FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1995

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

ON

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

FEBRUARY 22, 1995

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WEDNESDAY, FEBRUARY 22, 1995

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

The Committee met at 10:06 a.m., in room SD–106 of the Dirksen Senate Office Building, Senator Alfonse M. D'Amato (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN D'AMATO

The CHAIRMAN. The Committee will come to order.

Today's hearing is on the Humphrey-Hawkins Act. I might say for the record, I'm going to ask that my statement on Humphrey-Hawkins be included in the record as if read in its entirety, in order to save time.

I'm going to touch on another subject.

But I'd like to note that in today's Wall Street Journal, Senators Mack and Bennett have an excellent op-ed article. I want to congratulate both of them on it, because it really raises some very important questions as it relates to the need for changes in Humphrey-Hawkins and its goals.

So I want to commend my two colleagues, and I know that they're going to pursue that line of questioning.

But I'd like to take this opportunity to comment on the formal signing yesterday of the agreements providing for $20 billion in loans and loan guarantees for Mexico.

As I have said in the past, and reiterated yesterday, I remain strongly opposed to the President's unilateral decision to use $20 billion from our Exchange Stabilization Fund, the ESF, to bail out a mismanaged Mexican government and global speculators.

I think the President was wrong to go around the representatives of the people. I think Congress should have had the final say on the spending of $20 billion of taxpayers' money.

We now know that the President's use of the ESF is totally unprecedented. This fund was intended to stabilize the dollar, not the peso. The President has committed to use the ESF to make loans to Mexico for up to 5 years and to back Mexican securities for up to 10 years.

Until now, ESF has never been used for loans or loan guarantees to any nation for more than 1 year.

I remain particularly concerned that the President's plan will draw the United States into a deeper and more intrusive relationship with Mexico. As Senator Brown testified several weeks ago be-

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fore this same Committee, no one likes the banker who forecloses on the family farm.

I'm fearful that economic instability in Mexico will lead to political instability in Mexico. I have been advised by people on Wall Street, very knowledgeable people, that Mexico faces "an economic meltdown."

Now, what is that predicated on? Just look at the facts. Look at the record.

On Monday, the Bank of Mexico, apparently under pressure from our Treasury, increased short-term interest rates to 50 percent, up 10 percent, from 40 to 50 percent. I don't see how 50 percent interest rates can be good for the Mexican economy. Fifty percent interest rates will only discourage economic growth, real growth.

We know that the devaluation of the Mexican peso was a terrible mistake. We should not be bailing out Mexican banks. We should be strengthening the peso, a point that a number of my colleagues have made repeatedly.

So I'm concerned that the President's bail-out of Mexico will leave American taxpayers holding the bag.

How will Mexico repay these loans?

Who is going to put private dollars into this kind of an economy?

How will they go about a privatization, given the history that has taken place? It's one thing to talk about privatization, it's another thing to bring it about.

The Banking Committee will hold hearings in March on the President's use of the ESF to bail out Mexico. I think we have to find out whether the Administration's inaction or silence during 1994 helped precipitate this crisis.

Was information withheld from Congress and the American people? We need to learn if the Administration advised Mexico to devalue the peso.

We must examine the President's legal authority to use the funds and the conditions that the Administration has imposed on Mexico.

And finally, Congress must be in a position to see to it that those conditions are carried out.

In short, we have to do all that we can to protect the American taxpayers' investment.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

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

I want to welcome Chairman Greenspan before the Committee this morning to testify on the Federal Reserve's monetary policy report to the Congress.

I might suggest, Mr. Chairman, that since you are so intimately involved in addressing the Mexican financial crisis, including a number of visits on the Hill, that you might want to address at some point this morning, even if briefly, the various questions raised by Chairman D'Amato, so they don't simply remain hanging out there.

I know it's a matter that you've been very deeply into and I think it might be helpful if you indicated for the record your own view on some of those items.

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This oversight hearing today is particularly important, in my view, because of the aggressive monetary policy the Fed has been pursuing over the last 12 months.

The Federal Reserve has doubled the underlying rate of interest with seven successive tightening moves. So aggressive has the tightening been that the following reaction has become typical. The opening paragraph of a front-page story on homeowners with adjustable rate mortgages which appeared in The Washington Post last week read as follows:

> Mention the words Federal Reserve to Alexandria resident, Ann Gibson, and a low-level panic begins to set in. The 34-year-old parochial school teacher knows first-hand what it means when the Fed decides to raise interest rates.

The Fed used to operate and sort of was only known in rarefied circles. But it's obviously now hitting a large number of people all across the country.

The Fed made such a decision again on the first of this month. It pushed up both the Fed funds rate and the discount rate a half-percentage point. Banks quickly followed, raising the prime rate to 9 percent.

In my judgment, this move was an error for three reasons.

One, the pipeline was already full with tightening pressure; two, there were signs of slowing in the economy; and three, there were no significant signs of inflation.

I wasn't alone in that judgment. The Fed's tightening announcement evoked this response from the Chamber of Commerce: "The Fed attacked economic growth." And the Chamber of Commerce's statement went on to say:

> The Federal Reserve continued its war on the economy today when it hiked short-term interest rates for the seventh time in the past 12 months. The Fed move occurred against the backdrop of benign inflation and increasing indications that economic growth may be falling off.

The National Association of Manufacturers also issued a strong statement:

> The Fed's action is overkill. The economy is already beginning to slow down and earlier rate increases have still not had their full effect on real activity. Further, inflation was very low in the fourth quarter. The Fed should have left rates as they were and waited for more evidence on growth and inflation.

The National Association of Homebuilders was also critical of the Fed's tightening:

> Every indication that we've seen from our surveys of builder members shows that the previous Fed interest rate hikes were already starting to slow the housing market. Instead of letting the full effects of the previous hikes work their way through the economy, the Fed has again prematurely bumped up rates and that move could threaten the overall economic recovery.

Now those are statements from the Chamber of Commerce, the National Association of Manufacturers, and the National Association of Homebuilders.

The news since the widely criticized tightening announcement has only heightened my concern about the Fed's present course. Two days after the tightening, the Labor Department announced that the unemployment rate jumped three-tenths of a point in January, to 5.7 percent. The pace of job growth slowed to 134,000.

We learn that the weakness in retail sales carried into the new year. Sales in January were up a meager two-tenths of a percent,

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the same as in December. Consumer debt levels are now at very high levels, pointing to continued weakness. Many Americans are going to feel the pinch, like the teacher I quoted at the outset of this statement. Their payments on adjustable-rate mortgages are rising because of the Fed's action.

Not surprisingly, the housing industry has signalled signs of distress. Homebuilding has declined in 3 of the last 4 months. The January decline announced last week was particularly sharp. Housing starts fell 9.8 percent. Single-family starts fell 12.4 percent. The 8.6 percent decline in permits authorized portends continued weakness.

If you add in declining car sales, the corresponding temporary shutdowns of certain car factories, and I note a story in today's Wall Street Journal that Chrysler has idled another auto plant this week which states:

> Chrysler's decision to idle the plant comes as rising interest rates seem to be slowing car sales.

All of this establishes a broad-based case that the economy is slowing down. And remember, this is before we have seen the effects of the latest tightening, and all of the effects, I assume, of the November tightening.

My concern, simply put, is that the Fed has overshot the mark. In fact, Mr. Chairman, you have told us on occasion that monetary policy works on a lag-time basis. The Fed is now out on the limb, risking the jobs of working Americans, and all for what? There are still no signs of accelerating inflation. It remains at its lowest level in three decades.

Take producer prices. The core rate of producer inflation edged up a slight two-tenths of a percent most recently in January. Core producer price inflation is running at just 1.5 percent above a year ago.

A look at the anecdotal evidence is similarly encouraging. A headline in The Wall Street Journal on February 2nd: "Price Increases for Steel Isn't Sticking. With Inventories High, Imports Rising."

There's been no acceleration in consumer prices. A year ago, when the Fed first tightened, the core CPI was running at 3.1 percent above the previous year. The most recent figures show core CPI up just 2.9 percent above a year ago.

The performance of the GDP deflator, a broad gauge of inflation, has been even more impressive. During the first half of 1994, it was running at a 2.9 percent rate. In the third quarter, it decelerated to 1.9 percent. For the fourth quarter, it came in at 1.6 percent. These are hardly signs of accelerating inflation. The signs seem to be of economic slowing. Those signs seem to be cropping up daily.

In summary, my concern is that the Fed is unnecessarily risking the jobs of working Americans, unnecessarily making the lives of families with adjustable rate mortgages and other similar borrowing situations more difficult.

In the past, when the Fed has raised interest rates this aggressively, the economy has frequently gone into recession soon thereafter.

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Mr. Chairman, I look forward to exploring these matters with Chairman Greenspan this morning.

Thank you.

The CHAIRMAN. Senator Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Mr. Chairman, Chairman Greenspan, today's hearing is important, I believe, for several reasons. Aside from another opportunity to query you, Mr. Chairman, on the intricacies of interest rates, rate hikes, and their effect on the economy which we're going to do.

Today's hearing provides a convenient, I believe, and timely forum to address some basic issues, like the necessarily independent role of the central bank in a free market economy, and the distinction between fiscal and monetary policy as effective means to foster economic growth.

I find today's hearing, Mr. Chairman, particularly timely in light of the recent Mexican peso crisis.

Just a few weeks ago, we gathered here in this room to shed light on what gave rise to the Mexican peso crisis and to learn more about what was necessary, if anything, to prevent further instability in both U.S. and international financial markets.

Although we did not have the opportunity to discuss either the then-pending proposal or the final deal cut between the United States and Mexico to prop up the peso, we did come, Mr. Chairman, to learn this—that critical to Mexico's plight was its lack of an independent central bank. We learned that despite early warnings of the need to devalue the peso and eventually, belated and forced devaluation of the peso, the Bank of Mexico was still printing money as late as December of last year.

We discovered, Mr. Chairman, that the Bank of Mexico had about as much independence from the Mexican political apparatus as the big toe on your foot does.

A tool for short-term political gain, the central bank facilitated the artificial illusion that Mexico was a model of economic success.

Ironically, Mr. Chairman, while at the same time we're demanding that Mexico depoliticize its central bank in exchange for our support, there are those who believe that we should subject the Fed right here to further political accountability, whatever that is. Efforts to force the Fed to be more responsive to short-term political soundings misapprehends the central purpose, I believe, and the function of a central bank in a free market economy.

Long-term price stability, a central goal of the Fed, is in congress with political cycles that inherently seek short-term economic gains. Indeed, forcing the Fed to offset poor fiscal policy proves a net loss in the long term.

Monetary policy, I believe, is a poor substitute for sound fiscal policies. Indeed, it is to fiscal policy that I believe we should look to achieve economic gains—in employment and job production, not monetary policy.

It is lower taxes, less regulation, and fewer mandates on the private sector that fuel the engine of productivity and add jobs to our economy. Maintaining low, accommodative interest rates to prop up the economy only facilitates volatility in our markets.

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If our fiscal policy reflected a more accommodative stance on taxes and regulation in the first place, monetary policy would not have to be used as a tool, Mr. Chairman, to artificially rev up our economy.

It seems to me that the focus of several previous hearings we've held in this Committee dealing with substantial losses on our financial markets only reinforce this point.

If controlling the economy for inflation were the Fed's sole focus, much of the volatility in interest rates we've seen would not have occurred, and I suspect that we could avoid the kind of substantial losses we've seen in our financial markets.

I appreciate you, Mr. Chairman, appearing before us today to discuss the state of the economy and the Fed's monetary policy objectives over the next 18 months and I look forward to hearing your testimony.

The CHAIRMAN. Senator Boxer.

OPENING STATEMENT OF SENATOR BOXER

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

I have no formal statement at this time. I would just like to state my concern about the repeated rate boosts on my State of California, and ask unanimous consent to place into the record an article. The headline is "Fed's Repeated Rate Boosts Hitting Home in California. Housing—Adjustable Note Payments Will Rise and the Ground Floor is Moving Away from First-Time Buyers."

My State is very interest-rate sensitive and I'm sure that, Mr. Greenspan, you know that. And I also admire what you try to do, which is to not let inflation get away from us.

But I still want to hear your point of view on that score and how this is impacting in my State.

I also am interested to know your feelings on the Mexican peso agreement, and I will have some further questions on that point.

The CHAIRMAN. Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you very much, Mr. Chairman. We appreciate you having this hearing.

Chairman Greenspan, it's a pleasure to welcome you, as always. We look forward to hearing your views on monetary policy and its impact on the economy, as well as the spirited debates that usually come along to follow it.

I would agree with the article already referred to written by my colleagues which reflects on the irrational economic theory embedded in the underlying legislation that assumes somehow central planning can dictate that monetary policy shall achieve full employment, zero inflation, and a balanced budget.

It's too bad they didn't think to include a chicken in every pot and a free lunch. It would have had as much economic sense.

As you know, recent economic data points to a slowing economy and growing international trade deficit.

In addition, even though the Fed has raised interest rates during the past year, the dollar continues to weaken. My own personal view is that weakness in the dollar and the economy reflect bad fiscal policy—too many taxes and too much regulation. And I would

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think that the Senate would be better off focusing on improving the fiscal atmosphere, while the Fed should be allowed to contain its focus to developing a sound monetary policy.

Chairman Greenspan, I'm increasingly concerned about the impact of Government regulation on our economy. The recent estimates have placed the annual cost of such Government regulation at between $400 billion and $600 billion a year.

We all know that regulations are necessary and we contemplate regulations being issued to carry out the dictates and the legislation we pass. And there are many regulations that obviously cannot be dispensed with.

Nevertheless, I think that some consideration of the impact that these regulations have on our economic growth and the ability to create good-paying jobs should be discussed.

Finally, as several of my colleagues have mentioned, with the Mexican bail-out underway, I think there will be a number of questions we need to discuss with you on the handling of that issue.

It's a pleasure as always to welcome you before the Committee and I look forward to your testimony and the sessions that will follow.

Thank you.

The CHAIRMAN. Senator Mack.

OPENING STATEMENT OF SENATOR MACK

Senator MACK. Thank you, Mr. Chairman. Welcome back, Chairman Greenspan.

In the past year, the Federal Reserve has increased the Federal funds rate 7 times, from 3 percent in February 1994, to the 6-percent level today.

This sharp rise in short-term interest rates has boosted borrowing costs, raised adjustable-rate mortgage payments, and created financial losses for many leveraged investment funds.

While it would be easy to blame the Fed for this, and many do, I do not think this is appropriate. In my view, the sharp rise in interest rates is the result of damaging fiscal policy supported by the Administration and the focus on multiple economic goals which the Humphrey-Hawkins Act forces upon the Fed.

Let me explain.

In 1993, the Clinton Administration signed into law a $250 billion tax increase which raised tax rates on middle-income Americans and small businesses. In addition, in 1993, the Clinton Administration oversaw the addition of a tremendous amount of regulation. The Federal Register, a list of all additions or proposed changes to Federal regulations, expanded to 70,712 pages. This was the highest total number of pages in the Federal Register since 1980, and the third highest total ever, and a jump of nearly 8,000 pages from 1992.

These increases in tax and regulatory burdens acted like a wet blanket on the recovery. As a result, even though the economy had officially come out of recession in May 1991, growth was moving ahead slowly. During 1992 and 1993, job creation was much lower than in past recoveries and the economy appeared to be stumbling.

Because the Humphrey-Hawkins legislation mandates the Fed be responsible for boosting employment, the Fed was forced to push

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interest rates down and hold them artificially low. The inflationary consequences of holding rates artificially low have now forced the Fed to respond by raising rates dramatically.

I understand your dilemma, Mr. Chairman. With commodity prices advancing, the dollar falling, capacity utilization to high levels, and the economy growing faster than expected, despite higher taxes and regulatory burdens, you must be concerned about potential inflationary pressures.

It is important that the U.S. economy avoid a boost in inflation that could drive up interest rates even further in the future. However, it is also important that we avoid stop-and-go, up-and-down monetary policy.

Volatility in interest rates and uncertainty in financial markets also inhibit the ability of our economy to expand and boost living standards.

Blaming the Fed for interest rate uncertainty is wrong. Bad fiscal policy, combined with an outdated piece of legislation called Humphrey-Hawkins are to blame.

I would hope that we could hear from you, Mr. Chairman, about how this legislation might make you follow policies in the short run that are detrimental to the economy in the long run.

The CHAIRMAN. I'd like to call upon co-author, Senator Bennett. [Laughter.]

OPENING STATEMENT OF SENATOR BENNETT

Senator BENNETT. Thank you. I'll make it clear, as my co-author has, that we did not write the headline that appeared in The Wall Street Journal.

[Laughter.]

Mr. Chairman, we welcome you here. I have just come back from Utah and the hustings, as they say. I promised one of my constituents who was taking your name-in-vain—he's a real estate developer—that I would pass this on to you because I think it is something that perhaps we ought to have discussed in this circumstance where we're talking about rising rates.

He said, "Does the Fed think that when they raise the interest rates, we automatically stop construction? Because, in fact, we keep building buildings, we simply charge more for them to cover the increased cost of the loans that we have to get, the construction loans. We can't go out of the construction business. We simply price our product to cover the cost and, as a result, we add to inflation rather than fight it when we have the rising interest rates."

I've now discharged my duty to my constituent, but I think that is a point that you might want to address.

I would also hope as we get into the question of the economy and the future, that we try to draw some lessons for the United States from the Mexican experience.

You said as you were at that table last time something about your favoring a gold standard or some tie of the dollar to gold. And I would hope that we can get into that further and see what that might have done if we had done it, with respect to the Mexican crisis and lessons we might learn here.

I find, talking to my constituents, most of them think that the U.S. abandoned any connection between gold and the dollar back

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in Franklin Roosevelt's time. They're always surprised to hear that we had a connection between gold and the dollar as late as 1971, and Richard Nixon's Administration.

So that's a dialogue you and I have had here before and I would hope we could touch on that again.

With that, Mr. Chairman, I'm looking forward to hearing what Chairman Greenspan has to tell us.

The CHAIRMAN. Chairman Greenspan, we welcome you and we're certainly interested in your statement.

Your entire statement will be put into the record as if read in its entirety.

Mr. Chairman.

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

Chairman GREENSPAN. Thank you very much, Mr. Chairman. I, as always, appreciate the opportunity to discuss the Federal Reserve's conduct of monetary policy.

As required by law, we have already delivered to the Congress our formal report detailing the performance of the economy and the implementation of policy. In my remarks this morning, I will summarize that discussion and expand further on some of the key factors bearing on monetary policy.

Nineteen ninety-four was a good year for the American economy. Economic growth quickened, with real gross domestic product expanding 4 percent over the 4 quarters of the year. We now have enjoyed over 3 years of relatively brisk advance in the Nation's output of goods and services, and this economic progress has been shared by many Americans. Payrolls swelled 3½ million last year, and the unemployment rate closed 1994 at 5½ percent, more than a percentage point below its level 1 year ago.

The data that have been published in the first weeks of 1995 have offered some indications that the expansion may finally be slowing from its torrid and unsustainable pace of late 1994.

While hours of work lengthened in January, employment growth slowed from its average of recent quarters and the unemployment rate rose. Moreover, recent readings on retail sales suggest a more moderate rate of increase, and housing activity has shown some softness. Nonetheless, the economy has continued to grow, without seeming to develop the types of imbalances that in the past have undermined ongoing expansion.

Of crucial importance to the sustainability of the gains over the last few years, they have been achieved without a deterioration in the overall inflation rate. Inflation at the retail level, as measured by the CPI, has been a bit less than 3 percent for 3 years running now—the first time that has occurred since the early 1960's. This is a signal accomplishment, for it marks a move toward a more stable economic environment in which households, businesses, and governmental units can plan with greater confidence and operate with greater efficiency.

As I have stated many times in congressional testimony, I believe firmly that a key ingredient in achieving the highest possible levels of productivity, real incomes, and living standards is the achievement of price stability. Thus, I see it as crucial that we extend the

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period of low inflation, hopefully returning it to a downward trend in the years ahead. The prospects in this regard are fundamentally good, but there are reasons for some concern, at least with respect to the nearer term. These concerns relate primarily to the fact that resource utilization rates have already risen to high levels by recent historical standards.

Clearly, one factor in judging the inflationary risks in the economy is the potential for expansion of our productive capacity. If so-called "potential GDP" is growing rapidly, actual output can also continue to grow rapidly without intensifying pressures on resources. In this regard, many commentators, myself included, have remarked that there might well be something of a more-than-cyclical character to the evident improvement of America's competitive capabilities in recent years. But it is still too soon to judge whether the improvement is a few tenths of a percentage point annually, or even more.

It is fair to note, however, that the fact that labor and factory utilization rates have risen as much as they have in the past year or so does argue that the rate of increase in potential is appreciably below the 4-percent growth rate of 1994.

Knowing in advance our true growth potential obviously would be useful in setting policy, because history tells us that economies that strain labor force and capital stock limits tend to engender inflation instabilities that undermine growth. It is true, however, that, in modern economies, output levels may not be so rigidly constrained in the short-run as they used to be. It is possible for the economy to exceed so-called "potential" for a time without adverse consequences by extending work hours, by deferring maintenance, and by forgoing longer-term improvements. Moreover, as world trade expands, access to foreign sources of supply augments, to a degree, the flexibility of domestic productive facilities for goods and some services.

Aggregative indicators, such as the unemployment rate and capacity utilization, may be suggestive of emerging inflation and asset price instabilities. But they cannot be determinative. Policymakers must monitor developments on an ongoing basis to gauge when economic potential actually is beginning to become strained—irrespective of where current unemployment rates or capacity utilization rates may lie.

If we are endeavoring to fend off instability before it becomes debilitating to economic growth, direct evidence of the emerging process is essential.

In this context, aggregate measures of pressure in labor and product markets do seem to be validated by finer statistical and anecdotal indications of tensions. In the manufacturing sector, for example, purchasing managers have been reporting slower supplier deliveries and increasing shortages of materials. Indeed, firms appear to have been building their inventories of materials in recent months so as to ensure that they will have adequate supplies on hand to meet their production schedules. These pressures have been mirrored in a sharp rise over the past year in the prices of raw materials and intermediate components.

There are increasing reports that firms are considering marking up the prices of final goods to offset those increased costs. In that

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regard, January's core CPI posted its largest gain since October 1992, perhaps sounding a cautionary note. In the labor market, anecdotal reports of "shortages" of workers have become more common.

However, an ongoing inflation process would be expected to involve a different expectational climate than seems to prevail today. Despite the marked improvement in consumer confidence overall, the survey readings on consumers' views of whether jobs are easy to get fall far short of the previous cyclical peak in 1989. Moreover, there is some evidence that the number of people voluntarily leaving their jobs is subnormal currently. This suggests that deep-seated job insecurity has not fully dissipated despite strong job growth recently.

Some analysts attribute this phenomenon to workers' concerns about losing health insurance and, for some, pension coverage if they change jobs. Whatever the cause, the lingering sense of insecurity doubtless has been a factor damping wage growth and overall labor costs. Since the latter, on a consolidated basis, accounts for roughly two-thirds of overall costs in our economy, slower wage growth combined with strong cyclical productivity growth has restrained increases in unit labor costs and hence, in prices of final goods and services.

However, as overall output growth of necessity slows in an environment of high resource utilization, so will cyclical productivity growth. Moreover, if labor market tightness assuages job insecurity, pressures to raise wages might well intensify and unit labor costs could accelerate. In the later stages of previous business cycles, declines in profit margins absorbed some of the increases in unit labor cost, but some were passed through into final goods prices and inflation picked up.

Thus far in the current cycle, price increases have been muted, not only by subdued unit labor costs, but also by a prevailing concern among firms that, despite capacity pressures, enough slack remains in the system to foster competitive inroads on those who try to price above the market.

But this form of discipline may also become less effective if pressures on resources persist. Consequently, it may be that these pressures will lead to some deterioration in the price picture in the near term; but any such deterioration should be contained if the Federal Reserve remains vigilant.

It was to preserve and to extend the gains associated with low and declining inflation—and to avoid the instabilities and imbalances attendant to rising inflation—that we began the process of tightening 1 year ago. Our view at that time was that the accommodative policy stance we had adopted in earlier years to contain the effects of financial strains on borrowers and lenders was no longer appropriate once their balance sheets had been greatly strengthened.

In these changed circumstances, absent policy action, pressures on capital and labor resources could build to the point where imbalances would emerge and costs and prices would begin to accelerate, jeopardizing the durability of the current expansion. In the event, the strength in demand and the potential for intensification of

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pressures on prices were even more substantial than envisioned when we started down the road.

As we thought might be possible at this time last year, a significant upturn in inventory investment induced a stronger economy than was generally anticipated. Additional strains on capacity became increasingly evident in higher prices at early stages of production processes.

Moreover, in financial markets, the effects of the policy firmings were muted to an extent by an easing of terms and conditions on bank loans and by a drop in the foreign exchange value of the dollar. In these circumstances, the Federal Reserve needed to take further steps to head off potential instabilities that would threaten the economic expansion.

Our conduct of policy in 1994, as it will be in 1995, was against the background of a rapidly expanding global financial system. Events of the past 2 months have taught us once again that the global nature of trade in goods, services, and financial instruments exerts an exacting discipline on the behavior of central banks. Technology has defeated distance by slashing the costs of gathering information and of transacting. Advances in computing and financial engineering during the past 10 or 15 years have enabled investors and speculators to choose among a wide array of investment instruments, allowing them to manage risks better and, when they chose, to exert their notions about future market movements forcefully through the use of leverage. The former, improved risk management, has done much to make markets more resilient, while the latter, easier recourse to leverage, may add to the volatility of financial prices at times.

These developments have freed up the flow of international capital, thus potentially improving the efficiency of the allocation of the world's resources and raising world living standards. They have also permitted markets to respond more quickly and with greater force to a country's macroeconomic policies. This puts a special burden on the Federal Reserve, because the U.S. dollar is effectively the key reserve currency of the world trading system. In that role, we enjoy an increased demand for our financial instruments. However, this role also heightens the share of the demand for dollar assets that is related to more volatile portfolio motives.

The new world of financial trading can punish policy misalignments with amazing alacrity. This is a lesson repeated time and again, taught most recently by the breakdown of the European Exchange Rate Mechanism in 1992, and the plunge in the exchange value of the peso over the past 2 months. In the process of pursuing their domestic objectives, central banks cannot be indifferent to the signals coming from international financial markets. Although markets can be harsh teachers at times, the constraints that they impose discipline our policy choices and remind us every day of our longer-run responsibilities.

Looking ahead to the prospects for the U.S. economy, we must remember that the Nation has entered 1995 with its resources stretched. We do not now have the substantial unused capacity that made possible the especially favorable macroeconomic outcomes of 1993 and 1994—rapid real growth and stable or declining inflation. As a result, the likely performance of the economy in

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1995 almost surely will pale in comparison with that of the previous 2 years. The growth in output arguably must slow to a more sustainable pace and resource utilization settle in at its long-run potential to avoid inflationary instabilities. Inflation, itself, is unlikely to moderate further and may even tick up temporarily. But overall, the performance of the economy still should be good. We expect growth to continue and inflation to be contained.

The Federal Reserve for its part will be attempting to foster financial conditions that will extend that good performance through 1995 and beyond. Our policy actions will depend on an ongoing assessment of a number of forces acting on the economy. One is the effects on spending of the rise in interest rates that have occurred over the past year. These effects are difficult to pinpoint with any precision, because they occur with a lag and have a diffuse influence on the behavior of households and firms throughout the economy. Data rarely point in one direction, and the available information on spending fits this rule. As yet, the performance of the economy suggests a slowing in interest-sensitive spending, but mostly concentrated in housing activity.

Our reading of the historical record is that the cumulative effect of higher interest rates should lead to a significant deceleration in spending. But, to date, the jury remains out on whether the slowing that is in train will be sufficient to contain inflation pressures.

That judgment also rests importantly on a reading of business cycle developments more generally—cycles which often relate to the interaction of physical stocks and flows. These dynamics are most clearly seen in inventory investment, which has always been an important swing factor in the post-World War II era. In 1994, the increase in inventory investment in real terms added almost 1 percentage point to GDP growth. It appears most unlikely that business people will wish to build their stocks at the pace they did in 1994. But whether their actions with respect to inventories will turn that plus for growth last year into a significant minus in 1995 remains to be seen. However, incoming information does not suggest that a substantial inventory correction is imminent.

Similar stock-flow interactions should be at work in spending for consumer durables. Large increases in real outlays for consumer durables over the past 3 years, partly financed in recent quarters by unsustainably rapid growth in the volume of credit, may well have exhausted most of the pent-up demand that had accumulated when the economy was sluggish in the early 1990's.

In another area, actions of this Congress regarding the Federal budget deficit will have important consequences for the economic outlook. A credible program of fiscal restraint that moves the Government's finances to a sounder footing almost surely will find a favorable reception in financial markets. That market reaction, by itself, should serve as a source of stimulus that would help to offset in whole or in part the drag on spending that otherwise would be associated with reductions in Federal outlays and transfers over time.

It is also important to remember that a larger issue is at stake during these deliberations on the Federal budget. Too much of the small pool of national savings goes toward funding the Government, to the detriment of capital formation. By trimming the defi-

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cit, those resources will likely be put to more productive uses, leading to benefits in the form of improved living standards.

I and my colleagues appreciate the time and the attention that the Members of this Committee devote to oversight of monetary policy. Our shared goal—the largest possible advance in living standards in the United States over time—can be best achieved if our actions ultimately allow concerns about the variability of the purchasing power of money to recede into the background. Price stability enables households and firms to have the greatest freedom possible to do what they do best—to produce, invest, and consume efficiently.

But the best path to that long-run goal is not now, and probably never will be, obvious. Policy-making is an uncertain enterprise. Monetary policy actions work slowly and incrementally by affecting the decisions of millions of households and businesses. And we adjust policy step-by-step as new information becomes available on the effects of previous actions and on the economic background against which policy will be operating. No individual step is ever likely to be decisive in pushing the economy or prices one way or another—there is no monetary policy "straw that broke the camel's back." The cumulative effects of many policy actions may be substantial, but the historical record suggests that any given change in rates will have about the same effect as a previous change of the same size.

