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FEDERAL RESERVE MONETARY POLICY AND CREDIT CONDITIONS

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

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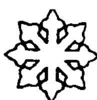

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FEDERAL RESERVE MONETARY POLICY AND CREDIT CONDITIONS

THURSDAY, MAY 9, 1991

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10:06 a.m., in room SD–628, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes and Smith, and Representative Armey.

Also present: William Buechner and Paul Taylor, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The committee will come to order.

The Joint Economic Committee meets this morning to discuss the recent conduct of monetary policy by the Federal Reserve.

Monetary policy has always been an important and significant factor influencing the American economy. But I must say that at this particular juncture in our history, it has assumed even greater importance because of the constraints that have been placed on the use of fiscal policy subsequent to the budget agreement to respond to the problems of the current recession—a recession, incidentally, that I at least take a more serious view than the conventional wisdom.

The main question we want to address this morning is whether the Federal Reserve has responded appropriately to the challenge of trying to move the economy out of a downturn. We need to explore whether the Federal Reserve has brought interest rates down enough to help bring about the end of the recession and to begin the process of recovery, or whether a further reduction in interest rates would be appropriate.

Last week, the Board of Governors reduced the discount rate from 6 percent to 5½ percent, and lowered the Federal funds rate one-fourth of a point to 5¾ percent.

Despite this action, or even after this action, the Fed has reduced interest rates much less during this recession than it did in the last three recessions: During the 1969-70 downturn, the Fed reduced the Federal funds rate by 60 percent; during the 1973-75 recession, the reduction was also 60 percent; and in 1981-82, it was 55 percent.

Since July 1990, which has now been identified as the beginning month for the recession, the Fed has reduced the Federal funds rate by only 30 percent; or if you go back to early 1989, by 40 percent, significantly less, in other words, than the rate reduction in the prior three recessions.

This modest monetary stimulus has come at a time when many financial institutions are experiencing difficulties with capital adequacy and portfolio quality. These difficulties put pressures on financial institutions to keep both loan rates and underwriting standards at high levels and, at least it is strongly asserted to us, has reduced the transmission of monetary stimulus to borrowers in the economy.

A number of matters have complicated the conduct of monetary policy during this recession, including, I think, the belief that the recession was caused by the war in the Persian Gulf and would end when the war ended; the weakened capital position of many banks, and the credit crunch that we confront; the continuing fear of inflation and high long-term interest rates resulting from the economic policies and conditions in Germany and Japan; and the reported disagreements in recent months among monetary policymakers on the Federal Open Market Committee.

Today's hearing will examine these and other issues affecting the current conduct of monetary policy.

Periodically, the committee finds it very helpful to bring together a panel of distinguished academic economists to analyze and discuss recent developments in the economic policies of the Federal Government, and to help provide counsel to the Congress in carrying out its own responsibilities. We are very pleased to have with us today three distinguished economists as our panelists for this hearing: Professor James Tobin of Yale, a Nobel Laureate in Economics; Professor Hyman Minsky, Distinguished Scholar at the Jerome Levy Economics Institute of Bard College in New York; and Professor Edward Kane, the Reese Professor of Banking and Monetary Economics at Ohio State University.

Gentlemen, we are very pleased to have you with us. Before I turn to you for your opening statements and then for our discussion period, I will turn to Congressman Armey, the Ranking Republican Member of the Joint Economic Committee, for any comment he may have, and also to any of my other colleagues who are here who also may wish to have an opening statement.

Representative ARMEY. Thank you, Mr. Chairman.

Let me say I do have an opening statement, which I would ask leave to put in the record.

Senator SARBANES. Without objection.

Representative ARMEY. And then just simply thank you for holding these hearings. I think the time is right for such hearings. And also, I appreciate the fine, distinguished panel that you've gathered together.

Thank you.

[The written opening statement of Representative Armey follows:]

WRITTEN OPENING STATEMENT OF REPRESENTATIVE ARMEY

It is a pleasure to join in welcoming three distinguished economics professors—Professors Kane, Minsky, and Tobin—before our committee this morning. As a former economics professor, I am familiar with each of your distinguished academic careers.

Last Tuesday, the Federal Reserve lowered the discount rate, the third cut since December. I have indicated on numerous occasions that monetary policy is a tough subject, and I find it a challenge to grade the Federal Reserve. Others, however, are less reluctant to pass judgment, often before the test is over. The test that the economy must pass is the restoration of prosperity, and the test is still in progress. We have heard some encouraging news. Indeed, the Washington Post indicated yesterday that they see "hints of an end to the recession" across the United States and particularly in New England. I very much hope that this is correct, and so today, we want to make sure that nothing that Government does retards the return of robust, sustainable growth to the economy.

While recent data are not conclusive, this information contains some positive signals. The civilian unemployment rate declined somewhat and household employment and the employment population ratio increased recently. Productivity has been rising, and some idled auto workers in Professor Kane's State of Ohio are being called back to work. We want to make sure that our monetary and banking systems assist a sustainable, long-term recovery for the whole country.

Clearly, there are still some problems to overcome, as my JEC colleagues from the Northeast, Mid-Atlantic and Midwest states can attest. In Texas and the Southwest, we took our lumps in the real estate industry early. Real estate in the Northeast appears to be just starting to show some signs of life. The rolling nature of geographic difficulties in banking and real estate has to be understood.

Congress must also be careful that "if it ain't broke" we don't try to fix it. Clearly, the members of the Board of Governors and the presidents of the regional Federal Reserve banks are discussing approaches to our economic problems. We expect diversity of opinion and take it as a sign of health in a free country. Short-term rates have fallen, but the stubbornness of interest rates on loans of longer maturity suggests that the financial markets, as well as the Federal Reserve, continue to be concerned about renewing growth without increasing inflation. I look forward to hearing our distinguished witnesses this morning.

Senator SARBANES. Senator Smith.

Senator SMITH. No opening statement, Mr. Chairman. I'm looking forward to their testimony.

Senator SARBANES. Very good. Well, gentlemen, we will begin. I think we will just start with Mr. Tobin and move right across the panel to Mr. Minsky and Mr. Kane.

STATEMENT OF JAMES TOBIN, PROFESSOR, DEPARTMENT OF ECONOMICS, YALE UNIVERSITY, NOBEL LAUREATE IN ECONOMICS

Mr. TOBIN. Thank you, Mr. Chairman. It's not often that we go in reverse alphabetical order like that. That's fine. I'll try to answer briefly the questions that you posed in your letter to us. First of all, has monetary policy been appropriate in light of the credit crunch and the length and depth of the recession?

I was glad the Federal Reserve lowered its discount funds rate on the first of May. But I do think larger reductions, maybe in steps of 50 instead of 25 basis points for the Federal funds rate, would have been preferable.

The funds rate—the basic cost of money to the banks—was cut only a quarter of a point. Still, it was important for the Fed to dispel the impression that was given during the Group of Seven meetings a few days earlier that the United States could lower interest rates only if rates were going down together with those of Europe and Japan, and Germany in particular.

A generalized cut in rates might be welcome to stimulate global economic activity and trade, but it's certainly not the only way to reduce interest rates and increase economic activity in the United States.

We can increase foreign demand for our goods even if the other countries don't take measures to expand demand in their own countries. We can do that by lowering our interest rates relative to those in other markets—in Germany, Japan, and Britain. That tends to bring the dollar down and make U.S. goods more competitive, both with imports in our own market and in overseas markets. And we certainly need further improvement in our exports to propel recovery from this recession. In fact, exports was the category of expenditure on American goods and services that most forecasters have emphasized as a promising driving force to recovery. Therefore, it was unfortunate that the Fed allowed the dollar to appreciate so much in the previous 2 months. That was going the wrong direction as far as improving the competitiveness of American goods is concerned. And that's one reason why I think the Fed could have acted sooner, and in larger bites, to reduce American interest rates and to overcome the trend toward appreciation of the dollar in the exchange markets after the Persian Gulf war.

I think monetary policy has been too slow and too grudging in lowering rates to fight the recession.

Real interest rates are extraordinarily high in this economy right now, especially if you look at nominal rates in relation to the rates of change of prices of producer goods, capital goods and houses. These rates are relevant as the targets for borrowing by many people in the economy. Now they borrow money to buy things that are not appreciating in value. In those terms, the interest rates are close to 10 percent—extremely high. And the recent indications are that fixed business investment, as well as residential and nonresidential construction, are very weak—disastrously weak areas in our economy.

The second question was whether the Federal Reserve should lower interest rates further. And if so, what's the appropriate level?

Well, I already said that I think the Fed should lower rates further. I wouldn't pretend to know the appropriate level. I think you have to decide as you go along; make a move; then see what happens; and then make another move. So I wouldn't think we can tell in advance what the right level of interest rates will be. That, in fact, is the way the Federal Reserve has been making policy since the end of 1982—by what might be called "finetuning;" relying on feedbacks of information from the economy in response to their policy at one meeting of the FOMC to decide what to do at subsequent meetings.

As you said, Senator, this recession is unlike previous ones in the sense that monetary policy is the only game in town for arresting the recession and starting a recovery, and managing the recovery once it does start. The reason for that is that fiscal policy has been incapacitated as an instrument of macroeconomic stabilization by the excesses of the fiscal policies of the 1980's, when the fiscal stimulus to aggregate demand was too big a factor in the economy. And also, fiscal policy is sidelined by the budget compromise of October 1990.

I think there's perhaps too much emphasis on when the recession will end and, in the very narrow sense, on having a positive growth rate in the real GNP, from one quarter to the next, rather than a negative one. That event by itself is not of great economic significance, any more than the passage from very low positive rates of growth to negative rates of growth. That is why the criterion for recession is such an important event.

Recovery might begin by a positive growth rate for next quarter or the quarter after that rather than the sequence of negative ones. But that doesn't mean further recovery is an automatic guaranteed consequence. In fact, the Fed will have to manage and finetune the recovery from then on, just as it did in the 1980's after it decided to reverse policy toward the end of 1982.

This recession is now dated from July 1990, by the official referees of that judgment at the National Bureau of Economic Research. But actually, the economy had been in a slowdown, or what sometimes has been called a growth recession, much longer than that.

Right now, we are in the ninth quarter of real GNP growth below an annual rate of 2 percent. And if you regard 2 percent rather than zero as par, the slowdown started much sooner than July 1990.

The normal growth of the labor force and productivity permits the economy to grow at an annual rate of between 2 and 2½ percent without reducing unemployment rates and other measures of excess capacity. If the economy doesn't grow that fast, excess capacity and unemployment will rise. For nearly 2 years, then, we have been adding to the slack in the economy, raising the gap between actual output and potential output until it's now around 5 percent. So that's 2 years of normal growth that would be needed just to get back to the track of potential output.

Almost all the recessions since 1945 have been deliberately provoked by monetary policies that were designed to arrest and reduce inflation. Now this one is an exception, because a surge of inflation was not a problem in 1989-90. Inflation had stayed throughout the 1980's in the range that the Fed had found to be acceptable when Chairman Volcker and his colleagues turned the economy around in 1982—around 4 to 5 percent. Wage and price inflation are still well behaved, so I don't see any reason now to prolong this recession by a new anti-inflation crusade.

The third question was does the current structure and condition of financial intermediaries impede the transmission of monetary policy to the real economy?

I think the answer is that the caution of commercial banks in lending does impede the transmission, but doesn't prevent it. The result is that monetary policy has to be easier. The Federal funds rate and the discount rate have to be lower in order to have the same effect on the availability of credit to business and household borrowers, and on the rates banks and other lenders charge. The Fed's rates have to be lower than they would be if these particular circumstances in the commercial banking industry didn't apply.

The natural result is that the differential of bank lending rates above the cost of funds to the bank have risen. Lending rates are what they charge to their commercial loan customers, mortgage customers, and consumer loan customers. The cost of their funds is what they have to pay either to depositors to keep deposits in their banks or to borrowers in the Federal funds market to get additional funds.

The prime rate is now 300 basis points above the discount rate, twice as large a differential as in the late 1980's. It now exceeds the 3-month CD rate by as much as it did in the depths of the recession in 1982. Nevertheless, if basic money markets fall, as they have been, bank lending rates and long-term bond rates come down also.

As banks seek to raise their capital ratios—many of them are quite properly under regulatory pressure to do that—they have to increase the margin between their lending rates and the rates they offer their depositors. The result is that some of their borrowers move to the open markets or to other intermediaries, and so do some of their depositors.

The assets and liabilities of the banks have to be reduced together. The wider margins also give banks opportunity to earn profits and slowly, gradually, add to their capital.

The central bank can mitigate the effects of this process on the bank's borrowing customers by providing banks with more reserve funds at lower costs. And that's the purpose of Federal Reserve easy money policy.

It shouldn't be thought that all the borrowers shed by the banks as they seek to raise their capital ratios are necessarily deprived of credit. The same process is also moving the depositors out of the banks. The two sides can get together again and make loan transactions in the open market, or on the balance sheets of other nonbank intermediaries.

The last question was about the Federal Open Market Committee—Is it, as currently constituted, the proper forum for making monetary policy decisions?

I did testify at some length on the structure of the FOMC in November 1989, and I attached to my prepared statment this morning a copy of that testimony.

I guess the current concern about the constitution of the Federal Open Market Committee is related to recent press reports of dissension between some Federal Reserve bank presidents, the Chairman, and other members of the Board of Governors. You referred to that, Mr. Chairman, in your opening statement.

As my 1989 testimony says, I do have on principles of democratic political legitimacy serious doubts about the powers of the presidents of the district banks as voting members of the FOMC. The reason for those doubts is that the bank presidents are not appointed by any regular political process. They're not appointed by the President, and they're not confirmed by the Senate. They're not even appointed by the Federal Reserve Board of Governors, which would give them some indirect relationship to elected officials. They are appointed by boards of directors of the district banks. The structure of governance of the system dates back to 1913, a time when no one anticipated that the Federal Reserve would be the major instrument of domestic macroeconomic policy for the Federal Government. It's also true that Federal Reserve bank presidents are not even paid on the scales of appointed Government officials, like the Governors of the System.

So my suggestion is that the bank presidents should either be appointed in the regular manner like the Governors of the Federal Reserve System, or they should not have votes at the FOMC. Their input at the FOMC meetings on the regional economies where they are coming from is probably valuable information for the committee's decisions. But I don't think it should give them the right to have a vote. Of course, Congress can do anything it wants, and Congress passed the Federal Reserve Act and set up this system. But in terms of principles of democratic legitimacy, I would think that either they are appointed in the same fashion as the Governors or they don't have votes.

