

**FEDERAL RESERVE'S FIRST MONETARY POLICY
REPORT FOR 1992**

HEARING
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED SECOND CONGRESS
SECOND SESSION
ON
OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSU-
ANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF
1978

FEBRUARY 25, 1992

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



U.S. GOVERNMENT PRINTING OFFICE

52-899 ←

WASHINGTON : 1992

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

ISBN 0-16-039124-5

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TUESDAY, FEBRUARY 25, 1992

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

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

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance this morning and particularly our witness this morning, the Fed Chairman, Alan Greenspan.

Let me begin by expressing the regret of Senator Garn that he is not here this morning. His flight last night from Salt Lake City was cancelled because of mechanical problems and there was no other flight available for him to take to be here by this hour this morning.

So he regrets that and asked that I express that to you.

This is a very important hearing this morning in that we will take testimony on the Fed's semiannual monetary policy report to the Congress.

This testimony comes 19 months after the beginning of a recession from which there has been no real recovery, and 3 years since we last saw a quarterly Domestic Product growth rate of as much as 2 percent. The economy has clearly been performing at a very low and insufficient rate now for an extended period of time.

Your prepared remarks today indicate, as you have said other places recently, that you are now beginning to see some signs of greater strength in the economy, some modest stirrings of a pick-up. We'll want to discuss those with you in some detail today so that we don't either over-estimate or under-estimate exactly what those signs may indicate.

Certainly, I hope, and this committee would hope, that you're right, that we are seeing growing strength in the economy. I must say it's awfully hard to identify from the vantage point that I have.

Last year, we had some signs and as you know, you indicated to us at one point that you thought earlier in the middle of last year that maybe things were starting to pick up and then that didn't really materialize.

The latest data on new unemployment claims and new mortgage applications indicate that any improvement that we may be seeing could be brief and that it might in fact vanish.

I think we've got to take whatever steps we can to get a recovery going and to sustain it and to get back on a strong upward growth track.

The lead story in the morning news today and last night has to do with these major plant closings announced by General Motors. They're a matter of very great concern to anyone who pays attention to the erosion and destruction of more and more of our industrial base.

It's a very sad story for America when any major industrial plant, a state-of-the-art plant that's been around for decades, is eliminated, is closed and 4,000 or more workers per plant are told that they're no longer needed and there's no replacement work for them.

In Michigan yesterday, plant closings were announced that will eliminate over 9,000 jobs in the months ahead for people working for General Motors in the automobile industry. Two of those plants, the Willow Run plant, very much in the news, and one in Flint, Michigan, my hometown, a V-8 engine plant, will involve the loss in each case of over 4,000 jobs.

These are workers with 10, 20, 30 years of experience, some of the most skilled workers in our society. You may have seen them yesterday, distraught, in tears in many cases because their lives are being taken apart professionally and there is no alternative work for them.

I must say that, as I look at the effect of all of our Government policies, and particularly monetary policy, I am the most distressed about the fact that we're not able to provide enough jobs for our people in America.

We've got now some 16 million people in America who need full-time work and can't find it.

The other day, in Alan Dixon's hometown of Chicago, there was a hotel that announced that it was opening up and it had a few jobs to offer. Several thousand people turned out in sub-zero temperatures and a snowstorm, standing for blocks in line trying to submit a job application for one of those jobs.

We then later saw the same thing happen in Los Angeles. They had a job fair out there. There were a few jobs being advertised at the job fair. Several thousand people came. They were in line again for many blocks. Many couldn't even get into the building to try to compete for one of those jobs.

And just yesterday, we saw this situation, the competition between this automobile plant in Arlington, Texas, and the one in Willow Run, Michigan, a situation which reflects the fact that there are not enough jobs to go around in this country. And so, someone was bound to lose. But when that happens, I think America loses.

We have among the laws of this country the Humphrey-Hawkins law that sets as a national goal an effort to have policies in place that will employ our people, that will provide an opportunity for people to go out and earn a living, provide for themselves, provide

for their families, and provide the economic strength that the country needs.

The country today is limping badly economically. I got a letter the other day from a worker in another facility in Michigan that told me about a 31-year-old man who had been out of work, couldn't find replacement work, had a family, was distraught, committed suicide.

That's not an uncommon situation.

The family violence, the broken families, people having to go out and become vagabonds across the country looking for work, is a sorry commentary on our failure to put in place a national economic recovery plan that can get people to work.

There is a lack of a sense of urgency in this town because this town is too insulated and remote from the problem. There are too many people in Washington whose employment is secure and who are very remote from these problems and do not understand them in human terms.

I think that's a dangerous condition for the country and it's inflicting great hardship on people across the United States.

Against that background, the Fed report indicates that the money growth that the Fed plans to provide will only be enough to allow the economy to grow by roughly 2 percent this year. I don't think, frankly, that's a sufficiently high goal for the country and we ought to be putting in place policies that allow us to set and reach a higher goal.

By the Fed's own calculation, that will not be enough to appreciably lower the unemployment rate from its current recession peak. In fact, the Fed's report points out that its economic projections are consistent with the administration's own outlook. And their forecast, even assuming that the President's recovery package were to be enacted in every detail, would only bring the average unemployment rate down this year from 7.1 percent to 6.9 percent.

Now let me repeat that, because when I first saw this in the President's budget report, I thought it was a misprint. But it says in here that if all of the economic initiatives being suggested are adopted, that unemployment will come down, according to the official Bush administration estimates from 7.1 percent to 6.9 percent.

In other words, the administration's plan says it will come down $\frac{2}{10}$ ths of 1 percent over this calendar year. To offer that as the goal for the country that we ought to aim for and build our policy to support tragically misreads the situation in the country and how serious the unemployment problem is out there.

I don't understand why it is that that should be the path that we put ourselves on in terms of an economic recovery strategy.

With inflation now running below 3 percent and, by some indications, actually declining, it is not clear to me what is preventing us from having a more aggressive economic growth strategy, including a more aggressive strategy at the Federal Reserve.

I might say that even that very weak economic recovery that is being projected depends upon the Fed hitting its money growth target. In terms of the information that we've been given by the Fed, for the past 5 years, the Federal Reserve has consistently undershot the mid-point of its target range for M2, one measurement of money supply. And cumulatively, that's an undershot of more

than 6 percent over that length of time, which I think can be argued, had that not occurred, would have helped us sustain a much stronger economy.

Last year, the Fed's report "stressed," and I quote, in its words, that "M2 expansion noticeably above the lower end of the range likely would be needed to foster a satisfactory performance of the economy in 1991."

But that didn't happen.

Now the Chairman said to us just now before starting the hearing that the money supply numbers in the last few months have been higher and he's more encouraged by them. He can elaborate on that here, and that there have been some changes in the past data.

But I've got to say that when the Fed consistently comes in at the low end of its own money supply range month after month, year after year, I think that becomes part of the problem.

I don't suggest by that that it's an easy problem to solve, but I think it has to be solved in combination with other things.

Frankly, I don't think it's acceptable, nor should it be acceptable to the Fed, to say that an unemployment rate near 7 percent at the end of this year is something that's good for America or that we ought to just swallow hard and accept.

We've got to do better than that. Mr. Chairman, you're one of the leaders in this country in the area of policy who can make an impact on unemployment and who has got to show I think a great sense of urgency on the unemployment situation.

We just can't tolerate these numbers going on month after month after month after month. These are real people. There are real lives being torn apart. I think more has to be done to deal with it. The suffering, if we could put it in dollar terms, is almost beyond measure.

Last month, when you were here, you told us that we did not need any fiscal stimulation, that the monetary stimulation already in place, in your judgment, would be sufficient.

I must say to you that if 2 percent growth is what we're likely to get out of what is now out there in the way of monetary stimulus, I think that's selling the country short. That's going to bring us in well below where we need to be and it's going to leave us with an accumulating set of problems, human problems and economic problems, that are of great concern to me.

Let me now yield and go in the order in which members have arrived. Let me start first with Senator Gramm for his comments.

OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Thank you, Mr. Chairman.

Chairman Greenspan, I look forward to hearing your report this morning. I think everybody is concerned about the economy. I think the magic of the right economic policy is not only what policy can help us jump-start the economy, but also put the economy on the road to sustained economic expansion.

I have continued to be concerned about the low rate of growth in the money supply. My problem is that we have had such a changing make-up of what is used for all the functions that we have seen

money used for in the past, that I have a very difficult time determining what is the right definition of money to look at in terms of gauging the amount of liquidity in the economy.

But one thing that I share with the Chairman is that at least in terms of our monetary targets, that we always seem to have been on the low end of those targets.

Had I had the power to control the money supply, and I'm glad that I don't. I support the position that we have taken that the control of the money supply should be outside the hands of politicians. But I would have liked to have seen the money supply grow faster in the last 12 months than it has. I am more concerned about that than I am about the discount rate. But my concern is somewhat tempered by the fact that we have had a dramatic change in the monetary instruments of the country and it's hard for me to ferret out exactly where we are on that subject.

I am deeply concerned about the economy. I had hoped that we could adopt the President's economic stimulus package. I know that there are those who are concerned that such a package is not needed given the level of monetary stimulus.

I think it is needed. And I think the good thing about it is the President's package is well structured so that it is certainly not going to do the economy any long-term harm.

I can't say the same for the package that has been reported by the House Ways and Means Committee, which would make the tax system more progressive, which would permanently raise \$91 billion in taxes over a 5-year period, which would give a short-term tax cut, but then would take that money back after the election, leaving the total level of taxes up \$191 billion.

I would assume that you would agree that that would be harmful to the economy under any circumstances and certainly under the current circumstances.

But I'm glad you're here today. I look forward to hearing what you have to say.

The CHAIRMAN. Senator Dixon from Illinois.

OPENING STATEMENT OF SENATOR ALAN J. DIXON

Senator DIXON. Mr. Chairman, I'm pleased to be here this morning as the committee hears from the Chairman of the Federal Reserve Board, Alan Greenspan, *on the state of our economy and our future economic prospects.*

The Federal Reserve exercises considerable power over the economy. And I think it's imperative that this power be used to achieve vigorous, sustainable, real economic growth. It's also important for the Federal Reserve to act decisively when the situation demands it.

As I've stated before, I think the Fed was somewhat slow to recognize the seriousness of our current recession and act decisively to address it.

But though we will talk a lot this morning about monetary policy and its impact on the economy, we must not lose sight of the fact that the Federal Reserve cannot by itself solve all of our economic problems.

No matter what the Fed does with the money supply and interest rates, it cannot offset the fact that our international competition has a strong industrial policy and we do not. It cannot by itself restore American productivity growth to what it should be. It cannot by itself correct our low savings rate. It cannot by itself ensure that every American has access to high quality health care and the opportunity to obtain a job that a family can live on, buy a home on, and educate their children on.

If the United States is to be able to compete in the ever tougher international area—and let there be no mistake, there is no other choice, we must compete—we have to be willing to abandon old theories that no longer fit the changed realities. We have to be willing to try new ideas. We have to avoid letting ideology artificially narrow our range of choices.

Most importantly, we have to begin acting now to address the fundamental long-term problems that this recession has so clearly exposed.

I thank the Chair.

The CHAIRMAN. Thank you very much.
Senator Graham from Florida.

OPENING STATEMENT OF SENATOR BOB GRAHAM

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Chairman, I have a statement that I would like to submit for the record. But to supplement that, it seems to me that what is missing is a sense of urgency in terms of our national economic leaders.

I have spent all of my life in Florida and in my adult life, I have never seen the sense of despair that is so evident today. Not only have we suddenly been transformed from one of the most prosperous and growing States in the country to a State with one of its highest levels of unemployment in the Nation, but a sense of lack of hope and optimism for the future is increasingly pervasive.

I spent some time on Saturday with a gentleman who sells building supplies. He was commenting about how difficult his business has been. And I said, hasn't the reduction in interest rates on homes made it possible for there to be more construction? And he said, no, because people won't buy a house regardless of the interest rate if they don't feel secure in their own economic future and their ability to continue to meet those obligations. And so they are reluctant to take on obligations.

I think that we need to have economic policies that will substantively deal with the immediate issue of job creation, the longer term issues of quality and competitive jobs and in so doing, give a sense of leadership, hope and purpose to the American people.

As we get into an analysis of your remarks and some questions, I hope that we can have the benefit of your ideas as to what we ought to be doing as a national government in order to play a role in those reforms.

PREPARED STATEMENT OF SENATOR BOB GRAHAM

Mr. Chairman, the people of Florida are very concerned about the economy. In my adult life I have never seen so many Floridians

who are hurting because of the loss of employment, and are also concerned about the future of their jobs, the future of their families, their community, their State and Nation.

The Federal Government's responsibility is to focus on an agenda to rebuild America's economic strength to allow our country to compete well into the 21st century. Our Government should proceed on a dual track by developing both a long-term and short-term strategy.

For the short-term Congress needs to consider what can be done to lift the economy out of its current recession. We need to know what we can do which would have an impact in the next 6 to 18 months.

Several weeks ago, this committee heard from the new head of the Resolution Trust Corporation, Mr. Albert Casey. Mr. Casey, when asked what he thought the causes of the current recession are and what are the prescriptions, answered as follows:

What I see is that the economy is suffering from a lack of job creation. We bemoan and bewail the fact that we do not have consumer confidence. The reason we do not have consumer confidence, in my opinion, is the fact that the people do not feel assured of their income status. So I feel that job creation is the secret to us coming out of this situation.

I agree with that analysis. The focus of our short-term economic agenda must be on job creation, giving Americans the opportunity to get back to work and to rebuild a sense of confidence in their future. In fact, I introduced six bills on January 23, 1992, which are targeted at short-term job creation and economic recovery.

I look forward to today's hearing to listen to Chairman Greenspan's thoughts on what he feels the causes of the current recession are and what the prescriptions in both the short-run and long-run for the improvement of the American economy should be.

The CHAIRMAN. Thank you.
Senator Wirth?

OPENING STATEMENT OF SENATOR TIMOTHY E. WIRTH

Senator WIRTH. Thank you, Mr. Chairman.

Mr. Greenspan, thank you again for being with us this morning. It seems you spend a great deal of time with this committee. We appreciate your being here.

There seems to be broad agreement everywhere that we have to invest more, we have to follow an investment rather than a consumption strategy, we have to focus more on education and our own productivity. There seems to be broad agreement on that and concern if we can get there.

Coupled with that is a concern reflected, I think, in the Chairman's opening remarks, that we also have to do something quite immediately, and yet, we don't have the tools to do something immediately.

We have this enormous deficit run up in the last decade. We have a huge debt overhang and an increasing interest on the debt which normally we might be able to use that money as a stimulative approach to this economy, but we don't seem to be able to do that now. We're caught between this kind of short-term dilemma of being unable to do anything and this need for very long restructuring.

Added to that are the concerns that I continue to hear over and over and over again about the inability of people to borrow money. Our financial institutions are still deeply constrained. It is very hard for small businesses, very hard for others to get access to our financial institutions. And yet, it appears that there's lots of money around.

There's a troubled sense out there, Mr. Chairman, which I'm sure you hear as well. I think that was reflected in the comments of Chairman Riegle, reflected in the comments of my colleagues here.

We look forward to hearing from you today and hearing your prognosis as to where we might go.

I might finally note, Mr. Chairman, it's interesting. In Mr. Greenspan's opening comments, he talks about—it's a very cautious statement, as he is a cautious man. Saying the prospective incipient recovery could peter out. There are clear signals—this is a remark that maybe we're not coming out of this as some have suggested we are.

Anyway, we're pleased to have you here and I look forward to hearing your testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. I have a statement from Senator Sanford for the record.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you, Mr. Chairman.

Mr. Greenspan, I, too, would like to welcome you back to this committee to give your semiannual report on monetary policy. I look forward to your insights, perhaps more than ever before because this economy is in trouble.

It is interesting to note that in the Fed's last monetary policy report of the 101st Congress approximately 19 months ago, we were talking about the longest peacetime expansion of the U.S. economy. At that hearing, I pointed out that if the budget deficits continued as projected, we would add another trillion dollars to the national debt in only 5 years. Yet, here we are, 19 months later immersed in the longest recession—hopefully we are approaching the end—since the end of World War II. And we've just received a budget that shows that the national debt is projected to increase by \$1 trillion in the next 2 years.

What is equally distressing to me is the virtual unanimity of opinion:

That the recovery is going to be slow and painful.

That growth will be at a level of approximately one-third as robust [if that is the right word] as prior recoveries.

That 5 years will pass before the economy reaches what is generally considered full employment.

And that because of these annual record breaking deficits, the Federal Government is virtually incapable of providing any meaningful fiscal stimulus, as it has done in prior recessions.

There also seems to be broad based agreement among the many economists who have testified before numerous committees both here in the Senate and in the House that fiscal stimulants tend to

be less effective than anticipated because they rarely take effect until after the recovery is well underway. In addition, the impact of fiscal stimulants is subject to varying and conflicting interpretations. So, monetary policy is usually credited as being the most effective tool to control the ebbs and flows of the economy and its cyclical nature. From what I understand, Mr. Greenspan, you subscribe to this general theory and for that reason have been advocating a policy of "stay the course."

The entire country was struck with your articulation of the deep rooted discontent being felt by the American people. It certainly echoed what North Carolinians are telling me. I suppose that raises several critical questions:

How do we remedy the situation? Or in other words,

What additional steps can the Fed take?

What can or must Congress do?

What must the American people do or be asked to do?

And how long will it take?

As you know, I am particularly interested in halting the incidence of bank failures. I have advocated early intervention, including RFC-type of investments in viable but marginally capitalized banks, to keep the losses from expanding geometrically. The ripple effect of a bank failure on a community is usually much deeper than the impact of other business failures. I believe that our country's economic health is directly linked to the health of its banks and other financial institutions.

Similarly, the credit crunch is not only threatening businesses which are suffering, as they usually do, from the stress of the recession, but healthy businesses are nervous about their banking relationships and access to ongoing financing needs. This is an issue of immense importance to our Nation. As perhaps the Nation's most visible banking regulator, your views and prescriptions are widely disseminated and respected.

I hope you will address all of these issues directly and offer us your suggestions to cure, or to begin to cure, our Nation's economic woes. I want to hear whatever you have to say, even if the cure is unpleasant. I have learned in my recent travel around North Carolina that the people are willing to take the medicine if we tell them the truth and offer long term solutions to our problems.

I look forward to your testimony and to having an opportunity to ask you some questions.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Chairman Greenspan, we'll make your full statement a part of the record and we'd like your comments now.

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

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

I'm pleased to appear before this committee to present the Federal Reserve's monetary policy report to the Congress.

The CHAIRMAN. Could I ask you, if I may interrupt, just to pull the mike a little closer because I want to make sure that folks in the back of the room can hear you. Thank you.

Mr. GREENSPAN. The policy decisions discussed in this report were made against the backdrop of a troubled economy. The recovery that seemed to be in train at the time of our last report to Congress stalled, job losses have mounted, and confidence remains low.

Looking forward, there are reasons to believe that business activity should pick up. Indeed, anecdotal reports and early data seem to be indicating that spending is starting to firm in some sectors. These signs should not be exaggerated. The prospective incipient recovery could peter out, as indeed the much more vigorous recovery of last spring petered out.

There are nonetheless distinct financial indications of improvement at this time. Moreover, there are clear signals that core inflation rates are falling, implying the prospect that within the foreseeable future, we will have attained the lowest rates of inflation in a generation.

Still, the outlook remains particularly uncertain. This means that we at the Federal Reserve have to be particularly sensitive to signs that the anticipated strengthening and business activity is not emerging and be prepared to act should the need arise.

The uncertainty stems in large measure from the unprecedented balance sheet adjustments now underway. Understanding these adjustments and the appropriate role for monetary policy under the circumstances requires stepping back several years.

As I've discussed with you previously, Mr. Chairman, the 1980's saw outsized accumulation of certain kinds of real assets and even more rapid growth of debt and leverage. To a degree, this build-up of balance sheets was a natural and economically efficient outcome of deregulation and financial innovation. It also may have reflected a lingering inflation psychology from the 1970's.

That is, people may have expected a rapid increase in the general price level and especially in the prices of specific real assets that would make debt financed purchases profitable.

But in retrospect, the growth of debt and leverage was out of line with subsequent economic expansion and asset price appreciation. Indeed, the burden of debt relative to income mounted as asset values, especially for real property, declined or stagnated.

In part, our current economic adjustments can be seen as arising out of a process in which debt is being realigned with a more realistic outlook for incomes and asset values.

A primary example of the accumulation of debt and real assets occurred in commercial real estate markets. In the early 1980's, when space was in unusually short supply, commercial real estate received an additional push from the Economic Recovery Tax Act, which provided an acceleration of depreciation allowances for capital goods.

While an adjustment was appropriate and overdue, that for commercial structures was excessive, resulting in tax lives that were far shorter than economic fundamentals would dictate. This shift in incentives led to a surge in debt-financed commercial construction during the 1980's. Financial institutions, of course, participated in this process. Banks lent heavily against real estate collateral for corporate restructurings and for consumer credit and, in addition, for more traditional business purposes.

Life insurance companies also expanded their portfolios rapidly with growth in real estate loans especially prominent.

By the end of the 1980's, the inevitable correction was upon us. The economy was operating close to capacity, so that growth had to slow to a pace more in line with its long-run potential.

In the commercial real estate sector, soaring vacancy rates and a change in tax laws in 1986 brought the boom to an end producing sharp decreases in prices of office buildings in particular.

These developments resulted in declines in the value of assets and growing problems in servicing the associated debt out of current income. Because of the run-up in leverage over the previous years, these problems have become more severe than might be expected just from the slowing in income and spending.

And the difficulties of both borrowers and lenders have fed back on spending, exacerbating the economic downturn and inhibiting the recovery.

Faced with mounting financial problems and uncertainty about the future, people's natural reaction is to withdraw from commitments, where possible, and to conserve and even build savings and capital. Both households and businesses, concerned about their economic prospects over the past 2 years or so, have taken a number of measures to reduce drains on their cash flow and to lower their exposure to further surprises.

Part of this process has involved unusually conservative spending patterns and part has involved the early stages of a restructuring of financial positions.

Businesses have cut back staffing levels and closed plants. They have tried to decrease production promptly to keep inventories in line. Firms also have taken steps to lower their risk exposures by restructuring their sources of funds to reduce leverage, enhance liquidity, and cut down on interest obligations.

The response of households has been to increase their net worth by restraining expenditures. To reduce interest expenses, they have paid down consumer debt and as long-term interest rates have declined, they have refinanced mortgages and other debt at lower interest rates.

Lenders too have drawn back. With capital impaired by actual and prospective losses on loans, especially on commercial real estate, banks and other intermediaries have not only adopted much more cautious lending standards, but also have attempted to hold down asset growth and bolster capital.

To a considerable extent, this response has been rational and positive for the long-term health of our financial intermediaries. But in many cases, it seems to have gone too far, impelled to an extent by the reaction of supervisors to the deteriorating situation.

The Federal Reserve has taken a number of measures to facilitate balance sheet restructuring and adequate flows of credit. With other supervisors, we have directed examiners to consider not only the current market value of collateral against performing loans, but the overall quality of credits. We also have met on numerous occasions with bankers as well as bank examiners to clarify bank supervisory policies and to emphasize the importance of banks continuing to lend and take reasonable risks.

Monetary policy also has in part been directed in recent quarters to supporting balance sheet restructuring that is laying the groundwork for renewed, sustained economic expansion.

We recently reduced reserve requirements on transaction balances. This will free up some funds for lending or investing and should over time enhance the ability of banks and their customers to build capital.

In addition, lower short-term interest rates clearly have been helpful to debtors. But reductions in short-term rates that were expected very soon to be reversed or that were not seen as consistent with containing inflation would contribute little to the strengthening of balance sheet fundamentals to enhance our long-term economic prospects.

In part because we have seen declines in long- as well as short-term rates, and increases in equity prices, progress has been made in balance sheet restructuring. Household and debt service has fallen appreciably as a result of lower interest rates, refinancings and equity issuance.

The condition of our financial institutions also is improving. An improved earnings outlook and a generally favorable equity market have spurred a number of holding companies to sell substantial volumes of new shares, contributing to a significant rise of capital ratios in the banking system, despite still large provisions for loan losses.

The balance sheet adjustments that are in progress in the financial and nonfinancial sectors alike are without parallel in the post-war period. Partly for that reason, assessing how far the process has come and how far it has to go is extraordinarily difficult.

As increasingly comfortable financial structures are built, though, the restraint arising from this source eventually should begin to diminish.

In any case, the nature and speed of balance sheet restructuring are important elements that we will need to continue to monitor on a day-by-day basis in assessing whether further adjustments to the stance of monetary policy are appropriate.

Against this background of significant progress in balance sheet strengthening, as well as lower real interest rates, the Board members and Reserve Bank presidents expect a moderate upturn in economic activity during 1992, although in the current context, the outlook remains particularly uncertain.

According to the central tendency of these views, real output should grow between 1¾ and 2½ percent this year. The unemployment rate is projected to begin declining, finishing the year in the vicinity of 6¾ to 7 percent.

An especially favorable aspect of the outlook is that for inflation. The central tendency of the Board members' and Reserve Bank presidents' forecast is that inflation, as measured by the Consumer Price Index, will be in the neighborhood of 3 to 3½ percent over the four quarters of 1992, compared with a 3 percent rise in 1991.

However, the CPI was held down last year by a retracing of the sharp run-up in oil prices that resulted from the Gulf crisis.

Consequently, our outlook anticipates a significant improvement in the so-called core rate of inflation. With appropriate economic

policies, the prospects are good for further declines in 1993 and beyond, even as the economy expands.

To support these favorable outcomes for economic activity and inflation, the committee reaffirmed the ranges for M2, M3, and debt that it had selected on a tentative basis last July. These are the same as the ranges used in 1991.

The 1992 ranges were chosen against the backdrop of anomalous monetary behavior during the past 2 years, which seems to be related in part to the balance sheet adjustments I have been discussing.

The appropriateness for the ranges for monetary and credit growth and the appropriate pace for growth relative to the ranges thus will depend on how the ongoing process of balance sheet restructuring affects spending, as well as the relationship of various measures of money and credit to spending.

Our focus, quite naturally and appropriately, has been on our immediate situation—the causes of the recent slowdown and the prospects for returning to solid growth this year.

However, as we move forward, we cannot lose sight of the crucial importance of the longer run performance of the economy. As I have noted before, much of the difficulty and dissatisfaction with our economy comes from a sense that it is not delivering the kind of long-term improvement in living standards we have come to expect.

The contribution monetary policy can make to addressing this deficiency is to provide a financial environment of reasonable price stability. Through a combination of fiscal policies directed at reducing budget deficits and monetary policies aimed at noninflationary growth, we can achieve the strong economic performance that our fellow citizens rightly expect.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Chairman Greenspan.

I'm going to call on the other members that are now present for any opening comments before we begin the question period.

Senator Sasser?

OPENING STATEMENT OF SENATOR JIM SASSER

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

I want to this morning welcome the distinguished Chairman of the Federal Reserve Board, Dr. Greenspan, before the committee and just say, Dr. Greenspan, I apologize for being a little late here in your opening statement.

I was pleased to see that your recent pronouncements that are more optimistic about the economy's prospects than you had been in the past. I think you've been quoted as saying that you're beginning to see some stirring in the economy.

Now that's good. But the downside to that is that the press, at least according to the press, when you see stirrings, that means that interest rates are not going to go down any further in the foreseeable future.

Now, I haven't seen those stirrings. We haven't seen it in my area.

Just to give you an example, the Knoxville News Centinel in my home State of Tennessee reported just the other day that 9,000 people showed up and applied for 600 jobs in a manufacturing plant that opened in Piney Flats, TN. This manufacturing plan was paying \$4 an hour. So those are hardly, just marginally livable wages. But 9,000 people, Mr. Chairman, showed up to apply for just a few hundred jobs.

