

FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1990

HEARING BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE ONE HUNDRED FIRST CONGRESS SECOND SESSION

ON

OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSU-
ANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF
1978

JULY 18, 1990

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1990

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

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WEDNESDAY, JULY 18, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:04 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Sasser, Sarbanes, Sanford, Shelby, Kerry, Graham, Garn, Heinz, D'Amato, Bond, and Gramm.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance this morning, and particularly our very distinguished Chairman of the Federal Reserve Board, Alan Greenspan.

Our purpose in meeting is for the semiannual monetary policy report which the Fed will be presenting today to the Congress.

As we know, this is the second appearance here for Chairman Greenspan within a week's time. I think we had a very interesting discussion and a newsworthy discussion last week, and we'll have the chance to elaborate on that some today.

Since the Fed's last report in February, the economy has continued to grow and the current expansion now is over 7½ years. But I think it is fair to say that the growth has been quite slow and inflation, especially after this morning's report, seems certain to accelerate this year for the fourth year in a row.

The June CPI increase of ½ of a percent gives us an annual rate through 6 months of roughly 5.9 percent in CPI increase. That's a fairly healthy inflationary factor, and we'll be interested in knowing what your thoughts are on that and where you see that going through the remainder of the year.

The New York Times has just done an analysis that was published on Monday, which indicate that 16 States are either in or close to being in recessions at the present time. Obviously, that depends on the economic definition being used, but it's obvious that there are some serious economic soft spots across the country.

Also, when you were here last week, our discussion made a reference to your earlier testimony here with respect to whether or not we're experiencing a credit crunch in the economy. That testimony was some 4 weeks ago. Your feeling was at that time that there

was not evidence that convinced you that there was a credit crunch taking place.

Your testimony last week I think presented some different information, that some new data was emerging that was indicating that bank credit contraction might well be taking place and that monetary policy would have to be adjusted to offset that.

And we had some discussion on that and I think all the members of the committee will want to pursue that with you further today.

Also, because the RTC is accelerating its rate of spending with respect to the savings and loan clean-up effort, there's a question, too, as to whether that rather *substantial flow of money* might be otherwise distorting normal patterns of financial flows. I don't know to what extent you feel that has affected our measures of the money supply, as well, and in what ways that has to be taken into account.

Finally—and I know that this will come up in the course of the discussion today—we've been at the budget summit now for some weeks. It's not clear exactly when or if that process will yield a result. There's been plenty of public indication that pressure has been applied by people who think that the Fed should be lowering interest rates either to deal with the softness in the economy or in anticipation of a budget summit agreement.

So we would be interested in knowing as well your thoughts as to how the Fed might respond if there is a major deficit reduction agreement that's worked out. What might be both the market reactions to that and what policy adjustments might the Fed itself think are appropriate?

So, these will be issues that we'll want to discuss with you this morning, and we're very pleased that you're here.

Let me just start down the table here.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you very much, Mr. Chairman.

Last week, when Chairman Greenspan was before this committee to talk about financial modernization, the big news item came from his comments on the relationship between, on the one hand, financial health of the banking industry, and on the other hand, monetary policy and the condition of the overall economy.

Aside from the understandable focus on the Chairman's comments as they relate to near-term outlook for interest rates, what I'd like to do is emphasize the broader impact of what you said last week, Mr. Chairman.

The broader impact is that there is a fundamental relationship between the health of the Nation's financial institutions and the health of the Nation's economy.

It is because I am concerned about this broader consequence of financial institution health, when this committee recently held hearings on the possibility of a credit crunch, I said that I gave the benefit of the doubt to the expertise of the regulators when it comes to evaluating loan quality. It is because of the importance of financial institution health that I believe the committee should not ignore, as we did yesterday, a direct legislative request from the

Chairman of the Federal Reserve Board of Governors when he is concerned about the danger of fraud against financial institutions.

It was close—11 to 10. But nevertheless, we lost.

Finally, it is because of the importance of financial institution health that I applaud the chairman of the committee for his efforts through exhaustive hearings to continue to lay the groundwork for responsible legislative restructuring.

With that, Mr. Chairman, I look forward to your testimony.

The CHAIRMAN. Very good. Senator Sasser, chairman of the Budget Committee, and budget summiteer.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Yes; well, I'm surviving, is about all I can say, Mr. Chairman.

I'm pleased to see Dr. Greenspan, the Chairman of the Federal Reserve Board, here this morning. I want to welcome you, Dr. Greenspan, before the committee.

We always benefit from your economic wisdom and I'm confident that that will be the case today.

Dr. Greenspan, I want to commend you for the Fed going through a bit of easing just this past week. You stated, I believe, when you appeared before the committee just a few days ago something contrary to what the banking regulators had told the committee 1 month before. They were saying that there was no credit crunch.

The Fed, as I understand it, took the position that banks were tightening their lending standards and that the markets were tightening independently of the Fed's action. You took the action of easing somewhat, and I want to commend you for that, commend the Fed for it.

And as you know, traditionally, I've been one that's urged the Federal Reserve to ease on interest rates. But there are some things that cause me some concern, and perhaps we can pursue those a little further this morning, Mr. Chairman, when we get to the question period.

But I am concerned. The Japanese interest rates are now getting to the point where they're comparable with interest rates here in the United States. We find that West German long-term interest rates now are similar to the 8.45 percent Treasury bond rate here.

And we're still in the posture of borrowing a substantial amount of funds from abroad to finance our deficit.

So when we get to my turn to question, I'll be interested in hearing from Chairman Greenspan as to just how the problem of foreign interest rates, particularly Japanese and West German interest rates, interact with his ability to ease rates here in the United States and how that might impact on, or how the summit budget negotiations might give him a little more leeway there if we could reduce the necessity for Federal borrowing from foreign capital markets.

Thank you, Mr. Chairman.

[The complete prepared statement of Senator Sasser follows:]

Statement of Senator Jim Sasser, Senate Banking Committee,
July 18, 1990

Thank you Mr. Chairman. I would like to welcome Dr. Greenspan before the committee for his semiannual Monetary Policy Report. As always, I am sure that the committee will benefit from Dr. Greenspan's economic wisdom. Certainly, it was of great interest last week when Dr. Greenspan indicated in his testimony before this committee that the Federal Reserve would likely ease the federal funds rate. While I am pleased that the Fed did ease its policy last week, I am concerned that this easing may not continue.

Last year, the Fed followed a progressive policy of easing the federal funds rate for seven months. The rate fell from 9.75 to 8.25 percent. The recent action by the Fed brought the rate down to 8.0 percent.

It appears to me that economic conditions today are more serious than they were last year. Contrary to what we were told by the other banking regulators only one month ago, Dr. Greenspan has now stated that there is, in fact, a credit crunch. Banks are tightening their lending standards such that "markets are tightening independently" of the Fed's regulatory activities.

Moreover, housing starts are at their lowest level since 1982 during the depths of the Reagan recession. Last month I met with a group of business leaders in Nashville, many of whom are connected with real estate, who told woeful tales like those of eight years ago.

Mr. Chairman, looking back to the seven months in 1989, it's

apparent that the Fed can ease monetary policy. I think economic conditions call for an easing of rates more today than they did last year. Thank you.

The CHAIRMAN. Thank you, Senator Sasser.
Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I want to join you and the other members of the committee in welcoming Alan Greenspan back to our committee for the second report on monetary policy in 1990.

Alan, I believe this is the third time you've testified before this committee in 4 weeks, most recently on Wednesday, when there was, in response to something that you said, a rush to the exit, a littered room of broken chairs.

But I just want you to know that the fact that you have been here three times in 4 weeks means that we're going to continue to invite you back—until you get it right. [Laughter.]

Quite seriously, Mr. Chairman, there are a number of things we need to look at today. One of those is the question of our economic expansion.

It does continue—not as strongly as before. It is setting a new record each month. But the question is, in part, whether or not that expansion will be slowed, or even curtailed by the credit crunch that Chairman Greenspan referred to last Wednesday.

I think we also need to examine what the uncertainty over the budget summit may be exacting on our economy, just as much as we need to examine what a \$50 billion budget package of spending reductions and/or revenue enhancements might mean to decelerating the economy.

And most important of all, we must examine what happens—speaking of people getting it right—if people don't get it at all in the next several months and the budget summit drags on into October, November, and December. What are the consequences of that for us all.

Finally, I want, at the appropriate time, to raise the question that Senator Garn and others have referred to about the various kinds of other risks in our system. For example, the risks to banks because of what might be the inability of some banks to know whether a check is good before funds must be made available.

Other risks were exposed in a recent Price-Waterhouse study of the Federal Housing Administration insurance program, which is not in very good shape. We should also be concerned about Bill Seidman's and the FDIC's recent revelation that they are at an all-time low in terms of coverage of their insurance fund relative to assets.

We should also look at the other kinds of failings that we've seen. There was a news article on a student loan guarantee system which is federally insured.

The question, in other words, is whether there are some systemic problems that we in this committee, and you, as our central banker need to be taking a more comprehensive and thoughtful look at so that we don't go through the kind of trauma that we've been going through with respect to the moral hazards and risks associated with the S&L crisis.

Mr. Chairman, as I say, I welcome Chairman Greenspan back to the Senate, and who knows how many more times we'll have to call him back.

The CHAIRMAN. Thank you.
Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman.

Chairman Greenspan, I join my colleagues in welcoming you here this morning.

I'd be interested in the course of your testimony, and if you don't cover it there, subsequently in the question period, to get some reading from you of what you think the risks are of a down-turn and, indeed, a recession. And if it were to occur, how severe and extended you would expect it to be.

Second, I note that in your statement, in your testimony, you do discuss at some length the credit crunch issue.

It wasn't very long ago, less than a month, you testified before this committee on the credit crunch. And at that time, you indicated, and I quote:

To date, we have found that lenders have tightened their standards in certain sectors and locales, but there has not, so far at least, been a broad-based squeeze on credit. And lenders are generally not retreating from lending opportunities.

Now, that was on June 21.

Just last week, in testimony before this committee, and now in your submitted testimony this morning, you've apparently shifted your view on this issue. In fact, your testimony states, and I quote:

The weakness in the monetary aggregates in part signals a change in the behavior of depository institutions with potential for affecting overall credit provision.

And you go on to state:

It is difficult to discern the dividing line between lending standards that are still healthy and those that are so restrictive as to be inconsistent with the borrower's status and the best interests of the lender in the long-run. In recent weeks, however, we have slipped over that line.

And you go on to point out that the change in credit standards has its roots in part in the excesses of the 1980's, stating:

The weaker credits extended during that decade have come home to roost, and in so doing, have impinged to varying degrees on the current availability.

Now, this has been an issue that has been of concern to members of this committee and, in fact, we were inquiring about and sending warning signals about a credit crunch for some period of time, even prior to the June 21 testimony.

I'd be interested in whether something dramatic occurred between June 21 and last week, and then today, to cause this shift in your view, or whether there was a trend going on, developments going on that weren't fully perceived, but were perhaps even sensed by members of this committee responding as they were, of course, to anecdotal statements about a credit crunch which constituents were experiencing.

I hope to explore that with you in the question period.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Sarbanes.

Another budget summiteer, Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Thank you, Mr. Chairman.

Chairman Greenspan, let me try to sort of flesh out the question that I know everybody today would like you to answer because we would like to jump-start the summit, which responding to some law of political behavior, set out long before American Government came into existence, which is the greater the crisis, the more likely politicians are up to some point to sit down and do nothing.

Since the sequester order came out, I've seen no movement on the summit whatsoever, a lot of grunts and moans, but no action.

I'd just like to get you at some point, if you will, to give your response as to how you believe you could change monetary policy if the fiscal policy of the Nation were changed as follows.

If we had a real deficit reduction package in terms of permanent policy changes, of a minimum of a \$50 billion reduction in the deficit this year, if, by changes in permanent law enacted this year, we reduced the deficit over the next 5 years by the actions taken this year alone by a minimum of \$450 billion, possibly as much as \$500 billion.

Gramm-Rudman is set to expire October 1992. If we extended Gramm-Rudman a minimum of 3 years, with iron-clad enforcement of this agreement, including potential of the President having limited rescission powers if spending went above the cap set out in the bill.

I'd be interested in knowing what you believe that change in fiscal policy would do in terms of your capacity to ease monetary policy in light of that overall change.

The second question that I have and the thing that I've been more and more concerned about is the nature of the transaction that is occurring in the savings and loan industry.

Now, I know it's good politics in Congress to talk about all this wealth transfer. But in reality, we have a transaction that is fairly unusual in terms of financial transaction. That is, we are going out and borrowing tens of billions of dollars. We are then using that money to make deposits good that the deposit-holder never felt were in jeopardy.

So our transaction basically is Aunt Sarah in Tyler had \$25,000, her nest egg, in the local savings and loan. That savings and loan went broke, but Aunt Sarah was never worried because she had confidence in the Federal Government and its insurance fund. So she never changed her behavior.

And what happens is if we go out and borrow money and then we use that money to fill the hole that exists in the reserves of the financial structure, Aunt Sarah's deposit is good. She doesn't change her behavior because she never thought it was bad.

And so, I am concerned about what we are doing to the overall financial structure of the country when we're borrowing capital, at least temporarily pre-empting it from other uses. We're using it to fill a hole in reserves and we're not changing behavior on the other end.

Those are the two concerns I'd like to raise and I hope at some point in your comments, you can address them.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Sanford.

Senator SANFORD. I have got to go preside and Mr. Byrd is in the chair, so I can't be late.

I do want to comment—that's the most fascinating question I have ever heard, with all of those assumptions. I think the question is, if we continue to, as this budget agreement apparently will do, if we continue over the next 5 years to add close to another trillion dollars to the debt, if you'd work that into your answer, too, and what would that do to monetary policy, I think that would be very helpful to us.

And I'm sorry, Mr. Chairman, that time's run out on me.

The CHAIRMAN. Thank you, Senator Sanford.

Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

I want to keep my comments short because I usually find the answers much more interesting than our comments here.

Senator GRAMM. I thought mine was fascinating. [Laughter.]

Senator SANFORD. Absolutely.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Well, I'll tell you what. Once in a while you get lucky, Phil. [Laughter.]

With all the comments you make, something's bound to be fascinating. [Laughter.]

But I find the Chairman's comments generally much more interesting.

But I would say that I just happened to meet early again this morning the same economist who gave me the question that I asked you last week and you answered. But we discussed something further today, and that's the fact that long-term interest rates don't seem to have gone down too much as a result. There has been some favorable impact in the stock market.

We discussed why it was that the Federal Reserve's new move hadn't really affected long-term interest rates. And I suggested that perhaps the fact that—I see that you have set out in your testimony today that we have for too long financed the deficit, that we don't have enough savings to finance here. By borrowing abroad, now our debt is held in the international market.

Frankly, on the long-term interest rates, they're going to be set by the international markets. And unless and until we get serious about reducing the deficit and make fiscal policy coordinate with monetary policy, it doesn't matter what the Federal Reserve does in the long term.

As long as our creditors in other countries see a lack of will to bring down the substantial budget deficit, we're not going to get a very significant reduction in long-term interest rates. And without those, the Federal Reserve has its hands tied.

I would suggest that your prepared statement certainly reflects it, that unless we get serious and have a long-term budget agree-

ment, that we also implement, that we cannot expect the Federal Reserve to be the whipping boy and the one to blame for high interest rates.

We're going to have to get serious on the fiscal side and then perhaps the long-term interest rates and other factors will enable the Fed and its monetary policy to bring interest rates down.

I believe you touch on it. I would welcome any additional comments you have as you discuss that portion of your report.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bond.

Senator Shelby.

Senator SHELBY. Mr. Chairman, I have a written statement that I'd ask that it be made part of the record, and then I'll just have one brief comment to the Chairman. And he'll probably touch on it, anyway, either in his opening statement or by questions.

But what's bothering me is bothering a lot of Senators, Mr. Chairman, and that is how are we going to finance this deficit and continuing debt service that we have? And we're looking at these numbers. We all know what's going on in the so-called budget summit, but we haven't gotten to the summit yet, I don't believe the White House or the Congress.

And I just see us borrowing more and more money from overseas, as Senator Bond just alluded to, and what is that going to do to our monetary system?

Last week, in some testimony, you certainly sent a good signal, or it was interpreted as such, to the market, and they reacted accordingly on interest rates. I don't know what's going to happen there.

But some of the banks seem to be confused at times by signals coming from the Fed or coming from the press interpreting your remarks.

Maybe that's more accurate.

I hope today that you will try to—I wouldn't say straighten out those banks or those remarks, but perhaps make a signal that we can all understand forthrightly.

[The complete prepared statement of Senator Shelby follows:]

STATEMENT BY SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I am glad that you scheduled this morning's hearing because I am glad to have the opportunity to hear more on what Chairman Greenspan only hinted at last week. I would urge members of the audience to be careful about standing near the door, lest they be trampled by members of the press corps in their race to the telephone.

Chairman Greenspan, at last week's hearing, you hinted that interest rates may ease in the near future, in response to a credit crunch. It is also true that we have increasing evidence that we have entered a "rolling recession"; that is, with recessionary effects differing by industry and region. Job growth is slow in many areas, and very slow in some areas. My State of Alabama is well behind the national average in job growth [Alabama 1 percent job growth per year vs. national average of 1.8 percent] with no real apparent cause.

Last week you testified that "loan rates are moving up relative to the cost of money in the commercial banking industry, which is suggestive of the fact that markets are tightening independently of our actions" [as reported by the Washington Post]. Thus it is my understanding that by lowering interest rates, you mean to make credit more accessible to borrowers, while not deterring banks from being more careful about their lending criteria. I hope in your testimony you will address in more detail just what course you would like to see banks follow. I believe that banks are still receiving mixed signals and a little more guidance from you could help eliminate the confusion.

Mr. Chairman, I look forward to the question and answer period. Thank you, Mr. Chairman.

The CHAIRMAN. Very good.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, as you know, Mr. Greenspan has been in the forefront over the years, saying that the one great problem that we have to overcome, in addition to the deficit, is that of capital formation, that of savings.

And he's been saying this for a long, long time now, even before his tenure as Chairman of the Federal Reserve.

And I'd like to try to maybe put him on the spot a little bit and ask him and suggest to him if in the course of his testimony, or at some point in time, he might suggest to us the avenues available to encourage that savings. Not just the IRA, if that's a way, but what can we do? What can Congress do?

Should we try to bring about some incentives to bring about that kind of savings pool which is so desperately needed here in the United States?

Second, in our quest for revenues to deal with the deficit, it seems to me that we've got to be rather careful because if we raise revenues in the wrong way, in the wrong manner, we can actually do damage to capital formation and really bring about the recession that so many people are concerned about.

And one of the areas, and I admit, it may sound parochial and there are parochial overtones to it, is the proposition put forth relative to a stock transfer tax. I believe that would be devastating, not only to Wall Street, but I think as it relates to the investor, as it relates to capital formation, and as it relates to driving the marketplace from the shores of this country.

We talk about the ability of markets to move today. Not only can they move across State boundaries—and so while there is obviously a concern as it relates to New York. I think there's a much bigger concern that we should have as it relates to what problems could that possibly create.

And I'd ask the Chairman if he might speak to that issue as well. [The complete prepared statement of Senator D'Amato follows:]

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. Mr. Chairman, I join you in welcoming Federal Reserve Board Chairman Greenspan. I also welcome the Fed's report on monetary policy. Chairman Greenspan's recent comments before

this committee have been cited as an optimistic sign that the Fed is prepared to ensure that appropriate credit opportunities are available in the national economy.

Mr. Greenspan told us last week that the Federal Reserve may "have to consider offsetting monetary policy" to react to the potential damage to the economy of tighter lending practices. This action may alleviate the "credit crunch" that the New England region appears to be suffering right now. I look forward to hearing Mr. Greenspan amplify these remarks during his testimony today.

The Federal Reserve Board, under Mr. Greenspan's effective leadership, has succeeded in maintaining price stability and providing a healthy economic environment. However, there are many economic potholes in the road ahead that the Federal Reserve Board must avoid or fix to pave the way for the economy to move forward without a recessionary accident.

Although Mr. Greenspan has indicated that there may be a need for moderate offsetting changes to react to the "credit crunch," he also tells us that fundamental economic factors have not changed in a way that will allow the Fed to lower interest rates. The latest inflation and unemployment data suggest that the economy continues to teeter along a knife's edge between healthy growth and significant decline. In addition, economic and political developments in Europe and Japan continue to threaten our ability to effect significant interest rate reduction and economic growth.

Despite these obstacles, many people are hoping that the ongoing budget summit will lead to a deficit-reduction plan that will reduce interest rates and promote growth. In what I am sure will be his economy, I hope that Mr. Greenspan will identify today what a deficit reduction plan must entail to convince him that it would be appropriate to loosen Federal monetary policy.

The CHAIRMAN. Chairman Greenspan, we'll make your full statement a part of the record.

This is a very important report in and of itself, and particularly at this time. We'd be pleased now to hear your comments about it.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Chairman GREENSPAN. Thank you, Mr. Chairman.

If the chair doesn't mind, I would like to read the whole statement into the record.

The CHAIRMAN. Very good.

Chairman GREENSPAN. I think it's important that I try to.

The CHAIRMAN. Fine.

Chairman GREENSPAN. Because it is in response to a number of the questions which the committee has raised.

The CHAIRMAN. Very good. May I ask that you pull the mike a little closer so those in the back of the room can hear a little better? Thank you.

Chairman GREENSPAN. As usual, Mr. Chairman, I am pleased to be here today, and in this connection, to testify on our semiannual Monetary Policy Report to the Congress.

In my prepared remarks this morning, I shall discuss, as is customary on such occasions, current and prospective economic condi-

tions and the Federal Reserve's objectives for money and credit growth over the period ahead.

Two areas of particular note at present, with potential implications for the conduct of monetary policy, are the ongoing restructuring of credit flows in the U.S. economy and the prospects for a significant cut in the Federal budget deficit. I shall pay special attention to these topics in my statement.

ECONOMIC AND FINANCIAL DEVELOPMENTS THUS FAR IN 1990

When I came before this committee in February, I characterized the economy as poised for continued moderate expansion in 1990, and, in large measure, developments so far this year appear to have borne that statement out. Real GNP grew at a 2-percent annual rate in the first quarter, and indicators of economic activity for the second quarter suggest a further rise, though perhaps at a somewhat slower rate. Within this whole, however, the various sectors have moved along at fairly different paces.

On the distinctly positive side, exports have shown solid gains, buoyed by expanding markets abroad. The impetus from international trade has been important in the pick-up in industrial production this year.

In contrast, the news coming from the household sector in recent months has had a softer cast to it. Consumers appear to have pulled back a bit, as the slower overall pace of expansion and the more pronounced weakness in certain parts of the country—especially the northeast—seem to have taken some toll on confidence in the economic outlook. Moreover, having accumulated large stocks of automobiles and other consumer durables earlier in the expansion, consumers could be more selective about when to purchase replacements. Sales of new homes have also weakened, deterring building activity.

There are other pluses and minuses, as well, in the economic picture—by sector and by region. But, on balance, the economy still appears to be growing and the likelihood of a near-term recession seems low, in part because businesses have been working hard to keep their inventories in line with sales trends.

Although output overall grew rather modestly over the first half, the unemployment rate remained at its lowest level in almost 20 years. Over the past year, as employment has decelerated, so too has the labor force, in part reflecting a surprising decline in labor force participation rates for young people. Some flattening in the aggregate participation rate would be consistent with evidence that many individuals now perceive job opportunities as less abundant. Differences from past cyclical experiences, however, suggest that other factors also must be at work—if, in fact, the current pattern represents something more than noise in the data. This development certainly bears watching, for it may have implications for potential output growth.

Be that as it may, with hiring proceeding at a less rapid pace, the rate of increase in wages appears to have leveled out from its earlier upward trend. The core rate of inflation in consumer prices, proxied by abstracting from movements in food and energy prices, picked up sharply in the first quarter, but has moderated in recent

months. This moderation has been concentrated in the prices of goods, perhaps reflecting the ebbing of capacity pressures in a number of industries, while service price inflation has shown little sign of abating.

While the figures that were released today, Mr. Chairman, were higher than one would like to see, they don't, in my judgment, really fundamentally affect the underlying trends. In fact, $\frac{2}{10}$ of $\frac{1}{10}$ percent increase in the CPI resulted from a sharp increase in owner's equivalent rent, which is a technical evaluation of the cost of owning a home. And, with gasoline prices presumably flattening out this month, and I would assume that owner's equivalent rent will also slip back, I would be surprised if we did not get some *reduction in the rate of increase in the CPI reported a month from today, for the month of July.*

In 1990, Federal Reserve policy has continued to be directed at sustaining the economic expansion while making progress toward price stability. Ultimately, the two go hand-in-hand: A stable price level sets the stage for the economy to operate at its peak efficiency, while high inflation inevitably sows the seeds of recession and wrenching readjustment. In the short-run, however, the risks of inflation on the one hand, and of an economic downturn on the other, must be weighed in the policy-making process. The Federal Reserve saw those risks about evenly balanced over the first half of the year and made no adjustments in monetary policy.

Throughout this period, which has been marked by dramatic changes in the flow of funds through depository institutions, the Federal Reserve has been paying particularly close attention to conditions in credit markets. Evidence of a tightening of terms and reduced availability of credit has gradually accumulated, to the point where it became apparent in recent days that some action by the monetary authority was warranted. A number of indicators have been pointing in this direction, including the behavior of the monetary aggregates. Growth in M2, for example, which stalled out in the spring, has failed to strengthen materially, suggesting that the degree of financial restraint in train might be greater than anticipated or than appropriate to the evolving economic situation. This restraint is a function of developments in the credit markets, independent of monetary policy. The recent decline in the Federal funds rate to 8 percent, as a consequence of our action to reduce slightly the pressures in the reserve markets, represents an effort to offset the effects of greater stringency in credit markets.

Other market interest rates generally rose early in 1990, as it became apparent that the economy was not as weak as many had thought. Long-term yields were most affected, increasing a full percentage point by early May. Subsequently, however, signs of a softening of activity prompted a reversal of much of that run-up. Rates on long-term securities remain about a half percentage point above their year-end levels, but money market quotes are now little changed on balance. Throughout this period, rates on Treasury bills have remained somewhat higher than usual relative to those on private instruments, probably in part reflecting the large amount of bill issuance necessary to fund working capital for the RTC.

The run-up in market interest rates early in the year was one factor behind the sharp slowing in money growth over the first half of 1990. M2, which had been running close to the top of its target range in February, posted no net increase between March and June. This weakness, which moved the aggregate close to the bottom of its range, was too abrupt to be accounted for fully by the rise in market rates, however. Another of the factors at work was the restructuring of financial flows. One aspect of this restructuring was the closing of insolvent thrifts by the RTC and sale of their deposit bases. Although the RTC's activities do not directly affect M2, the availability of huge blocks of deposits to the remaining thrifts and banks lessened their need to raise rates to draw in funds. In combination with the more cautious attitude depositories have exhibited toward expanding their balance sheets, the deposit transfers contributed to an unusual degree of inertia in the pricing of retail deposits. Households responded to the relatively low returns on deposits by looking elsewhere, as suggested by heavy flows into stock and bond mutual funds and sizable noncompetitive tenders at Treasury auctions. Nevertheless, while the movements in yield spreads can account for a good share of the slump in M2 growth, a portion of it still requires explanation.