Because the effects of monetary policy are felt only slowly and with a lag, policy will have a better chance of contributing to meeting the Nation's macroeconomic objectives if we look forward as we act—however indistinct our view of the road ahead. Thus, over the past year, we have firmed policy to head off inflation pressures not yet evident in the data.

Similarly, there may come a time when we hold our policy stance unchanged, or even ease, despite adverse price data, should we see signs that underlying forces are acting ultimately to reduce inflation pressures. Events will rarely unfold exactly as we foresee them, and we need to be flexible—to be willing to adjust our stance as the weight of new information suggests it is no longer appropriate. That flexibility, Mr. Chairman, applies to the particular stance of policy—not its objectives. We vary short-term interest rates in order to further the goals set for us in the Federal Reserve Act, namely, promoting over time, as it states in the Act, "maximum employment, stable prices, and moderate long-term interest rates."

Achieving those goals has become increasingly more complex in the nearly two decades since they were put into the Federal Reserve Act, as a consequence of technology-driven changes in financial markets in the United States and around the world.

Suppressing inflationary instabilities—a necessary condition for achieving our shared goals—requires not only containing prevalent price pressures, but also diffusing unsustainable asset price perturbations before they become systemic. These are formidable challenges, which will confront policy—both fiscal and monetary—in the years ahead. It is, of course, unrealistic to assume that we can eliminate the business cycle, human nature being what it is. But

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containing inflation and thereby damping economic fluctuations is a reasonable goal.

We at the Federal Reserve look forward to working with the Administration and Congress in meeting our common challenges.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Greenspan.

Mr. Chairman, before I go to Senator Shelby, I'm just going to read two sentences. I'm not even going to ask you to comment because I think they're so poignant.

Page 13, you say: Too much of the small pool of national savings goes toward funding the Government, to the detriment of capital formation. By trimming the deficit, those resources will likely be put to more productive uses, leading to benefits in the form of improved living standards, and obviously, lower interest rates.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman Greenspan, you've talked about lower deficits for a long time. Would lower deficits be one of the best tools to foster growth in the economy and facilitate low unemployment?

Chairman GREENSPAN. It would, Senator, but I would emphasize that it is important in the current context that those deficit reductions occur wholly or almost wholly, if at all possible, from the expenditure side.

Senator SHELBY. How important are fewer regulations on the private sector, since they run up the cost of business in this country?

Chairman GREENSPAN. Senator, since I've been involved in Government, which goes back to the mid-1970's, there's one issue about regulation which I find most disturbing. It's that we tend to have various different types of abnormalities in the economy and we respond with a series of regulations to make certain that that event does not occur in the same way again. And the problem with doing that is not so much that it is inappropriate, but it is inappropriate not to, after a series of years, take a relook at that regulation and find whether in fact it was necessary or whether in fact it did what it was supposed to do.

I've become increasingly of the view that we ought to sunset all regulations. That would force us to relook at them and make certain that their original purposes were being carried out, rather than, as too often is the case, letting them remain on the books and create huge amounts of costs and tremendous amounts of paperwork to the dubious benefit of consumers or the American populace as a whole.

Senator SHELBY. Thank you on that issue. I'm going to shift over to the Mexican problem.

Is the deal that has been brought forth, the second proposal which is being implemented, as I understand, that you played a central role in, is that a better deal than the first proposal for the American taxpayers? And if so, why?

Chairman GREENSPAN. It's very difficult to judge. As I said in my prepared testimony before this Committee, I think that the types of actions that were contemplated in the first deal, or in Plan B, both are the least worst alternatives of those types of solutions confronting us.

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It is certainly the case that the details that are involved with respect to oil revenues is clearly a more sensible approach to getting at the issue of how to assure payment, and obviously, the aggregate size of the American commitment is significantly less than in the earlier version, the difference being largely supplemented by the IMF and other countries.

So in the strict sense, is there less risk to the American taxpayer—probably in a mechanical sense. But judging by the assured means of payment that has been constructed, indeed, in both versions, I always thought that the problem of risk to the American taxpayer was never the really important question with respect to these types of actions.

There was, as I indicated in earlier testimony, the whole question of what types of perverse incentives that Government guarantees create, what we economists call moral hazards that are involved in various different types of activities.

In that regard, it is still a problem. But I must say, as I said earlier, I see little alternative to moving in the direction that we are moving.

Senator SHELBY. Mr. Chairman, will we have to go back to the well again, or do you believe this will be sufficient for the bail-out of the Mexican economy? Or is that something that you don't want to judge today?

Chairman GREENSPAN. No. I think I can address that question.

Senator SHELBY. OK.

Chairman GREENSPAN. This type of operation either works or it doesn't work. My own view is that it will work. The presumption that you would add to this program indefinitely strikes me as not the appropriate response to the type of issue that is involved here.

Remember that what is crucial to this whole issue is that the Mexican government implement effective policies and that if they do, this issue will be resolved.

The purpose of the various financial programs here is to facilitate that. It is not a substitute and clearly, if it is not being perceived as working, the basic problem is the fundamental policies which are not being either implemented or working the way the Mexican government contemplates that they will work.

Senator SHELBY. Basically, it will be up to the Mexican government on their end to make sure it works. If they don't follow through, then we've really got a problem on our hands.

They would have a much larger problem, wouldn't they?

Chairman GREENSPAN. I think they fully understand that. The Mexican government is acutely aware of the nature of all of this and, from what I can judge from the remarks that I've heard, they are fully committed to taking what actions are required to return them to what was really an extraordinarily positive economic trend just a couple of years ago.

They have far more at stake than anyone and they are aware of that and their commitments, as best I can judge, are pretty solid.

Senator SHELBY. Mr. Chairman, thanks for yielding me your time.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Chairman Greenspan, I'd like to address this point of resource utilization which was reflected in the Fed's state-

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ment on February 1, 1995, when they took the rates up yet again for the seventh time, and also as reflected in your statement here today, as a premise for justifying the rise in rates.

There's an article that appeared in The Wall Street Journal just a week after the Fed tightened, when the Fed cited rising resource utilization. This article is titled, "Capacity Utilization Is Losing Credibility. Economists Say Data Don't Reflect Real Conditions."

The first paragraph says:

> No economic indicator gets more attention these days and deserves it less than capacity utilization, say a growing number of manufacturers and economists. It is one of the many economic indicators that the Federal Reserve uses to measure the economy's strength and to decide when and if to raise interest rates.

It then goes on to talk about the benchmarks that the Fed uses and this linkage, supposedly, between high-capacity utilization and the implication that there is coming inflation.

Now, there was some sharp criticism in that article, both by economists and by manufacturers. The president of Hartmarx, the clothing maker, said:

> You can't look upon capacity utilization unto itself any more. We're in a global market where plenty of people are willing to sell at lower prices.
>
> Despite the strong demand and the higher cost of wool and cotton, even Hartmarx's best-selling suits are up only 3.5 percent in price from a year ago. Yet, the company has been running its factories full out, at more than 95 percent of capacity for some time.

The auto people make the same point in the course of this article. The chief economist of Chrysler says that:

> The auto industry also has hidden capacity that allows it to pass through the thresholds that in the past would have sent car prices flying. Asked about the Federal Reserve's capacity-utilization number of 90.7 percent for the auto industry, he responds, "How do I put this nicely? It is misleading."

Not counted in the capacity data, he notes, is the potential for the industry to go to a third shift, import vehicles from foreign plants, or to eliminate traditional bottlenecks.

What's your response to all this criticism?

Chairman GREENSPAN. Senator, I thought I responded in my prepared remarks which I just delivered with respect to that question.

Senator SARBANES. Well, why don't you take me back, then, Mr. Chairman, to the relevant page, because I'd like to see, I'm very anxious to address it. Where would you reference me to?

Chairman GREENSPAN. I don't know where it is in the version you have, but why don't I just go through it and not worry about the specifics. I'll just repeat what I've said earlier.

But let me go a little further. The argument is that the factory capacity-utilization figures have a different significance from what they used to have many years ago.

Many years ago, as I recall the data, we were dealing to a large extent with a significant number of industries which were like the old open-hearth furnace operations, where you could create a rated capacity and unless you were willing to defer maintenance, you couldn't get any really effective, sustained activity in that furnace over the rated capacity. Indeed, back in those days, those data really represented, to a large extent, the degree of stress that existed within the basic system.

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The way the Federal Reserve effectively creates those data is to work on data from the Bureau of the Census, which circulates a survey among all manufacturers on how many shifts they run, how many hours they work, what their expected rates of operation are and what their current rates are. And indeed, the numbers that we evolve out of that system come from questionnaires from the companies themselves.

Senator SARBANES. Which lag badly, as I understand it.

Chairman GREENSPAN. They do.

Senator SARBANES. According to this article, you're now working with census data from 1992.

Chairman GREENSPAN. I agree with that. That is correct. But the problem, basically, is that we don't find that when we get the actual data that there are procedures which are implied that cause very radical changes. It's extremely unlikely that the types of changes we're going to see when we get the 1994 data will be revised sufficiently in a way that will create a material difference.

The reason I say that is because there's a much more important issue which has got nothing to do with the question of whether or not a particular operating rate is putting a particular set of concerns under pressure.

But we do have the results of stress; namely, indications that deliveries are lagging. The only reason that deliveries lag over an extended period of time is that the producing facilities are under stress. And in one sense, those data are far more relevant to a measure of how the system is effectively working than the statistical constructs which we at the Federal Reserve produce.

As I indicated in my prepared remarks, my own judgment is that there is no rigid ceiling either in any specific industry, with rare exceptions, or in the economy as a whole. It is basically a system in which one can view it as having a flexible ceiling which, the further you push into it, the more difficult it is to go further.

The evidence very clearly indicates that as we move into that zone, you begin to see shortages of materials crop up, as indeed, purchasing manager reports indicate. You see slow deliveries. You see the average work week rise. You see all of the indications that the system is under stress.

Senator SARBANES. Yes. But those indications may not, under current circumstances, result in price increases.

I see my time is up. Let me quote this article:

> In the intensely competitive computer industry, where there's a 91.2 percent utilization rate, prices late last year were actually down 9 percent from a year earlier.

Chairman GREENSPAN. Sure. I'm saying that it's only in the aggregate sense when one looks at the total system over history, that one sees significant inflationary pressures building when overall constraints are becoming evident.

There are numbers of different industries, and I think computers is clearly the most important case, where the technology is changing so rapidly, that prices are falling. The only question is the rate at which they are falling, not whether they are falling or rising.

I don't disagree with the statement that's made there.

The CHAIRMAN. Senator Bond.

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

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After listening to your statement and reading your prepared testimony, Mr. Chairman, I gather that a story I read last week, again in The Wall Street Journal, which was headlined, "Fed Nears Inflation Victory But Must Be Ready to Block Recession," probably does not accurately reflect your position at this point.

Are we ready to declare victory against recession, victory against inflation, and focus now solely on avoiding recession?

Chairman GREENSPAN. Senator, regrettably, monetary policy never ends. It's like a luggage carousel in the airports, where you never know where the end is and you phase in from one policy into another.

You rarely get to a point where you say, bang, that's it, we succeeded, or we didn't succeed, because the truth of the matter is you really don't know with any degree of certainty, except in retrospect. And in that regard, I think that we will not know with any assurance as to the efficacy of the policies we've been taking for the last couple of years, probably for another year or so, as we look back in time.

I wish it were otherwise, but that's the way it is. If it does turn out that we were highly successful, we will be off in a different environment. No one will remember. And it won't matter.

[Laughter.]

Senator BOND. Thank you. That's perfectly clear in my mind now.

[Laughter.]

Let me turn to another question.

I gather we recently posted a $108 billion trade deficit. Given the economic woes of two of our very large trading partners, Mexico and Canada, is this a concern? What should we be doing about it? How serious a problem do you see this?

Chairman GREENSPAN. I view the longer-term issue of the trade deficit as fundamentally the problem which we were discussing earlier and which the Chairman alluded to—namely, the problem of the inadequacy of domestic saving. Because to the extent that our very modest amount of private saving is pre-empted by negative Federal Government saving, we have rather small amounts of domestic saving to finance domestic investment.

By accounting definitions, the difference between domestic investment and domestic saving is our current account deficit, of which, you know, the trade deficit is by far the biggest item.

It is certainly the case that there are cyclical fluctuations which exist in our trade deficit, which reflect the state of the economy. But, over the longer run, what we should be concerned about is this shortfall of domestic saving. And since it does not appear likely that we can materially augment private saving by any means that we are aware of easily, the easiest way that we have from a policy point of view to augment total domestic saving, which includes private and Government, is to reduce the negative saving that is involved in our Federal Government budget deficit.

Senator BOND. And that is by reducing expenditures. Did I hear you correctly?

Chairman GREENSPAN. That is correct, Senator.

Senator BOND. I am confused about one part of the arrangements we've made with Mexico.

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As I understand it, the Exchange Stabilization Fund was originally set up to stabilize the dollar, to use if our dollar became very weak. And yet, we have committed a majority of the ESF's to Mexico, a $20-billion package. Some are saying, as long as a 10-year span.

Now, at the same time, the dollar has fallen to a 3-month low against the yen and a 28-month low against the German mark.

Do we really need an Exchange Stabilization Fund for our dollar? If not, why do we have it? If so, are we putting ourselves at risk by the resources that we have provided Mexico?

Chairman GREENSPAN. Senator, in trying to evaluate the so-called Plan B, one of the issues that was involved was clearly the question you raise.

We have very substantial resources to intervene on behalf of the American dollar in terms of both Deutsche mark and yen, the critical currencies which we hold. That is not materially affected in any important sense by any of the initiatives that are going forth with respect to Mexico.

Senator BOND. So maybe we don't need an Exchange Stabilization Fund, or at least not for the U.S. dollar.

Chairman GREENSPAN. No, I think we do. What I am saying is that the mechanisms that will be employed will not involve our effectively selling off our very substantial holdings both at the ESF and the Federal Reserve of Deutsche marks and yen. And so long as we have those resources our capability to intervene when and if we see fit to do so, is unimpaired.

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

The CHAIRMAN. Senator Boxer.

Senator BOXER. Thank you, Mr. Chairman.

Mr. Greenspan, do you agree with this comment of your Vice Chairman, Alan Blinder, who said—when you embark—this is a column you probably saw in The Journal.

He said, "The Fed was correct to launch its pre-emptive attack on inflation last February," but added pointedly that "When you embark on a course like that, you should know when to stop and be prepared to make a pre-emptive strike against recession as well."

Do you agree with that comment?

Chairman GREENSPAN. Well, I didn't use as colorful language as he did, but I have made similar types of remarks.

If we are dealing with a situation in which, in our judgment, monetary policy has long and variable lead times, then obviously, the point at which we perceive it is necessary to stop, has got to be well in advance of when the impacts that we see are beginning to take hold.

Senator BOXER. Yes.

Chairman GREENSPAN. So we are always looking into the future and not merely reacting to how events are occurring concurrently because that's the result of past policy.

Senator BOXER. Right. Having been a stockbroker a long time ago, I know that when I first started, I realized the market of course was responding to the future.

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If you had good earnings, the stock went down when it was announced because they're looking ahead to what the next earning's going to be.

Well, it's interesting because Mr. Blinder says, if you wait to see the whites of their eyes, you've waited too long, meaning the recession.

So I think that is colorful language.

Chairman GREENSPAN. Yes. But let me just say, Senator, that as we view the economy, while it is very clear that there are signs of slowing from the torrid pace of the fourth quarter, we do not see the imbalances which we usually see which is a precursor of an actual recession.

There is nothing in the data at this stage which would lead to that conclusion.

I don't think that our Vice Chairman is saying that. One of the problems I always have in reading articles when somebody is obviously talking extemporaneously is you're filtering the insights through a reporter, which sometimes is not perfect.

Senator BOXER. Well, I think sometimes when you speak extemporaneously——

Chairman GREENSPAN. Sorry, everybody.

[Laughter.]

Senator BOXER. I think sometimes when you speak extemporaneously, you're apt to say what you really believe.

That's my experience. But, then, again, I agree with you sometimes. It could be misread. But he basically said that the full impact of the interest rates are yet to come.

I just think it's interesting. I think it's important that that conversation take place around your table, and I feel that it must be.

Now on the Humphrey-Hawkins issue, I compliment my colleagues on writing a very interesting article. I don't want to summarize it because they make their points very well.

But they talk about the fact that the Humphrey-Hawkins Act was introduced in 1974 by a Republican and a Democrat, and they basically call it laughable, pernicious folly of liberals.

That's how they have summarized the Act.

Now I want to ask you this. I agree that it really is difficult to have an economy where you have low inflation and good job growth. But isn't that exactly what we're seeing now for the first time in a long time.

As I understand the numbers, we have a 5.7 percent unemployment rate and a 2.7 percent inflation rate.

I guess what I need to ask you is, therefore, not to comment on the legislation itself because all legislation should be looked at and updated, et cetera. But the basic premise that they are putting forward that you can't really, or you shouldn't really as a Government have these goals for balanced growth. Namely, the low inflation and a good employment rate.

I believe that those are difficult but important goals of Government. Do you see them as being totally contradictory and not something that we ought to concern ourselves with as policymakers?

Chairman GREENSPAN. Senator, I would say that there were considerable views at the time that the legislation was enacted that there was an element of contradictoriness in those goals. The eco-

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nomics profession has I think changed its views and become increasingly aware of the fact that low inflation has some very important positive elements toward the maintaining of long-term employment stability. And in that regard, we have been drifting, if I may put it that way, toward a view that price stability has some very positive macroeconomic implications.

What your colleagues are saying, as I read them, is that they want to continue to move in that direction and to, without necessarily getting involved in the specifics, as I understand Senator Mack, the Chairman of the Joint Economic Committee, has said he is contemplating trying to change the statutory structure which effectively embodies what changes have been occurring.

I hate to speak for him. He's here.

Senator BOXER. No, well, I wasn't asking you. I was asking your opinion and you didn't give it to me. I see that the red light is on, but let me just put my opinion out there, which should be a great shock to my colleagues.

That I do believe it is entirely appropriate for policymakers to keep our eye on jobs in our society, as well as the inflation rate and the whole notion of balanced growth. Not to manage it all. You can't, and you shouldn't. But having those goals in place I think give guidance to all of us and we keep our eye on the ball.

Thank you, Mr. Chairman.

The CHAIRMAN. I'd like to call upon the Chairman of the Joint Economic Committee, Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

Let me just pick up on that point, if I could. The whole discussion about Humphrey-Hawkins has to do with employment and jobs.

The question is how do you enhance job growth? How do you reduce unemployment most significantly? And that is to follow policies of price stability, in my opinion, over the long term. That's what in fact is going to allow us as a Nation and a society to be able to enhance the opportunities of our constituents.

I posed a question back on December 7, at a Joint Economic Committee. But I think it's important to ask it again today in the context of this hearing. Do you believe that the Humphrey-Hawkins legislation forces the Federal Reserve to follow policies in the short run that could be damaging to the economy in the long run?

Chairman GREENSPAN. I've thought about that a great deal, Senator, and I think that there's no question that the statute as it currently stands requires that we have an important emphasis on employment.

It used to be conceived of as a trade-off between employment and inflation. And to the extent that we would look toward maintaining employment levels that were there even though inflation was accelerating, my own view is that the employment levels which might appear good in the short run would not be sustained and that the onset of inflation would create a significant undercutting of long-term employment growth.

My own view and this is something that I've testified to on several different occasions, not only before this Committee, but others, is that even though the academic evidence is at this stage not wholly in one camp—there are still disputes going on—there is no

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question that there's been a very dramatic shift over the years toward a general awareness of the importance of price stability to sustain employment growth over the long term.

My own judgment is that to specify more clearly in the Federal Reserve Act that the long-term goal of the central bank is price stability as a mean of engendering macroeconomic stability and sustainable economic growth, is a minor set of word changes in what the Federal Reserve Act currently states, but in my judgment, something that would be helpful because we do and must endeavor as a group, not only the Federal Reserve Board, but the Federal Open Market Committee, to make our recommendations in the context of what the Federal Reserve Act stipulates.

Senator MACK. Well, that leads into my second question, which is a little bit more specific. Does forcing the Fed to focus on multiple policy objectives end up creating more inflation and higher interest rates than if the Fed were focused solely on price-level stability?

Chairman GREENSPAN. Senator, I think it did years ago. However, the Federal Reserve in the last 15 years or so, after the extraordinary experience that we had with inflation and its impact on the economy, has chosen to interpret the existing Act somewhat in the direction which you are indicating.

Even though the Act is written in sort of a vague manner which allows us to do that, I think it would be appropriate to clarify those issues to the extent that they are clarifiable, because, obviously, if we are given goals which are mutually exclusive, then it is an impossible choice.

To try to balance or get some golden mean between mutually exclusive goals has the same problem associated with it.

When the Humphrey-Hawkins Act was originally promulgated, my interpretation then was that there was a problem. Because of de facto policy interpretations of what the Act enables the central bank to do, it hasn't created a big problem for us. But there's no doubt that if you list the whole series of objectives without stating what your priorities are, it creates problems for an agency such as ourselves.

Senator MACK. A few more questions. Does complying with Humphrey-Hawkins create a less stable economy and more volatile financial markets? Do business cycles caused by volatile monetary policy harm long-term economic growth? And how would revamping Humphrey-Hawkins help alleviate cycles in the economy?

Chairman GREENSPAN. Senator, I said in my prepared remarks that it's naive to believe that monetary policy or, indeed, any governmental policies, can somehow eliminate the business cycle.

The business cycle is essentially a function of human nature. It's not something which we're about to repeal or change in any material way. The best we can do is to try to mitigate the cycles.

If we behave inappropriately, as I think many economists argued was the case of the Federal Reserve in years past, as indeed they still argue, you can actually exacerbate the business cycle.

If we had a central focus in which the purpose of the central bank was long-term price stability, I think that the numbers of mistakes that would result from trying to be excessively involved in trying to move against various different goals and the prob-

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abilities of instabilities that occur as a consequence of that, in my judgment, would be reduced.

Senator MACK. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Faircloth.

OPENING COMMENTS OF SENATOR FAIRCLOTH

Senator FAIRCLOTH. Thank you, Mr. Chairman, for being with us. I appreciate the number of testimonies and hearings you've been before lately and I know you might be exhausted with them.

I have a question that's very brief and it might not sound very pertinent, but I think it's really the question.

In the last several years, our trade deficit has been growing at 100 percent. $30 billion, $74 billion, $114 billion. If I'm figuring right, that's about 100 percent growth.

The President came up with an i.e., budget—I think that's a euphemism—but the national debt will grow by $1.1 trillion from 1995 to the year 2000. Now that's a 33-percent increase in the debt.

In your opinion, in years, how long before we are going to have to have a bail-out? This is what brought on the Mexican thing, domestic spending out of control. In honest years, how long before we're going to have to have a bail-out? There's every indication we aren't going to do anything about this. For 35 years, we haven't.

Chairman GREENSPAN. Senator, I hope you're mistaken on that. I seriously do hope you're mistaken that we will not do anything about this.

Senator FAIRCLOTH. Well, we haven't. I hope we do.

Chairman GREENSPAN. That is a factually correct statement. I just hope your forecast is mistaken, as I'm sure you do.

Senator FAIRCLOTH. I hope and pray we do something about it. But we haven't. Our record isn't good.

Chairman GREENSPAN. Yes. As I've argued before this Committee, and before you, Senator, on many occasions, we are not acutely aware or as aware as we should be about what the existing structure of policies project us to in the 21st century.

I thought that the Kerrey-Danforth Entitlement Commission made some extraordinarily important points in stating that there are, within a fairly narrow degree of probabilities, some very severe fiscal problems.

It's not even an issue of getting total Federal debt down. It's a question of whether it accelerates, as indeed it would, under the projections as we move beyond, say, 2120.

The probabilities of some extraneous event as yet unforecast occurring which will so alter that outlook that no action is required, approaches the remote.

Even if there is one chance in 100 that something beneficent could occur and alter the path, we still ought to adjust now to prevent those extraordinary events from happening. And if by some benevolence, our economic growth accelerates quite significantly, we always have the capability of putting back various different programs which were altered because of fiscal problems. We can do that 20 years from now, or whenever it becomes evident that is in fact the case.

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There has never been a problem to my knowledge of Administrations and Congresses putting in new entitlement programs. The issue has always been the other way, and I think we ought to recognize that and essentially respond to those data which I find very distressing that appear in the Kerrey-Danforth Commission.

Senator FAIRCLOTH. In other words, if we somehow strike a windfall, you don't think we'll have any problem getting the votes to reinstitute give-away programs.

Chairman GREENSPAN. No, sir.

[Laughter.]

Senator FAIRCLOTH. Would you advise this Congress to pass the Balanced Budget Amendment and to do it quickly?

Chairman GREENSPAN. Senator, over the years, I've always argued, and haven't changed my view, that there is a significant expenditure bias in our fiscal system, and that the appropriate way, in my judgment, through the Constitution, to handle that is to have an amendment which requires super majorities for appropriations, authorizations, and outlays. That is enforceable immediately by the fact that the Congress, if it fails to get, say, a 60-percent vote on an expenditure bill, then it doesn't happen. So it's enforceable.

My main concern about constitutional amendments on balancing the budget lies in the area of enforcement and where the very considerable difficulties would exist of how we would enforce that in the event that the budget did not come under the constitutionally-required statutes.

I feel quite uncomfortable with that issue, not to mention the issue that writing fiscal policy into the Constitution does bother me because that's something which should basically be in place 50 or 100 years from now.

Nonetheless, I do fully understand the frustrations that people in the Congress and in this Committee feel with respect to that issue and I understand why there is this extraordinary set of pressures to do something because I think the motives are the correct motives, that we have not succeeded in resolving this particular problem.

So, while I haven't changed my own view as to what I think is appropriate policy, I must say that I do understand where a number of Members of the Senate and, as evidenced by the House, where the House Members are coming from. I think the motives I would certainly subscribe to.

Senator FAIRCLOTH. Well, thank you. Just a quick response to that.

I have problems with the constitutional amendments some, too. I'm certainly going to vote for it. I don't think it's perfect. But I think it provides some constraint on spending, and this Congress has absolutely no control. It simply spends, spends, spends. It's the history of it for 40 years.

I think even a constraint fraught with some problems is better than no constraint.

I thank you.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Let's talk about price stability. Let's talk about budget deficits.

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As you may know, I have a little equation that I write out on every opportunity. I don't think it will ever become as famous as the Lapper Curve, but maybe the Bennett Equation will get into somebody's consciousness. And it runs like this.

One percent equals $48 billion a year.

And it stems from simple mathematics, that when the cost of financing a $4.8 trillion debt goes up by 100 basis points, or 1 percent—not an increase of 1 percent, but an increase of 1 percent of 100 percent—by the time that increase or decrease works its way through the $4.8 trillion, it produces an effect on the deficit one way or the other of $48 billion a year.

Now I realize that the debt is financed in long-term instruments, to some extent, and therefore, it will take a while. But if interest rates go from 3 to 4 percent, mathematically, the impact of that, if they stay at that level, is $48 billion a year.

We know how much pain we go through politically to try to cut $48 billion a year out of the budget, to try to get spending under control. Likewise, how much pain we go through if we try to pass a tax increase that produces $48 billion a year.

You put those two together, $100 billion, roughly, a year, you've got the amount on paper of the President's deficit reduction package that passed after so much difficulty and pain last year, by a single vote of the Vice President.

You, sir, and your colleagues, by simply moving the percentage point up one, can wipe out that entire amount over a 5-year period by this mathematical formula, or you can double it.

As I look at that, I become more convinced, therefore, that we must do whatever we can to see to it that interest rates are as low as possible for deficit reasons. And in trying to find some way to get them as low as possible without producing pernicious economic effects, I keep coming back to gold. Can we talk about that?

What would happen if we were to re-establish some kind of tie, and I'm not putting any specific proposal on the table. I'm not endorsing at this point gold-indexed bonds or whatever. But if we could somehow establish a tie between the dollar and gold, would it in fact bring down real interest rates and give us the potential of the kinds of savings on the deficit that the Bennett Equation implies?

Chairman GREENSPAN. Senator, anything which would change the view of long-term inflation prospects in the United States, whether it be a gold standard, whether it be credible monetary and fiscal policy, or some combination, will effectively reduce both nominal and real interest rates.

If one looks in the past as to what types of interest rates occurred when expectations of long-term inflation were nonexistent, you see very low rates.

What you basically get effectively is real rates with very little, if any, inflation premium embodied in them. And those clearly are a fraction of where they are today.

I should emphasize, however, that the transition of going from where we are today to that type of event cannot occur overnight. It takes time. Because people's views don't alter that rapidly.

But there's no question that if you could remove the inflation bias which affects both risk premiums that are embodied in the

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real long-term rate, as well as the inflation premium which is superimposed on that, and those effects would filter back to short-term rates, there is just no doubt that you would have very significantly lower interest payments on Federal debt.

Senator BENNETT. I hear what you're saying about the amount of time it would take to make the transition.

Check my history. We went off the gold standard at the time of the Civil War and lived with greenbacks for some—I don't know how many years.

Chairman GREENSPAN. I think 1879 is when we went back.

Senator BENNETT. Something like that. When the decision was made to go back on the gold standard, was it not announced, I believe, 6 or 7 years in advance?

Chairman GREENSPAN. Yes. We basically reduced the greenbacks, as I remember them, on a scheduled pattern to essentially remove them from effective circulation.

At least that's my remembrance. It may be faulty.

Senator BENNETT. But if we could indeed lower the cost of funding the debt by 3 percentage points, we could take $150 billion a year out of the deficit on that alone. I think that's a sufficiently interesting number, that we should pursue it.

Thank you.

The CHAIRMAN. Senator Grams.

OPENING COMMENTS OF SENATOR GRAMS

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

Chairman Greenspan, I also thank you very much for your testimony today.

While I was very impressed with the presentation, I'm a little troubled by the fact that you are required by law to carry out the policies that you've been discussing this morning.

In my opinion, the Federal Reserve Board should be limited to the responsibility of overseeing America's monetary policy, duties such as monitoring the supply of money, keeping an eye on the stability of our currency, and controlling the rate of inflation, which, as you know, are awesome tasks in themselves.

