

FEDERAL RESERVE'S SECOND 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 PURSU-
ANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF
1978

SEPTEMBER 22, 1995

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FRIDAY, SEPTEMBER 22, 1995

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

The Committee met at 10:00 a.m., in room 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 is pleased to welcome Chairman Greenspan here today. Also I'd like to make a comment on something.

I have a very short statement before I turn to Senator Mack.

Chairman Greenspan, we're pleased to have you here to discuss the Federal Reserve's Semiannual Monetary Policy Report.

These hearings provide us with an excellent opportunity to explore the successes and challenges that the Fed has experienced and anticipates in its implementation of monetary policy.

Today's hearing comes at a very opportune time as we are at a critical juncture in setting the course for the future U.S. economic policy.

We are particularly pleased to have you here to join us immediately before the next FOMC meeting on Tuesday. That's the Open Market's Committee meeting of the Fed.

I believe that the Fed has done an extraordinary job in conducting monetary policy. You know I have not always been complimentary, but I have to say, let's look at the record.

Under Chairman Greenspan's able stewardship, the economy has fared as well as we could have hoped. Interest rates are around 6 percent. Inflation is running at about 2.5 percent, and unemployment figures are exceptionally low.

Unfortunately, there is one troubling spot in the economy, one that is beyond the exclusive control of the Federal Reserve, and that is the economic growth rate.

Our economic growth has been hindered by the tax and spend policies of this Administration, past Administrations and past Congresses, so this is not a matter of bashing Democrats.

This year, Americans were forced to spend record amounts of money paying taxes, instead of manufacturing and creating jobs. This Congress is finally setting fiscal policy on the right track by reducing unnecessary taxes and spending. We will finally balance this country's budget.

I'm confident that this Congress will reduce the Federal budget deficit with or without the Administration's cooperation. It is essential. It is really the reason that the people have sent us here, to do their business. Over the years, we have lacked the courage to do it.

Earlier this week, our Committee, the Banking Committee, completed action on its portion of the deficit reduction package. Approving this package required each Committee Member to make difficult decisions.

I'm pleased that the Committee was able to report to the Budget Committee a balanced and fair bipartisan package that will reduce the size and cost of Government and protect the taxpayers.

But the purpose of today's hearing is to focus on monetary policy, not fiscal policy.

Yesterday, Senator Mack introduced the Economic Growth and Stability Act, which refocuses the Federal Reserve's attention on fighting inflation and maintaining price stability.

I'm proud to cosponsor this important piece of legislation, and I want to commend my Senator, friend and colleague, Senator Mack, for the job that he has done in bringing us to this point.

American families and corporations need a stable economic environment to make future plans and investment. Working together, the Federal Reserve can tackle inflation while the Congress, with the right fiscal policy, can stimulate the long-term growth that this country needs to prosper and keep Americans working.

I look forward to hearing Chairman Greenspan's views on this important piece of legislation, as well as his views on the current state and future of the American economy.

Senator Mack.

OPENING STATEMENT OF SENATOR MACK

Senator MACK. Thank you, Mr. Chairman.

First of all, let me thank you for scheduling and holding these hearings this morning and also I want to thank you for your support of the legislation introduced yesterday. Welcome Chairman Greenspan.

When you testified before the Joint Economic Committee last December, I asked you whether the Humphrey-Hawkins Act forced the Fed to follow policies in the short run that hurt the economy in the long run.

Your answer was simple and straightforward: yes.

In fact, you went on to say, and I quote:

I personally believe that a stable price level contributes very forcefully to long-term economic stability and maximum sustainable economic growth.

I agree. I believe that the United States must fundamentally alter the way it perceives and legislates monetary policy.

Technology has rapidly transformed our economic system, and today, more than ever, the Government must let go of the reins and free America's entrepreneurs to tame the information age.

However, the potential of technology is not yet fully apparent in the economy.

After avoiding a scare with recession, the economy appears to be rebounding slightly.

Housing, industrial production and auto sales have moved higher over the past several months, and the Philadelphia Federal Reserve Survey shows continued expansion in September.

Short-term interest rates have declined slightly this year, while long-term interest rates have moved from almost 8 percent to around 6.5 percent.

In addition, inflation remains surprisingly stable. However, I do not believe 2.5 to 3 percent consumer price increases indicate price stability.

Despite all of this news, overall economic growth was disappointing in the first half of this year, and wages have not been able to grow strongly.

Additionally, many economists place our potential growth near 2.5 percent, and forecast growth at that level through the end of 1996.

What troubles me is that many seem to be satisfied with this unimpressive growth. However, I am not. We are the richest and most advanced country in the world. We should be growing faster than 2.5 percent. Our goal should be 4 percent growth or higher.

I believe that attempts to micromanage the economy from Washington and a belief that we could spend our way to prosperity are the real culprits behind our slow growth. We must reverse those trends.

That is why Republicans in Congress are moving forward on balancing the budget through spending reduction and tax cuts.

However, while tax and spending cuts must proceed in order to get the economy growing again, long-term sustainable growth is only possible when monetary policy is focused on price stability.

That is why I have introduced legislation to give the Fed that primary goal.

With inflation at 2.5 to 3 percent, moving the economy to price stability is now possible in a reasonable timeframe without undue hardship.

The Fed has been constrained for nearly 20 years by an archaic law, the Full Employment and Balanced Growth Act of 1978, or what has been referred to as the Humphrey-Hawkins Act.

While the Fed's performance in bringing inflation down has been commendable, the job must be finished. The Humphrey-Hawkins Act was the high water mark in an era of big Government that believed the economy could be manipulated by Government mandate. Humphrey-Hawkins is a relic of times gone by.

As the world moves into the 21st century, we must stop asking the Fed to fine-tune the economy, and all of us must give up the command and control thinking of the past. This means the Humphrey-Hawkins Act should be repealed and replaced with legislation that serves to focus the Fed on one goal, price stability.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.
Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Chairman D'Amato. It's a pleasure to once again welcome Alan Greenspan, the Chair-

man of the Board of Governors of the Federal Reserve to the Committee.

Mr. Chairman, Chairman D'Amato, I appreciate your calling these hearings on monetary policy. These twice-a-year hearings think serve a very important purpose in enabling the Federal Reserve to be accountable to the Congress, and to the country for the matter, with respect to its policies and of course to have an opportunity for the Chairman to come before the Committee and explain the thinking of the Board with respect to the economy.

There's a tendency in some quarters, I'm concerned, that if the inflation is low and we're not in a recession, that the Fed has done its job.

However, I believe the Fed ought to be more concerned about jobs and growth than on occasion it seems to be.

For example, in the July report, most members of the Federal Open Market Committee expected unemployment to rise from the current 5.6 percent range to between 5.75 and 6.1 percent by the end of 1996.

I regard that as unacceptable. We've had unemployment below the once-feared 6 percent rate. I think it was asserted it was the natural rate of unemployment as I recall. We've had it below 6 percent for more than a year and inflation is trending down, not up. Down, not up.

Instead of being satisfied with a higher unemployment forecast, as we go into 1996, I think the Federal Reserve should be using its powers to help prevent more joblessness.

When the FOMC, the Federal Open Market Committee, lowered interest rates on July 6th, it noted, I quote, "inflationary pressures have receded." Since then the inflation used has been even more favorable. As measured by the CPA, inflation has risen at a mere 1.9 percent annual rate for the 3 months reported since July 6.

Actually, according to testimony which Chairman Green span gave earlier this year about a possible overstatement of the CPI, that would mean that actual inflation has been virtually zero.

Nor can a serious threat to core inflation be found. Labor costs represent two-thirds of total costs. With a continuing strength of productivity, unit labor costs have been completely flat over the last four quarters.

We last saw that happen in 1965, 30 years ago.

Financial analysts at WEFA and elsewhere have pointed out that the argument Chairman Greenspan used to justify higher interest rates last year would justify lower rates today.

As WEFA stated in their September 11th analysis, quote:

The slow down in inflation has turned monetary policy from neutral to restrictive. Indeed, the real Federal funds rate at about 3 percent is now high compared with the average 2 percent of the past decade. Hence, the Fed has ample room to ease credit conditions.

WEFA believes that the sufficient conditions for further easing of credit conditions are now being met. Given a quasi-moribund inflation, an evidently weak economy, and a rallying bond market, the time seems ripe for more accommodative monetary policy. End of quote.

Last year, we were told that interest rates had to be raised to their long run equilibrium level. That was part of the rationale for taking the rates up. At current rates of inflation, however, real

short term rates have reached excessively high levels by historical standards.

The Federal funds rate average 1.85 percent for the last 40 years, but is running at 3.1 percent today. The prime rate is even more significant to the economy than the Federal funds rate since it reflects the rate at which companies borrow from the banks.

Because of the unusually wide spread between the prime rate and Federal funds rate, today's real prime rate of 6.1 percent is much higher than the historical average of 3.4 percent, almost double.