The cause of the meager growth this year in the broader monetary aggregate, M3, is clearer: The RTC closed down a very large number of S&L's, taking many of those institutions' assets onto the Government's balance sheet and thereby effectively reducing the overall funding needs of the depository system. In addition, increased loan losses and the phasing-in of tighter capital requirements circumscribed the expansion of credit at many other thrifts and banks. With depository credit growth limited, M3—which contains much of the associated funding—essentially stalled. By June, M3 growth was well below the 2½ percent lower bound of the target range the FOMC had set in February.

That range had itself been reduced a full percentage point from the target provisionally set last July in recognition of the potential effects of the ongoing contraction of the thrift industry. Lacking historical experience with a financial restructuring like the current one, however, it was unclear exactly how the flows would end up being redirected through the financial system and, in particular, how much of the thrift lending would be picked up by commercial banks. While the economy more broadly is about where we expected it to be, the configuration of the financial system is somewhat different, leading to less M3 growth than had been anticipated.

CREDIT CONDITIONS

The weakness in the monetary aggregates in part signals a change in the behavior of depository institutions, with potential for affecting overall credit provision. The conservative pricing of retail and wholesale deposits represents one aspect of their efforts to widen profit margins. In light of concerns about their capital positions, banks and thrifts also have reined in lending activity and imposed stiffer terms on loans.

The change in credit supply conditions may have significant implications for borrowing, spending, and policy. I would not call this

change technically a "credit crunch," as those words connote a contraction of lending on a major scale, with many borrowers effectively shut out of credit markets, regardless of their qualifications. We are not seeing symptoms of that kind of widespread, classic crunch, as in the past when deposit rate ceilings or usury ceilings limited the market's ability to adjust and forced cut-offs of credit. But I can well appreciate that my view on this topic may be perceived as a semantic nicety by a borrower who today is suddenly unable to get a loan on the terms formerly available. To the borrower, it makes little difference why the lender is pulling back or how pervasive the change in credit conditions is.

From a policymaker's perspective, however, it is essential to sort the issues out. This means discerning the breadth and depth of the shift in credit conditions, its causes, its effects, and the extent to which it may ultimately be a desirable development. Clearly, the verdict is not yet in on the current episode; in economics, we are seldom able to make a definitive diagnosis until well after the fact, but to do our job, we must hazard some answers.

First, what do we observe? The evidence on this score continues to grow; numerous reports indicate that depository institutions and other lenders have become more selective in extending credit. In addition, Federal Reserve surveys of large banks support this sense that terms have been tightened in particular parts of the country and on certain types of loans. Especially hard-hit have been financings for mergers and LBO's, commercial real estate, and construction and development. There also is evidence that small and medium-size companies, as well as the poorer quality credits among the larger firms, have faced some tightening of credit availability. The change in credit conditions has taken various forms, including tougher standards for credit approval, higher collateral requirements, increases in interest rates, and, in some cases, loans have been simply unavailable. Even investment-grade corporations appear to be facing slightly higher costs in accessing bank credit facilities. At the same time, a huge widening of spreads on less-than-investment-grade bonds has effectively shut down that market to most new issues.

But on a number of other types of credit, changes in prices and non-price terms appear to have been relatively minor. For example, the rates on residential mortgages, consumer loans, and the debt of investment-grade corporations have remained about in their usual alignment with other market interest rate. Because these credits may trade on securities markets and thereby access a broad range of investors, the interest of banks and thrifts in holding the obligations in portfolio has little, if any, effect on the cost to borrowers. These obligations account for a major share of the credit extended in the economy, and hence, the slowing of depository credit and the sluggish behavior of the monetary aggregates—while indicative of some tightening of credit—likely overstate the impact of the depositories' behavior on economic activity.

No doubt a sizable portion of lenders' increased reluctance to commit funds for certain purposes reflects a natural and healthy reaction to a slowdown in growth as the economy moves closer to capacity restraints. Prospects for continued strong production and sales increases fade, and the odds rise that some borrowers will

prove unable to meet their obligations. In other words, part of the ongoing shift in credit conditions is what amounts to a regular cyclical event. But there is more to it than that. Through one avenue or another, the change in credit standards has its roots in part in the excesses of the 1980's. The weaker credits extended through that decade have come home to roost, and in so doing, have impinged to varying degrees on the current availability of credit.

Perhaps the clearest example is the real estate sector and its principal lender, the thrift industry. Those S&L's that were the freest with their funds exist no longer, having been closed by the RTC, and the remaining S&L's face tighter regulations constraining their lending. The resulting void has been filled quite effectively for home mortgage borrowers, with highly developed secondary markets drawing funds in from elsewhere. For these borrowers, the shrinkage of the thrift industry does not represent a significant decline in intermediation services. But many other clients of thrifts, whose debt is less easily securitized, have been hard-pressed to find alternative sources of funds. Moreover, lax lending standards by both thrifts and banks contributed to overbuilding in commercial real estate, which has added to problems for lenders to this industry.

Rising capital requirements for banks and thrifts have interacted with large losses on soured loans and the financial market's distaste for providing additional capital to the institutions taking these losses. This interaction has resulted in strong incentives for depository institutions to conserve capital. Their efforts to build larger capital cushions, in turn, have been manifest in a somewhat more cautious approach to lending, as well as a stepped-up effort to sell off assets by, for example, securitizing loans. Partly as a result tighter credit conditions, the growth of credit, as measured by the change in the debt of domestic nonfinancial sectors, has come down into closer alignment with the expansion of nominal GNP. This process, which reflects a somewhat more cautious approach on the part of borrowers as well, is not an aberrant restrictive phase in the life of the financial system, but rather, a return to what had been the norm prior to the 1980's.

To be sure, when you go from excess credit creation to normal, it can feel like a tightening. And in that sense, credit conditions have tightened. Many of the loans made during the 1980's should not, by historical standards of creditworthiness, have been made. As standards reverted closer to normal, those weaker borrowers have been finding it far more difficult to access credit.

In addition, however, depository institutions appear more recently to be lending with greater caution in general. As a result, even creditworthy borrowers may have to look harder for a loan, put up more collateral, or pay a somewhat higher spread. For the Nation as a whole, the tightening of credit standards will leave the financial system on a sounder footing and contribute to economic stability in the long run. Nevertheless, in the here and now, the tightening is beginning to have very real, unwelcome effects. Diminished credit availability can constrain firms' spending, for example, limiting more of them to internally generated funds. It is difficult to discern the dividing line between lending standards that are still healthy and those that are so restrictive as to be inconsistent with

the borrower's status and the best interests of the lender in the long run. In recent weeks, however, in my judgment, we may have slipped over that line. Such developments can, and do, occur independently of central bank actions, and can have important influences on spending and output. Thus, the Federal Reserve must remain alert to the possibility that an adjustment to its posture in reserve markets might be needed to maintain stable overall financial conditions.

As best we can judge, the change in credit conditions currently is exerting a slight additional degree of restraint on the economy. The process of credit restraint may not have reached completion and some of its effects may not yet have been felt; hence it will require continued scrutiny. However, the tightening should eventually unwind as displaced borrowers find alternative sources of funds and as the banking system rebuilds its capital.

This restraint has implications for monetary policy at present, and the ongoing restructuring of the financial system has implications for the conduct of policy over the foreseeable future. It is clear that the financial restructuring will affect the channels through which policy actions are transmitted ultimately to economic growth and inflation; some will be diminished and others augmented. In these circumstances, the Federal Reserve has emphasized a flexible approach to policymaking, which includes attention to a wide range of economic and financial indicators.

RANGES FOR MONEY AND DEBT GROWTH IN 1990 AND 1991

At its meeting earlier this month, the Federal Open Market Committee reaffirmed the 1990 range of 3 to 7 percent it had set for the growth of M2. With the thrift industry likely to continue to shrink at a good clip and commercial banks expanding more circumspectly, depository institutions are not expected to be bidding aggressively for funds. As a result, although banks may replace more of their managed liabilities with retail deposits, M2 could well remain in the lower half of its target range through yearend. In view of changing credit flows, a slow rate of expansion in M2 seems consistent with continued moderate growth in output, but any pronounced weakness in the aggregate that drops it below its current range might represent greater monetary restraint than is desirable this year.

Looking ahead to 1991, the committee lowered the M2 range by percentage point on a provisional basis. We believe that this range is consistent with the continuation of measured restraint on aggregate demand—a necessity in the containment, and ultimate elimination, of inflation. Such restraint need not be a barrier to sustained growth. Indeed, it is a crucial requirement. As I suggested earlier, one thing that surely would jeopardize the current expansion would be for inflation to move upward, rather than downward, from the recent plateau.

FOMC members and other Reserve Bank Presidents generally foresee the policy embodied in the money ranges as leading to both sustained growth and diminished inflation in the period ahead. For 1990, their expectations center on an inflation rate in the 4½ to 5 percent range, with real GNP growth of about 1½ to 2 percent. But

with this year's slow growth helping to relieve pressures on resources, expectations for 1991 incorporate both somewhat lower inflation and somewhat higher real growth, at a rate closer to that of growth in potential output.

The path of M3 consistent with these projections has been heavily affected by changes in financial intermediation in recent quarters. Taking into account the current lending posture of the commercial banks and remaining thrifts, we now expect the closures of insolvent thrifts to show through in very subdued growth in M3.

Accordingly, the FOMC voted to lower the 1990 range for growth of this aggregate to 1 to 5 percent. This action does not signal a tighter policy stance, but rather our recognition that financial markets have been adjusting to the RTC's activities in a somewhat different manner than we had anticipated, making the lower M3 target appropriate. In view of the considerable uncertainties about both the scale of RTC activities next year, and the speed with which the banking industry will approach a more comfortable capital position, the new 1990 range was carried forward unchanged into 1991 on a tentative basis.

Overall debt growth during the rest of this year is expected to remain around the midpoint of its reaffirmed 5 to 9 percent monitoring range. The non-Federal sectors now appear to be increasing their debt about in line with nominal income growth, with the rapid pace of mortgage borrowing in recent years slowing into the single digits and corporate leveraging activity slackening. Growth of total debt in 1990 is likely to exceed that of nominal GNP, however, as the Federal Government's borrowing to fund RTC activities is expected to boost the total by roughly three-quarters of a percentage point.

For 1991, the FOMC has provisionally reduced the monitoring range for domestic nonfinancial sector debt to 4½ to 8½ percent. Debt growth in this range should be adequate to support continued economic expansion, while avoiding the excessive leveraging that characterized much of the 1980's.

A number of uncertainties come into play in the process of judging the outlook for the economy over the next year-and-a-half. Of particular concern in the context of monetary policy are the likely extent and persistence of the tightening of credit terms, the prospective path of potential output growth—especially in view of the recent slowing in the labor force—and the outlook for fiscal policy. It is the last of these that is the focus of the remainder of my comments today.

FISCAL AND MONETARY POLICY INTERACTION

The determination displayed by the Congress and the administration in their efforts to come to an agreement on cutting the deficit has been enormously heartening to all who are concerned about the long-term health of the U.S. economy. As a nation, we have been saving too little and borrowing too much; significant progress on the Federal deficit would be an important step in rectifying this situation. As you know, I favor not only eliminating the deficit, but also ultimately bringing the Government's accounts into surplus over time to compensate for the private sector's tendency to save

relatively little. In the long run, the Nation's saving and investment behavior is crucial in determining its productivity and hence, its standard of living.

Major, substantive, credible cuts in the budget deficit would present the Federal Reserve with a situation that would call for a careful reconsideration of its policy stance. What adjustment might be necessary, and how it might be timed, cannot be spelled out before the fact. The actions required will depend on the constellation of other influences on the economy, the nature and magnitude of the fiscal policy package, and the likely timing of its effects. I can only offer the assurance that the Federal Reserve will act, as it has in the past, to endeavor to keep the economy expansion on track.

Concerns that the Federal Reserve would be able to offset undesirable macroeconomic effects of a budget pact are, I believe, largely unfounded. It is true that, in general, monetary policy cannot be calibrated extremely finely in response to economic developments, as we are all subject to imperfect data and an imperfect understanding of the myriad economic interrelationships of the real world.

However, some doubts seem to focus on whether the various lags involved permit monetary policy to catch up to a change in the fiscal stance. I am less concerned, Mr. Chairman, on this point. We can decide that a policy adjustment is appropriate and implement it fully, all in the same morning, if need be, and the effects of the change will show through to interest rates and financial asset prices almost immediately. Granted, the impact on economic growth and inflation will be spread out over several quarters, but this is true of changes in fiscal policy as well.

In the final analysis, no one can guarantee that growth in the economy will proceed smoothly, without a hitch on a quarter-to-quarter basis. Nevertheless, a major cut in the budget is unquestionably the right thing to do. Because the Federal Government has been borrowing too much for too long, it is well past time to reduce the Government's draw on credit markets and to free up more resources for enhancing investment and production by the private sector. In this way, fiscal policy, by augmenting national saving, will be doing its part to promote maximum sustainable economic growth. With monetary policy similarly keeping sight of its long-run goal of price stability, the two together will have set a favorable backdrop for vibrant and enduring economic growth.

Thank you very much, Mr. Chairman.

**For use at 9:45 a.m., E.D.T.
Wednesday
July 18, 1990**

Board of Governors of the Federal Reserve System



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

July 18, 1990

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 18, 1990

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

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress, pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Alan Greenspan, Chairman

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Section 1: Monetary Policy and the Economic Outlook for 1990 and 1991

The Federal Reserve delivered its initial Humphrey-Hawkins report of 1990 to the Congress in February, and the period since then has been an especially challenging one for monetary policy decisionmaking. The already difficult task of moving a quite fully employed economy toward price stability without contractionary mishap has been complicated by a variety of disturbances to business activity and financial markets—among them developments that distorted some of the basic indicators of the Federal Reserve's influence on the economic system.

On the whole, events in the economy have been broadly in line with the projections for 1990 contained in the February monetary policy report. Inflation has been somewhat greater on average than most members of the Federal Open Market Committee and other Reserve Bank presidents expected in February; however, this mainly reflected the influence of transitory factors early in the year, and price increases recently have been more moderate. Meanwhile, the economy has continued to expand, but apparently rather sluggishly overall since the winter.

While these aspects of the economic situation were important elements in the FOMC's review of its policy plans earlier this month, the Committee also gave careful attention to developments in financial markets. Although market interest rates had changed little on net since February, slow growth of the monetary stock and other evidence in hand pointed to a small but significant tightening of credit supplies. This implied greater effective restraint on aggregate demand in the months ahead than was thought desirable, and in the past week the System shifted to a slightly more accommodative stance in the provision of reserves to depository institutions. As a result, the overnight federal funds rate, which had fluctuated narrowly around 8¼ percent throughout the first half of the year, has declined to about 8 percent, and other market rates of interest also have eased a bit in recent days.

Developments Thus Far in 1990

In the early part of 1990, economic activity appeared to be regaining momentum, a development that reduced previous concerns about recessionary risks. At the same time, even discounting weather-related spurts in food and energy prices and an unusual bunching of price increases for some other items, there appeared to be no abatement in underlying inflationary pressures. Through the first quarter, M2 remained near the top of the annual range set by the FOMC, and although M3 was near the lower bound of its range, this weakness

appeared consistent with the anticipated effects of the restructuring of the thrift industry.

The Federal Reserve maintained a steady pressure on reserve positions during the first quarter, rather than extending the sequence of easing steps that had fostered a drop in the federal funds rate of 1½ percentage points between June and December of 1989. However, in keeping with the tenor of most of the economic data released during the quarter, other interest rates generally moved higher, particularly at the long end of the yield curve. This shift suggested that market participants had reevaluated the prospects for moderating inflation and a further easing of monetary policy. Early in the year, bond yields in the United States rose along with rates in Japan and Western Europe, as developments in Eastern Europe suggested a further spur to worldwide economic activity, carrying the potential for greater inflation and heightened pressures on a limited international pool of savings.

In the second quarter, some of the weather-related increases in food and energy prices that had caused inflation to pick up earlier in the year were reversed, and price increases for many other goods and services moderated. Inflation trends remained in the range prevailing over the previous three years, though price pressures in the industrial sector gave signs of some easing. The incoming information pointed to a sluggish pace of economic expansion; most notably, growth in private sector employment slackened, consumer spending flattened, and real estate markets weakened. Moreover, advance indicators in some sectors—particularly durable goods orders and construction contracts—gave no evidence of a significant pickup in the second half. With the economy appearing somewhat less buoyant, over May and June bond yields in the United States retraced some of their earlier increases. Long-term rates in Japan and West Germany also declined, but by much less, with the result that yields in those countries have risen appreciably this year relative to those in the United States.

In foreign exchange markets, the dollar has depreciated somewhat on balance thus far this year, under the influence of a diverse set of economic, financial, and political developments around the world. The dollar has appreciated slightly in terms of the yen, while depreciating somewhat in terms of the German mark and other currencies of the EMS exchange rate mechanism and somewhat more in terms of the Swiss franc and pound sterling.

The monetary aggregates flattened out during the second quarter, and by midyear M2 was in the lower

half of its annual range and M3 had fallen below the lower bound of its annual range. The weakness in the monetary aggregates mainly, though not wholly, reflected a rechanneling of credit flows away from depository institutions. Total borrowing by domestic nonfinancial sectors moderated only a little in the first half of 1990 from the pace of 1989, and growth in the aggregate debt of these sectors was in the middle of the FOMC's monitoring range. However, the proportion of lending accounted for by depositories was down substantially. Much of the decrease related to the shrinkage of savings and loan associations: Marginal institutions continued to retrench, and the Resolution Trust Corporation transferred large volumes of assets to banks and onto its own books in the course of closing failed thrift institutions. Meanwhile, concerns about credit quality and pressures on capital positions led banks to adopt more cautious lending postures and to hold down asset growth.

The weakness in lending by depositories was reflected dramatically in the behavior of M3; this aggregate, encompassing managed liabilities as well as M2 deposits, comprises most of the liabilities used by these institutions to fund credit extensions. With depository credit damped, not only were managed liabilities weak, but banks and thrifts did not bid aggressively for retail funds—thereby contributing to reduced growth of M2. In addition, increases in expected returns on stocks and bonds may have restrained expansion of this aggregate, although some portion of the slowdown in M2 remains unexplained by changes in relative yields or income. The weakness in depository credit and the monetary aggregates likely has had, to date, only limited effects on spending: The bulk of the credit formerly supplied by depositories has been provided by other lenders, in part through the securities markets, with little change in the terms to most borrowers.

Monetary Objectives for 1990 and 1991

In reevaluating its ranges for money and credit for 1990 and in establishing tentative ranges for 1991, the FOMC had to take account of the redirection of credit flows away from depository institutions and the resulting effect on the growth of the financial aggregates relative to spending and prices. In February, the Committee expected that the continued shrinkage of the thrift industry would damp growth in M3; to take account of this, it lowered the M3 range for 1990 to 2½ to 6½ percent, one percentage point below the range set tentatively in July 1989. However, the contraction of thrift assets has been faster than anticipated, in part because of the step-up in RTC activity, and bank credit has expanded less rapidly. As a consequence, through

June, M3 grew at an annual rate of only 1¼ percent from its fourth-quarter 1989 base.

Barring a marked slowdown in RTC activity or a significant strengthening in bank credit, M3 growth is likely to remain sluggish over the balance of the year. As in the first half, the weakness in M3 growth is expected to be associated with a further substantial increase in velocity—the ratio of nominal GNP to money—rather than with substantial restraint on overall credit supplies. Recognizing this unusual behavior of M3 velocity, the FOMC voted in early July to reduce the M3 range for 1990 to 1 to 5 percent. At the same time, the Committee reaffirmed its range of 5 to 9 percent for total growth in the debt of domestic nonfinancial sectors. The Committee seeks to ensure that credit will remain available in amounts and at terms compatible with moderate expansion of the economy, and it will continue to assess the implications of developments at depositories for credit conditions more generally.

As noted above, the contraction of the thrift industry and the moderate growth in bank credit also has affected the growth of M2, as potential inflows of retail deposits have outpaced the needs of depository institutions for such funds. The velocity of this aggregate has risen, unexpectedly, but less than that of M3: Growth of M2 from its fourth-quarter base through June was at a 3¾ percent annual rate, within its annual range, though in the lower half. M2 velocity is likely to increase further over the second half of the year; however, a substantial slowing of M2 could suggest more restraint than would be consistent with sustained upward momentum of the economy, and thus the Committee reaffirmed the established range for M2 growth for 1990.

In setting tentative ranges for 1991, the Committee faced more than the usual uncertainty about the growth of money that would foster its objectives of sustained expansion and a gradual abatement of inflation. Developments in credit markets will be shaped not only by the special factors that have altered patterns of intermediation thus far this year, but also by the outcome of the current deliberations regarding the federal budget. At this point, the forces that recently have diminished the role of depository credit seem likely to persist for some time, and they may foster further upward shifts in monetary velocities, albeit probably smaller ones than now appear in train for 1990. To be sure, though, subsequent events may dictate adjustments to the ranges next February, when they are reexamined in light of developments over the second half of this year.

For growth in M2, the Committee tentatively adopted a range of 2½ to 6½ percent—one-half percentage

Ranges for Growth of Monetary and Credit Aggregates

Percent change, fourth quarter to fourth quarter	1989	1990		Provisional for 1991
		Adopted in February 1990	Adopted in July 1990	
M2	3 to 7	3 to 7	3 to 7	2½ to 6½
M3	3½ to 7½	2½ to 6½	1 to 5	1 to 5
Debt	6½ to 10½	5 to 9	5 to 9	4½ to 8½

point below the 1990 range. The adjustment is consistent with the Committee's intention to move over time toward the low trend rates of monetary expansion that would be consistent with price stability. At the same time, the range is expected to allow for sufficient expansion of money to sustain moderate growth in the economy. There may be some further upward shift in velocity, but the range should be wide enough to accommodate considerable variation in credit market conditions.

The range for growth of M3 was tentatively set at 1 to 5 percent, the same as that now in effect for 1990. Growth of this aggregate is especially sensitive to the pattern of credit flows. Thus, the continuing downsizing of the thrift industry is likely to result in slower growth of M3 than of M2 again next year, as managed liabilities in the broader aggregate run off. It also is likely to mean a substantial further increase in M3 velocity. Given that growth of this aggregate currently is running along the lower bound of the new range for 1990, even if the pace of credit flows at banks and thrifts were to pick up somewhat, M3 growth between 1 and 5 percent should be consistent with the Committee's basic objectives.

For debt, the FOMC adopted a tentative monitoring range of 4½ to 8½ percent, a half percentage point below the range for 1990. The Committee viewed slower growth of debt, more in line with the expansion of nominal income, as a healthy development for the economy. The rapid expansion of debt over the past decade, relative to the ability to service it, occasioned many of the difficulties with asset quality now facing our lending institutions.

Economic Projections for 1990 and 1991

The members of the FOMC and the Reserve Bank presidents not currently serving as members believe that the monetary ranges for 1990 and 1991 are consistent with achievement of sustainable economic growth

and a reduction of inflation over time. Most of them expect that the pace of expansion will be moderate over the remainder of 1990 and through next year, with the central tendency of their forecasts of real GNP growth being 1½ to 2 percent over the four quarters of 1990 and 1¾ to 2½ percent over the course of 1991.

Demand from abroad is likely to provide support for continued growth in U.S. production and employment. At current exchange rates, U.S. producers appear to be in a position to compete effectively in most international markets, and economic activity is growing relatively rapidly on average in other major industrial countries. In time, export demand should be bolstered by the shift toward more open, market-based economic systems in Eastern Europe; although the continental European nations may be most immediately affected by these developments, given the high rates of capacity utilization in those economies, the United States is likely to benefit both directly and indirectly from the increased demand for consumer and capital goods.

In the aggregate, demands from sectors outside of exports are unlikely to provide much impetus to manufacturing activity. Defense procurement is declining in real terms. And there is little prospect of a substantial resurgence in motor vehicle production: High levels of auto sales in the past several years appear to have satisfied demands that were pent up during the deep economic slump of the early 1980s. Demand for construction materials and equipment probably also will remain subdued, because building activity will be damped by the current overhang of vacant residential and commercial space. That overhang, more than any disruption of credit flows, explains the current weakness in construction, and, especially in the case of office building, it will take some time for existing space to be absorbed and to lay the base for a solid upturn in activity.

In sum, the growth of total output projected for 1990 and 1991 probably will involve rather slow gains for

Economic Projections for 1990 and 1991

	FOMC Members and Other FRB Presidents		Administration
	Range	Central Tendency	
1990			
<i>Percent change, fourth quarter to fourth quarter</i>			
Nominal GNP	5 to 6½	5½ to 6½	6.8
Real GNP	1 to 2	1½ to 2	2.2
Consumer price index	4 to 5	4½ to 5	4.8 ¹
<i>Average level in the fourth quarter, percent</i>			
Civilian unemployment rate	5½ to 6½	5½ to 5¾	5.6 ²
1991			
<i>Percent change, fourth quarter to fourth quarter</i>			
Nominal GNP	3½ to 7	5¼ to 6½	7.2
Real GNP	0 to 3	1¾ to 2½	2.9
Consumer price index	3½ to 5	3¾ to 4½	4.2 ¹
<i>Average level in the fourth quarter, percent</i>			
Civilian unemployment rate	5¼ to 7	5½ to 6	5.6 ²

1. CPI-W. FOMC forecasts are for CPI-U.

2. Percent of total labor force, including armed forces residing in the United States.

the goods-producing sectors of the economy. The service-producing industries are likely to continue to be the locus of important increases in output and, especially, employment. Demands for a wide range of services have remained robust thus far this year, and demographic trends suggest that such sectors as medical care and education will continue to experience appreciable growth.

The overall growth in economic activity forecast by the Board members and Bank presidents for the period ahead is expected to be consistent with a slight easing of pressures on resources and a diminution of inflation. With respect to the labor market, the central tendency of the forecasts for the civilian unemployment rate is 5½ to 5¾ percent in the fourth quarter of this year and 5½ to 6 percent in the final quarter of 1991; the jobless rate has fluctuated narrowly at a little below 5½ percent since late 1988. Moderate growth in demands on industrial capacity should be conducive to an extension of the recent more favorable trends in

producer prices for intermediate and finished goods, which were, respectively, virtually unchanged and up just 3 percent in the past twelve months.

Inflation at the retail level also should be damped over the remainder of this year by favorable developments in the energy sector. Despite the very recent upturn in crude oil prices, gasoline prices are widely expected to decline in coming months, as the return of refinery output to normal levels alleviates the tightness that has characterized the product market. With inflation for other goods and services expected to remain below the first-quarter pace, the central tendency of the policymakers' forecasts of the overall consumer price index is for an increase of between 4½ and 5 percent over the four quarters of 1990—compared with the 5¾ percent annual rate of increase recorded during the first five months of the year. The lower trajectory of the CPI is projected to be sustained in 1991, with forecasts for the year centering on the 3¾ to 4½ percent range.