But these responsibilities, however, should not include using monetary policy to control the unemployment rate, as the Humphrey-Hawkins Act tasks you to do. And it certainly should not include the responsibility of providing stimuli for an economy, as the recent tax and regulatory policies of the Clinton Administration has forced you to do as well.

These duties belong to Congress and the President and the best way to accomplish these tasks, to keep the economy healthy and vibrant, are to keep taxes low and to avoid undue regulations on the private sector.

Unfortunately, this is not what the Clinton Administration provided in 1993. Instead, they gave the American people the largest tax increase in our Nation's history—$255 billion worth of new taxes. Nothing is worse for economic growth than higher taxes, especially $255 billion in higher taxes.

As a result, the economy has not recovered as quickly as had been expected, and I believe you were called in under Humphrey-

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Hawkins to use monetary policy for a problem better suited to fiscal policy.

Now, in my opinion, there is nothing we can do which would be better for the economy than to repeal the Clinton tax hike, to unlock the ankle weights that have kept economic growth almost stagnant and has hurt middle-class Americans in the process.

Lower taxes, less regulation, less Government interference sounds to me like a real recipe for economic growth.

I'd like your views on the matter. In particular, I'd like to know if you would agree with me that one good way to unshackle the economy would be basically to repeal the Clinton tax increases of 1993.

Chairman GREENSPAN. Well, Senator, as I responded in earlier testimony, my view is that the primary goal first is to get the budget deficit down before looking at tax cuts.

But once that is done, the type of tax cuts that should be focused on is lowering the marginal tax rates because it is they which have the most inhibiting effects in the long run on economic growth.

But it's important to emphasize that there is a sequence of priorities here which at least I see as being crucial for long-term growth and that is that first efforts should be at significant reductions in budget deficits.

Senator GRAMS. So when we're talking about spending cuts, you believe that they're very important, that we get spending under control.

Chairman GREENSPAN. Absolutely.

Senator GRAMS. And I want to say this in regards to what we're hearing by a lot of people right now, is that we can't cut spending because it's going to hurt. In fact, we've heard arguments on the floor of the Senate in debate that if Americans knew where these cuts were coming, they wouldn't support a balanced budget amendment.

In other words, they're advocating business as usual and that Americans would put up with deeper deficits in order to escape a little bit of pain.

But from people I talk to in town meetings back in Minnesota, they're prepared to take less in Government services or less spending, one, in order to ensure the future of our children and grandchildren and, two, to get the deficit under control.

So if we don't live up to, really, our obligation of cutting spending, it would be very detrimental.

Would you agree that spending is important and that we're going to have to make those tough decisions?

Chairman GREENSPAN. I wouldn't say it's important, Senator. I would say it's crucial.

Unless and until we divert the rate of growth in Federal outlays from their excess over the rate in growth of the tax base, and indeed, ideally and in fact importantly, bring the rate of growth under the rate of growth in the tax base, which means that the deficit is coming down, unless we do that, we're going to have some very severe financial problems sometime in the 21st century.

Once it becomes evident that that type of problem could emerge and is not being appropriately addressed, at some point, that view

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begins to move forward in time and reflect itself in prices and interest rates in the current period.

These are the same reasons that I've argued that controlling the deficit over the long run by, for example, addressing some of the entitlement problems that have surfaced in the Kerrey-Danforth Commission for the 21st century. By addressing them now, not that they are changed now, but they are addressed now for change 20 years from now or more, I think that probably will have a positive effect in reducing interest rates, long-term interest rates, now because we're dealing with 30-year maturities.

And the converse of that is that if we fail to deal with this issue, we are apt to find that as we move into the 21st century, that those financial problems are going to get increasingly embodied in current long-term interest rates, and that will be quite inhibiting to economic growth and the expansion of standards of living.

Senator GRAMS. So I believe those who abdicate or will not face up to the tough decisions of really looking at how to balance the budget, are abdicating a lot of responsibility to our children and grandchildren.

One final question before I run out of time.

You mentioned about the regulations being really burdensome on the economy and lagging or holding back growth. And you mentioned sunsets.

I've been an advocate and have tried to introduce legislation while as a Member of the House to make sure that regulations, as well as other parts, are sunsetted to bring authority back or to bring oversight back to the authorizing committees that have jurisdiction. So would you say that sunsetting would be one way for Congress not to sidestep its responsibility of real oversight?

Chairman GREENSPAN. Senator, sunsetting is a very important process for both regulation and various different types of legislation.

If a bill, a regulation, or whatever cannot be brought back to the authorizing committees and be rapidly passed, then there's something wrong with what's going on.

If we don't do that, we end up with a ratcheting up in regulations where a lot of it is wholly unuseable, if I may put it that way, and we end up with a lot of programs doing the same thing.

I must say that I'm supportive of the Administration's view that we have too many training programs and the reason we have too many training programs is that we never excise the previous ones. We just keep adding.

Job training is a very crucially important issue in this economy because we've got some very serious problems with respect to dispersions of income and changing job skills.

But I don't think it serves us terribly well if we have obsolete programs which clearly have failed and we keep them on the books and they use taxpayer funds.

We ought to consolidate the process, review it, and indeed, we ought to do that, in my judgment, for virtually every program which comes before the Congress.

Senator GRAMS. If we're talking about sunsetting regulations, should we sunset taxes as well, such as the $255 billion tax increase?

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Chairman GREENSPAN. I cannot find reasons why all programs should not have specific time-certain end to them and be required to be reauthorized.

Senator GRAMS. Thank you very much, Chairman Greenspan.

Thank you, Mr. Chairman.

The CHAIRMAN. I find that a very interesting approach.

Chairman GREENSPAN. Mr. Chairman, I might say, if the Congress would do that, I suspect they might be startled at some of the results they would find in the hearings reviewing many of the programs which we seem to never review after we implement them.

The CHAIRMAN. You know, Mr. Chairman, maybe I'll ask our counsel to begin to look at that. We can call it the Greenspan Plan, and we'll start that with this Committee.

Chairman GREENSPAN. I would prefer another name.

[Laughter.]

The CHAIRMAN. Since we have had one round, before we begin our next and I call upon Senator Sarbanes, I would now like to follow up on something that this Senator finds very troubling.

And that is the question of the utilization of the funds that we are making available to help Mexico. There have been reports and briefings that as much as $10 billion will be made available to help shore up the Mexican banks. Is that a fair statement?

Chairman GREENSPAN. I don't know that, Senator.

The CHAIRMAN. OK. Then let me say, if that is the case, and I've been led to understand that that is the case, I'm deeply troubled.

I'm wondering what exactly it is that we're doing. I understand there's a very close relationship between the private banks and the Mexican central bank.

I'm also wondering, and I'm not setting this forth to you as a question, but in a rhetorical sense because you've indicated that you weren't certain of this, if we indeed encourage interest rates to be raised, and short-term interest rates go from 40 to 50 percent, that would seem to me to be a policy that is guaranteed to cause more defaults in the private sector in Mexico.

Certainly we've heard of a number of cases and, indeed, I've heard Mexican officials indicate that as interest rates were going up prior to this last raise, defaults in home mortgages were very severe. Wouldn't that put greater pressure on these banks?

I am deeply troubled by that kind of policy. It just seems to me to be, even in the best light, a Catch-22. Instead of moving the peso up, this policy moves interest rates up. And I don't see how we're encouraging the private sector or people to invest in the private sector or privatization if the Mexican government adopts this kind of policy. It seems to me that it's rather self-defeating. Who's going to put money into that kind of economy?

I find it very troubling, Mr. Chairman.

Chairman GREENSPAN. Mr. Chairman, if I may respond to that.

First of all, I've been informed that there is something in the proposal about assisting commercial banks, although there is no number. I have not seen a number and I don't know the answer to that particular question.

The problem that basically exists is that in order to get the peso to strengthen, which I think it should, you have to drain short-term

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pesos out of the system. In fact, you have to go from short-term claims denominated in pesos to longer-term claims.

That is basically what a central bank does when it is engaging in an open market policy to tighten money markets, the consequence of which is higher interest rates.

The near 50-percent interest rates which currently exist are lower real rates of interest at this stage than have existed in the late 1980's in Mexico.

Nonetheless, there's no question that even with these high nominal interest rates and still definite, significant real rates, that if they were to persist for a protracted period of time, I think they would certainly have the consequences you are referring to.

Indeed, it is important that the process that's involved here, as I understand it, is a transitional one and that as the inflation rate, which has surged as a consequence of the devaluation, comes back down, then I would presume that interest rates would come down accordingly before the types of consequences of a material sort you indicate.

Nonetheless, there is no doubt that this is a very difficult type of process. It's a very difficult type of policy that the Mexican government is endeavoring to implement.

I think they fully understand where they're coming from and were it not for the problems that emerged in the last couple of months, we wouldn't be here.

But having arrived where we are, so to speak, I'm not sure that there are all that many options involved. It's going to be a very tricky path to take. My own suspicion is that they will succeed. I can't give you any guarantees because it's a tricky one.

The CHAIRMAN. Well, Mr. Chairman, I think you've been more than candid, given the situation and the uncertainties that do exist. I thank you for that.

Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman Greenspan, I have to say to you, as I've listened to you this morning, I think you've really been playing with fire, or indeed, throwing gasoline on the fire.

First of all, do you think it would contribute to sensible policymaking and stability in the markets if the Federal Reserve were sunsetted every 3 to 5 years and we had to go through the whole process of the legislative debate?

Chairman GREENSPAN. I think that we should be required to come before our authorizing committees every 5 years, or maybe 10 years—I'm not saying that there's any particular type of period—and justify what we are doing.

Senator SARBANES. Does justify mean that you would go out of existence unless you were extended? In other words, you would be sunset. Is that what you mean by justify?

Chairman GREENSPAN. I'm basically saying at this particular stage that the Congress has the ability right now, by majority vote if it so chose, to put the Federal Reserve out of existence.

Senator SARBANES. Well, yes, we could move affirmatively. But the question I'm putting to you is, should the Federal Reserve's existence end, be sunsetted and not exist any more, unless the Congress affirmatively acts to keep it in existence?

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Chairman GREENSPAN. After a period of years, I would say yes to that. I would say all institutions of a democratic society should be reviewed, whether or not the figure is 5 years, 10 years, or some period.

The presumption that institutions should not be reviewed periodically in a democratic society is a mistake.

Senator SARBANES. I'm trying to get your definition of reviewed. Is your definition of reviewed that they should cease to function unless affirmatively continued? Is that correct?

Chairman GREENSPAN. That is correct, yes.

Senator SARBANES. All right. Defense Department?

Chairman GREENSPAN. Yes.

Senator SARBANES. All right. Now my next question, is it your intention that the report of this hearing should be that Greenspan recommends a return to the gold standard?

Chairman GREENSPAN. I've been recommending that for years. There's nothing new about that.

Senator SARBANES. So you'd like that. You want to reaffirm that position.

Chairman GREENSPAN. I have always held that a system of price stability which would come from any form of credible type of non-inflationary environment would be very beneficial to the financial system.

Senator SARBANES. And you think we should go onto the gold standard.

Chairman GREENSPAN. I personally would prefer it. That would probably mean that there was one vote in the FOMC for that, but it is mine.

Senator SARBANES. Now, do you favor cutting taxes if it would result in an increase in the deficit?

Chairman GREENSPAN. No, I do not.

Senator SARBANES. Do you favor, if spending cuts were made, should they be used for tax cuts or should they be used for deficit reduction?

Chairman GREENSPAN. I would say deficit reduction until we achieved something close to balance.

Senator SARBANES. Now, is it your view that we should try to balance the budget during an economic downturn? When the economy goes soft and revenues fall off because jobs are being lost and payments increase because we're making unemployment insurance, for example, available, do you believe we should seek to counter that and try to balance the budget during an economic downturn?

Chairman GREENSPAN. No, I do not.

Senator SARBANES. So you would run deficits in an economic downturn as a countercyclical measure.

Chairman GREENSPAN. Well, not necessarily. I'd say that I would rephrase your question to say that we should basically raise taxes and lower spending to achieve a balanced budget.

As I've said in other testimony, if the Congress passes a balanced budget amendment, it would be important to recognize that what that implies is that the real goal is a modest surplus.

So in the event that we are involved with some economic shortfalls, that the surplus would disappear, requiring no actions on the

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part of the Congress and therefore, no tax increases or expenditure cuts would be implicit in that action.

Senator SARBANES. Let me show you this chart, and then, Mr. Chairman, there is something I want to put in the record. I hope the Chairman would permit that.

This shows the movements in GDP beginning back in 1880 and coming forward. It shows tremendous fluctuation—this is the Great Depression and this was the post-war because we didn't really know how to do that transition. But it shows these tremendous fluctuations, boom and bust cycles. And we've done a pretty good job since World War II in ameliorating the movements in the business cycle.

Now, many credit counter-cyclical fiscal and monetary policies as helping to contribute to the post-World War II result, the results we see over there where we've in effect knocked off these very deep declines in the negative growth.

Would you agree with that analysis?

Chairman GREENSPAN. Well, let me just say, in looking at that chart, several of those very large spikes are post—what's your earliest line there?

Senator SARBANES. This is 1880.

Chairman GREENSPAN. OK.

Senator SARBANES. This is 1946.

Chairman GREENSPAN. Yes, that's 1946, and you go back to the Depression.

Senator SARBANES. This is the Depression.

Chairman GREENSPAN. Right. Then you go back to World War I.

Senator SARBANES. After World War II, though, we've eliminated this.

Chairman GREENSPAN. No. There's no doubt that we have seen significantly less fluctuations than we did in the pre-war period. Part of that basically reflects the issue that we had an inelastic currency in the period prior to the Federal Reserve which engendered some of the high volatility in the period prior to 1913 in that chart.

Senator SARBANES. That would be back here [indicating].

Chairman GREENSPAN. Yes. The big drop in 1920, 1921 is obviously the impact of World War I and its consequence. And the kickback in 1923 is merely the recovery from the exceptionally low 1920–21 recession.

So that if you start to filter out some of the specific episodes which are either war-related or not, part of that, not all, does dissolve. The big surges that you're seeing in the early 1940's obviously are coming out of the Depression and the expansion of World War II.

Having said all of that, it's not that I disagree with your conclusion. I'm just saying that the chart gives you a sense of much greater instability than eliminating certain episodes would lead you to believe.

Senator SARBANES. Well, I think the chart is pretty dramatic on the stability front.

Mr. Chairman, there are some items I'd like to put in the record, because I want to close out by coming back to the focus or the purpose of the hearing, which was the monetary policy.

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First is the statement of the U.S. Chamber of Commerce, part of which I quoted earlier about how the Federal Reserve continued its war on the economy today when it hiked short-term interest rates for the seventh time in the past 12 months.

Second, the statement of the National Association of Manufacturers, titled "NAM President Calls Increase in Interest Rates Overkill," which discusses how the GDP deflator has risen only by 1½ percent in the fourth quarter.

The total cost of wages and benefits rose by 3 percent, but with productivity growing at a healthy clip, unit labor costs are under control.

Third, the statement of the National Association of Home Builders expressing their very deep concern about the rise in interest rates.

And finally, I just want to quote from a letter I just received today from the president of the National Association of Home Builders:

> Instead of letting the full effects of its previous interest rate hikes work their way through the economy, the Fed again bumped up rates on February 1. This was the seventh time the Fed had increased short-term interest rates in the past year. We believe this move could threaten the overall economy.
>
> Since February 1994, the Fed has doubled the Federal funds rate target from 3 to 6 percent. Commercial banks have matched the Fed rate increases and raised the prime rate from 6 to 9 percent. This increase has affected the financing costs of builders who typically have floating-rate loans tied to the prime rate.
>
> Our deepest concerns, however, relate to the impacts of Federal Reserve policies on the ability of Americans to buy homes and on the health of the entire economy.

Then he goes on to lay out how young people are being denied, really, the opportunity to buy their first homes and the impact that this has had on the housing industry in terms of the number of housing starts and how it has brought a slowdown in the entire economy.

He closes with this observation:

> Given the long and variable lags in the impact of monetary policy on the economy, we believe that the danger of policy overkill is substantial at this time. As we look to the future, we strongly urge the Fed to wait until the effects of its past moves are clear before considering any further rate hikes.

Mr. Chairman, I spent some time laying that out. That's not my statement. These are the statements of significant actors in our economy—the Chamber of Commerce, the National Association of Manufacturers, and the National Association of Home Builders—all of whom are in unanimity in expressing their very deep concern about the policies that the Fed has been pursuing.

The CHAIRMAN. So ordered. All of those materials will be included in the record.

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

The CHAIRMAN. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Chairman Greenspan, I'd like to return back to your testimony about a few items.

I'm tempted to spend the time on Mexico, but I'm not going to because I don't know what good it would do.

We were pursuing in the first round this issue of price stability and we talked about one way to try to do that.

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You talk about resource utilization rates having already risen to high levels and that this is an indication of inflation on the horizon. When we get to the point where we reach capacity, then prices go up and deliveries slow down, and you gave us that kind of anecdotal evidence.

I can't help but relate this to my own experience managing a very rapidly growing business. For the first 5 years of our life, we doubled in size or more every year. So we were always at the top of our capacity and we were always building more capacity as rapidly as we could to catch up with the growth of the business.

So, in fact, we did not run into this kind of a circumstance that you're talking about in your testimony because as soon as the warehouse was full, I built another one. And then all of a sudden, we had tremendous capacity that was unutilized.

The secret to being able to do that is, of course, access to capital. You talk about capital moving around the world now much more rapidly than it ever has before. The freedom and the instant nature of capital is part of your testimony.

This all leads me back to another theme that you and I have talked about in the past, which is the capital gains tax.

It's my experience that the capital gains tax serves to lock capital in place and prevent its movement, and thereby, has an impact on the ability of business to increase its capacity and get out from under the strains of which you testify.

Would you comment on that? In the background of what Senator Grams and the rest of us are talking about, would, in your opinion, a reduction in the capital gains tax rate, or an indexing of capital gains for inflation, have the effect of freeing up capital that would then be available to have the kind of impact of creating additional capacity that would be necessary to reduce inflationary pressures?

Chairman GREENSPAN. Senator, it doesn't in and of itself create new capital. But what it does do, by freeing up capital, is it tends to facilitate the movement of capital employed in areas where the efficiency is less than it could otherwise be.

So what you do by having a mechanism which slows down the turn over of capital is to create less capital efficiency, less capital productivity in the system. And in that sense, you can say that you are creating new capital, but only in an indirect sense.

Senator BENNETT. But if I understand what you're just saying, you are shifting capital from old resources into new resources and thereby increasing the productivity of the economy. Is that a fair summary?

Chairman GREENSPAN. That is correct, Senator.

Senator BENNETT. OK. So it would seem to me that, as we address these issues, a capital gains tax reduction, either in rate or indexing or both, would in fact be a deficit reduction activity, and also have a beneficial impact on inflation.

Chairman GREENSPAN. Well, Senator, this gets to this controversial question of exactly what is the path of revenues that occurs as a consequence of changes in the capital gains tax. There has been a lot of rhetoric on both sides of this issue.

My own view is that it probably has not had a significant effect one way or the other on the deficit. But it is desirable to do because it improves the efficiency of the economy.

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And if you ask me over the longer run which way revenues go, I would have to say that my suspicion is that overall revenues, not revenues from the capital gains tax, per se, but revenues in the system as a whole would rise.

Senator BENNETT. Sure. As the economy becomes more efficient, it produces greater tax revenue.

Chairman GREENSPAN. Yes.

Senator BENNETT. Yes. OK. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Boxer.

Senator BOXER. Thanks, Mr. Chairman.

Senator SARBANES. Would the Senator yield for me for just an insert?

Senator BOXER. Yes.

Senator SARBANES. I'd like——

Senator BOXER. As long as it doesn't come out of my time.

Senator SARBANES [continuing]. To insert in the record two articles from The Wall Street Journal: "Capacity Utilization Is Losing Credibility—Economists Say Data Don't Reflect Real Conditions" and "Chrysler To Idle Auto Plant A Week In Another Sign Market Is Softening."

The CHAIRMAN. So ordered. Both will be included.

Senator Boxer.

Senator BOXER. Mr. Chairman, thank you again.

I want to comment on some of the things that my colleagues have said today. I'm going to really choose my words carefully in the interest of comity. I'm going to talk about a great amount of irony in some of their comments. I'd like to make some statements and, Mr. Greenspan, at the end I have just a couple of questions. I'm not pulling you into this in any way.

The whole notion of sunset and zero-based budgeting is something that I agree with. As a matter of fact, in 1976, I ran for local government and got elected on that platform. But we have to be careful that when we say these things, we mean them.

For example, case in point. When I sat through the mark-up on the unfunded mandates bill, which is really, it is revolutionary in nature, we offered sunset legislation for 3 years, we didn't get a Republican vote. Five years, didn't get a Republican vote. Ten years, didn't get a Republican vote.

So I think when we say we should sunset major programs, we should mean it whether we like the program or not.

I think that's good for both sides to think about.

Then the issue of having the guts to balance the budget that my friend who has come to us from the House, where I was privileged to serve, from Minnesota, saying, his people are ready for the tough choices.

We couldn't get one Republican to vote for the right-to-know amendment on balanced budget. Not one to say, show us your cards, or as Senator Byrd said, let's look under the hood here. What is it going to mean?

I want you to know that I sent a letter to everyone in the Republican leadership who was pushing the balanced budget amendment. Only one responded to me, and I think that person, because when I said show me your budget, he was the only one who did. And it's no wonder because he was the only one to say, Social Security has

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to be cut. Medicare has to be cut. Medicaid has to be cut in order to do it.

I didn't get any other responses.

So when we talk about these things, I think it's important that the actions of people follow through on the words of people.

On price stability as the key to prosperity, a very important point raised by Senator Mack.

I agree with him it is crucial. But at the same time, if you do not have a job, it doesn't matter to you that automobile prices stay the same, were stable 3, 5, 6 years in a row, or even if they went down, even if you had deflation. You need to have jobs in this society.

I think that the two things are important—controlling inflation and making sure that our policies create jobs or don't hinder jobs.

I think that that is very important.

I think Senator Sarbanes has showed us that it's working, the notion of trying to do all these things. Yes, they're hard. Yes, they're sometimes contradictory. But if we abandon one for the other, believe me, one for the other—I'm not for abandoning the fight against inflation at all, nor the fight for more jobs. Then we get into an unbalanced situation where a lot of people will suffer.

On the cost of regulation, Mr. Chairman, I think it is a truism that sometimes we overregulate. But, again, we take it to this extreme with proposals to do away across the board, with moratoriums on regulation.

I can assure you the cost in the Soviet Union of not regulating Chernobyl can hardly even be measured in terms of lost productivity, lost lives, and all the things that go with it. We have a series of regulations, and I'm going to ask unanimous consent to place these examples into the record at this time, which in essence, if it happened, would cost us more because they're safety provisions and if you don't do them, you'll lose lives.

I think that this whole notion of deregulation has to be looked at.

What did it cost us the last time we deregulated the S&L's? At my last count, it was $500 billion over 10 years. That's a lot of money, because people said, on both sides of the aisle, let's get out of the way and let's let the S&L's do whatever they want and make risky investments and all the rest.

So, again, I hope in the U.S. Senate, and I said this to the press after the election, that what we will do in the Senate, as opposed to the House, is to come together as reasonable people and yes, get rid of regulations that don't work, but don't say, that's the answer, because, again, we can go too far.

I have a question on the minimum wage, and I don't know how you're going to respond to this, Mr. Greenspan, because I really haven't read your opinion on it and perhaps I've missed it.

But, again, here we have a situation where the minimum wage is at a 40-year low in terms of purchasing power. The argument is made that if you raise the minimum wage, it is a job-loser.

So we have my colleagues on the Republican side who are suddenly very interested in job creation. In their interest for job creation, say that raising the minimum wage would be a bad thing to do.

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Now I take their argument to the time when I was a kid. The minimum wage was 50 cents an hour. I remember it clearly. I thought it was a lot, by the way. Fifty cents an hour.

Let's suppose that thinking had prevailed. We can't touch the minimum wage. Unemployment. We'd still have a 50-cent-an-hour minimum wage. Of course, I think we would have had a revolution. But if that thinking had prevailed, we'd have a 50-cent minimum wage.

And I'm not suggesting my colleagues support that. I don't know if they do or they don't. But you extrapolate the reasoning and it gets you back—why should you ever raise the minimum wage?

So my question is, without asking you specifically about the 90 cents over 3 years or 5, do you think that sometimes, it is important at certain points in history to raise that minimum wage because it has—even though it might cause some business to adjust in certain ways, over the long run, it's important to the stability of the country.

Chairman GREENSPAN. Senator, the issue of the minimum wage has a very long history to it, as I'm sure you're aware.

Senator BOXER. 1938, I think.

Chairman GREENSPAN. Actually, it goes back before then in the sense of arguments pro and con.

Senator BOXER. Right.

Chairman GREENSPAN. Up until very recently, it was the general consensus among virtually all economists that the minimum wage, by enforcing a specific, nonmarket level on the wage structure, actually reduced employment. It has only been in the last 2 or 3 years that there have been some studies which purport to show, on the basis of differential studies of New Jersey and Pennsylvania, for example, where one had a minimum wage change and the other did not, what would happen to teenage employment or employment generally. The conclusion there was that the minimum wage had very little effect on the level of employment.

However, the vast majority of economists, as far as I know, still hold the view that the minimum wage is a nonproductive aspect of economic structure. And therefore, the issue really doesn't get down to the question of whether you should raise it or lower it. The real question is does it work at all? The serious question that has been involved over the years is that if the minimum wage merely destroys jobs, the question is then obviously, how many does it destroy relative to what it does for the nondestroyed jobs?

I think it's a factual question which is quite appropriate to evaluate as to what extent a particular structure of minimum wage helps or hinders the employment markets. And the issue there has been under very considerable discussion among labor economists for decades.

I would say at this point that if you took a poll among those who have evaluated that, they would be very substantially opposed to the existence of the minimum wage, per se, on the grounds that it does more harm than good. But the issue requires continuous evaluation.

Senator SARBANES. Who would that poll be amongst?

Chairman GREENSPAN. I'm sorry?

Senator SARBANES. Who did you say?

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Senator BOXER. Labor economists.
Chairman GREENSPAN. Labor economists.
Senator BOXER. Well, I would just say——
Chairman GREENSPAN. People who study labor markets, of which there are many—it's a fairly broad profession. It's mostly economists, to a greater or lesser degree.
Senator BOXER. So to sum up your response——
Chairman GREENSPAN. Excuse me, Senator. If I may.
Senator BOXER. Yes.
Chairman GREENSPAN. I wasn't referring to economists employed by labor, if that's what you were referring to. That's not what I had in mind.
Senator BOXER. I know my time's up, but I want to try to sum up what I think you said.
You said the argument is not so much over what the minimum wage ought to be, but whether there ought to be one at all.
Chairman GREENSPAN. Yes.
Senator BOXER. Thank you.
The CHAIRMAN. Senator Grams, did you have, because we're going to go to Senator Bennett. Do you have an observation that you'd like to make?
Senator GRAMS. Just a quick comment.
The CHAIRMAN. Certainly.
Senator GRAMS. I don't want to answer all of my colleague's questions from California, her concerns that she raised. But to agree with her on the assessment that some regulations are good, but some are bad. And I would hope that she would join with us in our efforts for cost/benefit analysis and scientific data to make sure we look at what regulations are good or bad.
I would also like Chairman Greenspan to again, when we talked about sunsetting, how important I believe that is. And the question is raised whether we should sunset the Federal Reserve or even the Defense Department.
I don't think there's anything wrong with coming back to Congress for oversight, and if it's working well, that we should commend it, maybe some minor changes, and then reauthorize or reapprove it. But it gives us a chance to look at the programs that aren't working and to eliminate them as well.
Would you agree with that, Mr. Chairman?
Chairman GREENSPAN. I would, Senator.
Senator GRAMS. Thank you. That's all I'd like to say.
The CHAIRMAN. Senator Bennett.
Senator BENNETT. Let me make a brief comment on the minimum wage thing while the Senator from California is here.
I'm stunned to learn that she started when the minimum wage was 50 cents because so did I.
Senator BOXER. Thanks.
[Laughter.]
Senator BENNETT. And she's nowhere near as old as I am.
[Laughter.]
I remember earning a minimum wage as a kid myself. I used to work in the retail industry and here is a case study. It may be flawed, out of my memory.

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One of the big issues relating to the minimum wage in the late 1950's is whether or not it should apply to retail stores. Retailing had always been exempted on the grounds that a retail store was not engaged in interstate commerce.

That battle finally went the other way and Congress, in its wisdom, decided that a retailer affected interstate commerce and therefore, the Federal minimum wage could and should apply to Sears, J.C. Penney, Montgomery Wards, et cetera.

Rather quickly, clerks began disappearing in retail stores. And K-Mart, which is clerkless, practically, compared to the stores that I shopped in when I was a kid, began to become a factor on the scene.

Now I will not put a value judgment on that one way or the other and say it was a bad thing that those jobs disappeared. But traditionally, prior to the minimum wage being applied to retailing, retail clerks were housewives working second jobs. They did not anticipate supporting a family on it. This was something that they could do when their kids or teenagers were grown.

When I represented J.C. Penney, I was pleasantly surprised to discover that practically every Member of Congress at one time or another worked at J.C. Penney, probably for a very low wage.

Now you go into the retail stores and you find that, as I say, K-Mart started it. Wal-Mart is now the Nation's largest retailer and it has virtually no clerks.

At the other end of the spectrum, interestingly, coming later on, Nordstrom found a niche in retailing of clerks that render magnificent service at the very high end of the price range, where they could afford to pay the clerks to provide that kind of service.

You go to Japan. I've owned businesses in Japan and shopped in Japan. The stores are full of clerks. It is amazing. They are standing almost at every counter and they do not have a minimum wage.

So I think there is a historic demonstration of the economic principle that the Chairman was outlining for us, which is that a minimum wage does indeed eliminate jobs.

Senator BOXER. Would you yield to me?

Senator BENNETT. As I'm saying, I'm not making a value judgment. That may be right. You may want to eliminate those jobs. But I think the historic fact is that it does.

Senator BOXER. Senator, would you yield to me for a moment?

Senator BENNETT. Absolutely.

Senator BOXER. You know, I think there is no question about it, that if we had slave labor and didn't pay people anything, there would be a ton more clerks in the stores.