Businesses that bear the brunt of today's high interest rates have been urging the Fed to lower rates. When the Fed did not lower rates at its August 22 meeting, a disappointed representative of the National Association of Manufacturers responded, and I quote:

By not taking any action, the Federal Reserve missed an opportunity to achieve higher growth. The best course of action would have been to lower the Federal funds rate by 25 basis points bringing it down to 5.5 percent. A further cut in interest rates would have brought the economy out of its current slowdown more rapidly and set the stage for a resumption of stable growth by the end of the year. The Federal Reserve can provide some additional stimulus without risking any increase in inflation. The Nation's industrialists would strongly support cutting rates by 25 bases points at the next FOMC meeting. End of quote.

That's from the National Association of Manufacturers.

Following the lead of a Business Week cover story last year entitled "Why Are We Afraid of Growth?" the editorial page of the Wall Street Journal and the conservative shadow Open Market Committee have recently challenged the assumption that we should set a governor on economic growth at 2.5 percent, which seems to be the prevailing dogma.

We should also consider the interplay of Federal Reserve policy and budget policy. No one can confidently predict the precise outcome of this fall's budget negotiations. At the same time, no one should doubt that they will have a substantial contractionary effect that monetary policy should seek to offset.

Because monetary policy is now tight and monetary changes have long lags in taking effect, it would not be premature for the Open Market Committee to lower rates when it meets next week.

Finally, I just want to raise one additional point which appeared in the press just this morning. It's involved in this fall's budget battle and it's the question of the extension of the debt limit.

It disturbs me greatly to learn that Speaker Gingrich cavalierly, in my view, told a meeting of bond dealers yesterday, and I quote:

I don't care what the price is, I don't care if we have no executive offices, no bonds for 60 days.

He seems not to appreciate that not issuing bonds when the debt limit is reached would also mean an unprecedented default on our obligations to pay interest and principal on outstanding bonds, notes, and bills.

I know that this is a contentious issue and Chairman Greenspan may be tempted to use his not inconsiderable verbal skills to avoid a clearcut statement on this matter.

[Laughter.]

Senator SARBANES. But any default by the Government would have direct consequences for stability of the financial markets, or at least so many have advised us. The stability of the financial markets are, of course, one of the primary responsibilities of the Federal Reserve.

Since the consequences of a default appear so clear, I hope that Chairman Greenspan, in the course of his appearance here this morning, will be able to give the Congress and the public a clearcut statement on the consequences of such a default.

Mr. Chairman, as always, I look forward to hearing from Chairman Greenspan, and I look forward to an informative discussion this morning.

The CHAIRMAN. Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you very much, Mr. Chairman, and welcome, Chairman Greenspan. I certainly look forward to hearing your views on our Nation's monetary and fiscal policies, and listening to your skilled presentation as well as the spirited debate that I think may already have started.

I'd be interested in your comments on Senator Mack's bill because I have joined on as a cosponsor. I think monetary policy is an extremely important part of our overall economy and I think the objective of monetary policy should be to have a stable currency.

But when monetary policy is asked to fill in for shortcomings in fiscal policy, when it's asked to create jobs when our fiscal policy is out of kilter, then it's like asking monetary policy to push on a string.

When our tax policy discourages savings and investment, it's not realistic to ask monetary policy to push the creation of capital which is needed to grow our economy.

I think your visit today is particularly timely as we enter intense budget negotiations. I think we have to get our fiscal house in order. Our Nation's largest spending programs, particularly Medicare, face potential insolvency. We are in the process of adding several hundred billion dollars to our children and grandchildren's credit cards each year.

In my view, these reckless spending habits also threaten America's international competitiveness. We've seen many of our trading partners, Canada, Italy, Sweden, suffer severe currency crises as a result of deteriorating public finances.

I think the long-term viability of the American economy cannot be endangered by a totally out-of-whack fiscal policy.

There is talk of a pending train wreck, but I believe very strongly that a majority in this Congress are committed to balancing the budget. I had an opportunity recently to participate on a panel with a senior Administration official who said:

The Administration strongly supports the goal of a balanced budget. We must have a balanced budget within the foreseeable future, and it has to be scored objectively.

Now if that official is reiterating what the President promised in 1993—that we needed to cut spending to balance the budget, and we need to use the Congressional Budget Office to score any pro-

posal to reach that balanced budget, then I think we have a solution at hand.

We're willing to negotiate. As one of the appropriators who has been guaranteed a veto of an appropriations bill coming out of the Subcommittee, I stand ready, and I have told the Administration, we'll be happy to negotiate within the constraints that frankly were constraints that the President himself set forth in 1993.

I don't think there needs to be a train wreck, but frankly continuing to spend at a \$200 billion a year deficit, which is what the President's so-called balanced budget proposal would do, according to Congressional Budget Office scoring, is in itself a long-term train wreck that will drive down the dollar's value even more than the recent trade deficit has. It will threaten our economic viability and threaten the ability of our children and grandchildren to carry the burden of these increased debts.

Mr. Chairman, in the past, we've also talked about Government regulation and its impact on economic growth. I'm disappointed that the Senate has been unable to break the filibuster, the gridlock against regulatory reform.

I expect that we will continue to work on that.

I welcome your perspective on how the burden of regulation has affected growth in the private sector, and what we in Congress can do about it.

I look forward to hearing your comments. I thank you for being with us.

I thank the Chair.

The CHAIRMAN. Thank you, Senator.

Senator Faircloth.

OPENING STATEMENT OF SENATOR FAIRCLOTH

Senator FAIRCLOTH. Thank you, Mr. Chairman.

Thank you, Mr. Greenspan.

I want to thank Chairman Greenspan for being here today. I think the Federal Reserve has done its part to stabilize our economy during his tenure in office.

Interest rates have been generally low and inflation has been mild.

I do not think Congress has done its part. There's been a steady increase in spending the deficit and regulations over the last 40 years, but in particular over the last 10 years, we've seen a steady increase in rules, regulations, and deficit.

With the Republicans taking control of Congress, I had hoped and I thought the pattern would change. But I have been disappointed.

I was frustrated when the Senate failed to approve a balanced budget amendment. I think it was a grave mistake. I am certain that without a constitutional amendment that requires the Congress and its Members to balance the budget, we will not balance the budget.

Right now, we're going through a reconciliation process to get a balanced budget in 7 years. But to do that, in many cases, we're using "never was" and make believe money in the process to achieve the savings.

Certainly if we are doing that now, what will we be doing 7 years from now? Will we balance the budget?

The same can be said for regulatory reform which the Senate failed to pass. The same is true for elimination of Government agencies and cabinet departments that have failed to perform and have proven to be unproductive and, in many cases, not worthwhile.

The Senate hasn't taken on these matters. We simply will not curb our propensity to spend.

In each of these areas, we aren't enacting real change that will allow the country to cut spending and regulation so that we can produce private sector jobs and growth.

If we have a concern in the Congress about default and potential default on our \$5 plus trillion debt, or \$5 trillion debt, the real answer and what we should be doing is cutting spending. Very simply, that's the way you get your house in order so that you don't have the potential or the threat of a default.

I do want to hear Mr. Greenspan, what can the Congress do to help him in his job and seek his advice about what we can do to increase the productivity and the size of the private sector and not the governmental sector.

I thank you, Mr. Chairman, for being here this morning. I thank you for the many times you've led this Committee, and I appreciate the job you've been doing.

The CHAIRMAN. Thank you.
Senator Bennett.

OPENING STATEMENT OF SENATOR BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I recognize that we have a vote, and I say in advance to Chairman Greenspan, I apologize that I won't be able to return after the vote because of a conflict.

I've read your statement and appreciate your comments, particularly those that you make at the end regarding the importance of balancing the budget. I look forward to reading your full testimony.

Particularly, I'd like to hear your comments in response to Senator Sarbanes' questions regarding what would really happen in terms of a default on the debt if we didn't raise the debt limit.

I think that's an issue that's on all of our minds, and I look forward to your answers and will read the record with great interest. Again, I ask your indulgence for the fact that I can't be here to hear it in person.

The CHAIRMAN. Thank you, Senator.

There is a vote now, Mr. Chairman.

I'm going to ask that we take a brief adjournment for 10 minutes and then we'll return hopefully to get your testimony. We'll stand in recess for 10 minutes.

[Recess.]

The CHAIRMAN. Quick statement.

OPENING STATEMENT OF SENATOR KERRY

Senator KERRY. ~~Quick statement~~

Mr. Chairman, thank you very much. I'll be very brief.

I gather this was mentioned previously, but I want to go on record about it also.

On the front page of the New York Times today is a headline about the Speaker of the House threatening U.S. default if Clinton won't bend on the budget.

In the first paragraph, it says that he's going to do this for the first time, or threatens to do this for the first time in the Nation's history to force the Clinton Administration to balance the budget on Republican terms.

I find that to be one of the most extreme positions, contrary all of the best efforts of recent years of people to be reasonable here. But I would like you to comment, at the outset, if you would, on the implications of a threatened default or of the fact of a default on the stability of the marketplace, and particularly—you don't have to comment on the extremism of the statement but certainly I think it is important for people to understand the implications and potential impact of such an event.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you so much.

Chairman Greenspan, we finally got to you.

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

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

Before I start, I just wanted to thank you for your very kind remarks in your initial opening statement.