Now I emphasize that these views of mine are independent of any particular disagreement that may exist at one time in one direction or another between the bank presidents and other members of the committee. They are not a response on my part to the press reports that the disagreements were important in recent decisions.

Thank you.

Senator SARBANES. Thank you very much.

[The prepared statement of Mr. Tobin, together with attachments, follows:]

PREPARED STATEMENT OF JAMES TOBIN

I will try to answer briefly the questions posed by the Chairman in his letter of invitation.

1. Has monetary policy been appropriate in the light of the credit crunch and the length and depth of the current recession?

I was glad the Federal Reserve lowered its discount rate and the Federal Funds rate on May 1. However, larger reductions, say 50 more basis points, would have been preferable. The Funds rate, the basic cost of money to the banks, was cut only a quarter point.

It was important for the Fed to dispel the impression, given during the Group of Seven meetings a few days earlier, that U.S. interest rates could be lowered only in concert with Europe and Japan. Although a generalized cut in rates would be welcome to stimulate global economic activity and trade, it is not the only way to increase foreign demand for U.S. goods. A powerful way, under our control and actually welcomed by our G7 partners, is to lower U.S. interest rates relative to theirs enough to bring down the dollar in the foreign exchange markets, making American goods more competitive at home and abroad. We need further improvement in exports to propel recovery from this recession. It was unfortunate, therefore, that the Federal Reserve allowed the dollar to appreciate so much in the last two months. I attach to this Statement an article on this subject I published in The New York Times on March 24.

Monetary policy has, in my view, been too slow and too grudging in lowering interest rates to fight the recession. Real interest rates are extraordinarily high , especially in terms of price movements in producers' goods, capital goods, and houses. With nominal costs of capital around 10 percent and relevant price changes close to zero or even negative, it is no wonder that private fixed investment, residential and non-residential, is a disaster area.

2. Should the Federal Reserve further lower interest rates and, if so, what is the appropriate level of interest rates?

Yes, as I already suggested, the Fed should lower rates further. I do not know the appropriate level. I think it is correct to lower rates in steps while additional information is becoming available on the state of the economy, and on the foreign exchange value of the dollar.

It is important to remember that in this recession, unlike all previous recessions since 1945, monetary policy is the only game in town. Fiscal policy has been incapacitated as an instrument of macroeconomic stabilization by its excesses in the 1980s -- fiscal stimulus of aggregate demand was a big factor in the recovery that began in late 1982 -- and by the budget compromise of

October 1990.

I do not know when the recession will end in the sense that growth of real GNP turns positive, and I do not think that event by itself will merit three cheers. It will be only the possible beginning of a recovery, whose continuation is by no means automatic. The Fed will have to manage, indeed fine-tune, a 1990s recovery as it did the 1980s recovery.

We should not put so much emphasis on whether the quarter-to-quarter change in real GNP is positive or negative. The arbiters at the National Bureau of Economic Research date the recession from July 1990, but the economy has been in a slowdown or "growth recession" much longer. Right now we are in the eighth quarter of real GNP growth below an annual rate of 2 percent. Normal growth of labor force and productivity permits the economy to grow at an annual rate between 2 and 2.5 percent without reducing unemployment rates and other measures of excess capacity. For nearly two years we have been adding to the slack in the economy, raising the gap between actual and potential output to about 5 percent.

Almost all U.S. recessions since 1945 have been deliberately provoked by monetary policies designed to arrest and reduce inflation. This one is an exception, because inflation had stayed throughout the 1980s in the range the Fed found acceptable when Volcker and his colleagues turned the economy around in 1982. Since wage and price inflation are still well-behaved, I see no reason to prolong this recession by a new anti-inflation crusade.

3. Does the current structure and condition of financial intermediaries impede the transmission of monetary policy to the real economy?

The caution of commercial banks impedes the transmission but does not prevent it. The result is that monetary policy must be easier, the discount and Federal Funds rates lower, to have the same effects on the availability of credit to business and household borrowers and on the rates banks and other lenders charge. The differentials of those lending rates above the costs of funds to the banks have risen. The prime rate is now 300 basis points above the Federal Reserve discount rate, twice as large a differential as in the late 1980s. The prime rate exceeds the three-month Certificate of Deposit rate by as much as it did in the depths of recession in 1982. Nevertheless, as basic money market rates fall, bank lending rates and long-term bond rates do come down.

As banks seek to raise their capital ratios -- and many of them are quite properly under pressure from regulators do so, -- they have to increase the margin between their lending rates and the rates they offer depositors. As some of their borrowers and depositors respond by moving to the open market or to other financial intermediaries, the banks shrink their assets and liabilities and improve their capital ratios. The wider margins also give them the opportunity to earn profits and add to their capital. The central bank can mitigate the effects on banks' borrowing customers by providing banks with more reserve funds at lower costs.

It should not be thought that all the borrowers shed by banks as they seek to raise their capital ratios are necessarily deprived of credit. The same process also moves depositors out of banks, and the two sides may get

together in the open market or on the balance sheets of nonbank intermediaries.

4. Should the Federal Open Market Committee, as currently constituted, be the forum for making monetary policy decisions; if not, what changes, if any, would you recommend in the FOMC or the procedures used by the Federal Reserve to make monetary policy?

I commented at length on the structure of the FOMC in testimony before the House Subcommittee on Domestic Monetary Policy in November 1989. I attach a copy of my Statement on that occasion. (It includes also comment on H. J. Res. 409, which would commit the FOMC to the objective of zero inflation. This comment is relevant to my preceding answers today.)

I guess the current concern about the constitution of the FOMC is related to recent press reports of dissension between Federal Reserve Bank Presidents and the Board of Governors, its Chairman in particular. As my 1989 testimony says, I have serious doubts of the democratic legitimacy of the powers of the presidents as members of FOMC. But I would emphasize that those doubts are not the consequence of any presumption that the Bank presidents will be systematically more or less monetarist or more or less hawkish about inflation than the Chairman and other governors.

THE NEW YORK TIMES, SUNDAY, MARCH 24, 1991

Bring the Dollar Down

By James Tobin

NEW HAVEN

Victory in the gulf dissipated some of the clouds, but the February jump in unemployment shows that the economy is still in trouble. Can the Government lift the country out of recession?

In recessions, spending by consumers and businesses declines; demand for goods and services falls short of the economy's capacity to supply them. Businesses lose markets. Workers lose jobs. Normally, Federal fiscal and monetary policies can increase demand. Both have been used for this purpose in almost all business cycles since 1945. Why not now?

Fiscal remedies are simple. The Government steps up its own spending, or taxes are cut to enable taxpayers to spend more. Ronald Reagan gave the economy an overdose of fiscal tonic. Ironically, his Administration disavowed such "demand side" policies and billed its budgets not as anti-recession medicine but as supply-side incentives to boost long-run growth. However labeled, the military buildup and tax cuts did stimulate demand. But the exploding Federal debt that resulted has virtually ruled out use of anti-recession fiscal measures today.

The Fed should lower interest rates.

With fiscal policy sidelined, the task now falls wholly on monetary policy — the province of the Federal Reserve. By lowering interest rates and expanding credit, the Fed can promote recovery. It has already cut the Federal funds rate (what banks charge one another for overnight loans) by three and a half points since mid-1989. Why not cut it further?

There are three excuses: the abnormal caution of banks, the inflation danger and the need for foreign capital to finance the trade deficit.

To fight recessions, the Fed supplies banks with more cash reserves and cheaper credit; then the banks usually lend more to their customers, on easier terms. The present credit "crunch," it is argued, makes banks unresponsive to Fed policies. Banks are now unusually cautious, troubled by the bad loans on their books and struggling to comply with stiffer capital requirements. This caution shows up in higher interest rates for borrowers relative to market rates on Federal funds and other safe assets.

The lesson for the Fed is simply to cut the interest rates on safe assets more than usual. There is ample room between today's 6 percent and zero. Banks will use additional reserves if the Fed supplies them.

Central bankers always fear that excessive zeal against recession will ignite inflation. Their nightmare is an spiral like that of the 1970's, in which increases in wages and prices fed on each other. But the risk of a spiral looks negligible now. Price inflation remains moderate, despite recent wiggles in the indexes. Labor's bargaining position is weak, and wage gains are puny. Inflation is no barrier to a vigorous fight against recession.

A third alleged obstacle to anti-recession monetary policy is concern for the dollar. Pessimists say the Fed is trapped because cuts in U.S. interest rates could lead investors to move funds into foreign currencies with higher rates. We need to keep capital flowing in to finance our trade deficit. If the inflow slows, the dollar falls. The worriers say the Fed must gear interest rates and monetary policy to the foreign exchange rate, not to the American economy.

At the moment, this is no problem. Since the gulf victory, foreign money has flooded our markets and the dollar has soared. Furthermore, market expectations of increases in Germany's and Japan's interest rates have abated. All the more reason for the Fed to lower U.S. rates further, trying to bring the dollar down.

Dollar depreciation is good medicine for a country suffering from a recession and a trade deficit. It stimulates exports and slows imports. Further declines in the trade deficit would help mightily to arrest and reverse the recession, supplementing traditional channels of monetary influence. Lower interest rates and easier credit stimulate demands for machinery and plants, home building and consumer durable goods.

A lower dollar will reduce our trade deficit, but not soon eliminate it. What will attract money to finance it if our interest rates are too low? The answer lies in expectations that the dollar exchange rate will rise, relative to what it is.

What would create such an expectation? The dollar would have to fall first, enough to make the market believe it would subsequently rise. This would be a rational expectation, because in response to the low dollar our trade deficit would gradually decline, the more so if at the same time we took fundamental steps to improve our productivity.

The recession can be fought. We are not up a creek without a paddle. □

James Tobin, a Nobel Prize winner in economic science, is Sterling professor emeritus of economics at Yale.

FEDERAL RESERVE REFORM ACT OF 1989 (H.R. 3512)

House Committee on Banking, Finance, and Urban Affairs
Subcommittee on Domestic Monetary Policy
November 9, 1989
(Corrected November 14)

STATEMENT OF JAMES TOBIN
Sterling Professor Emeritus of Economics, Yale University

The most important decisions of macroeconomic management in the United States, and indeed in the world, are made by the Federal Reserve. For good or ill, its monetary policies determine the path of the American economy and strongly influence other economies throughout the world. Interest rates, stock and bond prices, exchange rates, trade balances, inflation rates, GNP growth, and unemployment rates, to mention only the most important variables, depend on the Fed's actions. The meetings of the Federal Open Market Committee (FOMC), held eight times a year, are the world's most decisive regular deliberations on government economic policy.

Of course, many other government policies have substantial economic effects. They concern taxes, regulations, public investments, transfer programs, commercial policies, and other familiar items on the agenda of Congress. For the long run, these may be more substantial than anything the Fed can do. But for management of aggregate demand in the short run, for stabilization of the economy against cyclical fluctuations, for avoidance of recessions and inflations, the Fed's monetary policies are virtually all the federal government has.

In the past, fiscal policies, as embodied in the overall demand-side impact of the federal budget, could be regarded coequal to monetary policies. But the extreme deficit-spending policies of the 1980s have effectively ended the possibility of using the budget as an instrument of short-term stabilization. Instead it has become an unwelcome fixture of the environment in which the Fed makes monetary policy.

H.R. 3512 raises a fundamental issue of democratic government. The issue is: Should the makers of the most important economic policy decisions of the federal government be so far removed from responsibility to the electorate as is the Federal Open Market Committee?

When the Federal Reserve System was founded in 1913, it was envisaged as

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an important financial reform and as insurance against financial panics, not as an agency controlling the whole economy. Even in 1935, when the currently governing legislation was enacted, no one imagined the decisive economic role the System has now come to play. Indeed in those days the federal government altogether was not assigned the responsibility for macroeconomic performance now taken for granted.

The FOMC has twelve members, seven Governors and five Federal Reserve Bank Presidents. Also present at the meetings and participating in the discussions are the seven Presidents who at the time are not voting members. (Membership rotates among the Banks, although not equally. The New York President always has a vote and the Chicago and Cleveland Banks have votes in alternate years; the others are two years off and one year on.) Nobody besides these Federal Reserve officials and their staffs attends the meetings.

The 14-year terms of the Governors can perpetuate the influence of the Presidents who appointed them long after the Presidents themselves have left office. There may be as few as two appointments in a Presidential term, two of twelve members of the decision-making body, the FOMC. Usually there are more, because Governors resign before their terms are up and the tenures of their replacements are limited to the time remaining in the 14-year terms. A case can be made, I think, for reducing the terms to ten years and the size of the Board of Governors to five. This subject is not addressed in H.R. 3512.

H.R. 3512 proposes to rectify at long last the timing of the four-year term as Chairman of the Governor so designated by the President. The timing is now accidental. No one intended that the President should wait for 30 of the 48 months of his term before choosing, with the advice and consent of the Senate, a Federal Reserve Chairman. That is when Chairman McCabe happened to resign in 1951, and the 1935 Act provides that a new Chairman shall serve for four years from date of appointment. Future accidents might shift the time again, maybe nearly to the end of the Presidential term, maybe to just after inauguration. It is surely a good idea to set the time rationally and permanently, and to allow for some overlap into the new Administration. Six months seems to me long enough, but one year, as the bill provides, would work well too.

The major violation of democratic legitimacy is the power of the Presidents of the district Federal Reserve Banks. Although they participate in definitive votes on crucial economic policy, they are neither appointed nor

approved by elected officials in either executive or legislative branches of government. Technically, legally, the Banks are private corporations owned by the member banks of the district. Thus the Presidents are selected by the Directors of the Banks, subject however to the approval of the Board of Governors. In practice, experience suggests, the Chairman can have considerable influence. In keeping with the legal fiction, the Bank Presidents are paid like private bank executives rather than federal officials. Appointed for renewable five-year terms, they generally have long tenures.

The Bank Presidents should not have it both ways. The regional information and perspective the Bank Presidents can bring to the FOMC doubtless have value. But if they vote like Governors, they should be appointed (and paid!) like Governors. They should be appointed by the President of the United States with the advice and consent of the Senate. The District Bank Board of Directors could make nominations, the Chairman and other Governors likewise. If the Bank Presidents are appointed (and paid) as they are now, then they should be allowed to attend the FOMC meetings but not to vote.

