MONETARY POLICY AND THE STATE OF THE ECONOMY

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MONETARY POLICY AND THE STATE OF THE ECONOMY

Wednesday, July 21, 2004

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

The committee met, pursuant to call, at 10:06 a.m., in Room 2128, Rayburn House Office Building, Hon. Michael G. Oxley [chairman of the committee] Presiding.

Present: Representatives Leach, Baker, Bachus, Castle, Royce, Lucas of Oklahoma, Kelly, Paul, Gillmor, Miller of California, Hart, Capito, Tiberi, Kennedy, Hensarling, Murphy, Brown-Waite, Barrett, Harris, Frank, Waters, Sanders, Maloney, Velazquez, Ackerman, Sherman, Meeks, Lee, Moore, Capuano, Ford, Lucas of Kentucky, Crowley, Clay, Israel, McCarthy, Matheson, Miller of North Carolina, Emanuel, Scott, Davis and Bell.

The CHAIRMAN. The committee will come to order.

This morning we are pleased to welcome back the chairman of the Federal Reserve, the Honorable Alan Greenspan.

Good morning, Mr. Chairman. We welcome you once again to the Financial Services Committee. Thank you for taking the time to discuss monetary policy and the economy and topics of interest to every Member of this committee and certainly to all Americans.

Chairman Greenspan, I first want to congratulate you on your reappointment and reconfirmation. I know I speak for most Americans and Members of this committee when I say we are happy to have your steady hand on the monetary policy tiller. I know you would probably like to spend a little more time on your golf game, and it definitely needs it, but we appreciate your dedication and service to the Fed.

Mr. Chairman, when the uptick in energy prices this spring brought with it a spike in inflation, many imagined that your well-advertised fist tightening of monetary policy would be more aggressive than the quarter-point move that the Open Market Committee made at the end of June.

All spring you said the tightening would be as swift and strong as necessary, and the second half of your statement was that the tightening would be gradual. As usual, you were correct on both counts.

More important, Mr. Chairman, is an issue you raised at your last appearance before this committee, and that is how we prepare our workers for the jobs of the 21st Century. You made the point that the best way to push up wages over time was to make sure that our workers are educated and ready to fill the new higher-skill jobs this vibrant economy creates as lower-skill, lower-wage jobs cycle offshore.

I know that that continues to be a strong interest for you, and rightly so. Creating jobs is a goal we all share. We all like to see lower unemployment than the current 5.6 percent rate and know that lower unemployment also means higher wages. The economy has averaged creating 250,000 jobs a month for this year, and I think the new jobs figure for June of 112,000 was an aberration.

I think that job creation will pick up, and that the average employment level for this year will be at or higher than the average for 2000 of 131.8 million. It is already at 131.4 million, even with that June low.

Mr. Chairman, we look forward to your testimony and to the discussion today.

With that, I yield to the distinguished ranking Member, the gentleman from Massachusetts.

[The prepared statement of Hon. Michael G. Oxley can be found on page 36 in the appendix.]

Mr. FRANK. Thank you, Mr. Chairman.

Mr. Chairman, on April 21st, you gave very powerful testimony to the Joint Economic Committee in which you noted that the good news was great increases in productivity, which were continuing, and you have been proven right against some of the skeptics who thought that the productivity increases in the late 1990s were transitory and that we would slip back to the normal, what had been the lower normal average.

But you also noted, and I was pleased that you did that, that virtually all of the gains from increased productivity had gone to pretax profits of nonfinancial corporate entities. And I would just say as an aside, if they are doing well pretax corporate, pretax profits these days, they are doing even better with after-tax profits. You noted that virtually none of the increase has gone to people who are getting paid wages. And as a result, the ratio in the economy, wages paid, compensation paid and wages to pretax corporate profits was really quite low by normal standards.

In the report today, you note that there has been some increase in employment costs as we measure it. But I also note—and I appreciate your being careful to point this out in the statement of the report—that what we have seen is an increase in employer contributions to health plans and an increase in employer contributions to pensions. But wage payments to workers, nonsupervisory workers, have, in fact, lagged inflation, and that is a serious social and economic problem.

I appreciate the fact that, unlike many others, you have noted that inequality is in and of itself a problem, and I thank you for doing that. There are some who try to ignore it. There are people who probably argue that, as long as the absolute level is fine, then inequality is not a problem. But we know in economics that the absolute level that is acceptable is in fact engined by what is available and what others have and what that does to prices, et cetera.

So this is the dilemma that we have. We have a situation in which we have begun to grow, although there has been some slowing down. We hope it is temporary, and we hope that the next months will be better. But it has not been as fairly distributed as we would like it to be, and even by historical standards, it has lagged.

That seems to me to have two problems. First of all is a political problem. You note in your statement, in the report, that protectionist sentiment is increasing. It will continue to increase. We are not India, but there is a lesson in India, when a government that had done very well in the macroeconomics area through its free-market policies unexpectedly lost an election, in part because they boasted with their slogan of India Shining about their success. And a lot of Indian people said, "Shine this, because, in effect, where is my piece of it?"

There was an article in the New York Times a while ago on the front page about how democracy in Latin America is no longer as universally or widely supported as we would like it to be because people there have seen no connection between democracy—that they have been told—and some improvement in their lives.

In America, you run the risk that there are people who increasingly believe people who work hard for a living, that they have no real skin in the game of economic advance. Now, you and I don't agree with that, but it is a factor that you have to take into account. And, indeed, to the extent that we continue to have great progress in the macro economy but real wages don't go up—and I suppose, workers should be grateful that the boss is now paying more for health care—but the worker is not any better off. The boss is paying more for the same health care and real wages are lagging, and so he and she understandably feel worse off.

There is also an economic problem. At some point, insecurity, instability, lack of liquidity is going to cause some problems for people, and so that is something that I think we need to address.

Last point is this: I want to say that I know you have gotten some pressure to increase interest rates more quickly through the Federal Reserve Open Market Committee. I hope you will continue to resist it. I would just remind people, we had this argument to some extent in the late 1990s. I admired the fact then that you were willing to defy what had sort of been conventional wisdom that, if unemployment got below 5.5 percent, it would be highly inflationary, you would get a lot of pressure from a lot of places, editorial pages and elsewhere, to raise interest rates simply because a lower unemployment rate would be inherently inflationary. It got to 3.9 percent without inflation. You argued, I think correctly, that productivity was making this possible.

You are again under some pressure from people to raise rates more quickly. I would just urge people to think about the implications that unemployment is still 5.6 percent. We had gotten it down to 3.9. But your report says that, at the end of 2005, you expect unemployment to be between 5 and 5.25 percent. As much as 1.3 percent higher, 20 percent higher in terms of where they are, 25 percent than it was, this is not a time to slow down the macro economy.

The people in the business community and elsewhere who focus on the fact that, well, maybe macro growth is too high and we begin to see a little bit of inflation, for them to urge on you measures that would slow things down at a time when unemployment is still much higher than it should be at 5.6 percent, when the percentage of Americans working is low, because part of what we have seen is a lower percentage of adult Americans working, when real wages have lagged, when real wages have been eroded, to argue at this point that you should slow down the macro economy is to exacerbate a situation that I think is already socially and potentially economically dangerous for the U.S.

So I urge you not to accept those kinds of pressures, but also, I hope you will join with us in thinking of ways—you have documented the problem. You have documented the problem of increasing inequality very well. It does not appear to me to be getting significantly better on its own, and I would hope you would join with us in figuring out ways to deal with it.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired.

We now turn to the distinguished chairman of the Federal Reserve, Dr. Alan Greenspan.

Again, we welcome you, Mr. Chairman, and good to have you back.

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

Mr. GREENSPAN. Thank you very much, Mr. Chairman. Thank you very much. I will excerpt from my prepared remarks and request that the full text be included for the record.

The CHAIRMAN. Without objection.

Mr. GREENSPAN. Thank you.

Mr. Chairman and Members of the committee, I am pleased as always to be here today to present the Federal Reserve's monetary report to the Congress. Economic developments in the United States have generally been quite favorable in 2004, lending increasing support to the view that the expansion is self-sustaining. Not only is economic activity quickened, but the expansion has become more broadbased and has produced notable gains in employment.

The evidenced strength in demand that underlies this improved performance doubtless has been a fact contributing to the rise in inflation this year. But inflation also seems to have been boosted by transitory factors such as the surge in energy prices. Those higher prices, by eroding households' disposable income, have accounted for at least some of the observed softness in consumer spending of late, a softness which should prove short-lived.

When I testified before this committee in February, many of the signs of the step-up in economic activity were already evident. Capital spending had increased markedly in the second half of last year, no doubt spurred by significantly improved profits, a low cost of capital and the investment tax incentives enacted in 2002 and enhanced in 2003.

Renewed strength in capital spending carried over into the first half of 2004. Orders in shipments of nondefense capital goods have been on the rise, and the backlogs of unfilled orders for new equipment continue to build.

A key element of the expansion that was still lacking in February, however, was evidence that businesses were willing to ramp up hiring to meet the stepped-up pace of sales and production.

Businesses' ability to boost output without adding appreciably to their workforces likely resulted from a backlog of unexploited capabilities for enhanced productivity with minimal capital investment, which was an apparent outgrowth of the capital goods boom of the 1990s.

Indeed, over much of the previous 3 years, managers had seemed to pursue every avenue to avoid new hiring, despite rising business sales. Their hesitancy to assume risks and expand unemployment was accentuated and extended by the corporate accounting and governance scandals that surfaced in the aftermath of the decline in stock prices and also, of course, by the environment of heightened geopolitical tensions.

Even now, following the pattern of recent quarters, corporate investment in fixed capital and inventories apparently continues to fall short of cash flow. The protracted nature of this shortfall is unprecedented over the past 3 decades. Moreover, the proportion of temporary hires relative to total employment continues to rise, underscoring that business caution remains a feature of the economic landscape.

That said, there have been much clearer indications over recent months that conditions in the labor market are improving. Most notably, gains in private non-formed payroll unemployment have averaged about $200,000 per month over the past 6 months, up sharply from the pace of roughly $60,000 per month registered over the fourth quarter of 2003.

The improvement in labor market conditions will doubtless have important follow-on effects for household spending. Expanding employment should provide a lift to disposable personal income, adding to the support stemming from cuts in personal income taxes over the past year. In addition, the low interest rates of recent years have allowed many households to lower the burdens of their financial obligations.

Although mortgage rates are up from recent lows, they remain quite attractive from a long-term perspective and are providing solid support to home sales. Despite the softness of recent retail sales, the combination of higher current and anticipated future income, strength in balance sheets and still-low interest rates bodes well for consumer spending.

Consumer prices, excluding food and energy, so-called core prices, have been rising more rapidly this year than in 2003. For example, a 12-month change in the core personal consumption expenditures price index stood at.8 percent in December of last year and climbed to 1.6 percent by May of this year.

Core inflation, of course, has been elevated by the higher index of energy prices and business costs and by increases in non-oil import prices that reflect past dollar depreciation and the surge in global prices for primary commodities.

But the acceleration of core prices has been augmented by a marked rise in profit margins, even excluding domestic energy corporations. Businesses are limited in the degree to which they can raise margins by raising prices. An increase in margins should affect, mainly, the level of prices, associated with any given level of unit costs but, by itself, should not prompt a sustained pickup in the rate of inflation going forward.

Indeed, some leveling or downward pressure on profit margins may already be in train, owing to a pickup in unit labor costs. Although advances in productivity are continuing at a rate above the long-term average, they have slowed from the extraordinary pace of last summer and are now running below increases in hourly compensation.

The available information suggests that hourly compensation has been increasing at an annual rate of about 4.5 percent in the first half of this year. To be sure, the increases in average hourly earnings of nonsupervisory workers have been subdued in recent months and barely budged in June. But other compensation has accelerated this year, reflecting continued sizeable increases in health insurance costs, a sharp increase in business contributions to pension funds and an apparently more robust rate of growth of hourly earnings of supervisory workers.

The larger wage gains for supervisory workers together with anecdotal reports of growing skill shortages are consistent with earlier evidence of rising wage premiums for skilled workers, relative to less-skilled workers.

As always, considerable uncertainties remain about the pace of the expansion and the path of inflation. Some of those uncertainties, especially ones associated with potential terrorism, both here and abroad, are difficult to quantify. Such possibilities have threatened the balance of world supply and demand in oil markets in recent months, especially as demand has risen with the pace of world economic growth. Yet aside from energy, markets exhibit little evidence of heightened perceptions of risk. Credit spreads remain low, and market-based indicators of inflation expectations, after rising earlier this year, have receded.

With growth of aggregate demand looking more sustainable and with employment expanding broadly, the considerable monetary accommodation put in place starting in 2001 is becoming increasingly unnecessary. If economic developments are such that monetary policy neutrality can be restored at a measured pace, as the FOMC, expects a relatively smooth adjustment of businesses and households to a more typical level of interest rates seems likely.

Even if economic developments dictate that the stance of policy must be adjusted in a less gradual manner to ensure price stability, our economy appears to have prepared itself for a more dynamic adjustment of interest rates. Of course, considerably more uncertainty and, hence, risk surrounds the behavior of the economy with a more rapid tightening of monetary policy than is the case when tightening is more measured. In either scenario, individual instances of financial strain cannot be ruled out.

In sum, financial markets, along with households and businesses seem to be reasonably well prepared to cope with a transition to a more neutral stance of monetary policy. Some risks necessarily attend this transition, but they are outweighed, in our judgment, by those that would be associated with maintaining the existing degree of monetary policy accommodation in the current environment.

Although many factors may affect inflation in the short run, inflation in the long run, it is important to remind ourselves, is a monetary phenomenon. As we attempt to assess and manage these risks, we need, as always, to be prepared for the unexpected and to respond promptly and flexibly as situations warrant.

But although our actions need to be flexible, our objectives are not. For 25 years, the Federal Reserve has worked to reestablish price stability on a sustained basis. An environment of price stability allows households and businesses to make decisions that best promote the longer-term growth of our economy and, with it, our Nation's continuing prosperity.

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

[The prepared statement of Hon. Alan Greenspan can be found on page 40 in the appendix.]

The CHAIRMAN. Thank you, Chairman Greenspan for appearing before this committee.

We have had this discussion before, and it is one I would like to return to, and that is the resilience of our American economy. Considering the fact that we have gone through some remarkable, markedly difficult times over the past 3 years, with the recession, the tragedy of 9/11, the following need to fight the war on terror with increased defense spending and the like, the business scandals that you referred to in your statement, I have said before, I would doubt there is any country or any economy in the world that could have sustained those kinds of body blows and yet, 3 years later, be in as strong a position as we are economically.

Were we just lucky? Or what is it about our system, monetary fiscal policy, our overall system, meaning the private sector and the Government and the like, what is it about the American economy and the American attitude that would allow us to make that kind of recovery in a relatively short period of time?

Mr. GREENSPAN. Mr. Chairman, you are raising what probably is the most important issue that has been on the policy agenda for the last number of years.

We were quite startled and, I must say, pleased, obviously, that this economy was able to absorb the very significant shocks to which you allude without contracting as, in most everybody's judgment, it almost surely would have, say, had they happened 20 or 30 years ago.

It is quite apparent that the most important element in this very evident increasing resiliency of our system is the associated flexibility in both financial markets and in the economy generally. I tried to address this issue in a number of presentations a few years ago, and it looked to me at the time as though the causes were several.

First and quite important was the bipartisan trend towards deregulation which started in the 1970s and has indeed gotten to the point where the notion of economic reform as a concept in the world is usually related to the questions of increasing deregulation and privatization. In a sense, the process that we have been going through is now increasingly being replicated elsewhere in the world.

In addition, obviously, there has been a significant increase in technological capabilities, especially information technologies, which enable businesses to respond in a far more expeditious way and respond to imbalances in demand and supply, and that has prevented significant problems from emerging before they were addressed.

And the broad areas of increasing globalization, as we have lowered our tariff barriers and broadened our interface with the rest of the world, have also been a major factor here in creating flexibility, because we can interact with our trading partners in the way in which shocks are absorbed by all of us and contained rather readily.

So the general proposition that I think we have learned from this, and, indeed, we have learned because it was not something that one would have put high on the agenda 3 or 4 decades ago, is that flexibility, anything that improves flexibility in the financial system or the economic system, is in and of itself a very important advance to enable the economy to grow and prosper.

The CHAIRMAN. Would you, in terms of fiscal policy—I know that you mentioned in your remarks at least twice the tax cuts and their affect on rejuvenating the economy. Was that, the fiscal aspect and the monetary aspect working together, was that a major factor also in getting us where we are today?

Mr. GREENSPAN. I think the tax cuts were effective in stemming the extent of the weakness of the economy several years ago. And, indeed, I have mentioned it, in fact, in my prepared remarks. There is no question in my mind that, somewhat to my surprise, the timing of the tax cuts came at a point when increasing effective demand to absorb the adjustments coming from the sharp stock market and capital goods decline of 2000 were necessary. So, in that regard, I would say yes.

Clearly, there was significant improvement in tax policy over the years, but I think we may have reached the peak in that regard in the 1986 act, and I cannot argue strenuously that we have made all that much improvement since then. Indeed, I think we have had a certain backup in a number of things that we have done. But, overall, I would say that looking forward, fiscal policy is going to become a very critical issue on the agenda for macroeconomic policy.

The CHAIRMAN. If I might add, I know that you have said that you enjoyed these sessions partly from the feedback that you get from Members all over the country, anecdotal instances and so forth.

For instance, I had a discussion with a trucking industry executive in my hometown a couple years ago, and he was last year's chairman of the American Trucking Association. He was all over the country, and I asked him how the transportation industry in general was doing, particularly the trucking industry. And he said they were doing very, very well, which is usually a pretty good harbinger of things to come, and I asked him specifically about his own company. He said he could hire 20 drivers without any problem. He could expand that much.

His problem, in his case, was finding qualified drivers, and I think it does point out perhaps the conundrum we have of trying to fit job skills and background and education with those jobs. I don't want to get a discussion going now. I just thought I would pass that on in that regard.

I am over my time and recognize Mr. Frank.

Mr. FRANK. Thank you.

Mr. Chairman, I was actually fascinated by your response on the tax question because, I must say, it sounded to me like you were giving a pretty good demand-side justification for the tax cuts, but you were ambivalent at best about the supply-side justification. And I would say, to the extent that you have said we have reached good tax policy in 1986, I am inclined to agree. I just hope we are not about to make that even worse.

So I think there is general agreement in the country that demand-side stimulus works, and we did, as you say, manage to get the timing right. I think there were other ways to provide that demand stimulus, but I am struck by your being more enthusiastic about the demand-side aspect than the other.

But there is another aspect of the tax cuts that you address in the monetary report. Let me read to you page 9: “The deficit in the Federal unified budget has continued to widen. In large part, the rise in the deficit is attributable to further rapid increase in spending on defense and other programs and the loss of revenues resulting from the tax legislation enacted in recent years.”

You go on to say on the next page: “As of the first quarter of 2004, national saving measured net of estimated depreciation was still equal to just about 2 and a half percent of GDP compared with a recent high of 6 and a half percent in 1998. If not reversed over the longer haul, such low levels of national saving could eventually impinge on private capital formation and thus slow the rise of living standards.”

You do say in here that the major reason for this drop, substantial drop, in national saving from 6.5 percent in 1998 to 2.5 percent today is the swing in the Federal budget from surplus to deficit. So, what you are saying is that, the tax cuts had some positive near-term demand-side impact. We also have to deal with the fact they contributed substantially, according to the report—not alone, but substantially—to an increasing deficit which has, in fact, been a major reason for a substantial drop in the savings rate.

You note that, if this is not reversed over the longer haul, it could impinge on private capital formation and slow the rise of living standards. I agree with you. What do we do about it?

Mr. GREENSPAN. Well, first of all, let me just say that, as I have indicated before this committee before, I do think that the partial elimination of the double taxation of dividends was an important long-term structural supply-side change, so I would like to amend your remarks in that context.

The issue in the short run, with respect to the fiscal policy, is unlikely to be a problem, largely because increasing revenues——

Mr. FRANK. That is why I asked about the long run. Let me ask the next question—I only have 5 minutes, Mr. Chairman. You have sketched this out as a long-range problem, that the tax cuts had a short-term stimulative effect with a little bit of supply-side capital gains, and they are having a longer-term potentially negative effect.

What I am asking, is there some way we can deal with these negative effects without doing the long term, so I am interested in the long haul.

Mr. GREENSPAN. Well, I think there is a much broader question, which comes down to fiscal policy at this stage, and it relates to the fact that, in budgets put together 30, 40 years ago, we had very few programs which extended beyond a few years. True, we would have, for example, an aircraft program which would be a 3- or 4-year program. We would have some agricultural programs. But long-term commitments, either on the tax side or on the expenditure side, were rare.

This has turned around 180 degrees, and what we are missing is a process which essentially can address a long-term outlook where the ability to forecast, either revenues or mostly expenditures on key programs, is clearly quite poor.

This means, in my judgment, that you need a mechanism which adjusts programs as you move forward. Therefore, I would say not only do we need PAYGO, which is an important, in my judgment, critical issue in budget programming, as well as discretionary spending caps, but I think we also have to begin to think of how we nudge programs back to where we thought we were pushing them in legislation, either through triggers or sunset legislation or other——

Mr. FRANK. But you ignore the tax side, and that disappoints me, Mr. Chairman——

Mr. GREENSPAN. Well, I——

Mr. FRANK. Let me, just to summarize, you thought from the tax policy, with the exception of the capital gains, we were better off in 1986 than we have been since in terms of the structure of the tax policy. You also said that the tax cuts that we had, while they had a demand-side impact when we were in trouble, but we don't need that now, that they have a long-term—they have been a significant contributor to the deficit, the swing from negative—from positive to negative in the reduction in the savings rate.

What about the question of tax policy going forward? We are about to talk about another major tax cut, beginning with the world trade decision but going much beyond that. Have you nothing to say about tax policy?

Mr. GREENSPAN. Well, I will say this, as I have said it to you before, I think it was a mistake not to extend PAYGO both for tax and expenditure programs and let it expire in September 2002 and that I, myself, as you know, prefer a lower tax burden in general because I think it assists economic growth and increases the revenue base. But, ultimately, that determination is the Congress's.

The question that I think is necessary to focus on is to put a structure out of where the Congress can make those decisions, where I don't think you can at this point.

Mr. FRANK. Well, I will call the gentleman, I thank you.

Mr. Chairman, I appreciate this rare burst of deference to us on the tax issues. You haven't been reticent about making recommendations that are within our constitutional jurisdiction, and you shouldn't be. So, when you somehow decide it would be inappropriate for you to recommend tax levels, I am a little bit puzzled.