Now we heard testimony just the other day before the Senate Appropriations Committee from Dr. Herbert Stein and Dr. Charles Schultze, two distinguished economists that I'm sure you're very familiar with, and they both indicated to us that interest rates have room to come down further and that in past recessions, real interest rates have often been negative during the course of the recession.

And I might add that Dr. Stein indicated that he sees no signs of recovery at all. Of course, Dr. Stein I believe was chairman of the Council of Economic Advisers—was it under President Ford or Eisenhower? I forget.

Mr. GREENSPAN. It was under Nixon.

Senator SASSER. Under President Nixon.

Mr. GREENSPAN. And partly under Ford.

Senator SASSER. So I'm concerned. Now, last July, Dr. Greenspan, you told us that, and I quote: "Today, there are compelling signs that the recession is behind us."

Now that was last July. Now you see some stirring in the economy. But I don't think we can be sure enough about what's happening not to take some further steps to bring these rates down.

I might add, Dr. Greenspan, I'm not sure you're aware of this, but it was just announced at 10 this morning that there's been a large, unexpected drop in consumer confidence in February. The Conference Board that conducts the survey indicates that the consumer confidence level, Mr. Chairman, is now at the lowest level ever recorded since they began measuring consumer confidence in 1967, and there has been a drop from the January level down. So that is not good news.

So my message to the Chairman this morning is I hope that he can take another look at the interest rate pictures, and I think, given the precarious situation this economy is in, we need a further reduction.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Sasser.
Senator Domenici?

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Senator DOMENICI. Mr. Chairman, let me thank you for being so accommodating. I wouldn't have expected that we would give an opening statement, so I will make mine brief.

There are many things that I would like to say, but let me just make a couple of observations and then I will follow up on them further.

My recollection is the last time you were before us, you said one of the real problem areas that deserved serious watching and look-

ing over was the real estate in the United States and what was happening to it.

It's rather hard for many of us to explain to our constituents what real estate, which is generally not thought of as part of the working man's problem, how it relates to the American economy and our recovery.

I would hope that when my turn comes, that you might answer that in a way that we might all understand as to its impact on growth and growth's impact on jobs.

Having said that, I wonder whether or not the banking situation, while it has obviously stabilized in terms of the banks and they are doing better as banks, I wonder if the American banking system is still reluctant to lend money to feed the growth in our kind of economic activities. And if they aren't, I'm interested in knowing how you arrive at that. And if they are still reluctant, why are they.

And I guess last, I'm very concerned about a happening in the banks and I don't quite understand it, so I hope we'll get an answer if we have time. And that's why the portfolio of banks, that which they have investments in, has grown so much of late in terms of the portion of the investment that's in bonds and Treasuries.

I know that's security, but obviously, banks weren't always prone to take the most secure for most of their portfolio. They took risks with their business community. And I kind of wonder why that is and perhaps you can explain it later.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Domenici.

Senator Kerry?

Senator KERRY. Mr. Chairman, I don't have an opening.

The CHAIRMAN. Very good.

Senator Sarbanes?

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I'll be very brief.

Chairman Greenspan, I am disturbed, to put it mildly, with the latest figures that Senator Sasser reported that have come from the Conference Board, this further drop in consumer confidence. Actually, quite a significant drop, as I understand it, from 50 percent to 46 percent. It really puts it at the lowest level in almost 25 years, almost a quarter of a century.

Mr. Chairman, when my turn comes to questioning, I hope that I can still be here. I have one of those mornings with a lot of conflicting engagements. But let me just read you something that appeared in the Washington Post on February 18, 1992, because it really underscores a concern I have.

And I'm now quoting.

In December, after the Fed dramatically and unexpectedly cut by a full percentage point its discount rate, the interest rate at which Federal Reserve Banks lend money to financial institutions, rates on long-term U.S. Treasury securities fell significantly, as did those on corporate bonds and 30-year fixed-rate home mortgages. The cut left the discount rate at 3.5 percent, the lowest level since 1964. Mortgage rates dipped to 8 percent, setting off a stampede of homeowners to refinance old higher-rate loans and sparking a surge of sales of both new and older homes. Corporate treasurers rushed to lock in the low rates and issued more new bonds in January than in any other month in history. But the low rates lasted only a few weeks.

Rates on 30-year Treasury bonds, which dipped below 7.4 percent, by last week had rebounded to 7.9 percent. Angry homeowners wanted to know where their 8 percent mortgage money had gone.

And then this is the critical paragraph.

Financial analysts cited a variety of factors for the jump in long-term rates, including a statement by Greenspan at his confirmation hearing that while he could not be certain, he believed that the December cut in short-term rates would be enough to get the economy moving again. If renewed recovery is just around the corner, analysts said, investors have no reason to expect further declines in long-term rates, especially with a \$400 billion Federal budget deficit forcing the Treasury to sell unprecedented amounts of securities.

Now, my concern is that, unfortunately, the signals that you have sent over the last couple of months since what I think the Journal called a conversion to rival Ebenezer Scrooge that took place just before Christmas time when you made the 1-point cut in the discount rate. But your then position that everything was fine, in a sense, nothing more needed to be done, sent a signal that in effect you were expecting a turn up. Your anticipation was that rates would come back up again and that the long-term market took that signal and behaved accordingly.

And while I know that the market operates independently of the Fed, that nevertheless, the Fed helped to contribute to this increase of at least half a point in the long-term rates.

And when my turn comes to question, if I can still be here, Mr. Chairman, I hope to address that. And if I'm not, I hope the Chairman will respond to it in writing to the committee.

The CHAIRMAN. Very good.

Senator Mack has just arrived, but I want to give him an opportunity to make an opening comment, should he wish to do so.

Senator MACK. Thank you, Mr. Chairman. I have no opening comment at this point and I'll await my turn to raise some questions.

The CHAIRMAN. Very good. Chairman Greenspan, you've heard Senator Sasser and Senator Sarbanes make the point that the Conference Board consumer confidence data apparently out this morning is at its lowest point since they started that survey many, many years ago. And if I understand it correctly, it's dropped from 50 percent in the previous month to 46 percent in February.

Am I quoting that properly?

Senator SASSER. Yes, those are the figures that were given to me.

Mr. GREENSPAN. It's actually 50.2 percent to 46.3 percent.

The CHAIRMAN. All right, 50.2 percent to 46.3 percent. Is that in fact, so far as you know, the lowest level it's been since they've been doing this survey?

Mr. GREENSPAN. As far as I'm concerned, for the Conference Board survey, it is. It will be important to see what type of confirmation we get from the University of Michigan survey, which will be out, I believe, later this week.

But as far as I recall, that is correctly the lowest level for the Conference Board survey. And I must agree with you, I find it quite disturbing.

The CHAIRMAN. You find it quite disturbing.

Mr. GREENSPAN. I do, indeed, yes.

The CHAIRMAN. Well, I do, too. That's a big drop, from 50 percent to 46 percent. This is a very well established measurement effort that goes on.

What does that say to us? What interpretation do we give that if in fact the numbers are right? In 1 month, to see that kind of a drop. That's nearly a 10 percent drop, if you will, from 50 percent to 46 percent.

Mr. GREENSPAN. I think we have to be aware that the University of Michigan survey is showing similar weakness in consumer confidence, but not at the levels that the Conference Board index is. The reason is they're measuring somewhat different things.

As I understand it, the Conference Board index has got more emphasis on the notion of job availability and the sense of job opportunities than the University of Michigan does. Since there's clear indication that the weakness is in that area, it's showing up particularly in that index more than the University of Michigan's.

The CHAIRMAN. Well, jobs are disappearing all over the country. I mentioned the GM plant closings of yesterday. You heard about the case down in Tennessee that Senator Sasser just cited. We had major job reductions announced last week by Boeing, the week before by United Technologies.

Virtually every major company in America is reducing, making permanent reductions in their work forces. And I'm seeing that with most of the medium-sized and small companies as well. It's not just limited to the large companies.

Jobs are disappearing all over the country. Reading your statement today, I see you're obviously very cautious. You say the signs of any pick-up in the economy "should not be exaggerated," that the prospective incipient recovery could peter out as it did last spring.

You say here, the outlook remains particularly uncertain. That's on the first page of your statement. And then over on page 12, you say, while there might be a moderate upturn in economic activity during this year, in the current context, the outlook remains particularly uncertain.

I think that given your own statements and given everything that we can see, more has to be done. I don't think that standing pat is getting the job done. I think you're getting a message back through this consumer data. As you point out, you'll be getting the University of Michigan data a little bit later. But I think you're getting a message back that there's a lack of confidence in the country and that the widespread unemployment is a major problem in America.

It's a problem to the individuals who are having to try to cope with it and who do not have alternative job opportunities.

I don't think you're going to get confidence turned around in any meaningful way until we start getting people back to work. In fact, I would assert that the level of unemployment is now so high and has gone on so long, that it's contributing to increasing the deficit. The deficit is larger than it would be otherwise if we were having higher growth and more people back to work. What more can you do?

Mr. GREENSPAN. Well, I think there are basically two tools that are involved here.

First of all, remember that the basic level of economic activity is, in historical terms, not as negative as the state of confidence is, as I've mentioned to this committee previously. That is not something which I consider encouraging; I find it, on the contrary, an issue of concern.

The rate of lay-offs, the rate of job losses is, if our data are anywhere near accurate, well below where they were in 1982, well below where they were in 1975. And yet, what we have is a degree of concern about job security which is as great, if not greater, than those past periods.

I think what we are learning is that the concern is really for the longer term, as well as for the short-term.

When we went into a recession in the past, there was a significant sharp reduction in jobs, but they came back reasonably quickly and the general expectation of people was that a lay-off was merely that, a lay-off, not a job loss.

I think there's a different attitude now and I think that explains why. Whereas, if you look at the raw data on labor conditions, it's very difficult to find any sense of the discouragement that one picks up in these various consumer attitude surveys.

The CHAIRMAN. Let me just take a minute to try to explain what I think is going on here, and then I'm going to yield to my colleagues.

Jobs are disappearing everywhere you look. And the jobs that are disappearing are good jobs. They're high value-added jobs, many of them in the manufacturing base. They pay wages well above the minimum wage. Many of them have health benefits. Many of them have pension plans.

Those are the jobs that are disappearing, and they're disappearing in all 50 States. There's not a State in which that's not happening. There's not an industry that I know of in which that's not happening, except possibly for health care, where cost are out of control because we haven't reformed the system.

So you've got a major loss of good jobs in the country.

People who were displaced are finding that they can only get jobs at a lower skill level and a lower income level. You've got engineers that end up driving taxi cabs. You have teachers who can't find work teaching and are maybe working in a hamburger place.

What you're having is some movement of people who become unemployed at a higher skill and wage level down the scale into lesser job opportunities, below their skill level and at lower wages.

The people of the country are trying to tell us something and they're trying to say something to you and to the Federal Reserve, as they are to the President and to the Congress.

And that is that there is a deep economic sickness in the country. Jobs are disappearing. These are not temporary lay-offs. These are permanent lay-offs. These are permanent job reductions. It's IBM and it's United Technologies and it's Sears & Roebuck and it's General Motors and it's Boeing, the "who's who" of American companies.

We don't have a strategy right now to do something about it and I think you have to do more, quite frankly. I think every policy arm of the Government has to do more. We've got to have an aggressive economic strategy coming out of the Government as a

whole. We've got to have a more aggressive monetary policy strategy.

I think you're too passive, quite frankly. I don't say that just to you, but I think the response of the Federal Reserve Board has been very modest, very guarded, very slow, and I think not adequate to the problem.

The message you're getting back from the public is that they want more done because the sickness out there is more pervasive and deeper than we've seen before.

You yourself have said it. You've said you've not seen economic conditions like these and confidence problems like these ever before in your professional lifetime.

There has to be a link between that observation and what people are reacting to and experiencing in their own lives when they tell us that and we get that message. We're going to have to do something that goes beyond what we normally do to try to respond to it.

I don't understand how there's a disconnection between the signals we're getting and the policy response that we're making in return to the signals. You've got to explain that here today. You've got to tell us why we can't do more when more is needed.

Mr. GREENSPAN. I think the general view of economists—and this is quite pervasive throughout the profession although not unanimous by any means—is that the economy will start to quicken sometime in the second quarter.

If that is in fact the case, we will be coming out of this particular period with perhaps a degree of momentum which, while scarcely adequate to bring the unemployment rate down this year—I don't think that's going to be very easy to do—at least puts us on a path where we'll get some reasonably solid growth.

I think the basic concern that economists generally have had, and I certainly have shared that view and do as I've said before this committee, is that what is occurring is an extraordinary reaction to the very heavy debt expansions and declines in asset values that occurred in the latter part of the 1980's.

That is, we are going through a type of adjustment which, as Senator Wirth said in his opening remarks and with which I agree, is quite different from anything we have looked at.

The CHAIRMAN. Yes, but Mr. Chairman, if that's so, and people are drawing down their debt levels and getting stronger in terms of their balance sheets, why is confidence plummeting?

What you're saying to us just doesn't add up. The public is saying to you as well, it doesn't add up. There's a great anxiety out there.

Mr. GREENSPAN. No, I don't quite agree with that. I would say that one of the reasons why the rebalancing is taking place, why consumers, households and businessmen are in effect restructuring their balance sheet is a general concern.

If that consumer confidence were not low, then I don't think we would be seeing the significant retrenchment in consumer credit that we have seen, in the endeavor on the part of households to lower their debt service charges.

So I don't consider that particular relationship unexplainable. That to me is part of the process that we're observing.

The CHAIRMAN. I'm over my time and I appreciate my colleagues' forbearance on that.

Senator Domenici?

Senator DOMENICI. I wonder if—did you want to go ahead of me and you can use my time for your opening remarks?

Senator MACK. No, no. You go ahead. I've got time. I'll wait.

Senator DOMENICI. Let me say to our Chairman, I think there are at least two reasons for us having a situation where the consumer confidence continues to decline, as compared with the economic facts.

One of them is a message from the citizens of the United States, not only about the current state of their employment or unemployment, but rather, about no confidence in the future. I think that's the difference. Americans have always had a degree of confidence in the future. I think they have no reason, in their opinion, to have much confidence in their Government. And I use the word Government. I don't use just the President. I use Government.

They know that this enormous deficit has to mean something. Our lack of manufacturing prowess has to mean something.

So I think that's one of the main reasons and frankly, the signals that we continue to give to them, some of us, is that we want to fix the economy right now and we want to do some things to make people feel like the economy is fixed by doing some immediate things.

They are more concerned with hearing from us, what are we going to do to make America's economy stronger over the long haul? And I continue to say that the net savings of the United States is so low compared to comparable countries, that that's the principal negative for the long term.

And that's hard to explain, but it's the opposite of being in debt so much. If we weren't in debt so much, the net savings would be higher. If that were the case, business would have a much better opportunity, as I understand it, looking as I can look at what people have to say about our kind of economy.

Therefore, it seems to me that we ought to be concerned about the future of the debt of the United States, even as we talk about tomorrow's problem and today's problem.

Having said that, let me return to my questions of you regarding the banking system. I have one sitting here next to me that's much more expert and I hope he talks about the banking situation with you.

But I wanted to ask, why are banks putting so much of their available resources into portfolios of bonds and Treasuries, as compared to other times? What's leading them to that?

Mr. GREENSPAN. First of all, I think what they are getting is a significant increase in liabilities as the money supply increases as is typical in a period of weak economic activity.

What tends to happen is that holdings of bonds, usually U.S. Treasury instruments, or bills or other types of securities, tend to be a reserve that eventually is supposed to be employed for purposes of lending. But, as a consequence, (1) of the weak economy and (2) the very strong desire on the part of business to reduce short-term debt, we are getting a considerably, extraordinarily

heavy volume of corporate debt being issued to replace short-term liabilities, a large part of that obviously being bank loans.

So at this particular stage, I would say that it's not so much that there is a significant desire to invest in those instruments, per se, but alternate means of lending are not materializing, and that explains a goodly part of that particular process.

I might say, parenthetically, Senator, there are those who say that because, in the risk-based capital analysis, Government securities are not charged with the capital requirements of, say, business loans, that there is a tendency toward Government securities.

I think that's probably partly correct, but it's by no means a large part of this explanation.

Senator DOMENICI. I had heard that was the principal reason. If you have any objective evidence that it isn't, if such is available, I'd like for you to put it in the record at your convenience.

Mr. GREENSPAN. Surely.

[Chairman Greenspan subsequently submitted the following information for the record:]

Casual inspection of the aggregate balance sheet data suggests risk-based capital guidelines have substantially influenced banks' asset composition, since U.S. Treasury and agency obligations have been a growing share of bank credit since around the time that risk-based capital considerations became an important potential influence on banks' asset management. However, this development, which is typical of the late stages of recessions and early recoveries, in part at least is clearly the cyclical reflection of weak loan demand. In an attempt to distinguish between the attractiveness of Government securities based on their qualities of availability and liquidity, on the one hand, and on their favorable impact on risk-based capital ratios, on the other, banks were grouped by risk-based capital ratios. If banks with relatively low risk-based capital ratios, or capital ratios below BIS guidelines, have a relatively strong incentive to improve this ratio, then such banks might be expected to have a comparatively strong demand for Government and agency securities, regardless of the state of loan demand.

The table illustrates that, over two recent periods, banks with low risk-based capital ratios actually raised the share of low risk-weight assets in their portfolios by less than better capitalized banks. A likely reason for the reluctance of these banks to shift their portfolios toward low risk-weight assets is their very low levels of profitability, which would have been depressed even further if low risk-weight and low-yield assets had been substituted for higher risk-weight, higher-yield assets.

As for the better-capitalized banks, their acquisitions of low risk-weight assets did not appear to be motivated primarily by a desire to boost risk-based capital ratios. In 1991, for example, banks that began the year with risk-based capital ratios above 12 percent raised the share of their portfolios accounted for by U.S. Treasury and agency securities by more than those banks with capital ratios in the neighborhood of 8 percent. This suggests that the banking system's recent acquisitions of Government securities primarily reflects low loan demand rather than a reluctance to acquire assets with high risk weights.

PERCENTAGE POINT CHANGES IN THE RATIO OF LOW-WEIGHT TO TOTAL ASSETS

[ALL COMMERCIAL BANKS, BY RISK-BASED CAPITAL RATIOS]

| Risk-Based Capital Ratio | 3/31/90 to 12/31/90 | 12/31/90 to 12/31/ 91 |
|--------------------------|------------------------|-----------------------------|
| Under 8 percent..... | .01 | 1.08 |
| 7 to 8 percent..... | .25 | 1.04 |
| 8 percent and over..... | .45 | 2.48 |

**PERCENTAGE POINT CHANGES IN THE RATIO OF LOW-WEIGHT TO
TOTAL ASSETS—CONTINUED**

[ALL COMMERCIAL BANKS, BY RISK-BASED CAPITAL RATIOS]

| Risk-Based Capital Ratio | 3/31/90 to 12/31/90 | 12/31/90 to 12/31/ 91 |
|--------------------------|------------------------|-----------------------------|
| 8 to 9 percent..... | 1.07 | 1.45 |
| 9 to 10 percent..... | -.39 | 3.28 |
| 10 to 12 percent..... | .45 | 2.32 |
| 12 percent and over..... | .26 | 2.53 |

Note: Low-weight assets include U.S. Treasury securities; obligations of U.S. Government and U.S. Government-sponsored agencies; and general obligation securities issued by States and political subdivisions.

Senator DOMENICI. With reference to—let's leave the real estate for a minute, other than a general question.

Has the precipitous drop in real estate values been abated? Is it continuing? Is it regional? What is your assessment?

Mr. GREENSPAN. As of the latest data that we have, which is through the last several months, there is no evidence yet that we've hit bottom.

There is some evidence that the impact of those real estate values on the portfolios of commercial banks are stabilizing, but we have got no concrete evidence which suggests that commercial values are stabilizing and even remotely showing signs of turning up.

Senator DOMENICI. You indicated last time that one part of real estate has led us out of recoveries on a number of occasions, and that's homebuilding. Homebuilding is going up in America in terms of starts.

Nonetheless, are we justified in seeking additional incentives for homebuyers such as proposed in the President's package?

Mr. GREENSPAN. As I've indicated here before, I'm not supportive at this stage of a number of fiscal measures in this particular area.

However, there's no question that were that done, it would add to starts. I would suggest, however, that if the Congress is going to move in this direction, that it do so relatively promptly and decide one way or the other because there is some evidence to suggest that even though there is an expectation that if some form of housing credit is put into the law, it will be retroactive to February 1. There's enough uncertainty about that to raise some concerns about people holding back pending an evaluation of what type of legislation would be forthcoming.

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

The CHAIRMAN. Senator Graham?

Senator GRAHAM. Thank you, Mr. Chairman.

To put a human face on the reason why I believe we have this tremendous lack of confidence, I had an unanticipated meeting recently with a Floridian whose history over the last 3 years is essentially this.

He'd worked for 20 years for Eastern Airlines and had reached a position where he was earning \$16 an hour. When the airline went down, his job was terminated. He was out of work for the better part of 18 months, during which time he had to declare personal bankruptcy, lost his home.

He now is employed. In fact, he's employed twice. He has two 25-hour-a-week jobs, each of which pays close to minimum wage. Because they are both part-time, he has no health insurance and therefore, lives with the anxiety of what will happen to himself and his children in the event that there is an illness.

Now that man doesn't show up on the unemployment statistics. He's employed. In fact, he's working 10 hours more a week than he was 3 years ago. But he's working at approximately 25 percent of the hourly income and without the benefits that he had had.

How do you tell that man that he's supposed to have confidence in the future and to do the sorts of things for his own economic well-being that will in turn stimulate an economic recovery?

I think that man symbolizes what's happened literally millions of times in this country and which has contributed, is in fact the principal cause for this attitude of uncertainty, lack of optimism and lack of hope.

I would have to say that your statement today would not give that gentleman a great deal of encouragement. You state on page 12 that the board members and reserve bank presidents "expect a moderate upturn in economic activity during 1992, although in the current context the outlook remains particularly uncertain. According to the central tendency of these views, real output should grow between 1¾ and 2½ percent this year, the unemployment rate is projected to begin declining, finishing the year in the vicinity of 3¾ and 7 percent."

I believe the most recent unemployment statistic was 7.1 percent, so you are not anticipating any significant recovery in terms of employment over the balance of 1992.

In that paragraph, what were your underlying assumptions in terms of any public policy actions that might be taken in 1992, or were those projections based on a continuation of the status quo?

Mr. GREENSPAN. Well, Senator, those data are the results of a survey that we take every 6 months of the views of the presidents of the reserve banks and the individual members of the board of governors.

We do not stipulate to them what particular assumptions they should make. We don't give them a uniform set of assumptions, but let them make their own judgments. So that we don't have knowledge of what economic or policy assumptions they would make.

This is essentially a view of the individual banks' forecasts and must be taken in that particular context.

I must say that it's not our goal per se; it is essentially a judgment as to what is likely to be the outcome over the next four quarters.

Senator GRAHAM. Well, were your views one of the contributors to his consensus?

Mr. GREENSPAN. Actually, I'm not in those numbers. I tend to be pretty much in line with the staff estimate since I contribute to that particular process.

But the part that I would say would reflect my view is that this is an extremely difficult period to make economic projections. Hopefully, we may be underestimating what's going on. But I think it's just as likely that we might be failing to even attain those levels that we're talking about.

That's the reason why I think it's crucially important, as I've said previously, that this situation be monitored on a very detailed, immediate basis and which, as I've indicated previously, I spend more of my time trying to find out what is going on in the monetary policy area and its relationship to the economy than I do in getting involved in forecasts. I think it's crucially important that we not be misled by what's happening currently.

Senator GRAHAM. I think it's always desirable to monitor, but monitor is a relatively distanced activity. That's John Madden up in the press box giving color commentary. We need the head coach on the field who is giving some leadership and direction.

What, if anything, would you recommend to the head coach based on the monitoring that you have been doing as to what steps we could take that would have a positive impact on the numbers that your consensus indicate would be occurring, which I would describe as being less than anemic, and would give some hope to this gentleman that I just described who is so representative of what's happening to Americans?

Mr. GREENSPAN. Well, Senator, I would say that we have to look at it from two basic governmental policy areas.

First, obviously, from my point of view is what we do with respect to monetary policy. As I've said, we have accelerated monetary ease throughout the second half of 1991. We have finally moved money supply growth onto a more acceptable path, although it's only been since last September that it has moved in that area.

We are aware of the fact that the amount of monetary stimulus that is in the pipeline may not be enough. The judgment we made back in December is that it should, but emphasized we may be mistaken and as a consequence, more might be required to be done.

And I would say that stance remains in place. As the economy shows some signs of edging higher, we are looking at that development in the context of our particular actions.

But I will say to you as I've said in the past and I would like to emphasize this morning, that any signs that are suggestive that we are not recovering as we think we should, further action will be taken. And obviously, the data that came out this morning were not consistent with our view that things are developing on a generally expansionary mode.

I would say to you also that there are other facts that are evolving which seem to be quite positive, but it is much too soon to make a judgment that recovery is solidly on its path.

And finally, let me say, Senator, that I trust the economy will do better than what these forecasts are showing and that certainly, in 1993, by all of the evidence that we have, we should be in a period of definite acceleration.

Senator GRAHAM. But is the answer that we're going to be left with John Madden's analysis, or are we going to have a direction to the leadership on the field as to action to take?

Mr. GREENSPAN. When we're talking from the point of view of monetary policy, when we act, it will be announced. I don't want to get involved in an evaluation until we are prepared to do something very specific.

I might say further that clearly, the fiscal side is an area which we have discussed and is not irrelevant to this consideration. And I think that there is a great deal of discussion going on within the Congress, within the Government, on this issue as well.

The CHAIRMAN. Mr. Chairman, I think it's very dangerous to leave the economy on the knife edge this way. I really think so.

Senator Mack?

Senator MACK. Mr. Chairman, if I can, I'd like to yield a little time to Senator Domenici?

The CHAIRMAN. Yes, by all means.

Senator DOMENICI. If I can take just a minute of his time. I can't wait for the next round of questions.

But I might just carry the distinguished Senator from Florida, the way he has described things just a little further and say there's another part of it. There's a fellow up in the press box and there's the coach. But then there's a team. And the team seems to me to be unwilling to respond.

Maybe one might say, while everything's in the doldrums, they've gone to sleep. As a matter of fact, the first time they are called upon to play, they produce a package for the recovery like the U.S. House has produced, which no one thinks will contribute to the recovery, but will add \$34 billion to the deficit, put \$90 billion in new taxes on and give the taxpayers credit for about \$45 of it in a lend-lease program of a tax cut—you give it to them for 2 years.

So I'm not at all sure whether we ought to wait around for the coach or whether we ought to expect a little bit better performance from the team.

Thank you for yielding to me.

Senator MACK. Yes, certainly.

Mr. Greenspan, when I was down in Florida this weekend, I held a series of meetings with respect to the credit crunch, to the economy, and to real estate values.

The message clearly is that the economy is not improving in Florida. In fact, it's getting worse.

There are all kinds of different signals that are being sent. One of the senior lenders of a financial institution told me that, in essence, it would take a lot of courage on the part of his lending officers to even approach the lending committee with a loan that was in real estate. Another banker told me 25 percent of their assets are in Fed funds.

The CHAIRMAN. 25 percent?

Senator MACK. 25 percent of their assets are in Fed funds.

Another told me that their loan portfolio is 30 percent below what it was a year ago.

Now, I know it's always fashionable to beat up on the Chairman of the Federal Reserve. But that's not my intent because I really seriously question how much further you could go.

In all due respect, Mr. Chairman, you've indicated that the Fed has been rather timid, but the reality is, I've seen things done by

the Fed that I'd never dreamed would happen before—the number of reductions in the discount rate, the reductions in reserve requirements, and bringing Fed funds down to the level where they are now. As people at this hearing have asked, what good does it do to bring down interest rates if nobody's going to lend the money?