I believe it is important that the Administration have the opportunity to explain its economic strategy and outlook to the Fed. It is important because the President and his Administration have the ultimate responsibility to the nation for economic performance. Direct relationships to Federal Reserve actions arise from the Treasury's responsibilities for public debt management and for international financial and monetary relations. I would go further than H.R. 3512, and provide that the three executive branch officials -- Treasury secretary, CEA chairman, and OMB director -- participate without votes in FOMC meetings. There should be communications between them and the whole FOMC, not just the Chairman. These should occur routinely at the regular action meetings of the FOMC, not just three times a year. If the parts of those meetings at which votes are taken exclude non-voting participants, they should exclude the non-voting Bank presidents as well as the Executive officials.

The proposals of H.R. 3512, and my somewhat stronger proposals, are quite modest. They leave the Federal Reserve with considerable independence of the Executive, much more than most other central banks. Nevertheless they are condemned as bringing politics to bear on monetary policy. Politics? In a representative democracy? Think of it! Economic performance necessarily

involves political choices; it is hard to imagine issues of greater moment.

Consider, for example, the two big Federal Reserve policy decisions of the last ten years. In 1979 Paul Volcker and his colleagues decided to restrict money growth and bring about recession in order to overcome the inflation accompanying the second oil shock and the Iranian revolution. That policy eventually brought unemployment nearly to 11 percent and plunged many firms and financial institutions into bankruptcy. In late 1982 it was the Fed again that decided to suspend the anti-inflationary crusade and promote recovery although the inflation rate was still 5 percent. I am not arguing here whether either decision was right or wrong. I do argue that policies of such economic and political gravity should not be adopted by the FOMC all by itself.

Macroeconomic policy-making is a two-way street. Had there been more consultation about the mixture of fiscal and monetary policies between Federal Reserve and Administration in the early 1980s, we might have had a more moderate fiscal policy and a somewhat easier and lower-interest-rate monetary policy. That strategy would have been very advantageous to the nation.

I have little comment on the other provisions of H.R. 3512. I do not know enough about GAO audits to have an opinion whether FOMC actions should be exempt from them or not. I see no objection, but no great social gain either, in the proposed publication of the Federal Reserve budget. I do not favor the provision mandating immediate announcement of Fed policy decisions. There are times, I think, when Fed monetary actions are the more effective for not being announced immediately. Moreover, the fact that every FOMC meeting leads to some action at a known date means than a great deal of speculative attention will focus in advance on those action dates. We know from the speculative frenzy that used to anticipate the weekly release of money stock data that such activity is not necessarily constructive or stabilizing. That is also evident from the continuing speculation on releases of many other macroeconomic data. I would let the Fed decide whether and when to make policy announcements prior to the present 45-day deadline.

I am strongly opposed to H.J. Res. 409. The country faces no crisis that justifies a new single-minded anti-inflationary crusade. Volcker's decision to declare victory over inflation in 1982 has turned out well, and has been generally accepted by the country. For all practical purposes 4 to 5 percent

inflation has been defined by general consensus as price stability. The Fed has successfully managed a long recovery, which has brought unemployment to lower rates than most observers ten years ago thought possible without triggering an inflation spiral. And now the Fed seems to be managing a "soft landing," steering the economy between the Scylla of overheating and inflation and the Charybdis of recession. The Fed's successful fine-tuning since 1982 seems to me to be due to the pragmatism and eclecticism of its goals and its instruments. Let well enough alone.

Lowering inflation to zero in five years is bound to sacrifice output and jobs. Experience suggests that it probably involves recession, perhaps as deep as that of 1981-82. The country would enter this period of disinflation with unprecedented public and private debt, bearing interest rates geared to the stable 4 to 5 percent inflation of recent years. At zero inflation, those debts would become very burdensome to businesses, stockholders, and taxpayers.

The proposal relies on the abstract proposition that real economic outcomes -- production and employment -- are independent of nominal prices in dollars and of their rates of change. Therefore, it is over-confidently argued, disinflation is painless. The same argument was made in 1979, but the disinflation turned out to be quite painful. The proposition might be true in some hypothetical long run, but past recessions and recoveries demonstrate that it is not true in business cycles.

Should another supply shock hit, as in the 1970s, sticking to the commitment would be especially devastating to the economy. If the dollar depreciates further, as seems essential for significant progress on the trade deficit, inflation will appear to rise temporarily, and the Fed would be bound to impose additional monetary restrictions to meet the target.

It is true that the Federal Reserve, like any central bank, needs to maintain credibility that it will not promote or accommodate unlimited inflation, that the monetary system and the value of the dollar are not anchorless. The Fed has already established and maintained such credibility, long since. H.J. Res. 409 is not necessary for this purpose, and it is mischievous to the extent that failure to pass the resolution or to achieve its aims might be misinterpreted as indicative of inflationary policies.

Senator SARBANES. Mr. Minsky, please proceed.

STATEMENT OF HYMAN MINSKY, PROFESSOR, JEROME LEVY ECONOMIC INSTITUTE, BARD COLLEGE, NEW YORK

Mr. MINSKY. Thank you very much. I want to thank the committee for inviting me to participate. Luckily, I'm almost always in the middle, given that my name starts with M, whether you go forward or backward. No one ever thinks it a random thing where they start in the alphabet.

The chairman's invitation raised five interesting and important questions. The first two deal with whether, in the current situation, monetary policy and interest rates are appropriate.

Senator SARBANES. Mr. Minsky, I think it would help if you move the microphone closer.

Mr. MINSKY. Last week, the Federal Reserve apparently tilted from fighting inflation to supporting a recovery. I view this tilt as appropriate. However, in the current environment, we should not be too optimistic about its short-term efficacy.

The Federal Reserve's expansionary policy will lower Treasury bill and bond rates, as well as the prime rate. As recent experience has made lenders more apprehensive, the lower rates on default risk-free assets may have little impact on the financing terms available to ordinary businesses in the short run. For the time being, lender's heightened risk aversion may make the analogy between monetary ease and pushing on a string relevant. Nevertheless, lower financing terms for those who pass the lenders acceptance net should, with a lag, attenuate the recession.

The proportion of the labor force that is organized has been drastically reduced. As a result, the cost-push part of the inflation process is substantially weaker. The anti-inflation argument for monetary constraint is much less forceful today than it was a decade ago. Monetary policy can safely err on the ease side.

In order to turn the economy around, it is necessary to maintain aggregate gross profit flows, even as private investment and personal consumption are negatively affected by the level of indebtedness. Lower interest rates should lead to lower exchange rates for the dollar, which should help our balance of trade. This would be a plus for domestic profits.

Political uncertainty seems to be on the increase in Europe. This makes the safe haven aspect of the dollar more valuable and tends to increase its exchange rate. We saw a recent runup of the dollar. The Federal Reserve may need to use its monetary policy weapons aggressively to constrain such an appreciation of the dollar. An era of lower interest rates for assets that are deemed riskfree may well be on the horizon, even as assets that are regarded as risky carry significant premiums over the funds rate.

That was, of course, the experience in the Great Depression; a prior experience with a heavily indebted economy and, in that case, declining profit flows.

The last two questions the chairman asked deal with the powers and constitution of the Federal Open Market Committee. I have little to say about the internal structure of the Federal Reserve System.

To add to Jim Tobin's point, I believe the structure is still that the reserve and district banks are privately owned by the banks in their district.

It has been observed that the members of the Board of Governors seem to be turning over more rapidly than in earlier times. It may well be that the presidents of the reserve banks are more committed to the Federal Reserve System than the chairman and the members of the Board of Governors. Perhaps, Congress should inquire into whether these casual observations about the terms and time that people spend on the Board of Governors are true, and whether they are important.

This leaves us with the chairman's third question, and I want to spend most of my time addressing it—as I interpret it—Does the current structure and condition of financial intermediaries impede the transmission of monetary policy to the real economy?

A rearrangement of the words leads us to, "Does the current structure and condition of the real economy impede the transmission of monetary policy by financial intermediaries?"

This broadens the question beyond the current conditions analysis that the first two questions raised, and brings us to what is the appropriate structure of the financial system in order to make our economy function well.

In a famous passage, Keynes distinguished between speculation and enterprise. Keynes remarked that: "Speculators may do no harm as bubbles on a stready stream of enterprise. But the position is serious when enterprise becomes a bubble on a whirlpool of speculation. When the capital development of a country becomes a byproduct of the activities of a casino, the job is likely to be ill done."

The issues we need to confront, as we repair the financial and regulatory structure in the aftermath of the collapse of the various deposit insurance schemes, are: First, "how does our financial system—in principle, in its current institutional structure, and in its current condition—affect the capital development of our economy?"; and second, "can the capital development of our economy be improved by adjusting the financial system?"

A rough and ready interpretation of the history of the savings and loan industry will illustrate my concerns. The modern savings and loan industry—with Federally insured deposits, whose assets were mainly fixed payments, fully amortized long-term mortgages on one-to-four family homes—was an instrument of the Government policy to foster homeownership. The FHA and VA mortgage insurance programs were other instruments of this policy. From the 1930's through the 1970's,

the capital development of the country, even though it was biased towards the single-family home, was done well enough.

In the late 1960's and 1970's, the carrying costs for the liabilities of the S&L's rose above their earnings on performing mortgages. This eroded the equity of the S&L's. The practical monetarism of 1979-82 allowed interest rates to rise to unprecedented levels, exacerbating the plight of the already wounded S&L's.

Monetarists were remiss in not emphasizing that a shift from fixed to adjustable rate mortgages had to be in place before interest rates could be allowed to behave as they did in 1979 and 1981, in place perhaps 5 years earlier.

Insurers accept contingent liabilities. Federal deposit insurance was always a contingent liability of the U.S. Treasury. As originally formulated, deposit insurance was not a gift from the Government. The Government's contingent liability was contained by restricting the assets that the insured institutions could acquire and assuring, through examinations, that the insured had both positive cash-flows and sufficient equity to provide an adequate margin of safety to the insurer.

In the 1980's, S&L's, whose only capital was the contingent liability provided by deposit insurance, were allowed to continue operating. Many of these broke institutions were encouraged by agencies of the Government to grow out of their negatives by buying deposits and financing riskier aspects of the property and construction business. The Government, which operated through various agencies, lost control of its contingent liabilities. One result was that a plethora of construction projects was financed, which have not been able to earn validating returns. Such projects, of course, act as a dampening upon current capital development projects.

Similarly, the well-being of the capital development of the country was not fostered when the financial resources of the giant banks and insurance companies were used to fund Latin American projects, and commercial real estate and bridge loans were used for LBO's. The true costs of the financial binge of the 1980's are not the bailout of the S&L's, and the Government's refinancing of the FDIC; but in the malls, condominium complexes, hotels, and office buildings that are now worth a small fraction of what it cost to put them in place.

Other things that were lost was the modernization of plant and equipment that did not occur, and the deterioration of the Government-supplied part of the infrastructure. For more than 40 years, the structure of financial institutions, put in place during the Great Depression, successfully fostered the capital development of the country. In the last decade, they did it poorly.

I inverted the chairman's third question into: "Does the current structure and condition of the real economy impede the response of financial intermediaries to monetary policy?"

The liability structure that is a legacy of the leverage buyouts and other financial restructurings that took place in the 1980's, which sys-

tematically decreased the cash-flow margins of safety that firms could offer banks and other lenders, are part of the current structure and condition of the real economy.

The highly leveraged liability structures threaten to amplify a recession and diminish the likelihood that debt-financed private investment will lead us out of the recession.

Chairman Sarbanes' third question referred to financial intermediaries. The concept—financial intermediaries—covers much more than banks, savings and loans, insurers, and credit unions. Pension funds, for example, are also financial intermediaries.

In terms of Keynes' distinction between enterprise and speculation, pension funds—which provide a steady flow of contractual savings that has to be placed, and have predictable, long-term payment commitments—are presumably well designed for the financing of enterprise for the capital development of the country. Funded pensions should guarantee that the capital development of the economy should not suffer for the lack of finance, and may very well increase the overall rate of saving.

The paradox is that, since we've started funding State funds, State pensions, and things, the overall rate of investment seems to have gone down; and the overall rate of savings hasn't shown the dynamism you would expect. But, nevertheless, funded pensions were supposed to do that.

There was an article in the magazine section of last Sunday's New York Times, which showed that some of the pension funds were diverted from the financing of enterprise to the financing of speculation. Leveraged buyouts and threats of leveraged buyouts transformed the liability structures of many corporations, particularly our great corporations, so that they are neither engines of progress nor good credit risks. Leveraged buyouts could not take place without an equity component. The equity components for leveraged buyouts are often supplied by special leveraged buyout funds. The great firms that we all hear about have these funds under their control.

As the piece in the New York Times showed, State pension funds have been major investors in these leveraged buyout funds in taking the equity, that is, the highest risk portion of the leveraged buyouts. Flows of savings that, in theory, should be the source of finance for productive investments were diverted to finance these speculative maneuvers.

I suggest that Congress should look into whether such uses of the resources of pension funds are a fit use of the funds, because these funds always have a preferred tax status and, in some cases, they have liabilities that the Government guarantees.

I want to thank you for giving me the opportunity to share my concerns with you. I half apologize for broadening the agenda.

[The prepared statement of Mr. Minsky follows:]

PREPARED STATEMENT OF HYMAN P. MINSKY

Chairman Sarbanes' invitation raised five interesting and important questions.

The first two deal with whether, in the current situation, monetary policy and interest rates are appropriate.

Last week the Federal Reserve apparently tilted from fighting inflation to supporting a recovery. I view this expansionary tilt as appropriate although, in the current environment, we should not be too optimistic about its short term efficacy. The Federal Reserve's expansionary policy will lower Treasury Bill and Bond rates as well as the prime rate. As recent experience has made lenders more apprehensive, the lower rates on default risk free assets may have little impact on the financing terms available to ordinary businesses. For the time being lender's heightened risk aversion may make the analogy between monetary ease and pushing on a string relevant. Nevertheless lower financing terms for those who pass the lenders acceptance net should, with a lag, attenuate the recession.

The proportion of the labor force that is organized has been drastically reduced. As a result the cost push part of the inflation process is weaker. The anti-inflation argument for monetary constraint has much less force today than it had a decade ago. Monetary policy can safely err on the ease side.