The CHAIRMAN. I thank you, Mr. Chairman. We may have had our differences over the years. I don't mean to go back to those differences.

But I have to tell you I think that you've done an extraordinarily difficult job, given the fact that the Congress, and not just this Congress, and the Administration, and not just this Administration, and I've said it before, haven't cut the mustard.

We've been talking about balancing the budget, getting the deficit under control for a long time now. We just don't measure up. We're afraid to make the tough decisions. Everybody says cut, but then when it comes down to where you reduce, people argue don't cut my favorite program but cut everybody else.

Then when you start to make those tough decisions, they have an impact. So I think it's the old story. We want our cake and we want to eat it and we want to do it now, and then when we get fat and bloated and out of control, we look to blame everybody else.

Mr. Chairman.

Chairman GREENSPAN. Thank you.

I'm as always pleased to appear before this Committee and I will look forward to having significant colloquies on a number of very crucial issues which I think confront the financial markets in this country.

In July, the Federal Reserve submitted its semiannual report on monetary policy to the Congress. That report covered in detail the Federal Reserve's assessment of economic conditions and the forecasts of the Governors and Reserve Bank Presidents for economic growth and inflation. This morning, I would like to offer my views on recent developments.

As I reported earlier to the House Banking Committee, a moderation in economic activity in 1995 was inevitable following the frenetic pace of late 1994. It was also necessary if we were to avoid the creation of major inflationary instabilities.

By the end of 1994, pressures on resources were contributing to sizable increases in delivery lead times for raw materials and intermediate goods and steep markups in their prices; overtime in manufacturing was extensive. Fortunately, economic growth has slowed appreciably this year, inflation risks have receded, and as a consequence, the threat of severe recession has declined.

I also noted that one could not expect the transition to a more sustainable growth path to be entirely smooth. Rough patches were also encountered in past economic expansions, typically because businesses did not fully anticipate the changes in demand for output. The slowing in real gross domestic product growth at the beginning of this year was precipitated by a weakening in consumer spending and housing construction, partly as a consequence of higher interest rates and by the damper on net exports from the economic crisis in Mexico.

But the risk of a more serious slowdown thereafter was exacerbated by the failure of inventory investment to match the slackening in spending. Indeed, although stocks in the aggregate remained modest, a few major industries, such as motor vehicles and home goods, found themselves with substantial excesses. Attempts to control inventories triggered cutbacks in orders and output that, in turn, depressed employment and income in the spring.

At midyear, the uncertainties about the dimension of the inventory adjustment, and thus about the prospects for real GDP over the near term, were considerable. Nonetheless, it seemed that the point of maximum risk of undue weakness had been passed and that moderate growth was likely to resume in the second half of the year.

As events unfolded, revised data indicated that overall activity in the second quarter was not quite so weak as suggested by the initial estimates, largely because final sales were stronger. Moreover, *the available statistical indicators for the current quarter are consistent with a firmer pace of economic growth.* In the labor market, for example, payrolls have posted moderate increases on average over the past couple of months, and the unemployment rate has edged back down to 5.6 percent.

Industrial production also turned up in August after a sustained period of weakness that extended back to last winter. The surge in output should probably be discounted somewhat, given that this summer's unseasonably hot weather provided a transitory boost to the output of electricity.

Moreover, in a number of industries where efforts to pare stocks are continuing, inventory—sales ratios remained on the high side in July. Even so, the production data suggests that, on balance, manufacturers were confident enough about their sales prospects, and in the main, comfortable enough with their inventory positions, *to expand production once again.*

The underlying trends in final sales are favorable overall, in part because of the considerable decline in long-term interest rates and the sharp increase in stock prices this year. Retail sales have been

rising moderately on average since the spring, and home sales and starts have posted hefty gains. As for business investment, new orders for capital goods have fallen of late, but backlogs remain sizable. It thus appears that purchases of equipment will continue to grow, though perhaps at a slower pace than in the recent past. In addition, rising building permits point to further expansion in non-residential construction.

Meanwhile, the inflation picture is looking more favorable than it did in early 1995. Core inflation, as proxied by the 12-month change in the CPI, excluding food and energy, has moved back down to around 3 percent after a bulge earlier in the year, and there appears little reason to expect much change in inflation trends in the near term. Increases in labor costs have remained modest, even though unemployment has fallen to levels that history suggests might be associated with some acceleration in compensation. In addition, the deceleration in manufacturing activity this year has helped to ease pressures on capacity and to stabilize, and in many areas reduce, lead times on deliveries. With supply and demand in global commodity markets in better balance, prices of materials and supplies are no longer rising rapidly.

In light of these developments, the firming in monetary policy in 1994 and early 1995 appears to have been sufficient to head off a ratcheting up of inflation. As I have often stated, containing inflation, and over time eliminating it, is the main contribution the Federal Reserve can make to enhancing our long-term economic performance.

On the whole, the near-term prospects for the United States' economy have improved in recent months, in part because the strong increases in financial market values this year are likely to provide substantial support to household and business spending. But the outlook is not without concern. Firms' desired inventory levels are extremely difficult to gauge and the remaining adjustment process could play out more negatively than we anticipate. Moreover, although the economies of our key trading partners are recovering somewhat, they are still expanding only moderately on average and, as a consequence, the external sector is unlikely to contribute positively to real GDP growth in the United States.

Some observers have expressed fears that current efforts to eliminate the Federal budget deficit will prove a hindrance to the economy. I do not share those fears. Long-term interest rates have fallen a great deal this year, in part because of the growing probability that a credible multiyear deficit reduction plan will be adopted. The declines in rates are already helping to stimulate private, interest-sensitive spending, providing in effect a shock absorber for the economy.

Clearly, the Federal Reserve, in appraising evolving developments, will continue to take the likely effects of fiscal policy into account. But I have no doubt that the net result of moving the budget into balance will be a more efficient, more productive U.S. economy in the long run.

I continue to be impressed by the growing public recognition of the importance of deficit reduction and the commitment on the part of the President and the Congress to bring the budget back into balance in the reasonably near future. The challenge is enormous.

The budget deliberations will be contentious, and the deadlines now are extraordinarily tight. But these pressures must not be allowed to prevent us from taking concrete action to implement a program of credible multiyear deficit reduction.

Failure to take such action would signal the United States is not capable of putting its fiscal house in order, with adverse and serious consequences for financial markets and long-term economic growth.

Thank you, Mr. Chairman. I will be happy to respond to questions.

The CHAIRMAN. Mr. Chairman, I'm going to ask just a very few questions. I'm going to refer to your remarks in which you say the growing probability that a credible, multiyear deficit reduction plan will be adopted has already had an impact in reducing long-term interest rates. Do you believe that to be the case?

Chairman GREENSPAN. I do.

The CHAIRMAN. You then go on to say, I have no doubt that the net results of moving the budget into balance will be a more efficient more productive economy in the long run.

Do you feel strongly about that?

Chairman GREENSPAN. I do, Mr. Chairman.

The CHAIRMAN. You go on to say, I continue to be impressed by the growing public recognition that the budget deliberations will be contentious. That is an understatement?

Chairman GREENSPAN. It is indeed, Mr. Chairman.

The CHAIRMAN. It is nothing compared to what you're going to see in the American people when they hear that the elderly are going to be sacrificed, that the poor are going to be pushed to the side, that every sector imaginable from students to grandparents will be hurt by the cuts. That will be the rhetoric that comes.

Certainly I understand some of that.

You go on to say, the pressures must not be allowed to prevent us from taking concrete action to implement a program of credible, multiyear deficit reduction. Failure to take such action would signal that the United States is not capable of putting its fiscal house in order with adverse and serious consequences for the financial markets in long-term economic growth. How adverse would that be?

What impact would you see should we fail to put forth a real budget, a multiyear budget reduction program?

Chairman GREENSPAN. Mr. Chairman, as you know better than anyone, there has been a very considerable skepticism in recent years in the financial markets that the United States would be able to bring its budget deficit under control and reduce, very significantly, the underlying pressures for an expansion of very significant proportions in the 21st century.

As a consequence of that, there has been a significant inflation premium embodied in the long-term interest rates for dollar-denominated securities, which is reflected there.

As the year began, it became increasingly evident that the commitment, not only on the part of the Congress, but also of the President, to balance the budget were real and sincere endeavors. Even though obviously there are differences, both parties have pointed to the necessity of reaching a balanced budget within the

intermediate period, and finally, that has been getting through to the financial markets who are now beginning to start to discount that event. I think a very marked part, a significant part of the decline in long-term interest rates that we've seen so far this year is, to a very substantial extent, attributable to that expectation.

Should it prove to be wrong, then I think we will see a full reversal and perhaps an even greater reversal in the sense that discouragement tends to have an excessive secondary effect.

I must tell you, however, that it is my judgment that the expectations that indeed we will get successful results at the end of these—I'll change my verbiage—highly contentious activities—

The CHAIRMAN. Furious battles, ferocious.

Chairman GREENSPAN. Your verbiage is superior to mine, Mr. Chairman.

The CHAIRMAN. Only maybe in describing this little war.