Now I remember a hearing that we had in here maybe a year, year and a half ago. The members of our committee from the Northeast were railing about the failure of credit to flow into the economy.

But I would suggest again, as a fellow who was in the business of lending money, that one of the responsibilities of a lender is to evaluate risk. It's that simple. Your job is to try to evaluate risk.

I've got to say, I think one of the things that's going on in the banking community is they're evaluating the risk in the economy not from the Federal Reserve's perspective, but from what they see this Congress doing. There looking at what we've done with respect to changing tax laws—reverting back to previous periods and changing the rules.

Nobody knows what to expect in the future. They're worried about what might happen here in Washington.

So my thrust is not to beat up on the Chairman of the Federal Reserve, but I would say to the Chairman, I think it would be helpful for you to say to us, there's another part of economic policy. There's monetary policy and there's fiscal policy, and you guys have got to do something on the fiscal side. You've got to do something responsible with respect to the tax rates. Tax rates are going to affect growth. Tax rates are going to affect investment. Tax rates are going to affect savings.

That's where the responsibility lies.

I hear people in my State crying out that Government is impeding their opportunity with burdensome regulations. So, I would ask—is there room for the Fed to move or, in fact, is the Fed correct in saying it's really up to us to do something?

Mr. GREENSPAN. No, there is room for the Fed to move if we have to move further. It's not that we are at zero, so to speak. And I do think that the actions that we have taken to date are beginning to have a very material impact on the balance sheet restructuring which, in my judgment, is the fundamental problem which is restraining this economic structure.

Senator MACK. But Mr. Chairman, what's happening is that, yes, we are building up liquidity, but we're building up the liquidity in the banks. They're not lending the money.

Mr. GREENSPAN. I'm concerned about the issue of building up liquidity in households and in private businesses.

To be sure, the banks are building up huge amounts of liquidity. But that's not the issue I'm referring to. And what I'm saying is that, from what we can see, the extraordinary decline in interest rates is finally beginning in the last 2 or 3 months to have a very material effect on restoring balance sheets which were badly strained, to a position much closer to where normal economic activity and risk can materialize.

I don't think we're there yet. I think that's one of the problems that we have. But clearly, I think we have gone a considerable way in that direction.

Senator MACK. Would it make it easier for the Chairman of the Federal Reserve if there was some response on the fiscal side?

Mr. GREENSPAN. I'm a little concerned, as I've indicated before, not about the particular programs that are on the table of late, but about a bidding war which would create a significant increase in the long-term Federal deficit, and that is unquestionably one of the factors which is holding real long-term interest rates at levels higher than they otherwise would be.

And I would consider that the long-term rate is a crucial issue with respect to the restructuring of balance sheets. And I'm telling you that whatever it is that is done on the fiscal side—and as I've said previously, I'm not a great supporter of doing very much in this respect—I would urge that the Congress do what is to be done as quickly as possible, largely because the uncertainty that is being created by various different programs out there. I do not think this is having a useful effect on the markets.

Senator MACK. One of the areas that the Chairman of the committee mentioned is the number of jobs that are being lost. And you named Sears, Boeing and General Motors—a lot of large companies.

But let me just say to both chairmen that the kinds of businesses being closed and the kinds of jobs that are being lost in our State are not big businesses.

The CHAIRMAN. Right.

Senator MACK. They're the small, mom and pop operations that have been overwhelmed by Government involvement and Government regulation.

You can go across north Florida to little towns like Bristol, FL, whose only means of providing jobs is in the timber industry. The red cockaded woodpecker, an endangered species lives there. The people in Bristol believe they're going to lose their jobs and their businesses.

You can go into Cross City, FL, where regulations concerning how people can fish and what they can fish for are putting families out of business that have been in those businesses for generations.

You can go into Sarasota, FL, where people have lost their jobs in the boat industry because the Congress of the United States passed a luxury tax intended to make the wealthy pay more.

Do you know what they call the luxury tax in Sarasota, FL? They call it the lay-off tax, because the wealthy decided they weren't going to pay that increased cost. As a result, the poor guy who was out there working hard all day long has lost his job.

I think that there is more to fiscal policy than just tax policy. There's the regulatory side.

Frankly, Mr. Chairman, I think it would be helpful if we heard from you that there are two sides to this issue.

Mr. GREENSPAN. I have been strongly supportive of removing regulations where they are destructive of economic growth. I've been supportive of that for all of my professional life.

I think that as far as the banking industry is concerned, in the context of safety and soundness, that we give as much flexibility as we can to the commercial banking industry. And I'm also concerned about a regulatory environment nationwide which can inhibit especially small business in expanding because, as I think you

and other members of this committee have argued on numerous occasions, it's small business where a considerable amount of the job creation resides.

Senator MACK. Well, just a last comment.

The CHAIRMAN. Sure. Please.

Senator MACK. You mentioned flexibility. And I would respond that we heard statements from two different sources at this hearing with respect to the lack of flexibility. First, bankers said that they have less flexibility to work out problem loans because of regulators looking over their shoulders. Second, the regulators said they have less flexibility to deal with these problems because of the regulations which the Congress has imposed on them.

I thank you, Mr. Chairman.

The CHAIRMAN. You know, Senator Mack, I agree with you. You may have been out of the room, but when I cited the big company job reductions, I also made the point that among medium sized and small companies, I'm seeing the same thing.

It's interesting. The Small Business Federation the other day came in and said that their major problem right now at the top of the list is the increase of health care costs, and it is one of the areas where Government presumably might help get some cost controls in place that would ease some of those burdens.

If I may say before yielding to Senator Sasser, the balance sheet issue, Mr. Chairman, is an important issue. But so is the income statement issue. This may be part of where the problem is.

If there's an erosion on the income statement side, in terms of disposable income, which is money after taxes that people have to spend, if that's dropping or threatened at the same time that there's some marginal improvement in the balance sheet condition, you can find that either you're treading water or you're actually finding that you're not getting ahead of the game.

It would be a mistake to assume that people who refinance home mortgages are finding that that by itself is enough of an offset of the damage that either is happening or may happen on the income statement side of the equation.

I'd urge you to look at both of those.

Mr. GREENSPAN. I agree with that statement.

The CHAIRMAN. Senator Sasser?

Senator SASSER. Thank you, Mr. Chairman.

Dr. Greenspan, we've heard here this morning, I think, some transparent efforts to transfer responsibility for doing something about this recession to the Congress.

The truth is that the Congress is not responsible for this recession. Nor has it done anything so far to get us out of this recession. Because we in the Congress agreed in the budget summit agreement with the administration that we were going to maintain a lid on how we operated over here, and that we were passing the baton to monetary policy, to govern this economy.

Now, we've fallen off into a long recession. You yourself state this morning that it's unclear as to when and if we're going to get out of it in the near term.

We're relying on monetary policies to move us out of this recession. I'm wanting to know when monetary policy is going to work

and I want to know if we're going to get lower rates and if lower rates will move us.

We've been told in times past that we can't take the rates down below a certain level because of the necessity to borrow money from foreigners to finance the deficit. Perhaps that's been true because in 1988, foreigners purchased 41 percent of our foreign debt. In 1989, they purchased 35 percent.

But in 1990, that was down to only 4 percent of Treasury debt being purchased by foreigners, according to my numbers, up slightly to 14 percent in 1991.

Now we don't have the problem of trying to attract the foreign investment apparently to finance the deficit. So why not go ahead and bring the rates down? Why play sort of Russian roulette here with the economy? What have we got to lose by bringing these rates down and seeing if monetary policy will do it?

Then if monetary policy won't do it, then we're going to have to move in a stimulative way to try to stimulate the economy.

Mr. GREENSPAN. First of all, let me just say that I agree with your conclusion; namely, that the issue of financing our current account deficit is not a problem. It's the much more general thing. And that is reflected in the fact that the exchange rate has not been particularly weak in this most recent period.

What we are trying to do is to create a sense of stability in the system which will set the groundwork for a solid economic recovery.

It is important to understand that we have eased very considerably to a point now where we are beginning to get a significant acceleration in the money supply. We've had, as I indicated earlier, a 5 percent growth in M2 since September and a goodly part, something more than that, very recently, and obviously, a very strong growth in M1 and the other variables.

There has been an effect, a positive effect, from monetary policy on the economy. We can see the impact in the housing industry. We can see it in the corporate sector. We can see it in a number of different areas.

We are having an effect. The question basically is are we having enough of an effect and is more required? And that is an issue that is on a day-by-day evaluation process by the Federal Open Market Committee and the Federal Reserve Board.

Senator SASSER. Well, I just would submit to you, Mr. Chairman, that time is running out on monetary policy. We hear our colleague from Florida state to us that the banks in his area are not lending. They've got the money but they're not lending.

We've not getting the uptick in the economy out of monetary policy that we think we ought to get, or at least I think we ought to get. And we're hearing from most unlikely sources.

As I indicated earlier, Dr. Herbert Stein, a conservative economist by anybody's definition, who appeared just last week before the Appropriations Committee, on which I serve, and here's what he said, and I quote him.

The sluggishness and uncertainty of the performance of the economy in the past few months have, in my opinion, raised a legitimate question about whether we will soon see the usual strong recovery without additional measures to stimulate the economy. I believe such measures are needed.

Now that's a direct quote from Dr. Stein. He is saying, yes, the first weapon is monetary policy. But apparently, he is now starting to despair that the monetary policy will work. And if I quote him correctly, and I think I do, he's now saying that we ought to look in the direction of stimulative measures, that when we talk about stimulative measures, fiscal measures, that's where the Congress comes in.

We've done nothing so far, and we're still relying on monetary policy. I would submit, Mr. Chairman, that I see no reason why we can't bring the rates down further in this recession. I don't see that we've got anything to lose, and see if our monetary policy is going to power us out of this over the next month or two.

And even if we get a recovery going, by all of the predictions I've seen, it's going to be an anemic recovery. I think what this country needs is not an anemic recovery. We need to come out of this recession with a slingshot recovery, one that will put our people back in good jobs and get our economy moving ahead in a noninflationary way.

In other words, if you bring the rates down, you can always take them back up.

Now what's wrong with that argument? If we don't get the growth out of monetary policy, then we're going to have to go the stimulative route and that's going to mean increasing the deficit some more.

Mr. GREENSPAN. I think you are reproducing the types of discussions that are going on within the Federal Reserve and within the Government generally.

The reason that we decided to move on reserve requirements a few days ago was precisely because we considered that the lending issue, which had been of increasing concern to us, required additional action on our part.

Senator SASSER. Do you believe that reducing the reserve requirements, will that be as effective or more effective than lowering the discount rate?

I ask that as a question of information.

Mr. GREENSPAN. The discount rate is not as important as lowering the Federal funds rate, the actual interest.

Senator SASSER. The Federal funds rate. That's what I meant to say.

Mr. GREENSPAN. The answer is, no, it has a different effect. It does not in and of itself ease the economy generally. It directly affects the margins and lending propensities of the commercial banks, which obviously has a positive effect, but is not as effective as lowering the funds rate.

Senator SASSER. Well, my time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Kassebaum?

OPENING STATEMENT OF SENATOR NANCY LANDON KASSEBAUM

Senator KASSEBAUM. Chairman Greenspan, I would just like to say in the little bit of time that I've been here, I appreciate the fact that you don't try and create a rosy scenario. And I mean that with great sincerity. I think your analysis is a very honest one

when you say that the economy shows signs of edging higher. I think that, indeed, many of us tend to believe that. What is reflected is still a loss of confidence in the public that perhaps we know where we're going.

I would suggest that one of the reasons there's some confusion is we ourselves, from a fiscal policy standpoint and our own actions in Congress, aren't sure whether we want to create in one bill something that encourages spending as well as encourages savings.

It is a little difficult to do that in one bill.

I think that there is something that does get lost, to a certain extent. We come back to it but we just simply, I think, lose sight of the fact that what has had an uptick in just 1992 is the deficit, to \$400 billion projection now. That is the biggest drain on savings that there could possibly be.

Without coming to terms with that, we're never going to be able to take advantage of this tepid sort of re-emergence of the economy. But we all know that. It's easier to sort of look for a scapegoat somewhere else, I guess.

One of the reasons I think we're floundering with the best approach, and that's reflected, I think, in a certain uncertainty in the public as well, when we've not been able to put a focus on what we think might work best.

My question is off on an entirely different direction. The Japanese stock index is about half of what it was 2 years ago. To a certain extent, it's interesting because I suppose Japan is going through some of the same readjustments that we went through in their real estate markets, in their stock markets, and back to more realistic levels.

Should there be any concern about this happening? And perhaps the Japanese, in a desire to restore cash flow, would withdraw their securities from the Treasury.

Mr. GREENSPAN. From the U.S. Treasury, you mean.

Senator KASSEBAUM. Yes.

Mr. GREENSPAN. Well, Senator, we've already seen a very significant response on the part of Japanese banks and investors as a consequence of these significant declines in (1) stock prices and (2) real estate values in Japan. The amount of lending that the Japanese have been extending in the United States has come down quite considerably. And I think we've all seen the dramatic decline in their real estate investments in the United States.

Senator KASSEBAUM. But is it not true, Mr. Chairman, and I don't know, that their portfolios still hold a large amount of U.S. Treasuries, monetary treasuries?

Mr. GREENSPAN. That's correct. And we have not seen any evidence that suggests to us that we have a difficulty in that regard.

Senator KASSEBAUM. So you feel that what they've undertaken at home has really restored their balance.

Mr. GREENSPAN. Obviously, that's a forecast that is very difficult to make at this distance. But clearly, they've taken measures which have addressed the problems which they consider that they have.

Senator KASSEBAUM. Thank you. I think most of the other questions have been thoroughly exhausted.

Thank you.

The CHAIRMAN. Thank you, Senator Kassebaum. Senator Sarbanes?

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

Chairman Greenspan, right at the bottom of the first page of your statement here today, you say, and I quote:

Still, the outlook remains particularly uncertain. This means that we at the Federal Reserve have to be particularly sensitive to signs that the anticipated strengthening in business activity is not emerging and be prepared to act should the need arise.

Now what action do you have in mind if the need should arise?

Mr. GREENSPAN. If the need should arise, I would say that we would probably be moving the funds rate down. Obviously, I'm not sure that we need to do the discount rate, but if that occurs, that's available as well.

Senator SARBANES. All right. I thought that's probably what you were going to do. So my question really follows along, I thought the very concise line of questioning that Senator Sasser put to you.

Why not move the fund rate down now? Here's the Catch-22. You're saying, don't do anything on the fiscal side, as I hear you, essentially. Leave it to monetary policy.

Chairman Riegle pointed out, monetary policy doesn't seem to be working and the messages are coming in very strong from across the country that there's a big problem. Consumer confidence continues to plunge.

Your failure to move even more vigorously and monetary policy is going to precipitate action on the fiscal front which you say you don't want to see happen. So you create a Catch-22 situation.

Now Senator Sasser quoted Herb Stein, I thought, who, in effect, indicated that that was apparently the direction in which he was going to move.

When Jim Tobin was before us back about a month ago, he said, and I quote him:

I would like to emphasize that there is little upside risk in stimulative monetary and fiscal demand management for the next 2 years. That is, there is a small likelihood that Chairman Greenspan is going to find the economy so exuberant an a step up of inflation so threatening, that the Fed will need to slam on the monetary breaks.

The down-side risk—continued sluggishness or further recession—is asymmetrically large.

Now, if, by your own statement, what you would do is move down the Federal funds rate if the economy seems to be continuing to have trouble and if lots of people are saying, well, the economy seems to be continuing to have trouble, what's the down-side of trying to move down the Federal funds rate?

Mr. GREENSPAN. Well, Senator, first let me say that I think that monetary policy is working, as I've indicated before.

What monetary policy in this particular context should be focused on doing is trying to eliminate the restraints to growth which exist in the system at this stage. And I would argue that they are predominantly from the debt and balance sheet side, although I acknowledge that the point that Chairman Riegle made with respect to a proper balance in looking at both income and balance sheets is an appropriate evaluation.

As best we can judge, we are getting a significant effect in the markets.

Senator SARBANES. Well, why not get a more significant effect?

Mr. GREENSPAN. The question that you have to answer is whether or not, were we to move further, whether the response would be fully positive. When we moved on reserve requirements the other day, we got a very ambiguous response out of the financial markets.

Senator SARBANES. Well, I repeat, then, what I quoted to you at the outset of the hearing.

Financial analysts cited a variety of factors for the jump in long-term rates, including a statement by Greenspan at his confirmation hearing that while he could not be certain, he believed that the December cut in short-term rates would be enough to get the economy moving again.

If a new recovery is just around the corner, analysts said, investors have no reason to expect further declines in long-term rates.

Mr. GREENSPAN. That is the view of a number of analysts. It is not the view of the total community, if I may put it that way.

The crucial issue that we have got to be careful about is to make certain that we create a degree of stability in the financial system in all respects, not only with respect to money supply, but with respect to the relationship of various different segments of the financial system, such that we set the stage for a solid and prolonged expansion in economic activity, not one that is very quickly imbalanced.

Senator SARBANES. Well, if you don't move this economy out of the recession, you're going to precipitate or provoke or prompt other actions to take place which may work against this long-term objective.

You're not going to get very far if the papers keep running stories that say, "GM Loses Record 4.5 Billion. Names 12 plants to be closed."

That's on the front page of this morning's paper. GM's loss, the worst annual loss for an American corporation in history, brought last year's total loss for the big three—GM, Chrysler and Ford—to \$7.7 billion.

It seems to me that there's very little down-side risk of trying to move the rates. Otherwise, as Tobin said, continued sluggishness or further recession, that's an asymmetrically large risk to be taking in this situation.

Let me ask one other line of questioning because I want to get this in.

The Fed recently issued a report that indicated that there had been a concentration of income and wealth at the upper end of the scale over the last decade of significant dimensions. Is that correct?

Mr. GREENSPAN. That is correct, Senator.

Senator SARBANES. Now, I'm very worried about that for this reason.

And I notice that many of the President's tax proposals would do the same thing. The notion is you give additional money at the top and somehow, it works its way down, trickles its way down into the economy, and that then somehow provides you a stimulus. It's not

clear to me that that's going to work. In fact, I don't think it will work.

I think one of the problems is this growing inequity in income and wealth so that we are losing a middle class society or a mass purchasing society. And that what you have is an increasing concentration of the available financial resources in fewer hands. They may invest it in a productive way. They may not. In many respects, they are not doing so. There's been a speculative frenzy through the last decade that has helped to create this debt overhang about which you've talked and about which you're quite concerned.

Now the reason is that I'm concerned by this particular chart and its significance.

This is real after tax income per capita. It's a 3-year change in real disposable income per capita. So, in other words, this tracks over a 3-year period because obviously, over a 1-year period, if you move into a significant downturn, there have been instances in which you've had a drop in real after tax income per capita.

But what this chart shows is that, taking the 3-year period, which helps you to even out the ups and downs, we now for the first time in the post-war period, have a negative figure, which means that for most Americans, not the people at the very top, but most Americans are finding that their real disposable income is less now than it was 3 years ago.

So that their income situation is being squeezed.

So you have two problems. One is you have this unemployment rate at 7.1 percent, the highest in this recession. Not as high as in some previous recessions, but of course, you have to add to that people who have dropped out of the work force and aren't looking for work. And the record number of people working part-time, 6.7 million who want to work full-time.

And if you factor all of them in, we have a comprehensive unemployment rate of 10.8 percent.

So the unemployment rate is much more pervasive than the 7.1 percent figure would indicate.

But on top of that, you have a situation in which people who do have jobs face two anxieties or apprehensions. One is that they're not going to have a job. Here's GM saying 12 plants are to be closed. That hasn't happened yet, but they've now announced it. There are workers at these 12 plants all across America who now know that their job is going—going, going, and it's going to be gone fairly soon.

So that's the one problem. So even if you have a job, you're in apprehension that you're going to lose the job.

Second, even if you have a job, and perhaps you're not in apprehension that you're going to lose your job, your income situation is deteriorating.

The CHAIRMAN. You're sliding backward.

Senator SARBANES. Yes. Your standard of living is dropping.

Mr. GREENSPAN. That's one of the reasons this long-term consumer concern is as deep-seated as it is. There is a sense that the longer term is not developing in a way which the average household has historically been expecting.

The CHAIRMAN. Isn't that another way of saying, if you'll yield, though, that the traditional monetary response, as you've taken it step by step, may not be adequate to respond to this problem?

Don't you have to yourself acknowledge that at some point, you've employed monetary policy tools step by step, but monetary policy isn't sufficient by itself to get the job done.

Don't you at some point have to concede that something more needs to be done here?

I think you've got an obligation here.

Senator SARBANES. Well, Mr. Chairman, let me make this observation on that very point.

It was not until the Fed took down the discount rate just before Christmas by a full point, your so-called Ebenezer Scrooge conversion, that the amount of ease on the discount rate by the Fed in this recession became comparable—not greater than, but comparable to the amount of ease by the Federal Reserve on the discount rate in earlier recessions in the post-war period, up until that point.

In fact, the Fed's easing of policy measured by the percentage change in the discount rate compared with previous recessions was in fact tighter.

Now with that one point cut, you now are in the same range as in previous recessions. But in this recession, fiscal policy in effect has been neutralized, unlike those previous recessions in which fiscal policy was also used to provide a stimulus.

And you in fact have urged that fiscal policy be neutralized.

So you have a situation in which the Fed was following a tighter monetary policy than in previous recessions and there was no stimulative fiscal policy.

Now with the December action, the Fed is now following a monetary policy that is comparable to previous recessions. But there's still no stimulative fiscal policy.

That then raises the question, either the Fed—if the fiscal policy is going to remain neutralized, needs to have an easier monetary policy, or if the Fed is going to hold it where it is, you're going to get some sort of stimulative fiscal policy.

Isn't that a logical question to put to the Fed?

Mr. GREENSPAN. Yes. Certainly, if the economy does not show definite signs of picking up so it's not an ambiguous recovery fairly soon, I would say that is a very legitimate question to raise.

The CHAIRMAN. Well, what does "fairly soon" mean?

Mr. GREENSPAN. I would say that as we approach the spring.

The CHAIRMAN. We're approaching the spring. It's the end of February.

Mr. GREENSPAN. February is not the spring, Mr. Chairman.

The CHAIRMAN. No. You said approaching the spring. What do you have in mind?

Mr. GREENSPAN. I stand to be corrected. I would say sometime during the second quarter.

The CHAIRMAN. You mean, you think—is that the same thing as saying that you think we have to stand pat through the first part of the second quarter before we decide whether this policy is working?

Mr. GREENSPAN. No. I would say that if this economy is beginning to move, we should see signs of that within an issue of weeks, not months.

The CHAIRMAN. Well, this income statement problem that Senator Sarbanes has just illustrated, is, I think, part of the analysis that's been missing, so to speak.

You've said time and time again that we're in an unprecedented condition. We're in a situation, the likes of which you've not seen before. You've been very forthright about that, and I think that's been a very useful statement for you to make.

By the same token, with this unprecedented situation, as adverse as it is, we're nevertheless making traditional responses. We're trying the same traditional doses of medicine to treat a condition unlike any we've seen before.

To date, at least, the traditional approaches have not done the job. Back in the middle of last year, you thought maybe they were starting to work and you saw some glimmerings then. They pretty much faded away and now we're back and you see some glimmerings now, but you're not certain about it. In fact, you're very uncertain about it and you go to great pains today to make sure that nobody misunderstands the fact that you're not guaranteeing this recovery. Is that a fair summary thus far?

Mr. GREENSPAN. As I've said in recent weeks, there are positive signs, but we have to be careful not to assume that there's more there than we're seeing.

The CHAIRMAN. But there's no guarantee here that this policy is going to work, is there?

Mr. GREENSPAN. There's never a guarantee.

The CHAIRMAN. I understand. But you're specifically making it clear here today—

Mr. GREENSPAN. I'm saying of the particular structure or policies that we can contemplate, the policy that we at the Federal Reserve have been on over those last 6 or 9 months, is focused specifically on balance sheet problems. And that, in our judgment, is where the real severe problem lies.

But there's something different about this as well. Remember that we were concerned about this balance sheet issue and the extraordinary debt expansion at a much earlier stage. And as a consequence, in part, because of that sort of phenomenon, we started to ease in the spring of 1989, and as a consequence of that, we have been going down at a much more moderate base than would typically be the case during a recession.

But, again, this is a different type of recession. I know it doesn't feel this way and I don't feel this way, but in fact, the gross national product has been positive for the last three quarters.

Now, to be sure, it's a wholly inadequate recovery and it's been consistent with the rise in the unemployment rate, with the rate of job loss that none of us feel comfortable with. But it is different from an economy which is going down and one which is continuing to erode and which most monetary policy analogies have been drawn.

The truth of the matter is that it is very difficult to actually make judgments as to how monetary policy matches previous peri-

ods with respect to the degree of ease that we have initiated, going back to the spring of 1989.

It is true that there have been periods when the real short-term rate of interest has been negative. It's close to zero now.

It is also true that we've been at the bottom of cycles in which the short-term rate of interest was significantly above where it is now. We're not out of the middle range of that particular issue.

So that there is something different about this thing, which means that we are evaluating what we're doing in the context of the type of economy which we have not seen in the post-World War II period.

Senator SARBANES. Mr. Chairman?

The CHAIRMAN. I'll yield briefly. I want to stay on this course, though.

Senator SARBANES. I just want to throw one further dimension into this consideration.

How worried are you that there's going to be a world-wide recession, in light of the slowdown and stagnation that now seems to be taking place in other industrial countries? And what is the significance of that for us?

To the extent we had any growth last year in the economy, it came from the export sector. Now exports are down. U.S. exports fell in November and December. And if we look at the situation now in other major trading partners, they all are showing a decline in industrial production over the last 3 months.

Now how worried are you that we're going to confront a situation in which there's a synchronized downturn taking place around the world?

Mr. GREENSPAN. That's obviously an issue that we're always concerned about and one of the reasons why we spend a good deal of time in consultation with our colleagues abroad.

It is certainly the case that in northern Europe, in North America and Japan, we have seen similar types of balance sheet problems. Property markets abroad in many areas—this excludes some parts of Germany and France—have behaved in a manner not as bad as ours, but showing many similar signs.

But having said that, we don't see at this stage the synchronous of a world-wide problem because, indeed, as we have weakened, as the Canadians have weakened, as the British have weakened, there has been stability in Europe. And even though Japan has slowed down its rate of growth, it is not in the situation that the English speaking countries.

The issue that you raise is one that we're always concerned about and frankly, one of the major reasons why we have a G-7 summit, why we have G-7 finance ministers and central bank governors—essentially, to coordinate and to evaluate the particular synchronousness of the various different economies and try to avoid the type of problem which you very rightfully raise concerns about.

Senator SARBANES. Well, they met at that motel near Kennedy Airport. And I have to say to you, Mr. Chairman, it was like they were whistling in the wind. They walked out of there with a com-muniqué that really said nothing. And since then, you've had fur-

ther deterioration in these important indicators in these various countries.

That was a nothing meeting. In fact, they tried to hide it, so to speak. They sort of nipped in and out of—where was it? Garden City?

Mr. GREENSPAN. Garden City.

Senator SARBANES. Garden City, Long Island.

The CHAIRMAN. The press was on their way out there to find it and by the time they got there, the meeting was over and everybody was gone.

Senator SARBANES. They'd all scattered and they were in the airplane terminal and getting out of town.

That was some G-7 meeting, I have to say to you, in the light of this challenge.

The CHAIRMAN. Let me not take any more time now.

Senator Graham?

Senator GRAHAM. [Nods in the negative.]

The CHAIRMAN. Then I want to come back to what I was talking about a minute ago. Let me try to indicate what I think another problem is that we have here.