In order to turn the economy around it is necessary to maintain aggregate gross profit flows even as private investment and personal consumption are negatively affected by the level of indebtedness. Lower interest rates should lead to lower exchange rates for the dollar, which should help our balance of trade. This would be a plus for domestic profits.

Political uncertainty seems to be on the increase in Europe. This makes the safe haven aspect of the dollar more valuable and tends to increase its exchange rate. The Federal Reserve may need to use its monetary policy weapons aggressively to constrain such an appreciation of the dollar. An era of lower interest rates for assets that are deemed risk free may be on the horizon.

The last two questions the Chairman asked deal with the powers and constitution of the Federal Open Market Committee. I have little to say about the internal structure of the Federal Reserve System. It has been observed that the Members of the Board of Governors seem to turn over more rapidly than in earlier times. It may well be that the Presidents of the Reserve Banks are more committed to the Federal Reserve System than the Chairman and Members of the Board of Governors. Perhaps the Congress should inquire whether these casual observations are true and whether they are important.

This leaves me with the Chairman's third question: "Does the current structure and condition of financial intermediaries impede the transmission of monetary policy to the real economy?". A rearrangement of the words leads us to "Does the current structure and condition of the real economy impede the transmission of monetary policy by financial intermediaries?".

In a famous passage Keynes distinguished between speculation and enterprise. He remarked that "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes a bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill done." The issues we need to confront as we repair the financial and regulatory structure in the aftermath of the collapse of the various deposit insurance schemes are "How does our financial system, in principle, in its current institutional structure and in its condition, affect the capital development of our economy?" and "Can we improve the capital development of our economy by adjusting how the financial system and the real economy interact?".

A rough and ready interpretation of the history of the Savings and Loan industry will illustrate my concerns. The modern Savings and Loan industry, with Federally insured deposits, whose assets were mainly fixed payment, fully

amortized long term mortgages on one to four family homes, was an instrument of the government policy to foster home ownership: the FHA and the VA Mortgage Insurance programs were other instruments of this policy. From the 1930's through the 1970's the capital development of the country, even though it was biased towards the single family home, was done well enough.

In the late 1960's and 70's the carrying costs for the liabilities of the S&L's rose above their earnings on mortgages. This eroded the equity of the S&L's. The practical monetarism of 1979-82 allowed interest rates to rise to unprecedented levels, exacerbating the plight of the already wounded S&L's. Monetarists were remiss in not emphasizing that a shift from fixed to adjustable rate mortgages had to be in place before interest rates could be allowed to behave as they did between 1979 and 1981.

Insurers accept contingent liabilities. Federal deposit insurance was always a contingent liability of the United States Treasury. As originally formulated deposit insurance was not a gift from government. The government's contingent liability was contained by restricting the assets that the insured institutions could acquire and assuring, through examinations, that the insured had both positive cash flows and sufficient equity to provide an adequate margin of safety to the insurer.

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In the 1980's S&L's whose only capital was the contingent liability provided by deposit insurance were allowed to continue operating. Many of these broke institutions were encouraged to grow out of their negative's by buying deposits and financing riskier aspects of the property and construction business. The government, which operated through various agencies, lost control of its contingent liabilities. As a result a plethora of construction projects were financed which have not been able to earn validating returns.

Similarly the capital development of the country was not fostered when the financial resources of the giant banks and insurance companies were used to fund Latin American projects, commercial real estate, and bridge loans for LBO's. The true costs of the binge of the 1980's are not in the bail out of the S&L's and the government's refinancing of the FDIC, but in the malls, condominium complexes, hotels and office buildings that are now worth a small fraction of what it cost to put them in place. For more than forty years, the structure of financial institutions put in place during the Great Depression successfully fostered the capital development of the country, in the last decade they did it poorly.

I inverted the Chairman's third question into "Does the current structure and condition of the real economy impede the response of financial intermediaries to monetary

policy?". The liability structures, that are legacies of the leveraged buy outs and other financial restructurings that took place in the 1980's, which systematically decreased the cash flow margins of safety that firms could offer banks and other lenders, are part of the "current structure and condition" of the real economy. The highly leveraged liability structures threaten to amplify a recession and diminish the likelihood that debt financed private investment will lead us out of a recession.

Chairman Sarbanes' third question referred to financial intermediaries. The concept, financial intermediaries, covers much more than banks, savings and loans, insurers, and credit unions: pension funds, for example, are also financial intermediaries. In terms of Keynes's distinction between enterprise and speculation, pension funds, with regular accruing funds for placement and predictable long term payment commitments, are presumably well designed for the financing of enterprise. In addition funded pension funds provide a steady flow of contractual savings that has to be placed. In theory pension funds seek productive income yielding investments to finance. Funded pensions should guarantee that the capital development of the economy would not suffer for the lack of finance.

But as an article the Magazine section of last Sunday's New York Times shows some of the funds of pension funds were diverted from the financing of enterprise to the financing

of speculation. Leveraged buy outs and threats of leveraged buy outs transformed the liability structures of many corporations so that they are neither engines of progress nor good credit risks. Leveraged buy outs could not take place without an equity component. The equity components for leveraged buy outs are often supplied by leveraged buy out funds. As the piece in the New York Times showed state pension funds have been major investors in leveraged buy out funds. Flows of savings that should be the source of finance for productive investments were diverted to finance speculative maneuvers. I suggest that the Congress should look into whether such uses of savings are a fit use of funds which always have a preferred tax status and in some cases may have government guaranteed liabilities.

I want to thank you for giving me the opportunity to share of my concerns with you.

Senator SARBANES. Don't apologize at all. Thank you very much for your statement.

Senator SARBANES. Mr. Kane, please proceed.

STATEMENT OF EDWARD J. KANE, REESE PROFESSOR OF BANKING AND MONETARY ECONOMICS, OHIO STATE UNIVERSITY

Mr. KANE. Thank you, Mr. Chairman.

I wish to begin by expressing my appreciation to you and your committee for inviting me here to communicate my analysis of how current monetary and bank regulatory policies fit in with the idea that the U.S. economy is undergoing a credit crunch.

The conjecture that a crunch exists depicts the current recession as a consequence of misconceived policies that have placed thousands of deserving borrowers into a vise. In this vise, borrowers find themselves squeezed or crushed between a macroeconomic jaw that we could label monetary authorities, and a microeconomic jaw that's operated by bank examiners.

Now in policymaking, as in medicine, prescription tends to follow diagnosis. The policy prescription that's dictated by the credit crunch view is that Congress should force open the jaws of the vise so that these mistreated borrowers can lead the economy back to full employment.

To understand why this prescription is simplistic, it is necessary to look more closely at what the jaws of monetary and bank regulatory policies actually do.

To ascertain whether a macroeconomic credit crunch exists, it's not enough to determine that the flow of aggregate credit has decreased. The issue is whether the observed decline is brought about primarily by shifts in credit supply or shifts in credit demand.

The current reduction in aggregate credit activity is driven not by monetary and regulatory policies, but by a souring of the outlook both for banking and real investment in many geographic and economic sectors. This souring has revealed longstanding overcapacity in the U.S. deposit institution industry and mammoth overcapacity in commercial and multifamily real estate over many parts of the country. This overcapacity has reduced the viability of bank loans aimed at financing real estate projects and other risky enterprises.

In particular, the falloff in the demand for new office buildings and housing units has left builders desperate for funds, both to finance underoccupied projects that they cannot move, and to generate new projects by which to keep themselves employed.

Lending money to borrowers who see themselves as crunched out of an opportunity to speculate on the recovery of troubled assets is a dangerous business. Few such loans would be good either for the economy, for the troubled banking industry, or for the Bank Insurance

Fund. Congress must be careful not to press banks for types of credit flows that would weaken the industry further, and mindlessly expand the Nation's stockpile of real capital assets that are not worth what it costs to produce them.

Sudden and sizable declines in the economic viability of the activities of different sectors cannot be completely overcome by an equally sudden and sizable surge in commercial bank reserves. Time must be allowed for resources to move from where they are no longer needed into sectors where they can be productive in the future.

Monetary policy could not have entirely avoided a real estate recession. Declines in real estate activity and prices were necessitated by changes in the tax treatment of real estate, and by a needed reversal of policies that for decades allowed insolvent "zombie" deposit institutions to distort the flow of investment projects toward very risky enterprises.

Although there is clear room for a bit more interest rate decline today, the insufficient looseness in monetary policy we have had during the last 20 months cannot be corrected by forcing rates on short-term Government securities far, far down today.

Individual borrowers are apt to describe themselves as facing a credit crunch whenever the price or availability of their own specific opportunities to borrow deteriorate rapidly. Convincing evidence exists that many borrowers have experienced just such a deterioration. However, in cases in which this deterioration reflects deterioration in the borrower's own economic prospects, a tightening of credit terms is microeconomically efficient. These tighter terms set up incentives for financing flows and real resources to move away from activities revealed to be in excess of aggregate supply. These movements take time and are far from painless for the parties moved.

The difficulty authorities face in sorting out differences in the quality of individual credit demands is one reason why, in conducting open-market operations, aggregate credit availability is not specifically targeted by the Fed. Fed monetary policy appears to aim at setting an appropriate level of interest rates on short-term debt instruments of the highest quality. This means that differentials between the targeted short-term interest rates and other interest rates are left to be worked out in what are largely private markets for specific securities.

Movements in the differential between rates of various classes of risky instruments, and counterpart rates on high quality debt are importantly affected by one class of Government policies. These are measures that change opportunities for private institutions to shift business and portfolio risks onto government entities and ultimately, onto the taxpayer.

For insured deposit institutions, risk-shifting opportunities are largely a function of supervisory standards for bank capital and loan quality that Federal examiners and supervisory agents currently enforce. Much of the disruption that is being caused by tougher new standards developed in the wake of the FSLIC debacle is a transitional cost that must be paid

to restore the U.S. financial industry's health and world standing in the long run.

Institutions whose capital is deficient for the risks they have absorbed must be asked to shrink, recapitalize, or exit the industry. Authorities' efforts in the past to give undercapitalized institutions a break have aggravated the problem we face today by delaying healthy exits by poorly performing banks and thrifts.

A recent statement from the Shadow Financial Regulatory Committee urges Congress not to treat supervisory standards as a countercyclical policy instrument.

Nevertheless, one improvement could be made in these standards as they're being applied today, and that's for regulators not to second-guess with equal harshness the loan activity of strong and weak banks.

Congress could usefully insist that examiners and supervisors be careful not to overregulate strongly capitalized banks and thrifts. Whenever the capital of an institution is large enough to protect taxpayers from the risk of loss, its managers should be free to make the risk assessments on which their profits and the future growth of our economy depends.

The basic problem is that examiners aren't really rewarded for helping good banks make good loans, but they are, of course, criticized whenever loans go bad at any institution.

Something else also could be done to lessen the length and depth of the current recession. The unwinding of excess inventories of unwanted commercial and multifamily residential products are seriously impeded by officials at the FDIC and Resolution Trust Corporation, who are responsible for managing and disposing of a large portion of these assets. Instead of realistically maximizing the discounted salvage value of the over 100 billion dollars worth of real estate assets they've taken into their portfolio, these officials have proved reluctant to write troubled assets down to prices low enough to move them speedily back into private hands.

Instead, they're playing a waiting game, forcing back new construction to near zero levels in many areas until the rate of product retirement eventually restores the demand for new production.

Since World War II, recovery from economic recession has invariably been led by the construction sector. Traditionally, cyclical declines in interest rates have spurred construction by elevating the demand for new plant and housing during recessions. However, this time around, the overhang of housing inventory can absorb an increase in demand without new construction. At the same time, uncertainty about what the Government will do with its own real estate inventories makes new construction riskier than usual.

These considerations suggest that even though lower interest rates have led to the usual pickup in housing sales, the surge in sales will not be matched by a similar surge in new construction.

To an important degree, the spotty and delayed interregional development of the current recession reflects Government-fostered blockages in the spread to other parts of the country of market pressures from overhangs of real estate, both in the commercial and residential sectors located in the Sun Belt, the Oil Patch, and the New England regions.

The interregional transmission mechanism for this market pressure is the need for firms, which want to replace buildings or to expand their physical plant, to consider how much cheaper it may be to buy or rent existing plants and offices in overbuilt areas than to build them afresh in their traditional locations.

Similarly, housing in these regions should appear cheap to new households and to households that move either with an existing firm's operations, or in response to the regional shift in job opportunities.

One Government action that could reliably contribute to the process of macroeconomic recovery is to effect a more prompt markdown of the prices of Government holdings of distressed real estate. This price adjustment would partially validate the overly optimistic projections of labor and capital inflows that originally led the South, the Southwest, and New England to overbuild.

Not marking down the price of real estate and failing to keep empty or half-empty buildings in optimal shape, retards this rationalizing relocation process, and penalizes Federal taxpayers who must ultimately finance the costs of the delay.

Mr. Chairman, I had not intended to discuss the questions you raised about Federal Reserve's decision structures, but hearing my colleagues speak convinced me that I wanted to give you my view after all.

I believe dissension at the Fed and minor adjustments in internal Fed committee rules, internal pay scales, and appointment processes distract public attention from more important issues of accountability. What is important is to make the Fed and its individual top officials more accountable for the policy mistakes they make, more or less when and as they make them.

The Federal Reserve System is organized to fuzz over not just the responsibility for important Fed policy decisions, but even the macroeconomic force that these decisions have. The Fed descriptions of what system policies are seek to avoid blame rather than to promote an open and honest debate about what current monetary policy should be.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Kane, together with an attachment, follows:]

PREPARED STATEMENT OF EDWARD J. KANE

Mr. Chairman, I want to begin by thanking you and your committee for inviting me here to explain my analysis of what monetary and bank regulatory policies have to do with the idea that the U.S. economy is undergoing a credit crunch. The conjecture that a crunch exists depicts the current recession as a consequence of misconceived policies that have placed thousands of deserving borrowers into a vise. In this vise, borrowers find themselves being crushed between a macroeconomic jaw operated by "monetary authorities" and a microeconomic jaw operated by "bank examiners."

In policymaking as in medicine, prescription follows diagnosis. The policy prescription dictated by the credit-crunch view is that Congress should force open the jaws of the vise so that these mistreated borrowers can lead the economy back to prosperity again. To understand why this prescription is simplistic, it is necessary to look more closely at what the jaws of monetary and bank regulatory policies actually do.