Mr. GREENSPAN. I am just essentially saying, I have stated before, and I haven't changed my view, I prefer lower taxes.

Mr. FRANK. Even if it makes the deficit worse——

Mr. GREENSPAN. I am sorry.

Mr. FRANK. But even if it makes the deficit worse and has this long-term negative effect on national savings——

Mr. GREENSPAN. Well, then you get a trade-off. I would prefer lower spending, lower taxes and lower deficits.

Mr. FRANK. Thank you.

I yield to the Chair.

The CHAIRMAN. The gentleman from Iowa, Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

In your statement today and the last month, you have dwelled on a macroeconomics discussion I have never heard discussed by the Fed, and that is that there is greater cash flow in the economy, at least on the business side of the economy, than on investment. You described this as a risk-averse corporate America today.

Could you meat that out a bit, and then you have indicated in prior speeches that one aspect of this is that it looks like the economy coming through this year looks like it is going to be pretty steady growth. But the fact that there is less investment than might be the case probably implies that, coming into next year, we are going to have a sustained economic growth, and that is probably pretty good for whatever administration takes place, whether it be the lower-tax administration of today or perhaps a higher-tax administration of tomorrow, but that the basic underpinning of the economy looks pretty good going into next year.

Is that a valid observation or a valid conjecture on your part?

Mr. GREENSPAN. Well, Congressman, you raise an interesting aspect to the issue with respect to the obvious reluctance on the part of the business community to be aggressively expansionary at this stage of the business cycle, as they have typically been in the past. It has usually been advance hiring, advance capital investment, and notions of restructuring companies, to be prepared for increasing market shares, in other words, all in anticipation of significant improvement.

The fact that, for the first time in 3 decades, we are getting in an expansion period, a very significant shortfall in the level of capital investment plus inventory accumulation relative to cash availability says that we are far from behaving the way we typically did. As you point out, the reasons that I presume are the cause of it are a number of caution-creating factors.

But to the extent that these are capable of being assuaged, what it probably will be doing is, rather than creating a large surge in economic activity, to gradually stretch out economic activity if, indeed, a degree of confidence gradually returns. And that would be one of the reasons why a gradual expansion, which we now seem to be experiencing, does bode well for next year.

Mr. LEACH. Let me raise one final question, and it is an issue of priorities and advice to Congress. For three or four Congresses now this committee has passed a bill on the orderly unwinding of contracts, a netting bill. And it has been tied up with another committee, the Committee on Judiciary, and bankruptcy provisions, which are quite controversial.

Would you advise the Congress to go ahead with the netting provision unrelated to the bankruptcy bill in order to get this underpinning of financial stability out of the way in a legal sense?

Mr. GREENSPAN. I most certainly would, Congressman. We have been concerned for quite a while that the failure to include a number of these newer instruments into netting legality, if I may put it that way, puts us at risk in the event of some untoward event which would create significant financial problems.

I know of no resistance in the Congress to netting per se, and, of course, as you point out, the reason why the bill has not been moved forward is it has been tied to the bankruptcy bill, with its other problems. It strikes me that we are taking undue risk and really unnecessary risk in allowing that tie to exist rather than breaking the bill out from the bankruptcy bill and I would presume passing it very readily in both Houses of the Congress.

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

The CHAIRMAN. I would just say, "hear, hear," to that, Mr. Chairman. That is a great idea.

The gentlewoman from New York, Mrs. Maloney.

Mrs. MALONEY. Welcome here today, Mr. Greenspan.

Your arguments today provide support for the argument that the economy is recovering from the recession of the last few years, but that may not be the picture from the point of view of the American worker.

The latest figures for job growth show only a small increase, much less than would be expected if, as you suggest, the economy is growing significantly. There are 1.2 million fewer jobs now than there were at the official start of the recession in March of 2001. This is the worst job deficit since the Great Depression. The unemployment rate is 5.6 percent nationally. This is a 1.3 percent higher than when the recession officially began. In New York, in my hometown, it is now at 7.4 percent, up almost half of 1 percent from last month.

If we look at jobs as most persons do, as a measure of our economy, things have been getting generally worse over the span of the last 3.5 years. We still have not made up for the jobs lost in this Administration. If you include workers who are working part-time because they cannot find a full-time job and workers who want to work but are not in the labor force, the unemployment rate is roughly 9.6 percent. This is perhaps the worst figure of all, is the number of long-term unemployed, 22 percent of unemployed workers, 1.8 million people, have been jobless over half a year. This is a record setter, the longest period of such high long-term unemployment since this statistic was first collected over 50 years ago.

I would like to hear about who has benefitted from the improved figures that you cite. It is certainly not the workers. Real weekly earnings have fallen by 1.4 percent over the past year. Wages are not keeping up with inflation. We are setting records on low wages, too. The share of aggregate wages and salaries and national income is the lowest it has been in over 50 years, and the data shows that private—profits in businesses have soared while average wages have not. Aggregate wages and benefits of workers have grown only 8 percent while business profits have increased 62 percent and after-tax profits 83 percent.

This might be very good news for shareholders, but for workers, it is pretty depressing.

My question is, why has recent economic growth not translated into robust job growth and wages keeping pace with profits?

Mr. GREENSPAN. There are basically two reasons why the level of total employment has lagged in this recovery relative to previous recoveries.

The first is that we have had a historic rise in productivity, which means that even though the economy was rising, that most of the rise was supplied by increasing efficiencies rather than new employees.

Secondly, the extent of the recession in 2001 was the shallowest in post-World War II history. As a consequence of that, you didn't get the rebound that we historically have had.

As I point out in my remarks and, indeed, as I think I said in February as Congressman Frank had indicated, that all of the increase in productivity, which has been a factor in the last year or so in the acceleration in economic growth, has been reflected in increasing profit margins rather than an acceleration of real wages.

Nonetheless, real wages have been rising, but, as I pointed out in, my prepared remarks, that there has been a disproportionate rise in the 20 percent of payrolls, which were supervisory workers, relative to nonsupervisory.

Indeed, as I point out, this is consistent with other evidence that suggests that the difference in skill training for skilled workers versus lesser-skilled, continues to widen. It is showing up in a distribution of income which is reflected in the long-term rise in average hourly pay of supervisory workers relative to the average hourly earnings numbers to which you were alluding.

This, as I have argued in the past, I think is a major problem of matching skills of workers to the technological base of the economy, which I believe is an education issue and requires that we address that as quickly and broadly as we can.

Mrs. MALONEY. Thanks, Mr. Chairman.

The CHAIRMAN. The gentlewoman's time has expired.

The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Chairman Greenspan, I have noted that historians often critique the general's battle plan after the hostilities have ceased, but historians notably remain awfully quiet during the heat of the battle.

With that observation having been made, when you testified before the committee in February, many signs of the stepup in the economy were already evident. Renewed strength in capital spending apparent in 2003 carried over into the first half of 2004.

Going on with your testimony, there have been much clearer indications over recent months that conditions in the labor market are improving. Most important, most notably gains in private nonfarm payroll employment averaged about $200,000 per month over the past 6 months, up sharply from the pace of the fourth quarter of 2003.

You go on, the combination of higher current and anticipated future income, strength in balance sheets and still-low interest rates bode well for consumer spending. Profits of nonfinancial corporations rebounded to 12 percent in the first quarter of 2004, a pace of advance not experienced since 1983, as consolidated unit costs for nonfinancial corporate business sector actually declined during the same period.

In general, financial intermediaries are profitable, well capitalized and appear to be well positioned to manage in a rising wage environment. In short, financial markets along with households and businesses seem to be reasonably well prepared to cope with the transition to a more neutral stance of monetary policy.

I consider this to be not just good news but excellent news. I think the generals at the Federal Reserve have conducted a battle plan that has shown to be highly successful moving us in a stable and methodical direction. For that, I just want to publicly commend you and those at the Fed for your leadership in this manner.

I wish to, however, move to an era—or area of examination pursuant to the adoption of Sarbanes-Oxley, which was generated in an environment where many of us shared great disappointment in our free enterprise professionalism, where it was apparent that there were those in positions of responsibility that did not meet either their professional or fiduciary responsibilities.

To that end, after the implementation of a higher disclosure standard, higher accountability, independence of audit committees, there still remains one area not addressed by the Congress, which I am reluctant to bring up but which I would welcome your thoughts, and that is the tone at the top.

I recently reviewed a report of diversified financial institutions where, on average, the CEO was compensated at a basis of $12 million a year, and the average value of stock held in the institution they managed, not net worth, was reported to be $800 million. Now, that in itself is not troubling to me, because I believe, as a free enterpriser, innovative people should be awarded in accord with their success.

What was troubling about this report is these average levels of compensation appeared to have no profitability or losses of the corporation being governed. Compensation in itself does not indicate a problem, but it does indicate what the tone of management is with regard to their fiduciary obligations to shareholders.

In his appearance before the committee just last month, Chairman McDonough, chairman of the Public Company Accounting Oversight Board, indicated that compensation committees should act, if not boards should act and shareholders should act, but if, failing that, the Congress may at some time find it appropriate to act in this arena, not necessary to regulate or establish some formula by which one is compensated, but at least to provide additional notice, earlier awareness by shareholders of plans to be taken by boards.

In fact, the gentleman from Alabama, Congressman Terry Everett has recently submitted legislation to me which he is contemplating introducing relative to prior notice with regard to pension plan adjustments which may be adopted by a board in a public operating company. I think this is just a first step in a very long discussion about how we incent CEOs, CFOs and managers at the very highest levels to invest for the long term, to not be so concerned about beating the street every 90 days, to in fact bill value for shareholders and not be so concerned about the value of shares they own but the value of the corporation they are charged with leading.

I don't have a specific question to pose this morning, but merely wanted to have on the record my concerns about these matters in the context of our overall long-term economic fortunes and would ask and request the Fed's counsel and advice as we move forward in this very difficult area as to whether any action might be justifiable, whether examination over the course of the coming months is warranted or any direction which you or the Board may choose to advance in this arena. And I yield back the balance of my time.

Mr. GREENSPAN. To the extent that we have expertise in that area and, in some areas, we do and, some, we do not, we will be glad to make available to you what it is we have.

But fundamentally, these are value judgments as to how you want corporate governance to behave, and the shareholders still own the corporation, and it is their money that is being employed for purposes of CEO and general executive compensation. And if the Government gets too heavily involved in that transaction, I am fearful that, in an endeavor to improve corporate governance, we may in fact go in the wrong direction.

Mr. BAKER. Often, mere examination is very helpful.

Thank you.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

Let me do this first, just follow up on Mr. Frank, when he talked about tax policy. For example, some people are born on the top side of the mountain, and some people are born on the rough side of the mountain. I happened to grow up on the rough side of the mountain, and I had to climb up.

When you look at the tax policies that we are talking about, sometimes, it benefits just 2 percent of America and doesn't consider individuals who have grown up on the rough side of the mountain, You know, without hope and opportunity. I would not be here if it were not for public education, public housing and public—and some sort of health care that my parents had.

When you talk about the tax policies we put forth, I never hear the considerations taking place in regards to that, so we don't have to worry about countries, as the report indicated, in South America who no longer want to be part of a democracy.

That being said, I would like some time, not today, you know, when we talk about the tax policy, the effect that it may have on individuals who are on the rough side of the mountain and may need a hand up.

Let me ask these questions, I will just try to ask three questions, different subject matters, real quick because I know that time expires real fast, just so we can get some answers to them.

The first question is whether or not a comparative advantage still holds true for the American economy. Because, you know, one of the biggest issues that we are talking about now is outsourcing and traditional economic daily reports, free trade based upon the concept of comparative advantage.

We thought that the service jobs, the technological jobs would stay here in America. We are now finding that they are going oversees or to individual countries where there are highly educated but less-expensive workers.

So my first question is, do you believe that we need to rethink our ideas about free trade in light of what might be diminishing comparative advantage and technology and education in the United States? That is number one.

Then, I want to switch to just the question, in regard to what is taking place in the Senate Committee, with Richard Shelby, who is planning to introduce legislation that would create a stand-alone regulator for the GSEs that would be completely separate from Treasury and HUD and that the new regulator would have the authority over mission, goals, products and risk-based capital.

I want to get your thoughts on such a proposal, particularly in light of the fact that the Federal Reserve has moved to strip Fannie Mae and Freddie Mac and other government-sponsored enterprises of their ability to obtain daily interest-free loans from the Fed.

Lastly, if we get a chance to, on another topic that has been very much before this committee. I know that you are a bank regulator, but I wanted to ask you a question about the securities industries, because both John Reed, as interim chairman of the New York Stock Exchange, and now John Thane, as CEO, are making various changes to their structure, particularly in separation of regulatory structure, from running the securities auction.

Nevertheless, there are some who will say that the era of self-regulation is over. I want to know whether or not you believe that self-regulation should end and be replaced by direct regulation, and what do you think about the trade-through rule? Should it end or be expanded?

Mr. GREENSPAN. Well, I will try to answer those fairly quickly. Each one is a 20-minute lecture, as you well know.

I would merely repeat on the first question of free trade, I think the United States has immeasurably gained from the opening up of markets in the post-World War II period. And we, more than anybody, have gained by the tremendous rise in trade throughout the last half century.

I think were we to start pulling our horns in any way, because we are fearful of competition, which we seem to be handling rather well, I think we will find at the end of the day that it will diminish our growth and standards of living, and we will likely find that a number of consequences which we hadn't expected would create a far more negative view of the way the world is working than we would like.

So I would emphasize, as I did to the Chairman, that the advantages of globalization have been profound for the United States, and I hope we carry them forward. We do have problems with the distribution of income, which I have addressed with you previously. But that is a different issue and does not relate to the question of whether we have free trade or not.

With respect to the GSE regulator issue, I have not commented, you know, nor have any of my colleagues on the specific structure or the form of the regulator. In our testimony, I have argued the necessity of increasing the share of home mortgages purchased by the GSEs which are securitized rather than kept in portfolios at—

we at the Fed perceive—a significant subsidized rate. But we haven't thought through any of the issues with respect to where the regulator is located and what he does. With respect to the so-called overdrafts that the Federal Reserve essentially has been changing, what happened was that initiallly we perceived that, as a matter of convenience, it was quite helpful to treat GSEs differently from other private corporations in various different things, specifically the payment principal and interest to the banks.

What occurred as a consequence of our varying from how we handle other private corporations, was a huge increase in what we call daylight overdrafts, which are very large, intraday lending. And what we chose is that, as these drafts got very large and these institutions got very large and the amounts got very large, was to effectively handle these issues of payments exactly the way all private organizations do; we would be working in that direction, and I think it is very much to the advantage of the financial system as a whole. But that in and of itself has got nothing to do with the regulator question in any sense.

And with regard to your final question, I think self-regulation is an extraordinarily important issue—I would be more general. Private-sector generation, essentially counter-party regulation or self-regulation, is a very important element in the regulatory structure generally. And I trust that we, in our endeavor to get the proper balance between Federal, State, and private regulation, keep in mind our purpose is to get the optimum functioning of our particular financial and, business organizations as well.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman Greenspan, you said you are very optimistic about the economic outlook for the country. But at the same time, you said business caution remains a feature of the economic landscape. And I wonder what you think the sources of that caution are and what would end that caution? Is that caution merely a protracted convalescence from the bursting of the bubble and the aftermath of that? Or has the regulatory environment inadvertently inspired hesitancy on the part of business investment? And, perhaps, are there some other factors?

You know, we hear from executives and from economists warning about the litigation risk in America today. Whether it is from some State Attorney General or from an ambitious plaintiff lawyer, there is that factor. But whatever it is, we know one thing: To my knowledge, there is only one European firm that has listed its stock in the United States this year. So whether it is litigation costs and fear of that or concern about the cost of Section 404 audits or the regulatory costs, for some reason, capital that once flooded into our capital markets is hesitant from overseas. And at the same time, you cite this business caution here domestically. And I was wondering if you would give us, in your view, the sources that generate that.

Mr. GREENSPAN. Congressman, I think we know that the caution exists because we can measure it, the extent of how they behave.

What causes that obviously has got to be conjecture, because we are trying to delve into the psyche of individual decision-makers.

I think that there is no question that the aftermath of the bursting of the bubble and the corporate scandals still linger and induce a sense of unwillingness to take the types of risk that businesses had invariably taken in the past. And that was reflected in the fact that, as I indicated earlier, capital expenditures tend to generate to significantly exceed cash flow in the recovering stage of the business cycle with a very substantial implicit rise in corporate debt, which, of course, we are not having at this particular stage.

To the extent that there is a fear of making the mistakes, it gets down to some degree of being unsettled, as indeed I suspect they should be, at seeing the type of corporate behavior which nobody believed was consonant with an American capitalist system. And that has undoubtedly had an effect on its aftermath.

I think that the issue of potential terrorism is latent. It is there. I have no way of making a judgment as to how significant it is. It is very difficult to find any evidence outside of the long-term futures markets in crude oil, which presumably reflect some degree of world instability in supply. But if you look at the United States' financial system with all of its various spreads and relationships, trying to measure this type of risk, it is very hard to find.

So it is something which we don't really know all that much about. We observe it. We get the same sort of response when we speak to corporate executives that you do. There is an issue of litigation risk in here, but there has always been litigation risk. But when it is tied up in the question of corporate behavior and responsibilities, it clearly is inducing a higher level of caution than probably existed in the past.

Mr. ROYCE. Mr. Chairman, if I have time for one other question.

Chairman Greenspan, in preparing for your visit here, I read an economic research note from a very respected economist in which he called the Federal Reserve, in his view, the world's biggest hedge fund. And his rationale for making that claim is that the Fed has encouraged the financial markets to participate, in his view, in the carry trade where one can borrow cheaply on the short end of the yield curve and invest those borrowings in a longer-dated security. So, according to this economist, the Fed encouraged the carry trade in 1993 when they took the Fed funds down to where it equaled the rate of inflation. And the current period is cited as another era, in his view, of the carry trade, since the Fed funds rate is negative or below the rate of inflation.

The risk cited in this paper of his is that these Fed-encouraged carry trades can encourage artificial bubbles in asset prices. This claim is applied to the housing bubble today. But, you know, the equity bubble in the 1990s could also be explained from that perspective. And I just wanted to get your thoughts on this critique of Fed policy.

Mr. GREENSPAN. Well, Congressman, so long as the normal tendency is for long-term rates to be higher than short-term rates, there will always be some carry trade. And, indeed, one can even argue that commercial banks are largely carry trade organizations.

But as I point out in my prepared remarks, the awareness currently of the risks in taking extended positions in the carry trade markets is clearly being unwound. And our judgment is that, while there is some and there will always be some, it has not been a problem.

Certainly, if you have an extended period and you lock in these differences, you can create great distortions. But when we move rates down, as we have on several different occasions, we are acutely aware that, in that process, we will increase the carry trade.

The more important question is, what is the significance if we do that? And if we perceive that that was creating bubbles or distortions, obviously, we wouldn't do that. We are well aware of what happens when we move, but we try to adjust our policies in such a manner as to significantly minimize any secondary consequences of such actions. And, indeed, I think the recent history suggests that, so far at least, we are successful in doing that.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from North Carolina, Mr. Miller.

Mr. MILLER OF NORTH CAROLINA. Thank you.

Good morning, Mr. Chairman. In your testimony earlier today, you said the increases in average hourly earnings of non-supervisory workers had been subdued in recent months and barely budged in June.

I have had some difficulty actually finding some job-to-job comparisons. I have seen industry-to-industry comparisons, that the industries that are gaining jobs pay 21 percent less than the industries that are losing jobs. The manufacturing sector has been losing. The service sector has been gaining. They are also less likely to pay health care benefits and have retirement benefits. And, of course, you know that we have had significant manufacturing job loss throughout the country and, in my own State of North Carolina, more than almost 160,000 manufacturing jobs lost in the last four years.

The figures I have show that the jobs created in North Carolina have paid about $4,000 less than the jobs that we have lost and were about 10 percent less likely to have health care.

Mr. GREENSPAN. That is in your State, not in the country, you are saying?

Mr. MILLER OF NORTH CAROLINA. In my State.

What are the job comparisons? How much are the jobs that we are losing in the last 4 years? How much have they paid? How much of the jobs have we gained paid? And what is also the total compensation, including health care and retirement benefits?

Mr. GREENSPAN. Well, we have tried to address that question and tried to analyze the aggregate structure of employment relative to the question as to whether the job increases over the last year, for example, have been in industries which have below-average wages.

Mr. MILLER OF NORTH CAROLINA. Right.

Mr. GREENSPAN. And what we have found is that that is true but to a very small extent.

Conversely, when we have done the same type of calculation, not by industry but by occupation, we get the other result. Namely, that there seems to be an upgrading in the types of jobs when looked at from an occupational point of view.

Now, both of these data of changes are very small. But even if you want to look at them as though they are meaningful, it is not inconsistent and it may, in fact, be the case that, within industries, you are getting a slight shift towards industries with lower average earnings but, at the same time, an upgrading within the industries with respect to occupations.

But I think the bottom line of all of this is that we have not been able to find a significantly meaningful change in the quality of the jobs being produced relative to the quality of jobs being lost for the Nation as a whole over the past year. It is conceivable that, if we had far greater detailed data, we might unearth something significant. But, so far, our statisticians using the full details that the Bureau of Labor Statistics publishes both with respect to occupation and with respect to industry, there is very little evidence of a particular bias one way or the other.

Mr. MILLER OF NORTH CAROLINA. It sounds like that fairly long answer said, the reason I can't find jobs or job comparisons is that they really aren't there but that you would agree with me, that, if North Carolina jobs—new jobs—are paying $4,000 less than the manufacturing jobs that we have lost, that is pretty subdued.

Mr. GREENSPAN. Well, I am saying that, when you look at it from the point of view of the economy as a whole, it balances out from, there are good and bad.

Remember, there is a more interesting question which surely is what this issue is about which we cannot make a judgment on. Most of the data that everybody quotes are the net change in jobs from one period to the next. The type of question that you should really be interested in, and I think we all are, is if we had gross figures. In other words, the total number of not net jobs but gross additional additions to jobs and what they pay relative to the jobs that were lost and what they pay. The Bureau of Labor Statistics does not have data at that level of detail. And until we did have data of that sort, we really can't answer this question in any meaningful sense.

The CHAIRMAN. The gentleman's time has expired.

Mr. MILLER OF NORTH CAROLINA. Well, not quite.

The CHAIRMAN. The gentleman from Texas, Mr. Paul.

Mr. PAUL. Thank you, Mr. Chairman.

Good morning, Chairman Greenspan. Yesterday's testimony was received in the press as you painting a pretty rosy picture of the economy. You have already remarked a second time on one statement you made that I would like to comment on again, because I think my colleagues should pay close attention to it: And that is your statement that corporate investment in fixed capital and inventory has apparently continued to fall short. The protracted nature of this shortfall is unprecedented over the past 3 decades. The proportion of temporary hires relative to total employment continues to rise.

