FEDERAL RESERVE'S SECOND 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 PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

JULY 21, 1992

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

U.S. GOVERNMENT PRINTING OFFICE

57-527 CC WASHINGTON : 1992

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-039736-7

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

DONALD W. RIEGLE, JR., Michigan, *Chairman*

ALAN CRANSTON, California
PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
ALAN J. DIXON, Illinois
JIM SASSER, Tennessee
TERRY SANFORD, North Carolina
RICHARD C. SHELBY, Alabama
BOB GRAHAM, Florida
TIMOTHY E. WIRTH, Colorado
JOHN F. KERRY, Massachusetts
RICHARD H. BRYAN, Nevada

JAKE GARN, Utah
ALFONSE M. D'AMATO, New York
PHIL GRAMM, Texas
CHRISTOPHER S. BOND, Missouri
CONNIE MACK, Florida
WILLIAM V. ROTH, JR., Delaware
PETE V. DOMENICI, New Mexico
NANCY LANDON KASSEBAUM, Kansas
ARLEN SPECTER, Pennsylvania

STEVEN B. HARRIS, *Staff Director and Chief Counsel*
LAMAR SMITH, *Republican Staff Director and Economist*
PATRICK J. LAWLER, *Chief Economist*
EDWARD M. MALAN, *Editor*

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

CONTENTS

TUESDAY, JULY 21, 1992

Page
Opening statement of Chairman Riegle ... 1
Prepared statement ... 4
Opening statements and remarks of:
Senator Garn ... 5
Prepared statement ... 7
Senator Cranston ... 7
Senator Bond ... 7
Senator Kerry ... 8
Senator Domenici ... 11
Senator Graham ... 12
Senator Gramm ... 13
Senator Sasser ... 15
Senator Sarbanes ... 23
Senator D'Amato ... 27
Senator Dixon ... 28
Senator Sanford ... 29

WITNESS

Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Washington, DC ... 17
Prepared statement ... 69
The U.S. economy and monetary policy ... 69
The U.S. economic outlook ... 72
Recent behavior of the monetary aggregates ... 73
Prospective behavior of the monetary aggregates ... 75
Concluding remarks ... 76
Response to written questions from:
Senator Riegle ... 109
Senator Graham ... 138

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Monetary policy report to the Congress ... 77
Analysis of economic performance under nine Presidents ... 104
Federal Reserve press release dated May 12, 1992 ... 139
Interagency statement on supervisory practices regarding depository institutions and borrowers affected by disturbances in Los Angeles ... 143
Testimony by Lawrence B. Lindsey before the House Banking, Finance, and Urban Affairs, Subcommittee on Housing and Community Development, May 14, 1992 ... 146

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1992

TUESDAY, JULY 21, 1992

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

The committee met at 10:05 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. I realize that we have standing-room-only here and I would like to say to the press, as we've seen in the past, sometimes when the Fed Chairman arches an eyebrow or tilts his shoulder one way or the other, it sets off a news alarm and people run for the door to report that.

I would ask today that, as reporters come and go, that they do so in an orderly way and try to maintain as much quiet in the room as possible so that we can move along this morning.

I think the overflow attendance we have today underscores the enormous importance of this hearing today and the whole question of how our economy is doing and where monetary policy fits into that picture.

And so we welcome Chairman Greenspan today. He has been here a number of times before, commenting on these very issues. There is an abundant committee record of previous comments and observations by the Chairman, many of which we're going to want to ask about today a little bit later on in the question period because I think a number of the comments we were given earlier have not been borne out very well, and I think we have a need for some explanations in those areas.

I'm going to make my own opening statement a part of the record. I'll call on my colleagues to do likewise. And then we'll call on Chairman Greenspan for his opening statement.

Chairman Greenspan, the accumulating evidence I think shows that the American economy is in serious trouble and that the damage is piling up everywhere we look.

The Federal Reserve policy adjustments to help revive the economy I think have not worked effectively. Today, we need some new candor and some fresh thinking from the Fed.

A mere repetition of what we've heard before will not do. I think the record now clearly shows that the Fed monetary policy moves

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

have been too little and too late, and that, despite reassurances that you have repeatedly given this committee, the economy remains wounded and struggling today.

Unemployment is rising. Consumer confidence is weak. Our trade deficit is worsening and nearly 85 percent of the American people indicate in national opinion polls that, in their view, our country is on the wrong economic track going into the future and they want to change to a new economic strategy that can lift the country. Numbers like that are unprecedented in all the time that public opinion measurements of that sort have been taken.

Incomes of American households are declining and it's not just the recession. Obviously, people out of work have an elimination of income, in some cases, eligible for unemployment insurance compensation, but not all cases. But generally, quite apart from the unemployed people, if you take all people in the country, on a per capita basis, incomes have been declining.

For the first time in more than 40 years, per-capita disposable incomes have declined now over a full 3-year period. In fact, starting back when the current administration took office. This is in fact the first administration in which incomes have declined on a per-capita basis since that of Herbert Hoover.

We have some charts here today that I'm going to refer to. The first one relates to unemployment.

If you look at that chart, starting in 1990, the unemployment rate was down to between 5 and 6 percent. But coming through 1990, 1991, now into the middle of 1992, that unemployment rate has continued to climb. It reached its highest level in June at 7.8 percent, and there is nothing in that data that would indicate that we're likely to see it turn around any time soon.

Also, if you take a look at what is happening as we deal with this prolonged recession, we have on this second chart a line that depicts the way our economy has moved as we have come out of previous post-war recessions. We've averaged all of those together to see what our experience has been.

In the average recession payroll employment goes down, such as we have seen in this depression, hits a low point, and then in all of those other recessions, we come out of that. We come out of it with a strong upward trend. We start to recoup the losses that we incurred during the recession, and then we get back up into a positive area where the number of jobs exceeds the previous peak.

But in this situation, the line at the bottom of the chart shows that we have stayed now down near the bottom in this recession and instead of a "V"-shaped or a "U"-shaped come-back into a recovery, it's looking more like an "L"-shaped curve where we're continuing to stay down at a very depressed level.

And if you look at the latest data on nonfarm payroll employment it's actually turned down.

On the next chart here, if you can look at what has happened to real disposable personal income on a per-capita basis, during 3-year periods. This chart goes back all the way to 1950. It comes through all those successive decades. And for the first time in that whole stretch of time, we have broken through the zero line, moved into a negative territory in terms of the change on incomes over the latest 3 years.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

This erosion of economic strength and erosion of living standard is not just for those that are unemployed, but as well for those that have managed to hold onto their jobs.

Finally, the last chart concerns monetary policy.

The Federal Reserve sets for itself a target growth rate for various components of the money supply, one of those being the M2 target.

What this chart depicts is that the Fed, after setting its target, has not been able to hit even the mid-point of its target in any year since 1986. If you take the top chart, the dotted line indicates where growth in M2 at the mid-points of the target ranges would have placed us. The blue line underneath that is what has actually been achieved.

You can see that there has been a substantial shortfall and, in fact, if we had been up at the mid-point of that M2 target range, we would have a substantially higher money supply out there, by 8 percent, than is presently the case.

If you look at the chart on the bottom, you will see what is ominously happening so far in 1992. While the Fed target for M2 growth is a range of between 2½ percent and 6½ percent, you will see that since February, M2 has been trending down. In April, M2 crossed below the low end of that range, moved below the 2½ percent growth line. And in June, in terms of the latest data that we have, M2 is now well below the Fed's own range.

I think it's very disturbing, when the Fed sets a wide policy range for what it thinks is necessary to try to accommodate an orderly functioning of the economy and then to find that the policy is not generating a result that even brings it within the low end of its own range.

This committee has repeatedly urged the Fed orally and in writing, to adopt a more aggressive economic growth strategy. And frankly, the Fed has resisted that. The Fed has applied the old-time economic medicine, strangling the money supply in the name of fighting inflation, and now unemployment has risen, as I say, to 7.8 percent, and I think it's likely to go higher.

We are not creating the new jobs needed for new entrants into the labor force. Despite whatever qualifications and training they bring, there are a lot of unemployed college graduates, graduate engineers, and others throughout our society today.

In fact, over 15 million Americans are now unemployed, underemployed, or only able to work part-time because they can't find full-time work. And more massive job eliminations are being announced every day by companies all across the 50 States.

Any stunted recovery that we have is almost invisible, with increasing signs that we may slide back into a third phase of this recession.

On the Fed money supply issue alone, the target growth rate is 2½ to 6½ percent and yet, so far this year, the Fed policies have malfunctioned, I think, badly enough that since April, they've even fallen below the low end of their own target range.

Significantly, referring a moment again to the chart I had earlier up there, if the Fed had met just the mid-point of its growth targets for M2 since 1986, the money stock today in the country would

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

be 8 percent higher than it is, and I think it's fair to say we would have a stronger economy as a result.

Something is fundamentally wrong when the Fed is unable to keep M2 growth within its own target range. And I think the Chairman today owes the country an explanation for this failure and what can be done to fix it.

The time has come for the Fed to frankly admit that monetary policy by itself is insufficient to deal with our serious economic problems and that other more aggressive economic growth initiatives are needed now.

Just yesterday, the world currency and financial markets were in disarray, prompting a major currency intervention effort. But that was a one-shot deal that solves none of the underlying problems. And certainly, higher German interest rates increase the threats to economic recovery here in the United States.

The world economic and financial order has changed fundamentally in recent years. But I have yet to hear the Fed offer a revised view of these new realities, to level with the American people as to the scale of the problems and to advocate broader strategies that can restore sustained economic growth here in America.

In fact, the Fed has continued to oppose the more encompassing economic initiatives needed to restore U.S. job growth, higher productivity, and broad based economic expansion.

The strategy has been to minimize and tiptoe around the problems while they have worsened and public confidence, to a large degree, I think has been squandered.

Many of the questions I'm raising now, as you well know, have been put to you before in this committee. You've given answers on the record. And we've got to get to the bottom today as to why those answers have gone as far awry as they have.

PREPARED STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

Chairman Greenspan—the accumulating evidence shows that the American economy is in serious trouble and the damage is piling up everywhere we look.

The Federal Reserve policy adjustments, to help revive the economy, have not worked effectively. Today we need some new candor and fresh thinking from the Fed. More of what we've heard before won't do. The record shows—that the Fed monetary moves have been too little—and too late—and despite the reassurances you have repeatedly given this committee the economy remains wounded and struggling.

Unemployment is rising, consumer confidence is weak, our trade deficit is increasing, and nearly 85 percent of the American people indicate in national opinion polls that our country is on the wrong economic track going into the future and they want a change to a new economic strategy that can lift the country.

Incomes of American households are declining. And it's not just the recession. For the first time in more than 40 years, per capita disposable incomes have declined over a full 3 year period, starting

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

when the current administration took office. This is the first administration in which the economy has declined on a per capita basis since Herbert Hoover's.

Repeatedly this committee has urged the Fed—orally and in writing—to adopt a more aggressive economic growth strategy. You have resisted that. You have applied the old time economic medicine—strangling the money supply in the name of fighting inflation—and now unemployment has risen to 7.8 percent. We are not creating the new jobs needed for new entrants into the labor force—despite their qualification and training.

Over 15 million Americans are now unemployed—underemployed or only able to work part time because they can't find full time work. More massive job eliminations are announced every day. It's a tragedy.

Any stunted recovery we have, is almost invisible—with increasing signs that we may slide back into a third phase of this recession.

On the Fed money supply issue alone, your target rate of growth is from 2½ percent to 6½ percent and yet so far this year Fed policies have malfunctioned so badly since April that you have even fallen below the low end of your own target range. If the Fed had met the midpoint of its growth targets since 1987, the money stock should be 8 percent higher than it is today. Something is fundamentally wrong when the Fed is unable to keep M2 growth within its own target range and you owe the country an explanation for this failure.

I think the time has come for you to frankly admit that monetary policy is insufficient to deal with our serious economic problems and that other more aggressive economic growth initiatives are needed now.

Just yesterday the world currency and financial markets were in disarray—prompting a major currency intervention effort.

But that was a one-shot deal that solves none of the underlying problems. Certainly higher German interest rates increase the threat to economic recovery here.

Clearly the world economic and financial order has changed fundamentally in recent years. But I have yet to hear the Fed offer a revised view of these new realities—to level with the American people as to the scale of the problems—and to advocate broader strategies that can restore sustained economic growth in America.

In fact, the Fed has continued to oppose the more encompassing economic initiatives needed to restore U.S. job growth, higher productivity, and broad based economic expansion.

The strategy has been to minimize and tiptoe around the problems—while they have worsened and public confidence has been squandered.

During the question period—I will pursue these issues with you in detail.

Senator Garn?

OPENING STATEMENT OF SENATOR JAKE GARN

Senator GARN. Thank you, Mr. Chairman.

First of all, let me ask unanimous consent that my full statement be placed in the record.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The CHAIRMAN. Without objection, so ordered.

Senator GARN. Mr. Chairman, both mister chairmen, this hearing reminds me of one that was conducted when I was a freshman Senator and Arthur Burns was chairman of the Federal Reserve. That hearing wasn't too much different, in a way, than this. Arthur was being blamed for all the sins of the economy. Afterwards, I was talking to him and I said:

Mr. Chairman, I haven't been here too long, a year or so. But it seems to me that there are other factors involved in this than just the Fed and monetary policy.

Maybe I'm rather naive, but it seems to me that a few years ago, no one ever heard of the Chairman of the Fed. They just didn't know who he was.

Now we continue to hear, and have for many years, that the Chairman of the Fed is the second most important person in the country, next to the President.

And I said:

How do you explain that? He said:

'Well, Senator, it used to be we had some stable fiscal policy in this country. We had a Congress that tried to balance the budget and manage that side of it, and you can't really separate monetary and fiscal policy from each other. My job becomes more difficult every single day to play with the M's and monetary policy when Congress will not responsibly deal with the fiscal policy.'

Well, that's nearly 18 years ago, but I really believe we have the exact same situation. While I would share some of the concerns of the Chairman about monetary policy, I suppose I wouldn't be as nice as Chairman Greenspan will be. I'd sit here, if I were the witness, and talk about fiscal policy and the failures of Congress.

So, obviously, there's enough blame to go around.

I don't know how it's possible, like Arthur Burns said all those years ago, to separate monetary and fiscal policy. They do go together and it takes cooperation on both sides. I would say there's been a lot of failure on both sides, but certainly, when you consider that the first year that I was here, the year that I was talking to Arthur Burns, the total budget to run this country and defend it with more than 40 percent of that budget going to defense, was $318 billion.

The interest on the national debt just 17 years later is almost as big as the entire budget was then. The debt this year will exceed by almost $100 billion what the total budget of this country was, for everything, just 17 years ago.

I would suggest we look at this thing with some balance. While we can be critical of you and the Fed for not being fast enough, slow enough, aggressive enough, unaggressive enough, or whatever, I would say, maybe some of those things are correct. But, on the other hand, I think the ultimate culprit is the Congress of the United States which is composed of both Republicans and Democrats. For the last couple of decades we, the Congress, have been totally, completely irresponsible on fiscal policy.

Until we start to work together on monetary and fiscal policy, one side can't solve the other. If we had our house in order, we couldn't solve it by ourselves. If you did everything perfectly, in light of many Congresses' irresponsible fiscal policy of, you couldn't solve it, either.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

That's my main message today. Both sides need to start working together or this problem of the economy will not be solved.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR JAKE GARN

I am happy to welcome Chairman Greenspan to the committee but I doubt that he is very happy to be with us today. He has every right to be unenthusiastic because the principal mission of the Congress in these times of economic uncertainty is to find someone to blame. While there is plenty of blame to go around, the least comfortable participant in a hearing is always the person on the hot seat.

This morning's hearing will give us an opportunity to be specific about what is right and what is wrong about economic policy in the United States.

It may well be true that the Fed has not been sufficiently aggressive in supplying credit to the economy, an issue that I am sure we will discuss.

But before we are too hard on the Fed, we should remember that this Congress has gone out of its way to undermine the economic expansion.

Earlier this year President Bush sent Congress a stimulus package designed to help first-time homebuyers and to stimulate investment.

What was the congressional response? A watered-down bill with a tax increase. Fortunately we have a President who will stand up to Congress and veto such anti-growth legislation.

No doubt this economy has structural problems. It is having to adjust to a new noninflationary environment and to a winding-down of the cold war.

But does anyone want to go back to the days of raging inflation and mounting defense budgets? I think not.

The future we face will be one on heightened international competition. To succeed we must stay the course in our battle against inflation. We must stay the course in shifting resources from defense spending to productive investment.

Most of the rest of the world has learned that the way to be competitive is through reliance on the private sector to allocate resources to their most efficient uses.

It would be a great tragedy if, when the rest of the world is embracing freedom and free enterprise, the United States were to follow Congress back to the tax-and-spend policies of the past.

Mr. Greenspan, I wish you good luck.

The CHAIRMAN. Thank you, Senator Garn.

Senator Cranston?

OPENING REMARKS OF SENATOR ALAN CRANSTON

Senator CRANSTON. I'll withhold my message until I hear Alan Greenspan's message.

The CHAIRMAN. Very good.

Senator Bond?

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

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

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I'm pleased to join in welcoming the Chairman of the Federal Reserve in this semiannual appearance. We are obviously going to be very much interested in your discussion.

I've just come back from several weeks I've spent touring my State of Missouri extensively, and there's some areas where they report that jobs seem to be plentiful, everything is working well. These are not areas, obviously, where there has been defense cutbacks or where slow auto sales have hurt the area. But, by and large, I am struck that my constituents still have a strong worry about the future and they have concerns about where our country is going, based on what they see nationally.

And I think as I talk with them at greater length, the cause of their unease is not monetary policy. They have said to me, you can't push on a string any longer. What they are concerned about is Congress' fiscal policy, the Federal budget deficit, as my colleague and our leader from Utah has said.

This obviously, the deficit is reflected in the steepness of the yield curve, the long-term rates being essentially beyond the capacity of the Federal Reserve to control.

I hear a lot of discussions about the Government regulatory burdens which have increased significantly in recent years, burdens imposed by Congress and by administrative agencies which many have cited as being the primary cause of the loss of jobs, or at least the failure to create new jobs.

I find it somewhat ironic that you get to sit at the table and be grilled by us on monetary policy when I'm sure that you could turn around and ask Congress quite a few questions about fiscal policy and about how we're conducting the business in this country.

This should be a very interesting discussion and I look forward to hearing your comments and to posing some questions to you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Kerry?

OPENING STATEMENT OF SENATOR JOHN F. KERRY

Senator KERRY. Mr. Chairman, thank you.

Listening to the various opening comments, I guess it underscores the dilemma that we find ourselves in, a lot of fingers pointing in different directions and a lot of blame to go around.

Mr. Chairman, I think it must be particularly difficult for you to sit there because you're not responsible for all of what is happening and I think most of us understand that and that may be even gratuitous in the saying of it.

I don't mean it that way.

But you are the most influential economic spokesperson of the Nation. While I don't expect you to come up here and announce bad news or be as gloomy as perhaps you might feel inside, or some people might, with the obvious repercussions of your doing so, I think this is a time for real candor about the fix, if you will.

I listened to my colleague, Senator Garn, blame it on Congress for fiscal policy. I must tell you, I think there's just a general fakery that Congress and the administration have engaged in, and I personally feel a lot of anger about it and a considerable amount of frustration.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I am one of those few here who did not vote for the Andrews agreement. I have not voted for the last few budgets. But we are quickly blamed for what is going on, all of us. I think that those budgets and that agreement were the greatest fakery that we could engage in, based on false assumptions about growth, false assumptions about interest rates, false assumptions about unemployment, and ultimately, false assumptions about the rate of deficit reduction, and everybody knew it when we entered it and everybody even knows it better today.

It's that kind of fakery that has lost the credibility of the Congress and the entire governing process and left us all grappling for answers and pointing in different directions. It's inexcusable.

Now I think, today, I would hope that you could share with us some thoughts about some things that maybe extend beyond monetary policy, which is obviously not the sole cure to this problem.

Your staff has recently—the staff in Boston—been sending me, as I think they do others, a monthly report card on the national and New England economies. It's a very good product. But the numbers in it are very disturbing.

National unemployment rate up nine-tenths of 1 percent since last year, the height of the recession, to a 7.8 percent. Unemployment in New England up eight-tenths of 1 percent in almost that same period, up to 8.3 percent. Consumer confidence down last month nationally. And in Massachusetts, over 10 percent of the population is unemployed in places like Brockton, Fitchburg, Lowell, Lawrence, and in New Bedford and Fall River and other places, it's upward of 12 percent.

We have higher unemployment today in almost every sector of our economy in Massachusetts than we did over a year ago, and the same can be said for most of New England.

Obviously, every single one of those unemployed people has a particular story of agony to tell, Mr. Chairman, as you well know. I heard on NPR this morning driving in, the story of a woman in Los Angeles, I think it was, in California, anyway, who had lost a $600-a-month studio because she lost her job. Takes her 2 year old son, all her possessions, rents storage space, starts to live in the storage space without water, electricity or plumbing, until they discover her there, kick her out, possessions gone.

That's been repeated over and over again.

On July 2, the Department of Labor reported a huge, broad shrinkage in payrolls, totally 117,000 jobs, not the kind of thing that you would expect in any economic recovery of any kind. Factories are continuing to fire workers by the tens of thousands, construction laying off people by the tens of thousands. Even jobs in wholesale and retail are falling.

Last month, business health and personal services let go 15,000 employees.

And to all of this, in fairness, you at the Federal Reserve have responded, dramatically, I might add, slower than many of us here wanted, not at the moment that many of us thought it should have happened, but you have responded, lowering the discount rate seven times over the past 18 months and the Federal funds rate 17 times during that same period.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

And yet, incredibly, the monetary supply, after growing at a slow pact in 1991–1992, has in fact begun to shrink since January up until this last reduction that you've just made.

So we now have a 3-percent discount rate, a 3½ Fed funds rate in this country, which is the lowest that it has been since President Kennedy was in office. And yet, the recession like recovery continues to engulf the country and consumer optimism, as I think a couple of my colleagues have said, is just at an all-time low.

Now, I think it ought to be obvious, and I look to you today for some statement to this effect, that monetary policy alone is not going to resolve this problem for this country. And for a long time, many of us here in Congress, notwithstanding the deficit which we all understand—I voted for Gramm-Rudman, expected it to do its job. And for 2 years, it did, until the fakery set in. And with the fakery has come a doctrine of avoidance that has consumed Government. And it is motivated by a crass desire to get re- elected on the notion that we don't have to pay for anything, that we can still deliver services up to the level that people expect.

We don't have to invest in our colleagues. We don't have to invest in libraries. We don't have to invest in roads and bridges. We don't have to invest in railroads. We don't have to invest in research and development. But somehow, the United States of America is going to compete anyway with everybody else in the world who is doing those things.

Now, Mr. Chairman, you are the most influential voice in economic policy in this country. It is time for us to cut out the fakery. And it is time for us to really consider what we're going to do here.

I think that if you were to speak up and talk about the relationship of the exponential growth in the economy that comes from investment, not Government spending, but investment in infrastructure, in putting people back to work and in creating that, I think we might begin to get a reality base with respect to some of the things we have to do in this country.

Maybe you don't believe those things. If you don't, then there is a real gap between what most people in this Nation are suggesting we need and what our chief economic spokesman believes we need.

Business Week just recently, and I'm sorry to go on, Mr. Chairman, but I want to lay this foundation for this testimony today, Business Week issued a recommendation in its lead editorial—"Remedies for a Uniquely Frail Recovery"—noting that this recovery is not only weaker than previous recoveries, but fundamentally different, requiring "flexibility and originality in policy-making."

Business Week's recommendations to you were that you could purchase 30-year Treasury bonds in the open market to push the long-term rates down and jawbone the banks to reduce prime lending rates as well.

To the Congress, Business Week suggested that we include a significant Federal capital spending program that would pump money into low-tech roads and bridges, high-tech fiber optic highways, and worker training programs. And such programs, Business Week editorialized, should be regarded not as Government spending, but as Government investments that would generate jobs and improve the productivity of the work force.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

There were other recommendations, but I hope that today, we can get a sense from you at this critical moment of your report to the Nation and of our brief time that we have legislative days left, even in an election year, that you will help us to understand what beyond monetary policy could make a difference and how we could constructively deal with this extraordinary problem of a unique deficit, while simultaneously needing such critical investment in our Nation.

I hope that we can have a constructive dialog in the process.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Kerry.

Senator Domenici?

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Senator DOMENICI. Mr. Chairman, I join today in the hope that Chairman Greenspan will give us the benefit of his expertise as to what we ought to do or what is going wrong in terms of the expectation of a stronger recovery.

Frankly, the American people ought to know that we are not in a recession. The problem is that we have not got out of the recession with a strong enough growth pattern to have an effect that is typical when we've had a recession and started recovery.

We don't have the big punch, the big growth that adds energy to this economy and puts people back to work in larger numbers and increases our growth more significantly.

Frankly, I think you ought to tell us why you think that's happened because I join with those in saying that while you might have done some of the things that you did in terms of interest rates sooner, it's obvious that you can't hardly come down any more either in the discount rate or its interest effect.

We are at many numbers that would indicate this shouldn't even be at this low a rate. It's there. Very, very low, and still, it does not add the revitalization. I think you ought to tell us frankly why, at least as you see it.

I'm somewhat concerned about a deficit that is as big as ours and that will come down for 3 or 4 years if we left everything alone and then will go busting through the rafters again. To hear people say that we ought to spend a lot more Federal money really disturbs me. Maybe I could be convinced that to spend $200 or $230 or $240 billion in the next 4 years would really revitalize the economy.

Frankly, I think it might revitalize Government. But I'm not sure the revitalization of Government is synonymous with revitalizing the economy.

I believe part of the American problem today is an enormous anxiety on the part of the average American. I think that anxiety doesn't have to do as much with their current State.

Clearly, we have people without work. We have people that need better jobs. But people who have good jobs are also worried about this economy. And I think that's an anxiety that comes from fear in the future, fear as to what's going to happen in 3, 4, 5, or 10 years to them and their children.

And I believe, more than anything else, a real commitment that the market place and average Americans could understand regarding fixing this deficit would do as much to restore confidence as

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

anything, not all by itself, a total recovery, but it's desperately needed, because what we are talking about when we have this big a deficit is that we are giving up in terms of our ability to produce work and have growth and we are saying, we can't do that, so let's just spend more than we take in, perhaps forever, until there's nothing left.

So, from my standpoint, I hope you will tell us today why the things you did in response to a prolonged situation of not significant increases in growth, why it didn't work. I think that's an interesting exercise for you. And of all the things that have been said, I think you owe us that because you did those things expecting more out of this economy, or at least some of us assumed you did, and it didn't happen.

I believe it has to do with structural problems in the American economic system and in the fiscal policy of this country. I don't think we can fix them in a minute or even in a year. But I'd like your views on what we ought to get started doing.

I'm also worried about spending money, on the one hand, and taxing on the other hand and saying, because we're spending it differently and taxing differently, it's all going to work.

I have a great deal of difficulty with a plan that says, spend $220 billion in the next 4 years, tax $150 billion in new taxes, but everything's going to work out. It's going to really cause us to get going.

I'd like you to address that kind of an issue for us.

I thank the Chairman for calling it. It's very important that we hear from you, Chairman Greenspan. And I join with those who have said, it's not all your fault, but you do owe us an explanation since your Federal Reserve is there for a very important purpose. In times of recession, you play a very vital role. We forget about your vital role in the nonrecession periods.

My last one has to do with the banks and money supply. You might want to address that before you leave here. Something is amiss in terms of bank loans for businesses and growth and maybe it's the economy. Maybe it's something else. But I think you ought to tell us about that.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Domenici.

Senator Graham of Florida.

OPENING STATEMENT OF SENATOR BOB GRAHAM

Senator GRAHAM. Thank you, Mr. Chairman. I appreciate your holding this hearing and again, the opportunity to hear from Chairman Greenspan.

The purpose of the meeting today is to carry out the statutory obligation of a report on monetary policy pursuant to the Full Employment and Balanced Growth Act of 1978. The title of that act I think is an accurate statement of what our economic destination should be—full employment, balanced growth.

The concern that many Americans and many of my constituents in Florida are feeling is why are we not accomplishing those objectives of full employment and balanced growth, even though we have been using, I would say in an extreme degree, traditional economic measures?

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

We are in a period of super Keynesism in terms of efforts to move us out of this recession. We have massive Federal budget deficits, indicating the degree of our Government spending. We have some of the lowest interest rates in modern American economic history. We have a weakened dollar.

All of those measures are traditional steps in order to stimulate an economy during a period of recession.

In spite of that, rather than achieve the goal of full employment and balanced growth, we are seeing one of the weakest periods of economic performance.

Mr. Chairman, I would like to submit for the record an analysis which was published in the New York Times of economic performance under nine Presidents.

The CHAIRMAN. Without objection, so ordered.

Senator GRAHAM. And particularly, comment on two similar periods, the 1969 to 1972 period, the first term of President Nixon, and the 1989 to 1992 period, the first term of President Bush.

Gross domestic product during the Nixon period grew 12.4 percent. During the Bush administration, it has grown 2.5 percent. Jobs under the Nixon administration grew 8.3 percent. They've grown 0.7 percent under President Bush. Disposable income, 10.8 under Nixon. One point two under Bush.

Industrial production, up 14.7 under Nixon. Down 0.4 under Bush. Hourly wages, up 9.8 under Nixon. Down 1.7 under Bush.

Those are the effects of applying this accelerated set of measures, of increased Government debt and spending, lower interest rates, and a weakened dollar to our current economy.

So the question is why isn't the prescription working? What has happened to the patient that has caused the prescription that in the past has been successful to be so anemic?

Some suggestions include that we're paying the price of the accumulated public and private debt, the loss of economic sovereignty due to globalization of the economy, the shrinking middle class, constrictions on credit, especially as it relates to entrepreneurs and housing. All of those have been cited as fundamental changes in the economy that have contributed to the fact that the old prescriptions against the current patient of the American economy not having the expected results.

So I would be very interested in your analysis of what is the pathology of the American economy and why are the prescriptions not having the intended results. And what are the new prescriptions that you think we should be administering, both in terms of monetary and fiscal policy.

Thank you.

The CHAIRMAN. Thank you very much.

Senator Gramm of Texas.

OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, I want to thank you for holding the hearing. I think it's very timely. I think it's very important.

I hope that we can here today focus on what Congress can do. The only logic for having you Chairman Greenspan, here before the committee is to try to be instructed by you as to what the problems are and what we can do about them.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

We can all speculate on what we would have done had we been in your job. But none of us were in your job, and I guess the odds are very high that none of us will ever be in your job. Some would rejoice in that, and I am among that group.

[Laughter.]

But we are here in the U.S. Senate. We have an opportunity today to do something. We have a relatively unimportant bill before the Senate today, at least in the cosmic terms we're talking about. Any member of the Senate could go over today and offer an amendment to cut the capital gains tax rate. Any member of the Senate could go over today and offer an amendment to limit the growth of entitlements.

So what I'd like to ask, Chairman Greenspan, is basically this. I'd like to ask you to tell us what we can do in the Congress to try to get the economy going at a faster pace.

We have two approaches that have been proposed. One approach is basically to raise taxes, raise marginal tax rates, impose additional taxes on business, to increase domestic spending. Is that the path to recovery? Would we, if we increased domestic spending by $59.4 billion and raised taxes by $39.3 billion, would that benefit the economy?

Would we help the economy if we cut the capital gains tax rate? I think the answer is yes. Would we help the economy if we reformed entitlements and dramatically reduced the Federal budget deficit? I think the answer is yes.

What I think you can do here today is to give us your views as to which of the two paths America should take. One is to raise taxes and raise spending in order to get America moving at a faster pace. And we should avoid pretending, as Business Week would pretend, that this, somehow, is not really Government spending—what a farcical position to take, talking about phoniness in the debate about deficits. This is the Government path, more spending, more taxes.

The other path which has been proposed and which this Congress has consistently rejected is a path of, number one, gaining control of spending. The President has proposed binding limits on the growth of entitlements. If we adopted that proposal, would it help the economy or would it hurt the economy, in your opinion?

If we cut the capital gains tax rate, would it help the economy or hurt the economy?

If we had a $5,000 tax credit for buying a new home, first time homebuyers, as the President has proposed, would that help the economy or would that hurt the economy?

If we reinstituted passive losses in the real estate industry, which the President has proposed, would that help the economy or would that hurt the economy?

What I'd like to do here today is not focus in on whether or not you should have increased the money supply faster. First of all, that time has passed. Nobody disputes what you're doing now as being the right thing to do. I think we all believe that it is. The question is what we in Congress should be doing now. Should we be raising taxes and increasing spending? Should we be cutting taxes and gaining control of spending?

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Those are two distinct paths that we can go down, and I think it would be very beneficial here today to get you to give us your view as to what we ought to do.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sasser, chairman of the Budget Committee.

OPENING STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Well, thank you, Mr. Chairman.

I want to welcome you this morning, Mr. Greenspan. It's always a pleasure to have you appear before the committee. You come this morning at a particularly important time.

Now you're here this morning and you will give us your indication or your report on the economy. I must say to you that I don't see much change in the economy from your last appearance before this committee. Or for that matter, the appearance before that one.

Certainly, unemployment is worse. There's no doubt about that. The June unemployment rate of 7.8 percent is the worst we've had in 8 years, since the major recession of 1983. Nearly 10 million people are unemployed and that doesn't count the millions who are working part-time who want to be working full-time. And that doesn't count the millions who have become so discouraged, that they have quit looking for work.

As we convene here this morning, 1 in every 10 of our fellow citizens is on food stamps.

Just last week, it was reported that industrial production declined in June for the first time in 5 months, and the economy is mired in the worst period of stagnation since before the Second World War.

And I've said it so many times, and others have said it so many times, that now it's, I think, become part of the conventional wisdom. That the past 4 years have seen the worst economic performance of any 4-year period since the days of Herbert Hoover in the late 1920's.

Now today, we hear what the response of the Federal Reserve is and has been to the problem that we're facing.

The Fed has been called the greatest instrument of economic policy making in the world, and that may be a little hyperbole, but there's probably some truth to that.

But my problem has been, from the very outset, and I've discussed this with you now over a period of years, that the Fed and the administration, the Bush administration, have accepted the view that inflation is the big problem, that inflation has been a bugaboo which has to be defeated, and that the economy needed a soft landing that would be brought about by higher interest rates.

That's what was being said in 1988 and 1989.

The administration, and I think the Fed also, adopted an elitist economic strategy and, as a result, unfortunately, the economy, rather than having a soft landing, simply crashed on the runway.

The real problem, as I see it, Mr. Chairman, is that the Fed and the administration don't seem to have a problem in taking the lead in fighting inflation with high interest rates. But they do have a problem when it comes to creating job growth and creating economic growth.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Now last year, we had several noted economists that testified before this committee. If I'm not mistaken, Mr. Chairman, one was Mr. James Tobin of Yale. They also testified before the Budget Committee, that there was really very little down-side risk to a more expansive monetary policy.

But the Fed and the administration ignored their advice and continued to cling to what I believe is an overly conservative and an overly restrictive approach.

Almost 2 years ago, at what we now know was the start of this recession, Mr. Greenspan, you told me before this committee, and I quote—here's what you said:

> Monetary policy has the ability to act quickly enough to support economic expansion.

And this response came to a complaint that I was making at that time about interest rates being too high, monetary policy being overly restrictive for what I perceived to be an adverse economic time that we were moving into.

It's clear now that something went wrong over the last 2 years. I'll be interested in pursuing that with you.

But the problem is that the Fed has responded to this recession too late. You have reduced interest rates significantly over an extended period of time. But this was done so, in my judgment, at a very deliberate and incremental pace that came too late.

And one of the major reasons is that the Fed's lower rates have consistently followed negative economic developments rather than preceded them. I firmly believe that if the Fed had been sending a clear and consistent signal over the past 2 years that it was going to stay ahead of the curve on the bad news in the economy and exercise leadership and growth, I don't think we'd be in the present situation.

If the Fed had concentrated on keeping the economy growing rather than concentrating on an exaggerated fear of inflation, and I think that is one of the very real problems for the central bank in this country. We simply are overly concerned about the problem with inflation and cannot seem to understand that we have a dual purpose, one, of growing an economy in conjunction with dealing with inflation, I don't think we'd be in the present situation.

Indeed, we had the problem of between early 1988 and extending into the spring of 1989, the Fed pushed the Federal funds rate from 6½ percent up to an incredible 10 percent, at the same time that the economy was holding a fairly steady 4 percent inflation rate.

So I think that is one of the real problems. The Fed has been behind the curve from the very beginning.

Now, it's easy to claim 20/20 hindsight today, Mr. Greenspan. I think you know of the enormous respect that I have for you and your judgment. But I would remind you that some of us were saying in 1988, and certainly in 1989, that inflation is under control and let's kill the economy in an effort to dig an even deeper grave for inflation.

Well, here we are today and we're going to do the best we can from this juncture. But I wanted to make that statement, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Sasser.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Chairman Greenspan, we're going to make your full statement a part of the record. It's a lengthy statement. I'd like you to summarize it as you wish today, and I hope that you'll also take the occasion to respond in your remarks to some of the points that have been raised by members.

We'd like to hear from you now.

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

Mr. GREENSPAN. I shall, Mr. Chairman.

Mr. Chairman, and members of the committee, I am pleased to have this opportunity to present the Board's semiannual report on monetary policy to Congress. Earlier this month, when the Federal Open Market Committee formulated its plans and objectives for the next year and a half, it did so against the backdrop of an economy still working its way through serious structural imbalances that have inhibited the pace of economic expansion. In light of the resulting sluggishness in the economy and of persistent weakness in credit and money, the system on July 2 cut the discount rate by ½ a percentage point and eased reserve market conditions commensurately. These actions followed a reduction in the Federal funds rate in early April. The recent easings of reserve conditions should help to shore up the economy and, coming in the context of a solid trend toward lower inflation, have contributed to laying a foundation for a sustained expansion in the U.S. economy.

Our recent policy moves were just the latest in a series of 23 separate easing steps beginning more than 3 years ago. In total, short-term market interest rates have been reduced by two-thirds. The Federal funds rate, for example, has declined from almost 10 percent in mid-1989 to 3¼ percent currently. The discount rate has been cut to 3 percent, a 29-year low. Despite the cumulative size of these steps, the economic recovery to date nonetheless has been very hesitant. Based on experience over the past 3 or 4 decades, most forecasters would have predicted that a reduction of the magnitude seen in short-term interest rates, nominal and real, during the past 3 years would by now have been associated with a far more robust economic expansion.

Clearly, the structural imbalances in the economy have proven more severe and more enduring than many had previously thought. The economy is still recuperating from past excesses involving a generalized over reliance on debt to finance asset accumulation. Many of these activities were based largely on inflated expectations of future asset prices and income growth. In short, an overbuilding and overbuying of certain capital and consumer goods was made possible by overleverage. And, when realities inevitably fell short of expectations, businesses and individuals left with debt burdened balance sheets diverted cash flows to debt repayment at the expense of spending, while lenders turned considerably more cautious.

This phenomenon is not unique to the United States. To a greater or lesser extent, similar adjustments have gripped Japan, Canada, Australia, the United Kingdom, and a number of northern European countries. For the first time in a half century or more, sev-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

eral industrial countries have been confronted at roughly the same time with asset-price deflation and the inevitable consequences. Despite widespread problems, we seem to have at least avoided the crises that historically have been associated with such periods in the past.

In the United States especially, important economic dynamics ensued as the speculative acquisition of physical assets financed by debt outpaced fundamental demands. In some markets for physical assets, such as office buildings, a severe oversupply emerged, and prices plummeted. In others, such as residential housing, average price appreciation unexpectedly came to a virtual standstill, and prices fell substantially in some regions. Firms that had been subject to leveraged buyouts based on overly optimistic assumptions about the future values at which assets could be sold began to encounter debt-servicing problems.

More generally, disappointing earnings and downward adjustment in the values of assets brought about reduced net worth positions and worsened debt-repayment burdens. Creditors naturally pulled back from making risky loans and investments, and as pressures mounted on lenders' earnings and capital, some features of a "credit crunch" appeared. With borrowers themselves becoming more cautious about taking on more debt, as well as about spending, credit flows to non-Federal sectors diminished appreciably.

It is not that this process was unforeseeable in the latter years of the 1980's. The sharp increase in debt and the unprecedented liquidation of corporate equity clearly were unsustainable and would eventually require a period of adjustment. What was unclear was the point at which financial problems would begin to constrain spending and how strong those constraints would be. Forecasts of difficulties with debt and strained balance sheets had surfaced from time to time over the past decade. But only in recent years did it become apparent that debt leverage had reached its limits, inducing consumers and businesses to retrench. Moreover, the degree of retrenchment has turned out to be much greater than experience since World War II would have suggested.

The successive monetary easings have served to counter these contractionary forces, fending off the classic "bust" phase that seemed invariably to follow speculative booms in pre-World War II economic history.