The Fed really has multiple responsibilities, and you have one as a bank regulator at a time when the banking system has got major problems that have accumulated and some major risks in the banking system.

You also have this monetary policy responsibility and this macroeconomic policy responsibility through what is done with money supply and interest rates.

I can see how at times these can conflict with one another. What may be required for one may be different than what may be required for the other. And if that happens, I can see why, depending upon the balance of view within the Fed, you might tilt one way versus the other way. It might solve one problem, but have the effect of making the other problem worse.

We've got some of that going on here. Some of that may be unavoidable simply because the banking problem is of such a size and dimension that it's really unprecedented. We recently had to pass legislation to loan the deposit insurance fund for the banking system \$70 billion and we had to put in certain emergency authorities that you asked for to respond to, hopefully, avoidable bad events in the banking system.

The effort to try to shore up the banking system and to try to reliquify the banks and deal with balance sheet problems, particularly among the big banks, I think may have caused the Fed to take its eye off the macroeconomic requirements of the economy at an unprecedented time, where analysis is particularly difficult, where historical situations are not necessarily of great use in looking at what's going on today.

I've been very struck by the number of times where you have said, in frankness in congressional hearings, including before this committee, that the mixture of economic and financial circumstances are different than any that you have seen in your adult lifetime, and that they are creating effects, confidence problems and other things that go beyond anything in our contemporary experience.

You've said it over and over again.

I think today that we in our own ways are saying the same thing to you. Senator Mack was saying that he's seeing things in Florida that are outside the scope of experience that he's seen, at least in any recent time. That's certainly true in what I'm seeing in my part of the country, but I see that across the 50 States now.

In the effort to try to deal with the financial structure problem in banking institutions, we have underplayed the need to come up with an effective macroeconomic strategy to stabilize the country on the income and job side. Some of it is due to the huge trade deficits we have and the fact that certain U.S. industries have been targeted by other countries and are disappearing here. That's leading to some of this unemployment.

The danger here is that if we don't deal with stabilizing this economy on the employment side, we run the risk that this recession can turn into something worse, a depression. And in fact, we've got some depression elements now in some areas of the economy.

I regularly hear that from people in the commercial real estate business.

We're approaching that in the automobile industry. I am very struck by the fact that with these nine plant closings, General Motors, the largest manufacturing company in America, will have been cut in half in terms of the size of its workforce since 1985.

Last year in this country, of cars purchased by citizens, not fleet sales to rental car companies or to units of Government, just cars purchased by citizens, one-half were foreign cars.

When you look at the erosion of the domestic automobile base, the companies and the job base, the credit rating downgrades, the fact now that the domestic auto industry will have lost something on the order of \$10 billion over the last 5 quarters—you talk about unprecedented conditions. And it's not certain that we're going to be able to pull out of that tailspin in an orderly way.

Closing plants does not by any means necessarily stop the erosion of market share, which is what we're seeing here.

The Fed and the policy makers at the top of our Government, of which you are one, have got to come up with a macroeconomic strategy that really starts to lift this economy.

I think to set a 2-percent growth rate is a weak response considering what we've been through and the need to get ourselves back up to a level where we can compete internationally and hold our job base, hold our national income base.

We ought to be targeting something like 4 percent annual growth.

Can we get to a 4-percent growth rate?

Mr. GREENSPAN. I don't think that we've been talking about 4 percent because we do have a significant slowing down in the labor force. But I think where the central focus has been with respect to growth is clearly in the area of productivity, finding ways in which we can increase output per work hour. Strictly for demographic reasons and, more importantly, having essentially absorbed the desire on the part of women to get into the work force, we have now arrived at a point where the labor force growth is going to match the adult population to a substantial extent, which means

that it's going to be a good deal slower than it's been over the years.

It is the case, and this will be especially true of women, that having far more experience in the work force, their productivity will begin to accelerate and that will be an important element in raising the long-term productivity and growth rate of the United States.

But I do think——

The CHAIRMAN. Chairman Greenspan——

Mr. GREENSPAN. Just let me say that the issue you raise, Mr. Chairman, is a crucial one, in the sense that we can spend much too much time concerned about short-term forces. If we fail to look where it is we're going to come out and where it is that we are going, we may succeed, or proximately succeed, in the short-term, and find ourselves in a very difficult long-term situation with respect to world competition, with respect to standards of living of the United States, and very specifically, with respect to the issue that Senator Sarbanes was raising relative to the distribution of income because I think implicit in all of this is an understanding that education is a crucial issue.

And the evidence that we have with respect to why we are getting a dispersion of incomes or, more exactly, a concentration of incomes, is that the premium that people are able to earn because of college degrees over and above high school degrees is widening.

That is a force which I think is not very encouraging to the structure of this society.

So I would argue that part of our productivity view, part of our general long-term endeavors should recognize that our educational system is an economic policy.

The CHAIRMAN. And whether you have an income or not has a huge bearing on whether you can get advanced education.

You've got people all over the State of New York, from Senator D'Amato's State, and all over the State of Michigan, who want to go on for advanced education and don't have the incomes to do it; families are scraping, a lot of time at very low wage jobs.

A lot of the women that are working obviously work because they want to work professionally. But there are a vast number that are working because there's a need for an income supplement because of the backslide in wages of the other wage earner in the household.

You've got this problem and I don't see any recognition of it. I see a failure to recognize the erosion of the job base and the earning power of people in the country. It's sophistry to talk about advanced education, as important as it is, if we can't pay for it, if people don't have the money to pay for it.

The Humphrey-Hawkins law says that we're supposed to be aiming for an unemployment rate in this country of 3 percent if we take one age classification of workers, or 4 percent if we take another classification.

That's the national goal we've set for ourselves. We did that because that's what makes a strong Nation.

Our unemployment rate now is almost twice as high as that. In fact, I think if we were calculating it accurately, it's far more than twice as high as that.

You and I and the people in this room, for the most part, are insulated from that fact because we're not caught directly in that dilemma. More and more American people are. And they're saying to us in every way they know how to say it, that something's got to be done to get them out of that situation. Otherwise, America is going to keep sliding backward.

National public opinion polls in the New York Times and other papers say that 80 percent of the American people think that we're on the wrong economic track going into the future and they want to get off and onto a different track.

I think that statistic is a powerful message conveying the public's dissatisfaction as to what they actually see happening in their lives.

And with all due respect, I think our discussion today doesn't close the gap in terms of being able to say to the American people, here's a policy response that's going to bring this unemployment rate down substantially and quickly. I don't hear that.

What I'm hearing is that your answer is that people should be patient, that we're trying the traditional remedies that we've tried in the past, even though this is an unconventional situation. We haven't seen signs yet that it's really working. A little bit here but that could disappear, and so we're hedging that. We're saying that it may very well evaporate on us again.

I frankly don't know how we can say that to the people at this time. I don't know how you can say it. I don't know how the President can say it. And the people aren't buying it.

When we vote on your nomination here in a couple of days, you're going to be confirmed by this committee, but I daresay, if there were a public referendum on it, I think they're ready to vote people out. They might well vote you out, deservedly or not, and the Fed out because they don't see the policies working.

Our obligation is to have policies that work, not policies that might work or policies that, given enough time and patience, have the chance of working.

I think people are saying, look, we've had that. Now we need policies that we know will work.

I ask you to go back and take another look because if the Federal funds rate, as you said to Senator Sarbanes, is the next step you'd take and it might help on the margin, let's find out if it will help on the margin. Let's try to get this confidence level going up rather than going down.

And if that isn't going to do it, then I think you've got to break out of some of your own long-term thinking and say that maybe we do have a problem that's going to require some kind of a fiscal response, as much as that may be anathema to you.

If you or I had to go home tonight and say to members of our family, I'm sorry that I'm not able to find work. I'm sorry I've been unemployed for 8 or 10 or 12 months, or a year or 2 years. I'm sorry we don't have enough food around this table tonight to feed everybody properly.

If we had to do that, we'd have a much greater sense of urgency about this problem.

There are millions of Americans who have training, who have education, who have good work records, and who are in that situa-

tion this very day. We're sitting here without an ability to respond to their problem now. I just don't think that's adequate.

Senator D'Amato?

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

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

Mr. Chairman, I'd like to make some observations and maybe ask one question. I recall Chairman Greenspan, more than 18 months ago raising the question of why the Federal Reserve was not bring down the discount rate. I recall an exchange with you and even at one point asking what world were you observing. That in the real world, businesses were failing, people were hurting, and that your concern for inflation was absolutely inappropriate at that time given the real conditions that existed.

Now we can say that the interest rates have come down. There has been an improvement for those people who are able to refinance their debt and the refinancing will give them additional expendable income.

I have to say that lower interest rates came much later than they should have and done in a manner that created untold and unnecessary pain to many individuals and members of the business community.

The overregulatory zeal is in large part to blame for the credit crunch. I can understand moving away from tax regulation, but to make a radical change from regulation to overzealous regulation has created much uncertainty.

The change in regulatory philosophy can be compared to a person sailing a boat for the first time. Someone who has never navigated and makes the boat zig and zag. I understand that this is an imperfect situation and that it is one that is often beyond the control of the Federal Reserve, the regulators, and Congress. Among those areas we could change and provide some help and relief, however, the record clearly reflects that the Federal Reserve was continually late in acting. By not acting, the Fed exacerbated the problem.

So we had to wait an inordinate period of time for the interest rates to come to a level where it began to ease the pain for many.

But the pain is still there for many people.

Mr. Chairman, today, in the real estate market, specifically commercial construction, where there is not an overhang developers cannot get mortgages. The examiners continue to conduct overzealous examinations, notwithstanding that you and the other regulators have attempted to get the message to the examiners to ease up.

Businessman after businessman, developers and others, have told me that their line of credit is still awfully thin and in many cases is being pulled.

What can the Fed do to get credit to those people in the business community who are credit worthy, who do have projects that should receive funding?

It makes no sense to simply reduce interest rates when banks refuse to make loans. Banks want to engage in nonrisk activities

only. The safest of the safe activities involves banks buying Treasuries, and that's what the banks have been doing.

Can't the Fed and other regulators set a policy where by institutions that withdraw from commercial lending activities will not get the benefit of the discount rate of interest and the proposed lower rate of reserves?

It would seem to me that we should look to implement a policy that would encourage banks to make prudent loans and not simply buy Treasuries to improve their balance sheet.

Mr. GREENSPAN. Well, Senator, you are raising an issue which I think is causing considerable concern amongst the regulators. It's a very frustrating experience and I think you characterize it quite correctly.

The action we took the other day to lower reserve requirements addresses this issue in part. But you're quite correct that making reserves available or lowering interest rates, if it doesn't come out the other end, has got a rather lukewarm impact.

We have tried where we can. For example, we were concerned about the highly leveraged loan classification which we thought was creating an adverse impact of the nature that you suggested, and we are in the process of eliminating that.

The really very crucial issue rests in the question of the classification of loans in real estate. And the problem that we have got is that there are clearly real estate loans which are highly desirable, profitable, viable loans which individual banks, in part reflecting fears of various rating agencies and securities people, are afraid to put on the books as real estate. And that is causing difficulties which we are endeavoring to try to ameliorate.

The success that we have had has been a good deal less than we would like by any means.

Senator D'AMATO. Marginal.

Mr. GREENSPAN. And we are meeting fairly often to try to address this subject and see what we can do. But I agree with you, at this stage, that the results have been marginal.

Senator D'AMATO. Mr. Chairman, let me suggest to you that when I am home and meet with various people in the business community, their across-the-board observation is that the rate reductions have not generated much, if any, new loan activity.

The one thing that Fed policy has brought about is improving banks' balance sheets. The banks are earning money without risk which is fine—it has some benefits.

If we are also looking to pass on a benefit to the consumers, to the borrowers, we haven't done that yet.

If your purpose is to stimulate loan activity, it would seem to me that along with the carrot should go the stick.

You might be loathe to look to exercise that kind of regulatory power, but it would seem to me that it is necessary. I don't know if you have done it, but you might want to call in the various financial institutions and indicate to them that the administration and the regulators are not undertaking certain policies just so banks can improve their balance sheet without providing opportunities for financial growth to the private sector.

That's not what the system's about. Have you thought about that?

Mr. GREENSPAN. Yes, we have.

Senator D'AMATO. Have you called them in?

Mr. GREENSPAN. Well, no, we haven't. Obviously, the examiners are talking about this.

Senator D'AMATO. This has got to be with you and the guys who got us in this mess.

Mr. GREENSPAN. We have discussed a number of these issues. Remember, we don't have the statutory authority to—

Senator D'AMATO. But you've got a lot of authority and a lot of power, Mr. Chairman. Don't be so self-effacing.

Mr. GREENSPAN. Well, we have considerable authority and the question is are we endeavoring to find ways to convince bankers to make real estate loans per se?

Senator D'AMATO. Right.

Mr. GREENSPAN. A lot of them are highly undesirable.

Senator D'AMATO. We understand that.

Mr. GREENSPAN. But to make ones which are profitable and productive to the system.

Senator D'AMATO. And sound. Well, Mr. Chairman, let me just repeat it again.

If indeed you have embarked upon a course of action to get the interest rates down to spur the economy it makes no sense to me that banks are not making loans.

As it relates to continuing in the construction business, developers who cannot get permanent mortgages say that they will never again undertake a new development. That is thousands of people throughout the country, tens of thousands, who will not be employed in construction. I am referring to projects where there are needs, legitimate needs, not overdevelopment. This results in loss to the tax base on the Federal level and the local level. It also results in people being out of work in all of the related industries.

This adds up to a real problem considering that the real estate and construction industry, adds up to close to 30 percent of the GNP.

When you have the kind of drag on such a large portion of the gross national product, you will inevitably have economic doldrums and not the kind of recovery we have expected.

It seems to me that the Federal Reserve has an obligation to say to these people that they will not get the lower reserve requirements, or the benefit of the Fed discount window if they do not make loans available to credit worthy applicants. Otherwise, what is your policy? Am I wrong or right? If I'm wrong, tell me.

Mr. GREENSPAN. No, I think you're raising the right issues, but there are a number of related issues which obviously we have to be very careful about to maintain the safety and soundness of the banking system.

Senator D'AMATO. Right.

Mr. GREENSPAN. And the viability of the market system as such.

Senator D'AMATO. Mr. Chairman, you're not going to get the banks to loosen up unless you let them know that there's some type of penalty attached with their failure to make loans available.

Right now, there is no incentive for banks to lend money. There is only a penalty. The penalty is the regulator coming in and questioning a bank about making real estate loans to a particular

person. The penalty of lending is also placing capital at risk. If indeed you can make an investment, a Government security where there's no risk, why lend money?

If we're going to help the banks and if the banks are going to be federally insured, we have an obligation and the ability to say that this isn't just a free market per se when there are Government guarantees involved.

I would hope that we would be more aggressive marketing the program you are implementing to ease reserve requirements and the regulators acting together to ease credit. Indeed, the easing of credit has not sufficiently made monies available where they should be. Even shopping centers that are 97 percent rented, with AAA tenants can't get permanent financing.

I give you that as an example although you will find similar stories and cases in area after area of the country. These anecdotal situations add up to describe the state of the economy—an incredible depression.

I'm simply going to say to you that if you drop the interest rates down another 2 points—we are not yet at historic lows.

Even if you do reduce the discount rate and reserve requirements it will have no effect unless you back it up with a policy that says, hey fellas, we're not giving you these opportunities to simply improve your balance sheet.

The Fed's goal is not to simply see that the balance sheets of the banks improve. The Fed's goal is to see that credit worthy people get credit in the form of loans.

Is that true or not?

Mr. GREENSPAN. [Nods in the affirmative.]

Senator D'AMATO. For the record, the Chairman nodded his head yes.

Thank you, Mr. Chairman.

The CHAIRMAN. A couple of other things before we finish today.

One of the other members raised the issue of the luxury tax on boats and I want to just touch on it with you for a minute.

This is sort of a personal question. I don't mean it to be an offensive question to you. Have you ever owned a boat that cost more than \$100,000? I'll explain the question in a minute.

Mr. GREENSPAN. No, Mr. Chairman, I have not.

The CHAIRMAN. I didn't picture you speeding around in one of those boats.

[Laughter.]

I didn't ask the question thinking the answer would be yes. I haven't, either, and most people don't because to get to the point where you can own a boat that costs \$100,000 or more, you not only have to be able to pay for the boat, but you've got to be able to pay to dock and maintain the boat and deal with it in the wintertime. It's very expensive to run a big boat just in terms of the amount of gasoline and so forth that you use.

Senator D'AMATO. And you certainly can't do it on the salary of a U.S. Senator, right?

The CHAIRMAN. Well, or I would assume the salary of the Chairman of the Fed.

In any event, as you may know, we have a luxury tax now on boats in this country that sell for more than \$100,000. If you buy a

boat that sells for \$90,000, there is no luxury tax. It only starts on those boats that sell for over \$100,000.

Now, the point was made that there's been a very sharp fall off in the sale of these big boats. That usually happens during a recession, as there have been for a lot of other things. The question is how much the luxury tax on the margin is responsible for that.

I want to just explain to you for a minute how it works and then I want to ask your opinion as an economist.

Let's say you went out tomorrow to buy a boat that costs \$110,000. The luxury tax on that would be a thousand dollars because you pay the 10 percent luxury tax on the cost of the boat above the \$100,000 figure.

So the \$110,000 boat would cost you \$111,000.

My question to you would be, is it likely that because a boat costs \$110,000 versus \$111,000, the sales of those boats will be cut in half?

Mr. GREENSPAN. Well, it's obvious that a less than 1 percent increase cannot contract the market by 50 percent. It's hard for me to evaluate this without having all of the additional data. It's clear that the boat market was declining well in advance of the tax and there's a lot of competitive relationships between boats that are made here and boats that are made in foreign shipyards.

So that it's very tough to get an idea of what the incidence of the taxes concern. But if you're asking me as an economist, does a less than 1 percent tax on a luxury item of that sort have the possibility of contracting the demand significantly, the answer is of course not.

The CHAIRMAN. We make these boats in Michigan, a boating State. We border on the Great Lakes, of course, and other States that are on the water also have boating industries. We've had some impact due to this luxury tax in terms of people being laid off in this area.

If you take a \$200,000 boat, the luxury tax would be \$10,000, so that would boost the price of that boat from \$200,000 to \$210,000. Now the \$10,000 is a bigger dollar figure. To have enough money to buy a \$200,000 boat and maintain it, pay the insurance on it and everything else, you've got to have an awful lot of discretionary income, unless that's your business purpose. I don't know what percentage of the American people are in the market for boats that sell for more than \$200,000, but I've got to believe that it's a tiny, tiny fraction.

I just thought that I, having been asked about that issue, would raise it with you.

I want to finish with this. I posed this general question to you just before Senator D'Amato started.

You're a very wise man. You've been at this a long time. I'd like to think that you're not somebody that's going to be the prisoner of conventional thinking if unconventional thinking is required by unusual circumstances.

Aren't we perhaps at a point where it's time to start thinking about doing something new and different on the margin here, maybe outside the scope of your direct decisions, but in a broad macroeconomic sense, to get this country really on a strong and certain growth track?

Mr. GREENSPAN. Mr. Chairman, I think that when we have a situation of the type that we have now with property values falling, with balance sheets creating different types of effects than we have seen in the past, I think all economists are looking at the question that you have raised.

It's my judgment that, so long as the evidence continues to be available, what we are doing is working. We should hold off making any radical changes in policy implementation until we've concluded that whatever it is that we are doing no longer has a reasonable expectation of restoring us to a particularly viable balance.

We at this point, if one wants to take a benevolent view of the way things are emerging, have the capability of coming out of this in a highly stable economic environment, one in which we will not be involved in a cold war, one in which we can look forward to significant growth in this economy and rising standards of living.

As things now stand, we are still on that track. I have not yet certainly convinced myself that we are at a point where a radical shift in policy is required.

If we get to a point where it is becoming evident that the conventional policy tools are not doing the job that we think they ought to be doing, then I think we should be looking at alternate means.

At the moment, I would say that is premature.

The CHAIRMAN. Well, Mr. Chairman, I would submit to you, we've got a serious erosion in our job position in the United States. We're losing higher paying jobs all over the place, among companies of all sizes. People find replacement work generally at a level below their skill level.

That is a trend that's now in place, and I don't see it changing. And I'm not hearing business leaders tell me that it's changing.

On top of that, while we've got the benefit of the end of the cold war and hopefully, a reduction in defense spending and some kind of a peace dividend, we've got an enormous conversion problem because we have a whole military industrial complex that's been in place to support that activity, which means there's high value added work, involving high wages and high skills, that is not needed anymore.

That part of the economy, quite substantial, needs replacement work and there's really nothing out there that I can see that shows where that all is going to go. In fact, what I see in related type activity is job shrinkage, like the plant closings that were announced yesterday.

We don't have a conversion strategy that we have developed or have put forward. We're assuming that somehow or another, magically, the Adam Smith type invisible hand will sort this all out and the state-of-the-art, highly skilled, large work forces and factories and so forth will gravitate over into something else.

I don't know how to make this urgent to the top policy makers in our Government because they have this almost perfect detachment from the problem. The problem involves millions of people. It's all around us. It's increasing the deficit because of so many people unemployed and underemployed, and there's really no plan to get them back on track and reabsorbed somewhere where they've got

high value added work, where they have high incomes and they are able to contribute to a higher national income.

We have these hearings over and over again. They're civilized, as they should be. But the baseline data is not giving us the kind of evidence that you need. It isn't just the evidence of coming out of a recession and getting up to some kind of an anemic 2 percent growth rate. After the kind of recession that we have had, typically, when we come out, we come out at a much higher growth level.

We're not even anticipating that out of the President's plan, or even the Fed's plan.

Add to that what Senator Sarbanes was talking about. Real disposable personal income per capita has not only been dropping, but is now at the lowest point at any time since 1950.

That is a trend line that I think is extremely important. Not just important. It's destabilizing. It starts to cut sort of the guts out of our economic system. And the faith out of it as well because people can work harder and harder and not get ahead. They can send a second wage-earner in the family to work, or even a third wage-earner in a family to work, and find out their disposable income as a family unit isn't where it was even 15 or 20 years ago.

We need an economic plan for America. I don't know how else to say it. People want it. They're desperate for it. That's the reason that President Bush is in trouble today in the polls. You analyze the data. You're a data analyst. You'll see that it's the economic concerns that are at the heart of that.

You have to help fashion a plan. You're one of the few people around with a big enough mind and enough experience to be able to move outside the conventional mode of thinking and reconsider in terms of how to get America off these declining trend lines.

The issue here is not to get back to an anemic 2 percent real growth rate and hold it for four quarters or for five quarters and then go back into the tank again. The projections of the size of the deficit, even with 2 percent growth rates, is horrendous. We're going to be buried under such a mountain of debt. We've got a balance sheet problem that's getting worse by the day.

We've got to get people to work. We've got to have a job strategy.

Now, we need your help in devising one. But if you don't recognize the need and speak out for it, we're probably not going to get it done.

I want you to be able to come in here today and say on the basis of all of your professional work experience, we've analyzed this every which way and we've talked with the President, the other leaders in the private sector, business leaders, and labor leaders. We've got a plan here that we know will work. We are absolutely confident it will work. We're going to get back on a growth track that's going to enable us to match the growth track of our industrial competitors.

We're going to be able to match what we see Europe doing. We're going to be able to match what we see Japan doing in the future. And here's our plan. Here's how we're going to put it into effect.

Yes, there are some new elements to it, but it's good for America. We're going to get our people to work. We're going to get our un-

employment down to the Humphrey-Hawkins levels that are laid out in law.

If you were saying that today, you know what would happen to the consumer confidence numbers? Instead of going like this [indicating], they'd start going like this.

With your characteristic measured response and caution and being elliptical in the responses and so forth, the public reaction will be that that's not going to get it done because the nature of the problem is too big, too deep, there's too many facets to it, it's too perverse.

We need some help from you. You're one of the few people in this country that can give some leadership on this question right now at a time when it really matters. If you don't do it, I'm not sure where it's going to come from.

Mr. GREENSPAN. OK.

Senator D'AMATO. Mr. Chairman?

The CHAIRMAN. Senator D'Amato?

Senator D'AMATO. I just want to pursue two things. First, I would like to make an observation.

A lot of the problem with this issue is perception. We passed the luxury tax to place 10 percent surtax on boats that sold for more than \$100,000, on vehicles over \$30,000, along with furs and jewels and airplanes. What we did may not be quite measurable in terms of the economic fall-out, but we once again gave consumers a reason, to say, no, you're not going to take advantage of me.

I can assure the Chairman that, although it may not be a significant percentage of the boating population in terms of numbers, there are large numbers of people that buy boats for well over \$100,000—for even \$200,000, \$300,000, \$400,000, and \$500,000. Many of these people have simply said, if you're going to charge me a 10 percent premium for this item, I'm not going to buy it.

That's a fact.

I live in one of the boating capitals of the world—Long Island. I've watched the boats come in and out of our harbors—boats that are owned by the people of Nassau and Suffolk and Queens and Brooklyn and the visitors that come to our shores. I want to tell you that the prevalent feeling about the luxury tax is that as a matter of principle, people of affluence have simply said, I'm not going to pay 10 percent.

The luxury tax certainly put a dampener on purchasing luxury items.

What we wound up doing was not getting the rich guy which is, by the way, a rather perverse philosophy. We shouldn't be just trying to get the rich guy or impose a tax on success. People should pay their fair share, but we have entered into a new kind of very troubling, very divisive attitude where, instead of encouraging success, we're looking to get people who have been successful.

In the long run, luxury tax is one area where Congress has had a devastating impact on my State. One of the great centers of diamonds and jewelry, it has been devastated because, again, exactly the people who have expendable income said, I'm not going to pay that 10 percent premium.

You may say it's not much, 10 percent over \$10,000. To me, it's the principle. If one were to go to the diamond exchange he would

see that working middle class families are impacted by this legislation—the people who produce and who sell merchandise, et cetera, are impacted because less purchasing of luxury items means job losses.

So we didn't end up getting wealthy people with the luxury tax. We didn't make them pay a premium because they just said, the heck with you. We're not going to partake. I think this has been a fairly consistent pattern with the luxury tax.

One of the things we can do to help that situation, given the fact that we've seen such a lag, is to repeal that obnoxious type of tax.

We shouldn't repeal the tax just as it relates to boats, but as it relates to autos and furs and everything else because taxing items is not the way to encourage growth and economic activity and employment.

I would like to address with the Chairman, if I might, the question of the tax credit for first time homebuyers because I believe that could have a very significant impact on the growth of the housing market—not maybe in the totality of the entire economy but certainly, in sales and in increasing the values of one- and two-family owner-occupied homes.

I would like the Fed to study the impact a \$5,000 credit on first time homebuyers would have on the housing market?

What, if any, impact would the tax credit have as it relates to the creation of jobs over the next 24-month period of time. I think that's the kind of thing the American people would like to know.

Mr. GREENSPAN. We've obviously looked at that and concluded, as I indicated in an earlier question, that such a credit would obviously have some job effects since it would clearly have some acceleration of home sales and home construction as a consequence.

It probably would borrow a bit from the future in that part of the effect would be to move up the purchases of homes into the relevant tax credit period.

I did make another point, Senator, with respect to that. Whether or not Congress decides to go ahead with that, it should make that decision fairly quickly because we are beginning to get some evidence, albeit somewhat mixed as well, that people are holding off pending whether that law will pass.

And so I would urge you to come to a fairly quick conclusion on this question because whether one likes this credit or not, the one thing nobody likes is to have uncertainty out there which would create problems for the market and lose jobs and lose construction.

Senator D'AMATO. I agree with the Chairman on that point. I think that's very important that we act expediently. One way or the other, even if we have to take some of the proposals and act on them piecemeal, let's enact them.

If we don't consider the tax initiatives soon, the uncertainty acts as a drag on the economy. There are people today who are holding off some type of economic activity in anticipation of some future tax benefit.