Chairman GREENSPAN. I do seriously believe that the awareness of all parties of the critical nature of resolving this problem has gotten to a level that I fully expect that we will achieve it, and I think we will achieve it without creating a problem of default with respect to our Federal finances.

The CHAIRMAN. Let me ask you this. If we don't achieve it, what takes place?

Chairman GREENSPAN. If we don't achieve it, I think that the financial markets, very specifically first the bond market, and other financial markets would respond negatively, and I fear that might have consequences on economic activity.

The CHAIRMAN. Interest rates?

Chairman GREENSPAN. Interest rates, long-term interest rates would rise.

The CHAIRMAN. Substantially?

Chairman GREENSPAN. I don't want to characterize what the size of the number is, but it is enough to be disturbing.

The CHAIRMAN. All right, I'm going to turn to Senator Sarbanes, and I'm going to ask all of our Members who are here to adhere to the 5 minutes. This way, we can keep going back for additional questions.

Senator Sarbanes.

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

Mr. Greenspan, I have three questions I want to try to cover in this round.

The first one is really, in a sense, off to the side. But you make the point in your statement that the revised data for the second quarter indicated that overall activity was not quite as weak as suggested by the initial estimates.

Chairman GREENSPAN. That is correct.

Senator SARBANES. That raises a problem I've been concerned about, and that is the discrepancy that seems to exist between the first data reports and the revised data reports.

Of course policy is made off of that data, off of those data reports. The private sector reacts to them and so forth. It just leads me to be concerned about the statistical infrastructure, and particularly in light of what's now happening because we have very deep cuts taking place in the budgets of the agencies responsible for putting forth these statistics.

I guess my question to you is, how important is it to have a first rate statistical infrastructure, and wouldn't it serve all of our policymaking purposes and the activities of the private sector if we could actually enhance the validity and the timeliness of the statistics upon which we rely for many of our estimations of economic activity?

Chairman GREENSPAN. In general, Senator, I would say that the data that are available to do analysis, both in the public sector and the private sector, are generally quite good compared to a number of other countries.

We do have a very major issue with respect to the fact that our economy is changing quite rapidly, especially as we get to increasingly conceptual products and experience a big shift from manufacturing to services. Indeed there is an increasing indication that the clear line that we have always seen between manufacturing on the one hand and services on the other is blurring and our understanding of how to measure true value-added with respect to this changing environment requires an increasing view of how the newly emerging aspects of our economy are proceeding. In that regard, I think we do have to increase our statistical understanding.

I would say, with respect to the resources question that is implicit in this type of question, I think what we have to do is recognize first that our primary goal is to get aggregate spending down in the total because that's clearly crucially important.

When you get to the issue of the composition of the cuts—how one trades off various different values within those budgets—I do think that we have to recognize that the statistical programs do create important value-added to the overall private and public decisionmaking that exists in our society.

So I certainly wouldn't put it as a sort of luxury item in the budget or at the bottom rung by any means of where various priorities are.

But I do think that it is really up to the Congress and not up to the users of statistics, who have an obvious parochial concern, to make judgments of that nature. The only thing I can say to you is that having a viable data system is important, and I think it is going to be especially important in the years ahead, as our economic system continues to change in many different ways.

Senator SARBANES. Well, I would just make the observation that the dollar amounts involved are not very large with respect to this statistical infrastructure, but the extent of the cuts in percentage terms are quite significant and they may drastically impede the Bureau of Economic Analysis, the Census Bureau, and the Bureau of Labor Statistics to provide accurate statistics. I think actually we need to do better.

Let me ask you now about the question I raised at the end of my opening statement with respect to the possibility of a default on the public debt.

Secretary Rubin said, in a statement yesterday, it would be unprecedented and unwise for anyone in a position of authority to dismiss the consequences of default on the debt of the United States of America for the first time in our history. Even the appearance of a risk of default can have adverse consequences.

A default itself would increase the cost of debt for the U.S. Government for many, many years to come. A sovereign country's creditworthiness is a precious asset not to be sacrificed under any circumstances. You wouldn't differ with that observation, would you?

Chairman GREENSPAN. Well, I would differ at the margin. I think the risk of default is quite significantly different from actual default itself.

We have been on the brink of risking a default on innumerable occasions over the years, and it has not happened. The markets, at least as far as I can judge, until recently, if even up to now, have not really fully factored in, insofar as differentials that we can see, any real expectation of default, although I have not looked at these data for the last 48 or so hours, so I don't know what these numbers would look like relative to that.

However, what we do not know is what the consequences of actual default would be. Obviously, it has never occurred before and one must presume that it would be adverse. How adverse is difficult to say.

My main concern is that it could add to the cost of debt in the future as far out as one could see, largely because, at the moment and over the years, U.S. Treasury securities, as Secretary Rubin implied, have been held in very high regard in financial markets, and in part it's the issue of their extraordinary liquidity and the extent to which they have a history of no evidence of any form of default.

I don't know, nor do I think anyone else really can make a judgment, but one has to assume it is negative. Clearly, to default for the first time in the history of this Nation is not something which anyone should take in any tranquil manner.

Senator SARBANES. Well, Mr. Chairman, I see my time is up. I'll just close by reading into the record, an excerpt from a letter of November 9, 1993, from then-Federal Reserve Board Chairman Paul Volcker to then-Treasury Secretary Donald Regan.

Chairman GREENSPAN. That was 1983?

Senator SARBANES. 1983. Sorry. I quote:

The failure of the Congress to act on the debt ceiling would, in either case, create uncertainty in confusion and banking and money markets that count on timely payment, and in individual cases could result in hardship in addition to the broader implications for confidence in the Government's credit. A failure to increase the debt limit would not only create havoc in the payment system, because of the necessary delays that I have outlined, but it would also undermine confidence at home and abroad in the Government's ability to manage its affairs.

I take it the current Chairman of the Fed wouldn't disagree with that?

Chairman GREENSPAN. I would not.

Let me emphasize one issue which has not been discussed, but is implicit in Chairman Volcker's statement. There are a number of very considerable technical issues that would arise in the event of default because we have a highly computerized system of Treasury transactions and book entry calculations which, while not crucial to the system as a whole, would undoubtedly exhibit some element of disruption which is probably of a larger order of magnitude than what would have been implicit when Chairman Volcker was commenting on that issue back in 1983.

The CHAIRMAN. Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

I will turn to the issue of price stability in a moment. I had really planned to go directly there, but since we've gotten into this discussion about Speaker Gingrich's comments and the debt ceiling, I feel compelled to make some comments with regard to that.

First of all, I think that Speaker Gingrich frankly is reflecting a very, very adamant attitude of most of the Republican Members of the House.

I think most people have recognized that there was a substantial change that took place in the House as a result of the elections in 1994. These individuals are saying that, in essence, if we don't get control of this spending, that is, if we don't get some agreement, we are not prepared to vote to increase the debt ceiling.

I think that's something that people just ought to understand as part of the reality of the makeup of this debate.

I would say to you, having spent 16 years in the banking business and having been a lender from time to time, when you have a credit that's in trouble, if you're not going to call that debt, if you're going to extend it, you certainly are going to get something for doing that.

What most of the Members are saying is, if you want us to extend the credit limit of the Federal Government, we want to have a plan in hand that says, here is how we're going to deal with budget issues for the next 7 years.

Frankly, I find that a pretty reasonable approach to trying to solve the problems that this Government faces with respect to its spending and its deficit.

Now I will return back to the issue that I wanted to discuss with the Chairman.

In your statement, and I'll quote it again:

As I have often stated, containing inflation and, over time, eliminating it is the main contribution the Federal Reserve can make to enhancing our long-run economic performance.

Within that context, you and I have conversed at these hearings for the past year, and I believe we both agree that under the Humphrey-Hawkins Act, the Fed is mandated to follow policies in the short run that damage the economy in the long run.

Do you believe that focusing the Fed primarily on long-term price stability is a better way to promote long-term economic growth and low unemployment than commanding the Fed to meet numerous conflicting short-term policy goals?

Chairman GREENSPAN. Well, as I've said many times in the past before this Committee, I don't see that there are any significant conflicts between price stability and sustainable maximum long-term economic growth, which at the end of the day is really what economic policy is all about.

Financial systems are means by which that can be determined. One of the characteristics of a financial system that would contribute to sustaining maximum long-term growth is price stability.

I think that we're learning, as the years go on, that to the extent that we can achieve that, we will get lower interest rates, both nominal and real, and we will get a higher rate of growth overall in that type of environment.

Senator MACK. What happens to employment in those conditions?

Chairman GREENSPAN. Employment should, under those conditions, follow real economic growth, as it always does. That is, to create employment without growth, meaning creating employment without a rising standard of living, is not a goal that we should seek.

So that my judgment is that there is no inconsistency in the issue of maintaining long-term maximum economic growth and employment growth and price stability.

Senator MACK. Are you of the opinion, though, that the Fed—let me ask it a different way. Should the Fed have more than one objective? As you know, I have—

Chairman GREENSPAN. I don't think we should have more than one primary objective because we really only have one tool which is the Federal funds rate.

