CONDUCT OF MONETARY POLICY

Report of the Federal Reserve Board pursuant to Section 2B of the Federal Reserve Act and the State of the Economy

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

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CONDUCT OF MONETARY POLICY

WEDNESDAY, JULY 18, 2001

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to call, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Michael G. Oxley, [chairman of the committee], presiding.

Present: Chairman Oxley; Representatives Roukema, Bereuter, Baker, Bachus, Castle, King, Royce, Ney, Paul, Weldon, Ose, W. Jones of North Carolina, Biggert, Cantor, Hart, Capito, Ferguson, Rogers, Tiberi, Miller, Grucci, LaFalce, Kanjorski, Waters, Sanders, C. Maloney of New York, Watt, Bentsen, Sherman, J. Maloney of Connecticut, Hooley, Carson, Meeks, Lee, Mascara, Inslee, Gutierrez, S. Jones of Ohio, Capuano, Ford, Hinojosa, Israel, and Crowley.

Chairman OXLEY. The Financial Services Committee will come to order.

Good morning, Mr. Greenspan. Chairman Greenspan, it is good to have you back before the committee; I note that you were the first and only witness at the very first hearing held by the then new Financial Services Committee, and then, as now, you were here to share with us your views on the state of the economy.

I am proud to note for the record that since you were here on February 28, this committee has been hard at work and has compiled a long record of hearings and legislation with plenty more to come. I may note also that the Fed has been busy in that same period, cutting interest rates four more times since you were here last.

Chairman Greenspan, we have seen a number of heartening signs for the economy. Energy prices, particularly gasoline prices, are lower. We no longer have daily crisis reports from California about blackouts. The markets, while still volatile, also are up over their levels of 4 months ago, and consumer confidence remains high.

Looking at those indicators and others, it is tempting to think that we have turned the corner, that two or three quarters of slow growth were enough to reverse the economy, and that we are in recovery. However, I sense in all of the economic reporting, continued uncertainty and potential potholes ahead in the road to recovery. That is why I am glad you are here to share with us your insight, some of what William Greider once referred to as "The Secrets of the Temple."

Since you were here, Mr. Chairman, Congress has passed and the President has signed a tax cut aimed at stimulating the Nation's economy. The first vestiges of that tax cut will arrive in taxpayers' mailboxes within 2 weeks in the form of rebate checks. The last taxpayers should have these checks before the end of September. The committee would be interested in hearing how you think those checks and the rate cuts enacted will affect the economy in the third quarter and the second half and beyond.

I am sure Members also are interested to learn if you believe any other tax changes, targeted or broadly based, would be useful to get economic growth back on track, keep it there or stimulate productivity. For example, at a hearing in March, Majority Leader Dick Armey and economists Larry Kudlow and Jim Glassman endorsed the idea of allowing companies to expense technology purchases. The idea seems to hold the promise of increasing and maintaining productivity, and we would be interested in your opinion. Perhaps you have other suggestions as well.

I also hope you will have time while you are here to address ways we might better direct the flows of capital to companies, particularly the newer and smaller ones that are the engines of both job growth and often of innovation in our economy. When capital is not directed efficiently to the companies that need it, in my view, the whole economy suffers.

Also, Mr. Chairman, I think the committee will be interested in hearing your views on trade, on the balance of payments and on the value of the dollar in foreign exchange markets. I, for one, would be especially interested in your views on efforts to increase trade, particularly the Administration's focus on gaining Trade Promotion Authority and developing a Free Trade Area of the Americas.

Most of Latin America, except for Mexico, is suffering economically to one extent or another, though not as badly as Argentina at this moment. It seems to me that its free trade agreement with the United States has helped insulate Mexico from the current slowdown while benefiting the U.S. at the same time. I am sure we will all be interested in your views on creating a hemispheric free trade zone.

In particular, I think we would be interested in hearing your thoughts on currency boards and dollarization of other countries' economies in view of the ravages Argentine currently is suffering. And I imagine many would like to hear your views on why the current level of the dollar has been sustained through this recent round of rate cuts, and whether the level may change naturally next year after the introduction of the euro is complete.

And finally, Mr. Chairman, I think all of us on the committee would like to hear some direct predictions about when you believe the economy will have finally turned the corner. I don't imagine you are carrying any predictions of a return to "dot.com"-level stock market returns any time soon, but I think we would all like to hear some reassurance that you see a return to strong, steady growth sooner rather than later, and can give us some suggestions about how to get there and how to sustain it. I know I will look forward to your comments with interest.

And, again, we thank you for your appearance, and I now recognize the Ranking Member, the gentleman from New York, Mr. LaFalce.

[The prepared statement of Hon. Michael G. Oxley can be found on page 44 in the appendix.]

Mr. LAFALCE. Thank you very, very much, Mr. Chairman. I was about to open up my remarks by saying, Chairman Greenspan, I know you are reluctant to comment on fiscal policy, but because it is so important to the conduct of monetary policy and our economy, I was going to go ahead and ask you to comment anyway.

And then I heard Chairman Oxley also ask you to comment on a few things such as the desirability of expensing for technological equipment or investments, fast track authority for the Presidency, the hemispheric trade agreement, and so forth. So I decided, no, I shouldn't even be a little bit reluctant to ask you to comment on fiscal policy.

I do believe, returning to that issue, that your support for substantial tax cuts earlier this year was critical to the quick passage of the massive tax cut package this spring. As a matter of sound fiscal policy, not to mention sound public policy, I was deeply troubled by the tax cut package, and I believe we now expect that the Congressional Budget Office is going to be revising their Federal revenue estimates downward as a result of the slowing economy. And you, in your testimony, are going to say there is going to be a slowing economy in comparison to what we initially were projecting. And lower revenue projections also exacerbate the budget problems created by the tax package. In short, we will have too little revenue to achieve the twin goals of meeting current spending requirements and, in my judgment, anticipated future needs.

To address the anticipated budget crunch, I believe the Administration is laying the groundwork for what I think is going to constitute a raid on the Social Security and Medicare Trust Funds. And Secretary O'Neill has already, in a sense, dismissed the trust funds as an accounting fiction, and OMB Director Daniels has been equally almost contemptuous of the concept.

I believe that good fiscal policy requires a balance of revenues and desired spending, and also an adequate preparation for future needs. This could mean maintaining budget surpluses, but it surely means protecting the Social Security and Medicare Trust Funds in anticipation of the baby boomers' retirement. And on this basis I believe we have failed to achieve sound fiscal policy so far this year.

Now, these are not simply my views. The International Monetary Fund had this to say in its latest article for consultation with the United States. Are you familiar with this, Chairman Greenspan?

Mr. GREENSPAN. I am, Congressman.

Mr. LAFALCE. OK. Good. And I will quote from it. The IMF said, quote: "The trust funds for Social Security and Medicare were established originally as part of reform plans to partially prefund these programs to allow them to meet their long-term obligations. To achieve this purpose, the surpluses of these trust funds actually have to be saved in order to put aside real resources to meet the programs' future liabilities."

In this context, the IMF goes to question the wisdom of the Administration's apparent willingness to raid these trust funds.

In the same statement the IMF questions the sustainability of the tax cuts in the face of spending pressures and suggests that policymakers should be flexible in implementing the tax cut package.

I am concerned that we might be watching a train wreck proceed in slow motion as the tax cut package is phased in, and you have expressed considerable optimism in the past about our ability to accommodate the tax cuts based on expectations for sustained strong productivity growth. I will be interested to hear if you continue to have such optimism, or whether you have any reason to be at least less comfortable about that prospect.

It seems clear to me that we have thrown fiscal caution to the wind this year. We have rolled the dice, and I am troubled that we have seen some signs that the gamble will not pay off.

I thank you, Chair.

Chairman OXLEY. The Chair now recognizes the Chairman of the Subcommittee on Domestic Monetary Policy, Technology and Economic Growth, the gentleman from New York, Mr. King.

Mr. KING. Thank you, Chairman Oxley.

Chairman Greenspan it is a pleasure to welcome you here this morning, and I, on behalf of the entire panel, thank you for coming in and giving us of your time and your knowledge. And I think it is a tribute to the clout that you have that you will find Members of this committee trying to attach you to whatever views they might have on issues that even go far beyond your own. So I wish you well as the morning goes by as you bob and weave the thrusts and parries of Members of this committee.

I am not going to bore you with a long statement. I would just like to say there were several things on my mind as we are entering this state of the economy. One is, as far as the reduction of interest rates, when do you think that one could reach a point of diminishing returns, when the maximum benefit that could be obtained from cutting interest rates will have been reached? Second, another one is what the continuing strength of the dollar means in the face of the continued reduction of interest rates; but also, second, whether or not it is impairing our export markets to an extent that it is having a negative impact on the economy? And I guess the logical question from that is, is it time to consider perhaps ways of weakening the dollar to help us as far as our trade deficit is concerned?

Another point is I know that over the past several months you seem to put a lot of stock in consumer confidence; that with all the variables out there, maybe the one most important is the maintenance of consumer confidence. And I would be interested in your thoughts as to where you think consumer confidence is going, and, again, how integral is that to the ultimate recovery that we are all hoping for?

And also, I guess, one final thing, and I will leave it at that, is the Trade Promotion Authority. If we are talking about long-term growth of the economy, how essential do you believe it is that something such as TPA is enacted and the President is given that

power to negotiate? What impact would that have here and also in world markets and in our relation to world markets?

So with that I will yield back the balance of my time. And again, thank you for your time and interest. Thank you. I yield back.

Chairman OXLEY. The gentleman yields back.

The Chair is now pleased to recognize the Ranking Member of the subcommittee, the gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman.

And welcome, Chairman Greenspan.

I truly hope that the Chairman will tell us this morning that he believes that we have turned a corner, and that better economic conditions are ahead. Unfortunately, in my opinion, the single most dramatic change for Members of the committee to consider since the Chairman's last visit is the worsening fiscal situation of the Federal Government. With the rosy budget forecasts at the beginning of the year, Chairman Greenspan took the position that tax cuts and the relaxing of the Federal Government's decade-long fiscal discipline was the appropriate course for Congress to follow. Since February, economic forecasters have had to dramatically reduce their growth estimates downward. As a result, many budget forecasters are estimating that any remaining surplus outside of the Social Security and Medicare Trust Funds may have been fully committed already to the Bush tax plan.

This situation could be further worsened, given reports in today's *Wall Street Journal* and other newspapers, that Majority Whip DeLay and other Republicans are urging additional emergency spending this year. Also, since the Chairman's last visit, the Fed continued its dramatic interest rate corrections. First, the Fed raised rates six times through May of 2000, and then sharply reversed the course and lowered rates on six separate occasions this year for a total of 275 basis points.

Despite these efforts to correct for past actions, the Fed has thus far been unable to spur much of a reaction in long-term interest rates. The interest rate on the 10-year Treasury note averaged 5.3 percent for the week ending on July 11, as compared to 5 percent the week ending January 3. I hope the Chairman will address this issue in his testimony as the impact of static long-term interest rates is felt by all Americans. Some market observers believe investors may be reacting to fears that our worsening Federal fiscal situation—they may be threatening a return to deficits in the next few years.

Finally, I would like to comment on one other issue in which the Fed is heavily involved. I have recently begun to hear complaints that the forthcoming revisions to the Basel Capital Accord that suggests that the new accord could unnecessarily raise capital requirements at U.S. banks. While this issue may sound arcane, it has a major impact on the amount of loans that U.S. banks can make to individual borrowers. I am closely monitoring the work of the Basel Committee, and I urge the Fed to use U.S. influence on the committee to oppose any proposal that increases capital requirements on U.S. institutions that are already considered today to be well capitalized. This is an especially bad proposal given the current weakness in the economy.

I look forward as always to the Chairman's comments. Thank you.

Chairman OXLEY. The gentlelady's time has expired.

We now turn to the distinguished Chairman of the Fed. And again, Mr. Chairman, welcome to the Financial Services Committee.

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

Mr. GREENSPAN. Well, thank you very much, Mr. Chairman and Members of the committee. I will be excerpting from my prepared remarks and request that the full text be prepared for the record.

Chairman OXLEY. Without objection.

Mr. GREENSPAN. I appreciate the opportunity this morning to present the Federal Reserve's Semiannual Report on Monetary Policy.

Monetary policy this year has confronted an economy that slowed sharply late last year and has remained weak this year, following an extraordinary period of buoyant expansion.

By aggressively easing the stance of monetary policy, the Federal Reserve has moved to support demand and, we trust, help lay the groundwork for the economy to achieve maximum sustainable growth. Our accelerated action reflected the pronounced downshift in economic activity, which was accentuated by the especially prompt and synchronous adjustment of production by businesses utilizing the faster flow of information coming from the adoption of new technologies. A rapid and sizable easing was made possible by reasonably well-anchored inflation expectations, which helped to keep underlying inflation at a modest rate, and by the prospect that inflation would remain contained as resource utilization eased and energy prices backed down.

In addition to the more accommodative stance of monetary policy, demand should be assisted going forward by the effects of the tax cut, by falling energy costs, by the spur to production once businesses work down their inventories to more comfortable levels, and, most importantly, by the inducement to resume increases in capital spending. That inducement should be provided by the continuation of cost-saving opportunities associated with rapid technological innovation. Such innovation has been the driving force raising the growth of structural productivity over the last half-dozen years. To be sure, measured productivity has softened in recent quarters, but by no more than one would anticipate from cylical influences layered on top of a faster long-term trend.

But the uncertainties surrounding the current economic situation are considerable, and until we see more concrete evidence that the adjustments of inventories and capital spending are well along, the risks would seem to remain mostly tilted toward weakness in the economy. Still, the Federal Open Market Committee opted for a smaller policy move at our last meeting, because we recognized that the effects of policy actions are felt with a lag, and, with our cumulative 2¾ percentage points of easing this year, we have moved a considerable distance in the direction of monetary stimulus. Certainly, should conditions warrant, we may need to ease further, but we must not lose sight of the prerequisite of longer-

run price stability for realizing the economy's full growth potential over time.

Despite the recent economic slowdown, the past decade has been extraordinary for the American economy. The synergies of key technologies markedly elevated prospective rates of return on high-tech investments, led to a surge in business capital spending, and significantly increased the growth rate of structural productivity. Capitalization of those higher expected returns lifted equity prices, which in turn contributed to a substantial pickup in household spending on a broad range of goods and services, especially on new homes and durable goods. This increase in spending by both households and businesses exceeded even the enhanced rise in real household incomes and business earnings. The evident attractiveness of investment opportunities in the United States induced substantial inflows of funds from abroad, raising the dollar's exchange rate while financing a growing portion of domestic spending.

By early 2000, the surge in household and business purchases had increased growth of the stocks of many types of consumer durable goods and business capital equipment to rates that could not be sustained. Even though demand for a number of high-tech products was doubling or tripling annually, in some cases new supply was coming on even faster. Overall, capacity in high-tech manufacturing industries, for example, rose nearly 50 percent last year, well in excess of its already rapid rate of increase over the previous 3 years. Hence, a temporary glut in these industries and falling short-term prospective rates of return were inevitable at some point. This tendency was reinforced by a more realistic evaluation of the prospects for returns on some high-tech investments, which, while still quite elevated by historical standards, apparently could not measure up to the previous exaggerated hopes. Moreover, as I testified before this committee last year, the economy as a whole was growing at an unsustainable pace, drawing further on an already diminished pool of available workers, and relying increasingly on savings from abroad. Clearly, some moderation in the pace of spending was necessary and expected if the economy was to progress along a more balanced growth path.

In the event, the adjustment occurred much faster than most businesses anticipated, with the slowdown likely intensified by the rise in the cost of energy that until quite recently had drained businesses and households of purchasing power. Growth of outlays of consumer durable goods slowed in the middle of 2000, and shipments of non-defense capital goods have declined since autumn.

Moreover, weakness emerged more recently among our trading partners in Europe, Asia, and Latin America. The interaction of slowdowns in a number of countries simultaneously has magnified the softening each of the individual economies would have experienced on its own.

Because the extent of the slowdown was not anticipated by businesses, some backup in inventories occurred, especially in the United States. Innovations, such as more advanced supply-chain management and flexible manufacturing technologies, have enabled firms to adjust production levels more rapidly to changes in sales. But these improvements apparently have not solved the

thornier problem of correctly anticipating demand. Although inventory-sales ratios in most industries rose only moderately, those measures should be judged against businesses' desired levels. In this regard, extrapolation of the downward trend in inventory-sales ratios over the past decade suggests that considerable imbalances emerged late last year. Confirming this impression, purchasing managers in the manufacturing sector reported in January that inventories in the hands of their customers had risen to excessively high levels.

As a result, a round of inventory rebalancing was undertaken, and the slowdown in the economy that began in the middle of 2000 intensified. The adjustment process started late last year when manufacturers began to cut production to stem the accumulation of unwanted inventories. But inventories did not actually begin falling until early this year as producers decreased output levels considerably further.

The rate of liquidation appears to have been especially pronounced this winter, and the available data suggest that it continued, though perhaps at a more moderate pace, this spring. A not inconsequential proportion of the current liquidation undoubtedly is of imported products, and thus will presumably affect foreign production, but most of the adjustment has fallen on domestic producers.

At some point, inventory liquidation will come to an end, and its termination will spur production and incomes. Of course, the timing and force with which that process of recovery plays out will depend on the behavior of final demand. In that regard, the demand for capital equipment, particularly in the near term, could pose a continuing problem. Despite evidence that expected long-term rates of return on the newer technologies remain high, growth of investment in equipment and software has turned decidedly negative. Sharp increases in uncertainty about the short-term outlook have significantly foreshortened the timeframe over which business are requiring new capital projects to pay off. The consequent heavier discounts applied to those long-term expectations have induced a major scaling back of new capital spending initiatives, though one that presumably is not long-lasting, given the continuing inducements to embody improving technologies in new capital equipment.

In addition, the deterioration in sales, profitability and cash flow has exacerbated the weakness in capital spending. Pressures on profit margins have been unrelenting. Although earnings weakness has been most pronounced for high-tech firms, where the previous extraordinary pace of expansion left oversupply in its wake, weakness is evident virtually across the board, including most recently in earnings of the foreign affiliates of American firms.

Much of the squeeze on profit margins of domestic operations results from a rise in unit labor costs. Gains in compensation per hour picked up over the past year or so, responding to a long period of tight labor markets, the earlier acceleration of productivity, and the effects of an energy-induced run-up in consumer prices. The faster upward movement in hourly compensation, coupled with the cylical slowdown in the growth of output per hour, has elevated the rate of increase in unit labor costs. In part, fixed costs, non-labor

as well as labor, are being spread over a smaller production base for many industries.

The surge in energy costs has also pressed down on profit margins, especially in the fourth and first quarters. In fact, a substantial portion of the rise in total costs of domestic non-financial corporations between the second quarter of last year and the first quarter of this year reflected the increase in energy costs. The decline in energy prices since the spring, however, should be contributing positively to margins in the third quarter. Moreover, the rate of increase in compensation is likely to moderate, with inflation expectations contained and labor markets becoming less taut in response to the slower pace of growth in economic activity. In addition, continued rapid gains in structural productivity should help to suppress the rise in unit labor costs over time.

Eventually, the high-tech correction will abate, and these industries will reestablish themselves as a solidly expanding, though less frenetic, part of our economy. When they do, growth in that sector presumably will not return to the outsized 50 percent annual growth rates of last year, but rather to a more sustainable pace.

Of course, investment spending ultimately depends on the strength of consumer demand for goods and services. Here, too, longer-run increases in real incomes of consumers engendered by the rapid advances in structural productivity should provide support to demand over time. And thus far this year, consumer spending has indeed risen further, presumably assisted in part by a continued rapid growth in the market value of homes, from which a significant amount of equity is being extracted. Moreover, household disposable income is now being bolstered by tax cuts.

But there are also downside risks to consumer spending over the next few quarters. Importantly, the same pressure on profits and the heightened sense of risk that have held down investment have also lowered equity prices and reduced household wealth despite the rise in home equity. We can expect the decline in the stock market wealth that has occurred over the past year to restrain the growth of household spending relative to income, just as the previous increase gave an extra spur to household demand. Furthermore, while most survey measures suggest consumer sentiment has stabilized recently, softer job markets could induce a further deterioration of confidence and spending intentions.

While this litany of risks should not be downplayed, it is notable how well the U.S. economy has withstood the many negative forces weighing on it. Economic activity has held up remarkably in the face of a difficult adjustment toward a more sustainable pattern of expansion.

The economic developments of the last couple of years have been a particular challenge for monetary policy. Once the financial crises of late 1998 that followed the Russian default eased, efforts to address Y2K problems and growing optimism—if not euphoria—about profit opportunities produced a surge in investment, particularly in high-tech equipment and software. The upswing outstripped what the Nation could finance on a sustainable basis from domestic saving and funds attracted from abroad.

The shortfall of saving to finance investment showed through in a significant rise in average real long-term corporate interest rates

starting in early 1999. By June of that year, it was evident to the Federal Open Market Committee that to continue to hold the funds rate at the then-prevailing level of 4¾ percent in the face of rising real long-term corporate rates would have required a major infusion of liquidity into an economy already threatening to overheat.

Chairman OXLEY. Mr. Chairman, if I could just interrupt briefly to announce to the Members that there is a vote on the floor of the House. I plan to continue the hearing and the Chairman's statement, so if the Members want to go over to the floor and vote and then come back, and then we will obviously have that opportunity for questioning when the Chairman is completed with his statement.

Thank you, Mr. Chairman.

Mr. GREENSPAN. The increase of our target Federal funds rate of 175 basis points through May of 2000 barely slowed the expansion of liquidity, judging from the M2 measure of the money supply, whose rate of increase declined only modestly through the tightening period.

By summer of last year, it started to become apparent that the growth of demand finally was slowing, and seemingly by enough to bring it into approximate alignment with the expansion of potential supply, as indicated by the fact that the pool of available labor was no longer being drawn down. It was well into autumn, however, before one could be confident that the growth of aggregate demand had softened enough to bring it into a more lasting balance with potential supply. Growth continued to decline to a point that by our December meeting, the Federal Open Market Committee decided that the time to counter cumulative economic weakness was close at hand. We altered our assessment of the risk to the economy, and with incoming information following the meeting continuing to be downbeat, we took our first easing action on January 3. We viewed the faster downshift in economic activity, in part a consequence of the technology-enhanced speed and volume of information flows, as calling for a quicker pace of policy adjustment. Acting on that view, we have lowered the Federal funds rate 2¾ percentage points since the turn of the year, with last month's action leaving the Federal funds rate at 3¾ percent.

Most long-term interest rates, however, have barely budged despite the appreciable reductions in short-term rates since the beginning of the year. This has led many commentators to ask whether inflation expectations have risen. Surely, one reason long-term rates have held up is changed expectations in the Treasury market, as forecasts of the unified budget surplus were revised down, indicating that the supplies of outstanding marketable Treasury debt are unlikely to shrink as rapidly as previously anticipated. Beyond that, it is difficult to judge whether long-term rates have held up because of firming inflation expectations or a belief that economic growth is likely to strengthen, spurring a rise in real long-term rates.

One measure often useful in separating the real interest rates from inflation expectations is the spread between rates on nominal 10-year Treasury notes and inflation-indexed notes of similar maturity. That spread rose more than three-fourths of a percentage point through the first 5 months of this year, a not insignificant

change, though half of that increase has been reversed since. By the nature of the indexed instrument, the spread between it and the comparable nominal rate reflects expected CPI inflation. While actual CPI inflation has picked up this year, this rise has not been mirrored uniformly in other broad price measures. For example, there has been little, if any, acceleration in the index of core personal consumption expenditure prices, which we consider to be a more reliable measure of inflation. Moreover, survey readings on long-term inflation expectations have remained quite stable.

The lack of pricing power reported overwhelmingly by business people underscores the quiescence of inflationary pressures. Businesses are experiencing the effects of softer demand in product markets overall, but these effects have been especially marked for many producers at earlier stages of processing, where prices generally have been flat to down thus far this year. With energy prices now also moving lower and the lessening of tautness in labor markets expected to damp wage increases, overall prices seem likely to be contained in the period ahead.

Forecasts of inflation, however, like all economic forecasts, do not have an enviable record. Faced with such uncertainties, a central bank's vigilance against inflation is more than a monetary policy cliche; it is, of course, the way we fulfill our ultimate mandate to promote maximum sustainable growth.

In reducing the Federal funds rate so substantially this year, we have been responding to our judgment that a good part of the recent weakening of demand was likely to persist for a while, and that there were significant downside risks even to a reduced central tendency forecast. Moreover, with inflation low and likely to be contained, the main threat to satisfactory economic performance appeared to come from excessive weakness in activity.

As a consequence of the policy actions of the Federal Open Market Committee, some of the stringent financial conditions evident late last year have been eased. Real interest rates are down on a wide variety of borrowing instruments. Private rates have benefited from some narrowing of risk premiums in many markets. And the growth of liquidity, as measured by M2, has picked up. More recently, incoming data on economic activity have turned from persistently negative to more mixed.

The period of sub-par economic performance, however, is not yet over. We are not free of the risk that economic weakness will be greater than currently anticipated, and require further policy response. That weakness could arise from softer demand abroad, as well as from domestic developments. But we need also to be aware that our front-loaded policy actions this year, coupled with the tax cuts under way, should be increasingly affecting economic activity as the year progresses.

The views of the Federal Reserve Governors and Reserve Bank presidents reflect this assessment. While recognizing the downside risks to their current forecast, most anticipate at least a slight strengthening of real activity later this year. This is implied by the central tendency of their individual projections, which is for real GDP growth over all four quarters of 2001 of 1¼ to 2 percent. Next year, the comparable figures are 3 to 3¼ percent. The civilian unemployment rate is projected to rise further over the second half

of the year, with a central tendency of 4¾ to 5 percent by the fourth quarter and 4¾ to 5¼ percent four quarters later. This easing of pressures in product and labor markets lies behind the central tendency for PCE price inflation of 2 to 2½ percent over the four quarters of this year and 1¾ to 2½ percent next year.

As for the years beyond this horizon, there is still, in my judgment, ample evidence that we are experiencing only a pause in the investment in a broad set of innovations that has elevated the underlying growth and productivity to a rate significantly above that of the two decades preceding 1995. By all evidence, we are not yet dealing with maturing technologies that, after having sparkled for a half decade, are now in the process of fizzling out. To the contrary, once the forces that are currently containing investment initiatives dissipate, new applications of innovative technologies should again strengthen demand for capital equipment and restore solid economic growth over time that benefits us all.

Thank you, Mr. Chairman. I look forward to your questions.

[The prepared statement of Hon. Alan Greenspan can be found on page 46 in the appendix.]

Chairman OXLEY. Thank you, Mr. Chairman.

Let me begin with some questions. I was reminded when you talked about the effects of the tax cut and the interest rate cuts, I was reminded back in 1981, my freshman year in the Congress, and my first major vote was on the Reagan tax cut. And I particularly remember in 1982 the Reagan tax cut, as you will remember, didn't take effect or didn't pass until August of 1981. And we heard some criticisms early in 1982 in the first quarter that the tax cut was not working. And indeed, there were different circumstances, obviously, and the economy was in far worse shape back then, particularly because of stagflation.

What is your sense of the lag time or the time that it would take the effect of the lower interest rates and the lower tax rates to really have a stimulative effect on the economy?

Mr. GREENSPAN. Mr. Chairman, the experience we have had over the years is that such a tax cut tends to impact over a number of quarters. And it is unlikely that we will see any immediate impact, and, indeed, it usually stretches out and accumulates over time. If past experience holds, I think we should be seeing the impact develop as we get into the latter months of this year and into the year 2002.

Chairman OXLEY. And indeed, if you look at the history, I guess the economy really started picking up in 1983, and by 1984 it was rather substantial and initiated the longest—at that time, the longest period of economic growth that we had in a non-war situation. So obviously, I think all of us would caution patience in this regard.

Let me ask you about the trade promotional authority, formerly known as Fast Track, that is currently before the Congress. How much weight do you attach to that initiative in terms of our ability to maintain competitive areas in trade and sustain our economic growth?

Mr. GREENSPAN. Well, Mr. Chairman, I think the data are unequivocal that the extraordinary expansion in trade in recent decades has been a material factor in rising standards of living

throughout the world and has been a major contributor to growth in the United States. I think that the increasing ability to interchange goods and services with our trading partners and the competition which that induces is an important and, in fact, an indisputable and necessary factor for continued cutting-edge growth, which this country is so well known for.

My own impression is that while the overall international trading system would be assisted by Fast Track and the implications of a broader range of trade agreements, I think it is the United States which would benefit the most.

Chairman OXLEY. Thank you.

Let me ask you about the dollar. There are many manufacturers in my home State of Ohio who have been affected by the strength of the dollar and their inability to export as much as they would like. As a matter of fact, since 1995, mid-1995, the dollar appreciation has been about 33 percent in real terms. And indeed, the manufacturing sector has taken the biggest hit. The headlines today were clearly directed at the manufacturing sector and the continued softness in the manufacturing sector.

Should the Fed, should the Treasury, should the Congress pursue policy that would soften the dollar? Or are you convinced that the marketplace ultimately will work in that regard?

Mr. GREENSPAN. First, as I have said before this committee previously, there is a general agreement within the United States Government, I think for very good reasons, that the dollar's exchange rate is discussed only by the Secretary of the Treasury, and the purpose of that is that over the years it has been our experience that we need a single spokesman, and it has very clearly worked well.

There is no question that econometric models do show that exchange rates obviously affect trade. In fact, trade is one of the factors which impacts on the exchange rate. But the data also show that the really major impact, both plus and minus, on trade is the economic growth or lack thereof of our trading partners. It is far more important to our exporters what is happening in the markets overseas than what is happening to the exchange rate per se.

Chairman OXLEY. Thank you, Mr. Chairman. My time has expired.

I now recognize the gentleman from Vermont, Mr. Sanders.

Mr. SANDERS. Thank you, Mr. Chairman.

And, Mr. Greenspan, nice to see you again.

Mr. Greenspan, I think many millions of Americans wonder why when issues come down the pike that on one hand affect the wealthy and multinational corporations and on the other hand effect working people, you always seem to side with the wealthy and the multinational corporations. I would like to ask you three questions that I think Americans would like to know the answer to.

My understanding is, unless you have changed your view, that you are opposed to raising the minimum wage, which is today at a disastrously low $5.15 an hour. So I would like you to tell us if you think that a working person or a family can live on $5.15 an hour.

The second question that I would like to ask you is about the recently passed tax bill in which the wealthiest 1 percent of the pop-

ulation received 38 percent of the tax benefits. And at a time when millions of Americans today are working longer hours for lower wages than they used to, why is it that you think it is good public policy the 38 percent of the tax breaks, hundreds and hundreds of billions of dollars, should go into the hands of the wealthiest people in this country?

And my third question deals with the trade issue, as you know, and it doesn't get enough discussion, and, Mr. Chairman, I hope that this committee can get more involved in that issue. United States of America today has a record-breaking trade deficit of over $400 billion. Over the last 20 years we have lost millions of decent-paying manufacturing jobs. Young people who graduate high school who do not go to college, in fact, today, because of the decline in manufacturing, are earning 25 percent less than was the case 20 years ago, because the manufacturing jobs are not there, and they are now working in McDonald's. We have an $84 billion trade deficit with China, and American workers are put in the position of having to compete against desperate people in China who make 20 cent an hour. And I suspect that you are supportive of our trade relations with China, would like to see Most-Favored-Nation status passed again tomorrow.