The Monetary Policy Jaw

During the 1950s and 1960s, the then-prevailing theory of monetary policy (the availability doctrine) sought to slow the flow of credit in booms and to speed it up in recessions. Because the demand for credit is presumed to vary procyclically, countercyclical monetary policy sought to

create conditions of excess demand for credit (i.e., tight credit) in periods of high or rising inflation and conditions of easy credit in times of high or rising unemployment.

Even using this theory of monetary policy, to ascertain whether a macroeconomic credit crunch exists, it is not enough to determine that the flow of credit has decreased. The issue is whether an observed decline was driven primarily by shifts in credit supply or shifts in credit demand. The current reduction in aggregate credit activity is driven not by monetary and regulatory policies, but by a souring of the outlook both for banking and for real investment in many geographic regions and economic sectors.

This souring has revealed longstanding overcapacity in the U.S. deposit-institution industry and mammoth overcapacity in commercial and multifamily real estate over many parts of the country. This overcapacity has reduced the viability of bank loans aimed at financing real estate projects and other risky enterprises. In particular, the falloff in the demand for new office and housing units has left builders desperate for funds both to finance underoccupied projects that they cannot move and to generate new projects by which to keep themselves employed.

Lending money to borrowers who see themselves as "crunched" out of an opportunity to speculate on the recovery of troubled assets is a dangerous business. Few such loans would be good either for the economy, the troubled banking industry, or the Bank Insurance Fund. Congress must be careful not to press banks for credit flows that would weaken the industry further and

mindlessly expand the nation's stockpile of real capital assets that are not worth what it cost to produce them.

Sudden and sizeable declines in the economic viability of the activities of different sectors cannot be completely overcome by an equally sudden and sizeable surge in commercial-bank reserves. Time must be allowed for resources to move from where they are no longer needed into sectors where they can be productive in the future.

This is not to say that monetary policy cannot in some ways smooth the transition process. In particular, Federal Reserve policymakers were overly slow to recognize that the rolling recession that began in the Southwest during the mid-1980s would undermine real estate prices in other regions. They were also slow to see that tightening the supervision of thousands of economically insolvent deposit institutions as envisioned in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 was going to introduce important dislocations into pre-existing flows of real-estate credit.

Nevertheless, monetary policy could not have entirely avoided a real-estate recession. Declines in real-estate activity and prices were necessitated by changes in the tax treatment of real estate and by a needed reversal of policies that for decades allowed insolvent zombie institutions to distort the flow of investment projects.

Similarly, an insufficient looseness in monetary policy during the last 20 months cannot be corrected by forcing rates on short-term government securities down very far today. The dramatic surge in the supply of

commercial-bank reserves that would be necessary to lower short rates substantially would lay a dangerous foundation for future inflation and balance-of-payments woes. The rate of inflation that rational forecasters would have to project for the postrecovery period would rise greatly.

The test of whether monetary policy is "easy enough" is not whether we have prosperity. The assessment must turn on whether the short-run benefits from further expansion in employment and economic growth would be more than offset by the unfavorable longer-run effects of additional monetary expansion on the rate of inflation and the balance of payments.

The Jaw of Bank Supervisory and Regulation

Individual borrowers are apt to describe themselves as facing a credit crunch whenever the price or availability of their own specific opportunities to borrow deteriorate rapidly. Convincing evidence exists that many borrowers have experienced such deterioration. However, in cases in which this deterioration reflects deterioration in the borrower's own economic prospects, a tightening of credit terms is microeconomically efficient. These tighter terms set up incentives for financing flows and real resources to move away from activities revealed to be in excess aggregate supply. These movements take time and are far from painless for parties that move.

The difficulty authorities face in sorting out differences in the quality of individual credit demands is one reason why, in conducting open-market operations, aggregate credit availability is not specifically targeted by the Fed. Fed monetary policy appears to aim at setting an

appropriate level of interest rates on short-term debt instruments of the highest credit quality, although many observers wish that monetary or reserve growth were used as the measuring rod instead.

Differentials between targeted short-term interest rates and other interest rates are left to be worked out in private markets for specific securities. Two particularly interesting other classes of interest rates are those on high-quality longer-term debt and on loans to borrowers of different levels of credit quality.

Differentials between rates for different maturities and different levels of credit quality may be treated as pricing in part the future consequences of current government policies. Movements in the differential between long and short interest rates on high-quality securities are (to a first approximation) dominated by movements in the expected rate and volatility of future inflation. Movements in the differential between rates of various classes of risky instruments and counterpart rates on high-quality debt are importantly affected by changes in opportunities for shifting private risks onto government entities.

For insured deposit institutions, risk-shifting opportunities are largely a function of supervisory standards for bank capital and loan quality that federal examiners and supervisory agents currently enforce. The tightening of these standards that has followed in the wake of the FSLIC debacle is long overdue.

Much of the disruption that is being caused by these new standards is a transitional cost that must be paid to restore the U.S. financial industry's

health and world standing in the long run. Institutions whose capital is deficient for the risks they have absorbed must be asked to shrink, recapitalize, or exit the industry. Authorities' efforts in the past to give undercapitalized institutions a break has aggravated the problem we face today by delaying healthy exits by poorly performing banks and thrifts.

The attached Statement No. 67 of the Shadow Financial Regulatory Committee urges Congress not to treat supervisory standards as a countercyclical policy instrument. Nevertheless, one improvement that could be made is for regulators not to second-guess with equal harshness the loan activity of strong and weak banks. Congress could usefully insist that examiners and supervisors be careful not to overregulate _strongly capitalized_ banks and thrifts. Whenever the capital of an institution is large enough to protect taxpayers from the risk of loss, its managers should be free to make the risk assessments on which their profits and the future growth of our economy depends.

What Else Might Lessen the Length and Depth of the Current Recession?

Banking weakness and the S&L mess greatly complicate the task of economic recovery. Many markets for real estate have enormous excess inventories or "overhang" of unwanted commercial and multifamily residential product. The unwinding of this inventory is seriously impeded by the high proportion of the unwanted assets that belongs effectively to the U.S. taxpayer. Government officials at the Resolution Trust Corporation are principally responsible for managing and disposing of these assets. Instead of maximizing discounted salvage value, these officials have proved

reluctant to write troubled assets down to prices that are low enough to move them speedily back into private hands.

Everyone knows that only two complementary ways exist for working off excess inventories. The first is for sellers to mark down the price they ask for the product severely enough to make it attractive for buyers to take excess inventories off the sellers' hands. The second is to play a waiting game: cutting back new production to near-zero levels until the rate of product retirement eventually restores a demand for new production.

Authorities' preference for playing the waiting game creates needless uncertainty. The macroeconomic consequences of this uncertainty have prolonged and deepened the current economic recession. Since World War II, recovery from economic recession has invariably been _led_ by the construction sector. Traditionally, cyclical declines in interest rates have spurred construction by elevating the demand for new plant and housing during recessions. However, this time around, the overhang of housing inventory can absorb an increase in demand _without_ new construction. At the same time, uncertainty about what the government will do with its real-estate inventories makes new construction riskier than usual. These considerations suggest that, even though lower interest rates have led to the usual pickup in housing _sales_, the surge in sales will not be matched by a similar surge in new construction. This means that the current recession will prove longer and deeper than usual.

To an important degree, the spotty and delayed interregional development of the current recession reflects government-fostered blockages

in the spread to other parts of the country of market pressures from overhangs of commercial and residential real-estate in the sun belt and oil patch regions. The interregional transmission mechanism for this market pressure is the need for firms that want to replace buildings or to expand their physical plant to consider how much cheaper it may be to buy or rent existing plants and offices in overbuilt areas than to build them afresh in their traditional locations. Similarly, housing in these regions should appear cheap to new households and to households that either move with an existing firm's operations or in response to the regional shift in job opportunities.

One government action that could reliably contribute to the process of macroeconomic recovery is to effect a prompter markdown of the prices of government holdings of distressed real estate. This price adjustment would partially validate the overly optimistic projections of labor and capital inflows that originally led the South, Southwest, and New England to overbuild. Not marking down the price of real estate and failing to keep empty or half-empty buildings in optimal shape retards this rationalizing relocation process and penalizes federal taxpayers who must ultimately finance the costs of the delay.

Senator SARBANES. Thank you very much.

I think we will have 10-minute rounds. There are only three of us. I think that will work.

Recognizing the point that some who assert a credit crunch are borrowers, who, in easier times, were able to obtain credit and perhaps shouldn't have then or now, there's a plethora of reports from the grassroots, from borrowers who seem to appear in every sense to be creditworthy, and yet, are having difficulty gaining access to credit. So I want to separate the credit crunch problem in that respect.

When Chairman Greenspan testified before this committee—this was now a couple of months ago—he said, and I quote, "The restraint on credit availability at depository institutions represents a continuing clear risk to the outlook and, therefore, is a critical challenge for policy. What is of most concern to us is restraint on lending by commercial bankers to otherwise creditworthy customers."

At the end of April, appearing before the Senate Banking Committee, Chairman Greenspan was quoted in the Wall Street Journal as saying, and I quote, "All the evidence we have suggests that the credit crunch is still with us."

I take it, Mr. Kane, you essentially don't agree, and you can respond to that, obviously. But let me hear from the other two as to whether they think there is a credit crunch of the nature that I have just outlined.

Mr. TOBIN. Well, I think the banks are understandably cautious about assuming risks of the sorts that they assumed in the 1980's, which got them into lots of trouble. And I don't think there's an awful lot that can or should be done about that. I agree with Ed Kane that you shouldn't use the discipline of the regulatory authorities and the bank examiners as a tool of countercyclical monetary policy.

I think Chairman Greenspan perhaps is using the credit crunch as an excuse for the Fed's not easing further than they have. He is giving the impression that more easing wouldn't do any good because there was this structural problem. But I think the opposite is true. Bankers caution that that's more reason for the Federal Reserve to provide additional reserves, which would be to the banks like money burning a hole in your pocket. If banks can earn only 5 percent on Federal funds and on other short-term liquid assets as bank investments, then those creditworthy borrowers that you were talking about, Senator, will be more appealing to the banks than if they could earn 6 percent on Federal funds and other short-term assets. That, it seems to me, is what the Federal Reserve can do about it. It's about the only thing they can do about it.

I certainly do not agree that the pressure that the banks and other depository institutions are under to improve their capital ratios should be relaxed. I think the capital ratios are too low and need to be increased. We paid a great deal for too lax capital ratios, and too lax supervision of banks' asset choices in the 1980's. I don't think we want

to get into that again on the grounds that we're now in a recession and need more bank lending.

The best we can do is to use monetary policy to reduce the short-term safe money market interest rates, and let those reductions percolate through both the banking system and the rest of the economy into the capital markets. That will, I think, work. But it will take lower rates than it would have if we didn't have this history of misbehavior by the financial institutions, which now makes them more cautious and under pressure to increase their capital ratios.

Senator SARBANES. Mr. Minsky.

Mr. MINSKY. Thank you. Businessmen and bankers live in the same emotional climate. Bankers have been hurt by nonperforming assets.

There's a great difference between the earlier credit crunches in the 1970's and 1980's, and even earlier, and today. In the earlier credit crunches, banks were hurt by interest rate differentials. Short rates rose above long rates. They lost on their portfolio. They were bleeding to death. But nonperforming loans were not the major problem. Today, banks are hurt by nonperforming loans. Nonperforming loans are sort of a double whammy. First of all, it makes the loan officer much more aware of the possibilities of things going wrong when things have been going wrong with the assets he put on his books. And second, it immediately decreases the capital of the bank.

Now, we're moving toward a capital-based lending base rather than the reserve-based lending base as a result of the attempt to have all the banks around the world work on the same level. And there's a perversity in the reaction when you have a capital absorption ratio type of banking where different assets absorb capital in different degrees, when you have, in the aftermath of nonperforming assets, decreased capital.

If in the recession you have nonperforming assets decreasing the capital of the banks, you're decreasing the ability of banks to acquire assets that absorb capital that are your private liabilities. So whereas their ability to acquire Government securities is barely impaired, their ability to acquire private debt is impaired.

In all this discussion of capital absorption ratios; they forgot that the capital of a bank is a residual. It's the difference between the price you mark the assets at and the price of your liabilities, where your liabilities are guaranteed at par, presumably. But your assets can fluctuate, especially when you have to mark down Latin American loans, real estate construction loans, and bridge loans.

So the ability of Citicorp, or Chase, and the other banks that were involved in such activities to finance—the banks in New England that were involved in the real estate boom—has been diminished by the present recession.

Obviously, with the ability to finance private loans being scarcer, the loan officers are going to start paring the people they finance. New customers are going to be turned away who otherwise would have been accepted. Old customers will find their lines of credit diminished

because there's less to go around. And therefore, that's one of the reasons, I think, why the Treasury's proposals look for a fix to this with capital infusion from nonbank corporations by allowing them to go into banks.

In other countries, when this happens, you have sort of a standby Reconstruction Finance Corporation, and the Government infuses capital. But we don't have that option.

Senator SARBANES. I see Senator Sanford has a legislative proposal to try to do that, to sort of bring back the notion of the RFC in order to address the problem; recognizing that given the multiplier effect of credit expansion, if you have credit contraction, you have a multiplier working in the opposite direction. So you get a many times over contraction in order to try to address their capital situation.

Mr. Kane.

Mr. KANE. I agree with Jim Tobin.

The macroeconomic problem has been worsened by having an insufficient expansionary monetary policy during the last nine quarters of growth recession. The Federal Reserve Board Chairman has been using the idea of a credit crunch as an excuse, and it just doesn't wash. Banking weakness demands additional monetary ease, not less of it.

As far as the reports from the grassroots are concerned, what they're reporting is tremendous disruptions in financing sources, both from failures that are occurring and from the threat of failures. Examiners are not helping in the two ways where they could help.

One way is to help the public to identify good banks. Borrowers invest a certain amount in their banks by giving them access to special information about their firms, so that banks are better able to tell whether they deserve credit. Not being able to assess the quality of their bank makes it hard for borrowers when things go wrong for that bank. There would be more market discipline in banking if examiner ratings were made public. There would also be more discipline for the examiners to do a better job if they could be criticized for underrating banks, as well as for overrating them, which seems to be the only pressure they get.

Senator SARBANES. I am going to defer to Congressman Armey, who may have a vote coming up, and I will come back later.