Lower interest rates have lessened repayment burdens through the refinancing and repricing of outstanding debt, and together with higher stock prices, have facilitated the restructuring of balance sheets. Indeed, considerable progress in this regard has become evident for both households and businesses. The much more subdued rate of household and business credit expansion has reduced the leverage of both sectors. Household debt service payments as a percent of disposable personal income have retraced about ½ of the runup that occurred during the previous expansion, and further progress appears in train. Similarly, nonfinancial corporations' gross interest payments as a percent of cash flow are estimated to have retraced much of the roughly 10 percentage point increase that occurred in the expansion. The improvements in balance sheets, together with the beneficial effects of lower interest rates, have been reflected in reduced delinquencies on consumer

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

loans and home mortgages, increased upgradings of firms' debt ratings, and narrowed quality spreads on corporate securities. Furthermore, lower interest rates, along with two reductions in reserve requirements, have appreciably cut the funding costs of depository lenders, materially improved interest margins, and fostered the replenishment of depository institution capital.

Although greatly moderating the potential adverse effects of the necessary adjustment process on economic activity, monetary stimulus also has stretched out the period over which adjustments will occur. A more drawn out adjustment of impaired balance sheets, as we now are experiencing, obviously is much preferable to the alternative: an adjustment through massive financial and economic contraction. Yet the ongoing corrective process has meant that the economic expansion has been hobbled in part by the continued restraint on spending by still overleveraged and hence cautious debtors. Balance sheets ultimately will reach comfortable configurations, but even before then, we should experience a quickening pace of economic activity as the grip of debt burden pressures begins to relax. Last year, I characterized this process as the economy struggling against a 50-mile-an-hour headwind. Today, its speed is decidedly less, but still appreciable.

Uncertainty about how far the process of balance sheet adjustment would have to go and for how long the spending retrenchment of overleveraged debtors would continue has become a factor in shaping Federal Reserve policy over the past few years. This uncertainty has been shared by many other observers, who, based on past experience, were somewhat skeptical about the strength and persistence of spending restraint by both the private and public sectors, and dubious about the persistence of disinflationary forces. Against that background, more rapid or forceful easing actions more than likely would have been interpreted by market participants as risking a resurgence of inflation. That would have led to higher rather than lower long-term interest rates. As I have indicated many times before this committee, lower long-term rates are crucial in promoting progress toward more stable balance sheet structures in support of sustained economic expansion.

Bond yields have not come down more primarily because investors have been inordinately worried about future inflation risks. While they seem to exhibit only modest concern over a reemergence of stronger inflation during the next few years, investors apparently fear a resurgence further in the future, to a large extent as a consequence of expected outsized budget deficits exerting pressure for monetary accommodation.

Other forces have added to the restraint on the economy associated with balance sheet adjustments. The scaling back of defense spending has been retarding near-term economic growth. At the same time, budgetary problems among States and localities have forced painful cutbacks by those units and burdensome tax increases as well.

In addition, the noticeable slowdown in economic growth in other major industrial countries since mid-1990 has further tended to depress demand for goods and services produced in the United States.

Clearly, in this environment, with conflicting forces of expansion and contraction continuing to vie for supremacy, any projection

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

must be viewed as tenuous. In this context, the central tendencies of the projections of Federal Reserve Board members and Reserve Bank presidents are given in the Board's report. They project that the economic expansion is likely to strengthen moderately to a range of 2¾ to 3 percent over 1993. Such a pace is expected to reduce the unemployment rate noticeably over the next year and a half. This outlook is supported by several considerations, including the stimulus now in train from recent interest rate declines and the progress being made by borrowers and lenders in repairing strained balance sheets. Some pent-up demand for business capital goods, housing, and consumer durables should surface as the incentives for spending retrenchment abate.

In our judgment, the interest rate declines to date, working to offset spending constraints related to balance sheet strains, should not endanger the further ebbing of inflationary pressures. Even as the anticipated strengthening of the economic activity occurs, monetary policy will continue to promote ongoing progress toward the longer-run objective of price stability, which should lay the foundation for sustained economic expansion. The financial fundamentals, such as money and credit growth, point to a continuation of disinflationary trends, and the central tendency of our projections for CPI inflation next year is 2¾ to 3¼ percent. Were this to be realized, inflation would be about back to a pace last seen on a sustained basis around a quarter-century ago. As I have often noted to this committee, the most important contribution the Federal Reserve can make to encouraging the highest sustainable growth the U.S. economy can deliver over time is to provide a backdrop of reasonably stable prices on average for business and household decision-making.

The relationship between money and spending also has been profoundly affected by the process of balance sheet restructuring. The broad monetary aggregates M2 and M3 currently stand below their annual growth ranges, despite the earlier substantial declines in short-term interest rates. My previous testimonies to the Congress noted that aberrant monetary behavior emerged in 1990 and has since intensified. We at the Federal Reserve have expended a great deal of effort in studying this phenomenon and have made some progress in understanding it. To summarize our findings to date: the weakness of the broad monetary aggregates appears importantly to have reflected the variety of pressures that rechanneled credit flows away from depository institutions, lessening their need to issue monetary liabilities. The public, in the process of restructuring and deleveraging balance sheets, found that monetary assets had become less attractive relative to certain nonmonetary financial assets or to debt repayment.

These disintermediation and restructuring forces have tended to boost the velocity of the broader aggregates. Increasing M3 velocity has been evident for some years, but the tendency for M2 velocity to rise was obscured until recent quarters by the opposing influence of declines in short-term market rates. M2 velocity appears to have registered an appreciable increase in the first half of this year, and the Federal Reserve has had to take the emerging behavior of velocity into account in deciding how much weight to place on slow M2 growth in guiding its policy actions.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Looking ahead, the recent increases in M2 velocity may well continue, although the uncertainties in this regard are considerable. Predicting either the share of depository intermediation in overall credit flows or the share of money in the public's overall demand for financial assets is currently far more difficult than usual.

Against this background of considerable uncertainty about evolving monetary relationships, the committee retained the current ranges for money and credit growth this year. These growth ranges are 2½ to 6½ percent for M2, 1 to 5 percent for M3, and 4½ to 8½ percent for debt. This year's ranges were carried forward on a provisional basis for 1993, until such time as additional experience and analysis can be brought to bear on the issue of monetary behavior.

In any event, the FOMC will revisit the issue of its monetary and credit ranges for 1993 no later than its meeting next February. By then more evidence will have accumulated about evolving monetary relationships. In light of the difficulties in predicting velocity, signals conveyed by monetary data will have to continue to be interpreted together with other sources of information about economic developments.

I expect that the economic expansion will soon gain momentum, which lower inflation should help to maintain. Although the economy still——

The CHAIRMAN. Let me just stop you there, Mr. Chairman, because we've been listening and we're going to continue to listen to you finish. But I think, if that's the punchline, that you expect economic expansion will soon gain momentum, I'd like you to elaborate a bit.

What do you mean by that? What do you expect?

Mr. GREENSPAN. Why don't I finish my statement, Mr. Chairman, and then I'd like to go back to that very important issue, which is critical to the economic outlook of this country.

The CHAIRMAN. All right.

Mr. GREENSPAN. Although the economy still is working its way through structural impediments to more vigorous activity, the advances that already have been made in this regard augur well for the future. Banks and other lenders, having made considerable strides in rebuilding capital, have greater capacity to meet enlarged credit demands. The strengthening of household finances to date has established a firmer foundation for future consumer outlays. And the restructuring of business balance sheets so far, together with improved labor productivity and profitability, has better positioned producers to support sustainable output gains. These gains would be even larger if the Federal Government can make significant progress toward bringing the budget into balance, releasing saving for productive private investment and brightening further the prospects for ongoing advances in living standards for all Americans.

Thank you very much, Mr. Chairman, and I'm available to respond specifically to questions.

The CHAIRMAN. Before we go to the questions, I want you to elaborate on what you mean here by when you say, I expect that the economic expansion will soon gain momentum. I think everybody's entitled to more than that. What does that mean?

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Mr. GREENSPAN. In the context of my prepared remarks, the fairly extensive analysis of the economy, which we in the Federal Reserve have been engaged in, has very clearly evidenced an extraordinary balance sheet restraint on economic activity.

Economic activity is expanding. It has been expanding since the recession ended last year. It has been expanding at a subnormal rate. It has been expanding at a rate which has not been adequate to bring the unemployment rate down. Indeed, it has been too slow to prevent it from rising. But it is, nonetheless, expanding.

The major reason why it is falling short of a long-term rate of growth which would bring the unemployment rate down is that adjustments to the balance sheet, which got so badly out of kilter during the latter part of the 1980's because of a dramatic decline in the value of assets, have caused restraint that is continuing to this day.

However, there are signs that we are now seeing that while we have not completed the adjustment process so far, we are well beyond the half-way point, and we're beginning to see various areas of improvement emerge.

This has not been enough as yet to create an expansion in bank loans or bank credits. It has not been enough to create any evidence that I can as yet see of a quickening of the pace right at this moment.

But the economy is expanding and as the balance sheet processes continue to improve, then the pressure—that analogy that I made to a headwind which is now still appreciable—will continue to slow down and a far more normal, balanced economic growth will ensue.

I don't know when that specific time is going to present itself. We are looking at a phenomenon which we have not seen for half a century. We do not have easy guidelines to make judgments of precisely when and how the adjustments are taking place.

But we do have a very considerable amount of evidence which suggests that the repair of balance sheets is moving ahead at a fairly significant pace. And we expect that when the time arises that balance sheets are back to normal, that we will be looking at a far more normal economic structure.

I would like to say that, even though everything will be in a balanced state by then, we do have this very large budget deficit, which, if it continues to hang over the economy, if it continues to stretch out and create very significant increased Federal liabilities, that will be a restraint on long-term economic growth because it is diverting private saving from productive capital investment which is a necessary element in increasing productivity and standards of living.

Senator KERRY. Mr. Chairman——

The CHAIRMAN. Well, before we start the questions, I'd like to note that Senator Sarbanes has joined us. Did you have an opening comment you wanted to make? If so, then we'll start the formal questions after that.

Senator SARBANES. I understand that others have made opening statements. Is that correct?

The CHAIRMAN. Yes.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Mr. Chairman, I'm pleased to join the committee in this hearing on the Humphrey-Hawkins hearing which we hold semiannually.

I must say that I'm very much concerned by Chairman Greenspan's statement, and particularly the line of questioning which you've just put to him.

Yesterday, in the New York Times, Chairman Greenspan, Kenneth Gilpin wrote an article saying that Chairman Greenspan will try to explain to Congress this week why the central bank's efforts have not succeeded.

Now we've got unemployment at 7.8 percent. That's the highest rate since March 1984. That's the official unemployment figure. The comprehensive rate, which includes not only those that are out of work and looking for work, but also those that are so discouraged that they're not searching for work, plus people that are working part-time who want to work full-time—they're looking for full-time work, but they can only find part-time work—is 10.9 percent, just under 11 percent.

Last summer, you came in and told us, and I quote:

> We are well on the path of actually achieving the type of goals which we've set out to achieve; namely, a solid recovery with unemployment down to its lowest sustainable level and inflation wholly under control.

And in February, just this past February, you told us that the steerings of a recovery then visible should take hold in the second quarter.

Now when we had the hearing on your reappointment at the end of January, I asked you whether, as I understand it, it's your view that nothing further should be done.

And you responded, yes, that's correct, Senator. If I had my choice, knowing all the uncertainties, of which there are numerable ones, but one has got to make a decision, the decision I would make at this stage is for the moment to do nothing.

I subsequently asked you, how long do you think the unemployment rate is going to stay above 6 percent? What do you expect the unemployment rate to be for 1992?

And you responded—I would say certainly above 6 percent.

I then asked, would it be at 7 percent?

And you responded, I wouldn't try to guess at this stage. I would say at the moment, unless this economy begins to pick up at a pace faster than I suspect it is going to, we are not going to get very much progress on the unemployment rate. We'll get some, but not a lot.

And then Senator Riegle asked, does that mean then it could stay above 7 percent for the year?

And you reply—I would doubt that. And if it did, then I would say that the recovery is nonexistent.

Let me repeat that. This is your response to Senator Riegle's question whether the unemployment rate could stay above 7 percent for the year. I just insert there it's at 7.8 percent at the moment.

And you responded—I would doubt that, and if it did, then I would say the recovery is nonexistent. If it stays above 7, especially

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

if it edges higher, that is suggestive of very weak growth rate or, in fact, even a decline.

Now not only has it stayed above 7 percent; it's done more than edge higher. It's jumped three-tenths of a point in 2 successive months. It's gone from 7.2 percent to 7.8 percent. So that we're now at the highest figure in over eight years. And then we're told this morning that we're soon going to have momentum.

Now this article yesterday quoted one of the market analysts at the Chase Manhattan Bank, saying:

Mr. Greenspan can say we are in a recovery, but there is no number he could point to to say that it will pick up steam.

Another Wall Street economist says:

I think we can expect a depressing rambling speech.

This is from your testimony here today.

[Laughter.]

But the real problem is that the economy is not responding to lower interest rates.

Now, I don't have any of the feeling of the urgency that many of us attach to the current economic situation. In many senses, we're back to repeating sort of what we've heard before, and each time you've come in, you've made these statements and subsequent economic activity has not borne out the statements.

Last summer, according to you, we were well on the path of achieving these goals, et cetera, et cetera. And yet, we keep coming up against an economy that is lagging. In fact, the real interest rates in the country are higher than they've been in previous recessions.

If you go back, I think that's correct. If you go back and look at the previous recessions, real interest rates were lower. The Fed had done more to try to stimulate the economy than has taken place in this recession.

In previous recessions, 14 months after the trough, which most people now think is where we are in this recession, all the jobs that had been lost had been recovered. In fact, the Bureau of Labor Statistics testified at the unemployment hearings last week that we in previous recessions, 14 months after the trough, had gained somewhere between 130 percent to 240 percent of the jobs.

In this recession, we've gained 9 percent.

We just continue to bounce along sort of at the bottom end of the recession, and yet, we're constantly getting these—I think it's not unfair to say, bromides, that sort of say, well, you know, it's working out. Everything's coming out all right.

I don't see it. And Mr. Chairman, when my questioning comes, I hope to have the chance to explore this in greater depth with the Chairman.

The CHAIRMAN. Chairman Greenspan, let me just say to you very directly, I think it's fair to say that we've had a very good working relationship with you on this committee, and we've worked on a lot of issues here in public session. We've worked on them together privately, and we'll continue to do that because of the nature of, I think, the constructive working relationship that we have.

Having said that, I have to tell you, I'm very disappointed in the statement today. I don't really think it does say much, especially

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

to people out in the country that are really struggling and sliding backward, of which there are now a vast number. The unemployment rate in my home State right now is 8.8 percent. California, you know, is struggling and in real difficulty. The rate there is up to 9½ percent.

The people who are out there in that situation are not finding alternative jobs. As jobs are eliminated, they're not finding replacement work at the skill levels that they now have. They're increasingly desperate to find work.

That is separate from the problem that for all the people, including those who still have their jobs, average per-capita income has been sliding backward.

What I get out of your statement is stay the course. That's the bottom line. You say here, in the line that I asked you to elaborate on, "I expect that the economic expansion will soon gain momentum."

I don't think that's a sufficient statement for you to make in light of what you've said repeatedly on the record in this committee because you've said that before one way or the other. Senator Sarbanes has just cited some of those quotations.

Why is there any more reason for us to think that you're right this time, when we look at the record and see that you've said essentially the very same thing before in past months and it's turned out not to be right? Especially when the unemployment continues to rise.

Mr. GREENSPAN. First of all, let me just say that 6 months ago, when I was before the committee for the February Humphrey-Hawkins testimony, where I indicated many of the types of remarks that Senator Sarbanes suggested, our official forecast at that time for 1992 was lower than it is today. We have revised our numbers up.

Now it is certainly the case that the unemployment rate is higher. The gross domestic product was revised up from a central tendency of 1¾ to 2½ percent, to the current forecast for the year of 2½ to 3¼ percent.

Now, unfortunately——

The CHAIRMAN. Do you have an unemployment forecast for us today?

Mr. GREENSPAN. Yes, I do. I was about to get to that.

Where we did go wrong is we did not anticipate the extent of the extraordinary rise in the labor force that has occurred during the last 6 months. It is an extraordinary rise, far greater than anybody had forecast and, as a result of that, our judgment as to where the unemployment rate would have been was very closely related to that particular issue. And indeed, I was quite surprised at the unemployment rate going as high as it did.

The ratio of employment to population is the same now as it was at the beginning of the year. But the increased participation in the labor force by the population has created a significant rise in the unemployment rate.

But as far as forecasting economic activity is concerned, if anything, we've revised our numbers upward, not downward. And as best we can judge, while the growth is clearly subnormal, it is still

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

growth and the economy has been growing at a fairly persistent rate.

It is not, as we have discussed before, at a level which I would consider adequate to restore economic balance. But we do have growth.

The CHAIRMAN. Well, wait just one second. I want to ask you to put that answer in the context of this chart that shows what the average recoveries in jobs have been in other post-war recessions versus what we've seen so far this time.

The gap is so vast.

I don't hear you saying anything to the people out in the country that are in real trouble except hang on, that sometime in the future, we hope and think things will get better. We can't tell you when. We can't tell you how much. And we realize we've been saying it over and over again for months. Not just in the report that you cite. You've been in here on other occasions saying the same thing. You said the same thing last year to us.

What is happening is people in the country don't have any confidence any more in what's being said because the economy is not showing the kind of strength that it needs or that we've seen in the past. Now something's changed, and it seems to me that you're using the same old policy formulations.

I realize that inflation fighting is number one on the list of goals down at the Fed. That's obvious from what you've said here today. I don't think that's sufficient. I don't think the country is giving you a signal that they think it's sufficient. The country wants more growth. They want more job growth. And to simply say, we're not quite doing as well as we've done in the past, that's no answer.

Mr. GREENSPAN. But Mr. Chairman, I think that, first of all, let's distinguish between what is happening in the economy, what it is that we at the Federal Reserve were projecting in the past, and what's happened since.

The actual numbers on gross domestic product have pretty much followed the projections that we've been making to a great——

The CHAIRMAN. But they're inadequate. Forget the projections. The point is——

Mr. GREENSPAN. Mr. Chairman, I don't——

The CHAIRMAN.—your plan isn't strong enough.

Mr. GREENSPAN. Sure. I don't disagree with that, and that's the reason why we have moved interest rates down as much as we have.

This has been an extraordinary decline in short-term rates. It's been an extraordinary expansion of liquidity. It would be the type of liquidity that, were it not the case that we are confronted with these very unusual circumstances, would have been a highly inflationary and an irresponsible degree of monetary ease in the context of the past.

It's only in the context of this very unusual situation that the amount of ease that we have introduced is capable of containing what we consider to be a major financial problem in the context of not setting off a renewed bout of inflation which would create many more difficulties for us in the future than I think we contemplate.

This is not to say that we have not in Federal Reserve policy moved very appreciably toward an endeavor to create adequate li-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

quidity and to make sure that what positive forces are moving are indeed financed. And to that extent, I think we have succeeded.

The CHAIRMAN. Well, let me just say, and I'm going to yield to Senator D'Amato who has come in for an opening comment, and that is this.

I don't think the policies have succeeded, with all due respect. And I don't think the American people think so. Now there's polling data all over this country that will tell you that. I have one here from the Los Angeles Times. I don't have the time right now to get into it. I will later. The public isn't buying this.

Mr. GREENSPAN. I didn't say that the policy overall has created a viable economic environment.

The CHAIRMAN. Well, that's helpful, that you make that clarification.

Mr. GREENSPAN. I'm making a very specific, focused point on creating adequate liquidity to confront a very serious balance sheet problem which has emerged, not only in the United States, but also has been a problem confronting many nations throughout the world for many of the same reasons.

Senator SARBANES. Mr. Chairman, let me just point out that the M2 rate has grown less than the bottom of the Fed's range. How can you talk about monetary liquidity?

The CHAIRMAN. We've covered that earlier. We'll come back to this. If the goal is liquidity because you've got a financial structure crisis, in a sense, that you're trying to deal with, and that's the whole thrust of policy, at least that is a more straightforward statement of what policy is aimed at. And when we see this body count in terms of higher and higher unemployment, at least we can understand why the emphasis is one way and not another.

Let me call on Senator D'Amato for an opening comment, and also submit statements from Senators Dixon and Sanford for the record, and then we'll continue on with the questions.

Senator D'Amato?

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

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

Chairman Greenspan, I believe that the Federal Reserve has acted in an almost timid manner in attempting to bring about economic recovery. Instead of being ahead of the curve the Fed has reacted which has exacerbated the economy's problems.

For anyone to suggest that the Federal Reserve has created the economy's problem, I think that would be an overstatement. It has been well over a year now, however, and we've spoken many times about ways to stimulate the economy rather than responding to bad news as it relates to employment and other statistics.

The Fed continues to be reactive rather than proactive, however. Consequently, I think they share a good part of the blame for the stagnant economy.

Second, the differential in terms of the yield curve further contributes to the slow economic recovery. I know that you read the Wall Street Journal from cover to cover, so I hope you saw yesterday's article, "Steepest Ever Yield Curve May Mean It's Time to Invest."

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The policy of the Fed to lower interest rates doesn't work if commercial banks do not respond with an increase in lending activity but continue to buy Government paper.

Why should banks make loans to the general public when the interest rate they can earn by investing in a long-term security of about 5 years maturity comes close to 8 percent and carries no risk, and no regulator scrutiny?

I have brought this issue up with the Secretary of Treasury and I have raised it with you. I hear nothing from either of you other than we're going to study it. If one looks at the record, banks have increased their portfolio of Government securities by roughly 20-plus percent or $125 billion in the last year while decreasing their lending activity to the private sector by 4 percent or about $25 billion.

It seems to me that the Fed could play an important role in turning this around by buying back those Government securities, thereby eventually reducing the interest rate spread.

Overall, I think there's been a total failure to help the economy.

I have to suggest to you that the coordination between the Treasury and the Fed, has been abysmal and ineffective as far as developing a strategy to lead the country out of the recession.

The fact that I did not vote for your reconfirmation as Fed Chairman during the committee markup reflects that I think that you just continue to do the same thing. You respond rather than look ahead.

For month after month, continuing for almost 2 years now, you have come up here singing the same song, telling us about the economic recovery. This shows me that you and the rest of the Fed are in an ivory tower and don't know what's taking place on Main Street.

You haven't taken the time to speak to the little businessman yourself and you apparently don't believe the stories that credit is not being made available to them.

The Fed's policy, and Treasury's policy, has exacerbated the economic problems that we have today. It's mind-boggling to me that you just continue to exercise these policies. When you are questioned about the lack of economic recovery we get nothing but excuse after excuse after excuse.

It's clearly a failure of leadership. Thank you Mr. Chairman.

PREPARED STATEMENT OF SENATOR ALAN J. DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning for our semiannual monetary policy hearing. I look forward to receiving the comments of the distinguished chairman of the Federal Reserve Board, Alan Greenspan, and to learning his assessments of the state of our economy and our future economic prospects.

Since early 1989, the Federal Reserve has reduced the discount rate from 7 percent to 3 percent, and the Federal funds rate from 9⅞ percent to 3¼ percent. The economy, however, has not adequately responded to this huge dose of monetary stimulus. Economic growth is sluggish at best, and in spite of short-term interest rates that are now lower than they have been for over 30 years, unemployment levels are appallingly high.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

While I think the Fed should have moved more quickly, I think that no one can dispute the fact that the Federal Reserve has used its monetary policy tools to try to stimulate the economy. Our current economic crisis, therefore, cannot be laid primarily at the door of the Federal Reserve Board. Instead, the failure of monetary policy tools to resolve our economic problems is probably the strongest evidence anyone could ask for that a broad-based attack on our structural economic problems is desperately needed and long overdue.

Many of us have been talking about the need for a comprehensive approach to dealing with our economic problems and enhancing our international competitiveness for a considerable time now. We need to deal with a Federal debt load that is becoming more and more burdensome to our economy. We need a more effective U.S. industrial policy. This does not mean we must imitate what the Europeans or the Japanese do; it does mean that we have to institute policies that allow American-based manufacturers and American workers to compete more effectively with their foreign counterparts.

Because of the gridlock in our Government, we have not been able to establish the kind of tough, new effective policies that will address the deficit problem, create more jobs here at home, and stimulate the kind of productivity increases in our economy that we absolutely must have. Americans, however, do not want gridlock; they want action. They want Congress and the President to address these terrible problems.

That is what they want from us. That is what they are entitled to expect from us. And that is what the President and the Congress, acting together in the public interest, must do.

PREPARED STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you Mr. Chairman.

Our country is in an economic tailspin. Anxiety over the lack of real recovery from the recession is apparent not only on Wall Street, but on Main Street U.S.A. as well. The American public is craving responsible, pro-growth policies from Washington that will generate a genuine recovery.

We have seen short-term interest rates drop more than 4 percentage points over the last 20 months—the lowest in nearly 30 years. Yet the economy continues to flounder. Increasing unemployment figures reflect the basic fear Americans harbor over their job security and future income. This skepticism is represented by the stubbornly high long-term investment rates. While short-term rates have been dropping, long-term rates have risen almost three-tenths of one percentage point since January. Lack of confidence and fear of future inflation have caused consumers and investors to hold off on purchasing big ticket items like homes, and borrowing for long-term business investments like new plants and equipment which will in turn create much needed jobs.

In addition to the lack of real economic recovery, I am very concerned over the specific impact of lower short-term rates on certain segments of our population. Interest rates on certificates of deposit and other savings accounts have plunged to Depression-era levels in the wake of the latest cut in rates. Many elderly Americans de-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

pend on interest earnings for their income and current economic conditions could be devastating to them. I think it is a legitimate concern that if rates are too low, they will drive depositors out of the banks in search of riskier, but higher yielding investments. I think it is important that we take steps to see that this does not happen, because a vibrant banking system is essential to sustained economic prosperity. I am interested to know if the Chairman believes that there is a threshold for short-term rates that when crossed, results in more negative affects on the economy than positive results, and where that threshold might be.

I also think it is important that as we try to increase the momentum of economic recovery, we recognize the fact that our economy is closely tied to the strength of the global economy. Other countries like Japan and Germany are facing economic woes as well. However, it is vitally important that we understand the structural problems that developed in the United States as a result of the economic policies of the last 12 years to craft policies that will once again make us a leader in the global economy. It is imperative that we encourage business investment that will enhance long-term growth and restore our international strength that has waned over the last few years.

Finally, I would like to thank Mr. Greenspan for appearing before us today. I would like to impress upon him the importance of maintaining independence at the Federal Reserve. Speculation over the role of political influence in the Fed's latest rate cut is very disturbing. It is grossly irresponsible to allow election year politics to influence decisions regarding the economy. Consumer confidence as reflected in long-term rates will not improve without assurances that the White House is not implementing an "anything to win" attitude that completely disregards our long-term economic future.

Again, I think Mr. Greenspan for joining us this morning. I look forward to hearing his comments. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Domenici?

We're going to have order in the room.

Senator DOMENICI. Chairman Greenspan, you indicated that the balance sheets were beginning to move in the right direction and that, in your opinion, bodes well.

Are you also talking about the balance sheet of families, of the working people of the country, of the middle class, or are we just talking about business and industry?

Mr. GREENSPAN. No, I'm talking about balance sheets of households and balance sheets of businesses, small and large.

The household balance sheets have been under very significant strain as debt service charges have gone up. That is, we had a rise in the ratio of interest and amortization charges on household debt which moved up above 18 percent of personal disposable income, as debt expanded very dramatically in the 1980's. About half of that rise that occurred in the 1980's has now been reversed. And from what we can see of the process in the most recent data, that adjustment is occurring quite rapidly at this point.

Senator DOMENICI. Do you have any way of measuring that remedying of itself out there in the market place in terms of how much has to occur before people and businesses start spending more money?

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Mr. GREENSPAN. Yes. I would suspect that we're getting very close to that point and that's the reason why I sense that some degree of acceleration is probably not too far into the future.

All we know at this moment is that the repayment of consumer debt continues, but we also know that the very dramatic decline in interest rates has reduced the payment costs on both mortgage debt and in consumer debt in a very appreciable manner. And it's that process which, in the household sector, is moving at a pace which is far more rapid than it has been and one which would presumably begin within a reasonable period of time, to create increased incentives for consumers to start again purchasing both large ticket items and spending in the consumer areas generally.

Senator DOMENICI. Chairman Greenspan, it's my understanding and recollection that at the end of the 1970's, that is, 1979 and 1980, 1981 period, interest rates were in excess of 21 percent. Inflation was in excess of 15 percent. And unemployment ended up in excess of 10 percent.

Now, today, if my numbers are right, we have 17 million more Americans employed than we did then.

You are telling us that part of this unemployment number is because more people are seeking jobs than you had anticipated in your projections, and that accounts for some of the unemployment.

What caused the increase in job seekers during this recessionary period, such that economic growth, as you projected it, in fact, it is higher than you projected, did not bring unemployment down?

Mr. GREENSPAN. It's still a puzzle because where a significant part of the higher so-called participation rate of the population occurred is among adult men, which has been a relatively stable ratio over the years.

We have seen continued growth in the number of women, say 25 years of age and older, going into the work force as a percent of the population. That has slowed down some.

But we had a fairly dramatic decline in the participation of men a year or so ago, and that looked to be stabilizing. We presumed that the fairly stable, in fact, slightly declining, overall participation in the labor force would continue, which meant that, effectively, the ratio of employment to population would be relatively stable.

That forecast has turned out to be correct. The forecast which was wrong was we did not anticipate the rebound in the proportion of men, adult men, in the labor force. We are not sure whether that is a stastical aberration or that it happened in the real world. But the numbers that create this very significant rise in the unemployment rate in recent months occur largely as a consequence of that phenomenon.

Senator DOMENICI. In my opening remarks, I indicated that, obviously, to some extent, the policies that you had carried out were not moving the economy ahead as fast as any of us wanted. I don't think as fast as the President would like. And I wondered if you would give us any suggestions as to what we ought to be doing, aside from your particular activities. And I think you nodded that you would.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Would you share with us today, if there is a concern that we ought to be moving this economy at a higher pace, what your suggestions are?

Mr. GREENSPAN. Well, at the moment, what we are observing is the underlying workings of the structural difficulties, and what we're looking at is a gradual solution to these underlying problems.

As I indicated to you earlier, I suspect that as far as consumers are concerned, we're getting reasonably close to where increased consumer spending will be a significant factor in the economy.

But unless plant and equipment expenditures, capital goods, begin to accelerate, it's very difficult to make the case that the economy's rate of growth will accelerate.

We have had a marked improvement in profit margins largely because productivity has improved so dramatically, and that's one of the reasons why, even with the economic growth that we see, the level of employment is quite stagnant. But what that implies is that profit margins, which had been depressed very significantly, are now beginning to open up, and that process historically has usually meant that capital investment would begin to move.

If that process falls into place, then we will get an expansion which I would say to you would be sufficiently adequate to bring the unemployment rate down significantly. And implicit in the forecast of the Federal Open Market Committee's members is a projection which has certain of those characteristics in it.

If that does not occur, then it means basically that this process is undergoing a far more stretched out procedure. I don't believe that's happening and I don't agree with the proposition that, looking back 6 months, 9 months ago, that the economy has in fact moved so differently from that which we expected at that time.

It is certainly the case, however, that the unemployment rate is much worse than we expected. But that is not true of real economic growth. And the problem here is that, unless and until we get economic growth picking up to a somewhat higher level, we are going to have considerable difficulty in moving the unemployment rate down.

We are confronted with a very serious policy choice. I would not deny that there is the possibility that were we to engage in some fiscal stimulus at this stage, that we would accelerate near-term growth.

However, that is highly risky and, in my judgment, could probably—in an analysis of where that would carry us—be counter productive in the longer term.

I think we were all very much chagrined when the budget deficit accelerated as much as it did in recent years during a period of economic expansion because we all knew that at some point, after an extraordinary expansion of economic activity during the 1980's, the economy had to turn down.

As I've said before this committee on many occasions several years ago, the business cycle is not dead. It's still out there and will get us at some point. But when it emerged, we were confronted with a very substantial deficit which limited our capability of engaging in the type of fiscal policy actions which so many times in the past have proved useful.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

And so I think we've arrived at this particular point in having allowed the deficit to get out of hand, where our choices are really quite limited.

I do think we could move ahead with the fiscal policy mix, but only at a significant, potential long-term cost which, in my judgment, would be a mistake to engage in.

I must say to you, I do not believe this notion that we can "jump-start" the economy. That is an unfortunate analogy which does not apply to economic processes. The more relevant consideration or analogy is more the question of turning an ocean liner around fairly quickly.

The way which we have to revivify this particular economy is going to be different and more difficult than I think we've had in recent cycles.

I can't give you an easy answer to what it's doing. All I can tell you is that the economy, underneath the structure that is now evolving, is improving, that while we are not getting the response that I would like to see as yet, I do nonetheless expect to see those responses. The reason we have not, after producing such an extraordinary decline in short-term interest rates, gotten the response in the economy is an indication of how difficult the structural imbalances were. Other countries are having precisely the same problem as we are but I would say at this point that the United States is far more advanced in coming out of this than our trading partners are.

Senator KERRY. Mr. Chairman?

The CHAIRMAN. I must say, that sounds an awful lot like recovery's right around the corner.

Mr. GREENSPAN. No, Mr. Chairman.

The CHAIRMAN. With all due respect, you have said in virtually the same words that you've just used now, you've said this to us now repeatedly, stretching back for at least a year's time.

I can give you the citations.

Mr. GREENSPAN. No, but there is a difference.

The CHAIRMAN. You see the risk, on the one hand—I don't think you see the risk in terms of all the damage that is happening to the economy. You don't seem to be able to see that. You see the future risk, the inflation risk, but the damage in terms of all the unemployment and the business failures and the loss of confidence and all kinds of massive job eliminations and so forth that are going on, you look at that and you have a very benign reaction.

Mr. GREENSPAN. No, I don't have a benign reaction, Mr. Chairman. I think it's a very serious problem.

As you may recall, in a past committee meeting, I said to you that I had never seen such a degree of concern on the part of the American people with respect to our future. That is something I am very seriously aware of, very much concerned about, and one which I find is the major issue which confronts the economy.

But I also want to point out, Mr. Chairman, that the economy has been increasing. We're talking here as though it has not changed.

What I had said in the past is that we would get a moderate recovery going. We have a moderate recovery. It's not as though the events have not unfolded the way we suggested they might. They

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

have. We have a growth rate now which is relatively consistent with what we have been forecasting for almost the last year.

The one area where we have been off and off badly, which I acknowledge and which I find difficult to explain fully, is the unemployment rate, which is essentially a labor force question and not an economic growth question.

I'm not saying to you that there is not great distress out there. I see it all the time and I run into it all the time. It's something which we should have very great concern about.

But we should be very careful not to take actions which are short-term, quick-fixes to a problem, the costs of which we're going to pay at a much later date. We've had too much of this extraordinary increase in deficit spending for which we are paying a very major price.

We don't have the capability of continuing to expand this budget deficit without longer-term consequences.

The CHAIRMAN. Well, massive unemployment increases the budget deficit, doesn't it?

Mr. GREENSPAN. I would say that weak economic growth increases the budget deficit.

The CHAIRMAN. That's exactly what we've got and it's helping to drive up the deficit.

Senator Cranston?

Senator CRANSTON. The Los Angeles Times poll that Chairman Riegle referred to indicates that just 19 percent of Americans expect an improvement in U.S. economy, 22 foresee worse conditions, and 54 expect no change at all.

Do you predict any actions occurring, or events developing, or plan any specific actions that you believe will improve the situation in a significant way in the not too distant future?

Mr. GREENSPAN. Are you talking about monetary policy?

Senator CRANSTON. Whatever.

Mr. GREENSPAN. Senator, we, as I indicated in my prepared remarks, have moved short-term interest rates down very considerably. We have been confronted with, in many instances, indications that credit is not moving, that the money supply is not moving. Indeed, we have been most concerned about the fact that bank loans have been relatively stagnant for quite a while.

That has been the reason why we have responded and endeavored to create an environment in which there are incentives to lend.

The problem that we have got, as best we can judge, is two-fold. One, there are indications that a number of institutions are concerned about their capital and therefore, are not lending and, as a consequence of that, have created what we have in the past described as a credit crunch, which effectively impacts on small- and medium-sized business lending.

But there's also very strong evidence that the general demand for loans is quite low. And as a consequence of that, a very substantial amount of economic activity has been financed by internal cash flow. That is, either consumer incomes for households or cash flow for business, and that the demand for funds is not very great.

So that, while we are seeing a general weakening in the overall credit structure, we nonetheless are seeing economic activity still

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

expanding at a moderate rate, which means that the system is, to a large extent, bypassing the intermediary process.

Now, a number of actions are obvious when one looks at this type of phenomenon other than standard monetary policy as such because we've engaged obviously in fairly massive endeavors to increase liquidity.

We do have structural problems here and, as a consequence, we are looking at issues such as the leverage ratio, which is one of the elements of the risk based capital requirements that were imposed on banks. And as we have indicated in several comments and public issuances, we are trying to create a change, an addition to the risk based capital guidelines for banks which will enable us to eliminate the leverage ratio.

And in my judgment, that is a material issue which is affecting the banks, even though at this particular stage, aggregate demand is still quite weak.

So, in one area, we are looking to improve the transmission from monetary policy into lending, and we hope that we're going to be able to eliminate the leverage ratio sooner rather than later.

Senator CRANSTON. It seems to me that the situation that you describe as a lack of aggregate demand for credit may be analogous to the people who are unemployed and have given up on looking for work at the present time.

I think many business people have searched hard for an institution to make a loan to them and they've sort of given up because they've found it very, very difficult to obtain adequate credit any place.

Do you believe that that is about to loosen up and that there will be more credit available?

Mr. GREENSPAN. Well, certainly, to the extent that we are able to first bring interest rate risk into the broad risk based capital system. Once we're able to do that, we will ease up in certain areas with respect to capital restraints.

The trouble at this particular stage is that there's still a lack of demand for credit. People have over borrowed and they have decided essentially that they've got too much in the way of debt and have been paying it down at a very pronounced rate.

This is the reason why the reduction in interest rates has had such an extraordinary effect on the restructuring of balance sheets. As mortgage rates have come down, there has been a very dramatic reshuffling of mortgage credit where interest payments by mortgage debtors have come down quite dramatically. It's that process which is improving consumer balance sheets very dramatically. And a similar process in the business sector is creating a much improved balance sheet structure for business which will enhance capital investment.

It's in these two areas where monetary policy is effectively moving balance sheets toward a position which will be supportive of economic activity.

Senator CRANSTON. Thank you very much. My time is up.

The CHAIRMAN. Senator Gramm?

Senator GRAMM. Thank you, Mr. Chairman.

Chairman Greenspan, I want to refocus our discussion because I'm afraid that what has happened here is that everybody said,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

we're not blaming you for the recession, and then very promptly, everybody has blamed you for the recession.

You have talked about monetary policy and talked about your past predictions and talked about your current policy and what you're doing. But what has been left out of this whole discussion is the fiscal policy part of the equation.

I simply want to tick off a series of policies, and I want you to tell me in your professional judgment, if we all share the common goal of getting America out of the doldrums, putting people back to work, generating economic growth, would these policies help or hurt.

Number one, adopting the President's comprehensive program to gain control of entitlement spending by setting binding caps that trigger reform in entitlement spending. Would that help or hurt in putting Americans to work and in terms of generating economic growth?

Mr. GREENSPAN. Well, Senator, I don't want to comment on any particular proposal. But if you were asking me whether or not restraints on expenditures generally would be productive to the long-term growth of this country, most certainly.

Senator GRAMM. Let me ask you another one, and this is a bipartisan proposal. It was defeated by 9 votes in the House. It failed on cloture by 2 votes in the Senate. I refer to a constitutional provision mandating a balanced budget.

If the balanced budget amendment to the Constitution had been adopted, and if effective implementation legislation had been put into effect, would that have strengthened the economy, helped create more jobs, helped generate more economic growth, and would that have helped to bring down long-term interest rates?

Mr. GREENSPAN. Senator, as I have testified before the Congress, I would far more favor, if we're going the constitutional route, to have an amendment which would require supermajorities for expenditures, not at the outlay level, but at the authorization and the appropriation level, with sunset legislation for all entitlement programs.

My view is that if it is worth spending public monies, one should readily be able to get supermajorities rather than 50 percent, because it's very easy to spend public monies if you don't have to finance it.

In my judgment, that sort of amendment would contain expenditures quite significantly and precisely the way your first question was addressed. I would prefer that to merely a stipulation requiring the Congress to put through implementing legislation. A constitutional amendment which would require, say, 60 percent or two-thirds majorities for every money bill, automatically constrains that particular activity without implementing legislation. In my judgment, it would go a considerable distance toward bringing the budget deficit down and not confront us with a situation in which we might have a constitutional amendment, but we would fail in the implementing legislation which would be required to address it.

Senator GRAMM. Well, the amendment we voted on required 60 percent to increase the deficit, 60 percent to borrow money.

Do you believe, had we cut the capital gains tax rate 3 years ago or last year, on both occasions, we had votes on both occasions, and

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

it was defeated, do you believe that that would have helped the economy had we done that?

Mr. GREENSPAN. Yes, I do, Senator.

Senator GRAMM. Do you believe that increasing domestic spending and raising tax rates, raising the AMT and raising the payroll tax to pay for it, even if you balance the two, would benefit the economy?