I think there has to be a value judgment of a society as to how much we value someone's work.

I agree with you. There are ways you can upgrade the positions like they have done at Nordstom's. I'm familiar with that store and you're right. It's a whole new way of selling.

Senator BENNETT. Sure.

Senator BOXER. If you ever go into a Good Guys to get electronics, they're standing a la the Japanese style because they do work on a commission basis as well.

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But I just think we almost have to approach that issue of the minimum wage, not only economically, but from the standpoint of justice in this society.

Senator BENNETT. I understand that. And my reaction to that as I've looked at the issue is to recognize that that portion of the economy where unemployment is the highest, running 30 and 40 percent, is inner-city black youth, males, primarily. Those are the people who cannot get a job.

It is a prominent economist who said, he does not see the social value in saying that a black youth in the inner-city who is looking to begin a career is better off being unemployed at $5.25 an hour than having a job at $4.25 an hour. And that if by Federal fiat, we say that job has to disappear and he has to remain unemployed, we're probably not doing the right thing.

I don't think anyone's talking about slavery here, Senator. I think we're talking about the market finding a price that can allow youth that need the entry-level experience, that you had when you worked at 50-cents-an-hour and I had when I worked at 50-cents-an-hour, that are not getting it, perhaps because of Federal fiat.

Senator SARBANES. Would the Senator yield just for a minute?

Senator BENNETT. Sure.

Senator BOXER. The 50-cents-an-hour, if you adjust it for inflation, would be way up.

Senator SARBANES. I'd like to just make two points to the Senator.

One is that the recent studies on the New Jersey and Pennsylvania experiences, when they took their minimum wage up above, well above the Federal level, show that it did not cost them jobs.

So you have to address those studies and take them into account. I've not been over them carefully enough.

Senator BENNETT. Nor have I.

Senator SARBANES. Second, on the Japanese experience, if you gave me the ratio that the Japanese have between the top-paid person in the company and the bottom-paid person in the company, which is a very narrow ratio, I might trade off the minimum wage for that.

In other words, if you told me, look, in all American companies, the janitor is going to get—I think it's one-eighth, at least, of what the top guy is making in the company, and that's going to be the prevailing wage structure. Japan's wage structures are defined by culture, not by law, but defined pretty strongly by culture. That might be worth considering. But that's not what we have, of course. We have this tremendous gap between what the people at the top are pulling down and what they're willing to pay the people at the lower levels of their enterprise.

I doubt that it happened in your enterprise, but it happens in enough enterprises, I would say in the majority of enterprises, that it's a problem.

Senator BENNETT. Well, we probably shouldn't prolong this a great deal. But I would suggest that if you took the cost of a Japanese executive to his company, the total cost of keeping a Japanese executive in the style to which he becomes accustomed, you find there are a whole series of nonwage perks that end up costing the company just about what an American top executive costs.

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It just doesn't show up in his take-home pay.

We can talk about that over lunch. This is not an appropriate forum for that.

The CHAIRMAN. Let me ask at this point if any of our Members have any other questions for Chairman Greenspan.

Senator BOXER. Can I just put some questions into the record?

The CHAIRMAN. Certainly.

Senator BOXER. Thank you.

The CHAIRMAN. Before we recess, Mr. Chairman, let me express my thanks on behalf of all of the Members of the Committee for your being here today and for sharing your thoughts. Let me also make an observation and thank you for your candor. It has been refreshing, particularly as it relates to the questions on sunset and sunsetting. When one is ready and willing to say, yes, it should apply to all, it should apply, yes, to the Federal Reserve. Let's take a look at it, to the Defense Department.

I have to tell you, refreshingly candid.

We stand in recess.

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

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

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PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

The Committee is pleased to welcome Federal Reserve Board Chairman Greenspan to discuss the Federal Reserve's conduct of monetary policy report required by the Humphrey-Hawkins Act. These semiannual hearings provide the Congress with an important opportunity to explore the goals and implementation of the Fed's monetary policy.

Mr. Chairman, you no doubt will remember 1994 as a difficult year for the Federal Reserve's conduct of monetary policy. The Fed raised interest rates seven times over the past year and short-term interest rates doubled with the Federal funds rate rising from 3 percent to 6 percent. The Fed has tightened and then tightened again in an effort to control inflation and offset the Clinton Administration's lack of fiscal restraint.

I am concerned that continued rate increases will begin to yield diminishing economic returns. And I am especially concerned that the frequency and size of interest rate increases is taking a heavy toll on individuals, working families, and even large corporations who simply cannot budget or plan well for a future in which there is so much economic uncertainty.

Interest rate volatility creates an economic environment in which it is difficult to operate. This volatility makes long-term planning virtually impossible, puts home ownership out of reach for many Americans and, with each rate hike, the cost of capital increases. As this cost increases, the inevitable result will be a decrease in investment by the private sector.

Mr. Chairman, I am not blaming the Fed for this situation. The Fed acted in response to an economy that was showing signs of overheating. I am anxious to hear your response to these conditions and your forecast for what 1995 has in store for our economy.

I am in complete agreement with the statement in your report that "Economic prospects for the long run will be further enhanced if Congress and the Administration succeed in making further progress in reducing the Federal budget deficit." I am confident this Congress will reduce the Federal budget deficit, with or without the Administration's cooperation.

Mr. Chairman, I am sure you are aware that *The Wall Street Journal* this morning includes an interesting article by Senators Mack and Bennett about the Humphrey-Hawkins Act, its origins, its objectives, and its shortcomings. This statute deserves to be revisited and it will be this morning. You will be asked to answer whether this statute aids or impedes the Fed's ability to achieve and sustain economic stability. I look forward to your statement and to a spirited discussion period.

PREPARED STATEMENT OF ALAN GREENSPAN

CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

WASHINGTON, DC

Mr. Chairman and other Members of the Committee, I appreciate this opportunity to discuss the Federal Reserve's conduct of monetary policy. As required by law, we have already delivered to the Congress our formal report detailing the performance of the economy and the implementation of policy. In my remarks this morning, I will summarize that discussion and expand further on some of the key factors bearing on monetary policy.

Recent Developments

Nineteen-ninety-four was a good year for the American economy. Economic growth quickened, with real gross domestic product expanding 4 percent over the four quarters of the year. In manufacturing, industrial production advanced nearly 6 percent. We now have enjoyed over 3 years of relatively brisk advance in the Nation's output of goods and services, and this economic progress has been shared by many Americans. Payrolls swelled 3½ million last year, and the unemployment rate closed 1994 at 5½ percent, more than a percentage point below its level 1 year ago. And workers were producing more on average: Output per hour in the nonfarm sector increased about 1½ percent over the four quarters of last year, suggesting some tilting up to the underlying trend of labor productivity that promises sustained and substantial benefits in the coming years.

The data that have been published in the first weeks of 1995 have offered some indications that the expansion may finally be slowing from its torrid and unsustainable pace of late 1994. While hours of work lengthened in January, employment growth slowed from its average of recent quarters and the unemployment

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rate rose. Moreover, recent readings on retail sales suggest a more moderate rate of increase, and housing activity has shown some softness. Nonetheless, the economy has continued to grow, without seeming to develop the types of imbalances that in the past have undermined ongoing expansion.

Of crucial importance to the sustainability of the gains over the last few years, they have been achieved without a deterioration in the overall inflation rate. The Consumer Price Index rose 2.7 percent last year, the same as in 1993. Inflation at the retail level, as measured by the CPI, has been a bit less than 3 percent for 3 years running now—the first time that has occurred since the early 1960's. This is a signal accomplishment, for it marks a move toward a more stable economic environment in which households, businesses, and governmental units can plan with greater confidence and operate with greater efficiency.

As I have stated many times in congressional testimony, I believe firmly that a key ingredient in achieving the highest possible levels of productivity, real incomes, and living standards is the achievement of price stability. Thus, I see it as crucial that we extend the period of low inflation, hopefully returning it to a downward trend in the years ahead. The prospects in this regard are fundamentally good, but there are reasons for some concern, at least with respect to the nearer term. Those concerns relate primarily to the fact that resource utilization rates have already risen to high levels by recent historical standards. The current unemployment rate, for example, is only a bit above the average of the late 1980's, when wages and prices accelerated appreciably. The same holds true of the capacity utilization rate in the industrial sector.

Clearly, one factor in judging the inflationary risks in the economy is the potential for expansion of our productive capacity. If "potential GDP" is growing rapidly, actual output can also continue to grow rapidly without intensifying pressures on resources. In this regard, many commentators, myself included, have remarked that there might well be something of a more-than-cyclical character to the evident improvement of America's competitive capabilities in recent years. Our dominance in computer software, for example, has moved us back to a position of clear leadership in advanced technology after some faltering in the 1970's. But, while most analysts have increased their estimates of America's long-term productivity growth, it is still too soon to judge whether that improvement is a few tenths of a percentage point annually, or even more, perhaps moving us closer to the more vibrant pace that characterized the early post-World War II period. It is fair to note, however, that the fact that labor and factory utilization rates have risen as much as they have in the past year or so does argue that the rate of increase in potential is appreciably below the 4 percent growth rate of 1994.

Knowing in advance our true growth potential obviously would be useful in setting policy, because history tells us that economies that strain labor force and capital stock limits tend to engender inflation instabilities that undermine growth. It is true, however, that, in modern economies, output levels may not be so rigidly constrained in the short run as they used to be when large segments of output were governed by facilities such as the old open-hearth steel furnaces that had rated capacities that could not be exceeded for long without breakdown. Rather, the appropriate analogy is a flexible ceiling that can be stretched when pressed; but, as the degree of pressure increases, the extent of flexibility diminishes. It is possible for the economy to exceed "potential" for a time without adverse consequences by extending work hours, by deferring maintenance, and by forgoing longer-term improvements. Moreover, as world trade expands, access to foreign sources of supply augments, to a degree, the flexibility of domestic productive facilities for goods and some services.

Aggregative indicators, such as the unemployment rate and capacity utilization, may be suggestive of emerging inflation and asset price instabilities. But, they cannot be determinative. Policy makers must monitor developments on an ongoing basis to gauge when economic potential actually is beginning to become strained—irrespective of where current unemployment rates or capacity utilization rates may lie. If we are endeavoring to fend off instability before it becomes debilitating to economic growth, direct evidence of the emerging process is essential. Consequently, one must look beyond broad indicators to assess the inflationary tendencies in the economy.

In this context, aggregate measures of pressure in labor and product markets do seem to be validated by finer statistical and anecdotal indications of tensions. In the manufacturing sector, for example, purchasing managers have been reporting slower supplier deliveries and increasing shortages of materials. Indeed, firms appear to have been building their inventories of materials in recent months so as to ensure that they will have adequate supplies on hand to meet their production schedules. These pressures have been mirrored in a sharp rise over the past year in the prices

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of raw materials and intermediate components. There are increasing reports that firms are considering marking up the prices of final goods to offset those increased costs. In that regard, January's core CPI posted its largest gain since October 1992, perhaps sounding a cautionary note. In the labor market, anecdotal reports of "shortages" of workers have become more common. To be sure, increased wages are a good thing if they can be achieved without commensurate acceleration in prices, but they are not beneficial if they are merely a part of a general pickup in inflation. A hopeful sign in this regard, however, is that to date the trends in the expansion of money have remained subdued, and aggregate credit is growing moderately. These developments do not suggest that the financial tinder needed to support the ongoing inflation process is in place.

That kind of ongoing process also would be expected to involve a different expectational climate than seems to prevail today. Despite the marked improvement in consumer confidence overall, the survey readings on consumers' views of whether jobs are easy to get fall far short of the previous cyclical peak in 1989. Moreover, there is some evidence that the number of people voluntarily leaving their jobs is subnormal currently. This suggests that deep-seated job insecurity has not fully dissipated despite strong job growth recently.

Some analysts attribute this phenomenon to workers' concerns about losing health insurance and, for some, pension coverage if they change jobs. Whatever the cause, the lingering sense of insecurity doubtless has been a factor damping wage growth and overall labor costs. Since the latter, on a consolidated basis, accounts for roughly two-thirds of overall costs in our economy, slower wage growth combined with strong cyclical productivity growth has restrained increases in unit labor costs and hence in prices of final goods and services.

However, as overall output growth of necessity slows in an environment of high resource utilization, so will cyclical productivity growth. Moreover, if labor market tightness assuages job insecurity, pressures to raise wages might well intensify and unit labor costs could accelerate. In the later stages of previous business cycles, declines in profit margins absorbed some of the increases in unit labor cost, but some were passed through into final goods prices and inflation picked up. Thus far in the current cycle, price increases have been muted, not only by subdued unit labor costs, but also by a prevailing concern among firms that, despite capacity pressures, enough slack remains in the system to foster competitive inroads on those who try to price above the market. But this form of discipline may also become less effective if pressures on resources persist. Consequently, it may be that these pressures will lead to some deterioration in the price picture in the near term; but any such deterioration should be contained if the Federal Reserve remains vigilant.

Policy Action and Financial Markets

It was to preserve and to extend the gains associated with low and declining inflation—and to avoid the instabilities and imbalances attendant to rising inflation—that we began the process of tightening 1 year ago. Our view at the time was that the accommodative policy stance we had adopted in earlier years to contain the effects of financial strains on borrowers and lenders was no longer appropriate once their balance sheets had been greatly strengthened. In these changed circumstances, absent policy action, pressures on capital and labor resources could build to the point where imbalances would emerge and costs and prices would begin to accelerate, jeopardizing the durability of the current expansion. In the event, the strength in demand and the potential for intensification of pressures on prices were even more substantial than envisioned when we started down that road. As we thought might be possible at this time last year, a significant upturn in inventory investment induced a stronger economy than was generally anticipated. Additional strains on capacity became increasingly evident in higher prices at early stages of production processes.

Moreover, in financial markets, the effects of the policy firmings were muted to an extent by an easing of terms and conditions on bank loans and by a drop in the foreign exchange value of the dollar. In these circumstances, the Federal Reserve needed to take further steps to head off potential instabilities that would threaten the economic expansion. Over the past year, including our most recent action, we have raised money-market interest rates seven times, pulling the Federal funds rate up 3 percentage points, to 6 percent. Four of these actions were associated with increases in the discount rate. The discount rate now stands at 5¼ percent, or 2¼ percentage points higher than it was at the onset of tightening.

A stronger track for economic activity, higher credit demands, and a revival of inflation fears pushed up yields on securities with intermediate- to longer-term maturities from 1½ to 3 percentage points over the past year. Most of that rise was posted in the first three quarters of 1994. As Federal Reserve action—particularly the

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¾ percentage point move in November—came to convince most market participants that policy would sufficiently restrain excess aggregate demand, those inflation fears and uncertainty premiums subsided a bit. This change in attitude, reinforced by signs of moderating demand, has helped to trim interest rates on long-term Treasuries and fixed-rate mortgages more than one half of a percentage point from their peaks in November.

The adjustment in financial markets to rising interest rates was not, by any means, smooth. At the beginning of this process of tightening, many members of the Federal Open Market Committee (FOMC) shared a concern that some market participants, made complacent by the relatively high and stable returns on long-term assets that had prevailed for a considerable stretch of time, had taken on substantial risk in their portfolios as they reached for yield—in some instances leveraging heavily. Taking account of this, our first three steps were small—with each translating into a ¼ percentage point rise in the Federal funds rate—to allow market participants an extended opportunity to readjust their portfolios in light of rising short-term rates. As markets became accustomed to the new direction of short rates, the FOMC picked up the pace of firming. Measures of bond-price volatility, both actual and those inferred from options prices, moved higher when monetary policy first began to firm, but rolled back much of that run-up as the year progressed.

While securities markets were turbulent from time to time, in general, they remained quite resilient and performed their economic function of allocating credit quite well. Indeed, in some respects, credit has apparently been easier to get, likely in reflection of the improved assessment of financial prospects for borrowers and the larger capital cushions of many lenders. In many securities markets, quality spreads, when measured by the difference between rates on private and Treasury instruments of comparable maturities, have been quite thin. Commercial banks trimmed their own lending margins—effectively absorbing some of the rise in market interest rates before they got to borrowers—and exhibited a renewed aggressiveness in competing for loans. Bankers themselves reported to us further easing of terms and standards on business loans over the course of 1994 and into 1995. The pickup in total borrowing by nonfinancial businesses was focused primarily on bank loans and other shorter-term sources of funding. This shift toward shorter maturities, no doubt, importantly resulted from the substantial run-up in longer-term interest rates over the year, but there probably was some role played by banks' efforts to make more loans and interest income, especially as trading income declined.

Households also increased the pace of their borrowing. Double-digit annual growth of consumer credit helped to fund considerable outlays for durable goods, especially autos. This, too, may have been related, in part, to the eagerness of commercial banks to make consumer loans. And a wide menu of mortgage instruments gave homebuyers some flexibility in coping with the rise in interest rates. The increasing share of mortgage originations at flexible rates—often involving concessionary initial terms—and, perhaps, some easing of loan qualification standards permitted some buyers who otherwise would not have been able to obtain financing to go ahead with their home purchases. All told, improved access to credit provided important support to spending.

Some Recent Lessons

Events of the past 2 months have taught us once again that the global nature of trade in goods, services, and financial instruments exerts an exacting discipline on the behavior of central banks. Technology has defeated distance by slashing the costs of gathering information and of transacting. Advances in computing and financial engineering during the past 10 or 15 years have enabled investors and speculators to choose among a wide array of investment instruments, allowing them to manage risks better and, when they chose, to exert their notions about future market movements forcefully through the use of leverage. The former, improved risk management, has done much to make markets more resilient, while the latter, easier recourse to leverage, may add to the volatility of financial prices at times.

These developments have freed up the flow of international capital, thus potentially improving the efficiency of the allocation of the world's resources and raising world living standards. They have also permitted markets to respond more quickly and with greater force to a country's macroeconomic policies. This puts a special burden on the Federal Reserve, because the U.S. dollar is effectively the key reserve currency of the world trading system. In that role, we enjoy an increased demand for our financial instruments. However, this role also heightens the share of the demand for dollar assets that is related to more volatile portfolio motives. The new world of financial trading can punish policy misalignments with amazing alacrity. This is a lesson repeated time and again, taught most recently by the breakdown of the European Exchange Rate Mechanism in 1992 and the plunge in the exchange

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value of the peso over the past 2 months. In the process of pursuing their domestic objectives, central banks cannot be indifferent to the signals coming from international financial markets. Although markets can be harsh teachers at times, the constraints that they impose discipline our policy choices and remind us every day of our longer-run responsibilities.

While there are many policy considerations that arise as a consequence of the rapidly expanding global financial system, the most important is the necessity of maintaining stability in the prices of goods and services and confidence in domestic financial markets. Failure to do so is apt to exact far greater consequences as a result of cross-border capital movements than might have prevailed a generation ago.

The Economic Outlook

Looking ahead to the prospects for the U.S. economy, we must remember that the Nation has entered 1995 with its resources stretched. We do not now have the substantial unused capacity that made possible the especially favorable macroeconomic outcomes of 1993 and 1994—rapid real growth and stable or declining inflation. As a result, the likely performance of the economy in 1995 almost surely will pale in comparison with that of the previous 2 years. The growth in output arguably must slow to a more sustainable pace and resource utilization settle in at its long-run potential to avoid inflationary instabilities. Inflation, itself, is unlikely to moderate further and may even tick up temporarily. But overall, the performance of the economy still should be good. We expect growth to continue and inflation to be contained.

The Federal Reserve for its part will be attempting to foster financial conditions that will extend that good performance through 1995 and beyond. Our policy actions will depend on an ongoing assessment of a number of forces acting on the economy. One is the effects of the rise in interest rates that have occurred over the past year. The effects of higher interest rates on spending are difficult to pinpoint with any precision because they occur with a lag and have a diffuse influence on the behavior of households and firms throughout the economy. Data rarely point in one direction, and the available information on spending fits this rule. As yet, the performance of the economy suggests a slowing in interest-sensitive spending, but mostly concentrated in housing activity. Our reading of the historical record is that the cumulative effect of higher interest rates should lead to a significant deceleration in spending. But, to date, the jury remains out on whether the slowing that is in train will be sufficient to contain inflation pressures.

That judgment also rests importantly on a reading of business cycle developments more generally—cycles which often relate to the interaction of physical stocks and flows. These dynamics are most clearly seen in inventory investment, which has always been an important swing factor in the post-war era. In 1994, the increase in inventory investment in real terms added almost one percentage point to GDP growth. It appears most unlikely that business people will wish to build their stocks at the pace they did in 1994. But whether their actions with respect to inventories will turn that plus for growth last year into a significant minus in 1995 remains to be seen.

Incoming information does not suggest that a substantial inventory correction is imminent. Standard inventory-sales ratios remain on the low side of historical experience; those ratios look even lower compared with historical experience if one subtracts wholesale and retail markups from the published inventory investment figures to get a better handle on the underlying physical units of stocks. Moreover, even if there were a swing in inventory investment, it would have a more muted effect on domestic production than the inventory cycles of just a few years ago. Rough estimates suggest that, currently, perhaps a quarter of the nominal value of all wholesale and retail stocks are imported, whereas the share was substantially less as recently as the late 1970's.

Similar stock-flow interactions should be at work in spending for consumer durables. Large increases in real outlays for consumer durables over the past 3 years, partly financed in recent quarters by unsustainably rapid growth in the volume of credit, may well have exhausted most of the pent-up demand that had accumulated when the economy was sluggish in the early 1990's.

In another area, actions of this Congress regarding the Federal budget deficit will have important consequences for the economic outlook. A credible program of fiscal restraint that moves the Government's finances to a sounder footing almost surely will find a favorable reception in financial markets. That market reaction, by itself, should serve as a source of stimulus that would help to offset in whole or in part the drag on spending that otherwise would be associated with reductions in Federal outlays and transfers over time. It is also important to remember that a larger issue is at stake during these deliberations on the Federal budget. Too much of the small

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pool of national saving goes toward funding the Government, to the detriment of capital formation. By trimming the deficit, those resources will likely be put to more productive uses, leading to benefits in the form of improved living standards.

Federal Reserve policy makers had to weigh these factors and more in determining their individual forecasts. As is detailed in the semiannual Monetary Policy Report, the central tendency of the forecasts of the Board members and the Reserve Bank presidents was that real GDP would grow at a rate of 2 to 3 percent over the four quarters of 1995. This slowing from last year's unsustainable pace was viewed as sufficient to bring output growth more in line with that of its potential, helping to stabilize the unemployment rate in the range of the past few months, near 5½ percent. The governors and the Reserve Bank presidents forecast some edging up of consumer price inflation in 1995, with the central tendency of their forecasts bracketed by 3 and 3½ percent. If we are to do our part in helping the economy operate at its fullest potential over time, we need to remain watchful to ensure that this cyclical upswing in the inflation rate expected for 1995 does not become firmly entrenched.

Monetary and Credit Aggregates

In discussing these matters at its meeting earlier this month, the FOMC determined that the provisional ranges it had chosen for the monetary aggregates and domestic nonfinancial debt in July 1994 remained consistent with its current outlook for economic activity and prices. Moreover, these ranges conform to the projected deceleration in nominal income that is associated with our efforts to contain inflation and keep the economy on a sustainable path. The 1-to-5 percent range for M2 provides a reasonable benchmark for longer-run growth of this aggregate that could be expected if the behavior of its velocity was to return to its historical pattern under conditions of price stability. This would not be true for M3, however, which historically has grown faster than M2, but which has been depressed in recent years by a number of factors, including the difficult financial adjustment of banks and thrifts. If the broader aggregate M3 returns to its previous alignment, its range of 0-to-4 percent would have to be adjusted upward. At 3-to-7 percent, the monitoring range for the growth of total domestic nonfinancial debt is centered on the actual growth of that aggregate over the past 3 years, but is 1 percentage point lower than the monitoring range in 1994. While the performance of the monetary and debt aggregates compared with these ranges will continue to inform the FOMC's deliberations, the uncertainties about the behavior of their velocities will necessitate careful interpretation of their behavior and a watchful eye toward a wide variety of other financial and nonfinancial indicators.

Information Release

One final point: To make our policy intent as transparent as possible to market participants without losing our flexibility or undermining our deliberative process, at its latest meeting, the FOMC decided to preserve the greater openness of its policy making that it established last year. To that end, all decisions to change reserve market conditions will be announced in a press release on the same day that the decision is made.

The debate surrounding each policy decision will be reported, as is currently the practice, in comprehensive minutes of the meeting that are released on the Friday following the next regularly scheduled meeting of the FOMC. For students of monetary policy making, those minutes will be supplemented by lightly edited transcripts of the discussion at each FOMC meeting. Transcripts for an entire year will be released with a 5-year lag. Continuing our current practice, the raw transcripts will be circulated to each participant shortly after an FOMC meeting to verify his or her comments, and only changes that clarify meaning, say to correct grammar or transcription errors, will be permitted. A limited amount of material will be redacted from these transcripts before they are released, primarily to protect the confidentiality of foreign and domestic sources of intelligence that would dry up if their information were made public. A complete, unredacted version of the transcripts of each FOMC meeting will be turned over to the National Archives after 30 years have elapsed, as required by law.

After careful consideration, the FOMC believed that these steps, which essentially formalize the procedures that we have been using over the past year, strike the appropriate balance between making our decisions and deliberations accessible as soon as feasible and retaining flexibility in policy making, while preserving an unfettered deliberative process.

Challenges Ahead

I and my colleagues appreciate the time and the attention that the Members of this Committee devote to oversight of monetary policy. Our shared goal—the largest

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possible advance in living standards in the United States over time—can be best achieved if our actions ultimately allow concerns about the variability of the purchasing power of money to recede into the background. Price stability enables households and firms to have the greatest freedom possible to do what they do best—to produce, invest, and consume efficiently.

But the best path to that long-run goal is not now, and probably never will be, obvious. Policy making is an uncertain enterprise. Monetary policy actions work slowly and incrementally by affecting the decisions of millions of households and businesses. And we adjust policy step-by-step as new information becomes available on the effects of previous actions and on the economic background against which policy will be operating. No individual step is ever likely to be decisive in pushing the economy or prices one way or another—there is no monetary policy "straw that broke the camel's back." The cumulative effects of many policy actions may be substantial, but the historical record suggests that any given change in rates will have about the same effect as a previous change of the same size.

Because the effects of monetary policy are felt only slowly and with a lag, policy will have a better chance of contributing to meeting the Nation's macroeconomic objectives if we look forward as we act—however indistinct our view of the road ahead. Thus, over the past year we have firmed policy to head off inflation pressures not yet evident in the data. Similarly, there may come a time when we hold our policy stance unchanged, or even ease, despite adverse price data, should we see signs that underlying forces are acting ultimately to reduce inflation pressures. Events will rarely unfold exactly as we foresee them, and we need to be flexible—to be willing to adjust our stance as the weight of new information suggests it is no longer appropriate. That flexibility, Mr. Chairman, applies to the particular stance of policy—not its objectives. We vary short-term interest rates in order to further the goals set for us in the Federal Reserve Act, namely, promoting over time "maximum employment, stable prices, and moderate long-term interest rates."

Achieving those goals has become increasingly more complex in the nearly two decades since they were put into the Federal Reserve Act, as a consequence of technology-driven changes in financial markets in the United States and around the world. Suppressing inflationary instabilities—a necessary condition of achieving our shared goals—requires not only containing prevalent price pressures, but also diffusing unsustainable asset price perturbations before they become systemic. These are formidable challenges, which will confront policy—both fiscal and monetary—in the years ahead. It is, of course, unrealistic to assume that we can eliminate the business cycle, human nature being what it is. But containing inflation and thereby damping economic fluctuations is a reasonable goal. We at the Federal Reserve look forward to working with the Administration and Congress in meeting our common challenges.

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR BOXER FROM ALAN GREENSPAN

Q.1. Last March, Mr. Luis Colosio, the Presidential candidate of the PRI in Mexico, was assassinated. A month later the United States, Mexico, and Canada announced a new, expanded $6 billion swap arrangement to help stabilize the peso. I understand the Fed was involved in negotiating that swap arrangement. Were you worried then that the then current value of the peso was not sustainable?

A.1. The trilateral foreign exchange swap facility was established on April 26, 1994, in connection with the creation of the North American Financial Group on that date. It had been agreed, in principle, before the assassination of Mr. Colosio on March 23. The enlargement of the pre-existing swap facility between the Federal Reserve and the Bank of Mexico reflected the growing importance of Mexico to the United States, especially following the conclusion of the NAFTA.

This swap facility is not intended to be used to defend an unsustainable exchange rate, but rather, as was stated in the press release on April 26, "to expand the pool of potential resources available to the monetary authorities of each country to maintain orderly exchange markets." The possibility that at some point Mexico might have to modify its exchange rate regime was recognized at the time the facility was established, but that possibility was not part of the rationale for the facility.

Q.2. Was the Federal Reserve aware last year that the Bank of Mexico was losing reserves rapidly? Was the Federal Reserve in regular consultation with the Bank of Mexico throughout last year? When did you become convinced that the peso had to be devalued?

A.2. The Federal Reserve has maintained a wide range of contacts with the Bank of Mexico for many years, and following the establishment of the North American Financial Group last year consultations among authorities in Mexico, Canada, and the United States were intensified. Through that process we became aware not only that the Bank of Mexico was losing reserves but also that the Mexican government was building up dollar-indexed liabilities in the form of Tesobonos.

We had been concerned for some time that Mexico's exchange rate might not be sustainable, given Mexico's growing current account deficit and evident waning confidence of foreign investors toward peso-denominated investments. After mid-year it became increasingly clear to many observers that the prevailing level of Mexico's exchange rate, which was then trading near the limit of its band against the dollar, could not be sustained short of a significant further tightening of monetary policy.

Q.3. By December 20, 1994, when Mexico devalued the peso did they really have any alternative?

A.3. By December, given the policies that had been implemented in Mexico and the consequences of those policies in terms of lost reserves and increased short-term dollar-indexed debt, the Mexican authorities probably had no realistic alternative to allowing the peso to float.

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Q.4. There are a number of theorists who have made the argument that the Federal Reserve Board ought to buy large amounts of pesos, thereby restoring the 3.5 peso-to-dollar exchange rate. Do you think that is a plausible strategy? If not, why not?