What a sorry situation we have created—when we need the help the most, we have actually been exacerbating the economy's problems as the result of indecision.

First time homebuyers are probably reluctant to purchase for fear that they might forego a tax benefit, notwithstanding that in

most cases, we have enacted this type of legislation with some retroactivity.

The American public and first time homebuyers probably don't realize that there would most likely be a retroactivity provision. Nor would you as an investment adviser or an attorney, counsel your client to go ahead and purchase—particularly when there is the possibility of \$5,000 credit for a first time homebuyer.

So I think that the element of uncertainty and its effect on the housing market is an important observation. I thank the Chairman for his usual courtesy and for an opportunity to share my thoughts.

I'm wondering, Mr. Chairman, if there is any way of working out an economic model that might give us some idea as to how many jobs have been lost in what geographic areas.

Is there some way to get some kind of projection?

Mr. GREENSPAN. Well, there are several models around. We have done some work, as a lot of others have. Why don't I put in the record some of the results that we have concluded as a consequence of our evaluation.

Senator D'AMATO. I'd very much appreciate that.

Thank you, Mr. Chairman.

[Chairman Greenspan subsequently supplied the following information for the record:]

The tax credit should add to housing activity over the near term. Some potential first time homebuyers no doubt would accelerate their purchases to qualify for the credit. Judging from past experience, most of the homes purchased by the first time buyers will be existing homes; but the increased demand for new homes in response to the tax credit should trigger additional production, because the current inventory of unsold new homes is lean.

Despite its attractions, the proposed tax credit would have some negative effects. By inducing some people to switch to owning from renting during the next year or two, the tax credit would reduce demand for multifamily rental housing, an already depressed segment of the housing market in which production has been low and mortgage default rates high. In addition, the proposal is expensive, in terms of forgone tax revenues, with most of the credits likely going to homebuyers who would have made their purchases anyway.

The proposed tax credit will affect the timing of decisions but will not appreciably increase housing demand over the long run. Home purchases and even household formations moved forward to take advantage of the credit will be largely offset by reduced purchases and household formations after the next year or two.

Several organizations have attempted to quantify the impacts of the proposed tax credit. Two major question marks complicating all these efforts, including ours at the Federal Reserve, are: (1) How many households will move the timing of their purchases forward into 1992 to take advantage of the credit? and (2) Will consumers and lenders treat the credit as if it were cash? Available data and historical experience give us little hard evidence on these issues.

Regarding the timing effects, we do know from the Census Bureau's American Housing Survey that, of the 4.6 million households that moved into owner-occupied housing units in 1989, 1.7 million were first time homebuyers. Of these first time buyers, roughly three-quarters purchased a previously occupied home. It seems likely that 1.5 to 2.0 million households would be first time buyers this year even without the tax credit. However, there is no adequate basis for determining how many additional buyers would move their decision forward and purchase this year instead of in 1993 or later.

The second question is whether the tax credit will have the same effect as cash. The Census Bureau estimates that, in 1988, only 6 million of the Nation's 38 million renter households could qualify for a mortgage to purchase a modestly priced home in their region. Analysis by the National Association of Home Builders suggests that \$5,000 in cash would enable an additional 1.6 million renter households to qualify. The tax credit likely would be valued less than cash by both consumers and lenders. But how much the credit would be discounted is uncertain.

Because of these and other uncertainties, estimates of the housing market effects of the proposal differ greatly. At the high end, the National Association of Home Builders estimates the proposal would increase single family housing starts by 25 percent (or almost 250,000 units) this year. Owing to offsetting reductions in multifamily construction and payback effects in late 1993 and 1994, the NAHB's estimate of the effect on total starts over the 3 year period is much lower: a 4 percent increase. At the low end of the range of estimates we've seen, the forecasting firm DRI projects a much smaller short-run impact: a rise of 35,000 in single family starts in 1992 and 5,000 units in 1993. DRI does not estimate any offsetting effects on multifamily rental construction, nor do they quantify the payback effect of later years.

The uncertainties about consumer and market reactions to the proposal leave me reluctant to offer a precise numerical projection, but my judgment is that the construction impact of the proposed tax credit would be closer to the low end of the range of estimates than to the high end.

What about the employment effects? A rule of thumb that could be applied to the estimate of the starts effect is that every additional housing start should generate roughly 1.5 person-years of employment.¹ Of course, because of the housing market "payback" in subsequent years, any near-term gain in employment will tend to be reduced in those years.

Even the short-run employment effects depend on how the tax credit is financed. If the tax revenue lost were to be offset through cutbacks in spending on other Federal programs, or through a tax increase, the resulting job losses would need to be netted against the direct gains in construction employment.

Finally, I would like to reiterate one point I made during my appearance before the committee: However the Congress decides to act on this proposed tax credit, the decision should be made promptly. Builders and consumers may be expected to delay their decisions until the tax consequences are clear. The current uncertainty is more detrimental to the housing market than either decision the Congress will make on this proposal.

The CHAIRMAN. Senator D'Amato, I just want to show you this one thing. This is out of the President's budget report which was just sent up here the other day, where they scored here how much the plan, the President's economic plan, if enacted in total, will improve the unemployment situation.

You can see here, it will take it down on the average for the year 1992, from what they estimate to be 7.1 percent down to 6.9 percent. So it's two-tenths of 1 percent.

Now, obviously, that's some improvement. But the issue is, do we need something that goes beyond that because the unemployment in States like yours and mine is just so much higher?

Senator D'AMATO. I think we do need something more—clearly. That is one of the reasons I mentioned this issue to Mr. Greenspan. When the Fed has invested so much effort to finally get the interest rates down. We need to work harder to make loans available to credit worthy borrowers. The depth of this recession has been remarkable. Last evening I was at a dear friend's, one of the first clients I represented when I came out of law school, a very, very, very successful businessman. He breathed a sigh of relief because he's getting a \$24 million mortgage, that he is hopefully closing on at the end of this week. Otherwise, he'd be in a terrible situation, because although he had gotten a construction loan, and is totally rented, he had great difficulties getting permanent financing.

This person is a large, successful developer.

¹ A Department of Labor survey suggests that approximately 30 hours of employment are generated for every \$1,000 in construction spending on single-family housing. If construction costs (excluding land costs) average \$100,000 for the typical house purchased by a first time buyer, then each house generates 3,000 hours of employment. Annual hours for full-time workers average roughly 1,900, so each house would generate approximately 1½ person-years of employment.

Across this Nation, however, the same story is told over and over again—by the small business community and the small real estate developers.

Talk about loss of consumer confidence, these are the only stories you hear.

That is why I think, Mr. Chairman, that unless we get that credit out to the public, to those who need it and to those who are credit worthy, we're just going to continue to be mired in this recession for a long period of time and there will be a lot more pain attached with it.

The CHAIRMAN. Mr. Chairman, we'll have some questions for you for the record from some of the members of the committee, and we ask you to respond to those in writing.

The committee stands in recess.

[Whereupon, at 1:17 p.m., the committee was recessed.]

[Prepared statement of Alan Greenspan and Monetary Policy Report to Congress follow:]

Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

U.S. Senate

February 25, 1992

Mr. Chairman and members of the Committee, I am pleased to present the Federal Reserve's Monetary Policy Report to the Congress. The policy decisions discussed in the report were made against the backdrop of a troubled economy. The recovery that seemed to be in train at the time of our last report to Congress stalled, job losses have mounted, and confidence remains low.

Looking forward, though, there are reasons to believe that business activity should pick up. Indeed, anecdotal reports and early data seem to be indicating that spending is starting to firm in some sectors. These signs should not be exaggerated; the prospective incipient recovery could peter out, as indeed the much more vigorous recovery of last spring petered out. There are nonetheless distinct financial indications of improvement at this time. A number of measures suggest that the balance sheets of many households and businesses have been strengthened, a development that should facilitate spending in a recovery. Similarly, banks and other lenders have taken steps to bolster their capital positions so that they will be able to supply the credit to support additional spending. And, most recently, broad measures of money have strengthened. Moreover, there are clear signals that core inflation rates are falling, implying the prospect that within the foreseeable future we will have attained the lowest rates of inflation in a generation, an encouraging indicator of future gains in standards of living for the American people. Still, the outlook remains particularly uncertain. This means that we at the Federal Reserve have to be particularly sensitive to signs that the anticipated strengthening in business activity is not emerging and be prepared to act should the need arise.

As background, I would like to discuss our recent economic performance, reviewing in some detail the causes of the disappointments we've experienced, and the important balance-sheet adjustments in process that promise eventually to support a resumption of sustainable economic growth.

Macroeconomic Performance and Monetary Policy in 1991

Following the contraction of economic activity in the autumn of 1990 that resulted from the invasion of Kuwait and the subsequent sharp rise in oil prices, economic activity continued to decline in the first quarter of 1991. In response to the weakening of activity and anemic money growth, the Federal Reserve eased policy substantially over late 1990 and into early 1991.

By the spring, many signs pointed to economic recovery. The quick and successful conclusion of the Gulf war bolstered consumer confidence. Growth of the money stock was strengthening. Homebuilding had begun to stir, consumer spending had turned up, and industrial production was advancing. The lower interest rates and the retracing of the earlier jump in oil prices appeared to be providing support for an expansion of aggregate demand. In these circumstances, the odds appeared to favor a continued moderate recovery in jobs and employment during 1991.

Over the third quarter, however, evidence began to surface that the recovery had not taken hold. The impetus to consumer sentiment and spending that was provided by the completion of the Gulf war seemed to ebb, and consumer outlays turned down again. Businesses, apparently caught by surprise by this development, saw their inventories back up in the late summer and fall. With demand slackening, businesses engaged in another round of layoffs, and private nonfarm

payrolls declined over the second half of 1991 while the civilian unemployment rate rose to 7.1 percent.

In addition, growth of the monetary aggregates slowed unexpectedly during the third quarter. Expansion of M2 virtually ceased, while M3 actually contracted--a nearly unprecedented occurrence. Judging from our surveys of banks, other contacts in the financial industry, and anecdotal information from borrowers, the supply of credit for many borrowers remained quite tight, particularly for those firms without access to open market sources of funds. Moreover, private credit demands weakened further.

Against this background, and with signs that inflationary pressures were diminishing, the Federal Reserve took a number of steps to ease policy further in the second half of 1991. Through both open market operations and reductions in the discount rate, money market interest rates were lowered nearly two percentage points between August and December.

These monetary policy actions, building on those over the previous 2-1/2 years, have resulted in a large cumulative reduction of interest rates. The federal funds rate has declined nearly 6 percentage points from its cyclical peak, and the discount rate by 3-1/2 percentage points. Other short-term interest rates have fallen substantially as well. The prime rate also has been reduced appreciably, but by somewhat less than market rates as commercial banks have sought to bolster lending margins. In longer-term markets, bond and mortgage yields have dropped 1 to 2 percentage points on balance from their cyclical highs, with much of the decline coming in the latter half of 1991. The decreases in interest rates appear to have given stock prices a boost as well, with most major indexes rising to record levels early this year.

Despite substantial decreases in interest rates in late 1990 and throughout 1991, however, M2 growth was only about 3 percent in 1991, the same as the sluggish pace of expansion of nominal GDP. M3 rose only 1-1/4 percent. Both aggregates ended the year only modestly above the lower bounds of their respective annual ranges. Growth of domestic nonfinancial sector debt, at 4-3/4 percent, also was near the lower bound of its monitoring range. Outside the federal sector, debt increased less than 3 percent for the year in reflection not only of depressed spending but also of a deleveraging in the household and business sectors and financial difficulties of many state and local governments.

The behavior of the monetary aggregates in 1991 relative to other economic variables was somewhat puzzling. Doubtless, part of the slow money growth was related to the weakness in borrowing and spending. But even after taking account of weak spending, growth of money was unusually slow. The velocity of M2 was about unchanged over the year rather than falling as would ordinarily be expected in circumstances of sharp declines in short-term market interest rates. It appears that certain interest rate relationships gave households incentives to limit their money holdings. Commercial banks, restraining their own balance sheets in response to weak loan demand and in an attempt to conserve capital, lowered deposit interest rates appreciably, especially late in the year. On the other hand, interest rates on consumer debt, particularly when adjusted for the lack of tax-deductibility, remained relatively high. As a result, many households apparently used deposit balances to pay off or to avoid taking on consumer credit. Also, the steep yield curve and the attractive returns recorded by bond mutual funds, as well as impressive gains in the stock market, apparently led many households to shift funds out of

deposits and into capital market instruments, which are not included in the monetary aggregates.

Finally, a brisk pace of activity by the Resolution Trust Corporation appears to have depressed the monetary aggregates, especially M3. When the RTC takes savings and loan assets onto its own balance sheet, they are financed with Treasury securities, rather than depository liabilities. In effect, the RTC has taken on some of the role of thrift institutions, but its liabilities are not included in the monetary aggregates. In addition, the disruption of banking relationships as institutions are resolved, including the abrogation of some time deposit contracts, seems to lead investors to reassess their portfolio allocation and, in some cases, to shift funds out of deposits.

Thus, a number of factors reduced the public's demands for monetary balances in 1991. Some of these factors tended to raise the velocity of money, so that to an extent slow growth of M2 was not reflected in income flows. But the pattern of money and credit growth over the the last half of the year appeared also to stem importantly from forces depressing spending and economic activity, which the Federal Reserve attempted to counter through easing money market conditions.

Balance Sheet Adjustments

Understanding these forces and the appropriate role for monetary policy under the circumstances requires stepping back several years. As I have discussed with you previously, the 1980s saw out-sized accumulation of certain kinds of real assets and even more rapid growth of debt and leverage. To a degree, this buildup of balance sheets was a natural and economically efficient outcome of deregulation and financial innovation. It also may have reflected a lingering

inflation psychology from the 1970s--that is, people may have expected a rapid increase in the general price level, and especially in the prices of specific real assets, such as real estate properties, that would make debt-financed purchases profitable. But in retrospect, the growth of debt and leverage was out of line with subsequent economic expansion and asset price appreciation. Indeed, the burden of debt relative to income mounted as asset values, especially for real property, declined or stagnated. In part, our current economic adjustments can be seen as arising out of a process in which debt is being realigned with a more realistic outlook for incomes and asset values.

Rapid rates of debt-financed asset accumulation were broad-based during the 1980s. For example, households purchased cars and other consumer goods at a brisk pace. Although household income was increasing swiftly in this period, the growth of expenditures was faster. Household saving rates dropped from about 8 percent at the beginning of the decade to a 4 to 5 percent range by its end. This was reflected in part in burgeoning consumer installment credit, which expanded at an average annual rate of 15 percent between 1983 and 1986. In addition, mortgage debt expanded at an 11 percent pace between 1983 and 1989. Most of this increase was against existing homes, representing borrowing against rising values either in the process of home turnover or as owners borrowed against higher equity. Mortgage borrowing also financed a substantial amount of buying of new homes, which in some parts of the country at times seemed to be motivated more by speculative considerations than by fundamental needs.

The 1980s also witnessed a dramatic increase in desired leverage of the business sector, which fostered a wave of mergers and buyouts. These transactions typically involved substantial retirements of equity financed through issuance of debt; equity retirements

in the nonfinancial corporate sector exceeded new equity issuance by a staggering \$640 billion in the 1984-1990 period. Such restructurings often were based, at least in part, on a well-founded quest for increased efficiency, and gains were achieved by a number of firms. However, many of these deals also were predicated on overly optimistic assumptions about what the economy could deliver--that rapid economic growth could continue without setback and that asset prices would always rise.

A primary example of the accumulation of debt and real assets occurred in commercial real estate markets. In the early 1980s, when space was in unusually short supply, commercial real estate received an additional push from the Economic Recovery Tax Act, which provided an acceleration of depreciation allowances for capital goods. While an adjustment was appropriate and overdue, that for commercial structures was excessive, resulting in tax lives that were far shorter than economic fundamentals would dictate. This shift in incentives led to a surge in debt-financed commercial construction during the 1980s.

Financial institutions, of course, participated in this process by lending heavily; indeed, their aggressive lending behavior probably contributed to the speed of debt accumulation. During the economic expansion, bank credit expanded at an average annual rate of nearly 9 percent, well in excess of the growth of nominal income. Banks lent heavily against real estate collateral, for corporate restructurings, and for consumer credit, and, in addition, for more traditional business purposes. Life insurance companies also expanded their portfolios rapidly, with growth in real estate loans especially prominent.

By the end of the 1980s, the inevitable correction was upon us. The economy was operating close to capacity, so that growth had

to slow to a pace more in line with its long-run potential. Inflation did not pick up much, contrary to what some might have expected as capacity was approached. In the commercial real estate sector, soaring vacancy rates and a change in tax law in 1986 brought the boom to an end, producing sharp decreases in prices of office buildings in particular.

Together, these developments resulted in declines in the value of assets and growing problems in servicing the associated debt out of current income. Because of the runup in leverage over previous years, these problems have been more severe than might be expected just from the slowing in income and spending. And the difficulties of both borrowers and lenders have fed back on spending, exacerbating the economic downturn during the Gulf crisis, and inhibiting the recovery.

Faced with mounting financial problems and uncertainty about the future, people's natural reaction is to withdraw from commitments where possible and to conserve and even build savings and capital. Both households and businesses, concerned about their economic prospects, over the past two years or so have taken a number of measures to reduce drains on their cash flow and to lower their exposure to further surprises. Part of this process has involved unusually conservative spending patterns and part has involved the early stages of a restructuring of financial positions.

Businesses, for example, have strived to reduce fixed costs. To do this, they have cut back staffing levels and closed plants. They have tried to decrease production promptly to keep inventories in line. Firms also have taken steps to lower their risk exposures by restructuring their sources of funds to reduce leverage, enhance liquidity, and cut down on interest obligations.

The response of households has been analogous. To increase their net worth, households have taken steps to increase their savings by restraining expenditures. To reduce interest expenses, they have paid down consumer debt, and as long-term interest rates have declined, they have refinanced mortgages and other debt at lower interest rates.

Lenders too have drawn back. With capital impaired by actual and prospective losses on loans, especially on commercial real estate, banks and other intermediaries have not only adopted much more cautious lending standards, but also have attempted to hold down asset growth and bolster capital. They have done so in part by aggressively reducing what they pay for funds, by more than they have reduced what they charge for credit. Like other businesses, they have taken steps to pare expenses generally, including reducing work forces and looking for cost-saving consolidations with other institutions. To a considerable extent, this response has been rational and positive for the long-term health of our financial intermediaries. But in many cases it seems to have gone too far, impelled to an extent by the reaction of supervisors to the deteriorating situation.

The Federal Reserve has taken a number of measures to facilitate balance sheet restructuring and adequate flows of credit. Together with other supervisors, we have directed examiners to consider not only the current market value of collateral against performing loans, but the overall quality of the credits. We also have met on numerous occasions with bankers as well as bank examiners to clarify bank supervisory policies and to emphasize the importance of banks continuing to lend and take reasonable risks.

Monetary policy also has in part been directed in recent quarters to supporting balance sheet restructuring that is laying the

groundwork for renewed, sustained, economic expansion. We recently reduced reserve requirements on transactions deposits. This will free up some funds for lending or investment and should over time enhance the ability of banks and their customers to build capital.

In addition, lower short-term interest rates clearly have been helpful to debtors, but their contribution to the restructuring process would be relatively muted if long-term rates had not also declined at the same time and stock prices were not buoyant. Reductions in short-term rates that were expected very soon to be reversed or that were not seen as consistent with containing inflation would contribute little to the strengthening of balance sheets fundamental to enhancing our long-term economic prospects.

In part because we have seen declines in long- as well as short-term rates and increases in equity prices, progress has been made in balance sheet restructuring, and hopefully more is in train. As a result of lower interest rates, household debt service as a percent of disposable personal income has fallen in the past year, from about 19-1/2 to about 18-1/2 percent. Moreover, further declines are in prospect as more refinancing occurs and as interest costs on floating-rate debt, such as adjustable-rate mortgages, gradually reflect current interest rates.

In the business sector, similar patterns can be observed. With corporate bond rates close to their lowest levels in more than a decade, a large number of firms in recent months have called, retired, and replaced a considerable volume of high-cost debt. A flood of issuance of longer-term debt and equity shares has reduced dependence of firms on short-term obligations. A number of the equity deals constituted so-called "reverse LBOs"--the deleveraging of highly leveraged and therefore rather risky firms. The ratio of corporate

debt to equity in book value terms has only begun to edge down, but the increase in equity, together with the lower level of interest rates, has enabled many corporations to make significant headway in lowering interest expenses over the past two years, and further decreases in corporate debt burdens are presumably in prospect. Restraint on inventories and other spending has contributed to this result by keeping outlays in close alignment with internally generated funds. And the strengthening of balance sheets is paying off in terms of credit evaluations. Downgrades of nonfinancial firms, though still greater than upgrades, are well below the levels of last winter and spring, and upgrades have risen slightly.

The condition of our financial institutions also is improving. In the banking sector, wider interest margins seemed to be boosting profits by the end of last year. In addition, many institutions have taken difficult but necessary measures to control noninterest expenses. Reflecting an improved earnings outlook and a generally favorable equity market, the stock prices of large banks have doubled on average from their 1990 lows, and the premium paid by many money-center banks on uninsured debentures has dropped several percentage points. Increased share prices have spurred a number of holding companies to sell substantial volumes of new equity shares in the market, contributing to a significant rise of capital ratios in the banking system, despite still-large provisions for loan losses. Measures of bank liquidity, such as the ratio of securities to loans in bank portfolios, have risen appreciably, signalling an improved ability of banks to lend.

The balance-sheet adjustments that are in progress in the financial and nonfinancial sectors alike are without parallel in the post-war period. Partly for that reason, assessing how far the

process has come and how far it has to go is extraordinarily difficult. As increasingly comfortable financial structures are built, though, the restraint arising from this source eventually should begin to diminish. In any case, the nature and speed of balance sheet restructuring are important elements that we will need to continue to monitor on a day-by-day basis in assessing whether further adjustments to the stance of monetary policy are appropriate.

Economic Expansion and Money and Credit Growth in 1992

Against this background of significant progress in balance-sheet strengthening as well as lower real interest rates, the Board members and Reserve Bank Presidents expect a moderate upturn in economic activity during 1992, although in the current context the outlook remains particularly uncertain. According to the central tendency of these views, real output should grow between 1-3/4 and 2-1/2 percent this year. The unemployment rate is projected to begin declining, finishing the year in the vicinity of 6-3/4 to 7 percent.

An especially favorable aspect of the outlook is that for inflation. The central tendency of the Board members' and Reserve Bank Presidents' forecast is that inflation, as measured by the Consumer Price Index, will be in the neighborhood of 3 to 3-1/2 percent over the four quarters of 1992, compared with a 3 percent rise in 1991. However, the CPI was held down last year by a retracing of the sharp runup in oil prices that resulted from the Gulf crisis. Consequently, our outlook anticipates a significant improvement in the so-called core rate of inflation. With appropriate economic policies, the prospects are good for further declines in 1993 and beyond even as the economy expands.

To support these favorable outcomes for economic activity and inflation, the Committee reaffirmed the ranges for M2, M3, and debt

that it had selected on a tentative basis last July--that is, 2-1/2 to 6-1/2 percent for M2, 1 to 5 percent for M3, and 4-1/2 to 8-1/2 percent for debt, measured on a fourth-quarter-to-fourth-quarter basis. These are the same as the ranges used for 1991. The 1992 ranges were chosen against the backdrop of anomalous monetary behavior during the last two years. Since 1989, M2 has posted widening shortfalls from the levels historical experience indicates would have been compatible with actual nominal GDP and short-term market interest rates.

The appropriate pace of M2 growth within its range during 1992 thus will depend on the intensity with which forces other than nominal GDP turn out to affect money demand. Depository institutions are likely to continue reducing their rates on retail deposits in lagged response to the steep declines in money market yields before year-end. Those deposit-rate reductions could be significant, especially if banks are not seeking retail deposits, given their continued caution in extending credit and borrowers' continued preference for longer-term sources of credit to strengthen balance sheets. With the effects of lower deposit rates contributing to further shifts of funds into longer-term mutual funds and into debt repayment, and with the RTC remaining active in resolving troubled thrifts, the velocity of M2 could increase this year, independently of changes in market interest rates.

The ongoing restructuring of depository institutions, as in the last two years, is likely to continue to have an even larger influence on M3 than on M2 growth. Assets previously on the books of thrifts that are acquired by the RTC will be financed by Treasury debt rather than the liabilities of thrifts. Managed liabilities in M3 should continue to be more depressed by resolution activity than

retail CDs. The reaffirmed range for M3 growth thus remains lower than for M2.

Nonfinancial debt growth is likely to be a little faster than last year's 4-3/4 percent increase. The wider federal deficit in prospect for 1992 will increase Treasury borrowing. Assuming output and incomes are again expanding, balance sheets in somewhat better condition, and credit conditions no longer tightening, the borrowing of households and businesses may pick up a little, although their overall posture probably will remain cautious.

Will these ranges for money and credit growth prove to be appropriate? Obviously, we believe that the answer is yes. But I should reemphasize the sizable uncertainties that prevail. The ongoing process of balance sheet restructuring may affect spending, as well as the relationship of various measures of money and credit to spending, in ways we are not anticipating. In assessing monetary growth in 1992, the Federal Reserve will have to continue to be sensitive to evolving velocity patterns.

Concluding Comments

Our focus, quite naturally and appropriately, has been on our immediate situation--the causes of the recent slowdown and the prospects for returning to solid growth this year. However, as we move forward, we cannot lose sight of the crucial importance of the longer-run performance of the economy. As I have noted before, much of the difficulty and dissatisfaction with our economy comes from a sense that it is not delivering the kind of long-term improvement in living standards we have come to expect. The contribution monetary policy can make to addressing this deficiency is to provide a financial background that fosters saving and investment and sound balance sheet structures. Removing over time the costs and uncertainties associated

with ongoing inflation encourages productivity-enhancing investment. Moreover, inflation tends to promote leverage and over-accumulation of real assets as a hedge against increases in price levels; progress toward price stability provides a backdrop for borrowing and lending decisions that lead to strong balance sheets, far less apt to magnify economic disturbances.

A crucial aspect of our recent economic performance is the difficult situation of our financial sector. Clearly, some of the weakness of the economy over the past two years arose from the restraint on the supply of credit--the so-called credit crunch. Both depository institutions and other financial intermediaries made some of the same mistakes of judgment about the likely appreciation of asset prices as did borrowers. In addition, though, the balance sheets of many financial intermediaries themselves were not robust; many lacked adequate capital to continue to lend to good credit risks in the face of losses from their previous lending mistakes. Our emphasis on improving the capitalization of depository institutions over time, where we have already made substantial progress, should help bolster their ability to lend both in good times and bad. We could make further strides in strengthening our depository institutions through removal of outmoded constraints on their behavior. By loosening strictures on the ability of these firms to compete across arbitrary boundaries of product line and geography, we would improve their profitability and capital. Their strengthened position should augment their ability to lend and potentially could reduce demands on the federal safety net.

Finally, we should consider carefully the effects of the extremely low rates of national saving that we have experienced for a

decade. Certainly, low personal and corporate saving rates have contributed to the deterioration in balance sheets that has impaired our economic performance in recent years. The large stocks of federal debt that have been built up, too, likely have adversely affected our economic prospects by putting upward pressure on real interest rates and thus stunting the growth of the capital stock, on which our future incomes depend. In considering the various fiscal options that are before you as members of the Congress, I urge you to keep in mind their long-term implications for national saving. Through a combination of fiscal policies directed at reducing budget deficits and boosting private saving and monetary policies aimed at noninflationary growth, we can achieve the strong economic performance that our fellow citizens rightly expect.

For use at 10:00 a.m., E.S.T.
Wednesday
February 19, 1992

Board of Governors of the Federal Reserve System



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

February 19, 1992

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 19, 1992

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,

A handwritten signature in black ink, appearing to read "Alan Greenspan".