The Administration's economic projections, presented in connection with its mid-session update of the budget, indicate similar expectations about inflation trends but a more favorable outlook for real GNP. As a result, the Administration's projection of nominal GNP growth is somewhat above the central tendency of those of the FOMC participants, and might imply the need for faster monetary growth than is currently contemplated by the Committee. These differences must be regarded as small, however, relative to the

degree of uncertainty that attaches to any prediction of the economy--and, in particular, of the short-run relation between growth in GNP and money stock. More important, the differences do not signal any basic inconsistency between the goals of the Federal Reserve and the Administration, for the Federal Reserve would welcome a more rapid expansion of output that occurred in the context of solid progress toward price stability.

Section 2: The Performance of the Economy During the First Half of 1990

Activity in many sectors of the economy followed an erratic course during the first half of the year, in part because of transitory factors, such as last winter's unusual weather. On balance, production expanded further during the first half of 1990, but evidently no faster than the reduced pace of 1989. The comparatively slow rate of growth largely reflected weaker spending by domestic businesses and households, while merchandise exports apparently remained on a fairly strong growth path. Although job creation in the private sector of the economy has slowed this year, the civilian unemployment rate has remained near 5 1/4 percent, the lowest level in nearly twenty years.

Prices rose sharply early in the year, but the increases moderated this spring. In the first quarter, there were large weather-related surges in food and energy prices and a bunching of increases in prices of some other goods and services. Given the character of the spurt, most analysts—and policymakers in the Federal Reserve—judged that the runup in aggregate price indexes overstated underlying inflation trends. In the event, some of the transitory elements of the earlier spurt were reversed in the spring and inflation moved down. Despite the recent slowing, however, the twelve-month change in the CPI as of May, at 4.4 percent, was about the same as that recorded for each of the past three years. In part, the persistence of inflation during a period of slower economic growth reflects continued cost pressures from relatively tight labor markets and weak productivity performance. However, there have been encouraging signs, particularly at the earlier stages of processing, that an easing of resource constraints in the manufacturing sector is reducing some of the pressures that had boosted prices from 1987 to early 1989.

The Household Sector

Total personal consumption expenditures were buffeted this winter by large swings in outlays for energy items and motor vehicles. Expenditures for home heating declined sharply in the first quarter as unseasonably warm temperatures in January and February followed a December that had been colder than usual. This influence was largely offset by a rise in motor vehicle sales. In late 1989 sales of cars and light trucks had been depressed by a scaling back of incentives and by large price increases for new model-year vehicles. Around the turn of the year, enriched incentive programs revived these sales. To date this year, sales of cars and light trucks have averaged 14 million units (annual rate)—a pace not far below the total for

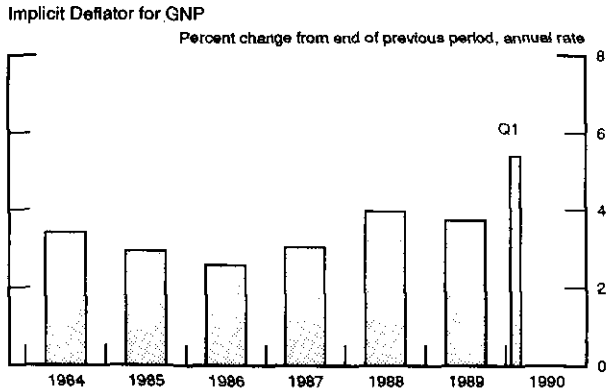
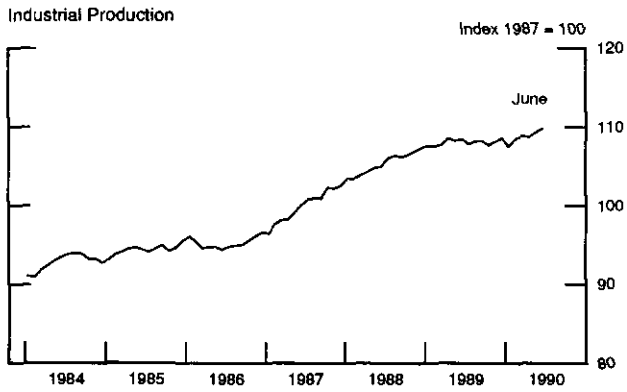
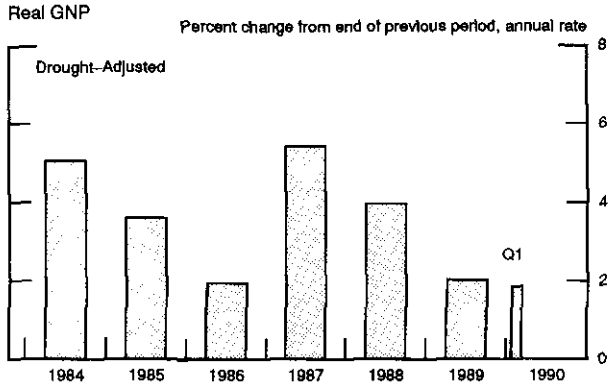
1989—and seem largely to reflect replacement demand and growth in the driving age population.

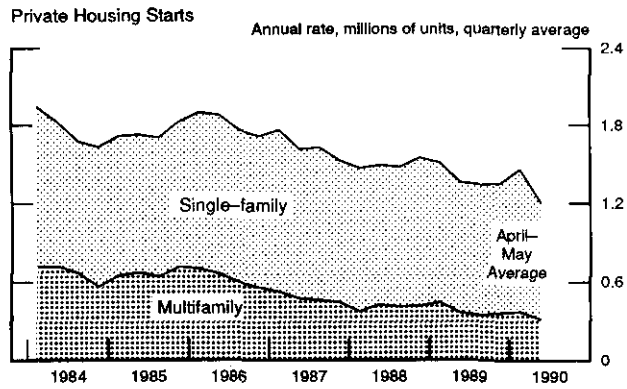
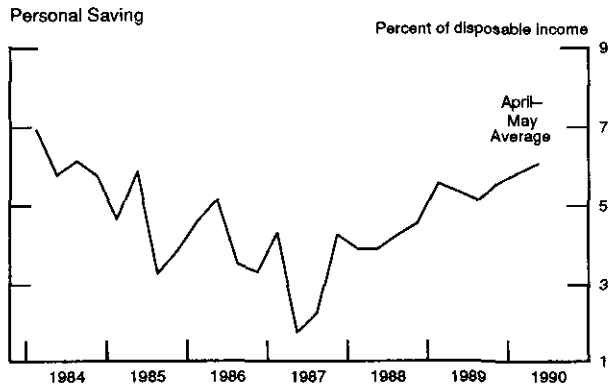
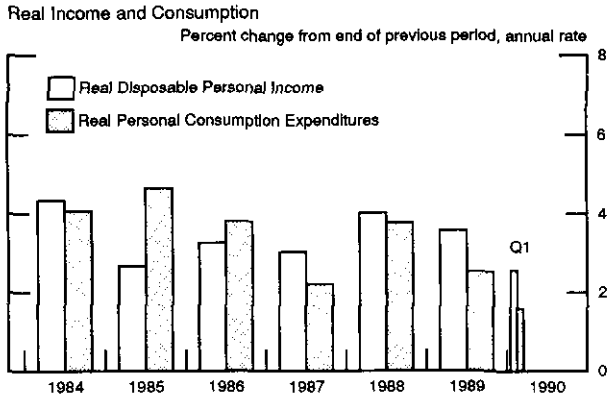
Abstracting from the swings in outlays on home heating and motor vehicles, consumption spending appears to have stagnated this spring after posting a moderate gain in the first quarter of 1990. The recent sluggishness in spending reflects declines in outlays for a wide variety of consumer goods, including furniture and other household durables. In contrast, spending for services other than energy, especially medical services, continues to outpace real income growth.

Growth of consumption has slowed this year against a backdrop of somewhat smaller gains in real disposable personal income. But consumption has slowed even more than income, and the personal saving rate rose above 6 percent in the spring. Consumers may be spending more cautiously as they reassess their income and wealth prospects in light of the slower growth of the economy and a softening of residential property values in many parts of the country. These factors probably have been particularly important in the Northeast, where consumer sentiment has deteriorated markedly. However, other indicators, such as delinquency rates on consumer loans, do not reveal broad pressure on household finances. Nor are there signs that credit availability has been reduced: Federal Reserve surveys of bank lending officers suggest no change in the willingness to lend to consumers.

Residential investment spending also was affected by unusual weather patterns this winter. Housing starts were strong in the first two months of the year, as mild temperatures allowed builders to catch up on work delayed by cold weather in late 1989 and to begin projects that normally would have been started later in the year. Then starts slumped this spring, in part reflecting a "payback" for the winter activity. Averaging over this period, residential construction appears to have weakened; in the first five months of the year, housing starts totaled 1.36 million units (annual rate), somewhat below the pace of activity in 1989. By region, housing markets have been very weak in the Northeast, while homebuilding has been better maintained, albeit at moderate levels, in the North Central and Western regions of the country.

Both demand and supply factors have contributed to the recent weakness in housing construction. Sales of new and existing homes generally have been moving lower for more than a year; in part, demand may have been restrained by slower growth in income and reduced investment motivation for home purchase because of softening house prices. Demand also may





have been tempered this spring by some edging up in mortgage rates. Since early May, however, mortgage rates have moved down about ½ percentage point, and there is no evidence that access to home loans has been curtailed.

On the supply side, building is being deterred in some parts of the country by an overhang of unsold or unrented housing units. In addition, it appears that a reduction in credit availability for construction may be playing some role in damping building activity. To a degree, this less favorable credit climate is attributable to the cutback in financing supplied by thrift institutions owing to the closure of savings and loans as well as the more stringent capital requirements and lending limits mandated by the Financial Institutions Reform, Recovery, and Enforcement Act. At the same time, other institutions do not appear to be filling the void completely. In part, the shift in credit availability reflects the elimination of the imprudently aggressive lending that capsized so many thrift institutions. A number of commercial banks also have recently experienced reductions in their lending capacity as they have written off, or reserved against, bad loans. But, in addition, the number of sound lending opportunities undoubtedly has shrunk as a consequence of economic weakness and soft property values in specific locales.

The Business Sector

The financial position of the business sector deteriorated further during the early part of 1990. Before-tax profits from current operations of nonfinancial corporations edged down in the first quarter after falling nearly 18 percent over the four quarters of 1989. Profits have been squeezed by a combination of marked increases in wages and benefits during a period of weak growth in productivity, competitive pressures from both home and abroad that have prevented firms from completely passing increases in labor costs through to prices, and higher debt-servicing costs associated in part with increased leverage.

Shrinking profits, which have reduced the availability of internal funds, along with the slower growth of final sales and easing of capacity pressures over the past year, have muted the demand for new plant and equipment. Reflecting these developments, real business fixed investment has decelerated considerably since the first half of 1989.

Although total real spending on producers' durable equipment rose at an annual rate of about 7 percent in the first quarter, spending was boosted by a rebound in outlays for motor vehicles and a resurgence in aircraft shipments following the settlement of the strike last

November at Boeing. Excluding these transitory swings, real equipment spending slowed further in the first quarter, and shipments of most types of capital goods—especially industrial machinery—remained soft in April and May. One bright spot in the equipment picture, however, has been the growth in outlays for computers and other information-processing equipment, after some slowing during the second half of 1989.

Nonresidential construction was boosted by favorable weather early in the year, but most of the gain has since been reversed. The weakness is most evident in office and commercial real estate, for which vacancy rates are high and data on contracts and permits suggest the outlook for building remains decidedly negative. In some areas, this reflects sluggish growth in the regional economies. However, activity also may be hindered by the shift in the credit climate, as more speculative projects that previously might have been financed no longer qualify. An exception to the weakness in business construction has been in the industrial sector; lead times can be quite long for these projects, however, and much of the continued strength undoubtedly reflects in large part decisions made when capacity pressures were mounting in 1988 and early 1989. Indeed, contracts and permits for new industrial construction have been trending down for about a year.

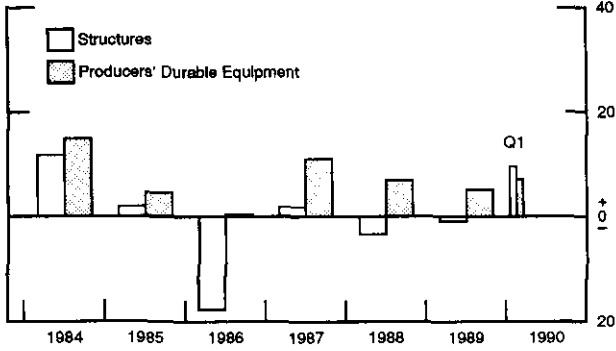
The emergence of uncomfortably high inventories in some sectors in late 1989 led to corrective actions in the first part of this year. Most prominently, manufacturers of motor vehicles cut production sharply and reinstated widespread sales incentives to eliminate an overhang of stocks on dealer lots. In most other sectors, stocks have been trimmed or have been increased only modestly this year, and they appear to be in good alignment with sales trends. Among the possible exceptions are wholesale distributors of machinery and nonauto retailers, where some mild overhangs appear to have developed this spring; these could precipitate further adjustments, probably affecting both domestic and foreign producers.

The Government Sector

The federal budget deficit over the first eight months of the fiscal year was \$152 billion, up from \$113 billion in the year earlier period. About \$15 billion of this increase resulted from spending by the Resolution Trust Corporation, and further RTC outlays during June imply that the year-to-year increase in the deficit is likely to widen. Most of the RTC spending reflects financial transactions in which existing federal insurance obligations to thrift depositors are being recognized in the government's budget outlay and public

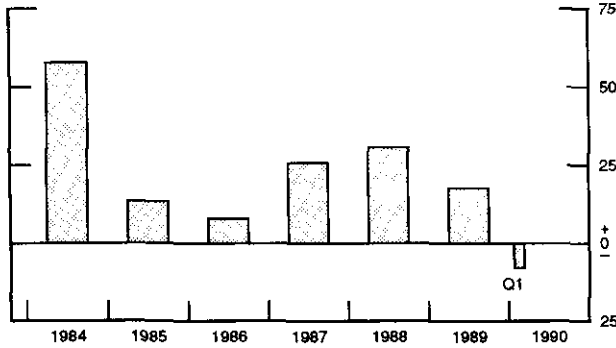
Real Business Fixed Investment

Percent change from end of previous period, annual rate



Changes in Real Nonfarm Business Inventories

Annual rate, billions of 1982 dollars



After-tax Profit Share of Gross Domestic Product *



* Ratio of profits from domestic operations with inventory valuation and capital consumption adjustments to gross domestic product of nonfinancial corporate sector

debt accounts. The RTC's borrowing and spending thus should have little effect on real economic activity or interest rates.

However, several other budget components have contributed to the higher deficit. Spending on Medicare and other health care programs, and some discretionary spending for the space and other programs, has surged. During the same period, revenue growth has lagged as weak corporate profits have cut into receipts and last year's surprisingly large personal income tax collections have not been sustained. The latter suggests that some of last year's receipts reflected special factors, such as the deferral of tax liabilities in response to the phased reduction of income tax rates under the Tax Reform Act of 1986, and the capital gains realized during sharp movements in financial markets.

Federal purchases of goods and services, the part of expenditures that is included directly in GNP, fell in real terms over 1988 and 1989, owing mainly to declines in defense spending. Real defense purchases continued to move lower in the first quarter of 1990; however, the downtrend in total purchases was interrupted by a pickup in nondefense spending, mainly a transitory surge in space expenditures. In the second quarter, compensation for temporary Census workers added to federal purchases.

Real state and local government purchases increased at an annual rate of 4½ percent in the first quarter, compared with the 3 to 3½ percent pace recorded over the past three years. Revenue growth generally has not kept up with gains in spending, however, and an increasing number of state and local governments face significant budgetary difficulties; indeed, the overall deficit of the sector (excluding social insurance funds) was about \$45 billion (annual rate) in the first quarter of 1990, almost \$11 billion greater than the deficit recorded in the 1989 calendar year. These difficulties are compounded by growing spending requirements in several important areas. An increase in the number of school-age children has boosted public school enrollments, the number of medicaid recipients has increased, and prison populations have risen rapidly. Meanwhile, legislatures have been reluctant to increase personal income taxes, and federal grants and increases in state excise taxes have failed to prevent the widening of the gap between spending and revenues.

The External Sector

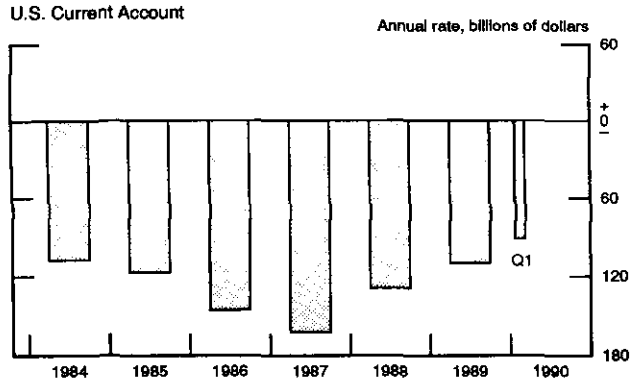
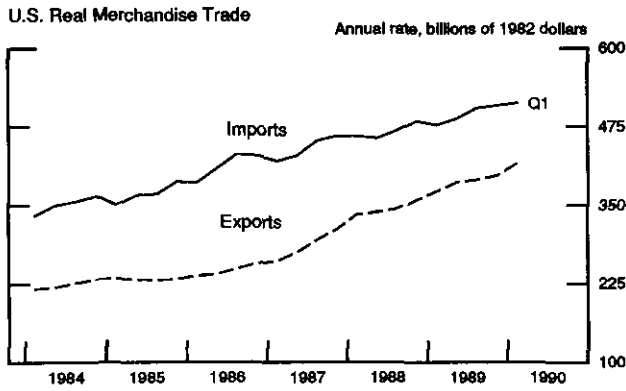
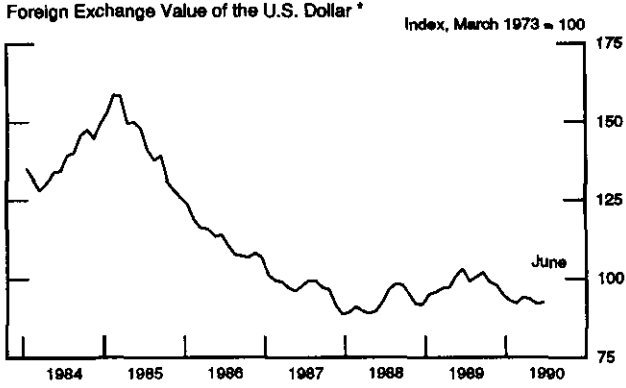
Movements in the exchange rate have been smaller than those in 1989, when the dollar appreciated about 12 percent in terms of the other G-10 currencies over the first half of the year and then depreciated by a

similar amount between last summer and this past February. The dollar appreciated approximately 2 percent between February and March this year, but has since declined about 4 percent, partly in response to publication of weaker data on U.S. economic activity and the associated washing out of expected increases in interest rates.

While the value of the dollar has not changed dramatically on a trade-weighted average basis against the other G-10 currencies this year, there have been some divergences in bilateral exchange rates. On balance, the dollar has depreciated significantly against sterling and the Swiss franc, and somewhat less against the German mark and related currencies. In contrast, the dollar has appreciated against the yen, despite exchange market intervention by the Bank of Japan and other central banks to support the value of the yen early in the year. Against the currencies of our other major trading partners in the Pacific Basin, the dollar has depreciated against the Singapore dollar, but appreciated in terms of the South Korean won and the new Taiwan dollar.

Prices of non-oil imports, which fell at about a 3 percent annual rate between the first and third quarters of last year, rose at a similar pace between the third quarter of 1989 and the first quarter of 1990, partly in response to the drop in the dollar between last summer and the early part of this year. Prices of imported oil surged around the turn of the year, moving above \$20 per barrel in January, but since then they have more than retraced this runup. On the export side, prices rose at an annual rate of just 1½ percent in the first quarter of 1990 after recording little change, on balance, over 1989 as a whole. In the first quarter, prices for agricultural exports fell somewhat, but there was an acceleration in prices for exported consumer and capital goods that appears to have been related to some pickup in prices for these items in domestic markets around the turn of the year.

Merchandise exports continue to provide an important impetus to growth in the domestic economy, although the increases in exports have slowed somewhat from the very rapid advances recorded in the latter part of the 1980s. So far this year, exports have been boosted by strong shipments of aircraft with the rebound in activity at Boeing, as well as by notable increases in other classes of machinery, agricultural products, industrial supplies, and consumer goods. Two factors have contributed to further large gains in the quantity of U.S. exports: Many of our major trading partners abroad have continued to register strong economic growth, and the average dollar prices of U.S. exports have declined somewhat relative to



* Index of weighted average foreign exchange value of U.S. dollar in terms of currencies of other G-10 countries. Weights are 1972-76 global trade of each of the 10 countries.

average prices abroad. Movements in nominal exchange rates do not appear to have contributed significantly to either export growth or overall U.S. external adjustment in recent quarters; the effects of the large depreciation of the dollar through 1987 have waned, and any residual positive effects probably have been offset by the average strengthening of the dollar last year. However, the depreciation of the dollar since last summer should lend some stimulus to external adjustment in coming quarters.

Meanwhile, slower import growth has accompanied the slackening pace of activity in the United States. Total imports were boosted by a surge in oil imports in the first quarter, but, on balance, non-oil merchandise imports have edged down this year. The slowdown in imports has been pronounced in automotive products and consumer goods, reflecting both weaker domestic final demands and the inventory adjustments in these sectors of the U.S. economy.

Together, the continued growth in exports and the slowdown in imports narrowed the merchandise trade balance to \$105 billion at an annual rate in the first quarter of 1990, its lowest rate since early 1985. The current account deficit was reduced to \$92 billion at an annual rate.

Net private capital inflows, and a large statistical discrepancy, provided the counterpart to the current account deficit in the first quarter of 1990, as they did for 1989 as a whole. Most of the private capital inflow in the first quarter came through the banking sector. Private foreign investors continued to acquire U.S. corporate bonds in the first quarter; however, they sold a small amount of U.S. Treasury securities, and they continued to sell U.S. corporate stocks as they have since last October. Foreign direct investment flows into the United States slowed markedly in the first quarter to a rate well below that recorded in recent years. Official capital showed a net outflow in the first quarter, as it did throughout most of 1989, reflecting the net sale of dollars in exchange market intervention.

Labor Markets

Job growth was strong early in the year, but has softened recently. In January and February, increases in nonfarm payroll employment averaged more than 350,000, fueled by large increases in service-producing industries as well as by robust hiring in construction during the warmer than normal winter weather. Since March, however, job growth has averaged about 125,000 per month, despite the net addition of about 300,000 temporary workers to help carry out the 1990

Census; private payrolls have increased less than 20,000 per month. Manufacturing employment has continued to shrink this year at about the same rate as in the second half of 1989, and construction payrolls also have declined since the winter. Meanwhile, job growth in the service-producing industries has slowed in recent months. Although hiring gains have continued strong for health services, growth in jobs in business services has moderated, and there have been only small gains in employment at retail establishments.

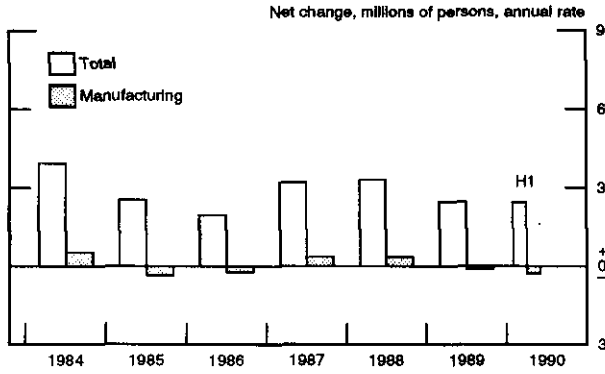
Growth in the labor force also has been subdued in recent months. To an extent, this reflects longer-run demographic trends; but it may also reflect a tendency for fewer people to seek jobs when the growth of employment opportunities is perceived to have slackened. Survey data suggest that individuals have increasingly viewed jobs as harder to find.

The slower rates of growth in employment and the labor force have been roughly matching, and the civilian unemployment rate has remained near 5¼ percent throughout the year. While unemployment rates have risen noticeably in the Northeast and moved up in some Midwestern states, jobless rates in other regions of the country either have changed little or have edged down.

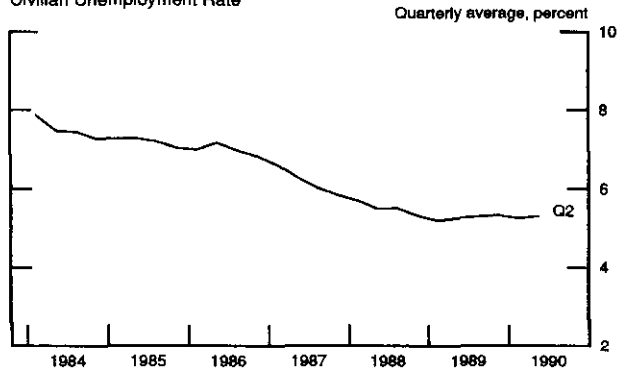
With labor markets remaining relatively tight by historical standards, pressures on labor costs have not abated. Although the rate of increase in straight-time wages has changed little over the past year and a half, benefit costs, which currently constitute roughly one-fourth of compensation, have picked up markedly. In part, this increase reflected the higher social security taxes that went into effect in January, but benefits also have been boosted by the continued rise of health insurance costs and an acceleration of lump-sum payments and bonuses. All told, employee compensation in private nonfarm industry rose 5¼ percent over the twelve months ended in March, a bit above the pace recorded in the year ended last December.

In addition to gains in hourly compensation, unit labor costs have been boosted by a poor performance in labor productivity, as output per hour in the nonfarm business sector rose just ¼ percent between the first quarter of 1989 and the first quarter of 1990. While productivity has remained strong in the manufacturing sector, rising almost 5 percent at an annual rate in the first quarter, productivity performance outside of manufacturing has been quite weak. As a consequence, unit labor costs in the first quarter of 1990 were 5 percent above their level a year earlier, about the same increase as recorded over 1989 as a whole, but well above the rates that prevailed earlier in the expansion.

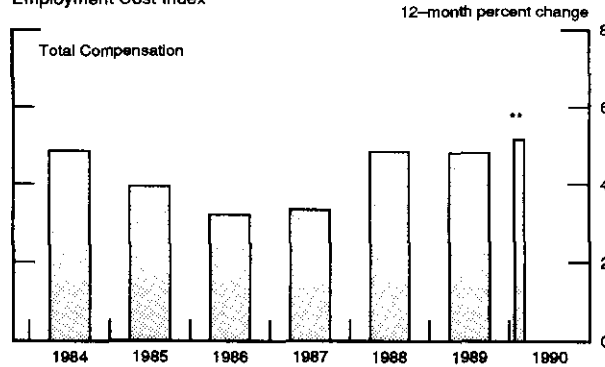
Nonfarm Payroll Employment



Civilian Unemployment Rate



Employment Cost Index *



* Employment cost index for private industry, excluding farm and household workers.