A.4. The Federal Reserve has never intervened in exchange markets to buy or sell Mexican pesos and would be very reluctant to do so, especially on a large scale. In any case, the purchase of pesos by the Federal Reserve, even in large amounts, would not by itself restore and maintain the level of confidence required for a restoration of the 3.5 peso-to-dollar exchange rate. It would be necessary also—indeed, more important—for monetary policy in Mexico to be geared to maintaining that exchange rate regardless of monetary policy changes implemented in the United States and other countries. That is Mexico's choice. It is not the Federal Reserve's role to dictate monetary policy to an independent central bank in a sovereign state.

Q.5. I understand that the Federal Reserve monitors monetary policy, exchange rates, and the bank reserves of foreign central banks. In light of yesterday's agreement with Mexico are you confident that the Mexicans have the reserves they need to carry out their reform program?

A.5. We monitor a range of economic and financial developments in many countries, including Mexico, because they may have important implications for the U.S. economy. If backed by strong economic policies, the agreements signed on February 21 by the U.S. Treasury and the Government of Mexico should provide sufficient financial resources to achieve the goals of the program.

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For use at 10:00 a.m., E.S.T.
Wednesday
February 22, 1995

Board of Governors of the Federal Reserve System

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

February 21, 1995

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 21, 1995

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

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

Sincerely,

Alan Greenspan, Chairman

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Section 1: Monetary Policy and the Economic Outlook for 1995

The U.S. economy turned in a strong performance in 1994. Real gross domestic product increased 4 percent over the four quarters of the year. The employment gains associated with this rise in production outpaced growth of the labor force by a sizable margin, and the unemployment rate thus declined substantially. Price increases picked up in some sectors of the economy in 1994 as labor and product markets tightened, but broader measures of price change showed inflation holding fairly steady: The consumer price index increased about 2¾ percent over the year, the same as the rise during 1993. Signs that growth is moderating have emerged in the past month or so, but the bulk of the evidence suggests the economy continues to advance at an appreciable pace.

Federal Reserve policy during 1994 and early 1995 was aimed at fostering a financial environment conducive to sustained economic growth. As the economy moved back toward high rates of resource utilization, pursuit of this aim necessitated acting to prevent a buildup of inflationary pressures. Federal Reserve policy had remained very accommodative in 1993 in order to offset factors that had been inhibiting economic growth. By early 1994, however, the expansion clearly had gathered momentum, and maintenance of the prevailing stance of policy would eventually have led to rising inflation that, in turn, would have jeopardized economic and financial stability. Taking account of anticipated lags in the effects of policy changes, the Federal Reserve began to firm money market conditions last February. The Federal Reserve continued to tighten policy over the course of the year and into 1995, as economic growth remained unexpectedly strong, eroding remaining margins of unused resources and intensifying price increases at early stages of production. Developments in financial markets—for example, easier credit availability through banks and a decline in the foreign exchange value of the dollar—may have muted the effects of the tightening of monetary policy.

Short-term interest rates have increased about 3 percentage points since the start of 1994, with the federal funds rate rising from 3 percent to 6 percent. Other market interest rates have risen between 1½ percentage points and 3 percentage points, on net, with the largest increases coming at intermediate maturities. Through much of the year, intermediate- and long-term rates were lifted by more rapid actual and expected economic growth, fears of a pickup in inflation, and market expectations of additional policy moves. However, a further substantial tightening in November and some tentative signs of moderation in economic activity around year-end and in early 1995 appeared to reduce market concerns about increased inflation pressures and additional Federal Reserve policy actions. As a result, long-term rates declined, on net, from mid-November through mid-February.

The foreign exchange value of the dollar in terms of other G-10 currencies declined almost 6½ percent last year, even as the economy picked up and interest rates rose. The positive effects on the dollar that would normally have been expected from higher U.S. interest rates were offset in large part by upward movements in long-term interest rates abroad. Indeed, foreign long-term rates increased as much on average as U.S. rates during 1994, owing to much more rapid than expected growth abroad, especially in Europe. Concerns about U.S inflation may have contributed to the weakness in the dollar in the middle part of last year; late in the year, the dollar rallied for a time, as tighter monetary policy apparently reduced investors' inflation fears. The dollar weakened again, however, in early 1995, perhaps reflecting the emerging indicators of moderating growth in the United States. In addition, financial markets were roiled early this year by severe financial difficulties in Mexico. A sharp depreciation of the peso had adverse effects not only in Mexico but also in a number of other countries, and these developments also may have contributed to the weakness of the dollar.

Despite the rise in U.S. interest rates in 1994, private sector borrowing picked up in support of increased spending, abetted in part by more aggressive lending by intermediaries. The debts of both households and businesses grew at their fastest rates in five years. The step-up in growth of private debt was accompanied by changes in its composition. Businesses shifted toward short-term funding sources as bond yields rose, increasing their bank borrowing and commercial paper issuance, while cutting back on new bond issues. Similarly, households turned increasingly to adjustable-rate mortgages as rates on fixed-rate mortgages increased substantially. Banks encouraged the shift of households and businesses to bank borrowing by easing lending standards and not allowing all of the rise in market rates to show through to loan rates. By contrast, federal borrowing was slowed in 1994 by policies adopted in previous years to narrow the federal deficit, as well as by the effects of the strong economy on tax receipts and

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Ranges for Growth of Monetary and Debt Aggregates[1]
Percent

Aggregate	1993	1994	1995
M2	1–5	1–5	1–5
M3	0–4	0–4	0–4
Debt[2]	4–8	4–8	3–7

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

2. Monitoring range for debt of domestic nonfinancial sectors

spending. Taken together, the debt of all nonfinancial sectors expanded 5¼ percent, about the same as the increase of a year earlier and a figure that was in the middle portion of the 1994 monitoring range of 4 percent to 8 percent.

Growth in the broad monetary aggregates remained subdued in 1994. M3 expanded about 1½ percent, well within its 0 percent to 4 percent target range and slightly more than its increase in 1993. M3 was buoyed by growth of more than 7 percent in large time deposits, as banks turned to wholesale markets to fund credit expansion. For the year, M2 rose only 1 percent, an increase that was at the lower bound of its 1 percent to 5 percent target range. In contrast to 1992 and 1993, the slow growth in M2, and the resulting further substantial increase in its velocity (the ratio of nominal GDP to the money stock), was not a consequence of unusually large shifts from M2 deposits to bond and stock mutual funds. Rather, it seemed to reflect behavior similar to that in earlier periods of rising short-term market interest rates. During such periods, changes in the rates available on retail deposits usually lag changes in market rates, providing an incentive to redirect savings from these deposits to market instruments. These shifts tend to have an especially marked effect on M1 because yields on its components either cannot adjust or adjust quite slowly to shifts in market rates. M1 growth last year was 2¼ percent; it had been 10½ percent in 1993. Only continued strong growth in currency, much of which likely reflected increased use abroad, supported M1.

Money and Debt Ranges for 1995

At its most recent meeting, the Federal Open Market Committee (FOMC) reaffirmed the 1995 growth ranges for money and debt that were chosen on a provisional basis last July. The money ranges—1 percent to 5 percent for M2 and 0 percent to 4 percent for M3—are consistent with the Committee members' expectations of a slowing of nominal income growth as the expansion moves to a more sustainable pace, but also rest on the anticipation of further increases in the velocities of these aggregates. The velocity of M2 is likely to be boosted by lagged effects of the increases in short-term interest rates during 1994 and early 1995 and possibly by increased flows from M2 deposits into long-term mutual funds, as investor concerns about capital market volatility recede. The M2 range also provides an indication of the longer-run growth that could be expected under conditions of reasonable price stability if that aggregate's velocity resumes its historical pattern of no long-term trend. M3 velocity has been on a steep upward path in recent years, but the rate of increase might be expected to slow in the near term. Part of the increase in M3 velocity in the early 1990s resulted from weak growth of bank credit, in part reflecting substantial loan losses and consequent capital impairment, and the contraction of the thrift sector as failed institutions were liquidated. However, the recent strength in bank credit and the end of the contraction in thrift sector credit suggest that M3 growth could pick up, perhaps appreciably, and its velocity could begin to level out. The resumption of a more normal relationship between M3 and nominal income might call for a technical adjustment of the target range for M3 at mid-year or in 1996.

The monitoring range for growth in the debt aggregate in 1995 is 3 percent to 7 percent. This range is 1 percentage point lower than the monitoring range in 1994, reflecting the more moderate path anticipated for expansion in nominal spending and borrowing. Private sector debt growth will likely remain fairly strong in the coming year, boosted by substantial

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Economic Projections for 1995
Percent

Indicator	Federal Reserve Governors and Reserve Bank Presidents		Administration
	Range	Central Tendency	
Change, fourth quarter to fourth quarter[1]			
Nominal GDP	4¾–6½	5–6	5.4
Real GDP	2–3¼	2–3	2.4
Consumer price index[2]	2¾–3¾	3–3½	3.2
Average level, fourth quarter			
Civilian unemployment rate	5¼–6	About 5½	5.5–5.8[3]

1. Change from average for fourth quarter of 1994 to average for fourth quarter of 1995.
2. All urban consumers.
3. Annual average.

capital investment as well as merger and acquisition activity. Credit availability is unlikely to constrain private sector borrowing, as banks continue to be eager to lend and as quality spreads in financial markets remain relatively narrow. The outlook for the federal deficit suggests that Treasury borrowing will be comparable to that in 1994.

The monetary and debt aggregates will continue to be among the variables monitored by the Committee to inform its policy deliberations. Given the uncertainties about the behavior of the velocities of the aggregates, however, the Committee will also need to continue assessing a wide variety of other financial and economic indicators.

Economic Projections for 1995

The members of the Board of Governors and the Reserve Bank presidents, all of whom participate in the deliberations of the Federal Open Market Committee, expect the economy to settle into a pattern of more moderate expansion in 1995, after a burst of growth that has brought rates of resource utilization to the highest levels since the latter part of the 1980s. Most of the Board members and Reserve Bank presidents expect the rise in real GDP over the four quarters of 1995 to be in a range of 2 percent to 3 percent.

Effects of the past year's increases in interest rates probably will show through more strongly in the coming year, reflecting the typical lags between Federal Reserve policy actions and changes in the pace of economic growth. Residential building, especially of single-family units, is the part of the economy in which those effects are likely to emerge earliest and stand out most clearly, but reactions to the higher rates probably will be showing up in other interest-sensitive sectors as well.

Other influences also will be working to moderate the rate of growth. For example, large increases in real outlays for consumer durables over the past three years, partly financed in recent quarters by unsustainably rapid growth in the volume of consumer credit, probably have exhausted most of the pent-up demand that had accumulated when the economy was sluggish early in the 1990s. Similarly, business investment in new equipment has been rising extremely rapidly for some time and has moved to quite a high level; businesses likely will be shifting to more moderate rates of spending growth before too long. Inventory investment seems likely to moderate as well, as sustained additions to stocks at the pace of recent quarters would almost surely generate an unwanted backup of inventories at some point.

In other areas, however, increased strength may be forthcoming. Nonresidential construction, which often tends to lag other sectors of the economy over the course of the business cycle, now appears to be picking up steam. In addition, net exports may be a less negative factor in coming quarters than they were in 1994. Many foreign industrial economies entered the new year with considerable forward momentum; that

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should keep real exports of goods and services on a solid uptrend, even allowing for lower exports to Mexico as a consequence of the peso's devaluation and the likelihood of little or no growth in that country in 1995. Imports, meanwhile, should begin to slow as growth of demand in this country eases.

The Board members and Reserve Bank presidents expect that output growth of the magnitude they anticipate will be accompanied by moderate increases in employment and little change in the unemployment rate. Forecasts of the unemployment rate for the fourth quarter of 1995 are tightly clustered around 5½ percent.

An especially encouraging development in 1994 was that inflation remained relatively quiescent even as the economy moved to high rates of resource utilization. However, the costs of materials and components have been rising rapidly, squeezing profit margins in some sectors, and anecdotal reports of pressures on wages and finished goods prices have proliferated in recent months; increases in average hourly earnings and consumer prices picked up in January. Assessing the prospects, members of the Board of Governors and the Reserve Bank presidents think the most likely outcome for this year is that inflation will run somewhat higher than in 1994. Such an outcome would be consistent with patterns of price change during earlier periods when the economy was operating at levels of resource utilization like those seen recently. The central tendency of the Federal Reserve officials' CPI forecasts, measured in terms of the change from the final quarter of 1994 to the final quarter of 1995, spans a range of 3 percent to 3½ percent.

The economic prospects anticipated by the governors and Reserve Bank presidents for 1995 appear to be closely in line with those of the Administration. The Administration's forecasts of real GDP growth and inflation are in the middle of the Federal Reserve's central tendency ranges, and the Federal Reserve forecasts of the unemployment rate are centered near the low end of the annual range that was published in the *Economic Report of the President*.

Over the coming year, the Federal Reserve will seek to foster continued economic expansion while avoiding the provision of so much liquidity that the expected near-term step-up in inflation develops sustained momentum. Much progress has been made over the past couple of business cycles in reducing the role that inflation plays in the economic decisions of households and businesses. Moving ahead, the challenge will be to preserve and extend this progress, given that the Federal Reserve can best contribute to long-run prosperity by establishing an environment of effective price stability.

Economic prospects for the long run will be further enhanced if Congress and the Administration succeed in making further progress in reducing the federal budget deficit. An improved outlook for the federal deficit over the remainder of this decade and beyond could have significant favorable effects in financial markets, including a shift in long-term interest rates to a trajectory lower than that which would otherwise prevail. Such a shift in long-term rates would be an essential part of a process in which a larger share of the nation's limited supply of savings would be channeled to productivity-improving investment, thereby boosting growth in output and living standards.

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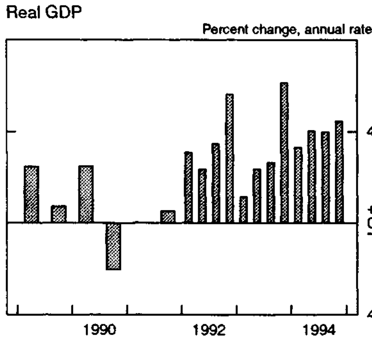
Section 2: The Performance of the Economy

The economy recorded a third year of strong expansion in 1994. Real GDP grew 4 percent over the four quarters of the year, industrial output rose nearly 6 percent, and the number of jobs on nonfarm payrolls increased about 3½ million, the largest gain in ten years. Labor and product markets tightened appreciably. Price pressures intensified in the markets for materials, but broader measures of price change showed inflation holding steady.

Real GDP



As in 1992 and 1993, the economic advance during 1994 was driven mainly by sharp increases in the real expenditures of households and businesses. Consumer purchases of motor vehicles rose further in 1994, and purchases of other consumer durables increased even faster than they had in the two previous years. Residential investment posted a small gain, on net, over the four quarters of the year, despite sharp increases in mortgage interest rates. Business investment in office and computing equipment slowed from the spectacular pace of 1993 but continued to rise rapidly nonetheless, and business investment in other types of equipment accelerated. Real outlays for nonresidential construction, which had been a weak sector of the economy in previous years, picked up in 1994; outlays for office construction ended a long slide that had stretched well back into the 1980s. Business investment in inventories, which had been quite restrained in previous years of the expansion, increased appreciably in 1994. Much of the inventory buildup apparently was intentional and reflected the desires of firms to stock up in anticipation of continued strength in sales or to build stronger buffers against potential delays in supply.

In contrast to the strength in private expenditures, government purchases of goods and services edged down on net over the four quarters of 1994. Federal purchases of goods and services, which had declined sharply in 1993, fell further in 1994 as a consequence of actions taken in recent years to reduce the size of the federal deficit. Meanwhile, the real purchases of state and local governments rose only modestly. Although the expanding economy has provided states and localities with a stronger revenue base, many of these jurisdictions are striving to hold spending in check; a number of states have chosen to cut taxes.

As in the two previous years, a significant portion of the rise in domestic spending in 1994 went for imports of goods and services, which increased about 15 percent in real terms during the year. Meanwhile, growth of real exports of goods and services picked up noticeably, with gains cumulating to about 10 percent over the year. Foreign economies strengthened in 1994, and the price competitiveness of this country's products in world markets was aided by a subdued rate of rise in production costs and a somewhat lower exchange value of the U.S. dollar.

Labor and product markets tightened in 1994. After ticking up in January of last year in conjunction with the introduction of a new labor market survey, the civilian unemployment rate fell sharply over the remainder of the year, to 5.4 percent in December. The level of the unemployment rate in January of this year—5.7 percent—was a full percentage point below that of a year earlier. In manufacturing, gains in production exceeded the growth of capacity by a sizable margin during 1994, and the rate of capacity utilization climbed nearly 3 percentage points. Its level in recent months has been essentially in line with the highest level achieved during the economic expansion of the 1980s.

Inflation pressures picked up in some markets in 1994. Prices of raw industrial commodities rose even more rapidly than in 1993, and price increases for intermediate materials accelerated sharply, especially after midyear. However, the inflation impulse in these markets did not carry through with any visible force to the consumer level, probably because unit labor costs, which make up by far the largest part of value added in production and marketing, continued to rise at a modest rate. The employment cost index of hourly compensation in private nonfarm industries actually slowed noticeably from the pace of 1993, and productivity gains in 1994 held close to the pace of

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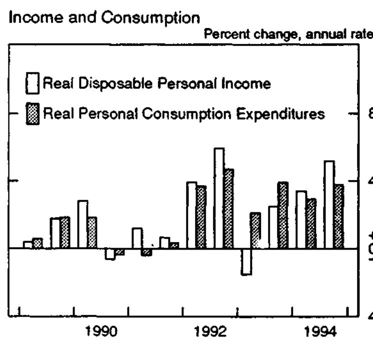
the previous year. As for retail prices, 1994 was the fourth year in a row in which the rise in the total CPI has been around 3 percent. The CPI excluding food and energy rose just 2.8 percent over the four quarters of 1994, after an increase of 3.1 percent in 1993; the rate of rise in this index, which is widely used as an indicator of underlying inflation trends, fell by almost half from 1990 to 1994.

The Household Sector

Real personal consumption expenditures advanced nearly 3½ percent over the four quarters of 1994, about in line with the average pace of the two previous years. Support for the rise in spending came from rapid income growth, and, according to surveys, sharp increases in consumer confidence. Outlays for durable goods continued to rise especially rapidly, seemingly little affected by rising interest rates. Nor did spending appear to be much affected, in the aggregate, by poor performance of the stock and bond markets, which cut into the real value of household assets. Credit generally was readily available during 1994, and growth of consumer installment debt picked up substantially, to a pace comparable with some of the larger increases that were observed during the expansions of the 1970s and 1980s.

Income and Consumption



Real consumer expenditures for durable goods increased about 8 percent in 1994, bringing the cumulative rise in these outlays over the past three years to nearly 30 percent. The stock of durable goods that households wish to hold apparently continued to rise quite rapidly in 1994, and at least some households probably were still making up for purchases that had been put off earlier in the 1990s when the economy was sluggish and concerns about job prospects were widespread. Real expenditures for motor vehicles moved up an additional 3 percent over the four quarters of 1994, after gains of about 9 percent in each of the two preceding years; increases in sales of vehicles in 1994 might have been a bit stronger still but for capacity constraints and various supply disruptions that sometimes limited the availability of certain models. Real outlays for durable goods other than motor vehicles rose about 11½ percent over the four quarters of 1994, a pickup from the already rapid rates of expansion of the two previous years. Purchases of personal computers and other electronic equipment continued to surge in 1994, and spending on furniture and household appliances moved up further.

Consumer expenditures for nondurables and services exhibited mixed patterns of change in 1994. Real outlays for nondurables increased 3 percent over the year, a pickup from the subdued rate of growth recorded in the previous year and, for this category, a larger than average advance by historical standards. By contrast, real expenditures for services increased roughly 2¼ percent, a slightly smaller gain than that of 1993; growth of outlays for services was held down, to some degree, by a decline in real outlays for energy, as warm weather late in 1994 reduced the amount of fuel needed for heating.

Real disposable personal income rose 4¼ percent during 1994. Except for a couple of occasions in previous years when income growth was boosted temporarily by special factors, the rise in real disposable income in 1994 was the largest increase since the 1983–84 period. Growth of wages and salaries accelerated in 1994 in conjunction with the step-up of employment growth. Income from capital also rose: Dividends moved up along with corporate profits, and interest income turned back up after three years of decline. By contrast, transfer payments, the growth of which tends to slow as the economy strengthens, registered the smallest annual increase since 1987. The net income of nonfarm proprietors appears to have about kept pace with the average rate of growth in other types of income. Farm income rose moderately on an annual average basis, as an increase in the volume of output more than offset the effects of sharp declines in farm output prices that developed over the course of the year.

Consumers' perceptions of economic and financial conditions brightened considerably during 1994. By year-end, the composite measures of consumer confidence that are prepared by the Conference Board and

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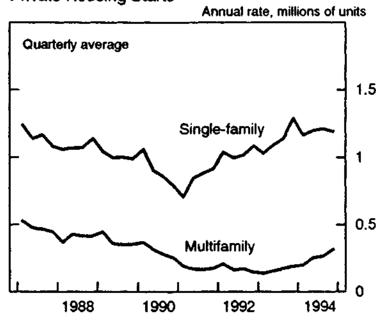
the University of Michigan Survey Research Center had both moved to new highs for the current business expansion. Consumers became more optimistic over the year in regard to both current economic conditions and future economic conditions. Perceptions of employment prospects also improved, with a growing proportion of respondents saying that jobs were plentiful and a reduced proportion saying that jobs were hard to find. Surveys taken early this year indicate that confidence remains high.

In contrast to most other indicators for the household sector of the economy, household balance sheets—which had strengthened appreciably in previous years—showed no further improvement in 1994. According to preliminary data, the aggregate net worth of households appears to have recorded a relatively small increase in nominal terms over the year, and, in real terms, net worth probably declined slightly. Household assets rose only moderately in nominal terms, and the growth of nominal liabilities picked up somewhat, as a result of the sharp increase in use of consumer credit. Early this year, stock and bond prices have risen, on net, giving some renewed lift to household wealth.

With personal income growing faster than net worth during 1994, the ratio of wealth to income fell over the course of the year. In the past, declines in this ratio sometimes have prompted households to boost the proportion of current income that is saved, in an attempt to restore wealth to more desirable levels, and this same tendency may have been at work, to some extent, in 1994. After dipping in the first quarter of the year to the lowest level of the current expansion, the personal saving rate rose a full percentage point over the remainder of the year, to a fourth-quarter level of 4.6 percent. Even then, however, the saving rate remained quite low by historical standards. Rising levels of income and employment and increased confidence in the outlook apparently convinced consumers to push ahead with increases in outlays, most notably those on consumer durables. In addition, although improvement in household balance sheets apparently flagged, signs of outright stress in household financial conditions were not much in evidence: Delinquency rates on mortgages and other household loans generally remained quite low relative to their historical ranges.

Residential investment held up remarkably well in 1994 in the face of sharp increases in mortgage interest rates. Preliminary data indicate that, in real terms, these investment outlays were up about 2 percent, on net, over the four quarters of the year, after gains of 17 percent and 8 percent, respectively, in 1992 and 1993. Although starts and sales of single-family houses fell back from the exceptionally high peaks that were reached briefly in late 1993, they remained at elevated levels. In total, 1.20 million single-family units were started in 1994, topping, very slightly, the highest annual total of the 1980s. Sales of existing homes were about the same as the previous annual peak, set in 1978, and although sales of new homes remained well short of previous highs, their annual total was closely in line with the brisk pace of 1993. Only in the past month or so have indications of a weakening in housing activity started to show up more consistently in the incoming data.

Private Housing Starts



Declines in the starts and sales of single-family houses in early 1994 basically reversed the huge gains of late 1993. Whatever tendency there may have been for these indicators to exhibit at least a temporary setback after a period of unusual strength was probably reinforced by the initial reactions of builders and homebuyers to increases in mortgage interest rates that had begun in the final quarter of 1993. Exceptionally severe winter weather in the Northeast and Midwest early in 1994, coming on the heels of favorable conditions in late 1993, probably also helped to account for the sharpness of the downturn. In any event, starts of single-family homes ticked back up a bit in the second quarter of the year, sales of existing homes flattened out, and the rate of decline in sales of new homes slowed.

In the second half of the year, the signals were mixed: Sales of existing homes trended down at a moderate pace during this period; however, single-family starts and sales of new single-family homes changed little, on net, from the second quarter to the fourth quarter. Sizable gains in employment and

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income and rising optimism about the future of the economy apparently helped to blunt the effects of increases in interest rates during the second half of the year. In addition, the availability of a widening variety of alternative mortgage instruments and, perhaps, some easing of loan qualification standards may have permitted some buyers who otherwise would not have been able to obtain financing to go ahead with their purchases.

Late in 1994 and in early 1995, a softer tone seems to have taken hold in key indicators of single-family housing activity. Sales of new homes tailed off toward the end of last year, and the ratio of the number of unsold homes to the number of sales, which had turned up early in 1994, continued to rise. The ratio in December was slightly to the high side of the long-run average for this series. Starts of new single-family houses, which had increased in November and December, fell sharply in January, to a level noticeably below the lower bound of the range of monthly readings reported during 1994.

Various measures of house prices showed small-to-moderate increases in 1994. The median transactions prices of new and existing homes that were sold in the first half of the year were roughly 3½ percent above the level of a year earlier, and a similar rise was reported during that period in price indexes that adjust for changes in the quality and regional mix of homes that are sold. After mid-year, the four-quarter changes in transactions prices slowed, but the rate of rise in the quality-adjusted indexes picked up somewhat. All told, prices have been firmer in the past couple of years than they were earlier in the 1990s.

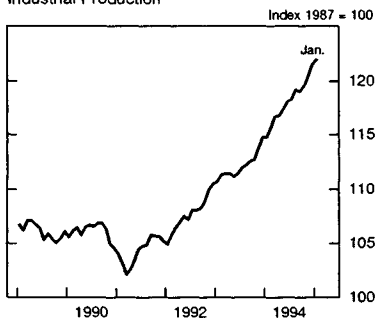
After falling to exceptionally low levels in late 1992 and early 1993, construction of multifamily housing units increased throughout 1994. Although the level of activity in this part of the housing sector was not especially high, gains during the year were large in percentage terms: Starts of these units moved up about 65 percent from the fourth quarter of 1993 to the fourth quarter of 1994, at which point they were more than double the lows of a couple years ago. The national average vacancy rate for multifamily rental units remained relatively high in 1994, but markets in some areas of the country had tightened enough to make construction of new multifamily units economically attractive. Reauthorization in August 1993 of a tax credit on low-income housing units also provided some incentive for new construction. The financing of multifamily projects was facilitated through more ready availability of credit and increased equity investment.

The Business Sector

Robust expansion was evident in 1994 in most of the economic indicators for the business sector of the economy. Real output of nonfarm businesses increased about 4¼ percent over the four quarters of the year, nearly matching the large gain of 1993. For a second year, business investment in fixed capital advanced exceptionally rapidly. Inventory investment also picked up appreciably, spurred by large, sustained increases in sales. Business finances remained on a sound footing: Investment expenditures continued to be financed predominantly with internal funds, and signs of financial stress were largely absent.

Industry entered 1994 with considerable momentum, and expansion was maintained at a rapid pace throughout the year. Industrial production rose nearly 6 percent over the four quarters of 1994, a rate of expansion exceeded in only one of the past ten years. The production of business equipment advanced especially rapidly, buoyed by rising investment in the domestic economy and further large increases in exports of capital goods. Production of intermediate products—which consist mainly of supplies used in business and construction—also moved up substantially during 1994, as did the output of materials, especially those used as inputs in the production of durable goods. The industrial sector also appears to have had a strong start in 1995, as industrial production rose 0.4 percent in January.

Industrial Production



The rate of capacity utilization in industry increased about 2½ percentage points over the twelve months of 1994. In manufacturing, the operating rate rose about 3 percentage points during the year. By year-end, utilization rates in some industries had

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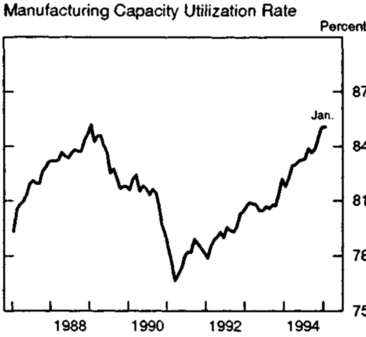
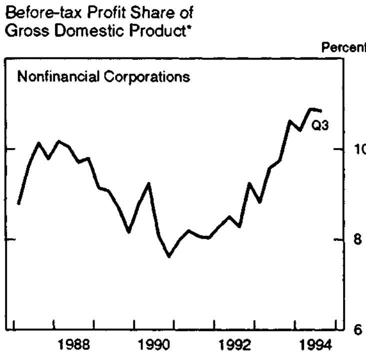


moved to exceptionally high levels. Most notably, the average operating rate among manufacturers engaged in primary processing (basically, the producers of materials) had climbed to the highest level since the end of 1973, surpassing, by small margins, the peaks of the late 1970s and late 1980s.

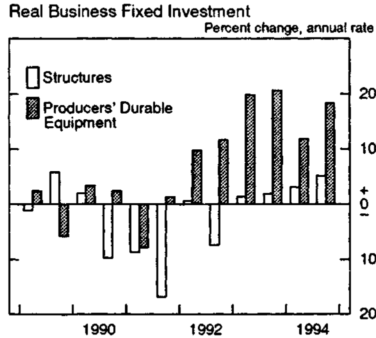
After rising 23½ percent over the four quarters of 1993, corporate profits increased another 4 percent over the first three quarters of 1994. The profits earned by nonfinancial corporations from their domestic operations increased about 7½ percent over the first three quarters of 1994, after a gain of 21½ percent in 1993. Although the 1994 gain in these profits was partly the result of increased volume,



* Profits from domestic operations with inventory valuation and capital consumption adjustments divided by gross domestic product of nonfinancial corporate sector.

profits per unit of output also rose. In the second and third quarters, before-tax profits of nonfinancial corporations amounted to nearly 11 percent of the gross domestic output of those businesses—the highest that this measure of the profit share has been since the late 1970s. A shift in the capital structure of corporations toward reduced reliance on debt, as well as cyclical recovery of the economy, has helped to push the profit share to this high level. In contrast to the experience of nonfinancial corporations, the profits of private financial institutions from their domestic operations fell about 7 percent on net over the first three quarters of the year, as net interest margins narrowed. The decline reversed some of the large rise in profits that these institutions had reported in 1993.