Thank you very much.

Representative ARMEY. Thank you, Mr. Chairman.

Let me thank all three of you gentlemen for some very good testimony. I found it quite complementary.

I'm going to dare to risk Alfred Marshall's famous observation that synthesis is innovation, and see if I can't draw on all three of you on points that I found in your testimony to formulate a question.

Mr. Tobin, you made the point that fiscal policy today, by and large, is incapacitated. Therefore, we must necessarily rely more on monetary policy. And Mr. Minsky, you brought back that old analogy of pushing on a string, which suggests that perhaps monetary policy isn't too

reliable for recovery from recessions. And Mr. Kane, I thought, made some very important points with respect to the real estate overhang; and to, what I would call, the behavioral aberrance of the RTC, if I might be a little rhetorically innovative.

Now, what I'm going to suggest is that our recession seems to be more structural than monetary. Monetary policy has historically not been effective in recovering from recessions and fiscal policy seems, certainly on the spending side, to be incapacitated with the debt overhang. We just simply don't have anywhere to go in increasing the spending.

So given a failure to do something on the fiscal side or the structural side, if we were to try to put the burden more heavily on monetary policy through reduction of interest rates and on efforts to expand the money supply, could we not be setting the preconditions of another stagflation like we saw in the late 1970's. The stagflation of the 1970's was one of the great monetary and fiscal policy dilemmas of our generation. Keynes didn't even acknowledge such an event was possible. Isn't it possible that we can untie something of the structural Gordian knot by enacting some fiscal policy measures? And I have three suggestions in mind.

For example, some reinstatement of the passive losses to reestablish profit possibilities in the real estate industry; some reinstatement of preferential capital gains taxing to correct, at least, if for no other reason, the inequity of current capital gains tax at effective rates of upwards of 50 to 55 percent—but certainly, making investment more attractive—and perhaps some reforms in the mandates given to RTC by Congress. And I'm thinking in particular that we require RTC to sell at the highest appraisal value, or not sell at all, so that their ability to do what we might see done normally in private inventory reductions is pretty well precluded by the mandate under which they operate.

What I was going to suggest is that, in fact, perhaps we do have some fiscal and structural things that we can do to alleviate the need to be so totally dependent on monetary policy, which I frankly believe to be a very risky corner to have painted ourselves into.

Now, I don't know if that pleased Marshall, but it just tickled me plumb to death. I'll see if you all would like to respond.

Mr. Tobin. I don't think that we should conclude that monetary policy is in a position of ineffectuality, like pushing on a string. I think there is plenty of leverage that the Federal Reserve could have by lowering interest rates still.

One avenue of transmission of monetary stimulus to the real economy is through the exchange rate—the foreign exchange rate. That's an important one. One effect of monetary policy is in reducing interest rates to lower the exchange rate, as I said in my prepared statement, and as Mr. Minsky also said.

I think we are not in a 1930's situation, where interest rates are already so low that they can't be made any lower by adding to the

supply of bank reserves. There's plenty of room between the 5¾ percent Federal funds rate, and a zero Federal funds rate. There's a lot of room that still can be used. Before I concluded that you can't get anywhere in reversing this recession by monetary policy, I would use a good deal more of that room.

It's quite possible that many of our problems are structural in the sense that they're inherited from the tax reform, and other events of the past few years, or from the past decade. But that doesn't mean that adjustments cannot be be made. As Professor Kane said, we need to stimulate investments that are not in the particular areas that were overbuilt during the 1980's—office buildings and commercial real estate. But those investments will be facilitated by easier money policy, and by lower general interest rates. I think that's the way we should go.

I personally don't think that if an expansionary fiscal policy to help us in this particular recession were required, or were even available to us under the budget agreement, that I would vote for or support reduction of capital gains taxes. That's not a very efficient way of encouraging investment. Lower general interest rates would be a better way. The structure of the tax system with regard to capital gains and everything else, I think, is a longer run issue, and not one to be decided as antirecession policy.

If you were doing some antirecession fiscal policy, I think the most logical thing to do would be to reinstate unemployment insurance as a more effective support of unemployed workers. It has diminished in the number of unemployed who are eligible and covered by the system, and in the adequacy of their benefits. In previous recessions, we have usually extended the length of benefits with Federal money. That would be a direct way of using fiscal policy in the present circumstances if it were possible under the present budget legislation.

Representative ARMEY. Thank you. Mr. Minsky.

Mr. MINSKY. The point I wanted to make on the "pushing on a string" situation is, first of all—and only for the time being, not as a permanent situation—that monetary policy is relatively more reliable in aborting and turning around a recession when the recession was brought about by an interest rate inversion in which short rates peaked above long rates, and when there was a deliberate anti-inflationary policy that fostered the recession rather than when the situation of the financial organizations was affected adversely by a large amount of nonperforming assets that affected the equity positions of the banks.

And, of course, we've seen how far the equity positions of the large banks have been driven down in the market by what happened to their stock prices during this period, rather than what was the official book value of equity. When organizations sell at a fraction of their book value, you have to go back and ask what's happened to the underlying profit flows and the underlying condition of the organization that made that happen. So the reliability of monetary policy has been lessened by these developments. That's how we got here—put it that way.

That doesn't mean that there isn't room for monetary policy easing. And, in particular, if it's true that there's going to be a movement of funds to the United States because of the safe-haven business—the heightened political uncertainty in Europe being one of the reasons—then the Federal Reserve should offset that by an interest rate policy to prevent any further rise of the exchange rate of the dollar.

Now, in terms of fiscal policy, I think we should distinguish, as Mr. Tobin did, between the macroeconomic effects of fiscal policy, and the details of the tax and spending structure. And in terms of the macroeconomic impact, we are down to the automatic stabilizers. As Mr. Tobin pointed out, there are two sides to the automatic stabilizers, the reduction in tax receipts and the expansion of government spending.

There is a very serious aspect of fiscal policy that may be making fiscal policy not only not expansionary, but perhaps even regressive or perverse. States and municipalities are running into enormous deficits—running from the Sun Belt, to Texas, California, and New York. It seems to be almost every place—I haven't seen how the Midwest is doing on this. They're cutting expenses, and they're raising taxes. So if you want to incorporate State and municipal governments and the Federal Government into a great big government sector, we're finding that a major part of Government is acting to prolong and deepen the recession.

Thank you.

Mr. KANE. I'd like to draw an analogy between the weakness in the banking industry and what it does to monetary policy, and what happens when you're driving and you have your air conditioner going on a very, very hot day. That is, this power drain requires you to operate your engine a little faster. That analogy underscores the point that Jim Tobin's been making. I think we could put a greater burden on monetary policy, and we should do so. But the problem is to get a prompt change in policy when economic recovery gets underway.

If we look at the history of the Federal Reserve, they've almost always overstayed ease going into both the recovery and the early boom period. That's where the focus of inflationary impacts has to be.

It is kind of sad for them not to be willing to help the economy today because they feel they can't do the right thing later. It's just really a question of working harder at identifying the turnaround when it comes. Actually, the political system is usually pretty good at identifying when the turnaround comes, especially when elections are coming up not too far in the future.

As for your structural remedies, I think the most important one is to deal with the RTC. But I don't think the problem really is the mandate they have from Congress. It's the fact that they don't have enough money from Congress.

Congress just gave them some more money recently. But the RTC was starved for funds and that forced its leaders—instead of getting the most troubled assets back into private hands where they can be best

managed and most need to be managed—to get rid of the best assets, the ones that were easy to manage, that anybody can manage. And so their funding difficulties established exactly the wrong set of incentives. I think the RTC has effectively renegotiated their mandate in terms of what they will take as mark downs. They made some new announcements on pricing strategy. But, again, there's a bureaucratic reluctance to expose themselves to sales where some of the buyers will make a good deal subsequently. They're afraid that they'll be criticized for such success.

Maybe what Congress could do is to say that they realize that this is a problem, are going to check for corruption, but aren't going to nail the bureaucracy for the fact that a few success stories occur among the buyers.

Representative ARMEY. Thank you.

Senator SARBANES. Would you yield for a moment?

What do you say, Mr. Kane, to the argument that we get from the private sector—at least some of the private sector—that says, if the RTC unloads these assets at low prices in order just to clear them out and dispose of them, that it will in effect depress the market in that particular area to the great injury and disadvantage of the private sector, and the activities they're trying to carry on. And therefore, they come in and say to us, well, we don't really want them to engage in this kind of fast action that I take you essentially, perhaps, were suggesting. I'm really putting the question to you.

What is your response to that argument?

Mr. KANE. Well, there are two elements of response. One is that any time one has a large inventory of things, there is a strategy needed as to how quickly you sell it. So the idea is not to put the entire inventory up for sale tomorrow and then have to move it out by tomorrow. What is so wrong with the policies we follow is that we don't allow buyers to initiate bids—to pick things out and say, hey, I could use a few offices from this bank and a few other offices from that S&L. Instead, we have people sitting in Washington deciding what would be convenient for them to move and when, and they don't project what they're going to sell in the distant future.

I think the RTC should be run more like a junkyard because it owns junk. That stuff should be open for inspection to anyone who thinks they can use it. Moving stuff fast should be the focus.

Second, I think a lot of people who say that these markets will be hurt by fast reprivatization have it wrong. The overhang of RTC assets is a problem for the market. The market is pricing those assets, but it's also pricing the uncertainty about when the Government will really begin to move the assets. That worsens rather than alleviates the problems of our recession.

Representative ARMEY. OK. Thank you, Mr. Chairman. I must go to another meeting.

Senator SARBANES. Thank you very much.

Representative ARMEY. Thank you, gentlemen.

Senator SARBANES. Senator Smith.

Senator SMITH. Mr. Chairman, thank you. In response to the question that you asked—having served in the real estate profession myself before coming into Congress—I've heard that argument as well. But when that same real estate broker has the opportunity to sell a property when he gets a buyer who makes an offer for less, he's not reluctant to accept it if the seller is willing to.

But I think you're very perceptive, Mr. Kane, with what you say about the RTC. It's a criticism that I've heard as well, that, frankly, bureaucrats in Washington are not qualified to sell those properties; and I think it's a real problem. It makes no sense to have the taxpayers holding this inventory, and we certainly ought to be much more aggressive in the marketing of that property. We may have some differences as to how it's to be marketed or at what price, but at least we ought to be more aggressively trying to market it.

That leads me into a broader question. I'd like you all to comment on this, if you could.

The criticism has been brought up on a number of occasions that monetary policy by the Federal Reserve Board cannot be consistent when you have, for example, the Treasury Department independent of the Federal Reserve or vice versa. In addition, you have the RTC controlling this or that asset. All of it impacts and affects all of us as taxpayers. Yet, there is no consistent coordination of policy. If you look at some of the other, more aggressive, democracies of the world, they don't have a structure like that.

Respond to that, if you will, briefly. How can we have a policy where there's no consistency, where nobody has control?

Mr. TOBIN. I think you have to distinguish between macroeconomic policy, which has to do with business-cycle fluctuations, recessions, recoveries; and structural policies, which have to do with the structure of the banking system, its supervision and regulation, and the details of taxation.

I think we do have control. The Federal Reserve does have control over the former, over the policies that affect the movement of demand for goods and services in the economy, so far as the Government has control at all. It's a vast private economy, and the Federal Reserve is trying to influence its direction by changing one or two important variables—these short-term interest rates.

The Treasury doesn't have much power in this area, except insofar as the Federal Reserve is influenced by the President and the Secretary of the Treasury, as may have happened in recent weeks. But the Federal Reserve has all the moves. They meet eight times a year. They can act any day by telephone meetings, and change the Federal funds rate or the discount rate. Those things do have influence in producing recessions

when they want to have recessions, as in 1979. They sure got one. And back in 1974, likewise. When they wanted to have a recovery in 1982, they managed to have a recovery. And they can do it again.

Now it's true that there is considerable conflicting jurisdiction in the regulatory area, in the areas of structural policies. I'm not so sure that things are so different in other countries in these respects; in those countries, too, my distinction is important. It could well be that the German Central Bank has considerable power to affect the general cyclical economic climate both in Germany and in all of Europe. But the German Government, the Minister of Finance, and all the others have the same problem of getting together on what to do about East Germany as we do about our problems. So I'm not sure it's really so different.

Senator SMITH. I know you want to respond. I'd like you to. Maybe it's too simplistic; but it just seems to me that if your universities said, teach this economics class, but there are some parameters; you can't teach this and you can't teach that, and we can't get into this; this student here, or this group of students, you have to give a B to—that's a lot of parameters, and I don't think you would have charge of your economic's class. Some would say, we ought not to have anybody in charge of it.

You cut the interest rates, you improve recession; you increase them, and we go back to inflation again. It's very cyclical. Some would leave the latter part of the word off and say, maybe it's just sick in the sense that there just does not seem to be a consistent policy.

You look at the other nations of the world, and they don't have this kind of structure, and it seems to work for them.

I don't know. Just a brief response from you. I'm not trying to argue with you. I'm just concerned about it.

Mr. MINSKY. We all are. Unfortunately, one of the issues that you raised is that we can't take the inventory that the RTC has and ship it over to Kurdistan or Bangladesh, and help alleviate some of the problems there. The inventory happens to be an inventory of structures to a large extent, and land that was grossly overpriced, and things like that.

It's every country, I think, of any size that has problems of consistency in its policies. Jim Tobin just pointed out the problems that they have in Germany right now between the fiscal measures and the monetary measures.

We discussed the independence of the Central Bank in 1913 and 1935. The decision in 1913 was to have the Comptroller of the Currency and the Secretary of the Treasury on the Board of Governors. In 1935, we removed them. The administration apparently is proposing returning some administration officials to the Board of Governors. The Congress will have to face that issue as it discusses reform.

The idea that you can have, in a country as big as ours, a nice, tight little package, and once you put it in place, everything will work

smoothly, I think we ought to discard that. We'll always have economic problems of structure and where the intervention ought to be.

Senator SMITH. Not that it's going to work smoothly, necessarily, but accountability is very important. I mean, whether the administration, the Congress, or whoever is accountable to the American people, the independence of the Federal Reserve Board leaves some doubt as to whether it is accountable to anybody.

I know the Governors are appointed by the President, of course. But still, there is that independence. I maintain that I might take the position that that does not make for strong policy. At least you can fail or you can succeed and be held accountable for it, if you set the policy and can run the policy.