** Percent change from Q1 1989 to Q1 1990.

Price Developments

After surging in the first quarter of 1990, price increases moderated this spring. Food and energy prices were boosted early in the year by weather-related developments, and prices for a wide range of other goods and services also picked up sharply. However, by May, the transitory effects of the weather on inflation largely had been reversed, and price increases for many other items slowed significantly.

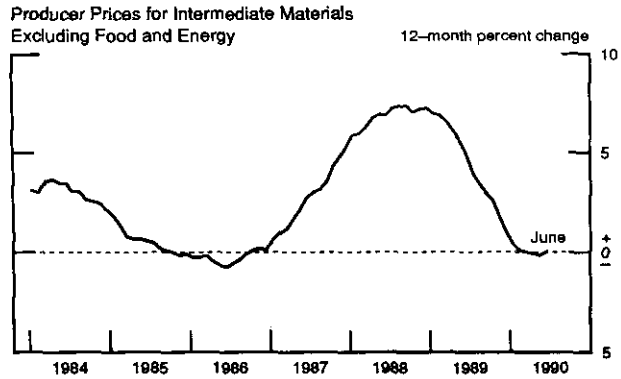
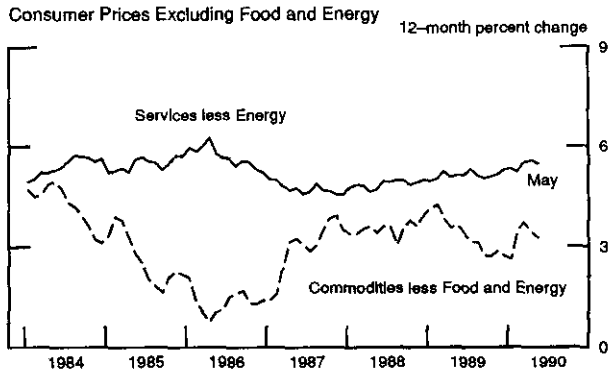
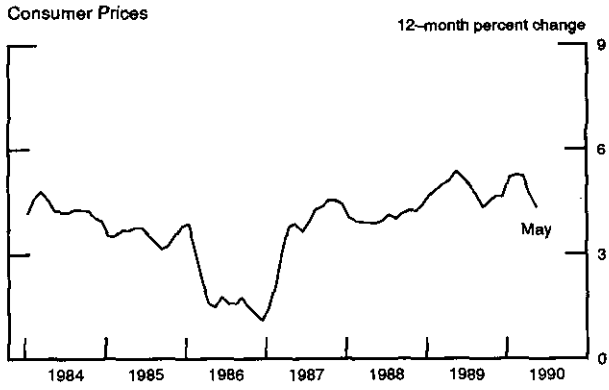
Energy prices surged this past winter, as a result of demand pressures from the unseasonably cold weather in December and supply disruptions at U.S. refineries and in Eastern Europe. The posted price of West Texas Intermediate oil, the benchmark for U.S. crude prices, rose about \$3 per barrel to a peak of \$22 in January. Since early February, on balance, the posted price for WTI has moved down substantially, in large part reflecting the effects on crude markets of increased output by OPEC nations. Movements in energy prices at the consumer level normally follow developments in crude oil prices. Gasoline prices, however, remain higher than in December. In part, pump prices have been boosted by the additional costs to refiners of complying with environmental standards. In addition, inventories of gasoline were relatively low during the first half of the year as a result of a variety of supply disruptions at refineries.

Overall, consumer food prices were boosted by sharp increases in prices for fresh fruits and vegetables after the freeze in December, but during the spring these prices retraced most of their earlier climb. The prices for other foods for home consumption have continued on an upward course. In addition, the prices of foods and beverages purchased at restaurants have risen at a 6 percent annual rate so far this year, about 1½ percentage points above the average rate of increase over the past two years; these prices probably have reflected a dwindling supply of entry-level workers and related increases in labor costs, and perhaps in some regions by the higher federal minimum wage.

The CPI excluding food and energy rose about 4¾ percent over the twelve months ending in May, near the upper end of the range experienced during the current expansion. Price increases for consumer goods, particularly apparel, rose sharply early in the year. However, the burst in prices did not carry through to the second quarter, as prices for commodities excluding food and energy changed little in April and May.

In the service sector, inflation rose markedly in the first quarter, in part reflecting some bunching of increases for items whose prices tend to change in irregular jumps, such as public transportation fares and auto registration fees. Although inflation in service prices moderated in the spring, there was little retracing of the earlier increases; indeed, in May, the CPI for nonenergy services was 5½ percent above its level twelve months earlier, the upper end of the range of increases seen over the past three and a half years. As in 1989, increases in prices of rents and medical services contributed importantly to the rise in overall service prices so far this year. However, there also have been widespread pickups in prices for a variety of labor-intensive services, and it is likely that, in addition to strong consumer demands, higher labor costs have boosted service prices.

The signs of moderating inflation for goods at earlier stages of processing, which had surfaced as capacity utilization rates moved down during 1989, appear to have continued into 1990. After rising 4¼ percent in 1989, the PPI for finished goods excluding food and energy has increased at an annual rate of about 3¾ percent during the first six months of 1990. Producer prices for intermediate materials excluding food and energy increased at an annual rate of just ¾ percent between December and June, roughly the same rate of increase as recorded over 1989 as a whole. The moderation of inflation for goods at the producer level is perhaps one indication that earlier moves toward monetary restraint and the slower pace of economic activity have worked to ease the resource constraints that had pushed up materials prices between 1987 and early 1989.



Section 3: Monetary and Financial Developments During the First Half of 1990

Shifts in financial intermediation and credit flows, stemming from the continued restructuring of the thrift industry and a more cautious attitude of banks toward certain credit extensions, exerted a major influence on the monetary aggregates and their relation to economic activity during the first half of 1990. In anticipation of further contraction in the thrift industry, and its associated effects on depository intermediation, the Committee reduced the annual growth range for M3 by a full percentage point in February. In the event, M3 has slowed even more dramatically than had been anticipated, leaving this aggregate below the lower bound of its reduced range. Not only has the thrift industry contracted more rapidly than expected, but commercial banks have picked up little of the lending forgone by thrifts and, in fact, have curtailed their own lending in some sectors, thus further depressing depository credit. With little need to fund asset growth, banks and thrifts have pursued retail deposits less aggressively, leading to the opening of a sizable gap between yields available in the open market and those on such deposits. Partly as a result, M2 also has slowed, moving down into the lower portion of its annual growth range.

The deceleration of the monetary aggregates mainly reflects a reduction in the share of credit provided by depositories, rather than a sharp slowing of income or total credit flows. The velocities of both M2 and M3 posted sizable increases, particularly in the second quarter. Total debt of domestic nonfinancial sectors grew at an annual rate of 7 percent over the first half of the year—down only slightly from its pace in the latter half of 1989 and in the middle of its monitoring range. However, growth of total debt was boosted by federal government borrowing to support thrift resolutions; the debt of nonfederal sectors grew somewhat less rapidly than it did last year. Uncertainty about the effects of the restructuring of credit flows, and about the reasons for the extent of the slowdown in money growth, underlined the need for the FOMC to assess the behavior of the aggregates in light of information on spending and prices and the likely course of monetary velocities.

The somewhat more cautious lending posture that commercial banks have recently adopted is mainly a response to heightened credit risks caused by the more moderate pace of economic expansion overall and a downturn in several sectors. The resulting loan write-offs and pressures on capital positions may also have induced some tightening of standards. Growing markets for securitized loans largely have filled the vacuum created by the retrenchment of thrifts in the area of

mortgage lending, with little attendant effect on the cost or availability of residential mortgage credit to households. Both banks and thrifts have cut back on other types of lending that can less easily be rechanneled, however, including construction and nonresidential real estate loans, loans to highly leveraged borrowers, and loans to small and medium-sized businesses. To offset tighter credit market conditions, which could exert undue restraint on aggregate demand, the Federal Reserve has recently adopted a slightly more accommodative stance with regard to reserve provision, fostering a small decline in market interest rates.

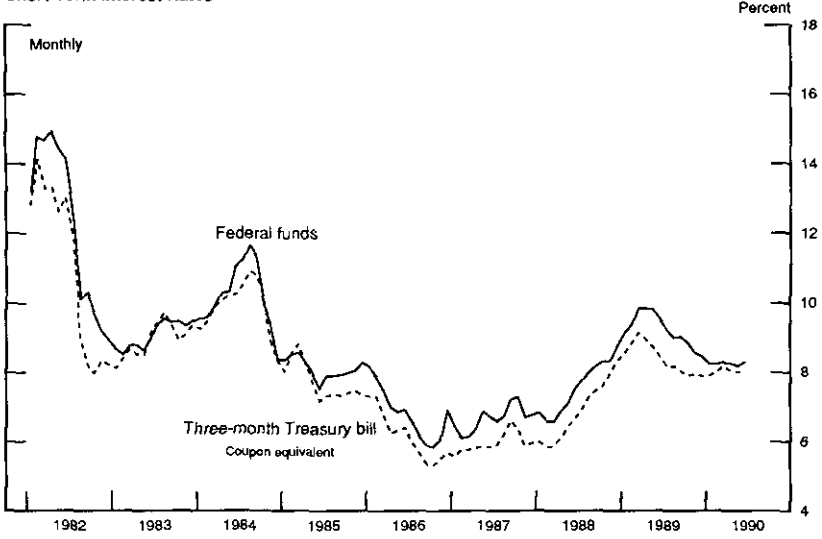
The Implementation of Monetary Policy

The FOMC maintained a steady degree of pressure in reserve markets during the first six months of the year. Policy had been eased in the second half of 1989 amid concerns that the economic slowdown might cumulate and thereby threaten the expansion. In the first half of 1990, however, the Committee viewed the balance of evidence as suggesting that underlying trends were generally consistent with its objectives of sustaining economic growth while containing and eventually reducing inflationary pressures.

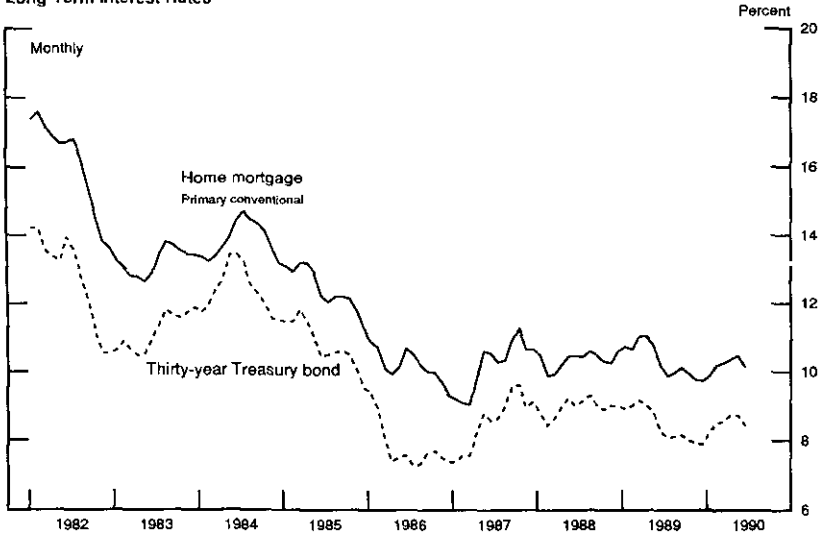
In the opening months of the year, incoming information on spending and prices caused markets to reevaluate the prospects for a near-term reduction of inflationary pressures and further easing of monetary policy. As a result, market interest rates rose, despite a steady federal funds rate. The rise was most pronounced at the longer end of the maturity spectrum, and it restored the usual upward tilt to the yield curve that had been absent much of last year. Developments in Eastern Europe, which portended increases in demands on the world's limited pool of savings, also contributed to increases in long-term rates in the United States and abroad. By late April, market participants expected a near-term tightening of U.S. monetary policy.

In early May, the pendulum of market opinion began to swing away from the view that a tightening of U.S. monetary policy was in the offing. Beginning with a lackluster employment report on May 4, economic data have pointed to a somewhat slower pace of activity and reduced price pressures. In addition, a pronounced slowdown in the monetary aggregates began in April, followed by outright declines in May. Although both M2 and M3 recovered a little in June, they remained below the midpoint and the lower bound, respectively,

Short-Term Interest Rates

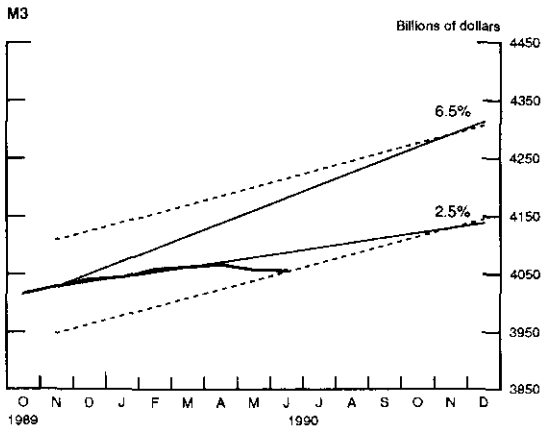
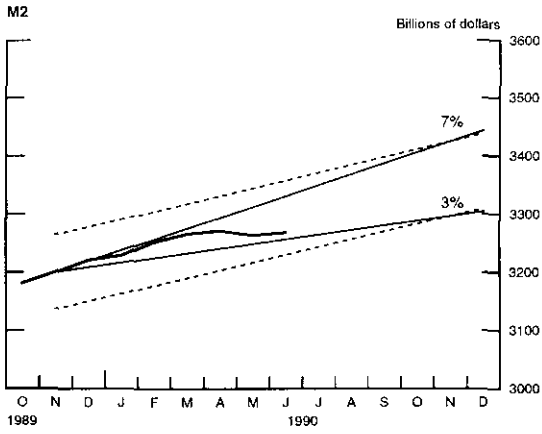


Long-Term Interest Rates



Observations are monthly averages of daily data;
last observation for June, 1990.

M2 and M3: Target Ranges Adopted in February and Actual Growth



of their annual ranges at midyear. Evidence also suggested that restricted credit availability, in part the result of tightened credit standards, may have spread beyond commercial real estate, construction, and merger-related lending. In response to this firming of credit conditions, the Federal Reserve began providing reserves slightly more generously through open market operations in mid-July.

Market interest rates, which already had receded somewhat from their early spring highs, declined further with the Federal Reserve's recent easing, though intermediate and long-term rates remained above the levels seen last December. Lower interest rates also bolstered the stock market, and some share price indexes reached record highs this month.

Spreads between high-quality private instruments and Treasury issues narrowed slightly over the first half of 1989. This narrowing reflected the continued availability of funds for investment-grade borrowing as well as increases in the borrowing needs of the RTC, which are met partly through the Treasury. The pickup in Treasury borrowing for the RTC was necessitated by the faster pace of thrift resolutions, which require the government to carry thrift assets on its own balance sheet pending their disposition. The market for investment-grade issues continued to function reasonably well, with stable rate spreads between quality tiers and generally well-maintained issuance volumes. On average, however, the business sector faced somewhat higher borrowing costs, largely as the result of numerous downgradings of debt issues. The collapse of Drexel Burnham Lambert had a marginal impact on an already debilitated market for below-investment-grade issues, widening spreads somewhat more between yields on such bonds and those on other long-term securities.

Monetary and Credit Flows

Growth of the monetary aggregates was sluggish over the first half of 1990, with M2 and M3 expanding at annual rates of only 3½ percent and 1¼ percent, respectively, from the fourth quarter of 1989 through June. *The weakness in money growth primarily reflected a redirection of credit extensions away from depository institutions owing to the continued downsizing of the thrift industry and a more cautious lending posture of commercial banks.*

The deceleration of M2 growth did not begin until the second quarter of 1990, when growth slowed to a 2¼ percent annual rate from the 6 to 7 percent range seen in the previous three quarters. Retail deposits (which include NOW accounts as well as savings, small time deposits, and similar instruments) had begun

to decelerate in the first quarter, slowing to a pace of less than 4 percent from the 5¼ percent rate seen in the fourth quarter of 1989. The effects of this slowdown on M2 were partially masked, however, by a surge in currency growth—apparently owing in part to increased demand from overseas—and a bulge in some of M2's wholesale components, mainly overnight RPs and Eurodollars. By the second quarter, a steep runoff in retail money market mutual fund (MMMMF) shares and a sharp decline in demand deposits reinforced weakness in core deposits in damping growth in aggregate M2.

Increases in the opportunity costs of holding M2 balances—that is, the rise in other interest rates relative to those on M2—retarded growth in this aggregate during the first half of the year. This was particularly evident for retail MMMFs. Through much of 1989, the yield curve was inverted, and MMMFs, whose portfolios typically average about 30 to 40 days in maturity, had historically large yield advantages relative to longer-term Treasury bills and short-dated Treasury notes. As a result, MMMFs expanded briskly. As the yield curve began to flatten towards year-end, flows into MMMFs ebbed, though they remained a key element of overall M2 growth. With the steepening of the yield curve in the early part of 1990, MMMF growth stopped in March. The recent rally in the stock market also may have depressed MMMFs, as data through May indicate strong inflows to equity mutual funds, a substantial portion of which may have been transferred from MMMFs.

When yield curves have become more steeply upward sloping in the past, the effect on M2 of weakness in MMMFs and other liquid balances often has been partially offset by strength in retail time deposits, as households lengthen the maturity of their assets. This year, however, retail CD rates were unusually slow to respond to the rise in market rates through April, contributing to unexpected weakness in M2. The reluctance of banks to raise deposit rates in response to rising market rates was particularly evident in the intermediate-term area where, for example, the rise of 100 basis points in the yield on the three-year Treasury note during the first four months of the year elicited an increase of less than 20 basis points in rates on bank retail CDs of comparable maturity. Evidence of the rising opportunity cost of holding M2 can be seen in the unusually heavy volume of noncompetitive tenders in Treasury bill and note auctions, which suggest a shift out of M2 balances.

The unwillingness of banks to price their deposits as aggressively as in the past is partly an indirect result of the contraction of the thrift industry. During the

Growth of Money and Debt (Percentage change)

		M1	M2	M3	Debt of domestic nonfinancial sectors
<i>Fourth quarter to fourth quarter</i>					
	1980	7.4	8.9	9.5	9.5
	1981	5.4 (2.5)*	9.3	12.3	10.2
	1982	8.8	9.1	9.9	9.1
	1983	10.4	12.2	9.8	11.2
	1984	5.4	7.9	10.6	14.2
	1985	12.0	8.9	7.8	13.1
	1986	15.5	9.3	9.1	13.2
	1987	6.3	4.3	5.8	9.9
	1988	4.3	5.2	6.3	9.1
	1989	0.6	4.5	3.3	8.1
<i>Quarterly (annual rate)</i>					
	1990				
	Q1	4.8	6.0	2.7	6.9
	Q2	3.6	2.3	0.4	7.0 ^e
<i>Semiannually (annual rate)</i>					
	1990				
	H1	4.2	4.2	1.6	7.0

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

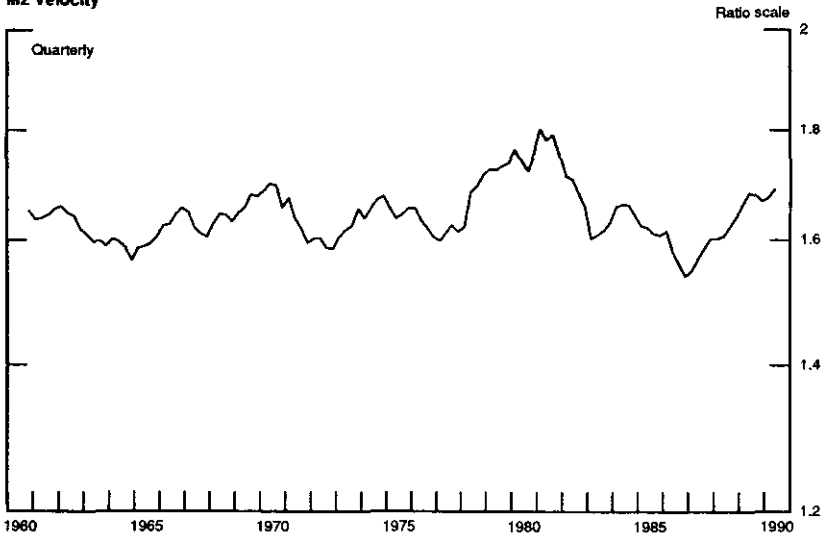
^e - estimated

3-year Treasury Note and 2.5-year Commercial Bank CD Rates



NOTE: Rates taken on coupon-equivalent, 365-day basis.
Preliminary data for June, 1990 CD rate.

M2 Velocity



NOTE: M2 Q2 1990 velocity based on projected GNP for Q2 1990.

first six months of 1990, commercial banks enjoyed \$62 billion in retail deposit inflows—about a 10 percent increase at an annual rate—while thrifts were shedding \$28 billion in retail deposits—about a 5 percent annual rate of contraction. Much of this deflection of deposits toward commercial banks was the direct result of RTC resolutions. In the first half of the year, the RTC resolved 170 thrifts holding \$32 billion of non-brokered retail deposits, much of which was immediately assumed by commercial banks.

Although deposit transfers do not directly depress M2, they may have contributed to the weakness in this aggregate by reducing banks' need to raise their offering rates to attract additional deposits at a time when growth in bank credit was slow. Through the first half of 1990, commercial banks were able to fund nearly 80 percent of their total credit growth with retail deposits—almost double the proportion seen in recent years—even though they allowed spreads between market rates and their retail offering rates to widen substantially.

Widening opportunity costs of holding M2 can explain only some of the moderation in this aggregate in the first half of 1990, however. M2 may also have been responding to slower spending, and other factors, some of which may have been associated with deposit restructuring under the RTC. Brokered deposits formerly attracted to thrifts by relatively high yields may have been particularly sensitive to the recent sluggishness in deposit pricing; about \$7 billion of brokered deposits were held at thrifts that were resolved in the first six months of the year, and many of these high-rate contracts were subsequently abrogated or not rolled over by the acquiring institutions. Evidence also suggests that, in light of large deposit inflows from thrifts, banks have curtailed marketing and promotional activity designed to attract retail deposits. Finally, the issuance of short-term Treasury paper to fund RTC holdings of former thrift assets has boosted the supply of, and raised the rates on, a close M2 substitute just when depositories were becoming less aggressive in seeking retail deposits. The rise in opportunity costs and these other factors contributed to an increase in the velocity of M2 in the first half of 1990, though some of this increase remains difficult to explain.

The link between changes in depository intermediation and M3 is somewhat more direct. This aggregate encompasses managed liabilities, as well as deposits and other sources of funds in M2, and is thus a better barometer of the overall funding needs of banks and thrifts. As has been evident since last summer, the contraction of the thrift industry and the failure of

banks fully to pick up the slack has already resulted in a significant slowdown in growth of depository credit relative to that of aggregate nonfinancial sector debt and a concomitant increase in M3 velocity. This trend continued into the first half of 1990, as growth in depository credit all but ceased—though overall debt growth continued at a moderate pace—and M3 fell well below the lower bound of its annual growth cone.

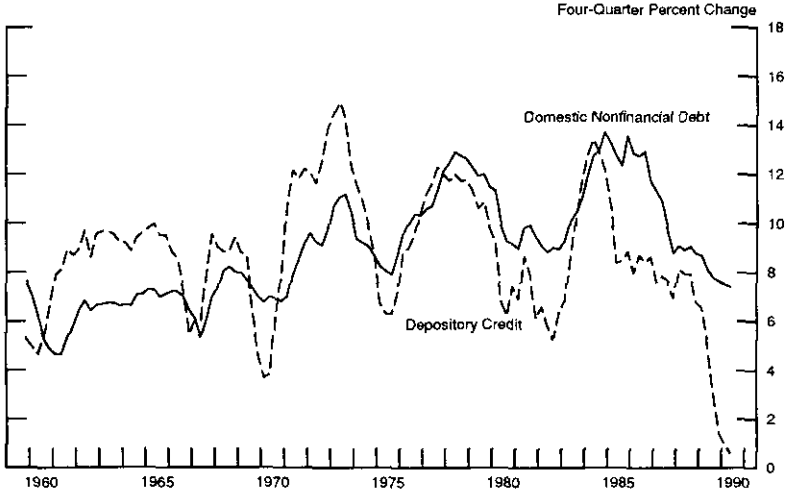
Although the FOMC foresaw some significant dampening effects on M3 growth in 1990 in association with the continued shrinkage of the thrift industry, the actual weakness in M3 so far this year has been more pronounced than anticipated. In setting out its expectations for M3 in 1990, the Committee recognized that considerable uncertainties surrounded the thrift industry contraction in terms of the pace of RTC resolutions, the extent of asset shrinkage at capital-impaired thrifts, and the desire of commercial banks to step into the breach. To this point, a faster-than-expected shrinkage of thrift assets has been manifested not only in weaker M2 deposit inflows, but also in faster runoffs of large time deposits and other M3 managed liabilities at thrifts. In addition, commercial banks apparently have filled less of the void left by thrifts than was originally anticipated. As a result, they too have pared their M3 managed liabilities, further depressing this aggregate.

Rates on large time deposits, like those on retail deposits, have remained low relative to yields on Treasury bills. Facing a substantial deterioration in the quality of their assets and constraints on capital, banks apparently have attempted to bolster profit margins and have not aggressively pursued new lending opportunities. Not only have deposit rates been held down, but loan rates also appear to have been raised slightly relative to market rates and non-price terms have tightened for certain types of credits.

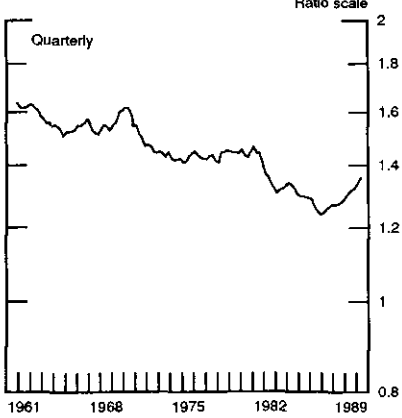
The pullback in credit supplies, together with some levelling out of demands for credit, likely contributed to a deceleration of bank asset growth. Over the second quarter, growth of bank credit slowed to a 5½ percent pace from the near 7 percent rate of growth seen over the first quarter of 1990 and the second half of 1989, with much of the deceleration centered in real estate and consumer lending. Although the slowdown in real estate lending has been especially pronounced in New England, this type of lending remains sluggish in several other regions as well. Some of the deceleration in consumer lending represents sales of loans by banks attempting to bolster capital-asset ratios. Even adjusted for these sales, however, growth of consumer loans at banks slowed further in the second quarter from an already reduced first-quarter pace. The weakness in consumer borrowing this year is due primarily

Weakness in Depository Credit

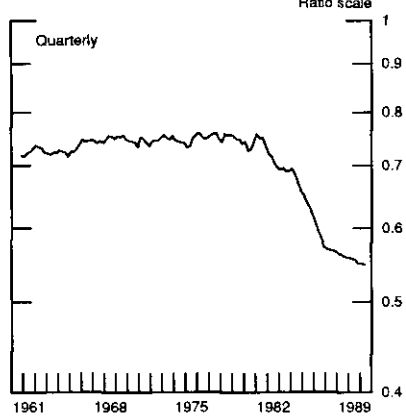
Domestic Nonfinancial Debt and Depository Credit



M3 Velocity



Debt Velocity



NOTES: Q2 1990 velocities based on projected GNP for Q2 1990. Debt for Q2 1990 partially estimated.

to sluggish retail sales, particularly of automobiles and other durable goods; banks evidently have remained willing lenders to households, and interest rates on consumer loans have changed little.