Alan Greenspan, Chairman

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Section 1: Monetary Policy and the Economic Outlook for 1992

When the Federal Reserve presented its midyear monetary policy report to Congress last July, a moderate economic upturn was under way. Consumer spending and housing activity had risen considerably since the winter, bolstered by the decline in oil prices, by a rebound in consumer confidence in the wake of the allied victory in the Persian Gulf conflict, and by lower interest rates. Inventories had been trimmed appreciably, orders were rising, and businesses, while still cautious, had begun to increase employment and production. The key monetary aggregates had accelerated and were around the middle of their 1991 target ranges. With the stance of monetary policy seemingly conducive to an upturn in economic activity, the Federal Reserve, after having progressively reduced pressures on reserve positions earlier in the year, maintained a more neutral money market posture in the spring and early summer.

As the year wore on, however, the incipient recovery lost its momentum. Consumer spending turned down, and business and consumer sentiment began to erode. Inventories at wholesale and retail trade establishments began to increase relative to sales, inducing a new outbreak of production adjustments and layoffs that continued through year-end. Although the economy—as measured by its real gross domestic product—continued to grow in the second half of the year, the pace of expansion was only marginally positive.

The faltering of the recovery process apparently owed to a variety of forces, some of which were operating well before the oil price shock of 1990 tipped the economy into recession. In a sluggish economy and amid unexpectedly weak asset values—particularly in real estate—deteriorating financial positions of debt-laden households and corporations further dampened credit demands and aggregate spending. Financial intermediaries, chastened by their negative experience with earlier loans, became more hesitant about extending new credit; the resultant tighter lending standards deepened the slowdown in economic activity and inhibited the subsequent recovery. In the government sector, where deficits remained large, not only at the federal level, but also in many state and local jurisdictions, efforts to curb spending and increase revenues constituted a further drag on aggregate demand in the short run.

Inflation, meanwhile, moved down over the second half of 1991. Weak demand reduced pressures in both

labor and product markets, and, after some acceleration of wages and prices in 1989 and 1990, an underlying disinflationary trend has now been established. Important in this process has been a reduction in inflation expectations, visible not only in a variety of survey data but also in the behavior of securities markets.

With actual and prospective inflationary pressures easing, economic activity flagging, and the broader monetary aggregates weakening and growing near the bottom of their target ranges, the Federal Reserve resumed easing money market conditions in the second half of the year. As a result, the federal funds rate fell from 5¼ percent in July to 4 percent by year-end, and most other short-term rates followed suit; the discount rate was also reduced over this period, from 5½ percent to 3½ percent, the lowest rate in nearly 30 years. Long-term interest rates, which had failed to respond to declines in money market rates in the early months of the year, came down significantly in the latter part of 1991, partly in response to the easing in inflationary expectations. Although long-term rates have backed up some in recent weeks, they remain appreciably below the levels of last summer. The decline in rates has helped reduce the financial burdens of highly-leveraged households and corporations, who have taken this opportunity to refinance mortgages and to replace existing debt with new lower-cost bonds. Lower interest rates also have contributed to an increase in stock prices, inducing firms to boost equity issuance and to pay down debt, further strengthening their balance sheets. With the decline in U.S. interest rates, the foreign exchange value of the dollar has largely reversed the upward movement that had occurred earlier in the year.

The unusually slow growth of the key monetary and credit aggregates last year was, to a degree, indicative of the continuing restraint on private credit usage and spending. The aggregate debt of domestic nonfinancial sectors—abstracting from federal government debt, which continued to grow briskly—expanded only 2¼ percent in 1991, the slowest advance in decades, and below the pace of nominal GDP; households, nonfinancial businesses, and state and local governments all retrenched, curbing spending and borrowing in order to buttress deteriorating financial positions.

The weakness in the monetary aggregates M2 and M3 reflected not only subdued overall credit usage but

Ranges for Growth of Monetary and Credit Aggregates

| | 1990 | 1991 | 1992 |
|--|--------|----------|----------|
| <i>Percentage change, fourth quarter to fourth quarter</i> | | | |
| M2 | 3 to 7 | 2½ to 6½ | 2½ to 6½ |
| M3 | 1 to 5 | 1 to 5 | 1 to 5 |
| Debt | 5 to 9 | 4½ to 8½ | 4½ to 8½ |

also a continued decline in the share of credit intermediated by depositories. With the thrift industry contracting further, commercial banks exercising caution in their credit extensions, and borrowing demand concentrated in longer-term instruments, depository credit continued to shrink as a share of overall credit extensions. As a result, the velocity of M3—a monetary aggregate that comprises most of the liabilities used by depositories to fund credit growth—increased again in 1991, as M3 grew only 1¼ percent, near the bottom of its target range. Depository restructuring also restrained M2, which grew in line with nominal GDP despite a steep drop in short-term market interest rates, which ordinarily would have been expected to depress the velocity of this aggregate. Banks, eager to improve capital positions, reduced deposit rates more than loan rates, increasing the incentive for households to pay down debt rather than to accumulate monetary assets. Less aggressive pursuit of retail accounts by depositories also led investors to switch into other financial assets, such as bond and stock mutual funds. Flows into these funds helped finance credit that had formerly been intermediated by depositories, facilitating shifts to longer-term borrowing and reducing the adverse effects of any retrenchment by banks and thrifts on the cost and availability of credit to many borrowers. However, some types of lending that are not so easily rechanneled—such as construction loans and credits to small and lower-rated businesses—have been curtailed, and a number of borrowers now face more stringent credit terms.

Monetary Objectives for 1992

In formulating its objectives for monetary policy for 1992, the Federal Open Market Committee has sought to promote a sustainable upturn in economic activity while continuing to build upon the hard-won

gains against inflation that have already been made. The task of translating these objectives into specific ranges for money and debt continues to be complicated by the ongoing restructurings of depositories and by the evolving attitudes towards credit on the part of borrowers and lenders. The Committee believes that the rechanneling of credit flows away from depository institutions could well continue to produce slower growth in the broad monetary aggregates than normally would be associated with a given path for nominal GDP.

Taking account of these effects, the Committee has deemed the ranges for 1992 tentatively adopted last July as appropriate for achieving its objectives. The M2 range for 1992 is 2½ to 6½ percent, unchanged from 1991. Demands for M2 relative to income would be damped if, as seems likely, banks and thrifts continue to reduce deposit rates in lagged response to the decline that has occurred in market rates. These deposit-rate reductions could be especially large if credit continues to be channeled outside depositories, and in this case, relatively modest growth in M2 would be adequate to support a satisfactory outcome for the economy. On the other hand, as the balance sheets and capital positions of depositories continue to improve, banks and thrifts may adopt a generally more accommodative posture with respect to credit extensions and would therefore have greater need for retail deposits. In that event, somewhat faster growth of M2 would be appropriate.

On balance, the Committee's M2 range for 1992 allows room for a variety of developments in the intermediation process and thus in the behavior of monetary velocity. Flexibility in interpreting M2 within its range is particularly important at this time, in light of the ongoing and unpredictable shifts in the patterns of credit usage and financial intermediation

Economic Projections for 1992

| Measure | Memo: 1991 Actual | FOMC Members and Other FRB Presidents | | Administration |
|--|----------------------|--|---------------------|----------------|
| | | Range | Central Tendency | |
| <i>Percentage change, fourth quarter to fourth quarter¹</i> | | | | |
| Nominal GDP | 3.2 | 4 to 6 | 4½ to 5¾ | 5.4 |
| Real GDP | .2 | 1½ to 2¾ | 1¾ to 2½ | 2.2 |
| Consumer price index² | 2.9 | 2½ to 3½ | 3 to 3½ | 3.1 |
| <i>Average level in the fourth quarter, percent³</i> | | | | |
| Unemployment rate | 6.9 | 6¾ to 7¼ | 6¾ to 7 | 6.8 |

1. Actual for the fourth quarter of the preceding year to the fourth quarter of the year indicated.

2. All urban consumers.

3. Percentage of the civilian labor force.

that likely will continue to buffet our financial system. Looking ahead to future years, the Committee also recognizes that the range for M2 growth may eventually have to be lowered in order to put in place the monetary and credit conditions consistent with price level stability.

The target range for M3 for 1992 remains at 1 to 5 percent. Although credit growth is expected to pick up somewhat in 1992, in line with a firming of economic activity, much of this credit likely will be financed outside the depository system. The thrift industry is expected to contract further as activity by the Resolution Trust Corporation continues apace, and banks, faced with continued—though moderating—pressures on capital positions, will still be somewhat hesitant to expand. At the same time, additional households are likely to refinance adjustable-rate mortgages with fixed-rate obligations that can easily be securitized, and corporations will probably continue to turn to equity markets and long-term bonds rather than bank loans. As a result, depository funding needs are likely to remain damped relative to the pace of economic activity, and the velocity of M3 should consequently rise further.

The monitoring range for the aggregate debt of domestic nonfinancial sectors for 1992 is 4½ to 8½ percent, also unchanged from 1991. Federal government borrowing is expected to remain heavy in 1992, given the large budget deficit. Debt growth of

nonfederal sectors, however, should remain fairly subdued relative to economic activity, as borrowers and lenders alike maintain a cautious approach to leverage, stemming in part from a desire to make further repairs to damaged balance sheets.

Economic Projections for 1992

Although the long-standing structural problems that aborted the fledgling recovery last summer clearly are being addressed, the speed of their resolution—and the associated restraint on economic growth—is quite difficult to gauge, augmenting the usual uncertainties in assessing the economic outlook. On the whole, however, the members of the Board of Governors and the Reserve Bank presidents believe that, with the easing of monetary conditions to date providing considerable impetus to the economy, the most likely outcome is for a moderate reacceleration of activity over 1992. At the same time, they anticipate that the trend toward price stability, which now appears to be rooted more securely, will be sustained through this year.

The forecasts of most of the governors and presidents for growth of real gross domestic product are in a range of 1¾ to 2½ percent measured from the fourth quarter of 1991 to the fourth quarter of 1992. With employers likely to be cautious about hiring until they are fully persuaded of the sustained vitality of the

upturn, gains in employment are expected to come slowly. Thus, only a small improvement in the unemployment rate is anticipated this year, with the central tendency of projections being a range of $6\frac{3}{4}$ to 7 percent for the fourth quarter of 1992. With regard to inflation, the central tendency range for the CPI increase this year is 3 to $3\frac{1}{2}$ percent. These forecasts are, in general, very similar to the projections presented by the Administration in the fiscal year 1993 budget. Indeed, the Administration's forecast for nominal GDP is well within the Committee's central tendency range and thus appears to be quite consistent with the FOMC's monetary ranges.

In their discussion earlier this month of the economic outlook, the Board members and Reserve Bank presidents observed that the effects of recent job losses and weak consumer confidence are likely to restrain activity in the near term. Under the circumstances, the Board members and Bank presidents stressed that economic developments need to be monitored closely to guard against the possibility that the economy might falter. Nonetheless, the monetary stimulus already in train is expected to provide effective support for economic growth this year, and in this regard the early indications of a marked pickup in residential real estate activity and a rise in retail sales are a particularly favorable sign.

It is also expected that the drags on growth from credit supply disruptions and from the restructuring of household and business balance sheets will begin to lessen over the year. As noted above, this is obviously an area of substantial uncertainty. However, as household and corporate debt loads diminish in an environment of stronger economic activity, and as lower interest rates continue to ease financing burdens of borrowers, consumers and businesses should be poised to participate more fully in the economic expansion. Moreover, the problems of credit availability that have plagued the economy over the past couple of years should begin to ease in 1992 as the economic recovery takes hold and lenders become more confident about extending credit.

Nonetheless, the pace of expansion this year is expected to remain weaker than in previous business cycle recoveries. In large part, this expectation reflects some still unresolved economic and financial imbalances in particular segments of the economy. The persistent overhang of space in office and other commercial buildings undoubtedly will inhibit new construction in that sector for some time. In addition, the budgetary constraints that have capped government spending are likely to linger; a good many states and localities are finding that budget gaps are reopening, despite the spending cuts and tax increases they instituted last year. Meanwhile, the external sector is expected to have a relatively neutral net influence on domestic production this year; foreign demand—particularly from Mexico and developing countries in Asia—should continue to boost export growth, but the anticipated pickup in domestic purchases is likely to draw in additional imports as well, limiting the potential for further substantial improvement in the trade balance.

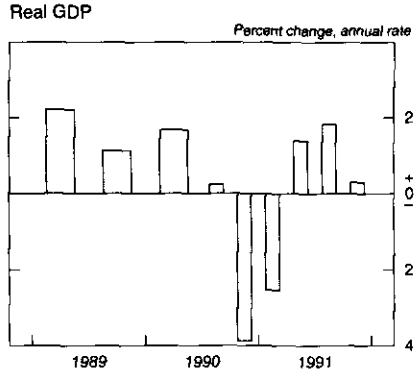
Only a minority of Board members and Reserve Bank presidents foresee a smaller increase this year in the overall CPI than the 3 percent rise experienced in 1991. But the pickup in inflation suggested by the 3 to $3\frac{1}{2}$ percent central-tendency range is deceptive: the underlying trends of price movement are more favorable. The CPI was held down to a substantial degree last year by the unwinding of the energy price shock that followed Iraq's invasion of Kuwait in August 1990, and further sharp declines in energy prices do not appear likely in the current environment. However, an ongoing deceleration in prices is evident for a wide range of other goods and services, and with inflationary tendencies under considerable restraint from several factors—including further moderation in labor cost growth, continued slack in industrial product markets, and small increases in import prices—"core" inflation is expected to move down appreciably in 1992. Indeed, this trend should carry into 1993—a pattern that bodes well for the achievement of a balanced, sustained economic expansion.

Section 2: The Performance of the Economy in 1991

The year 1991 began with the U.S. economy in the midst of recession. Activity had contracted sharply after the jump in oil prices that followed Iraq's invasion of Kuwait in August 1990, and this weakness spilled into the first quarter with further reductions in production and employment. By the spring, however, economic data indicated that the decline in economic activity had bottomed out. The rapid conclusion of the Persian Gulf war boosted consumer confidence, and the reversal of the earlier runup in oil prices and the cumulative effects of declining interest rates were providing support for an increase in household spending. Indeed, construction of single-family homes had already turned up noticeably by April, and consumer spending posted a moderate rise in the second quarter. Although businesses continued to liquidate inventories at a fairly rapid pace, industrial production grew steadily from April through July, and hiring activity increased.

However, the pickup in the economy evident from April to July failed to develop any momentum, as the thrust to domestic demand initiated by the end of the Gulf war dissipated during the summer. The absence of a more robust recovery likely reflected the drag on aggregate demand from some longer-term economic and financial adjustments. For example, imbalances long evident in the commercial and multifamily construction sectors damped enthusiasm for new projects, and ongoing difficulties in the financial sector continued to restrain credit availability; these influences undoubtedly muted the stimulus that normally would have been forthcoming from the decline in interest rates. Fiscal restraint evident at all levels of government weighed on aggregate demand in a way not typically observed in previous economic cycles. Significant restructurings of operations in a number of sectors had the effect of retarding employment and income growth, at least in the short run. And concerns about debt-servicing burdens as well as about economic prospects sustained a reluctance on the part of businesses and consumers to borrow and increase spending.

Despite their cautious planning, some businesses experienced inventory backups in the late summer and fall, necessitating another round of production adjustments. In part, the impact of these adjustments was felt abroad as businesses cut back their imports of foreign goods. However, domestic adjustments were evident as well, and, apart from atypical weather patterns that temporarily increased the demand for electricity, industrial production was flat over the



second half of the year. The sluggish pace of activity in the industrial sector was joined by weakness in other parts of the economy, and overall, the nation's real gross domestic product is estimated to have risen a scant $\frac{1}{4}$ percent at an annual rate in the fourth quarter of last year. In the labor market, layoffs proliferated once again, and the civilian unemployment rate rose to 7.1 percent at the end of 1991.

The deterioration in both industrial activity and nonfarm employment extended into this year, with factory production down sharply in January and private payrolls edging beneath the low of last April. On the other hand, housing market activity appears to have picked up somewhat since the beginning of the year, and nominal retail sales rose about $\frac{1}{2}$ percent in January.

Inflation slowed in 1991, with consumer prices up 3 percent over the year, much less than the 6 percent rise posted during 1990. In part, the slowing in inflation reflected the sharp drop in oil prices early in the year; consumer energy prices in December were $7\frac{1}{2}$ percent below their level at the end of 1990, with the decline concentrated in the first quarter of the year. Food price inflation also moderated considerably, amounting to only 2 percent last year after three years of increases in excess of 5 percent.

Even apart from food and energy, inflation now appears to be on a downward trend. To be sure, there were sizable increases in the CPI excluding food and energy early in the year, as higher federal excise taxes and a passthrough of the sharp rise in energy prices boosted prices for a variety of goods and services.

But, with the subsequent reversal in oil prices and no further major tax hikes, price pressures eased visibly beginning in the spring. On balance, the CPI excluding food and energy rose less than 4 percent at an annual rate in the second half of 1991, well below the 5 percent pace of 1990. Labor cost pressures also diminished last year, although substantial increases in health care expenses remained a problem for employers. As measured by the employment cost index, nominal compensation per hour rose about 4½ percent over 1991, somewhat less than the increases recorded in each of the three previous years.

Household Spending—Consumption and Residential Construction

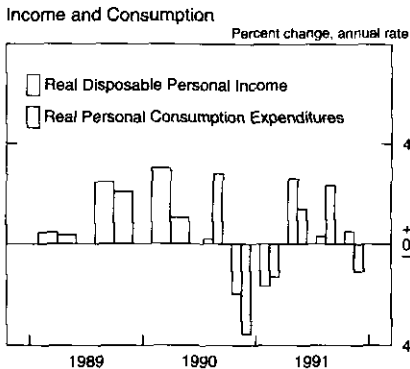
With household finances adversely affected by job losses and declining real incomes, real consumer spending rose just ¼ percent over the year, the same as in 1990. At the beginning of the year, consumer purchasing power already had been sapped by the rise in energy prices and by declines in employment. And, while the retreat in oil prices then in progress and an improvement in consumer confidence following the end of the Gulf war provided a boost to spending in the spring, the failure of the recovery to take hold and concerns about financial prospects and debt burdens restrained spending in the second half of the year. On balance, real consumer outlays edged down between July and December, retracing part of the rise that had occurred during the spring and early summer.

The weakness in consumer spending over the past year was particularly evident for durable goods. A sharp drop in motor vehicle purchases accounted for

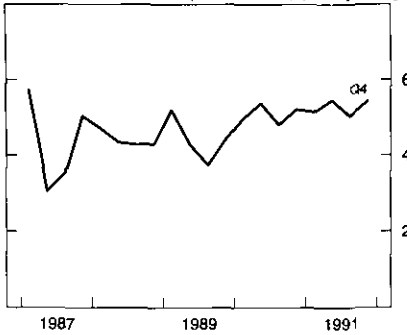
much of the overall decline in spending on durables; indeed, the level of motor vehicle sales in 1991, at 12¼ million units, was the lowest since 1983. Outlays for other durable goods were down slightly over the year, after a 1½ percent decline in 1990. As with total spending, purchases of other durables picked up somewhat in the spring and early summer, but then fell in the fourth quarter as consumers retrenched. Spending on nondurable goods also declined last year, with expenditures down sharply in the fourth quarter, especially for apparel. In contrast, outlays for services continued to trend up at a pace similar to that registered in the two previous years.

The patterns of change among the components of consumer spending—particularly the steep decline in outlays for “big ticket” durable goods—underscore the role of household balance sheet concerns in restraining economic growth last year. Household debt burdens rose substantially during the 1980s, when consumers stepped up spending on motor vehicles and other consumer durables, often financing their purchases with credit. In some parts of the nation, this spending boom spread to residential real estate as well, with the associated borrowing, which was often predicated on expectations of rapidly rising family incomes, adding further to the financing burdens of households. As income growth weakened over the past year and a half, consumers struggled to meet the monthly obligations on their accumulated debt, and apparently deferred some discretionary spending in the process. This financial stress also was evidenced by an increase in delinquency rates on consumer and mortgage loans last year to levels comparable to those experienced in the previous two recessions.

A renewed pessimism on the part of households may also have contributed to the reluctance of consumers to step up spending over the latter part of 1991. As noted previously, consumer confidence, which was quite low at the beginning of the year, rose markedly upon the conclusion of the Gulf war. However, as it became apparent that the anticipated recovery in the economy was not materializing and announcements of layoffs resumed, confidence turned down, dropping especially sharply toward the end of the year. In January 1992, the Survey Research Center’s index of consumer sentiment stood at the levels of last winter, while the Conference Board’s confidence index was below that seen in the 1981–82 recession. Many analysts observed that consumers appeared to be more apprehensive than normally might be expected, given the broad macroeconomic circumstances—for example, the unemployment rate has remained well below that reached in the early



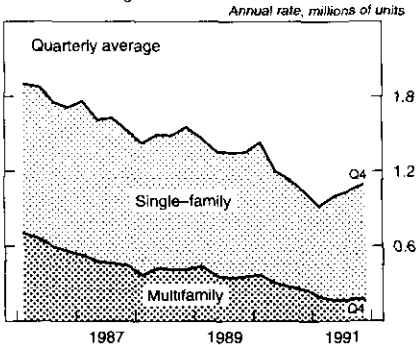
Personal Saving
Percent of disposable income, quarterly average



1980s—suggesting that concerns about longer-run economic prospects may have contributed to the heightened anxiety among households last fall.

After dropping sharply in January, housing starts posted a moderate recovery over the remainder of the year, fueled by a reduction in mortgage rates to their lowest levels since the 1970s. Sales of new and existing single-family homes rose over the year, with the pickup in demand reportedly especially pronounced from first-time buyers. Reflecting the strengthening in demand, the excess supply of unsold new homes diminished, and the pace of single-family housing starts moved above 900,000 units at an annual rate by the fourth quarter, an increase of more than 16 percent from a year earlier. Nevertheless, production was well

Private Housing Starts
Annual rate, millions of units



below that of earlier years, and, despite the upturn in activity, the single-family housing market remains softer than would be expected given recent mortgage rates and the rising number of households in prime homebuying ages. Continued lender caution about granting *land-acquisition and construction loans* reportedly has damped production in some locales. However, given the absence of significant price pressures in the housing market, restraint on the demand for single-family homes, stemming from weak income growth, concerns about employment prospects, and poor conditions for home selling, likely has been a more prominent influence on homebuilding than supply constraints.

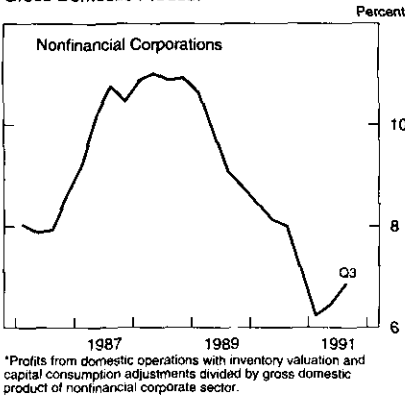
In the multifamily housing market, an excess supply of vacant units and restraints on credit availability continued to depress construction last year. Starts of multifamily units fell about 30 percent over the twelve months of 1991, and the number of starts during the year was the lowest since the 1950s. There have been numerous reports of restrictive lending practices damping activity in this sector. But vacancy rates for rental units remain exceptionally high—and rents soft—suggesting that in many areas new projects might well be of questionable economic viability. Until market supplies begin to tighten discernibly, activity in this segment of the market is unlikely to show appreciable improvement.

Business Spending—Investment in Inventories and Fixed Capital

In early 1991, the investment climate was dominated by the effects of the decline in the demand for business output and the jump in energy prices during the second half of 1990. With profit margins down sharply and inventory imbalances emerging in a number of sectors, businesses reduced production and employment substantially between October 1990 and March 1991. Cutbacks were especially sharp in the motor vehicle sector over that period, although output of most other types of goods and materials turned down as well.

By the spring, inventories generally were better aligned with sales, and operating profits, while still low, had turned up. As a result, the improvement in aggregate demand in the second quarter was accompanied by an increase in business output, and industrial production rose an average 0.7 percent per month from April to July. Despite the firming in sales, businesses remained cautious, and inventory levels continued to decline through midyear.

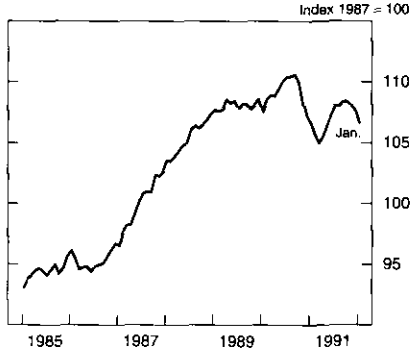
Before-tax Profit Share of Gross Domestic Product*



In late summer, however, final demand slackened, and after seven months of decline, business inventories accumulated at a substantial rate from September through December. The rise in inventories was centered in wholesale and retail trade, and inventory-sales ratios there moved into ranges that appeared undesirably high in light of carrying costs and expected sales. A portion of the accumulation appeared to consist of goods ordered from abroad; indeed, a partial reaction to the overhang may have been visible in the sharp drop in nonoil imports in November. Nonetheless, retailers evidently also reduced orders

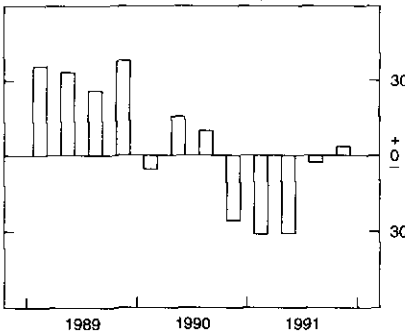
from domestic suppliers, contributing to the sluggish pattern of manufacturing output in the fourth quarter. By January of this year, factory production had dropped back to its level of a year earlier, and the operating rate in industry was back down to levels that, prior to last winter, had not been seen since the brief industrial slump of 1986.

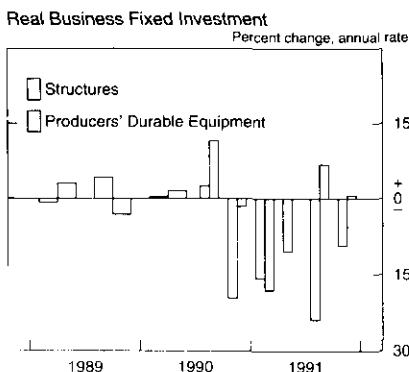
Industrial Production



Business investment in fixed capital fell 7 percent in real terms over the four quarters of 1991. As is typical during recessions, spending was inhibited by weak profits, a rise in excess capacity, and uncertainty regarding the outlook for sales. However, investment outlays last year also were depressed by a desire on the part of many businesses to reduce debt burdens and by a continued oversupply of office and other commercial space. Even adjusting for cyclical considerations, last year's weak pace of investment appeared to extend the relatively slow rate of capital formation evident for some time. The capital stock in the nonresidential business sector, net of depreciation, has risen about 2¼ percent at an annual rate over the past decade—down from 3¼ percent annually during the previous decade. In part, this pattern has owed to a shift toward shorter-lived assets—such as computers—that depreciate more quickly. However, such outlays, by generating a relatively high flow of capital services per dollar of investment, have cushioned the impact on productivity of the slowing pace of capital formation. Even so, the quantity of investment, which has also been depressed by large federal budget deficits and the resulting low level of national saving, has

Changes in Real Nonfarm Business Inventories
Annual rate, billions of 1987 dollars





been inimical to productivity growth and thus to the advance of living standards.