Mr. GREENSPAN. I don't want to comment on specific types of proposals of that nature, but I would be inclined, as I've indicated to you and to other members of this committee, to be focusing more on trying to restrain spending as a means of reducing the deficit than endeavoring to work on the tax side because, in my judgment, it is very difficult over the long run to get budget deficits down from the tax side because there is a tendency, as best I can judge the process, to spend when one taxes. It's far easier to get the deficit down, although politically far more difficult to implement, if one works from the expenditure side.

Senator GRAMM. Let me conclude by giving you a fairly broad question, but I think an important one.

We have all here today second-guessed what you have done. I'd like to give you an opportunity to respond, and I'd like to ask you, if you could dictate policy in the Congress, what could we do that would help put Americans back to work?

If you could just tick off two or three things, what would you have us do?

Mr. GREENSPAN. I would say, first of all, that what we must focus on is what, in my judgment, the American people are most concerned about—not the next 6 months, perhaps not the next year or so. But they are very seriously concerned, with valid reasons, about the long-term future of this country. Any actions I would support in that regard would focus on that.

And as far as Government policy is concerned, as I've indicated in numerable occasions before this committee and before other committees, it is essential that we bring the budget deficit down as rapidly as we can because it's a corrosive force which is doing very great damage to the American economy.

It's diverting private savings from capital investment. It's created a situation in which the net capital stock increases, the stock of capital which creates growth in productivity and standards of living in this country, is slowing down very dramatically and it is to a large extent the result of that deficit.

So if we wish to create jobs and higher standards of living for the American people in the future, and change the long-term outlook, it's in that area which I would be most focused.

The CHAIRMAN. Senator Graham of Florida?

Senator GRAHAM. Thank you, Mr. Chairman.

In my opening statement, I suggested that what is happening today in our economy is significantly different than the assumptions upon which many of our computer models and expectation analyses have been predicated, that the kinds of initiatives, and it's not just lower interest rates. It's a historically weak dollar. It's unprecedented Federal spending and budget deficits, all of which are classical Keynesian economics in terms of stimulative, and none of them have had the intended result, as witnessed by the economic

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

performance during the 3½ years of the Bush administration as compared to the economic performance exactly 20 years earlier during the Nixon administration.

And so the question is what is different in the economy today that's causing the prescriptions not to make the patient well?

What's your analysis, what's your diagnosis of the principal changes that have occurred in the economy in the last 20 years? And then the next question is going to be, what economic policies do you think we ought to take to reflect that change in our economic anatomy?

Mr. GREENSPAN. Senator, I believe that most of the analysis, not all, but most of the analysis which is involved in standard macroeconomic policymaking, as it has existed over the last 2 or 3 generations, has focused on what we economists talk about as the income and product account, meaning the income statement, cash income received, expenditures, employment creation, and the like.

Implicit in that evaluation is that the balance sheets of both households and businesses would not have a material impact on those decisions. And indeed, through a very significant part of the 1940's, 1950's, 1960's, and 1970's, that was substantially the case. And I might add, well, into the 1980's.

That changed, and it changed basically because when borrowing reached the limits that it reached and the balance sheets experienced the type of strain which they eventually did, the impact on so-called income and product account relationships, to which I would relate, on the side, monetary policy, was quite considerable and unprecedented in any of our evaluations of previous decades.

Therefore, the reason why I stated in my prepared statement that what we are looking at is a phenomenon that we have not seen for more than a half century, is that we haven't.

This is the type of economy which has many of the characteristics which we perceived prior to World War II and some of the speculative imbalances and balance sheet effects which were not evident in the post-World War II period, in large part because we came out of World War II with an extremely high degree of liquidity.

There was very little in the way of debt burdens. The levels of incomes relative to debt service remained very high for several decades. But eventually, we ran up against the wall of restraint and for the first time, we have seen such extraordinary things as declining money supply, declining loans, declining consumer credit.

And that is a very unusual phenomenon, and the conceptual framework around which our general view of the way macroeconomic policy functioned has changed. The same tools that we used in the past which presupposed neutral balance sheets are not working to the extent that one would have expected.

They are working in part, but I think it's perfectly obvious that they're not working anywhere near as potently as they have in the past.

Senator GRAHAM. Well, if that's the fundamental difference, that is, the change in the characteristic of the balance sheet and the importance that that's having both in our private and public lives, what do you think are the prescriptions for monetary policy and recommendations for fiscal policy that would address that issue?

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

You've talked thus far about stimulating capital goods purchases, reducing Federal budget deficits as quickly as possible. Are there any other items that you would put on your prescription list?

Mr. GREENSPAN. Senator, as I indicated in my prepared statement, the basis of Federal Reserve policy in recent years has been largely to confront this balance sheet problem which manifested itself most evidently in the credit crunch starting in mid-1990, but has got a number of other characteristics associated with it which are all related. And until we have cleansed the balance sheet, getting back to more normal relationships, it's going to be very difficult to get the same effects out of fiscal and monetary policy that we got in the past.

The impact, for example, of the monetary policies which we've initiated has created an extraordinary spread between short-term interest rates and long-term interest rates, by far, historically unprecedented. We consider that necessary to confront this particular type of problem, but it would surely not be an appropriate policy when balance sheets are back to normal.

Senator GRAHAM. Is there anything that monetary or fiscal policy could do during this process of cleaning up balance sheets to avoid the tremendous human cost that's currently being paid?

Is there any way to make this transition less painful?

Mr. GREENSPAN. It is unquestionably an extremely painful transition. One of the problems that we have with such transitions is how we got here which is by, in large part, producing a budget deficit during periods of economic growth and prosperity and low unemployment which made it pretty much inevitable that when we eventually, as indeed we would, got into a recession, we would have our major policy tool of the past essentially impotent.

Now, can we use it? The answer is, yes, we can. The trouble, unfortunately, is it can only be done by trading off short-term benefits with long-term costs. That is a very major decision on the part of the Congress. It's not the type of thing which one does readily.

I cannot say to you that under all circumstances should one avoid such a trade-off. But it is a trade-off. We would in effect be undercutting some longer-term growth and stability of this economy were we to move in that direction.

That is a very difficult choice to make. My own personal inclination as a citizen, not as a policymaker, is that I would choose not to do that.

But that is a major value judgment that the Congress has to make in the name of the American people.

The CHAIRMAN. Senator Sasser, chairman of the Budget Commmittee.

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

Mr. Greenspan, a moment ago, Senator Gramm of Texas inquired of you about this constitutional amendment to balance the budget. You were wise enough to not get into that farcical political thicket. But, of course, you and I know that that is something that would not go into effect if it were passed by the Congress and ratified by the States for at least 5 years. And we're talking about an economy that's in trouble right now.

Further, Senator Gramm of Texas asked you about curtailing entitlements.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Well, now, you're not suggesting that in a time of economic weakness, that we cut back on civil service retirement, military retirement, cut Social Security payments, reduce Medicare payments, reduce food stamps, reduce veteran's pensions, reduce railroad retirement payments.

In the short term, that would have a deleterious effect on an economy that's already in trouble, would it not?

Mr. GREENSPAN. Well, Senator, I was responding to the longer term issues.

Senator SASSER. I know you were responding to the longer term.

Mr. GREENSPAN. I very purposefully chose to indicate that.

Senator SASSER. What we're talking about now is trying to get an economy out of the ditch that it's in right now. We're not talking about getting it out 5 years from now.

Mr. GREENSPAN. No, but when I'm talking about the issue of balancing the budget, getting it back into balance, I'm not talking about the next year or so. I'm not even talking in the context of 5 years because I think that 5 years to solve the size of the deficit we have created would be very difficult to do.

But if we don't get started on the process, we're going to be in very serious trouble. I would be talking about evaluating spending priorities to go into effect sometime in the future, not the period immediately ahead. Unless we do that, we're never going to get moving in the appropriate direction.

Senator SASSER. I just want to make the point that this business about passing a balanced budget amendment which may go into effect in 5 years, and this proposal about cutting these entitlements, social security, Medicare, food stamps, veterans' pensions, civil service retirement, those types of things, that's not going to get us out of this ditch we're in the short-term.

Now some of us urged this administration in January of 1989, when they first came into office, and the business cycle was still fairly robust, to do something about the deficit at that time.

Now they continued to fiddle while Rome burned and now we find ourselves in the posture we're in today. We find that unemployment is up. We talked about that today. It's up to 7.8 percent. But industrial production is also down. Housing, both by way of starts and permits, that's also down.

Exports are down.

All of the indicators that you're looking at are indicating continued economic weakness.

Now, Mr. Greenspan, a few moments ago, we talked about the importance of greater investment in plant and equipment. Now just a few months ago, the Congress passed legislation that would have included investment incentives in the form of accelerated depreciation.

If we had those investment incentives in place now, that would have included accelerated depreciation or capital expenditures in plant and equipment, don't you think that the economy would be moving along stronger today than it is?

Mr. GREENSPAN. I suspect that capital investment would be somewhat higher, but the Government deficit probably would be somewhat higher as well as a consequence.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Senator SASSER. The President vetoed that effort, to try to get some capital investment moving.

Senator SARBANES. Why would the deficit have been higher? The deficit in fact would have been lower because the package that was put together by the Congress and sent to the President contained——

Mr. GREENSPAN. I was responding very specifically to that. I would say——

Senator SARBANES. No, but the thing that Senator Sasser was talking about was in a package that was not only deficit neutral, but in fact, provided a little plus on reducing the deficit side.

Mr. GREENSPAN. Senator, I was only responding to the question of whether accelerated depreciation would affect the level of capital investment, which I think it probably would. But I also do think that it probably would have caused some reduction in corporate taxes which would not have been made up by the aggregate increase in the economic activity, which would have occurred as a consequence.

Senator SARBANES. No, no, Mr. Chairman. You led it into the deficit question. The item which Senator Sasser made reference to was contained in legislation which other——

Mr. GREENSPAN. Well, then, I misheard him.

Senator SARBANES. Which had other provisions in it that not only provided to be deficit neutral, but in fact, picked up a little bit to address the deficit.

Mr. GREENSPAN. I misheard him.

Senator SARBANES. I ask my colleague, isn't that correct?

Senator SASSER. That's correct. Mr. Chairman, I very much appreciate Senator Sarbanes' inserts here. They are very worthwhile. However——

Senator SARBANES. I'll yield the Senator some of my time. I yield him some of my time.

[Laughter.]

Am I next in line, Mr. Chairman?

The CHAIRMAN. Yes.

Senator SARBANES. Well, I yield some of my time to the Senator.

Senator SASSER. Mr. Chairman, as you know, I've long been a proponent of lower interest rates. You and I have kicked this around since you have been Chairman of the Federal Reserve Board, and even talked about it in your first confirmation hearing. I believe lower interest rates are a tool to spurring economic growth.

I was pleased when the Fed began reducing rates, as I said earlier. I think they came too late and as Mr. Tobin said, too little, too late. But at least, at long last, the Fed began lowering rates.

Now, in this atmosphere of falling rates, I am struck by the fact that rates on savings instruments are falling faster than those on loans.

In other words, my mother's CD in the bank, her rates are just going down like that. But the fellow that goes to the bank to borrow some money, his rates are not going down that precipitously.

In other words, the way the Fed's interest rate policy has filtered down, it appears to be working principally to the detriment of savers and not incurring as positively to those who are lenders.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Now I would cite as evidence of this, and I'm following up on something Senator D'Amato said earlier, I would cite as evidence of this the average 6-month bank certificate of deposit was paying 6¼ a year ago. It's now paying 3.97, a decline of 2.28 percentage points.

But the rate for a fixed-rate mortgage has fallen only 1½ percentage points, to 8.12 percent. This is the average.

Now here's what I'm coming to.

According to the press, these low interest rates helped banks earn a record $7.6 billion during the first 3 months of the year, compared with $5½ billion in the first quarter of 1991, and $3.1 billion a year ago.

The American Banker, the organ of the banker, a very authoritative publication dealing with the banking industry, reported last week that banks at almost all regions of the country had increased their second quarter profits, and I quote, "sharply."

Now my question is this. Are banks using the opportunity of the drop in rates simply to increase their profit spreads, which I suspect they're doing, instead of making the loans necessary to get this economic recovery going?

I'm hearing from business people in my State, and particularly small business people, they're having great difficulty still getting loans, that there is a credit crisis out there. Yet, we see the banks' profits up sharply.

What's your response to that?

Mr. GREENSPAN. I think, first of all, your factual statements are quite correct. That is, that interest margins of banks have opened up and one of the basic reasons that they have done so is largely to restore their capital positions.

There was very great concern in the banking community a couple of years ago that the combination of sovereign lending, LDC lending generally, and the commercial real estate problems which hit the banks, was going to create major difficulty for the commercial banking industry.

One of the reasons, I might say, that we moved interest rates down considerably for short-term bank-type funding instruments was an endeavor to try to assist them in increasing their capital position, as indeed was the reason for two reductions in reserve requirements.

So, in that respect, what we perceived of is a necessary policy response to try to restore a viable commercial banking system which, in many people's judgments, not only our own, was in some difficulty.

There has been a major improvement in banking since. But there are still considerable concerns which are a carry-over from the lending problems that occurred in earlier quarters which has tended to cause bankers to pull back, and the way they pull back is to open up their margins.

In other words, what they do is they offer less to depositors since they don't want the money and they charge more to borrowers as a means of trying to improve their capital position.

So the consequence of this, obviously, is to create a significant slowing down in lending, which is what we have perceived. It tends to create a considerable concern on the part of numbers of people

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

who are holding bank deposits and whose incomes come down very dramatically. And it's one of the reasons why a number of people have decided, granted the difference between the costs of borrowing, whether it's mortgage or whether it's consumer installment credit, and the difference of what they can get on their deposits, to use the deposits to pay off debt. And that's one of the reasons why money supply, incidentally, has behaved as sluggishly as it has. We have been concerned about the same issue that you raise, Senator.

Senator SASSER. Well, what are you doing about it, Mr. Chairman?

Mr. GREENSPAN. What we're trying to do is to encourage a restoration of the capital position so that the banks are no longer concerned about that. And as I indicated to Senator Cranston earlier, we are looking very closely at the leverage ratio which was imposed as a necessary concomitant to the risk based capital requirements which are being imposed world-wide to substitute for so-called interest rate risk.

But now that we are in the process of getting interest rate risk embodied into the overall risk based capital policy, I believe that we will fairly quickly be able to dispense with the leverage ratio and although I must say to you there are disputes within the Federal Reserve and elsewhere about this issue, in my judgment that should be a significant factor in easing up on what is still a credit crunch.

We still have significant reluctance on the part of a number of commercial banks to make business loans. And since that means loans to largely small- and medium-sized businesses, that is a significant problem because that's their major source of financing.

But we do have in a number of our surveys indications that that process is beginning to ease and that there are significant hints that lending to smaller businesses is beginning to evolve. The National Federation of Independent Businesses show somewhat less constrained evidence of this problem. But it still exists. It has not gone away.

Senator SASSER. Here's my concern. I'll say this and then I'll yield to my colleague from Maryland. Here's my concern.

We're reducing interest rates and the banks are using these reduced rates and taking this to cut the return that they give savers who save in their banks.

They in turn then take funds and invest them in long-term Government securities. And we now find that the banks, in my view, are getting well from their ill-advised leveraged buy-out policies and loan policies of the 1980's, simply by squeezing the mom or pop who has the CD and taking the funds that they get from the Fed at a low rate and then investing them in long-term Government bonds.

So, in effect, the taxpayers are bailing out the banks from their problem loans of the 1980's, it appears to me. And the CD-holders are helping pay the freight on it.

Is it true now that banks are the largest borrowers of U.S. Government securities?

Mr. GREENSPAN. Yes. They are very significant purchasers.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Senator SASSER. That is a phenomenon that has occurred just over the past 6 months, isn't it?

Mr. GREENSPAN. Well, no, it's a little longer than that. It's over a year. But the crucial question here is whether in fact that particular process is a major factor in the loan restraint.

What we have done, as I think I indicated in a letter to the Chairman at one point, is to try to disaggregate various different types of banking institutions by the extent to which they are well capitalized, on the grounds that the undercapitalized banks would be tending to go in the direction of not lending and buying Government securities as a means, as you put it, of getting well.

What we found in that analysis is that the extent of increase in holdings of U.S. Government securities was fairly broad across all of the various different capital positions, meaning highly capitalized banks were also very heavy purchasers of Government securities, which suggests that the major, not the sole, but the major reason for that accumulation is basically a lack of loan demand.

In other words, as we pump reserves into the commercial banking system, they either have got to lend it or they've got to put it in securities because we pumped liquidity into the system.

But from what we can evaluate, while I still think there is an element of credit crunch involved in a number of institutions, by far the largest part of the motive for accumulating the securities is a lack of loan demand, rather than an endeavor to invest in Government bonds as distinct from making loans.

Senator SARBANES. Well, how do you square that with the repeated stories we're hearing from people on Main Street who say, we can't get loans from the banks for credit worthy projects?

And these are people who have been in established business activity and who now find their access to credit crunched. And it really raises the question whether—you're trying to push this monetary ease out there, but whether when it finally gets out there, it's not simply being, in a sense, diverted in the way that Senator Sasser has outlined, rather than being used in order to stimulate economic activity.

Mr. GREENSPAN. Senator, I think it is both. The type of anecdotal evidence that you pick up and we pick up is largely correct.

These are not stories that are made up by people who have grudges or something like that. They are substantially valid concerns.

I'm saying, however, that I don't think you can explain the whole huge increase in Government securities by that because we have other evidence to indicate a substantial part of that is lack of loan demand itself.

The CHAIRMAN. Let me just say. Senator Kerry, you were next in the order. You had to leave to preside and I think between us, we've worked out arrangements so that you could come back. You're actually next in the order. I think I need to call on you and then go to Senator Sarbanes.

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

With respect to this issue of the Fed on the level of the real interest rates and the long-term rates, is the Fed considering buying, in order to lower the interest rates or force them down, buying long-term?

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Mr. GREENSPAN. Well, Senator, we did engage in some of that. The problem that we have and, indeed, I suspect it's the reason why the Treasury has refrained from doing more than modest curtailment of their offering of long-term securities, is that the evidence of what the effect would be is not very persuasive.

In short, if, and this is an extreme statement, if all of the abnormally high level of long-term rates is due to inflation expectations, meaning that essentially, no one will buy a long-term bond unless he gets at least a premium over his expectation of inflation, then the price of long-term bonds and the level of interest rates will have nothing to do with how much is supplied.

It's that phenomenon watered down which is what concerns people at the Treasury and the Fed in these actions. In other words, our view is that it might do some good, but it's very likely to be quite deminimus.

And indeed, we moved forward to do a couple of these types of what we call coupon passes largely because we have a declining maturity schedule in our Federal Reserve Government portfolio which we're in the process of trying to flatten out and in the process are moving in the direction of buying some more coupons, but we're not engaged in a massive endeavor because there's no evidence of which we are aware that it will work in any appreciable manner.

I assure you that were the evidence there, the Treasury would be engaged in this operation because their actions would be far more formidable in affecting interest rates than ours.

Senator KERRY. What evidence do you have, then, following up on Senator Sasser's line of inquiry, that the banks aren't just relying on that spread as a quick means of gaining this profitability that they've gained in recent time and increasing their assets and so forth, but they're not lending?

Are you saying, then, that the lack of demand is exclusively business oriented, or is it more a reflection of the lack of confidence? Or is it a reflection of the fact that the loan officers themselves are looking at the economy and saying, well, I don't see any prospect that I'm going to get the rent on my money, so we're not going to lend?

Mr. GREENSPAN. I think it's all of the above. First of all, obviously, you have to ask yourself, if you're a banker——

Senator KERRY. Let's assume—let me just go down the line here.

Assume it is all of the above, and I think there is an ingredient of all of the above in there. And you have acknowledged that you're not going to break the cycle with monetary policy. You can't go much lower than you are today. Correct?

Mr. GREENSPAN. I'd just as soon not comment one way or the other on that because that will be suggesting policies which we have not yet defined at this point.

Senator KERRY. Well, it's an all-time low for 29 years.

Mr. GREENSPAN. I will grant you that interest rates are very low.

Senator KERRY. Now, you say also that you see signs, and you've referred to this a number of times in the testimony this morning, that the structural change is taking place.

What are the specific signs that the structural change is working its way out? And you said also that we're at the half-way mark.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Now depending on where you begin to measure, I certainly can measure 2 or 3 years of this work-out. Does that mean we have 2 or 3 years from the half-way mark that we're now at for these signs you're talking about to really become evident?

Mr. GREENSPAN. I would say that it's about half-way on the broadest measures of balance sheet stress that we have for households. I'd say that it is a good deal more than that for the business sector.

It doesn't, however, follow that you have to go completely back to where we were before you begin to get a freeing up of spending because, as I indicated in my prepared remarks, I believe that as we continue to improve, the tightness that the balance sheets have induced in consumer and business behavior will start to relax. The constraints are not fully removed until we get back to better balance. Whether it's a year, year and a half, 2 years, I don't know. But well before then, you begin to get the relaxation occurring. It just does not go to 100 percent until the system's——

Senator KERRY. The relaxation you're referring to is really going to have to come from a change in confidence. And the change of confidence is going to have to come from some kind of perceptible demarkation points, i.e., the leading indicators, the plant and equipment investment, R&D. Something's got to shift here.

Mr. GREENSPAN. No, I would say that you can get confidence at least in part merely from the improvement of the individual balance sheets.

In other words, for people who have overborrowed, businesses who have overborrowed and have been saddled with fairly heavy interest and debt service payments, when the value of their house stopped going up or went down, or the value of commercial property went down and they are stuck with that debt, it's only when that debt is paid down significantly—where that is no longer an issue—that they feel more comfortable in going out and spending or investing. And I would say that very process itself is going to be the most important in obtaining a cleansing of balance sheets and a restoration of confidence.

Now implicit in there, I will certainly grant, is that employment growth is not irrelevant to this. The stagnant employment growth that we have seen has been a factor which has prevented a more rapid resolution of the balance sheet problem.

But even with the stagnant growth that we have had, there has been a significant balance sheet resolution and it's continuing.

That, from an individual's point of view, is far more apt to restore individual confidence than any broad measure of leading indicators or anything that people see.

I don't think that people basically engage in spending or investing on the basis of what they read necessarily in the newspapers. They are mainly involved in their own personal financial status. I would guess that a substantial part of how people behave depends on their own sense of what their status is, as distinct from what they view the economy as a whole is.

Senator KERRY. I know the light is on and my time is up. But would not that sense of status change dramatically nationally with some investment from which most people agree you get a different return than your traditional Government spending of either entitle-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

ments or defense spending, but rather, capital investment that most States separate in their budgets? And we do not nationally and we greatly handicap ourselves.

Would not $10 billion, $20 billion, $30 billion of investment in that kind of infrastructure greatly enhance that status outlook that you've referred to sufficient to kick in a lot of the transition and the structural change?

Mr. GREENSPAN. Well, Senator, I'd be more inclined to believe that while many economists have and will continue to view productive investment as adding to the productive capability of the economy, I would be doubtful that the average individual pays all that much attention to that when it reflects what he or she is going to spend on or how he or she is going to behave.

Senator KERRY. But this is their neighbor, Mr. Chairman.

Mr. GREENSPAN. Sure.

Senator KERRY. You're talking about their neighbor on their street. And when you walk down the homes of America and 1 out of every 10 people in the street is unemployed and they see more people losing their jobs and they don't see it turning around, they tend not to go out and feel confidence and spend, do they not?

Mr. GREENSPAN. What you ask is an issue of degree—well, let me be very explicit.

I would say the lay-off rate is a crucial element in consumer's confidence. It's not so much the level of unemployment. It's the extent to which people are losing jobs because that is the issue which concerns most people.

If they are employed, the unemployment rate itself doesn't give them any signals about whether or not their job security is high or low. But if the lay-off rate is high, meaning the unemployment rate is rising, then I would say that has a significant effect on consumer confidence.

Senator KERRY. Isn't that precisely what we have?

Mr. GREENSPAN. I would say that we've had part of that, yes. But we have more than that. As I've indicated in the past, there is a very deep-seated concern not about the next year or the next 2 years, but about the broader future, and that is where a very substantial part of the sense of distress that the average American has had in recent years comes from.

The CHAIRMAN. Senator Sarbanes, the chairman of the Joint Economic Committee.

Senator SARBANES. I just would follow up Senator Kerry's question with the observation that in this recession, the percentage of people losing their jobs who are being permanently terminated as opposed to being laid off, to be called back when economic activity picks up has shifted markedly. And what's happening now is people are—they're not being laid off and told, well, economic conditions have slowed down, but when they strengthen again, you'll come back to work.

They're being given a pink slip and that's the end of it. There's no job there, whether economic conditions pick up or not. They have to start out, then, on a whole new career path in order to try to find a job. I think that's having a very sharp impact on people's outlook about the future.

The CHAIRMAN. A huge impact.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Mr. GREENSPAN. You're quite correct, Senator, in the sense that the proportion of job losers to job layoffs has gone up appreciably.

But I do think that if you take a look at the ratio of job-losers to employment, while it's clearly gone up, it's still very significantly below where it was, for example, in 1982. And even, my recollection, looking at those data, is that it's about where it was back in 1984 or 1983.

Senator SARBANES. Well, of course, 1982 was the worst recession since the 1930's, since the Great Depression.

Mr. GREENSPAN. Sure.

Senator SARBANES. The unemployment rate went to just under 11 percent. It's 7.8 percent now. It went to 11 percent then.

Mr. GREENSPAN. But what I'm trying to say is that while it is certainly the case, and you're quite right in addressing this issue, that the composition of job loss has changed, the absolute level is still not in record territory or even remotely close to it.

Senator SARBANES. I'm going to get to that because I want to spend some time on the recovery of jobs in this recession compared with other recessions.

Before I do that, though, I want to clear off the agenda what I regard as—I hope it's just a housekeeping item. If it's not, then I have some very serious concerns about what's going on down at the Fed.

In 1989, the Fed did a survey of consumer finances. This survey obtains information from households about their income, assets, and liabilities.

In a hearing in September 1990, I asked about the data from this survey and indicated an interest—this was at a Joint Economic Committee hearing—in having that data available in order to be able to analyze it.

You then indicated, "It will take another year before those data are readily available." We kept in constant touch with the Fed staff throughout the balance of 1990 and into 1991, and as we got into 1991, it was indicated to us by Fed staff that the release of the data was a few months away.

Finally, in March 1992, the Fed made available a preliminary data tape, but missing from it were about 10 percent of the cases, and we think perhaps the most significant ones because they were apparently the ones at the upper end of the scale if you're going to try to analyze the import of this data.

I raised this issue with you again at a hearing on April 17 about getting this data. There was also apparently pending a study that the Fed itself had done, an in-house study about the data and what it showed. You said at that hearing that you had something in your in-box. You'd make it available soon. And shortly thereafter, you did release the in-house study.

But we've not yet obtained the full data. Now the Fed staff indicated that it would be available—this was back in April, when a discussion was held with them—in a couple of months.

More than a couple of months have passed. We've not yet gotten the full set of data. We're very anxious to have that data available.

I'm sort of at a loss to understand why it's so difficult. I don't want to move to a position of wondering what's going on here. Why can't we get this data. And I hope that it's simply some kind of bu-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

reaucratic problem. And I would just ask you to take any steps that are necessary in order to assure that the balance of this data which would make the preliminary data tape provided in March a complete data tape, be furnished promptly.

Mr. GREENSPAN. I frankly had thought that had been completed at this stage because it was a processing problem with respect to IRS tapes and the individual names on some of that which I thought was the problem. I thought it had been resolved.

The CHAIRMAN. Well, don't just sit there and nod your head no. We've got telephones in the back room. I'd like to get an answer before we clear out of here today as to what the problem is and when we're going to have it.

Mr. GREENSPAN. Let me say this. There's absolutely no reason that I know of why those data should not be made available to you sooner rather than later. If there is a reason that is holding it up which we can change, I will see that it gets changed.

Senator SARBANES. I appreciate that very much. And I do want to say, Mr. Chairman, that you personally have been responsive in the manner you've just indicated consistently throughout. But when we try to come out of these sessions and then carry it through, we seem to run into some difficulty.

So if you could——

Mr. GREENSPAN. I will try to see whether I can get this resolved as expeditiously as possible.

Senator SARBANES. We appreciate that very much. Now I want to address this issue of what I now call a jobs recession. And I really want to get your view as to what's going on.

This is changes in payroll employment from the cyclical peak, percent change. This line here represents the average of 6 previous recessions. And this line represents the current recession.

Now what this shows is that in all of the current recession and the average of the 6 previous recessions, starting from the cyclical peak, you obviously had job loss as you move into the recession. That's in part the definition of a recession. And you came down here and you get here—these are the number of months from the peak. In other words, when you started downwards.

We hit a point down here about—this is 12, 14 months after the peak. And then you started back up in these previous recessions, the average, and so, at 22 months out here, they had more than recovered the jobs that had been lost. More than recovered them.

In this recession, that hasn't happened. Here we are, 2 years after, almost 2 years after the peak, and we're tailing along here in terms of job recovery. The contrast between what's happening here and what happened in previous recessions, where this represents job recovery, is absolutely striking. It's a complete deviation from the previous pattern.

In fact, we asked the Bureau of Labor Statistics when they were before us for the last hearing. They were keeping it a somewhat different way. They said, this was the percent of lost jobs recovered after 14 months from the trough. In other words, they were measuring it from the trough, which they took to be about March 1991.

So you're coming out of the low point, out of here—in other words, they were measuring it from here. You come out of here and move up.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I asked them, if you want to talk about percent of lost jobs recovered after 14 months, the percentages are all over 100 percent. You have more than recovered the jobs lost and in fact, begun to grow.

And I said, well, they don't give us the figures for the other recessions. They said, would you like me to do each of the recessions? And I said, if you would, please. Now just listen to this.

So they took the first recession after the war. They said the trough was October 1949. In other words, down here. After 14 months, they'd recovered 174 percent. In other words, not only recovered the jobs lost, but more than recovered the jobs lost.

Then they said, the next recession, the trough was May, 1954. It recovered 128 percent.

April 1958, 132 percent.

February 1961, after 14 months, 169 percent. In other words, the economy had come back, recovered all the jobs lost, and gone beyond that.

Then November 1970, after 14 months, 244 percent.

March 1975, was the trough of the next recession, after 14 months, 191 percent.

July 1980, after 14 months, 151 percent.

November 1982, after 14 months, the percent of lost jobs recovered is 139 percent.

Then I said, what is it in this recession?

Nine percent. Nine percent. Now in every one of these previous recessions, the lowest figure for any of them 14 months after the trough was 128 percent. And in one instance, it had gone as high as 244 percent. Now in this recession, it's only 9 percent.

The CHAIRMAN. Fourteen months after the trough.

Senator SARBANES. Exactly, 14 months after the trough, we're still down here. We've only recovered 9 percent of the jobs. In every previous recession, the lowest figure was 128 percent of the jobs had been recovered, and then it went on up from there to as high as 244 percent.

Now this is a dramatic contrast, absolutely dramatic, in my view.

Now either it's wrong to put the trough where people are putting it—the President of the United States 2 successive months told us in the days just before the unemployment figure came out that the economy was getting better, but the American people didn't realize it. And then the unemployment rate jumped three-tenths of a point. And the next month he said roughly the same sort of thing, and the unemployment rate jumped another three-tenths of a point, to go to 7.8 percent, the highest in this recession and the highest since March of 1984.

The American people know that something is wrong with the economy, but the President doesn't seem to understand it.

Now, what's happened?

Mr. GREENSPAN. There are several elements of explanation. First, and most important, obviously, is that the extent of cyclical recovery in this particular period, 14 months after the cyclical low, is very substantially less. The recession basically was shallower than most and one would expect that the recovery would be less, but it's been even less than one would expect on the basis of the shallowness of the recession.

Senator SARBANES. But isn't the growth——

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Senator KERRY. Mr. Greenspan, you're just confirming what he just said.

Mr. GREENSPAN. Well, I'm talking about economic—you'll see where I'm getting.

Senator SARBANES. What is the growth rate of the economy generally coming out of previous recessions?

Mr. GREENSPAN. It depends on how deep the recession was, largely. But, on average, we've had much deeper recessions and have had 4 to 6 percent or more in quarterly growth in the early quarters of a recovery.

Senator SARBANES. Now we've had 2 percent growth in the last quarter?

Mr. GREENSPAN. Are we talking about the second quarter?

Senator SARBANES. Yes.

Mr. GREENSPAN. Probably somewhere in that area.

Senator SARBANES. And that's the first quarter since the first quarter of 1989 that we've had 2 percent growth.

Is that correct?

Mr. GREENSPAN. No. For the first quarter, we had 2.7 percent.

Senator SARBANES. All right. These 2 quarters are the first time we've had 2 percent growth since 1989.

Is that right?

Mr. GREENSPAN. That's correct, yes.

Senator SARBANES. And the 2 percent growth figure is a very low figure compared with previous recessions in terms of coming out of the recession.

I think the lowest previously was, what, 3.8 percent or something of that magnitude, of the previous recessions?

Mr. GREENSPAN. That would sound to me approximately correct, yes.

Let me go on. What we've got here, first of all, is that the major reason that the economy in terms of growth not employment, has moved up slowly is that productivity has also picked up, which has obviously meant that, with any level of economic growth, you need fewer people. And as a consequence, productivity growth has also been a factor here.

The CHAIRMAN. But let me just stop you there.

To what extent is the improvement in productivity the fact that workers are being gotten rid of? And so the output is up per worker because there are workers being thrown out the side door.

Mr. GREENSPAN. That's a measurement problem. To the extent that you get increased output per work hour merely by laying people off who weren't doing anything, that's a phony statistic.

I'm saying leave the statistics aside. I would say that evidence we have got, establishment by establishment, company by company, is that real productivity has been improving. That would mean that if you were to let people go, you get lower production.

I would just say, finally, there's another problem here which is basically that our long-term growth has slowed down. And as a consequence, since we're looking at the extent to which we came out of recovery in the earlier periods, because you had a higher growth rate, you're going to be getting a faster pick-up in the overall trend.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

And finally, just let me say that I suspect, although I do not know for sure, that we're likely to get some modest upward revision in those data. I think we have some evidence which suggests that.

But that's not going to change the configuration that you're talking about. That gap will exist and the fundamental reason for that gap is the issue of growth in gross domestic product, which is subnormal.

Senator SARBANES. Well, now you spoke earlier on the unemployment figure, that you had an unanticipated surge in the size of the labor force.

Now are you making that observation in the context of the fact that for over a year, people were commenting that the growth in the labor force was far less than they had expected?

Mr. GREENSPAN. I'm sorry. Would you just repeat that again for me, Senator?

Senator SARBANES. Are you making the observation that recently, there's been an unexpected surge in the growth of the labor force?

Mr. GREENSPAN. In the published data.

Senator SARBANES. In the context of the fact that for a year, more than a year, we've been worried up until the last few months that the labor force was growing far less than anyone had expected?

Mr. GREENSPAN. That's correct, sir.

Senator SARBANES. So you're comparing it against this very slow growth in the labor force. But that's really moving the situation back toward normal.

The abnormal situation was the slow growth in the labor force which we were experiencing, which suggested that a lot of people were so discouraged by the economic news, that they simply dropped out of the market. Then they begin to think, well, maybe things are getting better. They come flooding back in looking for jobs and your unemployment rate—but the abnormality is not the number now looking for jobs. The abnormality were the people who had become so discouraged, they dropped out of the labor force.

Mr. GREENSPAN. Let me say, looking at those data, both the contraction and the expansion, I just don't find it credible that it's unmeasured discouraged workers who are involved there. Those numbers are just too large.

I don't know what the answer is, but it's probably not a crucial factor in the employment data as such, as far as I can judge.

When we're looking here at basic growth in the economy which is slow—I suspect, for example, that the first half is quite dull—all I know at the moment is that the 2.7 percent increase in the first quarter probably in part reflected abnormal adjustments in seasonals and that the real underlying rate was probably closer, but not all the way back, to 2 percent.

I don't know what the second quarter number is going to be. We don't have enough data.

The CHAIRMAN. Are you saying that the first quarter number probably is going to be revised downward?

Mr. GREENSPAN. I don't think it's going to be revised down. Basically, what I'm saying is that the weather in the first quarter was

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

more conducive to economic activity than the formal seasonal adjustment factors captured. So that we have, for example, the fact that the weather was much better in January and February and therefore, we got much more housing construction than normally is the case in the winter months.

Those numbers embody themselves in the GNP accounts and that's what we're publishing.

So that, for example, if, and I don't know the answer, the figure for the second quarter is published at 2 percent or slightly less, what that is basically saying is that we borrowed some of the second quarter from the first quarter because of the seasonal adjustment factors.

I would be inclined to look at this pattern as somewhat of an average of the two, which is in the context of the rising productivity, even after you adjust for the labor force growth, barely adequate to keep the unemployment rate unchanged because we do know that the employment to population rate remained unchanged.

Senator SARBANES. Mr. Chairman, I know that my time is expired and I'd just close with this observation.

That is simply to say that Mr. Greenspan's attitude toward this economic situation is in tandem with and consistent with the administration's attitude in the sense that it's sort of no problem. We're sitting here trying to deal with unemployment that has risen sharply. It's now at its highest figure in over 8 years. And we're sort of being told, well, there's this and there's that. There's really no problem. It's like the President who says, the economy's getting better and the American people don't know it.

The fact of the matter is that the American people know exactly what's happening and they know there's a lot of economic trouble out there.

Mr. GREENSPAN. Well, I would say, Senator——

Senator SARBANES. We keep trying to sound this alarm that there's a problem and the response we're getting, when you finally cut through it all, is sort of, well, no problem. No problem.

I don't agree with that. I think there is a problem, and I think that it's a problem that needs to be addressed on many fronts. But it's difficult to do it when the administration refuses to recognize the problem and when the Fed sort of, in effect, says, stay the course.

It's the same sort of quotes we were getting from you back last year, in February.

Mr. GREENSPAN. Senator, if I might say, remember we have used the major tool at our disposal 23 times since mid-1989. We've lowered reserve requirements twice.

We have engaged in what has to be historically one of those extraordinary periods of monetary ease.

Clearly, we wouldn't have engaged in anything remotely like that if we did not have concern about the nature of the economy and the problems.

Senator SARBANES. Senator D'Amato was right on that point. You're always after the fact. You're always trailing the economic developments.

We had both Samuelson and Tobin here. Senator Sasser and I chaired a hearing back in January.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Senator SASSER. If I might correct my colleague, I said that before Senator D'Amato said it.

[Laughter.]

Senator SARBANES. That's absolutely correct. And we had Tobin and Samuelson, two Nobel Prize winning economists who came in here and said the Fed is too little and too late, that there's not this large inflation over and that they ought to be moving to try to stimulate the economy and be moving sooner than they're doing, particularly at a time when fiscal policy has been, to a large degree, immobilized.

Your response in this recession in terms of easing monetary policy, until your December action, was significantly less than what the Fed had done in previous recessions, even though in those previous recessions fiscal policy was also acting in an effort to try to address the recession.

It wasn't until the December action that you got anywhere near the average of previous Fed action and the extent to which you had eased policy.

We find ourselves in the situation in which we find ourselves.

Thank you, Mr. Chairman.

The CHAIRMAN. It seems to me that's the problem. The strategy really hasn't worked and there's not enough of it, frankly.

I think the record will show that when you commented on how the numbers for the first half will look after these adjustments that will be made for seasonal factors and so forth, that the economy is not showing any real spurt of growth. I think you used the word dull, d-u-l-l, to describe it. I think that's the word I heard you use. Is that right?

Mr. GREENSPAN. I think so.

The CHAIRMAN. Let me ask you this. Is unemployment apt to go to 8 percent?

Mr. GREENSPAN. Is it?

The CHAIRMAN. Yes.

Mr. GREENSPAN. I really don't know. I certainly hope not.

The CHAIRMAN. Well, I hope not, too. But I'm asking you—you know, you're a forecaster. We're asking you to look ahead here.

Do you think it's likely to? It looks to me like it's going that way. I'd like you to tell me that you disagree with that and you think that we've hit the high point on unemployment.

Mr. GREENSPAN. Let me tell you what I know.

What I know at the moment is industrial production in July seems to be somewhat higher, at least as far as we can judge from weekly data. We do know that there is a level of orders coming which is not consistent with continued deterioration, although it's by no means robust at all.

What we have very little capability of doing is projecting the labor force.

Senator SARBANES. Did you project an unemployment rate earlier in the year for the end of 1992?

Mr. GREENSPAN. In February? Yes, we did.

Senator SARBANES. What did you project that rate to be?

Mr. GREENSPAN. 6¾ to 7 percent.

The CHAIRMAN. 6¾ to 7 percent?

Mr. GREENSPAN. Yes.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The CHAIRMAN. Now that was as a year-end number?

Mr. GREENSPAN. That's the average for the fourth quarter of 1992.

Senator SARBANES. What was the unemployment rate when you made that projection?

Mr. GREENSPAN. The unemployment rate was 7.1, I think, when we made the estimate.

The CHAIRMAN. It's now 7.8. Have you revised that number?

Mr. GREENSPAN. Yes, we have.

The CHAIRMAN. What's your revised number now for the year-end number? Is it still 6¾ to 7?

Mr. GREENSPAN. No. It's 7¼ to 7½.

