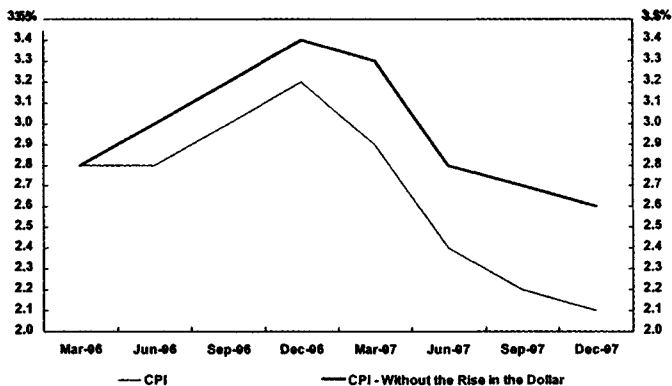


Figure 7

40222

Salomon Brothers

Trade-Weighted Change in Industrial Country Operating Rate vs. Change in U.S. Core Intermediate PPI Inflation

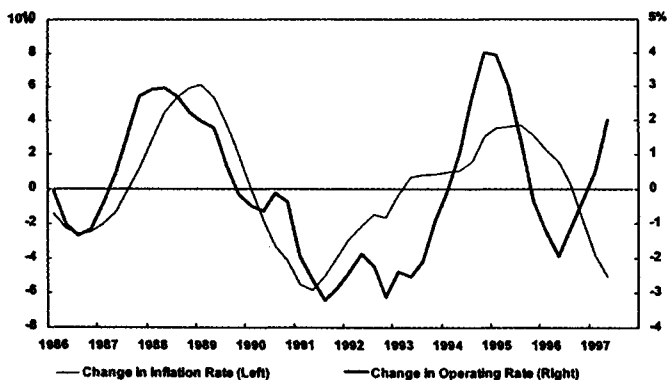


Figure 8

40223

Salomon Brothers

Early Warning Signs On Inflation

Crude Materials In the PPI and Periods of Fed Tightening

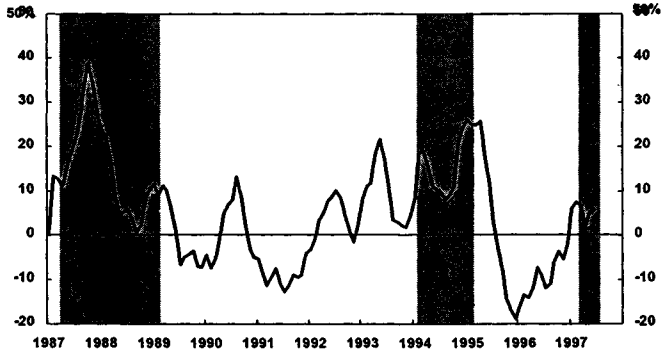


Figure 9

100228

Salomon Brothers

Household Holdings of Risk Assets

(As a Share of Net Worth)

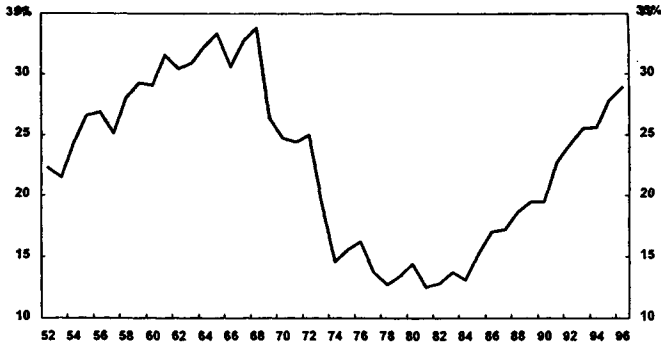


Figure 10

100225

Salomon Brothers

Robert DiClemente
August 15, 1997

Answers to questions.

1. I disagree strongly that there is any real conflict between monetary policy and welfare reform. Indeed, without the Fed's commitment over these past 15 years to reducing economic volatility and promoting lower interest rates by lowering inflation expectations, employment would be lower, joblessness higher and welfare reform would have been less tenable. Lower and lower unemployment has been an indirect benefit of the Fed's policy to create a platform for maximum sustainable growth. As I illustrate in my testimony, economic volatility has been cut in half since 1983 and with the decline in inflation, lenders demand smaller risk premiums. More credit is available to support jobs and investment at any interest rate level than earlier. Today, the percentage of the population employed is the highest on record. Macro policies cannot deal with structural rigidities that make it hard to employ potential workers that lack skills and training. However, policies other than monetary policy are perfectly suited to attacking this issue.

2. Rising wages do not cause inflation and rising unemployment does not cure inflation. Monetary discipline avoids both. Wages rise over time commensurately with productivity. To be sure, if monetary growth is too fast or interest rates are held artificially low, employers can bid wages up as a symptom of excess demand, but the jobs created in this instance are transitory. Real sustained increases in incomes and living standards depend on improved efficiencies and have little to do with central banks.

3. Rising resource utilization, including higher operating rates, and a more fully employed labor force, working longer weeks and record overtime, indicates that demand in the economy has been outstripping our ability to supply goods and services. Those limits appear to have been raised somewhat in recent years, perhaps due to some genuine increase in productivity that has not been adequately measured. However, diminishing slack demonstrates that even with faster trend economic growth, the U.S. economy is spending and investing at an even more rapid rate. I am somewhat concerned that this situation is not sustainable. In recent weeks, commodity prices have been moving higher and delivery times have lengthened (prior to the Teamsters strike). Monetary growth has persisted at the top end of its desired range. These signs may be indicating that policy will need to be tightened modestly in coming months. It is not necessary or even desirable for the Fed to base its judgment on unemployment or the rate of growth. And, I don't believe that all Fed officials do this. If the economy is behaving in a manner that is potentially unstable, it will exhibit these symptoms I mentioned, and officials need not prejudge some appropriate speed limit for growth or unemployment.

Testimony of James K. Galbraith, Professor at the Lyndon Baines Johnson School of Public Affairs and the Department of Government, The University of Texas at Austin, before the Committee on Banking and Financial Services, United States House of Representatives, Hearings on the Conduct of Monetary Policy under the Full Employment and Balanced Growth Act of 1978, July 23, 1997.

Mr. Chairman, Members of the Committee, it is a privilege for me to appear before you today. I have served on the staff of this Committee, and helped to organize hearings on the Conduct of Monetary Policy at their inception in 1975. I helped to draft the provisions of the Humphrey-Hawkins Act that now govern these hearings, and I continued to work on them until leaving for the Joint Economic Committee in 1981. Sixteen years later, I am proud to appear for the first time as a witness.

These hearings are the leading public forum for discussion and occasionally for criticism of monetary policy. I have been very pleased to see a growing agreement that criticism of monetary policy, when warranted, *is* constructive, including important public comments earlier this year by many congressional leaders of both parties. Members of Congress sent a bipartisan message to the Federal Reserve this Spring that interest rates should not be raised without clear and compelling reason. That was the right message to send, I congratulate those who sent it, and I believe the message was heard very clearly.

Partly because of this success, it is not my purpose today to criticize Federal Reserve policy in recent weeks. I would rather review what I believe to have been important progress, with the hope that more progress will follow.

Two years ago, most economists believed in a natural rate of unemployment, at around six percent, below which inflation would start to accelerate unless a tight monetary policy produced new unemployment and took the pressure off. There were just a few of us who disagreed, who urged that we could have steady progress against unemployment without increased inflation.

The evidence is now in, and the verdict is clear: we were right and they were wrong. Unemployment has fallen far below previously-predicted inflation thresholds, and the rise in inflation so far has been negligible. In the past year, real economic growth rates have exceeded the widely-asserted "speed limit" of 2.5 percent by more than a full percentage point, with no bad consequences. We are clearly better off for having supported economic growth and progress toward full employment, even without mentioning the enormous benefits of extra growth for the federal budget, well known to all in this room.

How has the Federal Reserve responded? It is true that a persistent internal lobby has repeatedly pressed for a more restrictive policy as unemployment fell. But for the most part the Federal Reserve has chosen to resist this advice, to hold its fire, to wait and see. Chairman Greenspan's reports take a realistic view of the actual lack of inflation, and they acknowledge that previous forecasts of rising inflation have persistently proved false. I also detect some fitful movement away from the pernicious idea of the pre-emptive strike, the notion that we should launch our anti-inflation missiles even while the enemy is sleeping peacefully in bed.