What we cannot do is have a multiple of goals which are partially conflicting and endeavor to successfully tradeoff and balance them in a manner which will successfully create a degree of stability and maximum long-term growth.

It is conceivable one can do it, but it is increasingly more difficult the more collateral goals that one has, and especially the more inconsistent goals that one may have. But I think that having a primary goal of price stability is the most important thing which a central bank can contribute to a market economy.

Senator MACK. I appreciate that comment.

Countries throughout the world, including New Zealand, Canada, and the United Kingdom have enacted legislation focusing their central banks on price stability. Some of these countries give so-called legislative hard targets for inflation. Do you believe the Fed policy would be more accountable if the Fed were required by Congress to meet hard targets? Or should the Fed establish its own definition of price stability?

Chairman GREENSPAN. Well, I think in general that it's better if the Fed defined what the particular definition of price stability is, because it will change slightly from time to time, depending on the structure of the market and what type of environment in which we're living.

However, we should be held fully accountable for meeting those goals and I would suspect that were we not to meet them, we would hear both from the Congress and the markets.

Senator MACK. Mr. Chairman, my time has expired, and I'll wait until—

The CHAIRMAN. OK. Senator Faircloth.

Senator FAIRCLOTH. Thank you, Mr. Chairman.

Just a brief comment on Senator Mack's statement and the Gingrich statement.

I do not totally or I do not disagree with the mindset that Speaker Gingrich has enunciated. I think that it clearly is time that we face reality and the President begins to negotiate realistically and on a thorough basis with the Republicans and that we do something.

As you said, Mr. Chairman, the American public has raised to a pretty high idea now, or it has taken to the idea that we simply have to reduce spending, we have to balance the budget.

I think if we miss this opportunity by not doing it while we have the support of the American public generally, the opportunity might not present itself again right away, and I think I don't have any problem with what Speaker Gingrich has had to say, although I haven't studied his statement in detail.

To move to another question, and I just have two brief ones, I've introduced a bill a few weeks ago that would stop the creation of the new international bailout fund that the U.S. and the International Monetary Fund have created to take care of future problems like Mexico.

I did this because I think it's a bad idea. I think it would encourage investors to think that they would be bailed out no matter what they did in these other countries, particularly Third World countries, and would lead to a more reckless economic policy than we have now, when they don't have that assurance, and have to analyze and make decisions on these third and whatever second world countries on the ability to repay within themselves and not some international bailout.

Would you give me an opinion as to how wrong I might be?

Chairman GREENSPAN. Well, I can't at the moment, because I must admit, Senator, I have not seen the details of your bill. But if you would make it available to me, I will promise to respond as quickly as I can with an answer to that question.

Senator FAIRCLOTH. Well without any specifics, do you think it's a good idea to have some monetary fund sitting to bail these countries out all around the world?

Chairman GREENSPAN. Oh, I don't think anybody believes that. The question is always in the details, and I would like to see them before I come forth with a general conclusion.

If you ask me though if I think that we should be involved in inappropriate lending around the world, I obviously would say not. I think the crucial question is to get the definition of what is appropriate.

Senator FAIRCLOTH. Well, as I understand the fund as it was being proposed, it simply would be. It would be inappropriate lending on our part.

The very liberal editor of the Wall Street Journal, Bob Bartlett—

[Laughter.]

Chairman GREENSPAN. Yes, I'm sure he'd appreciate that.

Senator FAIRCLOTH [continuing]. Says that the gross domestic product in this country, in an article today, was 3.5 percent roughly from 1950 through the early 1970's.

From 1989 through 1994, it averaged 2 percent, and the best projection that we can come up with now, through the year 2005, says it won't get above 2.5 percent.

What would you think, why is the reason this country can't achieve the growth it had in 1950 through say the 1970's?

Has it been Government regulation, policy, or spending, or deficit? What's hurt the productivity?

Chairman GREENSPAN. Well, I must say, Senator, that this is one of the issues which has confounded economists over the decades. Sometime in the mid to early 1970's productivity slowed down quite dramatically in this country, after exhibiting a fairly robust pace from the end of World War II basically through the 1960's. Probably it was artificially inflated in the latter part of the 1960's, but it's clear that there's a different regime out there.

After a very considerable analysis, there's not been a great deal of insight thrown on this. Nonetheless, it does strike me that we have the capability of increasing our productivity rates and increasing the growth rates in this country by, as I've indicated many times before this Committee, increasing the competitive capability and incentive structure of our economy.

There is nothing like competition and incentives to create economic growth.

While I certainly am concerned that we are not moving as fast as we would like, there is evidence that we have begun to accelerate some, and it's largely in those areas where regulation is modest to non-existent, and competition is extremely fierce, and incentives are very substantial.

I'm talking mainly of the computer and telecommunications software type of areas of our economy, which are really changing the underlying structure of what we have got. I do think that while we may or may not be able to reach the growth rates of the immediate post World War II period, which may have reflected a technological catching up and therefore could not be expected to continue indefinitely, there is no question in my mind that we can and we should try to expand the underlying growth rate in this society.

Senator FAIRCLOTH. Mr. Chairman, if I may just one more quick question while I have it on my mind.

You mentioned a competitive situation as an incentive for growth. But you mentioned, and lack of rules and regulations, but you mentioned incentives, would that mean from Government or?

Chairman GREENSPAN. It basically means reducing the regulatory burdens which inhibit incentives, hopefully a reduction in marginal tax rates and the capital gains tax which I have argued before this Committee on numerous occasions as being desirable, and clearly, I might add, because this issue has not been raised in the context of economic growth, is getting our Government deficit to a point at least of neutrality where it is not absorbing the saving of the society which is so crucial to the issue of growth.

If we are looking at growth, we have to look at all of these things. At the moment, the most important thing and the biggest inhibitor that I can see is largely this extraordinary structural budget deficit which is draining private saving from productive uses.

Senator FAIRCLOTH. Thank you.

Thank you so much, Mr. Chairman.

The CHAIRMAN. Senator Grams.

OPENING STATEMENT OF SENATOR GRAMS

Senator GRAMS. Thank you very much, Mr. Chairman.
Welcome again, Mr. Greenspan.

Just to paraphrase a little bit about my opening statement, Mr. Chairman, before I get into my first question.

But as you know, we are required by law, specifically the Humphrey-Hawkins Act, to hold these hearings, and we are on the verge of a major debate over these very same hearings.

The principal issue in this debate is whether we will continue to require the Federal Reserve Board to continue its current responsibility of artificially boosting growth in employment while keeping interest rates and inflation low at the same time, as my colleague, Senator Mack has questioned in regarding to the Humphrey-Hawkins Act itself.

Mr. Chairman, I believe that these are unrealistic goals. The purpose of the Federal Reserve Board, I believe, is to oversee monetary policy, to oversee price stabilization, low inflation and interest rates. Economic growth can't be produced by the Federal Reserve Board any more than from any other Government entity.

Economic growth comes from the private sector and from the businesses that create jobs, from the common sense and the hard work of the American people.

Now Government can do something to help stimulate economic growth, I think, as Senator Faircloth was just talking about, by cutting taxes, as you have mentioned, balancing the budget, and reducing burdensome regulations. But that is the role of Congress, not the Federal Reserve.

That's exactly what we must do this year if we are truly committed in carrying out the message that I believe the American people delivered last November.

Mr. Greenspan, earlier this year, you and I, in one of these hearings, had a positive discussion over the issue of sunset laws. The requirement that Congress reexamine and reauthorize, in other words, oversight of programs, taxes and regulations by a date certain, or allow those programs to expire.

I was pleased to find that we did agree that sunset laws would serve an important purpose in requiring Congress to measure the cost effectiveness and the usefulness of existing laws before allowing them to continue on indefinitely.

I believe all laws and regulations should include a sunset date if Congress is to carry out the responsibility of properly overseeing the Government. That goes for the laws whose jurisdiction falls under this Committee, as well.

With that in mind, I'd like to hear your views on sunset requirements for the following laws, and specifically, and you can comment on them in general or specifically, but the following laws:

The Community Reinvestment Act, the Truth In Savings Act, the Truth In Lending Act, the Home Mortgage Disclosure Act, the Real Estate Settlements Procedure Act.

Again, it's not to eliminate these laws but to go back and look at how have they carried out the intent under which they were passed.

Chairman GREENSPAN. Senator, as I recall the context of the discussion, which I will summarize and still hold to, I believe that if a law is a sound one, it will be re-passable after a period of time, and should not just automatically continue on because no one is looking.

If there is an underlying bias toward increasing government expenditures, which I believe there is and which I think the evidence clearly demonstrates, then we have to find a technical process to at least counter that upward bias.

I have always believed that sunset legislation is a very useful tool in that regard.

My general view is that all legislation should be subject to sunset legislation, including as in our previous conversation when Senator Sarbanes asked about the Federal Reserve and I said absolutely. All institutions of Government should be subject to periodic review automatically in order to appraise whether in fact the moneys that are involved in implementing various different types of programs are being as effectively used as possible.

Senator GRAMS. Because purposes and situations change. No one should be afraid of a sunset because, as you mentioned, if the agency is carry out its role, there should be no problem in reauthorizing it or at least adjusting it.