Bank lending to businesses also has been depressed this year. Surveys of commercial bank lending officers through early May suggest that the slowdown in bank credit largely reflects diminished demand for credit and deteriorating conditions in the real estate market, although tighter lending terms and more stringent credit standards were frequently cited for borrowers below investment grade, including many small businesses. Banks seem to have raised lending rates somewhat to small firms, judging from the slight increase in the spread between rates on small business loans and on federal funds. Separate surveys in which small businesses were queried about general credit availability have pointed to some recent increases in the difficulty these firms face in obtaining credit, though on balance they found credit availability little changed from mid-1989. The slowdown in bank business lending this year has mainly reflected reduced merger activity. Bank retrenchment in this area is consistent with other private credit judgments, as evidenced by the major slump in the market for bonds below investment grade.

The reduced volume of corporate restructurings, coupled with a diminished household demand for credit, has slowed the growth of the aggregate debt of domestic nonfinancial sectors to a 7 percent annual rate from the fourth quarter of 1989 through May of this year, compared with the 8 percent rate seen last year. Debt growth is currently in the middle of its monitoring range and broadly consistent with growth in nominal GNP. With the increasing leverage and the attendant dramatic declines in debt velocity witnessed in the 1980s apparently ending, the Committee reduced the 1990 monitoring range for debt by 1½ percentage points in February.

Debt growth decelerated in the first half of the year despite a spike in U.S. government borrowing, which owed primarily to the growing working capital needs of the RTC. RTC spending, net of capital raised off-budget by the Resolution Funding Corporation, jumped to \$31 billion in the second quarter, up from the \$4 to \$5 billion levels of the previous two quarters. This spending is financed through the Treasury and is therefore included in the debt aggregate.

The pace of household borrowing slowed considerably in the first six months of 1990, reflecting decelerations in both mortgage and consumer credit. The recent slowing of home mortgage borrowing appears

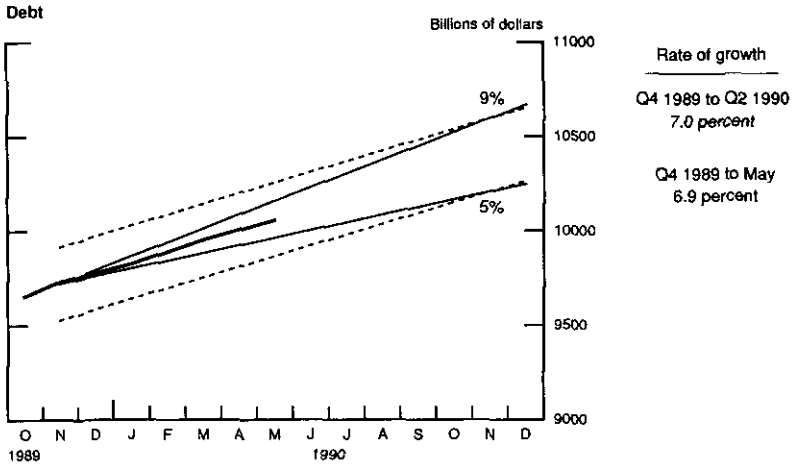
to be largely the result of reduced demand, owing to increases in interest rates earlier in the year and weakening economic activity in some regions of the country. Although banks have picked up only some of the slack for thrifts in the area of mortgage lending, the expanding market for securitized mortgages has facilitated an orderly flow of mortgage credit. In fact, spreads of mortgage-backed securities over comparable Treasury issues remain low by historical standards and rates on home loans have not risen noticeably relative to other long-term rates.

Consistent with households' sluggish spending, overall consumer installment credit has risen at a 2¾ percent rate from the fourth quarter of 1989 through May of this year, well below the 5½ percent clip in 1989. Some of this deceleration reflects substitution of home equity loans for previously existing consumer indebtedness; households apparently continue to recognize the lower relative after-tax cost of mortgage debt since the 1986 tax reform, which phased out the interest deductibility of non-mortgage household indebtedness. The slowdown in consumer loans on the books of depositories has been even more pronounced, reflecting a marked pickup in securitizations. The trend toward securitization of consumer loans, which has been evident in the last few years, appears to have accelerated in 1990, possibly because depositories are making efforts to reduce assets in order to meet the new risk-based capital requirements.

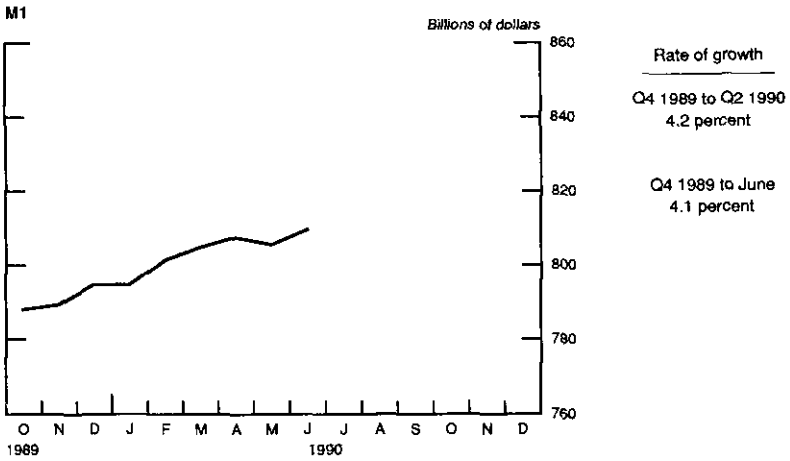
Through the first half of the year, the total borrowing of nonfinancial firms has been maintained at about the same pace as in the last half of 1989 despite a sharp drop in equity retirements. Although business lending by banks has slowed, commercial paper issuance picked up the slack, particularly in the first few months of the year. More recently, in light of declines in bond yields, firms have stepped up their issuance of bonds and slowed their use of commercial paper. Despite a recent slight narrowing of spreads relative to investment-grade securities, issuance of below-investment-grade bonds has remained in the doldrums. Spreads between investment-grade paper and Treasury issues are still low by historical standards, held down in part by supply pressures in the Treasury market.

In the municipal market, the increase in market interest rates and the downgradings of a number of key issuers during the first half of 1990 combined to slow refunding issuance to a crawl. As a result, the total debt of state and local governments expanded at only an annual rate of 3 percent in the second quarter, compared with 4½ percent in 1989.

Debt: Monitoring Range Adopted in February and Actual Growth



M1: Actual Growth



The CHAIRMAN. Thank you, Mr. Chairman. That is a very detailed statement and I appreciate the fact that you read the entire statement into the record.

Let me start with a blunt question, and I'd like as frank an answer as you can give.

You make it clear that we need to have a budget package, and it needs to be substantial in terms of a deficit reduction. Everyone on this committee agrees with that as a goal.

You talk about some positive effects that will come from that, assuming that's achieved. I want to ask the opposite question.

EFFECTS OF NOT ACHIEVING A BUDGET PACKAGE

There's not much progress that's discernible yet. Should we not get a budget package, if there's a stalemate and we don't get one, what does that mean for your ability or the Fed's ability to maintain a stable and balanced monetary policy?

Chairman GREENSPAN. Well, I think the question answers itself, Mr. Chairman. It obviously makes it more difficult for us.

The CHAIRMAN. How much more difficult?

Chairman GREENSPAN. It depends on what is going on in the economy. It depends on basically what is going on in the budget itself and what the borrowing requirements—

The CHAIRMAN. Wouldn't it give a pretty serious jolt? In other words, haven't expectations now been raised, not just here, but around the world? If we were to have the budget summit come to a dead end, I would think that you'd have quite an effect in terms of monetary reaction and financial market reaction, or do you not agree with that?

Chairman GREENSPAN. Well, Mr. Chairman, that depends on whether the markets have discounted it or altered their stance with the expectation that a significant budget action will be implemented by the United States.

I still sense a very large element of skepticism in the markets. Were that not the case, I think we would have seen a fairly major action in the bond market already, as this summit process began to evolve. I think there is a deep-seated skepticism which is encumbent upon us to dissipate because I think it does us no good.

I can't say to you what I think will evolve with respect to monetary policy or with respect to the markets because there are so many elements involved in answering that question that I'm not sure I could do adequate justice to it in a realistic manner.

The CHAIRMAN. Very good. Let me move to something that relates to that.

When you were here last week, you indicated the need to adjust the money supply and Fed policy to try to offset this credit-tightening that you've elaborated on today.

Is that credit-tightening, if it were not offset, sufficient by itself to nudge us over into a recession? Does it offer that kind of a threat?

Obviously, you're going to try to offset it. You've already made a policy decision to do that. But how material a threat would that be to the health of the economy as a whole if it isn't dealt with?

Chairman GREENSPAN. It's very difficult to say. In our judgment, looking at the economy as it has evolved over the last 6 months, we think that the economy of the United States, its growth, its inflation prospects, the levels of unemployment, would all be best served at this stage, on balance, if the degree of credit-tightening or—put it this way—the degree of credit-availability in the economy from whatever source remained relatively stable.

In our judgment, a tightening is not an appropriate response, or put it this way, a tightening is not something that we would like to see happen. I can't tell you what the consequences are. It clearly does raise the risks of tilting us over into recession. I don't know whether it would be adequate to do that, but it raises the risks more than we would like.

And so, as we view our actions, it is not an easing; it is basically an offset to independent market tightening.

The CHAIRMAN. All right. Now, when you do that, and you've explained it, I think, clearly last week and today, when you make that offsetting adjustment, is it your intention to try to hold interest rates where they are, or is it your intention to try to nudge interest rates down somewhat from where they are?

Chairman GREENSPAN. It's our intention to keep credit conditions about where they are.

The CHAIRMAN. Well, but I want to—

Chairman GREENSPAN. That's an important distinction, Mr. Chairman.

The CHAIRMAN. Well, that's what I want to get clarified because—

Chairman GREENSPAN. Maybe I can explain something which I think might help in this respect.

The CHAIRMAN. Yes.

Chairman GREENSPAN. There's a general view that we in the Federal Reserve fully control the state of credit conditions. And it's presumed that if we fix the Federal funds rate, that that would freeze the state of credit conditions in the short end of the money market.

That is not, in fact, the case because there are other forces which impinge upon the market, either pushing credit conditions to a tighter or an easier stance. And it is that which affects the economy, not necessarily what we do.

So we are often required to move to counter market forces if we perceive that they are having undesirable effects.

The CHAIRMAN. So the bottom line of that is that you're not really aiming here with this policy adjustment that you're in the process of making to move interest rates as such. You're making a policy adjustment to make sure that credit availability in the aggregate is in the amount that you think we need to have.

Is that right?

Chairman GREENSPAN. That is correct, Mr. Chairman.

The CHAIRMAN. I want to ask you one other question and that's with respect to our reliance on international borrowing.

The sense that I've had as we've had these discussions over now some years is that our maneuvering room in terms of monetary policy and fiscal policy is very directly connected with how the rest of the world views our financial situation and their willingness to

continue to lend us money and the rates of interest at which they're willing to lend us money.

If we were to veer off course very far here from what the international community viewed to be an unsound financial and economic condition and strategy, wouldn't that have the effect of driving up interest rates in the sense that the international community would want a higher rate of interest generally in order to lend us the large amounts that they do every day?

Chairman GREENSPAN. Certainly, if they perceive that our policies are becoming irresponsible, there is greater risk, and that risk is reflected in higher rates.

The CHAIRMAN. If the Fed tried in some artificial way to drive down domestic interest rates, that the rest of the world viewed as being irresponsible and unsound and unsustainable, might it not then in fact actually have the reverse effect and drive up interest rates because foreigners would not be willing to lend us money?

Chairman GREENSPAN. I think the effect would be to take what has been a very moderate growth in the money supply in recent years to a much sharper degree of acceleration as we endeavored to push interest rates down by flooding the market. The money supply would accelerate. Inflation would not be that far behind, inflation premiums would rapidly embody themselves in interest rates, and we would be worse off.

The CHAIRMAN. Thank you.

Senator Heinz.

Senator HEINZ. Mr. Chairman, I think you and the Chairman already talked about one of the questions I wanted to ask, which is what happens if the budget summit ends up over the next 2 or 3 months in a period of procrastination and nothing happens?

The answer to that question was it would make Alan Greenspan's job a lot tougher than it is, and I don't know anybody who volunteers, on this committee certainly, to have his particular burden of responsibility.

Chairman GREENSPAN. I might say, that is a minor issue. What concerns me, far more, obviously, is what it does to the American economy.

Senator HEINZ. Exactly. The question is could the uncertainty of postponing a resolution of this issue—and I say "could" advisedly—create such uncertainty that not only would it be difficult for the Fed to manage it, but it might tilt what is already a fragile economy into a recession?

Chairman GREENSPAN. Senator, I don't think any of us can look into the future and come up with a scenario, one which anyone has any confidence in.

All I would say to you is that I don't think we should position ourselves to take the types of risks that we would if you don't resolve this problem.

RISKS OF NOT REDUCING THE FEDERAL DEFICIT

Senator HEINZ. Among the kinds of risks, I assume there are a variety of them, there's high inflation, high interest rates, and recession.

Are those some of the risks?

Chairman GREENSPAN. At the moment, the major risk is not a crisis, as such. The basic problem with the Federal deficit is that it has reduced domestic saving in this economy for a number of years and has had a corrosive, virtually invisible effect in undermining our net capital investment and productivity advances.

Senator HEINZ. You make that point very clearly on page 14 of your statement, which I want to refer to specifically.

I think most of the members of the committee would agree with you that we have a very serious lack of savings in this country and we all talked about that.

I would like to ask you to focus for a moment on the other side of the equation—namely, investment.

Now, I know, to an economist, *saving tends to equal investment*, in the old simplistic macroeconomic models that we all got in school, Economics 1.

But you know that's not the case because we know that if there are a lot of savings, there tends to be more investment. But by the same token, if there aren't adequate opportunities for people to earn good returns on their investment, if it's more attractive to invest abroad than in the United States, as lots of companies have been doing for a very long time, for 10 or 15 years, for a variety of reasons, if other countries create, either fairly or unfairly, rules of the game that give their economies an edge, and we don't, that depresses returns to investment in this country.

If our tax system unfairly penalizes returns to equity investors, and I think you believe it does, obviously, that has an impact.

My question to you is, in a time period where clearly, particularly in the manufacturing sector, product life cycles are shorter, the requirements for investment, retooling, new investment, are accelerating all the time in order to account for the rapidity of change and obsolescence, is the United States lacking a sufficient return to new investment, such that people think it better to consume rather than to invest?

Chairman GREENSPAN. I think the evidence, Senator, certainly leans in that direction. The major reason why I think we have to address the budget problem is not because there is a dawning crisis in front of us.

In fact, since there may not be, it's all the more urgent that we attack the issue because it's very easy to go from month to month and say nothing has happened, while the corrosive undermining of the saving and investment process continues over the long term, creating the type of problem, Senator, which you raise.

Senator HEINZ. My question actually went beyond the budget deficit, because, while that can lower the overall cost of capital in an economy, if the overall return to investment is higher some place else, or differentially low in the United States, people will go some place else, irrespective of whether their cost of capital is 3 percent, 6 percent, or 9 percent. You may get a lower cost of capital overall, but they'll go where they can get the biggest return.

So my question really reached out beyond the budget issue. But I don't have time to pursue it.

Chairman GREENSPAN. Well, let me just say quickly, the reason I raised the budget issue is that I think it is critical to the issue you raised.

Senator HEINZ. I don't disagree, but I was trying to get beyond it. Obviously, time is not going to permit us to do that.

I note on page 11 of your statement that you indicate that restraint, talking about restraint and how it's clear, and I quote, "that the financial restructuring," which you discuss at length, "will affect the channels through which policy actions are transmitted, ultimately to economic growth and inflation. Some will be diminished, others augmented."

As we look back on the last 10 years, which you identified as a period of excessive credit growth, and we look at specific failures such as the S&L failure, and as we look at all of the other areas where Government is exposed, which total an estimated \$6 trillion from existing deposit insurance programs, loan and pension guarantees, direct loans, implied Government guarantees of debt issued by Government-sponsored enterprises, and all the rest, does it seem to you that Congress needs to do a better job of examining and understanding the weaknesses and, indeed, the failures, as well as the prospective problems in the current system, and to implement much more comprehensively, thoughtfully, and aggressively than before, reforms necessary in other areas—I'm going beyond the S&L problem—to ensure the protection of the Federal Government from other types or even levels of financial risk?

Chairman GREENSPAN. Senator, I think we all have to increase our knowledge of that whole structure of risks, and, hopefully, we are rapidly moving in that direction.

To address the type of problem implicit in your question, we developed the statement that I delivered here last week on our philosophy toward banking regulation and changing banking structure changes, specifically emphasizing the question of capital.

In a sense, all of the problems that we perceive are reflective in one way or another of the fact that we probably have capital cushions that are too low throughout the system.

Senator HEINZ. Mr. Chairman, thank you. My time has expired.

The CHAIRMAN. Thank you, Senator Heinz.

Before yielding to Senator Sarbanes for his questioning period, Senator Graham, do you have a brief opening comment that you want to make?

Senator GRAHAM. Mr. Chairman, I appreciate the Chairman appearing again with us today. I do not have an opening statement.

The CHAIRMAN. Very good.

Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman Greenspan, I first want to ask about a statement on page 4 of your testimony.

Throughout this period, rates on Treasury bills have remained somewhat higher than usual relative to those on private instruments, probably in part reflecting the large amount of bill issuance necessary to fund working capital for the RTC.

My question is how much higher as a consequence of funding working capital for the RTC?

Chairman GREENSPAN. It's obviously significantly less than a hundred basis points and maybe less than fifty.

My guess, without looking at the numbers, is 20 to 40.

Senator SARBANES. Twenty to 40 basis points?

Chairman GREENSPAN. My more thoughtful colleagues say a quarter of a percentage point.

Senator SARBANES. Now, I'm interested in the ranges for growth of monetary and credit aggregates which you've set out in the report.

Are these ranges as wide as they've been in any report submitted by the Federal Reserve?

Chairman GREENSPAN. Yes.

Senator SARBANES. Four-point range?

Chairman GREENSPAN. Yes.

Senator SARBANES. That's as wide as it's ever been?

Chairman GREENSPAN. I don't think they have been wider than that.

Senator SARBANES. At what point does it become so wide that it's meaningless?

Chairman GREENSPAN. I would say much beyond four points.

Senator SARBANES. We're at that point right now, in effect. Are we now being given by the Fed a range that is so wide, that it's really a meaningless exercise?

Chairman GREENSPAN. No, on the contrary. In fact, one of the issues that you raised in your opening remarks, Senator, with respect to what has been happening in recent weeks, is the fact that money supply growth has stalled out again. It appeared in June to be coming out of what was a very sharply depressed May level, and looked as though it was going to be on track, but then it stalled out—in the context of the ranges which we are contemplating.

As I've indicated in my prepared testimony, we use those ranges as a meaningful measure of how we think the various aggregates ought to grow consistent with our view of the appropriate policy stance.

So I'm saying to you that they are quite meaningful.

Senator SARBANES. Well, suppose it was a 6 point range. Would that mean anything, to lay out a 6 point range?

Chairman GREENSPAN. I think that you set a range to correspond to where a specific monetary aggregate is likely to fluctuate without significantly altering the thrust of one's policy stance.

In my judgment, a 6 point range is unlikely to capture that.

Senator SARBANES. In other words, if it fluctuates that much, it's outside the policy range.

Is that right?

Chairman GREENSPAN. I would say if it fluctuates that much and has no impact upon the economy, one has to raise a serious question as to whether it is a useful monetary aggregate on which to focus policy.

Senator SARBANES. Well, this is one item I want to keep an eye on.

When the chairman asked you about interest rates and whether you were expecting to have a policy that would lower interest rates, you used a different phrase in response to that and made a point of it.

Was that phrase, "credit availability"?

Chairman GREENSPAN. "Credit conditions."

Senator SARBANES. Credit conditions. And I take it that what you were saying by that is that you do not anticipate a monetary policy that would result in the lowering of interest rates.

Chairman GREENSPAN. At present our policy is as I stipulated it in my prepared testimony.

In other words, our policy is contingent: We would do certain things under certain conditions. Of course, when we meet at an FOMC meeting we may make a very specific change to policy.

Senator SARBANES. Well, you want to keep credit conditions as they are, as I understand it.

Is that correct?

Chairman GREENSPAN. I would say in the current context, in the judgment of the committee, and one to which I fully subscribe, stable credit market conditions at this stage would be appropriate for the best performance of the economy.

Senator SARBANES. And I take it, since you made such a point of the distinction, that that would therefore encompass interest rates at about their current level.

Chairman GREENSPAN. I very purposefully discussed the distinction between short-term interest rates, the Federal funds rate, and credit conditions.

Most of the time, the vast majority of the time, they're indistinguishable. But not all the time. And it is in this specific period that they have deviated sufficiently to induce an offsetting action on the part of the Federal Reserve, and that's the reason why we moved as we did on Friday.

Senator SARBANES. Now in your statement, on page 3, you say,

In the short run, however, the risks of inflation, on the one hand, and of an economic downturn on the other, must be weighed in the policy-making process. The Federal Reserve saw those risks as about evenly balanced over the first half of the year and made no adjustments in monetary policy.

I take it you're now making adjustments in monetary policy.

Is that correct?

Chairman GREENSPAN. I think that's a semantic question. It depends on whether or not you are—

Senator SARBANES. You mean the question as to whether you're making adjustments in monetary policy?

Chairman GREENSPAN. No. If you're defining policy in the narrow sense, obviously, we have changed. If you're defining policy in a broader sense, meaning that we are endeavoring to maintain stable credit conditions, then the answer is we have not.

Senator SARBANES. I see. So, on the one hand, you've adjusted policy, and on the other hand, you've not adjusted policy.

Chairman GREENSPAN. It depends on the way you define it.

Senator SARBANES. That's why Truman always wanted a one-handed economist. [Laughter.]

Chairman GREENSPAN. Now, let me be very specific, Senator, so it's clear.

Senator SARBANES. President Truman, he said he wanted a one-armed economist so he didn't get these "on the one hand" and "on the other hand" answers. [Laughter.]

Let me ask you this question.

The CHAIRMAN. You wanted to clarify.

Chairman GREENSPAN. Yes.

Senator SARBANES. I don't want to deny you your other hand, please.

Chairman GREENSPAN. The only thing I don't want to leave unclear is that what we do is policy, but let's define exactly what it is that we're doing and why we are doing it. That's a very important issue in understanding how the Federal Reserve interacts with the system.

Senator SARBANES. Let me ask just one final question on that point, Mr. Chairman. I understand that.

The CHAIRMAN. All right. I'm sensitive to the time limits. If we could make it short.

RISKS OF INFLATION AND ECONOMIC DOWNTURN

Senator SARBANES. You say the Federal Reserve saw those risks as about evenly balanced over the first half of the year. That was the risk of inflation, the risk of economic downturn.

I take it you now see those risks differently. Is that correct?

Chairman GREENSPAN. I would say that we probably view the risks of a recession and inflation as about the same, but we feel uncomfortable with that way of looking at it, if for no other reason than the surest way to get a recession going in this country is to allow inflation to take hold.

In other words, I'm uncomfortable with that distinction if we fine-tune it too much.

Senator SARBANES. Well, no, let me put the question to you.

You've stated in your statement that you saw the risks as about evenly balanced over the first half of the year.

How do you now see the risks? Evenly balanced? Moreso on the recession side? Moreso on the inflation side?

Chairman GREENSPAN. I would say at the moment they're still generally evenly balanced, though perhaps a shade more toward recession than they were earlier in the year.

Senator SARBANES. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

Alan, you said—

The CHAIRMAN. If you'll suspend for a minute, I want to just describe for the home viewing audience the noise they hear in the background.

Whenever the Chairman of the Fed is here and says something that some at the press table think is in the immediate news category, there's a burst of reporters out the door, and chairs are often tipped over.

In fact, we now have in the budget of the Banking Committee a "broken chair allowance" that we have to factor in on those occasions when the Chairman of the Federal Reserve is here because so much importance is attached to his comments and the speed of reporting those comments.

The noise that often occurs in the background is the sudden exit of reporters who are running for telephones to inform the world as to what has been said.

I won't trespass on your time in saying that, but I just want to help people understand what the commotion is when they hear it on their television set and yet, can't see it.

Senator D'AMATO. And a 60-point drop in the stock market.

Senator GRAMM. Well, Mr. Chairman, I guess it simply shows the importance of a shade of difference. Whether the observer is capable of making a judgment about that shade of difference, we don't know, but at least they'll read about it tomorrow.

Alan, let me ask you a question. I want to go back to your comment about how you believe the market has really discounted a major deficit reduction, the likelihood of a major deficit reduction action by Congress.

I see that as good news for two reasons. One, it shows the market has not lost touch with reality, and that always encourages me.

Second, I think it shows that the rewards are big if, with the economy getting a little softer, a shade of softening, if that were occurring with expectations already built up that we were about to dramatically reduce the deficit and change the fiscal policy of the Nation, then I think the rewards of that action, on the positive side, would be relatively small, they having already been discounted. The reaction on the negative side, if we didn't do it, might be big.

But I think the fact that the markets clearly have discounted any affirmative action substantially means that if we do something and it's dramatic, the reaction is likely to be large and positive.

Do you agree with that?

Chairman GREENSPAN. On the size of the budget cut?

Senator GRAMM. Yes.

Chairman GREENSPAN. I would say so, yes. Let me say this in the context of what these words mean.

I think it's important to define what the forces are out there. At this particular stage, as I've said in my testimony, I don't see any cumulative evidence that is working toward a recession. In fact, inventories are in reasonably good shape.

If further credit-tightening does not occur in the markets, we should not expect to go off the track that we are currently on.

And so, when we are dealing with this issue of what's more important—inflation or recession, and what the balance is—I think that's too simple an approach. I think we have to keep in mind that we are endeavoring to keep the economy on an even keel as best we can.

SAVINGS AND LOAN PROBLEM

Senator GRAMM. Let me ask you a question about the S&L bail-out, both working capital and the bail-out cost itself.

Obviously, we are now past the situation where a private entity is guaranteeing the payment of principal with a zero-coupon Treasury bond. That was the case we were in last year, and there was a legitimate debate about whether that should be on-budget or off-budget.