Can you tell the American people why you think not raising the minimum wage, maintaining a disastrous trade policy, and giving huge tax credits for the rich works for the benefits of the average American?

Mr. GREENSPAN. Certainly.

Mr. SANDERS. I and millions would love to hear it.

Mr. GREENSPAN. First of all, I think you misclassify me by saying that I always come out on the part of multinational corporations.

Mr. SANDERS. I would love to hear you say something different today.

Mr. GREENSPAN. I hope I come out in favor of the strength and growth and sustainability of the American economy.

First, with respect to the minimum wage, the reason I object to the minimum wage is I think it destroys jobs, and I think the evidence on that, in my judgment, is overwhelming. Consequently, I am not in favor of cutting anybody's earnings or preventing them from rising, but I am against them losing their jobs because of artificial Government intervention, which is essentially what the minimum wage is.

So it is not an issue of whether, in fact, I am for or against people getting more money. I am strongly in favor of real incomes rising, and, indeed, that is the central focus of where I would come out.

Mr. SANDERS. Are you for abolishing the minimum wage?

Mr. GREENSPAN. I would say that if I had my choice, the answer is, of course.

Mr. SANDERS. You would abolish the minimum wage?

Mr. GREENSPAN. I would, yes, because if what I say is accurate, then the minimum wage does no good to the level——

Mr. SANDERS. And you would allow employers to pay workers $2 an hour if the circumstances provided that?

Mr. GREENSPAN. The issue is that they will not be paying $2 an hour because they won't be able to get people.

But let me go on to your next questions. We have had this argument before. The issue of the tax cut is that, as you may recall, I very studiously avoided committing myself to anybody's tax cut back earlier this year. I was for a tax cut in principle, but whether it was that which was being argued by the Democratic Minority at that time, or whether it was the President's, I never commented on. And therefore, I still don't comment on the structure of the tax cut per se.

With respect to trade, the evidence that I have been able to gather suggests to me that there is no evidence that trade either adds or subtracts jobs. When we were dealing on the side of very strong labor markets and job creation, I never argued in favor of trade expansion because it would create jobs. I argued because it would increase productivity and standards of living. Consequently, I argued that it neither increases nor decreases jobs.

Chairman OXLEY. The gentleman's time has expired.

The Chair now recognizes subcommittee Chair, Mr. King.

Mr. KING. Thank you, Mr. Chairman.

Chairman Greenspan, I hope you didn't cover this while I was away. I am sorry. I would just like to ask you the extent to which you think the bad economic news out of Argentina will have an impact on the U.S. economy, if so, when and to what extent; and what measures do you think the United States can do to anticipate any of those deleterious impacts?

Mr. GREENSPAN. Congressman, I think that the problems that Argentina is struggling with at this stage are largely domestic. Clearly, they have significant debt problems, and they are working with the International Monetary Fund and other international agencies to come up with a plan to resolve the problems with which they are dealing.

It is evident that there is a slightly better tone in Argentine markets and international markets with respect to Argentine financial instruments, as is evidenced by the apparent agreements that are occurring between President de la Rua and the provincial leaders. That has had a clearly positive effect on markets, and for the moment, it looks as though things are improving. But they have got difficulties ahead of them, and I think they are working very hard to resolve them.

The degree of so-called contagion, which is the effect on us and everybody else, is not very large at this particular point, and frankly, I don't expect it to become very large unless something which is wholly unexpected occurs. But, for the moment, it is a very difficult problem that they have. They are working on it, and we trust that they will resolve it in satisfactory fashion.

Mr. KING. Could I ask the same question about Japan, the sluggishness of the Japanese economy, the impact that would have on the overall Asian economy, and in fact, the congeneric effect on the United States.

Mr. GREENSPAN. It is apparent the weakness in the Japanese economy is impacting on other economies because they are a major importer of goods and services, especially in the technological goods areas, and as a consequence, you can see some of the effects in Southeast Asian exports—especially the high-tech area, being im-

pacted, because not only are we weakening in that area, but so are the Japanese.

The Japanese problem, as I indicated on many occasions before this committee, is essentially that they have to come to grips with their so-called financial intermediation system, which is largely commercial banks, and the very substantial non-performing loans which have occurred as a result of the fairly dramatic decline in commercial real estate collateral, which is usually the backbone of the Japanese banking system.

If that gets resolved—and Prime Minister Koizumi is clearly pushing on getting that resolved—they are going to have trouble moving forward, but Koizumi, as far as I can judge, is moving in the right direction, and I trust that they are able to implement the types of policies which he has been promulgating for a while.

Mr. KING. On the question of inflation, these interest rate cuts that we have had over the past several months. Do you see a threat of that fueling inflation? I know last year you were concerned about inflation. Do you see now that the cuts are being made that inflation is being fueled?

Mr. GREENSPAN. Congressman, there is very little evidence of inflation in our economy in the sense that, as you go from layer to layer, you may see some inevitable changes in prices, but if you extract out the very substantial direct and secondary effects of energy price increases, which have now crested and are turning down, it is very difficult to find inflationary pressures.

But, as I said in my prepared remarks, forecasting is, at best, something which has a mixed record, and as a consequence, we as central bankers are always watching this process very closely.

All I can say to you is that, at the moment, I see no evidence of it. But that is not the same thing as saying that I can project with great confidence that for the indefinite future it will remain that way.

Mr. KING. Thank you, sir.

Chairman OXLEY. Time has expired.

I turn to Mr. LaFalce.

Mr. LAFALCE. Thank you, Mr. Chairman.

I said I was really going to focus on broad monetary policy rather than other issues, but then you made some statements. Let me go to a statement you made in response to Mr. Sanders' questions, where you said there is no good evidence that suggests that trade either increases or decreases jobs, but that it is good because it increases standards of living.

Mr. GREENSPAN. I should have said, jobs overall. It does obviously affect jobs within individual industries, certainly.

Mr. LAFALCE. But there is evidence that it does increase standards of living?

Mr. GREENSPAN. Yes.

Mr. LAFALCE. Now, we can always argue for it, because it can open up economies, because it can improve the relations between countries; if you are trading goods, you are not trading armies, and so forth.

But I want to focus on what you did say, there is evidence that it increases standards of living, because the question would be, for whom? I think I am reading between the lines that you are saying

"in the aggregate," because you are saying that there are no aggregate increases in jobs, but there may be an increase for some and a decrease for others.

But, also, with respect to the standard of living, although there is an aggregate increase in the standard of living, is it disproportionate? Do the studies indicate that certain countries engaging in trade, for example, developing countries, would see an increase in their standard of living, whereas there may or may not be a causal relationship between that trade and an increase in the standard of living in a developing country?

I don't know the answer. I am searching.

Mr. GREENSPAN. No. The evidence, as best I can judge, is that trade very significantly increases the average level of real income in developing nations. But the analysis also suggests that there is no evidence that trade alters the distribution of income within a developing country, which suggests therefore, that if you can get the total level of real income to rise, which is another way of saying productivity to rise, you pull up the whole level of income in those societies.

And as a consequence, I would say that the extent to which trade increases productivity—increases competition which generates the productivity—it is across the board.

I do not deny that there are very significant differences that show up in a lot of different countries. But, as a broad general statement, what I have said, as far as I understand it, is what the data do show.

Mr. LAFALCE. I can accept that. But I think that also it indicates that there are going to be a number of pocket areas, or industries, or peoples that would not be beneficiaries that might be harmed. And I really think that public policy has to focus on the best means of dealing with them.

And I don't think we have done a good job of that in the United States, or at least I think we can do a much better job.

Mr. GREENSPAN. I agree with that, Congressman. I think that, as I have indicated before, if indeed we are getting, as a consequence of competition, a movement of capital from the less-productive industries in this country and abroad to the cutting-edge technologies, that is another way of saying that part of the industries in the country or some of the industries and some of the companies are going to be cutting back. And there are workers there, through no fault of their own, who are losing their jobs, and I think that we ought to address that. What I do not think we ought to do, however, is use protectionist legislation in order to prevent that adjustment process from occurring.

Mr. LAFALCE. OK.

Let me switch to monetary policy. I am always troubled by what I draw to be the good news/bad news dichotomy. If there is bad economic news, well, this could be good news for investors, because it is an indication that the Fed is going to lower rates in the future. And if there is good economic news, well, this could be bad news for investors, because it is an indication that the Fed would be less likely to decrease rates and possibly, you know, increase them, and so forth.

I don't know what, if anything, can be done about that.

But to what extent—I mean, it is one thing to say that you will conduct monetary policy, not with an eye to the markets but with an eye to the economy. On the other hand, there is such a relationship between the markets and the economy that it is—I think not almost, it is impossible to conduct monetary policy without factoring in and giving great weight to what impact the market movements will have on the real economy.

How do you deal with that?

Mr. GREENSPAN. Well, Congressman——

Mr. LAFALCE. With great difficulty, I am sure.

Mr. GREENSPAN. Of course. That is why monetary policy is a difficult activity. I don't deny that. What we do is focus on the economy, and clearly to the extent that financial factors in our judgment are affecting the economy or will affect the economy, clearly we focus on them.

But remember that there are often occasions when financial activity will not affect the economy. So while it is true that there is a very close relationship, it is not airtight, and it is not the same as saying that if you target the financial variables rather than the economy, you will automatically obtain maximum sustainable economic growth, which is our fundamental goal.

In a number of instances that does happen to be true, but you have to be very careful to make the distinction between what we are focusing on. So that we examine and evaluate financial factors only to the extent that they will impact on the American economy one way or the other.

Chairman OXLEY. The gentleman's time has expired.

The gentlelady from New Jersey, the Vice Chair of the committee.

Mrs. ROUKEMA. I thank the Chairman and Chairman Greenspan. We welcome you here today. And I have listened, tried to listen very intently. But Mr. LaFalce has preempted the focus of my question, which had to do with monetary policy and the rate cut; and I don't know if when I was over there voting, if you had any implications—or if there are any total implications about what your action may or may not be in August when you have the next Open Market Committee meeting.

And I don't want to put you to the test here, but let me just say that I have strongly supported and think that you have been very well advised in the past on your rate cut proposals.

That having been said, you can feel free to say what you wish or ignore the question in terms of the upcoming evaluation.

Mr. GREENSPAN. I will scrupulously opt for ambiguity on that very specific question.

Mrs. ROUKEMA. I noted that. But we can come to some assurance or conclusion based on what you have said thus far, that is, that there is an improved economy here, that there are heartening signs in the economy. Yes?

Mr. GREENSPAN. I do think that we are seeing signs that the bottom is beginning to structure itself. It is still tentative, and clearly the risks, as we put it in our official statements, are toward economic weakness, and indeed that is the case.

But if you look at it in terms of the rate of deterioration, it is slowing, very clearly. In fact, as I put it in my prepared remarks,

what is really quite remarkable is that with this extraordinary litany of negative elements that have been going on day by day, month by month, the economy is still standing, if I may put it that way.

And that is suggestive of the fact that there is some monumental support in the system. And in that regard, while I would scarcely want to forecast the intermediate or short-term period, because there are a lot of negative factors throughout, there are the first signs that something of a positive nature seems to be developing. And as I said, the data that are coming in, which have been unrelentingly negative for quite a period of time, have now turned mixed.

Mrs. ROUKEMA. I am glad to hear you say that. It underscores what you did say in your formal statement. But I wanted to hear you say it in the context of a question of rate cuts in the future.

Let me ask you this as the Chairwoman of the Housing Subcommittee—by the way, in terms of the overall tax bill, I voted for it, and I voted for it enthusiastically, although I would have had it more savings- and investment-oriented.

But I wonder, on the housing front, if you would make any recommendation or have any opinions about how we not only make it more economical, but provide more incentives through the tax code or investment strategies to get more housing out there, and to make it very accessible to middle-income and low-income people, particularly with respect to mortgages, mortgage down payments, and so forth.

We need that kind of help, and I wonder if you, from your perspective, could give us an insight or a recommendation.

Mr. GREENSPAN. Well, I think it is important first to recognize that we are not doing a bad job on housing. I mean, the housing start figures this morning, for example, were reasonably good despite all of the negative elements involved in the various high-tech areas. If you look at the broad markets for certain consumer durable goods, like motor vehicles, which are still doing reasonably well, and housing, we have to say that the data are not bad.

We can see by the extraordinarily high level of refinancings that are going on that people are beginning to lower their costs of servicing, and most remarkable is that despite all of the general weaknesses that we perceive in the economy, the underlying market value of one- to four-family homes is moving up significantly.

Capital gains in this area have been really quite remarkable. And as I indicate in my prepared remarks, there is very evident strength that is coming into the consumer markets from the extraction of equity out of homes.

What this suggests is that we have constructed a very sophisticated housing economy, and it is having a significant effect on consumer spending and indeed the rest of the economy, so that while I would certainly not disagree with the desire to improve upon it—and I think there are a lot of things we can do—I think it is important for us to recognize that it is in reasonably good shape at this stage, and that we have done an awful lot which has improved the system as a whole.

Chairman OXLEY. The gentlelady's time has expired.

Mrs. ROUKEMA. Thank you. I appreciate it.

Chairman OXLEY. Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman.

Chairman Greenspan, it is widely held that the future of the economy is based on increased productivity from technological excellence. You yourself have said many times that the advances in technology were a primary force in the expansion of the United States economy in the 1990s.

Unfortunately, many of the companies that drove the successes of the country in the last decade are facing dire circumstances today. As a result, people are losing jobs, investors have seen their savings depleted, and a recent report indicated that the average 401(k) retirement balances have fallen over a 1-year period for the first time. Our technology sector may take years to recover.

It would appear that the Fed's policies may have contributed to this pattern of bubble-and-bust, raising interest rates six times from June of 1999 to May of 2000 and then sharply reversing course and cutting rates dramatically this year.

My questions are about the Fed's actions of the last 2 years and going forward, the impact of severe problems in the technology sector on the fiscal situation here in Washington.

Looking back, why did the Fed continue to raise rates as technology companies were hemorrhaging workers and market cap through May of 2000 and going forward? What is the impact on the fiscal situation of the Federal Government if productivity does not increase but remains strong in the years ahead, especially since many of the increases in productivity of the last 10 years were powered by the technology sector that is suffering now so substantially in our economy.

Mr. GREENSPAN. I tried to address that in some detail while you were out voting, so rather than take your time at the moment, I tried to explain some of that issue in my prepared remarks.

Let me just say that the productivity data which are showing softness in the last two or three quarters have come down pretty much in line with what one would expect if the underlying productivity trend were rising. So it is not something which suggests that this is a bubble without any underlying fundamentals. Indeed, it is very likely that the second quarter data—which we don't have yet, so I am making very rough approximations—are very likely to be positive, reversing the negative number in the first quarter.

But overall, I think that the budget outlook does depend on productivity increasing at a pace faster than it did in the 20 years prior to 1995. I see no evidence to suggest that that has changed, that is, that the numbers being used by OMB or CBO for long-term projections have been compromised in any significant way.

The important issue that I try to make—not in the remarks I made while you were out voting, but it is in my prepared remarks which I didn't deliver—is that it is to be expected that we will often, as central banks, move up rates and move them down as we confront significant changes in the business cycle, and what we were responding to in the last couple of years was a surge in investment—remember that we were getting increases in production, 50 percent at an annual rate, for all high-tech, on average. That is utterly unsustainable. We were leaning against it, as indeed the capital markets were. And then as the process came to a better ad-

justment, we reversed, which is precisely what you would expect us to do and what we have done in the past, and I would certainly expect we will do in the future. And the process of trying to address imbalances between investment and savings, which emerged in 1999, and the reverse, is a typical central bank policy process. And looking back, I think we did about as good as you could for that type of cyclical set of events.

Chairman OXLEY. The gentlelady's time has expired.

The Chair is pleased to recognize the gentleman from Long Island, Mr. Grucci.

Mr. GRUCCI. Thank you, Mr. Chairman.

Mr. Chairman, it is great to have you with us again, and your insight is also helpful to Members here, certainly to me. In listening to the first part of your prepared text—and I apologize for having to step out to vote on the Journal, but I did hear that you talked about inventories as a function of the economy.

My question goes along these lines: we have inflation at a low, and it is in check. We have interest rates at their lowest point in a long time. Access to capital seems to be fine, and the housing starts are strong, as you have indicated. So why are there still high inventories?

And to the extent that you can answer this question, what are the inventory levels, and how long do you think it will take before we can bring them down so that we can get back into manufacturing—which I would assume is the message that will help stimulate the economy; and if indeed that isn't, are we missing something as a stimulus package, for example, omit a capital gains reduction?

Mr. GREENSPAN. Congressman, I think the evidence suggests that inventories are still declining. In other words, the rate of liquidation, while it has slowed some, is still adjusting, and it is a reflection of the improvement in the technologies which has enabled rapid adjustments to take place. And I think it will go on for a while in the high-tech area where, for example, in communications equipment we are only now beginning to see the inventory rise come to a halt. In other areas of high-tech there is some liquidation, but just now beginning. In the first quarter, a very significant part of the adjustment was in motor vehicles, which had extended inventories to their days supply well in excess of normal, and with a few model problems now, inventories are reasonably well in place.

The important issue is that you do not need an end to inventory liquidation before production starts to come back. What you need is a dramatic slowing in the rate of decline, because if consumption holds up and production is below consumption, which is inventory liquidation, just slowing the rate of liquidation raises the level of production and jobs.

We have not yet got to that point, but that is the process which we expect to evolve, especially if overall final demand holds up reasonably well.

Mr. GRUCCI. To the issue of capital gains, do you see that as a help to the economy at this point, capital gains reduction?

Mr. GREENSPAN. Congressman, I have always been in favor of capital gains reductions as a general, overall policy. I have stipu-

lated that I did not think that the capital gains tax as such was, from an economist's point of view, an effective means of raising revenue.

I think it is a public policy issue, but from an economic point of view, I find it not a useful tax to raise revenue. So that I am obviously, other things being equal, and they rarely are, but other things equal, I am always in favor of addressing the capital gains tax in the effort to reduce it. I wouldn't say that I would be in favor under all conditions, but as a longer-term issue, if you could substitute other taxation for capital gains taxation, I would always be in favor of that.

Mr. GRUCCI. Thank you.

I yield back the remainder of my time.

Chairman OXLEY. The gentleman yields back the balance of his time.

The gentleman from Pennsylvania, Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Chairman, welcome to the committee. I want to follow on something Mr. Sanders said. He gave you an opportunity to defend your purest position as a free marketer when you testified you were opposed to the minimum wage.

That is a little disappointing. I understand your——

Mr. GREENSPAN. Remember, it is not because it is a free market issue; it is because I think it destroys jobs, and I don't like to see people lose their jobs.

Mr. KANJORSKI. Mr. Chairman, we were down to about 4 percent unemployment. We couldn't find hide nor hair of employees to work. There are still a great deal of American employees who are being paid the minimum wage.

But not to argue that point with you, you may have provided the answer, too.

In my area of Pennsylvania, in the last 3 weeks, we have lost about 1,500 highly prized manufacturing jobs to Mexico; and the statements of the companies that were leaving were that they can't pay $18 an hour in Pennsylvania, but they certainly could compete at $1 an hour in Mexico. And maybe by doing away with the minimum wage, we can save those jobs in Pennsylvania, because then we can compete with Mexico.

If that is the policy, I would assume that would result. But I am not getting into that.

I am going to give you the other side of the coin. Most recently, something troubling, a company that was losing money, significant loss of money and potentially going into insolvency, had just paid one of its CEOs a bonus of $16 million. And then a health care company, which is in dire straits as a result of the entire health care field, announced as a salary for their CEO to be $40 million a year with stock options of $160 million a year.

Obviously, he is not affected by the minimum wage. But I was wondering whether you think there are any policy considerations there that—if we can reduce the minimum wage, do we just set this economy afire and let hell be damned and anybody draw anything that they can support.

Mr. GREENSPAN. Well, Congressman, I am disturbed by some of those numbers myself. I don't think that shareholders are essen-

tially looking after their interests properly, and I think some of the reasons why some outsized payments are being made, especially under so-called "golden parachutes" or the like, are based on motives which I don't consider to be particularly sterling.

Whenever you deal with an economy such as we are dealing with, which is effectively an open market, competitive economy, it is very difficult to find all forms of what appears to be cut-throat competition and egregious actions, I don't deny that. The problem basically is that the countries or the economies which try to eliminate that end up as stagnant economies, and I think that is inappropriate.

But if you ask me whether I feel comfortable with some of those payments, I do not.

Mr. KANJORSKI. The final question is really more to policy, Mr. Greenspan. I looked at your statement and heard your testimony, and I would project that you are one of those economists that has seen an end-year turn, and the economy is OK.

I am not as optimistic in that, particularly in light of the problems still continuing in Japan and now the potential in the EU of going under. From what I understand of the American economy, other than really housing and the auto industry and unusual consumer optimism, we could slowly be deteriorating into a recessionary problem.

My question is, assuming things do not occur as you anticipate, is it time that we have a contingency plan, since we are facing a global economy without the institutions in place to necessarily put on the brakes or control the stimulant effect that Government could have on various economies around the world, even though we have a rather sophisticated way of doing it in the United States?

Can you give me some assurances that the Federal Reserve is working with those people, if not the Congress, toward a contingency plan if, come December or January of this year, the downturn is continuing and the stabilizing base that you are talking about doesn't readily appear?

Mr. GREENSPAN. Well, first of all, let me just say Congressman, that it is difficult to take our economy and take consumers and housing—consumer expenditures and houses—and say the rest is not doing well. If you have stable consumer and housing sectors, that is going to support the total system, because that is a very big part of the economy.

Mr. KANJORSKI. Do you believe that is going to continue and not deteriorate?

Mr. GREENSPAN. I can't say that.

Mr. KANJORSKI. Well, I guess I am.

Mr. GREENSPAN. All I can say to you is it has been remarkable.

Mr. KANJORSKI. Should we worry if housing starts to deteriorate and consumer confidence starts to fall in the next several months?

Mr. GREENSPAN. Oh, sure. As I said in my prepared remarks, I think that we are not out of the woods, and there are clearly risks that a number of things that could go wrong could very well go wrong.

But to respond to your question very specifically, we obviously are in continuous contact with our trading partners abroad. We have meetings periodically amongst central bankers in various dif-

ferent areas of the world. And there is, working through finance ministers and central bankers, especially for the G–7 and the G–10, a secretariat and infrastructure to effectively integrate all of our various different policies and discuss them one way amongst ourselves.

So that the answer is, yes, we do obviously communicate. We are in constant communication in one sense, in that we know how to get in touch with somebody very quickly, and when we have to, we always do.

Chairman OXLEY. The gentleman's time has expired.

The gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

Welcome, Chairman Greenspan. We here in the United States have one of the lowest personal savings rates in the world, and in the past, that has been because we have run deficits in every year and because Americans just don't save.

We have done something about the deficit situation; with a little bit of fiscal discipline, we have turned that around. But we are still down to the fact that Americans don't like to save and invest. We have got—in 1999, I think it was—a 2.2 percent investment rate, which was the lowest savings rate since the Great Depression.

Now, in order to affect that, one of the things we have tried to do in the past is to push the creation of IRAs, 401(k) plans, medical savings accounts, flexible spending accounts for health care, education savings accounts, items like this.

I would argue that maybe that has done some good. But our support for these things has been half-hearted.

For example, with medical savings accounts it is very, very difficult under the regulations that were set up to actually have those offered to many Americans with flexible spending accounts for medical care. They, in fact, can't be rolled over from year to year. So 70 percent of the employees that are offered that option don't do it because they will lose it at the end of the year because it is not a true health banking system.

And I guess my question is, if we were to actually expand this type of savings incentive in the market for people, could the creation of true medical savings accounts and flexible savings accounts and so forth lead to a significant expansion of the economy, because you would have that savings and investment in the capital markets that would go on then to cause increasing production activity? And I would like your view of that.

Mr. GREENSPAN. Well, first of all, let me just say that the average householder would not agree that they are saving less. The reason they would argue that is that when they think in terms of savings, they take all of their assets, and so that where our savings rate, the one that we publish, shows a very low savings rate, in fact, it is negative if you take it literally, it is partly a fiction in the sense that what we do is we exclude the capital gains that people perceive as a value. So that if you have, as indeed we do, a reduction in disposable income by including taxes on capital gains and indeed taxes on the capital gains of stock options, you actually reduce disposable income significantly, but don't take into consideration the fact that those taxes were paid on incomes or receipts which are not included in disposable income.

So the average householder doesn't view it as a reduction. Their view is that despite the fact that their 401(k)s have gone down in the last year, as the Congresswoman mentioned before, they are up very sharply from where they were 5, 10 years ago, and the average householder has a significant rise in net worth.

Our statistics may show that they are not saving. They are saying, "I don't understand what you are talking about." But having said that, I do think that the issue of 401(k)s and IRAs specifically have been very useful vehicles to enable the average householder to accumulate wealth, and, in my judgment, there is nothing more important for the stability of a society of our type than everybody believes that they have a piece of it, they are a part of it, they benefit from it. I think anything that can be done to increase wealth at all income levels is highly desirable.

Mr. ROYCE. You spoke last year here of our tendency in the markets to rely increasingly on savings from abroad or on investments from abroad. Would the creation of true medical savings accounts and the expansion of flexible spending accounts for medical care and other health banking concepts, would that help in terms of accruing savings in the market?

Mr. GREENSPAN. Congressman, I don't want to discuss any particular form of program as such.

Mr. ROYCE. I see.

Chairman GREENSPAN. All I can say is that what is crucial for this country going into a period when we are going to get a very significant increase in the ratio of retirees to workers, it is crucially important that we increase the savings rate generally and enable a pickup in investment which will accelerate productivity, because it is a necessary condition for producing an adequate amount of goods and services to essentially service both the retirees and the workers. Whatever financial system we construct to do that should focus on answering the question, does this enhance savings, and therefore does it assist in addressing this long-term problem that we have?

Mr. ROYCE. Thank you.

Chairman OXLEY. The gentleman's time has expired.

The gentlelady from California, Ms. Waters.

Ms. WATERS. Thank you very much.

I would like to welcome you to our committee today. We, as always, are very pleased to have you come, Chairman Greenspan.

Before I focus on the question that has been most on my mind, I just would like to take exception to your description of housing in this country. We have been holding extensive hearings in this committee, and many people on this committee, many Members, believe there is a housing crisis. There certainly is a housing crisis in California, and I am very surprised at your description of housing and the fact that you believe that it is doing well in this country, and we shouldn't have to worry about it at this point in time.

Having said that, we have to make public policy here to take care of all of our taxpayers. We are not only concerned about the middle class and the upper middle class and the way we have to take care of a lot of poor people, we have to do that, and we have to develop public policy to do that.

You and I may disagree on a lot of what we have to do for poor people. We may disagree on minimum wage, subsidized housing, Federal intervention, capital creation for business. We disagree on all of that, but, at the same time, I and others have to be concerned about public policy to deal with all of these issues to make sure that we do what we can do to have a decent quality of life for Americans who may not fit into the middle-class or upper-middle-class model.

Having said that, this tax cut that has been passed in this Congress is public policy. Based on the projections of the income, the revenue now that was supposedly going to be received by our Government, it was based on the generous surplus that was being projected over a period of time. Now, you have described more than once here today that there is a softening of the economy, that the money that went into the high technology sector of our society oftentimes may have been money that was taken away from other sectors of our society. But there is a free fall now in that sector, and the jobs are being lost. The layoffs are perhaps more than were expected.

Given that and some of the problems that are being described here in Argentina and Brazil and other kinds of things that are impacting on this economy, how are we going to protect the programs and the services that many of us have worked very hard to provide for the average American, given the tax cuts? We are going to now have to take away from funding these programs and services to pay for this tax cut.

Now, I know this is not politically popular to have to discuss this tax cut, but I would like to ask you again to reflect on housing, and what you said to us about housing being in good shape and the fact that there is a lot of refinancing going on, but talk to us a little bit about people who don't own housing, who are looking for a place to live who can't afford rents and can't afford down payments, and then talk to us about how we implement a tax cut and take care of the very basic programs that we have become accustomed to in this country to take care of the average person.

Mr. GREENSPAN. Well, Congresswoman, let me say the reason why I say that housing is better than we talk in terms of, let's look at the positive side. We have had a significant increase in the proportion of families who own homes. A disproportionate part of that rise has been minorities and lower-income groups. Indeed, a goodly part of the reason why housing is doing as well as it is is immigrants buying homes. So the issue of merely saying what has to be done, and I don't disagree with you that a lot has to be done, should not blind us to the fact that there has been some fairly significant improvement. Indeed, all of the activities that have been under way for a number of years have actually done a lot of good.

Let's acknowledge that, because if we are going to consciously say we have got a long way to go but we haven't made any progress, then people get discouraged. In other words, if you just keep saying, we are trying to move from A to B, but we never can get there, you lose confidence in what you are doing.

I think it is important for us to say we have made progress in this area, but we have got a lot more to make, and that the actions that were taken previously with respect to housing affordability

have paid off, have worked. If you are not going to say that, then you are basically saying new initiatives have no more reason to work than the old.

So I think it is a question of whether or not you are looking at the glass half full or half empty. I am happy to think that there is a very positive story to be said—to be put out front here, and, frankly, I think it is a story which effectively stipulates that if we go forward, there is good reason to presume that we will succeed. That is good, not bad.

Chairman OXLEY. The gentleman's time has expired.

Mr. Miller.

Mr. MILLER. Thank you, Mr. Chairman.

I agree with your statement that the housing market is extremely robust today. I have been in the industry for over 30 years myself, but I go back to the early 1980s when, you recall, the prime rate reached close to 25 percent. People couldn't buy homes, they couldn't sell their homes, and it took until the mid-1980s for recovery to start. I built mainly in the California area, and when the recovery started, builders were basically building on foreclosed properties, and they had artificially lower market value on those properties than they should have normally paid if they had bought vacant land and gone through the entitlement process at that point in time.

So prices were kept down fairly low through the mid-1980s. Late 1980s, though, you saw a huge, robust market similar to what we have today, especially 1989, first of 1990. Builders at that point in time were building on newly entitled property, but, as today, they could not keep up with the pace and demand based on the protracted process they had to go through to get entitlements to develop land.

And then in 1991 a huge recession hit California. The State of California made it worse by increasing taxes, which drove many families out of California. So you did have some relief in the demand for housing, but, at the same time, many people owned homes that they owed more on the home than the house was worth based on market value, because they had bought homes in an artificially inflated market in 1989, first of 1990, because you could build a home; a line would stand in front of it to buy the home.

It took through the middle 1990s for that to start to change, and even as 1996 and 1997 approached, many builders were still building on foreclosed properties that were taken back by lenders, and they were buying them at reasonable rates, and they were ready to go.

In the last few years, though, specifically in California, where you have demand about five times the supply that is being provided in the marketplace, builders are having to go back and build on newly entitled property, and, as you know, the EIR process has completely eliminated any time line where in the Government has to respond to the entitlement process on maps.

Today we are facing the same situation that we faced back in the late 1980s, is when you build a home, you build a subdivision, people are standing in line to buy it. They are buying at high prices. People today are able to refinance their properties and take a lot of money out of them because prices are high based on demand

that is tremendous, yet the supply is not keeping up with the demand again.