The CHAIRMAN. You now think it's going to be between 7¼ and 7½.

Mr. GREENSPAN. This is the central tendency of the individual forecasts of the FOMC members and the nonmember Reserve Bank presidents.

The CHAIRMAN. You're saying that's their number, not your number?

Mr. GREENSPAN. Well, I didn't make a specific forecast. I have not actually myself made a short-term forecast.

The CHAIRMAN. Let me tell you what I feel happening, and not just in my State of Michigan, but across the country.

We could talk the rest of the day about the data because there's a lot of data news out there. I wish there were not so much bad news, but that's what we're having.

I feel the economy continuing to slip on us. I think unemployment is going to continue to go up. We continue to get these large announcements of permanent job eliminations by major companies, GM just the other day on white collar employees, but it's one company right after the other—Alcoa—there's almost no major American company that's not on the list right now.

So it looks to me as if unemployment has a very good chance of going above 8 percent.

Would you dispute that? Do you think that that's something that could easily happen here?

Mr. GREENSPAN. I really don't know. It depends very much on projections of labor force growth, and I'm at the moment very uncomfortable with the data. I would like to hesitate because I just don't feel comfortable with it.

The CHAIRMAN. Let me suggest why I think you're seeing this strange action in the labor force data where more and more people are seeking work than historical data might suggest.

Senator SARBANES. Now, Mr. Chairman, that's not——

The CHAIRMAN. Let me just say, people are hurting. People need income. That chart I showed you earlier about per-capita income falling, that's what people do when they need money they don't have. They seek work. We've got all these people seeking work and not enough work to be found.

I don't know how to get that message in from where people live up through the levels of analysis to the Federal Reserve Board. I don't think the message is getting through up there.

Now you may be able to tell me that you're hearing it, but if you're hearing it, I don't see it coming out in the policies. I don't

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

even hear it coming out in the statements that are being made today.

I read that opening statement very carefully and I listened to you as you delivered it. I saw all the emphasis on inflation and the whole concern and the tilt of policy that way.

I didn't hear very much about the very serious problem out there with unemployment and under-employment and the number of people who are struggling to try to make do with less disposable income.

I'm not saying you can solve that problem all by yourself, but if you don't see that problem and if that problem isn't accorded a very large part in the policy considerations, then I don't think things are going to change very much. I think unemployment is apt then to continue to go up.

Mr. GREENSPAN. I would say, Mr. Chairman, that we are acutely aware of those data. We follow them very closely.

The CHAIRMAN. Well, I don't hear you talk about it very much.

Senator SARBANES. Mr. Chairman, let me just take this a step forward because I don't want this hearing to leave the impression that this unemployment rate is due to some unusual growth in the labor force.

For months, Janet Norwood, who is now retired as Commissioner of Labor Statistics, came before the committee and testified on the unemployment rate in the context of the fact that the labor force was growing less than it was reasonable to anticipate it would grow on the basis of demographic projections and so forth and so on.

We in fact would say to her, well, if the labor force had grown as you expected it to grow, anticipated it to grow, what would the unemployment rate be?

And the response was, it would be about a point higher than it was. In other words, it was at 6.8, it would have been 7.8, but for some reason, the labor force wasn't growing the way it ought to grow on the basis of the projections.

Now what has happened is that the labor force has in fact grown the way it ought to grow on the basis of the projections, and the unemployment rate has gone to 7.8 percent. But it's not an adequate answer to the question of why we're at 7.8 percent to say we've had an unexpected large growth in the labor force.

We've had the growth in the labor force that in fact you expected. What was unusual is that earlier on, the labor force wasn't growing the way it was expected to grow, and therefore, the unemployment rate was understated.

But you've got a 7.8 percent unemployment rate now on the basis of a labor force whose projections now meet what one would have anticipated would take place.

Mr. GREENSPAN. I agree with that, Senator. I think that——

Senator SARBANES. All right. Well, I want to be very clear about that.

Mr. GREENSPAN. I'm just saying that, basically, we had that dip in the participation rate that Janet Norwood was talking about, and at that particular point everyone was puzzled by it. The vast majority of forecasters that I know assumed that it would not go back to where it was. And the truth of the matter is it did. In other

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

words, the aberration, looking back historically, is the dip, not the recovery. I'm just talking about the rate of change.

Senator SARBANES. What that means now is you've got just under 10 million people out of work. You've got another 1.1 million who are so discouraged, they're not looking for work. You've got 6 million people working part-time who want full-time work. That takes us up to 17 million people either totally or partially unemployed in this country today.

The comprehensive unemployment rate is just under 11 percent. And yet, we get this kind of, well, it's all going to kind of work out somehow.

It's not working out.

The CHAIRMAN. Let me try to make it as pointed as I can make it for you.

The University of Michigan——

Mr. GREENSPAN. Mr. Chairman, may I just request a 2-minute recess?

The CHAIRMAN. Of course. Of course.

Mr. GREENSPAN. Thank you.

The CHAIRMAN. We'll take a brief recess and then we'll resume.

[Recess.]

The CHAIRMAN. The committee will resume. We hope to finish shortly. It's been a long morning. There's a lot of ground to cover here. So we want to finish our work and have our witness free to go as soon as we can here.

I want to say to you again, so we don't lose track of the discussion we were having, I think there is a real risk that unemployment is going to go to 8 percent or higher. I just see too much slippage in the economy. I see too many job eliminations. An awful lot of people right now highly qualified, with advanced degrees in engineering and other fields, people coming out of college with advanced degrees, can't find work even though they look all over the place.

I got a letter the other day from a man who wrote from Texas with advanced training and a college degree who has been through, as I recall from memory, three job retraining programs in different areas and still can't find a job, as hard as he tries.

I also think that we're running the risk that we could be very close to going into a third leg of this recession. I want to tell you why I say that, in addition to what's been said earlier here this morning.

The University of Michigan index of consumer confidence was reported just a few days ago as having dropped in early July. And so, you've got the question of how much did it drop, but also the fact that the trend is down rather than up.

It dropped from a figure of 80.4 percent in June back to 77.1 percent in early July.

Now there have been a number of other economic events come piling in on top of that, including worsening trade deficit numbers and a lot of other things.

Take for example this national survey that's been referred to earlier that has just been done by the Los Angeles Times. They just published this within the last week, and I just want to read you

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

what they found after going out and actually doing a scientific sample of consumer opinion across the country.

The headline on their story is "Confidence Slides Among Consumers." The subheadlines are "Economy. A growing number now say that the country is in a serious slump that won't end soon. Gloom underscores President Bush's political problems."

Now just let me read you a little bit of the story. They lead out this way:

A springtime rally in consumer confidence has petered out amid a barrage of bleak economic news, with growing numbers of Americans now saying the Nation is in a serious slump and optimism for a quick upturn is slipping, according to a new Los Angeles Times poll.

The shift in public sentiment, which underscores President Bush's political problems and could foreshadow slower levels of consumer spending in the coming months, was apparent when people were asked their predictions for the near future.

Just 19 percent expected an improving economy in the next 3 months, down from 28 percent in late March. Similarly, 42 percent now say the country is gripped by a serious recession, up by 35 percent in the spring. Overall, the poll portrays a public that is gloomier about the economy than most professional economists, who generally believe that a fragile recovery is in progress.

Of those surveyed, 86 percent said a slump persists.

And then it says:

'The new findings are consistent with the deterioration of economic activity that we've seen over the past 2 or 3 months,' said Mr. Mark Zandy, an economist with Regional Financial Associates in Westchester, Pennsylvania. 'People are very concerned with their economic situations, and the future looks less bright today than in the spring, when the economy seemed to be accelerating.' John Brennan, director of the Times poll, said 'that the clearest message of the survey is that the public now expects more of the same bad economy, rather than an upturn that was hinted at in the March poll.'

'We had a little bright news last time and now that's gone away,' he said.

And it tells how they did this survey and it was done across the country, and so forth.

I only cite this—there are dozens like this that could be cited. And you're seeing them, too. But as I talk to people across the country, you're about the most optimistic person I've talked to, quite frankly. You're more upbeat. And so I say to myself, what is it that you're seeing that everybody else is missing? Or what is it that they're seeing that causes them to have a greater level of concern that you are missing, or that the Fed is missing?

The sense that I have is that consumer confidence is now trending down again, and I think you've got some discrete measures of that from the University of Michigan, from this poll, and from some other things. There's data that reinforces that.

You can see why people would be holding this view in light of all of the weakness and the soft spots that are out there.

I'm asking you again now, and I want as frank an answer as you can give me, is there any risk here that we could go into a third leg of this recession?

Mr. GREENSPAN. Mr. Chairman, first of all, let's define what we mean by that. I would take the notion of a third leg of a recession to mean that the level of economic activity goes to new lows.

The CHAIRMAN. I don't mean it that way. I mean the growth that we've been seeing could now sputter out, stall, and we could start down again here and go to a lower level and perhaps even into a negative level.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Mr. GREENSPAN. That's what I'm getting at. In other words, if you're talking about a question of lower growth as distinct from lower levels, every recovery has been characterized by rates of growth which have been unstable but positive.

I would be quite surprised if we had a negative gross domestic product number in the foreseeable future. I would not be surprised if we had ups and downs in the growth pattern.

The CHAIRMAN. So the growth rate in fact——

Mr. GREENSPAN. In fact, the second quarter is going to be almost surely a lower growth rate than the first. Now I wouldn't call that a dip. That's not alien to history. That occurs fairly often.

The CHAIRMAN. Well, it may not be. It's certainly not an encouraging sign, is it? Wouldn't we like to see the growth rates increasing?

Mr. GREENSPAN. I would like to see the growth rate continue to rise quarter by quarter. But it almost never happens that way.

The CHAIRMAN. But, you see, I think that perhaps there's a correlation between these two things. In other words, the fact that the second quarter data looks to be weaker than what we think we saw in the first quarter probably relates to what consumers are telling us, not just consumers, business people as well.

I think the signals are coming in from across the country that the problems seem to be getting worse and the outlook is not brightening and people are finding that they are less confident, and that they are stepping back. That means that they're going to step back in their purchasing behavior and other things. In other words, I think these things probably are two ways of the same message being delivered.

Now let me hear your response to that.

Mr. GREENSPAN. First of all, Mr. Chairman, the decline in the Michigan survey, which, as you point out, was about 3 points, is only a very small part of the recovery that has occurred in that survey in recent months.

So if one were to look at it on a chart, it's not as though one is getting a big rise and then fall. What you're getting is a significant rise and a small adjustment.

The CHAIRMAN. But it's the trend line that concerns me.

Mr. GREENSPAN. Well, it's only 1 month. I will grant you that if it goes on 2 or 3 months, then that is a trend. But I would not consider 1 month a trend.

Second, we do have other evidence which suggests that the consumer is not all that discouraged. As you're acutely aware, motor vehicle sales have picked up. That is, we are getting——

The CHAIRMAN. Very modest.

Mr. GREENSPAN. Well——

The CHAIRMAN. A lot of fleet sales in that, too.

Mr. GREENSPAN. There are some fleet sales. I certainly acknowledge that. But even when one abstracts from the fleet sales, there has been a pick-up in sales.

Now, I'm not saying it's a boom. It is not a boom. But it's certainly consistent with some modest recovery and indeed, the assembly schedules that have occurred as a consequence of that have been one of the bright spots in the industrial scene.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

That is, we are getting a significant amount of statements that orders have picked up and they attribute it to secondary suppliers of the motor vehicle industry, which is a not insignificant issue.

The CHAIRMAN. Is there anything more that you or the Fed can do to try to get some more strength into this economy at this point?

Are you pretty well played out in terms of what's available to you to try to get more stimulus into the economy?

Mr. GREENSPAN. We are looking at the issue of, as I said, the leverage ratio and the capital standards which I suspect would be helpful. We have looked at and we continue to look at the question which I discussed——

The CHAIRMAN. Have you tried jawboning the banks? Is it possible to ask the banks to take a look and see if they can't find some worthwhile borrowers out there that maybe they're not seeing now because of the attraction of the fixed-rate, no-risk Government securities is a little blinding to them?

Mr. GREENSPAN. Mr. Chairman, as you know, we have this regular survey of the senior loan officers of the banks and they have indicated to us, and we take them at their word, that they have been seeking loans and been finding some, but not a great deal.

In other words, there is a discrepancy between the judgments I hear personally, speaking to individual bankers, and what I hear speaking to borrowers.

You get a sense in which there is a communications——

The CHAIRMAN. There's a credibility gap there somewhere.

Mr. GREENSPAN. There is a lack of awareness. Part of the problem basically is not difficult to understand. That is, a lot of loans were made in the last decade which shouldn't have been. A lot of people received loans who thought they were credit worthy and therefore, if they were credit worthy in the past, they should be basically getting loans now.

What's happened is that there has been a far more conservative lending procedure on the part of loan officers, most of which I think is justified. That creates a particular attitude which strikes a number of borrowers as being unresponsive.

I have a suspicion that there's probably a problem on both sides of that issue. There are people who shouldn't be getting loans who think they should, but there's no question that there are people out there who are credit worthy who are not getting loans.

The CHAIRMAN. You know, it seems to me, one of the things that we have not talked about directly today is that the Fed has this sort of built-in conflict of interest here because you are one of the major bank regulators, and you're responsible for overseeing a number of banks in the country, keeping them healthy, making sure their capital positions are adequate, that they're not doing foolish things, loading up on too many commercial loans or whatever it happens to be.

The banks got into big trouble, not just the ones under your supervision, but the ones under the supervision of other regulators. Last year, we had to pass legislation to provide a $70 billion taxpayer loan because the Bank Insurance Fund was broke. Not the S&L's now, but the commercial Bank Insurance Fund was broke and had a deficit, the GAO tells us, at the end of last year.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I can see, on the one hand, when you're managing monetary policy to try to increase the supply of money and credit to stimulate the economy, that, on the other hand, you've got to keep an eye, a very close eye, on bank balance sheets because you're responsible for keeping your part of the banking system healthy. And I can see why you might be torn sometimes between actions that would help the banks and actions that they might take on their own behalf as they restore their tattered balance sheets, versus a more aggressive push to get credit through the system to worthy borrowers to try to finance more of a lift in the economy generally.

We've had some conversation about it today, and I worry about how that inherent conflict may, in fact, be balanced at the present time. I'm concerned that we may have a situation here where the banks are rebuilding their balance sheets, a lot of it by, as you say, this very substantial increase in their holdings of Treasury securities, risk-free—they can pick up the spreads that are out there—and yet, we continue to see the economy weak, languishing. We're certainly not recovering anything like we have in other previous recoveries.

Senator Sarbanes points out we're well past a trough point in this recession and we still have not really come out of it with any strength. We have not regained the jobs.

I would hope that the Fed would not be voiceless in terms of speaking more aggressively about the need to get the economy going, and that banks within the bounds of prudence and safety and soundness, I think have to be more aggressive in trying to find the worthy loans, the good loans that small business people and others are attempting to get, that homeborrowers are trying to get.

We had a major problem with mortgage discrimination based on race, which your own Fed studies have shown us. One of the worst problems is out in Los Angeles, as a matter of fact, according to the data. A lot of credit worthy minority borrowers, Afro-American borrowers, want to borrow money to buy homes and to upgrade their homes and they can't get the money because, in effect, they're being discriminated against in the borrowing process, which is outrageous, but it's going on, and your own studies show that.

Mr. GREENSPAN. I agree with that.

The CHAIRMAN. Well, but if you spoke about it, if you gave a major speech about it, if it was a major thing that you said and hammered, I suspect that we'd see more of those loans happening. And what that would do is not only solve the inherent unfairness of it, but it would get more of that credit out there to create jobs and give some additional lift to the cities, particularly that so badly need it.

It's like looking with one eye. The one eye at the Fed sees the inflation problem and really has that in focus and has all of the concerns about how that relates to long-term interest rates and expectations and so forth and so on, but has a very hard time seeing out of this other eye in terms of the need to really get much more lift into this economy.

And quite frankly, if the Fed can't do it, if you look at that problem and you say, look, we're played out. We've done what we can do. We've cut rates 23 times and whether we're late or not, we've

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

done about all we can do. And so, don't expect us to be able to bolster this economy. You're going to have to look elsewhere.

Well, if that is so, then it's important that you say that to us and not come back to us with a reformulation of the old thinking that says, well, we've played out all of our tools and we don't see any other tools that don't have some inflation risk connected in some way, so we've just got to ride this thing out, no matter how grim it may get for people.

I must say I have a very hard time accepting that because I think it is, first of all, the wrong strategy, but I think it's a callous strategy. When people are being ground down out in the society, when working families are being ground down, when the middle-class is being ground down, I think there's always a way to explain why it's necessary or why it may be good for them in the long run, or inflation control may require this. I don't just aim this at you. It's a universal problem in Government that gets big and gets remote.

In the meantime, people who have got to get from today to next week to next month to 6 months down the road are having a very, very difficult time doing it.

People here in this town are getting by all right. They have health care. They've got pretty good salaries, for the most part, and so forth. It's not true out in the countryside. That's why you've got something of a political rebellion underway.

I don't know how to get the message through to the Fed. I don't think you're hearing it because I don't see it coming back out of your testimony or your prepared statement today. I don't detect the urgency about this problem that the people are asking for.

Now you may say, well, they don't understand. That's sort of what the President has been saying, that things are better than the people think they are.

If he believes that, somebody really needs to sit him down and have a talk with him because people know what's going on in their lives, and the anxiety that they're reflecting in these polls and this consumer survey data from Michigan is real. It's not will-'o-the-wisp. It's not something that people are inventing.

People want to be optimistic. They want to be upbeat. The fact that they're not is because they see adverse and perverse things going on in their lives and around them.

And we're not doing enough to fix it. And frankly, if the Fed has run out of tools that work, which is the way it looks to me at this point, then I think you've got an obligation to suggest the use of some additional tools that may be outside the scope of what the Fed can do.

I don't think silence or saying, let's just all take a deep breath and tough it out, is an adequate response to the problem.

I don't know how to budge you from where you are. We've asked you before. We've asked you orally. We've asked you in writing. I don't know what it takes to put across a convincing case.

We may have to just change the political leadership of the country. That may be what the public decides to do because they're not satisfied. And they're not satisfied because the situation is just not what it should be.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Let me just yield to my colleagues. I hope that we can cover this question of how your M2 has trailed now off in the last 3 months below even your own low-side estimate. I also think before you leave today we've got to find out what's happening in these currency markets and whether these steps taken yesterday are going to be anything more than just a short-term fix.

Senator Sasser?

Senator SASSER. Thank you, Mr. Chairman.

Mr. Greenspan, returning just a moment to a line of questioning that I pursued earlier relative to the banks purchasing long-term Government securities. We have a situation here where the Fed discount—the discount rate is 3 percent. The Federal fund rate is 3.25 percent. CD's average 3.9 percent. We've got a 6 percent prime rate. But the banks can get a return of 7.6 percent on Government securities at no risk.

And, as a result, we've seen last year a 23 percent increase in the bank purchase of Government securities, while concurrently, according to the Fed study, we've seen a 1 percent decline in bank loans.

Now I think it's highly desirable and most important that some disincentive be fashioned by the Fed to discourage banks from investing so substantially in Federal securities at the present time.

In other words, we need desperately to get this money out into the stream of commerce and get it out there trying to grow this economy.

You spoke a moment ago of perhaps some tentative disincentives that you have been contemplating. Could you be more specific at this time?

Mr. GREENSPAN. Well, Senator, first let me say that there is risk if the banks were investing in long-term U.S. Treasuries, in the sense that interest rate risk could be quite considerable in the event that the markets turned against them and there was a significant rise in long-term rates and hence, a decline in bond prices.

As a consequence of that, the substantial part of what the banks hold are shorter-term securities, where the yields are very much lower.

The ability of banks to make money by taking deposits, CD's, and putting it into Treasury bills or short-term notes is really quite limited. I would think that, were they desirous of making money, the major way you do that is to go into the loan market.

Senator SASSER. Why are they putting so much money into the securities market?

Mr. GREENSPAN. The way they perceive it——

Senator SASSER. That there's no loan demand out there.

Mr. GREENSPAN. There's not enough loan demand. They have no alternatives but to put it there.

Senator SASSER. I'll tell you, Mr. Greenspan, that runs counter to what I'm seeing in my State and what I'm hearing from people.

Mr. GREENSPAN. I'm not saying that that is completely true. I'm saying that's a major explanation. It's not the full explanation.

Senator SARBANES. Has the Fed taken any steps—on the one hand, you talk to the bankers. They say there's no loan demand. On the other hand, you talk to the people on Main Street and they

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

say, well, we've got plenty of loan demand. We can't get the loans out of the banks.

Well, now, you know, there are two different perceptions there. Has the Fed taken any steps to try to bring those into harmony?

Mr. GREENSPAN. What we have done in conjunction with our colleagues in the other regulatory agencies is to assume that there is a form of capital restraint, which is what the credit crunch basically is, and that that's the major reason why people perceive that they're not getting loans when they are presumably credit worthy.

And what we have done basically is to try to find means by which we can soften that load and we've taken a number of actions which, as I indicated earlier, I hope will eventually lead with the change in the leverage ratio, which will create much less of a position of capital constraint which is the source of the credit crunch to the extent that it still exists.

My own impression, however, is that, judging from the balance sheets of the borrowers, the desire for loan demand is not there in any huge volume and, indeed, what we find is that there is a very significant amount of corporate offerings made especially by the larger corporations, the proceeds of which are used to pay off bank debt. And that's been a material element in the general weakness of bank loan demand in the aggregate data and, of course, it's been a factor in the money supply growth as well.

Senator SARBANES. When did you last meet with the President to discuss the economic situation?

Mr. GREENSPAN. To discuss the banking situation?

Senator SARBANES. No, the economic situation, the status of the economy.

Mr. GREENSPAN. I'd say several weeks ago.

Senator SARBANES. Several weeks ago?

Mr. GREENSPAN. Yes.

Senator SARBANES. Are you meeting with the President on a regular and consistent basis?

Mr. GREENSPAN. Not on a regular basis. I'd say periodically, I would meet with him and tell him what I think is happening.

Senator SARBANES. So you don't feel there's a problem in terms of communication between you and the President. You're essentially on the same wave length.

Mr. GREENSPAN. It's hard for me to know whether or not I'm on the same wave length. But I do try to communicate what I believe is happening to the President when he asks me to.

Senator SASSER. Mr. Greenspan, something you mentioned when you were before the committee before, and I want to go back to that.

It appears to me that we're rapidly losing a sense of equity in income distribution in this country. There's an ever increasing concentration of wealth, with the top 1 percent of the population.

And when you were asked about this phenomenon when you appeared before the committee I think at your last appearance, you responded that you were also concerned about this trend.

Now, I think following your statement, the Federal Reserve participated in a study with the Internal Revenue Service which did indeed prove that the rich are getting richer. And the study shows

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

that the very rich dramatically increased their net worth during the 1980's.

The wealthiest 1 percent of the population increased its share of private net worth from 31 percent in 1983 to 37 percent in 1989.

The New York Times reported that by 1989, the top 1 percent, which represents about 840,000 households, was worth almost $1 trillion more than the 84 million people who comprise the bottom 90 percent of Americans.

Now, you commented on the inequality in family incomes and I think this has contributed to the feeling of pessimism about the economy in general. You testified a few months ago that you had never seen in your career—I'm just quoting generally now, not precisely—that you had never seen in your career the pessimism about the long-term prospects of the economy that you see now.

Now I think that this redistribution of income that we're seeing here is contributing significantly to this long-term pessimism.

How can we justify the fact that 1 percent of the richest people in this country reap the lion's share of the economic progress of the 1980's? What can we do about this trend? I know you're concerned about it. What would you suggest be done about it?

I say this because I think this is an underlying factor in the pessimism affecting this economy.

Mr. GREENSPAN. Senator, from the income side, which also is an element involved on the wealth side, what we have observed is a significant spread that's opening up between returns to education and skill. I know it's certainly the case that the premium or, I should say, the earnings of college educated people, has increased significantly relative to those who are high school graduates or drop outs. And the income distribution is very clearly reflecting educational and skill capabilities.

This, in turn, seems to be related to the extraordinary change in the technological basis of output or, more exactly, to what I like to call the conceptual basis, meaning that there is far greater input from ideas, and increasingly so over the years, as distinct from physical volume in the gross domestic product.

It's reflected in the down sizing of computerized products and to a significant shift from bulk type of output to more conceptual computer related type of output. This is a world-wide phenomenon.

What it tends to do with respect to earnings is to put a significant premium on skills and that's very important for us, to make sure that——

Senator SASSER. If I could just interrupt there, Mr. Greenspan.

I won't contest the fact that this may be a world-wide phenomenon. I don't know whether that's the case or not. I suspect it is. But this phenomenon is not—it doesn't impact in other countries the way it's impacting here.

Mr. GREENSPAN. That's probably correct.

Senator SASSER. And we're not seeing the great enrichment that's taking place at the top in other countries that we're seeing here.

Now bear in mind, we're talking about the top 1 percent. We're talking about 840,000 households in a country of, what, 280 million people now.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I frankly don't think that that can be fully explained away on the basis of just educational capabilities.

Mr. GREENSPAN. No, what I was saying is that you can explain a goodly part of the income distribution in this regard. I'm not sure, since I haven't really evaluated it from the wealth side, whether that is basically the case.

But the point I was about to make is that the crucial element here is a judgment about our educational system and the need to make certain that we can convey the skills to the people in this society so that they can participate fully in the types of conceptual related output that seems to be associated with increasing standards of living.

Senator SASSER. Well, I hear what you're saying, Mr. Greenspan. I'm not sure I can totally accept that explanation.

We're running out of time. Let me just ask you one other quick question.

Now, last week, the German central bank raised its key interest rate from 8 percent to 8.75 percent. This means that German short-term interest rates are now about 5½ percent higher than comparable U.S. rates.

This huge interest rate gap is putting tremendous downward pressure on the dollar.

Outside of Germany, the European economies are generally weak. Higher interest rates help push these countries into recession, but they're going to have to raise their interest rates to get into conformity with the Germans.

These higher German interest rates have put great pressure on the dollar and the Fed has rushed into the breech in an effort to try to bolster the dollar and were successful in shoring it up yesterday.

But in the long run, in order to protect the dollar, I fear that the Fed is going to have to move off these low interest rates policies and entertain the idea of higher rates.

Now what's your reaction to that?

Mr. GREENSPAN. Senator, I don't think I ought to comment on that because that's——

Senator SASSER. Well, here's the point I'm making, Mr. Greenspan. I think you're running out of bullets over there at the Fed. In other words, you've cut the rates significantly. I think you've been behind the curve all the way. But you have cut the rates.

We're not getting the reaction that we ought to get or that we expected. I think the banks are using these low rates to turn around and invest in Government securities, get a safe return in that way. I don't think they're putting it out in the economy.

I think you're running out of time at the Fed because the Germans are not cooperating with you. As their rates go up, they're putting pressure on the dollar and I think at some juncture, you may have to entertain raising your rates.

You're running out of options, Mr. Chairman, in monetary policy. And I think unless this economy turns around and turns around fast, it is not going to do that, we're going to have to look once again at some kind of fiscal stimulus.

Now when you were before us a few months ago, you said, I'm not ready for any fiscal stimulus now, but I don't rule it out.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I'm saying to you that, in spite of your earlier testimony that we regret fiscal stimulus later, if we turn to it, I think that's ultimately where we're going to turn, particularly with this pressure that the Germans are putting on the dollar.

What say you to that, Mr. Chairman?

Mr. GREENSPAN. Let me just say as a general rule on this particular subject, I certainly see no net benefit to the U.S. economy from depreciating the dollar further. I don't believe, as some people do, that somehow we can galvanize the economy essentially by trying to spur exports at the expense of others in the international community.

So clearly, that is not an avenue of——

Senator SASSER. So, then, we must bolster the dollar.

Mr. GREENSPAN. I'm sorry?

Senator SASSER. So, then, we must bolster the dollar.

Mr. GREENSPAN. I would prefer not to comment, if I may, on any details of policy directly because I don't think I can do that without having unnecessary market effects.

The CHAIRMAN. Well, Mr. Chairman, if I may, if Senator Sasser will yield. I don't think we want you to comment in terms of the specific policy options that you may be planning right now or contingencies that you may have. But I think you owe us some illumination of the quandary that we seem to be in.

We did have a very unsettled day yesterday in the currency markets until there was an intervention. The higher German interest rates are a fact of life. They've now happened, and we've got to deal with them.

I see that working in an adverse way on our economy. I think Senator Sasser is exactly right. High German interest rates don't help us. They just wedge us into a tighter corner and they wedge the Fed into a tighter corner.

Mr. GREENSPAN. Mr. Chairman, leaving aside the overall general levels, remember that the actions that the Germans took the other day were to raise the discount rate. But the discount rate in Germany, in and of itself, does not move the market rates. And the market rates did not move very much.

So that it's the market rates which effectively function relevant to our market rates in inducing capital flows.

The reason why there is considerable expectation of rising German rates is that usually, the Lombard rate, which is the effective rate at which borrowing is made, is usually raised when the discount rate is concerned and there's been market expectation that would happen, and that's where a lot of the conversation and concern and anticipation has occurred.

I don't know of anything which suggests what's going to happen. But at the moment, we have not seen a rise in effective market rates so far as the Germans are concerned.

The CHAIRMAN. Well, that doesn't change the quandary that we're in. I don't know that you would really take exception to that point.

Mr. GREENSPAN. I'm not. I'm just making this as a collateral remark.

The CHAIRMAN. I appreciate, and Senator Sasser appreciates, the sensitivity of anything you say in this area at this time and we're

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

not trying to push you into saying something that you're not ready to say.

But I want to express the concern that I have that I think we've now gotten ourselves wedged into a corner here where events in foreign countries like, for example, interest rate decisions in Germany, are becoming very, very difficult for us to be able to deal with because of their implications for us and how weak our economy is, and how we've weakened it over a period of time.

It hasn't just been the last 2 or 3 years. If you go back over the last 10 years, I think you can see a progressive weakening of our economy. We've got a terrible trade problem. Our productivity problem has not been solved despite some improvement. We've got a huge unemployment problem, a huge structural deficit problem. And we still have very high long-term interest rates and high real interest rates over and above inflation.

You've brought down the short rates. In fact, the short rates today, when you take out the inflation factor, are at less than zero. The effective rate of short-term borrowing is more than offset by inflation. That is quite extraordinary. It's a long time since we've seen anything like it.

The problem is we're not getting the lift in the economy. We're not getting the job creation. We're not getting the kind of strong, sustained recovery that we need to have. I don't think it's good enough, in the end, simply to acknowledge all that and say, well, the world's changed and we're still trying to make sense out of it, but this is the best we can do.

I think the public is asking for more than that and they have a right to expect more than that.

I would hope that you would go back and talk to the other Fed governors. You've heard an expression of opinion of members of both sides of the aisle here. Of course, some members were not able to be here today. But I think you're hearing enough of a concern broadly stated from people from different regions and different parties that I think it's input that you need to weigh carefully, and that I would hope that the other members of the Board of Governors would weigh carefully.

If in fact you're out to the end limits of what you can do, and that's the cold, hard fact of the matter, then I think we have to begin a discussion about what other tools are available in other directions, and you have to be prepared to get into that discussion. I think we in the Congress do as well.

The people want answers and we're not providing them. I don't think we've given them that today with this monetary policy review and outlook. I think it just doesn't do the job.

So more is going to have to be done.

I might just further say that tomorrow here, we'll be meeting again. We'll have Lester Thurow, the dean of the MIT school of management. We'll have Mr. Pete Peterson, former commerce secretary, and Professor Robert Eisner of the economics department at Northwestern, who will be commenting on these same issues. And then again, we'll have some witnesses on Wednesday, Mr. Pat Choate and Mr. Lee Thompson, CEO, Smith Corona, to come in and talk about some of these same issues as to what's wrong with the economy and how do we fix it.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Chairman Greenspan, we thank you for your appearance today. You've been very patient. We appreciate that.

The committee stands in recess.

[Whereupon, at 2:18 p.m., the committee was recessed.]

[Prepared statement of witness and additional material supplied for the record follows:]

TESTIMONY BY ALAN GREENSPAN, CHAIRMAN BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JULY 21, 1992

Mr. Chairman and members of the Committee, I am pleased to have this opportunity to present the Board's semiannual report on monetary policy to the Congress. Earlier this month, when the Federal Open Market Committee formulated its plans and objectives for the next year and a half, it did so against the backdrop of an economy still working its way through serious structural imbalances that have inhibited the pace of economic expansion. In light of the resulting sluggishness in the economy and of persistent weakness in credit and money, the System on July 2 cut the discount rate by ½ percentage point, and eased reserve market conditions commensurately. These actions followed a reduction in the federal funds rate in early April. The recent easings of reserve conditions should help to shore up the economy, and coming in the context of a solid trend toward lower inflation, have contributed to laying a foundation for a sustained expansion of the U.S. economy.

THE U.S. ECONOMY AND MONETARY POLICY

Our recent policy moves were just the latest in a series of twenty-three separate easing steps, beginning more than three years ago. In total, short-term market interest rates have been reduced by two-thirds. The federal funds rate, for example, has declined from almost 10 percent in mid-1989 to 3¼ percent currently. The discount rate has been cut to 3 percent—a twenty-nine year low. Despite the cumulative size of these steps, the economic recovery to date nonetheless has been very hesitant. Based on experience over the past three or four decades, most forecasters would have predicted that a reduction of the magnitude seen in short-term interest rates, nominal and real, during the past three years would by now have been associated with a far more robust economic expansion.

Clearly the structural imbalances in the economy have proven more severe and more enduring than many had previously thought. The economy still is recuperating from past excesses involving a generalized overreliance on debt to finance asset accumulation. Many of these activities were based largely on inflated expectations of future asset prices and income growth. In short, an overbuilding and overbuying of certain capital and consumer goods was made possible by overleverage. And, when realities inevitably fell short of expectations, businesses and individuals left with debt-burdened balance sheets diverted cash flows to debt repayment at the ex-

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

pense of spending, while lenders turned considerably more cautious.

This phenomenon is not unique to the United States. To a greater or lesser extent, similar adjustments have gripped Japan, Canada, Australia, the United Kingdom, and a number of northern European countries. For the first time in a half century or more, several industrial countries have been confronted at roughly the same time with asset-price deflation and the inevitable consequences. Despite widespread problems, we seem to have at least avoided the crises that historically have been associated with such periods in the past.

In the United States especially, important economic dynamics ensued as the speculative acquisition of physical assets financed by debt outpaced fundamental demands. In some markets for physical assets, such as office buildings, a severe oversupply emerged, and prices plummeted. In others, such as residential housing, average price appreciation unexpectedly came to a virtual standstill, and prices fell substantially in some regions. Firms that had been subject to leveraged buyouts based on overly optimistic assumptions about the future values at which assets could be sold began to encounter debt servicing problems.

More generally, disappointing earnings and downward adjustment in the values of assets brought about reduced net worth positions and worsened debt-repayment burdens. Creditors naturally pulled back from making risky loans and investments, and as pressures mounted on lenders' earnings and capital, some features of a "credit crunch" appeared. With borrowers themselves becoming more cautious about taking on more debt, as well as about spending, credit flows to nonfederal sectors diminished appreciably.

It is not that this process was unforeseeable in the latter years of the 1980's. The sharp increase in debt and the unprecedented liquidation of corporate equity clearly were unsustainable and would eventually require a period of adjustment. What was unclear was the point at which financial problems would begin to constrain spending and how strong those constraints would be. Forecasts of difficulties with debt and strained balance sheets had surfaced from time to time over the past decade. But only in recent years did it become apparent that debt leverage had reached its limits, inducing consumers and businesses to retrench. Moreover, the degree of retrenchment has turned out to be much greater than experience since World War II would have suggested.

The successive monetary easings have served to counter these contractionary forces, fending off the classic "bust" phase that seemed invariably to follow speculative booms in pre-World War II economic history. During those severe episodes, sharp declines in output and income were associated with a freezing up of credit availability, widespread bankruptcies by borrowers, and closings of newly insolvent financial institutions. Thus, balance sheets were cleansed only through the massive writing off of loans, involving a widespread destruction of creditor capital.

To be sure, elements of this historical process have been at work in recent years, but the monetary policy stimulus since mid-1989 has forestalled such a severe breakdown. Lower interest rates have lessened repayment burdens through the refinancing and repricing

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of outstanding debt, and together with higher stock prices have facilitated the restructuring of balance sheets. Indeed, considerable progress in this regard has become evident for both households and businesses. The much more subdued rate of household and business credit expansion has reduced the leverage of both sectors. Household debt service payments as a percent of disposable personal income have retraced around one-half of the runup that occurred during the previous expansion, and further progress appears in train. Similarly, nonfinancial corporations' gross interest payments as a percent of cash flow are estimated to have retraced much of the roughly 10 percentage point increase that occurred in the expansion. The improvements in balance sheets, together with the beneficial effects of lower interest rates, have been reflected in reduced delinquencies on consumer loans and home mortgages, increased upgradings of firms' debt ratings, and narrowed quality spreads on corporate securities. Furthermore, lower interest rates, along with two reductions in reserve requirements, have appreciably cut the funding costs of depository lenders, materially improved interest margins, and fostered the replenishment of depository institution capital.

Although greatly moderating the potential adverse effects of the necessary adjustment process on economic activity, monetary stimulus also has stretched out the period over which adjustments will occur. A more drawn out adjustment of impaired balance sheets, as we now are experiencing, obviously is much preferable to the alternative: an adjustment through massive financial and economic contraction. Yet the ongoing corrective process has meant that the economic expansion has been hobbled in part by the continued restraint on spending by still overleveraged and hence cautious debtors. Balance sheets ultimately will reach comfortable configurations, but even before then we should experience a quickening pace of economic activity as the grip of debt burden pressures begins to relax. Last year I characterized this process as the economy struggling against a 50-mile-an-hour headwind. Today its speed is decidedly less, but still appreciable.

Uncertainty about how far the process of balance-sheet adjustment would have to go and for how long the spending retrenchment of overleveraged debtors would continue has been a factor in shaping Federal Reserve policy over the past few years. This uncertainty has been shared by many other observers, who, based on past experience, were somewhat skeptical about the strength and persistence of spending restraint by both the private and public sectors, and dubious about the persistence of disinflationary forces. Against that background, more rapid or forceful easing actions more than likely would have been interpreted by market participants as risking a resurgence of inflation. That would have led to higher rather than lower long-term interest rates. As I have indicated many times before this Committee, lower long-term rates are crucial in promoting progress toward more stable balance sheet structures in support of sustained economic expansion.

In fact, long-term interest rates have stayed disturbingly high in the face of sharply lower short-term rates. A greater decline in long rates would have encouraged additional restructuring of business and household balance sheets and fostered stronger spending on

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

business fixed investment goods, housing, and consumer durables. Bond yields have not come down more primarily because investors have been inordinately worried about future inflation risks. While they seem to exhibit only modest concern over a reemergence of stronger inflation during the next few years, investors apparently fear a resurgence further in the future, to a large extent as a consequence of expected outsized budget deficits exerting pressure for monetary accommodation.

Other forces have added to the restraint on the economy associated with balance-sheet adjustments. The scaling back of defense spending has been retarding near-term economic growth. A significant reallocation of resources is an inevitable consequence of the phase-down of defense spending, involving the redeployment of military personnel as well as industrial and technological capacity into civilian activities. Such shifting of resources away from military production promises a welcome boost to long-run prospects for the Nation's productivity and growth. Nonetheless, the process of transition involves significant frictions and lags, and in the meantime the falloff of the military budget has represented a drag on aggregate demand. At the same time, budgetary problems among states and localities have forced painful cutbacks by those units and burdensome tax increases as well.

In addition, the noticeable slowdown in economic growth in other major industrial countries since mid-1990 has further tended to depress demand for goods and services produced in the United States. Fortunately, continued rapid economic growth on the part of developing countries, whose imports from the United States have grown in relative importance, has prevented a greater weakening in the expansion of our exports.

THE U.S. ECONOMIC OUTLOOK

Clearly in this environment, with conflicting forces of expansion and contraction continuing to vie for supremacy, any projection must be viewed as tenuous. In this context, the central tendencies of the projections of Federal Reserve Board members and Reserve Bank presidents are given in the Board's report. They project that the economic expansion is likely to strengthen moderately, to a range of 2¾ to 3 percent over 1993. Such a pace is expected to reduce the unemployment rate noticeably over the next year and a half. This outlook is supported by several considerations, including the stimulus now in train from recent interest rate declines and the progress being made by borrowers and lenders in repairing strained balance sheets. Some pent-up demand for business capital goods, housing, and consumer durables should surface as the incentives for spending retrenchment abate.

In our judgment, the interest rate declines to date, working to offset spending constraints related to balance-sheet strains, should not endanger the further ebbing of inflationary pressures. Even as the anticipated strengthening of economic activity occurs, monetary policy will continue to promote ongoing progress toward the longer-run objective of price stability, which should lay the foundation for sustained economic expansion. The financial fundamentals, such as money and credit growth, point to a continuation of disinflationary trends, and the central tendency of our projections for CPI inflation

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

next year is 2¾ to 3¼ percent. Were this to be realized, inflation would be about back to a pace last seen on a sustained basis around a quarter century ago. As I often have noted to this Committee, the most important contribution the Federal Reserve can make to encouraging the highest sustainable growth the U.S. economy can deliver over time is to provide a backdrop of reasonably stable prices on average for business and household decision-making.