I think we're past that point. I think, clearly, now, the working capital, in my opinion, should not be on-budget until we get an as-

assessment of the loss. But once we've got the loss, that's an on-budget loss.

The question is, though, with the great uncertainties about it and with it actually, with asset disposal in the out-years potentially lowering the deficit as assets are sold, do you believe that the capital cost of the S&L bail-out should be built into the Gramm-Rudman targets or just isolated from it?

Chairman GREENSPAN. I would think they should be isolated.

Senator GRAMM. I agree with you because I think, No. 1, they create a potential mischief in terms of manipulation, where you would borrow money at the end of one fiscal year and dispose of assets in another.

And I think also, by creating tremendous uncertainty, you create the potential that our ability to meet the targets is affected by the gods and not by us.

Let's assume that we get a worst-case scenario and we don't get an agreement and the sequester goes into effect on October 1. A little over \$100 billion. Current services spending is up \$70 billion, \$75 billion. So we're cutting \$25 billion below the level we spent at last year. Bad public policy. Across-the-board cuts make no sense.

But at that point, if it really came down to a choice between suspending the sequester and, in essence, giving up on the Gramm-Rudman process, or leaving it in effect, at least until Congress did something, and if they didn't, leaving it in effect for the fiscal year, what would be your fiscal prescription?

Chairman GREENSPAN. That is an extremely tough question. I just would want to say that I hope that the Congress doesn't allow itself to get to that point.

I think that the presumption of a \$50 billion or \$60 billion cut strikes me as the right order of magnitude for the first year. And I see no reason why proper policy cannot be implemented.

Senator GRAMM. You know, we have a bad habit of the stock market collapsing in October. In 1987, we had the 508 points and then we had the budget summit agreement in effect in 1988, such as it was. And then in 1989, we had the 100 point drop.

Are you concerned that if we get to October and the sequester's triggered, we've got the uncertainty as to whether Congress is going to detriquer it, whether they're going to take action, that we might have another slump in the stock market?

Chairman GREENSPAN. I could answer that question as a private citizen, Senator, but I would like to suggest to you that it would not be appropriate for me to address that question one way or the other.

In all seriousness, there's no way that I could know the answer to that question.

Senator GRAMM. Well, I would think, though, Alan, that you would suspect that if, in fact, we had fiscal chaos in October, which we had in 1987 and we had in 1989, that that would not be good for the equity markets.

Chairman GREENSPAN. Fiscal chaos would not be good in September or November or December. [Laughter.]

Senator GRAMM. Well, October is where the law creates the chaos.

But if you don't want to answer, that's fine.

Chairman GREENSPAN. Senator, there are so many hypothetical outcomes here. You can spin all different types of scenarios, which I don't think really are all that useful.

I think what we ought to do is focus on getting an agreement going, getting the budget deficit problem under control, and getting it behind us once and for all.

The rewards of getting that budget problem behind us are extremely large. While I understand the very difficult problems that the Congress and the administration are going through, the pay-off is so large, that it strikes me that we should not be trying to figure out what would happen under a variety of different conditions.

Senator GRAMM. Thank you, Mr. Chairman.

The CHAIRMAN. Before yielding to Senator Shelby, I want to put an important fact into the record that we've just recently been given.

You serve as a member of the RTC Oversight Board which must try to figure out how to resolve the problems in the savings and loan industry. I want to say for Senator Gramm's benefit, before he leaves, we have recently gotten an analysis from the RTC through June 12 of this year, on the dollar value of all of the assets that have been taken back from failed thrifts. That's everything from golf courses to residential properties to land, what have you.

That's everything from golf courses to residential properties to land, what have you.

And of all of the properties now in possession that have been taken in by the RTC, 69 percent of the total asset value represents assets within the State of Texas. That is an interesting, I think, illustration of the fact that, while it's a huge national problem, at least in terms of what there is on the junk pile, fully 69 percent of the dollar value of the assets are found within a single State.

That relates very importantly to the State-chartered powers problem, which is a critical part of the overall thrift problem.

Senator GRAMM. Mr. Chairman, could we at this point put the number on the screen that you call if you want to buy any of these assets? [Laughter.]

The CHAIRMAN. Unfortunately, we already own them. [Laughter.]

We own them as the public and now we need to try to sell them. But it's a very interesting fact.

Let me also say, Senator Kerry, you've joined us. Did you have any brief opening comment? If not, Senator Shelby.

Senator KERRY. Thank you, Mr. Chairman, I don't.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

I don't want to get into hypotheticals, Mr. Chairman, not too many, anyway. But let's just suppose, knowing your background and knowing your knowledge of what the financial markets look forward to us in Washington to do, not to say. They discount what we say, but they really watch what we do.

If, in fact, in the next several months, we make real, not imagined, deficit reductions here, that would be profound, would it not? It would be the right signal or a good signal to send to the Fed?

Chairman GREENSPAN. Yes, it would. It certainly would, Senator.

Senator SHELBY. Would it be better for us to make multiyear outlooks in the deficit rather than just we're going to do a quick-fix for this year?

Chairman GREENSPAN. I would say it's not just better; it's essential.

Senator SHELBY. It's essential.

Having said that, so I would assume that any real reduction in interest rates in the market, real, real big, would be linked to the reduction in the deficit of what the Congress really does, not what it says.

Chairman GREENSPAN. That's correct, Senator.

Senator SHELBY. OK. Now, you mentioned earlier that other forces other than the Fed, you know, the Fed, and you're the Chairman of the Fed for many years, set out monetary policy and we thought, so many people still do, I think, think that you as the Chairman can just set it without regard to anything other than what goes on in the United States of America.

Well, we know that's not true.

But isn't it a fact that as we have become more and more dependent on our ability to borrow internationally from the Japanese and the Germans and the Swiss and others that will come forward, that they sort of have a leash on our economy, in a sense.

In other words, what happens in Europe, what happens in Frankfurt, what happens in Tokyo, is a leash on what you do at the Fed, just like a lot of domestic things that happen.

Is that a fair statement? Is a leash too strong?

Chairman GREENSPAN. A leash is a little strong. I think it's clear that—

Senator SHELBY. A rope?

Chairman GREENSPAN. No, no, those are factors that we have to consider, and it does have an effect on what we do.

Senator SHELBY. OK. But it is a burden, isn't it, a sense of burden that we—

Chairman GREENSPAN. It makes it more difficult, certainly.

NEED TO INCREASE SAVINGS

Senator SHELBY. OK. So that ties in, does it not, Mr. Chairman, to our low savings rate; in other words, our savings pool has not grown as our appetite for money has grown.

And when you talk about here at the table, and you've done this for years now before this committee, and you're speaking as the Chairman of the Fed, you're talking about a low interest rate and so forth in this country. It's just about essential to the future of our economy to up that savings rate in this country, isn't it?

Chairman GREENSPAN. I think that's the most important domestic economic policy issue.

Senator SHELBY. No. 1. Would that be your No. 1 priority?

Chairman GREENSPAN. Yes.

Senator SHELBY. That, and what would be your second? Cutting the deficit?

Chairman GREENSPAN. Well, no. Cutting the deficit is part of that.

Senator SHELBY. Or would they be simultaneous?

Chairman GREENSPAN. No. Cutting the deficit is part of the strategy to enhance domestic saving in the United States.

Senator SHELBY. How much, Mr. Chairman, of the domestic savings is the Fed eating up in the borrowing each year?

In other words, the savings pool out there, domestically in the United States?

Chairman GREENSPAN. How much do we, the Fed?

Senator SHELBY. Yes. No, not the Fed; the Government.

Chairman GREENSPAN. The Government.

Senator SHELBY. Oh, not you. I knew you didn't borrow it; you create it. [Laughter.]

Go ahead. In other words, roughly, what is the percentage of our domestic savings pool that is eaten up by the Federal Government's borrowing each year?

And if you don't have that figure, if you could furnish it for the record.

Chairman GREENSPAN. I do have the figures here, but I'd like to submit them for the record because that's an important number which I want to make certain I get correct.

[Chairman Greenspan subsequently submitted the following:]

Federal Budget Deficit and Domestic Saving

Fiscal Years	Federal Budget	Net Domestic	Deficit as Share
	Deficit ¹	Nonfederal Saving ²	of Saving ³
	(1)	(2)	(3)
	----Billions of dollars-----		--Percent--
1970	2.8	74.7	3.8
1971	23.0	86.4	26.7
1972	23.4	98.7	23.7
1973	14.9	125.9	11.8
1974	6.1	138.2	4.4
1975	53.2	128.1	41.5
1976	73.7	155.8	47.3
1977	53.6	171.5	31.3
1978	59.2	201.0	29.4
1979	40.2	214.3	18.7
1980	73.8	195.3	37.8
1981	78.9	229.6	34.4
1982	127.9	221.2	57.8
1983	207.8	220.2	94.4
1984	185.3	314.2	59.0
1985	212.3	302.2	70.2
1986	221.2	286.4	77.2
1987	149.7	217.4	68.9
1988	155.2	278.3	55.7
1989	151.9	279.7	54.3

1. The federal budget deficit, recorded as a positive number, is on a unified budget basis.

2. Net domestic nonfederal saving is drawn from the national income and product accounts, table 5.1; it is the sum of personal saving, undistributed corporate profits (with inventory valuation and capital consumption adjustments), and the state and local government budget surplus or deficit (-).

3. Entries in the third column equal the corresponding entries in column (1) divided by those in column (2), with the result multiplied by 100.

Senator SHELBY. And have our borrowings internationally continue to go up almost vertically? Or have they ebbed some?

Chairman GREENSPAN. Net borrowings abroad, which are best measured by the current account deficit, have come down a bit.

Senator SHELBY. And that's good news.

Chairman GREENSPAN. It's good news, but if we can get the budget deficit down further, we're likely also to bring the current account deficit down with it.

Senator SHELBY. Last, I want to get onto something that you mentioned, availability of credit, the tightening of credit.

We had a hearing and you were here several weeks ago, Secretary Kemp was here, and others. A lot of the builders in the country, especially in my area of the south and Alabama and so forth, they feel like they've been squeezed too much by the credit agencies, by their banks. Even if they've got good credit, they're solvent, they're doing well, especially in the area of home construction and land development.

Do you see any easing of this or any of your studies showed this to be true? Or does it depend on region to region?

Chairman GREENSPAN. It depends on the region. But there's no question that there are problems in real estate virtually across the country.

Senator SHELBY. Is most of the overexpansion in real estate in commercial real estate?

Chairman GREENSPAN. Yes, very substantially so. There are fairly high vacancy rates in commercial real estate pretty much across the country. It differs region by region, but it's generally high almost everywhere, especially for office buildings.

Senator SHELBY. Is that concentrated a lot in the East? I know it's everywhere, but—

Chairman GREENSPAN. No, I would say it's across the country.

Senator SHELBY. Spread across.

Chairman GREENSPAN. There are differing problems in the East, the issues are more severe in the East, obviously, but it's a problem which, as far as vacancies are concerned, is a nationwide phenomenon.

That is not obviously true in residential real estate to anywhere near the extent that it is with—

Senator SHELBY. But you've got a different market there with the secondary market, have you not?

Chairman GREENSPAN. Yes.

Senator SHELBY. Mr. Chairman, my time has expired.

The CHAIRMAN. Thank you, Senator Shelby.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Alan, in February of this year, you went and spoke about your favorite topic, or at least the area that you identified with, one as being in need of treatment, and that is savings.

At that time, we talked and you said that you thought, and I'm reading, that the double taxation of dividends was an area—you picked it out—as one of the structural problems, and that if we eliminated double taxation on dividends, that that would enhance savings.

Chairman GREENSPAN. It would certainly improve the financial structure.

SUGGESTIONS TO INCREASE SAVING

Senator D'AMATO. What other suggestions do you have for us as it relates to methodology to attempt to enhance savings, understanding the importance of reducing the deficit, putting that aside—we all agree with that.

Chairman GREENSPAN. Senator, I think the first thing that we've got to be clear on is that when you reduce savings—I'm sorry—when you increase savings, you have to reduce consumption.

Any incentive, any tax incentive, any policy incentive, always has to be looked at in terms of, does it actually reduce consumption relative to income or is it merely a transference from one savings vehicle to another?

In that regard, we are having great difficulty finding policies other than endeavoring to bring the budget deficit down to zero and, as I indicated in my prepared text, hopefully, to surplus to increase saving in significant amounts.

There's no question that there are small, marginal types of programs which probably help in minor ways.

Senator D'AMATO. IRA, for example.

Chairman GREENSPAN. Exactly.

Senator D'AMATO. That would be a marginal increase?

Chairman GREENSPAN. Yes. The evidence there is mixed, and if there is a net increase in saving from IRA's, and there may be, it's relatively small.

Senator D'AMATO. So you do list the double taxation of dividends, the elimination of that, as a positive step.

Chairman GREENSPAN. That is unquestionably desirable, yes.

Senator D'AMATO. Some form of IRA as a marginal improvement.

Chairman GREENSPAN. Yes. Well, let me just say that it depends on the form of it.

I have not come across a program or a policy to increase saving significantly in this country other than, at this stage, going toward a budget surplus.

I wish it were otherwise. I do not like the notion of having to look to the Government to supply savings to the private sector.

But there is no question at this stage that we need that. We need the savings. And hence, rather than look to a variety of different gimmicks, of which I've seen too many over the years, it's far more important that we look to getting the budget deficit issue behind us, moving toward surplus, and then looking for other means to augment saving at that time.

Senator D'AMATO. Let me touch on—I was going to do a no-no and talk about a broad-based energy tax as a way of reducing the deficit.

What is your feeling in regard to that?

Chairman GREENSPAN. Senator, I realize that there are a lot of new items that will be going on the table in these budget negotiations.

I would prefer that I not be requested to comment on any of these. I think it would just muddy the waters, and I would prefer to stand aside on this one.

Senator D'AMATO. So if I were to then propose to you what would be the most beneficial in terms of reducing the deficit, a hypothetical if you had to choose your poison, would it be a stock transfer tax, or would it be a broad-based energy tax?

You would decline to answer. You would not like to answer which way you would choose your death.

Chairman GREENSPAN. I would just as soon refrain at this stage, if you wouldn't mind.

Senator D'AMATO. Do you believe, if you care to answer, the stock transfer tax would be in the best interest of dealing with the problems?

Chairman GREENSPAN. I repeat, Senator—I would just as soon not get involved at this stage.

Senator D'AMATO. OK. And I respect that. But I have to say, for the record, that I honestly believe, Mr. Chairman, and Chairman Greenspan, that the stock transfer tax would absolutely do total violence to the principle of attempting to bring about capital formation, that it would all but eliminate and push the small investor, who already today treats the market with great skepticism, and I believe, based upon programmed trading, this business of coming in to say that the SEC should regulate Chicago and the margins, maybe they should, maybe they shouldn't. But if they come in and regulate the margins and you don't have programmed trading under control, you're not going to do anything.

And I'm afraid that Senator Gramm's comment as it related to October coming and hitting one of these points in time when we have 100 or 200 plus drop in the market, is going to take place. It will absolutely take place.

And we're talking about nothing but greed. It's just greed that powers the Wall Street houses to undertake this.

Again, I spoke to a number of the operators of the investment banking community. They all suspended. They all got out. But then when they saw their best friends back in making moneys, how do they say to their management people, why, X, Y, and Z firm are back in and we're not going to do it?

And I think to date, there's only one—I think it's Dean Whitter is the only major firm that's not back in. Maybe I'll get a call from someone else who will say, no, we're not back in. Well, fine.

But everybody else is back in there, and they're doing it at, I believe, the detriment of shareholders, the average shareholder. They're doing it to incur their own profit advantage for the trading houses themselves. And I think that they're helping to destroy a great system and it's going to ultimately, we're going to lose confidence in this and then we're going to get the kind of overregulation that we all abhor.

I've gone past my time. I certainly recognize that the Chairman is in a difficult position, given the negotiations. I'd like to free him from that restraint.

Chairman GREENSPAN. I thank you, Senator.

Senator D'AMATO. All right, thank you. Thank you.

The CHAIRMAN. Very good.

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Chairman, on one of the Sunday morning programs, it's been reported extensively in Monday's press, the Chairman of the Federal Deposit Insurance Corporation, Mr. Seidman, made some observations about the solidity of the commercial banking system.

He commented that he felt that the insurance fund was adequate to handle a mild recession, but that if economic conditions should deteriorate beyond that, that he had some serious concerns.

As I read those articles, I had a sense of recall of similar statements being made back in 1987 relative to the savings insurance fund.

CONDITION OF INSURANCE FUND FOR COMMERCIAL BANKS

What is your assessment of the state of the insurance fund for commercial banks? And second, based on that assessment, what, if any, recommendations would you make for congressional action?

Chairman GREENSPAN. Well, Senator, I can't go beyond what Bill Seidman has said. He's obviously in charge of it. He's far more knowledgeable about the specific elements within his system that would change under various economic conditions.

Clearly, I respect his judgments on that.

With respect to the broader question, as I indicated here earlier and as I indicated here last week, the reason we need more capital in our depository institutions is because we have to make certain that our depository institutions maintain an adequate capital buffer so that questions about the adequacy of the FDIC funds just don't arise.

The basic thrust of my remarks here last week—enhanced capital and prompt resolution—was directed at insulating the insurance funds.

Senator GRAHAM. So is the answer that you do not have any recommendations beyond those initiatives that are already in place for Congress relative to the security of FDIC?

Chairman GREENSPAN. I would assume if there are any recommendations, they will evolve in the context of the FIRREA-mandated study which the Treasury is involved with and to which we at the Fed are contributing.

Senator GRAHAM. The reason I'm emphasizing this is because, during the period, 1987 and 1988, we had a number of persons who represented various S&L regulatory agencies who came before the committee, and when asked, what should Congress do, essentially said nothing. We have the situation under control. We don't need any steps at this point.

In fact, a representative of the Treasury almost said it would be unpatriotic if we were to do anything because that would create a false fear in the public when no such fear was justified.

So I want to be clear that your recommendation at the present time is that no congressional action is called for pending the studies that are currently underway as to the deposit insurance system.

Chairman GREENSPAN. Well, remember, Senator, that FIRREA mandates that the fund go to 1½ percent of deposits from the 0.7 it is at today.

I would hope that these studies will be forthcoming reasonably quickly and, to the extent that any actions are required or any suggestions are appropriate, that they would be made in an expeditious fashion.

Senator GRAHAM. And I would like to conclude this set of questions with this request.

If there are any circumstances that come to your very advantaged perspective that would alter your sense of urgency and congressional action, that you would alert us to that change in position at the earliest moment.

Chairman GREENSPAN. We certainly will.

The CHAIRMAN. Senator Graham, would you yield at that point on my time, because this is, I think, an extremely important issue. I think Bill Seidman has given an important warning signal in his public comments.

As I understand it, we now have about \$12 billion left in the bank insurance fund and it's protecting a total of about \$2.5 trillion dollars in total deposits, of which \$1.9 billion are explicitly insured.

Obviously, you've also got bank capital in the balance sheets, however one values that, as partial protection. But there is a very small balance in the bank insurance fund.

With that in mind and Chairman Seidman's expressed concern, I think a look needs to be taken at that fund now and not just in the context of the FIRREA-mandated studies and other adjustments.

Given the fact that we are seeing the economic softening in various areas of the country, and softening in real estate values and stated bank balance sheet numbers and so forth. I think we have to assure ourselves that we don't have a problem there that we're not alert to.

So I would ask you and the Fed to take a fresh look, not in any crisis sense, at that now, if you would. I want you to indicate to us if the Fed independently sees anything out there.

Chairman GREENSPAN. We shall do so, Mr. Chairman.

The CHAIRMAN. Very good. I thank you for yielding.

Senator GRAHAM. Yes. A collateral question which caused me to read Mr. Seidman's remarks with special alarm is that economic conditions seem to be moving so rapidly and in many cases, in a negative way.

It was almost exactly 23 months ago that one of the most well-positioned persons in the country, the then Vice President of the United States, made a statement that his economic assesemnt of the future was such that he felt we could achieve our Nation's economic and fiscal goals solely within spending reduction strategies.

That position was reasserted 7 months ago in the State of the Union address.

This week, we've had a report from the President's budget advisers that if we were to follow that strategy, that very serious negative occurrences would be the result.

What do you think has happened in the 23 months since August 1988, and the 7 months since January 1990, that have caused the assessments of some of the most knowledgeable and best informed people in the Federal Government to now be so wildly out of touch with what current economic circumstances are?

Chairman GREENSPAN. Well, there are a lot of technical differences that have emerged with respect to estimating the budget deficit and specifically, receipts. The effects of the Tax Reform Act of 1986 were not clearly evident until fairly recently. In other words, we were getting receipts data coming in under the new statutes, the nature of which was not sufficiently clear to the estimators. So that I think for a while, there was a presumption that as an aftermath of the 1986 Reform Act, the ratio of tax receipts to taxable incomes was actually higher than it has ultimately turned out to be with respect to liabilities.

Senator GRAHAM. And that was not a circumstance that was foreseeable either in August 1988 or January 1990?

Chairman GREENSPAN. I think not, but I don't know the answer to that. My impression is a lot was learned in the April tax receipt period, specifically with respect to final settlements.

That was certainly one element. There were clearly other elements involved. There were estimates of the rate of growth of nominal, taxable income which were higher than has turned out to be the case, and their interest rate assumptions turned out to be lower than has turned out to be the case.

What we're seeing in this particular process is that when you try to estimate the difference between two totals, both of which are of the trillion-dollar order of magnitude, relatively small percentage changes have fairly significant impacts on the deficit that we calculate.

Senator GRAHAM. I guess, if those types of circumstances in a relatively short period of time, 23 or 7 months, could have caused such an extreme difference in the end result—

Chairman GREENSPAN. Excuse me. Let me introduce one additional issue which is relevant.

The way in which the budget is forecast by the administration is to assume that the requests of the President are fully implemented by the Congress.

And depending on what those requests are, you can get a very significantly different budget forecast than from what we've called baseline, or what we used to call current services.

I think that the numbers we're looking at today are on a current services basis, whereas, those in the two cases you were raising were, I believe, the administration's forecasts which assume policy implementation in full.

Senator GRAHAM. I can understand that, to some degree, starting in August 1988. But in January 1990, making projections for the fiscal year that will begin October 1, 1990, what deviations from the—

Chairman GREENSPAN. Is that 1990? OK. The fiscal 1991 period.

Senator GRAHAM. I'm talking about the State of the Union address that was delivered in January 1990 and the statements that were made about the economy at that time, in contrast to the statements that were made Monday by Mr. Darman, Mr. Brady, and other representatives of the administration as to the state of the economy at that point.

And I'm trying to understand how there could have been such a variation, since the Congress has not taken action on the President's budget request in any definitive form for the fiscal year that

will begin October 1. I don't see how that could have been a factor in causing such a dramatic shift over the 7 months' period.

Chairman GREENSPAN. I would have to look at the full details, which I have not as yet had a chance to look at, but I do think you can explain a very substantial part of that strictly by the issue of whether you consider the President's policies to be fully implemented or not.

There were unquestionably technical differences with respect to the economic forecasts which are relevant, but only partly so.

Senator GRAHAM. Mr. Chairman, my concern, which, as I indicated, was elevated by the statements of Mr. Seidman, is we seem to be in a period of tremendous economic flux. If circumstances can change as dramatically in 7 months as they have, if the shifts can occur in just a matter of weeks, almost dated by your testimony before this committee, I think that it behooves us all to have a very highly elevated antennae in terms of observing these events that are occurring with increasing rapidity so that we can understand them and attempt to take actions that will be in the Nation's benefit.

The CHAIRMAN. Thank you very much, Senator Graham.
Senator Kerry.

Senator KERRY. Thank you, Mr. Chairman. Mr. Chairman, thank you. I appreciate the opportunity to visit with you yet again.

I want to pick up—I had wanted to ask a number of questions. Some of them were asked by the Senator from Florida. But I shared his concern about the comments on "Face the Nation" on Sunday, and the reports thereafter.

I want to ask a number of questions about that, if I may, as well as a couple of others.

I understand we have about \$13.2 billion or so in the FDIC fund now, with \$2 billion of losses expected this year, bringing it down to \$11 billion, which means about 60 cents in the fund for every \$100 of insured deposits, which is about half what the Congress intended and what people have determined is sound business.

On the other side of the ledger, against that seemingly somewhat impoverished fund, is an increasing series of reports from various people around the country—Stanford economist, among others, Dan Brombaugh, who is widely reputed to have been one of the early forecasters of the S&L crisis—he is now suggesting that we're at the point at which, in a short period of time, taxpayers are going to have to make a contribution to the closure of insolvent banks, that either we're going to have to contribute additional money to pick up the tab for these bank failures on the commercial side, and, in addition, that there may be additional money needed simply through the premiums that banks are going to pay for insurance and so forth.

Now, it has been asserted by some others, let me quote them, that once you subtract the expected losses from FDIC assets, the net reserves are probably around zero.

Mr. Brombaugh himself says, I quote;

We're in the midst of reliving the S&L crisis in the commercial banks. The stage we are in is about the same as 1984 and 1985 with the thrifts, when the problems at many savings and loan associations were far more serious than their financial reports revealed.

We are moving down the same road as the thrifts," another economist said, "but the road is not so steep and we're not so far along.

Can you comment on that because I think it has an enormous implication?

You know, our citizens are not only angry, but they're now hearing these reports and they're scared. That's having, I think, something of an effect on their use of money. Certainly, retail is feeling that, I think to a degree. But more importantly, some people are even questioning whether they ought to put their money into some banks and how safe it's going to be down the road if this scenario plays out.

Chairman GREENSPAN. I think that that report which you cited is an exaggeration.

I must tell you that I don't have those types of concerns. The types of concerns I have focus more on making certain that we build up our competitive capabilities as a banking system and that we improve the structure of the entire financial system.

I would scarcely argue that we're in a position where the situation is about to unwind. I think that's just an issue which comes up periodically, and there's no real basis for it.

We do have to raise capital in our commercial banking system. Lenders do have to be somewhat more prudential, relative to the type of lending that occurred in the mid and latter part of the 1980's, but those are readily resolvable issues, in my judgment, and not something to create any really serious concern.

Senator KERRY. Now, if we are augmenting the amount of capital that these institutions are holding, while simultaneously dealing with the credit issues that you have talked about, therefore, as you have called it—I mean, you've suggested the semantical problems in your own articulation of the credit problem and what some call a credit crunch is for you a shift in credit bases, but to the consumer it has the same effect.

But if you have that, coupled with the increased capitalization requirements for these institutions, coupled with the earlier comments in your testimony which I read concerning the diminishing labor force, plus the prospect that we are sitting on here of increasing taxes while simultaneously reducing spending, that seems like a monumental conglomerate of simultaneous drag on your economy that's going to have an enormous impact on your forecasting, I would think.

Chairman GREENSPAN. Senator, some of those things I think are quite healthy. In fact, I believe that, even though it has been quite painful to have the rate of increase in credit slow down, it is very important for it to come back to a more normal trend. This slowdown includes not only the money supply elements that are proxies for overall credit, but also the expansion in mortgages, in corporate debt, in consumer credit, all of which had been adding to a very high rate of total expansion, especially with the mergers and acquisitions and LBO's.

But the process by which the deceleration occurs makes it feel as though it is harmful to the system, when the truth of the matter is, it is not.

I'll put it this way: It probably doesn't feel any different to the average potential borrower whether or not we are coming down

from an abnormal level of expansion of credit back to normal, or whether we are going from normal to too restrictive.

It is a continuum, in a sense, so far as he is concerned. But it matters very much to the overall system.

I feel somewhat more secure about the soundness of the system today than I would have, say, 2 or 3 years ago.

Senator KERRY. And is that because we're dealing with it?

Chairman GREENSPAN. Well, basically, because the rate of credit expansion, which I've found rather disturbing, has come down, and because we are dealing with it. Whatever concerns one may have about the system, they have to be less now than they were, say, 3 years ago. Capital has actually increased. The rate of borrowing has come down. The credit standards, if anything, have improved. Those strike me as plusses, not negatives.

Senator KERRY. And unemployment is up.

Chairman GREENSPAN. No, unemployment is down.

Senator KERRY. Not in New England.

Chairman GREENSPAN. Well, I certainly grant you that unemployment is up in New England from a very low level and you are experiencing the worst part of the problems that we are confronted with.

But if you think of it in terms of the national figures, including New England, the unemployment rate is still at the lowest level in approximately 15 years.

Senator KERRY. Well, now, in the course of the current revision of the estimates of the deficit, now at \$168 billion, and then the S&L on top of that, we're looking at an enormous contraction this year under Gramm-Rudman, and it depends obviously on whether we start talking about moving the dates or what happens, and that's not on the table at this point in time.

Looking at the kind of deficit reduction that we're now looking at, and recognizing the President has now said, I think we need taxes and we're going to need some revenue to do it, I know you don't want to deal in specifics, and I'm not asking you in specifics. But is there a range of revenue to reduce that deficit that begins to become excessive and, in your view, have a negative impact on the economy?

What is the balance between cuts in revenue that, in your view, that—

Chairman GREENSPAN. Senator, there are differences between spending and taxes in the way one balances or brings the budget deficit down.

The differences do affect the economy in certain different ways because, obviously, different types of taxes and different types of program changes have different types of effects within the economy. I would suspect, however, that, overall, it doesn't matter that much. That is, it is the total size of the deficit reduction that is crucial. And rather than worry about the effect of the composition on the economy, I think we ought to focus very clearly on getting a cut in the area of \$50 or \$60 billion. That strikes me in today's context as the magnitude of deficit reduction which could be implemented without undercutting the growth in the economy.

Senator KERRY. Now, if I could, and I don't want to abuse the time too much here, but I'd like to just ask another question.

The CHAIRMAN. All right. If you're going to move off that subject, I'd like you to just yield for a minute I'm not totally clear on this and it may be that I just didn't hear it right or there may have been a word left out here or there.

But are you saying, in a package of that size, \$50 to \$60 billion, that the exact component that might be new revenue as opposed to spending cuts really isn't the key question in your mind. The key question is what is the size of the total package.

Chairman GREENSPAN. It's basically the total package and whether it is credible, and whether it has subsequent wedge effects. In other words, as we discussed earlier, the first year number is really a proxy for a much broader program.

The CHAIRMAN. Right.

Chairman GREENSPAN. But it's the total program which is the crucial issue and its composition is of a lower order of importance.

I'm not saying that the composition has no effect. I have expressed before this committee many of my views on the balance of taxes versus spending, and I certainly don't retract those.

The CHAIRMAN. I understand.

Chairman GREENSPAN. But I think the crucial issue by far is the overall program. And I must say to you, Mr. Chairman, when you look at including the types of problems that we have been discussing, the economy has been behaving much better than a lot of people had feared.

We have been confronted with scare stories now for about what was going to happen to the economy now for 2 or 3 years, ever since the 1987 stock market crash.

I think we must say, in retrospect, that things are not going all that badly. We are comfortable that we've been able to keep money supply growth at a relatively low, stable pace, which, in our judgment, ultimately will pay off with a lower rate of inflation and, with greater stability. In part because of the fact that inventories have been brought under control, we are not subject to the degree of instability that we had gone through.

I grant you that the rate of growth is slow, and whenever the rate of growth is slow, you're closer to the edge, clearly, than you are when the growth rate is higher. But the point at issue is that, having said all of that, I think things are not too bad. And I must say, I'm rather pleased with the way the system is working.

We've got a huge problem with respect to the resolution of the savings and loans, which has a very material effect on how we do our business. But having gone through a period where there were very rapid resolutions in June, for example, without a significant impact on interest rates or a significant distortion in the system, we ought to be somewhat aware that this is suggestive of an economy which is not on the edge of either falling into a recession, or taking on highly inflationary characteristics.

I think that we've done better than I think we probably could have forecast as a reasonable judgment after the 1987 crash.

The CHAIRMAN. Well, I appreciate your saying that. If you'll yield just for another minute, I want to try to nail down, the point that I also thought I heard being made in response to your question, Senator Kerry.

I hear you saying that if we could get a deficit reduction package that is in the \$50 to \$60 billion range, and that is built in so that you get the out-year wedge effects then whether that were split 50/50 between revenues and spending cuts or somewhat more or somewhat less either way, the macroeconomic effect of that package, as you would see it, would be much the same.

The big deal, as you see it, is to get the package with whatever blend between revenue and spending cuts—as long as it adds up to that kind of a total, and it's real and it goes into the out-years.

Is that right?

Chairman GREENSPAN. If it's real and enforceable.

The CHAIRMAN. Well, that's a very important point because you're in effect saying here that the macroeconomic effect of the package is really dependent upon having the package, and that if we end up fighting endlessly on the composition and a little bit more of this or a little bit more of that, we may well be missing the point.

Chairman GREENSPAN. Yes. But let me say this: Obviously, I'm not talking at the extremes.

The CHAIRMAN. No, I understand. I'm not posing the question that way.

Chairman GREENSPAN. As I've said to this committee before, if we were to do it all on the tax side, to be very honest, I don't think it would ultimately function.

The CHAIRMAN. No, I'm not saying that.

Chairman GREENSPAN. But the answer is yes. Within a range, the differential macroeconomic impact cannot be large enough for us to be concerned with.

This issue of resolving the budget deficit problem is so difficult that to add additional difficulties, when they don't matter all that much, strikes me as inappropriate.

The CHAIRMAN. Well, and it's an important, refreshing comment by you. And I think it helps the debate.

This being said at 12:20 in the afternoon, and I don't know whether it will make its way out of here the way I think it ought to. But I think the questions that Senator Kerry has posed and the answers that you've given are important and I think they put this debate in a somewhat new and clearer light. I think it's helpful.

Senator Kerry, why don't you finish up?

Senator KERRY. Thank you very much, Mr. Chairman. I thank you for drawing that out further.

I had thought I had understood it as that, but I am happy that you've focused more on it, and I think it's helpful.

Mr. Chairman, assuming we get the package, is it your view that the Fed should move to interpret the results of that package or that the credit markets should do so on their own with the risk that they might bid the interest rates down too low or not enough.

Chairman GREENSPAN. I think that at the end of the day, it's the credit markets that count. We obviously will be focusing very closely on how the markets respond and how the markets evaluate the package.

EMPLOYMENT DECELERATION

Senator KERRY. Now, beyond—well, let me hold off on those questions. I don't need to do those now.

I do want to ask you this, though. I was struck in your testimony about the employment deceleration, but the labor force, also. And you talk about some of the aspects of the labor force.

I wondered if you weren't underplaying the impact and the problem we face in this country of now having seen many, many women brought into the labor force, considerable minorities brought into the labor force, the birth rate being such that the bubble is over on the baby boom, and that we face a serious problem in terms of growth.

I know that we're increasingly feeling this in New England.

I wonder if it is not underplayed somewhat in your testimony and in the importance for this country's ability to be able to "get moving again," and to really see the kind of growth that we want.

Do we have the capacity for growth in the labor force that will permit that at this point in time?

Chairman GREENSPAN. Well, Senator, we've had an odd slowing in labor force growth, really since the beginning of the year. It is reflected to a large extent in the participation rates of females, age 20 to 24, and of teenagers. But even in the rate of growth in the participation of adult women, which had been such a major factor adding to our labor force, we've seen some slowing down.

Now, it is quite possible that this is merely a statistical aberration. Data often do that. They often give you mixed signals. I think, however, that we do know that the trend growth rate of the labor force must have slowed down because we have independent estimates of slowed employment growth and our insured unemployment system essentially confirms that the unemployment rate has also remained very low. So the arithmetic of the system is confirming that there is a slowdown out there in the labor force.

What we do not know is whether it is a temporary 6-month oddity, which we've seen many times in the past, or whether there's something more fundamental here. I don't think we will know that for a number of months, maybe not for a number of years. But it's something that has happened, and it is clearly not all the result of the slowing down in economic growth. What its full implications are, we do not yet know.

Senator KERRY. I'd like to ask you just a last sort of generic question, if I may.

There was a period in this country when Franklin Roosevelt talked about fear being the only thing that we had to fear. And I find in New England, speaking for New England, but I think for a lot of parts of this country right now, if you look at the polls, the most significant figure that pollsters are now focused on is the perception by Americans that they don't know what the future is going to be. They don't believe it's going to be as good, for some reason.

I think it's something of great concern when you measure what's happening in housing and homelessness, in education, the functional literacy of 20 percent of our high school graduates and so forth, other problems in the work force.

I think people are feeling these things. And now the S&L crisis, the comments of Seidman and so forth.

I'd just like to ask you as this principal figure in the structure of our country on economic matters, if you might speak to that sense of fear for a moment and to the question people have, which I think is restraining economic activity and slowing us down to a degree.

And I wonder if that is of concern to you, do you perceive that? And if, in any way, you do, what is your prescription?

INCREASED PRODUCTIVITY

Chairman GREENSPAN. Well, Senator, what we do perceive is that the economy, and more importantly, productivity, has slowed its growth. This is not an issue of the last few years; it's really an issue which differentiates the early post-World War II period from, say, the last 20 years.

I think it is certainly the case that the slowed growth in living standards which we've experienced in this country has changed the level of optimism, if one could put it that way, that one sensed earlier in the post-World War II period. My working life really starts right at the end of World War II and goes through this period, so I'm aware that there was a discontinuity out there somewhere 20 years ago.

The 1980's have actually been something of an improvement from the 1970's. I think there were increased senses of optimism, and I think they still carry over. You're quite right that the S&L issue has created a problem as far as the economic outlook is concerned and the difficulty of getting our Federal budget deficit down has been a problem. The trade issues also have created some particular problems. But overall, we probably were in our worst stages, if you want to put it that way, in the latter part of the 1970's. In other words, that's when inflation was beginning to take hold, and a degree of instability and concern about the future of the country, got to very severe levels.

We are still growing more slowly than I think we should be growing. And I do think, to come to the ultimate answer to your question, that the bottom line to all of this is that we have got to get productivity increasing at a faster pace. The only way I can see that occurring is by resolving the investment and saving issue, which is the reason I said earlier to one of your colleagues that I thought the highest domestic economic priority in this country is increasing the saving rate.

Improving the rate of growth in the economy would change a number of the problems which you identified. However, referring to my earlier statement, I think it's very easy to exaggerate the negatives. Nevertheless in many respects we underestimate a lot of the positives. Things are not as good as they could be and I think it's fairly evident that were we able to pick up our growth rates, the attitudes as you identified them—and I sense them as everyone does—would change.

Senator KERRY. I thank you very much, Mr. Chairman. Thank you.

The CHAIRMAN. Thank you. You know, I would just like to add to that, and ask you one more question, then we'll finish here. You're been very patient.

In my own mind, I think our overriding national goal has to be getting the productivity growth rate up. We're doing about 1 to 2 percent a year in recent years, on the average. We need to try to double that.

I believe you can actually lay out a pretty clear-cut set of strategy options that can increase national savings and investment in private and public physical capital as well as human capital to beef up productivity growth to those rates.

But if we can do that, we can solve our other problems. If we don't get that done, I think our problems are going to increase.

Let me take you to page 10 of your testimony, and this is the one item I want to finish with.

On page 10, with respect to what you see happening in terms of the tightening of credit standards and what's going on in some form of a credit contraction, you made this statement:

Nevertheless, in the here and now, the tightening is beginning to have very real unwelcome effects.

And then down about 6 lines you say:

In recent weeks, however, we may have slipped over that line.

In terms of the tightening down process going beyond what would seem to be sound from the point of view of at least the monetary policy impact that you would like.

Tell me what the data is. What are you hanging your hat on that is causing you to make that kind of definitive statement here?

Chairman GREENSPAN. First of all—

The CHAIRMAN. I'd like you to summarize it, and then I want to know if it's something we can have so that we can take a look at it ourselves.

Chairman GREENSPAN. First of all, we see in the aggregate data a significant slowing down in the rate of growth in the various credit aggregates from levels which we had always perceived in our analysis to be excessive relative to the needs of financing a certain level of nominal GNP. It's clear in the early stages and, in fact, I would say up until recently, that it was not only desirable, but very healthy for the financial system. We began to see evidence of that as we, for example, looked at the balance sheets of the financial intermediaries and the income statements, of the depository intermediaries. What you could see at that particular point was a gradual deceleration.

The question basically then arises, is there a point at which it becomes too restrictive? In other words, do you get to a point where commercial banks in particular are beginning to pull back to where it looks as though the commitments being made will then start to flatten out significantly, effectively, creating a tightening in the credit markets?

What we were looking for and did not see in any reasonable way, say in the spring, was a widening of margins in banking, meaning that commercial banks were seeking to increase their margins because they were fearful of the threats to their capital or to the quality of their loan portfolios.

We began to see very early stages of that, which were not consequential. It's only very recently when, in talking to, for example, a lot of bankers about their loan policies and spreads, that we're beginning to get indications, although no hard evidence because the hard evidence won't be available for months. You won't see it for a while. But it is enough to see that the indications are credible, especially if you're getting the type of responses we are in, for example, the money supply data.

The money supply looked as though, after it had dipped down in May, and had started back up, it was really going to move, but it has since slowed down again rather substantially. The money supply is growing but it is growing at a relatively modest level indicative of the type of phenomenon which would exist if we are slipping over the line.

And while, obviously, I don't want to make too much of the specific line, there is enough, in my judgment, out there to suggest that the pressures on the economy were increasing.

That's one of the reasons why the probability of recession increased a shade, not much, and I think we have probably offset most of that in the action that we have taken.

The CHAIRMAN. Just last week, the action that you announced.

Chairman GREENSPAN. Yes. But I will tell you this—that when you get into this type of information, it is very important to try to collect it from a wide variety of sources. And this is one of the reasons why I think the Federal Reserve has an exceptional real time information processing system.

In other words, if you're waiting until you get the published number, with the rare exception of data that are published on a weekly basis, you'll always be acting much too late. You'll always be looking at the last war. We have no alternative but to try to anticipate what we think is happening. In that context it began to appear, when, for example, the money supply growth stalled out, that there was more here than we had originally appreciated.

In my judgment, had we done nothing, we would have increased the probability of the credit system beginning to crush the economy's growth. As best I can judge, we have alleviated that pressure at this particular stage, and that's why I remain hopeful that the economic growth that we're envisaging, which is not robust, but nonetheless, there, will continue.

The CHAIRMAN. Now, is my memory correct that about, oh, maybe 3 months ago, you and other bank regulators met with representatives of the largest banks of the country?

Chairman GREENSPAN. No, we met with representatives of the American Bankers Association, which includes both large and small banks.

The CHAIRMAN. Let me make that correction—representatives of a mixture of American banks. That session, as I understood it, was a—my word—"jawboning" session or a session to try to talk to the bankers about now being too restrictive, to tighten down to a prudent point, but not overdo it. And that's the general characterization that was made of that.

It sounds to me, if that is an accurate description of what happened, that in the time since you have not become convinced that

you were getting the effect that you wanted, and so you now have had to insert an element of monetary policy adjustment to deal with it.

Chairman GREENSPAN. Well, let me just rephrase the way you put it. What we were concerned about at that meeting at the ABA was that it not be perceived that the regulators and the examiners were suggesting to the bankers that they pull in their horns.

In a sense, there is a related issue here. We were concerned that they would, in fact, do what apparently has in part happened. But it was not clear at that time that it was going to become a general problem, and we surely hoped that it would not.

Up until recent weeks, I had every reason to hope that we would avoid that sort of phenomenon and that it was just a temporary phenomenon which we go through all the time. That did not turn out to be the case, but it's not something that you can know for sure or forecast with great definitiveness.

The CHAIRMAN. Well, I take it from what you said a moment ago that your data are still fragmentary. In other words, part of it is data that are coming in, part of it's your feel, and part of it is anecdotal, I would assume.

Chairman GREENSPAN. Well, I hope it's not feel. Feel is not very useful. I hope that it's real information. We don't just take summaries of comments from banks or something.

The point is that when you get evidence about what is going on in the lending and fee process within commercial banks—in the smaller banks, in the medium banks and in syndications—certain patterns begin to emerge that look more than random. And it's when you can draw that conclusion, then you're reasonably sure that certain fundamental things are going on, even if you don't have the exact numbers to verify it.

The CHAIRMAN. Well, I understood you to be saying a moment ago that the policy adjustment you made last week was matched to what your data suggest to you is the size of the problem.

I don't want to have it read back, but, in essence—

Chairman GREENSPAN. The rough order of magnitude. That is correct.

The CHAIRMAN. And so, it sounds as me, based on the data that you do have and the analysis that you have done, you feel you have now made the full policy adjustment.

You're not in the middle of six or eight different adjustment steps that you anticipate, of which and you've only made one, but rather that you've tried to make the full adjustment that fits the problem as you see it.

Is that fair?

Chairman GREENSPAN. Up to this date, I would say that is correct.

But as I indicated to you in my prepared text, we think this process is still moving. Whether it will move enough to make any further material difference, I frankly don't know. I hope not. It may well not. At this particular stage, I would say we are watching it very closely.

The main thing I think we have to emphasize about this, and the reason why I hesitate to call this whole thing a credit crunch, is that we are dealing with relatively small changes. I think they're

important enough to respond to, but if we had a real credit crunch of the type we used to have in the past, we are talking about a fundamentally different type of phenomenon.

The reason I tend to be somewhat resistant to responding to the contraction of credit growth that has been going on is that I perceive it as something healthy, something which will be advantageous to the long-term financial stability of our system. I think it is crucially important from a policy perspective to make that distinction.

The CHAIRMAN. Well, I agree with you. And I think you've made it clear today that this was fine-tuning. This was not—and you tell me if you don't agree—this was not a major policy adjustment. This was, you said it several different ways, was a fine-tuning adjustment.

And further you've said today that it was not designed to drive down interest rates. It was, in a sense, to hold interest rates—Chairman GREENSPAN. To hold credit conditions the same.

The CHAIRMAN. Level.

Chairman GREENSPAN. And, in general, to keep the markets stable.

It was an action that directly related to a specific credit problem that we perceived, and what we did was to offset it. We were not looking to fundamentally change the underlying credit conditions in the economy, which is what policy would do if, for example, we were looking at a more profoundly important change in either economic activity or inflationary pressures, because when we react to either of those, it's a major change in policy which tends to be progressive.

And as I've tried to convey, we do not view this in that manner.

The CHAIRMAN. I'm going to just finish with this comment. As things change further, and that can happen—obviously no one can read the future—

Chairman GREENSPAN. They can change in either direction.

The CHAIRMAN. Yes. I understand. But if you find that they do change in the next several weeks, next 2 or 3 months, and another policy adjustment is needed, whether or not we've got an official hearing such as this scheduled, I will certainly, and I know the committee will want to meet again with you if there's going to be any kind of a consequential policy adjustment over that kind of a timeframe.

I'm not saying that anyone foresees that or you foresee it, but if things are changing further to an extent that requires a further adjustment, I think that that would be something that we would want to at least have you illuminate for us.

Chairman GREENSPAN. Certainly.

The CHAIRMAN. Very good. We thank you very much. You've been very patient and very straightforward, as always.

The committee stands in recess.

[Whereupon, at 12:55 p.m., the committee was recessed.]

[Response to written questions follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

Alan Greenspan

- Q.1. In your testimony, you referred to bank surveys as an important part of the evidence suggesting a tightening of credit conditions. Some of these may be informal, but, if possible, please provide us with the recent results of those that are more formally and regularly conducted. When will these be updated, and how reliable do you think they are?
- A.1. Information on the recent pullback in credit supplies has been obtained from a variety of sources, including formal surveys, analyses of economic and financial data, and anecdotal information. The relevant formal surveys included the Senior Loan Officer Opinion Survey of Bank Lending Practices and the Survey of Terms of Bank Lending. These surveys of course take time to compile. As a consequence for rapidly changing market conditions, we are often required to engage in quick informal surveys to update the state of knowledge. Our most recent appraisal of credit tightening was based primarily on informal surveys, which have only recently been confirmed by a formal survey.

Senior Loan Officer Opinion Survey

The Senior Loan Officer Opinion Survey covers 60 of the nation's largest domestically chartered banks. Commencing with the most recent (August) survey, 18 U.S. branches and agencies of foreign banks have been added as respondents.) The format of the survey is not fixed, but rather asks questions on topics of current interest to the Federal Reserve. The survey is conducted 4 to 6 times a year.

In the Senior Loan Officer Survey for January 1990, many respondents reported tightening their standards for business loans to riskier borrowers and for merger-related loans to all borrowers. Standards for nonmerger-related loans to investment-grade borrowers were not significantly changed. Most respondents also reported less willingness to make real estate loans for acquisition, land development, and construction (ADC). Only one-third of the respondents said that their ADC loans were higher because of the thrift crisis, and several of these banks reported that they lent only to the higher-quality former customers of thrifts.

The Senior Loan Officer Survey for May 1990 asked questions about recent weakness in nonmerger-related

business loans. The responses suggested that weak loan growth was mainly the result of reduced funding needs of large and medium-sized customers. At the same time, however, over half the respondents reported that they had tightened credit standards and loan terms to both medium-sized and small borrowers. The May survey also found that a large majority of respondents had tightened lending standards for approving commercial real estate loans.

The Federal Reserve conducted another Senior Loan Officer Survey at the beginning of August, which collected additional information on credit conditions. A substantial minority of respondents indicated that, since the May survey, they had further tightened lending standards and terms on nonmerger-related business loans. The tightening was most noticeable for medium-sized businesses but extended as well to large and smaller firms. The greater stringency encompassed some widening of spreads of loan rates over base rates and increased costs for credit lines as well as tighter nonprice terms. As in the May survey, about three-quarters of respondent banks reported tighter lending standards to approve loans to finance office buildings and other types of commercial real estate. A substantial majority of branches and agencies of foreign banks, surveyed for the first time, indicated that in the last 6 months they too had tightened their lending standards both for business loans and for commercial real estate loans.

We believe that the Senior Loan Officer Opinion Survey is a reliable indicator of current thinking at large commercial banks. However, the questions in this survey are usually qualitative rather than quantitative. It is difficult, therefore, to infer other than very broadly the size of the impact of a change in lending practices from the responses to this survey.

Survey of Terms of Bank Lending

The Survey of Terms of Bank Lending to Businesses (STBL), is conducted during the first full business week of February, May, August, and November. It collects information from a sample of 340 banks of all sizes about quantities and prices of all business loans made during the survey week. Results of the August survey will be available in mid-September.

Unpublished data obtained from the STBL for May 1990 gave some evidence that banks had tightened terms on

business loans. Pricing and collateralization requirements for loans to smaller borrowers were tightened. For loans to larger borrowers the spreads over funding costs of prime-based loans made under commitment did not change much, but the same spreads on loans with pricing based on market rates widened.

The STBL is believed to be a fairly reliable indicator of lending terms. However, the survey covers only a sample of commercial banks and, consequently, universe estimates obtained from the survey are subject to sampling error. In addition, information about the size and industry of borrowers is not collected, so that, for instance, loans of small amounts or loans made under small commitments must be used as a proxy for loans to small borrowers.

Q.2. On page 12 of your statement you say that if M2 drops below its current range you may need to lower interest rates. Should we infer that the Fed may be planning to place more weight on M2 in policy decisions than it has in recent years?

A.2. M2 is one of several key indicators that figures importantly in monetary policy deliberations. The Federal Reserve sets annual ranges for M2, along with ranges for M3 and debt, that are believed to be consistent with its objectives for economic growth and progress toward price stability. Growth of these aggregates outside of their ranges would in any case signal a need to consider whether the stance of monetary policy was consistent with achievement of these goals. In the period ahead, M2 could be useful as a barometer of depository institutions' attitudes toward credit provision. Should banks and thrifts pull back further in the lending area, their reduced demand for funds probably would show through to a smaller appetite for deposit funding and a reduction in M2 growth. Under such circumstances, the Federal Reserve might find it appropriate to adjust policy to offset any significant additional reduction in aggregate credit availability. Therefore, the Federal Reserve will continue to scrutinize growth in M2 relative to its annual target range to assess what it is telling us about conditions in credit markets.

Nonetheless, we will continue to interpret movements in M2 in light of other information about financial markets and the economy. Monetary velocity has fluctuated widely in recent years, and the recent contraction in the thrift industry has amplified uncertainty about short-term relationships of money to spending and

prices. For that reason, a policy response would not be automatic should M2 stray below its target range, nor would the Federal Reserve refrain from taking action while M2 remained within its range should other factors warrant action.

- Q.3. At earlier hearings, you said that you planned to virtually eliminate inflation without recession by getting the economy to grow slowly enough that some slack in resource utilization would develop. We've had slow growth, but so far the unemployment rate has actually fallen and the Federal Open Market Committee has had to raise its forecast for inflation this year to a number that would be the highest in 9 years. Do you still think it is realistic to expect that we can really stop inflation relatively painlessly?
- A.3. Economic theory and experience both suggest that ultimately disinflation requires a reduction in inflation expectations. The question is, what policies will cause the necessary lowering of inflation expectations? Certainly, monetary and fiscal policies that are responsible and prudent would help to achieve a reduction of inflation expectations. Accordingly, it is the intention of Federal Reserve policy to move over time toward the low trend rates of monetary expansion that would be consistent with price stability. For a time, such a policy might involve some slack in resource utilization. Indeed, since the recent peak in early 1989, capacity utilization in the industrial economy has dropped a little more than 1 percentage point to about 83-1/2 percent. To be sure the unemployment rate remains relatively low by historical standards, even though it edged up to 5-1/2 percent in July. Part of the continued tightness in some labor markets in the context of sluggish economic growth reflects the unexpected slowdown in the growth of the labor force this year. We are still of the conviction that the rate of inflation should decline over time, but progress may only be apparent over a multi-year time horizon.