Mr. MINSKY. What you're raising is a very important issue of the independence of the central bank.

In every country in the West—or most countries in Western Europe and the States—have, to some extent, an independent central bank, even with a parliamentary government. Sometimes when the Government can't seem to get its hands on aggregate fiscal policy, as in Italy, the central bank is sort of officially told—you handle the problem that we can't handle politically.

So there are varying degrees of division of labor between the political administration and——

Senator SMITH. A parliamentary system, though, calls for immediate accountability.

Mr. MINSKY. Not for some of our allies.

Mr. KANE. Senator Smith, a large body of literature exists on the point you raised about whether an integrated macroeconomic policy mix can do a better job than a more fractionated system. There's no question theoretically that it can. But at the same time, we have to realize that political systems place constraints on the policy levers no matter whether we have an integrated decisionmaking policy, or a somewhat fragmented one.

Many of the contradictions in policies that we have in the United States today reflect opportunities in politics for small groups to extract things from the general taxpayer. These "things" cumulate into macroproblems that the Federal Reserve has to mop up, as we've now set up our Government.

I think the benefits of integrated policymaking in practice in the political world that we live in, as opposed to the purely economic models that my profession likes to focus on, may be oversold.

Many other countries that have a parliamentary system, which creates the accountability you describe, still seem to respect many of the same political restraints on the use of policy levers. Their results don't seem to be noticeably better than ours.

Senator SMITH. Thank you.

Senator SARBANES. I was interested in the response to the question of the possible uses that might be made of fiscal policy if we were to do that, and the view that unemployment insurance ought to be the first line of approach—as I understand it.

Let me just set a little background for the question I want to put.

Part of the budget agreement last October was an effort to shift from the deficit figure to spending caps, recognizing that the deficit figure was interrelated to the performance of the economy; and that if the economy started down, you would get certain expenditures that would automatically increase as an automatic stabilizer countercyclical effort; and that if you worked off deficit figures, when that happened, you would then be looking to cut elsewhere, and, in effect, complicate the downturn instead of bringing yourself out of the downturn.

What happened, of course, is that they then excluded from the budget restraint increases in unemployment insurance claims under the existing law. They did not exclude the administrative costs to, in effect, process those claims, and we had something of a crisis. We got the administration to declare an emergency in which the Congress concurred, which then takes you outside of the parameters of the budget agreement for $150 million in administrative costs in order to, in effect, process the claims that were excluded.

It is my own view the existing law for unemployment insurance is clearly inadequate to address the recession, and, in fact, the law must be changed as an emergency and taken outside the spending restraint because an adequate law was not in place. In other words, the concept was correct, but the concept was not adequate.

Now, the clearest example I have of that is that the amount of income being replaced by unemployment insurance in this recession is significantly less than it was in past recessions. That is partly because the basic benefits have been cut back, but it is much more because extended benefits now are operating under a trigger that is very difficult to kick in. Only eight States have now kicked it in. In some States, you have to have unemployment levels well into the double digits in order to apply it.

There is a trust fund for the extended benefits. That trust fund had $7.2 billion in it at the end of the last fiscal year. It is to receive another $700 million, it's estimated, in taxes in the course of this fiscal year. It will earn $600 million in accrued interest on the previous balance for an inflow into the fund of $1.3 billion. The outflow is estimated to be about $150 million. It may be somewhat more because a couple more States have kicked in the extended benefits. But the fact is that this trust fund for extended benefits is building up its surpluses at the very time that we are in a recession.

What I want to put to the panel, is whether any member of the panel thinks that that ought to be taking place? Or let me put it this way: What do you think of a situation in which we are now at 6.6 percent unemployment? We have some deep concerns about the recession.

The other thing about unemployment insurance is, even if we, in effect, strengthen the system as I am suggesting, and the recession then turns out not to be as severe as some fear, we won't draw on the unemployment insurance system. If it does turn out to be severe, then it is in place to draw on.

What do you think of a situation where we find ourselves now building up the surplus in the extended benefit portion of the trust fund at a time when the economy is in this recession?

Mr. TOBIN. Well, I think that's a bad situation. I think we should have triggers for extended unemployment insurance benefits that will kick in much sooner than the ones we have now, as you said.

In fact, as I recall—when you and I were together in the Kennedy administration—that was one of our major proposals, and it was eventually legislated. It doesn't apply now. But it's certainly a good idea to have built-in stabilizers of considerable strength. And one of them could be in the unemployment insurance system, and it's not there now. In addition to that, there's some kind of structural deterioration in the coverage of the system, not just for extended benefits, but for ordinary benefits. If there was a way to do it that can be done either by emergency or by whatever relates to the budget agreement—the budget legislation—then I think that's the obvious thing to do.

So I agree with you. It's a good thing that the present budget rules keep such built-in stabilizers as there are intact, as opposed to what Gramm-Rudman would have done in theory; although it didn't quite do it in practice because it was too painful to do. That's a good thing. But it's also true that the built-in stabilizers have been diminished in importance by what has been done to the tax system and, as we've just said, to the unemployment insurance system in recent years. They are not as strong as they were before. And I think what Hy Minsky said is extremely important—that State and local governments are in a drastic situation, where they have to work counter to the built-in destabilizers.

In normal times, if we didn't have this overhang of public debt, deficits inherited from the 1980's, and deficits in normal times, an obvious thing would have been some kind of Federal assistance lending to State and local governments to tide them over the recessions that are crippling them at the worst time—disasters for which they have no responsibility. It's not their policies that brought on these recessions. But revenue sharing, either on a countercyclical basis or in general, is one of the victims of the fiscal policies of the past 10 years.

Senator SARBANES. Mr. Minsky.

Mr. MINSKY. I want to second what Jim Tobin just said. In fact, a proposal that I was going to make, which I read in the paper recently, is that the level of New York City's fiscal crisis this year is just about what the prior transfers from the Federal Government would have picked up in New York City's budget. So if you had prior rules and regulations about Federal, State, and local responsibility for activities, there would be no fiscal crisis in New York City right now.

I would suggest that some countercyclical device be invented so that the responsibility of State and local governments for various mandated activities, and the responsibilities of the Federal Government to finance various State and local mandated activities, increase during recessions and decrease at boom times.

Senator SARBANES. Mr. Kane.

Mr. KANE. I can only second the analysis of my colleagues. The weakening of the built-in stabilizers at this time is very unfortunate. The Joint Economic Committee should work to increase their strength.

Senator SARBANES. Would you accept the proposition that, given the surplus in the fund, and given the rationale of the budget agreement, that the existing stabilizers should be outside of the limitations and that it does not represent a breaking of the budget discipline if, in fact, we were to strengthen the unemployment insurance system by, in effect, expanding the basis for asserting claims without putting a tax with it; which is, of course, what the budget discipline requires.

Mr. KANE. I think you can do that by focusing on the idea of what the fund is set up to do—to take some pressure off the ordinary budget to deal with problems of extended benefits. From this perspective, the fact that it's building up now when there is an increased need for extended benefits is proof that the financing and attached allocation mechanisms are not working properly. So you need to fix them up to restore the intended funding over the business cycle.

Senator SARBANES. We are hearing from employers who are saying, well, you know, we have been paying these taxes, and they are not being used for the purpose for which they were intended in this circumstance.

I want to ask a question about Secretary Brady's approach at the G–7 meeting, where he was seeking lower worldwide interest rates. First of all, do you agree that it is a proper substantive objective that interest rates elsewhere ought to be lower as well?

Mr. TOBIN. I agree, in general, but not on this particular occasion, that interest rates in the several G–7 countries are a legitimate subject for the ministers to be discussing with each other. Somebody has to worry about what the general level of interest rates is in the world as a whole. And then they have to worry about in which direction the different members should diverge from the overall global level of interest rates.

Now, in this case, it would seem pretty obvious that the United States, being a recession member of the G–7, would deviate in a downward direction from the interest rates elsewhere. I don't understand why Mr. Brady was so anxious that Germany and Japan reduce their interest rates if their economic situations were not recessionary like ours.

The emphasis put on uniformity of the move on interest rates seemed to be misguided in the first place. I believe from the press reports that that's what Secretary Brady was told by other people at the conference. They said it wasn't appropriate at this time to have a concerted global

lowering of interest rates, because the cycles of the various countries were not that well synchronized. If the Germans and Japanese were in economic positions where they thought that they should not lower interest rates, we should just go ahead and lower ours anyway.

It's too bad that the opposite impression was somehow created for a few days—the impression that agreed universal change was necessary to meet the U.S. problem. It was not necessary. In fact, we may do better from a national U.S. economic point of view to have a lower rate relative to theirs than we would have done if everybody had gone down together.

Mr. MINSKY. Well, I think the only rationale that I could find for Brady's position, the Secretary's position, was that they were in fear that the dollar would collapse relative to the mark and the yen, and that that would be bad.

There are significant pressures on Germany for expansion. I mentioned before that there's some evidence that the safe-haven aspect of the dollar is improving the collapse of the dollar. A small fall in the exchange rate would be desirable. The international financial repercussions of a very large fall in the dollar would be something that would set a limit to how great the differential could be, but I don't think we've reached it.

We could go it alone, and if the Europeans and Japan are willing to take the appreciation in their exchange rates, fine. But chances are they'd follow, because the American market is important to them.

Mr. KANE. I don't have anything to add.

Senator SARBANES. In September, Chairman Greenspan testified before this committee that if Congress were to enact a credible, long-term, enforceable budget agreement, he would expect the Federal Reserve to ease monetary policy to accommodate the change.

Now Congress has enacted such an agreement. The result of it was to, in effect, constrain the use of fiscal policy in an antirecessionary effort. You have indicated that you think the Fed should and could be following an easier monetary policy. I think you all agree on that. I want to put the question somewhat differently. Do you think that the Fed has delivered on its part of the bargain, so to speak, as contained in this statement of Greenspan? Or did we—we being the Congress—constrain ourselves on the fiscal side, and not get from the Fed a sufficient or adequate response to that on the monetary side, so that the net result in addressing a recession is a loss, not a gain?

Mr. TOBIN. Well, I do think that it was important from the long-run point of view of the economy to have the budget agreement. And I would have expected that the Fed, regardless of what the Chairman may have said, would take that into account in making their own policy. In fact, a credible budget agreement is helpful to Federal Reserve monetary policy insofar as it makes the markets think that there will be less recourse to the bond markets in the future. That should help lower long-term rates, relatively speaking.

The Fed did deliver some interest rate reductions. I don't think they were enough, and I don't think they are yet enough. But it's hard to say whether the Chairman has "violated" the contract you mentioned.

I think the bottom line is how are we doing in getting out of the recession. I think our conclusion here is not good enough, and we ought to get another delivery on the promise that Greenspan gave to you before.

Senator SARBANES. Does anyone have anything to add to that?

Mr. MINSKY. I think you raised some issues in this question about the mix between monetary and fiscal policy.

In the budget agreement, Congress tied its hands to respond to recessions with expansionary fiscal policy but not to respond to inflations with contractionary ones. But in desigining the fiscal structure—taxes and spending—perhaps Congress should pay some attention to the stabilizing properties. You could have no difference in where you are basically when you are at normal times, but have the fiscal posture become more contractionary when you move into expansion or high inflation, and more expansionary when you move into recession than the current fiscal structure. For example, following up the idea, you could make the unemployment insurance reaction more sensitive by making the tax structure more sensitive to income and inflation. You could perhaps make the Federal Government's contribution to State and local expenditures more sensitive to inflation or a contraction. We now seem to be moving into a position where the impact upon State and local governments of recessions are going to be severe, perhaps more severe than they were in the past, although I wouldn't be able to speak to that.

Senator SARBANES. It seems to me that in the past when we have had recessions, we have had an expansionary fiscal policy, and we have also sought an expansionary monetary policy. So that the two in tandem were working to try to counter the recession. Now we have a recession and, in fact, we have a contractionary fiscal policy.

Mr. MINSKY. When you take the aggregate, yes.

Senator SARBANES. And at a minimum, it seems to me, that ought to elicit out of the Fed, with respect to monetary policy, an even more expansionary monetary policy than you ordinarily would have in a recession. In fact, I quoted these figures earlier that showed that on the Federal funds rate, the percentage changes have suggested that the monetary policy in this recession is less expansionary than it was in previous recessions. That is compounded, it seems to me, by the fact that in this recession you also have a contractionary fiscal policy at work, which seems to me would argue not only that the monetary policy at a minimum ought to track past recessions but, in fact, ought to exceed them. But, in fact, it has fallen short.

Mr. Kane.

Mr. KANE. Yes. I think it's fair to say that the Fed has let you down.

Your question underscores the Fed's lack of accountability for the policies it follows. The Fed Chairman doesn't bargain even with Congress in an operational way to deliver anything in particular. Implicit contracts are inherently vague and hard to enforce.

Senator SARBANES. I have one final question. Senator Smith, do you have any more questions?

Senator SMITH. Yes, a couple quick ones. Go ahead.

Senator SARBANES. The Washington Post, in an editorial on May 2, titled "Pushing Interest Down," argues that the Federal Reserve should not reduce interest rates any further, because its recent easing is reawakening fears of inflation. Would you give us your brief view of that editorial observation?

Mr. TOBIN. Yes, that relates also to the point that Congressman Armey had been raising in his questions to us.

Well, first of all, I think one big improvement in the macroeconomic situation, compared with 10 years ago, is that the tradeoff between inflation and unemployment looks more benign than it did then.

Hy Minsky mentioned the absence of organized labor pressures on wages now compared with what was true in the 1970's. As a result, there's very little reason to think that we are on, or anywhere near, the brink of wage-price spiraling in which prices go up; then workers and their unions are able to get wages to try to catch up with the prices; and then the prices go up again; and so on. There's no sign of that kind of thing recurring. In fact, we didn't have any sign of recurrence of that even when we had unemployment rates as low as 5½ percent or lower—almost down to 5 percent—in 1988-89.

That's a very favorable development in our economy. From the point of view of the makers of macroeconomic policy, it means that this idea that we can't fight recession, because to do so will lead us to inflation, has much less to it than it had in the 1970's.

In addition, we don't have the stagflationary OPEC shocks that we were so unfortunate to suffer in the 1970's. But even if we did have them, I don't think they would result in the kind of secondary wave of inflation that brought all prices up to what was going on in the oil market in the 1970's. So I think the Washington Post was looking under the bed and finding dangers that aren't there.