Business fixed investment increased 13 percent in real terms over the four quarters of 1994, after a gain of 16 percent during 1993. Outlays for office and computing equipment, which had registered an astonishing gain in 1993, slowed in 1994, but the rise in these outlays still amounted to nearly 20 percent in real terms. Meanwhile, the growth of real expenditures for most other types of business equipment picked up.



Business investment in motor vehicles rose about 18½ percent over the four quarters of 1994. With the gains of 1994 coming on the heels of big increases in each of the two previous years, annual business outlays for vehicles reached a level about one-third higher than the peak year of the 1980s. Outlays for communications equipment also scored an especially big gain in 1994, more than 25 percent in real terms. Business purchases of industrial equipment advanced about 13 percent during 1994, one of the larger gains of the past two decades. By contrast, commercial

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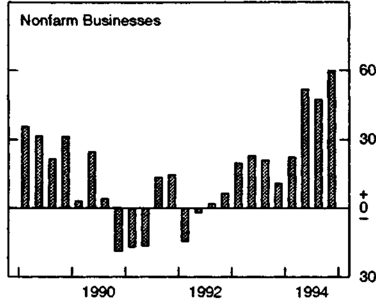
aircraft once again was a notable area of weakness; the investment cycle in that sector has been sharply out of phase with those of most other industries, owing to persistent excess capacity and poor profitability in the airline business.

Business investment in nonresidential structures rose about 4 percent during 1994, after an increase of 1½ percent in 1993 and declines in each of the three years preceding 1993. Investment in industrial structures rose for the first time since 1990, a response, more than likely, to high—and rising—rates of capacity utilization. Investment in office buildings also turned up in 1994, after a long string of declines that, in total, had brought spending on these structures down about 60 percent from the peak of the mid-1980s; declining vacancy rates and a firming of property values provided additional evidence of improvement in this sector of the economy in 1994. The investment data for other types of structures showed a mix of pluses and minuses: Expenditures on commercial structures other than offices moved up further, after large gains in 1992 and 1993; however, outlays for drilling declined for a fourth year, to the lowest level since the early 1970s.

Because a large share of the growth in business fixed investment in recent years has gone for items that depreciate relatively quickly—computers being a prime example—net additions to the stock of productive capital have not been as impressive as the data on gross investment expenditures might seem to indicate. Nonetheless, with the further increase in gross investment in 1994, net additions to the capital stock appear to have become more substantial. Still unclear is the degree to which these increases in the capital stock will ultimately translate into higher rates of increase in output per worker and faster rates of increase in living standards: as discussed in more detail below, the trend of growth in labor productivity, which is affected by the amount and quality of capital that workers have available, seems to have picked up in recent years but by a relatively small amount.

Business investment in inventories picked up sharply in 1994. Earlier in the expansion, firms had refrained from building stocks, even as the economy strengthened. Increased reliance on "just-in-time" systems of inventory control reduced the level of stocks that firms needed to maintain their normal operations, and, with a degree of slack still present in the economy, businesses usually were able to obtain goods quickly from their suppliers and thus were probably reluctant to hold stocks in house. At the end of 1993, the level of real inventories in the nonfarm business sector was only 2 percent larger than it had been at the start of the recovery in early 1991.

Changes in Real Business Inventories



Circumstances changed in 1994, however. Markets tightened as demand continued to surge, and supplies became more difficult to obtain on a timely basis. Anticipation of further growth in demand and increased concern about possible bottlenecks apparently prompted businesses to begin investing more heavily in inventories. Some firms may also have been trying to stock up on materials in advance of anticipated price increases. For the year as a whole, accumulation of nonfarm inventories was more than twice what it had been in 1993. This additional accumulation brought to a halt the previous downtrend in the ratio of nonfarm inventories to business sales, but the ratio remained quite low by the standards of the past quarter-century.

Inventory accumulation in the farm sector of the economy also picked up in 1994. Stocks of farm products had been drawn down in 1993, when farm production fell sharply because of floods in the Midwest and droughts in some other regions of the country. However, crop conditions in 1994 were unusually favorable throughout the year, and the output of some major crops climbed to levels considerably above previous peaks. With the demand for farm output rising much less rapidly than production, inventories of crops increased sharply. Livestock production also rose appreciably in 1994; inventories of livestock, which consist mainly of the cattle and hogs on farms and ranches, continued to expand.

The Government Sector

Federal purchases of goods and services, the part of federal spending that is included in GDP, fell

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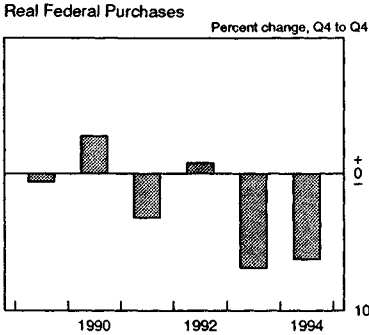
Real Federal Purchases



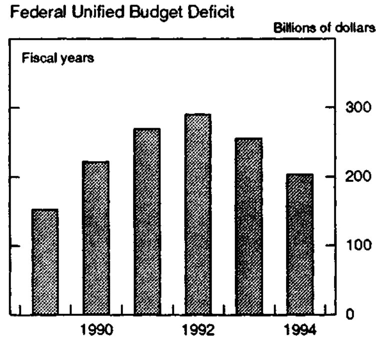
6.2 percent in real terms over the four quarters of 1994. Real outlays for defense remained on a sharp downtrend, and nondefense outlays, which had risen rapidly early in the 1990s, declined moderately for a second year.

Total federal outlays, measured in nominal dollars in the unified budget, increased 3.7 percent in fiscal 1994, after a rise of 2.0 percent the previous fiscal year. These increases are among the smallest of recent decades. Nominal outlays for defense fell again in fiscal 1994. In addition, the growth of outlays for income security (a category that includes the expenditures on unemployment compensation and welfare benefits) slowed further as the economy continued to strengthen. Increases in social security outlays also slowed somewhat in fiscal 1994; the rise was about a percentage point less than that of nominal GDP. Outlays for Medicaid slowed as well, but the rate of rise in those expenditures continued to exceed the growth of nominal GDP by a large margin.

Federal receipts were up 9 percent in fiscal 1994, the largest rise in several years. With rapid expansion of the economy giving a strong boost to almost all types of income, the major categories of federal receipts all showed sizable gains. Combined receipts from individual income taxes and social insurance taxes increased a bit more than 7 percent in fiscal 1994, after moving up 5.4 percent in the previous fiscal year. Receipts from taxes on corporate profits increased nearly 20 percent, slightly more than the gain of 1993.

The federal budget deficit declined to $203 billion in fiscal 1994, an amount that was equal to 3.1 percent of nominal GDP. Earlier in the 1990s, when the economy was sluggish, the federal deficit had climbed to a cyclical peak of 4.9 percent of nominal GDP. The previous cyclical low in the ratio of the deficit to nominal GDP, 2.9 percent, was reached in fiscal 1989. Since fiscal 1989, defense spending as a share of GDP has dropped appreciably, but this source of deficit reduction has been essentially offset by increased outlays for health and social insurance. Thus, the ratio of total federal outlays to GDP has changed little, on net; it was about 22 percent in both fiscal 1989 and fiscal 1994. The ratio of federal receipts to nominal GDP was about 19 percent in both of those fiscal years.

Federal Unified Budget Deficit



The stronger economy of recent years has provided state and local governments with a growing revenue base and a broadening set of fiscal options. Some governments have responded to these developments by cutting taxes, in most cases by small amounts. Effective tax rates of state and local governments appear to have edged down a bit, on average, over the four quarters of 1994, and nominal receipts apparently rose somewhat less rapidly than nominal GDP over that period.

Many states and localities also have been trying to restrain the growth of expenditures, but success on that score has been difficult to achieve because of increased outlays for entitlements and rising demand for many of the public services that traditionally have been provided by state and local governments. Transfers of income from state and local governments to persons rose about 9 percent in nominal terms over the four quarters of 1994, roughly the same as the rise during 1993 but less than the increases of previous years; from 1988 to 1992, the average compound rate of growth in these transfers was about 15 percent a year. In categories other than transfers, increases in spending have been fairly restrained in recent years;

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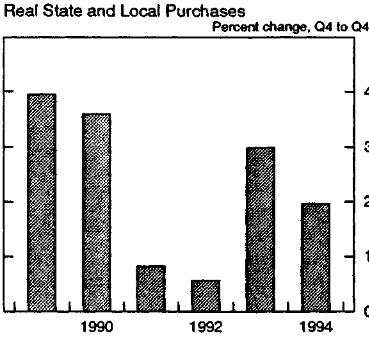
Real State and Local Purchases



nominal purchases of goods and services (which account for about 80 percent of the total expenditures of state and local governments) have been trending up less rapidly than nominal GDP since the early 1990s.

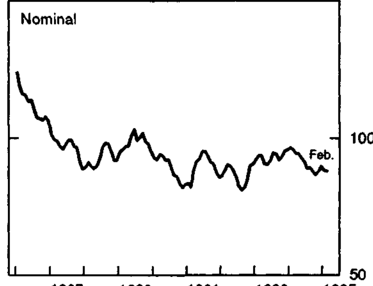
In real terms, the 1994 rise in purchases of goods and services by state and local governments amounted to just 2 percent. Compensation of employees, which accounts for about two-thirds of total state and local purchases, increased 1½ percent in real terms over the four quarters of 1994, a gain that was roughly in line with the growth of state and local employment over that period. Construction outlays declined slightly in real terms during 1994, as gains over the final three quarters of the year were not sufficient to offset a first-quarter plunge. Nonetheless, real outlays for structures remained at high levels; a strong uptrend in construction expenditures over the past ten or twelve years has more than reversed a long contraction that began in the latter half of the 1960s and bottomed out in the first half of the 1980s.

The deficit in the combined operating and capital accounts of all state and local governments (a measure that excludes the surpluses in state and local social insurance funds) amounted to about 0.6 percent of nominal GDP in calendar 1994, little changed from the corresponding figure for 1993 and down only slightly from a cyclical peak of 0.8 percent in 1991. The recent cyclical peak in this measure was larger than the peaks reached in recessions of the 1970s and 1980s, and declines in the deficit during this expansion have not been as large as the declines that occurred during other recent expansions. Historically, the combined operating and capital accounts of state and local governments have been in deficit more often than they have been in surplus; as a share of nominal GDP, the annual surpluses and deficits since World War II have averaged out to a deficit of 0.3 percent.

The External Sector

When adjusted for differing rates of increase in consumer prices, the trade-weighted average foreign exchange value of the U.S. dollar declined 5½ percent against the currencies of the other G-10 countries in 1994. This depreciation was slightly smaller than the almost 6½ percent nominal depreciation of the dollar, as U.S. inflation exceeded foreign inflation by a small amount. An index of exchange rates that also includes the currencies of several of the major U.S. trading partners in Latin America and East Asia showed about the same degree of real depreciation as did the index for the currencies of the G-10 countries. In the first few weeks of 1995, the dollar has weakened, on balance, in nominal terms against the currencies of the G-10 countries, but it has moved up in terms of the Mexican peso.

Foreign Exchange Value of the U.S. Dollar *



*Index of weighted average foreign exchange value of the 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.

Growth of real GDP in the major foreign industrial countries rebounded sharply during 1994, significantly exceeding the pace of recovery widely expected at the start of the year. In the United Kingdom and Canada, where recovery was already well established, growth continued to be vigorous. In Germany, France, and other continental European countries, where activity had been sluggish during 1993, strong expansion of real GDP resumed and strengthened as the year progressed. Recovery was evident in Japan as well, but the pace of expansion there remained somewhat subdued relative to that of the other indus-

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trial countries. Although most of these economies clearly had moved past the troughs of their recessions, considerable slack remained. As a result, consumer price inflation remained low and, in some cases, fell further. On average, in the ten major foreign industrial countries, consumer prices rose 2 percent during the year, even less than the price increase in the United States.

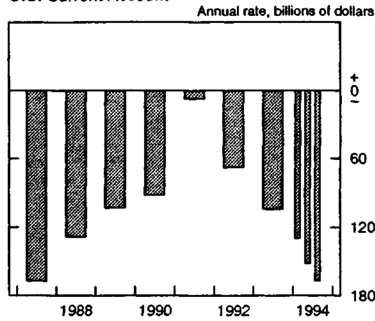
Economic growth in the major developing countries in 1994 continued at about the strong pace of 1993. In Asia, the newly industrializing economies grew rapidly, as external demand was sustained by lagged effects of depreciation of their currencies against the yen and by recovery in the industrial countries. Growth in China, although still quite rapid, was somewhat slower than that in 1992–93, as credit conditions were tightened somewhat further and various controls were imposed to damp demand.

In Mexico, real GDP growth rose markedly during the second and third quarters of 1994 from its near-zero rate in 1993, in part because of fiscal stimulus. However, the economic policy program put in place at the end of the year in response to the peso crisis is likely to restrain growth once again in the coming year. The Mexican macroeconomic stabilization program is designed to maintain wage restraint, reduce government spending and development bank lending, and result in significant improvement in the current account deficit in 1995. The program includes guidelines on increases in wages, guidelines on increases in final energy product prices to consumers and to industry, net cuts in public expenditures, and a reduction of lending by development banks. Mexico has committed to maintain the current floating exchange rate regime, and the Bank of Mexico has agreed to restrain the growth of money. Structural reform measures include continued privatization and lessened restrictions on foreign investment. Further measures could be required if inflation and the exchange rate do not respond as projected.

The nominal U.S. trade deficit in goods and services increased to about $110 billion in 1994, compared with $75 billion in 1993. Imports grew noticeably faster than exports, as U.S. growth about equaled that of U.S. trading partners and as the lagged effects of dollar appreciation during 1993 continued to be felt. The current account deficit averaged about $150 billion at an annual rate over the first three quarters. Net investment income moved from a small positive to a moderately negative figure in 1994, reflecting recovery of foreign earnings on direct investment in the United States and the effects of higher interest rates on high and rising U.S. net external indebtedness.

U.S. Current Account

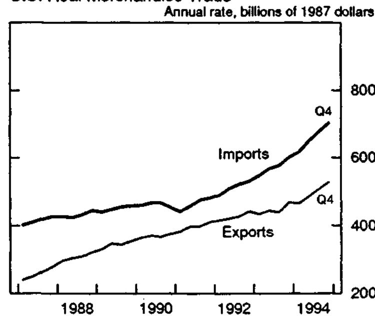
Annual rate, billions of dollars



Based on initial estimates for the fourth quarter, exports of goods and services grew 10 percent in real terms during 1994. Computer exports continued to rise rapidly in real terms, about 30 percent for the year; this gain contributed significantly to the double-digit growth in total exports. After declining in 1993, agricultural exports bounced back last year; the much-improved harvest of 1994 eased supply constraints that previously had been limiting shipments of farm products. Other categories of merchandise exports averaged more than 8 percent real growth during the year, as the pace of activity in the economies of U.S. trading partners improved significantly. Geographically, the increase in U.S. merchandise exports was accounted for by increased shipments both to developing countries in Latin America and Asia and to Canada and Japan.

U.S. Real Merchandise Trade

Annual rate, billions of 1987 dollars



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Imports of goods and services rose about 15 percent in real terms over the four quarters of 1994, reflecting the vigorous growth of U.S. income during the year. Imports of computers continued to expand extremely rapidly in real terms. Of the other import categories, imports of machinery and automotive products were particularly buoyant. Import prices rose about 4 percent in 1994, influenced by depreciation of the U.S. dollar, increases in world commodity prices, and a rebound in oil prices, which had declined in 1993 and early 1994.

In the first three quarters of 1994, recorded net capital inflows were substantially larger than those of 1993, an increase that coincided not only with the growing current account deficit, but also with a sharp swing in unrecorded transactions in the U.S. international accounts, from a positive figure in 1993 to a negative one in the first three quarters of 1994.[1]

Among the recorded capital flows, increases in foreign official assets in the United States were substantial in 1994, but somewhat smaller than in 1993. In particular, the large reserve accumulations in 1993 by certain developing countries in Latin America experiencing massive private capital inflows were not repeated in 1994.

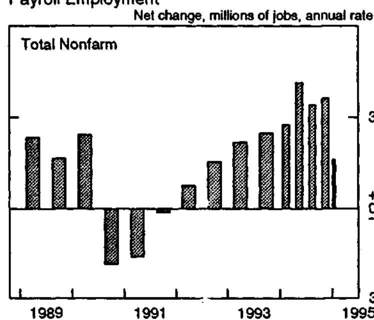
U.S. net purchases of foreign securities, particularly bonds, fell sharply from record 1993 levels. Private foreign net purchases of U.S. securities also fell, but only slightly. Rising interest rates on bonds denominated in dollars and many other major currencies produced capital losses for U.S. holders of long-term bonds and resulted in flows out of U.S. global bond funds. In the first three quarters of 1994, U.S. investors made heavy net purchases of stocks in Japan; Japan alone accounted for more than one-third of all U.S. net foreign stock purchases. In developing countries, those that received the largest net equity inflows from U.S. investors in 1993 (Hong Kong, Mexico, Argentina, Brazil, and Singapore) were less favored by investors in 1994, while interest picked up in a wide assortment of other developing countries, including South Korea, Chile, Indonesia, China, India, and Peru.

The first three quarters of 1994 also witnessed a revival of foreign direct investment in the United States while U.S. direct investment abroad remained at near-record levels. The direct investment inflow was swelled by takeovers of U.S. companies and by the revival of profits and reinvested earnings reported by affiliates of foreign companies in the United States.

Labor Markets

Employment rose substantially in 1994. The total number of jobs in the nonfarm sector of the economy increased 3.5 million over the twelve months ended in December, after a gain of 2.3 million during 1993.[2] About a quarter of a million of the rise in jobs during 1994 was in the government sector, mostly at the local level. Job growth in the private nonfarm sector amounted to 3.2 million, the largest gain since 1984. Increases in employment at nonfarm establishments were sizable in each quarter of 1994. A further gain in payroll employment, smaller than the average increase of the past year, was reported in January of this year; however, total labor input rose considerably faster than employment in January as the workweek lengthened.

Payroll Employment



Producers of goods boosted employment more than half a million in 1994. The job count in construction increased about 300,000 over the year; employment at general building contractors rose briskly for a second year, as did the number of jobs at firms involved in

1. In effect, recorded net capital inflows in the first three quarters of 1994 were larger than necessary to balance the rising current account deficit. Moreover, outflows of currency to foreigners, an item that is not reflected in recorded transactions and, therefore, is a part of unrecorded net inflows in the international accounts, increased substantially in 1994, suggesting that the other unrecorded outflows of capital may have been even larger than the published data on errors and omissions indicate.

2. The Bureau of Labor Statistics has announced that the level of nonfarm payroll employment in March 1994 will be raised 760,000 when revised estimates are released this summer. The revision may lead to larger estimates of job growth in both 1993 and 1994.

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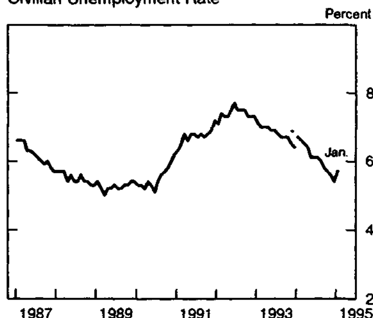
special trades related to construction. The number of jobs in manufacturing increased about 275,000 during 1994, after five years of decline. Producers of durables accounted for most of the rise in manufacturing employment; among these producers, job gains were widespread. Employment at factories that produce nondurables rose slightly in total, as advances in some industries—such as printing and publishing and rubber and plastics—were partly offset by continued secular declines in the number of jobs in industries such as apparel, tobacco, and leather goods. The average workweek in manufacturing, which had stretched out in 1992 and 1993 when factory employment was declining, lengthened further in 1994, rising to new highs for the postwar period. The high fixed costs that are associated with adding new workers probably continued to be an important factor in firms' decisions to rely still more heavily on a longer workweek as a way to boost labor input. Growth of factory output surpassed the rise in labor input by a sizable amount in 1994, a reflection of substantial gains in productivity that were realized in this sector of the economy in the most recent year.

Employment in the private service-producing sector rose nearly 2¾ million during 1994, after a gain of 2 million in 1993. The number of jobs in retail trade increased about 800,000 over the year. Auto dealers, stores that sell building materials, and those that sell general merchandise were among the retail outlets that reported impressive gains. Hiring at eating and drinking places also moved up briskly; after three years of slow growth around the start of the decade, hiring at these establishments has increased substantially in each of the past three years. Employment at firms that supply services to other businesses rose about 710,000 in 1994, even more than in 1993. Once again, job growth within this category was especially rapid at personnel supply firms—those that essentially lease the services of their workers to other employers, often on a temporary basis. Employment at businesses that supply health services increased a quarter of a million in 1994, about the same as the gain in 1993; hiring at hospitals has flattened out over the past couple of years, but elsewhere in the health sector job growth has continued at a rapid clip.

Strength also was evident in 1994 in data from the monthly survey of households. After ticking up in January of 1994, when a redesigned household survey was implemented and new population estimates were introduced, the civilian unemployment rate turned back down in February and declined in most months thereafter. The rate increased last month, to 5.7 percent, but was still a full percentage point below that of a year earlier.[3] Appreciable net declines in unemployment rates have been reported over the past year for nearly all occupational and demographic groups.

Civilian Unemployment Rate*



* A redesigned survey and revised population estimates were introduced in January 1994; data from that point on are not directly comparable with those of earlier periods.

Data on the reasons why individuals are unemployed seem to be tracing out patterns fairly similar to those seen in previous business cycles. Most notably, the number of persons who are unemployed because they lost their last job has declined sharply, on net, over the past year. The number of individuals in this category had soared earlier in the 1990s, when the economy was struggling to gain momentum and many large companies were restructuring their operations. However, with the more recent decline, the number of these "job losers," measured as a percentage of the labor force, has moved back toward the lows of the late 1980s. Much of the decline in the number of job losers this past year has been among workers who were permanently separated from their previous jobs. The number of persons unemployed for reasons other than the loss of a job (that is, the sum of "job leavers" and new entrants or re-entrants unable to find work) also has declined over the past year. As in other business cycles, the number of these individuals, measured relative to the size of the labor force, has been displaying a cyclical pattern considerably more muted than that of job losers.

3. Research undertaken by the Bureau of Labor Statistics suggests that the unemployment rate would have run about two-tenths of a percentage point lower in 1994 but for the changes that were introduced in January of last year. Other series from the household survey also were affected by the introduction of the new survey and the revised population estimates; therefore, data for the period starting in January 1994 are not directly comparable with those for the period ended in December 1993.

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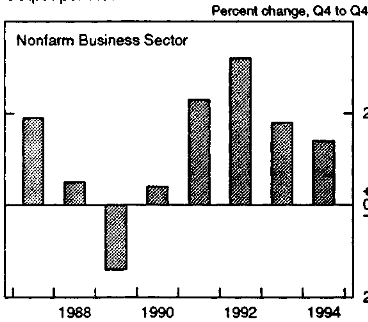
Growth of the civilian labor force—which consists of the individuals who are employed and those who are seeking employment but have not yet found it—picked up a bit in the second half of 1994 and in early 1995. However, even with these increases, the cumulative rise in the labor force in the current business expansion has been relatively small compared with the gains recorded in other recent expansions; growth of the working-age population has been slower this decade than it was in the expansions of the 1970s and 1980s, and the share of the population participating in the labor force, which trended up in earlier expansions, has changed little, on net, during this one.

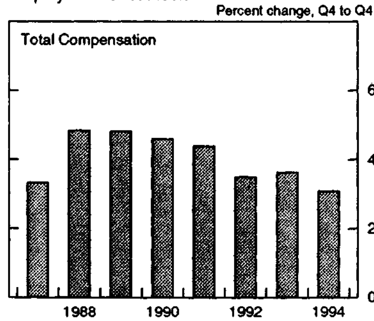
Output per Hour



According to preliminary data, output per hour of labor input in the nonfarm business sector increased 1.4 percent over the four quarters of 1994, after a rise of 1.8 percent in 1993 and still larger gains in 1992 and 1991. Over the business cycle, productivity gains typically are largest in the early years of expansion, and, in that regard, the recent experience does not appear to be unusual. Abstracting from cyclical variation, the trend of productivity growth in recent years seems to have picked up somewhat from the unusually sluggish pace that prevailed through much of the 1970s and 1980s, but, at the same time, the pickup has not been nearly so large as some anecdotal reports might appear to suggest. For example, from late 1988 to late 1994, an interval of time that is long enough to capture all the phases that productivity goes through during the business cycle, the average rate of rise in output per hour in the nonfarm business sector amounted to slightly more than 1¼ percent, up only modestly from an average rate of rise of about ¾ percent during most of the 1970s and 1980s.[4]

The rate of increase in hourly compensation moved down another notch in 1994. The employment cost index for private industry, a measure of hourly labor costs that comprises both wages and benefits, rose 3.1 percent during the twelve months ended in December of 1994, after increases of 3.6 percent in 1993 and 3.5 percent in 1992. The rise in the wage component of compensation was slightly less than that of 1993, and the rate of increase in hourly benefits slowed appreciably. Increases in benefits were restrained, in large part, by another year of deceleration in health care costs and a further slowing in workers' compensation insurance costs. The rise in nominal compensation per hour in 1994 was the smallest yearly increase in the fifteen-year history of the series, the previous low of 3.2 percent having come midway through the expansion of the 1980s. Toward the end of that decade, as bidding for labor resources intensified, increases in compensation moved up for a time to around 5 percent a year.

Employment Cost Index*



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

Unit labor costs in the nonfarm business sector rose 2.0 percent over the four quarters of 1994, after an increase of just 0.6 percent over the four quarters of 1993. In manufacturing, a sector of the economy in

4. Whether even this small degree of improvement in the productivity trend will stand up through future revisions of the data is not clear. For example, among the many difficult issues that are involved in the measurement of productivity is the choice of an appropriate set of prices to be used in valuing the output of goods and services. Currently, aggregate output is tallied using the prices of 1987, but some major changes in relative prices have taken place since then, the most notable of which is a huge decline in the price of office and computing equipment. Using the prices of a more recent year to gauge real output would result in less weight being given to office and computing equipment and, in turn, a smaller contribution from this rapidly growing category to growth of real output. All else equal, the growth of productivity also would be negatively affected by switching to the prices of a more recent year.

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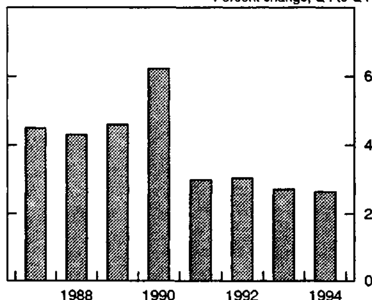
which productivity has advanced quite rapidly in recent years, a rise in output per hour of 4.6 percent during 1994 more than offset a modest increase in hourly compensation, and unit labor costs declined noticeably for a second year.

Price Developments

Although price increases picked up in some parts of the economy in 1994, the broader measures of price change continued to yield readings that were quite favorable. The rise in the total CPI was about 2¾ percent in 1994, the same as the increase during 1993. The CPI excluding food and energy also rose about 2¾ percent over the four quarters of 1994, after increasing slightly more than 3 percent in 1993. The producer price index for finished goods increased 1¼ during 1994, after edging up just ¼ percent during the previous year. As in 1992 and 1993, the past year's increases in all these price indexes were among the lowest readings of the past quarter-century. Measures of inflation expectations held steady in 1994, but continued to show readings that were somewhat higher, on average, than the actual rates of price increase. Price data for January of this year were less favorable than those of 1994: The total CPI moved up 0.3 percent last month, and the CPI excluding food and energy jumped 0.4 percent, the largest monthly rise in that measure since late 1992.

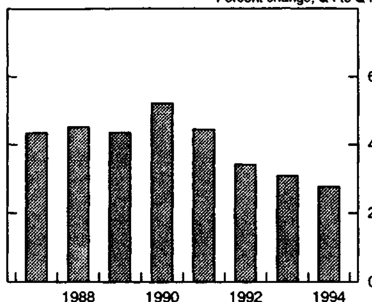
Consumer Prices *



* Consumer price index for all urban consumers.

The pickup of price increases last year was confined largely to markets for materials. Prices of primary industrial inputs, which had moved up sharply during 1993, continued to surge in 1994, and price increases for intermediate materials accelerated as the year progressed. Prices of imports also picked up somewhat, influenced by the depreciation in the exchange value of the dollar; as was true in the domestic economy, the largest price increases for imported goods were those for materials. Gains in productivity apparently enabled manufacturers of finished goods to absorb these increases in the costs of domestically produced and imported materials without raising their own prices very much.

Consumer Prices Excluding Food and Energy *



* Consumer price index for all urban consumers.

Early this year, materials prices continued to surge. The producer price index for crude materials other than food and energy jumped 3 percent in January, to a level about 17½ percent above that of a year earlier. Further along in the production chain, the PPI for intermediate materials other than food and energy rose 1 percent last month; the index has moved up 6 percent during the past twelve months, the largest such rise since the late 1980s, when the twelve-month rate of increase in intermediate materials prices topped out at slightly more than 7 percent. By contrast, the PPI for finished goods other than food and energy again showed only a modest increase in January. Since mid-January, the prices of a number of industrial commodities have backed away from earlier highs, but, given the volatility that these prices sometimes exhibit, the experience of a few weeks may not signal the emergence of a new trend.

In the CPI, the prices of commodities other than food and energy rose 1½ percent over the four quarters of 1994, about the same as the rise of 1993. Prices of new cars and new trucks, responding to strong demand and, at times, shortages in the supply of some models, moved up faster than prices in general; prices of used cars rose especially rapidly for a third year. The prices of tobacco products, which had fallen sharply in 1993 when producers made steep

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one-time price reductions, turned back up in 1994, rising moderately over the four quarters of the year. By contrast, prices of home furnishings changed little over the year, and the CPI for apparel fell noticeably. In January of 1995, the CPI for goods other than food and energy jumped 0.4 percent; this rise followed a string of months in which the index had increased very slowly.