Instead, the Federal Reserve may be moving toward the view that actions to tighten money and credit, with their harsh consequences for workers and businesses, should be taken only on the basis of firmly accumulated evidence. Since the evidence does not show accelerating inflation, the prudent course is to take as little action as possible. And indeed for most of the past two years, excepting only last March, this wisdom seems to have guided monetary policy.

Let me now turn to an evaluation of the economy. Why is it that inflationary pressures have been absent despite steady progress against unemployment? To some people this appears to be a paradox. In my view, there is no big mystery. The evidence linking low unemployment to rising inflation was never very persuasive, though it has become less so in recent years. And contrary to what many believe, the present expansion has not been particularly strong, so that even those who argue that strong growth normally leads to rising inflation have little ground, as things are, for expecting inflation to rise.

The figures I have attached to my testimony place the current economic expansion in comparative perspective. Figure 1 shows that while our expansion is now the third longest in post-war history, it has been much weaker than the Kennedy-Johnson expansion of 1961-1970 or the Reagan-Bush expansion of 1982-1990. Figure 2 shows that productivity growth has been essentially similar to that in other expansions since 1970, though much lower than in the 1950s and 1960s. Figure 3 shows that progress against unemployment has been at best normal by historical standards, while Figure 4 shows that average real wages have only very recently begun to rise above their stagnant performance in the expansions of the 1970s and 1980s.

Together, these figures paint the portrait of a recovery that is unremarkable by historical standards, well below the performance trends of the 1950s and 1960s. There is therefore no reason to expect "demand-push" inflation to occur. And no such inflation has occurred. As for supply-shocks, we have been fortunate to live in a time of comparative peace and tranquillity, without the cost-inflations that accompanied either the Vietnam war or the troubles in the Middle East of 1973 and 1979.

We should therefore not allow an overly rosy view of recent growth and employment to breed an unwarranted pessimism about inflation. The fact is that while things could be worse, they could also be better. There is more room for additional growth, and it would appear that measured unemployment can continue to fall for quite some time without triggering any inflationary tripwires.

I have dealt elsewhere with my critique of the concept of a natural rate of unemployment, or NAIRU, and have provided the committee with a few copies of a recent article, "Time to Ditch the NAIRU," from the Winter, 1997, *Journal of Economic Perspectives*. Neither I nor anyone else can say with complete certainty that no inflationary barrier exists. I cannot tell you that 4.5 percent unemployment, for example, would be absolutely "inflation-safe." But it is a fact that every previous inflation warning, based on an unemployment threshold estimated by established techniques, has proved a false alarm. At a minimum, therefore, the appropriate diagnosis is, "so far, so good." And the right policy is, at a minimum, "steady as she goes." It is past time to be frightened of shadows.

It is a possibility, today, that the original interim Humphrey-Hawkins targets of four percent unemployment with reasonable price stability might be reached within a year or two, for the first time since the bill was passed. Achieving those targets would have huge benefits. It would raise living standards for working Americans. It would assure achievement of a balanced budget, indeed with room for additional public expenditures and/or tax reductions. If sustained over a long period, genuine full employment would eliminate concerns about the solvency of Social Security, even without program changes, and it would undoubtedly also improve the finances of Medicare. Sustained full employment is also crucial if welfare reform is not to turn into a human and social disaster.

Over the long term, steady full employment would also be the single most important way to reduce inequality in the United States and restore the predominance of the middle class. Figures 5 and 6 illustrate the relationship between unemployment and inequality over a long time span from 1920 through 1992 in the United States. The dark line in Figure 5 is a measure of inequality in the structure of hourly wages, mainly in manufacturing, based on research I will publish in full later this year. It is computed from the data in the Economic Census for the years 1958-1992, and from data collected by the Conference Board and other sources for the years 1920-1947, with some assumptions to fill in the missing years and make the two series compatible. The light line represents the measured rate of unemployment for the same years. Figure 6 presents the same information in a scatter diagram, so as to underline the strong positive association between inequality and unemployment.

Figure 7 shows the relationship between unemployment and the *change* in inequality in hourly wages. This figure illustrates that when unemployment is above a critical value, about 5.5 percent as estimated here, there is a tendency for inequality to rise. High unemployment hurts low-paid workers more than those who are highly paid. On the other hand, when unemployment is below 5.5 percent, there is a tendency for inequality to fall. I have therefore suggested that this critical value become known as the "*Ethical Rate of Unemployment*," and that it be considered a ceiling for the acceptable rate of unemployment in the future.

What should the role of monetary policy be in the pursuit sustained full employment? A policy that simply holds the line on interest rates unless and until an inflation danger becomes unmistakable in the data would not, in fact, be the worst way to proceed. If that is present policy, so much the better.

On the other hand, if inflation has truly receded, we should ask whether current interest rates need to be as high as they are. Real interest rates, adjusted for the present and expected low rates of inflation, remain very high by historical standards, and the fact that they are higher than present rates of real economic growth means a sustained and ultimately unsustainable transfer from debtors to creditors, from the middle class to the wealthy, continues to occur. A return to normal would entail a lowering of the nominal interest rate, bit by bit, over the next several years, undertaken in a determined and credible way so that long-term rates also declined. If we can have full employment and reasonable price stability, as appears possible at this time, then why can't we also have low and stable interest rates?

Congress has an important role in monetary policy. These hearings under the Humphrey-Hawkins Act affirm that while the Federal Reserve has a high degree of independence from the executive branch, it is not a fourth branch of our government, but rather, a creature of Congress. More generally, the Federal Reserve is accountable to the Congress, and it is subject to the will of Congress as expressed by law or Concurrent Resolution. The very fact that the Chairman of the Federal Reserve Board must by law appear before Congress twice yearly is an important symbol of this point.

Congress has indeed been heard from informally on monetary policy in recent weeks, and I believe that timely words from senior leaders in both parties have helped offset pressures from banking and speculative interests who tend to favor higher and more unstable interest rates. If Congress wishes to make further progress, it might consider speaking to the Federal Reserve in formal terms, for example by placing an instruction to the Federal Reserve in a concurrent resolution. There is precedent for this: House Concurrent Resolution 133 in 1975, the resolution that inaugurated these hearings, also instructed the Federal Reserve to conduct monetary policy "so as to lower long-term interest rates." And at the end of 1982, as part of a continuing resolution, Congress ordered that monetary policy "achieve and maintain a level of interest rates low enough to generate significant economic growth and thereby reduce the current intolerable level of unemployment." These are good precedents for future action.

Today, Congress might usefully insist that monetary policy continue to pursue the goals of full employment and reasonable price stability set forth in the Humphrey-Hawkins Act. These goals are now achievable, realistically and within a reasonable time. It would be a crowning act -- for Congress and for the Federal Reserve -- to close out the Twentieth Century by achieving them. The main danger is that the Federal Reserve will be carried away by discredited dogmas and unwarranted fears. A "hold the course" instruction would help to prevent this, particularly if the Federal Reserve were also told that actions to raise interest rates would have to be justified in detail before Congress on grounds of actual evidence of rising inflation.

If full employment and price stability are indeed truly to be obtained, Congress also has to beware of rash fiscal policies that might upset our present economic balance. It is a mistake, in a recession, to react to a rising budget deficit by pursuing a tighter policy -- by raising taxes and cutting spending. It is just as serious a mistake to react to full employment by cutting taxes too sharply. In both cases, policies driven by the superficial arithmetic of the budget can be profoundly counterproductive for the economy.

Despite claims that tax cuts raise saving and investment, the truth is that all tax cuts, even cuts in capital gains taxes, stimulate consumption above all. An excessive tax cut will trigger a sharp increase in consumption of manufactured goods. Since we are near full employment in manufacturing, such additional goods will be supplied from abroad. The first consequence of a large tax cut now is therefore a sharp rise in our trade deficit -- something that happened in a big way following the tax cuts of 1982-84. There is therefore the possibility that instead of an inflation crisis, we may generate for ourselves a crisis of the trade balance. The tempting way way to deal with such a crisis, in the short run, would be to raise interest rates and so to generate higher unemployment and once again reduce consumption.