I think that is very, very significant and probably should be taken in the context of the rosy picture of the economy.

Also, at the end of your statement, you make a comment about inflation in the long run, which I entirely agree with. And that is, it is important to remind ourselves, you say, that inflation in the long run is a monetary phenomenon. However, you sort of duck the issue on the short run, that various factors affect inflation in the short run, and yet I think monetary policy is pretty important in the short run. And our temptation here and too often with central banks is to measure inflation only by Government measurement of CPI, where the free-market economists, from Ricardo to Mises to the current free-market economists, argue the case that, once a central bank interferes with interest rates and lowers them below the real rate, that investors and others do make mistakes, such as overinvestment and now investment over-capacity, excessive debt, and speculation. And, therefore, I think that we should concentrate more on the short run effects of monetary policy

Over the last several months, you had been hit by two groups. One half is saying that you are raising rates too fast, and the other half says you are way too slow. And of course it begs the question of whether or not you are really right on target. But from a free-market perspective, one would have to argue that you can't know and you don't know, and only the market can decide the proper money supply and only the market can decide the right interest rates. Otherwise, we invite these many problems that we face.

As the economy slowed in 2000, 2001, of course, there was an aggressive approach by inflating and lowering the interest rates to an unprecedented level of 1 percent. But lo and behold, when we look back at this, we find out that manufacturing really hasn't recovered, savings hasn't recovered, the housing bubble continues, the current account deficit is way out of whack, continuing to grow as our foreign debt grew, and consumer debt is rising as well as Government debt.

So it looks like this 1 percent really hasn't done much good other than prevent the deflating of the bubble, which means that, yes, we have had a temporary victory, but we have delayed the inevitable, the pain and suffering that must always come after the distortion occurs from a period of time of inflating.

So my question to you is, how unique do you think this period of time is that we live in and the job that you have? To me, it is not surprising that half the people think you are too early and the other half think you are too late on raising rates. But since fiat money has never survived for long periods of time in all of history, is it possible that the funnel of tasks that you face today is a historic event, possibly the beginning of the end of the fiat system that replaced Brenton Woods 33 years ago? And since there is no evidence that fiat money works on the long run, is there any possibility that you would entertain that, quote, "We may have to address the subject of overall monetary policy not only domestically but internationally in order to restore real growth"?

Mr. GREENSPAN. Well, Congressman, you are raising the more fundamental question as to being on a commodity standard or another standard. And this issue has been debated, as you know as well as I, extensively for a significant period of time.

Once you decide that a commodity standard such as the gold standard is, for whatever reasons, not acceptable in a society and you go to a fiat currency, then the question is automatically, unless you have Government endeavoring to determine the supply of the currency, it is very difficult to create what effectively the gold standard did.

I think you will find, as I have indicated to you before, that most effective central banks in this fiat money period tend to be successful largely because we tend to replicate which would probably have occurred under a commodity standard in general.

I have stated in the past that I have always thought that fiat currencies by their nature are inflationary. I was taken back by observing the fact that, from the early 1990s forward, Japan demonstrated that fact not to be a broad universal principle. And what I have begun to realize is that, because we tend to replicate a good deal of what a commodity standard would do, we are not getting the long-term inflationary consequences of fiat money. I will tell you, I am surprised by that fact. But it is, as best I can judge, a fact.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Alabama, Mr. Davis.

Mr. DAVIS. Good morning, Mr. Chairman.

One of the challenges that I think we deal with as lawmakers and policymakers is that, frankly, a lot of the public and the constituency that we serve doesn't necessarily understand a lot of the economic policymaking process in this Country, that they don't have a good understanding of the facts beyond a lot of the political rhetoric. And I think that that is a bipartisan concern that we have, that there is this kind of nebular fog that exists around making sound economic decisions as policymakers.

And another related concern that we have is, sometimes, some of our own officials contribute to that confusion by the way they talk about these issues.

So with that as the backdrop, Mr. Chairman, let me ask you about some very specific observations that President Bush has made, and let me ask you to comment on their accuracy. And these are taken from one particular speech the President gave on April 24, 2003, but I will represent to you that they are a pretty consistent rendition of other comments he has made on the issue of deficits.

Quoting the President, "now you hear talk about deficits. And I am concerned about deficits. But this Nation has got a deficit because we have been through a war, and I told the American people, we would spend what is necessary to win the war," close quote.

I am going to ask you to comment on the accuracy of that assertion which, as I read it from the President, is that the proximate cause of the deficit was the spending on the war, by which he presumably means Afghanistan and Iraq.

And then I want you to comment on this observation by the President: "And the best way to deal with the deficit is to address the two things that affect the deficit. First, increase revenues to the Treasury through economic growth and vitality."

That observation, as I understand it, is the President's comment that the best strategy for getting the deficit down is to raise revenues through growth and vitality, presumably the kind of growth that he would argue comes from his tax cuts.

I want you to comment on the accuracy of that statement, that the best glide path to bringing the deficit down is to increase revenues.

Third observation from the President, remember, he mentioned two things that affect the deficit. And he said: "And, second, make sure Congress does not overspend your money. Make sure it focuses on the things that we need and doesn't spend beyond the things that we need."

I take that to be the President's observation that discretionary spending by Congress is the next most significant factor in the rising deficit. And I am presuming that he means to distinguish discretionary spending from an entitlement-based spending such as Medicare and Social Security. That also strikes me as a controversial proposition.

So to make sure you understand my question, can you comment on the accuracy of all three of those observations by the President, first of all, the primary cause of the deficit—or the cause of the deficit, spending on the war. Second of all, that the best glide path for reducing the deficit is raising revenues through tax. And, third of all, that it is discretionary spending and not entitlement base spending. And if you believe that the President is inaccurate in all of those observations, does that concern you that the chief executive has gotten it so fundamentally wrong when it comes to describing the state of our economy?

Mr. GREENSPAN. Well, Congressman, I am not going to comment on the specific views of the President. I happen to agree with him.

Mr. DAVIS. Can you comment on the accuracy?

Mr. GREENSPAN. Well, the point of the issue is the question of the extent to which military spending is part of the increase in spending and therefore the deficit is a numerical issue. And, I mean, there is no question that the deficit would be smaller if we did not have military spending.

Mr. DAVIS. Do you agree that that is the primary reason that we have the debt?

Mr. GREENSPAN. I frankly don't know. I think that clearly part of the deficit—well, it depends on where you start. If you start say several years ago and come from here, a goodly part has been the loss of the very high revenues we were getting from the capital gains taxes and from the exercise of stock options. And the elimination of those revenues were a significant factor in the rise in the deficit, as well as declining revenues as a consequence of the economy going down.

Mr. DAVIS. Would the tax reductions also be a factor on those declining revenues?

Mr. GREENSPAN. Yes. But I don't have the numbers directly in front of me. There are all sorts of reasons. But over the broader term, of the major issues in the debates on fiscal policy is the question of the extent to which certain tax policies, by increasing the efficiency and the growth of the economy, will increase the revenue base.

And I have always been one of those who believe that that is a very important issue and policy. There are others who believe that the mechanisms work in different ways. There is not, as best I can judge, complete agreement about a number of these issues. And when you say, in certain senses, there is fact. Certain of the statements you raised are questioning of fact. Others are a question of interpretation of the way the economy functions.

And I would say I would agree with a goodly part of the general thrust of what the President has been saying with respect to that, but not necessarily with the specific numbers, because I had not actually done the arithmetic that would be required to make that judgment.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from Pennsylvania, Ms. Hart.

Ms. HART. Thank you, Mr. Chairman.

And thank you for spending some time with us today, Chairman Greenspan.

I want to go back to some comments you made briefly and alluded to a little bit about the skills of the American workers, many of the workers who are currently unemployed, not matching the needs of our growing technological base and that, further, you stated, that, analyzed by occupation, job growth has been kind of higher in some of the higher-wage areas, which I am assuming means the ones that require more skill. And you have talked about improving our education system in the past.

The President has a plan to move forward and improve elementary and secondary schools as we have been working on but, recently, announced an initiative to also improve community colleges' ability to train workers and retrain them as technology improves. Do you believe that community colleges should be involved in this process? Is that the level of training that you are talking about, number one, and is it possible that a large number of the workers who are currently unemployed are just not employable in the new jobs or the new economy, that we need to take those workers and that those are the ones that are causing some of the more stubborn unemployment?

Mr. GREENSPAN. Well, Congresswoman, I have observed in the past that one of the major growth industries in this Country is community colleges. And the reason for that is that they have recognized that this rapidly changing structure of skill requirements in the labor force requires that education not end at some point in one's life, but it is an ongoing issue. Because, with the skill level requirements changing so continuously, unless you are continuously updating your capabilities, you are going to fall behind the curve, and indeed that has been a major problem.

The community colleges have seen this particular niche requirement in our society, and they have obviously addressed it successfully. If they hadn't, the enrollments would not be surging to the extent to which they are. And in that regard, I find it difficult to believe that we could address the educational issues with respect to the question of maintaining the skills of the American workforce without recognizing that there are several different types of levels of knowledge that we need. First, obviously, is basic primary education, because if you don't have that, if you can't read well or can't do arithmetic well, you are stymied in moving forward. But, then, there is the very broad abstraction of being able to learn, which is what our school systems are trying to do. And beyond that is the application to specific types of skills and jobs, which is what the curricula of the community colleges tend to be. And people find, I gather, that what they gain from those community colleges is very significantly worth the cost.

Ms. HART. Okay. That having been said, do you see, in an analysis of those people who are unemployed, though, a lot of them being the folks who could benefit the most from that skill updating?

Mr. GREENSPAN. Well, as we know from the data, that when people get laid off, they usually have difficulty regaining the wage level that they had before they were laid off. And this leads to the question as to whether they could do better by shifting the profession they are in. And lots of them have decided, because of the type of jobs that they had, that they would do better doing something different. And here is where community colleges, I think, really do a good job.

Because we have—the nature of the turnover in our labor force is really extraordinarily large and rising. And it implies that not only do you not have lifetime employment, as they used to have in Japan, but we are finding more and more that many people, maybe even most, have more than one profession during their working lives. And this is the reason why we see that there has been such a remarkable pickup in enrollments, say, during the period when recession occurs, that the labor shrinks. And when they trace down what happens, they are all going back to school. And when, in effect, the economy picks up, they come back into the labor force. And this, I might add, is one of the reasons why, despite the surge in employment, the unemployment rate has not gone down commensurately.

Ms. HART. Thank you, Mr. Chairman.

The CHAIRMAN. The gentlelady's time has expired.

The gentleman from Georgia, Mr. Scott.

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

Chairman Greenspan, in your report, you mention that there is the—conditions in the labor market are improving. You also mentioned they are improving at a rate of 200,000 jobs per month, new jobs per month.

This is not the case in the African-American community. The unemployment level among African-Americans at the same period has risen from 9.7 percent to 10 percent, while the unemployment rate among white Americans is 5 percent. That is double. And the situation is very drastic, and most drastic among African-American males between 20 and 45 years of age, nearly 700,000 unemployed, African-American women, nearly 700,000, in those very critical, most-productive earning years between the ages of 20 and 45.

As our foremost economist, as our authority on these matters, I would be interested and I think the Nation would be interested to know, why is this? Can you pull the covers off of this racial imbalance and explain to this Nation why this imbalance among African-Americans, this growing economy that is moving and yet the African-American unemployment rate is increasing?

If, in fact, the Nation's unemployment rate was 10 percent, it would be catastrophic. And it is a catastrophic situation in the African-American community. Why is it, and what must we do in Congress to correct this imbalance?

Mr. GREENSPAN. Well, Congressman, I think you are addressing one of the failures of our society. And I think that having such large groups of potentially productive workers not operating at their highest potential level is a vast misuse of resources.

I think the matter, any way we cut it, part of it is discrimination. We try to hide that fact, but I don't think it has been eliminated. I think it has improved somewhat, but it is clearly a major factor.

We have got to find a way to enhance the educational skills of all of our workforce. And where there are significant problems, as there are in the African-American workforce, which you point out, I think we have to make certain that we double up on our efforts.

But aside from education, I am not sure that there is an answer. I am reasonably sure that, if we can get sufficient education and get skill levels up, the pressure of the marketplace, even though there is significant residual discrimination, will create a major improvement. But without starting at the education level, I would be discouraged with the capability of success.

With education, I think we have got a reasonably strong case to resolve this issue once and for all.

Mr. SCOTT. How do you account for the fact, Mr. Chairman, that there are African-Americans with MBAs, there are African-Americans with this education? That, I think you hit it on the head in your first comment, discrimination.

Wouldn't it be appropriate that there be called, at the highest levels of Government and industry, a summit to address this critical issue? It is not going to go away. And if, in fact, it is, as you say—and I think you speak the truth, that it is rank discrimination—it is rank racism in the employment marketplace, that we should hold accountable chief executive officers of our major companies, the movers and the shakers, the decision-makers, and that, as our chief spokesman for the economy, that you could provide that leadership to say, once and for all, let us deal with this issue?

I assure you that, if the Nation's unemployment level overall was 10 percent unemployment, there would be a summit. There would be action taken. Don't you think that that would be a critical movement on the part of the leadership of us in public policy and the Congress and the White House and the Executive Branch and in industry?

The CHAIRMAN. The gentleman's time has expired. The Chairman may respond.

Mr. GREENSPAN. I was just going to say, anything that can be done in this area is clearly important to move forward on.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Chairman, let me start with a given. And that is that our economy depends on an efficient transportation network. I believe you would agree with that. Would you not?

You are saying that you do?

Mr. GREENSPAN. I do. Yes.

Mr. BACHUS. You have predicted sustained economic growth, increase in output orders.

My question to you, in making your calculations, in making your forecast, in deliberating, did you calculate the present inefficiencies in our transportation network, the limitations in our transportation network? I mean, I could give you some examples. For instance, our transcontinental railroads are jammed. Our velocity and train speed is actually decreasing. You know, our interstate highways are heavily congested. Our transit times, in the last 10 years, have decreased significantly. Does this threaten—particularly in a global economy where we are predicting border crossings to double in the next 10 years, are you concerned over the limitations in our transportation infrastructure?

Mr. GREENSPAN. I think the deregulation of trucking, railroads, and airlines, and air transport unwound what was, I thought, the really serious set of problems which very significantly reduced the flexibility of our system.

So while I don't deny—and, indeed, the Chairman was mentioning the shortages of skilled drivers for trucking—I don't deny that there are bottlenecks here and problems there, but I would not indicate that I thought that transportation inefficiencies were a serious problem, certainly nowhere near what they were 30 years ago.

I think we have got problems, obviously, with rail transport, specifically endeavoring to subsidize the Amtrak system and related sorts of rail transport. But we are, remember, a very heavily passenger-car, light-truck, SUV society.

Mr. BACHUS. I agree.

You mentioned 30 years ago. Are you aware that—just take the year 1970—that, since 1970, we have actually had a tripling of mileage driven by Americans. During the same period of time, we have twice as many registered drivers. We have something like three times as many tractor trailers on the road. Yet, our roads, our network of roads, has only grown by 6 percent.

So I do agree with you that the competition and the deregulation helped tremendously and brought some efficiencies into the market. But I would urge you to pay close attention to that transportation grid and the just-in-time economy that we are in. Because I believe that it is seriously restraining our economy now. I think some reason why you have a backlog on orders and you have unfilled orders is you have many places where it takes 30 to 60 days to get a rail car, where, 5 years ago, it took 3 to 6 days.

And, in your calculations, begin to take a look at that. We are projecting that it will cost—that it will take $375 billion over the next 6 years just to maintain our interstate highway system, our national network of roads and rail and maritime, and yet the projections are to spend $300 billion. So we are going to actually spend an amount that is less than the amount to simply maintain it.

And if these projections which you are making—and I don't doubt the demand is there, the productivity is there—that we look at that as perhaps a weak link in our system and become aware of that.

And with that, I will yield back the balance of my time. But if you would like to respond to that.

Mr. GREENSPAN. You are raising an issue of priorities in funding for both State finance and Federal finance. And I think that, while I don't deny the numbers you are positioning, there is the question of, if you lined up all of the priorities that one can assert with respect to all claims on the Federal budget, they would be unfinanceable.

And so we, of necessity, have to make choices, and these are choices which are very difficult to make. And I think where economists can be helpful, we are. Where we don't know as much as we need to know—and I don't know myself as much as I think I would need to know—to make judgments, we are not very helpful.

Mr. BACHUS. And I know——

The CHAIRMAN. The gentleman's time has expired.

Mr. BACHUS. In making these calculations, I wish you would pay close attention—I am not—to what we have. There has been a lot of congestion out there and a lot of inefficiencies.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from New York, Ms. Velasquez.

Ms. VELASQUEZ. Thank you, Mr. Chairman.

Mr. Greenspan, the trade deficit grew to approximately $145 billion in the first quarter of this year, escalating from a $127 billion deficit in the final quota quarter of 2003. To finance this trade deficit, the U.S. must borrow from foreigners at a rate of approximately $1.6 billion a day. Do you believe that our substantial budget deficit, which is adding considerably to our outstanding public debt, will undermine foreigners' confidence that the U.S. will be able to pay back this constantly growing debt?

Mr. GREENSPAN. So far, as best we can judge, the foreign willingness to hold long-term obligations of the U.S. Government has not diminished.

Clearly, I can't say to you that there is no level at which they will start to respond negatively. And, indeed, as I was indicating in conversations at the Senate yesterday, that, with respect to financing our current account deficit, I think our concern is that unless we bring it down in some form or another we will begin to build up a level of dollar claims against American residents, which will eventually place our foreign trading partners in a position where, even though they may say the rate of return here is very good, that they have to diversify out of the heavy accumulation of U.S. dollar obligations. There is, as I said yesterday, no evidence that we are anywhere near a problem of that nature. But if you project down the road, I can't see how we can avoid it one way or another.

Ms. VELASQUEZ. But, Mr. Chairman, many economists believe that if foreigners lose interest in loaning us money or in buying up our assets, interest rates could soar, making it impossible to pay down our debt. With no buyers to be found, stock prices and real estate values could plummet and America could find itself in a long-term depression.

Do you agree with this assessment?

Mr. GREENSPAN. No, I do not. I do not, largely because I cannot believe that we will allow ourselves to get in a position where, in order to finance our Federal Government deficit, we would have to be reaching out both domestically and abroad to borrow money at very high interest rates.

Ms. VELASQUEZ. And how we will not allow ourselves to find ourselves in that position? By reducing the deficit and I guess rolling back taxes?

Mr. GREENSPAN. As I indicated earlier, what we are missing at this particular stage is a process for approaching fiscal policy in the sense that we are confronted with something new, namely that our commitments are now very long term and our ability to forecast the way it is going to come out is rather limited. This suggests to me that we have got to find ways in which we not only project short-term budgets but we project long-term budgets and simultaneously find means by which, if our forecasts are turning out to be wrong, there are automatic adjustment process triggers, for example, which alter either tax rates or expenditure programs. That would ensure that the deficit does not get to the point of extraordinary imbalance where we would be forced into a position where we could not get money to finance our deficits except at exceptionally high interest rates.

Ms. VELASQUEZ. Mr. Chairman, with the final approval of the JP Morgan Bank One merger coming on the heels of the Bank of America Fleet merger, the rise of a super tier of U.S. banks is evident. These banks will each control $1 trillion in assets, together controlling more than 40 percent of the industry's total assets.

First, does such concentration pose risks to the banking system and, as a result, to the U.S. economy? And, second, do you believe that our current system of regulation is sufficient to oversee such large and diverse corporations that pose such great risk to the financial system?

Mr. GREENSPAN. Well, first of all, we obviously are observing the phenomenon and the trends to which you allude. And were, in our judgment, that we were in a potentially serious supervisory regulatory State with respect to these large institutions, I would indeed be most concerned. These institutions are very large, but the crucial issue of concern is the degree of concentration in specific types of businesses or products. And in many instances, although these are very large institutions, they are quite diversified and, hence, they don't have the type of—they don't create the type of threat of systemic problems, which could readily be the case were there a significant concentration. Nonetheless, we do continuously monitor this issue; and I trust that the combining of both Federal and, where applicable, State supervision and the private sector's counterparty's supervision will remain sufficiently adequate to sustain what is in effect a reasonably good balance at this stage in our financial structure.

The CHAIRMAN. The gentlelady's time has expired.

The gentleman from Minnesota.

Mr. KENNEDY. Thank you, Chairman, for your service and for spending time with us today. I would like to continue on the discussion on trade deficits and move from problem focus to solution focus.

You know, we had a good export growth, and we were growing exports largely in some cases because of a weaker dollar. But with our growing economy, our imports are growing; and we find the rest of the world not growing at quite the same pace, with Europe still behind us, with China having some concern as to whether the growth is too fast and they need to move towards a lower level of growth, a soft landing.

We also have to make sure we are keeping American exports competitive. And you have talked at great length today how part of that is making sure we have a low tax, low spending, you know, low deficit environment. You have talked at great length about the need for us to improve our education system so that all members of our society are qualified for the work of the future. You have talked about how we need to keep trade open, that we need to continue to expand trade—yes, enforce our agreements, but expand trade. And of course, we need to keep the regulatory burden that you have also talked about moving so it is a less heavy hand in our environment.

But I would like to ask you about three things. Number one, when we are talking about keeping America competitive to get this trade deficit down, how impactful is the significant differences and the weight on the economy from excessive lawsuits in this country versus others?

Secondly, international taxes. We have got an international tax bill that we are trying to work through this Congress and get to the President's desk. But even with that passing, with European countries being able to rebate their back taxes at the border, how significant is that international tax difference in our ability to be competitive and our ability to reduce this trade deficit?

And then, thirdly, is there anything that we ought to be pushing our foreign trade partners, whether in Europe or in China, to do to help us, have them take more of the burden of carrying the economy rather than us always being the growth engine of the world?

Mr. GREENSPAN. Well, Congressman, we have a longstanding problem in our trade accounts. And that is, the propensity of Americans to import relative to our incomes is much larger than our trading partners' willingness to import relative to their incomes at any given structure of prices or exchange rates.

What that means is that, other things equal, with everybody growing at the same rate, hypothetically, we would be incurring an ever-larger trade and therefore current account deficit. And this has been a fundamental problem which we have confronted—it was identified, I might add, 40 years ago, and it hasn't changed except at the edges. So we are essentially in a position where, in order to keep our trade deficit down, we have to work in a sense far more effectively than our trading partners.

Clearly, the price and exchange rate structure has not fully adjusted to this differential, because, had it done so, it would have readjusted our trade accounts accordingly. This means that our trade problems are essentially becoming our finance problems and how we finance the debt that is implicit here.