But it's when the program has totally failed that it should be taken off the books. Maybe that's what has a lot of people afraid.

Mr. Greenspan, just a final question here quickly.

Is there any time line that you would suggest in overseeing these laws and imposing a sunset? Would you give them 2 years, 5 years? What would be an appropriate time to suggest to really get a good handle on how the program has produced?

Chairman GREENSPAN. Well, I'm not sufficiently expert in making judgments on these individual programs as to what the particular timeframe for a fair appraisal period is.

I would leave that to those who are more familiar with the programs and specifically, obviously, to the Congress where this judgment must ultimately lie.

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

The CHAIRMAN. Senator, do you have any other questions that you'd like to pursue?

Senator GRAMS. No.

The CHAIRMAN. Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

I really only have a couple of points to followup on.

In your last comment to the last question I asked, in essence said that the Fed would be accountable to both the Congress and to the markets, and I just want to run through the way we've crafted this legislation.

As you know from our earliest discussions, my thoughts were to in fact put some specific numerical ranges in the bill.

I, over a period of time, realized that I was one of those individuals that said we ought to have less Government, not more Government and concluded that I should not attempt to micromanage the Fed to the extent that I had initially thought.

So I came up with a piece of legislation that basically says: (a) That the Fed should define what price stability is; (b) That the Fed should tell us how it in fact is going to measure that; and (c) How you're going to get to that particular target.

The reason that I felt good about that approach is because my feeling again was that ultimately the market is going to be the great guardian of monetary policy.

But I would be interested in your telling us how the market would in fact effect that role?

As you have to go through the decisions as to (a) what price stability is, (b) how it will be measured, and (c) how you're going to get there, tell us what the role of the market is in that process.

Chairman GREENSPAN. Well, the issue essentially is that central bank credibility is ultimately tested in the marketplace.

If a central bank is involved in maintaining a sound monetary policy which leads to financial and economic stability, inflation and risk premiums on the debt instruments of the particular Government that's being considered will tend to be competitively lower in the world.

My own judgment is that we must, as a central bank, be simultaneously accountable to the people in a democratic society because if we are to maintain our independence, it is terribly important that the American people, to the extent that they can understand what we are doing and why.

I grant and in fact I acknowledge that there are certain areas where we cannot disclose what we're doing without some short delay because markets would react in a manner which would probably be counterproductive to effective policy.

But aside from those rather minor areas, it is very important for us to have the confidence of the marketplace, the financial markets specifically, and obviously in a democratic society, the American people and the Congress as the elected representatives of the people.

The one thing that I want to emphasize in your bill, which we fully support, and indeed is the one aspect in general of Humphrey-Hawkins which we thought has been a major contribution to this issue, is that I or my colleagues or whoever is related to the Federal Reserve in particular programs, periodically come before the Congress and explain what it is we are doing and why.

Senator MACK. This is in essence really kind of a followup question because I suspect, from what you've said, that the measure of your success has to do with real interest rates.

Since the late 1970's, real long-term interest rates have averaged three or four times what they were in the 1960's, and again I am talking about real long-term interest rates, roughly 4 percent versus roughly 1 percent.

If Federal Reserve policy were focused on price stability and the markets believed in that focus, wouldn't long-term interest rates fall back to their lower levels of the 1960's?

Chairman GREENSPAN. Not necessarily. The reason is there's a lot to long-term real interest rates than merely the inflation risk premiums which are embodied in those rates. I suspect that part of the reason why real long-term interest rates are higher than they were a generation ago, not only in the United States but also in our major trading partners, is that we're all saving less.

We are saving less, to a large extent, because governments are dissaving, so that the national saving rates are lower.

I suspect that a not insignificant part of that difference in real long-term interest rates that you quote is a reflection of the saving shortage and the saving disinclinations.

Nonetheless, there's no question that to the extent that central bank credibility is increased in the area of maintaining a noninflationary stable financial system, those risk premiums will fall. But whether or not one can measure them in the context of the historic periods without making these other adjustments, I have my questions.

Senator MACK. Thank you, Mr. Chairman.

The Chairman. Senator Sarbanes.

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

I was interested in some of the comments of my colleagues about defaulting on the debt.

It seems to me the people are playing with fire and that's their choice to make. I think it's a very dangerous pastime, and it certainly ought not to be done without fully appreciating the potential consequences. Would you agree with that?

Chairman GREENSPAN. I certainly would.

Senator SARBANES. Do you feel you have a responsibility, as apparently Chairman Volcker felt he had in 1983, to outline what the potential consequences are?

Chairman GREENSPAN. Well, I clearly expect that we will resolve the issues on the budget before the Congress and the Administration without going to default.

We have never defaulted in the past and I think it would be a major mistake to do so. I do not expect that to happen.

Senator SARBANES. I don't ever recall a responsible official in the Government, certainly not at the level of the Speaker, who's threatened to see such a default take place. I think it's fair to say that's never occurred before.

Let me turn to these real interest rates that we just touched on.

In July 1993, you presented a long explanation of how real interest rates are an important guide for monetary policy.

Do you recall that testimony?

Chairman GREENSPAN. I do.

Senator SARBANES. Good. Well, we're proceeding on the same grounds.

At the time, real short-term interest rates were near zero. What you testified was below the equilibrium level and would eventually be associated with resource bottlenecks and rising inflation.

You also made the observation that real rates above equilibrium would tend to be associated with slack disinflation and economic stagnation.

Now this chart shows the real interest rates, the current rates, which are in the green, compared with the 40-year averages.

On the Fed funds, the 40-year average 1.84 percent, the current rate 3.13 percent.

On the prime rate, where I earlier alluded to the fact that there was a greater gap, the 40-year average 3.37 percent, and the current prime rate 6.13 percent.

So real interest rates currently are well above their long-term averages.

Now what are the implications of that for monetary policy?

Chairman GREENSPAN. Well, first of all, Senator, let me just say that the choice of the 40 years does pick up an earlier period which I think, in response to Senator Mack's question, I indicated is prob-

ably being pressured by other forces so that if you use a more recent period, the numbers will be somewhat higher.

Nonetheless, it is the case—

Senator SARBANES. The gap will still exist.

Chairman GREENSPAN. The gap will still exist, of course.

What I said back in 1993 is generally correct. That is that when you have real long-term interest rates or real short-term rates generally above some equilibrium for a protracted period of time, it is generally associated with a weakness in economic activity.

What I meant to say, and will repeat today, is when I say generally associated, I mean other things equal.

What you have to realize is that every particular period has its own complexities to add to that general proposition, and it is important to look at all aspects of the financial structure to see whether the symptoms that one normally would expect, on average, from real interest rates above equilibrium are in fact occurring.

At the moment, it's a mixed bag. I grant you that real interest rates, short-term rates, are marginally above where their intermediate average has been and we have general indications that the economy is nonetheless moving forward.

Most importantly, there is not, at this particular stage, any clearcut indications that credit is being constrained; that is, commercial and industrial loans are moving well, and the moneys are available. We see obviously that consumer loans in the banking system are moving exceptionally strongly.

We have to balance that with the fact that indeed real rates are somewhat above long-term averages and probably above long-term equilibriums.

But one has to look at the total context to make the decisions on specific short-term policy issues.

Senator SARBANES. Mr. Chairman, I'd just point out to you that a year ago, 2 years ago, you were using the gap between the equilibrium rate and the existing real rate as a rationale for taking the interest rates up.

Chairman GREENSPAN. That is correct because, at that particular time, other indications of financial activity were fully consistent with that position as we stipulated it at the time.

Senator SARBANES. Well, do you now perceive the gap as an argument for taking the rates down, as one factor for taking the rates down?

Chairman GREENSPAN. Yes, certainly.

In fact, the issue that we raised in our recent easing this summer was basically that we perceived that our perspective view of inflation was that the inflation rate would ease and come down, as indeed it did. So the answer to your question is, yes, that was a reason and a factor which was involved in our deliberations.

The CHAIRMAN. Senator, we're getting close to the time and I promised the Chairman we're going to get out, so if you have any other questions that you'd like to wrap up.

Senator SARBANES. I'd like to ask the Chairman, if the Fed perceived an inflation concern, would the one response on the part of the Fed to address that be to take the interest rates up?

Chairman GREENSPAN. You mean an accelerated inflation from here?

Senator SARBANES. Well, you'd look forward and you say, we are worried a bit about inflation. We want to make sure it doesn't start moving on us.

What would you do in order to address that problem? Would you raise the rate?

Chairman GREENSPAN. I don't know how to answer that without knowing the full context of what it is we are looking at.

In days when we could respond by——

Senator SARBANES. Let me simplify it then.

In those instances in which you do raise the rates, in order to address potential inflation problems, what is it that then follows from doing that that helps to bring the inflation problem under control?

Chairman GREENSPAN. If we are observing an economic situation in which we perceive that increasing instabilities are emerging—for example, pressure on resources reflected in increasing delivery lead times in materials, major increases in overtime hours in industry, evidence of significant and growing shortages in various different segments of the labor market—all these indicate that we are under the types of pressures which basically would create the inflationary instabilities which would lead to significant economic contraction after that episode was completed.