My question is specifically based on the historical perspective. Do you see us entering a problem like we did in the 1980s, like we did in the 1990s, when demand cannot keep up with the free market system because they are unable to entitle properties at the rate necessary to build?

Mr. GREENSPAN. I think the issue varies very significantly by sectors of the country. That is, the problems that emerge in housing always seem as though they are unresolvable. I think that one of the things we have found is that the homebuilding industry in this country is really remarkable in the sense that it continues to come back, no matter what the problems are.

Mr. MILLER. But with different players, it comes back.

Mr. GREENSPAN. Indeed. In fact, I was about to comment that I remember, I think it was back in the 1950s or the 1960s, I was in southern California, and everyone was bemoaning that the homebuilding industry was absolutely dead, all of the home builders had gone out of business, and 2 years later they couldn't build enough homes.

It was a whole new set of players. But what has happened, as you well know, is that we have smoothed out the building cycle, and indeed, with the finance that has been built into the system, we have taken a lot of the movement out of the cycle. But there are very considerable problems—I don't want to get into them as you know them far better than I.

Mr. MILLER. We have taken the financing problem out; that is, rates going up tremendously like they did in the 1980s, which caused the recession to occur in housing. They have remained stable. But my concern, and I hear some friends of mine on the Democrat side, they are concerned about affordable housing. You cannot build homes rapidly enough to guarantee an affordable housing market, because there is such demand, we are artificially inflating the cost of housing again.

That is my concern: if we can sustain a marketplace that is robust with Government processing artificially decreasing the amount of supply on the market.

Mr. GREENSPAN. Clearly if that happens, then there is a problem. But we have had a very long period of very significant demand. It is unlikely to continue to grow. In other words, as you know, there has been a significant decline in building and in prices of very high-priced homes, especially in California, and, in fact, it is pretty much across the board so that we are going to see ups and downs. I don't deny that there is a problem, but you don't see it in the macro-data at this particular point, although I certainly acknowledge the fact that for individual areas or individual types of housing, there are difficulties.

Chairman OXLEY. The gentleman's time has expired.

The gentleman from Illinois, Mr. Gutierrez.

Mr. GUTIERREZ. Thank you very much, Mr. Chairman. I am from the city of Chicago, and I built a lot of the bungalow belt in the city of Chicago. So there is a lot of home ownership, but there is also a lot of renters.

And let me just share with the Chairman my experience. My experience is that we have a market in which more and more people are put into poverty because more and more of them are paying in excess of 30 percent of their income for rent. It is not a question, Mr. Chairman, not even of people being able to own a home, it is the difficulty of people to pay rent. I have increasingly seen numbers of people who are paying 40, 50, up to 60 percent of their income in rent relative to their income.

So I know the macro-picture. I want to share with you that in the inner cities, which I think is important to our national economy and to a robust economy that we don't have a Nation that is so divided, we are normally between those that are further and further put away from ever owning a home and are having difficulty every day in raising their rent.

I want to go back, Mr. Chairman, to your comment on immigrants and the fact that home ownership has increased. I was hoping I could encourage you to speak again about the importance of immigrants to the Nation's economic health.

The last time you were here, in fact, in front of the committee last year, in the midst of a relatively low unemployment, you, said, quote: "There is an effective limit to new hirings unless immigration is uncapped." I was hoping that you could take a minute to speak a little bit more on that point and why it is important, what is the importance of immigration and its vitality to our economy, and, to take it a step further, what it would mean for U.S. businesses if the immigration population was rapidly reduced.

Mr. GREENSPAN. What was the last part of it?

Mr. GUTIERREZ. If the immigrant population was rapidly reduced in this country.

Mr. GREENSPAN. Congressman, I have always argued that this country has benefited tremendously from the fact that we draw people from all over the world, and the average immigrant comes from a less benign environment. Indeed, that is the reason they come here. They appreciate the benefits of this country more than those of us who were born here, and it shows in their entrepreneurship, their enterprise, and their willingness to do the types of work that make this economy function.

I would be very distressed if we were to try to shut our doors to immigration in this country. I frankly don't envision that happening, but I understand that there is always that tendency on the part of people who are here, having come here or having come here four generations earlier, to want to shut the door. I don't think that is a good idea.

Mr. GUTIERREZ. Mr. Chairman, I agree. I have a congressional district that, when you look at per capita income, we rank the lowest of all of the congressional districts in the State of Illinois. We also have the lowest unemployment in my congressional district, which can only lead me to believe that incomes are low, but people are working. Obviously I have the highest immigration population in the State of Illinois or anywhere in the Midwest, so I agree with you.

You also spoke about the necessity to increase savings and wealth so that as we have an older population, they can sustain themselves. Could you talk a little bit about immigrants and—be-

cause I understand that in the 1950s, there might have been, I think it was 15-, 16-to-1 for every one that was on Social Security vis-a-vis our Social Security Trust Fund, and then in the next 10 to 15 years it may be 2-to-1, that is 2 people paying in to every one. And the relationship of immigrants being 70 percent of them are of working age—they tend to think that they are all children coming across the borders—and if 70 percent of them are of prime working age, what that could do to our Social Security Trust Fund.

And if you have any figures on what immigrants contribute to the trust fund vis-a-vis—I am talking about net, vis-a-vis what they receive, because a lot of people complain about immigrants, because they say they cost more than they contribute, but I once saw a study that said in the next 20 years, they are going to contribute $500 million more net into the Social Security Trust Fund. That is immigrants, people who were not born in the United States, but are legally and lawfully here in this country.

Mr. GREENSPAN. Well, I think the law stipulates that with, obviously several exceptions, you don't draw Social Security benefits until you are 62 at a minimum, but you contribute very substantially to it prior to that. To the extent that immigrant population on average is well below 62 years, it necessarily flows that you do build up the fund as a consequence of that.

I wouldn't, however, argue for immigration on the grounds that it helps the Social Security system. It does. I grant you that. I think we ought to do it on the grounds that it is the right thing to do.

Chairman OXLEY. The gentleman's time has expired.

The gentleman from Florida, Dr. Weldon.

Dr. WELDON. Thank you, Mr. Chairman. As always, it is a pleasure to hear your testimony. I apologize I had to run out.

I did want to ask you, Chairman Greenspan, when do you expect the economy to rebound?

Mr. GREENSPAN. Well, I think the best way to answer that is what we see at this stage is an economy which is still weak, and indeed in certain respects is still deteriorating. But the rate of deterioration is clearly slowing, and indeed there is considerable evidence to suggest we are approaching stability at a lower level.

The next stage, of course, is as you put it, a rebound. I don't know whether or not you would describe what is going to occur as a rebound, but clearly, as things begin to coalesce in a positive manner, you get cumulative reduction in uncertainty and risk premiums, and people reach out, start to invest, and the economy starts coming back.

Dr. WELDON. Let me press you a little further. Are we talking about the fourth quarter? Are we talking about the next calendar year?

Mr. GREENSPAN. I purposefully don't want to answer that in a specific way, because I don't think that we know exactly. If I had to make a forecast, I would say that toward the end of this year we will see things improving, and clearly some next year, but you can't forecast that well, and I think is it a mistake to have a point estimate. Indeed, as I discuss in my prepared remarks, what we recognize is there are distributions of probabilities around a number of different forecasts, and we can't forecast that well. We can

observe the process and make projections on how we think things are evolving, but other than saying what I just said, we can't go very much farther now. I know that there are probably people who will tell you that the economy is going to grow 6.25 percent over the next 3 years.

Dr. WELDON. I wouldn't ask you to be that specific.

Mr. GREENSPAN. What I am trying to get at is it is outside of the scope of anybody's capacity to be that specific.

Dr. WELDON. Well, I appreciate your frankness. I just have one other quick question for you.

As you know, GDP was growing back in 1995 at about a little over 2 percent, and then it bound up to a little over 4 percent in 1996, and then it went really high in 1999. My observation was that a certain portion of that was due to the tremendous amount of speculation in the dot.com community, and as we all know, many of those investment opportunities were built on business assumptions that didn't pan out.

Would you say it is reasonable to assume that barring any further kind of robust speculation in an economic sector like that, we should not expect those levels of growth again? As you know, we have got up to 5 percent growth rate in GDP, and a lot of people were saying that, in so many words, it is impossible to sustain and that it was built on that speculative environment that existed.

Mr. GREENSPAN. Congressman, the way we make that judgment is to look at whether or not both capital and labor resources are being strained. What we observed in 1999 was that the number of workers who were willing and able to work was going down, meaning we were draining our pool of people who had no jobs but wanted to work. And we observed that our excess facilities were being dissipated in the sense that we were putting pressure on both labor and capital resources.

What that tells you is you cannot go on indefinitely at that growth rate. And whatever that growth rate is at that time, it is higher by definition, than what is sustainable.

Dr. WELDON. If I understand you correctly, you look at those figures, employment levels more so than the percentage of growth in the economy per se.

Mr. GREENSPAN. Yes. And the reason essentially is that the missing element is the rate of growth of productivity, output per hour growth. And if you really want to judge whether the economy is straining or not, meaning whether it is growing beyond its long-term capabilities, there are all sorts of signposts which can give you that type of evidence—whether it is the unemployment rate, whether it is those not in the labor force, but who would work if a job were available, whether or not operating facilities and plants are being pressed, or whether there are shortages of capacity in certain areas.

There are all of those signals that we employ to determine whether, in fact, a specific rate of growth is sustainable. And back in 1999 it was not.

Chairman OXLEY. The gentleman's time has expired.

Let the Chair announce that there is a vote on the floor. That is a second notice. We plan to keep the hearing going. Mr. Paul is going to go over to vote and then come back in the chair.

So we will continue with recognition of the gentleman, Mr. Bentsen from Texas.

I would advise the Members if they want now to go over and vote, and then come back, we will try to keep the same order of questions.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman Greenspan, your testimony and also your semi-annual report seem to me to be a little more bearish than what you told us when you were here in February. And obviously, since that time, we have had more experience with the economy. You and the Fed have had more opportunity to see things that we may not see, or more time to look at those things and think about them.

But it seems, when you testified back in February, that while the Fed was concerned about the backup in inventories and the inventory sales ratio, there was a feeling that with this sort of new paradigm in the economy, that that would be able to correct itself—hopefully, be able to correct itself more quickly. And the bigger concern was consumer confidence and consumer behavior, which obviously, none of us can interpret.

In your testimony today and looking at what the central tendency of the Board is, that the concern about inventory sales backup and the manufacturing sector of the economy is much more pronounced than perhaps it was in February; that as opposed to looking at maybe a third and fourth quarter recovery, we are seeing, if I quote you correctly, the structure of the bottom coming together at this point in time. And so the problem does seem to be more profound.

What also concerns me is that based upon your report, you do not seem to indicate—contrary to some of the columnists in the Washington area—you don't seem to indicate that this is a liquidity issue necessarily, that there is still sufficient liquidity in the capital and credit markets, but that this is clearly a demand side problem.

What I would like to ask you is—and I guess reading your testimony—obviously you give us no indication of where the Fed is going which is, of course, your primary role when you come here. But it does seem to me that you all appear to be still somewhat concerned about the lack of strength in the economy.

At the same time, it appears, since you were here in February, the world economic condition has worsened as well, and we know that there continue to be problems in Turkey. Argentina is suffering problems. The European economy has not rebounded. The Japanese economy has fallen back into recession and the Asian economy, except for perhaps the Chinese, is appearing to be slack as well.

At the same time, the dollar remains exceedingly strong to the other main foreign currencies, and what concerns me is a new round of contagion that doesn't necessarily affect just emerging economies, but has a negative impact on the U.S. economy. And I would be interested in your comments on that.

Also, the fact that the Bush Administration has signaled that perhaps there will be a change in the U.S. approach to contagion and to how we address international economic meltdowns, although

I don't think they know exactly what their policy is. And fine, I don't want to delve into the fiscal policy, and you may not want to answer this.

But in your comments—which, again, if you read through them are very bearish, I think you do mention that you think that there is a potential for an uptick in the outlook, in part because of reducing energy prices and the tax cut. And I have to ask you, because again I know you are not a Keynesian, that the tax cut, as I see it, is rather back-loaded, and I find it hard to believe that you or the Fed would think that it is stimulative, as you might make it appear, unless you think it is stimulative from a psychological standpoint and not a quantitative standpoint.

Mr. GREENSPAN. Congressman, let me just say that if you go back and you read the February testimony, you will find an awful lot of qualifications as to what was going on at that particular time. And in a certain sense, even though the actual point forecast is lower now than it was back then, if you want to take it literally, the risks were greater back then. In fact, you may recall I was talking about the possibility of the fabric of consumer confidence being breached by the weakening of the economy going on, which would have been a very significant downside contraction. That has not happened. And, indeed, in a certain sense, I would say I am far less concerned today about the type of breach in the structure that was emerging late last year and early this. And as I pointed out in my prepared remarks, it is important to recognize that despite all of the shocks that are involved in both the domestic and international economy, our economy is still doing, not well, but clearly far better, given what has happened, than I would have forecast 6, 8, 9 months ago.

So let me just say that, yes, the forecast is lower, but the range around that forecast is much narrower than it was, at least from my point of view, going back 6 months ago. And I think that is a very important issue.

I am not saying that we are about to recover in a strong way. In fact, in the remarks I have indicated the long litany, as I put it, of the negatives that are out there are things that we can't just push aside. But in a more important sense, we have come a long way through this adjustment process, and we are still standing. And that is good news as far as I am concerned.

Chairman OXLEY. The gentleman's time has expired.

The Chair would announce a brief recess for the vote.

We would expect that when Mr. Paul returns, he could take the chair and we could begin the questioning again.

Mr. BENTSEN. Mr. Chairman, the other issues, if he could answer for the record, I would appreciate that.

[The information requested can be found on page 89 in the appendix.]

Chairman OXLEY. Absolutely.

The hearing stands in recess for 5 minutes.

[Recess.]

Dr. PAUL. [Presiding.] You mention about the Keynesian approach to economics of a few decades ago, believing that they could eliminate the business cycle; and your conclusion is, really you can't, because you can't control human nature. And I agree that

you can't control human nature and I agree that human nature and subjectivity is very important.

But I would also argue that businessmen are human beings and enjoy human nature—they are rational humans, and they react in a rational way to interest rates and the signals they get from you and the Federal Reserve. And therefore, when interest rates are artificially kept low, they will do precisely what they have done; they generate to overcapacity. And, of course, in a recession, this has to be liquidated and we are now in that stage.

It doesn't surprise the hard money school that we are in this phase of liquidating this overcapacity, and it should be; but we would also argue that the Fed may be doing exactly the wrong thing.

Everybody criticizes you. Nobody comes to you and says, "Oh, Mr. Greenspan, you print too much money; you generate too much credit; your interest rates are too low." But the argument from this other school is saying that, precisely the opposite.

It says that because, in the past, you manipulated interest rates, you have caused the boom, therefore, you have made it a certainty that we would have a recession. And literally, by quickly resuming the inflation, the debasement of the currency, that sometimes works and sometimes it doesn't work and that we are now in a period where it isn't working.

It didn't work in Japan, and this is part of human nature too, or the way the businessman responds. One time he responds the way you want and the next time he does not.

So, is there a possibility that you recognize that maybe interest rates were manipulated in the wrong direction, and maybe if we had to live with a fiat currency, it would have been better, since 1990, to take the average rate of the overnight rate and just make it 4.5 percent, just left it there, rather than doing this and causing all these gyrations?

I would like you to comment on this, these ideas about monetary policy, in the hopes that maybe we can avoid what we in the hard money school see as a very serious problem and one that could get a lot worse, where we do not revive our economy, just as Japan has not been able to revive theirs.

Mr. GREENSPAN. Mr. Chairman, so long as you have fiat currency, which is a statutory issue, a central bank properly functioning will endeavor to, in many cases, replicate what a gold standard would itself generate.

If you take the period in the United States where the gold standard was functioning as close as you can get to its ideal, which would be from probably 1879 probably through the turn of the century, you had a number of business cycles in that period. And in many respects, they had very much the same characteristics that we just observed in the last couple of years: the euphoria that builds up when the outlook improves and people overextend themselves and the markets shut them down.

Well, what shut down the market was the very significant rise in real, long-term interest rates in 1999, and in that regard, that is the way a gold standard would have worked. So I would submit to you that the presumption that if you have a hard currency re-

gime, you will somehow alter human nature any more than a fiat currency one will, I will suggest that that does not happen.

I certainly agree with you that if we would just pump out liquidity indefinitely, the distortions that would occur in the system would be very difficult to pull back together. I submit that is not what we do, and indeed, I would argue that given the fact that we have a fiat currency and that is the law of the land, we do as good a job as one can do in the context of the issues that you raise.

Dr. PAUL. I would like to follow up, but I can't break the rules. I would like to recognize Mr. Inslee from Washington.

Mr. INSLEE. Well, Mr. Chairman, I ask unanimous consent to allow the Chair to break the rules and allow you to continue your testimony and your questioning.

Dr. PAUL. Oh, no. That's OK. Go ahead.

Mr. INSLEE. Thank you.

Mr. Chairman, I noted several places in your testimony references to the high energy prices that we have experienced over the last several months. And it is at least some small comfort to my constituents—I am from the State of Washington—that you and others recognize how we have been hammered, particularly with wholesale electrical rates on the western coast of the United States, to the extent that in the State of Washington the estimates are that we will lose 43,000 jobs as a result of that spike in energy prices that we really could not accommodate. We were not that flexible.

And unfortunately, the Administration, despite our repeated requests, took absolutely no action to deal with this for at least 7 months. They now have encouraged, and the Federal Energy Regulatory Commission, as you are aware, has done something, at least modestly, to curtail some of this disproportionate pricing. But unfortunately, the FERC has still refused—although they have moved ahead to request refunds for some ratepayers in California, they have refused to do so for the Pacific Northwest. And that is of particular importance to us in the Northwest because, while prices are going down to some degree now, we had massive incursion of debt by a lot of outfits to try to stay solvent during this period of ramp-up in their rates, and we continue to have this hangover from this rapid escalation of rates.

We are now trying to work to get some refunds for ratepayers in the Pacific Northwest. We hope that FERC eventually will be dragged, kicking and screaming, to that position to help out.

I don't want to ask you for a specific comment on the propriety of refunds on the West Coast, but I would like to ask you, assuming that they are legal and practical and FERC can accomplish them, I just want to know if you can give us your comments as to whether that might have some beneficial effect on the demand side, that I know you are interested in.

Mr. GREENSPAN. You mean on whether or not refunds will improve the supply and demand for energy in the Northwest?

Mr. INSLEE. Or whether it will perhaps bolster our confidence, which right now has been taking a real hit in the Pacific Northwest.

Mr. GREENSPAN. Congressman, I think in your State one of the really very serious problems has been the drought and the obvious

shortfall of potable water availability. And a part of the job loss you suggest is the aluminum reduction plants, which found, not to anybody's surprise, if you are talking 10-, 20-, 30-cent kilowatt hour, you cannot make primary aluminum profitably in the world market at those prices. So what they did is they shut down and they sold their power contracts. The alternative would have been essentially to eat the costs, which would be very difficult.

As you are well aware, there has been a fairly significant decline in wholesale prices, pretty much across the whole western grid. And indeed, in California, they have slumped to levels they haven't seen for a couple of years.

I think that it is remarkable that you have the capacity to meet the demands, and we are a good way through the summer and have not really seen some of the awesome concerns materialize that a lot of people had. And I think quite legitimately, there has been a very significant amount of conservation that is going on of electric power, especially in the West. And for the moment, at least, the system seems to be working well.

And I do think that we are seeing fairly dramatic declines, or will be seeing them, in spot prices for both natural gas and for electric power. In the Consumer Price Index that was released this morning, as I recall, there is a remarkable decline in natural gas residential prices, and that is reflecting the two-thirds decline in the spot price of natural gas since late last year. There was a surge in electric power, which was the big increase, especially in California, but I think if you take a look at the wholesale structure now, it is going to come down. And that is going to be a positive factor, not only, as I pointed out in my prepared remarks, to profit margins of corporations, but I do think it is going to be a factor, as you imply, in the consumer area, and I think it could be an important one.

Dr. PAUL. The gentleman's time has expired.

Mr. INSLEE. Thank you.

Dr. PAUL. The gentleman from North Carolina.

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

Dr. Greenspan, it is a privilege to hear you today. I was not able to be in attendance when you spoke in the spring, so my question will go back to a news article that I read at that time. But first, I would like to say, in your response about the capital gains tax to a couple of my colleagues, that among those who are retired or close to retirement, I sincerely believe as—not as an economist; I was a history major in college, so that tells you—but that the average person that has investments, I believe sincerely would start moving those investments around and actually, I think, helping the economy if we, as a Congress, could drop that capital gains tax anywhere from 3 to 5 points.

But I did hear your answer on that, so I am not going to ask you to repeat yourself.

My question is, back in February there was an article in *U.S. News and World Report*, and you might have covered this in your prepared remarks; I was not here at that time. But it is called "A Debt Thing." And it says the recession could swamp consumers and companies. My question is, if over 34 percent of the average household income is going out into payments on installments such as

loans, mortgage loans, home equity debt and vehicle leases and vehicle payments, at what point do you, as the Chairman, you as an economist, get concerned about the average debts of the household?

Mr. GREENSPAN. It is difficult to say, because it will often vary depending on the type of debt that we are talking about. Debt service charges, for example, when you are dealing with short-term loans, are very high—in other words, you borrow and then you pay it off very quickly, and that will create a significant debt service charge, whereas long-term mortgages relative to the amount of debt do not.

I think that you do, however, get concerned when you begin to see the overall charge against a weekly paycheck get to a level which begins to affect people's ability to function. And while that doesn't usually impact on the economy, as such, what it does do is put you in a position that in the event that you get a decline in income, you create some fairly significant retrenchment requirements on the part of consumers.

So, as you point out, at the moment, the debt service burden, which is essentially the repayment of debt plus interest as a percent of cash incomes, at this stage is up to levels that have been pretty high in the past. So it is high at this stage. It is not at a level way beyond the experience of the last decade or two, but it is high, but not yet anywhere near the point given the level of assets which exist in the household sector—where it has moved to the edges of great concern. It could get there, but it has not gotten there yet.

And judging from the delinquency rates that we see in the banks and in the finance companies which, while they have moved up a bit, are not of particular concern, we are not at a point where one has to worry materially about that. But should it continue and should we find that the process gets to a point where you are beginning to see the stretching of the borrowing capacity, then it would. It has not gotten there yet, but it could.

Mr. JONES. Thank you, Mr. Chairman.

Dr. PAUL. The gentleman yields back.

The gentlelady from California, Ms. Lee.

Ms. LEE. Thank you.

Good afternoon Mr. Chairman. Good to see you.

First, I would like to follow up on Mrs. Roukema's and Ms. Waters' comments regarding housing; and I am, quite frankly, surprised at your response. At the same time that we have an increase in home ownership, Mr. Chairman, we also have a record increase in foreclosures. Also in California, of course, one of the highest cost areas in the country, 2 percent of all conventional loans were made to African Americans, only, and 2 percent of our largest lenders made less than 2 percent of their home loans to African Americans.

So I guess, just based on your view of the world, should we really assume that the Federal Reserve will not consider economic strategies actually to stimulate home ownership, especially for those making $40,000 or less?

And you also indicated that you believe in the importance, actually, of increasing and accumulating wealth in our society, yet African American and Latino unemployment rates are still twice that of whites. And so I haven't heard, really, any investment strategies

from the Federal Reserve to address these horrendous—and they are horrendous—economic disparities.

Mr. GREENSPAN. I agree with you, Congresswoman, and we do have a law: it is called the Community Reinvestment Act, which presumably addresses precisely the issue that you are addressing. I think you have to distinguish between the Community Reinvestment Act and the overall macro-housing policy in this country, which addresses home ownership and new construction in markets generally. For everybody, on average, that is working well.

It is not working well for a number of people, basically minorities, and we address that. In other words, we address that because if you could bring everybody up to the average or even just below the average, it would have a major, positive effect on the economy.

And so what we endeavor to do, in the context of an overall policy which I think is working, is recognize that parts of it are not. That doesn't mean that you don't address the parts that are not.

Ms. LEE. Sure. But what do we do for the parts that are not? I indicated home ownership. Fine. Great. We are moving in the right direction for some. But for those who are not part of that track——

Mr. GREENSPAN. Well, this is the reason why I say you have to build up standards of living. You have to build up wealth. You have to build up productivity and you have to raise people's levels so that they can afford housing.

I mean, when I was a kid, the thought of living in an owned home was so far remote from any conceivable notion that I had. We could not remotely consider purchasing a home.

Ms. LEE. But if you don't support increasing the minimum wage——

Mr. GREENSPAN. I don't support increasing the minimum wage, because I think it does precisely the opposite of what people think it does. And the facts are the facts. I have strongly argued this issue—and I grant you I am in a minority on this question—but I think the evidence is overwhelming that it does not do what a lot of people think it does in a positive direction. I think it is negative for the people at the lower end of the income structure.

Ms. LEE. So then how do you increase the standard of living?

Mr. GREENSPAN. You increase the standard of living by raising the overall level of productivity in the society and make certain that everyone has an opportunity to effectively engage in that economy. It is called "opportunity," and I think that is the most important thing that we can do to eliminate discrimination, create opportunity, enable people to pull themselves up from the bottom wherever they are and engage in this fairly prosperous economy.

So when I say that I think that the overall housing market is fine, which it is, that is not to say that I think that it is doing fine for everybody.

Ms. LEE. Thank you very much for at least clarifying that fact.

And finally, let me just ask you, with regard to Reg B, with regard to voluntary reporting, with regard to small business lending, are you going to schedule a vote on this sooner or later?

Mr. GREENSPAN. Where are we on Reg B now?

Mr. MATTINGLY. Congresswoman, I think the staff is still analyzing the——

Dr. PAUL. Could the gentleman identify himself at the mike appropriately?

Mr. MATTINGLY. I am sorry, sir.

My name is a Virgil Mattingly. I am General Counsel of the Federal Reserve Board.

Congresswoman, the Board staff is still evaluating those proposals. We did get a lot of extensive comment, but I am not sure when it is going to be scheduled.

Ms. LEE. Thank you very much.

Chairman OXLEY. [Presiding.] The gentlelady's time has expired.

The gentlelady from the great city of Cleveland, Ohio.

Mrs. JONES. Thank you, Mr. Chairman.

Chairman Greenspan, good afternoon. I am going to follow up with some of the questions that my colleague, Ms. Lee from California, asked. If you don't raise the minimum wage, and you wait on rising levels of productivity, what are the people who are making less than minimum wage, with no health care, paying high gas taxes, high gas prices, $2 for a gallon of milk, $3 for a loaf of bread, to do in the interim?

Mr. GREENSPAN. Let me ask you this: If you raise the minimum wage, and they lose their jobs as a consequence, does that help them?

Mrs. JONES. Mr. Greenspan, that is fear tactics. People have to have jobs, and I am suggesting to you that when we live in a community where the living standards are so low that people have no opportunity, what they do is they go to criminal enterprise in order to support their families.

But don't ask me a question; you answer my question. My question was, what do you——

Mr. GREENSPAN. Well, sometimes you can offer—look, I have expressed my view on this. I am in a minority on this. I acknowledge the fact that most people don't agree with me on this particular issue. But when the facts are what they are, I cannot but say what I believe. And I honestly do not believe that it helps the lower income.

Mrs. JONES. You know, I heard that answer, and I don't mean to interrupt you.

My question is, what do the people who are in that dilemma do in the interim while we are waiting for rising levels of productivity to occur?

Mr. GREENSPAN. Well, if I believed that the minimum wage actually helped, I would support not only the minimum wage but to increase it because——

Mrs. JONES. Do you support a living wage?

Mr. GREENSPAN. Well, I don't know what that means. I support the highest wages that people can get in the marketplace. I started off making $35 a week when I was a kid. That was barely a living wage and I worked my way up. So the question really is, do we have levels in this country which I think are extraordinarily difficult? The answer is yes, I do.

Do I think—I will ask myself the questions.

Mrs. JONES. Well, that is not fair, Mr. Greenspan. Now, you may be the Chairman of the Federal Reserve, but at this point this is my 5 minutes.

Mr. GREENSPAN. OK. Go ahead.

Mrs. JONES. I think I ought to be able to ask you some questions, right?

Mr. GREENSPAN. I am sorry.

Mrs. JONES. And I don't mean that derogatorily in any way. Let me ask this question.

We have high levels of household debt in the Nation currently. Do you favor some form of debt relief for highly indebted consumers at these interest rates or interest rate ceilings, or aggressive measures to curb predatory lending? All of these things come as a result of what I have said.

Mr. GREENSPAN. Yes. We, as you know, have been strongly supportive of actions to eliminate predatory lending. I personally find the individual cases most distressing, and it is an aspect of our financial system which has not shown, I think, great status. I think it is a small issue, relatively speaking, but it should be eliminated.

Mrs. JONES. It is a small issue. Let me stop you just for a moment, please.

Mr. GREENSPAN. No, I am trying to say when you look in terms of 8,000 banks and a lot of other institutions, it is a small issue in the sense that subprime lending is a large part of the market, and subprime lending, I think, helps minorities. It is a very important part of our financial——

Mrs. JONES. I can't disagree with you. But I only have probably 2 seconds and I want to take you just to one area. You say it is a small area, but when you are dealing with—most of the predatory lending occurs in minority and low-income communities that are already deeply in debt, and it is the only place by which they get some type of ability to build wealth through home ownership. It is a big problem, not a small problem.

Mr. GREENSPAN. I agree with you. I think it is a big problem for particular groups of individuals, and the reason why the issue has difficulty moving forward is it is not a big enough issue in the total financial system to get the type of support that you need to eradicate this particular practice.

Mrs. JONES. But I could get you to help me eradicate this.

Mr. GREENSPAN. I am on your side on this one.

Mrs. JONES. OK. I am going to call on you. I thank you, Mr. Chairman.

I yield back the balance of my time.

Chairman OXLEY. The gentlelady's time has expired.

The Chair is now pleased recognize the gentleman from California whether he is out of breath or not.

Mr. OSE. Mr. Chairman, thank you.

Mr. Chairman, thank you for joining us today. I want to specifically ask a prospective question dealing with the President's proposal on energy. I have been quite involved in the stuff with the FERC on the electricity and the like.

The fact of the matter, what they did was based on something I put in about a month prior to that. But I would appreciate any comments you might wish to offer about the economic benefits of the President's energy policy, as proposed, particularly relating to increasing the supply of oil and gas, FERC the electricity grid or

making it operate more efficiently—better gasoline, the issue of boutique fuels, natural gas distribution, issues of that nature.

Mr. GREENSPAN. Well, Congressman, I think that because the world economy has slowed its rate of growth, the demand for energy overall has slackened and it has taken the pressure off what appeared to be capacity restraints in the system, which we know are there, and they are there, as you point out, in a number of different areas.

We have had a very dramatic decline in natural gas prices in the last 6 months, in part because we have had a fairly marked pickup in drilling and the ability to find new sources, but also to a very large extent due to a decline in the rate of growth in consumption in a number of areas and actual declines in other areas.

We have seen a fairly dramatic decline in gasoline prices because we had a shortage of refinery capacity late last year, or early this year, and even though inventories of crude oil were building up at refineries, you couldn't put it through the refinery system to create inventories of gasoline. But now that has happened, and the price of gasoline has come down a considerable degree.