With respect to, very specifically, our competitive export capabilities, we obviously are at the cutting edge of the world's technologies, and American products do have very significant competitive capabilities. And I think we do a reasonably good job. But as you would point out, to the extent to which our exporters are burdened by various different types of regulations or litigation relative to our trading partners, we are at some disadvantages in certain bilateral relationships.

But I am not sure how one carries the tax issue forward. There is a great deal of literature on the issue of the valuate added tax and rebates with respect to the United States, which doesn't have such a system, and what the impact is. I am not sure I know enough about how those have come out to give you any useful insight.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Kansas, Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

The CHAIRMAN. If the gentleman would yield. We are trying to meet this vote and dismiss the Chairman, so we will go for about six, seven minutes.

Mr. MOORE. I will be as quick as I can.

Mr. MOORE. Mr. Chairman, thank you for being with us today. You know several promising trends in our economy. And I hope that our economy recovery is strong enough to withstand potential threats such as a slowly rising inflation state. In your written statement, you emphasize the importance of allowing households and businesses to make decisions that best promote the longer-term growth of our economy and with it our Nation's continuing prosperity.

Unfortunately, Mr. Chairman, many people in my district and throughout our country are finding it, I think, difficult to make the decisions that are best for themselves and their families. Many people are struggling to pay for the basics such as food, shelter, education and health care.

Inflation, and health care. Inflation and health care, I believe, are the greatest problems facing our country, and as our population continues to age, I think it is only going to get worse. I hear about this virtually every week and from individuals and small businesses when I go back to Kansas. According to the Department of Health and Human Services, health care spending was up 9.3 percent for 2002, which followed an 8.5 percent increase in 2001. The Urban Institute estimates that American households will spend an average of $15,000 on health care costs in 2004. Health care now accounts for nearly 20 percent of household personal income, and this situation is causing some families and individuals to choose between basic health care and other priorities or to go without necessary health care altogether.

Mr. Chairman, in your testimony you mentioned that our country's continued sizeable increases in health insurance—you talk about our health insurance costs. Since 2000, annual health insurance premiums for Americans have risen 37 percent for individuals and 41 percent for families, and the rising cost of health care is also putting a substantial burden and pressure, I think, on small businesses in our country.

Would you agree that sizeable increases in health care and health insurance costs presents our economy and families and small businesses with a potentially serious problem now and in the coming years?

Mr. GREENSPAN. I do, Congressman. In the context in which you quoted me, I was referring to the fact that a stable price level or noninflationary environment, history has indicated to us, is conducive to maximum sustainable long-term economic growth. That does not mean that there are not innumerable problems that would exist as a consequence of that, and I regret that I agree with you in your analysis of health care cost problems, because they will be, as best I can judge, the really major issue that fiscal policy is going to have to address in the years ahead.

Mr. MOORE. Secretary Thompson of Health and Human Services was quoted in a national newspaper yesterday that the cost of records and recordkeeping in health care is almost $140 billion a year and could be saved if they converted from paper, basically, to high-tech computers. Would you agree that that might be a good move for the health care industry?

Mr. GREENSPAN. I don't know about the size of the estimate. Those numbers tend usually to be a little larger than actually is achieved.

Mr. MOORE. Oh, really.

Mr. GREENSPAN. But they are still writing prescriptions on pieces of paper.

Mr. MOORE. Yes.

Mr. GREENSPAN. And how they understand what is on that piece of paper has never been clear to me. And digitalizing, a very significant part of the system, is undoubtedly a major priority for addressing the cost issue.

Mr. MOORE. And the last very quick question, I got here a little bit late, but I heard you talking about pay-go rules and budget enforcement rules that I think you said expired in 2002; is that correct, Mr. Chairman?

Mr. GREENSPAN. September 2002.

Mr. MOORE. And I believe you said it would be worthwhile for Congress to implement that budget pay-go enforcement rules that apply not only to new spending, but also to tax cuts as well. Is that correct, sir?

Mr. GREENSPAN. That is correct.

Mr. MOORE. Thank you very much. I yield back.

The CHAIRMAN. The gentleman from Texas for a couple of minutes.

Mr. BELL. I will roll everything into one question, Mr. Chairman. Thank you for recognizing me, and thank you, Chairman Greenspan.

I wanted to refer to the topic of wages that came up earlier today. In your statement you say, to be sure, the increases in average hourly earnings of nonsupervisory workers have been subdued in recent months and barely budged in June. I think that is reflective of a pattern that has occurred over several years now. You go on to say, other compensation has accelerated this year, which suggests that the money is there, it is just not going to the nonsupervisory workers.

As you are aware, the minimum wage, the Federal minimum wage, has not been increased since 1997. Those who are forced to live based solely on the minimum wage live at or very close to the poverty line, and I am just curious if you feel as if this wage situation in America is cause for alarm, and, if so, have we reached the point that it is time to look at increasing the minimum wage? In your opinion, what impact on the overall economy would an increase in the minimum wage have at this time?

Mr. GREENSPAN. As I have testified in the past, my concern with the minimum wage is that it increases unemployment and, indeed, prevents people who are at the early stages of their careers from getting a foothold in the ladder of promotions. And the evidence does suggest that it tends to be more counterproductive than not. As a consequence, raising the minimum wage is not, in my judgment, an effective way to address what is a significant problem in the distribution of income, which is what I discussed in my earlier remarks.

The CHAIRMAN. The gentleman's time has expired. We are going to have to break now.

Again, our thanks to the gentleman from Texas.

Mr. Chairman, it is always good to have you here, and we look forward to——

Mr. FRANK. Let me say, just add to it, I would thank the Chairman, but I would say on the topic the gentleman raised, I am still waiting for the Fed analysis of the economic impact on employment of the last minimum wage increase. It has been overdue. I think, frankly, there was an absence of bad news that led us not to get the analysis.

The CHAIRMAN. The Chair would indicate that Members may submit written questions for the Chairman.

[The following information can be found on pages 76 and 80 in the appendix.]

The CHAIRMAN. With that, the committee stands adjourned.

[Whereupon, at 12:06 p.m., the committee was adjourned.]

A P P E N D I X

July 21, 2004

Opening Statement

Chairman Michael G. Oxley

House Financial Services Committee

During the Hearing on Federal Reserve Monetary Policy
July 21, 2004

Good morning, Mr. Chairman. We welcome you once again to the Financial Services Committee. Thank you for taking the time to discuss monetary policy and the economy, topics of interest to every Member of this Committee and to all Americans.

Chairman Greenspan, I want to congratulate you on your re-appointment, and re-confirmation. I know I speak for most Americans and members of this Committee when I say we are happy to have your steady hand on the monetary policy tiller. I know that you'd probably like to spend a little more time on your golf game, but we appreciate your dedication and service to the Federal Reserve.

Mr. Chairman, when the up-tick in energy prices this spring brought with it a spike in inflation, many imagined that your well-advertised first tightening of monetary policy would be more aggressive than the quarter-point move the Open Market Committee made at the end of June. All spring, you said that the tightening would be as swift and strong as necessary, and the second half of your statement was that the tightening would be gradual. As usual, you were correct on both counts.

More important, Mr. Chairman, is an issue you raised at your last appearance before this Committee, and that is how we prepare our workers for the jobs of the 21st Century. You made the point that the best way to push up wages over time was to make sure that our workers are educated and ready to fill the new, higher-skill jobs this vibrant economy creates, as lower-skill, lower-wage jobs cycle offshore. I know that continues to be a strong interest for you, and rightly so.

Creating jobs is a goal we all share, Chairman Greenspan. We all would like to see lower unemployment than the current 5.6 percent rate and know that lower unemployment also means higher wages. The economy has averaged creating 250,000 jobs a month for this year, and I think the new-jobs figure for June of 112,000 was an aberration. I think job creation will pick up and that the average employment level for this year will be at, or higher, than the average for 2000, of 131.8 million. It's already at 131.4 million, even with that June low.

Mr. Chairman, we look forward to your testimony and to the discussion today. With that, I yield to the distinguished ranking member, the gentleman from Massachusetts.

July 21 2004

<u>Opening Statement by Congressman Paul E. Gillmor</u>
<u>House Financial Services Committee</u>
<u>Full Committee Hearing to Receive the Testimony of the Chairman of the Federal Reserve Board of Governors on Monetary Policy and the State of the Economy</u>

Thank you, Mr. Chairman, for holding this important hearing and thank you, Chairman Greenspan, for coming before us this morning to present your report on the current state of our economy.

I would like to take this opportunity to congratulate you on your confirmation for a fifth term as Chairman of the Federal Reserve Board of Governors and thank you for your fine stewardship of our economy for the past seventeen years.

While I will appreciate the benefit of your overall testimony on the progress of our economic recovery and future prospects, I would like to turn your attention to a piece of legislation considered yesterday on the floor of the House of Representatives: HR 3574, the Stock Option Accounting Reform Act.

Throughout our debate on this issue in the House Financial Services Committee and on the floor, I continued to express my concerns regarding the proposal and the dangerous precedent Congress would be setting by preempting the Financial Accounting Standards Board and politicizing our accounting standard setting process in this country.

I know that you have expressed concerns regarding HR 3574 in the past, warning Congress on the "bad mistake" it would be to approve such legislation, and wanted to ask you this morning to elaborate on your previous comments in light of the House passage of this legislation.

Again, thank you Mr. Chairman for coming before us this morning. I look forward to an informative session.

OPENING STATEMENT
CONGRESSMAN PETER T. KING
before the
HOUSE COMMITTEE ON FINANCIAL SERVICES

Monetary Policy Hearing
July 21, 2004

Thank you, Chairman Oxley.

I too want to welcome back our distinguished witness and good friend, Chairman Alan Greenspan. As always, we appreciate your thorough and insightful report on the state of our economy. I'd also like to congratulate you on your reappointment as Chairman of the Board of Governors for an impressive fifth term. It certainly reflects the confidence many have in your ability to guide our economy through the perils posed by economic uncertainties.

However, it appears the days of stagnant economic growth, hiring freezes, and market uncertainties are behind us. Unemployment appears to be holding steady at 5.6 percent with 1.4 million jobs created over the previous year. Fuel costs, which significantly increased in the spring, have begun to settle. The U.S. dollar exchange rate is stronger, and the housing market remains strong because of the availability of cheap money.

In my home state of New York, the securities industry has reported increases in business activity and stepped up hiring. Moreover, banks are reporting a pickup in commercial loan demand and further declines in delinquency rates.

Recent Congressional Budget Office numbers also show the rate of growth of the federal deficit slowing. This is the result of increased revenue over the last year because businesses are starting to generate profits due to strong consumer demand and availability of disposable household income.

However, with most economic signs pointing toward a sustained recovery, the Federal Reserve finds itself in the position of nurturing this growth without cutting it short due to creeping inflation. Some economists believe the Fed should have been more aggressive in raising interest rates. They argue inflation is starting to show its ugly head, due to a 3.3 percent increase over the last three months, and should be squashed immediately. They also argue this is the result of keeping interests so low for such a long period of time.

Nonetheless, the Fed decided to take an incremental approach toward thwarting inflation and ensuring continued economic growth by increasing the Federal funds rate 25 basis points. Since this is the first rate hike since May 2000, I am interested in why the Fed chose an incremental attack to combat inflation instead of sending a stronger signal with a larger rate increase.

Is the Fed concerned about cheap money leading to a potential housing bubble which could pop if rates are increased too fast? And are you telegraphing many of your actions to soften any interest rate hike impact on the markets? Are there any concerns associated with that approach?

Obviously, the trick is to grow the economy without fueling inflation or causing a sudden shock through the system with exorbitant interest rate hikes. Nonetheless, do you believe the economy can absorb uncertain factors such as a sudden spike in oil prices or a terrorist attack on our financial markets?

I'm encouraged by the economic reports I've seen thus far but, like many of my colleagues, I'm more interested in hearing your thoughts on these matters.

I know Members are eager to begin the hearing, so I'd just like to welcome you again and allow you to proceed with your testimony.

Thank you, Mr. Chairman.

For release on delivery
10:00 a.m. EDT
July 21, 2004

Statement of

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

House of Representatives

July 21, 2004

Mr. Chairman and members of the Committee, I am pleased to be here today to present the Federal Reserve's Monetary Policy Report to the Congress.

Economic developments in the United States have generally been quite favorable in 2004, lending increasing support to the view that the expansion is self-sustaining. Not only has economic activity quickened, but the expansion has become more broad-based and has produced notable gains in employment. The evident strengthening in demand that underlies this improved performance doubtless has been a factor contributing to the rise in inflation this year. But inflation also seems to have been boosted by transitory factors such as the surge in energy prices. Those higher prices, by eroding households' disposable income, have accounted for at least some of the observed softness in consumer spending of late, a softness which should prove short-lived.

When I testified before this Committee in February, many of the signs of the step-up in economic activity were already evident. Capital spending had increased markedly in the second half of last year, no doubt spurred by significantly improving profits, a low cost of capital, and the investment tax incentives enacted in 2002 and enhanced in 2003. The renewed strength in capital spending carried over into the first half of 2004. Orders and shipments of nondefense capital goods have been on the rise, and backlogs of unfilled orders for new equipment continue to build.

A key element of the expansion that was still lacking in February, however, was evidence that businesses were willing to ramp up hiring to meet the stepped-up pace of sales and production. Businesses' ability to boost output without adding appreciably to their workforces likely resulted from a backlog of unexploited capabilities for enhancing productivity with minimal capital investment, which was an apparent outgrowth of the capital goods boom of the 1990s. Indeed, over much of the previous three years, managers had seemed to pursue every avenue to avoid new hiring despite rising business sales. Their hesitancy to assume risks and expand employment was accentuated and extended by the corporate accounting and governance scandals that surfaced in the aftermath of the decline in stock prices and also, of course, by the environment of heightened geopolitical tensions. Even now, following the pattern of recent quarters, corporate investment in fixed capital and inventories apparently continues to fall short of cash flow. The protracted nature of this shortfall is unprecedented over the past three decades. Moreover, the proportion of temporary hires relative to total employment continues to rise, underscoring that business caution remains a feature of the economic landscape.

That said, there have been much clearer indications over recent months that conditions in the labor market are improving. Most notably, gains in private nonfarm payroll employment have averaged about 200,000 per month over the past six months, up sharply from the pace of roughly 60,000 per month registered over the fourth quarter of 2003.

The improvement in labor market conditions will doubtless have important follow-on effects for household spending. Expanding employment should provide a lift to personal disposable income, adding to the support stemming from cuts in personal income taxes over the past year. In addition, the low interest rates of recent years have allowed many households to lower the burdens of their financial obligations. Although mortgage rates are up from recent lows, they remain quite attractive from a longer-run perspective and are providing solid support to home sales. Despite the softness of recent retail sales, the combination of higher current and anticipated future income, strengthened balance sheets, and still-low interest rates bodes well for consumer spending.

Consumer prices excluding food and energy--so-called core prices--have been rising more rapidly this year than in 2003. For example, the twelve-month change in the core personal consumption expenditures price index stood at 0.8 percent in December of last year and climbed to 1.6 percent by May of this year. Core inflation, of course, has been elevated by the indirect effects of higher energy prices on business costs and by increases in non-oil import prices that reflect past dollar depreciation and the surge in global prices for primary commodities. But the acceleration of core prices has been augmented by a marked rise in profit margins, even excluding domestic energy corporations.

This surge in profits reflects, at least in part, the recent recovery of demand after a couple of years during which weak demand led to relatively heavy price discounting by businesses. Profits of nonfinancial corporations as a share of sector output, after falling to 7 percent in the third quarter of 2001, rebounded to 12 percent in the first quarter of 2004, a pace of advance not experienced since 1983. Half of this rise in the profit share occurred between the first quarter of 2003 and the first quarter of 2004, a period during which business costs were unusually subdued. In fact, consolidated unit costs for the nonfinancial corporate business sector actually declined during this period. The increase in output per hour in the nonfinancial corporate business sector of more than 6 percent accounted for much of the net decline in unit costs. The remainder was due to the effects of rising output in reducing nonlabor fixed costs per unit of output. Hence, at least from an accounting perspective, between the first quarter of 2003 and the first quarter of 2004, all of the 1.1 percent increase in the prices of final goods and services produced in the nonfinancial corporate sector can be attributed to a rise in profit margins rather than rising cost pressures.

However, businesses are limited in the degree to which they can raise margins by raising prices. An increase in margins should affect mainly the *level* of prices associated with any given level of unit costs but, by itself, should not prompt a sustained pickup in the rate of inflation going forward. In a market economy, any tendency for profit margins to continue to rise is countered largely by the entry of new competitors willing to undercut prices and by increased labor costs as more firms attempt to exploit the opportunity for outsized profits by expanding employment and output. That increase in competitive pressure, as history has amply demonstrated, with time, returns markups to more normal levels.

Over the past three decades, the share of the profits of nonfinancial corporations in the total nominal income of that sector has fluctuated around a longer-run average of roughly 10-1/2 percent. The profit share in the first quarter of this year, at about 12 percent, was well above that level. The gap suggested that the growth of unit profits would eventually slow relative to increases in unit costs. This outlook had accorded with analysts' expectations for earnings growth over the next year, which are substantially below the realized growth of profits in recent quarters.

Indeed, some leveling or downward pressure on profit margins may already be in train, owing to a pickup in unit labor costs. Although advances in productivity are continuing at a rate above the long-term average, they have slowed from the extraordinary pace of last summer and are now running below increases in hourly compensation. The available information suggests that hourly compensation has been increasing at an annual rate of about 4-1/2 percent in the first half of the year. To be sure, the increases in average hourly earnings of nonsupervisory workers have been subdued in recent months and barely budged in June. But other compensation has accelerated this year, reflecting continued sizable increases in health insurance costs, a sharp increase in business contributions to pension funds, and an apparently more robust rate of growth of hourly earnings of supervisory workers. The larger wage gains for supervisory workers together with anecdotal reports of growing skill shortages are consistent with earlier evidence of rising wage premiums for skilled workers relative to less-skilled workers.

For the moment, the modest upward path of unit labor costs does not appear to threaten longer-term price stability, especially if current exceptionally high profit margins begin to come under more intense competitive pressures at home and from abroad. Although some signs of protectionist sentiment have emerged, there is little evidence that the price-containing forces of ever-widening global competition have ebbed. In addition, the economy is not yet operating at its productive capacity, which should help to contain cost pressures. But we cannot be certain that this benign environment will persist and that there are not more deep-seated forces emerging as a consequence of prolonged monetary accommodation. Accordingly, in assessing the appropriateness of the stance of policy, the Federal Reserve will pay close attention to incoming data, especially on costs and prices.

What does seem clear is that the concerns about the remote possibility of deflation that had been critical in the deliberations of the Federal Open Market Committee (FOMC) last year can now be safely set aside. Those deflationary pressures were largely a consequence of the stock market slump, the capital goods contraction that commenced in 2000, and, as I noted earlier, the extreme business caution that followed from these events as well as from terrorist attacks, corporate scandals, and the lead-up to the war in Iraq. Both equity prices and capital goods spending have turned up over the past year, and the probability that economic activity might stagnate has receded.

As always, considerable uncertainties remain about the pace of the expansion and the path of inflation. Some of those uncertainties, especially ones associated with potential terrorism both here and abroad, are difficult to quantify. Such possibilities have threatened the balance of world supply and demand in oil markets in recent months, especially as demand has risen with the pace of world economic growth. Yet aside from energy, markets exhibit little evidence of heightened perceptions of risk. Credit spreads remain low, and market-based indicators of inflation expectations, after rising earlier this year, have receded.

With the growth of aggregate demand looking more sustainable and with employment expanding broadly, the considerable monetary accommodation put in place starting in 2001 is becoming increasingly unnecessary. In May, the FOMC believed that policy accommodation needed to be removed and that removal could be accomplished at a pace that is likely to be measured. At our meeting last month, the FOMC raised the target federal funds rate from 1 percent to 1-1/4 percent, and the discount rate was raised commensurately. Policymakers reiterated that, based on our current outlook, the removal of accommodation would likely proceed at a measured pace. But in light of the considerable uncertainty surrounding the anticipated evolution of price pressures, the FOMC emphasized that it will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

If economic developments are such that monetary policy neutrality can be restored at a measured pace, a relatively smooth adjustment of businesses and households to a more typical level of interest rates seems likely. Even if economic developments dictate that the stance of policy must be adjusted in a less gradual manner to ensure price stability, our economy appears to have prepared itself for a more dynamic adjustment of interest rates. Of course, considerably more uncertainty and hence risk surrounds the behavior of the economy with a more rapid tightening of monetary policy than is the case when tightening is more measured. In either scenario, individual instances of financial strain cannot be ruled out.

The protracted period of low interest rates has facilitated a restructuring of household and business balance sheets. Businesses have been able to fund longer-term debt at highly favorable interest rates and, by extending the maturity of their liabilities, have rendered net earnings and capital values less exposed to destabilizing interest rate spikes. Households have made similar adjustments. Between mid-2002 and mid-2003, homeowners were able to refinance at lower interest rates almost half of total outstanding home mortgage debt and thereby to substantially reduce monthly debt service payments. Households also substituted mortgage debt for more-expensive consumer credit. Moreover, those households and businesses that held long-term investment-grade bonds in that year accumulated realized and unrealized capital gains as long-term rates declined.

The FOMC judged this extended period of exceptionally low interest rates to have been helpful in assisting the economy in recovering from a string of adverse shocks. But in the process of returning the stance of policy to a more neutral setting, at least some of the capital gains on debt instruments registered in recent years will inevitably be reversed.

Prices in financial markets have already adjusted in anticipation of a significant amount of policy tightening, engendering additional alteration of balance sheets in recent months. An unwinding of carry trades--that is, market positions premised on low short-term financing costs--seems to be under way, at least judging from a pronounced shift in the trading portfolios of primary dealers. In addition, investors classified as non-commercial have established net short positions in ten-year Treasury note futures in recent months. Indeed, the swing toward a net short position on ten-year Treasury note futures has been the largest since the inception of the contract in the 1980s, likely offsetting a significant portion of the interest rate exposure of previously established carry trade positions.

Moreover, the recent increase in market interest rates has slowed the pace of mortgage refinancing and reportedly has precipitated some winding down of leveraged positions among major mortgage market participants. These circumstances are quite different from the situation prevailing at this time last summer. Then, record levels of refinancing in the second half of 2002 and the first half of 2003 had pushed the duration of mortgage-backed securities (a measure of the price sensitivity of fixed-income instruments to changes in interest rates) to exceptionally low levels. As mortgage and other long-term rates rebounded last summer, a consequence of rapidly improving economic conditions and the fading of deflationary concerns, refinancing fell sharply, removing most downward pressure on duration. Holders of mortgage-backed securities endeavoring to hedge the resulting shifts in interest rate gaps moved rapidly to shed Treasuries and receive-fixed interest rate swaps, and these actions magnified last summer's upturn in long-term interest rates. In the current environment, by contrast, it appears that the scope for such mortgage hedging effects to greatly amplify an increase in long-term rates is much diminished given the decline in the pace of refinancing and the associated increase in mortgage durations that have already occurred.