It's that type of environment which, if we perceive it is developing, as we did in the late months of 1993 and the early months of 1994, which induced a series of actions which we took subsequent to——

Senator SARBANES. How does raising the interest rates address those problems? What is the connection?

Chairman GREENSPAN. It basically creates pressures on various different aspects of the economy which, if they are overheating, tends to simmer them down.

Senator SARBANES. So it in effect slows down economic activity, the higher rates?

Chairman GREENSPAN. It slows economic activity from taking on a pace which is proceeding beyond the capability of the system for maintaining a degree of stability and not creating an inflationary surge which creates recession at the end of the day.

Senator SARBANES. Well, now let's just do the reverse.

If there's no inflationary problem, would cutting the rates provide an impetus to economic activity and to economic growth and to jobs?

Chairman GREENSPAN. It depends on the interaction between the short and the long end of the market.

There are often occasions when we would actually move short-term interest rates up if we thought that that was required to move long-term interest rates down.

In many instances, depending upon where in the business cycle one is, lower long-term interest rates are a very powerful force for economic expansion.

We, as you know, only have control over the overnight Federal funds rate.

Senator SARBANES. But I take it you assume that your impact on the short-term rates has an effect upon the long-term rates?

Chairman GREENSPAN. It does. Most of the time, it will tend to go with the short-term rate. Sometimes, especially later in the business cycle, the evidence suggests that it is often inverse.

Senator SARBANES. If there's no inflationary problem, wouldn't it be better for economy and the country to have lower-rates and more economic activity and jobs?

Chairman GREENSPAN. I would say that the best thing for the economy is to have that level of interest rates, both nominal and real, which maximizes long-term sustainable economic growth.

Senator SARBANES. Well now, isn't the inflation performance right now really rather extraordinary, in terms of—

Chairman GREENSPAN. Well, I hope we don't consider it extraordinary. I just hope we consider it good.

Senator SARBANES. Well, I mean extraordinarily good.

This is the best, these are employers' costs of labor. They are the lowest they have been now in quite some time. The CPI is at a what, a 30-year low I take it?

Chairman GREENSPAN. Yes, sir.

Senator SARBANES. Which all, it seems to me, argues into supporting the notion that we could, as the National Association of Manufacturers stated, and as I read in the opening statement, that we could have lower interest rates and pick up the benefit of increased economic activity.

My final question is, where does the mantra come from that 2.5 percent growth is all our economy can sustain without running into a severe inflation problem?

Chairman GREENSPAN. Well, I have difficulties with that, Senator. I think it's the result of economists looking at the combination of prospective long-term growth in productivity and the growth in the labor force. It is essentially the product of the two over the long run.

There is a presumption somehow that that is some fixed, rigid ceiling which we cannot proceed beyond without engendering inflationary forces.

If indeed productivity growth is subdued, we will find that as the economy tries to move beyond that for a protracted period of time—and that's an important issue, protracted period of time—it will eventually create strains and instabilities which historically have induced significant inflationary forces.

I think, however, that it is a mistake for a central bank, as we are often accused of doing, to somehow look at a growth rate and say that if the economy moves up to that rate, we are in danger and we have to take preemptive action. I do not think that is what we do or what we should do.

What in fact is the case is that when we begin to see that we are getting close to various measures of low unemployment rates or high operating rates, that is merely a signal that we ought to be careful about watching what in fact is going on in the economy.

If we find that the economy is not showing evidences of pressure or instability, it is inappropriate to respond to a particular statistic of that nature.

I do think that there is a useful notion of long-term economic potential which is basically related to the issue of productivity. I do

believe we have the capability of significantly improving that over the longer run.

But I do find myself quite uncomfortable when I often see, in the public press, that we at the central bank, when we see the growth rate moving up to a certain level, think that it is important that we choke it off, because that is not appropriate, that is not what we do, and I hope that's not something that we embody in any way or other in our policy stance.

The CHAIRMAN. Before I turn to Senator Grams, I want to just make one observation and that is it seems to me that there are dual considerations. A lot of this is psychological.

If we fail to enact a legislative solution which does not have all kinds of loopholes and manners by which to slip out, a legislative program which absolutely brings down deficits, eliminating the kind of borrowing which is increasing the national debt, I'd guess that we're going to have an incredible economic morass.

People including those in the business community have invested a lot of credibility in coming to believe that we're going to do something meaningful. Meaningful is not making cuts in a 10-year program in the 7, 8, 9, and 10th years, most of it coming in the last three. That's not meaningful, that's smoke and mirrors.

So if we put forth a budget plan that is built on smoke and mirrors, which is built on phony assessments, which is built on higher growth predictions so that we can get more money to fill in the cracks, it's going to be rejected.

The economic community is looking at us rather skeptically now. I think the consequences are going to be far worse, Mr. Chairman, than we have ever seen. I think this is our last best opportunity.

I think Senator Faircloth mentioned, if we don't do it now, when will we ever do it? The political stars seem almost to be aligned to give us that opportunity.

It's going to be a brutal battle, but I have to tell you something. Most of the votes we take are rather marginal. They really don't affect tremendously, one way or the other, what the outcome of this country's future is going to be.

This battle is over whether or not we can put in place a program, a legislative program that really will force us to make the spending cuts.

Why spending cuts? Because if we continue to spend the way we are, we're going to have to continue the high taxes. We are going to have to continue to search for more revenues and we are going to take revenues out of the investment pool.

It seems to me that the people who create real jobs and earn those moneys should decide how best to spend that money, whether it's purchasing new goods, new equipment, new items that they want, or saving, not the government.

Let me say this to you, Mr. Chairman. This is the most outspoken I have seen you or any chairman as it relates to why it is important to get this budget under control in the years to come.

I want to commend you because it's not easy. I know you have all kinds of pressures on you.

Chairman GREENSPAN. Well, I appreciate that, Mr. Chairman. I think that because I sense that there is a growing awareness, understanding, and concern about this whole issue, having been in

and out of Government for more than 20 years, I am more optimistic at this particular point about actually pulling this off, and I believe without default, than I have been in as long as I can remember.

It is very easy to get caught up in the level of the heated rhetoric that is currently going on, but that's a symptom that something real is happening.

I do not get discouraged by the extent of the decibels that are emerging as a consequence of all of this because if I didn't hear it and it wasn't happening, I would be discouraged that this was not real.

But I think that what we are looking at is something real. I know the President is sincere in his desire to get this deficit down and balanced, as indeed his economic advisors are.

It is clear in the Congress that these issues are being confronted, and if it were not as contentious as it is, I'm not sure that we would be evidencing any progress at all.

The CHAIRMAN. Senator Grams.

Thank you, Mr. Chairman.

Senator GRAMS. Thank you, Mr. Chairman.

I just wanted to followup on some of the statements that you were making, and also on what Senator Sarbanes was saying, and I think what you expressed, and that is the statement that a default would be irresponsible.

Now if that was the only argument on the table, I think we would look at that and would agree. I would agree with that.

But if we also add into the debate what I feel is long-term irresponsibility of spending more money than we have for 25 years of not balancing the budget, of running more and more deficits that basically has led us to this possible train wreck, or even the talk of a default, it's hard to believe that this great country would even be talking about this. But this is a residue of long-term mismanagement I believe by Congress.

So if you add in that debate, are we looking at default as a short-term pain that could result in long-term gain if it means that we would end up with a balanced budget as a result?

Chairman GREENSPAN. Well, Senator, I don't accept the tradeoff. I think we can do both and should do both. As far as I'm concerned, the issue of default should not be on the table.

The credit of the American Government, as the Secretary of the Treasury said, is terribly important to this country. It's an important asset which we have.

I would urge you to resolve this problem without resorting to the issue, at one point or another, of finding that we are unable to pay our debts, even temporarily.

Senator GRAMS. I want to read from your closing statement where you said, but these pressures, and you're talking about a balanced budget, in order to bring the budget into balance, the pressures must not be allowed to prevent us from taking concrete action to implement a program of creditable multiyear deficit reduction.

That is what I mean. We are going to get to a point where you're going to blink or not blink and I just hope that everybody takes this seriously. Default is probably the ultimate worst case scenario.

But I think that if we are going to set this country on a course of a balanced budget, we are going to have to stare that into the face.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Sarbanes, do you have anything further?

Senator SARBANES. Well, Mr. Chairman, I'd like to include in the record the full statement of the National Association of Manufacturers on August 22, 1995, headed "NAM Says the Federal Reserve Missed An Opportunity." I quoted from that earlier.

The CHAIRMAN. It is so ordered. The entire article will be placed in the record.

Senator SARBANES. Mr. Chairman, let me just leave one final question and then a couple of observations.

You constantly make reference to long-term economic growth. Can you have long-term economic growth without having short-term economic growth?

Chairman GREENSPAN. Algebraically no.

Senator SARBANES. Thank you.

The other observation I would make is that in the Depression, there was no inflation.

Chairman GREENSPAN. There was deflation.

Senator SARBANES. There was disinflation. We were below—

Chairman GREENSPAN. No, it was actually deflation.