Down that road, I fear, lies the dissipation of the gains we have made so far in this expansion, and the wreckage of our best hopes for sustained full employment with reasonable price stability and reasonably balanced trade. Certainly we should be wary of a potential economic slowdown, and we should be prepared to counter that eventuality if the evidence warrants. But just as we should not be too jumpy about inflation, so also we should not be too jumpy about recession. The path of wisdom at the moment, I believe, is for Congress as well as the Federal Reserve to refrain from major policy changes and to await developments, while pressing the economy gently forward. Certainly if the choice in effect is between cutting taxes and a gradual reduction in interest rates, we should choose lower interest rates rather than lower taxes.

The point of getting to full employment and of staying there is that sustained prosperity generates increased federal revenues with a given tax structure, even as it brings about a reduction of poverty and even as it strengthens the middle class. There will therefore be plenty of time ahead, if we are successful, to discuss whether to distribute the full employment dividend primarily to the wealthiest taxpayers, as some would favor, or to invest it in direct solutions to our pressing social problems. We should not be rushing toward either objective, lest we foster instability and kill the goose that is laying the golden egg. The most important thing is not to endanger sustained growth and a steady reduction of unemployment, recognizing that the point of reaching full employment is not simply to touch the goal for a month or two, but to reach it and hold it for the longest possible time.

I hope this testimony has been of some use to the Committee and I stand ready to answer any questions.

Figure 1

A Below-Average Expansion...

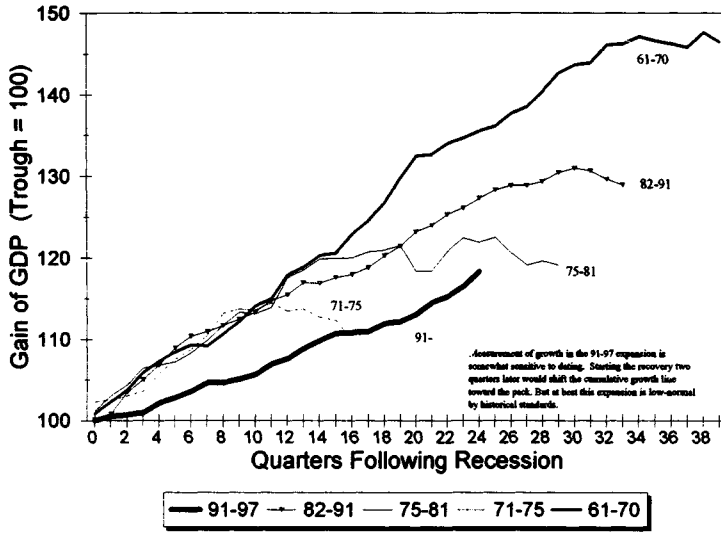


Figure 2

...with Low-Normal Productivity Growth

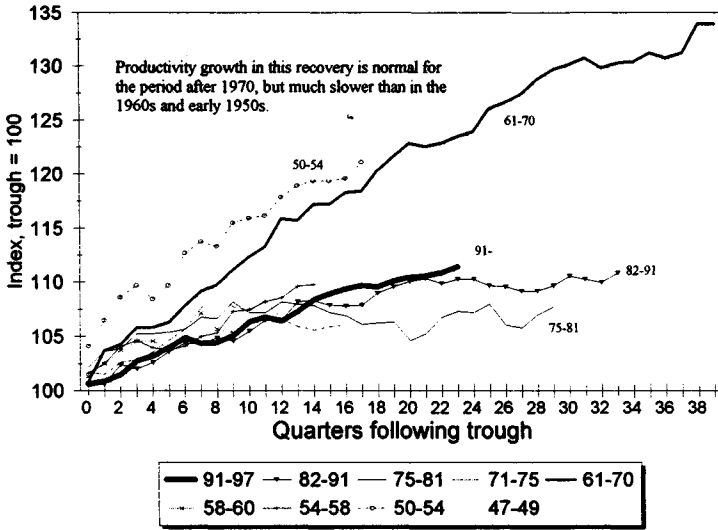


Figure 3

...Moderate Progress on Unemployment..

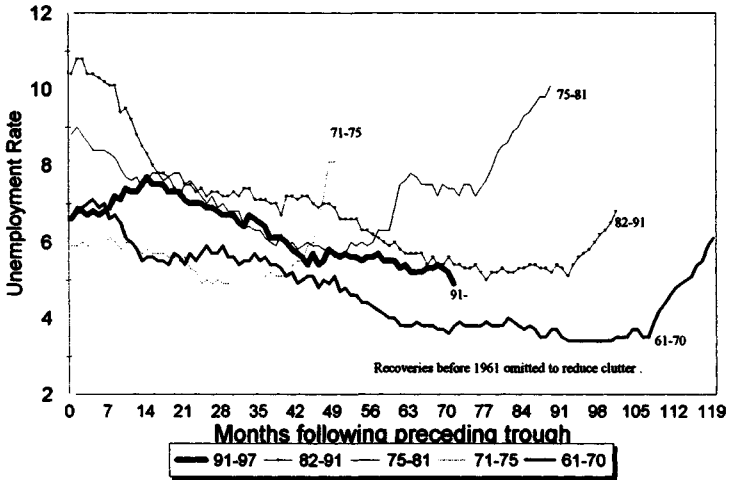


Figure 4

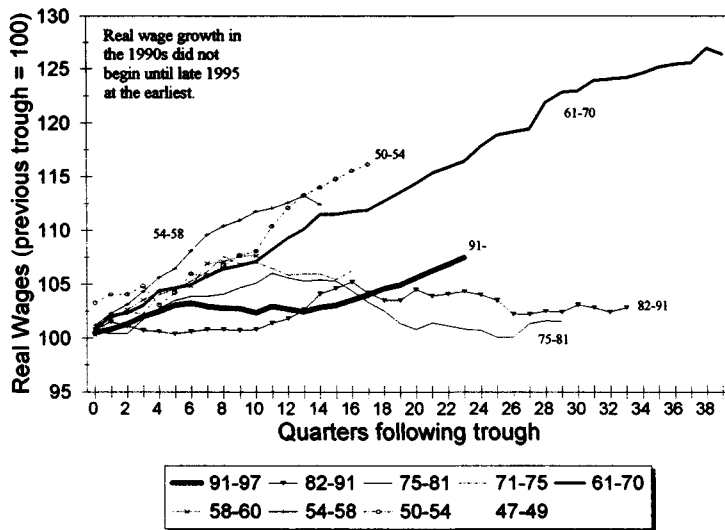
...And Stagnant Real Wages

Figure 5

Inequality and Unemployment, 1920-1992

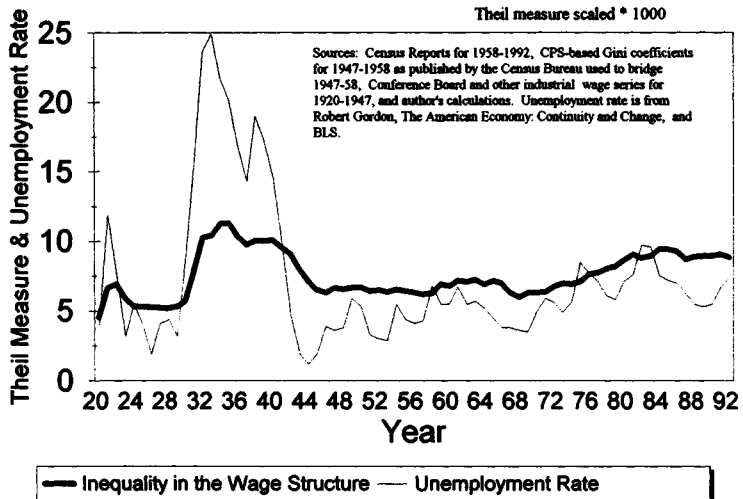
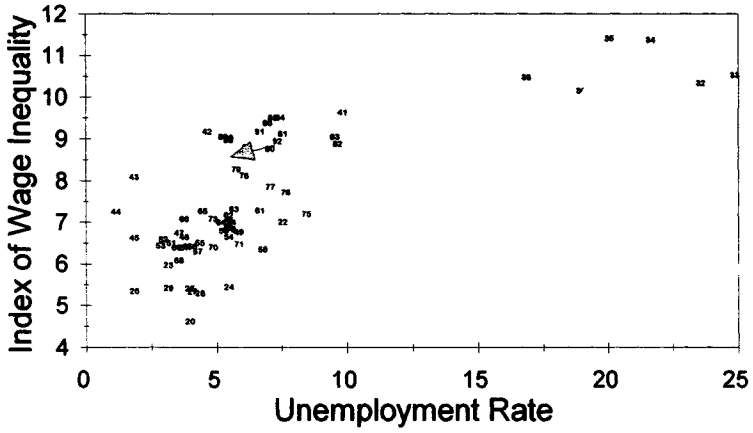