Lastly, very large fractions of the total outstanding obligations of businesses and households are long-term, fixed-rate debt. As a result, rising market interest rates will not have much immediate direct effect on business and household debt service burdens. Indeed, from early 1999 through early 2000, a period when interest rates on new home mortgage originations rose more than 150 basis points, the average interest rate on the total of home mortgage debt outstanding barely moved. Nonetheless, despite the lock-in of low interest rate costs on a substantial share of household and business liabilities, recent higher market interest rates will, in time, show through into increased charges against household and business income. To be sure, financial intermediaries and other creditors that extended loans or purchased securities in recent years at relatively low long-term interest rates will sustain capital losses as rates rise. In general, however, financial intermediaries are profitable and well-capitalized and appear to be well positioned to manage in a rising rate environment.

In short, financial markets along with households and businesses seem to be reasonably well prepared to cope with a transition to a more neutral stance of monetary policy. Some risks necessarily attend this transition, but they are outweighed in our judgment by those that would be associated with maintaining the existing degree of monetary policy accommodation in the current environment. Although many factors may affect inflation in the short-run, inflation in the long-run, it is important to remind ourselves, is a monetary phenomenon.

As we attempt to assess and manage these risks, we need, as always, to be prepared for the unexpected and to respond promptly and flexibly as situations warrant. But although our actions need to be flexible, our objectives are not. For twenty-five years, the Federal Reserve has worked to reestablish price stability on a sustained basis. An environment of price stability allows households and businesses to make decisions that best promote the longer-term growth of our economy and with it our nation's continuing prosperity.

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

Submitted pursuant to section 2B of the Federal Reserve Act

July 20, 2004

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 20, 2004

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

Contents

Monetary Policy Report to the Congress

Report submitted to the Congress on July 20, 2004, pursuant to section 2B of the Federal Reserve Act

MONETARY POLICY AND THE ECONOMIC OUTLOOK

The economic expansion in the United States became increasingly well established in the first half of 2004, but the pace of inflation picked up from its very low rate in 2003. At the time of the February *Monetary Policy Report to the Congress,* considerable evidence was already in hand indicating that the U.S. economy had made the transition from a period of subpar growth to one of more-vigorous expansion. Nevertheless, job creation remained limited, and gains in investment, although sizable, still seemed restrained by a lingering caution on the part of some businesses. In the event, businesses stepped up their hiring in the spring, and capital spending seems to have continued apace.

Over the first half of this year, energy prices soared; moreover, inflation in core consumer prices—as measured by the price index for personal consumption expenditures excluding the direct effects of movements in food and energy prices—increased from an exceptionally low rate of 1 percent over the four quarters of 2003 to an annual rate of a little more than 2 percent. To some extent, the upturn in core inflation reflected the indirect effects of higher energy prices, but other forces also played a role. Strengthening aggregate demand both at home and abroad induced a surge in the prices of many primary commodities and industrial materials. In addition, the decline in the foreign exchange value of the dollar in 2003 put upward pressure on the prices of imported goods and services. With strong demand in the United States and increased utilization of the productive capacity of the economy, firms were better able to pass on the higher costs of imports, raise the prices of domestically produced items that compete with imports, and in many cases boost their profit margins. Likely in response to the faster rate of price increases experienced this year, surveys suggest that near-term inflation expectations have moved up somewhat; still, expectations for price inflation over the longer term have remained in their recent range.

Monetary policy was very accommodative at the start of 2004 as the Federal Open Market Committee (FOMC) sought to provide continuing support to an economic expansion that had yet to produce a sustained improvement in the labor market and to ensure that the previous year's threat of an unwelcome disinflation would continue to recede. Although real GDP had accelerated sharply in the second half of 2003, the incoming data through the time of the March meeting suggested that employment was growing only slowly, as employers were relying on increased production efficiencies to satisfy considerable gains in aggregate demand. Surging oil prices were boosting overall inflation, while core inflation—though no longer declining—was still low. With subsequent labor market reports suggesting that hiring was on a stronger track, growth in output continuing at a solid pace, and core consumer price inflation possibly running higher, the FOMC announced in May that it saw the risks to the goal of price stability as having moved into balance. Even so, the Committee stated that it believed that the monetary policy accommodation then in place could be "removed at a pace that is likely to be measured." Indeed, at its June meeting, the FOMC decided that sufficient evidence was in hand to begin moving the federal funds rate back toward a more neutral setting and raised the federal funds rate ¼ percentage point to 1¼ percent, a decision that was widely anticipated by market participants.

Although some of the recent data have been on the soft side, the available information on the outlook for the U.S. economy is, on balance, positive. Households are enjoying a generally improving job market, rising real incomes, and greater wealth, all of which are providing them with the confidence and wherewithal to spend. In the business sector, capital spending apparently is continuing to increase briskly, bolstered by expectations of strong sales as well as by booming profits and supportive financial conditions; investment should also continue to be buoyed by firms' adoption of productivity-enhancing technologies. Moreover, inventories appear to be lean relative to sales even after taking account of the substantial improvements firms have made in managing their stocks, suggesting that stockbuilding may provide some impetus to production in the near term. The brightening outlook for economic activity abroad suggests that demand for U.S. exports should grow and provide a further lift to domestic production.

The prospects also seem favorable for inflation to remain contained in the period ahead. For one reason, some of the forces that contributed to the upturn in core inflation in the first half of 2004 are likely to prove transitory. In particular, the upward impetus from the rise in energy and commodity prices is likely to lessen in coming quarters. For another reason, the evidence suggests that the productive capacity of the economy is still not being fully used and that the attendant slack is probably exerting some downward pressure on inflation. If—as seems likely—the economy approaches full utilization of its productive capacity only gradually, that downward pressure should persist for a time. Moreover, productivity remains on a solid uptrend and should continue to restrain costs. To date, the gains in productivity have helped to boost profit margins. As firms compete to take advantage of profit opportunities, they may eventually be forced to absorb a portion of any increases in labor and other costs that occur. But history suggests that the absorption of costs has limits. Indeed, unit labor costs have turned up of late, as productivity growth has slowed below the rate of increase in hourly compensation. If increases in those costs were to develop any upward momentum, the well-behaved nature of inflation in recent years could be jeopardized.

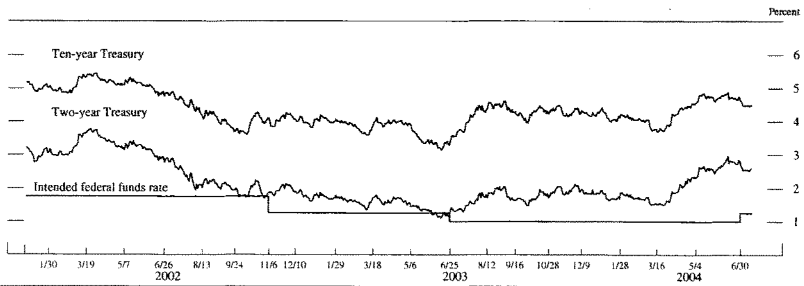
Monetary Policy, Financial Markets, and the Economy over the First Half of 2004

At the beginning of 2004, the FOMC was growing more confident that the economic expansion was likely to be self-sustaining, particularly in light of the significant firming of business outlays and the continued strength in household spending. Moreover, stimulative fiscal and monetary policies, in conjunction with receptive financial markets, appeared likely to provide substantial support to economic activity and to ward off any further disinflation. However, the Committee remained concerned about the persistent weakness in the labor market. At its January meeting, the FOMC left the target for the federal funds rate at 1 percent. The Committee generally felt that the apparent slack in labor and product markets and continued strong productivity growth were likely to keep the underlying trend in inflation subdued, but it nevertheless was cognizant that a highly accommodative stance for monetary policy could not be maintained indefinitely. Given these considerations, the Committee modified the language of its policy statement to gain greater flexibility to firm policy should circumstances warrant. The Committee achieved this added flexibility by removing its assessment that monetary policy would be accommodative for "a considerable period" and instead saying that the Committee could be "patient" in removing its policy accommodation.

At the time of the March FOMC meeting, the Committee believed that conditions were mostly in place for further solid economic growth. Industrial production had picked up broadly, and consumer and business spending continued to expand briskly. However, the employment reports for January and February still painted a picture of subdued hiring. With financial markets quite accommodative, the Committee recognized that maintaining the current stance of policy could fuel inflation pressures and perhaps encourage excessive risk-taking by financial market participants. The Committee concluded that the low level of core consumer price inflation and continued evidence of weak hiring argued for the retention of both its 1 percent target for the federal funds rate and the wording in its statement that the Committee could be "patient" with respect to changes in monetary policy.

At the May FOMC meeting, members noted a distinct improvement in the economic outlook. The labor market

Selected interest rates



NOTE. The data are daily and extend through July 14, 2004. The dates on the horizontal axis are those of FOMC meetings.

figures reported for March had proved to be strong, and the reports for the two previous months had been revised upward significantly. Consumer price inflation in the first quarter of the year was faster than it had been in the previous quarter. Although much of this rise was due to escalating energy costs, core inflation also stepped up, and survey-based measures of near-term inflation expectations had edged higher. In response to the indications of rising aggregate demand and a strengthening job market, yields on Treasury securities had risen appreciably. Accordingly, the Committee was of the view that the expansion would be vigorous and believed that the odds of any further disinflation had been substantially reduced. On the basis of the evolving outlook for economic activity and prices, the Committee revised its assessment of risks to indicate that the upside and downside risks for inflation had moved into balance. To underscore its belief that policy would probably soon need to move toward a more neutral stance while emphasizing that this process was not expected to be rapid, the Committee stated its judgment that monetary policy accommodation "can be removed at a pace that is likely to be measured."

At the time of the June FOMC meeting, incoming information tended to confirm that the economy was expanding at a solid pace but also indicated that inflation was higher than had been anticipated. Quotes on near-term money market futures and options suggested that market participants were nearly certain of an increase of 25 basis points in the target for the federal funds rate at that meeting and had priced in a cumulative increase of about 2¼ percentage points in the federal funds rate over the next year. The Committee agreed that the current substantial degree of policy accommodation was no longer warranted and decided to increase its target for the federal funds rate 25 basis points. The Committee noted that it considered the risks to both sustainable economic growth and stable prices to be roughly balanced and maintained its appraisal that policy accommodation "can be removed at a pace that is likely to be measured" but also emphasized that it will "respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

Economic Projections for 2004 and 2005

In conjunction with the FOMC meeting at the end of June, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, were asked to provide economic projections for 2004 and 2005. The central tendency of the FOMC participants' forecasts for the increase in real GDP is 4½ percent to 4¾ percent over the four quarters of 2004 and 3½ percent to 4 percent in 2005.

Economic projections for 2004 and 2005

Percent

Indicator	Federal Reserve Governors and Reserve Bank presidents: Range	Central tendency
	2004	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	6–7	6¼–6¾
Real GDP	4–4¾	4½–4¾
PCE price index excluding food and energy	1½–2	1¾–2
Average level, fourth quarter		
Civilian unemployment rate	5¼–5½	5¼–5½
	2005	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4¾–6½	5¼–6
Real GDP	3½–4	3½–4
PCE price index excluding food and energy	1½–2½	1½–2
Average level, fourth quarter		
Civilian unemployment rate	5–5½	5–5¼

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

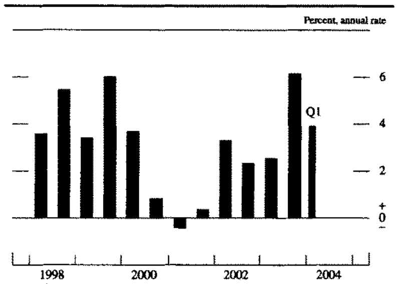
The civilian unemployment rate is expected to lie between 5¼ percent and 5½ percent in the fourth quarter of 2004 and to decline to between 5 percent and 5¼ percent by the fourth quarter of 2005.

Starting with this report, the Federal Reserve will provide projections for the price index for personal consumption expenditures excluding food and energy (core PCE), which the Committee believes is better as an indicator of underlying inflation trends than is the overall PCE price measure previously featured. Core PCE inflation appears to have run a little above an annual rate of 2 percent in the first half of 2004; for 2004 as a whole, most FOMC participants expect it to lie between 1¾ percent and 2 percent. For 2005, the central tendency of the projections for core PCE inflation is 1½ percent to 2 percent.

Economic and Financial Developments in 2004

After having surged in the second half of 2003, economic activity continued to expand at a solid pace in the first half of 2004. In the labor market, payroll employment started to increase last fall after a long string of declines and picked up further during the first half of this year. Headline inflation has been boosted significantly by the jump in energy prices this year, but core inflation has also moved up from the exceptionally low levels of late 2003.

Change in real GDP



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

The Household Sector

Consumer Spending

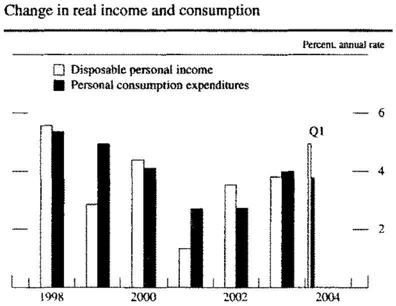
Consumer spending, which had gathered a good bit of steam in the second half of 2003, continued to move higher in the first half of 2004. The growth in spending was spurred by substantial gains in income. In addition, household wealth has risen sharply over the past year, and consumer surveys indicate that individuals are generally upbeat in their assessments of the economy's prospects and of their own situations.

Personal consumption expenditures rose at an annual rate of 3¾ percent in real terms in the first quarter. Spending on light motor vehicles, which had been supported in late 2003 by aggressive price and financing incentives, slipped somewhat in early 2004. But outlays for goods other than motor vehicles, which had risen 6½ percent in real terms in 2003, posted another huge increase in the first quarter; spending on services also perked up after having advanced only modestly in 2003. The available data point to a much smaller increase in consumer spending in the second quarter; the deceleration mainly reflects a sharp slowing in the growth of outlays on goods other than motor vehicles.

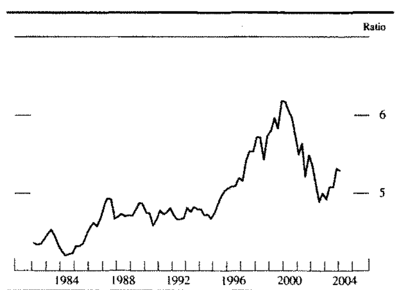
Real disposable personal income (DPI)—that is, after-tax income adjusted for inflation—rose at an annual rate of nearly 4 percent between the fourth quarter of 2003 and May 2004, a gain about in line with its rate of growth last year. To be sure, the rise in energy prices cut into the growth of real income in the first half of the year. However, aggregate wages and salaries, boosted by increases in both employment and earnings, rose appreciably in nominal terms. In addition, last year's tax legislation, which had already reduced withholding rates in mid-2003, added further to households' cash flow by increasing refunds and lowering final settlements this spring.

Household wealth increased only about in line with nominal DPI in the first quarter of 2004, and the wealth-to-income ratio was likely little changed in the second quarter as well. Nonetheless, the increase in wealth over the past year has been considerable—and probably large enough to more or less offset any lingering restraint on spending growth from the earlier declines in stock prices. Thus, with wealth approximately a neutral influence on the growth of spending of late, the personal saving rate has held fairly steady. In fact, the average saving rate over the first five months of the year—at 2¼ percent of DPI—was very close to the annual figures for 2002 and 2003.

Change in real income and consumption

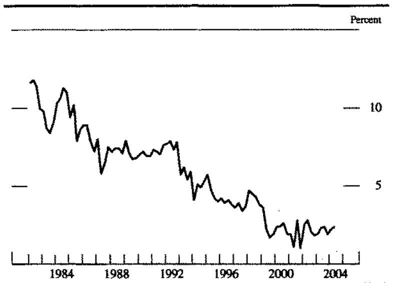


Wealth-to-income ratio



NOTE. The data are quarterly and extend through 2004:Q1. The wealth-to-income ratio is the ratio of household net worth to disposable personal income.

Personal saving rate

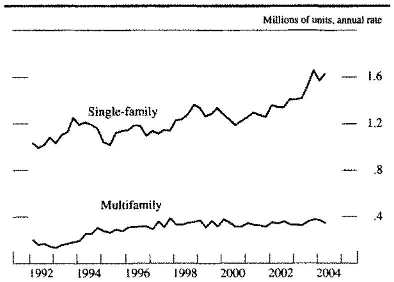


NOTE. The data are quarterly; the reading for 2004:Q2 is the average for April and May.

Residential Investment

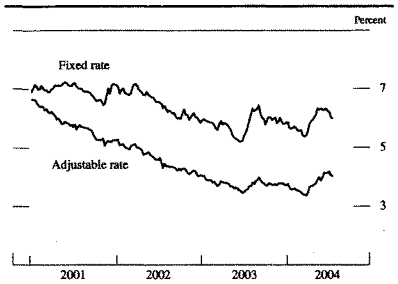
Activity in the housing sector remained torrid in the first half of 2004. Although starts in the single-family sector faltered a bit early in the year, in part because of unusually adverse weather, they subsequently snapped back and reached an annual rate of more than 1.6 million units in April and May—8½ percent greater than the already rapid pace for 2003 as a whole. Sales of new and existing homes have also been exceptionally strong, and they hit record highs in May. In general, housing activity has been supported by the favorable developments regarding jobs and income and, especially early in the year, by low mortgage rates. Rates on thirty-year fixed-rate mortgages, which had dipped to 5½ percent in March, rose markedly in the spring; they have edged down in recent weeks and now stand at 6 percent, a level still quite low by historical standards.

Private housing starts



NOTE. The data are quarterly; the readings for 2004:Q2 are the averages for April and May.

Mortgage rates



NOTE. The data, which are weekly and extend through July 14, 2004, are contract rates on thirty-year mortgages.
SOURCE. Federal Home Loan Mortgage Corporation.

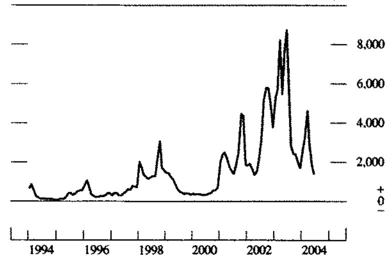
Home prices have continued to rise rapidly. For example, the national repeat-sales price index from the Office of Federal Housing Enterprise Oversight—which partially adjusts for shifts in the quality of homes sold—rose 7¾ percent over the year ending in the first quarter (the latest available data), a rate similar to the average annual gain since late 2000. By this measure—and many others—house price increases have outstripped gains in incomes as well as in rents in recent years.

Starts in the multifamily sector averaged an annual rate of 360,000 units over the first five months of the year, a pace slightly faster than that of the past several years. Low interest rates have apparently helped maintain the profitability of apartment construction, given that other fundamental determinants of activity in the sector have been weak: In particular, rents have remained soft, and in the first quarter, vacancy rates for multifamily rental properties reached a new high.

Household Finance

Household debt rose at an annual rate of about 10¾ percent in the first quarter of 2004. The especially rapid growth of mortgage debt was driven by the strong pace of activity in the housing market and the renewed wave of mortgage refinancing. However, the second-quarter rise in interest rates appears to have slowed the rate of refinancing and, consequently, the amount of equity being extracted from the value of homes through such transactions. Consumer credit—which constitutes the bulk of household debt aside from mortgage borrowing—expanded at an annual rate of about 6 percent over the first quarter of the year and at roughly a 4 percent pace in April and May. The growth of consumer credit likely has continued to be restrained by the substitution

Mortgage refinancing application index

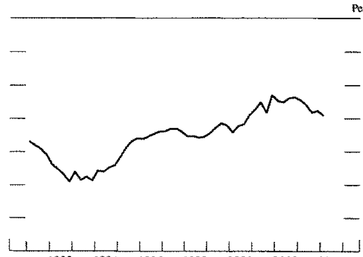


NOTE. The data are monthly and extend through June 2004.
SOURCE. Mortgage Bankers Association.

toward mortgage debt as a means to finance household expenditures.

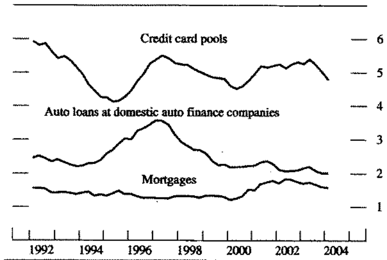
Low interest rates, in concert with strong growth in disposable personal income, have helped to keep financial obligations manageable for most households. In the first quarter of the year, the debt service ratio and the financial obligations ratio for the household sector in the aggregate, both of which gauge pre-committed expenditures relative to disposable income, continued to edge down from their peaks in 2001. Other indicators also suggest that the financial well-being of households has stabilized and may be improving. Delinquencies on credit card and auto loans generally declined in the first three months of the year, and bankruptcy rates, while still high, stepped down in the first quarter from their recent peak.

Household financial obligations ratio



NOTE. The data are quarterly and extend through 2004:Q1. The financial obligations ratio equals the sum of required payments on mortgage and consumer debt, automobile leases, rent on tenant-occupied property, homeowners' insurance, and property taxes, all divided by disposable personal income.

Delinquency rates on selected types of household loans



NOTE. The data are quarterly and extend through 2004:Q1.
SOURCE. For mortgages, the Mortgage Bankers Association; for auto loans, the Big Three automakers; for credit cards, Moody's Investors Service.

Rapid increases in home prices have continued to buoy household net worth this year. In contrast, stock prices are about unchanged. Although news on earnings and economic activity has generally been favorable, rising oil prices and interest rates and, perhaps, heightened geopolitical concerns have weighed on investor sentiment. Nevertheless, inflows into equity mutual funds have been even stronger thus far in 2004 than they were last year.