For the last 9 years, we've settled into a kind of accepted compromise that something like 4 or 5 percent inflation is the equivalent of no inflation. Paul Volcker decided in 1982 that he'd declare victory on the war on inflation and get out. He left 4 or 5 points that haven't been expunged. And there are some hawks around, some of them even on the Federal Reserve Open Market Committee, who think we should finish the job now. That proposal seems quite gratuitous to me. We've been going along quite well with this understanding that, as long as inflation stays where it is, it's OK; and let's let well enough alone.

Mr. MINSKY. The Federal Reserve loves to fight inflation. Even in a deflation, they fight inflation. It's a bias.

The view that you get from some aspects of monetary theory is that the lag between the change in what the Federal Reserve does and what happens to prices is long and variable, and they still believe that. So if you increase the money supply now and the reserve base during the recession, it's going to have inflationary consequences later.

The interesting thing about the settling in to 4 to 5 percent inflation is that this has been accompanied by—for a large portion of our labor force—wage increases that are less than 4 to 5 percent.

We've been seeing a deterioration of real wages during this expansion. This is one of the reasons why I believe that inflationary pressures that we would have from even more monetary ease even later on—not just immediately expansionary—can be attenuated. So that I think the Washington Post is wrong.

Mr. KANE. Mr. Chairman, I think that the Washington Post and Congressman Armey raise a legitimate issue. The test of whether monetary policy is easy enough must turn on whether the short-run benefits from further expansion in employment and economic growth would be more than offset by the unfavorable, long-run effects of additional monetary expansion on the rate of inflation and the balance of the payments.

But that said, I see a great need for the measurement of inflation expectations, therefore, as part of the economic intelligence that should be brought to bear at the Federal Reserve.

I've long urged that the Fed run a reliable survey of such expectations. Then we could address the question of not whether fears of inflation are rising, but how fast. This would let us answer, in something like a scientific way, whether the Washington Post is right or not.

Senator SARBANES. Senator Smith.

Senator SMITH. A couple of quick points.

The thing that concerns me as you look back in history at the various problems we've had in regard to recessions, depressions, and everything else, is that we have a situation now with a public debt—a national debt—of almost soon-to-be $4 trillion. Add to that the S&L debacle that will add considerably to that debt. The FDIC fund is bordering on insolvency, if it's not there. How do we get out of this? How is monetary policy—what policy is going to turn this around?

Mr. Minsky, you mentioned, I believe, something about the Federal mandates being funded. I agree with you. They ought not to be mandated if they're not funded. But how are we going to fund them? With what?

All of us in the Congress have differences of opinion on the priorities. We spend too much on defense. We don't spend enough on defense. Too much on welfare; not enough on welfare. The point is there's only so much to go around. You were talking about Mr. Brady. You can't really blame a guy for going out and trying to get interest

rates down when you're paying $200 or $300 billion a year in interest. So I just don't see anybody really coming to grips with it. Certainly, the Congress isn't coming to grips with the problem. We have the United States of America competing in the borrowing market, to say the least.

What's the answer? How do we get out of this? Anybody have any suggestions, noted economists that you are?

Mr. TOBIN. I think the problem that you're talking about——

Senator SMITH. Give us some advice.

Mr. TOBIN. [continuing] is a fundamental problem of American politics as far as domestic policy is concerned. It is that we have to face the realities as to how much taxes we have to pay for getting the public services that we want to have at all levels—Federal, State, and local.

Unfortunately, the same demagoguery about taxes that has led, in my opinion, to the vast increase in Federal debt that you referred to has also hit the State and local political arenas. And they have to balance their budgets. But it's political dynamite or suicide to do it by raising their taxes.

The Federal Government has devolved upon those State and local governments responsibilities that the Federal Government used to undertake, at least as far as a good part of the finance is concerned. At the same time, the Federal no-tax politics has infected State and local politics.

If we have a solution to the Federal budget problem that would stabilize the ratio of the debt to a growing GNP, we can manage the debt even at the unfortunately higher level that it has been lifted to in the last 10 years. But the question is whether we can do that and at the same time fulfill the governmental responsibilities that need to be fulfilled. And we probably can't do that without facing the need for paying higher taxes.

Senator SMITH. I know we're ready to wrap up, Mr. Chairman. I understand what you're saying. But if you look at the Federal level over the past 10 years, revenues have gone up tremendously. The outlays went out faster than the revenues came in. So I don't agree with you that it's a revenue problem, necessarily, in the sense that I understand the demagoguery on taxes and all that. But the point is that we do spend more than we take in. We have taken in several hundred billion dollars over the past 10 years, and yet that has been spent and then some to run up the debt further.

Go ahead Mr. Minsky.

Mr. MINSKY. One of the problems is that the first thing that you start with when you make up the budget of each year is the carrying costs on the Federal debt.

Senator SMITH. Well, that's my point.

Mr. MINSKY. And what we have is part of the legacy of the past decades that's increased.

Senator SMITH. You see, that's my point. That's what concerns me. It's not the other priorities in the budget that we all can fight over. It's the fact that in the very near future—perhaps within a year, maybe we're already there—interest on the national debt exceeds what we spend on defense, for example. It's gone from—I think when Jack Kennedy was President in 1963—I think interest was 3 percent of our whole budget—3 cents on every dollar to 15 or 16 cents today, and going up, not down.

Mr. MINSKY. In terms of the actual fiscal responsibility of the Government, perhaps not in terms of its social priorities, it's the first thing that's there. It's the fixed item.

Senator SMITH. And unless you go to the gold standard or something, and reduce interest rates to 2 percent—that's where the money is. As an economist, what is the——

Mr. MINSKY. I think Mr. Tobin hit it on the head. For a time, we have to have a tax system in place—we each have our favorite taxes—that will not only enable us to meet our obligations on the debt and some of our social and necessary infrastructure obligations, but at good times reduce the size of the national debt relative to gross national product.

In our history—in Jackson's time, when we were building at the end of the First World War, when we were building the Federal Reserve System—the country had too little national debt. That's one of the reasons why the National Banking Act broke down, and we replaced it with the Federal Reserve Act. In the 1920's, we cut the national debt relative to GNP significantly, so now we have to do the same thing as we have done in our history.

Senator SARBANES. Well, here is a chart of it right here [indicating].[1] This is the debt of the Federal Government—it's in the Joint Economic Committee's Annual Report—as a percent of the GNP. This is 1952. This is still trying to work down the debt out of World War II, and it works its way right down here, and here in 1980 at about 33 percent.

Mr. MINSKY. Just about the bottom.

Senator SARBANES. And then we see it soar back up again to nearly 70 percent. So now it is a much larger percentage of the GNP than it was.

Mr. MINSKY. And whereas it was built up before by emergency expenditures—a war or something equivalent—this time it was built up both by an expansion in defense expenditures—after all, we had almost the equivalent of a wartime expansion in defense during the 1980's—and by cutting taxes even as we did that.

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[1] See figure 18, Debt of the Federal Government, *The 1991 Joint Economic Report*, p. 48.

Senator SMITH. I really don't want to debate this, but, even during those years regarding defense, we still dropped from 27 to 20 percent of our budget in defense and down from 47 percent in the mid-1960's.

Mr. MINSKY. Because you had this bigger nut, this enormous nut, that you have to cover before you start thinking about anything else.

Senator SMITH. As an economist, though, what is the line where economic disaster occurs? What—30 percent, 50 percent, 99 percent interest on our budget? At what point in time have we reached disaster, seriously? How far can we go with the interest eating the percentage of our budget that it's eating?

Mr. KANE. Could I make the point that there's a lot of nonbooked interest as well.

Senator SMITH. That's right.

Mr. KANE. We have a lot of off-balance-sheet debt that is imposing burdens that really should be handled.

Senator SMITH. That's correct.

Mr. KANE. The chairman's graph would really look much worse if we went through and tried to deal with the off-balance-sheet debt of the Government.

The trouble that developed in FSLIC was quite foreseeable, and was seen by many people as it developed. And in the Bank Insurance Fund, experts in my field have been marching down here to say how insolvent that fund is on a reasonably calculated economic basis. We have a government system of accounting that really destroys budget discipline.

While we need a more responsible tax policy, we also need to run everything through the budget. I think much of the consequences that can't be controlled today flow from the off-budget commitments made long ago. There's very little that Congress can do with the formal budget today because of what was done informally years and years ago.

Mr. MINSKY. It would be nice to do a budget where you have footnotes on the contingent liabilities.

Mr. KANE. I don't think you need footnotes. I think you need to run them right through the body of the accounts.

Mr. MINSKY. You know what I mean, the way you do on a—but don't forget when you have a contingent liability at the bank, you get a contingent asset.

Mr. KANE. Not always.

Mr. MINSKY. As long as it's contingent.

Mr. KANE. It can be attached to a real asset.

Mr. TOBIN. I think the nightmare that you were speaking of, Senator Smith, is like this: You have a big inherited debt, and it has a large interest outlay. That interest itself creates so large a deficit that the debt grows faster than the economy is growing. That will happen when the interest rate that you have to pay on the debt is higher than the growth rate of the economy. That was true, or very close to that was true, in the period where the debt was growing so fast in the last decade. I don't

think it's true now, but maybe it will be again if interest rates have to be put up pretty high. I think there's a double whammy here, so to speak. On the one hand, you have a large debt and large deficits, and a large interest burden becomes a large part of that problem. The deficit uses a large part of the savings of the private sector of the economy, even when the economy is at full employment. In fact, if you take net saving by the rest of the economy, the non-Federal part of the U.S. economy, about half of the net saving of households and businesses—net of depreciation on the capital stock—about half of that is being used to finance the Federal deficit.

The United States is not a big saving country in the first place. And then when the Federal Government is commandeering a large part of private savings, that in itself increases interest rates and makes the problem worse. It adds to the vicious cycle problem I was speaking of. You have high interest rates because you have high deficits, and you have high deficits because you have high interest rates.

That doesn't mean there's going to be some blowup on a particular day. You probably will not be able to say that October 19 was the day when all this came to be reckoned with. I don't think that. It's more like an insidious waste of saving that should be used for public capital formation or private capital formation, but is not used for those purposes.

Senator SMITH. But every unit in America, from the family to a business, to a local government, school board, has a limit on its credit—with one exception, the United States of America. We have no limit.

Mr. MINSKY. That's not true.

Senator SMITH. It is true. It may not be true in principle, but it is true. In fact, that's what's happening. That's why we are where we are. To me, it's almost like putting a Band-Aid on a hemorrhage, unless this is turned around. A few years ago, former Congressman DeGuardia, who was an accountant, went in and talked about what you talked about, Mr. Kane. There is something like 40, 50, or 75 different accounting systems that the Federal Government uses—there's no consistency. Where's the limit on our credit?

Mr. MINSKY. All right. Let's talk about that, because I once raised the question, "what would it take for the United States to become an Argentina?" Not that we're close. But at one time, in 1914, Argentina had—at the beginning of the World War I—a comparable per capita income to the United States, and was as prosperous as the United States.

One of the things, as pointed out by Mr. Tobin a minute ago, if you do the budget of the United States in which you put the interest on the Government debt as the last item, you will find that you're running a surplus on everything else. Then at the end, you run a deficit, because the interest on the Government debt is there. That means that you're paying the interest on debt with debt.

Senator SMITH. Right.

Mr. MINSKY. That's what they did in the RJR—the Reynolds Nabisco takeover with these payment-in-kind bonds. It's a very dangerous situation when you pay interest on the debt with new debt, with bonds. You could have the bonds explode at a faster rate than gross national product, become an ever increasing part of the tax burden. The rate at which you have to increase the bonds in order to meet the interest on the debt increases. And you could set it up easily so that, in future years, it becomes what people expect from the fiscal side pressure, which is inflation at a very high rate. We're not close to that situation yet. But you cannot say that the U.S. Government will always be in a position where it could sell its debt at reasonable terms without immediate consequences. After all, the United States is now a much smaller part of the world economy than it was 40 years ago. And at the rate of growth of some of the other countries in the world, we're going to become an even smaller part of the world economy. And the smaller you are, the less dominant you are; the greater the possibility that your liabilities will become unacceptable in the world market. You depend more and more upon being accepted in the world market. It's one market. And that means that every year your exchange rate goes down. So that the rules, the traditional rules, of fiscal prudence still rule and still have validity. It's a very conservative position for me to take, I know.

Mr. KANE. Well, I think Senator Smith and you were talking about very different timeframes. In the short run, there is no discipline. In the long run, there is. But in the long run, we're all dead.

Mr. MINSKY. The long run ain't that long. It may not be too much longer.

Senator SARBANES. Well, we are paying a high price for the fact that for the past decade we have essentially pursued a borrow-as-you-go policy. That is what it amounts to. And now we have increased spending, defense spending, by very significant levels. And we, in effect, reduced the revenue flow.

My understanding is, compared with other advanced industrial countries, that we are not a heavily taxed society. Is that correct? Is that your perception?

Mr. TOBIN. That's correct, yes.

Senator SARBANES. So it's not as though the tax burden being carried by Americans is high. Everyone thinks it's high. No one wants to pay any taxes at all. But it's not as though the tax burden being carried by Americans is high in comparison with the tax burdens being carried by our international economic competitors. In fact, they are carrying more of a tax burden, and yet, we are running a $100 billion trade deficit. They must be doing something that enables them to compete. Part of it, of course, is that we have run up this debt and squeezed out the investment—the public investment—let alone the private investment in asset creation.

There are the budget priorities in the fiscal budget this year in this chart [indicating].[1] The interest on the 1980 debt is $149.6 billion. Not on all debt. Just the debt runup in the 1980's. Education is $45.5 billion; Federal capital outlays is $80.1 billion; Federal capital grants is $27.2 billion; and civilian research and development is $27 billion. We have put ourselves into this box, and we're paying the price for it.

Thank you all. You have been a very helpful panel. We appreciate it.

Senator SMITH. Thank you, Mr. Chairman.

Mr. KANE. Thank you.

Mr. TOBIN. Thank you.

Mr. MINSKY. Thank you, Mr. Chairman.

Senator SARBANES. The committee is adjourned.

[Whereupon, at 12:20 p.m., the committee adjourned, subject to the call of the Chair.]

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[1] See figure 26, Fiscal 1992 Budget Priorities, *The 1991 Joint Economic Report*, p. 75.