The CPI for non-energy services, a category that accounts for about half of the total CPI, rose slightly less than 3½ percent over the four quarters of 1994, after an increase of about 3¾ percent in 1993. The increase in these prices in 1994 was just a bit more than half the rise that was recorded in 1990, when CPI inflation hit its most recent peak. Prices of medical services continued to slow in 1994, and airline fares, which have been an especially volatile category in the CPI in recent years, fell appreciably after having risen sharply the previous year. However, auto finance charges turned up, and the rate of rise in owners' equivalent rent, a category that has a weight of nearly 20 percent in the total CPI, rose slightly faster over the four quarters of 1994 than it had during the corresponding period of 1993. Like the prices of goods, the CPI for non-energy services accelerated sharply in January of this year.

In 1994, for a fourth year, neither food prices nor energy prices provided much impetus to the inflation process. The consumer price index for food rose a shade more than 2½ percent over the four quarters of 1994, about the same as the rise of 1993. Food prices in 1994 were restrained, in part, by sharp declines in the prices of domestically produced farm products, which, in turn, were pulled down by the huge increases in crop and livestock production noted previously. With beef and pork prices declining over the year, the CPI for meats, poultry, fish, and eggs changed little in total. Retail prices of dairy products rose only a small amount. Prices of foods that are more heavily influenced by the costs of nonfarm inputs also showed only small to moderate advances in 1994: The increase in the CPI for prepared foods amounted to about 2½ percent, slightly less than the previous year's increase, and, for a third year, the rise in the price index for food away from home was less than 2 percent. Coffee was the only item in the CPI for food to show sustained price acceleration; freeze damage to the crop in Brazil caused world prices of raw coffee to surge and led to a price rise of more than 50 percent at retail over the four quarters of 1994. Fresh vegetable prices, which tend to be especially sensitive to short-run supply developments, took a jump toward year-end after Hurricane Gordon had damaged crops in Florida, but the run-up was partly reversed last month.

The CPI for energy rose about 1½ percent during 1994, after edging down ½ percent in 1993. Gasoline prices increased 4½ percent over the four quarters of 1994, reversing the decline of the previous year. Much of the increase in gasoline prices came in the third quarter and followed, with a short lag, a second-quarter rise in crude oil prices, which were moving back up from the low levels of late 1993 and early 1994. Prices of other energy products exhibited brief periods of rapid increase, but sustained upward pressures in these prices did not materialize. Fuel oil prices shot up temporarily early in 1994, when stocks were pulled down for a time by cold weather in the Midwest and the Northeast; later in the year, however, stocks were replenished and the earlier price increases were more than reversed. Natural gas prices followed a pattern similar to the price of fuel oil, rising sharply in the first quarter of the year but falling back thereafter, to a fourth-quarter level that was about 2¼ percent lower than that of a year earlier. Electricity prices rose only slightly during the year. In January of this year, energy prices were up moderately in the CPI.

With the favorable inflation performance of the past year, the average rate of rise in the total CPI since the business cycle trough in early 1991 has been 2.9 percent at an annual rate. Excluding food and energy, the rate of rise has been 3.3 percent at an annual rate. Inflation rates lower than these have not been sustained through the first few years of any business expansion since that of the 1960s, when both the CPI and the CPI excluding food and energy showed average rates of increase of less than 1.5 percent during the first four years after the business cycle trough of early 1961. Average rates of price increase during the current expansion have been much smaller than those reported during the expansion that began in the mid-1970s. They also have been somewhat smaller than those reported during the first few years of the expansion that began in late 1982, a period when price increases were braked in part by unusually steep declines in oil prices. In measuring the progress that has been made toward bringing the economy closer to the goal of long-run price stability, the ratcheting down of the rate of price advance from cycle to cycle since the 1970s is perhaps an even more meaningful indicator than the favorable trends in the annual price data of recent years.

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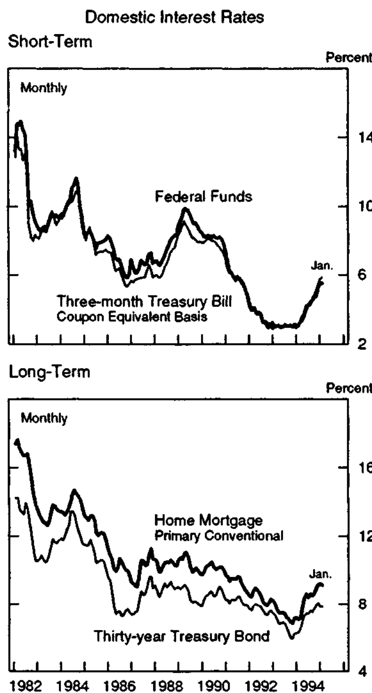
Section 3: Monetary and Financial Developments

With the economy generally strong, financial markets in 1994 and early 1995 have been characterized by somewhat more rapid growth in private debt and by higher interest rates. The increase in interest rates reflected, in part, the policy actions of the Federal Reserve. Concerned about inflationary pressures resulting from rapid economic growth and dwindling margins of available resources, the Federal Reserve firmed policy on seven occasions. These actions were



taken to foster a financial environment more likely to be consistent with sustained economic growth and low inflation. In total, the policy tightenings raised the federal funds rate by a cumulative 3 percentage points between early February 1994 and early February 1995. Other short-term rates rose by similar amounts. Over this span, the Board of Governors hiked the discount rate on four occasions by a total of 2¼ percentage points.

Longer-term rates increased 1½ percentage points to 3 percentage points on balance since January of 1994, with the largest increases posted at intermediate maturities. In addition to the policy actions, these rates were boosted through much of 1994 by greater-than-expected underlying strength in the economy and the resulting higher demand for credit, as well as by upward revisions to expectations in financial markets about the policy tightenings that would be required to counter an incipient increase in inflation. Since late last fall, however, the extent of Federal Reserve actions, along with incoming data suggesting some moderation in the pace of expansion, have calmed inflation fears and trimmed estimates of the eventual rise in short-term interest rates. As a consequence, longer-term rates have retraced some of their earlier upward movements.

Increases in intermediate- and long-term rates over the course of the year caused significant capital losses for some investors. Well-publicized losses at a number of investment funds in the first half of the year, along with substantial portfolio reallocations in view of the changed economic and financial outlook, may have contributed to increased financial market volatility at that time. On the whole, however, risk premiums remained modest, and volatility ebbed over the course of the year. Late in the year, the tax-exempt securities market dipped following the bankruptcy of Orange County that resulted from mounting losses in its investment fund, but the effects, beyond those on the fund's investors, proved to be small and short-lived.

One consequence of the higher and more volatile long-term interest rates was a shift in business borrowing away from the capital markets and toward shorter-term sources, such as banks. This shift, which reversed the move toward long-term financing that occurred as bond yields fell in 1992 and 1993, was marked by the first annual increase in bank business loans in several years. Consumer lending also accelerated in 1994, as the improved economic outlook encouraged increased use of consumer credit. Higher interest rates likely held down household mortgage debt growth, in that the resulting decline in refinancing activity limited the ability of households to "cash out" some of the equity in their homes. Higher rates also encouraged households to shift to adjustable-rate mortgages, which offered lower initial interest costs.

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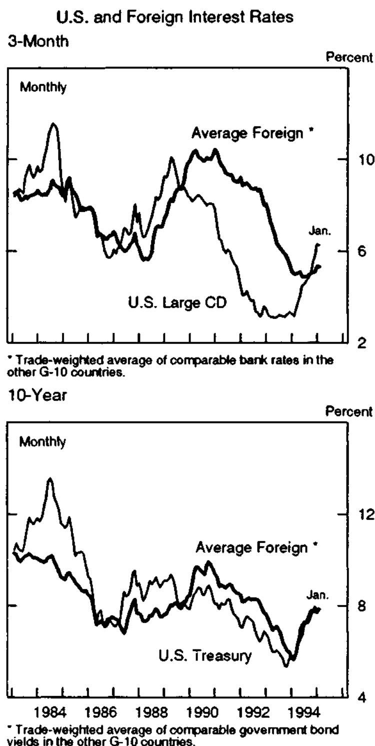
The debt of all nonfinancial sectors increased 5¼ percent in 1994, about the same increase as in 1993, as the pickup in business and household borrowing was offset by lower growth in government debt. The effects of the strong economy on government expenditures and receipts, policy moves to reduce the federal deficit, and retirements of tax-exempt securities that had been advance-refunded all contributed to the slowdown in government borrowing.

Banks funded much of the pickup in their loans with nondeposit funds and, in the second half of the year, with sales of securities. As a result, the doubling of loan growth was not reflected in significantly stronger expansion of the monetary aggregates. M3, which was boosted by relatively heavy issuance of large CDs, rose 1½ percent, a somewhat larger increase than in 1993. With banks pricing savings and small time deposits unaggressively as market interest rates rose, M2 grew 1 percent over the year, somewhat below its 1¾ percent pace in 1993. The increase in market interest rates relative to rates on transaction deposits slowed the growth of M1 to just 2¼ percent from the double-digit increases posted in 1992 and 1993.

The foreign exchange value of the dollar declined in terms of the other G-10 currencies last year, even as the U.S. economy expanded briskly and interest rates rose. In part, the weakness was the result of unexpectedly strong growth abroad, especially in Europe, where the recovery in many countries was more rapid than had been anticipated. As a result, long-term interest rates in many of the other G-10 countries increased by amounts similar to rates in the United States. Heightened concerns about inflation prospects in the United States may also have contributed to the weakness of the dollar. Indeed, the dollar rebounded late in the fall when tighter monetary policy evidently eased those concerns. The dollar declined, however, in early 1995 amid the signs of slower U.S. growth and concerns about the implications for the United States of turmoil in Mexican financial markets.

U.S. and Foreign Interest Rates



The Course of Policy and Interest Rates

In early 1994, short-term interest rates remained at the very low levels reached in late 1992, with the federal funds rate fluctuating around 3 percent—roughly in line with the rate of inflation. The Federal Reserve had maintained an accommodative policy stance throughout 1993. This stance was unusual so far into the expansion phase of a business cycle, but it was believed to be necessary because of a number of extraordinary factors that seemed to be inhibiting growth. These factors included efforts by households, firms, and financial intermediaries to repair strained balance sheets, business restructuring activities, and the fiscal contraction associated, in part, with the downsizing of defense industries.

During the recovery and expansion, however, considerable progress had been made by households and businesses in decreasing their debt-service burdens, and lending institutions had succeeded in rebuilding their capital positions. By late 1993, the economy was expanding rapidly, and incoming data early last year suggested that much of that momentum had likely carried over into 1994. In the circumstances, continued accommodative policy risked pushing the demands on productive resources to levels that ultimately would be associated with increased inflation.

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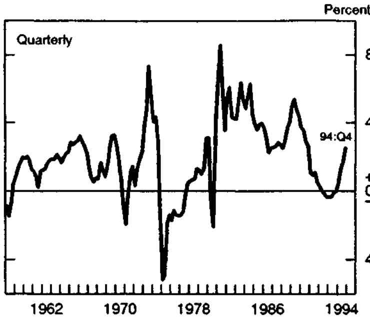
Real Federal Funds Rate *



* Real federal funds rate is the nominal federal funds rate minus the change in the CPI less food and energy over the last four quarters.

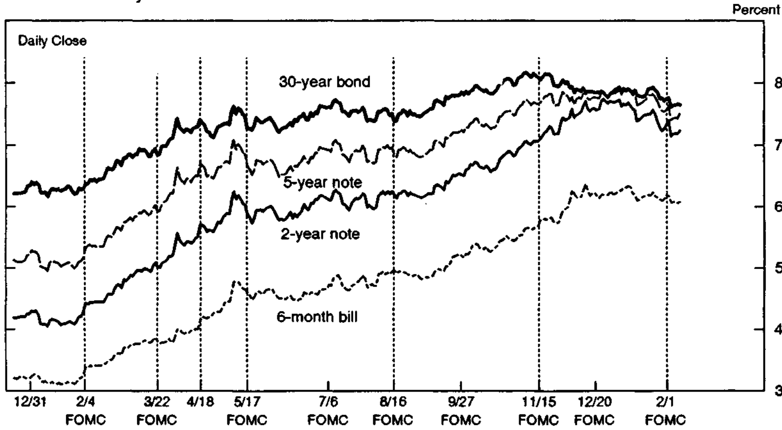
Consequently, the FOMC, at its meeting in early February 1994, agreed that policy should be moved to a less stimulative stance.

The pace at which the adjustment to policy should be made was less clear: A rapid shift in policy stance would minimize the risk of allowing inflation pressures to build, while a more gradual move would allow financial markets time to adjust to the changed environment. Although many market participants seemed to anticipate a firming move fairly soon, it would be the first tightening in many years, and some investors would undoubtedly reconsider their portfolio strategies, possibly causing sharp movements in bond and stock prices. In addition, a slower initial shift would allow more time to assess the strength of the economy and the effects of the change in policy.

In the event, the Committee tightened policy gradually through the winter and early spring. Pressures on reserve positions were increased by relatively small amounts in February, March, and April; once market participants seemed to have made substantial adjustments to the new direction of policy, a larger tightening move was implemented in May. Taken together, the four policy actions raised the federal funds rate about 1¼ percentage points. The May policy action was accompanied by an increase of ½ percentage point in the discount rate, voted by the Board of Governors.

Other interest rates moved up between 1 percentage point and 2 percentage points as a result of these policy moves, with the largest increases coming at intermediate maturities. Besides the effect of the policy actions, longer-term rates were boosted by incoming data suggesting continued robust growth, which heightened market concerns about a pickup in inflation and expectations of further tightening by the Federal Reserve. In addition, uncertainty about the timing and magnitude of future policy actions, as well as the capital losses that followed the tightenings,

Selected Treasury Market Rates



* Dotted vertical lines indicate days on which a monetary policy move was announced.

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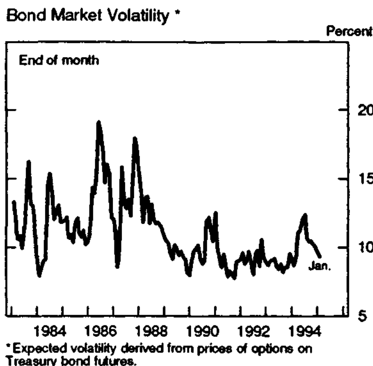

* Expected volatility derived from prices of options on Treasury bond futures.

encouraged investors to shorten the maturity of their investments and reduce their degree of leverage. The resulting portfolio adjustments likely contributed to increased market volatility and may have intensified the upward pressure on longer-term interest rates.

Incoming data in the late spring and early summer suggested that the economy continued to expand significantly, led by sales of business equipment, a rebound in nonresidential construction following bad weather earlier in the year, and a pickup in inventory investment. Inflation was of growing concern, as commodity prices increased rapidly, and measures of slack suggested that the economy was entering a range in which pressures on broad price indexes might begin to build. In part reflecting this concern, long-term rates moved up, and the dollar weakened. Given the relatively large policy action in May, however, the Committee decided to take no action at the July meeting and to wait for more information on the performance of the economy. The Committee saw the possible need for tighter policy, however, and issued an asymmetric directive to the Federal Reserve Bank of New York suggesting that policy would respond promptly to evidence of increased inflation pressures.

In the interval between the Committee meetings in early July and mid-August the economy continued to expand robustly, and, coming into the August meeting, it appeared that the markets expected a small further increase in reserve pressures. At its meeting, the Committee agreed that a prompt further tightening move was needed to provide greater assurance that inflationary pressures in the economy would remain subdued, and the members chose a tightening action somewhat larger than had been expected by the markets. A rise of ½ percentage point in the discount rate, voted by the Board of Governors, was allowed to show through fully to the federal funds rate. Short-term market rates rose following the policy move, while long-term yields declined slightly, perhaps as a result of downward revisions to expectations of future tightening.

In advance of the meeting in late September, most market rates increased as incoming economic data were seen in the market as raising the likelihood of higher inflation and the resulting need for tighter reserve conditions. The data suggested that the economy had not yet been greatly affected by the tightening in monetary policy: Employment was growing strongly, and final sales, especially of consumer goods, appeared to have firmed. Manufacturing activity had continued to expand rapidly, boosted in part by an increase in motor vehicle production. Given the uncertain duration of lags between changes in monetary policy and the resulting effects on the economy, however, it was not clear whether the effects of the earlier interest rate increases were smaller than had been expected or were still in train. Another possibility was that the underlying momentum of the expansion was greater than had been evident earlier. Given these uncertainties, the Committee took no immediate tightening action at its September meeting. As in July, however, the Committee agreed to an asymmetric directive suggesting that the likely direction of any move over the intermeeting period was toward additional restraint.

Broad measures of inflation remained moderate through the fall in spite of continued substantial economic growth in an economy that was running close to its estimated potential. Nonetheless, strong economic data and continued upward pressure on prices at earlier stages of production apparently heightened investors' inflation concerns, as well as expectations of future policy tightenings. Consequently, most market interest rates rose appreciably between the September and November meetings, with the largest increases occurring at intermediate maturities. At the November meeting, the Committee members agreed that the stance of policy was not sufficiently restrained given the clear risks of higher inflation. As a result, they chose a sizable firming of monetary policy, tightening reserve conditions in line with the increase of ¾ percentage point in the discount rate approved by the Federal Reserve Board.

The yield curve flattened appreciably in response to the larger-than-expected policy action. The increase in the federal funds rate pushed up most short-term interest rates. Long-term rates increased initially, but

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in late November and early December these rates more than reversed the earlier increases. Evidently, market participants ultimately interpreted the substantial policy tightening as demonstrating the Committee's intention to take the actions necessary to contain inflation at relatively low levels. By contrast, intermediate-term rates increased over the weeks following the November meeting as a variety of incoming data indicated that the economy's growth had accelerated further in the fourth quarter and additional tightenings might be required to slow growth to a more sustainable pace. By the time of the December meeting, rates on two-year Treasury notes were only a little below those on thirty-year Treasury bonds, although both yields remained well above short-term rates.

Financial markets were focused in early December on the failure of an investment fund run by Orange County, California, and the subsequent bankruptcy of the county itself. The municipal securities market bore the brunt of these developments, with rates rising for a time relative to those on comparable Treasury issues. The failure had a substantial effect on the finances of the municipalities that had invested in the fund. In addition, investors had to consider the likelihood of other state and local governments having similar investment difficulties. Over the following days and weeks, however, only a few other problem situations emerged, and they were on a much smaller scale.

In the period leading up to the December meeting, incoming data continued to show robust growth and subdued inflation. The Committee felt that the effect on economic activity of the policy actions during the year, and especially the substantial tightening moves in the second half of the year, were not yet visible, owing to the lags in the effects of monetary policy on the economy. As a result, the Committee decided to take no further policy action at the meeting, and to await additional information on the underlying strength in the economy and the effects of the earlier policy actions. This decision was reinforced by concerns that the financial markets might be somewhat unsettled owing both to the usual year-end adjustments and to uncertainty about the effects and incidence of the sizable market losses sustained by some investors over the year. In view of the substantial strength evident in the incoming data, however, the Committee again chose an asymmetric directive pointing toward further restraint.

In advance of the Committee meeting at the end of January, broad measures of inflation remained modest, although anecdotal reports suggested that some firms intended to raise prices early in the new year. Incoming data on production and employment continued to be upbeat, with healthy growth reported in virtually all industries and regions. Some indicators, however, raised the possibility of a slowing in the pace of the expansion. Nonetheless, output growth in the fourth quarter was the fastest of the year, and the Committee felt that, with output and employment at or even beyond estimates of their sustainable levels, the risks of rising inflation were still considerable. As a result, the Board of Governors voted an increase of ½ percentage point in the discount rate, and the Committee agreed to allow the increase to be fully reflected in the federal funds rate. Because it had been widely anticipated in the financial markets, other interest rates and the foreign exchange value of the dollar were little affected by the policy action. Interest rates turned down subsequently, as additional information on the economy seemed to reinforce the possibility that a slowdown was in process.

At the same meeting, the Committee also formally adopted two practices that had been followed on a provisional basis during 1994. First, the Committee voted to continue to announce any change in the stance of policy on the day the decision is made. These announcements, which had followed each of the policy tightenings agreed to in 1994, are intended to minimize any confusion and uncertainty about the stance of policy. In addition, a public announcement ensures that all financial market participants have the same access to information regarding changes in monetary policy. Second, the Committee agreed to continue releasing the transcripts of Committee meetings with a five-year delay. The published minutes of Committee meetings, which are available soon after the subsequent meeting, provide a relatively complete summary of the arguments presented and the reasons for a policy choice. The transcripts provide additional information, however, that may be of use to those interested in the details of the policy process. The Committee decided that a five-year delay struck an appropriate balance between the right of interested members of the public to obtain this added detail and the Committee's need to debate policy issues openly and without the sort of restraint that more rapid disclosure might generate.

Credit and Money Flows in 1994

The debt of all nonfinancial sectors grew 5¼ percent in 1994, somewhat below the middle of its monitoring range of 4 percent to 8 percent, and

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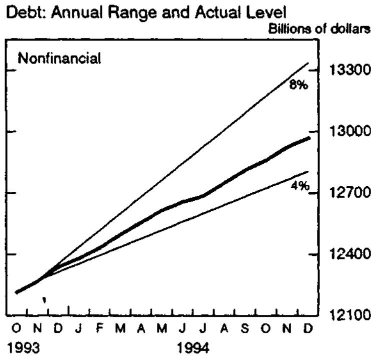
about the same increase as a year earlier. More rapid growth of private sector debt was offset by slower growth of public sector debt. As long-term rates rose well above their late 1993 lows, private sector borrowing shifted toward shorter-term sources of funds. In part as a result of this shift, financial intermediaries supplied a larger share of new debt than they had for several years. Much of the depository credit growth was funded with nondeposit funds, however, and growth in the broad monetary aggregates, which consist primarily of deposits, remained subdued.

Debt: Annual Range and Actual Level



Debt growth both in the federal and in the state and local government sectors slowed last year. Growth of federal government debt was smaller because of the narrowing of the federal budget deficit. The outstanding volume of state and local government debt actually declined as bonds that previously had been refunded in advance of their earliest call date were retired. Much of the bulge in tax-exempt issues in 1993 had been for the advance refunding of higher-cost debt issued in the 1980s. These offerings subsided early in 1994, as the amount of bonds eligible for advance refunding dwindled and borrowing costs rose.

Household debt growth increased modestly in 1994, as an acceleration in consumer credit was partly offset by slower growth in mortgage debt. The pickup in consumer debt reflected, in part, increased demand for consumer durables. In addition, responses to Federal Reserve surveys of banks indicated that many respondents were more willing to extend credit to households last year, which may have led them to ease terms and standards on consumer loans. Indeed, spreads between consumer loan rates and market rates narrowed significantly last year, as increases in loan rates lagged those in market interest rates. Consumer credit may also have been boosted somewhat by the increased use of credit cards offering rebates or other incentives. Rising mortgage rates in 1994 greatly reduced the volume of mortgage refinancings from the very high levels reached in 1993. The refinancings had contributed to an increase in mortgage debt because some households had taken the opportunity afforded by refinancing to cash out a portion of the equity in their properties. Higher rates on fixed-rate mortgages also induced many borrowers to shift to adjustable-rate mortgages that carried much lower initial rates. Concessional starting rates and the growing use of adjustable-rate contracts with initial fixed-rate periods lasting several years also may have contributed to this shift. Over the last few months of the year about half of all new home mortgages were of the adjustable rate variety. The shift to adjustable-rate mortgages and the sluggish adjustment of consumer loan rates mitigated the effect of higher market interest rates on household debt-service burdens.

The debt of nonfinancial businesses expanded in 1994 after three years of stagnation. Earlier efforts to restructure balance sheets by increasing equity capital and refinancing higher-cost credit appeared to leave businesses in a better position to increase debt in 1994, as the sector's debt-service burden had fallen about one-third from its peak five years earlier. A decline in equity issuance, perhaps resulting from the lackluster performance of the stock market, may also have boosted business borrowing. Business financing needs were strengthened by increased spending on capital and inventories, as well as merger and acquisition activity. The total value of mergers and acquisitions increased substantially last year, and the share of such activity requiring cash payments to shareholders—rather than swaps of shares—rose sharply, although it remained below the levels reached in the late 1980s.

Rising and more volatile long-term interest rates encouraged businesses to rely more heavily on short-term debt in 1994. This shift was reinforced by changes in supply conditions in various markets. Capital losses early in the year likely caused some of those supplying long-term funds to become more cautious; for example, some savers backed away from bond mutual funds. At the same time, banks were loosening terms on business loans as well as easing their underwriting standards. Banks attributed the easing of loan terms and standards to increased competition for business customers from other banks and also from nonbank lenders. The competitive posture of banks likely reflected, in part, the high level of profits

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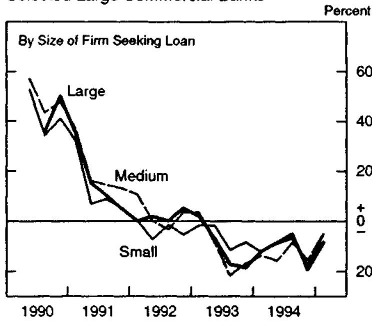
Changes in Business Lending Standards at Selected Large Commercial Banks *



Source. Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices.
* Percentage of domestic respondents reporting tightening standards over the past three months less the percentage reporting easing standards.

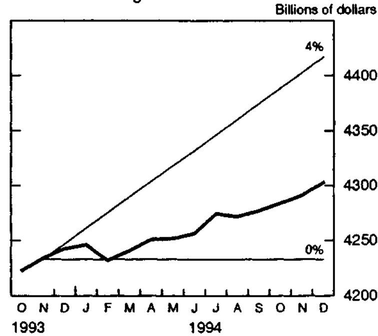
earned by banks in recent years and the resultant strengthening of their balance sheets. As a result of these factors, bank business loans increased more than 9 percent, their first annual increase in several years. Other sources of short-term business finance, including commercial paper and finance company loans, also expanded on the year.

The effect of the pickup in business and consumer loans on bank credit growth was partially offset by slower growth in bank securities holdings. Early in the year, banks purchased a significant volume of government securities, and reported levels of other securities holdings were boosted by an accounting change.[1] Much of this growth was reversed later in the year, however, as banks used sales of securities to fund loan growth. Reported securities growth also was damped by declining securities prices.[2]

In 1994 thrift sector credit expanded for the first time in several years, as the Resolution Trust Corporation virtually completed its liquidation of insolvent thrift institutions. In part, the increase in thrift sector credit also likely reflected the shift by households toward adjustable-rate mortgages. Thrift institutions and banks find holding adjustable-rate mortgages less risky than holding fixed-rate mortgages, and so adjustable-rate loans are less likely to be securitized and sold.

With bank credit growth picking up and thrift sector credit rising, growth of depository credit in 1994 nearly matched that of total nonfinancial debt. Thus, the share of credit provided by these intermediaries stabilized last year after having declined substantially since 1988. Despite the growth in depository credit, the broad monetary aggregates continued to expand sluggishly. Domestic banks funded much of their credit expansion from nondeposit sources, such as borrowings from their foreign offices, that are not included in the monetary aggregates. Funds from these sources are not subject to deposit insurance premiums, which may help account for their recent rise.

M3: Annual Range and Actual Level



The broadest monetary aggregate, M3, did pick up a bit as banks turned, in part, to large time deposits to fund asset growth. M3 expanded about 1½ percent, well above the lower bound of its 0 percent to 4 percent annual range and a somewhat larger increase than in 1993. Growth in large time deposits topped 7 percent for the year, marking the first annual increase in this component since 1989. Much of the increase in large time deposits was in senior bank notes, which are not subject to deposit insurance premiums.

M2 grew 1 percent in 1994—the lower bound of its annual range. The slow growth reflected, in part, relatively sluggish upward adjustment of retail deposit

1. New Financial Accounting Standards Board rules, effective at the start of the year, limited the ability of banks to net off-balance-sheet items for reporting purposes. The new rules affected items such as swaps and options, the cash values of which are reported on balance sheets in the other securities category.

2. A Financial Accounting Standards Board rule implemented at the start of the year required each bank to divide its investment account securities into those that it intended to hold to maturity, which could be reported at book value, and those that were available for sale, which had to be marked to market.

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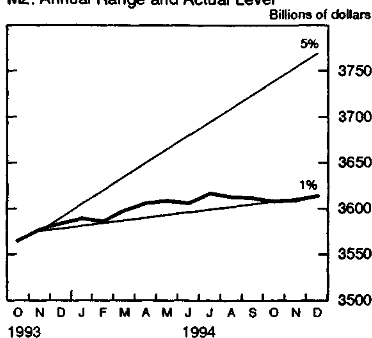
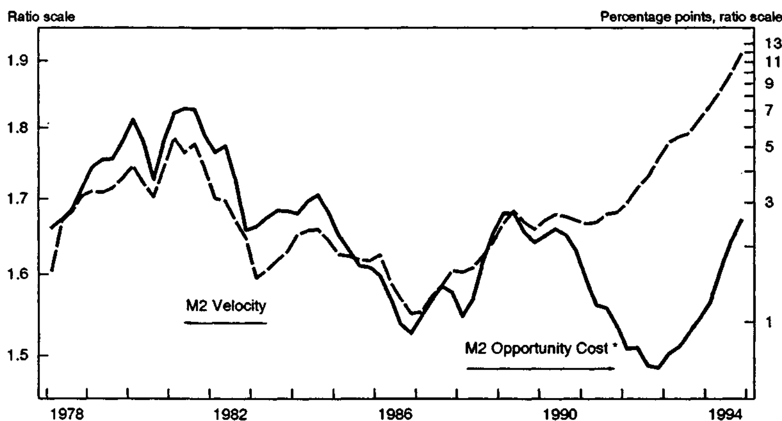
M2: Annual Range and Actual Level



rates. Rates on savings accounts and other checkable deposits (OCDs), including NOW accounts, responded about as slowly as they have in the past to the increase in market rates, while the response of rates on small time deposits was sluggish relative to historical norms. Evidently, banks believed that generating increased retail deposits would be more expensive than raising wholesale funds given that higher retail rates would have to be paid on existing liquid deposits and on time deposits as they were rolled over, as well as on any new deposits. Increasing retail deposits would also require higher advertising, administrative, and deposit insurance costs.