The same arguments are relevant to what has been going on in the electric power grid system and electric power use.

That should not in any way alter our view that there are long-term infrastructure problems out there, and that we need to get significant new energy-generating facilities, improved energy grids, the ability to drill for natural gas very specifically, because while we can import crude oil, there is a limit to how much natural gas we can bring in. In fact, we really are getting it largely from Canada, and liquefied natural gas is a very tough thing to import from other countries, so that we have to focus on making certain that we have adequate supplies of natural gas. And when we begin to look at the longer term, I think we are going to find that long-term policy is going to be required to make certain that the energy supplies in this country are adequate to the long-term needs of the economy.

Mr. OSE. Is the President's willingness to at least engage on this subject a positive first step?

Mr. GREENSPAN. I am sorry?

Mr. OSE. Is the President's willingness to engage on this subject of energy policy, is that a positive first step?

Mr. GREENSPAN. Oh, indeed. No question. I think that it is the type of issue which has importance in the longer term and can only be addressed in the longer term. And usually you have to come at issues when they are not perceived to be problems to get them appropriately addressed in that regard. I think it is important that we evaluate our whole, long-term energy needs and how they are going to be met.

Mr. OSE. I appreciate, in particular, your last remark about focusing on issues of this nature when they are not problems.

Given the abatement in pricing that we have all seen, both on the spot and the futures markets for natural gas and electricity, I think, Mr. Chairman, if there were one piece of counsel that we should share with our colleagues, it is that the way to avoid having problems is to address them before they are problems.

Thank you, Mr. Chairman.

Chairman OXLEY. The gentleman's time has expired.

I would agree with the gentleman from California and also say that markets work.

Mr. Chairman, we thank you again for providing us with your testimony and answers to our many questions. We appreciate it.

And let me say on a personal note, we thank you for your help on the SEC rulemaking authorities that dealt with broker-dealers and banks. And we are pleased to note that the SEC announced this morning that they would be extending that deadline till May of next year, which hopefully will give us all an opportunity to work in a concerted manner among the regulators to bring about the intent of Gramm-Leach-Bliley, and for that we thank you very much.

Without objection, the record for this hearing will remain open for 30 days for Members to submit questions in writing to the Chairman and have his responses placed in the record. Thank you again.

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

A P P E N D I X

July 18, 2001

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

July 18, 2001

Domestic Monetary Policy Testimony of Federal Reserve Chairman Alan Greenspan

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Good morning, Mr. Chairman.

I'm happy to welcome you back to the committee, noting that you were the first and only witness at the very first hearing held by the then-new Financial Services Committee. Then, as now, you were here to share with us your views on the state of the economy.

I'm proud to note, for the record, that since you were here on February 28 this committee has been hard at work and has compiled a long record of hearings and legislation, with plenty more to come. I note also that the Fed has been busy, in that same period, cutting interest rates four more times since you last were here.

Chairman Greenspan, we have seen a number of heartening signs for the economy. Energy prices, particularly gasoline prices, are lower. We no longer have daily crisis reports from California about blackouts. The markets, while still volatile, also are up over their levels of four months ago, and consumer confidence remains high.

Looking at those indicators and others, it's tempting to think that we have turned the corner – that two or three quarters of slow growth were enough to re-center the economy and that we are in recovery. However, I sense in all the economic reporting continued uncertainty, and potential potholes ahead in the road to recovery. That is why I am glad you are here to share with us your insight – some of what William Greider once referred to as "The Secrets of the Temple."

Since you were here, Mr. Chairman, Congress has passed and the President has signed a tax cut aimed at stimulating the nation's economy. The first vestiges of that cut will arrive in taxpayers' mailboxes within two weeks in the form of rebate checks. The last taxpayers should have those checks before the end of September. The committee would be interested in hearing how you think those checks, and the rate cuts enacted, will affect the economy in the third quarter, the second half and beyond.

I'm sure Members also are interested to learn if you believe any other tax changes – targeted or broadly based – would be useful to get economic growth back on track, keep it there or stimulate productivity. For example, at a hearing in March, Majority Leader Dick Armey and economists Larry Kudlow and Jim Glassman endorsed the idea of allowing companies to expense technology purchases. The idea seems to hold the promise of increasing and maintaining productivity, and we'd be interested in your opinion. Perhaps you have other suggestions.

I also hope you'll have time while you are here to address ways we might better direct the flows of capital to companies, particularly the newer and smaller ones that are the engines of both job growth and, often, of innovation in our economy. When capital is not directed efficiently to the companies that need it, in my view, the whole economy suffers.

Also, Mr. Chairman, I think the committee will be interested in hearing your views on trade, on the balance of payments and on the value of the dollar in foreign exchange markets. I for one would be especially interested in your views on efforts to increase trade, particularly the Administration's focus on gaining Trade Promotion Authority and developing a Free Trade Area of the Americas.

Most of Latin America is suffering economically to one extent or another – though not as badly as Argentina at this moment – except for Mexico. It seems to me that its free trade agreement with the United States has helped insulate Mexico from the current slowdown while benefiting the U.S. at the same time. I'm sure we'll all be interested in your views on creating a hemispheric free trade zone.

In particular, I think we'd be interested in hearing your thoughts on currency boards and dollarization of other countries' economies, in view of the ravages Argentina currently is suffering. And I imagine many would like to hear your views on why the current level of the dollar has been sustained through this recent round of rate cuts, and whether the level may change naturally next year after the introduction of the Euro is complete.

Finally, Mr. Chairman, I think all of us on the committee would like to hear some direct predictions about when you believe the economy will have finally turned the corner. I don't imagine you're carrying any predictions of a return to "dot-com"-level stock market returns any time soon, but I think we'd all like to hear some reassurance that you see a return to strong, steady growth sooner rather than later, and can give us some suggestions about how to get there and how to sustain it.

I know I'll look forward to your comments with interest. With that, I recognize the gentleman from New York, Mr. LaFalce.

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Statement of

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

United States House of Representatives

July 18, 2001

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

Monetary policy this year has confronted an economy that slowed sharply late last year and has remained weak this year, following an extraordinary period of buoyant expansion.

By aggressively easing the stance of monetary policy, the Federal Reserve has moved to support demand and, we trust, help lay the groundwork for the economy to achieve maximum sustainable growth. Our accelerated action reflected the pronounced downshift in economic activity, which was accentuated by the especially prompt and synchronous adjustment of production by businesses utilizing the faster flow of information coming from the adoption of new technologies. A rapid and sizable easing was made possible by reasonably well-anchored inflation expectations, which helped to keep underlying inflation at a modest rate, and by the prospect that inflation would remain contained as resource utilization eased and energy prices backed down.

In addition to the more accommodative stance of monetary policy, demand should be assisted going forward by the effects of the tax cut, by falling energy costs, by the spur to production once businesses work down their inventories to more comfortable levels, and, most important, by the inducement to resume increases in capital spending. That inducement should be provided by the continuation of cost-saving opportunities associated with rapid technological innovation. Such innovation has been the driving force raising the growth of structural productivity over the last half-dozen years. To be sure, measured productivity has softened in recent quarters, but by no more than one would anticipate from cyclical influences layered on top of a faster long-term trend.

But the uncertainties surrounding the current economic situation are considerable, and, until we see more concrete evidence that the adjustments of inventories and capital spending are well along, the risks would seem to remain mostly tilted toward weakness in the economy. Still, the FOMC opted for a smaller policy move at our last meeting because we recognized that the effects of policy actions are felt with a lag, and, with our cumulative 2-3/4 percentage points of easing this year, we have moved a considerable distance in the direction of monetary stimulus. Certainly, should conditions warrant, we may need to ease further, but we must not lose sight of the prerequisite of longer-run price stability for realizing the economy's full growth potential over time.

Despite the recent economic slowdown, the past decade has been extraordinary for the American economy. The synergies of key technologies markedly elevated prospective rates of return on high-tech investments, led to a surge in business capital spending, and significantly increased the growth rate of structural productivity. The capitalization of those higher expected returns lifted equity prices, which in turn contributed to a substantial pickup in household spending on a broad range of goods and services, especially on new homes and durable goods. This increase in spending by both households and businesses exceeded even the enhanced rise in real household incomes and business earnings. The evident attractiveness of investment opportunities in the United States induced substantial inflows of funds from abroad, raising the dollar's exchange rate while financing a growing portion of domestic spending.

By early 2000, the surge in household and business purchases had increased growth of the stocks of many types of consumer durable goods and business capital equipment to rates that could not be sustained. Even though demand for a number of high-tech products was doubling or tripling annually, in some cases new supply was coming on even faster. Overall, capacity in

high-tech manufacturing industries, for example, rose nearly 50 percent last year, well in excess of its already rapid rate of increase over the previous three years. Hence, a temporary glut in these industries and falling short-term prospective rates of return were inevitable at some point. This tendency was reinforced by a more realistic evaluation of the prospects for returns on some high-tech investments, which, while still quite elevated by historical standards, apparently could not measure up to the previous exaggerated hopes. Moreover, as I testified before this Committee last year, the economy as a whole was growing at an unsustainable pace, drawing further on an already diminished pool of available workers and relying increasingly on savings from abroad. Clearly, some moderation in the pace of spending was necessary and expected if the economy was to progress along a more balanced growth path.

In the event, the adjustment occurred much faster than most businesses anticipated, with the slowdown likely intensified by the rise in the cost of energy that until quite recently had drained businesses and households of purchasing power. Growth of outlays of consumer durable goods slowed in the middle of 2000, and shipments of nondefense capital goods have declined since autumn.

Moreover, weakness emerged more recently among our trading partners in Europe, Asia, and Latin America. The interaction of slowdowns in a number of countries simultaneously has magnified the softening each of the individual economies would have experienced on its own.

Because the extent of the slowdown was not anticipated by businesses, some backup in inventories occurred, especially in the United States. Innovations, such as more advanced supply-chain management and flexible manufacturing technologies, have enabled firms to adjust production levels more rapidly to changes in sales. But these improvements apparently have not solved the thornier problem of correctly anticipating demand. Although inventory-sales ratios in

most industries rose only moderately, those measures should be judged against businesses' desired levels. In this regard, extrapolation of the downtrend in inventory-sales ratios over the past decade suggests that considerable imbalances emerged late last year. Confirming this impression, purchasing managers in the manufacturing sector reported in January that inventories in the hands of their customers had risen to excessively high levels.

As a result, a round of inventory rebalancing was undertaken, and the slowdown in the economy that began in the middle of 2000 intensified. The adjustment process started late last year when manufacturers began to cut production to stem the accumulation of unwanted inventories. But inventories did not actually begin falling until early this year as producers decreased output levels considerably further.

Much of the inventory reduction in the first quarter reflected a dramatic scaling back of motor vehicle assemblies. However, inventories of computers, semiconductors, and communications products continued to build into the first quarter, and these stocks are only belatedly being brought under control. As best we can judge, some progress seems to have been made on inventories of semiconductors and computers, but little gain is apparent with respect to communications equipment. Inventories of high-tech products overall have probably been reduced a bit, but a period of substantial liquidation of stocks still seemingly lies ahead for these products.

For all inventories, the rate of liquidation appears to have been especially pronounced this winter, and the available data suggest that it continued, though perhaps at a more moderate pace, this spring. A not inconsequential proportion of the current liquidation undoubtedly is of imported products, and thus will presumably affect foreign production, but most of the adjustment has fallen on domestic producers.

At some point, inventory liquidation will come to an end, and its termination will spur production and incomes. Of course, the timing and force with which that process of recovery plays out will depend on the behavior of final demand. In that regard, the demand for capital equipment, particularly in the near term, could pose a continuing problem. Despite evidence that expected long-term rates of return on the newer technologies remain high, growth of investment in equipment and software has turned decidedly negative. Sharp increases in uncertainties about the short-term outlook have significantly foreshortened the time frame over which business are requiring new capital projects to pay off. The consequent heavier discounts applied to those long-term expectations have induced a major scaling back of new capital spending initiatives, though one that presumably is not long-lasting given the continuing inducements to embody improving technologies in new capital equipment.

In addition, a deterioration in sales, profitability, and cash flow has exacerbated the weakness in capital spending. Pressures on profit margins have been unrelenting. Although earnings weakness has been most pronounced for high-tech firms, where the previous extraordinary pace of expansion left oversupply in its wake, weakness is evident virtually across the board, including most recently in earnings of the foreign affiliates of American firms.

Much of the squeeze on profit margins of domestic operations results from a rise in unit labor costs. Gains in compensation per hour picked up over the past year or so, responding to a long period of tight labor markets, the earlier acceleration of productivity, and the effects of an energy-induced run-up in consumer prices. The faster upward movement in hourly compensation, coupled with the cyclical slowdown in the growth of output per hour, has elevated the rate of increase in unit labor costs. In part, fixed costs, nonlabor as well as labor, are being spread over a smaller production base for many industries.

The surge in energy costs has also pressed down on profit margins, especially in the fourth and first quarters. In fact, a substantial portion of the rise in total costs of domestic nonfinancial corporations between the second quarter of last year and the first quarter of this year reflected the increase in energy costs. The decline in energy prices since the spring, however, should be contributing positively to margins in the third quarter. Moreover, the rate of increase in compensation is likely to moderate, with inflation expectations contained and labor markets becoming less taut in response to the slower pace of growth in economic activity. In addition, continued rapid gains in structural productivity should help to suppress the rise in unit labor costs over time.

Eventually, the high-tech correction will abate, and these industries will reestablish themselves as a solidly expanding, though less frenetic, part of our economy. When they do, growth in that sector presumably will not return to the outsized 50 percent annual growth rates of last year, but rather to a more sustainable pace.

Of course, investment spending ultimately depends on the strength of consumer demand for goods and services. Here, too, longer-run increases in real incomes of consumers engendered by the rapid advances in structural productivity should provide support to demand over time. And thus far this year, consumer spending has indeed risen further, presumably assisted in part by a continued rapid growth in the market value of homes, from which a significant amount of equity is being extracted. Moreover, household disposable income is now being bolstered by tax cuts.

But there are also downside risks to consumer spending over the next few quarters. Importantly, the same pressure on profits and the heightened sense of risk that have held down investment have also lowered equity prices and reduced household wealth despite the rise in

home equity. We can expect the decline in stock market wealth that has occurred over the past year to restrain the growth of household spending relative to income, just as the previous increase gave an extra spur to household demand. Furthermore, while most survey measures suggest consumer sentiment has stabilized recently, softer job markets could induce a further deterioration in confidence and spending intentions.

While this litany of risks should not be downplayed, it is notable how well the U.S. economy has withstood the many negative forces weighing on it. Economic activity has held up remarkably in the face of a difficult adjustment toward a more sustainable pattern of expansion.

* * *

The economic developments of the last couple of years have been a particular challenge for monetary policy. Once the financial crises of late 1998 that followed the Russian default eased, efforts to address Y2K problems and growing optimism--if not euphoria--about profit opportunities produced a surge in investment, particularly in high-tech equipment and software. The upswing outstripped what the nation could finance on a sustainable basis from domestic saving and funds attracted from abroad.

The shortfall of saving to finance investment showed through in a significant rise in average real long-term corporate interest rates starting in early 1999. By June of that year, it was evident to the Federal Open Market Committee that to continue to hold the funds rate at the then-prevailing level of 4-3/4 percent in the face of rising real long-term corporate rates would have required a major infusion of liquidity into an economy already threatening to overheat. In fact, the increase in our target federal funds rate of 175 basis points through May of 2000 barely slowed the expansion of liquidity, judging from the M2 measure of the money supply, whose rate of increase declined only modestly through the tightening period.

By summer of last year, it started to become apparent that the growth of demand finally was slowing, and seemingly by enough to bring it into approximate alignment with the expansion of potential supply, as indicated by the fact that the pool of available labor was no longer being drawn down. It was well into autumn, however, before one could be confident that the growth of aggregate demand had softened enough to bring it into a more lasting balance with potential supply. Growth continued to decline to a point that by our December meeting, the Federal Open Market Committee decided that the time to counter cumulative economic weakness was close at hand. We altered our assessment of the risks to the economy, and with incoming information following the meeting continuing to be downbeat, we took our first easing action on January 3. We viewed the faster downshift in economic activity, in part a consequence of the technology-enhanced speed and volume of information flows, as calling for a quicker pace of policy adjustment. Acting on that view, we have lowered the federal funds rate 2-3/4 percentage points since the turn of the year, with last month's action leaving the federal funds rate at 3-3/4 percent.

Most long-term interest rates, however, have barely budged despite the appreciable reductions in short-term rates since the beginning of the year. This has led many commentators to ask whether inflation expectations have risen. Surely, one reason long-term rates have held up is changed expectations in the Treasury market, as forecasts of the unified budget surplus were revised down, indicating that the supplies of outstanding marketable Treasury debt are unlikely to shrink as rapidly as previously anticipated. Beyond that, it is difficult to judge whether long-term rates have held up because of firming inflation expectations or a belief that economic growth is likely to strengthen, spurring a rise in real long-term rates.

One measure often useful in separating the real interest rates from inflation expectations is the spread between rates on nominal ten-year Treasury notes and inflation-indexed notes of similar maturity. That spread rose more than three-fourths of a percentage point through the first five months of this year, a not insignificant change, though half of that increase has been reversed since. By the nature of the indexed instrument, the spread between it and the comparable nominal rate reflects expected CPI inflation. While actual CPI inflation has picked up this year, this rise has not been mirrored uniformly in other broad price measures. For example, there has been little, if any, acceleration in the index of core personal consumption expenditure prices, which we consider to be a more reliable measure of inflation. Moreover, survey readings on long term inflation expectations have remained quite stable.

The lack of pricing power reported overwhelmingly by business people underscores the quiescence of inflationary pressures. Businesses are experiencing the effects of softer demand in product markets overall, but these effects have been especially marked for many producers at earlier stages of processing, where prices generally have been flat to down thus far this year. With energy prices now also moving lower and the lessening of tautness in labor markets expected to damp wage increases, overall prices seem likely to be contained in the period ahead.

Forecasts of inflation, however, like all economic forecasts, do not have an enviable record. Faced with such uncertainties, a central bank's vigilance against inflation is more than a monetary policy cliche; it is, of course, the way we fulfill our ultimate mandate to promote maximum sustainable growth.

A central bank can contain inflation over time under most conditions. But do we have the capability to eliminate booms and busts in economic activity? Can fiscal and monetary

policy acting at their optimum eliminate the business cycle, as some of the more optimistic followers of J.M. Keynes seemed to believe several decades ago?

The answer, in my judgment, is no, because there is no tool to change human nature. Too often people are prone to recurring bouts of optimism and pessimism that manifest themselves from time to time in the buildup or cessation of speculative excesses. As I have noted in recent years, our only realistic response to a speculative bubble is to lean against the economic pressures that may accompany a rise in asset prices, bubble or not, and address forcefully the consequences of a sharp deflation of asset prices should they occur.

While we are limited in our ability to anticipate and act on asset price bubbles, expectations about future economic developments nonetheless inevitably play a crucial role in our policymaking. If we react only to past or current developments, lags in the effects of monetary policy could end up destabilizing the economy, as history has amply demonstrated.

Because accurate point forecasts are extraordinarily difficult to fashion, we are forced also to consider the probability distribution of possible economic outcomes. Against these distributions, we endeavor to judge the possible consequences of various alternative policy actions, especially the consequences of a policy mistake. We recognize that this policy process may require substantial swings in the federal funds rate over time to help stabilize the economy, as, for example, recurring bouts of consumer and business optimism and pessimism drive economic activity.

In reducing the federal funds rate so substantially this year, we have been responding to our judgment that a good part of the recent weakening of demand was likely to persist for a while, and that there were significant downside risks even to a reduced central tendency forecast.

Moreover, with inflation low and likely to be contained, the main threat to satisfactory economic performance appeared to come from excessive weakness in activity.

As a consequence of the policy actions of the FOMC, some of the stringent financial conditions evident late last year have been eased. Real interest rates are down on a wide variety of borrowing instruments. Private rates have benefited from some narrowing of risk premiums in many markets. And the growth of liquidity, as measured by M2, has picked up. More recently, incoming data on economic activity have turned from persistently negative to more mixed.

The period of sub-par economic performance, however, is not yet over, and we are not free of the risk that economic weakness will be greater than currently anticipated, and require further policy response. That weakness could arise from softer demand abroad as well as from domestic developments. But we need also to be aware that our front-loaded policy actions this year coupled with the tax cuts under way should be increasingly affecting economic activity as the year progresses.

The views of the Federal Reserve Governors and Reserve Bank Presidents reflect this assessment. While recognizing the downside risks to their current forecast, most anticipate at least a slight strengthening of real activity later this year. This is implied by the central tendency of their individual projections, which is for real GDP growth over all four quarters of 2001 of 1-1/4 to 2 percent. Next year, the comparable figures are 3 to 3-1/4 percent. The civilian unemployment rate is projected to rise further over the second half of the year, with a central tendency of 4-3/4 to 5 percent by the fourth quarter and 4-3/4 to 5-1/4 percent four quarters later. This easing of pressures in product and labor markets lies behind the central tendency for PCE

price inflation of 2 to 2-1/2 percent over the four quarters of this year and 1-3/4 to 2-1/2 percent next year.

As for the years beyond this horizon, there is still, in my judgment, ample evidence that we are experiencing only a pause in the investment in a broad set of innovations that has elevated the underlying growth in productivity to a rate significantly above that of the two decades preceding 1995. By all evidence, we are not yet dealing with maturing technologies that, after having sparkled for a half-decade, are now in the process of fizzling out. To the contrary, once the forces that are currently containing investment initiatives dissipate, new applications of innovative technologies should again strengthen demand for capital equipment and restore solid economic growth over time that benefits us all.

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

Pursuant to section 2B of the Federal Reserve Act

July 18, 2001

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 18, 2001

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to section 2B of the Federal Reserve Act.

Sincerely,

Alan Greenspan, Chairman

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Monetary Policy Report to the Congress

Report submitted to the Congress on July 18, 2001, pursuant to section 2B of the Federal Reserve Act

MONETARY POLICY AND THE ECONOMIC OUTLOOK

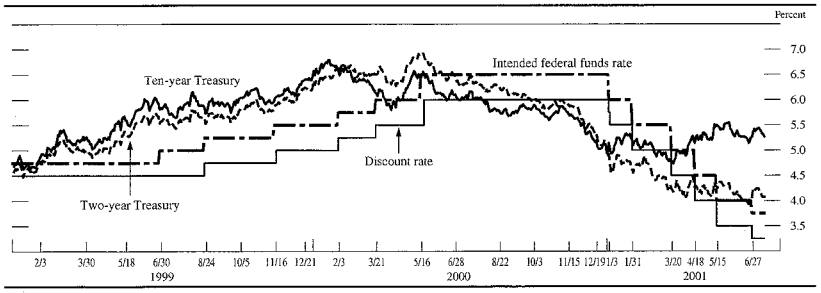
When the Federal Reserve submitted its report on monetary policy in mid-February, the Federal Open Market Committee (FOMC) had already reduced its target for the federal funds rate twice to counter emerging weakness in the economy. As the year has unfolded, the weakness has become more persistent and widespread than had seemed likely last autumn. The shakeout in the high-technology sector has been especially severe, and with overall sales and profits continuing to disappoint, businesses are curtailing purchases of other types of capital equipment as well. The slump in demand for capital goods has also worked against businesses' efforts to correct the inventory imbalances that emerged in the second half of last year and has contributed to sizable declines in manufacturing output this year. At the same time, foreign economies have slowed, limiting the demand for U.S. exports.

To foster financial conditions that will support strengthening economic growth, the FOMC has lowered its target for the federal funds rate four times since February, bringing the cumulative decline this year to 2¾ percentage points. A number of factors spurred this unusually steep reduction in the federal funds rate. In particular, the slowdown in growth was rapid and substantial and carried considerable risks that the sluggish performance of the economy in the first half of this year would persist. Among other things, the abruptness of the slowing, by jarring consumer and business confidence, raised the possibility of becoming increasingly self-reinforcing were households and businesses to postpone spending while reassessing their situations. In addition, other financial developments, including a higher foreign exchange value of the dollar, lower equity prices, and tighter lending terms and standards at banks, were tending to restrain aggregate demand and thus were offsetting some of the influence of the lower federal funds rate. Finally, despite some worrisome readings early in the year, price increases remained fairly well contained, and prospects for inflation have become less of a concern as rates of resource utilization have declined and energy prices have shown signs of turning down.

The information available at midyear for the recent performance of both the U.S. economy and some of our key trading partners remains somewhat downbeat, on balance. Moreover, with inventories still excessive in some sectors, orders for capital goods very soft, and the effects of lower stock prices and the weaker job market weighing on consumers, the economy may expand only slowly, if at all, for a while longer. Nonetheless, a number of factors are in place that should set the stage for stronger growth later this year and in 2002. In particular, interest rates have declined since last fall; the lower rates have helped businesses and households strengthen their financial positions and should show through to aggregate demand in coming quarters. The recently enacted tax cuts and the apparent cresting of energy prices should also bolster aggregate demand fairly soon. In addition, as firms at some point become more satisfied with their inventory holdings, the cessation of liquidation will boost production and, in turn, provide a lift to employment and incomes; a subsequent shift to inventory accumulation in association with the projected strengthening in demand should provide additional impetus to production. Moreover, with no apparent sign of abatement in the rapid pace of technological innovation, the outlook for productivity growth over the longer run remains favorable. The efficiency gains made possible by these innovations should spur demand for the capital equipment that embodies the new technologies once the overall economic situation starts to improve and should support consumption by leading to solid increases in real incomes over time.

Even though an appreciable recovery in the growth of economic activity by early next year seems the most likely outcome, there is as yet no hard evidence that this improvement is in train, and the situation remains very uncertain. In these circumstances, the FOMC continues to believe that the risks are weighted toward conditions that may generate economic weakness in the foreseeable future. At the same time, the FOMC recognizes the importance of sustaining the environment of low inflation and well-

Selected interest rates



NOTE. The data are daily and extend through July 12, 2001. The dates on the horizontal axis are those of scheduled FOMC meetings and of any intermeeting policy actions.

anchored inflation expectations that enabled the Federal Reserve to react rapidly and forcefully to the slowing in real GDP growth over the past several quarters. When, as the FOMC expects, activity begins to firm, the Committee will continue to ensure that financial conditions remain consistent with holding inflation in check, a key requirement for maximum sustainable growth.

Monetary Policy, Financial Markets, and the Economy over the First Half of 2001

By the time of the FOMC meeting on December 19, 2000, it had become evident that economic growth had downshifted considerably, but the extent of that slowing was only beginning to come into focus. At that meeting, the FOMC concluded that the risks to the economy in the foreseeable future had shifted to being weighted mainly toward conditions that may generate economic weakness and that economic and financial developments could warrant further close review of the stance of policy well before the next scheduled meeting. Subsequent data indicated that holiday retail sales had come in below expectations and that conditions in the manufacturing sector had deteriorated. Corporate profit forecasts had also been marked down, and it seemed possible that the resulting decline in equity values, along with the expense of higher energy costs, could damp future business investment and household spending. In response, the FOMC held a telephone conference on January 3, 2001, and decided to reduce the target federal funds rate ½ percentage point, to 6 percent, and indicated that the risks to the outlook remained weighted toward economic weakness.

The timing and size of the cut in the target rate seemed to ease somewhat the concerns of financial market participants about the longer-term outlook for the economy. Equity prices generally rose in January, risk spreads on lower-rated corporate bonds narrowed significantly, and the yield curve steepened. However, incoming data over the month revealed that the slowing in consumer and business spending late last year had been sizable. Furthermore, a sharp erosion in survey measures of consumer confidence, a backup of inventories, and a steep decline in capacity utilization posed the risk that spending could remain depressed for some time. In light of these developments, the FOMC at its scheduled meeting on January 30 and 31 cut its target for the federal funds rate another ½ percentage point, to 5½ percent, and stated that it continued to judge the risks to be weighted mainly toward economic weakness.

The information reviewed by the FOMC at its meeting on March 20 suggested that economic activity continued to expand, but slowly. Although consumer spending seemed to be rising moderately and housing had remained relatively firm, stock prices had declined substantially in February and early March, and reduced equity wealth and lower consumer confidence had the potential to damp household spending going forward. Moreover, manufacturing output had contracted further, as businesses continued to work down their excess inventories and cut back on capital equipment expenditures. In addition, economic softness abroad raised the likelihood of a weakening in U.S. exports. Core inflation had picked up a bit in January, but some of the increase reflected the pass-through of a rise in energy prices that was unlikely to continue, and the FOMC judged that the slowdown in the growth of aggregate demand

would ease inflationary pressures on labor and other resources. Accordingly, the FOMC on March 20 lowered its target for the federal funds rate another ½ percentage point, to 5 percent. The members also continued to see the risks to the outlook as remaining weighted mainly toward economic weakness. Furthermore, the FOMC recognized that in a rapidly evolving economic situation, it would need to be alert to the possibility that a conference call would be desirable during the relatively long interval before the next scheduled meeting to discuss the possible need for a further policy adjustment.

Capital markets continued to soften in late March and early April, in part because corporate profits and economic activity remained quite weak. Although equity prices and bond yields began to rise in mid-April as financial market investors became more confident that a cumulative downward spiral in activity could be avoided, reports continued to suggest flagging economic performance and risks of extended weakness ahead. In particular, spending by consumers had leveled out and their confidence had fallen further. The FOMC discussed economic developments in conference calls on April 11 and April 18, deciding on the latter occasion to reduce its target for the federal funds rate another ½ percentage point, to 4½ percent. The Committee again indicated that it judged the balance of risks to the outlook as weighted toward economic weakness.

When the FOMC met on May 15, economic conditions remained quite sluggish, especially in manufacturing, where production and employment had declined further. Although members were concerned that some indicators of core inflation had moved up in the early months of the year and that part of the recent backup in longer-term interest rates may have owed to increased inflation expectations, most saw underlying price increases as likely to remain damped as continued subpar growth relieved pressures on resources. In light of the prospect of continued weakness in the economy and the significant risks to the economic expansion, the FOMC reduced its target for the federal funds rate an additional ½ percentage point, to 4 percent. With the softening in aggregate demand still of unknown persistence and dimension, the FOMC continued to view the risks to the outlook as weighted toward economic weakness. Still, the FOMC recognized that it had eased policy substantially this year and that, in the absence of further sizable adverse shocks to the economy, at future meetings it might need to consider adopting a more cautious approach to further policy actions.

Subsequent news on economic activity and corporate profits failed to point to a rebound. In June, interest rates on longer-term Treasuries and on higher-quality private securities declined, some risk spreads widened, and stock prices fell as financial market participants trimmed their expectations for economic activity and profits. When the FOMC met on June 26 and 27, conditions in manufacturing appeared to have worsened still more. It also seemed likely that slower growth abroad would restrain demand for exports and that weakening labor markets would hold down growth in consumer spending. In light of these developments, but also taking into account the cumulative 250 basis points of easing already undertaken and the other forces likely to be stimulating spending in the future, the FOMC lowered its target for the federal funds rate ¼ percentage point, to 3¾ percent, and continued to view the risks to the outlook as weighted toward economic weakness.

The Board of Governors of the Federal Reserve System approved cuts in the discount rate in the first half of the year that matched the FOMC's cuts in the target federal funds rate. As a result, the discount rate declined from 6 percent to 3¼ percent over the period.