RECENT BEHAVIOR OF THE MONETARY AGGREGATES

The relationship between money and spending also has been profoundly affected by the process of balance sheet restructuring. The broad monetary aggregates, M2 and M3, currently stand below their annual growth ranges, despite the earlier substantial declines in short-term interest rates. My previous testimonies to the Congress noted that aberrant monetary behavior emerged in 1990 and has since intensified. We at the Federal Reserve have expended a great deal of effort in studying this phenomenon, and have made some progress in understanding it. To summarize our findings to date: The weakness of the broad monetary aggregates appears importantly to have reflected the variety of pressures that rechannelled credit flows away from depository institutions, lessening their need to issue monetary liabilities. The public, in the process of restructuring and deleveraging balance sheets, found that monetary assets had become less attractive relative to certain nonmonetary financial assets or to debt repayment.

The reduced depository intermediation stemmed from emerging problems of asset quality, which in turn prompted both the pulling back of depositories from lending and responses by regulators that reinforced those tendencies. One such response was the shutting down or sale of insolvent thrift institutions. In the process, some $90 billion of thrift assets have been taken onto the books of the Resolution Trust Corporation, where they are funded by government securities instead of depository liabilities. The managed liabilities of depositories have been most affected by this shift. However, retail depositors also have been induced to shift into other instruments by the abrogation of their original contracts by acquiring institutions and the consequent disruption of their banking relationships.

At banks and solvent thrifts as well, problems of asset quality, especially for commercial real estate, were mounting as the 1980's came to a close. Banks reacted by tightening their nonprice lending terms and credit standards appreciably and widening the spread of lending rates relative to costs of funds. Upward pressure on bank loan rates was augmented as investors, concerned about adequate bank capitalization, raised risk premiums on bank debt and short-term managed liabilities. In addition, regulatory initiatives, such as stricter capital standards, higher insurance premiums, and more intense supervisory scrutiny, raised the cost of depository intermediation. Reserve requirement cuts have represented only a partial offset. As intermediation costs rose, banks further increased loan spreads and redoubled efforts to securitize loans and otherwise constrain expansion in their balance sheets.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

More recently, the decline in short-term market rates, combined with the improvement in asset quality that was partly associated with the modest economic expansion, has considerably boosted bank earnings. Banks also have strengthened their financial condition by improving their liquidity position and by taking steps that should reduce noninterest expenses over the long run through restructuring and, in some cases, consolidation. A number of banks—especially large banks—have conserved capital by reducing dividends. Banks have regained access to capital markets and have significantly rebuilt their capital positions. Intermediation costs and pressures to bolster capital, however, have been further elevated by the added restrictions contained in the FDIC Improvement Act. Partly as a consequence, lending spreads have stayed relatively high, as suggested by a prime rate that is a substantial 2¾ percentage points above the federal funds rate. Recent survey responses suggest that nonprice terms and lending standards, though not tightening further, also have remained stringent.

Bank lending has shown few signs of strengthening, as demands for bank loans have stayed dormant. The internal cash flows of nonfinancial businesses have strengthened, and many firms have raised substantial funds in equity markets, so overall credit demands have been light. Large firms, especially those with good credit ratings, have preferred bond markets over-banks as a place to borrow. Meanwhile, households, feeling the strain of debt service burdens, have rechanneled cash flows away from retail deposits to the repayment of consumer debt at banks and other lenders. They were also encouraged to deleverage their balance sheets by the wider spread between consumer loan rates and retail deposit rates, which was accentuated on an after-tax basis by the phase-out of the tax-deductibility of interest payments on consumer loans.

With little need for new funding, banks and thrifts have lowered rates on retail time deposits, especially on intermediate- and long-term accounts, by more than market rates have declined. Under regulatory pressure, banks also have cut back reliance on, and returns to, brokered deposits. Even on NOW accounts, savings deposits, and money market deposit accounts, where inflows have strengthened, returns on the larger accounts—likely involving the most interest sensitive depositors—have dropped much faster than have the most common rates paid. The comparatively high returns on longer-term debt and equity instruments also have drawn household assets out of retail deposits. Bond and stock mutual funds in particular have recorded substantial inflows.

Thus, the weakness in the broader monetary aggregates, which has been even more pronounced this year, can be seen as an aspect of the entire process of rechanneling credit flows away from depositories and of restructuring the public's balance sheets. However, the disintermediation and restructuring forces, which have acted powerfully to depress the growth of money, have exerted a less powerful constraint on spending; that is, slower money growth has not tended to show through percentage point for percentage point to reduced nominal GDP expansion. Accordingly, these disintermediation and restructuring forces have tended to boost the velocity of the broader aggregates. Increasing M3 velocity has been evident for some years, but the tendency for M2 velocity to rise was

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

obscured until recent quarters by the opposing influence of declines in short-term market rates. Lower short rates reduced the potential returns given up by holding liquid M2 balances, thereby providing support to demands for M2 and countering the emerging tendency for its velocity to increase. But M2 velocity appears to have registered an appreciable increase in the first half of this year, and the Federal Reserve has had to take the emerging behavior of velocity into account in deciding how much weight to place on slow M2 growth in guiding its policy actions.

PROSPECTIVE BEHAVIOR OF THE MONETARY AGGREGATES

Looking ahead, the recent increases in M2 velocity may well continue, although the uncertainties in this regard are considerable. Returns on short-term market instruments relative to rates on M2 balances have dropped to unprecedented lows. Depositories may well reduce liquid deposit rates further to restore longer-run relationships with money-market rates. Should this occur, the resulting shifts in assets would reduce M2 demand without much influencing spending, further boosting the velocity of this aggregate. The velocity of M2 also would tend to increase if any pickup in credit availability at banks associated with stronger economic expansion were funded out of their sizable holdings of liquid securities and newly issued managed liabilities rather than through recourse to retail deposits.

Another significant imponderable involves the public's demand for M2 balances. The extent to which households will continue to repay or avoid debt by drawing down M2 balances is difficult to foresee with any precision, as one cannot accurately gauge households' desired leverage positions. An early completion of household balance-sheet adjustments would help to restore incentives to build liquid money balances, cutting into increases in M2 velocity. Any decline in long-term market rates could dissuade households from reaching for better returns out the yield curve beyond M2 maturities, and thereby bolster M2 demands even more than it would spending. This would further offset the tendency for disintermediation and deleveraging to raise M2 velocity. All told, predicting either the share of depository intermediation in overall credit flows or the share of money in the public's overall demand for financial assets is currently more difficult than usual.

Against this background of considerable uncertainty about evolving monetary relationships, the Committee retained the current ranges for money and credit growth this year. These growth ranges are 2½ to 6½ percent for M2, 1 to 5 percent for M3, and 4½ to 8½ percent for debt. On a provisional basis, the same ranges also were carried over to next year. If velocities were to show little further increase, then growth of the monetary aggregates within these specified ranges for both years would be consistent with the achievement of noninflationary economic expansion. The reduction in short-term interest rates resulting from our recent policy action enhances the odds on money growing within these ranges. On the other hand, if the unusual velocity increases seen so far this year were to persist over the next six quarters, then growth of M2 and M3 around or even below the lower bounds of their ranges could still be acceptable.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In any case, the current ranges represent a way station on the road to reasonable price stability. Even with a return to the traditional secular stability of M2 velocity, the midpoint of the current ranges would still be higher than needed to support long-run economic growth in the context of price stability. And, if velocity increases do in fact occur during a transition period to a higher long-run equilibrium level, then ranges somewhat lower than the current specifications would be warranted over this interval. But in light of the considerable uncertainties about nearer-term velocity developments, the Federal Open Market Committee did not commit itself to new, respecified ranges for M2 or M3 for 1992. Such a respecification would carry the presumption that the new range was clearly more consistent with broader economic objectives, and in view of the uncertain relationships involved, the FOMC did not wish to convey that impression. This year's ranges were carried forward on a provisional basis for 1993, until such time as additional experience and analysis could be brought to bear on the issue of monetary behavior. In any event, the FOMC will revisit the issue of its money and credit ranges for 1993 no later than its meeting next February. By then more evidence will have accumulated about evolving monetary relationships. In light of the difficulties predicting velocity, signals conveyed by monetary data will have to continue to be interpreted together with other sources of information about economic developments.

CONCLUDING REMARKS

I expect that the economic expansion will soon gain momentum, which lower inflation should help to maintain. Although the economy still is working its way through structural impediments to more vigorous activity, the advances that already have been made in this regard augur well for the future. Banks and other lenders, having made considerable strides in rebuilding capital, have greater capacity to meet enlarged credit demands. The strengthening of household finances to date has established a firmer foundation for future consumer outlays. And the restructuring of business balance sheets so far, together with improved labor productivity and profitability, has better positioned producers to support sustainable output gains. These gains would be even larger if the federal government can make significant progress toward bringing the budget into balance, releasing saving for productive private investment, and brightening further the prospects for ongoing advances in living standards for all Americans.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Board of Governors of the Federal Reserve System

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

July 20, 1992

Letter of Transmittal

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

Alan Greenspan, Chairman

Table of Contents

Pr

Section 1: Monetary Policy and the Economic Outlook for 1992 and 1993

Section 2: The Performance of the Economy in 1992

Section 3: Monetary and Financial Developments in 1992

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Section 1: Monetary Policy and the Economic Outlook for 1992 and 1993

Economic activity has increased on balance since the beginning of the year, but rather hesitantly in recent months, and inflationary pressures have continued to abate. Against this backdrop—and with money and credit exhibiting renewed weakness in the second quarter—the Federal Reserve has eased money market conditions twice—in April and again in early July. The descent of domestic interest rates, which began in 1989, has now carried nominal yields on many market instruments to the lowest levels in two or three decades.

In mid-February, when the Board presented its last semiannual report on monetary policy to the Congress, the economy seemed to be struggling to regain forward momentum. Growth had come almost to a standstill in the final quarter of 1991, and, while a hint of improvement was evident in some of the indicators that were available in mid-February, convincing signs of a strengthening of activity had not yet appeared. Moreover, in looking ahead at that time, it seemed likely that growth would continue to be retarded by the still incomplete resolution of major structural adjustments in a variety of sectors, financial and nonfinancial. Chief among those structural impediments were persistent problems in commercial real estate markets, budgetary stress at all levels of government, a downsizing of the defense industry, exceptional caution among financial intermediaries, and ongoing efforts of businesses and households to reduce the level of their indebtedness.

At the same time, however, considerable impetus to activity was thought to be already in train, partly as a result of the substantial easing of money market conditions that the System had implemented in the second half of 1991. Among other effects, the decline in short- and long-term interest rates was reducing debt-servicing obligations and was facilitating needed balance sheet restructuring by borrowers and lenders. In assessing the situation as of last February, the Board members and Reserve Bank presidents recognized that the uncertainties in the outlook were unusually large, but they believed that a moderate pickup in output from the especially sluggish pace of the fourth quarter of 1991, coupled with further improvement in underlying price trends, was the most likely prospect in 1992.

In the event, economic growth did move back into a moderate range in the first quarter of 1992. After keeping a tight grip on their expenditures during the holiday shopping season, consumers stepped up their spending sharply in early 1992; simultaneously, purchases of new houses soared, spurred in part by lower mortgage interest rates. An unusually mild winter also helped to buoy activity in January and February. Although businesses were able to accommodate much of the burst in spending through a drawdown of inventories, the rise in demand sparked a rebound in industrial output. Consumer sentiment, which had deteriorated in late 1991 and early 1992, began to tilt back up in late winter and early spring, and business executives expressed greater optimism. Economic growth, as measured by the annualized rate of change in real gross domestic product, moved up to 2¾ percent in the first quarter, the largest quarterly gain in more than three years.

The strength in final demand that seemed to be emerging in the early part of the year does not appear to have carried through the second quarter, however. Households, restrained by a soft labor market and the lack of significant gains in real income, clamped down on their spending after the burst early in the year; real consumption expenditures appear to have grown little, if at all, in the second quarter, and new home sales fell steadily from February through May. In addition, exports, which, over the past several years, had been an area of strength in the economy, showed little growth over the first five months of 1992. Although manufacturers boosted production in April and May, they tended to do so more by stretching the hours of their workers, rather than by adding employees to their payrolls. Declines in production became evident in the industrial sector in June, as firms apparently moved quickly to forestall unintended inventory accumulation. In the labor market, the data for May and June showed a disturbing rise in the unemployment rate, to a level of 7.8 percent. On the whole, the growth of total output in the economy likely was positive again in the second quarter—as it had been in each of the four preceding quarters. But, as the Federal Reserve had anticipated at the start of the year, the drag from ongoing structural adjustments has remained heavy.

Inflationary forces have been muted this year. Prices accelerated somewhat in the first quarter, but that flare-up proved to be short-lived, as increases in the consumer price index were small, on average, in the second quarter. The "core" rate of inflation, as measured by the change in the CPI excluding food and energy, averaged 3.8 percent at an annual rate in the first six months of 1992; this rate of rise was a little lower than the average rate of increase during

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

1991, and it was considerably less than the increase seen during 1990. With inflation expectations down appreciably from recent highs, and with firms striving to reduce their costs on all fronts, a trend toward gradual reduction in the rate of price increase appears to be well established at the present time.

Growth in the broad measures of money was quite weak in the second quarter, leaving both M2 and M3 in June below the lower bounds of their annual ranges. Measured from its average level in the fourth quarter of 1991, M2 increased at an annual rate of 1½ percent through June, while M3 edged down at a rate of ¼ percent over that same period. As is discussed in more detail below, the sluggishness of money during this period seemed to be more a reflection of changing patterns of finance than of restraint on nominal income growth. Still, private credit growth also was relatively slow, and, in the context of renewed softness in the incoming data on spending and production, the weakness in both money and credit added to concerns about the ongoing strength of the expansion.

In this environment, the System eased money market conditions slightly in April and implemented a one-half percentage point reduction in the discount rate on July 2 along with a commensurate further easing of money market conditions. In total, short-term interest rates have declined about three-quarters of a percentage point since the beginning of the year. Longer-term rates backed up early in the year as the economic expansion appeared stronger than many people had expected, raising market concerns about a revival of inflationary pressures. However, in recent months many bond and mortgage rates have retraced their earlier increases. Broad indexes of stock prices have remained close to record levels. In foreign exchange markets, the weighted average value of the dollar, in terms of the currencies of other Group-of-Ten (G-10) countries, appreciated until early March, but recent depreciation, occasioned primarily by a less robust outlook for the U.S. economy, has left the dollar somewhat below its 1991 year-end level.

Declining interest rates in recent years have contributed to sizable reductions in debt-service obligations, as both long- and short-term debt has been rolled over or refinanced at lower rates. In addition, lower long-term rates and high price-earnings ratios on stocks have encouraged businesses to reduce the interest-rate risk and the uncertainty associated with short-term funding by relying more heavily on issuance of long-term debt and equity. Households also have taken advantage of lower rates to refinance existing debt, especially mortgages. In addition, over-leveraged households, facing uncertain income and employment prospects and wide spreads between rates charged on consumer credit and yields on monetary assets, have moved to limit debt growth.

The resulting improvements in the financial conditions of households and businesses are evident in a number of indicators: Delinquencies on consumer loans and home mortgages have declined, ratings for a number of firms have been upgraded, and yield spreads have narrowed on private fixed-income securities relative to Treasury obligations. Of course, not all parties have benefitted from lower interest rates; households holding short-term deposits have experienced a sizable decline in interest income. On balance, though, lower interest rates have helped households and businesses strengthen their balance sheets, thereby building a firmer financial foundation for future economic expansion.

Efforts to return to more sustainable leverage positions have contributed to slow expansion of the debt of nonfederal sectors in the first half of this year. Heavy borrowing by the federal government has kept total debt expanding at the lower end of the Federal Open Market Committee's (FOMC) 4½ to 8½ percent monitoring range, based on current estimates. Depository credit remains especially weak, reflecting not only muted private loan demands, but also continued caution among depositories. Commercial banks no longer appear to be tightening their non-price terms of lending, but the degree of credit restraint remains substantial and spreads between loan rates and the cost of funds remain unusually wide. Bank capital positions have improved substantially over the past year; nonetheless, banks are likely to continue working to bolster capital, partly as a consequence of incentives contained in the FDIC Improvement Act.

The contraction of depository credit has been mirrored by the meager advance in the monetary aggregates. This is seen clearly in M3, which includes most of the liabilities banks and thrifts use to fund loans and other assets. But M2 also has been affected. Banks and thrifts have not actively pursued deposit funding in light of weak loan growth, and retail deposit rates have fallen considerably over the course of the year. Consumers consequently have sought higher-yielding assets outside M2, including those in the capital market where—despite the greater risks involved—returns have appeared more attractive. In addition, given the wide deposit-loan rate spreads, some M2 holders likely have opted to pay down debt rather than to hold monetary assets.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Ranges for Growth of Monetary and Credit Aggregates

	1991	1992	Provisional for 1993
Percentage change, fourth quarter to fourth quarter			
M2	2½ to 6½	2½ to 6½	2½ to 6½
M3	1 to 5	1 to 5	1 to 5
Debt	4½ to 8½	4½ to 8½	4½ to 8½

The rechanneling of credit flows away from depositories and the associated sluggish money growth have not been entirely benign; many borrowers face higher costs and stricter terms of credit now than in the past at given levels of market interest rates. Nonetheless, weakness of the monetary aggregates has not been associated with a similar degree of restraint on aggregate demand. Indeed, growth in nominal spending has considerably outpaced that of M2 and M3; put differently, both monetary aggregates appear to have registered sizable increases in their income velocities in the first half of the year. The rise in M2 velocity is particularly notable, given the marked drop in short-term interest rates in the latter part of 1991. Ordinarily, velocity tends to fall for a time after a decline in short-term rates.

Monetary Objectives for 1992 and 1993

In reviewing the annual ranges for the monetary aggregates in 1992, the Committee noted the substantial uncertainties created by the unusual behavior of M2 and M3 velocity thus far this year. If portfolio shifts ebb and more normal relationships of depository credit to spending begin to emerge, growth of the monetary aggregates within the existing ranges would be consistent with the Committee's objectives for making progress toward price stability and fostering economic growth. However, it is unclear whether the forces giving rise to the unusual behavior of the aggregates will wane in coming months or continue unabated. Faced with these uncertainties, the Committee chose to retain the 2½ to 6½ percent range for M2 and the 1 to 5 percent range for M3 announced earlier this year for 1992.

The Committee also reaffirmed the existing 1992 monitoring range for the aggregate debt of domestic nonfinancial sectors. The more cautious attitudes toward borrowing that have damped credit growth this year, and the improving balance sheets of borrowers, should lay the groundwork for sustained economic expansion in years to come.

The ongoing structural changes in the financial system and the tentative nature of the recovery greatly complicated the task of choosing ranges for the coming year. The Committee recognized that the range for M2 probably would need to be reduced at some point to be consistent with the Federal Reserve's long-run objective of reasonable price stability. However, pending further analysis of the recent relationship of money stock movements to income and interest rates, the Committee chose to carry forward the 1992 ranges for the monetary aggregates and debt as provisional ranges for 1993.

Economic Projections for 1992 and 1993

The members of the Board of Governors and the Reserve Bank presidents, all of whom participate in the discussions of the Federal Open Market Committee, generally believe that the most likely scenario for the economy in the second half of 1992 is one in which real GDP increases at a moderate pace and job growth is sufficient to impart a downward tilt to the unemployment rate. In 1993, output growth is expected to pick up slightly further from the 1992 pace, bringing additional small reductions in the unemployment rate. Inflation likely will hold to a gradual downward trend over the next year and a half.

In quantifying their views of the prospects for economic growth, the Board members and Reserve Bank presidents ended up with forecasts that are somewhat stronger than in February. A large majority of them see the most likely outcome for this year as being one in which real gross domestic product rises 2¼ percent to 2¾ percent over the four quarters of 1992; the central tendency of the forecasts for 1993 spans a range of 2¾ to 3 percent. With regard to the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Economic Projections for 1992 and 1993

	FOMC Members and Other FRB Presidents	
	Range	Central Tendency
1992		
Percent change, fourth quarter to fourth quarter		
Nominal GDP	5 to 6¼	5¼ to 6
Real GDP	2 to 3¼	2¼ to 2¾
Consumer price index	3 to 3½	3 to 3½
Average level in the fourth quarter, percent		
Civilian unemployment rate	7 to 7[illegible]	7¼ to 7½
1993		
Percent change, fourth quarter to fourth quarter		
Nominal GDP	4½ to 7	5½ to 6¼
Real GDP	2½ to 3½	2¾ to 3
Consumer price index	2½ to 4	2¾ to 3¼
Average level in the fourth quarter, percent		
Civilian unemployment rate	6½ to 7¼	6½ to 7

unemployment rate, the central tendency of the governors' and Bank presidents' forecasts for the fourth quarter of 1992 covers a range of 7¼ to 7½ percent, as compared with the second-quarter average of 7½ percent; the corresponding central tendency range for the final quarter of 1993 is 6½ to 7 percent.

The achievement of the projected GDP growth will depend in part on the progress in resolving the various structural adjustments noted earlier. In general, the Board members and Reserve Bank presidents believe that these structural problems will continue to exert negative drag on the economy in coming quarters, but that their force will gradually lessen. On that score, some of the recent trends have been encouraging. In the market for commercial real estate, which has been the most striking area of weakness in the economy in recent quarters, downward pressures on the prices of existing properties seem to have begun to diminish, and the rate of decline in new construction appears to be slowing. In addition, businesses and households also have made considerable progress in strengthening their finances, and even though that improvement evidently has not yet generated more expansive attitudes toward spending and investing, such a shift probably will be forthcoming at some point. An obvious risk in the outlook is that these, and the other, structural adjustments could persist with greater intensity than is anticipated; but, alternatively, a faster resolution of the structural problems—and a stronger pickup of the economy—is not out of the question either.

The governors and Bank presidents expect the rise in the consumer price index over the four quarters of 1992 to end up in the range of 3 to 3½ percent. Although an increase of this magnitude is to the high side of that which was realized in 1991, inflation rates were held down last year by the unwinding of the oil price shock that had occurred in 1990. Core inflation this year is expected to be lower than it was in 1991, and most Board members and Reserve Bank presidents believe that sustained progress toward the containment of costs and a further easing of inflation expectations will keep the trend rate of price increase on a course of gradual slowing next year as well. With

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

neither food nor energy prices anticipated to depart in any meaningful way from the broad trends of inflation, the total CPI also is expected to slow in 1993, dropping into a range of 2¾ to 3¼ percent, according to the central tendency of the FOMC participants' forecasts.

Earlier this year, in the *Economic Report of the President* and the *Budget*, the Administration issued forecasts that showed nominal GDP growth in 1992 and 1993 that falls within the ranges anticipated by Federal Reserve officials. Consequently, there would appear to be no inconsistency between the System's plans for monetary policy and the short-term goals of the Administration.

Looking more toward the long term, the prospect of a sustained period of declining inflation, together with a resolution of the many structural problems that currently afflict the economy, suggests the opportunity for substantial economic gains and a broadening prosperity. The Federal Reserve, for its part, can best contribute to the achievement of those objectives by keeping its sight firmly on the long-run goal of price stability. But the longer-range progress of American living standards will depend upon more than monetary stability. Sound fiscal policies and an open world trading system are essential if we are to enhance capital formation and achieve the greatest possible productivity of our human and physical resources.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

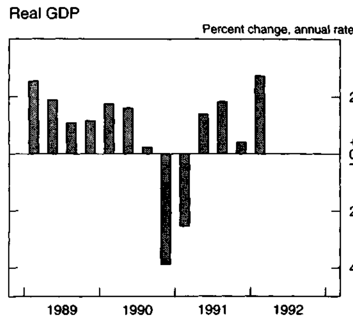
Section 2: The Performance of the Economy in 1992

After coming almost to a standstill in the final quarter of 1991, economic activity showed more vitality in the early part of 1992. Buoyed by a surge in final sales, real gross domestic product rose at an annual rate of 2¾ percent in the first quarter. Growth evidently slowed considerably in the second quarter; in that period, signs of softness began to surface once again in a number of the indicators. Most notably, industrial production and payroll employment turned down in June, after four months of increases, and, with an influx of jobseekers into the labor market, the civilian unemployment rate moved up sharply toward mid-year, to a June level of 7.8 percent—about three-fourths of a percentage point above the rate at the end of 1991.

The first-quarter surge in final sales was largely a reflection of a firming of demand in the domestic economy. Consumer spending strengthened markedly in the opening months of the year, housing starts and home sales jumped, and business fixed investment increased for the first time in several quarters. In the second quarter, domestic demand appears to have risen further, but, on the whole, at a slower pace than in the first quarter. By contrast, the external sector of the economy, which had contributed appreciably to growth of the economy in 1990 and 1991, has provided little or no impetus to activity this year; exports have been limited recently by the continued sluggishness of many foreign industrial economies, and imports appear to have moved up, after a couple quarters of flatness.

Although price movements were erratic from month to month in the first half of 1992, there was ample evidence that the underlying processes of disinflation still were at work. Wage increases moderated further, and productivity increases also contributed importantly to the containment of costs. The twelve-month change in the consumer price index excluding food and energy, a rough gauge of the underlying rate of inflation in the economy, dropped below the 4 percent mark; as recently as the first quarter of 1991, that measure had been running as high as 5½ percent. The total CPI rose only 3 percent over the twelve months ended in June, held down by small increases in food and energy prices over that twelve-month period.

Real GDP



The Household Sector

Indicators of the economic health of households were mixed in the first half of 1992. Households continued to make gradual progress in reducing their debt burdens in the first half of the year, and the incidence of financial stress seemed to diminish. However, neither income nor wealth displayed the degree of vigor needed to sustain strength in household expenditures.

When the year began, consumer spending was a major question mark in the economic outlook. Consumer outlays for goods had weakened appreciably in the final quarter of 1991, and consumer confidence, which had gone into an alarming plunge during the autumn, continued to soften into early 1992. But—such pessimism notwithstanding—consumers pushed expenditures up at a very rapid pace in January and raised them further in February; although spending softened in March, the rise in real consumption expenditures for the first quarter as a whole amounted to 5 percent at an annual rate, the strongest quarterly advance in four years. Purchases of durable goods rose briskly, and solid gains also were recorded for a wide range of nondurables. Given the size of those increases—and with housing sales also rising sharply in the early part of the year—it seemed for a time that the forces of expansion might be gathering considerable strength.

However, the first-quarter surge did not carry over into the spring. Indeed, it appears that real consumption expenditures probably were little changed in the second quarter as a whole. A bright spot, though, in the recent spending data has been the firmness of motor vehicle sales. After bottoming out in January at an annual rate of about 12 million units, the sales of cars and light trucks rebounded to a rate of about 12½ million units in the next three months and then

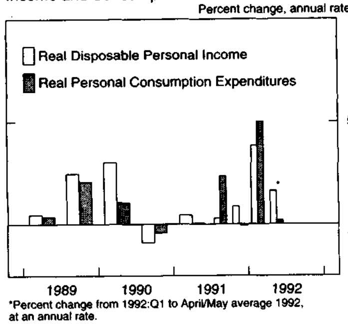
Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

moved up further in both May and June, reaching a level of 13¾ million units in the latter of those two months. Although a portion of the recent strength in auto sales apparently is a reflection of increased business investment in motor vehicles, it also seems likely that households that have put off buying new cars and trucks in the past couple of years now are entering the market in greater numbers.

Real disposable personal income fell after the oil price shock of 1990 and then turned up in the spring of 1991. Growth since then has been positive in each quarter, but a bit erratic and, on average, relatively slow. The level of real income in the first quarter of this year was about 2 percent above the recession low of a year earlier; the average for April and May was up less than 2 percent from the level of a year ago. Growth of wage and salary income has remained sluggish this year, and interest income has continued to decline. By contrast, government transfer payments to individuals have continued to grow rapidly in recent quarters, buoyed, in part, by a rise in unemployment benefits. Starting in March, disposable income also was lifted by a change in tax withholding schedules that altered the timing of tax payments to some extent, delaying a portion of those payments until 1993.

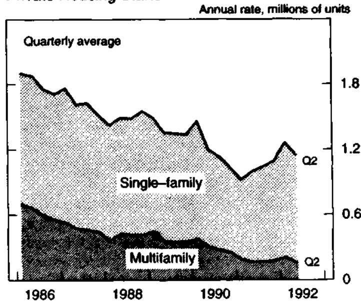
A combination of restrained debt growth and lower interest rates has led to reductions in the debt-servicing burdens of households, although, measured relative to income, the repayment burden still is relatively high by historical standards. The incidence of financial stress among households also appears to have eased somewhat in the most recent quarters for which data are available. Delinquency rates on consumer loans and home mortgages, which rose sharply

Income and Consumption



*Percent change from 1992:Q1 to April/May average 1992, at an annual rate.

Private Housing Starts



from mid-1990 to mid-1991, turned down in the second half of last year and declined further in the first quarter of 1992.

Real outlays for residential investment have been rising since the start of 1991. The first-quarter gain—11¾ percent at an annual rate—took outlays to a level close to 10 percent above that of a year earlier. Even so, spending gains over the year ended in the first quarter of 1992 recouped less than half of the sharp decline of the preceding four quarters.

For a brief time early this year, residential investment seemed to be picking up considerably more momentum. In the latter part of 1991, mortgage interest rates had dropped to their lowest levels in more than fifteen years, and the sales of new single-family houses, which already had been moving up at the end of last year, surged in January and remained strong in February. Reacting to the rise in demand—and aided by an unusually mild winter—builders boosted the pace of single-family housing starts to the highest seasonally-adjusted level in two years. In March, however, sales of new homes plummeted, and they weakened further in April and May. Starts also retreated; the number of single-family units started in the second quarter was 6 percent below the first-quarter average.

Several factors have affected the recent patterns of the housing indicators. The mild winter weather evidently permitted some starts to be undertaken a bit sooner than they otherwise would have been. In addition, a substantial backup of mortgage interest rates after January undoubtedly cut into demand to some degree; rates on 30-year fixed-rate conventional mortgages rose from about 8¼ percent in mid-January to 9 percent by March and remained above 8½ percent until June. Discussion of a possible tax credit for

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

first-time homebuyers also appears to have raised demand temporarily.

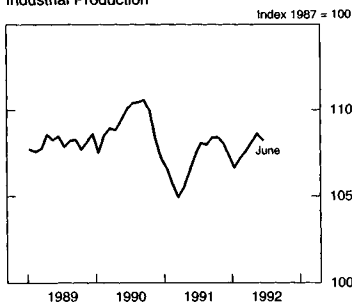
Moreover, the recovery in housing activity probably has continued to be retarded to some degree by negative influences that were evident in 1991. A significant number of potential homebuyers are being deterred by concerns about jobs and incomes. Others now view the purchase of a home as being a riskier, less attractive investment than it once seemed, owing to the sharp declines seen in house prices in some regions in recent years and to the lack of much price appreciation more generally. High vacancy rates and unfavorable demographic trends continue to be formidable obstacles to recovery in the multifamily sector. By contrast, an increasingly favorable factor is the improved affordability of housing: Lower mortgage interest rates—in part a reflection of the less inflationary environment of recent years—have substantially reduced the size of the monthly payment associated with the purchase of a home, measured relative to personal income. In that regard, the latest round of cuts in mortgage interest rates, to the lowest level since 1973, appears to have stimulated some pickup in real estate activity very recently.

The Business Sector

When the year began, the business sector of the economy was still in the process of adjusting to the sluggishness of demand and mild backup of inventories that had emerged in the second half of 1991. Industrial production, which had declined in the final two months of last year, fell further in January; assemblies of motor vehicles dropped sharply in that month, and cutbacks in output were reported in other industries as well. Those production cuts, coupled with the January surge in household spending, led to a reduction in business inventories, clearing away most of the excess stocks that had accumulated in the final four months of 1991.

Industrial production turned up in February, and, with orders and shipments trending up, additional gains followed in each of the next three months. Assemblies of motor vehicles rose considerably during this period and, by May, were at the highest level since the fall of 1990; although assemblies were reduced by a small amount in June, automakers have announced plans to step up assemblies in third quarter. Production of consumer goods other than motor vehicles also increased moderately over the four-month period beginning in February; a small portion of those gains was reversed in June, however. Output of business equipment (other than motor vehicles) rose in each month from February through June, bolstered by strong gains in the production of office and computing equipment.

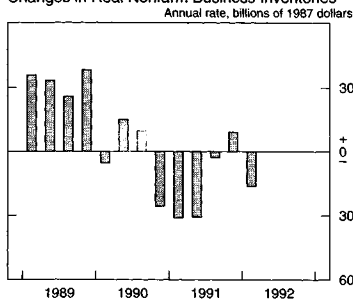
Industrial Production



Manufacturing and trade inventories, measured in real terms, fell further in February. Thereafter, inventories appear to have risen somewhat, on net. In manufacturing, the level of inventories at the end of May was relatively low, compared to the level of sales. But, in parts of the trade sector, stocks may have been slightly higher than desired, and with household demand looking sluggish once again, some businesses may have felt it appropriate to pull back a bit on orders for additional merchandise, triggering the production adjustments that were evident in June.

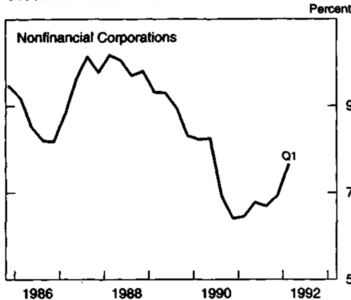
Business profits, which came under considerable pressure during the recession, began rising noticeably in the latter part of 1991 and increased sharply in the

Changes in Real Nonfarm Business Inventories



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Before–tax Profit Share of Gross Domestic Product*



*Profits from domestic operations with inventory valuation and capital consumption adjustments divided by gross domestic product of nonfinancial corporate sector.

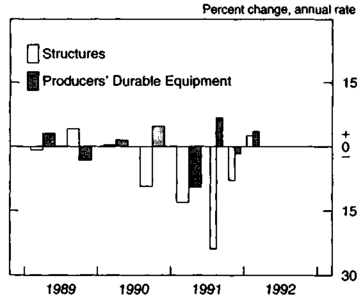
first quarter of 1992. The before-tax economic profits of all U.S. corporations jumped 12½ percent in the first quarter and were at the highest level since the first half of 1989. The profits of financial corporations have been boosted by sharp reductions in interest expenses and by a strengthening of their loan portfolios. The economic profits of nonfinancial corporations from their domestic operations also have been rising; in the first quarter of 1992, these profits, on a pre-tax basis, were more than 20 percent above their quarterly low of late 1990. That rise in profits was the result of small increases in volume, a moderate increase in the margin over unit labor costs, and substantial reductions in net interest expenses.

Stress has continued to be evident this year in a number of industries—notably retailing, airlines, and commercial real estate. Overall, however, corporate balance sheets have been strengthening. Issuance of equity by nonfinancial corporations has been outstripping share retirements in recent quarters, after several years in which the balance ran markedly in the other direction. In addition, the growth of business debt has remained sluggish this year, as internal sources of funds have proven to be large enough to finance a subdued level of business investment. Lower bond yields have enabled firms to replace higher-cost debt and have encouraged a shifting out of short-term liabilities. Among farm businesses, income has dropped back from the relatively high levels of 1989 and 1990, and farmers have cut back on their investment in machinery and equipment. However, farmers' balance sheets appear to be considerably stronger at this point than they were in the mid-1980s, when the sector went through an extended period of severe financial stress.

Business fixed investment turned up in the first quarter of this year, after declining in each quarter from late 1990 to the end of 1991. Real outlays for equipment increased moderately in the first quarter, and business investment in new structures turned up, after five quarters of sharp declines. The second-quarter indicators that are in hand suggest that equipment spending probably increased by enough to raise total real business fixed investment further in that period.

The first-quarter rise in equipment spending amounted to about 3½ percent at an annual rate. Increased outlays for computers and related devices more than accounted for the first-quarter gain; spending for that type of equipment has been rising briskly since mid-1991, boosted by product innovations, extensive price-cutting by computer manufacturers, and the ongoing efforts of businesses to achieve efficiencies through the utilization of new information-processing technologies. By contrast, spending for aircraft, which had been strong in 1990 and for most of 1991, has weakened substantially since last autumn; a first-quarter uptick in those outlays retraced only a small part of the fourth-quarter plunge. Business outlays for motor vehicles were down moderately in the first quarter, but they appear to have firmed in the second quarter. Spending for all other types of equipment, roughly half of which is industrial machinery, was down further in the first quarter in 1992, but at a much slower pace than in 1991. In total, equipment investment appears to be exhibiting the traditional lagged response to changes in aggregate economic activity, the recent pickup being supported by the rise in profits and increased cash flow.

Real Business Fixed Investment



Real outlays for nonresidential structures rose at an annual rate of 2½ percent in the first quarter. Investment in industrial structures was up for the second quarter in a row, and increases also were reported for utilities, private educational facilities, and hospitals and institutions. However, spending for gas and oil drilling fell further in the first quarter, and the outlays for construction of office buildings continued to decline.

In total, the first-quarter level of spending for offices and other commercial structures was about 40 percent below the level of two years earlier, but there are tentative indications that the steepest part of this protracted decline may now be over. Although spending for the construction of office buildings has continued to fall rapidly this year, the outlays for commercial structures other than offices—a category that includes such things as warehouses, shopping malls, and other retail outlets—have changed little, on net, over the past several months. In addition, there are indications that the rate of decline in prices of existing commercial properties has slowed, and transactions in commercial real estate reportedly have picked up in some areas of the country this year.

The Government Sector

Government purchases of goods and services—the part of government spending that is included in gross domestic product—increased at an annual rate of 3 percent in real terms in the first quarter of 1992, after declining about 1½ percent over the four quarters of 1991. Federal purchases, which fell 3 percent last year, rose at an annual rate of about 1 percent in the first quarter; nondefense purchases moved higher, and the decline in defense purchases was smaller than those seen in previous quarters. State and local purchases, which had declined slightly over the course of 1991, were boosted in the first quarter of 1992 by a surge in the outlays for structures.

Budgetary problems continue to confront many governmental units. At the federal level, the unified budget deficit over the first eight months of fiscal 1992—the period from October to May—totaled $232 billion; this total was about $56 billion larger than the deficit recorded in the first eight months of the previous fiscal year. Federal receipts in the current fiscal year are up only 1 percent from the same period of a year earlier, while outlays have climbed about 7½ percent. On the receipts side of the ledger, the income taxes paid by individuals have been damped by slow income growth, and, despite a pickup recently, the revenue from corporate profits taxes has been weak for the fiscal year to date. Receipts from excise taxes have risen considerably this fiscal year, but these do not account for a very large share of total federal revenue.

The sharp rise in federal spending this year is partly a reflection of a diminished flow of contributions to the United States from our allies in the Gulf War; these contributions are counted as negative outlays in the federal budget and their shrinkage therefore translates into a rise in recorded outlays. By contrast, spending has been held down this year by a reduction in outlays for deposit insurance programs. This reduction stems, in part, from delays in funding the activities of the Resolution Trust Corporation (RTC), the federal agency that is responsible for cleaning up the problems of insolvent thrift institutions. Excluding the allied contributions and the spending for deposit insurance programs, federal outlays have risen about 5½ percent this fiscal year. Federal financing of health care has continued to rise at a very rapid pace in fiscal 1992; grants to states for Medicaid, the fastest growing category in the health care budget, are running more than 30 percent above the level of a year ago. In addition, slow growth of the economy and actions taken to extend unemployment benefits have pushed federal spending for income support programs sharply higher, and outlays for social security have been boosted by cost-of-living adjustments and increases in the number of beneficiaries. Combined federal spending for other functions has risen only slightly in nominal terms this fiscal year. The mix of this spending is changing, however. Outlays for some nondefense functions—notably law enforcement, education, and health programs other than Medicaid—have risen fairly rapidly in fiscal 1992; outlays for defense have been cut back, even in nominal terms, once adjustment is made for the diminished flow of allied contributions.

Many state and local governments still are grappling with severe budgetary imbalances, and further progress toward correcting those imbalances was not evident in the first quarter of 1992. After four quarters in which state and local governments had managed to chip away steadily at the deep deficit in their combined operating and capital accounts, that deficit is estimated to have widened a little in the first quarter, to a total, excluding social insurance funds, of about $26 billion.

Last year's progress in reducing the combined state and local budget deficit was achieved partly through tax increases and partly through spending restraint. With deficits still large this year, legislators and

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

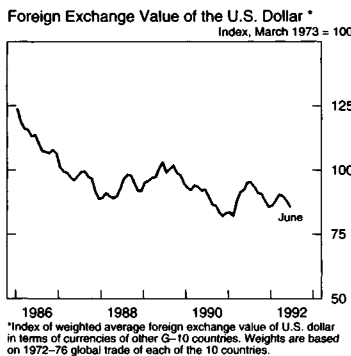
administrators are facing yet another round of painful choices. Tax hikes have been implemented in some places this year, and efforts to curb spending appear to be widespread, even as the demands for many types of government services have continued to rise. Increases in the wages and benefits of state and local workers have slowed considerably in recent quarters, with wage freezes being imposed in some cases. Although state and local employment has risen a little in recent months, partly because of election activity, the cumulative growth in the number of state and local jobs over the past year has been quite sluggish, and some governments have furloughed workers temporarily in order to hold down expenditures. Against the backdrop of these widespread attempts to restrain spending, the substantial first-quarter rise in real state and local purchases may well have been a temporary bulge, rather than the harbinger of a renewed uptrend in state and local spending.