In contrast to the previous several years, M2 behavior in 1994 was roughly consistent with its long-run historical relationship with movements in nominal income and opportunity costs as traditionally defined—that is, the difference between rates on short-term instruments (for example, Treasury bills) and those offered on retail balances. This consistency suggests that, unlike the past few years, the slow growth in M2 last year was not the result of portfolio shifts toward bond and equity mutual funds. Indeed, the growth in M2 plus long-term mutual funds ran slightly below the 1 percent pace of M2 growth. Net sales of equity mutual funds continued at a high level in 1994, although the pace of sales slowed somewhat late in the year. Equity fund sales were partly offset, however, by outflows from bond mutual funds in the last three quarters of the year. Apparently, falling bond prices and greater market uncertainty, and, perhaps, reports of derivatives losses at some funds, led households to scale back their holdings of bond mutual funds in favor of investments that posed less risk of capital loss. With deposit rates lagging, however, these outflows did not translate into faster M2 growth. Some of the withdrawals from bond funds may have been invested directly in Treasury securities. Reflecting such portfolio shifts, net noncompetitive tenders for Treasury bills, which had been negative in 1993,

M2 Velocity and M2 Opportunity Cost



* Two-quarter moving average of 3-month Treasury bill rate less average rate paid on M2 components.

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Net Sales of Shares in Long-Term Mutual Funds*
Millions of dollars (monthly average)

Period	Total	Equity funds	Bond funds
Year			
1991	10,820	3,821	7,000
1992	16,844	7,268	9,576
1993	23,445	11,832	11,634
1994	9,674	11,073	−1,399
Quarter			
1994:Q1	17,438	13,744	3,694
Q2	10,128	10,935	−808
Q3	9,826	11,166	−1,340
Q4	1,306	8,447	−7,141

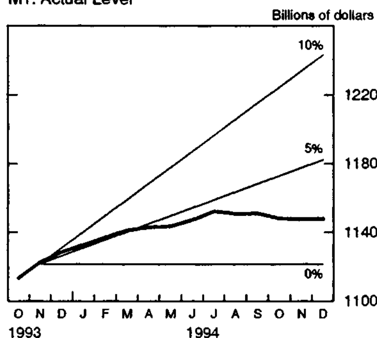
Source. Investment Company Institute.
*Gross sales of shares less redemptions.

totaled more than $16 billion last year, and net noncompetitive tenders for Treasury notes also increased substantially.[3]

Consistent with its historical behavior, M1 growth slowed sharply last year in response to widening differentials between market interest rates and those offered on transaction deposits. M1 expanded only 2¼ percent—down substantially from the double-digit increases recorded the previous two years. Following the typical pattern, demand deposits and OCDs were especially responsive to the rise in short-term interest rates. On balance, demand deposits edged up only ½ percent, compared with growth of 13¼ percent in 1993, as higher market rates encouraged deposit holders to economize on these non-interest-earning assets. In addition, the turnaround reflected the decline in home mortgage refinancing activity last year: Demand deposits had been boosted in 1993 because prepayments of securitized mortgages were held primarily in such deposits for a time before they were distributed. The rates offered on OCD accounts adjusted slowly to higher market rates last year, encouraging households to shift funds into higher-yielding assets. OCD growth also was depressed by the introduction of sweep account programs at some large banks. In these programs, the portion of customers' OCD balances in excess of a predetermined level are swept into money market deposit accounts at the end of each day.

In contrast to transaction deposits, the currency component of M1 continued to register strong growth last year. Currency increased 10¼ percent, the same rise as 1993 and close to the record increase in 1990. As has been the case since 1990, much of the currency growth appeared to reflect rapid expansion in U.S. currency circulating abroad. Informal reports suggest that foreign demand was particularly strong in 1994 in Russia and the other former Soviet republics.

M1: Actual Level



Foreign Exchange Developments

The trade-weighted foreign exchange value of the dollar in terms of the other G-10 currencies declined nearly 6½ percent on balance from December 1993 to December 1994. After displaying some strength at the start of 1994, the weighted-average foreign exchange value of the dollar fell about 10 percent from February through early November. Although U.S. growth continued to be stronger than expected, market perceptions about the strength of economic activity in the other industrial countries were also revised sharply higher as the year progressed. These changed perceptions led market participants to raise their expectations of market interest rates abroad, which, together with increased concerns over potential inflation pressures in the U.S. economy, put downward

3. The Treasury permits noncompetitive bids at its auctions to make it easier for smaller, less sophisticated bidders to participate. Those submitting noncompetitive tenders are assured of receiving the security, and the yield on the security they obtain is the average issue rate established at the auction. The level of net noncompetitive tenders during a period is the dollar volume of securities purchased under noncompetitive tenders less the volume of repayments of maturing securities that had been purchased under noncompetitive tenders.

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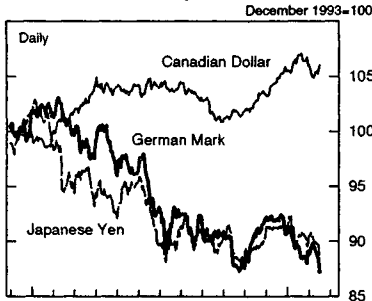
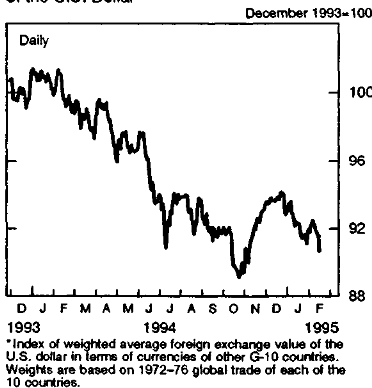
pressure on the dollar against most foreign currencies. The dollar rebounded somewhat at the end of the year as the greater-than-expected tightening action by the Federal Reserve in November reassured market participants that U.S. inflation risks were being addressed. In early 1995, however, with U.S. growth appearing to moderate, and the turmoil in Mexican financial markets raising concerns about possible implications for the United States, the dollar declined on balance, nearly reaching its fall 1994 low.

Selected Dollar Exchange Rates



Weighted Average Foreign Exchange Value of the U.S. Dollar *



*Index of weighted average foreign exchange value of the 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.

Long-term interest rates in major foreign industrial countries generally rose during the year. On average, yields on foreign government issues with maturities of ten years increased 200 basis points in the twelve months to December, about the same as in the United States. In Japan, where the evidence for a buoyant recovery remained somewhat mixed, long-term rates rose less. In contrast to long-term rates, foreign short-term rates were little changed on average and even declined slightly in several countries, including France and Germany. Major exceptions were Canada, where short-term market rates rose about 300 basis points, and the United Kingdom, where they rose 100 basis points. In both countries, official lending rates were increased during the year to contain inflation risks in the face of vigorous economic growth. During the first few weeks of this year, foreign long-term rates on average rose slightly further, but they have since retraced most of that rise.

During 1994, the dollar depreciated 8 percent in terms of the mark and declined by similar amounts in terms of the other currencies in the exchange rate mechanism (ERM) of the European Monetary System. The German economy expanded over the year, and the growth of the targeted monetary aggregate, M3, remained above target until the very end of the year. Market participants trimmed their expectations of further declines in official Bundesbank lending rates, and German long-term interest rates rose. The dollar depreciated by lesser amounts in terms of sterling and the lira, both of which had been withdrawn from the ERM in 1992. The persistent strength of the U.K. recovery raised concerns of renewed inflation pressures there, and the political uncertainties in Italy and, to a lesser extent, in the United Kingdom held back market enthusiasm for the two currencies.

The dollar also depreciated about 8 percent in terms of the yen during the year. At times, the dollar–yen rate fluctuated in response to developments in U.S.–Japanese trade talks. The dollar reached a historic low of 96.11 yen in November and was very weak against the German mark as well, and the Federal Reserve joined the U.S. Treasury in intervention purchases of dollars against yen and marks at that time. Subsequently, the dollar rebounded somewhat in terms of the yen and European currencies. In early 1995 the dollar weakened further, especially against the mark, in part because that currency attracted funds from markets upset by the peso crisis.

In contrast to its experience in terms of the ERM currencies and the yen, the dollar appreciated in terms of the Canadian dollar nearly 4½ percent during 1994. The relative weakness of the Canadian currency appeared to reflect pressures arising from the increases in U.S. short-term rates, concerns over the large fiscal deficits of the central government and the

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provinces and, at times, perceived risks associated with possible secession by Quebec. In the first few weeks of 1995, the Canadian dollar weakened further, as markets apparently became more concerned about the large outstanding Canadian federal and provincial debt and the persistent federal government deficit. As a result, market interest rates have risen further, and the Bank of Canada has moved up overnight rates several times, including an increase to match the upward shift in the U.S. federal funds rate following the most recent FOMC meeting. In response, the Canadian dollar strengthened, but more recently, has given up some of these gains.

The dollar depreciated nearly 5 percent in 1994 against the currencies of major U.S. trading partners in Latin America and East Asia when adjusted for relative changes in consumer prices. The dollar appreciated sharply against the Mexican peso, however, first in March and more significantly during the final two weeks of the year and in early 1995.

In response to continuing downward pressures on the peso and sizable losses of international reserves over the course of 1994, the Bank of Mexico announced on December 20 a 13 percent change in the lower bound of the range that it unilaterally had set for the peso–dollar exchange rate. The peso immediately fell to the new lower limit, from about 3.5 to 4 pesos per dollar, and reserve losses continued. As a consequence, the Bank of Mexico on December 22 permitted the peso to float and activated the North American Swap Facility, which provides up to $6 billion of short-term funds to the Bank of Mexico, evenly split between the Federal Reserve and the Treasury, and an additional C$1 billion from the Bank of Canada.

During the following days the peso remained volatile on exchange markets, fluctuating in a range between 5 and nearly 6 pesos to the dollar. On January 2, a package was announced totaling $18 billion in international financial support for Mexico, including an increase from $6 billion to $9 billion in the swap facilities extended by the United States (again split between the Federal Reserve and the Treasury), an additional C$500 million in the swap facility of the Bank of Canada, $5 billion in credit supported by other central banks acting through the Bank for International Settlements (BIS), and $3 billion in credit from commercial banks. On January 6 the IMF began talks with Mexico on a stand-by arrangement in support of Mexico's economic reform program, and on January 12, against the background of increased turbulence in international capital markets, the Clinton Administration, with the support of the bipartisan leadership of Congress, announced a proposal to provide $40 billion in guarantees on securities to be issued by Mexico in an effort to restore investor confidence.

Subsequently, the peso weakened further as support within the Congress for the guarantee proposal appeared to decline. The Mexican stock market also continued to slide, and short-term peso interest rates rose sharply. In late January the peso reached a new low of 6.55 pesos to the dollar amid signs that problems in Mexico were having effects on financial markets in other countries. In particular, equity markets in Argentina and Brazil had declined in volatile trading. More generally, investors appeared to be retreating from investments in a variety of emerging market economies, some of which have substantial current account deficits, while others maintain fixed exchange rates that pose the risk of becoming overvalued. On January 31 the Administration withdrew the request for approval of the guarantee program and, with the support of the bipartisan leadership of Congress, announced a new plan to provide $20 billion to support financial stabilization in Mexico using the resources of the Exchange Stabilization Fund (ESF) and, in the short run, the Federal Reserve. On February 1, the Federal Reserve's swap line with the Bank of Mexico was increased further to $6 billion as part of this package. The package will consist of short-term swaps, which will be provided by the Federal Reserve and the ESF, and swaps with maturities of three to five years and securities guarantees with maturities of five to ten years provided by the ESF. Repayment will be assured from the proceeds of exports of Mexican oil. Additional multilateral support for Mexico included an increase from $7.8 billion to $17.8 billion in the funds provided by the IMF under a stand-by arrangement that was approved on February 1 and an increase from $5 billion to $10 billion in the short-term credit supported by the central banks of a number of major industrial countries acting through the BIS.

The peso rebounded during the week following the announcement of the January 31 program and, on net, has since held most of that gain in volatile trading. Through mid-February, the dollar on balance has appreciated substantially against the peso since December 19, the day before the peso's devaluation.

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Growth of Money and Debt
Percent

Period	M1	M2	M3	Domestic Nonfinancial Debt
Year[1]				
1980	7.4	8.9	9.6	9.1
1981	5.4 (2.5)[2]	9.3	12.4	9.9
1982	8.8	9.2	9.9	9.6
1983	10.4	12.2	9.9	11.8
1984	5.5	8.1	10.9	14.4
1985	12.0	8.7	7.6	14.1
1986	15.5	9.3	8.9	13.5
1987	6.3	4.3	5.7	10.2
1988	4.3	5.3	6.3	9.0
1989	.6	4.8	3.8	8.0
1990	4.2	4.0	1.7	6.5
1991	7.9	2.9	1.2	4.6
1992	14.3	2.0	.5	4.7
1993	10.5	1.7	1.0	5.2
1994	2.3	1.0	1.4	5.3
Quarter (annual rate)[3]				
1994:Q1	5.5	1.8	.6	5.3
Q2	2.6	1.7	1.3	5.6
Q3	2.4	.8	2.0	4.4
Q4	−1.2	−.4	1.7	5.5

1. From average for fourth quarter of preceding year to average for fourth quarter of year indicated.
2. Adjusted for shifts to NOW accounts in 1981.
3. From average for preceding quarter to average for quarter indicated.

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NEWS

FOR IMMEDIATE RELEASE
Wednesday, Feb. 1, 1995

Contact: (202) 463-5682 Frank Coleman
Thomas Love

COMMENT ON FEDERAL RESERVE'S TIGHTENING
BY MARTIN A. REGALIA, VICE PRESIDENT AND CHIEF ECONOMIST
U.S. CHAMBER OF COMMERCE

U.S. Chamber: Fed Attacks Economic Growth

WASHINGTON -- "The Federal Reserve continued its war on the economy today when it hiked short-term interest rates for the seventh time in the past 12 months. The Fed move occurred against a backdrop of benign inflation and increasing indications that economic growth may be tailing off. Retail sales have slowed of late, housing is weaker and the government's main forecasting gauge, the index of leading economic indicators, eked out only a 0.1 percent gain in December. The stacks of inventories, which have grown at a dizzying rate over the past three quarters, were already casting a long shadow over economic growth in 1995," said Martin Regalia, vice president and chief economist of the U.S. Chamber of Commerce.

"The consumer price index was up only 2.7 percent in the 12 months ending in December, and the employment cost index showed the smallest increase, 3.0 percent for 1994, since the government began tracking the measure in 1981. Moreover, as Fed Chairman Alan Greenspan himself has noted, the link between strong economic growth and inflation has grown increasingly murky. The combined effect of these rate increases could kill economic growth," he concluded.

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NOTE: Regalia is available for comment.

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NAM PRESIDENT CALLS INCREASE IN INTEREST RATES 'OVERKILL'

WASHINGTON DC, February 1, 1995 -- Responding to the decision on the part of the Federal Reserve to raise the discount and Federal funds rates by 50 basis points, National Association of Manufacturers President Jerry Jasinowski said:

"The Fed's action is overkill. The economy is already beginning to slow down, and the earlier rate increases have still not had their full effect on real activity. Further, inflation was very low in the fourth quarter. The Fed should have left rates as they were and waited for more evidence on growth and inflation.

"There are several reasons not to tighten policy further.

• Inflation has remained low; with the implicit GDP deflator rising by only 1.5 percent in the fourth quarter.

• The total cost of wages and benefits rose by 3 percent, but with productivity growing at a healthy clip, unit labor costs are under control. In manufacturing, unit labor costs actually fell by almost 3 percent last year.

• The Fed's previous rate increases are clearly slowing the growth rate. Further, real interest rates are now very high. Real bond rates -- nominal rates less inflation -- more than 6.5 percent. These real rates are highly restrictive on economic activity.

• Productivity has been rising rapidly in manufacturing for more than a decade, and the technological improvements that led to these gains are now spilling over into the service sector. Stronger productivity and increased competition is creating a new economy that makes it possible to achieve higher growth with less inflation. With little threat of a significant rise in inflation, monetary policy should be highly restrictive during a period when the economy is slowing down," Jasinowski concluded.

Jasinowski is available for interviews on the Fed's action by calling (202) 637-3087.

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National Association of Home Builders

HOUSING NEWS SERVICE

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FOR IMMEDIATE RELEASE

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HOME BUILDERS CONCERNED ABOUT INTEREST RATE HIKE

WASHINGTON, Feb 1. – The National Association of Home Builders expressed concern today when the Federal Reserve Board raised interest rates by 1/2 percent.

"Every indication that we've seen from our surveys of builder members shows that the previous Fed interest rate hikes were already starting to slow the housing market," said Jim Irvine, president of NAHB. "Instead of letting the full effects of the previous hikes work their way through the economy, the Fed has again prematurely bumped up rates and that move could threaten the overall economic recovery."

Irvine noted that there is a lag of six to nine months from the time the Fed raises interest rates to the time it actually begins to slow the economy. "As we look to the future," he added, "the Fed should wait until the effects of this and past moves are clear before considering any further rate hikes."

During the past year, interest rates have increased more than two percentage points, which increases the monthly payment on a $100,000 mortgage by $140, an increase that has bumped out of the market thousands of young households trying to buy their first home.

While the housing market finished 1994 with 1.45 million housing starts, the peak of the housing cycle for single family construction was during the fourth quarter of 1993. Since then, the single family housing market has been winding down in the face of rising interest rates. NAHB is projecting 1.09 million single family starts in 1995, a decline of about 8 percent from 1994.

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Capacity Utilization Is Losing Credibility

Economists Say Data Don't Reflect Real Conditions

By Fred R. Bleakley
Staff Reporter of The Wall Street Journal

No economic indicator gets more attention these days and deserves it less than capacity utilization, say a growing number of manufacturers and economists.

It's one of many economic indicators that the Federal Reserve uses to measure the economy's strength and to decide when and if to raise interest rates. By the Fed's rule of thumb, when factories are churning out goods so fast they have to use 82% or more of their capacity, inflation is bound to rise. The latest reading of 85.4%, for December, was announced in mid-January, just two weeks before the Fed raised interest rates again. The data for January will be released tomorrow.

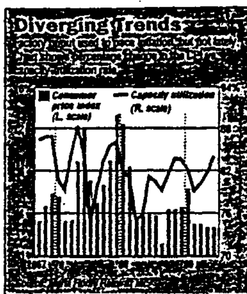
But like fresh money-supply data, which used to keep Wall Street traders and investors on the edge of their seats every Thursday afternoon, capacity utilization too may soon be discarded as a predictor of inflationary expectations, say its critics.

While manufacturers expect some rise in inflation this year beyond the 2.6% rise in the consumer price index in 1994, they believe the Fed has overreacted to an inflation threat in raising interest rates seven times in 12 months.

In the past, a high capacity-utilization rate implied coming inflation because it meant companies would be using less-experienced workers and less-efficient equipment to meet the extra demand for their goods. Prices would then rise as the resulting costs were passed along.

"You can't look upon capacity utilization unto itself anymore," says Homi Patel, president of clothing maker Hartmarx Corp. in Chicago. "We're in a global market where plenty of people are willing to sell at lower prices." Despite the strong demand and the higher cost of wool and cotton, even Hartmarx's best-selling suits are up only 3.5% in price from a year ago. Yet the company has been running its factories full out, at more than 95% of capacity, for some time.

Executives in the automobile, chemical, steel, food and computer industries also say capacity usage doesn't mean as much anymore. Capacity, they say, is



actually much higher than the Fed estimates in many cases. And, even when it isn't, the pervasive price-consciousness of consumers is acting as a brake that will keep overall inflation from getting out of hand.

But don't tell that to the Fed. Its inflation-fighting chairman, Alan Greenspan, still cites the need to be wary of rising capacity-utilization rates. He was backed up on his concern a few months ago by a senior economist of the Federal Reserve Bank in Kansas City, Mo. In a lengthy study, C. Alan Garner said, "The historical relationship between [high] capacity utilization and inflation still holds." He rejected the notion that technological advances in equipment, re-engineering of the work process or increased global competition had made it easier to rev up factory production without inflation.

Not all Fed economists buy Mr. Garner's conclusion. In what may become known as the war of the Midwestern Feds, Paul Bellew of the Chicago Federal Reserve Bank says "in a few months we will publish an article that takes issue with the Kansas City Fed's analysis." The Chicago Fed economist added, "When looking at manufacturing, you can't be oblivious to substantive changes."

The Fed's numbers "can go much higher before we start running into price pressures," says Maria Fiorini Ramirez, who runs her own economic consulting firm in New York. She cites numerous examples of industries where the utilization rate is high, but there is little or no inflation now or on the horizon. Food processors, for instance, have crossed the 82% utilization line, but a bumper-farm crop from last year is holding down prices. Low wage inflation helps, too.

In the intensely competitive computer industry, where there's a 91.2% utilization rate, prices late last year were actually down 9% from a year earlier. Compaq Computer Corp. says it's able to lower prices by adding capacity without building new factories. By running plants around the clock with faster machines that make computers with half the labor and components as before, the Houston company has boosted capacity more than sixfold since 1991, says Compaq's head of operations, Gregory Petsch. By his measure, Compaq is now operating at 85% of capacity.

David Wyss and other economists agree with Ms. Ramirez, saying the Fed's take on potential factory output is outdated and often understated. "It's the capacity number that's flaky," says Mr. Wyss, research director of DRI/McGraw-Hill. The Fed relies on an every-other-year survey of manufacturers by the Census Bureau, whose latest one won't be available until late this year. That means it is still using census data from 1992, making revisions yearly with capital-investment data filed by publicly owned companies and data from industry trade associations. The Fed then uses its monthly industrial-production survey to calculate the utilization rate.

In many industries, producer prices in the supply chain have continued rising, but they aren't making it into finished goods. "We're running capacity utilization in the mid-80's, which in the past is where you would get pricing flexibility" says Nicholas Filipello, chief economist of Monsanto Co. "In this environment, though, it's tougher to get." Although Monsanto has been able to pass along some of its rising petrochemical raw-material costs, big buyers of the plastics and fibers Monsanto makes are as tightfisted as ever, he says. One reason: They are under pressure from big retailers that don't want to become known as high-priced stores.

Under such conditions, many companies are increasing capacity in ways that official government figures often don't immediately capture. USX-U.S. Steel Group, for instance, was able to add nearly 10% more potential production to its capacity in the fourth quarter without any new capital expenditures. It did so by changing "people practices" says Paul Wilhelm, U.S. Steel's president. The changes were possible because, like the rest of the steel industry, U.S. Steel was operating at practically full capacity already. "We were able to really test the facilities and find things to fix," says Mr. Wilhelm.

Chrysler Corp.'s chief economist, W. Van Bussmann, says the auto industry also has hidden capacity that allows it to pass through the thresholds that in the past would have sent car prices flying. Asked about the Federal Reserve's capacity-utilization number of 90.7% for the auto industry, he responds, "How do I put this nicely? It is misleading." Not counted in the capacity data, he notes, is the potential for the industry to go to a third shift, to import vehicles from foreign plants or to eliminate traditional bottlenecks.

Although auto companies would have taken advantage of periods of heavy demand in the past to jack up prices, he says, "Now there's much more willingness to say that could backfire and alienate customers." As a result, new-car prices were up only 3.7% last year.

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THE WALL STREET JOURNAL

2/22/95

Chrysler to Idle Auto Plant a Week, In Another Sign Market Is Softening

By NEAL TEMPLIN
Staff Reporter of THE WALL STREET JOURNAL

DETROIT – Chrysler Corp., in another sign that the automotive market is softening, will idle its midsize-car factory in Bramalea, Ontario, for one week beginning Monday.

The plant, which employs 3,200 hourly workers, builds Chrysler's LH family of midsize cars, including the Dodge Intrepid and Eagle Vision and the Chrysler Concorde, New Yorker and LHS. So far this year, sales of midsize cars haven't risen nearly as much as the industry had forecast, although they increased about 4% in January from a year ago, said analyst Christopher Cedergren of AutoPacific Group.

Chrysler's decision to idle the plant comes as rising interest rates seem to be slowing car sales. Chrysler executives say consumers are increasingly bargain-conscious and are demanding more rebates and discount leases. Chrysler has slashed its forecast for 1995 U.S. light-vehicle sales by one million vehicles and now estimates the 1995 market at about 15.6 million cars and light trucks.

"There's a little slowdown," said Steve Wolf, sales manager at River Oaks Chrysler-Plymouth in Houston. Mr. Wolf added that even demand for the Jeep Grand Cherokee sport-utility vehicle, which has been a hot seller in recent years, is down slightly.

'Quite a Bit Softer'

"The industry is quite a bit softer than we had been projecting," said Tom Osborn, Chrysler's director of sales and marketing operations planning. "At least it was in January and as near as we can tell in February."

In the case of the LH, sales rose 5.9% from a year ago, but they haven't met Chrysler's far more ambitious production schedules and U.S. sales expectations. Chrysler produced 30,907 LH cars last month, but sold only 23,681 of them, according to DRI/McGraw-Hill's Global Automotive Group.

"We had hoped the market would be there," said Mr. Osborn, "but in fact it wasn't." Chrysler began offering equipment package discounts last month on the LH cars to spur sales.

The LH cars were well received when they first hit the market in 1992 because of their innovative styling. But the cars have been plagued by more quality problems than their leading competitors, and that may be affecting sales now.

Pulled From a List

Consumer Reports magazine, which is influential with car buyers, recently pulled the LH from its most-recommended list because of quality concerns. That hurt sales, says Mr. Wolf of River Oaks Chrysler-Plymouth, whose salesman had used the Consumer Reports recommendation to help close sales.

Georgine Claude of Schaumburg, Ill., purchased a 1993 Chrysler Concorde, but said the car had annoying problems such as leaking windows. She traded it in for a 1994 Intrepid but said that car had quality problems also, including a heater motor that blew out during last winter's record low temperatures. So, last summer, she sold her Intrepid and bought a Mercury Cougar from Ford Motor Co.

"The styling of the Concorde is beautiful," says Ms. Claude. "But as far as the engineering, it's bad news." Mr. Osborn, the Chrysler executive, said the criticism over LH quality is a recent development and it's too early to say if it's affecting sales. He said that Chrysler's internal quality scores for the 1995 model have risen substantially, and said that should be borne out when J.D. Power and Associates releases its influential initial-quality survey this spring.

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LEVEL 1 - 4 OF 4 STORIES

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HEADLINE: FED'S REPEATED RATE BOOSTS HITTING HOME IN CALIFORNIA

BYLINE: By JAMES F. PELTZ, TIMES STAFF WRITER

BODY: John Bates and his wife were delighted when they bought their Whittier house several months ago with an adjustable-rate mortgage. Its rate the first year was a low 5.25%.

Then came the Federal Reserve Board's repeated interest rate hikes, which sent mortgage rates and other lending costs sharply higher. The latest action was Wednesday, when the Fed raised rates for the seventh time in 12 months.

So when the Bateses' mortgage note turns a year old in May, it's a good bet that the lender will raise the rate by the maximum two percentage points allowed under the loan, to 7.25%. Bates figures the change will cost him an extra $250 to $300 a month.

"We haven't felt the squeeze yet, but we know it's coming," he said.

Indeed it is. And the Fed's rate hikes are causing financial pain not only for homeowners with adjustable-rate mortgages. They are also slowing sales in the California housing market, which only recently began pulling out of a prolonged slump.

When the California Assn. of Realtors announces its 1994 results next week, the group is expected to report that resales of single-family houses in the state rose about 6%, to roughly 465,000 units.

*

That would be smartly higher than the modest 2.2% gain of 1993, but it might have been stronger had interest rates been stable, analysts said. The upward march of rates began slowing sales in late 1994, and they will limit this year's sales gain to about 4.5%, said Leslie Appleton-Young, the association's vice president of research and economics.

"Will there be an impact? Yes," she said. "Where will it be felt? More strongly among first-time home buyers, who were kind of sneaking into the market anyway" through adjustable mortgages offering cheap rates in the

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first year, Appleton-Young said.

The rate hikes also began taking their toll on nationwide sales of new houses in last year's final quarter, limiting the annual sales gain to a scant 0.6%, the Commerce Department said Thursday. Still, that was the highest level of sales in six years, the agency said. PAGE 2 Los Angeles Times, February 3, 1995

In the West, where California accounts for about half the activity, sales of new homes rose 1.6% for the year to 191,000 units but were off 12% in the final month, the department said.

When rates began rising early last year, many homeowners flocked to adjustable loans. Countrywide Credit Industries Inc., the big mortgage lender in Pasadena, said nearly half its new loans in the quarter ended Nov. 30 were adjustable ones, compared to 17% a year earlier.

But adjustables are a lot more expensive today.

Mortgage News Co. in Santa Ana, which tracks the mortgage costs with about 100 Southern California lenders, said the initial rate on a typical adjustable-rate note tied to the yield of one-year Treasury bills was just under 4% a year ago. On Thursday it was 7.19%.

Some other adjustables are tied to the so-called 11th District cost of funds. That rate, calculated by the Federal Home Loan Bank of San Francisco, tends to move more slowly than Treasury bill rates, but it, too, has climbed. It stood at 4.6% in December, its highest level in two years.

Meanwhile, conventional 30-year mortgages with fixed interest rates -- many of which are tied to yields on 30-year Treasury bonds -- have been stable in recent months at around the 9% level.

As starting prices of adjustable-rate mortgages climb closer to fixed-rate loans, the fixed rate is regaining popularity.

"They're concerned about the rates going up further, so a lot of the buyers are not asking for adjustables now," said Marty Rodriguez, an agent with Alosta Inc., a Century 21 realtor in Glendora.

Whether fixed or adjustable rates predominate, sales in general are being retarded by the Fed's rate hikes, though the higher rates won't be enough to stop housing's recovery, some analysts say.

"I don't think it will have a major effect on slowing the market over a long period," said John Hekman, a vice president with Economic Analysis Corp., a research firm in Century City.

(BEGIN TEXT OF INFOBOX / INFOGRAPHIC)

U.S. New-Home Sales

Seasonally adjusted annual rate, in thousands of units:

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