Figure 6 **Unemployment and Wage Inequality**
 1920 to 1992

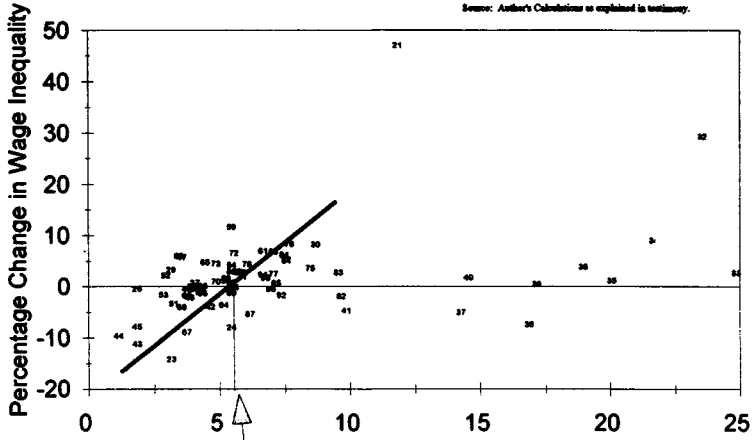


Arrow indicates approximate current position.

Figure 7

The Ethical Rate of Unemployment

Source: Author's Calculations as explained in testimony.



The Ethical Rate of Unemployment is defined as that rate below which inequality tends to decline, and above which inequality tends to rise.

James K. Galbraith
Answers to Questions posed by Congressman Jackson
Hearing of July 23, 1997

1. Fed Policy and Welfare Reform on a Collision Course

A potential collision between monetary and welfare policy is a serious concern. Monetary policy controls the supply of the unemployed. If the Federal Reserve acts to raise interest rates and produce unemployment, as it has done on numerous past occasions, then the resources now available to the states for the block grants that have replaced AFDC will quickly be overwhelmed, and many families that would have been eligible under the old welfare system will be left without that assistance.

At the same time, the fact that we do not now have an intense crisis of welfare policy owes something to the fact that the Federal Reserve has permitted unemployment to fall to five percent and lower. This is a major factor behind declining welfare caseloads to date, and the fact that even diminished block grants have been for the most part sufficient to replace AFDC in the short term. Unfortunately, this situation will not survive if the Federal Reserve tightens policy.

There are two possible solutions to the dilemma. One would be to restore automatic eligibility for safety-net programs. The other would be to pursue a policy of sustained full employment. To the extent that the first is politically unrealistic, it seems to me that the second is imperative.

2. Impact of Wage Increases

There is very little evidence that wage increases have been the major force behind inflation in the United States in modern times. Rather inflationary episodes have been the result of wars, oil shocks, and to some degree of institutional disequilibria in particular sectors such as health care. The recent rise in the minimum wage had no perceptible inflationary impact. A moderate rise in real wages therefore should not be viewed as a significant inflationary threat. To the contrary, moderate but sustained increases in real wages should be a principal objective of economic policy.

3. Is There Any Indication of an Inflationary Threat?

There has been no serious indication of accelerating inflation in the expansion so far. This may be, in part, because the expansion is not very strong by historical standards. Increased cost pressure from globalized manufacturing also plays a role. At any rate, we are not experiencing "rapid growth" by any historical measure. Should we pursue a policy that did lead to rapid growth and full employment, we would have a better test of whether inflationary pressures have subsided for structural reasons, or whether we need to reconsider the kind of anti-inflation policies -- such as the wage-price guideposts of the 1960s -- that have been used in the past to reconcile high growth, full employment and reasonable price stability.

Time to Ditch the NAIRU

James K. Galbraith

The concept of a natural rate of unemployment, or nonaccelerating-inflation-rate-of-unemployment (NAIRU), has ruled macroeconomics for about 25 years. Yet it is still controversial. A wide range of views exists over how the NAIRU should be estimated, a fact that in itself raises questions about the practical usefulness of the concept.

This essay presents a brief for no-confidence, in four parts. First, the theoretical case for the natural rate is not compelling. Second, the empirical evidence for a vertical Phillips curve and the associated hypothesis that lowering unemployment past the NAIRU leads to unacceptable acceleration of inflation is weak, and has become much weaker in the past decade. Third, viewed collectively, attempts to estimate the location of the NAIRU have become a professional embarrassment; disagreements remain on too many basic issues. Fourth, adherence to the concept as a guide to policy has major costs and negligible benefits. Conversely, the risks of dropping the natural rate hypothesis are minor, while the benefits from a sustained pursuit of full employment could be substantial.

Unresolved Theoretical Questions

The idea of the “natural rate of unemployment” is usually traced to the work of Milton Friedman (1968) and Edmund Phelps (1968). Specifically, the natural rate was born in Milton Friedman’s remarkable 1968 presidential lecture to the American Economics Association, as close as economists get to delivery from Olympus. Perhaps no other presidential address has ever been so influential.

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Before Friedman's lecture, most American economists accepted a stable Phillips curve as the best concise statement of the relation between the unemployment rate and inflation. Friedman introduced an expectations function into the Phillips curve, so that the inflation rate would now depend on both unemployment and past inflation expectations. Friedman showed that in his model, the expected rate of inflation predicts the actual rate of inflation only when unemployment is held at an equilibrium value, the natural rate.

Thus, Friedman drew the distinction between the short run, when variations of unemployment could affect inflation, and the long run, when, by construction, unemployment could not vary. Within the terms of this thought experiment, efforts to reduce unemployment below its natural rate equilibrium would appear successful in the short run, but would soon generate accelerating inflation, whose intolerability would force a retreat to the natural rate.¹

This argument swept the field, yet it is open to questions that were not widely raised at the time. First among these concerns are the shortcomings of the Phillips curve itself and, specifically, its lack of theoretical justification. The Phillips curve had always been a purely empirical relation, patched into IS-LM Keynesianism to relieve that model's lack of a theory of inflation.² Friedman supplied no theory for a short-run Phillips curve, yet he affirmed that such a relation would "always" exist. And Friedman's argument depends on it. If the Phillips relation fails empirically—that is, if levels of unemployment do not in fact predict the rate of inflation in the short run—then the construct of the natural rate of unemployment also loses meaning. This empirical issue, which is more troubling than most suppose, will be discussed in the next section. For the moment, it is sufficient to note that a theoretical argument that rests on an atheoretic foundation is likely to run into trouble sooner or later.

Friedman may have sensed this. For while his core argument was macroeconomic, a gloss on then-prevalent Keynesianism and the Phillips curve, he also phrased a version of it in microeconomic terms. According to this alternate version, the natural rate of unemployment is the point of intersection of supply and demand curves in an aggregate, classical market for labor. The two versions are quite distinct. If the main line of Friedman's argument concerning a vertical Phillips curve led toward a nonaccelerating inflation rate of unemployment, the notion of an aggregate labor market pointed the way toward the New Classical model. Friedman (1968, p. 8, emphasis added) said:

¹ Some readers may find it helpful to see this argument in algebraic form. Assume a linearized, expectations-augmented Phillips curve of the form $P_t = \alpha - \beta U_t + \gamma_{t-1} P_t$, where P represents the rate of inflation, U the rate of unemployment, $\gamma_{t-1} P_t$ represents the expectation held at time $(t - 1)$ of inflation at time (t) , and γ is a parameter governing the speed of adjustment of actual to expected inflation. The Phillips curve must be vertical at a long-run equilibrium unemployment rate: $U^* = \alpha/\beta$. Under the conditions discussed in the text, it follows that if $U < U^*$, then $P_t > \gamma_{t-1} P_t$, the conditions for equilibrium are violated, and expectations and actual inflation must chase each other upward in an accelerating spiral. Only at U^* will inflation be sustainably stable.