The External Sector

For the year to date, the foreign exchange value of the dollar, in terms of the currencies of the other Group-of-Ten (G-10) countries, has declined somewhat, on balance, from its level at the end of 1991. Appreciation early in the year has been offset by subsequent depreciation.

From its low point at the end of 1991, the dollar appreciated through about mid-March, reaching a level nearly 9 percent above where it was at year-end. The dollar was lifted during this period by data pointing to increasing strength in the recovery of U.S. economic activity which also worked to raise U.S. long-term interest rates relative to those in other countries. From mid-March through April, exchange rates fluctuated in a fairly narrow range. Beginning in May, however, the dollar began to decline as long-term interest rates eased, and as of mid-July, it had more than reversed the rise earlier in the year. The market's reassessment of the prospects for a strong U.S. economic recovery appears to have been a major factor underlying the declines in both the dollar and long-term rates.

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 based on 1972-76 global trade of each of the 10 countries.

Developments abroad reinforced these factors. The dollar rose sharply against both the Japanese yen and the German mark early in the year. Signs of further weakening of economic growth in Japan and the decline of the Japanese stock market worked to depress the yen. Reports of a decline in German output in the fourth quarter of 1991 and increasing expectations that the Bundesbank would not move further toward tightening German monetary policy contributed to the weakness of the mark. Beginning in late April, the dollar started to decline against the yen and the mark. News of a substantial widening of Japan's current account surplus and a belief that the Group-of-Seven nations supported appreciation of the yen contributed to a turnaround in the dollar's exchange rate against that currency. In Germany, economic activity proved stronger than expected in the first quarter and, along with rapid money growth in that country, led both to a reevaluation of the prospects for an early easing by the Bundesbank and to a rise in the mark.

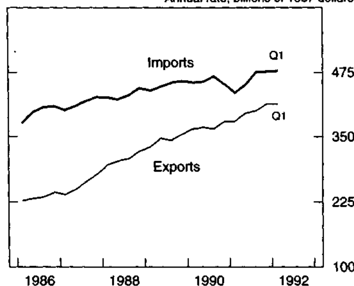
On balance, the dollar declined more than 3 percent against the mark and was little changed against the yen from the start of the year to mid-July. The dollar appreciated against the Canadian dollar; with Canadian real GNP flat in the fourth quarter of 1991 and posting only a small rise in the first quarter of this year, Canadian authorities eased interest rates and appeared to welcome the associated decline in their currency as a way to help stimulate economic activity. By contrast, the dollar depreciated moderately against the currencies of major developing countries over the first half of 1992, after adjustment for movements in relative price levels.

Prices of U.S. non-oil imports accelerated to a 6¼ percent annual rate of increase in the first quarter of 1992, more than double the rate of rise in the fourth quarter of 1991. The jump in import prices most likely reflected the lagged effects of the depreciation of the dollar that occurred during the latter part of 1991. Most of the price increase of the first quarter was reversed in April and May. The price of oil imports declined 15 percent in the first quarter, in response to

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

U.S. Real Merchandise Trade

Annual rate, billions of 1987 dollars



strong OPEC production and warmer than normal weather. However, that oil price decline was reversed in the second quarter in response to Saudi Arabian production restraint and indications that the Kingdom may be prepared to target prices at a somewhat higher level.

With growth of the U.S. economy still on a relatively slow track, real merchandise imports remained about unchanged in the first quarter, after only a small increase in the fourth quarter of 1991. Increases in imports of capital goods in the first quarter were about offset by declines in imports of consumer goods. Data for April and May show the quantities of imports of most categories of goods moving up noticeably from their first-quarter averages.

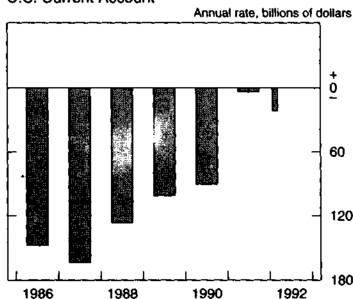
Export volume, which had climbed sharply in the final quarter of 1991, held around its fourth-quarter pace in the first five months of 1992. Despite its recent flatness, export volume in this five-month period was about 7½ percent above the level of a year earlier. The strongest growth in exports over the past year has been in capital goods, particularly to developing countries, reflecting strong investment demand in Latin America (especially Mexico), the Middle East, and in Asia. However, the general slowdown in growth in the major industrial countries last year, and the recessions in some countries, generally continued during the first half of 1992, depressing the growth of U.S. exports to these countries. At the same time, special factors that contributed to the strength in exports last year—notably the surge in investment demand in Latin America and replacement demands from the Persian Gulf countries after the war—have been less pronounced this year.

The merchandise trade deficit narrowed to an annual rate of $70 billion in the first quarter of 1992, slightly below the deficit recorded in the fourth quarter of 1991 and also a little below the 1991 average. The current account showed a deficit of $21 billion at an annual rate in the first quarter, compared with a deficit of $4 billion for calendar-year 1991. However, excluding unilateral transfers associated with Operation Desert Storm in both periods, the current account deficit in the first quarter—$23 billion at an annual rate—was about half the deficit seen in 1991. This improvement in current account transactions reflected a further widening of the substantial surplus on net service transactions (particularly in the areas of medical, educational, and other professional and business services) and an increase in net investment income receipts.

A large net capital inflow was recorded in the first quarter of 1992; foreign official holdings of reserve assets in the United States rose strongly, and private capital transactions showed a small net inflow. Within the private-sector accounts, the first quarter brought substantial capital outflows that were associated with U.S. purchases of foreign securities and increased direct investment abroad—particularly in intercompany debt flows to Canada and the United Kingdom. These outflows were largely offset by a sizable net capital inflow reported by banks, and by private foreign purchases of U.S. securities other than Treasury securities. Inflows associated with foreign direct investment in the United States amounted to less than $1 billion in the first quarter, down sharply from the average pace in recent years; acquisitions of U.S. businesses by foreigners fell sharply, and slow growth in the United States produced reduced earnings to be reinvested in this country. The net capital inflow in the first quarter exceeded the current account deficit by a wide margin, implying a substantial statistical discrep-

U.S. Current Account

Annual rate, billions of dollars



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

ancy in the international accounts—$16 billion at a quarterly rate. The disrepancy in 1991 had amounted to only $1 billion over the year as a whole.

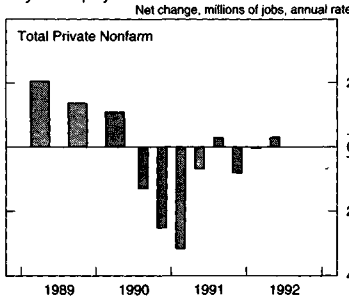
Labor Market Developments

Payroll employment, which had declined somewhat in the final quarter of 1991, fell further in January of this year. Thereafter, employment rose in each month from February through May, before turning down once again in June. In the private sector, the level of payroll employment in June was up only slightly from its level at the end of 1991, and it remained well below the pre-recession peak of 1990.

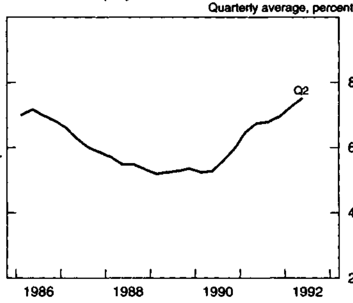
The sectoral patterns of change in the number of workers on private payrolls continued to vary considerably in the first half of 1992. Employment at establishments that provide services to other businesses rose fairly briskly, especially in the period from February through May. Those gains seemed to be a reflection of a firming of activity in the business sector, but they also may have been symptomatic of businesses' hesitation to push aggressively into expansion; it appears that firms may simply have been turning temporarily to outside help, rather than committing themselves to the expansion of their own payrolls.

Elsewhere, employment in the health services industry continued to rise in the first half of 1992, but in many of the other major sectors employment either changed little or declined. The number of jobs in the construction business in the second quarter was about the same as in the final quarter of last year. Employment in retail trade was also about flat over that same period. In manufacturing, employment fell slightly

Payroll Employment



Civilian Unemployment Rate



over the first half of the year, with small declines reported across a wide range of industries.

In total, about 200,000 new jobs were created in the first half of 1992, according to the payroll data obtained from business establishments and governments. An alternative employment series, compiled from the monthly survey of households, showed the number of persons with jobs rising by a larger amount—about 850,000—over that same period. Although a complete accounting of the reasons for the recent disparity between these two surveys is not possible, one possibility is that the payroll survey might not be fully capturing job growth at newly created establishments. If that is the case, then actual employment growth in the first half of this year may have been somewhat stronger than the payroll data indicate, although it still was not comparable to the gains seen at a similar stage of previous economic recoveries.

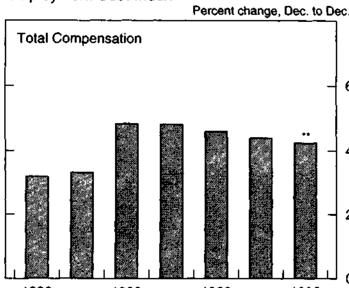
Despite the rise in employment in the household survey, there were further sharp increases in the number of unemployed, and the civilian unemployment rate rose from 7.1 percent in December to a level of 7.8 percent in June. Unemployment rates moved up, on net, for most occupational and demographic groups during the first half of the year, with especially large increases for adult men and teenagers. Much of the rise in unemployment in the first half consisted of persons who had lost their jobs. In addition, unemployment was boosted by a rise in the number of persons who had entered or re-entered the labor force, but were unable to find jobs; this influence was especially pronounced in May and June, the two months in which most of the first-half rise in the unemployment rate occurred.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The civilian labor force—the sum of those persons who are employed and those who are seeking work but cannot find it—grew very rapidly in the first half of 1992—about 3 percent at an annual rate. However, this surge in the labor force follows a period in which labor force growth had been quite weak, and the percentage increase over the past year is much smaller—about 1½ percent. Moreover, with the labor force participation rate now back to its previous peak and the working-age population estimated to be rising rather slowly in coming quarters, it does not seem likely that labor force growth can be maintained at its recent pace for very long.

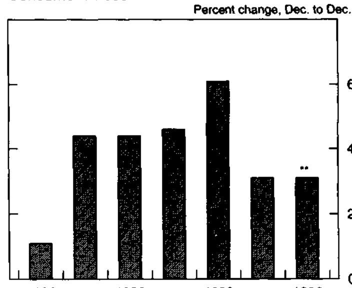
The softening of labor markets and easing of inflation expectations since mid-1990 has been reflected in a gradual, but persistent deceleration of labor compensation rates over the past couple of years. The twelve-month rate of change in the employment cost index for private compensation, after peaking at 5.2 percent in the first half of 1990, declined to 4.6 by the end of that year, slowed to 4.4 percent in 1991, and eased still further, to 4.2 percent in the twelve-month period that ended this past March. The annual rate of increase in straight-time wages has been running at less than 3½ percent in recent quarters. However, the cost of benefits that firms provide to their employees has continued to rise rapidly, propelled by the steep climb in the cost of medical insurance and by increases in payments for workers' compensation. Importantly, though, the slower rate of increase in nominal compensation per hour, coupled with a somewhat faster rate of deceleration in consumer prices, has been translating into increases in real hourly compensation.

Employment Cost Index *



*Employment cost index for private industry, excluding farm and household workers.
**Percent change from March 1991 to March 1992.

Consumer Prices*



*Consumer price index for all urban consumers.
**Percent change, June 1991 to June 1992.

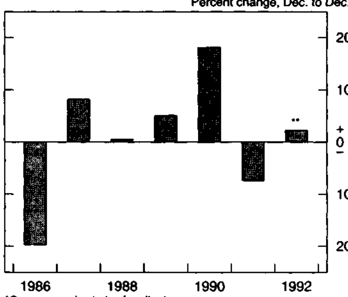
Productivity has been picking up. In the first quarter of 1992, output per hour worked in the nonfarm business sector was 1.9 percent above the level of a year earlier, a four-quarter improvement last achieved in early 1988, when the economy still was growing rapidly. At the same time that employers have been cautious in expanding output, they have continued to move aggressively to economize on labor input, thus boosting output per hour. The increase in productivity, together with the slowing of hourly compensation, held the rise in unit labor costs to just 1.2 percent over the year ended in the first quarter of 1992, the smallest four-quarter increase in labor costs in eight years.

Price Developments

All the measures of aggregate price change show inflation to have eased substantially from its most recent peak. The 3 percent rate of rise in the consumer price index over the past year is roughly half the rate at which that index increased in 1990; swings in energy prices account for a sizable part of that slowdown, but most non-energy prices have slowed as well. A halving of the rate of price rise also is evident in the fixed-weight price index for gross domestic purchases, a measure at takes account of the prices paid by businesses and governments as well as those paid by consumers. Measures of price change that are related to domestic production (rather than to domestic spending) have slowed by smaller, but still appreciable amounts. For example, the fixed-weight price index for gross domestic product, the broadest measure of price change for goods and services produced domestically, rose less than 3 percent over the four quarters ended in early 1992; that index had moved up

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Consumer Energy Prices*



*Consumer price index for all urban consumers.
**Percent change, June 1991 to June 1992.

at rates of 4 to 4½ percent in each year from 1988 to 1990.

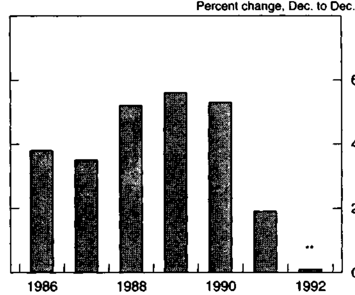
Consumer energy prices have continued to fluctuate since the end of the Gulf War, but those fluctuations have been relatively subdued. Energy prices at the retail level fell early in 1992, influenced by the mildness of the winter, the further cut in U.S. industrial production early in the year, the persistence of sluggish growth in other industrial countries, and the high level of OPEC production. Later in the winter, however, energy prices began to firm. The upswing in U.S. industrial activity that began in February gave some lift to prices, as did the return to more normal weather patterns in late winter. Further impetus to prices came in the spring, with the apparent mid-May shift by Saudi Arabia toward somewhat greater production restraint than had been expected. In response to these developments, the spot price of West Texas Intermediate moved up from a February low of about $18 per barrel to a level of more than $22 per barrel in June. The CPI for energy, basically following the lead provided by the oil markets, rose moderately in March, April, and May, and then jumped 2 percent in June. These increases more than reversed the declines seen early in the year. Even so, the CPI for energy in June was up only moderately from the level of a year earlier, most of the price swings of the last twelve months having essentially cancelled out. In the oil market, the price of West Texas Intermediate has softened a little, on net, since June and recently has been in a range not much different from that of a year ago.

Food prices have slowed considerably over the past year and a half. The CPI for food rose more than 5 percent in each year from 1988 to 1990. But last year they rose only 2 percent, and in the first half of this year, they changed little on net. A temporary runup in fruit and vegetable prices in late winter was reversed in the spring, and increases in the prices of other foods were small on average during the first half of the year. As of June the CPI for food was only 0.1 percent above the level of a year earlier.

The marked slowing of food prices since the end of 1990 is partly the result of declines in the prices received by farmers for their products. In addition, however, the food sector is being affected by forces similar to those that are shaping price trends in other parts of the economy: Demand growth has been relatively sluggish in the food sector, competition is intense in both food retailing and the fast food business, and increases in labor costs have been restrained. Price increases at grocery stores over the past year have been small even for those foods for which farm products account for only a small portion of value added, and the twelve-month rise in prices of food consumed away from home, a category dominated by nonfarm inputs, has been running in the lowest range since the mid-1960s.

The CPI excluding food and energy, which had increased at an annual rate of only 3 percent during the final three months of 1991, climbed at a rate of 4¾ percent in the first three months of 1992. The prices of non-energy services rose a little faster in the first quarter than they had in the latter part of 1991, and the prices of commodities other than food and energy, which had changed little in the fourth quarter, surged ahead at an annual rate of 5¼ percent. Apparel prices, which had declined in late 1991, moved up

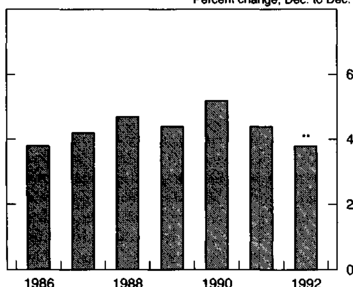
Consumer Food Prices*



*Consumer price index for all urban consumers.
**Percent change, June 1991 to June 1992.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Consumer Prices Excluding Food and Energy*



*Consumer price index for all urban consumers.
**Percent change, June 1991 to June 1992.

rapidly in the first quarter, and fairly large increases were reported for a number of other commodities. But, the first-quarter flare-up of price increases dissipated in the spring, as the annual rate of increase in the CPI excluding food and energy dropped to less than 3 percent over the three months ending in June. The price indexes for both commodities and services rose much less rapidly during this period than they had in the first quarter.

Looking beyond the many twists and turns that inevitably show up in the price data over any short period, the reports of recent months appear to be depicting a gradual, but broadly-based, slowing in the trend of consumer prices. The twelve-month change in the CPI for services excluding energy, a category that has a weight of more than 50 percent in the CPI total, has dropped back by about 2 percentage points since early 1991, to a pace of 4¼ percent; deceleration is evident for most types of services included in that total. A slower rate of price increase also has emerged across a broad range of CPI commodities, although, somewhat surprisingly, the slowing there has not proceeded as rapidly as in the markets for services.

A sustained easing of inflation pressures also is widely evident in the data on prices received by domestic producers. In June, the producer price index for finished goods other than food and energy was 2½ percent above the level of a year earlier; toward the end of the 1980s, this index had been moving up at more than a 4 percent rate. The prices received by producers of intermediate materials other than food and energy have risen less than ½ percent, on balance, over the past year; their cumulative increase over the past three years amounts to just 1¼ percent. The prices of industrial commodities, which tend to track roughly the contours of the business cycle, have firmed in the first half of this year, after sharp declines from the autumn of 1990 to the end of 1991; however, in the context of a still hesitant recovery, the recent firming of these prices has been relatively subdued compared to the increases seen during many past periods of stronger expansion in industrial activity.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Section 3: Monetary and Financial Developments in 1992

Monetary policy in 1992 has continued to be directed toward the goal of securing a sustained economic expansion while making progress toward price stability. In furtherance of these objectives, the Federal Reserve this year has eased money market conditions twice—once in association with a cut in the discount rate—and lowered reserve requirements.

On balance, most signs from financial markets this year have been consistent with a moderate pace of expansion in economic activity, but also seemed to indicate questions about lasting gains in reducing inflation. Short-term real and nominal interest rates have declined to unusually low levels and the yield curve has been extraordinarily steep while share prices have been at near-record levels—a pattern often associated with market expectations of a strengthening economy. In addition, the risk premiums on private credit instruments relative to Treasury obligations have narrowed, indicating growing market confidence in private borrowers and ample credit availability in securities markets. Households and businesses improved their balance sheets by constraining total debt growth, issuing equity, and refinancing costly existing debt with longer-term debt at lower rates. As a result of these actions and the decline in interest rates, borrowers have been successful in reducing the ratio of debt-service payments relative to income.

In contrast with the positive signals from other financial variables, the advance in the money and credit aggregates has been very subdued. M2 and M3 in June stood below the lower end of their annual growth cones, and the debt of domestic nonfinancial sectors was running at the lower end of its range. In part, the sluggish expansion of M2 and M3 seemed to be related to the actions of borrowers and lenders to restructure balance sheets, and was not reflected in commensurate weakness in spending. Under pressure to improve their capital positions and earnings, and facing weak loan demand from borrowers relying more heavily on longer-term debt from market sources, banks and thrifts have not been aggressively seeking to expand loan portfolios. In these circumstances, depositories have cut deposit rates substantially this year, and many customers have shifted their funds to alternative assets or applied their deposit balances toward debt repayment. These actions have resulted in appreciable increases in the velocities of the broad aggregates—a situation the FOMC has taken into account in assessing how much weight to place on slow growth in the aggregates in making policy decisions.

Implementation of Monetary Policy

Early in the year, economic releases and financial market indicators signaled an improvement in economic activity—consumer expenditures and confidence were up, M2 growth surged in late January and February, a wave of refinancing activity indicated households and businesses were successfully reducing debt servicing costs, and the ebullient tone in the stock market anticipated even stronger economic fundamentals in the future. The Federal Open Market Committee noted these positive developments at its meetings during the late winter and spring, but in view of ongoing impediments to robust expansion—including still-strained balance sheets and limitations on credit availability—concluded that the recovery was still fragile. Recognizing the tentative nature of the recovery, and confident that a disinflationary trend had been firmly established, the Committee remained especially alert in this period to the potential need for further easing of money market conditions if the economy failed to show continued improvement.

During the early months of the year, the bond market seemed to focus on the possibility of a strong recovery, and long-term interest rates backed up about one-half percentage point from early January through March. A robust recovery could rekindle upward price pressures and would produce stronger demands for credit. In addition, looming U.S. budget deficits, and potential credit needs of countries undergoing the transition from centrally planned to market economies, were seen as adding to upward pressure on interest rates in the future.

Despite the rise in long-term rates, corporate bond yields remained well below levels prevailing in recent years. Eager to refinance costly existing debt and to reduce the uncertainty and interest rate risk of short-term funding, many firms issued bonds and used a portion of the proceeds to pay down bank loans. Faced with tepid loan demand and continuing pressures on earnings and capital positions, banks lowered deposit rates promptly as market rates declined and did not raise them when intermediate and long-term market rates backed up in the first quarter. Households responded by shifting funds into non-monetary assets and by paying down debt at the expense of deposit accumulation. Although these and other portfolio adjustments appeared to play a prominent role in the deceleration of M2, the possibility that income growth might also be slackening, perhaps due to tight lending

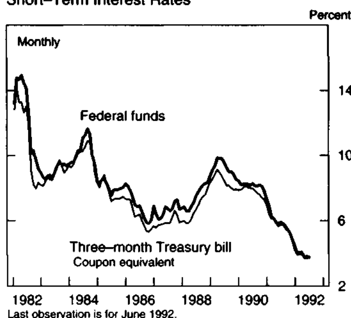
Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

terms at banks and the reluctance of businesses and households to borrow, could not be ruled out. Incoming data over the spring suggested only a modest further rise in economic activity after February, and given the Committee's concerns about the sustainability of the recovery, the Federal Reserve slightly eased the degree of reserve market pressure in mid-April. The federal funds rate declined to 3¾ percent, its lowest sustained trading level since the 1960s; other short-term rates generally followed suit, edging down about 25 basis points. Long-term rates registered little response to the policy action; the rate on the thirty-year Treasury bond was essentially unchanged in the days following the move.

The Federal Reserve's easing of reserve market pressure in April came only days after implementation of a previously announced reduction in reserve requirements. Reserve requirements are effectively a tax on depository intermediation; the cut in reserve requirements on transaction deposits from 12 to 10 percent was intended to reduce this burden on depositories and their customers and thereby to stimulate flows of credit. The effect on credit should come directly as sterile reserves are freed for lending and indirectly as increased earnings improve depository institutions' access to capital and their willingness to lend. This year's reduction in reserve requirements sparked little of the heightened volatility of the federal funds rate that ensued from the reserve requirement cut in 1990. In large measure, the smoother transition this year reflected the higher level of reserve balances available to cover daily clearing needs; balances have been boosted in recent months by a higher level of transaction deposits in concert with a sizable increase in bank clearing balances at the Federal Reserve.

Neither the April easing of reserve market pressure nor the cut in reserve requirements revived the broad monetary aggregates. Other financial indicators, though, suggested that the markets were anticipating continued economic expansion. Spreads on commercial paper and corporate bonds relative to Treasury rates continued to narrow, especially for less-than-prime issues, evidencing easier access to market sources of funds for businesses. Improvement in banks' capital positions placed them in a better position to meet loan demand, and many reported that they were no longer tightening credit standards. In addition, long-term interest rates edged down from their March peak, providing some stimulus to mortgage markets and debt restructuring. On balance, despite continued weakness in the broad monetary aggregates, many financial variables appeared to indicate that conditions conducive to a moderate economic expansion were in place.

Short-Term Interest Rates

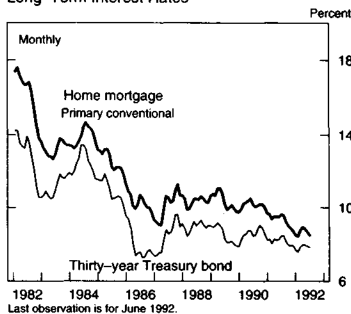


Last observation is for June 1992.

Still, overall credit growth remained quite subdued, suggesting that some impediments to borrowing and spending remained, and M2 and M3 turned down further in June. In these circumstances, and with direct readings on the economy indicating some weakening relative to earlier in the year, the Federal Reserve in early July cut the discount rate one-half percentage point to 3 percent and allowed this reduction to show through as a similar-sized easing of money market conditions. Banks responded quickly to the policy actions, cutting the the prime rate by one-half percentage point to 6 percent.

On balance, short-term rates generally have declined about three-quarters of a percentage point this year. Long-term rates, after falling in recent months,

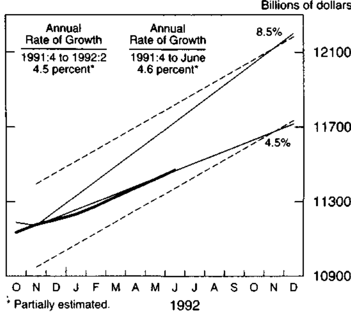
Long-Term Interest Rates



Last observation is for June 1992.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Debt: Monitoring Range and Actual Growth



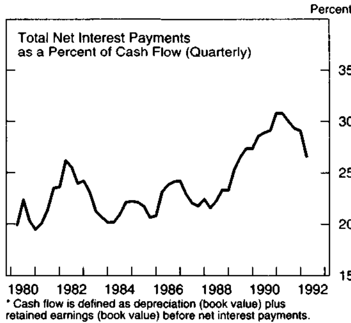
* Partially estimated.

have about returned to their lows of early January. The foreign exchange value of the dollar generally has tracked the course of long-term rates, appreciating from January through March and depreciating more recently. On a trade-weighted basis in terms of the currencies of the other G-10 countries, the dollar in mid-July stood at a level somewhat below its 1991 year-end level.

Monetary and Credit Flows

Overall credit flows have been damped this year, reflecting a moderate pickup in spending and efforts by borrowers to pare debt burdens. Although demands for credit by the federal government have been heavy, growth in the debt of other sectors has been lethargic,

Business Sector Net Interest Payments as a Percent of Cash Flow*



* Cash flow is defined as depreciation (book value) plus retained earnings (book value) before net interest payments.

placing the total debt aggregate around the lower bound of its annual range throughout much of 1992. Reacting to the difficulties that resulted from carrying heavily leveraged positions in a period of weak economic growth, and to wide spreads between the cost of borrowing and the returns on holding financial assets—especially deposits—households and businesses have sought to reduce debt and restructure balance sheets. Total debt, including that of the federal sector, grew about in line with nominal GDP, after many years in which debt growth exceeded income.

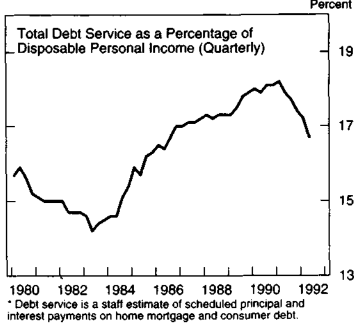
Along with limiting debt growth, borrowers have sought to strengthen their balance sheets by refinancing existing debt at lower rates. By issuing equity and refinancing debt, businesses have been successful in reducing debt-service burdens; the ratio of net interest payments to cash flow for businesses has declined appreciably this year. The decline in rates over the last year or so has been especially evident for high-yield bonds, indicating that lower-rated borrowers are regaining some of the access to capital markets lost during the credit distress in late 1990 and 1991. A substantial number of firms this year have been upgraded by rating agencies, reflecting improved economic prospects and the salutary effects of lower interest rates and stronger balance sheets on financial conditions.

Many households also have refinanced debt at more attractive rates. Mortgage refinancing began to increase late in 1991 and was very heavy early this year after mortgage rates fell sharply. Later, as mortgage rates backed up, mortgage refinancing applications subsided, but they remained brisk relative to recent years. Households evidently shared the view of businesses that long-term rates presented an opportunity to lock in attractive financing, and many opted to refinance with longer-term fixed-rate mortgages rather than risk future interest rate increases with adjustable-rate mortgages.

Just as for businesses, refinancings and debt reduction appear to have helped relieve the stress on household balance sheets. The ratio of household debt service payments to personal disposable income has declined appreciably through May. Delinquencies on consumer loans, auto loans, and home mortgages have fallen this year as well. On the other hand, many households with financial assets substantially exceeding debt have seen their spendable income decrease as a result of lower interest rates. Some of the decline in interest rates compensates for lower inflation—the purchasing power of the principal invested is not falling as rapidly as in previous years—but real

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Household Sector Debt Service
Relative to Disposable Personal Income*



* Debt service is a staff estimate of scheduled principal and interest payments on home mortgage and consumer debt.

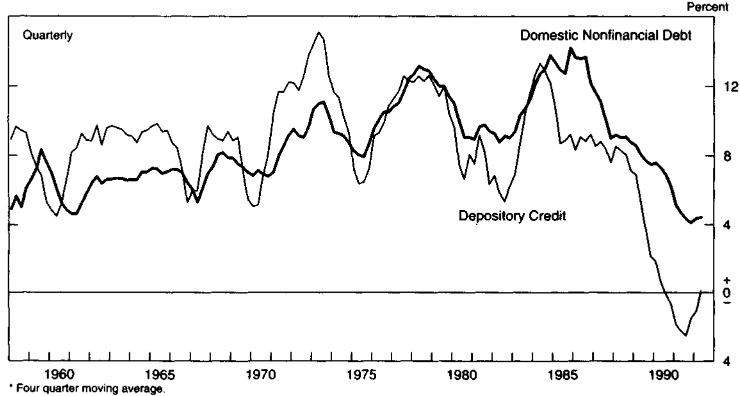
returns have declined as well, especially for short-dated assets.

State and local governments have exhibited a similar trend in credit demand; on net, total debt growth has been restrained, but gross issuance of bonds has ballooned as municipalities refinance existing debt. A substantial portion of the debt being refinanced likely was issued during the high interest rate episodes of the early 1980s.

Not only has total borrowing been muted, but banks and thrifts are accounting for a sharply decreasing share of the total. In fact, credit at depositories has declined over the last 2½ years even as total credit in the economy continued to advance, and this pattern has left its imprint on the monetary aggregates and their velocities. Part of this rerouting of credit flows reflects the closure of insolvent thrifts; the RTC usually assumes the assets of closed thrifts, and effectively finances them with Treasury obligations rather than deposits. Moreover, when the assets are later sold, depositories are not always the acquirers. The shift in credit flows away from depositories also reflects ongoing market and regulatory pressure on banks and thrifts to bolster earnings and capital. Responding to increased deposit insurance costs, to past and prospective loan losses, and to regulatory restrictions triggered as capital-asset ratios fall below the highest levels, depositories have maintained wide spreads between loan rates and deposit rates. The prime lending rate, for example, has remained unusually high relative to market rates and depository cost of funds, and depositories have tightened non-price terms of credit as well in recent years. On the deposit side, rates have fallen considerably as depositories have moved to limit balance sheet growth and bolster net interest margins.

Bank credit from the fourth quarter of 1991 to June managed only a 2¾ percent growth rate, slower than in 1991. Bank lending to businesses has contracted in

Growth of Domestic Nonfinancial Debt and Depository Credit*



* Four quarter moving average.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

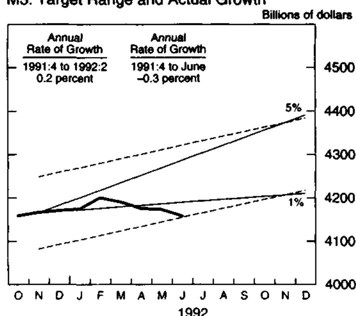
1992, leaving total loan growth at banks essentially flat. Overall, the contraction in bank business lending in 1992, which has been at an even faster pace than the decline in 1991, appears to reflect primarily weaker demand, as firms have opted to borrow directly in the market and have relied on strong increases in internal funds. Evidence from survey data indicates very little, if any, additional tightening of credit terms by depositories this year. However, the cumulative degree of tightening over the last two years remains substantial and many banks apparently still are responding to concerns about the condition of borrowers, cumulative loan losses, and pressures to meet or exceed fully phased-in capital requirements. Foreign banks, which had been aggressively seeking new business in the recent past, have reined in balance sheet growth and have tightened the terms of lending this year by somewhat more than domestic banks.

With loans falling relative to deposits, banks have elected to expand their security investment portfolios, pushing the share of government securities in total bank credit to its highest level in 20 years. It seems likely that some of this increase represents banks taking advantage of the steep yield curve to improve earnings by funding these securities with short-term deposits bearing low interest rates. The sharp rise in bank security investments has also been spurred by capital considerations: Mortgage-backed securities issued by government sponsored enterprises (GSEs) are treated more favorably than the underlying loans by risk-based capital standards. As a result, many banks have sold a substantial share of their home mortgage loan portfolios to GSEs and replaced them with the securities issued by these same agencies.

Although continued loan losses and increased deposit insurance premiums have added to bank costs, bank profitability has improved. Earnings have been bolstered by wider net interest margins and some improvement in the quality of loan portfolios. The market has looked favorably on these developments, as gains on bank share prices this year have outstripped advances in broad stock price indexes.

Conditions in the thrift industry appear to have improved this year, at least for solvent institutions. Thrifts in fairly secure financial condition have experienced better profit trends analogous to those of banks, and share prices of better capitalized SAIF-insured institutions have fared well over the first half of this year. Still, the improved profit picture for a portion of the thrift industry has not implied any expansion in overall thrift balance sheets; total thrift credit is estimated to have contracted at a 3½ percent

M3: Target Range and Actual Growth



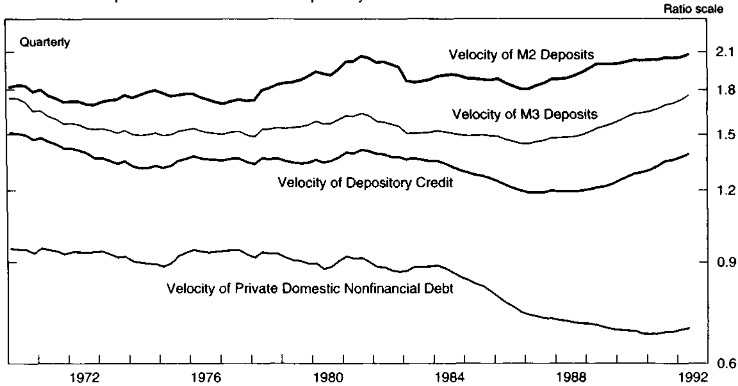
rate from the fourth quarter of 1991 to June. A large part of this contraction owes to the significant volume of RTC resolutions conducted through early April of this year. However, additional funds to cover losses have not been appropriated, bringing RTC resolutions to a halt after early April.

The limited growth in total bank and thrift balance sheets has carried important implications for the monetary aggregates. The velocities of the deposit components of the broader aggregates, M2 and M3, have tracked the upward trajectory of the velocity of total depository credit in recent years, and this trend has continued in 1992. M3, especially, has been hindered by the lack of growth of depository credit this year. This aggregate was essentially unchanged in June from its fourth quarter 1991 level, falling below the 1 to 5 percent annual range set by the FOMC. With retail deposits expanding—if only sluggishly—and depository credit subdued, banks and thrifts have shed large time deposits and other managed liabilities. At branches and agencies of foreign banks, large time deposits (Yankee CDs) have been flat this year, decelerating sharply from last year's rapid growth. Market concerns that lower Japanese stock prices had impaired the capital positions of Japanese banks evidently tarnished the appeal of Yankee CDs for some institutional investors. In response, U.S. branches and agencies of Japanese banks cut back Yankee CD issuance, shed liquid assets, and relied more heavily on funding in Eurodollar markets.

Institution-only money market funds were the only source of strength in the non-M2 portion of M3 during the first half of 1992. Investors capitalizing on the sluggish adjustment of money market fund yields to declining market rates accounted for much of the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Velocities of Deposits in M2 and M3 and Depository Credit

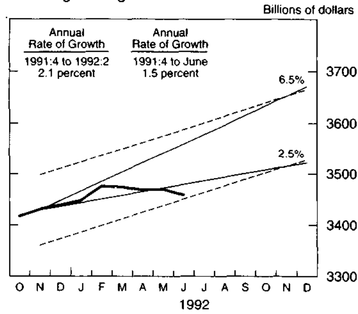


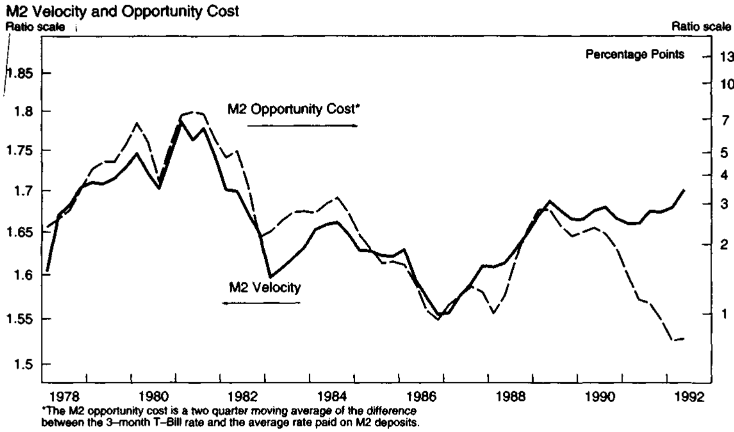
strength in money funds. In addition, some institutional investors, finding their resources augmented rapidly by inflows from former bank depositors, likely have parked some of the cash inflow in money market funds.

The implications of depository retrenchment and household balance sheet adjustments for longstanding empirical relationships between money and spending have been perhaps most pronounced for M2 growth. Despite the pickup in nominal income growth this year and very substantial stimulus from drops in short-term interest rates last year, M2 advanced at only a 1½ percent annual rate from the fourth quarter of 1991 to June, placing its June level below the lower bound of its annual range. The decoupling of the historical relationships among M2, GDP growth, and short-term interest rates is evident in the behavior of M2 velocity. M2 usually rises relative to income (its velocity falls) when market rates drop because rates on M2 deposits do not decline one for one with market rates, inducing portfolio shifts into M2 assets. But in recent months, M2 velocity has risen markedly despite a substantial decline in market rates and a standard measure of opportunity costs—the difference between short-term market rates and returns on M2 assets.

In this period of extraordinary retrenchment, depositories apparently have reduced deposit rates in ways not captured in standard measures of average deposit rates, and the pull of market alternatives has been stronger than is captured by comparisons of deposit rates to short-term market rates. For example, banks and thrifts appear to have made larger cuts in the relatively high rates offered to individuals with larger balances and in the rates offered on brokered deposits; holders of both types of accounts might be especially sensitive to rates on alternative investments. In addition, depositories have been particularly hesitant to compete for funds at intermediate- and longer-maturities. As a result, longer-term bank and thrift CDs have not been attractive investments for savers seeking to raise returns by moving out the upward sloping yield curve. In effect, depositories have used retail time deposits as managed liabilities in making

M2: Target Range and Actual Growth





*The M2 opportunity cost is a two quarter moving average of the difference between the 3-month T-Bill rate and the average rate paid on M2 deposits.

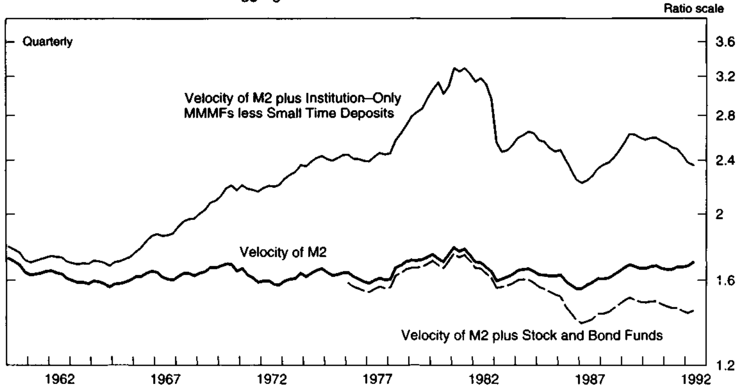
balance sheet adjustments. The result has been large outflows of retail time deposits, with a relatively large portion of the outflow finding its way to higher-yielding, nonmonetary assets. Depositors, witnessing substantial declines in the rates on their accounts relative to market alternatives, apparently exited M2 in favor of stock and bond funds or direct equity and bond investments. Of course, in doing so, these depositors sacrificed the benefits of deposit insurance and accepted the risk of asset-price fluctuations.