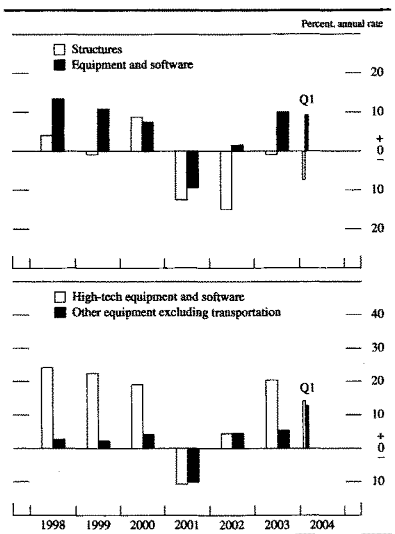
The Business Sector

Fixed Investment

For the most part, businesses appear to be shaking off the extraordinary reluctance to undertake new investment projects that was evident in 2002 and 2003. Indeed, although outlays on nonresidential construction have not yet turned up decisively, real spending on equipment and software (E&S) has been advancing briskly. The broadly based growth in E&S spending has been driven by increasingly favorable fundamentals: positive expectations for sales, high levels of corporate profits and cash flow, a desire to replace or upgrade aging equipment after a period of weak investment spending, and the continued low cost of capital.

Real E&S spending rose at an annual rate of more than 15 percent in the second half of last year, and it posted another sizable increase in the first quarter of 2004 despite flat business purchases of motor vehicles and a dip in deliveries of aircraft. Excluding transportation equipment, real spending on E&S rose at an annual rate of 13½ percent in the first quarter. In the high-tech category, real purchases of computers and software remained on the solid uptrend that has been evident for the past couple of years, and real outlays on communications

Change in real business fixed investment



NOTE. High-tech equipment consists of computers and peripheral equipment and communications equipment.

equipment increased further, reaching a level about 20 percent above the low in the fourth quarter of 2002. Spending for equipment other than high-tech and transportation, which accounts for about 40 percent of E&S (measured in nominal terms), also rose markedly in the first quarter. Such spending tends to be particularly sensitive to the prospects for aggregate demand. In addition, it may be receiving a lift from the partial-expensing tax provision, which is especially valuable for equipment with relatively long service lives for tax purposes; that provision is slated to expire at the end of 2004.

Equipment spending appears to have posted another solid increase in the second quarter. Outlays on transportation equipment seem to have rebounded, and the incoming data on high-tech equipment point to robust real expenditures. Some indicators for spending on other nontransportation equipment have been a bit soft recently. But the May level of shipments for this broad category was still above that of the first quarter, and backlogs of unfilled orders, which have risen impressively over the past year, continued to build.

Real nonresidential construction has remained about unchanged, on net, since the steep decline in 2001 and 2002. Construction of office buildings is still running at roughly half the pace of 2000, although vacancy rates have stabilized—albeit at very high levels—and the decline in rents has slowed. Factory construction also remains sluggish. Construction of retail and wholesale facilities, in contrast, has held up fairly well, a performance consistent with the strength in consumer spending. Outlays on buildings for health care and education also have been reasonably well sustained.

Inventory Investment

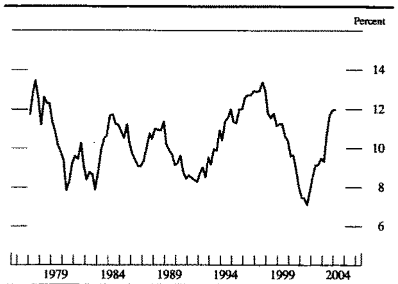
Inventory investment has generally remained subdued even as final sales have strengthened. Although real nonfarm inventory investment picked up to an annual rate of $30 billion in the first quarter, the accumulation occurred almost entirely in the motor vehicle sector, in which sagging sales and a high level of production early in the year created a noticeable bulge in dealer stocks, especially of light trucks. In the second quarter, the automakers reduced assemblies; but with sales running only a little above their first-quarter pace on average, inventories of motor vehicles remained elevated. Outside the motor vehicle industry, nonfarm inventories increased at a meager $6 billion annual rate in real terms in the first quarter, and the available data point to only a moderate step-up in real stockbuilding, on balance, in April and May. In general, non-auto inventories appear lean relative to sales, even after factoring in the downward trend in inventory–sales ratios that has accompanied the ongoing improvements in supply-chain and logistics management.

Corporate Profits and Business Finance

Continuing the gains of last year, profits of the business sector to date have remained strong. In the first quarter of 2004, earnings per share for S&P 500 firms were about 26 percent higher than their level four quarters earlier, and before-tax profits of nonfinancial corporations as a share of GDP from that sector edged up following a steep increase in 2003. A jump in profits in the petroleum and gas industries owing to higher oil prices was responsible for much of the rise in earnings. However, firms across many industries, with the notable exception of telecommunication services, registered solid gains in earnings. In response to this pattern of higher profits, analysts have been steadily marking up their forecasts for earnings in subsequent quarters.

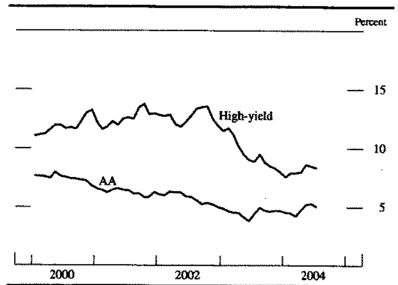
Net equity issuance has remained negative this year. Seasoned offerings have been scarce, the pace of initial public offerings has only inched up, and share retirements have continued to be strong. Corporations have continued to repurchase shares at a rapid rate to manage their

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



NOTE. The data are quarterly and extend through 2004:Q1. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.

Corporate bond yields



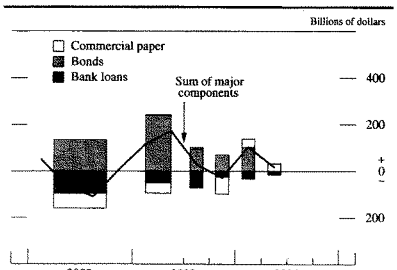
NOTE. The data are monthly averages of daily data. The final observation is the average of trading days through July 14, 2004. The AA rate is the Merrill Lynch AA index with a remaining maturity of seven to ten years. The high-yield rate is the yield on the Merrill Lynch 175 high-yield index.

cash positions, even as they have increased dividend payments.

Firms relied heavily on their elevated profits and substantial cash holdings to finance their investment in inventories and fixed capital in the first half of 2004. As a result, the growth of nonfinancial business debt remained modest. Much of the proceeds from bond issuance was used to pay down higher-cost debt, and the timing of the issuance of investment-grade bonds in particular was influenced by movements in interest rates; issuance spiked in March in the wake of the drop in yields but subsided in April as rates rebounded. Short-term debt financing showed signs of turning around after contracting over the previous three years. Commercial paper outstanding expanded in the first two quarters of 2004. Business loans at banks have fallen on balance so far this year but at a much slower pace than in 2003. The Federal Reserve's Senior Loan Officer Opinion Survey conducted in April 2004 indicated that demand for business loans had begun to expand and that commercial banks had again eased both standards and terms on these loans over the previous three months.

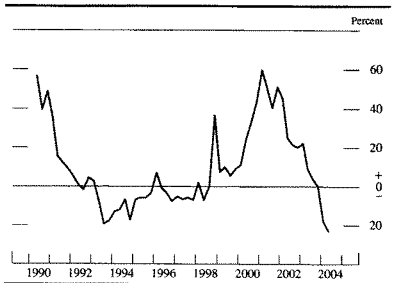
Strong profits, low interest rates, and continued deleveraging helped improve the credit quality of nonfinancial firms over the first half of the year. In the second quarter, the delinquency rate on business loans dropped

Major components of net business financing



NOTE. Seasonally adjusted annual rate for nonfinancial corporate business. The data for the sum of major components are quarterly. The data for 2004:Q2 are estimated.

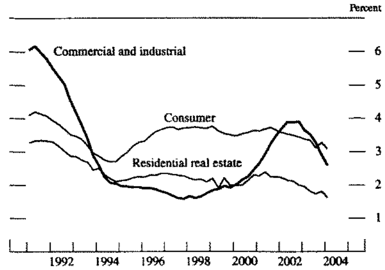
Net percentage of domestic banks tightening standards on commercial and industrial loans to large and medium-sized firms



NOTE. The data are based on a survey generally conducted four times per year; the last reading is from the April 2004 survey. Large and medium-sized firms are those with annual sales of $50 million or more. Net percentage is the percentage reporting a tightening less the percentage reporting an easing.

SOURCE. Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices.

Delinquency rates on selected types of loans at banks

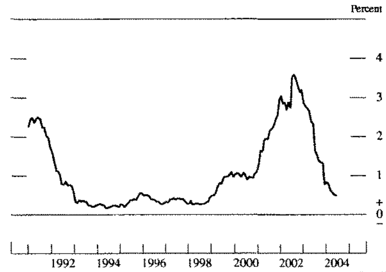


NOTE. The data, from bank Call Reports, are quarterly, are seasonally adjusted, and extend through 2004:Q1.

for the sixth consecutive quarter; the continued decline has reversed a large part of the preceding run-up. Early in the year the twelve-month trailing default rate on outstanding bonds fell into the relatively low range observed over much of the 1990s, and in June it registered another decline. Moreover, in the first part of the year, the pace of upgrades of bond ratings by Moody's Investors Service rose while the pace of downgrades fell.

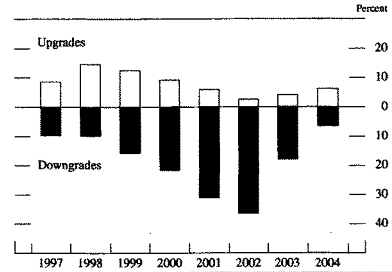
Borrowing against commercial real estate assets continued at a rapid pace during the first half of this year. Anecdotal reports suggest that some firms were using mortgages on commercial property to lock in low-cost, long-term funding. Despite the persistently high vacancy rates for most types of commercial property, the loans backed by these assets have continued to perform well.

Default rate on outstanding bonds



NOTE. The default rate is monthly and extends through June 2004. The rate for a given month is the face value of bonds that defaulted in the twelve months ending in that month divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the twelve-month period.
SOURCE. Moody's Investors Service.

Ratings changes of nonfinancial corporate bonds



NOTE. Data are at an annual rate; for 2004, they are the annualized values of monthly data through May. Debt upgrades and downgrades are expressed as a percentage of the par value of all bonds outstanding.
SOURCE. Moody's Investors Service.

Delinquency rates on commercial mortgages held by banks and insurance companies remained very low in the first quarter. A drop in delinquencies on commercial-mortgage-backed securities (CMBS) in recent months has partially reversed last year's rise, and the narrow risk spreads on CMBS suggest that investors have limited concerns about loan quality.

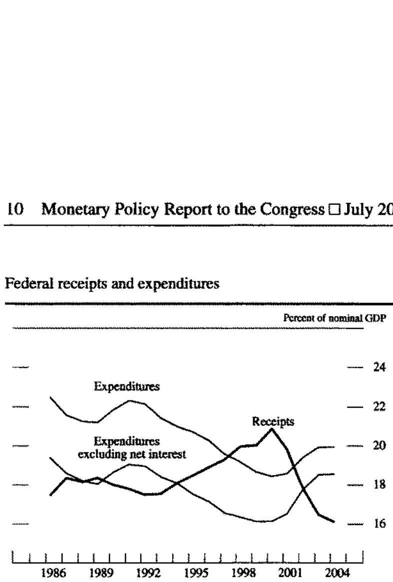
The Government Sector

Federal Government

The deficit in the federal unified budget has continued to widen. Over the twelve months ending in June, the unified budget recorded a deficit of $431 billion, $120 billion more than during the comparable period last year and equal to nearly 4 percent of nominal GDP. In large part, the rise in the deficit is attributable to further rapid increases in spending on defense and other programs and the loss of revenues resulting from the tax legislation enacted in recent years. In addition, interest costs, which fell sharply between fiscal 1997 and fiscal 2003 as a result of budget surpluses and declining interest rates, have leveled off and thus are no longer a significant factor helping to restrain the deficit. The primary deficit, which excludes net interest, totaled $276 billion over the twelve months ending in June, also approximately $120 billion more than over the year ending in June 2003.

Over the twelve months ending in June, nominal federal spending was nearly 7 percent higher than during the same period a year earlier and stood at about 20 percent of nominal GDP—virtually the same as in fiscal 2003 but 1½ percentage points above the recent low in fiscal 2000. Spurred by the war in Iraq, defense spending

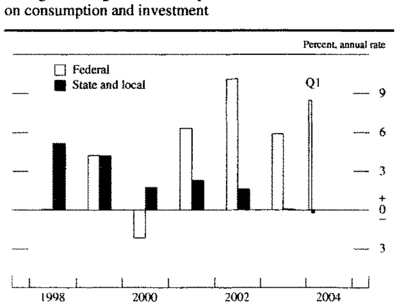
Federal receipts and expenditures



NOTE. The budget data are from the unified budget; through 2003 they are for fiscal years (October through September), and GDP is for Q4 to Q3. For 2004, the budget data are for the twelve months ending in June, and GDP is for 2003:Q4 to 2004:Q1.

ramped up another 14 percent; outlays for nondefense discretionary programs, which include homeland security, moved up further as well. Spending on the major health programs rose at a rapid clip, in part because the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) temporarily increased grants to the states under the Medicaid program and boosted payments to some Medicare providers. In addition, as noted, net interest payments, which had plummeted between 1997 and 2003, flattened out. Real federal expenditures for consumption and gross investment—the part of government spending that is a component of real GDP—rose at an annual rate of 8½ percent in the first calendar quarter of 2004; that increase reflected a surge in real defense spending, which now stands more than 30 percent above the levels that prevailed, on average, from 1997 to 2000.

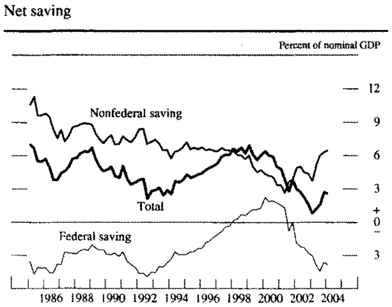
Change in real government expenditures on consumption and investment



Federal receipts in the twelve months ending in June were 1½ percent higher than during the comparable period of the previous year after having fallen markedly between fiscal 2000 and fiscal 2003. Receipts received a substantial boost over the past year from a strong gain in corporate taxes, which were lifted by robust profits. Social insurance taxes, which tend to move in line with wages and salaries, also increased. But individual income taxes were below last year's level: Although taxable incomes rose moderately, collections were reduced by the lower withholding rates in place since mid-2003 and by the effects of JGTRRA on refunds and final settlements this spring.

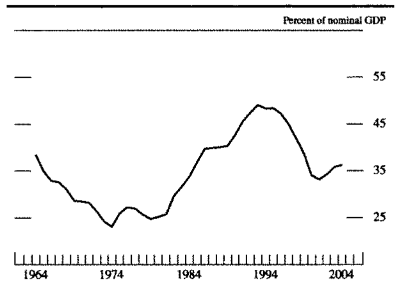
The deterioration in the unified budget since 2000 has been mirrored in a sharp downswing in federal saving—essentially, the unified surplus or deficit adjusted to conform to the accounting practices followed in the national income and product accounts (NIPA). Gross federal saving fell from a high of nearly 3 percent of nominal GDP in 2000 to negative 3 percent of GDP in the first quarter of 2004; measured net of estimated depreciation, federal saving fell from 2 percent of GDP to negative 4 percent of GDP over this period. In the past couple of years, the rise in business saving from the rebound in profits and reductions in corporate taxes has cushioned to some extent the effect of growing budget deficits on national saving. In fact, because of the dramatic increase in business saving in recent quarters, national saving has recovered some from the extreme lows of early 2003. Even so, as of the first quarter of 2004, national saving (measured net of estimated depreciation) was still equal to just about 2½ percent of GDP, compared with a recent high of 6½ percent in 1998. If not reversed over the longer haul, such low levels of national saving could eventually impinge

Net saving



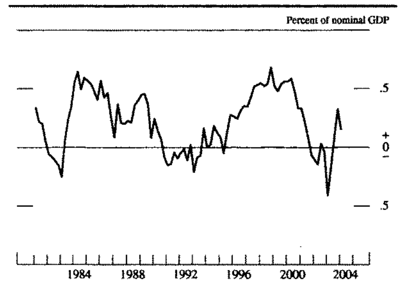
NOTE. The data are quarterly and extend through 2004:Q1. Nonfederal saving is the sum of personal and net business saving and the net saving of state and local governments.

Federal government debt held by the public



NOTE. Through 2003, the data for debt are year-end figures, and the corresponding value for GDP is for Q4 at an annual rate; the final observation is for 2004:Q1. Excludes securities held as investments of federal government accounts.

State and local government net saving



NOTE. The data, which are quarterly, are on a national income and product account basis and extend through 2004:Q1. Net saving excludes social insurance funds.

on private capital formation and thus slow the rise of living standards.

Reflecting the need to finance the sizable federal budget deficit, federal debt held by the public expanded at an annual rate of 11¾ percent in the first half of the year. The ratio of this debt to nominal GDP now exceeds 36 percent. The Treasury tilted its issuance toward longer-term and inflation-indexed securities somewhat, and announced semiannual issuance of a twenty-year inflation-protected bond beginning in July and a five-year inflation-protected note beginning in October.

State and Local Governments

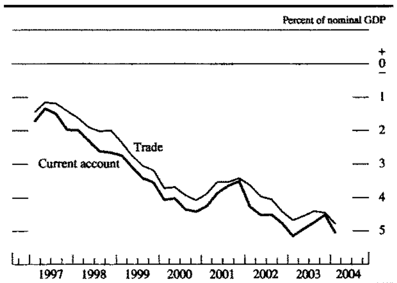
States and localities have started to see some improvement in their budget positions after having gone through several difficult years. Strong growth in household income and consumer spending has boosted revenues in recent quarters, as have the additional federal grants authorized under JGTRRA. And although rising medical costs and security needs have continued to put upward pressure on spending, state and local governments have generally held the line on hiring and have kept other outlays in check. The restraint on spending, in combination with a drawdown of reserve funds and some increases in taxes, has helped states and localities satisfy their balanced-budget requirements. In fact, between the third quarter of 2003 and the first quarter of 2004, NIPA net saving (excluding social insurance funds) for this sector averaged $21 billion at an annual rate (¼ percent of nominal GDP), compared with negative $7 billion in 2002 and negative $31 billion in the first half of 2003. (Net saving is roughly similar to the surplus or deficit in an operating budget.) Although a few states are still struggling with strained fiscal situations, most have entered fiscal 2005 (which started on July 1 in all but four states) with expectations of respectable growth in revenues and with budgets in place that allow for some increases in spending on high-priority services and some rebuilding of reserve funds.

Real consumption and investment spending by state and local governments was essentially flat in the first quarter of 2004; available indicators point to a moderate increase in the second quarter. Outlays for consumption items, which were little changed in 2003, appear to have remained subdued throughout the first half of the year. Investment expenditures also were about unchanged in the first quarter, but they turned up sharply in the spring, mainly because of a jump in spending on highways.

Significant demand for infrastructure spending and favorable interest rates led to robust issuance of state and local government debt to finance capital expenditures and to advance refund higher-cost debt. Nevertheless, over the first half of the year, net issuance edged down from its rapid pace in 2003 to about a 6 percent annual rate. The deceleration reflected a decline in short-term borrowing as improvements in the fiscal positions of state and local governments lessened the need for temporary funding of budget shortfalls.

The credit quality of municipal borrowers has stabilized after two years of deterioration; for the year to date, upgrades and downgrades of credit ratings have been roughly equal. In a marked change from last year's sentiment, rating agencies have begun to express guarded optimism about the credit quality of states because of improvements in state revenue flows and restraint on spending.

U.S. trade and current account balances



NOTE. The data are quarterly and extend through 2004:Q1.
SOURCE. Department of Commerce.

The External Sector

In the first quarter of 2004, the U.S. current account deficit expanded to an annual rate of $580 billion, or about 5 percent of GDP. As in the past, the widening was driven primarily by a larger deficit in trade of goods and services. The surplus on net investment income declined in the first quarter but remained well above its average value in the previous year. The deficit on net unilateral transfers rose because of a concentration of disbursements of government grants in the first quarter.

International Trade

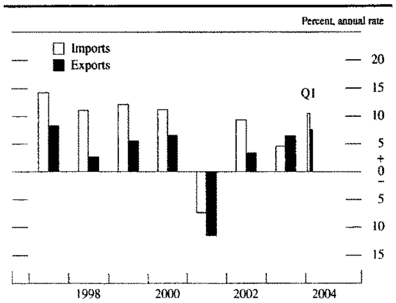
The U.S. trade deficit in goods and services registered $548 billion at an annual rate in the first quarter, about $46 billion larger than in the fourth quarter of 2003. On average, data for April and May suggest that the trade deficit continued to widen in the second quarter.

Real exports of goods and services increased at an annual rate of 7½ percent in the first quarter of 2004, well off the blistering 20 percent pace of the fourth quarter but still above the average for 2003. Solid gains in exports since mid-2003 arose in part from the strong economic performance of many of our major trading partners. In addition, the net decline in the exchange value of the dollar since 2002 continued to make U.S. goods and services more competitive abroad. Increases in exports of U.S. goods were widespread across our major trading partners, with the exception of Japan, and were concentrated in real exports of capital goods, industrial supplies, and consumer goods. Real exports of agricultural products fell sharply, hurt by foreign bans on U.S. beef products following reports of mad cow disease in a U.S. herd. Exports of services rose moderately.

Prices of total exports rose at an annual rate of 5¾ percent in the first quarter, boosted by another jump in agricultural prices along with substantial increases in the prices of other primary commodities and industrial supplies. Prices of U.S. agricultural exports have been pushed up by very strong global demand, particularly from China. For specific products, such as cotton and soybeans, lower production in some countries also contributed to price run-ups. More recently, prices of soybeans and other agricultural products have eased in the face of a slowing in the growth of demand from China and the anticipation of larger harvests. Even so, available data point to continued strong increases in export prices in the second quarter.

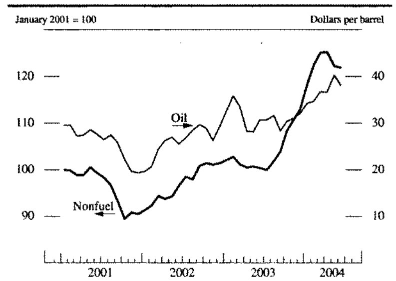
Supported by solid U.S. economic growth, real imports of goods and services rose at an annual rate of

Change in real imports and exports of goods and services



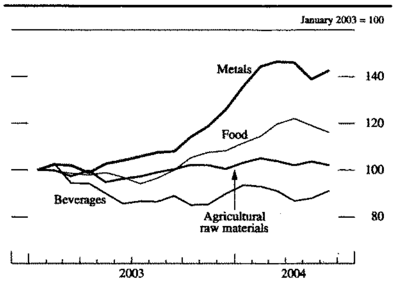
SOURCE. Department of Commerce.

Prices of oil and of nonfuel commodities



NOTE. The data are monthly and extend through June 2004. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is an index of forty-five primary-commodity prices from the International Monetary Fund.