- Q.4. The East and West Germans have just started a monetary union and the European Community as a whole appears to be moving fairly rapidly toward a continent-wide union. What kind of competition would such a European currency provide for the dollar as an international reserve currency? What would be the cost of losing our dominant status?
- A.4. The eventual adoption of a single currency by the European Community might be expected to reduce somewhat the international demand for the dollar as an official international reserve asset. This substitution out of the dollar as a reserve currency would be by non-Community countries, though most of these countries' demand for the new European currency would probably be satisfied by exchanging their holdings of existing European currencies (marks and sterling). The demand for dollar reserves by European Community members taken together, may be little changed. There could be some economies of scale which would reduce their total demand for reserves, but much of this reduction would be satisfied by eliminating their existing holdings of other members' currencies (mainly marks) which would become domestic currency and therefore not usable as international reserve assets.

Any net reduction in international demand for dollar reserves is likely to be small and probably would occur slowly. The "cost" of any reduced demand would come through a depreciation of the dollar's exchange value and higher U.S. net exports. In a sense, we would have to redeem the excess supply of dollars for goods and services which, other things equal, means lower living standards than would otherwise be the case for U.S. residents. On balance, the effects in this regard are likely to be very small.

Any reduction in the demand for dollar reserves due to the establishment of European monetary union could well be offset, at least to some degree, by an increased demand for dollar reserves from East Europe and the Soviet Union. These countries have held relatively modest amounts of dollars in the past due to their limited trade with the west. As the economies of these countries are opened to trade with the west, their demand for western currency, both dollars and other "hard" currencies, will probably increase.

- Q.5. Recent trade data have shown decreasing deficits. In the absence of a major budget agreement, what are the prospects for future trade deficits?
- A.5. It is difficult to quantify changes in the U.S. trade deficit associated with different levels of budget restraint. However, most econometric models suggest that it would take a major budget agreement to bring about a sustained further improvement in the U.S. trade deficit. With only a small package, the U.S. trade deficit may continue to improve slowly or it might deteriorate; without a substantial increase in savings from the U.S. private sector, the federal government deficit will continue to put pressure on the low level of private savings, requiring inflows from abroad (and associated trade and current account deficits) to sustain even modest levels of domestic investment.
- Q.6. You have referred to the weakness in money growth as a confirming sign of credit tightening, saying that not all the weakness can be accounted for by the thrift cleanup process. Do you have a quantitative estimate of the effect of thrift closings and downsizings of weak thrifts on M2?
- A.6. We do not have a quantitative estimate of the extent to which the thrift restructuring is depressing M2, but there is sufficient circumstantial evidence to lead us to believe that it explains some, though not all, of its weakness. Based on relationships that have been relatively successful in explaining M2 growth before this year, the recent growth rates of M2 have been far below those consistent with interest rates and with available information on the pace of growth of the economy. This aberrant behavior has coincided with the massive expenditures by the RTC to resolve insolvent thrifts. These expenditures, by shifting a sizeable volume of cash to banks at a time when bank lending has been weak, apparently have caused banks to offer less generous terms on deposits. In addition, the closing of a number of aggressive, insolvent S&Ls has greatly reduced the availability of high interest rates in that sector. Both have acted to reduce the quantity of M2-type assets demanded by the public.

- Q.7 At the hearing, you indicated that federal borrowing to raise working capital funds for the RTC appears to have raised Treasury bill yields relative to those on private instruments by about a quarter percentage point. Do you expect these wider spreads to persist? If the wider spreads were caused entirely by the RTC's needs, what would be the implied size of this secondary cost of the thrift cleanup?
- A.7. Any upward pressure on bill rates stemming from RTC working capital needs is likely to persist as long as those needs represent a significant addition to the amount of bills outstanding. However, estimating the absolute effect of the RTC's activities on bill rates is difficult. The 25 basis points cited above refers to the spread between bill rates and private rates, rather than to the absolute level of bill rates, which is more relevant for assessing the impact on the cost of the thrift cleanup. The narrowing would come about partly as a result of lower private rates. For example, interest rates in the CD market probably have fallen somewhat in response to the transfer of a sizeable volume of assets from the thrift sector, which formerly had been bidding aggressively for funding for those assets. The considerations outlined above suggest that the additional cost caused by higher bill rates might be on the order of several hundred million dollars at an annual rate while the additional borrowing is outstanding. When the RTC's holdings of assets begin to decline, the amount of bills outstanding will start to return to normal, and the upward pressure on bill rates should diminish. It might also be noted that no matter which segment of the capital markets provided the financing for the RTC's working capital needs, some upward pressure on rates in that sector would have been likely.
- Q.8. The chart on page 24 of your report is impressive. The gap between total debt growth and growth of depository credit is enormous. The former has eased only slightly while the latter has slowed to a stop. What other sources of credit have taken up the slack and by how much?
- A.8. In 1988 depository institutions accounted for more than 35 percent of the net increase in credit market funds supplied to domestic nonfinancial borrowers. (See Table.) In the period since then, their share has been a little more than 10 percent. The drop in the growth of depository credit is more than accounted for by the contraction of the thrift industry's balance sheet; commercial bank credit continued to expand, but at a

moderate pace given concerns about borrower creditworthiness and pressures on bank capital. Because thrifts' primary lending activity is home mortgage loans, the reduction in thrift lending has been concentrated in this sector.

There are two aspects of the replacement of thrift institutions in the supply of credit to the economy. First, other lenders have stepped up to acquire mortgage assets shed by thrift institutions, and to provide the mortgage credit that has been foregone by thrifts. These include commercial banks, insurance companies, and, through direct lending in the securities markets, the household sector (which includes nonprofit organizations). Much of the increased mortgage lending by these sectors has been done through the acquisition of mortgage-backed securities, whose issuance has ballooned since the start of the thrift crisis.

However, for the most part, these sectors have not stepped up their overall provision of credit to nonfinancial borrowers by the full amount of their increased mortgage lending. Instead, their enlarged purchases of mortgage assets have been at least partly at the expense of decreased lending to other borrowers. For example, insurance companies' share of the growth of domestic nonfinancial debt is little changed since 1988, while commercial banks and households--included in the "Other" line--increased their share by less than the decline in thrift lending. The largest increases in lending shares have been recorded by mutual funds and securities brokers and dealers. Some of the increase in credit extended by these intermediaries probably represents acquisitions of mortgage-related securities, but it also includes the purchase of other securities displaced by the increased absorption of mortgage assets by commercial banks and the household sector.

Shares of Changes in Domestic Nonfinancial Debt
(By percent)

	<u>1988</u>	<u>1989</u>	<u>1990-H1</u> [*]
Depository Institutions	38	12	11
Commercial banks	22	24	25
Thrift institutions	17	-12	-14
Insurance Companies	17	17	17
Pension Funds	8	9	12
Finance Companies	5	4	4
Money Market Funds	- 1	1	6
Other Mutual Funds	0	4	6
Securities Brokers & Dealers	- 1	13	8
Government Agencies	5	0	2
Other ^{**}	28	41	33

Source: Flow-of-funds statistics.

* - Preliminary estimates.

** - Computed as a residual. Largely consists of direct lending by the household, foreign, and government sectors.

- Q.9 -The Congressional Budget Office estimates that the RTC will need to resolve a total of 925 thrifts which are or will be insolvent by August of 1992. They estimate that an additional 792 institutions are now insolvent if their assets are measured on a market value basis and that most will fail within a few years after that time. The OTS, however, estimates the RTC caseload at 722 to 1037 and describes the rest of the industry as either "meeting or expected to meet the new capital standards" (621 thrifts) or "well capitalized and profitable" (1267 thrifts). To reach CBO's total of 1817 economically insolvent thrifts, one would have to include at least 159 of the thrifts that OTS describes as well capitalized and profitable in addition to all of those rated lower. If the CBO's analysis is correct, the new capital standards would certainly appear to be inadequate. How many thrifts do you estimate would be solvent and how many insolvent if their assets were measured on a market value basis?
- A.9. As you well know, neither generally accepted accounting principles or regulatory accounting rules require financial institutions to adjust their balance sheet to market values. Absent such information, any estimate of the number of "true" insolvents would be largely speculative. The most recent information available to us from the Office of Thrift Supervision indicates that as of March 31, 1990, 310 thrifts with assets of \$194.6 billion were in a weakened or insolvent condition and were scheduled for transfer to RTC conservatorship. At the time, the RTC was already operating 257 conservatorship with assets of \$120.4 billion. In addition, the OTS also identified 311 institutions with assets of \$148.6 billion as under-capitalized and not expected to meet regulatory capital minimums.

The best proxy for mark-to-market asset valuations would likely be the asset quality information collected and analyzed by the OTS as part of their examination process. Our access to such information is limited to select institutions in which we have a direct supervisory interest (e.g. applications approval). We would advise you to contact the OTS directly concerning such information.

But even with detailed examination information, a meaningful estimate of market values would have to incorporate a wide range of institution-specific and macroeconomic variables, and in the end would not likely produce a result in which we could place a great deal of confidence. A further complicating factor which the government must always contend with is

the discounted values associated with assets being sold in "firesale" or "liquidation" scenarios. When assets can be sold in market-based transactions between willing buyers and sellers not acting under duress, the buyers and sellers add value to the transaction as "on-going" concerns. Hence, even an accurate portrayal of asset market values on the books of an ongoing, operating thrift would not accurately reflect the government's likely costs of having to liquidate the institution.

As I have discussed several times in the past, knowing the ultimate cost of the bailout is only of real significance if it would materially affect the manner in which we are addressing the problem. I believe that we are taking forthright measures to resolve this crisis, and that we are moving forward with appropriate vigor, whatever the ultimate cost.

- Q.10. If the Treasury's proposal to require government-sponsored enterprises to attain triple-A ratings (abstracting from implicit federal guarantees) were enacted how many basis points do you think mortgage rates paid by homebuyers would have to rise relative to market yields to enable these agencies to provide an adequate return on new equity? What effect would that have on homebuilding?
- A.10. It is very difficult to gauge the effect of the Treasury's proposal to, in essence, substitute investor capital for implicit taxpayer guarantees on residential mortgage rates and housing activity. For one thing, it is unclear how much of the current subsidy of the perceived implicit federal guarantee to FNMA and FHLMC, the two principal housing agencies, gets passed along to homebuyers and how much goes to shareholders in these organizations. However, as proposals to limit the subsidy have gained force, stock prices of FNMA and FHLMC have fallen, suggesting that a significant portion of the subsidy may have been going to shareholders. Efforts to measure the influence on mortgage rates are plagued by the difficulties of separating liquidity effects associated with the large scale of the FNMA and FHLMC programs from the credit enhancement effects that are linked to the subsidy. Although empirical studies of the credit enhancement effects vary on the amount of the impact, they generally agree that it is relatively small.

- Q.11. The switch to risk-based capital standards makes lending to consumers and businesses relatively less attractive; those activities receive a higher risk-weighting than other assets. This is a positive step in terms of bank regulation because it rewards safety. But what are the broader macroeconomic implications of the shifts in credit allocation that may result?
- A.11. At the margin, risk-based capital requirements tend to make loans to businesses and consumers less attractive. Whether this will have much, if any, effect on the availability or cost of such credit depends on the extent to which the securitization process can be effective in transferring such credits to unconstrained investors, either other banks for which capital constraints are not binding or other investors. The recent experience in the mortgage market, as the thrift holdings of mortgage assets have contracted sharply, suggests that it is possible for credit demands to be readily met by new investors as traditional lenders cut back or withdraw. Nevertheless, this is a matter that requires continued monitoring to determine whether any reluctance by some banks to make credit available to businesses or consumers is adversely affecting these borrowers.
- Q.12. The cost to banks of raising second tier capital through the sale of subordinated debt rose by 40 basis points in the first half of this year. At the same time, bank stocks are down and in many cases are selling below book value. How much do you think this increased cost of capital will affect growth in loan volume?
- A.12. While bank access to capital markets already has deteriorated, the strong inflow of retail deposits from the contracting thrift industry has been putting downward pressure on these deposit rates and off-setting, at least to a degree, the effect of higher costs of capital on the overall cost of funds to banks. Nonetheless, many banking organizations may have reacted to their less favorable access to the capital markets by adopting a more cautious approach to lending and expansion of their balance sheets. We at the Federal Reserve have been and will continue to monitor this situation carefully.

- Q.13. The financial health of the insurance industry is currently being called into question. Issues are being raised about some of their assets, including holdings in low-grade bonds and real estate-related activities. If the problems are as serious as feared by many, how much effect might there be on real estate lending?
- A.13. In addition to the insurance industry's holdings of certain problem assets, concerns have been voiced about pressures on profit positions from intensified competition, especially in the guaranteed investment contract products area, and some erosion in recent years of capital positions. For the industry as a whole, it would appear that capital and reserves are adequate to withstand their present asset quality problems, although some individual institutions, of course, could experience pronounced difficulties. In light of these considerations, one could reasonably expect that the insurance industry will take a more cautious approach to lending, avoiding more risky credits. This could favor the residential mortgage market as solid mortgage assets--mortgage securities as well as whole loans--become more attractive.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM

Alan Greenspan

- Q.1. Savings and investment are critical components of economic growth. Increased savings through reductions in the federal budget deficit would increase the amount of funds available for investment and reduce the cost of capital. However, some observers noted that increased savings and a lower cost of capital alone may not result in additional investment in the United States. They assert that returns on equity are the major determinant in investment decisions. Consequently, investment in the United States may not increase if investments in other countries offer higher rates of return.

Do you agree that increased savings may not result in increased investment in the United States if other countries provide opportunities for higher rates of return on investments? If so, what steps should the United States take to increase rates of return for our industries relative to returns available in other countries?

- A.1. A marked reduction in the federal budget deficit likely would boost the level of plant and equipment spending in the United States, although there is considerable uncertainty about the size of such an investment response. It is important to keep in mind that two independent factors determine the level of investment spending. The first is the cost of capital, which represents the price of the assets, interest rates, depreciation, and taxes. The second factor is the marginal value of capital, which represents the value of the output produced by the new plant or equipment, net of labor and other non-capital costs incurred to run the facility.

Cutting the budget deficit would lower interest rates in the United States, by reducing the demand for savings relative to its supply. Moreover, given international linkages in the capital market, interest rates abroad might fall somewhat as well. As a result of the lower rates, the cost of capital would be reduced, and firms would find it profitable to undertake projects that previously had been uneconomic. Thus, cutting the deficit would be expected to raise investment spending.

Because firms can choose to locate new facilities in the United States or abroad, some of the new spending could be done on foreign soil. The choice of location depends on the expected marginal value of capital for

new facilities in the United States relative to the marginal value at new facilities abroad. Reducing the budget deficit would have no immediate effect on this comparison, which depends heavily on such things as exchange rates, relative labor costs, and transportation costs. However, to the extent that interest rates in the United States fall relative to rates abroad, the value of the dollar would be expected to depreciate. All else equal, a lower dollar would reduce the costs of producing in the United States relative to producing abroad. Over time, this shift in costs would reduce the number of U.S.-owned plants located abroad and increase the number of foreign-owned plants located in the United States. Hence, a reduction in the deficit would tend, in the long run, to raise the amount of business investment worldwide and, all else equal, to increase the share of that investment located in the United States.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SASSER FROM
Alan Greenspan

1. Due to the failure of certain savings and loans, the Resolution Trust Corporation (RTC), in essence the U.S. taxpayer, is now the largest holder of junk bonds in America. According to securities analysts, some \$4 to \$6 billion worth of these securities are now in government hands. It is expected that the amount could climb to \$10 billion.
 - a. What is your best estimate of the amount of junk bonds that the RTC holds?
 - b. What's the risk, if any, posed to the taxpayer?
 - c. How likely is it that the face value of these bonds will be recovered?
- A.1. On October 17, 1990, the RTC published the portfolio of junk bonds it held at that date. The list of the 439 issues, with a face value of \$3.3 billion at that date, is attached, as well as a copy of the press release that accompanied the list. The RTC anticipates publishing an updated list of its junk bond portfolio on a quarterly basis to reflect changes due to 1) sales or 2) new acquisitions.

High yield securities, by their very nature, contain a significant amount of risk to the investor. An additional risk to the taxpayer is that in times of a volatile market the disposal of the junk bond portfolio may be done in such a way as to not achieve maximum value. While market conditions may directly impact the value of the portfolio, they are entirely outside the control of the RTC.

On some issues, less than face value has been and will be achieved; on others, a premium to face has been and will be realized. The prices achieved may be impacted by events not within control of the RTC.

- Q.2. There has been much speculation that in the event there is a successful budget summit agreement, the Federal Reserve will ease its monetary policy to keep the economy growing. Without this type of response from the Fed, cutting the budget deficit at the magnitude that's being discussed could cause a major contraction in fiscal policy that could trigger a serious economic downturn.

I think most economists would say that the effect of monetary policy is felt more slowly than the effect of fiscal policy. So it's possible that waiting until after a budget agreement has been reached could cause a recession. Many economists think that the Fed should be easing rates in anticipation of budget summit agreement. If we move into a recession, the deficit will only widen further -- revenues would decrease, demand for social services would increase, and the cost of the savings and loan bailout would multiply by untold amounts.

- a. Do you believe that monetary policy can work quickly enough to counter the fiscal contraction?
 - b. Should the Fed be relaxing in anticipation of a budget agreement?
- A.2. Should Congress and the Administration come to agreement on a credible package instituting a major and lasting cut in the federal deficit, the Federal Reserve certainly would need to reconsider its policy stance. The appropriate response would depend on the composition and timing of the fiscal action, as well as the economic landscape at the time. An anticipatory adjustment to monetary policy could end up adding volatility to the economy, if the actual fiscal change were to turn out much different from what had been expected by the Federal Reserve. Consequently, a monetary policy change predicated on a forthcoming budget pact might well not be in the best interests of the economy.

Moreover, the lags in monetary policy are not so long as to make it ineffective in offsetting the effects of any likely fiscal restraint. Although it is commonly assumed that monetary policy effects work their way through the economy with considerable lags, while fiscal policy impacts are immediate, this characterization does not take into account some important features of the two types of policy. In particular, monetary policy changes can be suggested, debated, decided, and implemented in a

very short span of time, if need be. And financial market quotes and asset prices adjust to changes in monetary or fiscal policy very quickly, sending out signals to the rest of the economy. As with monetary policy, the economy's response to changes in fiscal policy also tends to be spread out over several quarters, and any shift in the budget stance is likely to be phased in over a period of quarters or years. To be sure, no one can guarantee that monetary policy will be able to counteract any effects of a deficit cut on a quarter-to-quarter basis, but on the whole, monetary policy has the ability to act quickly enough to support economic expansion.

- .3. As a member of the RTC Oversight Board, could you inform the Committee as to the short-term spending needs of the RTC. Treasury Secretary Brady has indicated that the RTC could run out of money this year.
 - a. Does Secretary Brady mean this calendar year or this fiscal year?
 - b. At the rate that the RTC is spending, and given the ambitious plans of the Oversight Board, when do you anticipate the need for funds, and how much will be needed?
- .3. Treasury Secretary Brady has stated that the RTC faces two limitations on resources: the overall \$50 billion limitation on losses and the obligation limitation (or "note cap"). Based on the RTC's calculation, it will use almost all of its borrowing capacity under the note cap in the first 2 months of FY 91. At that point, it would still have about \$12 billion in loss funds available. If the RTC were unconstrained by the note cap, we would expect it to exhaust almost all of its remaining loss funds by the end of this calendar year.

To address the anticipated resolutions in fiscal 1991, the RTC will need an additional \$40 billion in new loss funds beyond the loss funds remaining from the original appropriation. New working capital borrowings could be as much as an estimated \$60 billion in fiscal 1991, depending upon the pace of asset sales. These projections indicate that the RTC will need additional resources before the end of the calendar year to keep the cleanup process going.

- Q.4. As the financing arm of the savings and loan bailout, REFCORP is deemed to be off-budget. It borrows in the capital markets and turns over the proceeds to the RTC, which then uses the money to resolve insolvent savings and loans. This funding mechanism is expensive; it is 30 to 40 basis points over comparable Treasury securities. Now that the Administration has admitted that it will need enormous Treasury financing anyway to pay for S&L losses, does it make sense to do away with REFCORP, and instead, borrow directly from the Treasury? Would this save some money?
- .4. The primary reason for financing the RTC off-budget through REFCORP--the concern about undermining Gramm-Rudman-Hollings (GRH) budgetary discipline--is not applicable in the current situation. At the time FIRREA was being considered, there was a real risk that an ad hoc budgetary exemption for Treasury financing of RTC would set a precedent that would be extended to other large spending programs and threaten the discipline of the GRH process. Since that time, two developments have undercut justification for any further off-budget financing of the RTC. First, the RTC has decided to borrow working capital through the Federal Financing Bank; hence, substantial RTC outlays are already being recorded on-budget. Secondly, the GRH procedures are in the process of being revised by representatives of Congress and the Administration in the budget negotiations. In my view, the financing of RTC in the Treasury securities market would be appropriate in the context of a credible, substantial and enforceable budget agreement to reduce and, within a few years, eliminate our fiscal deficits. Not only would RTC outlays be financed at the more favorable rate on Treasury securities, but the overall structure of interest rates would decline as investors were convinced that pressures on our financial markets were being lessened.
- Q.5. In your testimony last week before this same committee, you engaged in an interesting colloquy with Senator Wirth about the economic origins of the thrift crisis. You said that if Regulation Q had not been repealed, and the thrifts had not been permitted to pay market rates of interest, there would have been a "tremendous flood from thrift deposits" into treasuries or money market funds.
- a. Had there been similar outflows of deposits from S&Ls and banks before 1980 during periods of high interest rates?
- b. What was different in 1980 that convinced everyone that Reg Q had to be repealed? Was it that interest rates had never been this high before -- 20 percent? Or was it

that there were no competitors to banks, like money market funds, available to attract deposits?

- c. If Reg Q had not been repealed, would S&Ls have lost all their deposits? Would they have retained their core or pass book deposits? And would the industry have recovered when interest rates finally declined in 1982-83?
 - d. The savings and loan industry grew at 20 percent per year in the 1980s. What would have been the cost of resolving the thrift problem in 1980 presuming that Reg Q was not repealed? Would it have been much smaller because the savings and loan industry would have been much smaller?
- A.5a. In earlier periods of high market rates relative to deposit rates there had been outflows or sharply reduced inflows of retail deposits at thrifts resulting in curtailed mortgage lending. During the 1970s, public awareness of alternatives to such deposits, most importantly money market mutual funds, exacerbated disintermediation problems. To lessen these problems, regulators responded by raising certain deposit rate ceilings and introducing new types of accounts.
- A.5b. There had developed a growing recognition that Regulation Q ceilings had contributed to swings in retail deposits at thrifts and thereby to that sector of the economy most dependent on thrift credit, residential housing. Moreover, past regulatory responses to maintain deposit flow through selected adjustments in rate ceilings and the creation of new accounts had created a complex structure and to some degree aggravated the mismatch of asset and liability maturities. Moreover, thrift profitability continued to vary inversely with market interest rates.
- A.5c. It is worth noting that deposit rate ceilings were not removed in 1980 but instead a procedure was established for an orderly phase out of those ceilings over a 6-year period. Ceilings on savings deposits, for example, were not eliminated until 1986. Nevertheless, these accounts declined only moderately; they fell about 13 percent over the period from April 1980 to April 1986 when the ceiling was removed, with much of this decline occurring when the money market deposit account was authorized in late 1982. Thus, it seems evident that thrifts would not have lost all their deposits had rate ceilings remained. However, they would have had more difficulty funding their assets and likely would have relied more on high cost short-term liabilities that would have preserved the

mismatch of asset and liability maturities, and pressures on earnings would have continued.

- A.5d. While the ability of thrifts to attract federally insured deposits at rates not governed by ceilings was a factor contributing to the thrift crisis, others, such as inadequate supervision, also played an important role. It is impossible to say what the cost of resolving the thrift problem would have been in 1980, or how much smaller the cost would have been if deposits had not been deregulated, as it is uncertain how regulatory ceiling would have been administered in response to unfolding events. In 1980 itself, the industry had a relatively strong capital-asset position--5-1/4 percent measured on a book-value basis--and the number of troubled institutions was small. The difficulties encountered by the industry arose in the following years. In the absence of deposit rate deregulation, it would seem that the insurance fund still would have had to deal with a sizable number of troubled institutions. While the types of problems faced by the regulators probably would have been different, resolution costs likely would have been lower.
- Q.6. The Fed eased its monetary policy for 7 months in 1989, but then held a steady course this year, until just last week. You yourself indicated that the Fed has found that the money supply isn't increasing at a very great rate; there is a credit crunch -- banks are tightening on their own; and housing starts are at their lowest level since the 1982 recession.
- a. Does the Fed need to be sending a strong and continued signal to the markets that it will avoid recession?
 - b. What justified the 7 months of easing last year versus today?
 - c. Can you make a case that there is no recession in the offing?
- A.6. The message the market should be receiving from the Federal Reserve is that monetary policy will be adjusted as needed in an effort to keep the economic expansion on track. However, this policy stance includes importantly attention to inflation pressures, for one of the surest ways to derail economic growth is to allow inflation to accelerate. High inflation inevitably brings in its wake recession and wrenching readjustment, while price

stability allows the economy to operate at its peak efficiency. Developments in world oil markets since the Humphrey-Hawkins hearings have not altered these basic facts, although they do have the potential to make it significantly more difficult in coming quarters for the Federal Reserve to attain its goals of simultaneously sustaining expansion and damping inflation.

Last year, the Federal Reserve eased pressures on reserve markets in a series of measured steps as the balance of risks appear to tip more in the direction of recession than of a pickup in inflation. Even with the adjustment in monetary policy, economic growth was quite sluggish late last year. Early in 1990, economic activity appeared to be regaining momentum and there seemed to be no abatement in underlying inflation pressures. In these circumstances, the Federal Reserve made no further changes in its reserve stance until July when it became apparent that credit stringency was threatening to impose an inappropriate degree of restraint on the economy.

- .7. One of the leading contributors to inflation today is the escalation of health care costs. Indeed, the consumer price index figures released today show that health care is running at approximately double the rate of inflation at 9 percentage points above a year ago, rising 0.7 in June.

I am concerned that we may be destroying the interest sensitive sectors, like housing, but not even touching those that aren't interest sensitive, like health care. Is health care a key component of inflation? How does the Fed's high interest rate policy affect inflation in health care costs?

- .7. Price increases for the medical care component of the CPI have for some time run above the overall inflation rate. For the 1980s as a whole, medical care costs rose about 3 percentage points per year faster than overall inflation.

To an important extent, the rise in medical care costs reflects supply and demand conditions specific to the health care area. For example, in the past 2 years, hourly compensation for private sector health services workers as measured by the employment cost index) has been rising at about a 6-3/4 percent annual rate, compared with a less than 5 percent pace for all private industry workers, likely reflecting shortages in some localities for nurses and other health care workers as this sector of the economy continues to expand.

However, inflation in medical service costs is not immutable. During the early 1980s, when the overall CPI inflation rate came down 9-1/2 percentage points, medical inflation fell 6 percentage points.

Monetary policy affects inflation in the medical care area through its influence on the degree of resource utilization in the economy more generally. In particular, a lessening of resource pressure helps bring down costs of various materials used in the medical area, such as chemicals and paper, and helps hold down labor costs in the medical care area, as workers need smaller nominal wage increases to keep up with overall inflation.