Senator SARBANES. Deflation.

Chairman GREENSPAN. Yes.

Senator SARBANES. It seems to me that if we adopt just completely a single objective, which might well lead the central bank to be trying to drive down inflation at a time when inflation was already very low, and we had jobs and growth problem, that this is going to create a situation in which we have no ability to try to give any impetus to the economy, particularly at a time when fiscal policy is being put into a very contractionary mode, which is happening now.

It's going to happen. The extent of it I think is being argued about but clearly it's going to take place. It seems to me you run the risk therefore of sacrificing jobs and growth, which I think is an important objective of a well-functioning economy.

The economy of the 1930's had no inflation. But I don't think it was, by anyone's standard, a well-functioning economy. In fact, I notice that you say in your statement, referencing the deficit reduction plan, the declines in rates are already helping to stimulate private interest sensitive spending, providing in effect a shock absorber for the economy.

Clearly, the Federal Reserve, in appraising evolving developments, will continue to take the likely effects of fiscal policy into account.

So that obviously you also, I guess, would have to weigh on your scale a contractionary fiscal policy and its impact upon the functioning of the economy in determining what path monetary policy would follow. Would that be correct?

Chairman GREENSPAN. Well, Senator, let me just say that price stability means that you're endeavoring to avoid both inflation and deflation. A deflationary economy is not one with price stability.

I think it is incumbent upon us to recognize that when we mean price stability, we don't mean getting inflation down no matter what we are looking at in the economy, because it is very easy.

If the sole thing that you wanted to do was to make certain that inflation did not take hold, it is very easy to do that. But what we are also obviously obligated to do, if price stability is our goal, is to recognize that deflation is not price stability.

The CHAIRMAN. I want to thank the Chairman very much for your time, for your patience.

Again, I want to say that I think under extraordinary circumstances that we are really going to do the kind of thing we should be doing. Mr. Chairman, you've done an extraordinary and remarkable job. I want to thank you very much for your candor.

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

The CHAIRMAN. We stand in recess.

[Whereupon, at 12:20 p.m., Friday, September 22, 1995, the hearing was concluded and the Committee was recessed, subject to call of the Chair.]

[Prepared statement and additional material supplied for the record follow:]

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

Mr. Chairman and Members of the Committee, I am pleased to appear here today. In July, the Federal Reserve submitted its semiannual report on monetary policy to the Congress. That report covered in detail the Federal Reserve's assessment of economic conditions and the forecasts of the Governors and Reserve Bank Presidents for economic growth and inflation. This morning, I would like to offer my views on recent developments.

As I reported earlier to the House Banking Committee, a moderation in economic activity in 1995 was inevitable following the frenetic pace of late 1994. It was also necessary if we were to avoid the creation of major inflationary instabilities. By the end of 1994, pressures on resources were contributing to sizable increases in delivery lead times for raw materials and intermediate goods and steep markups in their prices; overtime in manufacturing was extensive. Fortunately, economic growth has slowed appreciably this year, inflation risks have receded, and, as a consequence, the threat of severe recession has declined.

I also noted that one could not expect the transition to a more sustainable growth path to be entirely smooth. Rough patches were also encountered in past economic expansions, typically because businesses did not fully anticipate the changes in demand for output. The slowing in real GDP growth at the beginning of this year was precipitated by a weakening in consumer spending and housing construction, partly as a consequence of higher interest rates, and by the damper on net exports from the economic crisis in Mexico. But the risk of a more serious slowdown thereafter was exacerbated by the failure of inventory investment to match the slackening in spending. Indeed, although stocks in the aggregate remained modest, a few major industries, such as motor vehicles and home goods, found themselves with substantial excesses. Attempts to control inventories triggered cutbacks in orders and output that, in turn, depressed employment and income in the spring.

At midyear, the uncertainties about the dimension of the inventory adjustment, and thus about the prospects for real GDP over the near term, were considerable. Nonetheless, it seemed that the point of maximum risk of undue weakness had been passed and that moderate growth was likely to resume in the second half of the year. As events unfolded, revised data indicated that overall activity in the second quarter was not quite so weak as suggested by the initial estimates, largely because final sales were stronger. Moreover, the available statistical indicators for the current quarter are consistent with a firmer pace of economic growth. In the labor market, for example, payrolls have posted moderate increases, on average, over the past couple of months, and the unemployment rate has edged back down to 5.6 percent.

Industrial production also turned up in August, after a sustained period of weakness that extended back to last winter. The surge in output should probably be discounted somewhat, given that this summer's unseasonably hot weather provided a transitory boost to the output of electricity. Moreover, in a number of industries where efforts to pare stocks are continuing, inventory-sales ratios remained on the high side in July. Even so, the production data suggest that, on balance, manufacturers were confident enough about their sales prospects—and, in the main, comfortable enough with their inventory positions—to expand production once again.

The underlying trends in final sales are favorable overall, in part because of the considerable decline in long-term interest rates and the sharp increase in stock prices this year. Retail sales have been rising moderately, on average, since the spring, and home sales and starts have posted hefty gains. As for business investment, new orders for capital goods have fallen of late, but backlogs remain sizable. It thus appears that purchases of equipment will continue to grow, though perhaps at a slower pace than in the recent past. In addition, rising building permits point to further expansion in nonresidential construction.

Meanwhile, the inflation picture is looking more favorable than it did in early 1995. Core inflation—as proxied by the 12-month change in the CPI excluding food and energy—has moved back down to around 3 percent, after a bulge earlier in the year, and there appears little reason to expect much change in inflation trends in the near term. Increases in labor costs have remained modest even though unemployment has fallen to levels that history suggests might be associated with some acceleration in compensation. In addition, the deceleration in manufacturing activity this year has helped to ease pressures on capacity and to stabilize, and in many areas reduce, lead times on deliveries. With supply and demand in global commodity markets in better balance, prices of materials and supplies are no longer rising rapidly. In light of these developments, the firming in monetary policy in 1994 and early 1995 appears to have been sufficient to head off a ratcheting up of inflation. As I have often stated, containing inflation, and over time eliminating it, is the

main contribution the Federal Reserve can make to enhancing our long-run economic performance.

On the whole, the near-term prospects for the U.S. economy have improved in recent months, in part because the strong increases in financial market values this year are likely to provide substantial support to household and business spending. But the outlook is not without concern. Firms' desired inventory levels are extremely difficult to gauge, and the remaining adjustment process could play out more negatively than we anticipate. Moreover, although the economies of our key trading partners are recovering somewhat, they are still expanding only moderately, on average, and, as a consequence, the external sector is unlikely to contribute positively to real GDP growth in the United States.

Some observers have expressed fears that current efforts to eliminate the Federal budget deficit will prove a hindrance to the economy. I do not share those fears. Long-term interest rates have fallen a great deal this year, in part because of the growing probability that a credible, multiyear deficit reduction plan will be adopted. The declines in rates are already helping to stimulate private, interest-sensitive spending—providing, in effect, a shock absorber for the economy. Clearly, the Federal Reserve, in appraising evolving developments, will continue to take the likely effects of fiscal policy into account. But I have no doubt that the net result of moving the budget into balance will be a more efficient, more productive U.S. economy in the long run.

I continue to be impressed by the growing public recognition of the importance of deficit reduction—and the commitment on the part of the President and the Congress to bring the budget back into balance in the reasonably near future. The challenge is enormous: The budget deliberations will be contentious, and the deadlines now are extraordinarily tight. But these pressures must not be allowed to prevent us from taking concrete action to implement a program of credible multiyear deficit reduction. Failure to take such action would signal that the United States is not capable of putting its fiscal house in order, with adverse and serious consequences for financial markets and long-term economic growth.

NAM National Association
of Manufacturers

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NAM SAYS THE FEDERAL RESERVE "MISSED AN OPPORTUNITY"

WASHINGTON DC, August 22, 1995 -- Responding to the Federal Reserve's decision today to leave monetary policy unchanged, National Association of Manufacturers Vice President Michael Baroody said:

"By not taking any action, the Federal Reserve missed an opportunity to achieve higher growth. The best course of action would have been to lower the Federal funds rate by 25 basis points, bringing it down to 5.5 percent. A further cut in interest rates would have brought the economy out of its current slowdown more rapidly, and set the stage for a resumption of stable growth by the end of the year.

"The current slowdown has been worse than generally anticipated. In the second quarter, GDP increased by only 0.5 percent, and even this anemic figure is overstated. Using the new national income accounts, which will be introduced in December, rather than the current system, the second quarter growth rate would have been slightly negative. To date, the evidence for the third quarter has not been particularly favorable. For instance, in July manufacturing production continued to decline, for the fourth consecutive month. Factory jobs have decreased by almost 260,000 since March. The main reason for the continued stagnation is that industry will not be increasing production until existing inventories have been sold off. The third quarter is likely to show a growth rate of no more than 1.5 percent, well below trend.

"Under these circumstances, the Federal Reserve can provide some additional stimulus without risking any increase in inflation. The nation's industrialists would strongly support cutting rates by 25 basis points at the next FOMC meeting," Baroody concluded.

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