Prices of major nonfuel commodities

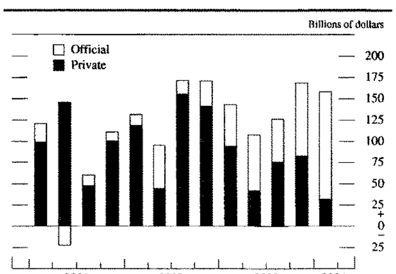


NOTE. The data are monthly and extend through June 2004. The metals category includes aluminum, copper, and iron ore; food includes cereals, vegetable oils and protein meals, seafood, and meat; agricultural raw materials consists of timber, cotton, wool, rubber, and hides; beverages consists of coffee, cocoa beans, and tea.
SOURCE. International Monetary Fund.

10½ percent in the first quarter. This increase was below the fourth-quarter pace but still roughly double the rate of increase for 2003 as a whole. Real imports of goods were boosted by a sharp increase in oil imports. Gains in imports of non-oil goods were also sizable and widespread across categories. Imports of services grew slightly in the first quarter.

The spot price of West Texas intermediate (WTI) crude oil surged above $40 per barrel in May and has since fluctuated close to that level. The run-up in the price since the beginning of the year has been driven by surprisingly strong global demand for oil. Supply issues have been important as well. These were mainly continued violence in Iraq, including the sabotage of oil facilities, attacks on foreigners in Saudi Arabia, ongoing unrest in Nigeria, political turmoil in Venezuela, and tax payment difficulties at a major Russian oil company. The recent increase in OPEC production (mainly by Saudi Arabia) has eased the upward pressure on prices a bit, but they have remained elevated.

U.S. net financial inflows



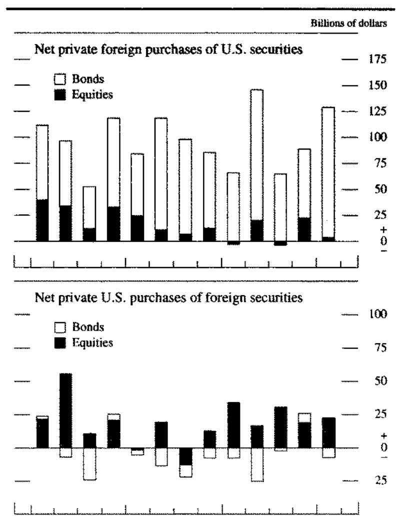
SOURCE. Department of Commerce.

Prices of imported non-oil goods rose at an annual rate of 5½ percent in the first quarter after minimal increases in the second half of 2003. Prices for imported consumer goods rose at an annual rate of 2¾ percent after being flat in 2003. Skyrocketing global commodity prices last year and early this year boosted prices of imported industrial supplies (especially metals) and of foods, feed, and beverages. The jump in commodity prices reflected strong demand, the net depreciation of the dollar over the past two years, and the limited expansion in supply of many commodities since the 2001 trough in commodity prices. Available data suggest a modest step-down in the rate of increase of import prices in the second quarter; the move in part reflects a flattening of consumer goods prices.

The Financial Account

The U.S. current account deficit has continued to be financed largely by foreign flows into U.S. bonds. For-

U.S. net international securities transactions



SOURCE. Department of Commerce and the Federal Reserve Board.

eign official inflows, already sizable in 2003, rose sharply in the first quarter of 2004 and then moderated somewhat. Similarly, private foreign purchases of U.S. bonds, which were significant in 2003, increased sharply in the first quarter and also appear to have moderated in the second quarter. In contrast, foreign demand for U.S. equities was weak in 2003 and has remained so in 2004. Purchases of foreign equities by private U.S. investors appear to be strengthening, but U.S. investors still show no appetite for foreign bonds.

Direct investment into the United States in the first quarter continued to be restrained by the slowdown of global mergers and acquisitions since 2002. In contrast, U.S. direct investment abroad was strong in 2003 and in the first quarter of 2004, as the effect of fewer mergers and acquisitions was offset by sizable reinvested earnings.

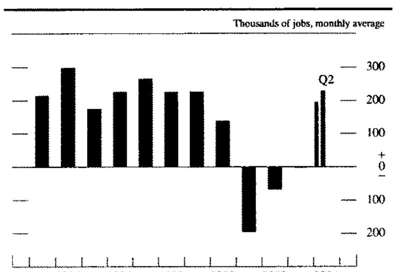
The Labor Market

Employment and Unemployment

The demand for labor turned up in late 2003 after an extended period of weakness, and it has gathered additional steam this year. After averaging about 60,000 per month in the fourth quarter of 2003, gains in private nonfarm payroll employment rose to an average of about 200,000 per month in the first half of 2004. The job gains were especially large in March, April, and May but ebbed somewhat in June. The civilian unemployment rate, which had fallen from a recent peak of 6.3 percent in June 2003 to 5.7 percent in December 2003, was little changed over the first half of the year. In June, it stood at 5.6 percent.

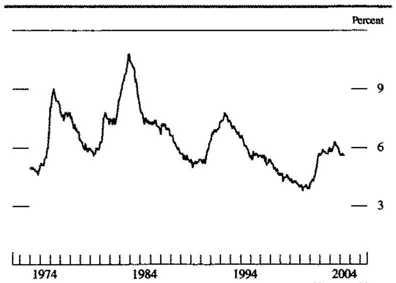
The increases in payrolls over the first half of 2004 were widespread. Especially notable was the turnaround in the manufacturing sector, in which employment bottomed out in January and then rose a cumulative 65,000 jobs through June. The rise in manufacturing jobs was concentrated in the durable goods industries—in particular, those making fabricated metals and other construction-related products, computers and electronic equipment, and machinery. After a long string of declines, employment at producers of nondurable goods was little changed, on net, over the first half. Job gains in virtually all other major sectors have been greater this year than last. In particular, hiring in retail trade, which had been lackluster in 2003, turned up appreciably, and construction employment increased further. The professional and business services sector also posted a sizable rise, in part because the rebound in manufacturing activity lifted hiring at temporary-help firms. A clear indication of the breadth of the employment increases is provided by the six-month diffusion index compiled by the Bureau of Labor Statistics (BLS). The index is equal to the percentage of industries that increased employment over the most recent six months plus one-half the percentage with unchanged employment; in June, the index moved up to its highest level since April 2000.

Net change in payroll employment



NOTE. Private nonfarm.

Civilian unemployment rate

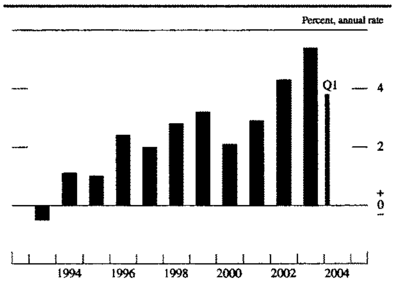


NOTE. The data are monthly and extend through June 2004.

Productivity and Labor Costs

Gains in labor productivity have slowed somewhat in recent quarters after the spectacular increases of mid-2003. Still, according to the currently published data, output per hour in the nonfarm business sector rose a remarkable 5½ percent over the year ending in the first quarter. Over the past three years, increases in productivity have averaged more than 4 percent per year, compared with average increases of about 2½ percent per year in the second half of the 1990s. During that earlier period, an expansion of the capital stock was an important source of productivity growth. However, in the more

Change in output per hour



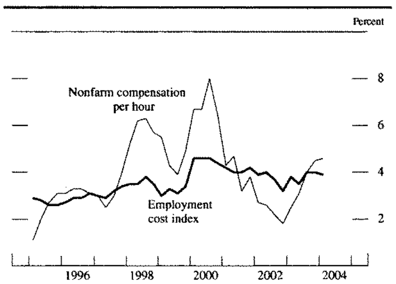
NOTE. Nonfarm business sector.

recent period, when the business environment—at least until the past few quarters—was characterized by sluggish demand, lean capital budgets, and an extraordinary reluctance of firms to add to payrolls, businesses appear to have raised their productivity mainly through changes in organizational structures and better use of the capital already in place. With hiring having picked up of late, measured productivity growth may slow in coming quarters; but if recent experience is any guide, businesses will continue to focus on achieving structural improvements in the efficiency of their operations. The upswing in investment spending now under way also bodes well for sustained favorable productivity performance in the period ahead.

The rapid productivity growth in recent years has helped to bolster increases in hourly compensation in the face of the soft labor market and the low consumer price inflation in 2003. As a result, increases in the employment cost index (ECI) measure of hourly compensation, which is based on a survey of private nonfarm businesses conducted quarterly by the BLS, have held fairly steady of late. In fact, the rise in the ECI over the twelve months ending in March—at a shade less than 4 percent—was virtually the same as the increases over the preceding two years. Benefit costs, which rose 7 percent over the year ending in March, have continued to be the fastest rising portion of hourly compensation; health insurance costs have remained on a steep uptrend, and employers have boosted their contributions to defined-benefit retirement plans to make up for earlier stock market losses. The rising benefit costs have likely exerted some downward pressure on wages, which rose just 2½ percent over the twelve months ending in March; the twelve-month change in the wage component of the ECI, which was close to 4 percent in 2000 and 2001, has been in the range of 2½ percent to 3 percent since late 2002.

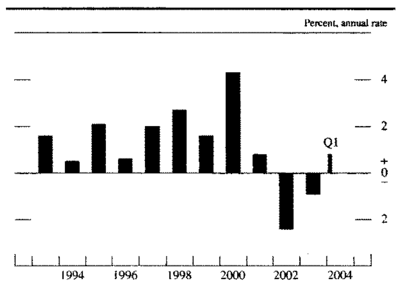
The change in compensation per hour in the nonfarm business (NFB) sector—an alternative measure of hourly compensation based on data constructed for the NIPA—has swung widely in recent years. Fluctuations in the value of stock option exercises, which are excluded from the ECI but included in the NFB measure, likely account for some of the differential movements in the two series. The four-quarter change in the NFB measure bottomed out at a bit less than 2 percent in 2002, when the value of exercised options was dropping; it has moved up steadily since that time and, in the first quarter, stood at 4½ percent—a rate not much different from the increase in the ECI. With productivity growth slowing to a pace below that of NFB hourly compensation, unit labor costs rose in both the fourth and first quarters after having trended down over the preceding two years.

Measures of change in hourly compensation



NOTE. The data extend through 2004:Q1. For nonfarm compensation, change is over four quarters; for the employment cost index (ECI), change is over the twelve months ending in the last month of each quarter. Nonfarm compensation is for the nonfarm business sector; the ECI is for private industry excluding farm and household workers.

Change in unit labor costs



NOTE. Nonfarm business sector.

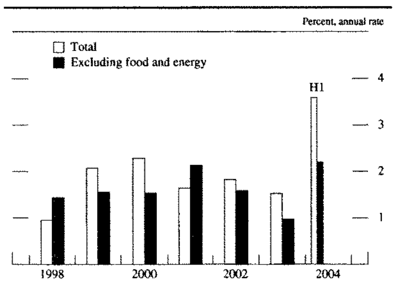
Prices

Inflation moved higher in the first half of 2004. After rising just 1½ percent over the four quarters of 2003, the price index for personal consumption expenditures (PCE) increased at an annual rate of 3½ percent between the fourth quarter of 2003 and May 2004. In that period, energy prices soared, and increases in core consumer prices picked up to an annual rate of 2¼ percent—more than 1 percentage point faster than the increase in 2003. Data for the consumer price index (CPI) are available through June and show some moderation in the core component of the series. Over the first half of the year, the core CPI rose at an annual rate of 2½ percent, compared with an increase of 1¼ percent over the four quarters of 2003.

Reflecting the surge in crude oil prices, PCE energy prices rose at an annual rate of more than 25 percent in the first quarter; they apparently posted another outsized increase in the second quarter. Gasoline prices increased rapidly through May as crude oil costs rose and as price markups were boosted by strong demand and lean inventories; although gasoline prices have fallen on balance since late May, they are currently nearly 30 percent above their level at the end of last year. As for natural gas, which can often substitute for fuel oil in the industrial sector, spot prices were elevated at the start of the year, fell somewhat in February and March, and trended up over the spring. The higher spot prices for natural gas this spring pushed up prices paid by consumers through June. PCE electricity prices appear to have risen at an annual rate of 3 percent over the first half of the year, a pace similar to that in 2003.

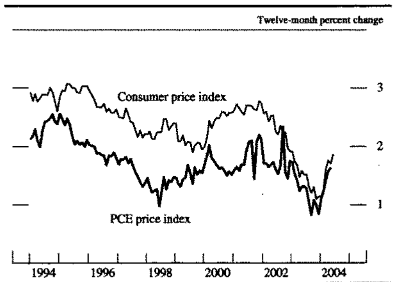
Although volatile from month to month, consumer food prices rose moderately on balance over the first half of 2004 after having moved up in late 2003. Robust global demand is imparting upward impetus to food prices, but U.S. producers are in the process of boosting supply, which should help restrain increases in retail food prices in coming quarters.

Change in PCE price index



NOTE. The data are for personal consumption expenditures (PCE). The changes for 2004 are from 2003:Q4 to May 2004.

Change in consumer prices excluding food and energy



NOTE. The data for the CPI extend through June 2004; for PCE, they extend through May 2004.

The step-up in core PCE inflation this year has been especially pronounced in a few categories. In particular, prices of motor vehicles have firmed after a noticeable decrease in 2003. In addition, increases in shelter costs, which were surprisingly low in 2003, are now running more in line with earlier trends. Core inflation has also been lifted this year by substantial increases, on balance, in a number of categories for which prices cannot be derived from market transactions and thus must be imputed by the Bureau of Economic Analysis—for example, prices of financial services provided by banks without explicit charge. These non-market-based prices, which were about flat in 2003, are difficult to estimate, and the imputed figures tend to be volatile.

A number of factors have contributed to the run-up in core inflation this year. Higher oil prices have doubtless raised the cost of producing other goods and services. So have the steep increases in prices of non-oil commodities such as copper and lumber, which came about as economic activity strengthened worldwide and as industrial capacity utilization both here and abroad tightened. Likewise, the decline in the dollar has boosted non-oil import prices and thus the costs of inputs for many domestic producers. The weaker dollar has also likely lessened the pressure on firms facing foreign competition to hold the line on prices—a consideration that is probably contributing to the widespread perception that firms' pricing power has increased lately. Moreover, unit labor costs have edged up recently after having declined noticeably in 2002 and 2003.

From a cyclical perspective, the sharp upturn in commodity prices is not surprising, given the pickup in the growth of industrial production. In fact, such large increases in commodity prices are typical as economic activity accelerates and capacity utilization rises—especially for products for which the supply is relatively fixed in the short run. Some portion of these increases usually proves transitory. More important, cyclical swings in commodity prices tend to have only a minor effect on overall inflation, both because they account for a small share of total costs and because changes in commodity prices tend to be partly absorbed in firms' profit margins, at least for a time.

The faster rate of inflation this year underscores the difficulty of gauging price pressures. Nevertheless, on the whole, the evidence suggests that slack remains in labor and product markets, which should be exerting some downward pressure on inflation. The unemployment rate—at 5½ percent currently—is not significantly lower than it was through much of 2002 and 2003, when core inflation was trending down. And despite the run-up this year, capacity utilization in the manufacturing sector is still below its longer-run average. In addition, the strong upward trend in productivity is continuing to help keep the rise in labor costs muted, and profit margins are sufficiently wide to give firms scope to absorb cost increases for a while without putting undue upward pressure on prices.

The upturn in actual inflation has been echoed in some measures of inflation expectations. For example, according to the Michigan Survey Research Center, the median expectation for inflation over the coming year has averaged slightly more than 3 percent since early spring after hovering in the area of 2¼ percent to 2¾ percent in 2003 and early 2004. The median expectation for inflation over the next five to ten years has been running a bit below 3 percent in recent months, a reading similar to the figures for 2002 and 2003. According to the Survey of Professional Forecasters conducted by the Federal Reserve Bank of Philadelphia, expectations of inflation over the next ten years held steady in June at 2½ percent. Inflation compensation over the next five years as measured by the spread between the yield on nominal Treasury securities and their indexed counterparts rose noticeably during the first half of 2004. To be sure, inflation compensation is also influenced by perceptions of inflation risk and the secular increase in demand for inflation-indexed debt, but the rise in near-term inflation compensation likely reflects, at least in part, higher inflation expectations. Similar to the survey-based measures of longer-run inflation expectations, inflation compensation for the period five years to ten years ahead was little changed on net over the first half of the year.

Broader NIPA price measures are available only through the first quarter, and the four-quarter changes in these series do not show the rise in inflation indicated by the monthly data discussed above. In particular, the rate of increase in the price index for GDP over the year ending in the first quarter was just 1¾ percent, the same as over the preceding year. The four-quarter change in the price index for gross domestic purchases—which is defined as the prices paid for purchases of domestic and imported consumption, investment, and government goods and services—dropped from 2¼ percent to 1¾ percent over the same period; the deceleration reflects mainly the effects of energy prices, which rose even more rapidly over the year ending in the first quarter of 2003 than they did over the most recent year.

Alternative measures of price change

Percent

Price measure	2002 to 2003	2003 to 2004
Chain-type (Q1 to Q1)		
Gross domestic product	1.7	1.8
Gross domestic purchases	2.3	1.7
Personal consumption expenditures	2.4	1.6
Excluding food and energy	1.6	1.3
Fixed-weight (Q2 to Q2)		
Consumer price index	2.2	2.8
Excluding food and energy	1.5	1.8

NOTE. Changes are based on quarterly averages of seasonally adjusted data.

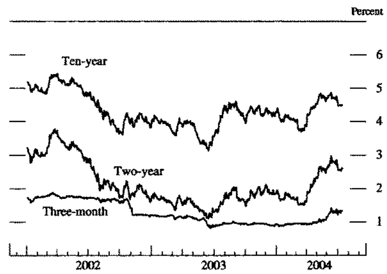
U.S. Financial Markets

As 2004 opened, financial market conditions were quite accommodative, with low corporate bond yields, narrow risk spreads, and relatively easy terms and standards on bank lending. Although equity prices changed little, and interest rates rose on balance in response to positive economic news and expectations of a tightening of monetary policy, financial conditions in the first half of the year remained supportive of economic growth. Business borrowing nevertheless remained tentative, while increases in the debt of the federal government and of households were sizable.

Interest Rates

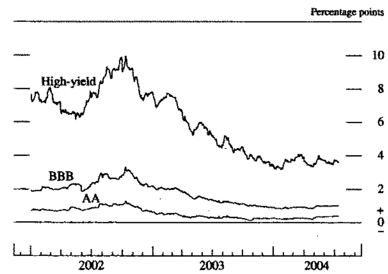
From the end of 2003 through the end of March, yields on nominal Treasury coupon securities fell, on net, about 30 to 45 basis points. Although interest rates rose immediately after the FOMC's January meeting in response to the Committee's decision to remove its statement that monetary policy could remain accommodative for "a considerable period," the increase proved to be short lived. Weak employment reports released in early February and

Interest rates on selected Treasury securities



NOTE. The data are daily and extend through July 14, 2004.

Spreads of corporate bond yields over the ten-year Treasury yield

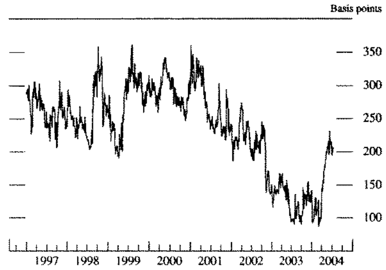


NOTE. The data are daily and extend through July 14, 2004. The spreads compare the yields on the Merrill Lynch AA, BBB, and 175 high-yield indexes with the yield on the ten-year off-the-run Treasury note.

early March prompted yields to fall amid doubts about the strength of the economic expansion. Federal funds futures contracts at the end of March appeared to indicate that market participants placed small odds on a tightening of monetary policy before late 2004, and contracts also seemed to price in only a gradual increase in the federal funds rate during 2005.

Interest rates backed up in the second quarter as data releases increasingly suggested that the economic expansion would remain vigorous. Yields on the two-year and ten-year nominal Treasury notes ended the first half of the year 90 and 36 basis points higher, respectively, than at the end of 2003, as markets adjusted to the greater likelihood of an earlier onset and more rapid pace of monetary policy tightening. The surprisingly strong employment reports published in April and May, higher-than-expected readings on core inflation, and surging oil prices all spurred increases in Treasury yields. After the release of the employment report in May, federal funds futures contracts priced in a hike in the target federal funds rate at the June FOMC meeting and a more rapid tightening of monetary policy than had been anticipated. With the evolving outlook for monetary policy, the volatility of short-term interest rates implied by option prices jumped in the first half of the year after staying in a relatively low range in 2003. Near-term interest rates declined a bit after the Committee's decision at its June meeting to raise the intended federal funds rate 25 basis points; the Committee's reaffirmation that policy accommodation likely could be removed at a "measured" pace apparently reassured investors that a steep rise in the federal funds rate probably was not in train.

Implied volatility of short-term interest rates



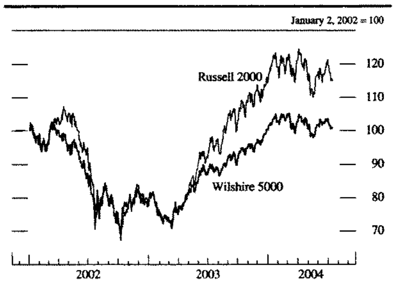
NOTE. The data are daily and extend through July 14, 2004. The series shown is the implied volatility of the three-month eurodollar rate over the coming four months, as calculated from option prices.

Yields on investment-grade corporate debt moved roughly in line with those on comparable nominal Treasury securities over the first half of the year, producing little net change in risk spreads from their level at the end of last year. Spreads on speculative-grade debt over Treasury debt declined a bit further after having narrowed sharply during 2003 as the economic expansion was seen as gathering steam.

Equity Markets

Over the first half of 2004, equity prices were subject to the strong crosscurrents of robust earnings reports, rising interest rates, fluctuating fears about geopolitical developments, and sharply higher oil prices. On balance, broad

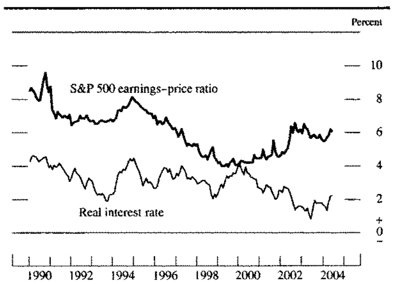
Major stock price indexes



NOTE. The data are daily and extend through July 14, 2004.

equity price indexes at the end of June had edged about 2½ percent to 3¼ percent above year-end levels after having surged 25–30 percent over the course of 2003. Over the first half, analysts raised their estimates of profits for coming quarters; the upward revision outstripped the more modest increase in equity prices and boosted the ratio of expected year-ahead earnings to stock prices. With real interest rates higher, however, the difference between the earnings–price ratio and the real ten-year Treasury yield—a crude measure of the equity risk premium—changed little to remain close to its average value over the past two decades and above its level during the late 1990s.