Economic Projections for 2001 and 2002

The members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, expect economic growth to remain slow in the near term, though most anticipate that it will pick up later this year at least a little. The central tendency of the forecasts for the increase in real GDP over the four quarters of 2001 spans a range of 1¼ percent to 2 percent, and the central tendency of the forecasts for real GDP growth in 2002 is 3 percent to 3¼ percent. The civilian unemployment rate, which averaged 4½ percent in the second quarter of 2001, is expected to move up to the area of 4¾ percent to 5 percent by the end of this year. In 2002, with the economy projected to expand at closer to its trend rate, the unemployment rate is expected to hold steady or perhaps to edge higher. With pressures in labor and product markets abating and with energy prices no longer soaring, inflation is expected to be well contained over the next year and a half.

Despite the projected increase in real GDP growth, the uncertainty about the near-term outlook remains considerable. This uncertainty arises not only from the difficulty of assessing when businesses will feel that conditions are sufficiently favorable to warrant a pickup in capital spending but also from the difficulty

Economic projections for 2001 and 2002

Percent

Indicator	Board of Governors and Reserve Bank presidents	
	Range	Central tendency
	2001	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	3½–5	3½–4¼
Real GDP[2]	1–2	1¼–2
PCE prices	2–2¾	2–2½
Average level, fourth quarter		
Civilian unemployment rate	4¾–5	4¾–5
	2002	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4¾–6	5–5½
Real GDP[2]	3–3½	3–3¼
PCE prices	1½–3	1¾–2½
Average level, fourth quarter		
Civilian unemployment rate	4¾–5½	4¾–5¼

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.
2. Chain-weighted.

of gauging where businesses stand in the inventory cycle. Nonetheless, all the FOMC participants foresee a return to solid growth by 2002. By then, the inventory correction should have run its course, and the monetary policy actions taken this year, as well as the recently enacted tax reductions, should be providing appreciable support to final demand.

In part because of lower interest rates, many firms have been able to shore up their balance sheets. And although some lower-rated firms, especially in telecommunications and other sectors with gloomy near-term prospects, may continue to find it difficult to obtain financing, businesses generally are fairly well positioned to step up their capital spending once the outlook for sales and profits improves. By all accounts, technological innovation is still proceeding rapidly, and these advances should eventually revive high-tech investment, especially with the price of computing power continuing to drop sharply.

In addition, consumer spending is expected to get a boost from the tax cuts and from falling energy prices, which should help offset the effects of the weaker job market and the decline over the past year in stock market wealth. Housing activity, which has been buoyed in recent quarters by low mortgage interest rates, is likely to remain firm into 2002. Significant concerns remain about the foreign economic outlook and the prospects for U.S. exports. Nevertheless, economic activity abroad is expected to benefit from a strengthening of the U.S. economy, a stabilization of the global high-tech sector, an easing of oil prices, and stimulative macroeconomic policies in some countries.

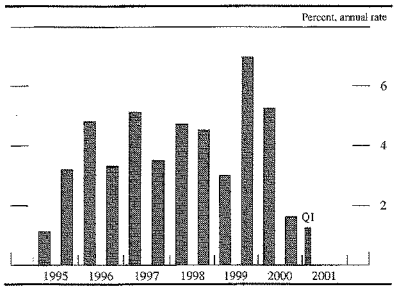
The chain-type price index for personal consumption expenditures rose 2¼ percent over the four quarters of 2000, and most FOMC participants expect inflation to remain around that rate through next year; indeed, the central tendency of their forecasts for the increase in this price measure is 2 percent to 2½ percent in 2001 and 1¾ percent to 2½ percent in 2002. One favorable factor in the inflation outlook is the behavior of energy prices. Those prices have declined recently after having increased rapidly in the past couple of years, and prospects are good that they could stabilize or even fall further in coming quarters. In addition to their direct effects, lower energy prices should tend to limit increases in other prices by reducing input costs for a wide range of energy-intensive goods and services and by helping damp inflation expectations. More broadly, the competitive conditions that have restricted businesses' ability to raise prices in recent years are likely to persist. And although labor costs could come under upward pressure as wages tend to catch up to previous increases in productivity, the slackening in resource utilization this year is expected to contribute to reduced inflation pressures going forward.

Economic and Financial Developments in 2001

Economic growth remained very slow in the first half of 2001 after having downshifted in the second half of 2000. Real gross domestic product rose at an annual rate of just 1¼ percent in the first quarter, about the same as in the fourth quarter, and appears to have posted at best a meager gain in the second quarter. Businesses have been working to correct the inventory imbalances that emerged in the second half of last year, which has led to sizable declines in manufacturing output, and capital spending has weakened appreciably. In contrast, household spending—especially for motor vehicles and houses—has held up well. Employment increased only modestly over the first three months of the year and turned down in the spring; the unemployment rate in June stood at 4½ percent, ½ percentage point higher than in the fourth quarter of last year.

The inflation news early this year was not very favorable, as energy prices continued to soar and as measures of core inflation—which exclude food and energy—registered some pickup. More recently,

Change in real GDP



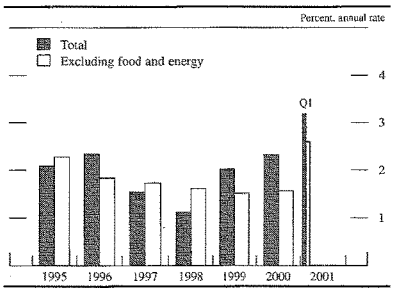
NOTE. Here and in the subsequent charts, except as noted, change is measured to the final quarter of the indicated period from the final quarter of the preceding period.

however, energy prices have moved lower, and the monthly readings on core inflation have returned to more moderate rates. Moreover, apart from energy, prices at earlier stages of processing have been quiescent this year.

The Household Sector

Growth in household spending has slowed noticeably from the rapid pace of the past few years. Still, it was fairly well maintained in the first half of 2001 despite the weaker tenor of income, wealth, and consumer confidence, and the personal saving rate declined a bit further. A greater number of households encountered problems servicing debt, but widespread difficulties or restrictions on the availability of credit did not emerge.

Change in PCE chain-type price index



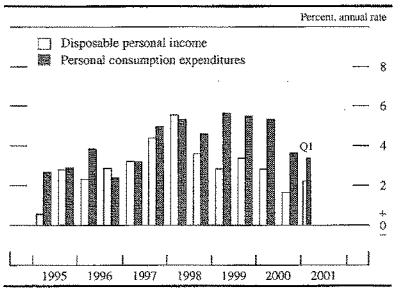
NOTE. Data are for personal consumption expenditures (PCE).

Consumer Spending

Real consumer spending grew at an annual rate of 3½ percent in the first quarter. Some of the increase reflected a rebound in purchases of light motor vehicles, which were boosted by a substantial expansion of incentives and rose to just a tad below the record pace of 2000 as a whole. In addition, outlays for non-auto goods posted a solid gain, and spending on services rose modestly despite a weather-related drop in outlays for energy services. In the second quarter, however, the rise in consumer spending seems to have lessened as sales of light motor vehicles dropped a bit, on average, and purchases of other goods apparently did not grow as fast in real terms as they had in the first quarter.

The rise in real consumption so far this year has been considerably smaller than the outsized gains in the second half of the 1990s and into 2000. But the increase in spending still outstripped the growth in real disposable personal income (DPI), which has been restrained this year by further big increases in consumer energy prices and by the deterioration in the job market; between the fourth quarter of 2000 and May, real DPI increased just about 2 percent at an annual rate, well below the average pace of the preceding few years. In addition, the net worth of households fell again in the first quarter, to a level 8 percent below the high reached in the first quarter of 2000. On net, the ratio of household net worth to DPI has returned to about the level reached in 1997, significantly below the recent peak but still high by historical standards. In addition, consumer sentiment indexes, which had risen to extraordinary levels in the late 1990s and remained there through last fall, fell sharply around the turn of the year. However, these indexes have not deteriorated further, on net,

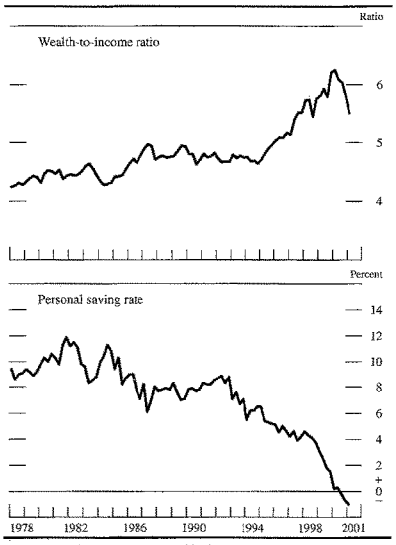
Change in real income and consumption



since the winter and are still at reasonably favorable levels when compared with the readings for the pre-1997 period.

Rising household wealth almost certainly was a key factor behind the surge in consumer spending between the mid-1990s and last year, and thus helps to explain the sharp fall in the personal saving rate over that period. The saving rate has continued to fall this year—from −0.7 percent in the fourth quarter of 2000 to −1.1 percent in May—even though the boost to spending growth from the earlier run-up in stock prices has likely run its course and the effects of lower wealth should be starting to feed through to spending. The apparent decline in the saving rate may simply reflect noisiness in the data or a slower response of spending to wealth than average historical experience might suggest. In addition, consumers probably base their spending decisions on income prospects over a longer time span than just a few quarters. Thus, to the extent that consumers do not expect the current sluggishness in real income growth to persist, the tendency to maintain spending for a time by dipping into savings or by borrowing may have offset the effect of the decline in wealth on the saving rate.

Wealth and saving



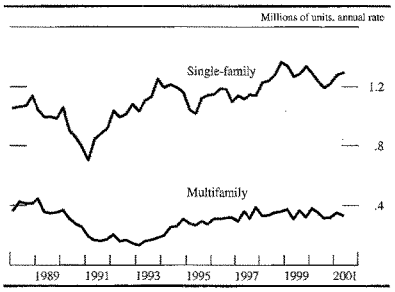
NOTE. The data extend through 2001:Q1. The wealth-to-income ratio is the ratio of household net worth to disposable personal income.

Residential Investment

Housing activity remained buoyant in the first half of this year as lower mortgage interest rates appear to have offset the restraint from smaller gains in employment and income and from lower levels of wealth. In the single-family sector, starts averaged an annual rate of 1.28 million units over the first five months of the year—4 percent greater than the hefty pace for 2000 as a whole. Sales of new and existing homes strengthened noticeably around the turn of the year and were near record levels in March; they fell back in April but reversed some of that drop in May. Inventories of new homes for sale are exceptionally low; builders' backlogs are sizable; and, according to the Michigan survey, consumers' assessments of homebuying conditions remain favorable, mainly because of perceptions that mortgage rates are low.

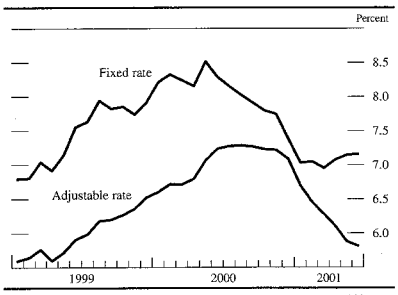
Likely because of the sustained strength of housing demand, home prices have continued to rise faster than overall inflation, although the various measures that attempt to control for shifts in the regional composition of sales and in the characteristics of houses sold provide differing signals on the magnitude of the price increases. Notably, over the year ending in the first quarter, the constant-quality price index for new homes rose 4 percent, while the repeat-sales price index for existing homes was up nearly 9 percent. Despite the higher prices, the share of income required to finance a home purchase—one measure of affordability—has fallen in recent quarters as mort-

Private housing starts



NOTE. The data extend through 2001:Q2; the data for that quarter are the averages for April and May.

Mortgage rates



NOTE. The data, which are monthly and extend through June 2001, are contract rates on thirty-year mortgages from the Federal Home Loan Mortgage Corporation.

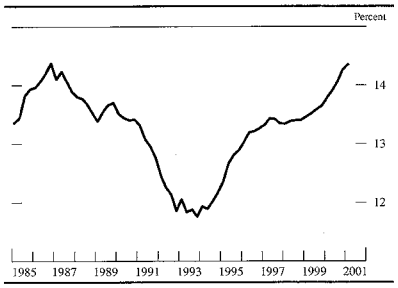
gage rates have dropped back after last year's bulge, and that share currently is about as low as it has been at any time in the past decade. Rates on thirty-year conventional fixed-rate loans now stand around 7¼ percent, and ARM rates are at their lowest levels in a couple of years.

In the multifamily sector, housing starts averaged 343,000 units at an annual rate over the first five months of the year, matching the robust pace that has been evident since 1997. Moreover, conditions in the market for multifamily housing continue to be conducive to new construction. The vacancy rate for multifamily rental units in the first quarter held near its low year-earlier level, and rents and property values continued to rise rapidly.

Household Finance

The growth of household debt is estimated to have slowed somewhat in the first half of this year to a still fairly hefty 7½ percent annual rate—about a percentage point below its average pace over the previous two years. Households have increased both their home mortgage debt and their consumer credit (debt not secured by real estate) substantially this year, although in both cases the growth has moderated a bit recently. The relatively low mortgage interest rates have boosted mortgage borrowing both by stimulating home purchases and by making it attractive to refinance existing mortgages and extract some of the buildup in home equity. The rapid growth in consumer credit has been concentrated in credit card debt, perhaps reflecting households' efforts to sustain their consumption in the face of weaker income growth.

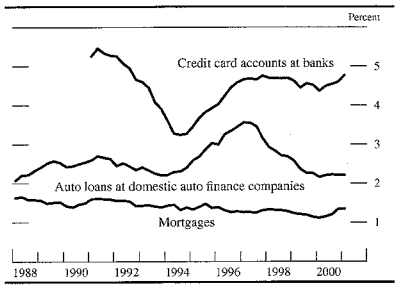
Household debt service burden



NOTE. The data are quarterly and extend through 2001:Q1. Debt burden is an estimate of the ratio of debt payments to disposable income; debt payments consist of the estimated required payments on outstanding mortgage and consumer debt.

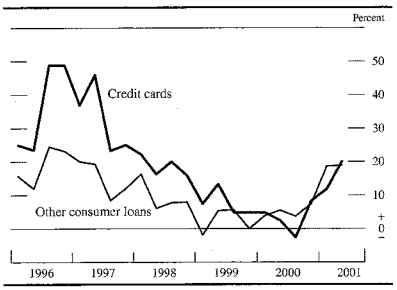
The household debt service burden—the ratio of minimum scheduled payments on mortgage and consumer debt to disposable personal income—rose to more than 14 percent at the end of the first quarter, a twenty-year high, and available data suggest a similar reading for the second quarter. In part because of the elevated debt burden, some measures of household loan performance have deteriorated a bit in recent quarters. The delinquency rate on home mortgage loans has edged up but remains low, while the delinquency rate on credit card loans has risen noticeably and is in the middle part of its range over the past decade. Personal bankruptcies jumped to record levels in the spring, but some of the spurt was probably the result of a rush to file before Congress passed bankruptcy reform legislation.

Delinquency rates on household loans



NOTE. The data are quarterly and extend through 2001:Q1. Data on credit card delinquencies are from bank Call Reports; data on auto loan delinquencies are from the Big Three automakers; data on mortgage delinquencies are from the Mortgage Bankers Association.

Net percentage of large commercial banks tightening standards for consumer loans



NOTE. The data extend through May 2001 and are based on the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, which is generally conducted four times per year. Net percentage is percentage reporting a tightening less percentage reporting an easing.

Lenders have tightened up somewhat in response to the deterioration of household financial conditions. In the May Senior Loan Officer Opinion Survey on Bank Lending Practices, about a fifth of the banks indicated that they had tightened the standards for approving applications for consumer loans over the preceding three months, and about a fourth said that they had tightened the terms on loans they are willing to make, substantial increases from the November survey. Of those that had tightened, most cited actual or anticipated increases in delinquency rates as a reason.

The Business Sector

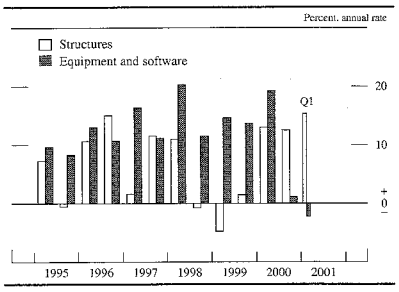
The boom in capital spending that has helped fuel the economic expansion came to a halt late last year. After having risen at double-digit rates over the preceding five years, real business fixed investment flattened out in the fourth quarter of 2000 and rose only a little in the first quarter of 2001. Demand for capital equipment has slackened appreciably, reflecting the sluggish economy, sharply lower corporate profits and cash flow, earlier overinvestment in some sectors, and tight financing conditions facing some firms. In addition, inventory investment fell substantially in the first quarter as businesses moved to address the overhangs that began to develop late last year. With investment spending weakening, businesses have cut back on new borrowing. Following the drop in longer-term interest rates in the last few months of 2000, credit demands have been concentrated in longer-term markets, though cautious investors have required high spreads from marginal borrowers.

Fixed Investment

Real spending on equipment and software (E&S) began to soften in the second half of last year, and it posted small declines in both the fourth quarter of 2000 and the first quarter of 2001. Much of the weakness in the first quarter was in spending on high-tech equipment and software; such spending, which now accounts for about half of E&S outlays when measured in nominal terms, declined at an annual rate of about 12 percent in real terms—the first real quarterly drop since the 1990 recession. An especially sharp decrease in outlays for communications equipment reflected the excess capacity that had emerged as a result of the earlier surge in spending, the subsequent re-evaluation of profitability, and the accompanying financing difficulties faced by some firms. In addition, real spending on computers and peripheral equipment, which rose more than 40 percent per year in the second half of the 1990s, showed little growth, on net, between the third quarter of 2000 and the first quarter of 2001. The leveling in real computer spending reportedly reflects some stretching out of businesses' replacement cycles for personal computers as well as a reduced demand for servers. Outside the high-tech area, spending rose in the first quarter as purchases of motor vehicles reversed some of the decline recorded over the second half of 2000 and as outlays for industrial equipment picked up after having been flat in the fourth quarter.

Real E&S spending likely dropped further in the second quarter. In addition to the ongoing contraction in outlays on high-tech equipment, the incoming data for orders and shipments point to a decline in investment in non-high-tech equipment, largely reflecting the weakness in the manufacturing sector this year.

Change in real business fixed investment

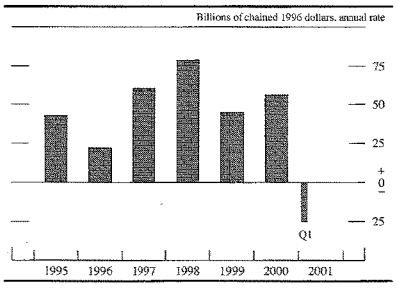


Outlays on nonresidential construction posted another sizable advance in early 2001 after having expanded nearly 13 percent in real terms in 2000, but the incoming monthly construction data imply a sharp retrenchment in the second quarter. The downturn in spending comes on the heels of an increase in vacancy rates for office and industrial space in many cities. Moreover, while financing generally remains available for projects with viable tenants, lenders are now showing greater caution. Not surprisingly, one bright spot is the energy sector, where expenditures for drilling and mining have been on a steep uptrend since early 1999 (mainly because of increased exploration for natural gas) and the construction of facilities for electric power generation remains very strong.

Inventory Investment

A sharp reduction in the pace of inventory investment was a major damping influence on real GDP growth in the first quarter of 2001. The swing in real nonfarm inventory investment from an accumulation of $51 billion at an annual rate in the fourth quarter of 2000 to a liquidation of $25 billion in the first quarter of 2001 subtracted 3 percentage points from the growth in real GDP in the first quarter. Nearly half of the negative contribution to GDP growth came from the motor vehicle sector, where a sizable cut in assemblies (added to the reduction already in place in the fourth quarter) brought the overall days' supply down to comfortable levels by the end of the first quarter. A rise in truck assemblies early in the second quarter led to some backup of inventories in that segment of the market, but truck stocks were back in an acceptable range by June; automobile assemblies were up only a little in the second quarter, and stocks remained lean.

Change in real nonfarm business inventories

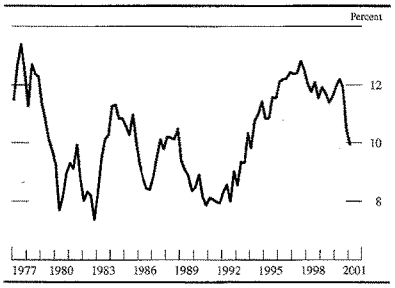


Firms outside the motor vehicles industry also moved aggressively to address inventory imbalances in the first half of the year, and this showed through to manufacturing output, which, excluding motor vehicles, fell at an annual rate of 7½ percent over this period. These production adjustments—along with a sharp reduction in the flow of imports—contributed to a small decline in real non-auto stocks in the first quarter, and book-value data for the manufacturing and trade sector point to a further decrease, on net, in April and May. As of May, stocks generally seemed in line with sales at retail trade establishments, but there were still some notable overhangs in wholesale trade and especially in manufacturing, where inventory–shipments ratios for producers of computers and electronic products, primary and fabricated metals, and chemicals remained very high.

Business Finance

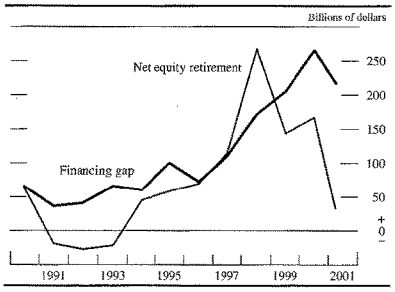
The economic profits of U.S. corporations fell at a 19 percent annual rate in the first quarter after a similar decline in the fourth quarter of 2000. As a result, the ratio of profits to GDP declined 1 percentage point over the two quarters, to 8.5 percent; the ratio of the profits of nonfinancial corporations to sector output fell 2 percentage points over the interval, to 10 percent. Investment spending has declined by more than profits, however, reducing somewhat the still-elevated need of nonfinancial corporations for external funds to finance capital expenditures. Corporations have husbanded their increasingly scarce internal funds by cutting back on cash-financed mergers and equity repurchases. While

Before-tax profits of nonfinancial corporations as a percent of sector GDP



NOTE. Data extend through 2001:Q1. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments, divided by gross domestic product of nonfinancial corporate sector.

Financing gap and net equity retirement at nonfarm nonfinancial corporations

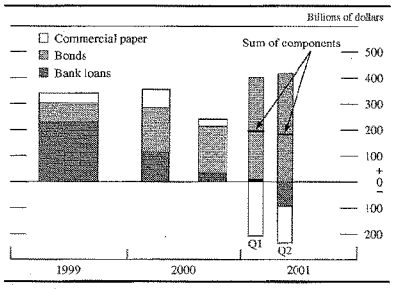


NOTE. The data through 2000 are annual; the final observation is for 2001:Q1 and is at an annual rate. The financing gap is the difference between capital expenditures and internally generated funds. Net equity retirement is the difference between equity retired through share repurchases, domestic cash-financed mergers, or foreign takeovers of U.S. firms and equity issued in public or private markets, including funds invested by venture capital partnerships.

equity retirements have therefore fallen, so has gross equity issuance, though by less. Inflows of venture equity capital, in particular, have been reduced substantially. Businesses have met their financing needs by borrowing heavily in the bond market while paying down both commercial and industrial (C&I) loans at banks and commercial paper. In total, after having increased 9½ percent last year, the debt of nonfinancial businesses rose at a 5 percent annual rate in the first quarter of this year and is estimated to have risen at about the same pace in the second quarter.

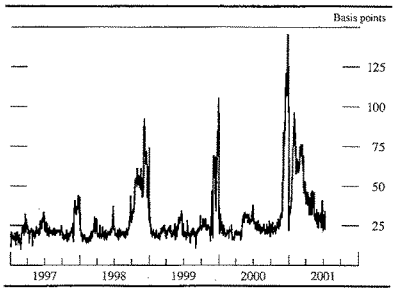
The decline in C&I loans and commercial paper owes, in part, to less hospitable conditions in shorter-term funding markets. The commercial paper market was rattled in mid-January by the defaults of two large California utilities. Commercial paper is issued

Major components of net business financing



NOTE. Seasonally adjusted annual rate for nonfarm nonfinancial corporate businesses. The data for 2001:Q2 are estimated.

Spread of low-tier CP rate over high-tier CP rate

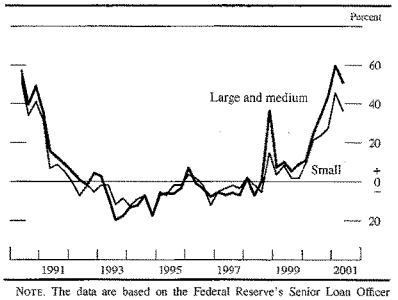


NOTE. The data are daily and extend through July 12, 2001. The series shown is the difference between the rate on A2/P2 nonfinancial commercial paper and the AA rate.

only by highly rated corporations, and default is extremely rare. The defaults, along with some downgrades, led investors in commercial paper to pull back and reevaluate the riskiness of issuers. For a while, issuance by all but top-rated names became very difficult and quality spreads widened significantly, pushing some issuers into the shortest maturities and inducing others to exit the market entirely. As a consequence, the amount of commercial paper outstanding plummeted. In the second quarter, risk spreads returned to more typical levels and the runoff moderated. By the end of June, the amount of nonfinancial commercial paper outstanding was nearly 30 percent below its level at the end of 2000, with many firms still not having returned to the market.

Even though banks' C&I loans were boosted in January and February by borrowers substituting away

Net percentage of domestic banks tightening standards for commercial and industrial loans, by size of borrower



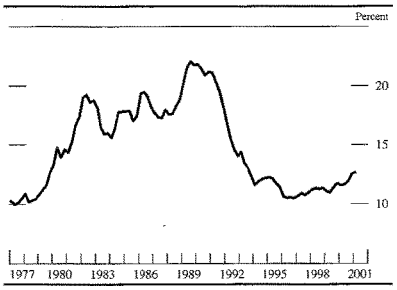
NOTE. The data are based on the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, which is generally conducted four times per year. The data extend through May 2001. Small firms are those with annual sales of less than $50 million.

from the commercial paper market, loans declined, on net, over the first half of the year, in part because borrowers paid down their bank loans with proceeds from bond issues. Many banks reported on the Federal Reserve's Bank Lending Practices surveys this year that they had tightened standards and terms—including the premiums charged on riskier loans, the cost of credit lines, and loan covenants—on C&I loans. Loan officers cited a worsened economic outlook, industry-specific problems, and a reduced tolerance for risk as the reasons for having tightened. Despite these adjustments to banks' lending stance, credit appears to remain amply available for sound borrowers, and recent surveys of small businesses indicate that they have not found credit significantly more difficult to obtain.

Meanwhile, the issuance of corporate bonds this year has proceeded at about double the pace of the preceding two years. With the yields on high-grade bonds back down to their levels in the first half of 1999 and with futures quotes suggesting interest rates will be rising next year, corporations apparently judged it to be a relatively opportune time to issue. Although investors remain somewhat selective, they have been willing to absorb the large volume of issuance as they have become more confident that the economy would recover and a prolonged disruption to earnings would be avoided. The heavy pace of issuance has been supported, in part, by inflows into bond mutual funds, which may have come at the expense of equity funds.

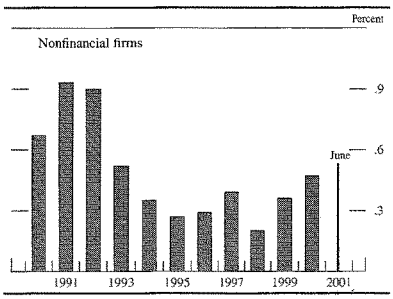
The flows are forthcoming at relatively high risk spreads, however. Spreads of most grades of corporate debt relative to rates on swaps have fallen a little this year, but spreads remain unusually high for lower investment-grade and speculative-grade credits. The

Net interest payments of nonfinancial corporations relative to cash flow



NOTE. The data are quarterly and extend through 2001:Q1.

Liabilities of failed businesses as a proportion of total liabilities



NOTE. Annual average. Value for June 2001 is a twelve-month trailing average.
SOURCE. Dun & Bradstreet.

elevated spreads reflect the deterioration in business credit quality that has occurred as the economy has slowed. While declines in interest rates have held aggregate interest expense at a relatively low percentage of cash flow, many individual firms are feeling the pinch of decreases in earnings. Over the twelve months ending in May, 11 percent of speculative-grade bonds, by dollar volume, have defaulted—the highest percentage since 1991 and a substantial jump from 1998, when less than 2 percent defaulted. This deterioration reflects not only the unusually large defaults by the California utilities, but also stress in the telecommunications sector and elsewhere. However, some other measures of credit performance have shown a more moderate worsening. The ratio of the liabilities of failed businesses to those of all nonfinancial businesses and the delinquency rate on C&I loans at banks have risen noticeably from their lows in 1998, but both remain well below levels posted in the early 1990s.

Commercial mortgage debt increased at about an 8¾ percent annual rate in the first half of this year, and the issuance of commercial-mortgage-backed securities (CMBS) maintained its robust pace of the past several years. While spreads of the yields on investment- and speculative-grade CMBS over swap rates have changed little this year, significant fractions of banks reported on the Bank Lending Practices survey that they have tightened terms and standards on commercial real estate loans. Although the delinquency rates on CMBS and commercial real estate loans at banks edged up in the first quarter, they remained near record lows. Nevertheless, those commercial banks that reported taking a more cautious approach toward commercial real estate lending

stated that they are doing so, in part, because of a less favorable economic outlook in general and a worsening of the outlook for commercial real estate.

The Government Sector

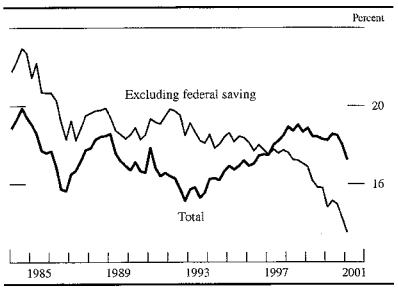
The fiscal 2001 surplus in the federal unified budget is likely to be smaller than the surplus in fiscal 2000 because of the slower growth in the economy and the recently enacted tax legislation. Nonetheless, the unified surplus will remain large, and the paydown of the federal debt is continuing at a rapid clip. As a consequence, the Treasury has taken a number of steps to preserve liquidity in a shrinking market. The weaker economy is also reducing revenues at the state and local level, but these governments remain in reasonably good fiscal shape overall and are taking advantage of historically low interest rates to refund existing debt and to issue new debt.

Federal Government

The fiscal 2001 surplus in the federal government's unified budget is likely to come in below the fiscal 2000 surplus of $236 billion. Over the first eight months of the fiscal year—October to May—the unified budget recorded a surplus of $137 billion, $16 billion higher than during the comparable period last year. But over the balance of the fiscal year, receipts will continue to be restrained by this year's slow pace of economic growth and the associated decline in corporate profits. Receipts will also be reduced significantly over the next few months by the payout of tax rebates and the shift of some corporate payments into fiscal 2002, provisions included in the Economic Growth and Tax Relief Reconciliation Act of 2001.