² James Tobin once elegantly described the Phillips curve as a set of empirical observations in search of theory, like Pirandello characters in search of a plot.

At any moment of time, there is some level of unemployment which has the property that it is consistent with equilibrium in the structure of *real* wage rates. At that level of unemployment, real wage rates are tending on the average to rise at a "normal" secular rate. . . . *A higher level of unemployment is an indication that there is an excess supply of labor that will produce downward pressure on real wage rates.* The "natural rate of unemployment," in other words, is the level that would be ground out by the Walrasian system of general equilibrium equations, provided there is embedded in them the actual structural characteristics of the labor and commodity markets. .

Such a labor market is free of money contracts and money illusion. Employment is purely a function of the real wage, acting on the marginal physical productivity of labor and on the marginal disutility of work. In such a market, nominal shocks can have only nominal, not real, effects: money (for which, read macroeconomic policy) is neutral, perhaps even in the short run. Friedman's formulation states explicitly that persistent unemployment below the natural rate must lead through the labor market to rising real wages, whose nominal element is at least the proximate cause of rising prices.

This story is pre-Keynesian in all its essentials. And the essential theoretical objections to it were set forth by Keynes (1936) in the *General Theory*. First, labor supply and demand cannot be modeled in terms of the real wage, for workers care about relative wages as well as real wages; this introduces an asymmetry between nominal wage cuts and nominal price increases. Second, workers cannot actually negotiate for their own real wages, because of an interdependency between money wages and the price level. These two objections, which are the foundations of the *General Theory*, undermine the concept of the labor supply curve (the "second classical postulate," as Keynes called it) and hence the very construct of an aggregative "labor market." The neoclassical synthesis buried these objections issue long ago, but never actually resolved them.

If there is no aggregative labor market in any sense meaningful to economics, then theories based on shifts in wages clearing labor markets will fail to hold. From a proper Keynesian perspective, the correct response to the neo-Walrasian formulation of the natural rate hypothesis is simply, "Sorry, but the 'labor market' is a misconception; it doesn't exist." Aggregate demand for output, and not supply and demand for labor, determine employment. By these lights, the aggregative labor market, lacking a defensible supply curve as well as any internal clearing mechanism, is simply a failed metaphor, unsuitable for use as the foundation of a theory.

A further line of objection to theory of the natural rate also has its roots in Keynes. Is long-run equilibrium really a good guide to macroeconomic policy? Friedman's NAIRUvian long run and the more strictly classical natural rate, based on rational expectations, are certainly beguiling. But are they relevant? Information may be asymmetric. Competition may be monopolistic. Nonlinearities and even chaos are possible. Equilibria may be multiple or continuous. In such cases, the long-run equilibrium may be undetermined or incalculable or beyond achievement. To put it another way, the future may be inherently unpredictable. Here, the

political scientists with their concept of “rational ignorance” may have something to teach economists. In a world of rational indifference, of a principled refusal to compute, surely all significant change is essentially unexpected, the short-run relations are what matter, and policies will usually work in the short run. As Robert Lucas (1981) once observed, the long run is no more than a sequence of steps that each occur in the here-and-now. If short-run policies necessarily fail—the Lucas position—you must live by the long run. But if short-run policies actually work—the Keynes position—it is fruitless to look that far ahead, and what you have to do is work from one short run to the next. The point is that one must choose one construct or the other, rather than trying to split the differences or otherwise base policy on both at the same time.

To be sure, these objections are easier to make in retrospect. In 1968, mainstream American Keynesians were committed to Samuelson and Solow’s (1960) version of the Phillips curve, so they could not object to Friedman’s specification that inflation was a function of unemployment and other factors. Being neoclassical synthetists, they could also hardly deny a role for expectations, nor that expectations must be satisfied in the long run, nor the policy relevance of the long run, nor that there existed a Walrasian aggregate labor market—a concept they had themselves resurrected in defiance of Keynes. The rhetorical power of Friedman’s argument was thus especially great against his American Keynesian targets. And so the game Friedman started, which was the search for a macroeconomics with suitably orthodox “microfoundations” in a proper classical labor market, has been going on ever since. Only the truest Keynesians—such as Nicholas Kaldor (1983) in the United Kingdom, Robert Eisner in the United States, and the post-Keynesians, generally speaking—could escape Friedman’s trap.

The Mismeasure of NAIRU

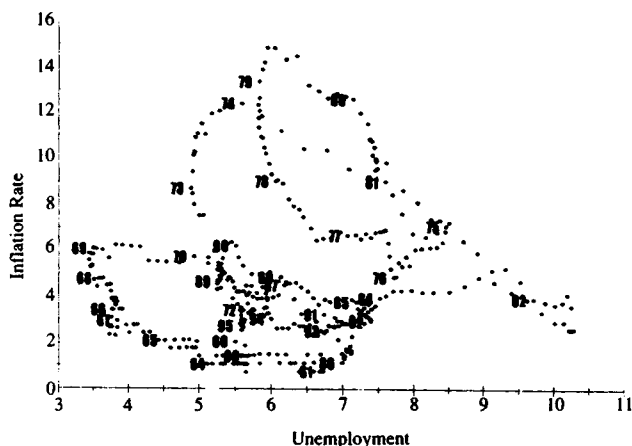
Supporters of the natural rate and the NAIRU tell an enticing story about how the inflation of the 1970s proved their theory correct. Robert Lucas (1981) summarizes the story well:

Now, Friedman and Phelps had no way of foreseeing the inflation of the 1970s, any more than did the rest of us, but the central forecast to which their reasoning led was a conditional one, to the effect that a high inflation decade should not have less unemployment on average than a low-inflation decade. We got the high inflation decade, and with it as clear-cut an experimental discrimination as macroeconomics is ever likely to see, and Friedman and Phelps were right.

This sweeping conclusion has been widely accepted, and it has had the effect of bolstering a weak theoretical argument with the authority of unpleasant fact. But is it right? Do the data still support the claim 15 years further on?

Figure 1, similar to diagrams in many textbooks, shows the breakdown of the short-run Phillips curve after 1969. In Figure 1, the dots represent monthly moving

Figure 1
Inflation and Unemployment
(12-month moving averages, 1960–1996)



averages (over 12 months), with yearly labels inserted at mid-year. At a glance, Figure 1 does resemble a shifting set of short-run Phillips curves. For example, one can pick out a constellation in the lower left for the 1960s and another constellation in the upper center representing the late 1970s, after the second oil shock. But on average, taking the data as a whole, there is only a very modest inverse relation between inflation and unemployment. Clearly, the range is very wide, with much horizontal movement; it's hard to look at this data and visualize a vertical long-run Phillips curve running down the middle. Moreover, the main upward thrusts contributed by a fairly small number of inflationary months—in the late 1960s, in 1973 and in 1979.

More important, the figure is not symmetric; Eisner (1996) explores this issue in persuasive detail. Leftward movements, when unemployment is falling, are substantially horizontal. In each expansion from the late '60s to the mid-'90s, inflation rose little as unemployment fell. However, rightward movements as unemployment rises do result in a fall in inflation. Recessions are indeed disinflationary, as no one disputes, and the disinflation is strong in the early phases, while unemployment remains comparatively low. However, additional very high unemployment adds little extra to disinflation.³

³ The slope is such that a 1 percent fall in unemployment means nearly a 1 percent rise in inflation. For the sake of the Phillips curve, at least the sign is correct, but the estimate is not statistically different from zero. As unemployment rises, a 1 percent rise in employment brings a 2.75 percent fall in inflation. This estimate has a 95 percent confidence interval of about 1.6, and thus it is significantly different from zero.