Real spending for equipment fell 3/4 percent over 1991, as outlays plunged in the first quarter and showed only limited improvement on net over the remainder of the year. The strongest area in investment spending was computers, for which real outlays increased more than 40 percent at an annual rate over the second half of the year; these gains were driven by new product introductions and by the substantial price cuts offered by computer manufacturers. In contrast, *business investment in other types of equipment generally declined, on balance, over the year.* Outlays for industrial equipment continued to deteriorate as excess capacity limited expansion in the manufacturing sector, and business purchases of motor vehicles dropped off sharply. In addition, domestic orders for commercial aircraft plunged after midyear, as a number of domestic airlines trimmed investment plans. Although the large backlog of unfilled orders that still remains should sustain production and shipments for some time, the slackening in demand indicated by the sharp downturn in aircraft orders suggests that the growth surge in this sector may have run its course.

Nonresidential construction plummeted 15 percent in real terms over the four quarters of 1991. The *contraction was broadly based, but especially large declines in outlays were evident for office buildings and other commercial structures.* Despite the sharp cutbacks in construction in recent years, prices of existing commercial properties have continued to fall, contributing to the substantial stress evident in the financial sector. Of course, the fundamental problem is the space overhang from the earlier overbuilding; indeed, the vacancy rate for office buildings nationwide was still close to 20 percent at the end of the

year. However, a lack of liquidity in this market—in particular, the reluctance of lenders to finance acquisitions of commercial properties—has made the adjustment still more difficult. Such problems are especially acute in the market for office buildings, where appraised values have declined nearly 30 percent since 1985 and where lenders and developers generally have shown little interest in new projects. For other commercial structures—primarily shopping centers and warehouses—the outlook is slightly less downbeat, with the data on new contracts and building permits suggesting that the steepest declines may have already occurred. Spending for industrial structures also generally declined over the year, as low rates of *capacity utilization curtailed plans for new factory construction.* Petroleum drilling activity, meanwhile, dropped sharply in response to the decline in oil prices.

Federal banking regulators have taken a number of steps to ensure that supervisory pressures do not unduly restrict real estate lending. The agencies have, for example, addressed issues relating to accounting and appraisal, to make sure that illiquid real estate exposures are evaluated sensibly and consistently. And, they have issued guidance to examiners and simultaneously to bankers—emphasizing that banks should not be criticized for renewing loans to credit-worthy borrowers whose real estate collateral has fallen in value—even when the banks need to build up capital or reduce loan concentrations over time. However, with so adverse a supply-demand imbalance in the property market, lenders understandably have remained reluctant to bear the risks of real estate exposures.

The Government Sector

Budgetary pressures were widespread in the government sector in 1991. At the federal level, the unified budget deficit increased to \$269 billion in fiscal year 1991, up \$48 billion from the 1990 deficit. In large part, the rise in the deficit was attributable to the slowdown in economic activity, which reduced *tax receipts and increased outlays for income-support programs* such as unemployment insurance and food stamps. However, as in 1990, the fiscal 1991 deficit also was affected by special factors: a pickup in net outlays for deposit insurance added to the deficit, while one-time contributions from our allies to defray the costs of Operations Desert Shield and Desert Storm reduced it. Excluding deposit insurance and these foreign contributions, the 1991 deficit totaled \$246 billion.

On the revenue side, federal tax receipts rose just 2 percent in fiscal 1991, the smallest increase in many years. The slowing in receipts largely stemmed from weak nominal income growth; indeed, personal income tax payments in 1991, which accounted for nearly half of total receipts, were about the same as in 1990 despite changes in tax provisions that were projected to raise \$16 billion in new revenues.

Meanwhile, spending rose nearly 6 percent in fiscal 1991. Part of the \$71 billion increase in nominal federal outlays reflected the slightly more rapid pace at which the Resolution Trust Corporation resolved insolvent thrift institutions last year. In contrast, outlays were reduced by allied contributions to the Defense Cooperation Account. These contributions, which are scored as negative outlays in the budget accounts, exceeded the outlays made in 1991 for U.S. involvement in the conflict; the excess will be put toward the replacement of munitions in 1992 and beyond. Excluding deposit insurance and contributions of allies, outlays rose about 9 percent in fiscal 1991. Spending for health programs continued to rise rapidly, elevated by large increases in health care costs and in outlays for the Medicaid program. Among other entitlement programs, outlays for social security and other income-support programs, which together account for one-third of total federal spending, rose more than 11 percent in fiscal 1991, reflecting substantial increases in the number of beneficiaries. In contrast, declining interest rates reduced the growth of interest payments on the federal debt. Defense outlays—excluding foreign contributions—were up 5½ percent between fiscal years 1990 and 1991, as the additional U.S. outlays for the Persian Gulf conflict were only partially offset by the spending cuts enacted in the 1990 budget agreement and in previous years.

Federal purchases of goods and services, the portion of federal spending that is included directly in GDP, fell 3¼ percent in real terms over the four quarters of 1991. Defense purchases jumped sharply early in the year to support operations in the Persian Gulf, but declined substantially over the remainder of the year as the effects of scheduled cuts in defense outlays were augmented by a dropoff in purchases for Desert Storm; on net, defense purchases were down about 4½ percent last year. In contrast, nondefense purchases were up slightly in 1991; increases in law enforcement, space exploration, and health research offset a drawdown in inventories held by the Commodity Credit Corporation.

The fiscal position of state and local governments, which had deteriorated sharply in 1990, remained

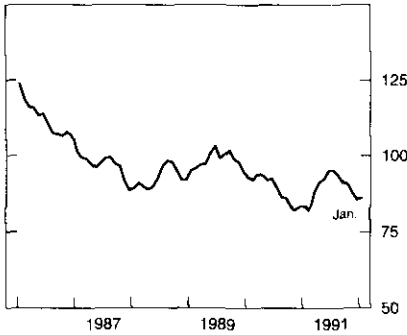
poor in 1991. The deficit in the combined operating and capital accounts (excluding social insurance funds) narrowed to \$34 billion in the third quarter from a high of nearly \$47 billion in the fourth quarter of 1990; the shrinkage of this deficit represents the first major improvement since 1984, when the state and local budget surplus peaked. Even so, relative to GDP, the deficit still is quite high on a historical basis. The credit quality of state and local government debt also continued to deteriorate last year, as illustrated by the downgrading of the general obligation debt of eight states by one rating agency; most of the rating changes were the direct result of budgetary imbalances.

The poor fiscal position of state and local budgets led to both severe restraints on spending and sizable tax hikes. Overall, real purchases of goods and services edged down over the four quarters of 1991. In nominal terms, total expenditures by these governments were up 4 percent last year, less than one-half the average pace of recent years. Receipts rose an estimated 7 percent over 1991, as numerous jurisdictions imposed a variety of new tax measures and federal aid to state and local governments—especially for Medicaid—increased substantially. Nonetheless, many state and local governments continue to report revenue shortfalls and spending overruns for the current fiscal year, setting the stage for another round of budget-balancing measures ahead.

The External Sector

Measured in terms of the other Group of Ten (G-10) currencies, the trade-weighted foreign exchange value of the U.S. dollar appreciated 14 percent, on balance, from December 1990 to July 1991, reversing more than one-half of the decline that had occurred from the middle of 1989 to the end of 1990. In large part, the rise in the dollar over this period reflected the quick end to the Gulf war and expectations of a recovery in the U.S. economy, as well as developments in Eastern Europe that initially weighed on the German mark. However, as the U.S. economic recovery faltered in late summer and market participants viewed further easing actions by the Federal Reserve as more likely, the dollar again turned down, averaging in December 1991 only about 3 percent above its level in December 1990. The dollar rebounded somewhat in January on market perceptions of a diminished likelihood of an additional easing in U.S. interest rates and expectations that German authorities would not push their interest rates up further.

Foreign Exchange Value of the U.S. Dollar *



*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.

On a bilateral basis, the dollar rose 19 percent against the mark between December 1990 and July 1991, amid disappointment about the effect of German unification on German inflation and trade. During the second half of last year, German monetary policy tightened, and the dollar gave up much of its previous gains, finishing the year just 4 percent above its December 1990 level. Other currencies in the European Monetary System generally moved with the mark during 1991, although sterling slipped somewhat near year-end. The dollar declined about 4 percent on net against the yen in 1991, as increasing Japanese trade surpluses led to the view that an appreciation of the yen would be welcomed by the authorities.

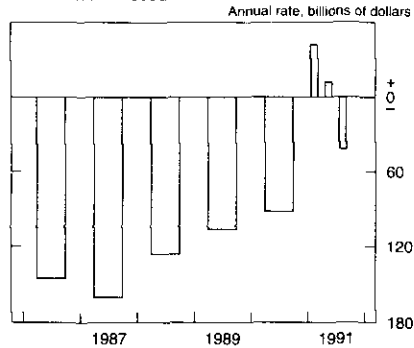
The merchandise trade deficit narrowed to less than \$75 billion in 1991, compared with \$108 billion in 1990; the trade deficit last year was the smallest since 1983. An especially large decline in the deficit was registered early in the year, as the drop in oil prices sharply reduced the value of imports. In addition, trade flows during the first half of 1991 were influenced by the weakening of U.S. activity (which reduced demand for imports), by continued growth abroad (which boosted exports), and by the lagged effects of the decline in dollar exchange rates that had taken place in 1990. However, imports rose sharply in the third quarter, and the trade deficit widened somewhat in the second half of the year. The current account balance recorded a small surplus, on average, during the first three quarters of 1991, a sharp improvement from the \$92 billion deficit in 1990. How-

ever, about half of that improvement resulted from cash grants from foreign governments to support operations in the Persian Gulf; excluding these transfers, the current account showed an average deficit of \$48 billion at an annual rate over the first three quarters of 1991. The improvement in the current account (excluding transfers) was somewhat greater than that in the trade balance owing to a strengthening of net service receipts in areas such as travel, education, and professional services.

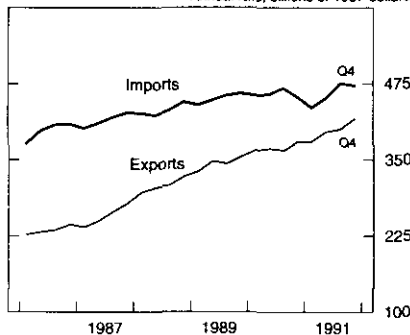
U.S. merchandise exports grew about 10 percent in real terms over the four quarters of 1991, tempering the production declines associated with the weakness in domestic demand. Exports rose fairly strongly in the second quarter, as high levels of investment in countries such as Germany and Japan boosted exports of computers and other capital equipment. Economic activity in the major foreign industrial countries weakened as the year wore on, however, and with a deterioration in the competitive position of U.S. companies following the appreciation in the dollar over the first half of the year, export growth slowed markedly in the third quarter. Exports surged again in the fourth quarter, led by sales of computers, aircraft, and other capital goods. However, some of the recent increase appears to represent a bunching of sales rather than an increase in economic activity abroad.

Merchandise imports excluding oil grew about 4 percent in real terms during 1991. Imports declined early in the year as weak domestic spending reduced the demand for foreign goods. As domestic demand in the United States turned up in the spring, imports rose—especially for automotive products, computers, and consumer goods—and remained strong through

U.S. Current Account



U.S. Real Merchandise Trade
Annual rate, billions of 1987 dollars



the summer. With the subsequent weakening in demand, however, some of the additional import volume apparently ended up on retailers' shelves. In response, U.S. businesses reduced orders from abroad, and import growth slowed sharply over the fourth quarter. The quantity of oil imports, which had plunged after the sharp rise in oil prices in the fall of 1990, generally moved up through the third quarter as refiners moved to rebuild inventories. However, oil import volumes turned down again in the fourth quarter, reflecting sluggish U.S. activity and unseasonably warm weather.

The sharp reduction in the recorded U.S. current account deficit in the first three quarters of 1991 was mirrored by changes in recorded capital inflows and the statistical discrepancy. The statistical discrepancy in the international accounts, which had jumped to \$64 billion in 1990, declined to virtually zero in the first three quarters of 1991.

Inflows of official capital were about matched by outflows of private capital in the first three quarters of 1991. Net official inflows amounted to \$16 billion despite net intervention sales of dollars in foreign exchange markets by the G-10 countries and a draw-down of reserves held in the United States by countries helping to cover the costs of Desert Storm; some countries also financed their contributions by borrowing and liquidating investments in the Euromarkets. Net private capital outflows were \$18 billion in the first three quarters, largely accounted for by banks. In part, these outflows reflected the increased net demand for funds in the Euromarkets associated with Desert Storm transfers. In addition, the elimination by the Federal Reserve of certain reserve requirements in

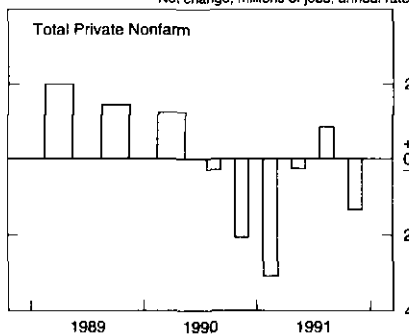
December 1990 led some U.S. agencies and branches of foreign banks to increase their issuance of large time deposits in the United States and to reduce their reliance on borrowing from abroad.

Securities transactions in the first three quarters of 1991 reflected the continued internationalization of financial markets. Although the net inflow was modest, private foreigners added substantially to their holdings of U.S. stocks and bonds, while U.S. residents bought a large volume of foreign stocks and bonds. Reflecting interest rate developments that encouraged shifting from short- to long-term financing, issues of foreign bonds in the United States and issues of Eurobonds by U.S. corporations were both strong. Capital outflows associated with U.S. direct investment abroad also were sizable, as U.S. investors positioned themselves to take advantage of EC 1992 and participated in the privatization of previously state-owned enterprises in countries such as Mexico. In contrast, foreign direct investment in the United States was far below recent peaks; foreign takeovers of U.S. businesses declined and reinvested earnings were depressed by the recession.

Labor Markets

Labor market conditions generally deteriorated in 1991, and the unemployment rate rose above 7 percent by the end of the year, the highest level since 1986. Employers had moved quickly to shed workers when the recession took hold during the second half of 1990, and this pattern continued into 1991, with nonfarm payroll employment down sharply over the first four months of the year. Economic conditions improved in the spring, and labor demand turned up

Payroll Employment
Net change, millions of jobs, annual rate



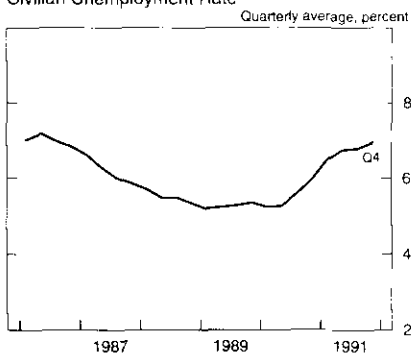
for a time. But the subsequent weakening in activity in the late summer led to a renewed bout of layoffs that has continued into early 1992, retracing the job gains recorded during the spring and summer.

The net job losses last year were widespread by industry and reflected both the cyclical weakness in labor demand associated with the recession and more fundamental efforts by many businesses to restructure operations and permanently reduce the size of their work force. Employment in manufacturing, which began its decline in 1989, fell more than 400,000 over 1991 with most of the losses in the durable goods sector. The continued contraction in commercial building depressed construction employment despite the moderate recovery in residential housing demand. Efforts to restructure existing operations and to downsize workforce levels were evident in the finance, insurance, and real estate sector as well, where job losses last year stood in contrast to the past pattern of continued hiring during recessions. Employment in trade establishments also fell substantially over the year, pushed down by the decline in consumer spending and the high degree of financial distress among retailers. In contrast, employment in services continued to trend up over the latter part of the year, as steady gains in health services more than offset sluggish hiring in the more cyclically sensitive business and personal service industries.

Reflecting the substantial declines in output and employment over the past year and a half, the unemployment rate rose more than 1½ percentage points between July 1990 and December 1991. Moreover, the distribution of job losses was especially wide as compared with previous episodes of rising unemployment. Increases in unemployment were broadly based across regions, industries, and occupations, and an unusually large proportion appeared to constitute permanent layoffs.

Nonetheless, the rise in the jobless rate has been less than in prior episodes of increasing unemployment. This is, in part, because labor force growth has been unusually slow over the past two years. In particular, the labor force participation rate, which stood at about 66 percent at the beginning of this year, is ½ percentage point below its average during the first half of 1990. This decline in participation appears to contain some elements of a cyclical pattern: the number of discouraged workers rose over the year, and sizable increases were reported in the number of retirees, perhaps reflecting to some extent a spate of early retirement programs. However, the weak labor force growth of recent years may also represent a downshift in the trend rate of increase in labor supply

Civilian Unemployment Rate

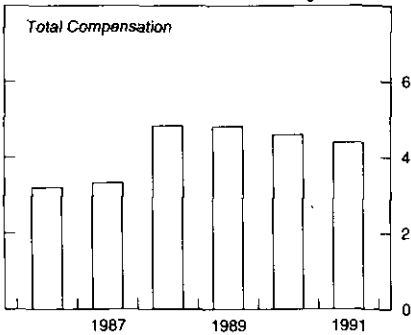


that—if not offset by productivity gains—could translate into a reduction in the rate of trend potential output growth. In this regard, the composition of the corresponding increase in nonparticipants is, in part, a favorable long-term development. There has been a sharp rise in recent years in the number of individuals who have left the labor force in order to attend school. Although that increase may, to some degree, reflect declining opportunity costs associated with the poor job prospects of last year, recognition of the longer-term decline in relative wages among lower-skilled workers may also have played a role. As these individuals reenter the labor force upon completion of their schooling, their increased skills should boost labor productivity and potential output in future years.

Efforts to increase labor productivity have also intensified in the business community. If the aforementioned plans to reorganize corporate structures and to downsize the labor force requirements of existing operations are successful, the possible outcome is a significant improvement in the productivity trend, much as occurred in the manufacturing sector after the considerable compression of manufacturing organizations in the early 1980s. The performance of productivity, which rose about 1 percent in the nonfarm business sector in 1991, has been somewhat better than is typical in a weak economy. However, last year's advance came after a decline in 1989 and no change in 1990, and it is difficult at this stage to distinguish more fundamental changes in productivity trends from the apparent cyclical tendency last year for employers to reduce labor inputs aggressively in response to deteriorating sales.

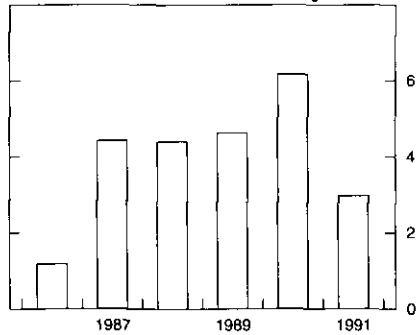
With widespread layoffs and the unemployment rate rising throughout the year, the upward pressures

Employment Cost Index* Percent change, Dec. to Dec.



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

Consumer Prices* Percent change, Dec. to Dec.



*Consumer price index for all urban consumers.

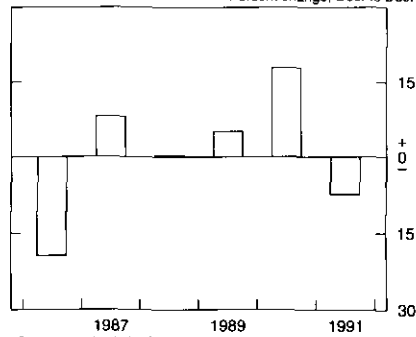
on wages that had intensified between 1987 and mid-1990 diminished somewhat over 1991. As measured by the employment cost index, increases in hourly compensation for private nonfarm workers rose 4½ percent over the four quarters of 1991, down from more than 5 percent in the first half of 1990. The wage and salary component of hourly compensation, which rose 3 percent at an annual rate over the second half of last year, exhibited the most deceleration. Although employer costs for benefits have also decelerated from their mid-1990 peak, increases in benefit costs—at 6¼ percent in 1991—remained well above those for wages alone. Expenses for health insurance have continued to spiral despite considerable efforts on the part of employers to control costs by negotiating directly with providers and by increasing workers' share of health expenditures. Employer premiums for workers' compensation insurance also rose sharply last year, reflecting both a swelling in the number of claims and the rapid pace of medical care inflation.

Price Developments

Evidence mounted over this past year that a significant slowing of inflation is under way. The consumer price index rose 3 percent over the year, about half the rate of increase in 1990. A sharp swing in energy prices accounted for a major part of this deceleration. However, the elements of a more fundamental diminution of inflation were in place: labor cost increases moderated; expectations of inflation eased; and upward pressures from import prices and industrial raw material prices were virtually absent during the year.

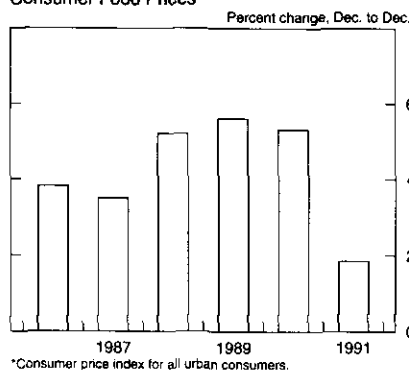
Energy prices dropped sharply in 1991, mirroring the changes in oil prices over the year. The CPI for energy fell 30 percent at an annual rate in the first quarter of last year, as the sequence of events in the Middle East reduced the posted price of West Texas Intermediate crude oil from a peak of about \$39 per barrel in October of 1990 to less than \$20 by February of last year. Oil prices subsequently held near that level, but gasoline prices firmed somewhat during the summer as reduced imports and domestic refinery problems led to some tightness in inventories. However, these forces were offset by declines in natural gas and electricity rates, and energy prices changed little, on balance, in the second and third quarters.

Consumer Energy Prices* Percent change, Dec. to Dec.

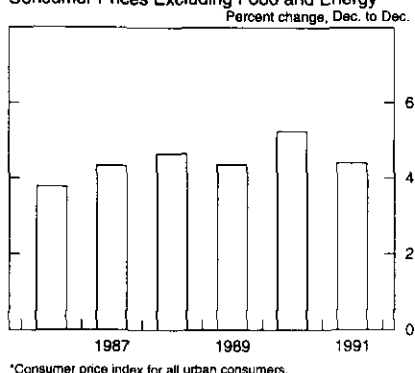


*Consumer price index for all urban consumers.

Consumer Food Prices*



Consumer Prices Excluding Food and Energy*



Price pressures again emerged in the fall as crude oil prices trended up in September and October on concerns about supplies from the Soviet Union. Since October, however, oil prices have retreated again, with the most recent quotes at about \$18 per barrel. These latest reductions probably will show up at the retail level in the first quarter of 1992; indeed, the energy component of the producer price index fell nearly 3 percent in January, and other preliminary information points to sizable declines in both retail gasoline and heating oil prices.

The CPI for food rose just 2 percent over 1991, well below the increases of 5 to 5½ percent observed in the three previous years. In part, the subdued pace of food price inflation reflects an increased supply of livestock products. Beef production turned up last year in response to the strong prices that prevailed in the preceding few years, and supplies of pork and poultry rose sharply; in response, meat and poultry prices fell about 2 percent over the year. The deceleration in food prices also extended to food groups where prices are influenced more by the cost of non-farm inputs than by supply conditions in agriculture; for example, the increase in the price of food away from home last year was the smallest since 1964. Elsewhere, there were large monthly variations in prices for fruits and vegetables, as adverse weather conditions temporarily boosted prices in the first half of the year and prices for some fresh vegetables jumped toward the end of the year because of the whitefly infestation in California.

The consumer price index for items other than food and energy rose 4½ percent in 1991, about ¾ percentage point less than in 1990. The index was boosted

early in the year by increases in federal excise taxes on cigarettes and alcoholic beverages and by an increase in postal rates. Price increases last winter also were enlarged by the passthrough of the rise in energy prices into a wide range of nonenergy goods and services. However, the subsequent decline in energy prices soon spread to the nonenergy sector, and except for an uptick during the summer associated with some bunching of price increases, this measure of core inflation moderated significantly over the remainder of the year.

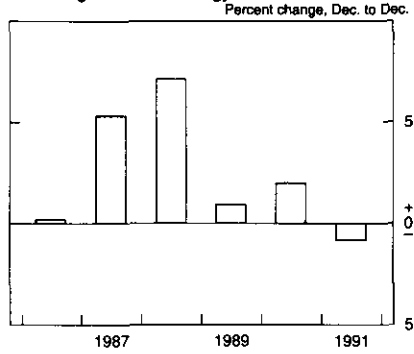
Prices for nonenergy services decelerated considerably last year, rising 4½ percent after an increase of 6 percent in 1990. Reflecting weak real estate markets, rent increases slowed sharply, with both tenants' rent and owners' equivalent rent up less than 4 percent last year. The drop in interest rates pushed down auto financing costs more than 7 percent. And, after a brief spurt early in the year, airfares receded as energy costs fell and the weak economy cut into demand; more recently, however, airfares have turned up again as carriers have reduced the availability of and increased restrictions on low-end "super-saver" fares. In contrast, prices for medical care services rose 8 percent over the year, while tuition costs and other school fees were up nearly 10 percent.

The CPI for commodities excluding food and energy rose 4 percent in 1991, about ½ percentage point faster than in 1990. In large part, the more rapid rate of inflation in goods prices reflected the aforementioned hike in excise taxes and, despite weak sales, larger increases in prices for both new and used cars. However, a slowing in price increases was evident for

a number of other goods, notably apparel, household paper products, and personal care items.

The easing of inflationary pressures has been even more evident at earlier stages of processing. The producer price index for finished goods edged down over 1991 after an average 5 percent annual rate of increase over the three preceding years; this index posted another small decline in January of this year. Falling prices for energy and consumer foods accounted for much of the overall deceleration last year. But even apart from food and energy, producer prices slowed to a 3 percent pace. Prices for intermediate materials excluding food and energy declined $\frac{3}{4}$ percent over the year, reflecting declining fuel and petroleum feedstock costs, an easing of wage pressures, and weak demand. The downturn in economic activity also depressed industrial commodity markets last year. After dropping sharply in the fourth quarter of 1990, spot prices for these commodities continued to decline gradually over most of 1991.

Producer Prices for Intermediate Materials
Excluding Food and Energy



Section 3: Monetary and Financial Developments in 1991

The principal objective of monetary policy this past year has been to help lay the groundwork for a sustainable expansion, without sacrificing the progress against inflation that had already been set in motion. The Federal Reserve progressively eased money market conditions in 1991 amid signs of continued sluggish economic activity, weak growth in the broader monetary and credit aggregates, and diminishing inflationary pressures. A more generous provision of reserves through open market operations, coupled with five separate reductions in the discount rate—which now stands at its lowest level in nearly 30 years—brought the federal funds rate and most other short-term interest rates down about 3 percentage points over the course of the year. These actions, building on earlier easing efforts, pushed the federal funds rate down to 4 percent, its lowest sustained level since the 1960s and nearly 6 percentage points below its most recent peak in the spring of 1989.

The faltering of the economic recovery in the second half of 1991 owed in part to an unusually cautious approach to credit on the part of both borrowers and lenders. Efforts by debt-burdened households and businesses to pare debt in order to strengthen balance sheets that had been strained by the general slowdown in income and by declines in property values exerted further *damping effects on credit demands and on aggregate spending*. Faced with deteriorating asset values and pressures on capital positions, depositories and other lenders maintained tighter lending standards and were somewhat hesitant to extend credit. The

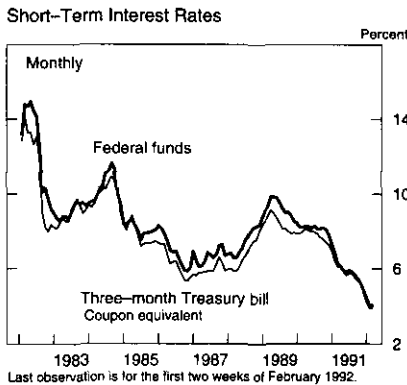
more circumspect attitude towards credit and spending on the part of borrowers and financial intermediaries was manifest in the behavior of the aggregate debt of domestic nonfinancial sectors, which grew near the bottom of the Federal Open Market Committee's monitoring range despite burgeoning U.S. Treasury borrowing. Not only was overall credit growth subdued, but credit flows continued to be rechanneled away from depositories, reflecting the more restrictive lending standards at banks and thrifts as well as efforts by borrowers to make greater use of longer-term debt and equity in order to strengthen their balance sheets. Partly as a result, the monetary aggregates M2 and M3 also finished the year near the bottoms of their target ranges.