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



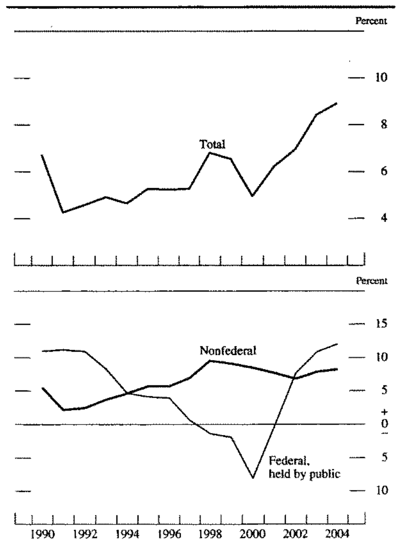
NOTE. The data are monthly and extend through June 2004. The forward earnings–price ratio is based on I/B/E/S consensus estimates of earnings over the coming year. The real interest rate is estimated as the difference between the ten-year Treasury rate and the expected ten-year inflation rate reported in the survey by the Federal Reserve Bank of Philadelphia.

Debt and Financial Intermediation

Aggregate debt of the domestic nonfinancial sectors expanded at an annual rate of about 8½ percent in the first quarter of 2004, a gain similar to last year's increase. Debt growth in the business sector has remained subdued so far this year, as ample internal funding has limited the need for external finance. In contrast, household debt has continued to expand rapidly, spurred by an elevated pace of home purchases and cash-outs from mortgage refinancing. The large federal budget deficit led to another sharp increase in Treasury debt in the first half of this year. Municipal borrowing moderated somewhat, on balance, in the first half of the year, as the improving fiscal condition of state and local governments reduced the need for short-term borrowing to cover budget gaps.

The growth of credit on the books of depository institutions picked up to an annual rate of 14 percent in the first quarter of 2004. Financing secured by residential

Change in domestic nonfinancial debt



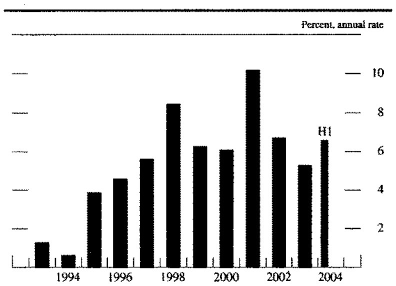
NOTE. For 2004, change is from 2003:Q4 to 2004:Q1 at an annual rate. For earlier years, the data are annual and are computed by dividing the annual flow for a given year by the level at the end of the preceding year. The total consists of nonfederal debt and federal debt held by the public. Nonfederal debt consists of the outstanding credit market debt of state and local governments, households, nonprofit organizations, and nonfinancial businesses. Federal debt held by the public excludes securities held as investments of federal government accounts.

real estate—including home mortgages, home equity loans, and mortgage-backed securities—drove the expansion. In contrast, business loans continued to run off, falling at an annual rate of about 5 percent in the first half of the year after a 10 percent drop in 2003. The deceleration was consistent with some signs that demand for business loans was beginning to recover as well as with an easing of standards and terms on these loans.

The M2 Monetary Aggregate

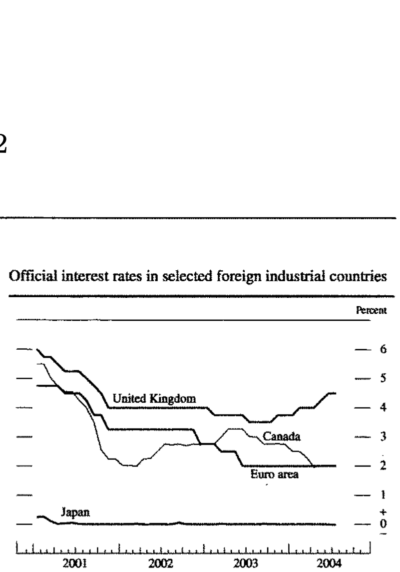
In the first half of 2004, short-term interest rates were stable and M2 grew at an annual rate of 6½ percent—a pace that was roughly in line with estimates of nominal GDP—after contracting at a record rate in the fourth quarter of 2003. Liquid deposits—the largest component of M2—had been depressed late last year by the ebbing of last summer's mortgage refinancing boom. Mortgage refinancings tend to boost M2 as the proceeds are temporarily placed in non-interest-bearing deposit accounts pending disbursement of funds to the holders of mortgage-backed securities. When refinancings slowed last year, the decline in such escrow accounts held down the growth of liquid deposits. In the first half of this year, M2 probably received a boost from the new round of mortgage refinancings that followed the first-quarter decline in mortgage interest rates. The strength in liquid deposits was partly offset, however, by continued weakness in money market mutual funds and small time deposits. Given the recent very low yields on these two components of M2, households likely viewed them as less attractive savings vehicles than other assets.

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.

Official interest rates in selected foreign industrial countries



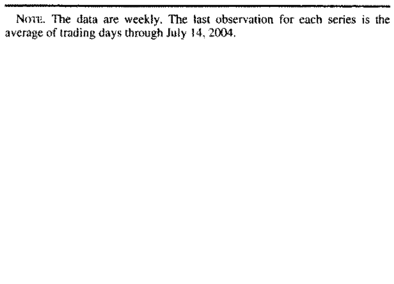
NOTE. The data are as of month-end; the last observation for each series is the average of trading days through July 14, 2004. The data shown are the call money rate for Japan, the overnight rate for Canada, the refinancing rate for the euro area, and the repurchase rate for the United Kingdom.

International Developments

Foreign economic activity expanded in the first half of this year at a pace only slightly below the rapid increase in the second half of 2003. Global trade has been boosted by strong demand, especially from the United States and China. The run-up in oil and commodity prices has contributed to rising, though still moderate, inflation across the industrial and developing countries.

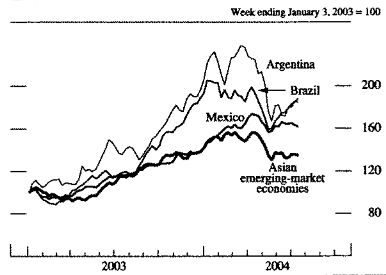
By the end of the first half of this year, monetary policy in most major foreign economies had either tightened or assumed a less accommodative tone. Citing high rates of capacity utilization and mounting inflationary pressures, the Bank of England has raised its target rate 100 basis points since early November. Mexico and China also have tightened policy. Elsewhere, including the euro area,

Equity indexes in selected foreign industrial countries



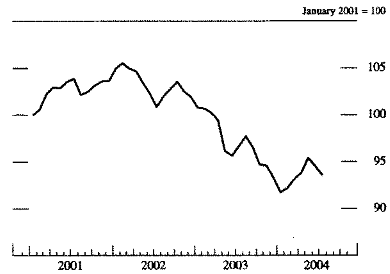
NOTE. The data are weekly. The last observation for each series is the average of trading days through July 14, 2004.

Equity indexes in selected emerging-market economies



NOTE. The data are weekly. The last observation for each series is the average of trading days through July 14, 2004. The Asian emerging-market economies are China, Hong Kong, India, Indonesia, Malaysia, Pakistan, the Philippines, Singapore, South Korea, Taiwan, and Thailand; the index weight for each of these economies is its market capitalization as a share of the group's total.

U.S. dollar nominal exchange rate, broad index

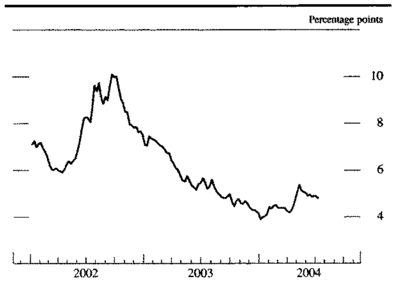


NOTE. The data are monthly and are in foreign currency units per dollar. The last observation is the average of trading days through July 14, 2004. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.

Canada, and Japan, central banks most recently have kept policy unchanged after easing previously. In general, official statements are expressing increasing concern over the inflationary risks associated with stronger economic activity and higher world energy and commodity prices.

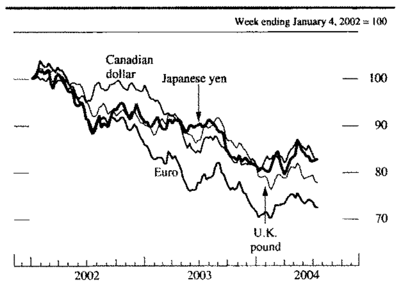
In foreign financial markets, equity price performance has been more mixed so far in 2004 than during the second half of 2003; sharply rising interest rates over the past few months have weighed on equity valuations, damping the effects of an improved earnings outlook. Since year-end, stock prices in Europe and Canada have changed little, on balance. In contrast, rapidly improving economic conditions in Japan have helped boost Japanese equity prices about 10 percent. Other Asian stock price indexes have fallen, on average, in part because of concerns about the possibility of an acute slowdown in China. Mexican stocks have been bolstered by strong earnings growth of leading Mexican communications firms and, more generally, by the strengthening U.S. expansion. Foreign long-term interest rates rose rapidly in the second quarter as new data (including from the United States) showing faster growth and higher inflation led market participants to expect more-aggressive monetary tightening. Over the first half of the year, the

Spread on internationally issued
sovereign debt of emerging-market economies



NOTE. The data are weekly averages. The last observation is the average of trading days through July 14, 2004. The series shown is the J.P. Morgan Emerging Market Bond Index Plus (EMBI+), which is the spread of the yield of certain dollar-denominated sovereign debt instruments of emerging-market economies over U.S. Treasury securities; over the period shown, the index encompassed nineteen countries.

U.S. dollar exchange rate against
selected major currencies



NOTE. The data are weekly and are in foreign currency units per dollar. The last observation for each series is the average of trading days through July 14, 2004.

spread on internationally issued sovereign debt of emerging-market economies over U.S. Treasuries moved up somewhat from its very low level.

After depreciating over the previous two years, the value of the dollar rose slightly, on balance, in the first half of 2004. The firming of the dollar has been attributed to perceptions by market participants that near-term monetary tightening in the United States would be faster than such tightening abroad.

Industrial Economies

A broadly based recovery appears to have been established in Japan over the first half of 2004. Real GDP rose at an annual rate of more than 6 percent in the first quarter after an even greater increase in the fourth quarter. Aided by demand from China, growth of Japanese real exports remained robust. Personal consumption and business investment also firmed. More-recent indicators show that domestic strength continued in the spring with large gains in household expenditures and improved labor market conditions. Deflation continued to wane in Japan. Consumer price deflation over the first half of the year was slight, and wholesale prices increased. In financial markets, the stronger economy boosted equity markets and helped drive up the yield on the ten-year bellwether government bond to more than 1¾ percent from its June 2003 record low of about ½ percent. After making substantial sales of yen for dollars in the first quarter, Japanese authorities ceased intervention in mid-March. Even so, the yen depreciated early in the second quarter before appreciating to around ¥109 per dollar.

Economic conditions in the euro area firmed over the first half of 2004, but performance varied across countries, and the region as a whole continues to lag the global upturn. Real GDP in the euro area increased at an annual rate of 2¼ percent in the first quarter; output in France, Spain, and several smaller member countries rose relatively briskly, while growth in Germany and Italy was less robust. In the first quarter, domestic demand firmed noticeably, except in Germany, where growth was due entirely to a spike in exports. German consumer spending remains anemic, held down by a weak labor market and low consumer confidence. Euro-area indicators for the second quarter initially were upbeat, but more-recent data have been mixed. Labor markets have yet to benefit from the recovery, and the average unemployment rate in the region edged up to 9 percent in the spring. Inflation for the euro area over the twelve months ending in June was near 2½ percent, a rate above the European Central Bank's medium-term goal of less than, but close to, 2 percent. Excluding energy, food, alcohol, and tobacco, prices rose slightly less than 2 percent over the same period.

Economic expansion in the United Kingdom continued unabated over the first half of 2004. Labor markets tightened further; the unemployment rate edged down to its lowest level in almost three decades, and labor earnings posted solid gains. Despite the strong economy, consumer price inflation over the twelve months ending in June was 1½ percent, remaining below the central bank's official target rate of 2 percent. Conditions in the U.K. housing market, however, remained red hot, with double-digit price increases, high levels of household mortgage and consumer borrowing, and sizable withdrawals of home equity.

The Canadian economy picked up steam in the first half of 2004 after a year plagued with difficulties including SARS, mad cow disease, and a regional power outage. Sizable gains in consumption and investment boosted output in the first quarter, and indicators are pointing to continued good performance in these sectors. Export growth was strong, as the robust economic performance of the United States appears to have outweighed the negative effect of Canadian dollar appreciation on trade. The unemployment rate was relatively stable over the first half, and employment bounced back in the second quarter from a first-quarter lull. Consumer price inflation decreased early in the year, but energy costs helped drive up the rate to 2½ percent over the twelve months ending in June. Prices excluding food, energy, and indirect taxes have remained more subdued, rising slightly less than 1½ percent over the same period.

Emerging-Market Economies

Estimates suggest that real GDP in China surged in the first quarter with continued outsized gains in fixed-asset investment. Fears of overinvestment, particularly in the steel, cement, and aluminum industries, led Chinese officials to intensify their tightening measures early in the second quarter. These measures included increases in reserve requirements and in some interest rates as well as stricter criteria for the approval of investment projects. A sharp slowdown in estimated real GDP for the second quarter suggests that these steps are working. Despite the recent slowing in growth, Chinese exports and imports soared in the first half of the year, and trade was close to balanced.

Growth in the other Asian emerging-market economies slowed only moderately in the first quarter from the fast pace at the end of last year. Exports, which continued to be the driving force behind that growth, were fueled by Chinese demand as well as by the recovery in the global high-tech market and stronger world demand overall. Consumer demand generally rose across the region with the notable exception of Korea, where high levels of consumer debt are weighing on spending. Although still only moderate, inflation across the Asian emerging-market economies is beginning to rise as stronger aggregate demand takes hold and higher energy and commodity prices pass through to prices more generally.

The Mexican economy has been propelled this year by strong demand from the United States. Gains have been broadly based, with sharp increases in industrial production, exports, construction, and retail sales. Employment in the industries most closely linked to U.S. trade also has started to increase. Responding to a rise in twelve-month inflation to slightly above its 2 percent to 4 percent target range, the Bank of Mexico has tightened policy several times so far this year. Elevated oil prices boosted the Mexican public-sector fiscal surplus to a record high during the first five months of the year and facilitated an increase in federal transfers to state governments.

In Brazil, GDP grew robustly in the first quarter, and indications are that economic activity continued to expand in the second quarter with support from strong external demand. Job growth has been robust, although unemployment has remained high. Inflation, however, continues to concern authorities. Asset prices weakened earlier this year, in part because of rising global interest rates but also because of market participants' unease about the direction of structural and fiscal reforms; since then, asset prices have partially rebounded.

The recovery in Argentina has continued at a rapid pace in recent quarters, but limited investment in the energy sector, reflecting a lack of structural reforms, has forced the government to import electricity, natural gas, and fuel oil from neighboring countries. Creditors have shown little enthusiasm for the country's latest debt restructuring plan, and the federal government faces difficult challenges in normalizing its international financial situation and reforming its fiscal relations with the provinces.

Chairman Greenspan subsequently submitted the following in response to written questions received from Congresswoman Sue Kelly in connection with the July 21, 2004, hearing before the Committee on Financial Services:

1) Chairman Greenspan, earlier this year the Federal Reserve levied the second highest civil money penalty against a bank for violating restrictions from the Office of Foreign Asset Control (OFAC), including Cuba, Iran, Libya, and Yugoslavia. The penalty was assessed for failure to comply with key contract terms and to cooperate quickly and fully with investigations undertaken by the Federal Reserve Bank of New York. The O&I subcommittee received testimony from the Federal Reserve Bank of New York on the actions taken by the Fed to tighten the contract terms associated with its Extended Custodial Inventory (ECI) Program, which was at the center of this unfortunate situation. I have two questions in connection with this situation.

a) I understand that the Federal Reserve has undertaken an internal process to review the entire ECI program for distributing banknotes abroad. What is the status of this policy review?

The Federal Reserve Bank of New York's experience with UBS prompted the President of the New York Reserve Bank, Tim Geithner, to charter a task force with the mandate to review the Federal Reserve's role in the distribution of cash internationally. The task force, which includes representatives from the Federal Reserve Bank of New York, the Reserve Banks' Cash Product Office in San Francisco, and Board staff, is assessing the benefits of the ECI program in the context of risks, such as legal, reputational, and operational, raised by the Federal Reserve's role in international cash distribution and is evaluating the effectiveness and reasonableness of the safeguards that have been, or could be, implemented to address such risks. Particular emphasis is being placed on policies and procedures that seek to ensure compliance with U.S. sanctions as implemented through OFAC regulations. The task force's assessment is nearing completion.

b) When do you expect that the Federal Reserve will have concluded this internal study? I would like to request that the results of that study be shared with this Committee.

The task force is committed to completing its review promptly and expects to have a final report by October 2004. The results of that review will be made available to the Committee. In the interim, Board staff is available to answer questions that the Committee or its staff might have on the progress of this important initiative.

c) Regarding the size of the civil money penalty assessed against UBS, I understand that the penalty size was assessed in relation to the size of the business line using a disgorgement theory. However, the penalty was--in comparison--not as stiff as the one levied against Riggs Bank for willful non-compliance with the Bank Secrecy Act. Of course, there is a difference between penalties assessed using your supervisory jurisdiction (as in Riggs) and your contract compliance jurisdiction (as in UBS). Nonetheless, under both situations a bank is affirmatively obligated to comply with OFAC restrictions. Do you believe that a common standard should exist regarding fines assessed by U.S. federal banking regulators for deliberate and willful statements and omissions of fact that impede a regulator's ability to enforce OFAC, anti-money laundering, and anti-terrorist finance requirements, regardless of whether such requirements apply through regulation or contract?

As noted in the testimony of the Federal Reserve Bank of New York before the Subcommittee on Oversight and Investigations concerning the UBS matter, banking organizations, like UBS, that operate ECI facilities overseas on behalf of the Federal Reserve are required by contract to comply with OFAC regulations restricting transactions with specific sanctioned countries. The remedy for UBS' breach of this contract requirement was termination of the contract by the Federal Reserve. The civil money penalty imposed on UBS by the Federal Reserve Board in May of this year was not assessed for UBS' failure to comply with OFAC restrictions, but rather, was assessed for the deception practiced by former UBS employees against the Federal Reserve. Any financial institution that, like UBS, is subject to the jurisdiction of U.S. bank regulators could be penalized under the same statutory framework for deliberate and willful statements and omissions of fact made in violation of U.S. law.

2) Chairman Greenspan, in the aftermath of September 11th, 2001, you were a strong proponent of legislation to provide a federal reinsurance backstop for terrorism.

a) I would like to get your thoughts on the stability that the Terrorism Risk Insurance Act (TRIA) has provided to our economy over the last two years?

Despite the fact that the Terrorism Risk Insurance Act (TRIA) has been in effect for two years, it is difficult to judge its influence, importantly because of a lack of systematic evidence. The Treasury is currently in the process of collecting information that should be helpful in developing a more definitive evaluation of the program and the possible implications of its expiration.

b) Yes or No, do you believe that there is a private market for terrorism reinsurance at this time with TRIA? Please explain.

Recent reports indicate that reinsurers are now offering coverage to some businesses for losses from non-TRIA-certified acts of terror, such as domestic terrorist attacks. That said, even with TRIA, reinsurance appears to be virtually nonexistent for catastrophic damages resulting from nuclear, biological, chemical, and radiological attacks. These examples suggest that while there would likely be some coverage available in the absence of TRIA, the private market for terrorism insurance would likely still be quite limited.

c) Earlier this year, the GAO released a report that concluded that there is no indication of a sustainable marketplace for terrorism insurance after TRIA expires. Another study by the Mortgage Bankers Association found that more than $400 billion of Commercial/Multifamily Debt would be at risk without the requirement under TRIA that insurers "make available" coverage. Could the failure to reauthorize

TRIA pose any potential impact on the marketplace for terrorism insurance or reinsurance, and thereby impair current or future construction and projects, or the overall economy?

As noted above, it is difficult at this time to determine the impact of the expiration of TRIA on the economy.

d) As you know, the take-up rates of terrorism insurance are rising and the country faces an imminent threat of a terrorist attack. Yes or No, do you believe that Congress should consider retaining a systematic approach to provide stability to the market and the economy prior to an attack--especially since there is no cost involved unless there is another event? Please explain.

The upcoming report by the Secretary of the Treasury should help determine what type of legislation, if any, may be called for if TRIA is allowed to expire on December 31, 2005. If the Treasury study finds that insurers would be expected to face significant difficulty in pricing certain types of terrorism risk without the federal backstop provided by TRIA, then some level of federal involvement may continue to be warranted.

Chairman Greenspan subsequently submitted the following in response to written questions received from Congressman Doug Ose in connection with the July 21, 2004, hearing before the Committee on Financial Services:

Q.1. Attached you will find a spreadsheet detailing specific commodities and the Purchaser Price Indexes (PPI) of those commodities from 2000 - June 2004 (according to the Department of Labor, Bureau of Labor Statistics). In particular, I am concerned about the unusually high increases in the PPI for commodities used to build homes, buildings, and transportation infrastructure in the last quarter. What factors account for the increasing PPI trend for commodities? Do you see this issue as an area of concern for future growth in our economy? If so, what can be done to stabilize the producer price indexes.

A.1. The rise in the prices of inputs used by the construction industry reflects the strong level of demand in that sector here in the United States and from abroad. Encouraged by the historically low level of mortgage interest rates, activity in the housing market has risen to record levels. Housing starts totaled 1.592 million units in 2000 but rose to 1.862 million units in 2003 and averaged 1.972 million units in the first half of this year. With the demand for new homes growing so rapidly, this has caused contractors to bid up the prices of lumber and the other inputs that are used in home construction. In addition, with the improving financial condition of many state and local governments, expenditures for road improvement projects have revived, and we have recently seen signs that the construction of nonresidential structures (such as office buildings) has begun to firm as well. In addition, rising demand from abroad for concrete and steel has helped to boost those prices.

Given the updrift in mortgage interest rates in the first half of this year, I would not expect construction activity to grow as rapidly as it has in recent years. Nonetheless, the fundamentals remain favorable in this sector. The more-moderate rate of growth in construction activity ought to relieve some of the upward pressure on the prices of the inputs to the construction industry that you cited.

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