For a time, the depressing effects on M2 of depository retrenchment and investor portfolio shifts on M2 were obscured by the confluence of various special factors. Early in the year, demand deposits surged as lower rates required businesses to build up compensating balances and as mortgage servicers held larger balances during the mortgage refinancing boom. Later, the abrupt deceleration in M2 appeared related to the effects of tax flows and RTC resolutions. Federal nonwithheld taxes this year were weak relative to previous years and this may have resulted in a smaller deposit buildup in March and April than could be anticipated by normal seasonal adjustment factors. In late March and early April, the RTC resolved a substantial number of institutions. In the past, a heavy volume of RTC resolutions has appeared to damp M2 growth for a month or two, apparently as acquiring institutions abrogate time deposit contracts and depositors take the opportunity to reallocate their portfolios in light of the current configuration of deposit rates and market rates. Thus the March/April RTC resolutions likely played a role in slowing M2 growth during April and perhaps even May.

As the weakness in M2 persisted, however, it became increasingly clear that these special factors were not the whole story. If the deceleration of M2 in March and April reflected evolving seasonal tax patterns, May and June should have witnessed an appreciable rebound in M2 growth. In fact, M2 continued to founder, leaving its level in June well below its February level and also below the lower bound of its annual range. Furthermore, RTC resolutions halted abruptly when additional funding for losses was not forthcoming. By June, M2 should have been largely free of RTC effects, but June M2 growth was, in fact, even weaker than in April and May. On balance, these special factors appeared to figure prominently in the month-to-month variations of M2 growth, but the overall advance of M2 this year was impeded by more fundamental forces.

These fundamental forces, involving balance sheet adjustments by depositories and money holders, appear to be boosting the velocity of M2. There is considerable uncertainty, however, about how long this process will persist, and whether it will permanently affect the equilibrium level or cyclical behavior of M2 velocity. One means of evaluating this question will be observations of the future performance of the P-star model in predicting inflation. This model is

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

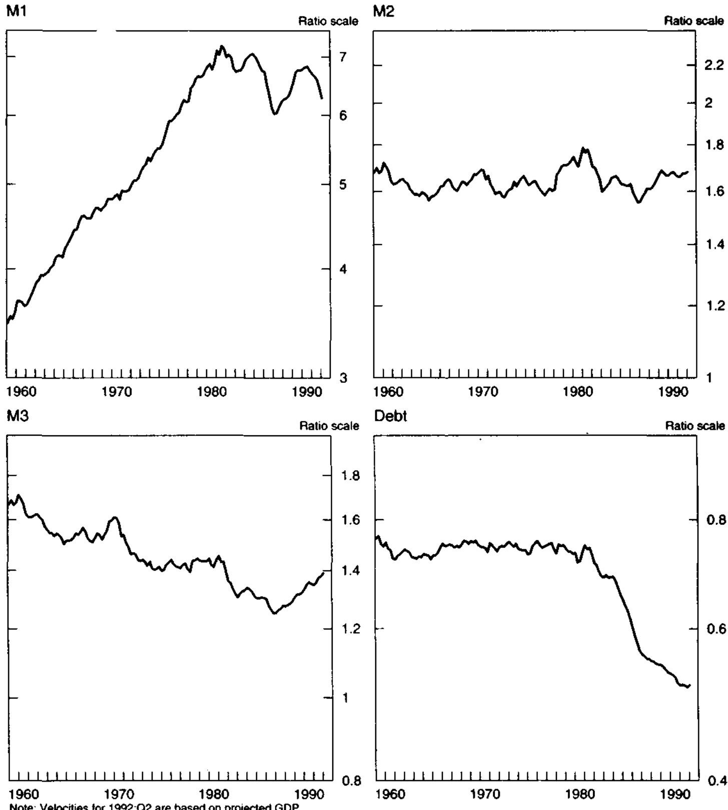


based on M2 per unit of potential output, normalized by equilibrium velocity, which had proven to be constant. Persistent underpredictions of inflation by this model would suggest that the rise in velocity relative to its historical average may be a more permanent phenomenon.

While highly interest-responsive depositors were tilting their portfolios toward capital market instruments, less rate-sensitive, more risk-averse households simply rolled over a portion of their maturing small time deposit holdings into more liquid M2 deposits, at little or no sacrifice in yield. In fact, while M2 growth overall this year has been moribund, growth in its liquid components has been robust and more in line with historical relationships to income and interest rates. M1, for example, has grown at a 12 percent pace through June, well above its average 8 percent growth rate during 1991. Especially since the introduction of NOW accounts in the early 1980s, the demand for M1 has become quite interest sensitive, leading to wide fluctuations in the velocity of M1, and the drop in M1 velocity this year is consistent with that pattern. Foreign demands for U.S. currency have been more subdued this year and currency growth has slowed a bit relative to the pace of 1990 and 1991. Even so, moderate growth in currency together with the brisk advance in transaction deposits have fueled growth in the monetary base of 7¾ percent from the fourth quarter of 1991 to June.

The unusual behavior of M3 and, especially, M2 velocity this year has sparked renewed interest in alternative definitions of the monetary aggregates. Two alternatives that have received some attention are M2 plus stock and bond mutual funds and M2 plus institution-only money funds less small time deposits. Both have grown substantially more rapidly than M2 in recent quarters. The former adds back into M2 the apparent destination of much of the recent outflows from M2; the latter subtracts the weakest component of M2—retail time deposits—to create a highly liquid aggregate, which behaves over time very much like M1. Both alternatives recently appear to have followed more closely historical relationships with income and opportunity costs than has M2. However, both show periods in the past in which their velocities have been highly variable and difficult to predict. The Federal Reserve is continuing to analyze these experimental monetary measures carefully.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



Note: Velocities for 1992:Q2 are based on projected GDP.
Debt for 1992:Q2 is partially estimated.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Growth of Money and Debt *(Percentage change)*

		M1	M2	M3	Debt of domestic nonfinancial sectors
Annually, fourth quarter to fourth quarter					
1980		7.5	8.9	9.5	9.3
1981		5.4 (2.5)*	9.3	12.3	10.1
1982		8.8	9.1	9.9	9.3
1983		10.4	12.2	9.9	11.4
1984		5.4	8.0	10.8	14.2
1985		12.0	8.7	7.6	13.9
1986		15.5	9.2	9.0	14.1
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	8.1
1990		4.2	4.0	1.7	7.0
1991		8.0	2.8	[illegible]	4.4
Quarterly (annual rate)					
1992	Q1	16.5	4.3	2.2	3.8
	Q2	9.9	0.0	−1.9	5.1
Semiannually, fourth quarter to second quarter (annual rate)					
1992	H1	13.4	2.1	0.2	4.5

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

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Economic Performance Under 9 Presidents

How the economy has performed, adjusted for inflation. Presidents' terms are measured from the last quarter before inauguration through the last quarter in the term. Figures for George Bush are annual averages through May except where noted.

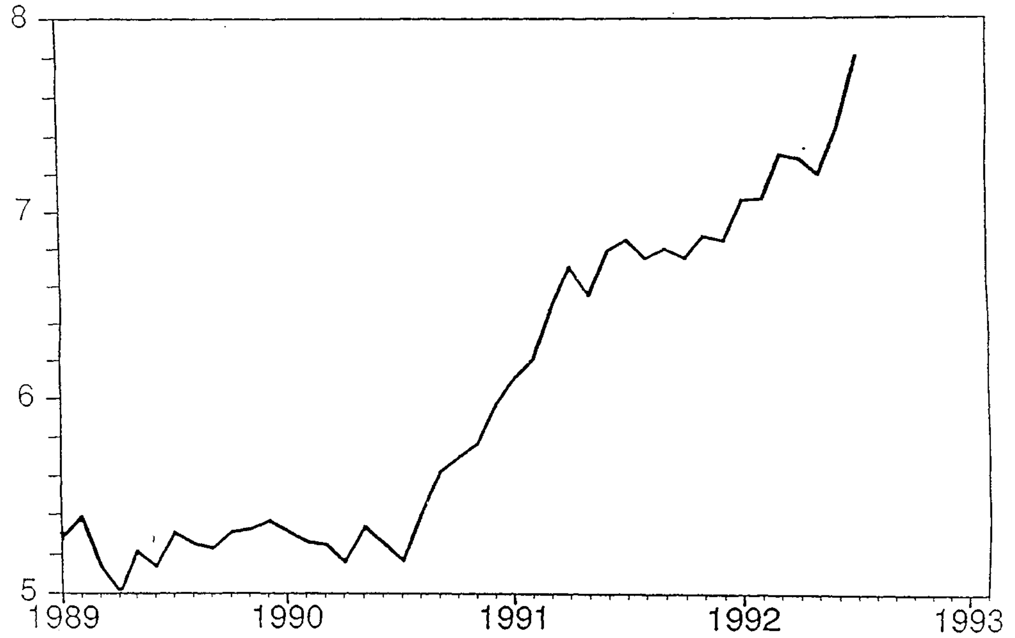
- **Gross Domestic Product:** Rate of economic growth. Bush figures are through March.
- **Jobs:** Growth in civilian nonfarm jobs.
- **Disposable Income:** Growth in personal income after taxes. Bush figures are through March.
- **Industrial Production:** Growth, from Federal Reserve Board data. Bush figures are through March.
- **Hourly Wage:** Growth in hourly private nonfarm compensation. Figures before 1960 not available. Bush figures are through December 1991.
- **Misery Index:** Inflation rate plus unemployment at end of term.
- **Inflation:** Rate at the end of the last full calendar year of term.
- **Interest Rate:** Composite yield on long-term Treasury bonds at the end of the term.

President		Gross Domestic Product	Jobs	Disposable Income	Industrial Production	Hourly Wage	Misery Index	Inflation	Interest Rate
Truman	(1945-52)	25.0%	5.9%	7.5%	35.3%	N.A.	3.8	0.8%	2.8%
Eisenhower	(1953-56)	9.4	3.3	10.0	14.6	N.A.	6.7	3.0	3.3
Eisenhower	(1957-60)	7.3	3.4	4.7	0.8	N.A.	6.9	1.4	3.9
Kennedy/Johnson	(1961-64)	20.4	6.4	12.1	36.6	10.8	6.1	1.0	4.1
Johnson	(1965-68)	19.4	9.7	15.5	26.2	12.2	8.1	4.7	5.7
Nixon	(1969-72)	12.4	8.3	10.8	14.7	9.8	8.9	3.4	5.9
Nixon/Ford	(1973-76)	7.6	8.1	7.5	5.2	5.8	12.5	4.9	6.7
Carter	(1977-80)	11.5	11.2	7.3	12.8	1.5	18.2	12.5	11.7
Reagan	(1981-84)	10.1	6.3	8.5	9.3	1.4	11.4	3.9	11.2
Reagan	(1985-88)	14.0	9.8	6.6	15.7	1.3	9.7	4.4	9.1
Bush	(1989-92)	2.5	0.7	1.2	– 0.4	– 1.7	10.5	3.0	7.8

Sources: Commerce Department/Bureau of Labor Statistics, Federal Reserve Board, Economic Policy Institute, Council of Economic Advisors

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

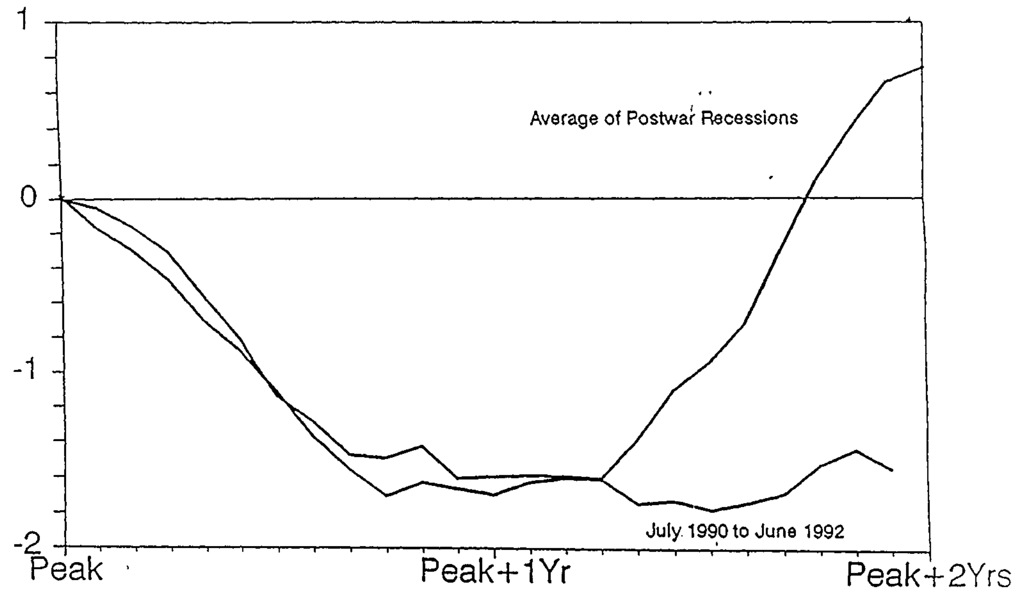
The Unemployment Rate
Percent of Civilian Labor Force



Joint Economic Committee

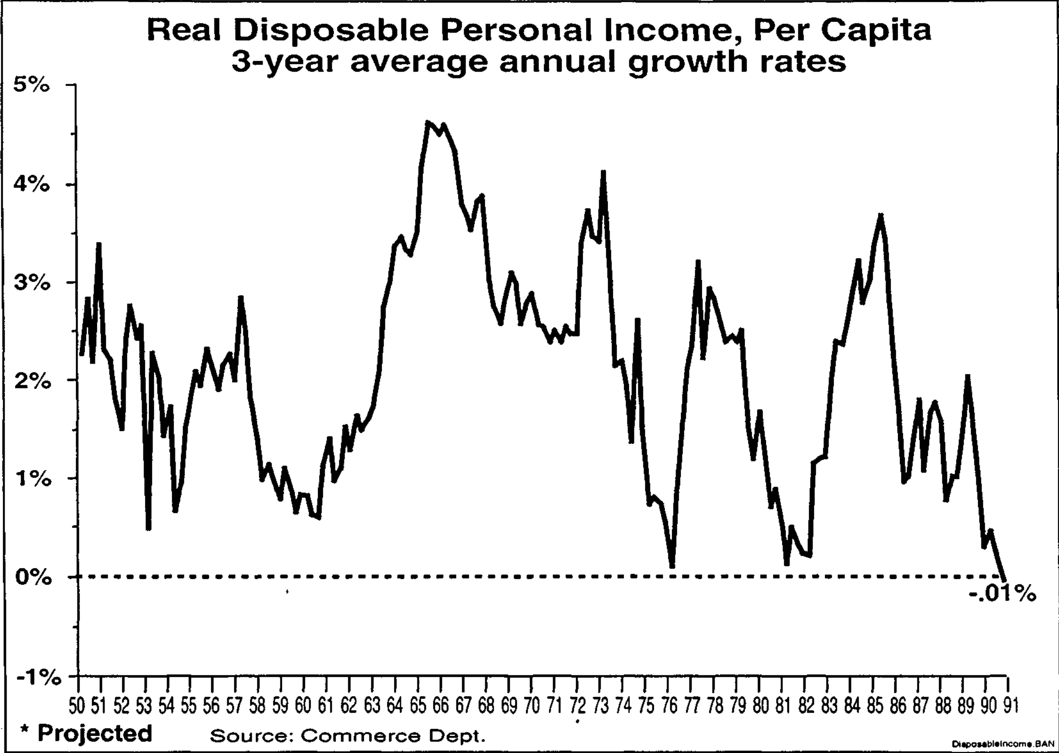
Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Nonfarm Payroll Employment
Percent Change from Business Cycle Peak

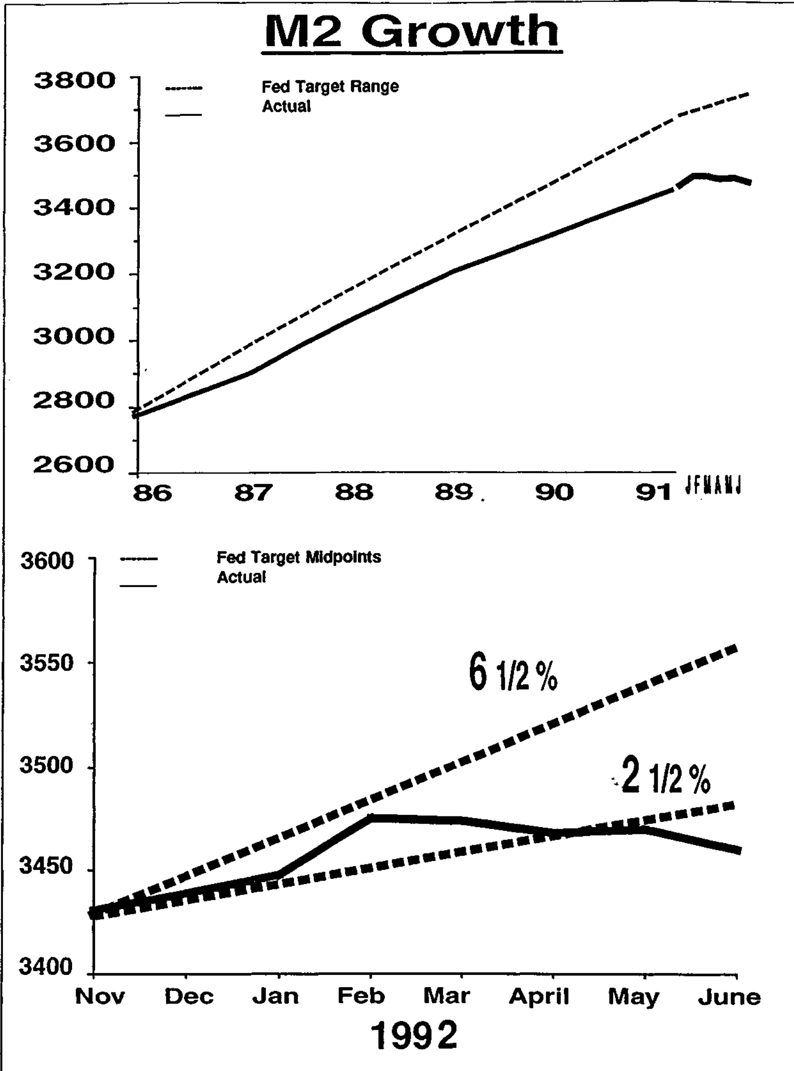


Joint Economic Committee

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM ALAN GREENSPAN

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

ALAN GREENSPAN
CHAIRMAN

September 11, 1992

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for the additional questions you and Senator Graham submitted to me following the July 21 hearing of the Senate Banking Committee on monetary policy. I am pleased to submit the enclosed responses to your questions. Please let me know if I can be of ~~further~~ assistance.

Sincerely,

Enclosure

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Q.1. You testified that if you had lowered short-term interest rates sooner or more forcefully over the past few years, fears of resurging inflation more than likely would have caused bond investors to require higher longer-term interest yields. That, you appear to conclude, would have led to an even weaker recovery.

You have taken action to reduce short-term interest rates 23 times since early 1989. For each reduction, please list the amount of the decline in the federal funds rate, the date on which financial market participants recognized the Fed's action, and the associated change in the yield on the longest-term Treasury bond.

A.1.

Effective Date of Easing of Money Market Conditions	Expected Change in the Federal Funds Rate (basis points)	Change in the 30-year bond rate (basis points)[1]
June 6, 1989	-25	-3
July 7, 1989	-25	-6
July 27, 1989	-25	-8
October 16, 1989	-25	10
November 6, 1989	-25	5
December 20, 1989	-25	-1
July 13, 1990	-25	-4
October 29, 1990	-25	8
November 14, 1990	-25	-1
December 7, 1990	-25	-16
December 19, 1990	-25	4
January 9, 1991	-25	9
February 1, 1991	-50	-12
March 8, 1991	-25	7
April 30, 1991	-25	-3
August 6, 1991	-25	-6
September 13, 1991	-25	-1
October 31, 1991	-25	1
November 6, 1991	-25	-1
December 6, 1991	-25	-8
December 20, 1991	-50	-9
April 9, 1992	-25	-9
July 2, 1992	-50	-13

[1]The rate on the 30-year Treasury bond at the close of business on the effective day of the policy change minus the rate at the close of business on the previous business day.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.1. Market participants generally become aware of changes in the Federal Reserve's stance in the reserves market on the day in which the change goes into effect. Still, the data shown above give, at best, only a rough notion of the market response to Federal Reserve easing actions _per se_. These actions are often anticipated, at least in part, implying that part of the effect of the easing may occur earlier. In addition, movements on the day of an easing may owe to other factors, including newly released economic and financial data, which may effect both real interest rates and expectations of inflation.

These data show that through November of 1991, the immediate bond market response to decreases in the funds rate was quite mixed. While it is impossible to say with any confidence what might have occurred had the Federal Reserve acted more forcefully in this period, the very damped response of long-term rates to major decreases in short-term rates over the period is unusual by historical standards, suggesting that investors remained concerned about long-term inflation prospects and raising the possibility that had an alternative policy path been followed inflation expectations would have risen sufficiently to push nominal rates higher.

Q.2. If it wished, the Fed could implement easing steps by purchasing long-term Treasury bonds in the open market. Do you believe that more aggressive Fed easing, carried out by buying Treasury bonds, would really have driven down the price of those bonds, even in an environment of high unemployment rates and declining inflation such as we have had over the past 18 months?

A.2. The effect of a Federal Reserve action to ease reserve conditions on nominal long-term interest rates depends importantly on the market's view of the subsequent path of short-term rates. If an aggressive easing were seen in the markets as risking a reversal of the progress that has been made against inflation, then long-term nominal rates could rise and prices of long-term bonds could fall, even if the easing were implemented through purchases of bonds by the Federal Reserve.

There is little empirical support for the notion that the effect of Federal Reserve actions on interest rates depends in a long-lasting way on the maturity composition of our open market operations. Most academic literature could be interpreted as suggesting that lowering the average maturity of debt held by the public, either by Federal Reserve portfolio decisions or by Treasury debt management, likely would have at most minor effects on long-term

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.2. Treasury rates. Market observation, on the other hand, does suggest that there may be some short-run effect of Federal Reserve and Treasury actions to influence the composition of Treasury debt in the hands of the public, especially when these actions are not expected by the market. The Federal Reserve has shifted its open market purchases slightly toward the long end of the market. However, any effects of such operations are likely to be modest, as nominal long-term interest rates are determined mainly by expectations of long-run inflation and real rates consistent with sustainable economic growth.

Q.3. If long-term yields would have risen after more aggressive Fed action to reduce short-term rates because of increased inflation fears, is it likely that they would have risen by more than the increase in inflation expectations? That is, is it likely that real long-term yields would have risen?

A.3. It is unlikely that real long-term interest rates would have risen in response to more aggressive easing of monetary policy. However, it is possible that the fall in real long-term interest rates would be moderated by increased risk premiums in long-term interest rates if investors became uncertain about what the more aggressive stance signaled concerning the Federal Reserve's long-term commitment to price stability. Increased risk premiums in interest rates could work against both the near-term economic recovery and longer-term economic growth by damping business investment. Moreover, higher nominal long-term interest rates may themselves have adverse effects on spending even if real rates fall. As discussed in my testimony, discomfort with portfolio configurations and debt servicing burdens appear to have been an impediment to spending. The decline in nominal long-term rates has encouraged and facilitated the restructuring of household and business balance sheets and the reduction of interest burdens, laying the groundwork for sustainable economic expansion.

Q.4. Even if the Fed has little effect on real long-term interest rates, aren't many sectors of the economy responsive to short-term rates? What about consumer spending, business investment financed by bank loans and finance companies, or housing financed by adjustable rate mortgages? What proportion of private debt in our economy is tied to long-term interest rates?

A.4. Although business and household spending decisions concerning the purchase of long-lived capital assets are most directly influenced by long-term interest rates,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.4. movements in short-term interest rates do have a bearing on developments in some sectors of the economy. For example, purchases of some consumer durable goods, especially motor vehicles, are influenced by short- and intermediate-term interest rates. Likewise, business decisions about inventory investment are based, in part, on the effects that short-term interest rates have on carrying costs--though most available evidence suggests the effects probably are small. The case of housing, typically a longer-term investment decision, is considerably different. The preponderance of housing is financed at fixed interest rates for long maturities. To be sure, declines in short-term interest rates may ease the qualification of some individuals for adjustable rate mortgages. But more fundamentally, even prospective home buyers considering adjustable rate mortgages must assess not only current short-term rates, but those interest rates likely to prevail in the future--the same considerations that underlie the determination of long-term interest rates. Thus, a decline in short-term interest rates that was not seen to be sustainable would have, at best, only a small effect on housing activity.

Nearly three-quarters of private sector debt is held in instruments typically having relatively long maturities and financing long-lived assets. The bulk of this debt outstanding was financed at interest rates above current levels. As a consequence, households and businesses have been taking advantage of the declines in long-term interest rates to restructure their balance sheets and reduce the burden of interest payments on existing debt. Any reduction in short-term interest rates that boosted inflation expectations and increased uncertainty premia in long-term interest rates would be detrimental to this adjustment process and would reduce the likelihood of engendering a sustained noninflationary recovery.

Q.5. I believe that the economic growth rates projected by the Fed for the next year and a half are not satisfactory, given our current situation. Is it your judgement that the Fed does not have the capability of inducing a faster recovery, or do you believe that a faster recovery would entail inflation rates higher than the Fed projects by an amount sufficient to make the long-term costs of that inflation outweigh the benefits of a faster recovery?

A.5. As you know, the view of the Federal Reserve has been that sustainable long-run economic growth at the highest possible rate will be fostered by an environment of price stability. Although monetary policy might stimulate

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.5. more rapid gains in output in the short run, it is doubtful that such a course could be maintained or would be best for the economy over the long run. Experience both in the United States and elsewhere has demonstrated that inflationary policies tend to reduce rather than expand an economy's long-run growth potential. Recent gains against inflation are laying the groundwork for sustaining greater prosperity in the future.

Q.6. The Fed's economic projections are labelled in your report as those of "FOMC Members and Other FRB Presidents." During the question period, you stated that your own projections are not included in those data, although you are a member of the FOMC. Indeed, as its chairman, your views are clearly more important and more relevant than those of any other member. Why are your projections excluded? For how long has that been the practice? Would any of your projections fall outside of the central tendencies given, and if so why?

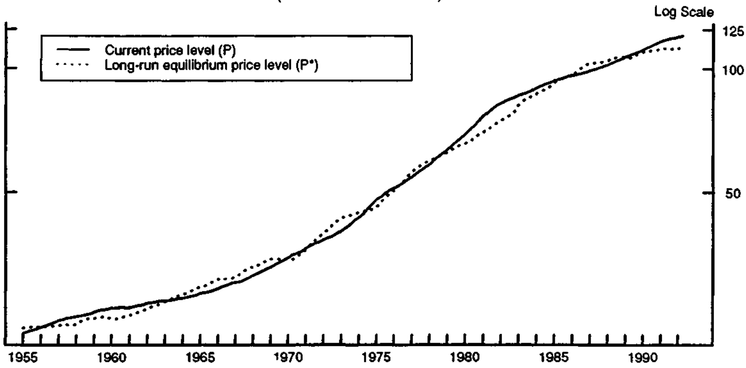
A.6. The economic projections that we submitted to the Congress are an accurate representation of the outlook of all the members of the FOMC, including myself, and of the other Federal Reserve Bank Presidents. In the preparation of the Monetary Policy Report to the Congress, I review the range and central tendencies of the projections submitted by the members of the Federal Open Market Committee and the other Federal Reserve Bank Presidents. If, in that process, I find that those projections do not adequately encompass my perspective on the economic outlook, I have an opportunity to make the appropriate adjustments to the reported projections. Of course, I make sure my views on current and prospective economic developments are well known to the members of the Board and the Presidents of the Reserve Banks in detailed discussions at meetings of the FOMC. More generally, my appearances before your Committee and the House Banking Committee twice a year to discuss economic and monetary developments offer ample opportunity for me to convey my views on the economic outlook and the conduct of monetary policy to the Congress and to the general public.

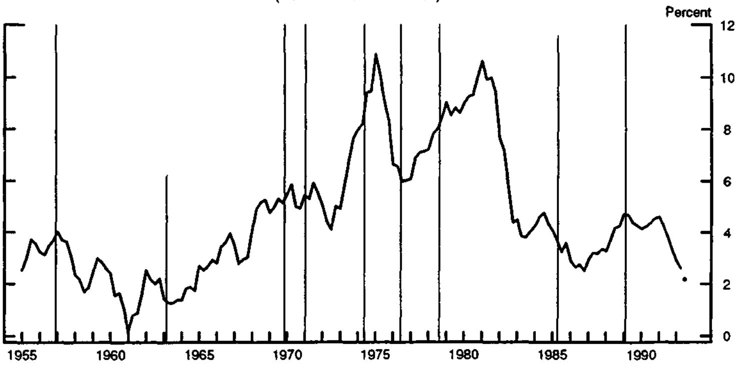
Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Q.7. What has been the recent behavior of P*, the measure you developed a few years ago to evaluate the future impact on inflation of recent changes in the size of M2?

A.7. Reflecting the slowdown in M2 growth over the past 2 years, P* has been rising quite slowly in recent years, falling below the actual price level. (See chart.) Consequently, the P* model indicates that a significant slowing in trend inflation is in train. To date, inflation forecasts of the P* model have been close to, though a little below, actual developments. However, looking forward, the moderation of inflation predicted by P* may well be more pronounced than what will actually develop. A key assumption of the P* model is that the velocity of M2 (V2) is a constant in the long run. The recent behavior of V2 casts some doubt on whether this assumption remains valid. In particular, despite sizable declines in market interest rates, V2 has remained roughly stable, rather than falling as expected. There appears to be a strong possibility that this behavior is consistent with movement toward a higher long-run level of V2. If so, the inflation forecasts based on an unchanged measure of long-run velocity will underpredict actual inflation for any given path of M2. As we noted in the July Monetary Policy Report to the Congress (pp. 23-24), the future performance of the P* model in predicting inflation is one indicator that the Federal Reserve will be monitoring in assessing whether there has been a permanent shift in the behavior of velocity.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis





The current price level (P, the solid line in the top panel) is the implicit GDP deflator, which is set to 100 in 1987. Inflation (bottom panel) is the percentage change in the implicit GDP deflator from four quarters earlier, where the 1992:Q3 value (shown by the dot) uses a P*-based forecast of the price level in this quarter. This forecast uses M2 data through 1992:Q2. P* uses the mean of the GDP velocity of M2 from 1955:Q1 to 1988:Q1.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Q.8. In your analysis of monetary developments, you conclude that M2 velocity is behaving oddly and therefore it may be appropriate to let M2 growth fall below its target range. In the charts on pages 23 and 25 of your report, though, the direct relationship between M2 and the level of economic activity appears to have been quite steady in recent years. More unusual are the relationships between interest rates and both M2 and gross domestic product, for all the reasons you describe elsewhere. Couldn't that suggest that you should be paying more attention to M2 and less attention to interest rates?

A.8. Although M2 velocity has been rather stable since 1989, it has nevertheless been higher than expected owing to important changes in the financial system. These changes include slow private credit growth relative to spending, a rechanneling of credit flows outside of the depository sector, and the restructuring of troubled depository institutions. These forces are unlikely to dissipate quickly, and probably will raise velocity in the future. Indeed, signs of increasing velocity already are apparent.

During the first half of 1992, V2 appears to have increased at a 2-3/4 percent rate, despite declining interest rates. In any case, the uncertainty regarding velocity forecasts is such that greater emphasis on monetary growth as an indicator of economic activity is not warranted at this time. The Federal Reserve is continuing to analyze closely various monetary indicators and their relationships to the economy. We will keep you informed of our findings.

Q.9. You describe many of our current problems as stemming from the buildup of debt on private balance sheets during the 1980s. In your opinion, what caused that debt buildup?

A.9. A number of factors contributed to the surge in debt on private balance sheets over the 1980s. Basically, however, these boil down to overly optimistic earnings expectations by borrowers and highly willing lenders.

A tight commercial real estate market at the beginning of the decade, coupled with more generous tax provisions in 1981, fostered the expectation by developers of strong returns from new investment in this sector. At the same time, a certain tunnel vision seemed to emerge in which investors in this sector--and their lenders--largely ignored the rush to this market by others. Similarly, the success of some early leveraged buyouts gave rise to the expectation of hefty gains from more questionable undertakings. Many households, too, absorbed large amounts

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.9. of debt on the presumption of large uninterrupted gains in income and asset values. In the end, these expectations all proved to be unrealistic. Moreover, lenders--junk bond investors, thrifts, banks, and life insurance companies--did not adequately factor in downside risks and were quite willing to bankroll these endeavors. In a market system, lenders are supposed to act as an important check on potential excesses, but unfortunately in the 1980s many lenders seemed to be afflicted by the same overoptimism as borrowers.

Q.10. Several times during the hearing, you stated your belief that eliminating the leverage ratio capital requirement for banks and relying solely on the risk-based requirement (with new rules covering interest rate risk) would have an important stimulative effect on bank lending. Leaving aside the question of whether that policy would create unacceptable safety and soundness risks, it would be useful to have some notion of the potential magnitude of its credit availability impact. Banks that are close to a required capital ratio are probably those most likely to take that ratio into account when making lending decisions. What proportion of bank assets are held by banks that have a leverage ratio of less than 5 percent, but have sufficient capital to meet the risk-based standards (including any increment required to cover interest rate risk) for well-capitalized banks? Suppose that banks increased their assets so that they reduced by half the percentage by which they exceed the risk-based standard for well-capitalized banks. By what percentage would assets of the banking system as a whole increase?

A.10. When considering the effect of leverage and other capital standards on the willingness of banks to lend, it is important to consider more than national averages and specific cut-off points for regulatory standards. Banks in some states or regions of the country have been more adversely affected by recent conditions than those in other areas. Moreover, in light of FDICIA, many institutions seek ratios significantly higher than minimum requirements so that they can have meaningful buffers, especially during periods of economic uncertainty, and also as a demonstration of financial strength to their customers. Because of these factors, it is not possible to measure the full effect of removing the leverage standard using reported bank data.

Indeed, data indicate that regulatory minimums do not immediately constrain most institutions. Regarding the specific scenario you describe, at the end of the first quarter of this year, only 6 percent of banking assets were held by banks that met the risk-based capital

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.10. requirements for "well-capitalized" but had a leverage ratio below 5 percent.[2] If these banks were relieved of the constraint of the leverage ratio and reduced by half the percentage by which they exceeded the risk-based standard, banking assets could increase by 0.3 percent.

While that figure is clearly small, I still believe that the leverage standard has been and continues to be a significant factor influencing bank lending policies. Once again, the effect on some regions has been more pronounced than national averages suggest and, perhaps most importantly now, the current numbers reflect a substantial decline in the assets of some important banks that was required largely because of the leverage standard. Although these institutions may now meet the leverage standard, they sometimes only have small buffers due to the standard and have significantly changed their practices in order to be assured of retaining such buffers. In addition, of all the regulatory capital ratios, the leverage constraint is viewed as most binding or of most concern by certain institutions. Some of these institutions appear to have become particularly more conservative in their lending activities in order to maintain leverage ratios well above the 5 percent benchmark. The additional leverage ratio buffer held by these institutions reflects a defensive strategy in light of the losses experienced by banks in recent years and the potential FDICIA sanctions imposed on banks whose capital declines.

Q.11. You point out in your testimony that banks have benefitted from the declines in interest rates. Presumably thrifts have as well. How vulnerable are banks and thrifts to a possible increase in interest rates in the future? And how would you assess the overall condition of the banking industry?

A.11. The vulnerability of depository institutions to rising interest rates is primarily a function of the extent to which the maturity or repricing dates of their assets exceed those of their liabilities. At the end of March, 1992 banks held only 15.8 percent of their assets in fixed-rate instruments with maturities greater than 5 years, which is not materially different from levels in

---

[2] At this time, an increment to the capital requirement to cover interest rate risk is not available. Consequently, the following data reflect the 1992 standards for risk-based capital without an adjustment for interest rate risk.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.11. earlier years. Even this current percentage of longer term assets may overestimate the true exposure of banks to rising rates, since an estimated 20 percent of reported longer term assets are collateralized mortgage obligations (CMOs), whose effective maturities, according to recent surveys, may often be significantly less than 5 years. Excluding these instruments, only 12.6 percent of bank assets are reported as having fixed rates and maturities greater than 5 years--virtually the same percentage reported by banks in 1988. Since thrifts generally have a greater concentration of long-term fixed rate assets, their exposure to rising rates is greater.

Although securities held by banks have enjoyed considerable capital appreciation during the recent decline in rates, most of this increased value has not been realized in bank earnings and balance sheets. Rather the principal benefit of declining market rates is being taken gradually through improved net interest margins. These margin gains, in turn, derive mostly from the ability of banks to manage both the rates earned on their assets and the rates paid on their deposits.

This ability to manage assets and liabilities can also be expected to mitigate the effects of adverse changes in market rates. Indeed, during the period 1978 through 1981, when rates were rising sharply, net interest margins of the commercial banking system remained relatively stable and actually widened slightly from levels of a few years before.

Finally, as you may recall, the banking agencies have recently issued for pubic comment a proposal for measuring interest rate risk in commercial banks and establishing a capital requirement for institutions with significant exposures. That proposal includes additional reporting of maturity or repricing information that will improve our ability to assess interest rate risk frequently on a systematic and industrywide basis. That reporting process will supplement the oversight activities now conducted through on-site examinations.

Regarding the second part of your question, the condition of the U.S. commercial banking system, while still far from satisfactory, is improving, with much of the industry reporting its strongest earnings and capital ratios in many years. Other banks, however, continue to bear the weight of problem loans. Exposures to commercial real estate, in particular, have been a major problem to many regional and money center banks and remain a matter of concern, especially in Southern California and in certain other regions of the country.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.11. One of the most positive developments, and one spread throughout the industry, is the improved level of profitability, as measured by return on assets (ROA). During the first quarter of this year (the latest period for which comprehensive industry data are available), more than 60 percent of all commercial banks earned a ROA of more than 1.0 percent, and the industry's average return was 0.88 percent. Both figures represent strong improvement, and second quarter results of major banking organizations suggest that this pattern continued through mid-year. Conversely, the percent of banks with first-quarter losses (6.9 percent) is lower than any full-year rate since 1981. Much of the improvement in industry earnings derives from the lower interest rate environment, which has enabled banks to improve their net interest margins and also achieve securities gains.

Many institutions have also made significant progress toward improving their capital ratios through new stock issues and higher levels of retained earnings. The industry's average ratio of equity to assets at the end of March, 1992 was virtually 7.0 percent--its highest level in more than 20 years. Since the end of 1988, total equity capital of the industry has increased more than 20 percent ($40 billion), significantly out-pacing asset growth. Nearly 98 percent of the banks now meet or exceed the fully phased-in 8.0 percent minimum risk-based capital standard required for the end of 1992, and more than 90 percent of the banks have ratios above 10 percent, which is required to meet the proposed definition of "well capitalized."

Tempering these improvements is the unacceptably high volume of problem commercial real estate loans. Those assets, combined with the high level of already foreclosed properties, is a major concern and one that continues to depress the earnings and condition of some banks. Although the industry's overall asset quality has not worsened in recent quarters, neither has it materially improved. Considering the amount of current excess capacity in real estate markets, many of problem loans will remain weak, at best, for some time to come.

These somewhat conflicting trends are reflected in the smaller but still large number of problem banks, which the FDIC placed at 1,051 at the end of 1991 (including FDIC insured savings banks). Although fewer than the nearly 1,600 problem institutions in 1987, their assets have grown to more than $600 billion and can be expected to keep the costs to the FDIC at unacceptable levels.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Q.12. Last October, the Federal Reserve Board released a study of Home Mortgage Disclosure Act data which revealed that banks reject mortgage applications by minorities twice as often as they reject applications by whites in similar circumstances. Poor whites get mortgages more easily than well-to-do minorities. In light of this study and in the aftermath of this spring's riots in south-central Los Angeles, what specific action has the Fed taken to combat lending discrimination and promote bank compliance with obligations under the Community Reinvestment Act?

A.12. The Board of Governors is very concerned about the wide differences in denial rates among racial groups that are indicated by the expanded data collected under the Home Mortgage Disclosure Act (HMDA). We are committed to enforcing federal laws prohibiting discrimination in any aspect of a credit transaction on the basis of race, sex, age, marital status or ethnic background, and have taken several steps to strengthen our efforts in this area in recent years.

I would first point out, however, that the home mortgage picture is more complicated than your question suggests. The 1990 HMDA data indicate that credit history was the single most commonly cited reason for loan denial for applicants of all races. However, the data do not capture any information about the credit history of the applicant -- or a number of other factors that lenders routinely consider in the credit evaluation process, such as debt and asset levels or job experience and tenure.

Given the complexity of the issue, we are moving forward with research efforts to better understand the data and the reasons why these disturbing patterns exist. At the same time, we have marshalled our resources to develop practical applications of the data for use in our regularly scheduled consumer compliance and Community Reinvestment Act (CRA) examinations.