To prevent these forces from stifling the recovery, the Federal Reserve eased money market conditions aggressively in the latter part of the year. In light of weak aggregate demand and reduced inflationary potential, long-term interest rates—which had largely failed to respond to monetary easings earlier in the year—came down substantially towards the end of 1991. This decline prompted a flood of mortgage refinancings and additional corporate and municipal bond offerings, which helped reduce the financing burdens of nonfederal sectors. Lower interest rates also contributed to a major stock market rally, which induced firms to boost equity issuance and pay down debt, partially reversing the trend of the 1980s towards increased leverage that had severely stretched corporate balance sheets.

On the whole, the nation made considerable progress in strengthening its balance sheet in 1991. Less reliance on debt, greater use of equity, and lower financing costs have helped ease debt-servicing burdens for many financially troubled households and corporations. Although, to date, the trend towards deleveraging has exerted a restraining effect on aggregate spending, over time, this trend should help put consumers, firms, and financial intermediaries on a sounder financial footing, paving the way for healthy, sustainable economic growth.

The Implementation of Monetary Policy

The Federal Reserve eased money market conditions several times in the first few months of 1991, extending the series of easing moves initiated in the latter stages of 1990. Against a backdrop of further declines in economic activity, abating price pressures, weakness in the monetary aggregates early in the



year, and continuing credit restraint by banks and other financial intermediaries, a more expansive open market posture was adopted, in conjunction with two one-half percentage point reductions in the discount rate, to engender a 125 basis point decline in the federal funds rate over the first four months of the year. Short-term Treasury rates generally followed suit, and banks reduced the prime rate in three 50 basis point increments to 8½ percent.

Long-term interest rates, by contrast, were roughly unchanged on balance over the first few months of the year. At first, these rates fell somewhat in response to the continued downturn in economic activity and declining energy prices, especially in light of initial successes in the Gulf war that ensured an unimpeded flow of oil. Success in the initial phases of the war also prompted a brief dip in the exchange value of the dollar, as safe-haven demands that had been propping up the dollar's value in the face of falling interest rates in the United States dissipated.

In March, bond yields drifted up on the post-war rebound in consumer confidence and other evidence, particularly from the housing industry, that an economic upturn was at hand. The improving outlook for recovery also contributed to narrowing risk premiums on private securities, especially on below-investment-grade issues, which had reached very high levels in January. The debt and equity instruments of banks performed especially well over this period, responding to lower short-term interest rates and the likelihood that an economic rebound would help limit the deterioration in their loan portfolios. Moderate official support for the dollar, better prospects for a U.S. economic recovery, and a rise in U.S. long-term inter-

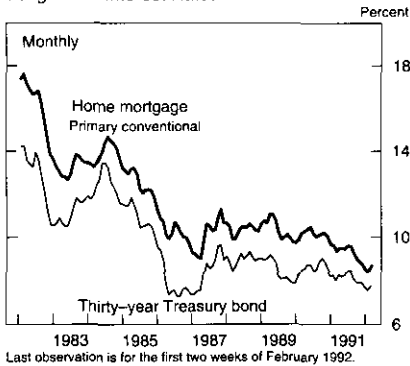
est rates relative to those abroad, together with an uncertain economic and political situation overseas, especially in the Soviet Union, helped to reverse the dollar's slide on foreign exchange markets.

As evidence of a nascent economic recovery cumulated through the remainder of the spring and into early summer, interest rates and the dollar continued to firm, and quality spreads narrowed further. Although the increases in rates during this period were most pronounced at the long end of the maturity spectrum, short-term rates backed up a bit as well as prospects for additional monetary easings faded. Indeed, with the pace of economic activity apparently quickening, and with the broader monetary aggregates near the middles of their target ranges, the Federal Reserve held money market conditions steady, as the stimulus already in train seemed sufficient to support an upturn in aggregate spending.

As the summer passed, however, the strength and durability of the recovery appeared less assured. Aggregate spending, production, and employment began to falter, easing wage and price pressures. In addition, the broader monetary aggregates suddenly weakened dramatically, with M2 coming to a virtual standstill and M3 actually declining in the third quarter. The softness in the aggregates was symptomatic of a warier approach to spending and borrowing on the part of households and corporations, whose balance sheet problems were exacerbated by the stagnant economy. In addition, credit standards at financial intermediaries remained restrictive, and spreads between loan and deposit rates remained high by historical standards, reinforcing households' inclinations to pay down debt rather than to accumulate assets.

To help ensure that these forces did not imperil the recovery, the Federal Reserve moved to ease money market conditions further during the latter part of the year. Pressures on reserve positions were reduced slightly in August and again in September, with the latter move accompanied by a 50 basis point reduction in the discount rate. With the economic climate remaining stagnant, price pressures subdued, and the broader monetary aggregates still mired near the bottoms of their target ranges, the System's easing moves became more aggressive in the fourth quarter, culminating in a full one-percentage-point reduction in the discount rate on December 20. All told, these moves combined to drive the federal funds rate down from 5¾ percent in July to 4 percent by year-end. Most other short-term interest rates declined by similar magnitudes and the prime rate was reduced by 2 percentage points, to 6½ percent.

Long-Term Interest Rates



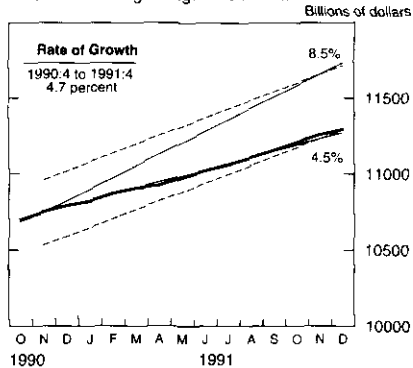
The decline in short-term interest rates, in combination with flagging economic activity, depressed credit demands, and prospects for lower inflation, contributed to bringing long-term interest rates down significantly in the latter part of 1991. The thirty-year Treasury bond rate dropped about a percentage point over the second half of the year, and mortgage interest rates tumbled to their lowest levels in many years. Declining interest rates prompted a spate of mortgage refinancings, corporate and municipal bond offerings, and a major stock market rally, which propelled most indexes to record highs. Although monetary growth bounced back a bit in the fourth quarter, both M2 and M3 remained near the lower ends of their respective growth cones. The dollar, which had begun to lose ground in foreign exchange markets in the summer—when the weakness in money and credit raised the specter of additional easings of U.S. monetary policy—depreciated further in the fourth quarter as the economic situation deteriorated and the pace of policy easings quickened. Rising interest rates in Germany also put downward pressure on the foreign exchange value of the dollar. In January 1992, the dollar rebounded somewhat, reflecting an emerging view that interest rate declines in the United States and interest rate increases in Germany, might have come to an end. The former view was also reflected in the U.S. bond market, where rates retraced a portion of their earlier declines, partly on brightening prospects for the U.S. economy but also on concerns that impending fiscal stimulus may increase federal government demands on credit markets.

Monetary and Credit Flows

Patterns of credit usage and financial intermediation, which began to shift even before the onset of the economic downturn, continued to evolve in 1991, distorting traditional relationships between overall economic activity and the monetary and credit aggregates.

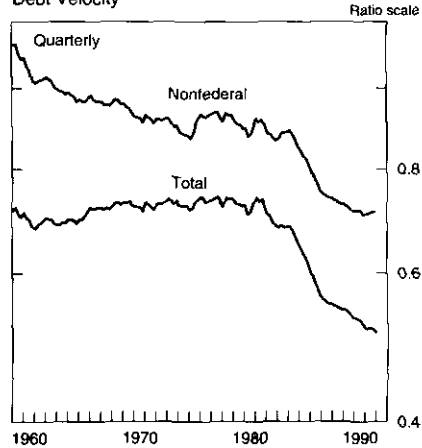
These changes were evident in the behavior of the aggregate debt of nonfinancial sectors, which expanded 4¾ percent in 1991, leaving this aggregate near the bottom of its monitoring range. Robust growth in federal government debt, owing to the economic downturn and to additional outlays for federal deposit insurance, masked an even weaker picture for nonfederal debt. Households, nonfinancial corporations, and state and local governments accumulated debt at an anemic 2¾ percent rate in 1991, the slowest advance in decades and below even the sluggish growth rate of nominal GDP.

Debt: Monitoring Range and Actual Growth



The small rise in nonfederal debt velocity last year runs counter to the pattern seen in the 1980s, when the accumulation of debt vastly outstripped growth in nominal GDP. The rapid buildup of debt in the 1980s was likely a result of the deregulation of interest rates and financial innovations, which combined to lower the cost of borrowing to households and businesses, spawning a surge in leveraging activity. Greater debt burdens may also have been accumulated under the assumption that nominal income growth would be sustained at the elevated pace of the mid-1980s and

Debt Velocity



that the prices of assets purchased with credit would continue to climb.

In recent years, however, asset values and income growth have fallen short of these expectations. In particular, depressed commercial and residential real estate values, coupled with slower income growth,

have eroded the net worth of some borrowers and severely strained the ability of highly-leveraged households and corporations to service debt. These difficulties, in turn, have fed back on to the strength of the financial intermediaries that extended the credit. In an effort to bolster depleted capital positions, reduce financing burdens, and shore up weakened bal-

Growth of Money and Debt (Percentage Change)

| | | M1 | M2 | M3 | Debt of domestic nonfinancial sectors |
|--|------|------------|------|------|---------------------------------------|
| <i>Fourth quarter to fourth quarter</i> | | | | | |
| | 1980 | 7.5 | 8.9 | 9.5 | 9.2 |
| | 1981 | 5.4 (2.5)* | 9.3 | 12.3 | 9.9 |
| | 1982 | 8.8 | 9.1 | 9.9 | 9.2 |
| | 1983 | 10.4 | 12.2 | 9.9 | 11.3 |
| | 1984 | 5.4 | 8.0 | 10.8 | 14.1 |
| | 1985 | 12.0 | 8.7 | 7.6 | 13.8 |
| | 1986 | 15.5 | 9.2 | 9.0 | 13.8 |
| | 1987 | 6.3 | 4.3 | 5.9 | 10.4 |
| | 1988 | 4.3 | 5.2 | 6.4 | 9.4 |
| | 1989 | 0.6 | 4.8 | 3.6 | 8.2 |
| | 1990 | 4.2 | 3.8 | 1.7 | 6.9 |
| | 1991 | 8.0 | 3.1 | 1.3 | 4.7 |
| <i>Quarterly growth rates (annual rates)</i> | | | | | |
| 1991 | Q1 | 5.2 | 3.5 | 3.3 | 4.5 |
| | Q2 | 7.4 | 4.3 | 1.8 | 4.0 |
| | Q3 | 7.5 | 1.1 | -1.1 | 4.9 |
| | Q4 | 11.1 | 3.3 | 1.2 | 5.2 |

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

ance sheets, both borrowers and lenders have adopted a more chary attitude towards additional credit.

This more cautious approach to leverage has interacted with the sluggish pace of economic activity to restrain borrowing across nearly all sectors of the economy. Nonfinancial business sector debt, held in check by the decline in financing needs associated with weak aggregate demand and by efforts of debt-laden firms to restructure their balance sheets, grew only ½ percent in 1991. Taking advantage of a buoyant stock market, particularly in the latter part of the year, corporations turned to equity financing; net equity issuance for the year was positive for the first time since 1983, and the ratio of the book value of nonfinancial corporate debt to equity, which had soared in the 1980s amid a flurry of corporate restructurings, actually turned down in 1991. Firms also took advantage of lower interest rates to refinance higher-rate long-term bonds and to reduce uncertainty about their future financing burdens by substituting long-term debt for short-term borrowing. Overall, the mixture of less debt, more equity, and lower interest rates had a salubrious effect on the financial positions of many firms. Indeed, the ratio of interest payments to cash flow for all nonfinancial firms declined in 1991, reversing some of the runup seen in the late 1980s. Consistent with an improving financial picture and prospects of an economic rebound, quality spreads on corporate issues narrowed considerably from their peaks in early 1991, especially on below-investment-grade securities. In addition, downgradings of corporate bonds dropped sharply in the third and fourth quarters, although they still ran higher than the pace of upgrades.

Deleveraging was also evident in the household sector in 1991. Consumer credit declined as households reined in expenditures, curbed their accumulation of financial assets, and pared existing debt burdens. Households took advantage of declining interest rates, particularly in the fourth quarter, by refinancing outstanding mortgages; they also substituted home equity loans for installment debt and other consumer credit which carry higher financing costs and are no longer tax deductible. By reducing their net accumulation of debt and refinancing a substantial volume of their remaining borrowings at lower rates, households were able to ease their financing burdens, reducing the ratio of scheduled debt payments to disposable personal income, which had risen sharply in the 1980s. Even so, loan delinquency rates rose through much of 1991, albeit to levels not out of line with what was seen in previous cyclical downturns. On the other side of the ledger, many households with net creditor

positions saw their interest incomes decline last year.

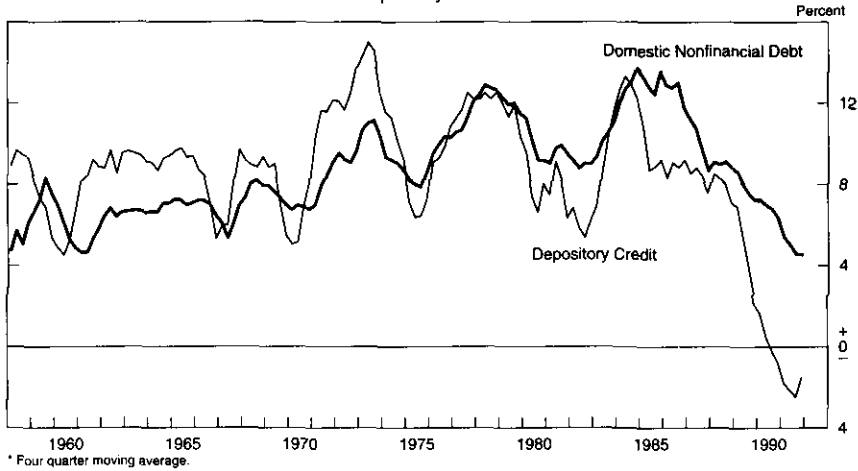
Faced with intensifying budgetary pressures and numerous downgradings, state and local governments also put only limited net demands on credit markets in 1991. The outstanding debt of this sector grew but 3 percent last year, the smallest increase in more than a decade. Gross issuance of municipal bonds was substantial, however, as states and localities moved to refinance debt at lower rates.

Efforts by borrowers to restructure balance sheets by substituting long-term debt and equity for short-term borrowing, along with more restrictive credit standards by some lenders and the closing and shrinkage of troubled thrifts, have affected the channels through which debt flows. In particular, in recent years there has been a major rerouting of credit flows away from depository institutions. The decline in the importance of depositories, when measured by the credit they book relative to the total debt of nonfinancial sectors, has been striking, and this trend was extended in 1991. Not only did the thrift industry continue to contract, as the direct result of RTC resolutions as well as the retrenchment of marginally-capitalized institutions, but commercial banks cut back on their net credit extensions. Indeed, bank credit increased only 4 percent, not even enough to offset the continued runoff at thrifts. Weakness was particularly evident in bank lending, which shrank ¼ percent last year; banks' holdings of government securities, by contrast, expanded at a rapid clip.

Although the shifting composition of bank asset flows in 1991 was reminiscent of patterns seen in previous periods of languid economic activity, the magnitude of the downturn in loan growth last year was more pronounced than the usual experience. Apparently, loan growth was depressed not only by reduced credit demands, but also by a more restrained bank lending posture. Faced with deterioration in the quality of their assets, higher deposit insurance premiums, and more stringent requirements for capital, banks retrenched, adopting a more cautious attitude regarding credit extensions. Concerns about capital, especially in light of rising loan delinquency rates and mounting loan loss provisions, induced many banks to continue tightening lending standards through the early part of 1991 and to maintain fairly restrictive standards over the balance of the year.

A more prudent approach to capitalization and lending decisions is, in the main, a positive development that ultimately will result in strengthened balance sheets for the nation's depositories. Reflecting this improved outlook, prices of outstanding bank debt and equity increased markedly from their lows in late

Growth of Domestic Nonfinancial Debt and Depository Credit*



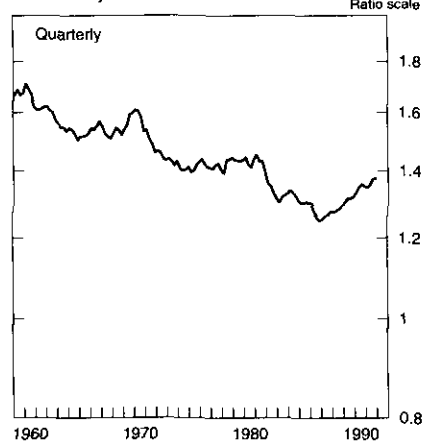
1990 and early 1991, outperforming broader market indexes. Bank profits, benefitting from wide spreads between loan rates and deposit rates, also showed improvement relative to the depressed levels of recent years, although they remained low by broader historical standards.

To date, depository retrenchment appears to have had some restraining effects on aggregate borrowing. Of course, in some areas, much of the credit formerly extended by banks and thrifts has been supplanted by other intermediaries and by credit advanced directly through securities markets, at little if any additional cost to borrowers. For example, growing markets for securitized loans largely have filled the vacuum created by depository restraint in the areas of residential mortgage and consumer lending. Similarly, many large businesses have turned to stock and bond markets to meet credit needs and to restructure balance sheets, reducing their reliance on banks as well. 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 and lower-rated borrowers, and loans to small and medium-sized businesses. Other financial intermediaries, including life insurance companies, have been afflicted by some of the same balance sheet problems plaguing depositories and have also curbed their lending to these sectors. As a result of the pullback in credit supplies,

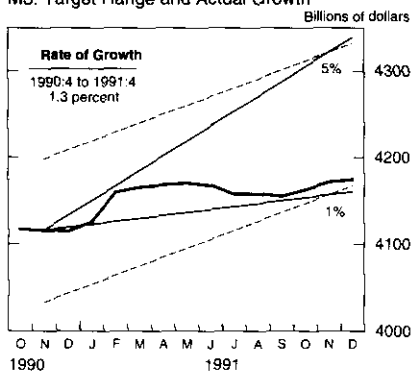
these borrowers now face somewhat more stringent borrowing terms.

As in 1990, the retrenchment of banks and thrifts and the associated redirection of credit flows away from depositories continued in 1991 to have profound

M3 Velocity



M3: Target Range and Actual Growth



effects on the broad monetary aggregates and their traditional relationships with aggregate economic activity. M3, which comprises most of the liabilities used by banks and thrifts to fund credit expansion, has been most affected by the reduced importance of depository credit in funding spending. The velocity of this aggregate, which declined through much of the 1980s, has trended up in recent years; this trend continued in 1991, as M3 rose only 1¼ percent, well below the pace of nominal GDP, leaving this aggregate near the bottom of its target range.

In the first few months of the year, M3 showed surprising strength, boosted in part by a firming of its M2 component, which benefited from declining interest rates. The most important single factor contributing to strong M3 growth in the early part of 1991, however, was the rebirth of the market for "Yankee CDs"—large time deposits issued by foreign banks in the United States. After the 3 percent reserve requirement against nonpersonal time deposits and net Euro-borrowings was lifted at the end of 1990, foreign banks showed a distinct preference for funding with such instruments, rather than borrowing from their overseas affiliates or in the federal funds or RP markets. Domestic depositories, by contrast, faced with high and rising U.S. deposit insurance premiums, exhibited no inclination to alter their funding strategies in favor of large time deposits.

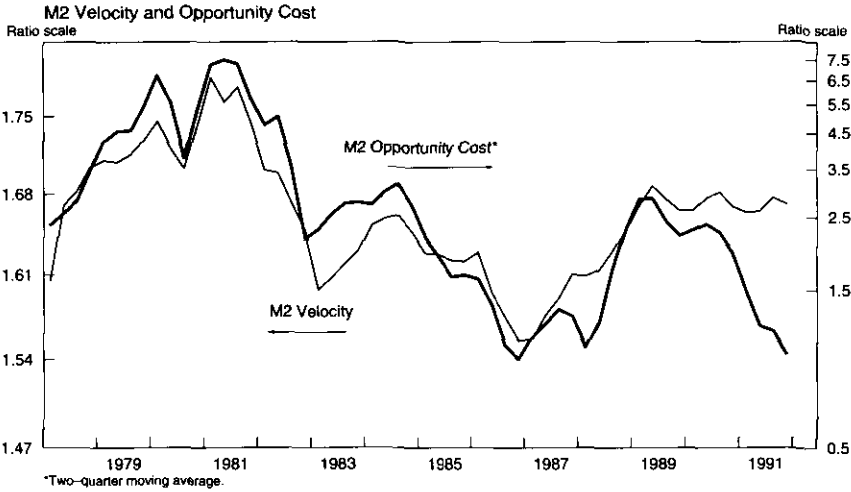
The surge in Yankee CD issuance, which totaled nearly \$40 billion over the first quarter, began to taper off a bit as the year progressed, revealing the underlying weakness in M3. After slowing somewhat in the second quarter, this aggregate contracted at a 1¼

percent annual rate in the third quarter, reflecting feeble loan demand in a tepid economy as well as the restructuring of depositories. The Resolution Trust Corporation played a direct role in damping M3 growth by taking assets formerly held by thrifts and funded with M3 deposits onto its own books and financing them with Treasury securities. Although M3 rebounded a bit in the fourth quarter, in line with some firming of bank credit, its growth remained subdued.

The effects of depository restructuring on M2 remain imperfectly understood. In the past, the velocity of M2 has tended to move in tandem with changes in a simple measure of the opportunity cost of holding this aggregate—that is, with changes in the returns on alternative short-term investments relative to those available on assets included in M2. Typically, when the opportunity cost of holding M2 declines as decreases in money market interest rates outpace drops in yields on deposits, holdings of M2 strengthen relative to expenditures—and velocity drops. In recent years, however, this relationship appears to have broken down, with the velocity of M2 holding up despite a steep, persistent drop in this measure of opportunity cost. This was particularly evident in 1991, when M2 expanded at about the same pace as nominal GDP despite a significant decline in such opportunity costs. M2 finished the year near the bottom of its target range and much weaker than would be expected on the basis of historical relationships among income, interest rates, and the public's appetite for monetary assets.

In the early months of the year, M2 growth accelerated somewhat from its lackluster pace of late 1990. Narrowing opportunity costs generated substantial inflows to liquid deposits, particularly those in M1, which more than offset continued runoffs in small CDs. Money growth also was temporarily boosted by strong foreign demands for U.S. currency as a safe haven during the crisis in the Persian Gulf. Through May, M2 growth remained broadly consistent with the general configuration of opportunity costs and income, and near the middle of its target range.

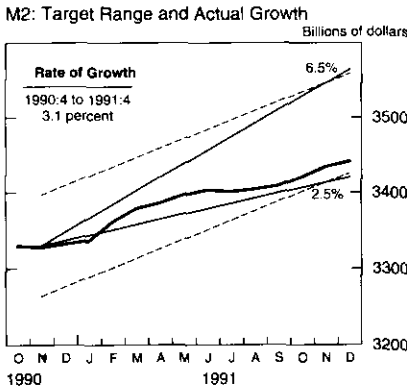
M2 began to slow in June, however, and stalled in the third quarter, despite expansion in nominal income and further declines in opportunity costs. Growth in this aggregate resumed in the following quarter, fueled by a surge in transactions deposits owing to additional declines in opportunity costs, but inflows to M2 remained fairly weak, and this aggregate ended the year only a little above the bottom of its target range.



Although the unusual behavior of M2 relative to income and opportunity costs has not been fully explained, it surely is related to the restructuring of financial flows and to the downsizing of the banking system. With inflows of M2 deposits apparently tending to be more than sufficient to fund weak depository credit growth, banks and thrifts seem to have pursued additional retail deposits less aggressively than in the past. Although rates offered on these deposits did not,

until very recently, fall unusually rapidly in response to declining market interest rates, depositories seem to have acted in other ways to reduce the cost of funds, including adjustments in advertising and marketing strategies that would not show up in traditional measures of opportunity costs. In addition, by keeping deposit rates very low relative to loan rates, partly in an attempt to bolster profit margins while shrinking their balance sheets, depositories provided households with a greater incentive to finance spending by holding down the accumulation of M2 assets rather than by taking on new debt. This incentive likely reinforced the impetus to borrowing restraint stemming from household concerns about their own balance sheets.

The slowdown in M2 growth, particularly in the third quarter, also appears to have been related to the configuration of returns on financial assets. Yields on small time deposits and money market mutual funds largely tracked the downward path of market interest rates, falling to their lowest levels since the deregulation of deposit rates and prompting significant outflows from these components of M2. Although some of these funds shifted into the liquid deposit components of M2—whose offering rates responded slowly, as they normally do, to the declines in market interest rates—a portion of these funds appear to have left the aggregate. The primary lure seems to have been the stock and bond markets, which offered higher returns,

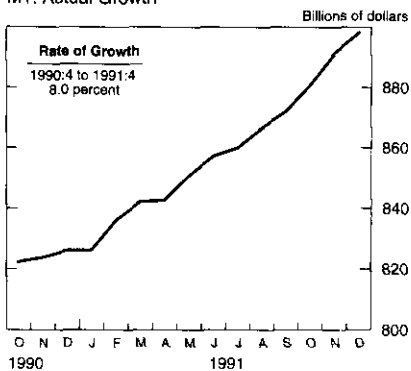


in part because of the steep upward slope of the yield curve. Indeed, inflows to stock and bond mutual funds were robust throughout 1991, and especially since midyear, when investors seemed particularly intent on reaching for higher yields by lengthening the maturity of their portfolios. Depositories, faced with weak loan demand and pressures on capital positions, seemed disinclined to compete aggressively for these funds by offering competitive rates on longer-term CDs.

The rapid pace of activity by the Resolution Trust Corporation also likely depressed M2 growth in the third quarter, as it did throughout the year. The abrogation of existing retail CD contracts and the disruption of long-standing depositor relationships often attending resolutions of failed thrift institutions may have encouraged investors to reshape their portfolios, substituting nonmonetary financial assets for M2 deposits.

Despite sluggish income growth, M1 expanded 8 percent in 1991, the swiftest advance since 1986. Unlike M2, this aggregate has responded to declining market interest rates about as would be expected given historical relationships. M1 was boosted by large inflows to NOW accounts, whose offering rates responded very slowly, until the end of the year, to declining market interest rates. Falling rates also brought new life to demand deposits, as compensating

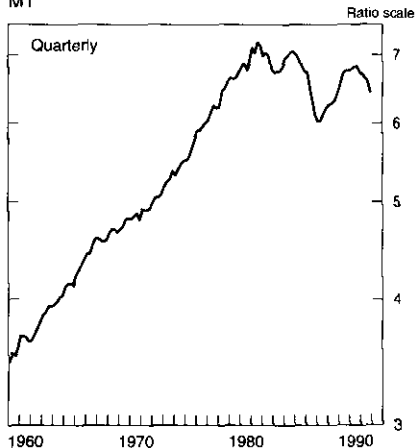
M1: Actual Growth



balances to pay for bank services surged. Demand deposits likely benefited as well from the pickup in mortgage refinancings, because the proceeds from mortgage prepayments are sometimes housed temporarily in demand accounts. Rapid growth in currency, owing in part to continued strong foreign demands, also contributed to the strength in M1, as well as in the monetary base, which increased 8¼ percent last year.

Velocity of Money

M1



M2