Federal saving, which is basically the unified budget surplus adjusted to conform to the accounting practices followed in the national income and product accounts (NIPA), has risen dramatically since hitting a low of −3½ percent of GDP in 1992 and stood at 3¾ percent of GDP in the first quarter—a swing of more than 7 percentage points. Reflecting the high level of federal saving, national saving, which comprises saving by households, businesses, and governments, has been running at a higher rate since the late 1990s than it did over most of the preceding decade, even as the personal saving rate has plummeted. The deeper pool of national saving, along with large inflows of foreign capital, has provided resources for the technology-driven boom in domestic investment in recent years.

National saving as a percent of nominal GDP



NOTE. The data extend through 2001:Q1. National saving comprises the gross saving of households, businesses, and governments.

Federal receipts in the first eight months of the current fiscal year were just 4½ percent higher than during the first eight months of fiscal 2000—a much smaller gain than those posted, on average, over the preceding several years. Much of the slowing was in corporate receipts, which dropped below year-earlier levels, reflecting the recent deterioration in profits. In addition, individual income tax payments rose less rapidly than over the preceding few years, mainly because of slower growth in withheld tax payments. This spring's nonwithheld payments of individual taxes, which are largely payments on the previous year's liability, were relatively strong. Indeed, although there was no appreciable "April surprise" this year—that is, these payments were about in line with expectations—liabilities again appear to have risen faster than the NIPA tax base in 2000. One factor that has lifted liabilities relative to income in recent years is that rising levels of income and a changing distribution have shifted more taxpayers into higher tax brackets. Higher capital gains realizations also have helped raise liabilities relative to the NIPA tax base over this period. (Capital gains are not included in the NIPA income measure, which, by design, includes only income from current production.)

The faster growth in outlays that emerged in fiscal 2000 has extended into fiscal 2001. Smoothing through some timing anomalies at the start of the fiscal year, nominal spending during the first eight months of fiscal 2001 was more than 4 percent higher than during the same period last year; excluding the sizable drop in net interest outlays that has accompanied the paydown of the federal debt, the increase in spending so far this year was nearly 6 percent. Spending in the past couple of years has been boosted by

sizable increases in discretionary appropriations as well as by faster growth in outlays for the major health programs. The especially rapid increase in Medicaid outlays reflects the higher cost and utilization of medical care (including prescription drugs), growing enrollments, and a rise in the share of expenses picked up by the federal government. Outlays for Medicare have been lifted, in part, by the higher reimbursements to providers that were enacted last year.

Real federal expenditures for consumption and gross investment, the part of government spending that is included in GDP, rose at a 5 percent annual rate in the first quarter. Over the past couple of years, real nondefense purchases have remained on the moderate uptrend that has been evident since the mid-1990s, while real defense purchases have started to rise slowly after having bottomed out in the late 1990s.

The Treasury has used the substantial federal budget surpluses to pay down its debt further. At the end of June, the outstanding Treasury debt held by the public had fallen nearly $600 billion, or 15 percent, from its peak in 1997. Relative to nominal GDP, publicly held debt has dropped from nearly 50 percent in the mid-1990s to below 33 percent in the first quarter, the lowest it has been since 1984.

Declines in outstanding federal debt and the associated reductions in the sizes and frequency of auctions of new issues have diminished the liquidity of the Treasury market over the past few years. Bid–asked spreads are somewhat wider, quote sizes are smaller, and the difference between yields on seasoned versus most-recently issued securities has increased. In part, however, these developments may also reflect a more cautious attitude among securities dealers following the market turmoil in the fall of 1998.

The Treasury has taken a number of steps to limit the deterioration in the liquidity of its securities. In recent years, it has concentrated its issuance into fewer securities, so that the auction sizes of the remaining securities are larger. Last year, in order to enable issuance of a larger volume of new securities, the Treasury began buying back less-liquid older securities, and it also made every second auction of its 5- and 10-year notes and 30-year bond a reopening of the previously issued security. In February, the Treasury put limits on the noncompetitive bids that foreign central banks and governmental monetary entities may make, so as to leave a larger and more predictable pool of securities available for competitive bidding, helping to maintain the liquidity and efficiency of the market. In May, the Treasury announced that it would begin issuing Treasury bills with a four-week maturity to provide it with greater flexibility and cost efficiency in managing its cash balances, which, in part because new securities are now issued less frequently, have become more volatile. Finally, also in May, the Treasury announced it would in the next few months seek public comment on a plan to ease the "35 percent rule," which limits the bidding at auctions by those holding claims on large amounts of an issue. With reopenings increasingly being used to maintain liquidity in individual issues, this rule was constraining many potential bidders. As discussed below, the reduced issuance of Treasury securities has also led the Federal Reserve to modify its procedures for acquiring such securities and to study possible future steps for its portfolio.

In early 2000, as investors focused on the possibility that Treasury securities were going to become increasingly scarce, they became willing to pay a premium for longer-dated securities, pushing down their yields. However, these premiums appear to have largely unwound later in the year as market participants made adjustments to the new environment. These adjustments include the substitution of alternative instruments for hedging and pricing, such as interest rate swaps, prominent high-grade corporate bonds, and securities issued by government-sponsored enterprises (GSEs). To benefit from adjustments by market participants, in 1998, Fannie Mae and Freddie Mac initiated programs to issue securities that share some characteristics with Treasury securities, such as regular issuance calendars and large issue sizes; in the first half of this year they issued $88 billion of coupon securities and $502 billion of bills under these programs. The GSEs have also this year begun buying back older securities to boost the size of their new issues. Nevertheless, the market for Treasury securities remains considerably more liquid than markets for GSE and other fixed-income securities.

State and Local Governments

State and local governments saw an enormous improvement in their budget positions between the mid-1990s and last year as revenues soared and spending generally was held in check; accordingly, these governments were able both to lower taxes and to make substantial allocations to reserve funds. More recently, however, revenue growth has slowed in many states, and reports of fiscal strains have increased. Nonetheless, the sector remains in relatively good fiscal shape overall, and most governments facing revenue shortfalls have managed to

adopt balanced budgets for fiscal 2002 with only minor adjustments to taxes and spending.

Real consumption and investment spending by state and local governments rose at nearly a 5 percent annual rate in the first quarter and apparently posted a sizable increase in the second quarter as well. Much of the strength this year has been in construction spending, which has rebounded sharply after a reported decline in 2000 that was hard to reconcile with the sector's ongoing infrastructure needs and the good financial condition of most governments. Hiring also remained fairly brisk during the first half of the year; on average, employment rose 30,000 per month, about the same as the average monthly increase over the preceding three years.

Although interest rates on municipal debt have edged up this year, they remain low by historical standards. State and local governments have taken advantage of the low interest rates to refund existing debt and to raise new capital. Credit quality has remained quite high in the municipal sector even as tax receipts have softened, with credit upgrades outpacing downgrades in the first half of this year. Most notable among the downgrades was that of California's general obligation bonds. Standard and Poor's lowered California's debt two notches from AA to A+, citing the financial pressures from the electricity crisis and the likely adverse effects of the crisis on the state's economy.

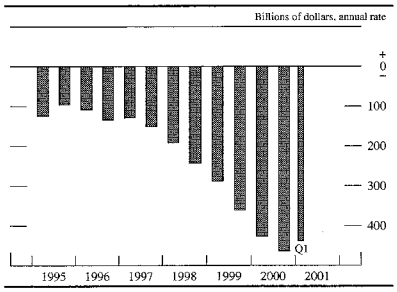
The External Sector

The deficits in U.S. external balances narrowed sharply in the first quarter of this year, largely because of a smaller deficit in trade in goods and services. Most of the financial flows into the United States continued to come from private foreign sources.

Trade and Current Account

After widening continuously during the past four years, the deficits in U.S. external balances narrowed in the first quarter of 2001. The current account deficit in the first quarter was $438 billion at an annual rate, or 4.3 percent of GDP, compared with $465 billion in the fourth quarter of 2000. Most of the reduction of the current account deficit can be traced to changes in U.S. trade in goods and services; the trade deficit narrowed from an annual rate of $401 billion in the fourth quarter of 2000 to $380 billion in the first quarter of this year. The trade deficit

U.S. current account

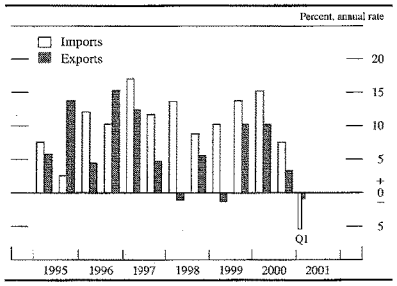


in April continued at about the same pace. Net investment income payments were a bit less in the first quarter than the average for last year primarily because of a sizable decrease in earnings by U.S. affiliates of foreign firms.

As U.S. economic growth slowed in the second half of last year and early this year, real imports of goods and services, which had grown very rapidly in the first three quarters of 2000, expanded more slowly in the fourth quarter and then contracted 5 percent at an annual rate in the first quarter. The largest declines were in high-tech products (computers, semiconductors, and telecommunications equipment) and automotive products. In contrast, imports of petroleum and petroleum products increased moderately. A temporary surge in the price of imported natural gas pushed the increase of the average price of non-oil imports above an annual rate of 1 percent in the first quarter, slightly higher than the rate of increase recorded in 2000.

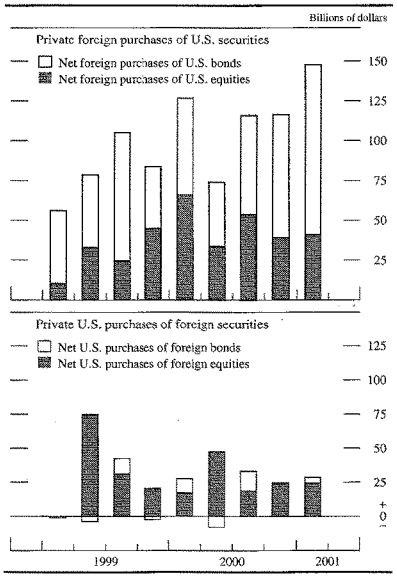
U.S. real exports were hit by slower growth abroad, the strength of the dollar, and plunging global demand for high-tech products. Real exports of goods and services, which had grown strongly in the first three quarters of 2000, fell 6½ percent at an annual rate in the fourth quarter of last year and declined another 1 percent in the first quarter of this year. The largest declines in both quarters were in high-tech capital goods and automotive products (primarily in intra-firm trade with Canada). By market destination, the largest increases in U.S. goods exports during the first three quarters of 2000 had been to Mexico and countries in Asia; the recent declines were mainly in exports to Asia and Latin America. In contrast, goods exports to Western Europe increased steadily throughout the entire period. About 45 percent of U.S. goods exports in the first quarter of 2001 were

Change in real imports and exports of goods and services



NOTE. Change for the half-year indicated is measured from the preceding half-year, and the change for 2001:Q1 is from 2000:Q4. Imports and exports for each half-year are the average of the levels for component quarters.

U.S. international securities transactions



SOURCE. Department of Commerce, *Survey of Current Business*.

capital equipment; 20 percent were industrial supplies; and 5 to 10 percent each were agricultural, automotive, consumer, and other goods.

After increasing through much of 2000, the spot price of West Texas intermediate (WTI) crude oil reached a peak above $37 per barrel in September, the highest level since the Gulf War. As world economic growth slowed in the latter part of 2000, oil price declines reversed much of the year's price gain. In response, OPEC reduced its official production targets in January of this year and again in March. As a result, oil prices have remained relatively high in 2001 despite weaker global economic growth and a substantial increase in U.S. oil inventories. Oil prices have also been elevated by the volatility of Iraqi oil exports arising from tense relations between Iraq and the United Nations. During the first six months of this year, the spot price of WTI has fluctuated, with only brief exceptions, between $27 and $30 per barrel.

Financial Account

In the first quarter of 2001, as was the case in 2000 as a whole, nearly all of the net financial flows into the United States came from private foreign sources. Foreign official inflows were less than $5 billion and were composed primarily of the reinvestment of accumulated interest earnings. Reported foreign exchange intervention purchases of dollars were modest.

Inflows arising from private foreign purchases of U.S. securities accelerated further in the first quarter and are on a pace to exceed last year's record. All of the pickup is attributable to larger net foreign purchases of U.S. bonds, as foreign purchases of both corporate and agency bonds accelerated and private foreign sales of Treasuries paused. Foreign purchases of U.S. equities are only slightly below their 2000 pace despite the apparent decline in expected returns to holding U.S. equities.

The pace at which U.S. residents acquired foreign securities changed little between the second half of last year and the first quarter of this year. As in previous years, most of the foreign securities acquired were equities.

Net financial inflows associated with direct investment slowed a good bit in the first quarter, as there were significantly fewer large foreign takeovers of U.S. firms and U.S. direct investment abroad remained robust.

The Labor Market

Labor demand weakened in the first half of 2001, especially in manufacturing, and the unemployment rate rose. Increases in hourly compensation have

continued to trend up in recent quarters, while measured labor productivity has been depressed by the slower growth of output.

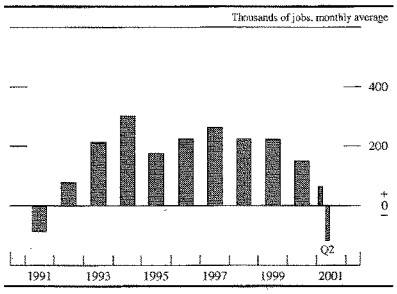
Employment and Unemployment

After having risen an average of 149,000 per month in 2000, private payroll employment increased an average of only 63,000 per month in the first quarter of 2001, and it declined an average of 117,000 per month in the second quarter. The unemployment rate moved up over the first half of the year and in June stood at 4½ percent, ½ percentage point higher than in the fourth quarter of last year.

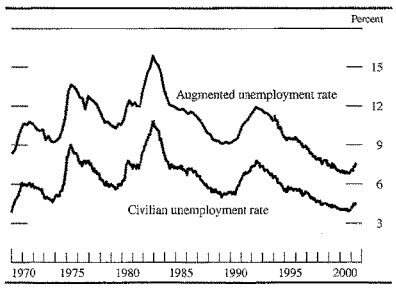
Much of the weakness in employment in the first half of the year was in the manufacturing sector, where job losses averaged 78,000 per month in the first quarter and 116,000 per month in the second quarter. Since last July, manufacturing employment has fallen nearly 800,000. Factory job losses were widespread in the first half of the year, with some of the biggest cutbacks at industries struggling with sizable inventory overhangs, including metals and industrial and electronic equipment. The weakness in manufacturing also cut into employment at help-supply firms and at wholesale trade establishments.

Apart from manufacturing and the closely related help-supply and wholesale trade industries, employment growth held up fairly well in the first quarter but began to slip noticeably in the second quarter. Some of the slowing in the second quarter reflected a drop in construction employment after a strong first quarter that likely absorbed a portion of the hiring that normally takes place in the spring; on average, construction employment rose a fairly brisk 15,000 per month over the first half, about the same as in 2000. Hiring in the services industry (other than help-supply firms) also slowed markedly in the second quarter. Employment in retail trade remained on a moderate uptrend over the first half of the year, and employment in finance, insurance, and real estate increased modestly after having been unchanged, on net, last year.

Net change in private nonfarm payroll employment



Measures of labor utilization



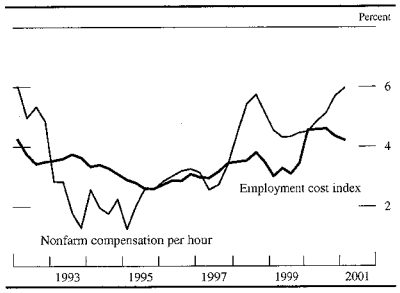
NOTE. The data extend through June 2001. The augmented unemployment rate is the number of unemployed plus those who are not in the labor force and want a job, divided by the civilian labor force plus those who are not in the labor force and want a job. In January 1994, a redesigned survey was introduced; data from that point on are not directly comparable with those of earlier periods.

Labor Costs and Productivity

Through the first quarter, compensation growth remained quite strong—indeed, trending higher by some measures. These gains likely reflected the influence of earlier tight labor markets, higher consumer price inflation—largely due to soaring energy prices—and the greater real wage gains made possible by faster structural productivity growth. The upward pressures on labor costs could abate in coming quarters if pressures in labor markets ease and energy prices fall back.

Hourly compensation, as measured by the employment cost index (ECI) for private nonfarm businesses, moved up in the first quarter to a level about 4¼ percent above its level of a year earlier; this compares with increases of about 4½ percent over the preceding year and 3 percent over the year before that. The slight deceleration in the most recent twelve-month change in the ECI is accounted for by a slowdown in the growth of compensation for sales workers relative to the elevated rates that had prevailed in early 2000; these workers' pay includes a substantial commission component and thus is especially sensitive to cyclical developments. Compensation per hour in the nonfarm business sector—a measure that picks up some forms of compensation that

Measures of change in hourly compensation



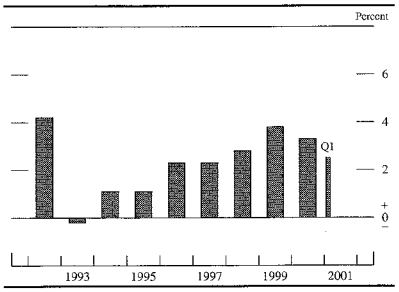
NOTE. The data extend through 2001:Q1. The ECI is for private industry excluding farm and household workers. Nonfarm compensation per hour is for the nonfarm business sector.

the ECI omits but that sometimes has been revised substantially once the data go through the annual revision process—shows a steady uptrend over the past couple of years; it rose 6 percent over the year ending in the first quarter after having risen 4½ percent over the preceding year.

According to the ECI, wages and salaries rose at an annual rate of about 4½ percent in the first quarter. Excluding sales workers, wages rose 5 percent (annual rate) in the first quarter and 4¼ percent over the year ending in March; this compares with an increase of 3¾ percent over the year ending in March 2000. Separate data on average hourly earnings of production or nonsupervisory workers also show a discernable acceleration of wages: The twelve-month change in this series was 4¼ percent in June, ½ percentage point above the reading for the preceding twelve months.

Benefit costs as measured in the ECI have risen faster than wages over the past year, with the increase over the twelve months ending in March totaling 5 percent. Much of the pressure on benefits is coming from health insurance, where employer payments have accelerated steadily since bottoming out in the mid-1990s and are now going up about 8 percent per year. The surge in spending on prescription drugs accounts for some of the rise in health insurance costs, but demand for other types of medical care is increasing rapidly as well. Moreover, although there has been some revamping of drug coverage to counter the pressures of soaring demand, many employers have been reluctant to adjust other features of the health benefits package in view of the need to retain workers in a labor market that has been very tight in recent years.

Change in output per hour, nonfarm businesses

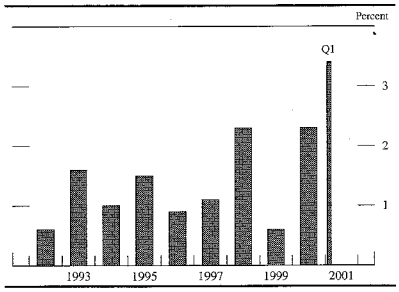


NOTE. Changes are Q4 to Q4 except the change for 2001:Q1, which is from 2000:Q1.

Measured labor productivity in the nonfarm business sector has been bounced around in recent quarters by erratic swings in hours worked by self-employed individuals, but on balance, it has barely risen since the third quarter of last year after having increased about 3 percent per year, on average, over the preceding three years. This deceleration coincides with a marked slowing in output growth and seems broadly in line with the experience of past business cycles; these readings remain consistent with a noticeable acceleration in structural productivity having occurred in the second half of the 1990s. Reflecting the movements in hourly compensation and in actual productivity, unit labor costs in the nonfarm business sector jumped in the first quarter and have risen 3½ percent over the past year.

Looking ahead, prospects for favorable productivity performance will hinge on a continuation of the rapid technological advances of recent years and on

Change in unit labor costs, nonfarm businesses



NOTE. Changes are Q4 to Q4 except the change for 2001:Q1, which is from 2000:Q1.

the willingness of businesses to expand and update their capital stocks to take advantage of the new efficiency-enhancing capital that is becoming available at declining cost in many cases. To be sure, the current weakness in business investment will likely damp the growth of the capital stock relative to the pace of the past couple of years. But once the cyclical weakness in the economy dissipates, continued advances in technology should provide impetus to renewed capital spending and a return to solid increases in productivity.

Prices

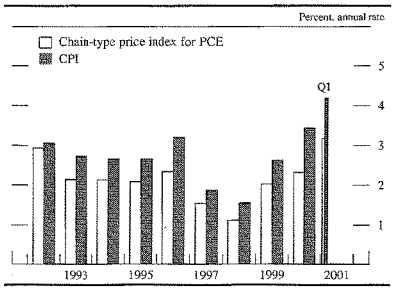
Inflation moved higher in early 2001 but has moderated some in recent months. After having risen 2¼ percent in 2000, the chain price index for personal consumption expenditures (PCE) increased about 3¼ percent in the first quarter of 2001 as energy prices soared and as core consumer prices—which exclude food and energy—picked up. Energy prices continued to rise rapidly in April and May but eased in June and early July. In addition, core PCE price inflation has dropped back after the first-quarter spurt, and the twelve-month change in this series, which is a useful indicator of the underlying inflation trend, stood at 1½ percent in May, about the same as the change over the preceding twelve months. The core consumer price index (CPI) continued to move up at a faster pace than the core PCE measure over the past year, rising 2½ percent over the twelve months ending in May, also the same rate as over the preceding year.

PCE energy prices rose at an annual rate of about 11 percent in the first quarter and, given the big increases in April and May, apparently posted another sizable advance in the second quarter. Unlike the surges in energy prices in 1999 and 2000, the increases in the first half of 2001 were not driven by developments in crude oil markets. Indeed, natural gas prices were the major factor boosting overall energy prices early this year as tight inventories and concerns about potential stock-outs pushed spot prices to extremely high levels; natural gas prices have since receded as additional supplies have come on line and inventories have been rebuilt. In the spring, gasoline prices soared in response to strong demand, refinery disruptions, and concerns about lean inventories; with refineries back on line, imports up, and inventories restored, gasoline prices have since fallen noticeably below their mid-May peaks. Electricity prices also rose substantially in the first half of the year, reflecting higher natural gas prices as well as the problems in California. Capacity problems in California and the hydropower shortages in the Northwest persist, though California's electricity consumption has declined recently and wholesale prices have dropped. In contrast, capacity in the rest of the country has expanded appreciably over the past year and, on the whole, appears adequate to meet the normal seasonal rise in demand.

Core PCE prices rose at a 2½ percent annual rate in the first quarter—a hefty increase by the standards of recent years. But the data are volatile, and the first-quarter increase, no doubt, exaggerates any pickup. Based on monthly data for April and May, core PCE inflation appears to have slowed considerably in the second quarter; the slowing was concentrated in the goods categories and seems consistent with reports that retailers have been cutting prices to spur sales in an environment of soft demand.

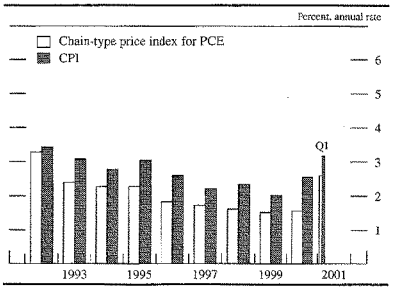
Core consumer price inflation—whether measured by the PCE index or by the CPI—in recent quarters

Change in consumer prices



NOTE. The CPI is for all urban consumers (CPI-U).

Change in consumer prices excluding food and energy



NOTE. The CPI is for all urban consumers (CPI-U).

almost certainly has been boosted by the effects of higher energy prices on the costs of producing other goods and services. Additional pressure has come from the step-up in labor costs. That said, firms appear to have absorbed much of these cost increases in lower profit margins. Meanwhile, non-oil import prices have remained subdued, thus continuing to restrain input costs for many domestic industries and to limit the ability of firms facing foreign competition to raise prices for fear of losing market share. In addition, apart from energy, price pressures at earlier stages of processing have been minimal. Indeed, excluding food and energy, the producer price index (PPI) for intermediate materials has been flat over the past year, and the PPI for crude materials has fallen 11 percent. Moreover, inflation expectations, on balance, seem to have remained quiescent: According to the Michigan survey, the median expectation for inflation over the upcoming year generally has been running about 3 percent this year, similar to the readings in 2000.

In contrast to the step-up in consumer prices, prices for private investment goods in the NIPA were up only a little in the first quarter after having risen about 2 percent last year. In large part, this pattern was driven by movements in the price index for computers, which fell at an annual rate of nearly 30 percent in the first quarter as demand for high-tech equipment plunged. This drop in computer prices was considerably greater than the average decrease of roughly 20 percent per year in the second half of the 1990s and the unusually small 11 percent decrease in 2000. Monthly PPI data suggest that computer prices were down again in the second quarter, though much less than in the first quarter.

All told, the GDP chain-type price index rose at an annual rate of 3¼ percent in the first quarter and has risen 2¼ percent over the past four quarters, an acceleration of ½ percentage point from the comparable year-earlier period. The price index for gross domestic purchases—which is defined as the prices paid for consumption, investment, and government purchases—also accelerated in the first quarter—to an increase of about 2¾ percent; the increase in this measure over the past year was 2¼ percent, about the same as over the preceding year. Excluding food and energy, the latest four-quarter changes in both GDP and gross domestic purchases prices were roughly the same as over the preceding year.

Alternative measures of price change

Percent, Q1 to Q1

Price measure	1998 to 1999	1999 to 2000	2000 to 2001
Chain-type			
Gross domestic product	1.5	1.8	2.3
Gross domestic purchases	1.2	2.3	2.2
Personal consumption expenditures	1.5	2.5	2.2
Excluding food and energy	1.8	1.6	1.7
Fixed-weight			
Consumer price index	1.7	3.3	3.4
Excluding food and energy	2.2	2.2	2.7

NOTE. A fixed-weight index uses quantity weights from a base year to aggregate prices from each distinct item category. A chain-type index is the geometric average of two fixed-weight indexes and allows the weights to change each year. The consumer price indexes are for all urban consumers. Changes are based on quarterly averages.

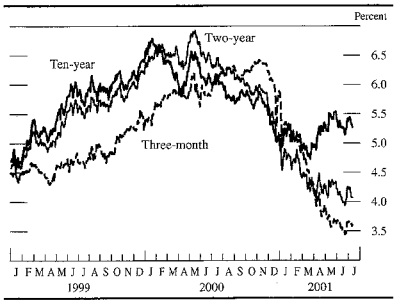
U.S. Financial Markets

Longer-term interest rates and equity prices have shown remarkably small net changes this year, given the considerable shifts in economic prospects and major changes in monetary policy. To some extent, the expectations of the economic and policy developments in 2001 had already become embedded in financial asset prices as last year came to a close; from the end of August through year-end, the broadest equity price indexes fell 15 percent and investment-grade bond yields declined 40 to 70 basis points. In addition, however, equity prices and long-term interest rates were influenced importantly by growing optimism in financial markets over the second quarter of 2001 that the economy and profits would rebound strongly toward the end of 2001 and in 2002. On net, equity prices fell 6 percent in the first half of this year as near-term corporate earnings were revised down substantially. Rates on longer-term Treasury issues rose a little, but those on corporate bonds were about unchanged, with the narrowing spread reflecting greater investor confidence in the outlook. But risk spreads remained wide by historical standards for businesses whose debt was rated as marginally investment grade or below; many of these firms had been especially hard hit by the slowdown and the near-term oversupply of high-tech equipment and services, and defaults by these firms became more frequent. Nevertheless, for most borrowers the environment for long-term financing was seen to be quite favorable, and firms and households tended to tap long-term sources of credit in size to bolster their financial conditions and lock in more favorable costs.

Interest Rates

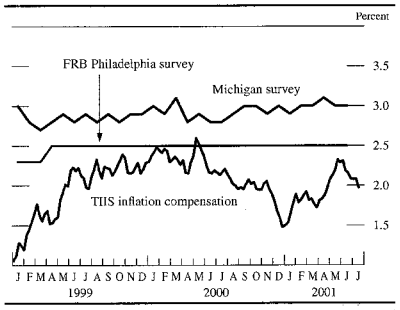
In response to the abrupt deceleration in economic growth and prospects for continued weakness in the economy, the FOMC lowered the target federal funds rate 2¾ percentage points in six steps in the first half

Rates on selected Treasury securities



NOTE. The data are daily and extend through July 12, 2001.

Measures of long-term inflation expectations



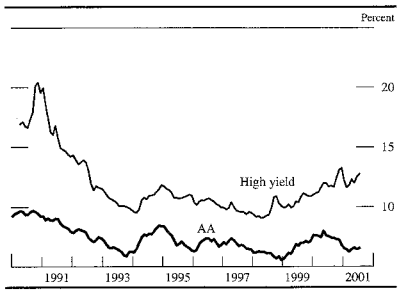
NOTE. The data for the Michigan survey, which are monthly and extend through June 2001, measure five-year to ten-year inflation expectations. The data for the FRB Philadelphia survey, which are quarterly and extend through 2001:Q2, measure ten-year inflation expectations. TIIS inflation compensation is the rate of inflation at which the price of the ten-year Treasury inflation-indexed security equals the value of a portfolio of zero-coupon securities that replicates its payments; data for this measure are weekly averages and extend through July 13, 2001.

of this year, an unusually steep decline relative to many past easing cycles. Through March, the policy easings combined with declining equity prices and accumulating evidence that the slowdown in economic growth was more pronounced than had been initially thought led to declines in yields on intermediate- and longer-term Treasury securities. Over the second quarter, despite the continued decrease in short-term rates and further indications of a weakening economy, yields on intermediate-term Treasury securities were about unchanged, while those on longer-term securities rose appreciably. On net, yields on intermediate-term Treasury securities fell about ¾ percentage point in the first half of this year, while those on longer-term Treasury securities rose about ¼ percentage point.

The increase in longer-term Treasury yields in the second quarter appears to have been the result of a number of factors. The main influence seems to have been increased investor confidence that the economy would soon pick up. That confidence likely arose in part from the aggressive easing of monetary policy and also in part from the improving prospects for, and passage of, a sizable tax cut. The tax cut and the growing support for certain spending initiatives implied stronger aggregate demand and less federal saving than previously anticipated. The prospect that the federal debt might be paid down less rapidly may also have reduced slightly the scarcity premiums investors were willing to pay for Treasury securities. Finally, a portion of the rise may have been the result of increased inflation expectations. Inflation compensation as measured by the difference between nominal Treasury rates and the rates on inflation-indexed Treasury securities rose about ¼ percentage point in the second quarter. Despite this increase, there is little evidence that inflation is expected to go up from its current level. At the end of last year, inflation compensation had declined to levels suggesting investors expected inflation to fall, and the rise in inflation compensation in the second quarter largely reversed those declines. Moreover, survey measures of longer-term inflation expectations have changed little since the middle of last year.

Yields on longer-maturity corporate bonds were about unchanged, on net, over the first half of this year. Yields on investment-grade bonds are near their lows for the past ten years, but those on speculative-grade bonds are elevated. Spreads of corporate bond yields relative to swap rates narrowed a bit, although they still remain high. Amidst signs of deteriorating credit quality and a worsening outlook for corporate earnings, risk spreads on speculative-grade bonds had risen by about 2 percentage points late last year, reaching levels not seen since 1991. Much of this widening was reversed early in the year, as investors became more confident that corporate balance sheets would not deteriorate substantially, but speculative-grade bond spreads widened again recently in response to negative news about second-quarter earnings and declines in share prices, leaving these spreads at the end of the second quarter only slightly below where they began the year. Nonetheless, investors, while somewhat selective, appear to remain receptive to new issues with speculative-grade ratings.

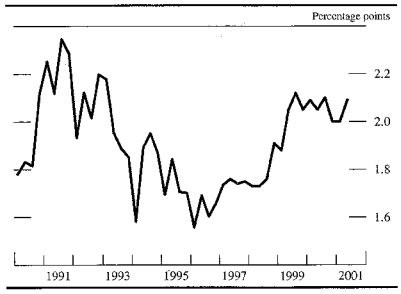
Corporate bond yields



NOTE. The data are monthly averages and extend through June 2001. The AA rate is calculated from bonds in the Merrill Lynch AA index with seven to ten years remaining to maturity. The high-yield rate is the yield on the Merrill Lynch 175 high-yield index.

Interest rates on commercial paper and C&I loans have fallen this year by about as much as the federal funds rate, although some risk spreads widened. The average yield spread on second-tier commercial paper over top-tier paper widened to about 100 basis points in late January, about four times its typical level, following defaults by a few prominent issuers. As the year progressed, investors became less concerned about the remaining commercial paper borrowers, and this spread has returned to a more normal level. According to preliminary data from the Federal Reserve's quarterly Survey of Terms of Business Lending, the spread over the target federal funds rate of the average interest rate on commercial bank C&I loans edged up between November and May and remains in the elevated range it shifted to in late 1998. Judging from the widening since 1998 of the average spread between rates on riskier and less-risky loans, banks have become especially cautious about lending to marginal credits.

Spread of average business loan rate over intended federal funds rate



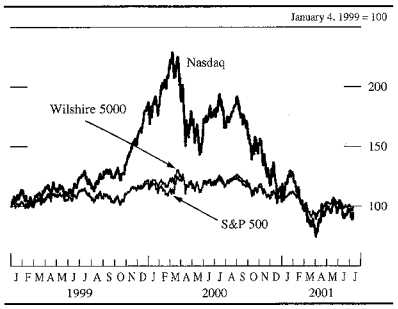
NOTE. The data, which are based on the Federal Reserve's Survey of Terms of Business Lending, are for loans made by domestic commercial banks. The survey is conducted in the middle month of each quarter: the final observation is for May 2001 and is preliminary.

Equity Markets

After rising in January in response to the initial easing of monetary policy, stock prices declined in February and March in reaction to profit warnings and weak economic data, with the Wilshire 5000, the broadest major stock price index, ending the first quarter down 13 percent. Stock prices retraced some of those losses in the second quarter, rising 7 percent, as first-quarter earnings releases came in a little above sharply reduced expectations and as investors became more confident that economic growth and corporate profits would soon pick up. On net, the Wilshire 5000 ended the half down 6 percent, the DJIA declined 3 percent, and the tech-heavy Nasdaq fell 13 percent. Earnings per share of the S&P 500 in the first quarter decreased 10 percent from a year earlier. A disproportionate share of the decline in S&P earnings—more than half—was attributable to a plunge in the technology sector, where first-quarter earnings were down nearly 50 percent from their peak in the third quarter of last year.

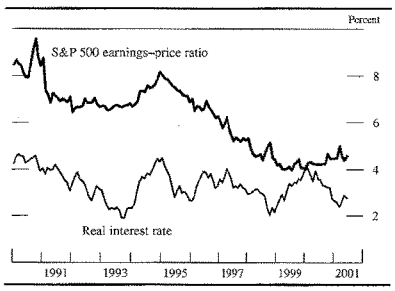
The decline in stock prices has left the Wilshire 5000 down by about 20 percent, and the Nasdaq down by about 60 percent, from their peaks in March 2000. Both of these indexes are near their levels at the end of 1998, having erased the sharp run-up in prices in 1999 and early 2000. But both indexes remain more than two and one-half times their levels

Major stock price indexes



NOTE. The data are daily and extend through July 12, 2001.

S&P 500 earnings–price ratio and the real interest rate



NOTE. The data are monthly and extend through June 2001. The earnings–price ratio is based on I/B/E/S consensus estimates of earnings over the coming year. The real rate is estimated as the difference between the ten-year Treasury rate and the five-year to ten-year expected inflation rate from the FRB Philadelphia survey.

at the end of 1994, when the bull market shifted into a higher gear. The ratio of expected one-year-ahead earnings to equity prices began to fall in 1995 when, as productivity growth picked up, investors began to build in expectations that increases in earnings would remain rapid for some time. This measure of the earnings-price ratio remains near the levels reached in 1999, suggesting that investors still anticipate robust long-term earnings growth, likely reflecting expectations for continued strong gains in productivity.

Despite the substantial variation in share prices over the first half of this year, trading has been orderly, and financial institutions appear to have encountered no difficulties that could pose broader systemic concerns. Market volatility and a less ebullient outlook have led investors to buy a much smaller share of stock on margin. At the end of May, margin debt was 1.15 percent of total market capitalization, equal to its level at the beginning of 1999 and well below its high of 1.63 percent in March of last year.

Federal Reserve Open Market Operations

As noted earlier, the Federal Reserve has responded to the diminished size of the auctions of Treasury securities by modifying its procedures for acquiring such securities. To help maintain supply in private hands adequate for liquid markets, since July of last year the System has limited its holdings of individual securities to specified percentages, ranging from 15 percent to 35 percent, of outstanding amounts. To stay within these limits, the System has at times not rolled over all of its holdings of maturing securities, generally investing the difference by purchasing other Treasury securities on the open market. The Federal Reserve also has increased its holdings of longer-term repurchase agreements (RPs), including RPs backed by agency securities and mortgage-backed securities, as a substitute for outright purchases of Treasury securities. In the first half of the year, longer-term RPs, typically with maturities of twenty-eight days, averaged $13 billion.

As reported in the previous *Monetary Policy Report*, the FOMC also initiated a study to evaluate assets to hold on its balance sheet as alternatives to Treasury securities. That study identified several options for further consideration. In the near term, the Federal Reserve is considering purchasing and holding Ginnie Mae mortgage-backed securities, which are explicitly backed by the full faith and credit of the U.S. government, and engaging in repurchase operations against foreign sovereign debt. For possible implementation later, the Federal Reserve is studying whether to auction longer-term discount window credit, and it will over time take a closer look at a broader array of assets for repurchase and for holding outright, transactions that would require additional legal authority.

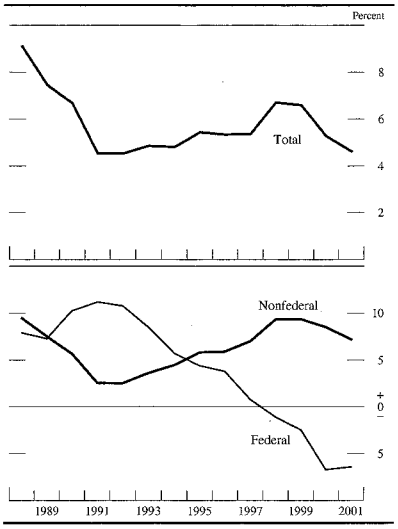
Debt and the Monetary Aggregates

The growth of domestic nonfinancial debt in the first half of 2001 is estimated to have remained moderate, slowing slightly from the pace in 2000 as a reduction in the rate of increase in nonfederal debt more than offset the effects of smaller net repayments of federal debt. In contrast, the monetary aggregates have grown rapidly so far this year, in large part because the sharp decline in short-term market interest rates has reduced the opportunity cost of holding the deposits and other assets included in the aggregates.

Debt and Depository Intermediation

The debt of the domestic nonfinancial sectors is estimated to have expanded at a 4¾ percent annual rate over the first half of 2001, a touch below the 5¼ percent growth recorded in 2000. Changes in the growth of nonfederal and federal debt this year have mostly offset each other. The growth of nonfederal debt moderated from 8½ percent in 2000 to a still-robust 7¼ percent pace in the first half of this year. Households' borrowing slowed some but was still substantial, buoyed by continued sizable home and durable goods purchases. Similarly, business borrowing mod-

Growth of domestic nonfinancial debt

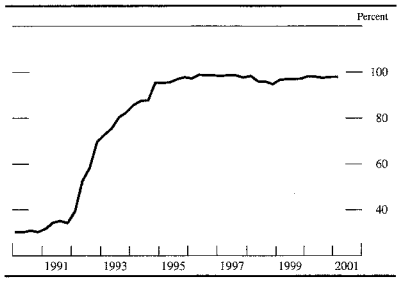


NOTE. Annual growth rates are computed from fourth-quarter averages. Growth in the first half of 2001 is the June average relative to the fourth-quarter average at an annual rate and is based on partially estimated data. Domestic nonfinancial debt consists of the outstanding credit market debt of governments, households and nonprofit organizations, nonfinancial businesses, and farms.

erated even as bond issuance surged, as a good portion of the funds raised was used to pay down commercial paper and bank loans. Tending to boost debt growth was a slowing in the decline in federal debt to a 6¼ percent rate in the first half of this year from 6¾ percent last year, largely because of a decline in tax receipts on corporate profits.

The share of credit to nonfinancial sectors held at banks and other depository institutions edged down in the first half of the year. Bank credit, which accounts for about three-fourths of depository credit, increased at a 3½ percent annual rate in the first half of the this year, well off the 9½ percent growth registered in 2000. Banks' loans to businesses and households decelerated even more, in part because borrowers preferred to lock in the lower rates available from longer-term sources of funds such as bond and mortgage markets and perhaps also in part because banks firmed up their lending stance in reaction to concerns about loan performance. Loan delinquency and charge-off rates have trended up in recent quarters, and higher loan-loss provisions have weighed on profits. Nevertheless, through the first

Percent of all U.S. commercial bank assets at well-capitalized banks



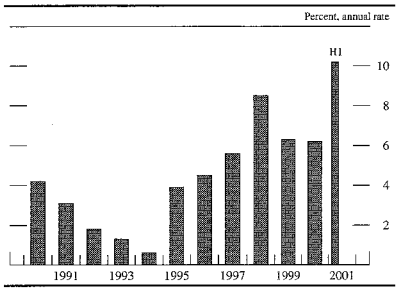
Note. The data are quarterly and extend through 2001:Q1. Capital status is determined using the regulatory standards for the leverage, tier 1, and total capital ratios.

quarter, bank profits remained in the high range recorded for the past several years, and virtually all banks—98 percent by assets—were well capitalized. With banks' financial condition still quite sound, they remain well positioned to meet future increases in the demand for credit.

The Monetary Aggregates

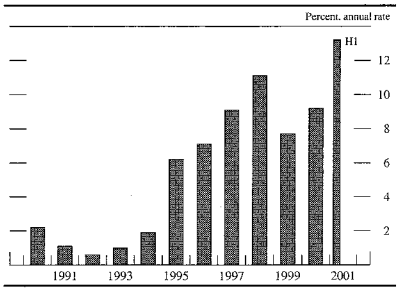
The monetary aggregates have expanded rapidly so far this year, although growth rates have moderated somewhat recently. M2 rose 10¼ percent at an annual rate in the first half of this year after having grown 6¼ percent in 2000. The interest rates on many of the components of M2 do not adjust quickly or fully to

M2 growth rate



NOTE. M2 consists of currency, travelers checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds. See footnote under the domestic nonfinancial debt chart for details on the computation of growth rates.

M3 growth rate



NOTE. M3 consists of M2 plus large-denomination time deposits, balances in institutional money market funds, RP liabilities (overnight and term), and eurodollars (overnight and term). See footnote under the domestic nonfinancial debt chart for details on the computation of growth rates.

changes in market interest rates. As a consequence, the steep declines in short-term market rates this year have left investments in M2 assets relatively more attractive, contributing importantly to the acceleration in the aggregate. M2 has also probably been buoyed by the volatility in the stock market this year, and perhaps by lower expected returns on equity investments, leading investors to seek the safety and liquidity of M2 assets.

M3, the broadest monetary aggregate, rose at a 13¼ percent annual rate through June, following 9¼ percent growth in 2000. All of the increase in M3, apart from that accounted for by M2, resulted from a ballooning of institutional money market funds, which expanded by nearly a third. Yields on these funds lag market yields somewhat, and so the returns to the funds, like those on many M2 assets, became relatively attractive as interest rates on short-term market instruments declined.

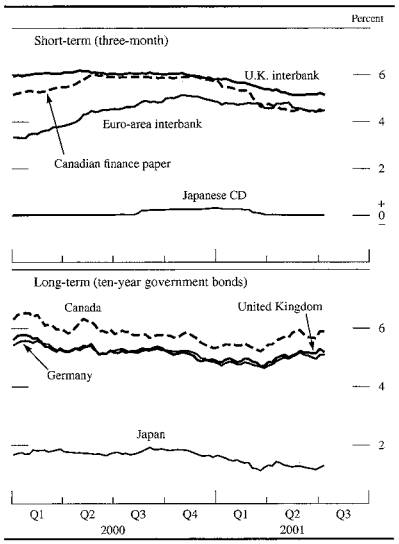
International Developments

So far this year, average foreign growth has weakened further and is well below its pace of a year ago. Activity abroad was restrained by the continued high level of oil prices, the global slump of the high-technology sector, and spillover effects from the U.S. economic slowdown, but in some countries domestic demand softened as well in reaction to local factors. High oil prices kept headline inflation rates somewhat elevated, but even though core rates of inflation have edged up in countries where economic slack has diminished, inflationary pressures appear to be well under control.

Monetary authorities in most cases reacted to signs of slowdown by lowering official rates, but by less than in the United States. Partly in response to these actions, yield curves have steepened noticeably so far in 2001. Although long-term interest rates moved down during the first quarter, they more than reversed those declines in most cases as markets reacted to a combination of the anticipation of stronger real growth and the risk of increased inflationary pressure. Foreign equity markets—especially for high-tech stocks—were buffeted early this year by many of the same factors that affected U.S. share prices: negative earnings reports, weaker economic activity, buildups of inventories of high-tech goods, and uncertainties regarding the timing and extent of policy responses. In recent months, the major foreign equity indexes moved up along with U.S. stock prices, but they have edged off lately and in most cases are down, on balance, for the year so far.

Slower U.S. growth, monetary easing by the Federal Reserve, fluctuations in U.S. stock prices, and the large U.S. external deficit have not undermined dollar strength. After the December 2000 FOMC meeting, the dollar lost ground against the major currencies; but shortly after the FOMC's surprise rate cut on

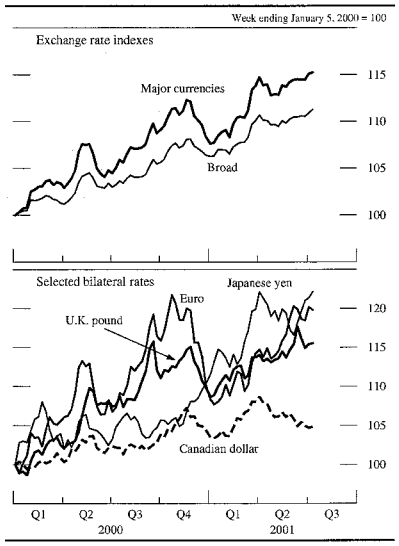
Foreign interest rates



NOTE. The data are weekly and extend through July 11, 2001.

January 3, the dollar reversed all of that decline as market participants evidently reassessed the prospects for recovery in the United States versus that in our major trading partners. The dollar as measured by a trade-weighted index against the currencies of major industrial countries gained in value steadily in the first three months of 2001, reaching a fifteen-year high in late March. Continued flows of foreign funds into U.S. assets appeared to be contributing importantly to the dollar's increase. Market reaction to indications that the U.S. economy might be headed toward a more prolonged slowdown undercut the dollar's strength somewhat in early April, and the dollar eased further after the unexpected April 18 rate cut by the FOMC. However, the dollar has more than made up that loss in recent months as signs of weakness abroad have emerged more clearly. On balance, the dollar is up about 7 percent against the major currencies so far this year; against a broader index that includes currencies of other important trading partners, the dollar has appreciated 5 percent.

Nominal U.S. dollar exchange rates



NOTE. The data are weekly and extend through July 11, 2001. Indexes (top panel) are trade-weighted averages of the exchange value of the dollar against major currencies and against the currencies of a broad group of important U.S. trading partners. Bilateral rates (bottom panel) are in foreign currency units per dollar.

The dollar has gained about 9 percent against the yen, on balance, as the Japanese economy has remained troubled by structural problems, stagnant growth, and continuing deflation. Industrial production has been falling, and real GDP declined slightly in the first quarter, with both private consumption and investment contracting. Japanese exports also have sagged because of slower demand from many key trading partners. Early in the year, under increasing pressure to respond to signs that their economy was weakening further, the Bank of Japan (BOJ) slightly reduced the uncollateralized overnight call rate, its key policy interest rate. By March, the low level of equity prices, which had been declining since early 2000, was provoking renewed concerns about the solvency of Japanese banks. In mid-March, the BOJ announced that it was shifting from aiming at a particular overnight rate to targeting balances that private financial institutions hold at the Bank, effectively returning the overnight rate to zero; the BOJ also announced that it would continue this easy monetary stance until inflation moves up to zero or above. After the yen had moved near the end of March to its weakest level relative to the dollar in more than four years, Japanese financial markets were buoyed by the surprise election in May of Junichiro Koizumi to party leadership and thereby to prime minister. The yen firmed slightly for several weeks thereafter, but continued weak economic fundamentals and increased market focus on the daunting challenges facing the new government helped push the yen back down and beyond its previous low level.

At the start of 2001, economic activity in the euro area had slowed noticeably from the more rapid rates seen early last year but still was fairly robust. Average GDP growth of near 2 percent was only slightly below estimated rates of potential growth, although some key countries (notably Germany) were showing signs of faltering further. Although high prices for oil and food had raised headline inflation, the rate of change of core prices was below the 2 percent ceiling for overall inflation set by the European Central Bank (ECB). The euro also was showing some signs of strength, having moved well off the low it had reached in October. However, negative spillovers from the global slowdown started to become more evident in weaker export performance in the first quarter, and leading indicators such as business confidence slumped. Nevertheless, the ECB held policy steady through April, as further weakening of the euro against the dollar (following a trend seen since the FOMC's rate cut in early January), growth of M3 in excess of the ECB's reference rate, and signs of an

edging up of euro-area core inflation were seen as militating against an easing of policy.

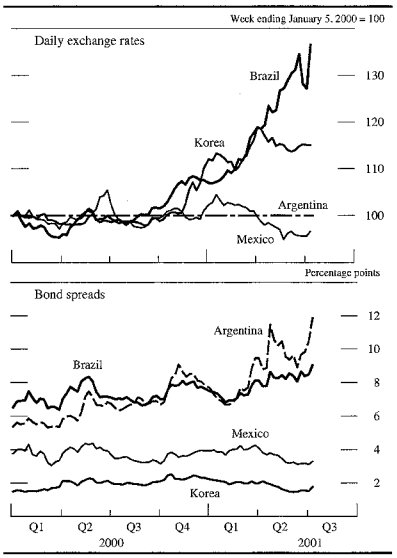
In early May, the ECB surprised markets with a 25 basis point reduction of its minimum bid rate and parallel reductions of its marginal lending and deposit rates. In explaining the step, the ECB noted that monetary developments no longer posed a threat to price stability and projected that moderation of GDP growth would damp upward price pressure. The euro has continued to fall since then and, on balance, has declined 9 percent against the dollar since the beginning of the year. Faced with a similar slowdown in the U.K. economy that was exacerbated by the outbreak of foot-and-mouth disease, the Bank of England also cut its official call rate three times (by a total of 75 basis points) during the first half of the year. The Labor Party's victory in parliamentary elections in early June seemed to raise market expectations of an early U.K. euro referendum and put additional downward pressure on sterling, but that was partly offset by signs of stronger inflationary pressure. On balance, the pound has lost about 6 percent against the dollar this year, while it has strengthened against the euro.

The exchange value of the Canadian dollar has swung over a wide range in 2001. In the first quarter, the Canadian dollar fell about 5 percent against the U.S. dollar as the Canadian economy showed signs of continuing a deceleration of growth that had started in late 2000. Exports—especially autos, auto equipment, and electronic equipment—suffered from weaker U.S. demand. Softer global prices for non-oil commodities also appeared to put downward pressure on the Canadian currency. With inflation well within its target range, the Bank of Canada cut its policy rate several times by a total of 125 basis points. So far this year, industries outside of manufacturing and primary resources appear to have been much less affected by external shocks, and domestic demand has maintained a fairly healthy pace. Since the end of March, the Canadian dollar has regained much of the ground it had lost earlier and is down about 2 percent on balance since the beginning of the year.

Global financial markets were rattled in February by serious problems in the Turkish banking sector. Turkish interest rates soared and, after market pressures led authorities to allow the Turkish lira to float, it experienced a sharp depreciation of more than 30 percent. An IMF program announced in mid-May that will bring $8 billion in support this year and require a number of banking and other reforms helped steady the situation temporarily, but market sentiment started to deteriorate again in early July.

In Argentina, the weak economy and the government's large and growing debt burden stoked market fears that the government would default on its debt and alter its one-for-one peg of the peso to the dollar. In April, spreads on Argentina's internationally traded bonds moved up sharply, and interest rates spiked. In June, the government completed a nearly $30 billion debt exchange with its major domestic and international creditors aimed at alleviating the government's cash flow squeeze, improving its debt amortization profile, and giving it time to enact fiscal reforms and revive the economy. Argentine financial conditions improved somewhat following agreement on the debt swap. However, this improvement proved temporary, and an apparent intensification of market concerns about the possibility of a debt default triggered a sharp fall in Argentine financial asset prices at mid-July. This financial turbulence in Argentina negatively affected financial markets in several other emerging market economies. The turmoil in Argentina took a particular toll on Brazil, where an energy crisis added to other problems that have kept growth

Emerging markets



NOTE. The data are weekly and extend through July 11, 2001. Exchange rates (top panel) are in foreign currency units per dollar. Bond spreads (bottom panel) are the J.P. Morgan Emerging Market Bond Index "plus" (sovereign yield) spreads over U.S. Treasuries.

very slow since late last year. Intervention purchases of the *real* by the Brazilian central bank and a 300 basis point increase in its main policy interest rate helped take some pressure off the currency, but the *real* has declined about 24 percent so far this year.

The weak performance of the Mexican economy at the end of last year caused largely by a fall in exports to the United States (notably including a sharp drop in exports of automotive products) and tight monetary policy carried over into early 2001. With inflation declining, the Bank of Mexico loosened monetary policy in May for the first time in three years. Problems with Mexican growth did not spill over to financial markets, however. The peso has remained strong and is up about 3 percent so far this year, and stock prices have risen.

Average growth in emerging Asia slowed significantly in the first half; GDP grew more slowly or even declined in economies that were more exposed to the effects of the global drop in demand for high-tech products. Average growth of industrial production in Malaysia, Singapore, and Hong Kong, for example, fell from a 15 percent annual rate in late 2000 to close to zero in mid-2001. The turnaround of the high-tech component of industrial production in those countries was even more abrupt—from more than a 30 percent rate of increase to a slight decline by midyear. In the Philippines and Indonesia, economic difficulties were compounded by serious political tensions. Currencies in many of these countries moved down versus the dollar, and stock prices declined. In Korea, the sharp slump in activity that began late last year continued into 2001, as weakness in the external sector spread to domestic consumption and investment. The Bank of Korea lowered its target interest rate a total of 50 basis points over the first half of the year in response to the weakening in activity. The Chinese economy, which is less dependent on technology exports than many other countries in the region, continued to expand at a brisk pace in the first half of this year, as somewhat softer export demand was offset by increased government spending.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

September 5, 2001

The Honorable Ken Bentsen
House of Representatives
Washington, D.C. 20515

Dear Congressman:

At the July 18 hearing on the Federal Reserve's semiannual monetary policy report, you asked me to respond for the hearing record to questions you raised with respect to international economic conditions.

I am pleased to enclose my response, which I am also transmitting to the Committee for inclusion in the record.

Sincerely,

Enclosure

Chairman Greenspan subsequently responded as follows:

With regard to world economic conditions, the world economy is experiencing a slowdown in real growth that has become widespread. To some degree this reflects the global nature of some industries, including in particular high-tech industries, and the common experience of countries in which those industries are important when such an industry experiences a business downturn. In addition, elevated global energy prices have had a negative impact on most countries as business costs have risen and as consumers have realized that they have less income to spend on non-energy items. There have been spillovers from the slowing we have experienced in growth of the U.S. economy onto demand and production in our trading partners. In turn, U.S. exports have been weakened by less vigorous growth abroad.

In the complex interdependencies of today's global economy, all economies are to some extent subject to spillovers from the rest of the world. This "contagion" is transmitted through demand and supply of traded goods and services and through financial market channels as asset prices adjust each day to fluctuations in demand and shifts in confidence that are not confined to one market or one country. Overall, the U.S. economy benefits greatly from this interaction with the rest of the world. Competition is enhanced; resources are allocated more efficiently; and U.S. firms are able to exploit more fully their productivity and technical advantages. We have observed in previous episodes that economic difficulties elsewhere have tended to increase the attractiveness to investors of U.S. assets and investment opportunities. No doubt, there are some risks that arise from our open participation in the global economy. But the fundamental strengths of the U.S. economy have been able to limit any negative impacts from events abroad.

Chairman Greenspan submitted the following in response to written questions received from Congresswoman Julia Carson in connection with the Committee on Financial Services hearing of July 18, 2001:

Q.1. Despite your efforts to reverse the effect of the interest rate hikes in 1999 and 2000, we are still seeing reports that the economy is faltering. GDP growth remains languid, unemployment is ticking upward, stock prices continue to cool and there are still fears that we may experience a full-fledged recession. While it is obvious that the Fed deals with many important goals of monetary policy, inflation is often the only goal that the Fed can control in the longer run. Other policy goals have allowed inflation to rise to unacceptable levels in the past, and high inflation imposes economic costs that lower efficiency. Many argue that the Fed should switch to focusing on a single goal, namely, an inflation target.

During the 1990s, five nations, including the United Kingdom, announced that the focus of their monetary policy would be shifted to controlling inflation. In Britain, the results have been good. Before the 1992 switch, inflation ranged anywhere from 12% to 4%. Since this change inflation has remained at or around the 2.5%-the inflation target set. This concept has always received a lot of attention for adoption in the U.S. Does the Chairman believe this is a good idea, and has the Fed ever analyzed what the impact of such an approach might have on the U.S. economy?

A.1. The Federal Reserve considers its primary monetary policy goal in the long run to be price stability, not only because that is the only objective it can attain over a long horizon but also because in the long run that is how we help promote the most efficient patterns of economic activity and most rapid sustainable economic growth.

In the short and intermediate run, monetary policy affects economic activity and employment as well as average prices. Accordingly, the Federal Reserve needs to take account of all the effects of its actions on economic performance in its monetary policy decisionmaking. The Federal Reserve has not taken a position on occasional legislative proposals in recent years to make inflation the main goal of monetary policy. Numerical inflation targets in other countries have only a short history and have not been tested in a variety of conditions.

Q.2. One of the chief vulnerabilities in the economy right now is the high level of household debt. According to your study entitled *Flow of Funds*, household debt rose five times faster than personal income in the first quarter of 2001. The costs of servicing this debt are cutting into consumer spending. Do you favor some forms of debt relief for highly indebted consumers-such as interest rate ceilings on credit card loans or aggressive measures to curb predatory lending practices?

A.2. While household debt service burdens are currently high, so is household net worth. Even with recent stock market declines, the ratio of aggregate net worth to income remains high, suggesting that much of the current borrowing is supported by the increased wealth of households. Even so, we remain concerned about the levels of household debt payments and continue to monitor it closely. However, we would not support interventions into the markets such as interest rate ceilings, which often harm the households they seek to help. Lenders might well ration credit or cease to make it available if ceilings make it unprofitable for lenders to extend credit, potentially placing many households in difficult situations because the credit they desire would not readily available. The focus should be on assuring that households are well-informed about the use of credit, not restricting credit availability. With respect to predatory lending, the Board has been concerned about predatory lending practices, and we are currently considering changes to the Home Owner Equity Protection Act (HOEPA) that are intended to further address concerns about predatory lending by expanding the coverage of the regulation and adding more consumer protections.

Q.3. In promoting recently enacted tax cuts, proponents argued that ample budget surpluses would prevent these cuts from having an adverse effect on the government's budget position. However, recent reports suggest that these projected surpluses are disappearing, due to a slowdown in the economy and under the impact of the tax cuts themselves. Do you believe the tax cuts were too large? Do you believe the cuts were the best way to counteract an economic slowdown, as some proponents of the cuts suggested? If Congress revisits the tax package, would you favor a more stimulative approach that gives the majority of the tax relief to middle and low income households, rather than a majority to the top 1%?

A.3. With regard to the size of the recent tax cut, I have previously testified that as a percent of GDP it was of average size. My testimony also noted that long-term budget projections are subject to substantial economic and technical risks, and I recommended that any long-term tax or spending initiatives should be phased in. I have also noted that tax initiatives historically have proved difficult to implement in the time frame in which economic slowdowns have developed and ended. In general, this tends to limit their usefulness as a discretionary policy instrument for counteracting economic slowdowns. Finally, I have often noted that decisions about the composition of government spending are the domain of the Congress, and it would be inappropriate for me to comment on such decisions. Similarly, it would be inappropriate for me to comment on the income distribution implications of possible future tax changes.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

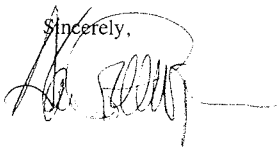
September 7, 2001

The Honorable Barbara Lee
House of Representatives
Washington, D.C. 20515-0509

Dear Congresswoman:

Thank you for your letter of July 23 related to conventional home loans made to African-Americans and Hispanics in California and nationwide by the largest financial institutions. Enclosed are a staff memorandum and supporting documents that respond to your questions, as clarified in a conference call with your Legislative Director, Danielle LeClair, and Robert Gnaizda of The Greenlining Institute on August 3. Attachment I responds to questions 1, 2, 3, 4, and 6 in your letter. Attachment II contains responses to questions 5 and 7.

Sincerely,



Federal Reserve Staff Memorandum

On August 3, 2001, Board staff discussed the letter dated July 23, 2001, from Congresswoman Lee to Chairman Greenspan with the Congresswoman's Legislative Director, Danielle LeClair, and with Robert Gnaizda of The Greenlining Institute. That conversation clarified the information requested; this memorandum memorializes the understanding reached in that conversation.

The letter from Congresswoman Lee contains seven questions. Attachment I includes the responses to questions 1, 2, 3, 4, and 6. As per our conversation, we have provided information for all insured depository institutions with total assets of $10 billion or more that are subject to the reporting requirements of the Home Mortgage Disclosure Act (HMDA) and that are subject to the Community Reinvestment Act (CRA). Seventy-seven institutions met these criteria in 2000. As agreed, our response uses HMDA data reported by the institutions themselves in 2001 for calendar year 2000. Attachment I presents the overall CRA rating and the lending test rating for these institutions. As agreed, we have provided the most recent ratings available. The ratings for institutions that are not supervised by the Federal Reserve were obtained from the other federal supervisory agencies.

Congresswoman Lee requested information about conventional home purchase loans made to African-Americans and Hispanics by insured financial institutions. Our response is based on institutions' self-reported HMDA data. With regard to an applicant's race, we have provided the information only for originations for which race was reported, in keeping with the August 3 conversation. To determine the applicant's race, we included loans for which either the applicant or co-applicant reported a race code of 3 (Black) or 4 (Hispanic). There were loans where the applicant reported a race code of 3 and the co-applicant reported a race code of 4 or vice versa. In such cases, the origination was counted once in the African-American totals and once in the Hispanic totals.

As noted in our conversation, under current CRA regulations an institution may elect to have its affiliates' lending count in the evaluation of the institution's own CRA performance. At the request of Congresswoman Lee's staff, however, the data provided in this response do not include lending by affiliates. Consequently, for those institutions with affiliates that make conventional home purchase loans, the data presented here are not a complete representation of the overall organization's lending.

Question 6 requests data related to applications approved by the Federal Reserve. As we discussed on August 3, many types of applications are not submitted to the Federal Reserve, but rather to the institution's primary federal regulator (OCC, OTS, or FDIC). As a result, in that conversation it was decided that we would indicate, only for the state member banks that met the criteria described in the second paragraph of this memorandum,

those that had applications subject to review for CRA (such as those to establish a branch or to merge with another institution) approved by the Federal Reserve in 2000 or 2001. The information provided relates only to applications filed by the state member banks listed, and does not relate to applications by or involving bank holding companies. There were no instances in 2000 or thus far in 2001 in which one of the state member banks listed in Attachment I filed an application with the Board that was not approved. Consequently, a "No" in either of the last two columns of Attachment I means that the institution did not file a CRA-related application in that year.

Attachment II includes responses to questions 5 and 7.

Attachment I
Requested Information for Questions 1, 2, 3, 4, and 6

					Conventional Home Purchase Loans Made to African Americans in Calendar Year 2000						*Conventional Home Purchase Loans Made to Hispanics in Calendar Year 2000*						*Application Information*	
Agency	Financial Institution	Total Assets(1) As Of 12/31/99 (millions)	CRA Rating	Lending Test Rating	Loans Made to African Am. in CA	Total Loans Made in CA	% of CA Loans Made to African Am.	Loans Made to African Am. Nationwide	Total Loans Made Nationwide	% of Loans Nationwide to African Am	Loans Made to Hispanics in CA	Total Loans Made in CA	% of CA Loans to Hispanics	Loans Made to Hispanics Nationwide	Total Loans Made Nationwide	% of Loans Nationwide to Hispanics	Application Received & Approved by FRB CY 2000	Application Received & Approved by FRB YTD 2001
OCC	Bank of Amer NA	$571,732	O	O	862	34567	2.5%	8878	147046	6.0%	6388	34567	18.5%	19092	147046	13.0%		
FRB	Chase Manhattan Bk	$332,198	O	O	0	2	0.0%	896	10508	8.5%	0	2	0.0%	879	10508	8.4%	Yes	Yes
OCC	Citibank NA	$327,899	S	HS	0	0	NA	305	3915	7.8%	0	0	NA	947	3915	24.2%		
OCC	First Union NB	$229,272	O	Not Rated (2)	0	38	0.0%	520	9640	5.4%	3	38	7.9%	702	9640	7.3%		
OTS	Washington Mutual Bank FA	$146,396	O	O	822	44058	1.9%	2439	87999	2.8%	5821	44058	13.2%	10603	87999	12.0%		
OCC	Wells Fargo Bank NA	$96,316	O	O	8	564	1.4%	10	991	1.0%	63	564	11.2%	82	991	8.3%		
OCC	Bank One NA	$93,893	S	HS	0	0	NA	2	3	66.7%	0	0	NA	0	3	0.0%		
FRB	HSBC Bk USA	$79,619	O	HS	0	0	NA	4	50	8.0%	0	0	NA	5	50	10.0%	Yes	Yes
OCC	Fleet NA Bk	$78,334	S	HS	86	2962	2.9%	1287	25814	5.0%	472	2962	15.9%	2609	25814	10.1%		
OCC	U S Bk NA	$75,384	O	O	8	306	2.6%	148	2648	5.6%	28	306	9.2%	263	2648	9.9%		
OCC	Keybank NA	$75,032	O	O	0	15	0.0%	445	3059	14.5%	1	15	6.7%	183	3059	6.0%		
FRB	Bank of NY	$71,794	S	LS	0	0	NA	1	77	1.3%	0	0	NA	1	77	1.3%	Yes	No
OCC	PNC Bk NA	$68,187	O	O	0	1	0.0%	35	1590	2.2%	0	1	0.0%	37	1590	2.3%		
OCC	Wachovia Bk NA	$63,557	O	Not Rated (2)	0	0	NA	680	8724	7.8%	0	0	NA	186	8724	2.1%		
OTS	California Federal Bank	$57,192	O	O	23	458	5.0%	23	498	4.6%	93	458	20.3%	96	498	19.3%		
FRB	Bankers TC	$51,156	O	Not Rated (3)	0	8	0.0%	0	23	0.0%	0	8	0.0%	0	23	0.0%	No	Yes
FRB	Southtrust Bank	$43,203	S	LS	1	3	33.3%	216	2966	7.3%	0	3	0.0%	118	2966	4.0%	Yes	Yes
FRB	Amsouth Bk	$43,189	S	HS	0	1	0.0%	811	10728	7.6%	0	1	0.0%	327	10728	3.0%	Yes	Yes
FDIC	Regions Bk	$42,237	S	HS	0	0	NA	353	5970	5.9%	0	0	NA	191	5970	3.2%		
OCC	Firststar Bk NA	$40,164	S	HS	6	239	2.5%	970	21215	4.6%	33	239	13.8%	545	21215	2.6%		
OCC	Mellon Bk NA	$39,619	O	O	1	44	2.3%	73	679	10.8%	0	44	0.0%	64	679	9.4%		
OTS	World Savings Bank FSB	$37,846	O	O	1254	35816	3.5%	3014	73391	4.1%	6173	35816	17.2%	10877	73391	14.8%		
OCC	Wells Fargo Bank MN NA	$36,529	O	Not Rated (2)	0	6	0.0%	92	2222	4.1%	0	6	0.0%	59	2222	2.7%		
OCC	Chase Manhattan Bk USA NA	$35,397	O	HS	137	5434	2.5%	2283	36439	6.3%	499	5434	9.2%	2006	36439	5.5%		
FDIC	Washington Mutual Bank	$35,036	O	O	0	1	0.0%	171	16582	1.0%	1	1	100.0%	606	16582	3.7%		
OCC	National City Bk	$34,003	O	O	5	351	1.4%	254	7727	3.3%	18	351	5.1%	163	7727	2.1%		
OCC	Bank One NA	$33,856	O	Not Rated (2)	117	1537	7.6%	1929	31709	6.1%	327	1537	21.3%	2231	31709	7.0%		
OCC	Union Bk of CA NA	$33,354	S	HS	23	1322	1.7%	23	1340	1.7%	148	1322	11.2%	149	1340	11.1%		
OCC	Union Planters Bk NA	$32,684	S	Not Rated (2)	77	1536	5.0%	2378	24282	9.8%	507	1536	33.0%	2131	24282	8.8%		

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					Conventional Home Purchase Loans Made to African Americans in Calendar Year 2000						Conventional Home Purchase Loans Made to Hispanics in Calendar Year 2000						Application Information	
Agency	Financial Institution	Total Assets(1) As Of 12/31/99 (millions)	CRA Rating	Lending Test Rating	Loans Made to African Am. in CA	Total Loans Made in CA	% of CA Loans Made to African Am.	Loans Made to African Am. Nationwide	Total Loans Made Nationwide	% of Loans Nationwide to African Am	Loans Made to Hispanics in CA	Total Loans Made in CA	% of CA Loans to Hispanics	Loans Made to Hispanics Nationwide	Total Loans Made Nationwide	% of Loans Nationwide to Hispanics	Application Received & Approved by FRB CY 2000	Application Received & Approved by FRB YTD 2001
OTS	Charter One Bank FSB	$31,953	S	HS	1	8	12.5%	650	17031	3.8%	0	8	0.0%	378	17031	2.2%		
FRB	Comerica Bk	$31,242	O	O	0	10	0.0%	116	2406	4.8%	2	10	20.0%	116	2406	4.8%	Yes	Yes
FRB	Summit Bk	$31,208	O	O	0	0	NA	125	2507	5.0%	0	0	NA	253	2507	10.1%	Yes	No
OCC	Bank One TX NA	$30,664	S	Not Rated (2)	0	0	NA	8	186	4.3%	0	0	NA	67	186	36.0%		
OCC	LaSalle Bk NA	$30,302	S	Not Rated (3)	0	11	0.0%	417	9034	4.6%	0	11	0.0%	763	9034	8.4%		
FDIC	Branch Bkg & TC	$29,631	S	HS	0	0	NA	790	9633	8.2%	0	0	NA	145	9633	1.5%		
OCC	Huntington NB	$28,760	S	LS	0	1	0.0%	44	1848	2.4%	0	1	0.0%	84	1848	4.5%		
FRB	Chase Bank of Texas	$25,435	O	Not Rated (2)	0	2	0.0%	4	86	4.7%	0	2	0.0%	11	86	12.8%	No	No
OTS	Sovereign Bank	$25,370	S	HS	0	0	NA	626	10827	5.8%	0	0	NA	631	10827	5.8%		
OTS	Citibank, FSB	$24,028	O	O	51	2969	1.7%	555	14054	3.9%	146	2969	4.9%	927	14054	6.6%		
OTS	The Dime Savings Bank of NY	$23,880	O	O	1	1	100.0%	362	3348	10.8%	0	1	0.0%	265	3348	7.9%		
FRB	Northern TC	$23,500	O	Not Rated (3)	0	8	0.0%	110	1366	8.1%	0	8	0.0%	92	1366	6.7%	No	No
FRB	Suntrust Bk	$23,326	S	LS	0	1	0.0%	816	18792	4.3%	0	1	0.0%	971	18792	5.2%	Yes	Yes
OTS	Astoria FS & LA	$22,651	O	O	0	0	NA	40	1994	2.0%	0	0	NA	111	1994	5.6%		
FDIC	Greenwood TC	$22,581	S	O	0	0	NA	33	259	12.7%	0	0	NA	11	259	4.2%		
FRB	Manufacturers & Traders TC	$21,623	O	HS	0	0	NA	3	123	2.4%	0	0	NA	0	123	0.0%	Yes	Yes
FRB	Bank One MI	$21,122	O	O	0	0	NA	0	1	0.0%	0	0	NA	0	1	0.0%	Yes	No
FRB	Harris T&SB	$20,210	S	HS	0	10	0.0%	122	2935	4.2%	0	10	0.0%	134	2935	4.6%	No	No
OTS	Standard Federal Bank	$19,623	O	O	0	0	NA	1	25	4.0%	0	0	NA	0	25	0.0%		
OCC	National City Bk MI/IL	$18,348	O	O	0	0	NA	10	285	3.5%	0	0	NA	8	285	2.8%		
FRB	Banco Popular DE PR	$18,258	O	O	0	0	NA	0	79	0.0%	0	0	NA	76	79	96.2%	No	No
FRB	Compass Bk	$18,183	S	LS	1	2	50.0%	447	5505	8.1%	0	2	0.0%	691	5505	12.6%	Yes	Yes
OCC	First Scty Bk NA	$17,774	O	Not Rated (2)	1	55	1.8%	56	5348	1.0%	2	55	3.6%	233	5348	4.4%		
FRB	Old Kent Bk	$17,744	S	HS	0	8	0.0%	29	836	3.5%	1	8	12.5%	34	836	4.1%	Yes	Yes
OCC	First Tennessee Bk NA	$17,486	S	Not Rated (2)	0	24	0.0%	44	815	5.4%	1	24	4.2%	18	815	2.2%		
OTS	Bank United	$17,269	O	O	9	976	0.9%	540	15546	3.5%	85	976	8.7%	1367	15546	8.8%		
FRB	Allfirst Bk	$16,377	S	HS	0	0	NA	23	507	4.5%	0	0	NA	17	507	3.4%	Yes	Yes
OCC	Bank One NA	$15,621	O	Not Rated (2)	0	0	NA	0	0	NA	0	0	NA	0	0	NA		
FDIC	Greenpoint Bk	$15,396	O	O	0	0	NA	0	0	NA	0	0	NA	0	0	NA		

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					Conventional Home Purchase Loans Made to African Americans in Calendar Year 2000						*Conventional Home Purchase Loans Made to Hispanics in Calendar Year 2000*						*Application Information*	
Agency	Financial Institution	Total Assets(1) As Of 12/31/99 (millions)	CRA Rating	Lending Test Rating	Loans Made to African Am. in CA	Total Loans Made in CA	% of CA Loans Made to African Am.	Loans Made to African Am. Nationwide	Total Loans Made Nationwide	% of Loans Nationwide to African Am	Loans Made to Hispanics in CA	Total Loans Made in CA	% of CA Loans to Hispanics	Loans Made to Hispanics Nationwide	Total Loans Made Nationwide	% of Loans Nationwide to Hispanics	Application Received & Approved by FRB CY 2000	Application Received & Approved by FRB YTD 2001
OCC	Hibernia NB	$15,313	S	HS	0	0	NA	228	5305	4.3%	0	0	NA	91	5305	1.7%		
FRB	European Amer Bk	$14,639	S	HS	0	0	NA	0	0	NA	0	0	NA	0	0	NA	Yes	No
OCC	National City Bk of PA	$13,558	O	O	0	1	0.0%	57	1579	3.6%	0	1	0.0%	6	1579	0.4%		
OTS	Commerical FB FSB	$13,374	O	O	0	0	NA	1	152	0.7%	0	0	NA	6	152	3.9%		
FDIC	Bank of Hawaii	$13,050	O	O	0	3	0.0%	42	3244	1.3%	0	3	0.0%	70	3244	2.2%		
OTS	Guaranty Bank	$12,984	O	HS	7	717	1.0%	122	5954	2.0%	36	717	5.0%	292	5954	4.9%		
OCC	Bank One LA NA	$12,947	S	LS	0	0	NA	11	103	10.7%	0	0	NA	2	103	1.9%		
OCC	National City Bk IN	$12,341	S	HS	0	1	0.0%	54	1359	4.0%	1	1	100.0%	47	1359	3.5%		
FDIC	Citibank NY ST	$12,050	O	O	0	0	NA	7	160	4.4%	0	0	NA	2	160	1.3%		
FDIC	North Fork Bk	$11,826	O	HS	0	0	NA	26	683	3.8%	0	0	NA	42	683	6.1%		
OCC	American NB&TC Chicago	$11,672	S	HS	0	12	0.0%	2	536	0.4%	0	12	0.0%	5	536	0.9%		
OCC	Wells Fargo Bk West NA	$11,455	O	Not Rated (2)	33	1378	2.4%	162	7406	2.2%	153	1378	11.1%	455	7406	6.1%		
FRB	Colonial Bk	$10,848	S	LS	0	0	NA	101	2972	3.4%	0	0	NA	116	2972	3.9%	Yes	Yes
OCC	Michigan NB	$10,840	S	LS	0	0	NA	10	83	12.0%	0	0	NA	2	83	2.4%		
FRB	M&I Marshall & Ilsley Bk	$10,826	O	O	0	0	NA	15	960	1.6%	0	0	NA	44	960	4.6%	Yes	Yes
FDIC	Peoples Bk	$10,746	O	O	0	0	NA	128	1937	6.6%	0	0	NA	125	1937	6.5%		
OCC	National City Bk	$10,145	S	LS	0	2	0.0%	52	1219	4.3%	0	2	0.0%	9	1219	0.7%		
OCC	Firstmerit Bk NA	$10,112	O	O	0	0	NA	5	115	4.3%	0	0	NA	0	115	0.0%		
OCC	Wells Fargo Bank Texas NA	$10,091	S	Not Rated (2)	0	2	0.0%	16	529	3.0%	0	2	0.0%	191	529	36.1%		

(1) The asset threshold test for HMDA reporting purposes is based upon an institution's total assets as of the preceding December 31st. Consequently, the asset threshold date for HMDA reporters in calendar year 2000 is December 31, 1999.

(2) Entity does not have a lending test rating because it was last examined under the assessment factor approach of the previous regulation.

(3) Entity is not subject to a lending test due to its CRA designation as a Wholesale or Limited Purpose institution (and is, thus, not examined using the lending test) or because it operates under an approved strategic plan.

Attachment II

Question #5

Are you actively considering having CRA exams emphasizing the percentage of conventional home loans made by race and ethnicity? If not, please explain reasons given the huge disparities in homeownership by race and ethnicity?

Response

The Board is not currently considering such an approach. The statute's focus is on encouraging depository institutions to help meet the credit needs of their entire communities, including the needs of low- and moderate-income neighborhoods, consistent with safety and soundness; the CRA statute directs the agencies to assess the records of the institutions they supervise in that regard.

The current CRA regulations reflect this same focus on credit needs and income levels. Further, the regulations consider credit needs to encompass a broader range of types of credit than just conventional home purchase loans. Given the CRA's emphasis on income levels and the variety of loans the agencies consider in evaluating an institution's CRA performance, emphasizing racial or ethnic analysis in the way your question suggests may not be consistent with the statute.

The agencies do, however, review the institutions they supervise for possible racial and ethnic credit discrimination (among other factors) in the fair lending portion of consumer compliance examinations. Any adverse findings relating to credit discrimination arising from a consumer compliance examination would be appropriately factored into the rating assigned to the institution for CRA performance as indicated in the regulation.

Question 7:

On Reg. B, it has been reported that your staff has recommended that Regulation B be modified to permit small business lending data to be gathered by race, ethnicity, and gender. Could you in detail explain the delays in implementing staff recommendations since they were first made and when a final Board vote will be taken and made public?

Response:

Regulation B implements the Equal Credit Opportunity Act (ECOA). In August 1999, the Board published a number of proposed amendments to revise and update the regulation. These amendments were proposed as part of the Board's periodic comprehensive review of its regulations. If adopted in final form, the proposed

amendments would eliminate the existing prohibition on the collection by creditors of certain types of information--such as the credit applicant's race--in nonmortgage loan transactions, including small business loan transactions. (For mortgage loans, data on race and ethnicity are collected under Regulation B for home purchase mortgages and under Regulation C for mortgage loans more generally.) This particular change would allow--but not require--creditors to collect information on race and ethnicity, at their option. The Board's proposal also addresses many other complex issues related to the implementation of ECOA, including creditor liability and when preapprovals should be considered credit applications.

The proposal to eliminate the prohibition on data collection elicited strong reactions both for and against the proposed change. Almost 600 of the approximately 760 comments received on the overall proposal addressed this issue. Community and consumer organizations, government agencies, small businesses, and some financial institutions generally supported changing the regulation, while most industry commenters and some small businesses, attorneys, and individuals opposed doing so.

Since the publication of the proposal and the close of the comment period, other regulatory responsibilities have necessitated deferral of further action. These responsibilities have included numerous regulatory projects related to the implementation of the Gramm-Leach-Bliley Act (many with statutory deadlines) and the Board's proposals to address predatory or abusive lending and to revise its Home Mortgage Disclosure Act regulation. The Board expects to take final action on the entire proposal as soon as practicable, given other demands. To date, the staff has made no recommendations to the Board for final action, and continues its in-depth analysis of the comments received regarding the data-collection and other proposed changes to the regulation.

Chairman Greenspan submitted the following in response to written questions received from Congressman Doug Ose in connection with the Committee on Financial Services hearing of July 18, 2001:

Q.1. Do you feel that the FERC order is a step in the right direction in the efforts to bring the state back to the industry standard of a 15% surplus power supply you have stated in the past is necessary to hold down prices?

A.1. As a general rule, prices are best set by private parties. Government intervention in the price-setting process must occur only in the most unusual circumstances, and with the greatest forethought as to the possible consequences. As you know, the price relief granted under the FERC order at the moment is not relevant, as electricity prices at the wholesale level have come down dramatically in California, partly reflecting greater conservation among final consumers and favorable weather. Ultimately, an adequate power supply will only be provided if a sufficient incentive to invest in capacity is provided.

Q.2. Which do you believe is the better approach in California: allowing market forces to drive up supply and returning to the private sector control of the energy infrastructure, or having the state government manage every aspect of the state's energy supply?

A.2. In every decision they make, regulators should, in my view, operate under a presumption *against* government intervention. Even with that presumption, however, there doubtless will be cases in which a government intervention may be unavoidable.

Q.3. Do you believe that the recent FERC order providing price mitigation in the California energy crisis will provide the relief needed in the California energy crisis? What impact will the focus on California's energy crisis have on the national economy?

A.3. Ultimately, the needed relief in California will come when an adequate margin of generating capacity is restored. I believe that the focus on California's energy crisis will have the constructive effect of bringing attention to the importance of the nation's energy needs, and of strengthening our mutual recognition that a vigorous marketplace is generally the best way to promote the broad public interest. An important question to be debated is the best role for the government in fostering new supply in the specific cases of electricity generation and transmission.

July 3, 2001

An Interest-Rate Target With No Bull's-Eye

It's disconcerting to hear calls for Japan to lower interest rates when its rate on overnight money already is virtually zero (actually 0.35 percent). Japan suffers from deflation that has depressed its economy and is helping drag down the world economy. Pushing interest rates below zero, however, is not the answer to Japan's problem. Do we expect Japanese banks to pay people to borrow money?

How on earth could the Bank of Japan have gotten interest rates to zero while prolonging and deepening Japan's deflation? The answer is interest-rate targeting, a misguided approach to monetary policy that has failed in Japan and is now failing here.

Political writer Bob Woodward nicknamed Fed Chairman Alan Greenspan "The Maestro," but there are some sour notes wafting out of the central bank's Marble Palace these days. The Fed has continuously lowered its interest rate target for six straight months, by 275 basis points, only to see price-sensitive commodities and the price of gold continue to decline, signaling an ongoing deflation. Rather than giving Japan advice, it would be better to send Greenspan a message that it's time to stop targeting interest rates here at home and begin using the price of gold as a reference point for the dollar.

My critics will say I'm no economist. Of course I'm not an economist. Neither was Adam Smith, who was a professor of moral philosophy at Glasgow University. I've always said if all the economists in the world were laid end to end, it would be a marvelous thing for humanity since they usually arrive at the wrong conclusion sitting in their ivory towers. I have arrived at a conclusion based on years of observing, studying and participating in economic policymaking and participating in actual commercial endeavors.

As I wrote in the Wall Street Journal last week, I believe the economy here and around the world is being seriously harmed by the Fed's inability to manage a floating paper dollar. With the dollar serving as the numeraire for the whole world, a deflating dollar means trouble for the global economy. Commerce slows, people lose their jobs and businesses fail when declining prices make it difficult for firms to earn a profit.

There is clear evidence that by targeting interest rates the Fed is depriving the economy of the full measure of new money (liquidity) that it needs. The price of gold has fallen from $385 in 1996 when the Fed first stumbled into deflationary monetary policy, and at $270 it is actually lower today than it was six months ago when the interest rate reductions began. Commodity prices are near their 15-year lows, and commodity futures prices reveal no market expectation that they will rise soon. The interest rate on one-year loans (3.63 percent), which the free market sets, is lower than the interest rate on overnight money (3.75 percent), which the Fed sets administratively, a classic sign the Fed's monetary policy is too tight.

Here's the rub: The Fed has no way to know how much liquidity the economy needs nor can it know what interest rates should be. The Fed simply guesses how much new money markets demand and then guesses again what interest rate is compatible with that amount of new money creation. That's where the Fed's interest rate target comes from - out of thin air as the result of two heroic guesses.

No wonder the Fed's Open Market Committee is constantly erring. There is no conceivable way 12 human beings can know from one day to the next precisely how much liquidity the economy needs and exactly what interest rates should be. Only the market can process all the information required to discover those answers and reveal them in market prices.

Fortunately, there is a better approach than interest-rate targeting. The Fed should stop guessing at the amount of liquidity the economy needs and let markets make that determination, and the Fed should stop targeting interest rates and let markets set them. The best market signal the Fed can watch to determine how much liquidity to inject or withdraw from the economy is the price of gold. If the Fed were to announce a policy of stabilizing the price of gold within a narrow range, preferably closer to $325 an ounce than to it's current price of $270, it would end the deflation, and the engines of growth would start up again.

If the Fed persists in its ill-fated struggle to stop the deflation by gradually lowering interest rates, we could be in for a long and painful wait for prices to grind down to a new equilibrium. The good news is that at some point prices will stabilize and growth will resume. The bad news is that many people will suffer a lot of unnecessary pain as businesses fail and workers lose their jobs in the process. Included among deflation's casualties could be the very elected officials who have handed their fate over to misguided central-bank bureaucrats by remaining silent as Maestro Greenspan conducts the economy as a slow waltz in three-quarter time.

THE WALL STREET JOURNAL THURSDAY, JUNE 28, 2001

Our Economy Needs a Golden Anchor

By JACK KEMP

How many more dashed hopes and false recoveries must we experience before politicians and monetary authorities accept the fact that our inability to manage fiat currencies is causing the global economic slowdown? They keep waiting for interest-rate reductions to kick in, yet more than six months after the Fed began lowering rates the economy continues to weaken. Waiting for the recently enacted tax cuts to provide "stimulus" will prove futile as well. The economy does not suffer a lack of consumer demand, and more money in people's pockets will not revive the supply side of the economy.

Unprecedented Experiment

Ronald Reagan once said he knew of no great nation in history that went off the gold standard and remained great. Since Aug. 15, 1971, when the U.S. ceased to redeem dollars held by foreign governments for gold, we have put that thesis to the test. For the first time in human history, not a single major currency in the world was linked to a commodity. Economist Milton Friedman called the situation "unprecedented" and said it is "not a long-term viable alternative." "The world," he said, "needs a long-term anchor of some kind."

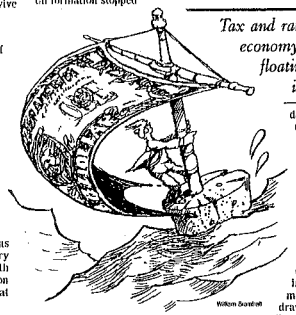
In the short term, at least, he was vindicated. In creating a world monetary system of floating fiat currencies with the stroke of a pen, President Nixon touched off world-wide inflation that lasted through the '70s and early '80s.

Yet America recovered to preside over the demise of world communism, and overcame the rising inflation and unemployment of "stagflation" to enjoy an unparalleled 18-year economic expansion. Today, the U.S. is at the pinnacle of its power and enjoying its greatest prosperity ever.

Were Messrs. Reagan and Friedman wrong? I don't think so. If the U.S. has so far come out on top in this experiment, it is only because other countries' economies have suffered even more from floating currencies.

Once the U.S. government ceased redeeming gold at $35 an ounce, its price quadrupled on world markets to $140 to reflect the dollar's diminished value. By breaking the gold link, the Nixon economic team forced the unwanted liquidity pouring out of the Fed—which had thus far built up in the Eurodollar market and the portfolios of foreign central banks—to remain inside the U.S. economy where it would manifest itself in price inflation. Robert Mundell was the first to predict, in January 1972, there would soon be a dramatic rise in the price of oil, with general inflation to follow.

Where the rest of the economics profession blamed the Arab oil-producing states for quadrupling the oil price in 1973, Mr. Mundell and those supply-siders who followed his intellectual lead knew that gold's quadrupling had led the way. Tax rates rose through "bracket creep," capital formation stopped



William Bradfield

in its tracks, and it soon took two workers to produce the same income that one had brought home before the experiment. The stagflation that had its roots in leaving the gold standard was compounded when Congress and three different presidents tried to fight it with wage and price controls and high marginal tax rates.

But discretionary monetary policy is Janus-faced, and instead of too much liquidity in the world economy we now have too little. Deflation began in 1996 when the Fed tightened monetary policy to combat some inflation it had created attempting to offset the economic drag of the Clinton tax hikes. A rising dollar then caused the dollar pegs of emerging economies to snap, set off the Asian, Brazilian and Russian economic meltdowns, and caused the price of oil and other commodities to collapse. Oil producers took a two-year holiday from drilling, which in turn created an oil shortage and drove energy prices sky high.

Now, the energy-price hikes are working their way through the economy and are misconstrued by the Fed as inflation. Once again, central bank errors in the discretionary management of floating fiat currencies have put the entire world economy at risk.

The Fed has cut interest rates 275 basis points since the start of the year, but the price of gold is still down to about $272 from $385 in 1996, having fallen $5 yesterday alone on the Fed's announcement that it was lowering the fed funds rate another 25 basis points. Commodity prices are near their lowest levels in 15 years, and the foreign-exchange value of the dollar has risen against all major currencies since the Fed began its interest-rate-easing cycle.

Tax and rate cuts won't boost the economy. The problem is a floating dollar. The solution is a gold peg.

Without a gold standard, the Fed has no means of determining how much liquidity markets demand, and all it does by targeting interest rates is guess how much liquidity to inject or withdraw to counteract mistakes it made earlier. The Fed may be on its way to mimicking the mistakes the Bank of Japan made when it lowered interest rates to zero, all the while prolonging and deepening Japan's monetary deflation.

This is no way to manage a currency. It's obvious that we have accumulated a long series of small deflationary errors by the Fed that are dragging down the U.S. economy and helping depress world commerce. It's time to restore a golden anchor to the dollar before our luck runs out and we suffer a real economic calamity.

The Fed may yet get lucky with its rate cuts, although the Bank of Japan never did. The only certain way to end this deflation is to have the Fed stop targeting interest rates and begin targeting gold directly—not by "fixing" the price of gold by administrative fiat as some people mistakenly characterize it, but rather by calibrating the level of liquidity in the economy, over which the Fed has exclusive and precise control, to keep the market price of gold stable within a narrow band closer to $325 than $275.

There is nothing mysterious about how gold could be used as a reference point or how a new monetary standard for a new millennium would work. It would simply mean the Fed would stop guessing how much liquidity is good for the economy and allow the market to make that decision for it. With the dollar defined in terms of gold and with American citizens free to buy and sell gold at will, the Fed would forget about raising or lowering interest rates and simply add liquidity (buy bonds) when the price of gold tries to fall and subtract liquidity (sell bonds) when it tries to rise. Markets would determine interest rates.

The paper dollar would once again be as good as gold—no more, no less. There would be no need for the U.S. government to maintain a large stock of gold or to redeem gold and dollars on demand since people would be free to do so on their own in the marketplace. As long as the Fed calibrated its infusions and withdrawals of liquidity by the market price of gold, the world would be free of monetary inflations and deflations caused by the whims and errors of central bank governors, as was the case for more than 200 years when the private Bank of England managed the pound sterling in exactly that way.

Nothing Simpler

The good news is that this could all be done easily, if President Bush and Treasury Secretary Paul O'Neill could work out an accord with Alan Greenspan. That accomplished, I believe Britain would soon follow to make the pound as good as gold and avoid having to adopt a sinking euro.

There is nothing simpler than a gold standard, as Alexander Hamilton pointed out when he persuaded the first Congress to adopt one. Just as President Nixon took us off with an executive order, President Bush can put us back on with the stroke of a pen. It would be politically popular, as ordinary people benefit most. At Camp David in 1971, as President Nixon signed the papers, he is reported to have said: "I don't know why I'm doing this. William Jennings Bryan ran against gold three times and he lost three times."

Mr. Kemp, co-director of Empower America, was the Republican vice-presidential nominee in 1996.