Table 1
Simple OLS Regressions of Inflation Acceleration on Unemployment Monthly Data

<i>Sample Period</i>	<i>Constant</i>	<i>Coefficient</i>	<i>R-Squared</i>
1960–1996	.121	–0.019 (3.58*)	.029
1960–1967	.132	–0.020 (2.49*)	.063
1968–1983	.132	–0.021 (2.31*)	.027
1984–1996	.017	–0.003 (0.30)	.0006

* Indicates significant at 0.01 level.

Notes: *T*-statistics in parentheses. Independent variable is monthly unemployment; dependent variable is monthly change in CPI-U inflation rate, taken as a 12-month moving average for the following year. These regressions are offered for purposes of illustration only.

For further evidence, consider the results of a too-simple regression, offered purely for the purpose of illustration, where unemployment and a constant term are used to explain the acceleration of inflation in monthly data. Table 1 presents the results of this regression for 1960–1996 and for three subsets of that period: 1960 to 1967 (ante-Friedman), 1968 to 1983 (the years of monetarist ascension) and 1984 to the present. The first two periods provide nearly identical, small-but-significant support for the hypothesis that lower unemployment leads to accelerating inflation. The third period offers no such connection.

Even when the relationship between unemployment and inflation was statistically significant, the very low *R*-squareds in Table 1 make clear that unemployment explained only a small part of the variation in inflation. The coefficient estimates also argue that even if a persistently low unemployment rate would have accelerated inflation, it would have done so quite slowly, with plenty of time to reverse policy if need be. (This point is strongly supported by other work in this symposium, including the papers by Gordon and by Staiger, Stock and Watson, and does not depend on whether one accepts the NAIRU as a theoretical device or not.) The fundamental policy implication of the natural rate hypothesis is that of tight limits on the rate of economic growth, lest inflation accelerate beyond control. However, the empirical evidence is in almost uniform agreement that inflation is highly inertial and that whatever limits may exist are at worst highly elastic.

The NAIRU hypothesis is related to the older Keynesian idea, introduced in the 1962 *Economic Report of the President*, of potential GDP and the GDP gap. As an empirical matter, gap analysis is often still used for rough-and-ready assessments of distance to the NAIRU. Here too, there are reasons to treat the evidence with caution.

A typical method of calculating the growth rate of potential GDP is to look at, say, the peak-to-peak annual growth rate from 1973 to 1989 to show that 2.5 percent,

or thereabouts, represents the long-run growth ceiling of the economy. But this extrapolation from one business cycle peak to the next interjects a fatal assumption: that the peaks are exogenous. All a peak means is that something happened to slow down productivity growth; the economy hit a new set of limits. Just what those limits were and why they changed remains a professionally troublesome mystery—unresolved at present after 25 years of research—as troublesome as the estimation of the NAIRU and, I believe, for a closely related reason.

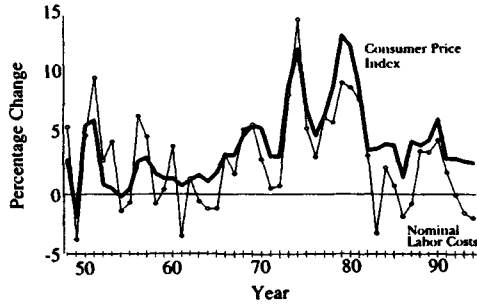
To understand the potential difficulty, suppose that erring policymakers have in the past reacted imprudently to “supply shocks” in ways that prematurely and systematically curtailed economic expansion. In that case, the business cycle peak is endogenous to policy. Suppose they did this because of the rise of a false doctrine of limits—such as the natural rate hypothesis. It is then possible that if growth policies had been more sustained, disciplined and aggressive, then the perceived decline in the trend productivity growth rate would have been smaller than it was, and the estimated natural rate would also have been lower than it has appeared to be.

The point is not that I can offer proof of such a hypothesis, but that economists cannot distinguish this possibility from the idea of an exogenous peak. We cannot reject the possibility that macroeconomic policy has been in thrall to the illusion of a supposedly objective, but in fact self-induced, decline in the trend rate of productivity growth, and that we have been running from the phantom of accelerating inflation for more than two decades. The result: a self-inflicted wound, a sociopsychological disability, of colossal proportions.

One disquieting clue in all of this, which like the productivity slowdown is usually treated as an empirical puzzle, concerns the behavior of wages. Surely, if the natural rate hypothesis means anything at all, it must imply that inflation stems from pressure in the labor market and is therefore wage driven. As noted earlier, Friedman’s formulation states this explicitly, arguing that a link exists from persistently low unemployment in the aggregate labor market to higher wages, which in turn lead to rising prices. While Gordon in this symposium argues that including wages in the model is a mistake, it is very hard to understand what the theory of a special link between unemployment and inflation can be, if it does not involve pressure through the labor market on wages and costs.

But the United States has not experienced wage-led inflation since the 1950s, except briefly in 1973, as shown in Figure 2. Since 1973, average real wages have by most measures been stable or falling. All accelerations of inflation have been led by commodities, especially oil, or by import prices via devaluation. Why not therefore conclude that the economy has almost always been *above* the NAIRU during this time and that the inflation rate should have been falling and even negative, but for these other factors? For that matter, why are no general equilibrium theorists proposing the NAIROP, or non-inflation-accelerating rate of oil production, or the NAIRODD, non-inflation-accelerating rate of dollar devaluation? What we seem to hear, instead, is an argument that NAIRU estimates ignoring wages “work better,” leaving us in the dark as to *why* the unemployment rate should be connected to the price level, and with the suspicion that, as with the old unexplained Phillips curve,

Figure 2
Inflation and Labor Costs, 1948–1994



the empirical good times (such as they are) must sooner or later come to an unexplained end.

The Shifting NAIRU

A large literature now exists on estimating the natural rate of unemployment, or the NAIRU. For a stationary NAIRU, simple expressions can be derived. In general, these rest on a regression framework that explains inflation with unemployment, some proxy for inflationary expectations such as lagged inflation, and other economic variables. In this approach, when the other factors are held constant, and the coefficient on the past inflation is such that inflation is not changing, then all that's left is to find the unemployment rate that matches this stable rate of inflation. One alternative approach rests on the individualized ratio of job separation to job finding—a structural characteristic of the labor market in steady state (Hall, 1979).

When these studies have specified that the natural rate be fixed, the estimates have had rather large statistical error terms. When the studies have allowed the natural rate to move, it has shifted considerably. For example, according to characteristic estimates by Adams and Coe (1990):

The natural rate of unemployment is estimated to have increased steadily from 3.5 percent in the mid-1960s to a peak of 7.25 percent in 1980, and then to have fallen back to about 5.75 percent in 1988. . . . Thus, roughly half of the increase in actual unemployment rates from the mid-1960s to their peak in the early 1980s can be attributed to increases in the natural rate.

Estimates of the NAIRU were at 6.0 percent or so for the overall unemployment rate following the recession of 1990, and many insisted they would stay there. At

present writing, they have generally fallen to 5.5 percent or lower.⁴ As in the past, the present estimates and reestimates seem largely a response to predictive failure, though models are now emerging that incorporate time variation (Gordon, this issue). Yet since the general abandonment of Perry-weighting for the changing demographic composition of the workforce some years ago (Perry, 1970), we still have no theory, and no external evidence, governing the fall of the estimated NAIRU. We simply observe that inflation hasn't occurred, and so the previous estimate must have been too high.

In general, the estimated NAIRU in a variety of studies has tracked the actual unemployment rate sluggishly. When unemployment rises, analysts tend to discover that the demographic characteristics of workers are deteriorating, or that the job-wage and wage-price dynamic has become unstable (Gordon, 1988). And then the unemployment rate drifts down again, those flaws mysteriously begin to disappear, and a lower NAIRU is estimated. Recent empirical studies like Eisner (1996) and Fair (1996) have confirmed this instability, both across time and in transnational comparisons.

It is often necessary to revise a parameter once or twice in light of new information. Differences of specification are also normal in the early stages of scientific inquiry. But to hold to a concept in the face of 20 years of unexplained variation and failure of the profession to coalesce on procedural issues is quite another matter. This record has become an embarrassment to the reputation of the profession. In saying this, I do not disparage any individual's work. My point is that momentous decisions of public policy cannot depend on the track record of any individual theorist or econometrician, however reliable that person's work has proven. It is necessary for the issue to be settled. If professional economists want to be taken seriously on the NAIRU, they have to come to agreement. Judging from this symposium, agreement on even the present location of the NAIRU or its confidence interval remains far away. Nothing remotely resembling the unified policy view of the 1960s Keynesians, with their commitment to the pre-NAIRU Phillips curve, exists today.

The innovation of a time-varying NAIRU, though attractive in the face of the record of stationary models, seems unlikely to resolve the practical problem. For now we need agreement not only on a value, but on the process generating the value. How likely is this, given for instance the present disagreement over so basic an issue as whether wages belong in a price equation? Or consider what time variation adds to policy discussion. If the implication of time-varying NAIRU models is that unemployment can be pushed down slowly, well past previously imagined limits, with the NAIRU in tow, well and good. But you can reach that conclusion without a NAIRU model; nobody argues for a crash program to achieve 3 percent unemployment next year. On the other hand, if the implication is that one must base interest rate policy on the ever-changing output of a computer model, I think

⁴ Mercifully, Akerlof, Dickens and Perry (1996, p. 43, Table 5) have produced estimates of the NAIRU ranging from 4.6 to 5.3 percent, in good time for the September 1996 reduction of the actual unemployment rate to 5.1 percent.

policymakers will wisely assign estimates a low weight to estimates of the time-varying NAIRU. And if the implication is that next year's NAIRU is a random walk from this year's, the practical consequence is not much different from that of abandoning NAIRU models altogether.

Can you imagine a petition, even from those contributors to this symposium who defend the idea of the NAIRU in their own research, calling on the Federal Reserve to raise interest rates sharply at the present 5.1 percent unemployment in order to ward off imminent inflation? Can you imagine such a petition being greeted with general approval across the economics profession? If you cannot imagine such a thing—for a contrast, one thinks of Einstein's 1939 letter to Roosevelt on the possibility of the bomb, something that conveyed definite information from a figure of authority backed by his colleagues—then we as a scientific profession have not advanced this concept to the point where it is suitable for practical use. Almost 30 years after Friedman's (1968) address, it is a fair question whether we will ever do so.

The Costs of NAIRUvianism

Speaking politically, the natural rate hypothesis has served a conservative cause. Since Friedman's speech, orthodox macroeconomics has virtually always leaned against policies to support full employment. In spite of stagnant real wages, it has virtually never leaned the other way.

For strict New Classicals, this effect must be forgiven. The logic of their case imposes opposition to all policies affecting employment through aggregate demand. But for NAIRUvians, who believe that demand policy may have an appropriate role in engineering "soft landings" at the NAIRU, it seems to be a matter of curiously irrational, systematic error. Some economists have been more eager to raise their estimate of NAIRU than to cut it. The NAIRU, like the wage rate, is downwardly sticky.

When a higher NAIRU accompanies higher unemployment, it cuts against the case for a policy of expansion, since a higher proportion of the existing unemployment is seen as necessary to preserve stable inflation. When unemployment is falling, a downwardly sticky NAIRU bolsters the natural caution of many economists concerning progrowth policy intervention. In consequence, policymakers are almost *never* presented with a clear case, based on natural rate analysis and supported by a consensus of NAIRU-adhering economists, for a proemployment policy.⁵ This pattern continues right up to the present, as some economists who a year ago insisted that the natural rate was 6 percent now insist on 5.5 percent, or perhaps 5 percent. Lower estimates will be forthcoming, after the fact, if unemployment continues to fall and inflation does not increase. But by then it will be too late, and potential gains from having the estimates in hand now will have been lost.

⁵ Come to think of it, if the process were symmetric, wouldn't New Keynesian economists be expected to take this position about half the time? An interesting hypothesis, suitable for further research.

Economics has in this way talked itself out of a role in solving the central macroeconomic problems of unemployment and stagnation. Taxonomy—the empty art of labeling existing unemployment as “structural,” “frictional” or “cyclical”—has substituted for the development of theory bearing on action. The theories that have developed reinforce the message implicit in the taxonomy chosen: once frictional, structural and cyclical unemployment are allowed for, there is truly nothing left to be done. The cost of unnecessarily high unemployment itself must therefore, to some extent, rest on the conscience of the economics profession.

There is a second cost to this style of thinking, one that falls on the economists rather than on the economy. This is a loss of influence. It is one thing to position oneself in the center of gravity of a national political debate, where one can condition theory with circumstance, address important problems, and recommend now one thing, now another, as conditions change. It is something else again to be always singing the same note, always revisiting the same issue, always revising past estimates, coming up with the “new NAIRU” and the “new new NAIRU” as though it were a matter of a political makeover. People stop paying attention, and rightly so.

All of this matters, of course, only if the unemployment itself is truly costly, all things considered. If a 5.1 percent unemployment rate is no improvement over 5.5 percent, why not go back to the estimated NAIRU and play it safe?

Analyses of the costs of unemployment typically focus on the unemployed themselves or on their immediate families and neighborhoods. When the actual unemployment rate falls to its present 5 percent range, opinions differ. Seven million citizens continue to seek work they cannot find. Another 700,000 or so are counted as discouraged, and some 4 million more are working part-time involuntarily. Millions more are working full-time in jobs that they would like to change if alternatives existed.

I believe these numbers remain far too high, particularly given the maldistribution of unemployment and the social pathology of having high rates of it concentrated in inner cities or among minority groups. Other economists obviously take a more sanguine view. But my point here is that the effects of unemployment are not isolated or confined to the unemployed; rather, they extend throughout the economy, to a matter that affects us all. Specifically, empirical researchers are now increasingly finding a link between unemployment and economic inequality, generally speaking (Danziger and Gottschalk, 1995; Karoly, 1996).

My own work strongly confirms the link between unemployment and inequality in the structure of wages. In recent and forthcoming work, Ferguson and Galbraith (1996) and Galbraith (in progress) have examined this relation for the periods 1920–1947 and 1958–1992, for fairly comprehensive wage data sets covering manufacturing, agriculture, utilities and transportation in the earlier period and all of manufacturing in the later one. The focus on the wage structure is a departure, with the virtue that it disregards the influence that unemployment undoubtedly has on inequality of income between those who are employed and those who are not. Our data isolate the change in dispersion of hourly wages among those who remain employed, when unemployment varies. We find that unemployment is a predominant cause of increased hourly wage dispersion in both periods, though

the picture is somewhat more complicated in recent years than in the earlier ones—inflation and the exchange rate also play a role in increasing inequality in the modern wage structure. The underlying intuition is straightforward. In periods of high unemployment, low-paid and weakly protected workers suffer wage erosion, relative to those in better paid, better organized and more skill-intensive occupations. In the pre–World War II data, this effect occurs mainly through the co-occurrence of mass unemployment and price/income depression in agriculture.

My conclusion is that high measured unemployment reflects conditions that have pernicious effects throughout the structure of wages and incomes. These conditions work to split the wage structure. They undermine the middle-class character of society, and they separate the comfortable from the poor. The relation between unemployment and inequality is therefore an additional reason for devoting intellectual and material resources to the pursuit of full employment. It also makes it reasonable to ask that advocates of speed limit theorems and natural rate hypotheses prove their cases convincingly and in a unified way, something that in three decades they have not done.⁶

What To Do About Inflation?

If we are stuck in the short run with a still-serious unemployment cum inequality problem, and if we reject the practice of using an estimated NAIRU as a serious guide to where to stop the reduction of unemployment, then what theory of inflation should we hold and what should we do about that risk?

I have devoted most of this essay to an attack on the NAIRU as it often enters the policy discussion, in the post-Friedmanian or New Classical versions under which inflation begins to accelerate promptly once the barrier is breached. But almost no one working seriously on this issue appears to believe in this hair-trigger version of the NAIRU anymore. Instead, what we have are analyses, including those in this symposium, showing very slow increases in the inflation rate over many years following a reduction of unemployment. For example, Gordon (this issue) argues that a reduction of unemployment one point below his estimated NAIRU will generate a rise in annual inflation from 2.3 to 5.4 percent by the year 2005. That is three full years after, according to present plans, the federal government will have balanced its budget. It seems a long time into the future for so little acceleration.

If Gordon is right, then we can enjoy a decade of 4.5 percent unemployment before the inflation rate crests at 6 percent. Or if we accept Akerlof, Dickens and Perry's (1996) estimate of a 5 percent NAIRU, we can have unemployment at 4 percent, full employment by the legal standard, for a decade at the same price,

⁶ Linking the estimates of wage dispersion from separate data sets going back to 1920, I find that unemployment accounts for some 55 percent of the variation in inequality over 72 years of data. Using a method similar to that used to calculate the NAIRU, we can determine that rate of unemployment below which inequality declines and above which it rises. This, the "ethical rate of unemployment" is estimated quite stably to be 5.5 percent.

or 4.5 percent at half the price (assuming approximate linearity in these relations). And of course there is always the possibility that the NAIRU might fall even more.

If this is what is now meant by the NAIRU research, then the basic argument of this essay is already noncontroversial. It hardly matters whether the NAIRU continues to play a role in models, so long as all agree that the benefits of moving below the estimated NAIRU by moderate amounts vastly exceed the costs. This, of course, was never the intent of Milton Friedman nor of most of the theorists and textbook writers who have belabored the natural rate hypothesis over the past three decades.

At the same time, we need to recognize that almost no one seems to think that the major risks of accelerating inflation come from low unemployment. Gordon's estimates, once again, are exemplary: they show a minor risk. But since we observe that major inflations have occurred in the past, we do need to ask ourselves why that was so and what might possibly be done to prevent a recurrence. Looking at history and again at the very few strongly inflationary episodes of the last 30 years as shown in Figure 1, one may reasonably argue that our most serious inflations hit, more or less unpredictably, as a result of war (Vietnam in 1967–69, Yom Kippur in 1973 and the subsequent OPEC oil embargo) and revolution (Iran in 1979 and the second oil crisis).

These events sharply destabilized existing patterns of wage, price and cost relations. Businesses and organized workers reacted, understandably, by trying to reestablish the previous patterns. They therefore set off a spiral, passing price and wage increases around the economy, igniting an essentially nonaccelerating but highly inertial inflation that lasted in each case until a recession broke the spiral and forced all of the players to accept a changed arrangement.⁷

What was needed, in these cases, was an inflation policy addressing problems of wartime supply management and commodity shocks. Vietnam was fought as a peacetime war; the massive civilian mobilizations and control mechanisms that stifled inflation during World War II were not imposed. That was a mistake: wars should be fought on a war footing or not at all. In the case of the oil shocks, the situation is more complex, since the events were abrupt and their genesis remains in some ways mysterious. In any event, not every natural or man-made disaster can be predicted.

It would therefore be reasonable to approach anti-inflation policy in general as a matter, first and foremost, of designing circuit breakers for shock episodes, so as to reduce the cost of adjusting to a new pattern of relative prices and therefore the need to do it through the brute-force method of mass unemployment. Some simple steps, like coordinating the timing of wage bargains and providing the president with limited discretion over cost-of-living adjustments in Social Security, federal pensions and other payment streams might help a great deal, as I once proposed (Galbraith, 1989).⁸ Sterner measures could be held in reserve.

⁷ Adrian Wood's *A Theory of Pay* (1978) provides the best theoretical discussion of this process with which I am familiar.

⁸ To be specific, my idea was that the president be allowed to set a single, uniformly applied, forward-looking rate of indexation for cost-of-living in the year ahead. This single rate of discretionary prospective

If this were done, then the very slow increases in inflation that might or might not happen as a result of pressure from low unemployment might be mitigated in benign ways. To decide what to do, it would be useful first to have some judgment from economists as to the exact mechanism at work. If it is pressure from wages, then a guideposts policy (together with some coordination of wage-bargain timing) might again be useful. If some other sector responding to low unemployment is somehow the villain, then perhaps “tax-based incentive policies” or a “market anti-inflation plan” proposal might be resurrected.⁹ There is time for experiment here, and it should begin while the problem is not serious. The point is that the Federal Reserve need be brought into action only as a last resort, when all else fails (including patience), and not as the first line of defense.

The assignment of sole responsibility for anti-inflation policy to the Federal Reserve, a *de facto* development that is technically illegal under the Full Employment Act of 1978, is a serious underlying problem. Nothing in the law prevents the president and Congress from exerting leadership in this area, which they largely abandoned in 1981 for political reasons and have been prevented mainly by political cowardice from reentering ever since. One of the serious unintended consequences of economists’ preoccupation with NAIRU has been to convey a message to political leaders that they need not feel any responsibility in this area, that the inflation-unemployment tradeoff can be fine-tuned with interest rates by the Fed. It isn’t so.

Conclusion: A World Without the NAIRU?

Can economics live without the aggregative labor market, the natural rate and the NAIRU? Could physics survive without ether? Surely the measure of scientific maturity lies in a willingness to match theory with evidence, to discuss anomalies with an open mind, and to move on when it is appropriate to do so. Occasionally, this may mean reconstructing one’s thinking from the ground up.

I believe that the case for basing anti-inflation policy primarily around the rate of unemployment was never persuasive—not in 1960 when the short-run Phillips curve came onto the American scene, nor when Friedman introduced the vertical version he called the natural rate. The evidence since that time weighs further against drawing implications for policy from either confection, and equally against drawing implications from modern versions. One need not object to the NAIRU as a purely mathematical construct. After all, a steady-inflation unemployment rate is merely an implication of models specified in a certain way. The problem comes when one is asked whether to raise interest rates, *today*, based on the fact that the

indexation would affect all recipients of federal transfer payments to individuals. It would compensate for expected inflation and serve as a signal to the wage process around which inflation expectations might coalesce. Losses in the real value of such transfers due to unanticipated shocks would not be compensated, as indeed they should not be.

⁹ Tax-based incentive policies originated with Sidney Weintraub and Henry Wallich, while the market anti-inflation plan was an idea of Abba Lerner and David Colander (Colander, 1986).

actual unemployment rate has dropped below the estimate of such a rate in someone's model. The uncertainty and disagreement among the best economists working on this issue, and the persistent failure of inflation to accelerate in recent years despite transgressing past NAIRUs, make this an easy call.

Of course, when inflation hits, it can be repressed by recession and stifled by stagnation. The test of policy, however, is to reconcile reasonable price stability with acceptable growth at the highest achievable levels of employment and to manage shocks with the least disruption.

To abandon the NAIRU as a construct in policy discussion is essentially to abandon the pretext of the impossibility of this task. This would open the way to the pursuit of a lower unemployment rate. Accelerated growth is one means toward this end—and Okun's law, a much more reliable empirical rule than the Phillips curve, reminds us that an extra point of growth could bring unemployment down by a half-point or so per year. It is a reasonable bet that lower interest rates, combined with a somewhat less restrictive budget policy, could bring a growth acceleration.¹⁰

Surely, a period of moderately accelerated growth is in order, mainly to recover ground lost to overly restrictive policies in the past. On the other hand, I do believe it would be a mistake to base policy *exclusively* on aggregate monetary and fiscal measures. Dispassionately reviewed, history makes a fair case that targeted employment policies, public capital investment programs and wage-price—but especially wage—guidelines have useful supporting roles in times of general prosperity.¹¹ I would especially argue for innovation now to establish circuit breakers and other institutional mechanisms that would make handling a future exogenous inflation shock an easier and less costly task.

Economists have been a bit too quick to reject such policies outright, on the ground that they have no role in the idealized world of the model, where an assumed market already functions with perfect flexibility. We have also spent too little time discussing how to make such policies as effective, unobtrusive and sustainable as possible. When theory and histories conflict—as they do in the case of the natural rate and as they also do here—we should perhaps pay more attention to history. And we should be less easily tempted, than we sometimes have been, by the siren songs of the gods.

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¹⁰ Friedman's (1968) argument against such policy is aptly inept: "If [the monetary authority] . . . takes interest rates or the current unemployment percentage as the immediate criterion of policy, it will be like a space vehicle that has taken a fix on the wrong star. No matter how sensitive and sophisticated in its guiding apparatus, the space vehicle will go astray." But surely, a space vehicle can fix a course by any star whatsoever. It is only necessary that the star be fixed and visible; the "natural rate of unemployment" is neither.

¹¹ See Galbraith and Darity (1994) and Rockoff (1984) for discussions of this history and related references.

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