The Federal Reserve Bank of Boston, in consultation with other federal supervisory agencies, has undertaken a study that uses the new HMDA data as its starting point. The study will collect additional information from loan applicants at over 100 financial institutions in the Boston area. Its purposes are to provide further insight on the credit decision process in general, suggest what criteria used by lenders in determining creditworthiness may be in need of review, and give us the information necessary to help prospective borrowers improve their likelihood of loan approval. The HMDA data are already augmenting the work of our examiners, perhaps most notably in monitoring compliance with the fair lending laws. With

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.12. the new data, examiners can more readily compare the characteristics of accepted and rejected applicants and look for any apparent differences in the way lending standards have been applied. We have devoted considerable resources to the development of an automated system that will facilitate the analysis of HMDA data and identify the "red flags" that may indicate illegal discrimination.

The data are also supporting the CRA examination process by providing a more complete profile of lending patterns for individual banks, and for the market as a whole. For example, examiners can now look at how loan application activity is distributed among various segments of the community; to what extent the sex of applicants seems to be related to the bank's propensity to lend; whether approval rates are higher for different types of loan products (such as conventional vs. government-insured mortgages); and how the bank being examined compares to its peers in its share of lending in specific neighborhoods. This information gives a more solid indication of areas of both strength and weakness with respect to CRA than in the past, and has enhanced our ability to conduct thorough, well-documented assessments of performance.

These and other initiatives are described in detail in Governor Lindsey's May 1992 testimony before subcommittees of the House Committee on Banking, Finance and Urban Affairs, a copy of which is enclosed.

Q.13. According to an article in USA Today, 20 percent of the banks in the nation with the lowest Community Reinvestment Act ratings are located in Los Angeles, which was rocked by riots following the Rodney King verdict. At Banking Committee hearings on the urban crisis, we heard consistently that lack of access to capital is a primary stumbling block to inner city development. What steps is the Fed taking to ensure that banks are fulfilling their obligations to lend to inner city neighborhoods where they take deposits?

A.13. Shortly after the events in Los Angeles, the Federal Reserve announced that it had joined the other federal regulatory agencies in adopting a supervisory statement that encourages efforts by banks and thrifts to work constructively with borrowers experiencing temporary difficulties in areas affected by the disturbances. In its May 12 press release, a copy of which is enclosed, the Federal Reserve also outlined other steps it would take to address the situation in Los Angeles, including plans to support the Ueberroth Rebuild L.A. Committee, sponsor

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.13. special training programs for lenders, assist in the formation of a community development corporation ("CDC") serving southcentral Los Angeles, and recognize investments to help reconstruct those areas in evaluating the CRA performance of the banks we regulate, regardless of the location of the investing institution.

In subsequent weeks, Community Affairs staff from the Federal Reserve Bank of San Francisco met with Los Angeles bankers, community organizations, city officials and members of the Rebuild L.A. Committee to further define the types of assistance we could provide. One outcome of those discussions is the Reserve Bank's sponsorship of a CRA conference in Santa Monica on September 21-22 that will focus on topics pertinent to the redevelopment activities underway in Los Angeles, such as economic development models and cultural diversity training. Second, the Reserve Bank will prepare a community needs assessment report for southcentral Los Angeles, including a study of the demographic and economic characteristics of the area and a catalogue of the nonprofit and public sector programs that could support community redevelopment activities there. We anticipate that the report will become available in the fall of this year. Finally, the Reserve Bank has worked with the local banking community to form a multi-bank community development corporation that will provide loans and equity investments to businesses in southcentral Los Angeles.

The Federal Reserve's Community Affairs Program has provided technical assistance to bankers and community organizations on community reinvestment and finance since the late 1970s. Among many other achievements, these activities have led to the formation of multi-bank mortgage lending pools that are providing affordable housing credit to lower income and minority communities in several states, including California.

In addition, the Federal Reserve conducts regularly scheduled examinations of the banks we supervise to assess the current level of CRA performance, as well as to put them on a path of better performance in the future. Examiners convey to bank management any areas of weakness detected, recommend measures for improvement and follow-up on those recommendations through correspondence, advisory visits and subsequent examinations. Since mid-1990, the agencies have also made public written CRA assessments for each bank examined, as well as the rating assigned to them. We believe that public disclosure has provided the banking industry a significant incentive to maintain a strong record of performance under the CRA.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Q.14. In your statement you discussed weak loan demand as a principal factor in holding back bank lending. Measuring bank lending activity and comparing it with previous business cycles has become complicated by increased securitization of bank loans, the increasing role of finance companies and other non-bank lenders, and, as reported recently by the Federal Reserve Bank of New York, the growing practice of booking loans abroad. How much do you estimate each of these factors has affected bank loan totals over the past 2 years? How satisfied are you with the quality of the data on those activities? Do we need to take any steps to improve those data?

A.14. The quality of data on these activities vary considerably. However, a lack of reliable data in some areas is not the only difficulty in estimating the effect of these activities on bank lending.

The data on consumer loan securitizations are good. The Federal Reserve obtains information on banks' consumer credit securitizations primarily from a statistical report filed by a sample of banks; additional information comes from the financial press. The amount outstanding of securitized consumer loans originated by commercial banks was $24 billion at the end of 1989 and $59 billion at the end of 1991.

Data on real estate loan securitizations by banks are unavailable. Total mortgage-backed securities are known fairly well, but the share of this stock that was originated by banks is not measured directly and is difficult to estimate. No effort is planned to obtain such information.

Data on the volume of loans to U.S. nonfinancial businesses by offshore offices of foreign banks have been very difficult to obtain. Data on lending to U.S. nonbank borrowers, collected by the Bank for International Settlements and reported in the New York Fed study, suggest that the amounts of business lending involved are substantial. Based on the BIS data, an estimated $116 billion of such loans were outstanding at the end of 1989 and $152 billion at the end of 1992. These estimates, however, are based importantly on assumptions regarding the composition of the offshore offices' assets. Beginning in September 1992, the Federal Reserve will collect a supplemental quarterly report from branches and agencies of foreign banks containing more detailed information on loan and deposit transactions with U.S. residents at offshore centers.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.14. Statistics on business loans originated by banks and sold outside the banking sector are obtained annually through a Federal Reserve survey of large banks. As of year-end 1991, such loans totaled an estimated $22.8 billion; they were $17.8 billion at the end of 1989. These data are thought to be reasonably accurate.

Reliable data on lending by finance companies are available from a monthly Federal Reserve survey of finance companies. As of year-end 1989 and year-end 1991, such loans totaled $268.3 billion and $301.3 billion, respectively.

As this question suggests, the proliferation of nonbank sources of credit and alternative methods of funding credits originated by banks has altered the relationship of bank credit to the economy, complicating the interpretation of bank lending data. Partly for that reason, it may be more useful to focus on growth of aggregate nonfinancial credit rather than credit provided through particular channels. Growth of total nonfinancial sector debt has been markedly less weak than that of depository credit. In any case, it is unlikely that simply adding the volume of credit provided by these various factors to the amount of loans in bank portfolios would provide an accurate estimate of what bank loans would have been in the absence of these alternative sources. For example, had banks not been able to securitize consumer loans in recent years, a portion of these loans might not have originated.

Q.15. Banks have reported substantial increases in their securities trading accounts. Does that reflect primarily increases in banks' trading activities or changes in reporting practice? Has increased securities trading by banks been associated with any change in trading volatility of Treasury debt?

A.15. Banks' trading account assets, measured either absolutely or relative to total bank assets, are near the upper end of the range of the past 5 years, as shown in the two upper panels of the enclosed chart. Banks' overall securities holdings, however, also have risen quite rapidly as a proportion of bank credit over the past few years. For that reason, the ratio of trading account assets to securities holdings in the past year has generally been the range of the past 5 years, as shown in the lower panel of the chart. Although we have no direct evidence of the motivations of banks to credit securities acquisitions to particular accounts, some banks may be booking their additional securities holdings as trading

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

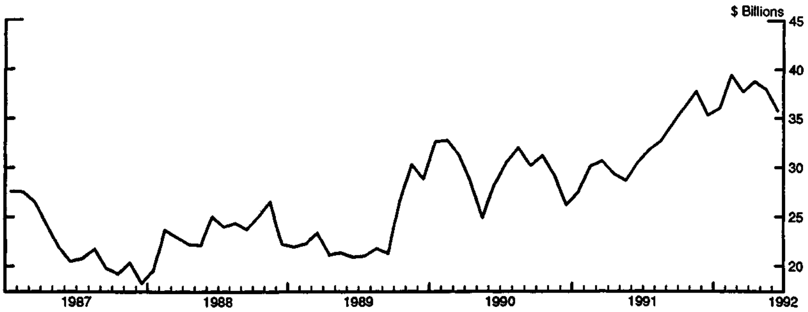
A.15. account assets because they do not expect to hold them to maturity. For example, they may expect to fund a pickup in loan demand by selling securities. Thus, the rise in trading account securities does not necessarily imply a rise in short-term bond trading in securities markets.

In any case, the increase in banks' securities trading accounts does not appear to have been associated with an increase in volatility in government securities markets. The volatilities of returns on 10- and 30-year treasury bonds, as measured by 21- and 41-day centered standard deviations of total returns, remain within their historical ranges.

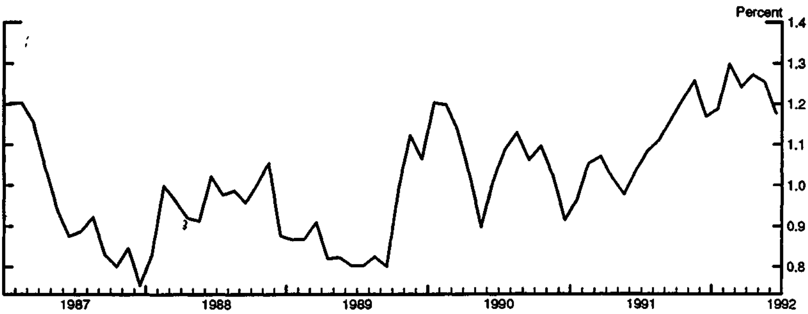
Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

19

Trading Account Assets of All Comercial Banks



Ratio of Trading Account Assets to Loans and Securities



Ratio of Trading Account Assets to Securities

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Q.16. While banking data over the past year show declines in business loans, they show a sizable increase in loans to non-bank financial institutions. What accounts for that increase?

A.16. The first panel of the table on the next page shows that seasonally adjusted loans to nonbank financial institutions (estimated from a sample of banks, and as published on the G.7 statistical release) grew by $1.8 billion at all commercial banks from June 1991 to June 1992. There was a particularly large increase in the series between November and December 1991. The table shows that the increase occurred in the foreign bank component of the series. As it turns out, this increase partly reflects a reclassification of loans by reporting banks, rather than an actual increase in loans. The lower panel shows data adjusted for revisions and reclassifications of loans. On this adjusted basis, the increase in the foreign bank component in December 1991 was somewhat less, and total nonbank financial loans fell by $0.6 billion over the June 1991 - June 1992 period.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Loans to Nonbank Financial Institutions
(billions of dollars)

Unadjusted for series breaks

	All Banks	Large	Small	Foreign
Jun 91	38.6	23.4	4.8	10.3
Jul 91	37.6	23.3	4.8	9.6
Aug 91	36.8	22.7	4.7	9.4
Sep 91	37.9	22.4	4.7	9.9
Oct 91	37.2	22.5	4.6	10.1
Nov 91	37.8	22.6	4.5	10.7
Dec 91	40.6	22.8	4.5	13.3
Jan 92	40.2	22.5	4.5	13.2
Feb 92	41.3	23.1	4.6	13.6
Mar 92	41.9	23.5	4.7	13.7
Apr 92	41.0	22.7	4.6	13.7
May 92	41.4	22.1	4.6	14.7
Jun 92	40.5	21.3	4.5	14.7

Adjusted for series breaks

	All Banks	Large	Small	Foreign
Jun 91	40.9	23.2	4.8	13.0
Jul 91	39.8	22.9	4.8	12.0
Aug 91	38.9	22.4	4.7	11.8
Sep 91	39.1	22.1	4.7	12.3
Oct 91	39.1	22.2	4.6	12.4
Nov 91	39.7	22.3	4.5	12.9
Dec 91	41.4	22.5	4.5	14.5
Jan 92	39.9	22.1	4.5	13.3
Feb 92	41.0	22.7	4.6	13.6
Mar 92	41.5	23.2	4.7	13.7
Apr 92	40.7	22.4	4.6	13.7
May 92	41.2	21.8	4.6	14.7
Jun 92	40.3	21.1	4.5	14.7

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Q.17. I am concerned about increasing bank participation in derivative securities markets.

Q.17.a. What data do you have measuring aggregate bank positions in the various derivative markets over the past few years?

A.17.a. The enclosed tables contain data on positions in derivatives markets that have been collected on the quarterly call reports since the beginning of 1990. (Certain data were collected in earlier years but less detail is available and the introduction of the new reporting scheme may have created breaks in some of the series that complicate their interpretation.) The data in table 1 are notional principal amounts of interest rate, exchange rate, and commodity contracts outstanding at quarter-ends. It should be noted that the counterparties to these OTC derivative contracts frequently are other U.S. banks. Thus, the aggregate figures shown reflect a substantial (but not quantifiable) amount of doublecounting.

Data on notional principal amounts indicate which banks are using the various products and also provide a crude measure of the scale of their activity. By themselves, however, such data do not provide a clear picture of how credit, market, liquidity, or operational risks are affected by use of these products. More meaningful data on credit exposures are collected for purposes of computing risk-based capital ratios. These data, shown in table 2, are gross replacement costs--that is, the costs of replacing the cash flows associated with various OTC derivatives at prevailing interest rates and exchange rates, should the counterparties default on their payment obligations. As can be seen from the data for 1991:Q4 and 1992:Q1, replacement costs can change substantially as market interest rates and exchange rates move away from the rates embodied in outstanding contracts. The substantial increases in exposure during the fourth quarter of last year coincided with the declines in U.S. interest rates and a weakening of the dollar, while the decreases in the first quarter coincided with a rebound in both U.S. long-term interest rates and the dollar.

Even these data overstate credit exposures (and perhaps the sensitivity of exposures to changes in market rates as well). Active participants in the derivatives markets have made widespread use of agreements that provide for the bilateral netting of gains and losses on multiple derivative contracts with a single counterparty. If these legal agreements are enforceable (as they

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 1
Insured Commercial Banks
POSITIONS IN VARIOUS DERIVATIVE MARKETS
(Notional principal amounts, billions of dollars)

Date	All instruments	Interest rate contracts			Foreign exchange contracts			Commidity and equity contracts [1]
		Swaps	Futures and forwards	Options	Swaps	Futures and forwards	Options	
1990–Q1	6,193	1,451	830	473	248	2,768	372	51
Q2	6,514	1,493	917	553	254	2,842	395	60
Q3	7,006	1,616	996	695	276	2,846	498	79
Q4	6,784	1,717	895	698	286	2,593	513	82
1991–Q1	7,038	1,564	1,024	712	290	2,781	584	83
Q2	6,887	1,577	968	706	290	2,675	585	86
Q3	7,324	1,816	1,067	767	295	2,762	526	91
Q4	7,446	1,756	1,226	854	306	2,593	573	138
1992–Q1	8,097	1,820	1,434	928	303	2,965	469	178

1. Swaps, futures and forwards, and options.

Source: Reports of Condition, Schedule RC–L.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Table 2
Insured Commercial Banks
POSITIONS IN VARIOUS OTC DERIVATIVES
(Gross replacement costs)

Date	All instruments	Interest rate contracts[1]		Exchange rate contracts [1,2]	
	$ billions	$ billions	Percent of notional principal	$ billions	Percent of notional principal
1990–Q1	91.9	26.4	1.3	63.6	2.5
Q2	80.4	26.0	1.2	54.4	2.2
Q3	109.7	24.2	1.0	85.5	3.0
Q4	104.7	27.7	1.2	77.0	2.8
1991–Q1	115.2	29.0	1.2	86.2	3.2
Q2	109.1	28.0	1.2	81.1	3.1
Q3	101.2	38.7	1.5	62.5	2.5
Q4	151.1	51.1	1.6	100.0	3.7
1992–Q1	91.9	42.2	1.5	49.7	1.7

1. Excludes futures contracts and spot foreign exchange contracts (original maturities of 14 days or less). Includes options purchased but excludes options written.
2. Includes commodity contracts.
Source: Reports of Condition, Schedule RC–R

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.17.a. generally would be in the United States under legislation enacted in recent years), the actual (net) credit exposures may be only 40 to 60 percent of the gross replacement costs included in table 2.

Q.17.b. How accurately can your examiners evaluate the degree of risk involved in these positions at individual banks?

A.17.b. The on-site examination process is the principal manner by which the Federal Reserve evaluates bank exposures to risks inherent in derivative activities. Regular full-scope, on-site examinations include detailed reviews of bank management systems and assessments of their capital adequacy, asset quality, earnings, and liquidity. These reviews cover positions taken in derivative instruments, whether on- or off-balance sheet, and the informational and management systems banks use to measure, monitor, and control their risks. Special focus is placed on mechanisms for conveying information on these activities within the institution, particularly with regard to risk guidelines and the enforcement of prudent limits on trading activities.

In addition to full scope bank examinations, the Federal Reserve also undertakes targeted examinations and holds other meetings with bank managements to address specific concerns in this area, as well as to review general market developments. In order to keep abreast of changes in derivative activities of U.S. banks, the Federal Reserve monitors conditions in the markets (including efforts related to its open market activities), reviews bank examination findings, analyzes payment and settlement systems, and also participates in ongoing discussions with other regulators and central banks.

The results of these efforts are used to update supervisory procedures and training programs that provide examiners with the information, techniques and tools necessary to accurately assess the risk of derivative products. These research and monitoring efforts also help shape policy statements regarding derivative activities of regulatory concern. For example, in February of this year, the Federal Reserve and other supervisory agencies issued a policy statement through the FFIEC that identified certain mortgage derivative products as unsuitable investments for the vast majority of institutions.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.17.b. The challenges created by derivative instruments have complicated the supervisory process for at least some institutions and require examiners to keep informed about new product developments and their related market risks. However, when used properly, these transactions can do much to reduce risks that banks incur as normal parts of their banking business and enhance the efficiencies of capital markets worldwide. That they have also increased the complexity of risk measurement is a concern that we as bank supervisors take seriously and are actively addressing through continuing education and by evaluating the industry's own risk management techniques and enforcing sound capital standards. It is critical that bankers have adequate expertise, information systems, and operational controls to understand, evaluate, and limit the risks in any activity they conduct. In that sense, those activities involving derivatives are similar to the more traditional activities of banks.

Q.17.c. To what extent do large positions in these markets limit the ability of regulators to close a failed bank? What steps could be taken to reduce such problems?

A.17.c. Large positions in derivative securities will not necessarily hinder the ability of regulators to close a failed bank. It is important to recognize that most of these derivatives have been designed as hedging instruments that should work in the direction of reducing risk. Nevertheless, given the complexities and interdependencies inherent in many of these derivative positions, the sudden failure of a major market participant might entail risk to the overall financial system, especially if the failure were to occur in an otherwise unsettled market environment.

The potential for such problems was evident in the stock market crash of 1987 and the bankruptcy of Drexel Burnham Lambert in early 1990. In both situations, the problems were contained, but the containment efforts required a number of extraordinary efforts on the part of the authorities and market participants. Those episodes, as well as the continued rapid pace of change and the innovation in financial markets, have prompted the Federal Reserve to take several steps to guard against the risks associated with these activities.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.17.c. In recent years, the Federal Reserve and the other banking agencies have developed programs designed to help examiners identify and assess the risk of derivative positions, as mentioned in response to question 17(b), above. In addition to market surveillance, statistical analysis, examinations, educational programs and other activities, the Federal Reserve has been extremely active in international efforts to formulate capital requirements to cover off-balance sheet derivative exposures. The Federal Reserve played a key role in the initial implementation of the 1988 Basle Accord on capital adequacy, which focused primarily on credit risk exposure and for the first time formally assessed capital charges on off-balance sheet positions.

More recently, the Federal Reserve has been involved in the ongoing work of the Basle Committee on Banking Supervision--currently chaired by President Corrigan of the Federal Reserve Bank of New York--to develop new capital rules to cover so-called "market risks," which include foreign exchange, equities and interest rate risk. The goal of this work is to ensure that banks hold capital adequate to protect against adverse market movements that could potentially generate significant losses from both on- and off-balance sheet exposures.

The Federal Reserve has also been involved in domestic and international efforts to enhance the integrity and reliability of payment and settlement systems. The principal focus has been to ensure that in times of either operational or financial stress, clearing and settlement systems can assure final (i.e., irrevocable and unconditional) settlement of obligations. This assurance is vital to the liquidity of a wide variety of markets for conventional and off-balance sheet instruments and is made more difficult over time by rapidly growing transaction volumes and increasingly complex instruments.

On the domestic front, the Federal Reserve Bank of New York has formed the Payment and Settlement Committee--consisting of senior executives from financial institutions, clearing organizations, and securities exchanges--to facilitate communication among private-sector institutions, and between those institutions and regulators, on payment, clearing, and settlement issues. In addition, both the Board of Governors and the New York Reserve Bank have formed committees of senior Federal Reserve officials who meet periodically to evaluate and discuss payments systems issues.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

A.17.c. The Federal Reserve is also involved in international efforts with respect to payment and settlement systems. The Basle Committee on Payment and Settlement Systems is charged with developing coordinated international policies on payment and settlement issues. The group consists of representatives from the central banks of the G-10 countries and is chaired by Governor Wayne Angell, a member of the Federal Reserve Board.

Finally, the Federal Reserve closely follows the various arrangements for netting on- and off-balance sheet exposures that have been developed or proposed in recent years. The Clearing House for International Payments (CHIPS) in New York nets dollar settlements among a large number of banking institutions and, in close collaboration with the Federal Reserve, has moved to strengthen its settlement procedures. Arrangements have been proposed in North America and Europe to net forward foreign exchange contracts among major banks, and the Federal Reserve has worked closely with other central banks and participant banks to ensure that those arrangements are sound. On a related front, the Federal Reserve has been active in developing and evaluating proposals to incorporate netting into the Basle Accord on capital adequacy. The concern in this work has been to recognize netting schemes that appropriately take into account the potential benefits of netting among counterparties, but do not result in capital charges that are insufficient to cover losses in the event of a significant market disruption.

Current efforts to identify market risks related to derivatives and to develop new capital rules to compensate for those risks should enhance the safety and soundness of individual institutions. Moreover, steps currently being taken by the Federal Reserve and others to improve the integrity and reliability of the payments system should allow financial markets to remain stable despite the failure of a bank or nonbank participant. Such efforts are expected to improve the ability of regulators to close institutions with large derivative positions expeditiously and with less risk to the overall financial system.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GRAHAM FROM

ALAN GREENSPAN

During Testimony on July 21, 1992

Q.1. How many foreign bank applications to establish foreign bank branches, agencies, representative offices or to acquire control of United States commercial banks or commercial lending companies have been received by the Board of Governors of the Federal Reserve System since December 19, 1991?

A.1. As of August 10, 1992, a total of 25 applications by foreign banks to establish a branch, agency, representative office or commercial lending company or to acquire a commercial bank have been received in the Federal Reserve System (i.e., at the Board and the Reserve Banks).

Q.2. How many of such applications have been formally accepted for processing by the Board of Governors of the Federal Reserve System since December 19, 1991?

A.2. Since December 19, 1991, 10 of these applications have been formally accepted for the Board for processing. The remaining 15 applications are under active review by the Reserve Banks, with several close to being accepted for Board processing.

Q.3. How many of such applications have been approved by the Board of Governors of the Federal Reserve System since December 19, 1991?

A.3. The Board has not yet acted on any of the applications.

Q.4. Why?

A.4. In each case, the factual record supporting the application is incomplete and, therefore, the application cannot be acted upon. Most applications are still within the 60-day processing time period, and each is under review to determine the sufficiency of information. In the cases where the time for processing has been extended in order to obtain a complete record, background checks requested from other federal agencies remain outstanding. The Board is prepared to act on any application as soon as the record is complete.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

FEDERAL RESERVE press release

For immediate release May 12, 1992

The Federal Reserve Board today announced a series of steps designed to expedite the provision of financial services and help rebuild areas of Los Angeles and other cities affected by recent civil disturbances.

Steps include a supervisory statement adopted by the Federal regulatory agencies regarding banks and thrifts that are working in a constructive and prudent fashion with borrowers experiencing temporary difficulties.

The statement from the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency and the Office of Thrift Supervision says that efforts to restructure debt or extend repayment terms -- so long as these efforts are consistent with safe and sound banking practice -- should not be subject to examiner criticism. A copy of the statement is attached.

Other steps approved by the Federal Reserve include:

. Investments in the affected areas by state member banks located outside those areas will be taken into account when assessing CRA performance and evaluating applications submitted to the Federal Reserve.

2. Provide human resources to the Ueberroth program and

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

provide space, to the extent possible, at the Los Angeles Branch of the Federal Reserve Bank of San Francisco.

3. Support the development of a multi-bank community development corporation to focus on South Central Los Angeles. This corporation would provide technical assistance, loans and equity investments for small business which are rebuilding, relocating or expanding in South Central Los Angeles.

4. Seek passage of an amendment to the Federal Reserve Act to grant clear authority to state member banks to make equity investments in community development projects and corporations. Presently, bank holding companies and national banks are authorized to make debt and equity investments in projects and corporations for public purposes such as low-income housing, small business development and job creation.

5. Develop and sponsor training programs for bankers and members of the community on the specific programs that will be available to business and property owners who are rebuilding in Los Angeles.

6. Expedite the applications process for state member banks and bank holding companies that are expanding into the affected areas or are undertaking new activities designed to assist in the economic redevelopment of affected areas.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Community Affairs office at the Federal Reserve Bank of San Francisco routinely offers training to bankers and community organizations on community reinvestment and finance. In expanding this program to affected areas, business and community training will include information on the types and operation of programs that are available to assist them, and on how to develop business plans and structure financial statements for presentation to a financial institution.

Senior management from the Federal Reserve Bank of San Francisco has already been in contact with the Los Angeles Mayor's office and has extended general offers of assistance in the efforts to restore communities affected by the disturbances.

To encourage financial institutions in areas not directly affected by the disturbances to help in the rebuilding effort, the Federal Reserve will give positive consideration in assessing CRA performance for active participation by a financial institution in programs where most or all of the financing provided may ultimately benefit low and moderate-income borrowers or neighborhoods located outside of the institution's delineated community.

In determining whether and to what extent positive consideration will be given, the Federal Reserve will assess the activities undertaken in the context of an institution's overall CRA program. Where such participation augments or complements an overall CRA program that is directly responsive to the credit

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

needs in an institution's delineated community, it will be considered favorably in reaching an overall CRA conclusion.

For further information, banking and community groups in the affected areas in California may telephone Ron Supinski at the Federal Reserve Bank of San Francisco at 415-974-3231 or Sandra Conlan at the Los Angeles Branch at 213-683-2902.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Interagency Statement on Supervisory Practices Regarding Depository Institutions and Borrowers Affected by Disturbances in Los Angeles.

It has been a long-standing practice of the Federal bank and thrift regulatory agencies (Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency and The Office of Thrift Supervision) to promote supervisory actions that encourage depository institutions to work constructively with borrowers who are experiencing difficulties due to conditions beyond their control. The recent disturbances in Los Angeles and other cities have placed financial pressures on businesses and individuals in the affected areas, in some cases adversely affecting their ability to repay loans in accordance with original terms and conditions. Often the financial pressures stemming from such events are transitory in nature, and borrowers are able to resume payments when economic conditions improve or the borrowers' financial positions stabilize. Under such circumstances, depository institutions may determine that the most prudent policy is to work with borrowers experiencing difficulty, in a manner that is consistent with sound banking practices, rather than take more precipitous actions such as foreclosure and/or forcing the borrower into bankruptcy.

Lenders may find that it is beneficial to work with borrowers experiencing difficulties by extending terms of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

repayment or otherwise restructuring the borrower's debt obligations. Such cooperative efforts can ease pressures on troubled borrowers, improve the capacity of such borrowers to service debt, and strengthen a depository institution's ability to collect on its loans. Depository institutions in areas affected by widespread disruption may also deem it appropriate to ease credit-extending terms for new loans to certain borrowers, consistent with prudent banking practices, in order to assist the borrowers in recovering their financial strength and place them in a better economic position to service their debts. With proper risk controls and management oversight, these steps can contribute both to the health of the local community, as well as serve the long-run interests of the lending institution. If carried out in a prudent manner, such efforts on the part of the lender will not be subject to examiner criticism.

In addition, depository institutions in the affected areas may find that their levels of delinquent and nonperforming loans will increase. Consistent with long-standing practice, the Federal bank and thrift regulatory agencies in supervising these institutions will take into consideration the unusual circumstances they face.

One of the principal objectives of the examination and supervision process is to achieve an accurate assessment of a depository institution's loan portfolio and financial

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

condition. In carrying out their supervisory responsibilities, the Federal bank and thrift regulatory agencies recognize that efforts to work with borrowers in communities under stress, if conducted in a reasonable way, are consistent with safe and sound banking practice as well as in the public interest.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Testimony by

Lawrence B. Lindsey

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Housing and Community Development

and the

Subcommittee on Consumer Affairs and Coinage

of the

Committee on Banking, Finance, and Urban Affairs

U.S. House of Representatives

May 14, 1992

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

I am pleased to address this Committee about the concerns raised by the 1990 Home Mortgage Disclosure Act (HMDA) data. I would also like to describe how we, at the Federal Reserve, are expanding our data analysis to strengthen our fair lending enforcement and Community Reinvestment Act (CRA) activities.

Last October, when Governor LaWare, as Chairman of the Federal Financial Institutions Examination Council (FFIEC), announced the release of the 1990 HMDA data, he indicated that he found the data troubling. I fully share his concern. The preliminary analysis of the nationwide data showed that three quarters of all mortgage loan applications are approved. But the statistics on applications which were not approved showed significant differences in loan denial rates among racial and ethnic groups. For example, while 14% of whites applying for conventional home purchase loans were denied, 21% of Hispanic and 34% of African American applicants were turned down. Disproportionately high rejection rates for Hispanics and African Americans were evident even when applicants with approximately the same income were compared.

Let me be absolutely clear about the position of the Board of Governors. Discrimination based on race, sex, or ethnic background is not only illegal, it is morally repugnant. Indeed, there is only one legitimate criterion on which to base loan decisions: the expectation that repayment will be made according to the terms stipulated in the loan agreement. Our efforts must

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

be directed at assuring that only this criterion is used to make home mortgage or other loan decisions.

The HMDA data make clear that the differences in denial rates when applicants are grouped by race do not change notably regardless of income. Turndown rates for minorities substantially exceed the rate for whites whether one looks at low income or high income groups. Similar patterns exist if one looks at neighborhoods instead of applicants. The proportion of home purchase loan denials increases as the percentage of minority residents increases regardless of the income level of the neighborhood. The fact that denial rates differ among racial groups in spite of statistically controlling for income underscores the troubling nature of these findings.

Many observers have pointed out that the home mortgage picture is more complicated than the preliminary analysis of the HMDA data indicates. These observers are undoubtedly correct. It should be noted that income is not the primary reason for mortgage denials. The 1990 HMDA data make clear that credit history was the single most commonly cited reason for credit denial for whites, African Americans and Hispanics. That fact should remind us that analysis of mortgage application decisions is analytically complicated and statistically tricky. Indeed, when the New York State Banking Department investigated the lending performance of 10 savings banks in that state, they found little suggestion of bias.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

As a result of the complexity of this issue, the Federal Reserve is increasing its efforts considerably toward better understanding the HMDA information. In the interim, the HMDA data will continue to provide our examiners with a basis for further analysis of whether institutions are considering all applicants fairly. I will turn to a discussion of these activities later in my testimony.

Background on HMDA

The Home Mortgage Disclosure Act (HMDA) was passed in 1975. The law is based on the concept that the public should have access to information about the home lending activities of institutions serving their communities. One purpose of the act is to encourage balanced lending through the provision of data to financial institutions, regulators, and the public at large.

To that end, the Federal Reserve Board's efforts to collect and process the data, and make it publicly available, have been in effect for some time. Since 1980, the Federal Reserve, on behalf of the federal financial regulatory agencies, has compiled information about the home lending activities of institutions covered by HMDA -- basically, those lending institutions with offices in metropolitan areas. By matching the specific loans reported with demographic data from the census file, we produced individual HMDA reports showing the home lending picture for each reporting lender, as well as aggregate reports for lenders as a whole in each metropolitan area.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

For regulators, HMDA data have augmented other procedures for detecting illegal credit practices and discrimination in consumer compliance examinations. For example, in checking for compliance with the Fair Housing and Equal Credit Opportunity Acts, examiners draw samples of mortgage files to compare with the institutions' stated underwriting policies to assure that all applicants are treated fairly. Similarly, in assessing Community Reinvestment Act (CRA) performance, HMDA data have often been a key indicator of how well banks are helping to meet the credit needs of their **entire** communities, including low- and moderate-income and minority areas.

Many banks have found that HMDA data provide valuable marketing information, enabling them to compare their performance with that of competitors. We have strongly encouraged banks to study their own HMDA data as a way to spot apparent "gaps" where credit services may not be reaching certain segments of their communities.

Community groups have often used the data to assess the home lending performance of institutions currently doing business in their neighborhoods, as well as those seeking to do so by merging with or acquiring a local institution. Through the CRA protest mechanism and other means, these groups and others have the opportunity to use the HMDA data and voice their concerns about a banking organization's CRA performance. HMDA data have also provided the basis for numerous studies over the years--by community groups, academic and news organizations, the Federal

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Reserve and others--of how home loans are distributed across neighborhoods, income and racial groups.

With the statutory changes that took effect in 1990, HMDA data now provide an even more valuable tool to all parties concerned -- especially to us, the regulators. For the first time, HMDA data collected for 1990 included information about applications that are denied or withdrawn; about the race, sex and income of applicants; and about the secondary market purchasers of loans sold by lending institutions. The data also include, in about 60% of cases, the principal reasons cited by lenders for credit denial.

Gathering and analyzing this new data represent a substantial commitment of resources by all the agencies. In fact, the new HMDA data was the most massive data collection effort ever undertaken by us, involving nearly 9,300 reporting institutions, representing about 24,000 reports for metropolitan areas, and more than 1.2 million pages of data. About $2.8 million has been spent to develop the system to process the HMDA data, and as of September of last year, the agencies had spent an additional $2.6 million to process the 1990 HMDA data. Last year we were able to make the data public about six months after the reporting deadline, and we are looking at ways to speed up the processing time starting with the 1991 data.

Caution Regarding Raw Data and The Boston Study

Although the HMDA data provide very useful information, the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

data are not perfect and we urge caution in drawing too many conclusions from a preliminary review of the data. This problem with drawing conclusions from the raw data is not just theoretical. It would be a mistake to discount the effect of a variety of factors that are at work in the loan process. According to the HMDA reports filed for 1990, credit history was the single most common reason for credit denial. However, the HMDA data do not contain any information regarding applicants' credit histories or a wide range of other factors that lenders consider in evaluating loan applications such as debt to income ratio or job experience and tenure.

We also must bear in mind the statistical ramifications of volume. For example, an institution which has a very aggressive outreach program compared to an institution in which no such effort is made will undoubtedly generate a higher volume of applicants. However, the institution with the outreach program may be statistically penalized for the effort because gathering a greater number of applications may result in receiving a large number from less qualified borrowers. This, in turn, may result in higher rejection rates in areas with high concentrations of low- and moderate-income people. This could be one reason why some minority-owned institutions turned down requests for home purchase loans relatively more frequently than other HMDA lenders.

The need for a better understanding of the data and more careful analysis is clear. As a result, the Board has authorized the Federal Reserve Bank of Boston to conduct--in consultation

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

with other federal supervisory agencies--a detailed study that should help answer some of the questions raised, at least in the Boston area, in our preliminary review of the HMDA data. In the study, we plan to gather additional data on African American, Hispanic and white applicants from over one hundred financial institutions operating in the Boston area. We believe that this data may prove useful in designing programs to reduce racial disparities in mortgage rejections.

The Boston study will give us an indication of which creditworthiness criteria are used by financial institutions in making mortgage loan decisions. Let me stress that this does not mean ratifying the existing set of criteria. Some of these criteria may have evolved through custom, and may not be statistically linked to the likelihood of timely servicing of the loan. This information may stimulate financial institutions to reassess their criteria for determining creditworthiness. The incoming information might also help us inform consumers about actions they could take to improve their likelihood of loan approval.

The second benefit of the Boston study will be an improved ability to determine how much of the discrepancy in lending rates among racial groups is accounted for by key financial and employment variables that loan officers consider in their credit evaluations. To the extent that these financial variables do not explain the discrepancies, we intend to use the HMDA data to guide examiners to specific loan application files for more extensive review.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Other Steps to Improve Enforcement

In spite of the limitations, the HMDA data are already augmenting the work of our examiners. For example, in CRA examinations HMDA data now provide a more precise picture of lending patterns for individual banks, and for the market as a whole. For example, examiners can now look at how application activity is distributed among various segments of the community; whether lending in low- and moderate-income neighborhoods is, in fact, proportional to low- and moderate-income borrowers; to what extent the sex of applicants seems to be related to the bank's propensity to lend; whether approval rates are higher for different types of loan products (such as conventional vs. government-insured mortgages); and how a bank which is being examined compares to its peers in its share of lending in specific neighborhoods. Such information, along with information gathered about other aspects of CRA performance during the course of the examination, can provide a more solid indication of areas of both strength and weakness of institutions with respect to CRA.

At the same time, we have been working to develop additional practical applications of the enhanced data for the examination process. Access has been provided to the mainframe computer for our examiners through the use of our software capabilities. Examiners can now readily retrieve and analyze this wealth of new data. We regard this type of automation capability as essential, given that the new HMDA aggregation tables for a single institution can be several hundred pages in length. We

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

continue to make additional modifications to enhance the examination process for fair lending and CRA. To accomplish this, the Federal Reserve has made a substantial investment of resources, and will give further advancement of this work high priority.

We are not acting alone in this process, but in concert with the other federal financial regulatory agencies to implement the HMDA analysis system. Because only 7% of the HMDA lenders are under the direct supervision of the Federal Reserve, we have been sensitive to the need to ensure that the other agencies have access to the HMDA data stored on the Board's mainframe, and to coordinate with them any necessary adjustments or additions to the system. An interagency working group has also been formed to work on more advanced analytical tools and training for examiners from all the agencies.

While we are working on the application of uses for the HMDA data to strengthen the examination process, we have been drawing on other methods at hand to promote compliance with fair lending laws. FIRREA allowed the imposition of civil money penalties to address any violation of law and regulation. We have already used this power to impose fines in the consumer area and other such enforcement actions addressing violations of the Equal Credit Opportunity Act and noncompliance with the CRA are in process. Although the actions to date have involved fair lending issues other than racial discrimination, we will not hesitate to impose the stiff fines that the law now permits for all types of violations.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

During 1991, we began a series of meetings with the Department of Justice, the Department of Housing and Urban Development, the Federal Trade Commission and the other financial institution regulators to discuss fair lending issues and our enforcement activities. In particular, we have been in contact with Department of Justice staff about an ongoing investigation of mortgage lending practices in Atlanta, which may lead to new techniques for determining whether a lender has illegally discriminated against creditworthy applicants. The financial institution regulators are in the process of retaining a consultant to review our civil rights enforcement training and procedures. These efforts should help us design new tools for analyzing the fairness of an institution's mortgage lending activity.

The FFIEC has just released a new brochure entitled Home Mortgage Lending and Equal Treatment that will be useful as we continue to emphasize the education of lenders, as well as consumers, about potential pitfalls in the mortgage lending process. The publication alerts lenders to subtle forms of discrimination that can occur, perhaps unknowingly, in the lending process, and how to avoid them. We are sending copies to all the banks we supervise, expecting that it will prompt many of them to take a closer look at some of the long-accepted loan origination, underwriting, appraisal and marketing practices that can have unintended discriminatory effects. We published a similar guide for consumers entitled Home Mortgages: Understanding the Process and Your Right to Fair Lending just over a year ago.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Community Economic Development

In short, we are committed to continued efforts that can detect and prevent illegal credit discrimination--but we are not stopping there. The ultimate goal of these laws is to assure that safe and sound lending takes place in every community in the country and that it is done fairly. We have long believed that this goal could be achieved by other programs that serve as a counterpoint to enforcement activities. Consequently, for many years the Federal Reserve, through its Community Affairs Program, has worked with lenders around the country to refine community development lending strategies. In 1991, we shared this type of experience and expertise through nine newsletters published by Reserve Banks, 124 conferences and seminars and more than 300 speeches at the invitation of banking and community organizations. Examples of these efforts include a new community development finance curriculum designed to teach bankers, nonprofit organizations and others the basic skills of community development lending using actual case studies; the development of manuals and software by Reserve Banks that can help lenders structure sound loans where public and private funds are involved; and our provision of technical support to multi-bank mortgage lending pools that are attempting to make housing credit more readily available to lower income and minority communities in several states. While many of these initiatives have a broader focus than just minority housing concerns, they all contribute to the assurance that we are making

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

progress in helping financial institutions serve their entire communities.

In conclusion, I am concerned, as you are, about the direction and use of the HMDA data. I am also deeply concerned about the many complex problems that seem to underlie the numbers. Obviously, there is a great deal to be done. The Federal Reserve stands ready to work with you, the industry, consumers and others in furthering this important effort.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis