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before the

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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ECONOMIC OUTLOOK FOR 1997

Thursday, March 20, 1997

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D.C.

The Committee met, pursuant to notice, at 10:00 a.m., in Room 2175, Rayburn House Office Building, the Honorable Jim Saxton, Chairman, presiding.

Present: Representatives Saxton, Manzullo, Sanford, Thornberry, Hinchey, Maloney, and McCrery; Senators Bennett, Sessions, Bingaman, Sarbanes, and Robb.

Staff P/resent: Chris Frenze, Robert Keleher, Mary Hewitt, Roni Singleton, Brenda Janowiak, Meredith Aber and Juanita Y. Morgan.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Good morning. It gives me great pleasure to welcome Federal Reserve Chairman Alan Greenspan to testify before the Joint Economic Committee this morning about the economic outlook and monetary policy.

In the past several years, the U.S. economy has experienced continued, though moderate, expansion with the notable feature of stable and low inflation. Another conspicuous characteristic of the expansion has been its longevity. It has persisted for more than 60 percent longer than the average postwar expansion. This has occurred despite both tax increases in 1990 and 1993, as well as increased regulatory burdens.

I believe the fact that the recovery has been sustained while inflation has abated is neither a coincidence nor an accident. One of the key benefits to lower inflation has been that it has fostered a sustained recovery. And, in my view, we can't overstate the importance of having gained control of inflation, Mr. Chairman, and for that we pass along our gratitude and our praise to you.

Specifically, credible disinflation works to lower interest rates, stabilize financial markets and interest-sensitive sectors of the economy,

promote efficient working of the price system, and in many ways works like a tax cut. All of these effects contribute to promoting the stability of the expansion.

But the manner in which disinflation is managed is also important in sustaining the expansion. With a focus on price stability, the Federal Reserve has adopted a gradualist approach to squeezing inflation out of the system. By not attempting to achieve price stability too quickly so as to jolt or shock the economy into a slowdown, monetary policy has sustained the expansion. In short, monetary policy has contributed significantly to sustaining the expansion by pursuing price stability in a gradualist manner. Certainly, it appears that the Federal Reserve has done a competent job, at least to date.

Because of the importance of price stability, I, along with some of my colleagues, have sponsored a plan to reintroduce a bill this year allowing the Federal Reserve to focus on price stability as its primary goal. This would allow the Federal Reserve to continue to pursue price stability with its many benefits without conflicting objectives. With inflation low, now is the opportune time to lock in our many gains and institutionalize this key policy objective. Several other countries have successfully adopted this strategy and, in fact, the approach has been endorsed by several key officials in the Federal Reserve system.

Of course, there are many well-known problems attempting accurately to measure price stability. And we look forward to the Chairman's insights on this question as well as your comments, sir, on monetary policy in general.

Again, we welcome you, Mr. Chairman, this morning, and before I turn to the Ranking Member on the Minority side, let me just say that the role that you have played, sir, is recognized by many in terms of its importance.

I noted with some interest and some humor the other day, I saw a political cartoon which emphasized this fact. The political cartoon was a caricature of the Chairman, and it had him—obviously it was early in the morning and probably at the breakfast table, and the Chairman said, good morning, and the caption was, "I wonder what he means by that?"

So we are very pleased to have you here this morning, sir, and we recognize the very important role that you have played in promoting and

sustaining the period of economic growth that we are currently experiencing.

[The prepared statement of Mr. Saxton appears in the Submissions for the Record.]

Representative Saxton. Senator Robb, let me yield to you at this point for whatever statement you may have, and then we will proceed with the Chairman's testimony.

OPENING STATEMENT OF SENATOR CHARLES S. ROBB

Senator Robb. Thank you, Mr. Chairman. I, too, delight in welcoming Chairman Greenspan to the meeting. We always look forward to your testimony with great interest. We hang on every word that you say, every word that we think you say, and every word that you don't say, and I doubt that the meeting this morning will be any exception. We are delighted to have you with us, and we look forward to your testimony.

Representative Saxton. Thank you very much, Senator.

Mr. Chairman, please proceed. If you have any special needs along the way, please just let us know.

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

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

Last month, the Federal Reserve Board submitted its semiannual report on monetary policy to the Congress. That report and my accompanying testimony covered in detail our assessment of the outlook for the U.S. economy. This morning I would like to highlight some of the key aspects of the current economic situation.

As I told the Congress last month, the performance of the American economy remains quite favorable. Real gross domestic product growth picked up to more than 3 percent over the four quarters of 1996. Moreover, recently released data suggest that activity has retained a great deal of vigor in early 1997.

In addition, nominal hourly wages and salaries have risen faster than prices over the past several quarters, meaning that workers have reaped some of the benefits of rising productivity and thus gained ground in real terms. Outside the food and energy sectors, increases in consumer prices

have actually continued to edge lower with the core Consumer Price Index (CPI) inflation rate of only 2-1/2 percent over the past 12 months.

The low inflation of the past year is both a symptom and a cause of the good economy. It is symptomatic of the balance and solidity of the expansion and the evident absence of major strains on resources. At the same time, continued low levels of inflation and inflation expectations have been a key support for healthy economic performance. They have helped to create a financial and economic environment conducive to strong capital spending and longer-range planning generally, and so to sustain economic expansion. These types of results are why we stressed in our monetary policy testimony the importance of acting promptly—ideally preemptively—to keep inflation low over the intermediate term and to promote price stability over time.

For some, the benign inflation outcome of the past year might be considered surprising, as resource utilization rates—particularly of labor—have been in the neighborhood of those that historically have been associated with building inflation pressures. To be sure, nominal hourly labor compensation, especially its wage component, accelerated in 1996. But the rate of pay increase still was markedly less than historical relationships with labor market conditions would have predicted.

Atypical restraint on compensation increases has been evident for a few years now. Almost certainly, it reflects a number of factors, including the sharp deceleration in health care costs and the heightened pressure on firms and workers in industries that compete internationally. Domestic deregulation has also intensified the competitive forces in some industries. But as I outlined in some detail in testimony last month, I believe that job insecurity has played the dominant role. For example, in 1991, at the bottom of the recession, a survey of workers at large firms by International Survey Research Corporation indicated that 25 percent feared being laid off. In 1996, despite the sharply lower unemployment rate and the tighter labor market, the same survey organization found that 46 percent were fearful of a job layoff.

Whatever the reasons for its persistence, job insecurity cannot suppress wage growth indefinitely. Clearly, there is a limit to how long workers will remain willing to accept smaller increases in living standards in exchange for additional job security. Even if real wages

were to remain permanently on a lower upward track than otherwise as a result of the greater sense of insecurity, the rate of change of wages would revert at some point to a normal relationship with price inflation. The unknown is when a more normal pattern will resume.

Indeed, the labor markets bear especially careful watching for signs that such a process is underway. So far this year, the demand for labor has stayed strong. Payroll employment grew briskly in January and February, and the unemployment rate remained at around 5-1/4 percent—roughly matching the low of the last cyclical upswing in the late 1980s. Also, initial claims for unemployment insurance remained low into March. In addition, the percentage of households telling the Conference Board that jobs are plentiful has risen sharply of late, which suggests that workers may be growing more confident about the job situation.

Finally, wages rose faster in 1996 than in 1995 by most measures. In fact, the acceleration was quite sizeable by some measures. This, too, raises questions about whether the transitional period of unusually slow wage gains may be drawing to a close. In any event, further increases in labor utilization rates would heighten the risk of additional upward pressure on wage costs, and ultimately prices.

To be sure, the pickup in wage gains to date has not shown through to underlying price inflation. Increases in the core CPI, as well as in several other broad measures of prices, have stayed subdued or even edged off further of late. As best I can judge, faster productivity growth last year offset the pressure from rising compensation gains on labor costs per unit of output. And nonlabor costs, which are roughly a quarter of total consolidated costs of the nonfinancial corporate sector were little changed in 1996.

Owing in part to this subdued behavior of unit costs, profits and rates of return on capital have risen to high levels. As a consequence, a substantial number of businesses apparently believe that, were they to raise prices to boost profits further, competitors with already ample profit margins would not follow suit. Instead, they would use the occasion to capture a greater market share. This interplay is doubtless a significant factor in the evident loss of pricing power in American business.

Intensifying global competition may also be limiting the ability of domestic firms to hike prices as well as wages.

Competitive pressures here and abroad should continue to act as a restraint on inflation in the months ahead. In addition, crude oil prices have largely retraced last year's run-up and, with the worldwide supply of oil having moved up relative to demand, futures markets project stable prices over the near term. Food prices should also rise less rapidly than they did in 1996, as some of last year's supply limitations ease. Nonetheless, the trends in the core CPI and in broader price measures are likely to come under pressure from a continued tight labor market, whose influence on costs will be augmented by the scheduled increase in the minimum wage later in the year. And with considerable health care savings already having been realized, larger increases in fringe benefits could put upward pressure on overall compensation. Moreover, although nonoil import prices should remain subdued in 1997, as the sharp rise in the dollar over the past year and a half continues to feed through to domestic prices, their damping effects on U.S. inflation probably will not be as great as in 1996.

The lagged effects of the increase in the exchange value of the dollar will also likely restrain real U.S. net exports this year. In addition, declines in real Federal Government purchases should exert a modest degree of restraint on overall demand, and residential construction will probably not repeat the gains of 1996.

On the other hand, financial conditions overall remain supportive to the real economy, and creditworthy borrowers are finding funding to be readily available from intermediaries and in the securities markets. Moreover, we do not see evidence of widespread imbalances either in business inventories or in stocks of capital equipment and consumer durables that would lead to a substantial cutback in spending.

The trends in consumer spending on items other than durables also look solid. Retail sales posted robust gains in January and February, and, according to various surveys, sentiment is decidedly upbeat. Moreover, consumers have enjoyed healthy increases in their real incomes over the past couple of years, along with the extraordinary stock-market-driven rise in their financial wealth.

Should the higher wealth be sustained, it could provide important support to consumption in 1997. But looking at the data through 1996, the surging stock market does not seem to have imparted as big a boost to spending as past relationships would have predicted. The lack of a more substantial wealth effect is especially surprising because we have also seen a noticeable widening in the ownership of stocks over the past several years. Indeed, the Federal Reserve's recently released Survey of Consumer Finances suggests that of the total value of all families' holdings of publicly traded stocks and mutual funds, the share held by those with incomes below $100,000 rose from 32 percent in 1989 [in 1995 dollars] to 46 percent in 1995.

It is possible, however, that the wealth effect is being offset by other factors. In particular, families may be reluctant to spend their added wealth because they see a greater need to keep it to support spending in retirement. Many have expressed heightened concern about their financial security in old age, in part because of growing skepticism about the viability of the Social Security system. This concern has reportedly led to stepped-up savings for retirement.

The sharp increase in debt burdens in recent years may also be constraining spending by some families. Indeed, although our consumer survey showed that debt usage rose between 1992 and 1995 for almost all income groups, changes in financial conditions were not uniform across families. Notably, the median ratio of debt payments to income for families with debt—a useful measure of the typical debt burden—held steady or declined for families with incomes of at least $50,000, but it rose for those with incomes below $50,000. We don't know whether these latter families took on additional debt because they perceived brighter future income prospects or simply to accelerate purchases they would have made later. Nonetheless, these families are probably the most vulnerable to disruptions in income, and the rise in their debt burdens is likely to make both borrowers and lenders a bit more cautious as we move forward.

Both the household and business balance sheets have expanded at a pace considerably faster than income and product flows over the past decade. Accordingly, any percentage change in assets or liabilities has a greater effect on economic growth than it used to. However,

identifying such influences in the aggregate data is not always easy. At present, the difficulty is compounded by concern that the currently published national statistics may not provide an accurate reading of the trends in recent years, especially for productivity.

In any event, other data suggest that wealth and debt effects may be exerting a measurable influence on the consumption and saving decisions of different segments of the population. According to the Consumer Expenditure Survey conducted by the Bureau of Labor Statistics, saving out of current income by families in the upper-income quintile evidently has declined in recent years. At the same time, Federal Reserve estimates suggest that the use of credit for purchases has leveled off after a sharp run-up from 1993 to 1996, perhaps because some families are becoming debt-constrained and, as a result, are curtailing their spending.

The Federal Reserve, of course, will be weighing those and other influences as it makes future policy decisions. Demand has been growing quite strongly in recent months, and the FOMC, at its meeting next week, will have to judge whether that pace of expansion will be maintained and, if so, whether it will continue to be met by solid productivity growth, as it apparently has been, official figures to the contrary notwithstanding.

Alternatively, if strong demand is expected to persist and does not seem likely to be matched by productivity improvement, the Federal Open Market Committee will have to decide whether increased pressures on supply will eventually produce the types of inflationary imbalances that, if not addressed early, will undermine the long expansion.

Should we choose to alter monetary policy, we know from past experience that, although the financial markets may respond immediately, the main effects on inflationary pressures may not be felt until late this year and into 1998. Because forecasts that far out are highly uncertain, we rarely think in terms of a single outlook. Rather, we endeavor to assess the likely consequences of our decisions in terms of a reasonable range of possible outcomes. Part of our evaluation is to judge not only the benefits that are likely to result from appropriate policy, but also the costs should we be wrong. In any action— including leaving policy unchanged —we seek to assure ourselves that the expected benefits are large enough to risk the cost of a mistake.

In closing, Mr. Chairman, I would like to note that the current economic expansion is now entering its seventh year. That makes it already a long upswing by historical standards. And yet, looking ahead, the prospects for sustaining the expansion are quite favorable. The flexibility of our market system and the vibrancy of our private sector remain examples for the whole world to emulate. We will endeavor to do our part by continuing to foster a monetary framework under which our citizens can prosper to the fullest possible extent.

Thank you very much, and I am available for questions.

[The prepared statement of Mr. Greenspan appears in the Submissions for the Record.]

Representative Saxton. Mr. Chairman, thank you very much. Just for the benefit of the Members, the vote which is underway is on a motion to adjourn, and there are apparently 10 minutes left in the vote, so House Members who may be here may want to take that into consideration.

Mr. Chairman, thank you very much for your opening statement. Mr. Chairman, I would just like to talk for a minute about the—apparently what you view as the primary function in today's Federal Reserve policy.

In recent testimony, you stated that low inflation, quote, was a cause of the good economy. In explaining that, you said, "Continued low levels of inflation and inflationary expectations have been a key support for healthy economic performance. They have helped to create a financial economic environment conducive to strong capital spending and longer-range planning generally, and so sustained economic expansion. Consequently, the FOMC believes it is crucial to keep inflation contained in the near term and ultimately to move toward price stability."

To help me understand this, my staff has put together some graphs the most important of which, I believe, is over here, to my left and your right. The two lines on that graph indicate inflation and long-term interest rates. Inflation is indicated by the red line, and long-term interest rate levels are indicated by the darker blue line.

It appears to me that there is a direct correlation on this chart between levels of inflation and levels of long-term interest rates. And incidentally, there is another chart, which we probably don't need to look

at, which shows very much the same correlation between levels of inflation and short-term interest rates, but for purposes of discussion I like to use this one, this chart.

Back during the late 1970s, of course, we had very high inflation, and the chart shows that we had very high interest rates. And then through the 1980s, as inflation was brought into check, long-term interest rates, as well as short-term interest rates, tended to come down along with inflation. And that trend has continued on through today, with some blips up and down from time to time, but generally it is true that inflation has come down and, correspondingly, interest rates have come down as well.

Doesn't this suggest the obvious conclusion that low inflation leads to lower interest rates?

[The charts submitted by Mr. Saxton appear in the Submissions for the Record.]

Mr. Greenspan. I think the evidence is overwhelming, and, indeed, if you went to more sophisticated techniques of evaluation, you would find the relationships even more impressive than that chart.

Representative Saxton. And doesn't this likewise mean that, therefore, monetary policy is the principal reason for the sustained nature of our expansion, not so much because you have targeted economic growth, but because the Fed has seen as its primary goal to focus on price stability and inflation?

Mr. Greenspan. Mr. Chairman, we don't separate those goals. We believe that a necessary condition for sustained economic growth, which is the maximum that can be achieved, is low inflation or price stability. It is our judgment, based on ample historical evidence, that when inflation begins to accelerate, within a very short period of time economic expansion runs into trouble, and the unemployment rate rises. And so we do not distinguish the goals of maximum sustainable economic growth from low inflation because we believe the evidence is increasingly becoming persuasive that one is a necessary condition for the other; that is, low inflation is a necessary condition for maximum sustainable growth.

Representative Saxton. Mr. Chairman, some experts, and I would point to Martin Feldstein in particular, have argued that macroeconomic policy or stabilization policy is now almost fully the responsibility of

monetary policy and not fiscal policy. In other words, our economic growth, which we are experiencing today, according to Martin Feldstein and others, is a result of the monetary policy that has fostered low inflation and low interest rates. Do you agree with that statement?

Mr. Greenspan. Only in part, Mr. Chairman, because if you look at that 10-year bond rate, I would suspect that we would find that there is an element in the current level which, were it not for the fact that there is a projected acceleration of budget deficits after the year 2002 as the demographics change, that that level, were the fiscal outlook superior, would be significantly lower.

If you had drawn that chart to take into consideration the 1950s and the 1960s, you would find that the 10-year Treasury bond rate would be quite a good deal lower, but the inflation rate would not be all that significantly different from where it is today. And the difference between those two periods, in my judgment, is, to a large extent, the result of the expectation that the longer-term fiscal outlook is unstable, and that probably has a not insignificant effect on where long-term interest rates are, especially 20- and 30-year bond maturities, which obviously carry over into that period.

So while unquestionably Dr. Feldstein is right with respect to the immediate period, I think it requires a qualification of not insubstantial moment.

Representative Saxton. Would you agree that what we have accomplished through monetary policy in recent years is to squeeze inflation out of our system in a gradual manner, and that this has certainly not disrupted economic growth, but has, in fact, fostered economic growth?

Mr. Greenspan. I would agree with that, Mr. Chairman.

Representative Saxton. Let me change direction here for just a moment and ask a question about the future. Understanding the past is certainly important to understanding the future, but as I indicated in my opening statement, there is from time to time some discussion about Fed policy and what it might mean for the future.

I have noted that recent data reflect remarkable, rather remarkable, stability in broad price inflation numbers. Producer prices have fallen in recent months. At the same time, forward-looking indicators of future

inflation, such as the dollar and commodity prices, suggest that there is no dramatic evidence, if any, that inflation is a concern or is on the horizon.

Given this evidence, I, for one, see no compelling reason to tighten monetary policy and to hike interest rates in the short term. How strong is the evidence that would justify tightening of monetary policy in the short term, in your opinion?

Mr. Greenspan. Mr. Chairman, I can't go into detail on that, largely because, as you know, we will be meeting with the Federal Open Market Committee. The Federal Reserve Board will meet with the Presidents of the Federal Reserve Banks early next week.

But let me just say this, as I tried to emphasized in my written testimony: I think the evidence is quite clear at this particular stage that tracing of inflationary patterns, given the relative tightness of the economy, is close to unprecedented in the sense that, as I indicated in the Humphrey-Hawkins testimony, if you look across the spectrum of various prices and where various pressures currently exist, it is very hard to find any evidence of a mushrooming inflationary set of pressures at this point.

What we at the Federal Open Market Committee are going to have to judge, however, is not so much the question of where prices are or have been, but, rather, what is the state of the economy later this year and into 1998, when any actions we may or may not take would become effective? And we have had to do that pretty much since we concluded, on the basis of really quite considerable experience, that monetary policy is forward-looking of necessity and as a consequence it tends, to need to be preemptive. Unless we follow that strategy, we will find our ability to maintain and foster a low-inflation environment and eventually to achieve price stability will be jeopardized.

So we always have these very difficult decisions to make, and it will be, I would suspect, as it has been in our recent meetings, a fairly detailed evaluation of all the various factors that are involved in making that judgment and the importance of going around that room, where all of the Presidents who represent the 12 Federal Reserve districts of the United States come to the table with realtime, up-to-date information on their various districts, which sets the framework for the discussions in the sense that they have more recent data than anything that is published and

that has been very useful for us in the past, and I assume it will continue to be useful to us in the future.

Representative Saxton. Well, I appreciate that.

Let me just conclude by just pursuing this issue one step further. I appreciate the up-to-date data that you deal with, and you have access to that. However, at the same time I—we have access to today's data, and, frankly, as I look through this data, for example, when I look at today's Consumer Price Index, I find that it is quite low and continuing to indicate that it will remain low. The GDP deflator is about as low as it has been for a couple of decades. The Producer Price Index is, likewise, quite low.

Regarding compensation for civilian workers, information has shown a slight uptick, but ever so slight, and I think you made reference in your opening statement to the fact that wages don't usually cause inflation but follow prices up. And so this doesn't seem to be, to me, an early warning signal. And there are other items that I can go into, but the general thrust, I guess, of the question that I have is, don't these indicators indicate quite clearly, at least to me as a Member of Congress, that inflation is under control and can be expected to stay under control, thereby alleviating the need for tightening interest rates any time soon?

Mr. Greenspan. Well, Mr. Chairman, I don't want to comment on your conclusion, but I will agree that the historical data which you cite are quite accurate. The state of inflation at this particular stage is clearly under control, as I indicated in my Humphrey-Hawkins testimony.

But the issue that I was raising with respect to the question of preemptive action refers to a period significantly out in the future when the maximum impact of any monetary policies that are taken or not taken have their impact. And so we have to look beyond the current state of affairs, but there is no question that it is really quite impressive what the existing inflationary rate is. It is quite benign, and all evidence, especially the numbers you cite and we can cite additional ones, show that there is very little doubt that at the moment the price situation is quite well under control.

What that says about the future is a more complex question, and that is the type of problem that we have to deal with. And it is uncertain at this particular stage as to how we will come out after our meeting. That

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is, the purpose of our meeting is essentially to bring our people together and to make judgments about what everyone envisages is in the process of going on and what they expect is likely to occur in the future.

Representative Saxton. Thank you very much, Mr. Chairman. I would like to conclude by just saying that low inflation, low interest rates, and this good economy are your achievement, and it is impressive.

Thank you.

Mr. Greenspan. Thank you.

Representative Saxton. Mr. Bingaman.

OPENING STATEMENT OF SENATOR JEFF BINGAMAN, RANKING MINORITY MEMBER

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

Chairman Greenspan, thank you for speaking with us today.

I wanted to just understand, you referred several times in one of your answers to maximum sustainable growth, I believe, as an end goal or objective that you and the Federal Reserve Board pursues. Can you give us an indication as to what you think the maximum sustainable level of economic growth is that we can hope to achieve for the rest of this decade?

Mr. Greenspan. The trouble, unfortunately, Senator, is that our statistics are inadequate to answer that question, and let me tell you why. As you probably know, there is a fairly significant dispute at this particular stage on the issue of the accuracy of the Consumer Price Index, and that same dispute exists pretty much with all of the price statistics which we have, and while the nominal gross domestic product, that is the actual number of dollars that we produce, is probably fairly accurate, there is clearly an upward bias in the prices we use to adjust those nominal dollars in real terms. As a consequence of that, the growth rate that we publish is underestimated. So is productivity, and so is potential output.

What I would suggest is that if you accept a particular number, which would be the presumption of what the general price level is overestimated by, one can convert that directly into an addition to what the normal forecasts, which range between, say, 2 percent and 2-1/2 percent, with our existing published data, so that the true real rate of

growth is that range plus the price bias that we have in the data we employ.

Senator Bingaman. So if Mr. Boskin's estimate is right, or his Commission's estimate is right, that we are understating these figures by —what does he say, 1.1 percent?

Mr. Greenspan. 1.1 for the Consumer Price Index. It would be somewhat less for the total gross domestic product deflator.

Senator Bingaman. But your thought is that taking the current rate of growth and adding that correction for statistical inaccuracies does constitute the maximum sustainable level of economic growth?

Mr. Greenspan. Well, I would define that more as trend growth. Maximum sustainable growth requires a little more definition. It would require us to define where we would be when serious pressures on resources began to emerge. In other words, it would be when we began to see that manufacturers were having difficulty meeting their delivery schedules, and, therefore, the lead times on the deliveries to customers were stretched out, the average work week would start to increase because there are not enough facilities to produce goods.

What you need is a sense of where the economy is beginning to run under forced strain. And the reason I say that is different from the trend number, is that the trend number merely is a long-term evaluation of what you would think about population growth and productivity growth adjusted for the right price adjustments. Maximum sustainable growth is a slightly different number, which probably varies a bit from the trend value in that in some periods it is more easy to put on additional pressures on the economy than at other periods. And so it is very difficult for us to get an exact number, but we know it in a qualitative sense.

Senator Bingaman. Let me ask about the preemptive strike approach that I think you have described in previous testimony, and again referred to today about the need to look ahead and anticipate what the situation will be in the economy in order to determine what interest rates to pursue.

Is there a risk in making these calculations that a move toward recession would be hastened by virtue of miscalculating that?

Mr. Greenspan. As I said in my prepared remarks, we have no choice but to forecast and act on a forecast, and the reason for that is that

we have had ample historical experience, a lot of it not very beneficent, that unless we do that, we will be behind the curve a good deal of the time. And monetary policy in years past has been demonstrably counterproductive in certain periods, largely because we were too late in moving.

We are, therefore, in a position where we know we have to move ahead of the curve, largely because the time frame in which monetary policy impacts is quite long. We don't have that choice. The question is: How do we assure that we make judgments that are accurate? And the answer is, it is very difficult.

What we try to do, as I indicated in my prepared remarks, is to try to make judgments about the relative probabilities of what the outlook is and then array a series of different types of monetary policy moves and make judgments not only as to what would be contributed if that judgment of the forecast is correct, but also what is the cost if we are wrong? And clearly, if we find that the costs of being wrong are substantial relative to the potential benefits, that would argue for not moving in a certain direction.

Conversely, if we conclude that an action we were to take would have reasonably beneficent effects, and if the forecast on which it is based is wrong, but not likely to have any material negative effects, this is a much more difficult monetary policy procedure than we have had in the past, but we have no choice because it is very clear that the past procedure just didn't work.

Senator Bingaman. Let me ask about one other issue here, and that is the very large trade deficit. I guess the figures this morning are that January of 1997, it was 12.2 billion as compared to 9.6 billion in January of 1996. And I gather it is approaching $200 billion a year, and has now. Some of the concern that I have heard expressed is that there is a direct correlation between the amount of trade deficit we have and the interest rates that are prevalent throughout our society. And to the extent you made the correlation with the Chairman here between interest rates and inflation, is there a similar correlation between interest rates and the strength of the dollar?

I am concerned that the strength of the dollar is such that is contributing to the large deficit and that a change in interest rates could affect the strength of the dollar.

Mr. Greenspan. Well, it is certainly the case that the stronger the dollar, other things equal—and I emphasize other things equal—the greater the trade deficit.

There is no evidence which I find compelling which however suggests that the trade deficit itself has a material effect one way or the other on interest rates. And the reason is that sometimes you have got to balance the deficit or, in a more general sense, the current account deficit which brings in all the other transactions, with the desire to hold dollars.

In other words, the demand for dollars can exist because of people around the world having portfolios, and they decide to move one way or the other. The supply of dollars is largely coming from a number of sources, one of which is because of the current account deficit. Sometimes, when you get a very significant demand for dollars, which drives up the exchange rate for the dollar, it essentially forces an increase in the trade deficit or the current account deficit. And so it is not clear which way the causation is going, and, indeed, I suspect it is going in both directions most of the time. So it is very tough to find a relationship between the trade or current account deficit and interest rates.

It is the case, obviously, that as the dollar strengthens, that import prices, other things equal, do follow, and that does bring down the rate of inflation generally, so that it is not clear exactly how a number of these relationships work. We even tried to filter out all of the factors that we can, and the complexity of the international economic situation is such that it is not easy to make simple judgments.

Senator Bingaman. I think I will stop on that, Mr. Chairman.

Thank you very much.

Representative Saxton. Thank you, Senator.

I would like to now go to Senator Bennett for his questions.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT

Senator Bennett. Thank you, Mr. Chairman.

I want to echo the kind words that have been heaped upon Chairman Greenspan. I notice in all of our debates on the Senate side, when Republicans want to brag about the good economy we give Mr.

Greenspan all of the credit, and the Democrats give the President all of the credit. When the Democrats want to complain about something, they give Mr. Greenspan all of the blame, and the Republicans give the President all of the blame. I don't know where it actually lies, but I am one who is a fan of Mr. Greenspan.

Let me ask you a few questions that maybe are a little unfair, but I am going to take advantage of your being here anyway and try to drag you into a few controversies you may want to avoid. I know from past experience that if you do want to avoid them, you will be able to without any difficulty.

May I ask if you see any significant economic benefit in the proposed $500 tax credit per child?

Mr. Greenspan. Well, Senator, I think you will find that most economists who relate growth to the tax structure find that it is marginal tax rates that matter with respect to economic growth. As a consequence, a credit of the type you are discussing is not, from an economist's point of view, an economic tax, it is for a series of other purposes. And that is for the Congress to make judgments on, not for economists who have sometimes very different points of view.

Senator Bennett. Economically then you don't see any particular benefit from this?

Mr. Greenspan. I have never argued that tax credits per se are superior to reducing marginal rates if growth is the essential purpose of the action.

Senator Bennett. Then let me go to the next one and talk about the rate, tax rate, on capital gains. Would you see benefits to the economy, both in terms of growth and impact on inflation, if we were to lower the rate on capital gains?

Mr. Greenspan. As I am sure you know, Senator, on the basis of some of my past statements, I am not a great fan of the capital gains tax as a means of raising revenue, and, indeed, my general view is that of all taxes which affect economic growth, and that is probably all taxes, the capital gains tax is likely the one which is most inhibiting per dollar of revenue raised.

So I would say right off that I would obviously prefer a capital gains tax which was zero, because I think that revenue should be raised by

other means. But having said that, I do believe that if there were a substantial cut, and more importantly if it were indexed for inflation, that it would contribute to economic growth over the long run.

The difficulty we have is that it is very hard to filter out those effects in econometric models in a way which gives you robust answers, so that one is left to one's judgment as to the way the economy works. In my experience it is clearly supportive of the notion that capital gains tax cuts do affect economic growth in a positive manner.

Senator Bennett. I want to pick up on your reference and make an analogy. I am currently rereading Barbara Tuchman's book, *The March of Folly*, in which she describes throughout history how governments have acted in collective folly, and the final section of her book deals with America losing its way in Vietnam.

The Secretary of Defense in those years, Mr. McNamara, was committed, as he outlines in his own memoirs, to statistical analysis and kept telling us, based on the statistics, that we were doing very well in Vietnam and that there was light at the end of the tunnel and that we were winning the war. People who were relying less on statistics but judgment, based on a long life of experience, kept telling him, there is something wrong in Vietnam, Mr. Secretary, we are losing the war; to which he would inevitably respond, show me the numbers to prove your point of view.

You now read Mr. McNamara's memoirs which I have done, and he now confesses in one of the most heart-wrenching mea culpas of a public man in our generation, just how bad his statistics were and how he should have listened to the sense of judgment.

If I may make that editorial comment, Mr. Chairman, I think the judgment the Chairman has left with us about capital gains, even though some computers at CBO or OMB cannot come up with the statistics, is the correct judgment. And I, for one, would be willing to make a deal with my friends on the Democratic side and give up my support for the $500 kiddy cut if they would give up their opposition to a reduction in the capital gains rate. I think the judgment of experience to observers would tell us the economy would be better off.

With that editorial comment, Mr. Chairman, thank you.

Representative Saxton. Thank you, Senator.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

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

I am pleased to join with the committee to welcome Chairman Greenspan before the Joint Economic Committee this morning.

Mr. Chairman, I have been carrying this: Reading Mr. Greenspan. Stay ahead of the game of interpreting the enigmatic Fed Chairman's body language.

I have been watching you closely this morning, and I don't think you used any of this body language, except I think I caught you once adjusting your eyeglasses with your fingertips.

Mr. Greenspan. Well, what does that mean again?

Senator Sarbanes. That is a wait-and-see posture, so it doesn't get you into trouble here this morning.

Mr. Greenspan. Right.

Senator Sarbanes. The more extreme positions require some real acrobatics, like the vertical leg sit, which is a general warning that things need to cool down. That is where you put your legs up over your head and so forth; the one-armed—the one-handed push-up and so forth.

Mr. Greenspan. I don't know any central banker who can do a one-handed push-up.

Senator Sarbanes. Let me ask you this question. I take it, as I understand your position, you would not favor any tax cut if it were to contribute—in the current economic circumstance, if it were to contribute to an increase in the deficit. I mean you would put reducing the deficit ahead of a tax cut, I take it?

Mr. Greenspan. Senator, I have testified with respect to that issue affirmatively before, and I would continue doing so.

Senator Sarbanes. I see.

Now, I want to make a few observations as a preliminary to the basic question I have to ask.

The Federal Reserve since January of 1996, now for more than a year, has left short-term interest rates unchanged. In my view, evidence continues to point to an economy that is growing at a sustainable pace without evidence of inflation, and I would argue there is no compelling

reason for the Fed to raise interest rates at this time. I know the Board will be addressing that issue in the near future.

Yesterday, the Labor Department announced a CPI increase of three-tenths of a percent in February. The core CPI, excluding volatile food and energy prices, rose two-tenths of a point. That is consistent with the fine inflation performance of the economy over the past 12 months, during which time the overall CPI rose 3 percent. The core CPI rose 2-1/2 percent. Thus, along with the year ending December 1994, that is the smallest such increase in 31 years. So we really are seeing a CPI performance that in historical terms is very impressive.

Gordon Richards, the economist for the NAM, was quoted in this morning's *Washington Post* as saying, there is no need to raise interest rates, and I quote him: The low, stable inflation rates reported yesterday reflect changes in pricing behavior in the 1990s. Industry is holding prices down in order to protect market share.

And there are many who believe that the globalization of the economy and the various trade agreements which have, in effect, broadened the area of free trade make it possible that imports exercise a significant influence on domestic pricing decisions.

This positive CPI report followed last week's report from the Labor Department that the prices charged by American producers fell, four-tenths of a point in February, their largest drop in two and one-half years. Even the core portion of this index, which excludes food and energy goods, dropped a tenth of a percent, the third decline in the past five months. Actually, the so-called core Producer Price Index is only up five-tenths of a percent since last February.

Bruce Steinbarg, a senior economist at Merrill Lynch, said, and I quote, "Despite robust growth during the past two quarters, there is simply no sign of inflation. There is literally no wholesale inflation in the U.S. economy," end of quote.

Now, finally, I want to turn to unit labor costs. Worker productivity grew at the fastest rate in three years at the end of 1996. Unit labor costs, which make up two-thirds of companies' production costs, rose only 1.4 percent in the fourth quarter, down from 3.3 in the previous quarter. A further indication that inflation remains under control is a Labor Department report that the Employment Cost Index, a statistic that you

have indicated in the past you follow with some attention, measures both worker pay and benefits, rose just eight-tenths of 1 percent in the final three months of 1996, the same as in the first half of the year.

Now, fortunately, I think, the Fed has sort of left the economy alone and kept its hands off of it, so to speak. We have seen the unemployment rate below 6 percent now for two and one-half years. Unemployment has remained at about 5.4 percent for the past year, but contrary to all the sort of dire predictions of the natural rate of unemployment people, which were using 6 percent, some even higher, as their benchmark, we didn't see a triggering of inflation, and you have, in past testimony, sort of cast, I think, doubts over that concept.

Now, what I really want to get to is that this sustained period of low unemployment is having very positive effects on the economy, including allowing many workers with fewer skills to find jobs, encouraging firms to give more training to employees already on their payrolls. The expansion now has been sustained long enough that it is reaching into the inner cities, by all accounts. I mean, mayors are now telling you that they are beginning to see it finally getting into their jurisdictions, making a difference. And, of course, we now have a serious challenge on the welfare issue, with the welfare legislation that was passed; and, of course, the question of moving people from welfare to jobs.

Now, *The New York Times* had a lengthy article, you know, discussing whether the reduction in the welfare rolls is because we are making changes in the welfare system or because the economy has functioned very well. And my own view is it is obviously both of those things.

I think efforts to change the welfare system in the context of an economy that is not vigorous and vibrant are going to be very disappointing and very frustrating.

Alice Rivlin, your Vice Chair, said recently in a speech: We are seeing enormous benefits from the tight labor markets. If it turns out we can keep job markets this tight without inflation for a while, the benefits will be very great, which I think runs to these points I was making.

And so my first question is, and it may be the only one—I see the red light is on—do you share the view that a sustained period of economic growth, with low unemployment, therefore, which will give

you some tightening of labor markets, is important if we are going to get workers with fewer skills into jobs, if we are going to get better training of workers who already have jobs, if we are going to be able to move people off of welfare into work?

Mr. Greenspan. Are you asking, Senator, whether I agree with that?

Senator Sarbanes. Yes.

Mr. Greenspan. Yes, I certainly do. I think that Vice Chair Rivlin has expressed it in some detail, and I think she is absolutely right.

That is the reason why I think we should endeavor, as best we can, to sustain this recovery in the solid form that it is for as long as we can, because there are very demonstrable benefits, as best I can judge, in exactly the form which you suggest, Senator.

Representative Saxton. Thank you.

Senator Sessions.

OPENING STATEMENT OF SENATOR JEFF SESSIONS

Senator Sessions. Chairman Greenspan, I also would like to say, as one who has been campaigning this past year and traveling throughout the State of Alabama, that I do feel that there is a healthy economy. In particular, the unemployment rate is low. Business people tell me they are having difficulty finding employees for jobs that they need to fill. I know of companies that are using buses to drive people to their plants. That is good.

What has troubled me a bit, and you began to discuss it seriously, in your remarks, is the fact that wages for average working Americans have not increased. What gives me a little bit of pause is that they are just beginning to show some increase. What gives me some concern is that I seem to be reading a feeling on your part that this is troubling. After maybe years, perhaps because of job insecurity, of wages not having gone up, they are beginning to move. For the first time middle America is beginning to get some benefits out of the growth process that has been going on, and now we may be thinking about shutting it down.

Would you comment on that?

Mr. Greenspan. Sure. The answer is, not at all, I trust. The increases that we have seen in overall compensation, especially since the

middle of last year, look to be matched by increases in productivity. There is some evidence that productivity has been accelerating.

The general point of view, which I have expressed before this Committee and others over the years, is that wage increases don't cause inflation. What causes inflation is costs going up, meaning that wage and other costs not matched by productive gains, will filter into price levels and that ultimately induces economic imbalances which curtail employment growth and create a good deal of hardship.

Our view is that we strongly support maximum increases, not only in production but in real wages, in the sense that the two over the years invariably move together. And so we don't perceive that our fundamental goal of maximum sustainable growth is not consistent with maximum sustainable growth in real earnings.

The issue that I am raising with respect to nominal changes is to try to evaluate the cost and price structure in a manner to see what it is that is potentially creating imbalances which could bring a recovery, a real recovery, to a close. But as far as we are concerned, as much productivity as we can get out of the system and as much real wage growth and purchasing power that we get out of the system, the better.

What we think is counterproductive, however, is nominal wage growth unmatched by productivity growth because what happens then is people get wage increases and they get wiped out by inflation, and they are worse off than they were to begin with. It is that process which we are concerned about and which we are always on the lookout for, to make sure that it does not emerge in any material way.

Senator Sessions. Senator Bennett mentioned your own judgment about things. Having been meeting people throughout my State, my judgment is that middle America, the families who are trying to do right, who are trying to raise the next generation of children that will be taking care of us, are really struggling. That is why the $500 tax credit per child is attractive to me and a lot of others, because we sense it is a good thing.

I hope that as you evaluate the policies you undertake, that maybe you will study some numbers in that regard, because I think when they are properly analyzed you will find that to be true. That is just my judgment.

Let me mention one other thing. I saw an article in *U.S.A. Today* the other day that interviewed people from around the world who were bragging about the United States' economy. The commentator, made several points which I wrote down. One person said that the United States economy is strong because of low taxes, less regulation and a greater commitment to the free market.

Would you agree with that?

Mr. Greenspan. Absolutely.

Senator Sessions. Thank you.

Representative Saxton. Mr. Hinchey.

OPENING STATEMENT OF REPRESENTATIVE MAURICE D. HINCHEY

Representative Hinchey. Thank you very much, Mr. Chairman. Good morning to you, Mr. Chairman.

Mr. Greenspan. Thank you, sir.

Representative Hinchey. You have indicated, again, that, as we all know, the economy has been growing steadily now for six, seven years, and that, of course, is good news.

My concern is that there are still aspects of our population, there are people in our economy, who have not benefited from that. They are principally wage-earners. We were given some evidence of that yet again yesterday on the front page of *The New York Times*. There was this picture of 4,000 people lining up in New York City for 700 advertised jobs.

That indicates that there are still a great many people in this economy who haven't had the opportunity to share the benefits. And that is one of the reasons why many of us are concerned about this theory of 2 percent economic growth, and the idea that seems to be prevalent in some circles is that you can't have growth above 2 percent because if you do, you will be promoting an inflationary situation.

So that is why so much attention, of course, is focused on your meeting yet again, coming up on the 25th, of the Federal Open Market Committee, because we are deeply concerned that a rise in interest rates will choke off the growth that we are currently experiencing and all those people out there, whether or not they have the opportunity to take part in

it, will be denied that opportunity yet again. So I just want to make that statement to you.

We know that there are only two ways for the public sector to influence growth, and that is fiscal policy and monetary policy. And the Congress has, by its actions, denied itself any ability to stimulate fiscal policy because of the budget circumstances and, therefore, all of the ball—the ball is entirely in your court, in the court of the Federal Reserve, and that makes your decisions even more important than they might otherwise be.

I would just like to focus attention on this chart for a moment, because I think that while it may be accurate to interpret it the way you and our Chairman have, there is at least one other way to interpret it, and I would suggest that it might be this: That inflation went up, beginning in 1973, because energy prices went up beginning in 1973, and the long-term interest rates followed because short-term interest rates went up then.

And if you follow the price of energy, you will see it correlates on that chart very, very closely, I would say almost precisely, with the inflation indicators, followed by the long-term interest rates.

So my point, in just drawing attention to this possible interpretation of that chart, is to indicate that there are some people in our economy today who I would argue are fighting the last war, in other words, the economic war of the 1970s, and basing economic decisions on a set of circumstances that were unique to that particular period of time and are not likely to occur again at any time in the foreseeable future. Energy prices are stable and have been for some time.

So that—also in recognition of the fact that just a week or so ago the Chairman had before us the Bureau of Labor Statistics, and they indicated to us that productivity in our economy is rising at a rate of about three times the rate of wage growth, not compensation, because that includes other very high wage-earners, but wage growth is lagging way behind productivity growth, giving another indication, yet again, that inflation is nowhere visible in this economy.

So I would just suggest these ideas to you, and ask you to reflect on them and to reflect on those ideas in the context of your decision-making process and also to respond to the idea that we can afford a growth rate

substantially higher than 2 percent, without inducing the threat of inflation, and thereby allowing large numbers of our population to participate more fully in the economic expansion that we have experienced now over the last six or seven years.

Mr. Greenspan. Congressman, as I have said before, we don't subscribe to any specific limit to growth. What we do look at, as I have mentioned previously in many testimonies before you and your colleagues, is whether, in fact, the economy is balanced or whether it is straining, and what are the conditions that are required to keep the economy in long-term balanced growth? Because it is only if that balance occurs that those who have not participated in this economy as yet—and I agree with you, there are a substantial number—that following up what Senator Sarbanes said, there is no question that if you can keep the economy moving on a solid balanced basis for an extended period of time, you will draw in people to the workforce, give them experience, give them skills, give them the capability of earning a significantly high real wage. That will enable them to maintain a capability even when the economy turns weak, so that there is clearly a very obvious net benefit in doing that.

I don't think there is an argument with respect to what the goal of policy should be. What we all have to do is to try to ask ourselves what policies, both fiscal and monetary, as well as regulatory and other policies, contribute to that goal, because the goal is very clearly worth reaching.

Representative Hinchey. Well, if I may, Mr. Chairman, there is no argument with that, and I know that you appreciate that as well as anyone. And you want to see this economy grow and be healthy and strong, and I don't doubt that for a split second.

What I am suggesting to you is that the economy can grow at a rate faster than 2 percent and if we prevent it, by monetary policy or other actions, from growing at a rate faster than 2 percent, if we deny it the opportunity to grow at the rate of 3 or even 3.5 percent, which is historically not unusual in the post-war period -- we have had much higher rates of growth than that in certain decades, in fact -- that if we deny the economy the opportunity to grow at those higher rates then we are, in fact, at the same time, denying large numbers of Americans the

opportunity to participate in whatever economic growth we are experiencing.

Mr. Greenspan. I would agree with that. I would just argue that it is not Federal Reserve policy, nor should it be, to somehow set a certain limit, a numerical limit, and try to endeavor as best we can to prevent the economy from growing faster than that. I think that would be a mistake.

Representative Saxton. Thank you, Mr. Chairman.

I would like to turn now to Mr. McCrery. And interestingly enough, Mr. McCrery is a major player with regard to our fiscal and tax policy, as he is a member of the Ways and Means Committee, and this is Mr. McCrery's first meeting this term with us.

So welcome aboard, and the time is yours.

OPENING STATEMENT OF REPRESENTATIVE JIM MCCRERY

Representative McCrery. Thank you, Mr. Chairman.

Chairman Greenspan, would you restate your view of the accuracy of the CPI as currently formulated by the Bureau of Labor Statistics?

Mr. Greenspan. We at the Federal Reserve Board, and a number of other economists, have endeavored to determine what type of biases there are in the CPI. It is virtually impossible to conclude after these evaluations that the bias is zero. It is some positive number.

There is great debate, because the numbers are not easy to come by, as to exactly how much of that bias is. It is our judgment at the Federal Reserve Board, on the basis of fairly extensive evaluations by the staff, that the range of that bias is annually a 0.5 to 1.5 percentage points, and that a substantial part of that, approximately half a percent or slightly more, is the result of an inability to correctly capture what we perceive to be improvements in the quality of goods that we produce, and that we fail to capture those quality changes and we allow the increased dollars that people pay for those goods to be reflected in presumably higher prices rather than a more effective technique that captures the increase in quality. And also what we usually combine in that grouping, because we have difficulty separating it elsewhere, is the significant improvement in new products which come on the market and are very rarely priced by the Bureau of Labor Statistics until they have aged quite considerably, which

means that we have lost a significant decline in prices, which almost invariably occurs with new products. If you continuously avoid capturing price declines, you will bias the index upward, so that is in general our conclusion, and we think we are probably in the mainstream of evaluators of the CPI in that regard.

Representative McCrery. If the government annually overstates the Consumer Price Index, is that inflationary?

Mr. Greenspan. No. It is just merely mismeasurement. It may be inflationary, if one presumes that because of it, in the way we index both benefits and taxes in our Federal budget, we get a larger budget deficit which we don't offset, then, yes, you could get an inflationary effect as a consequence of that. But there is no reason in and of itself that mismeasurement, statistical mismeasurement, has very much effect on inflation, that I am aware of.

Representative McCrery. But to the extent that it prevents the government from achieving a balanced budget, it does have an inflationary effect?

Mr. Greenspan. To the extent that the deficit is increased from what it otherwise would be, the answer is yes.

Representative McCrery. Then, in your view, Chairman Greenspan, is it desirable, from an economic standpoint, to have the Bureau of Labor Statistics accurately reflect the Consumer Price Index?

Mr. Greenspan. I most certainly do, Congressman.

Representative McCrery. Then, Mr. Chairman, I know from time to time you have an opportunity to talk to the President, who is in charge of the Bureau of Labor Statistics—I would urge you to mention to him that it is desired for our economy, for the Bureau of Labor Statistics to accurately reflect the Consumer Price Index in this country.

That would help us as policy makers in our efforts to produce a balanced budget, because, as you know, the choices are very difficult under the best of circumstances right now. But certainly if we could get the BLS to do their job, accurately reflect the CPI, it would make our choices, at least at the margin, a little easier, and we could probably get together more easily as a group on both sides of the Hill, on both sides of the aisle, and produce a budget that would be in balance in just a few years.

So you don't have to answer that, but I would urge you to mention that next time you talk to the President.

And just one more comment that I would like to make to you, as you go into your meeting next week, and I think you very well stated the considerations that you will be looking at, but from my experience as a baby boomer and from some acquaintances that I have who are in the generation after mine, I can tell you, just because we have discovered that mutual funds and 401(k) plans and IRAs doesn't mean that we feel any wealthier. We don't.

And I think I can speak for most people in my generation and the following generation. We don't really consider ourselves to be any wealthier. Just because we have some money in mutual funds, and we are continuing to do that for retirement, doesn't mean that we are going to go out and buy a new car or even a new house. We are not wealthier. We are saving for retirement, perhaps because of doubts about the Social Security system.

But more, I think, simply because we are better educated as to the realities of retirement and the availability, frankly, of some tools that policy makers in Washington have provided the marketplace.

So keep that in mind as you meet next week.

Mr. Greenspan. Thank you.

Representative Saxton. Mrs. Maloney.

OPENING STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY

Mrs. Maloney. Thank you, Mr. Chairman.

First, I would like to welcome Mr. Greenspan, who used to be, formerly was a resident of the great State of New York, the great City of New York.

First of all, I would like to commend you, Chairman Greenspan, and I commend the Fed, for beginning to promptly issue its announcement on monetary policy changes, which it began in February of 1994. The delay in its verbatim transcripts, which you have agreed to publish, only with a five-year lag, is long overdue.

What the public and the markets get instead are reported statements from Fed officials and staffers, which often destabilize markets and produce uncertainty.

Here are some of the reported statements that reached money market professionals during the last two months in anticipation of Fed action at the FOMC meeting next Tuesday. And I would like to give the quotes with the approximate dates:

On March 17th, San Francisco Federal Reserve Bank president, Robert Perry, said, and I quote, "The U.S. economy should grow more moderately, and that the question is whether more moderate growth can be achieved at the current level of interest rates," end quote.

March 14th, a voting FOMC member reportedly said there was, and I quote, "Increased concern about the higher pace of activity," end quote. And a Fed staffer reportedly said, and I quote: "There comes a point when you lose patience with the strength of the economy," end quote.

February 14th, a Federal source asked what they were waiting for, responded, and I quote, "That was a good question, but said that he was not sure we know," end quote.

February 14th, another Fed source said, I presume it was an FOMC member—and I quote, "Need 1.5 percent economic growth to feel comfortable," end quote.

And my question to you is: Please explain to me why the Fed has so many talking heads in a period of great uncertainty about future economic actions and how the public should interpret these actions? Why are there so many talking heads and why are we having such a long lag period on published material?

Mr. Greenspan. Well, to answer your last question first, we do publish in some detail the minutes of our meetings discussing the nature of the deliberations, what transpired during the Committee meeting and how we concluded it and why. What is missing is the detailed verbatim transcript, which you will find that if you match the minutes and the verbatim transcript, you don't learn terribly much more except who said what about certain things. But so far as to the reasons why the Fed did or did not act, I think, are fully explained for all reasonable purposes in the minutes.

The reason we have a five-year delay is that it has been my experience and everybody's experience that you tend to inhibit the give and take within a meeting if people know they are speaking on the record. I wish it were otherwise. I wish that that did not occur. It does. And as

a practical matter, if we want to be as effective as we can be within the meetings, it is important that the verbatim transcript be delayed significantly.

With respect to the other issue, what you call, chattering heads or whatever, that is a dilemma, and the dilemma basically is that on the one hand, it is important that our FOMC members convey to the public what is going on in their districts.

It is usually not staff people who talk. Staff people tend to be somewhat more restrained. But it is certainly the case that we encourage the Presidents of the regional Banks to go out into their districts, talk to people, make speeches, discuss what is going on, because what we do is sufficiently complex and arcane that the last thing for us to convey is some sense that we are some form of secret organization that does everything in secret and not tell anybody why we do anything. We get that impression, and I think that is most unfortunate, but it is very important that we try to offset that as best we can.

The downside of that is that periodically you get chattering heads, and if you ask me do I know what to do about it, the answer is, no, I don't. If you have a suggestion, I will be very delighted to hear what you might suggest we can do for for it.

Mrs. Maloney. My time is up, but may I request one brief additional question? I am wanted on the Floor for a Rule debate that we are having right now.

Very, very briefly, Chairman Greenspan, at the March 5th, 1997 Humphrey-Hawkins hearing, I posed the following question: The Federal Reserve estimates 2 to 2.5 percent growth in real output, and the Administration also predicts slow growth of 2 percent.

You, Chairman Greenspan, have said that the Consumer Price Index, the CPI, may overstate inflation by as much as 1.5 percent, so that the 3.2 percent recorded CPI inflation for 1996 may have been as low as 1.7 percent in 1996.

The Nation is predicted to have slow growth in 1997, with low inflation. Under these conditions, why would you tell us, in your prepared testimony at the Humphrey-Hawkins hearings, that the Fed is contemplating a preemptive strike in order to drive up short-term interest rates?

I have prepared a graph of CPI inflation from 1962 to February 1997, with the 1.5 percent points subtracted from the inflation rate, according to the bias you have suggested, and this chart clearly shows that the long period of low inflation, from the recession of 1990 to the present, has not occurred since the early 1960s.

With the 1.5 percent adjustment, the recent period has been a period of very low inflation. Would you agree that under these conditions, a restrictive Fed policy could turn into a contraction, an economic contraction?

And it really shows the same numbers as yours, only the 1.7 percent that you projected, which is extremely low in the 60s and currently now. [The charts submitted by Mrs. Maloney appear in the Submissions for the Record.]

Mr. Greenspan. The answer to your question is that if we perceived that we were engaged in a restrictive Federal Reserve policy action which led to a recession, that would be an inappropriate policy, in my judgment.

Representative Saxton. Thank you, Dr. Greenspan.

Mr. Manzullo.

OPENING STATEMENT OF REPRESENTATIVE DONALD MANZULLO

Representative Manzullo. Thank you, Mr. Chairman.

Chairman Greenspan, it is good to see you here this morning.

In the talk about the CPI, which is used as the basis for cost-of-living increases, for increasing rentals, et cetera, I didn't fully read the Boskin Commission Report but I read through enough of it, and as I examined it —perhaps if I am wrong, you can correct me—if an individual's real estate taxes on his or her home is increased, that does not show up on the CPI, would you agree with that?

Mr. Greenspan. I am not sure that is true.

We have a mixed discussion here, which concluded nothing of great moment.

It is a tricky question as to where—how it gets—see, I think the point at issue is that we have an item called Owners Equivalent Rent—

Representative Manzullo. Right.

Mr. Greenspan.— in the CPI that is measured by the reporters from the Bureau of Labor Statistics going out and evaluating single-family residences—residences which have the characteristics of owned homes but are, in fact, rented.

Now, when real estate taxes go up, to the extent that they filter into the rent of those homes, as ultimately they must, then the answer is yes, it does move into the CPI.

If you are saying, does the actual tax increase as a raw number add directly to the CPI, the answer is no. It is only through this indirect means which affects the total rental payment of those types of units which are comparable to owned units, but are, in fact, rented that it adds to the CPI.

Representative Manzullo. Okay. I didn't mean it to be a trick question, and obviously, I don't know how many economists it takes to agree on or disagree on something. The scenario is as follows: Real estate taxes are climbing in most communities at more than 2 or 3 percent a year.

The city I represent is under a Federal court-order on integration, and some have been spiked 30 and 40 percent. And many of the homes become worth less, because people don't want to buy them. And yet, people don't want to sell. And they are normally seniors who are on fixed incomes, who are now paying more real estate taxes, and their homes are worth less. So if the homes are worth less, that shows a decrease in the cost of homes and, therefore, a decrease in inflation, when, in fact, the seniors are paying more in taxes because they don't want to leave their homes and because they are on fixed incomes. To take the CPI and say it is overstating the rate of inflation, in my estimation, would be unfair to the seniors who are in that position.

Could you comment on that, Dr. Greenspan?

Mr. Greenspan. Sure. The actual value of homes doesn't go into the CPI.

Representative Manzullo. But the sale price does, of homes.

Mr. Greenspan. The sale price does?

Representative Manzullo. The rental equivalent.

Mr. Greenspan. Yes, the rental equivalent.

Representative Manzullo. But that could lag as far as one year behind—

Mr. Greenspan. Yes.

Representative Manzullo.— an increase in taxes.

Mr. Greenspan. It is only to the extent that the value of homes falls. If the value of homes falls and the landlord lowers the rent as a consequence of that, then that will appear in the CPI. But the value of homes per se does not directly affect the CPI.

Representative Manzullo. But the landlord in that case would be increasing the rent, because—

Mr. Greenspan. He would.

Representative Manzullo.—because his property is worth less, but his taxes are going up more.

Mr. Greenspan. Well, if the taxes are going up more and his costs are going up more, then, yes, the costs of real estate taxes that embodies itself in the value of rental properties will ultimately filter into the CPI, and in that sense, all indirect taxes, one way or another, will find their way into the general price level.

Representative Manzullo. Including increases in state and local taxes?

Mr. Greenspan. And sales taxes.

Representative Manzullo. Sales taxes, et cetera.

Mr. Greenspan. That is true.

Representative Manzullo. But is there a better way to measure the rate of inflation in the example that I gave, or would there be another tool or factor to put into the CPI to give us a better idea as to what the inflation is in the scenario that I gave you?

Mr. Greenspan. You mean "X" taxes, in effect. Because there is a series of price indexes, which are published by the Department of Commerce, which combine a lot of different data in which you can account the effect of indirect taxes, which includes real estate, sales taxes and other taxes, on the price level. And there is a price index which one can calculate, which is "X" tax. And, indeed, I think you are quite right in that regard, that if you look at it, it shows a lower rate of inflation than the actual published numbers.

Representative Manzullo. Thank you, Doctor.

Representative Saxton. Thank you, Mr. Manzullo.

Just for anybody who may be interested, there have been a lot of questions and references made to the CPI issue today. Just for the Members' information, Dr. Abraham of the Bureau of Labor Statistics has agreed to give us a response to the Boskin Commission Report, in a report that we hope will be issued sometime this summer. So it will be interesting to review this complicated issue again in light of that report.

Mr. Sanford.

OPENING STATEMENT OF REPRESENTATIVE MARK SANFORD

Representative Sanford. Yes, sir.

Thank you for being here, and thank you for your hand on the tiller of the price stability that we have enjoyed here over the last couple of years.

I want to follow up, though, with Senator Bennett's thoughts inasmuch as we are talking about long-term trends. In your conversations one of the things that you had said was that according to many economists, and you seem to include yourself in that bracket, marginal tax rates are what matter most to economic growth. And what I was wondering was, inasmuch as present Social Security taxes are the largest tax that 70 percent of Americans pay, are they right now a drag on economic growth?

Mr. Greenspan. All taxes are a drag on economic growth. It is only a question of the degree to which that occurs.

Clearly, one can evaluate it relative to the example of European countries, where the taxes are significantly higher and where they obviously are having considerable difficulty reducing unemployment.

The evidence in the United States is that while, as I said almost of necessity, any tax is an inhibition—an inhibitor to growth and to employment—it certainly doesn't appear that, relative to other countries, our burdens are as yet at a level which creates some really serious concerns.

Representative Sanford. The Social Security tax would be a tax on employment, to what degree do you think this, percentage-wise, hurts our present rate of employment?

Mr. Greenspan. It is difficult to say, because the unemployment rate is really as low as it has been for quite a long period of time. So you have to argue that the unemployment rate would be significantly lower than it is today, and I don't know what that number would be.

Representative Sanford. A couple tenths of a percent, or are we talking a percent?

Mr. Greenspan. I really would hesitate to say, largely because it is a complex question and it requires a number of different assumptions which I feel uncomfortable with.

The only thing I can do is attest to the direction. I think the implication of your question is quite correct.

Representative Sanford. I have here a copy of your speech in Philadelphia back in December, in which you addressed Social Security in a larger context. One of the things that you were concerned about in that speech was the unfunded liability that exists for the next generation. Specifically you touched on the savings rate, and how we clearly have a problem in terms of the low savings rate in this country.

Some people have suggested that the idea of a personal savings account, quasi-privatization, might be a way of doing something about the savings problem we have in this country. What are your thoughts on that?

Mr. Greenspan. Well, I think that people are starting to feel less and less secure about the future of the Social Security system, and that insecurity is inducing them to save more. I mean, your colleague, Mr. McCrery, was saying, and I think quite correctly, that a lot of apparent monies coming from 401(k)s and mutual funds are not going into consumption; they are going into increased retirement saving because there is a growing concern that the system is—

Representative Sanford. But clearly given our saving rate, relative to a whole host of other countries around the world, we have a very real problem in terms of saving rate?

Mr. Greenspan. Yes.

Representative Sanford. I hear younger folks in my District that they feel that you can only squeeze but so much blood from a turnip, and that given the amount of money they are already saving through the

Social Security system, they have nothing left over for any additional savings.

What else would you think, in terms of either reconfiguring the present Social Security system or alternative means toward increasing the saving rate, which, again, by world standards is relatively low?

Mr. Greenspan. That is one of the issues that frustrates us more than anything. We have, as you are surely aware, gone through program after program in an endeavor to find a mechanism to increase the household saving rate. And so far, you have got to conclude that with all the new tax devices, all the new fiscal devices, it is not so terribly evident that at the end of the day we have had all that much success.

But the issue is so important that we have got to keep focusing on it and try to find effective ways to do it, because there is a very large payoff at the end of the day. And it may well be that the mere increasing insecurity with respect to potential long-term Social Security benefits may inadvertently be the factor which finally funds the retirement system and not just the—

Representative Sanford. One last question, if I may, Mr. Chairman. While I know that public saving basically equals private savings some people have argued that the $350 billion a year income stream that now goes through Social Security might be more effectively invested in our own economy through the private markets. Would you agree with that, or no?

Mr. Greenspan. The question is not so much what it is invested in but whether or not it is fully funded. One of the advantages of private systems, as distinct from Social Security, as I indicated in that speech, is that one is an intergenerational transfer, that is Social Security, whereas all sorts of private retirement plans require that you fully fund the system, and other things equal, that will increase the saving rate.

Representative Sanford. Thank you, Chairman Greenspan.

Thank you, Mr. Chairman.

Representative Saxton. Dr. Greenspan, you have been very generous with your time, and we are going to finish here in just a few minutes, but I would just like to take an opportunity to try to dispel a notion that is prevalent, at least with some, and Mr. Hinchey has one short question and then we will be finished.

Let me just pursue this with you, just for the purpose of clarification for the public, anybody who is here that is interested, and I hope I am doing this correctly. Is it fair to say that your primary objective, among others, but your primary objective is to target inflation and to pay only secondary attention to the growth rate of our economy?

Mr. Greenspan. I wouldn't quite put it that way, Mr. Chairman. The reason I wouldn't is that we obviously are concerned about what the economy is doing. If we, for example, saw the economy weakening or an economy which required support, we would take out insurance, as we did last January 1996, when the economy continued to soften and we decided that it was desirable to move interests rates a notch lower, because we thought that even though the growth probabilities were fairly solid, that the risks balanced in such a manner that we did address that.

What I was saying before is the crucial question of long-term balance and sustainability of growth, and in that regard, what we tend to focus on is to make sure that the inflation rate stays down, because as the years go on it has become increasingly persuasive that a substantial amount of the solid growth that we have been getting, without imbalances, is the result of a low inflation rate. And it is our judgment that if we allow that to get away, we will at the end of the day find that we have set in motion a set of forces which will bring the long-sustained stable recovery to an end.

So it is a combination of trying to make the appropriate balance, and that is the type of development of monetary policy which we have evolved over the years, on the basis of experiences with monetary policy, which have not been wholly favorable in retrospect. In other words, we hope we are learning from experience.

Representative Saxton. Is it fair to say that your primary goal is to focus on inflationary characteristics within our economy to try to primarily control that factor?

Mr. Greenspan. I would say that our primary goal is maximum sustainable economic growth, with the emphasis on the word "sustainable," and that, in our judgment, a necessary condition for that to occur is to keep the inflation rate down and to move toward stable prices.

Representative Saxton. So that price stability is an obvious goal which you try to target?

Mr. Greenspan. Yes, it is a goal which is that we direct our actions toward because we need that to sustain long-term economic growth, which is our primary objective.

Representative Saxton. Now, let me turn this question slightly and ask it this way: There are those who are fearful, and read into some statements by some, that a high rate of economic growth is a cause of inflation and, therefore, the Fed looks at some level of growth—2.5 percent was mentioned this morning—as creating a danger to inflation and, therefore, you use the rate of growth as a target to prevent inflation from taking place.

Mr. Greenspan. We do not, Mr. Chairman.

Let me say what it is that long-term growth depends on. You know there are a lot of minor qualifications. It is fundamentally and algebraically related to the sum of the rate of growth in the labor force or working population, plus the rate of growth in productivity.

You could affect the first somewhat. Immigration policy obviously affects it. Issues of the degree of the number of discouraged workers and skills affect it, but you are not going to affect it much. That is fundamentally a population issue.

The real growth debate gets down to the question of productivity. As I said to you before, we don't know what the productivity growth rate is because we don't yet know what price level biases there are in the system. But our view is that we endeavor to translate the maximum sustainable growth notion into maximum sustainable productivity growth, because that is the real mover in the system.

I see no policy which makes any sense which says that don't allow productivity to grow more than X. I mean, I do not get it. What would be the purpose of doing that?

What we want to do is to create an environment in which productivity continues to grow, continues to increase and sustain real wage growth and is not subject to significant volatility. So we are often in a condition where the economy becomes highly unbalanced and turns down; it is that type of condition which we try to avoid by maintaining balance in the system. What we respond to are evidences of potential imbalances arising, not to the issue of what the growth rate is.

Representative Saxton. Well, Mr. Chairman, what you have just explained certainly appears to have worked over the period since the last quarter of 1991, and this period of economic growth that we have experienced.

Just let me ask you quickly, as I know you know, Senator Mack and I had introduced in the last Session, and are preparing to introduce again in this Session, a bill which is intended to make permanent the policy that you have demonstrated works vis-a-vis the Fed.

Have you looked at the bill and do you have any suggestions, pro or con?

Mr. Greenspan. I haven't looked at the bill since the last time it was brought forth, and we did convey to you and to Senator Mack some views as to how certain things might be worded. I do think that what we would like to do is to try to construct language which effectively reproduces what we think works as monetary policy, and rather than have specific numerical goals or things of that nature, which sometimes are difficult, and thus to have a legislative vehicle which you feel accomplishes your goal but is, in our judgment, consistent with exactly the way we do things, so that there is no miscommunication as to what the Congress wants us to do.

Representative Saxton. Thank you.

Mr. Hinchey, we have, it looks like, a series of votes underway. So, Mr. Hinchey has asked that he ask one final, hopefully quick question, so that we can adjourn.

Representative Hinchey. Very quick.

Mr. Greenspan. Very well.

Representative Hinchey. Mr. Chairman, the Bureau of Labor Statistics has indicated that over the last year real wages have grown at six-tenths of a percent and productivity has grown at 1.5 percent, almost three times as fast. What do those numbers tell us about the presence of inflation in the present economy? And also, what do you estimate the real growth of our economy has been over the course of the last 12 or 18 months?

Mr. Greenspan. First of all, for reasons I have discussed before, I think both of those numbers are underestimates, but the gap between them is not. And that gap is reflecting, I think, a rise in profit margins,

which occurs in a cyclical form. They go up and they go down, and you will often find that a chart of real wages and productivity, both using the same types of deflation procedures, will, over the long run, move together, although they will diverge in cyclical periods reflecting the fact that the share of income going to profits sometimes goes up, sometimes goes down, but over the long run tends to be reasonably stable.

I am sorry, the second part of your question was?

Representative Hinchey. The second part of it—excuse me. The second part of the question—let me just indicate that that—we have seen this divergence now apparently since at least 1981, and a growing divergence between productivity and real wages.

Mr. Greenspan. Yes. Part of that is the fact that the real wages are deflated by the Consumers Price Index, but the productivity data are deflated by the gross domestic product deflator, which includes a lot of computers and a lot of items where the prices are falling, so that what is happening is you are getting a distortion between the data.

If you use the same price indexes to deflate both productivity and real wages, then the gap closes virtually completely. So it is a statistical problem which we have in trying to decide exactly which of the appropriate price indexes to use.

Representative Hinchey. Would you be kind enough to supply me and maybe the other Members of the Committee with those numbers?

Mr. Greenspan. Certainly.

[Response from Mr. Greenspan to Mr. Hinchey appears in the Submissions for the Record.]

Representative Hinchey. And instruct us how you believe the Bureau of Labor Statistics is wrong about the numbers that they are promulgating?

Mr. Greenspan. No, they are not wrong, but they are just --

Representative Hinchey. Well, do not agree with your approach.

Mr. Greenspan. Certainly.

Representative Hinchey. My other question, Mr. Chairman, finally, was can you tell us what you estimate the real growth in the economy, given this argument about the CPI—

Mr. Greenspan. Yes, I—

Representative Hinchey. —what is your estimate of real growth in the economy, given your argument over the last 18 months?

Mr. Greenspan. As I said, I think it was to Senator Bingaman earlier on, what I would do is to take whatever bias you believe exists in the CPI, lower it a little bit, because the bias is less for the total gross domestic product deflator, and that number is as good an estimate as I would know to add to whatever other trend value of growth one would perceive as appropriate.

But I want to emphasize that we don't drive policy on the basis of those numbers. Our view is that our policy focuses only on the issue of perceived imbalances that can affect the economy.

Representative Hinchey. Could you give us that number?

Mr. Greenspan. Well, the point is that we don't have a specific number.

Representative Hinchey. How can you --

Mr. Greenspan. Mr. Hinchey, I have avoided using that number for years. And the reason is that I don't believe it is a meaningful number which policy is based on, and I am certain that if I were to give you a number, or even a range, I would be saddled with that and be spending the rest of my life explaining why it doesn't mean anything.

Representative Hinchey. Exactly.

Representative Saxton. Why don't you use—

Representative Hinchey. That is exactly the point.

Representative Saxton. Why don't you just use the two fingers on the glasses approach. That is it.

Thank you.

Mr. Sanford has one final, final question.

Representative Sanford. Some people have suggested that there are significant storm clouds out on the horizon, given what you have described as irrational exuberance in the stock market. I think that that was a warranted statement. How significant do you see those storm clouds?

Mr. Greenspan. Well, they are not necessarily dangerous. They are merely a reflection of the fact that the overall rate of risk premiums has fallen in the economy, and that incidentally is a partial consequence of the inflation rate being as low it is as. So I wouldn't want to argue that

lower-risk premiums per se are undesirable, because, clearly, high-risk premiums are undesirable.

Representative Sanford. Right.

Mr. Greenspan. The only issue that I think we have to be aware of is the fact that we want to sustain those and that history suggests that you have to be quite vigilant in looking at the future to make certain that they are sustained. And that is an important lesson that history continuously throws in our face. And I think we would be mistaken if we didn't remember that it is not a natural phenomenon to have low-risk premiums. It requires vigilance to keep the inflation rate down.

Representative Sanford. Thank you, sir.

Representative Saxton. Dr. Greenspan, thank you for being so generous with your time this morning. We appreciate it, and we will look forward to visiting with you on these matters again, hopefully, sometime in the near future.

Thank you for being with us.

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

[Whereupon, at 12:10 p.m., the Committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

It gives me great pleasure to welcome Federal Reserve Chairman, Alan Greenspan, to testify before the Joint Economic Committee about the Economic Outlook and Monetary Policy.

In the past several years the US economy has experienced continued, though moderate, expansion with the notable feature of stable and lower inflation. Another conspicuous characteristic of the expansion has been it's longevity; it has persisted for more than 60% longer than the average postwar expansion. This has occurred despite both tax increases in 1990 and 1993, as well as increased regulatory burdens.

I believe the fact that the recovery has been sustained while inflation has abated is neither a coincidence nor an accident. **One of the key benefits of lower inflation has been that it has fostered a sustained recovery.**

Specifically, credible disinflation works to lower interest rates, stabilize financial markets and interest sensitive sectors of the economy, promote efficient workings of the price system, and in many ways, works like a tax cut. All of these effects contribute to promoting the sustainability of the expansion.

But the manner in which disinflation is managed also is important in sustaining the expansion. With a focus on price stability, the Federal Reserve has adopted a "gradualist" approach to squeezing inflation out of the system. By not attempting to achieve price stability too quickly so as to jolt or shock the economy into a slowdown, monetary policy has sustained the expansion. In short, monetary policy has contributed significantly to sustaining the expansion by pursuing price stability in a gradualist manner. Certainly, it appears that the Federal Reserve has done a competent job, at least to date.

Because of the importance of price stability, I , along with some of my colleagues, have sponsored and plan to reintroduce a bill allowing the Federal Reserve to focus on price stability as it's primary policy goal.

This would allow the Federal Reserve to continue to pursue price stability with its many benefits without conflicting objectives. With inflation low, now is an opportune time to lock-in our many gains and institutionalize this key policy objective. Several other countries have successfully adopted this strategy and, in fact, the approach has been endorsed by several key officials of the Federal Reserve System.

Of course, there are many well-known problems attempting to accurately measure price stability and we look forward to your insights on this question as well as to your comments on monetary policy in general.

Again, we welcome you and look forward to your testimony.

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

Mr. Chairman and members of the Committee, I am pleased to appear here today. Last month, the Federal Reserve Board submitted its semiannual report on monetary policy to the Congress. That report and my accompanying testimony covered in detail our assessment of the outlook for the U.S. economy. This morning, I would like to highlight some of the key aspects of the current economic stiuation.

As I told the Congress last month, the performance of the U.S. economy remains quite favorable. Real GDP growth picked up to more than three percent over the four quarters of 1996. Moreover, recently released data suggest that activity has retained a great deal of vigor in early 1997. In addition, nominal hourly wages and salaries have risen faster than prices over the past several quarters, meaning that workers have reaped some of the benefits of rising productivity and thus gained ground in real terms. Outside the food and energy sectors, increases in consumer prices have actually continued to edge lower, with core CPI inflation of only 2-1/2 percent over the past twelve months.

The low inflation of the past year is both a symptom and a cause of the good economy. It is symptomatic of the balance and solidity of the expansion and the evident absence of major strains on resources. At the same time, continued low levels of inflation and inflation expectations have been a key support for healthy economic performance. They have helped to create a financial and economic environment conducive to strong capital spending and longer-range planning generally, and so to sustained economic expansion. These types of results are why we stressed in our monetary policy testimony the importance of acting promptly – ideally pre-emptively – to keep inflation low over the intermediate term and to promote price stability over time.

For some, the benign inflation outcome of the past year might be considered surprising, as resource utilization rates – particularly of labor – have been in the neighborhood of those that historically have been associated with building inflation pressures. To be sure, nominal hourly labor compensation, especially its wage component, accelerated in 1996.

But the rate of pay increase still was markedly less than historical relationships with labor market conditions would have predicted.

Atypical restraint on compensation increases has been evident for a few years now. Almost certainly, it reflects a number of factors, including the sharp deceleration in health care costs and the heightened pressure on firms and workers in industries that compete internationally. Domestic deregulation has also intensified the competitive forces in some industries. But as I outlined in some detail in testimony last month, I believe that job insecurity has played the dominant role. For example, in 1991, at the bottom of the recession, a survey of workers at large firms by International Survey Research Corporation indicated that 25 percent feared being laid off. In 1996, despite the sharply lower unemployment rate and the tighter labor market, the same survey organization found that 46 percent were fearful of a job layoff.

Whatever the reasons for its persistence, job insecurity cannot suppress wage growth indefinitely. Clearly, there is a limit to how long workers will remain willing to accept smaller increases in living standards in exchange for additional job security. Even if real wages were to remain permanently on a lower upward track than otherwise as a result of the greater sense of insecurity, the rate of change of wages would revert at some point to a normal relationship with price inflation. The unknown is when a more normal pattern will resume.

Indeed, the labor markets bear especially careful watching for signs that such a process is under way. So far this year, the demand for labor has stayed strong. Payroll employment grew briskly in January and February, and the unemployment rate remained around 5-1/4 percent – roughly matching the low of the last cyclical upswing, in the late 1980's. Also, initial claims for unemployment insurance remained low into March. In addition, the percentage of households telling the Conference Board that jobs are plentiful has risen sharply of late, which suggests that workers may be growing more confident about the job situation. Finally, wages rose faster in 1996 than in 1995 by most measures – in fact, the acceleration was quite sizable by some measures. This, too, raises questions about whether the transitional period of unusually slow wage gains may be drawing to a close. In any event, further increases in labor

utilization rates would heighten the risk of additional upward pressure on wage costs, and ultimately prices.

To be sure, the pickup in wage gains to date has not shown through to underlying price inflation. Increases in the core CPI, as well as in several other broad measures of prices, have stayed subdued or even edged off further of late. As best I can judge, faster productivity growth last year offset the pressure from rising compensation gains on labor costs per unit of output. And non-labor costs, which are roughly a quarter of total consolidated costs of the nonfinancial corporate sector, were little changes in 1996.

Owing in part to this subdued behavior of unit costs, profits and rates of return on capital have risen to high levels. As a consequence, a substantial number of businesses apparently believe that, were they to raise prices to boost profits further, competitors with already ample profit margins would not follow suit; instead, they would use the occasion to capture a greater market share. This interplay is doubtless a significant factor in the evident loss of pricing power in American business. Intensifying global competition may also be limiting the ability of domestic firms to hike prices as well as wages.

Competitive pressures here and abroad should continue to act as a restraint on inflation in the months ahead. In addition, crude oil prices have largely retraced last year's run-up, and, with the worldwide supply of oil having moved up relative to demand, future markets project stable prices over the near term. Food prices should also rise less rapidly than they did in 1996 as some of last year's supply limitations ease. Nonetheless, the trends in the core CPI and in broader price measures are likely to come under pressure from a continued tight labor market, whose influence on costs will be augmented by the scheduled increase in the minimum wage later in the year. And, with considerable health-care savings already having been realized, larger increases in fringe benefits could put upward pressure on overall compensation. Moreover, although non-oil import prices should remain subdued in 1997 as the sharp rise in the dollar over the past year-and-a-half continues to feed through to domestic prices, their damping effects on U.S. inflation probably will not be as great as in 1996.

The lagged effects of the increase in the exchange value of the dollar will also likely restrain real U.S. net exports this year. In addition, declines in real federal government purchases should exert a modest degree of restraint on overall demand, and residential construction will probably not repeat the gains of 1996. On the other hand, financial conditions overall remain supportive to the real economy, and creditworthy borrowers are finding funding to be readily available from intermediaries and in the securities markets. Moreover, we do not see evidence of widespread imbalances either in business inventories or in stocks of capital equipment and consumer durables that would lead to a substantial cutback in spending.

The trends in consumer spending on items other than durables also look solid. Retail sales posted robust gains in January and February, and, according to various surveys, sentiment is decidedly upbeat. Moreover, consumers have enjoyed healthy increases in their real incomes over the past couple of years, along with the extraordinary stock-market driven rise in their financial wealth.

Should the higher wealth be sustained, it could provide important support to consumption in 1997. But, looking at the data through 1996, the surging stock market does not seem to have imparted as big a boost to spending as past relationships would have predicted. The lack of a more substantial wealth effect is especially surprising because we have also seen a noticeable widening in the ownership of stocks over the past several years. Indeed, the Federal Reserve's recently released Survey of Consumer Finances suggests that of the total value of all families' holdings of publicly traded stocks and mutual funds, the share held by those with incomes below $100,000 (in 1995 dollars) rose from 32 percent in 1989 to 46 percent in 1995.

It is possible, however, that the wealth effect is being offset by other factors. In particular, families may be reluctant to spend their added wealth because they see a greater need to keep it to support spending in retirement. Many have expresses heightened concern about their financial security in old age, in part because of growing skepticism about the viability of the Social Security system. This concern has reportedly led to stepped-up saving for retirement.

The sharp increase in debt burdens in recent years may also be constraining spending by some families. Indeed, although our consumer survey showed that debt usage rose between 1992 and 1995 for almost all income groups, changes in financial conditions were not uniform across families. Notably, the median ratio of debt payments to income for families with debt – a useful measure of the typical debt burden – held steady or declined for families with incomes of at least $50,000, but it rose for those with incomes below $50,00. We don't know whether these latter families took on the additional debt because they perceived brighter future income prospects, or simply to accelerate purchases they would have made later. Nonetheless, these families are probably the most vulnerable to disruptions in income, and the rise in their debt burdens is likely to make both borrowers and lenders a bit more cautious as we move forward.

Both household and business balance sheets have expanded at a pace considerably faster than income and product flows over the past decade. Accordingly, any percentage change in assets or liabilities has a greater effect on economic growth than it used to. However, identifying such influences in the aggregate data is not always easy. At present, the difficulty is compounded by concern that the currently published national statistics may not provide an accurate reading of the trends in recent years, especially for productivity.

In any event, other data suggest that wealth and debt effects may be exerting a measurable influence on the consumption and saving decisions of different segments of the population. According to the Consumer Expenditure Survey conducted by the Bureau of Labor Statistics, saving out of current income by families in the upper-income quintile evidently has declined in recent years. At the same time, Federal Reserve estimates suggest that the use of credit for purchases has leveled off after a sharp run-up form 1993 to 1996, perhaps because some families are becoming debt constrained and, as a result, are curtailing their spending.

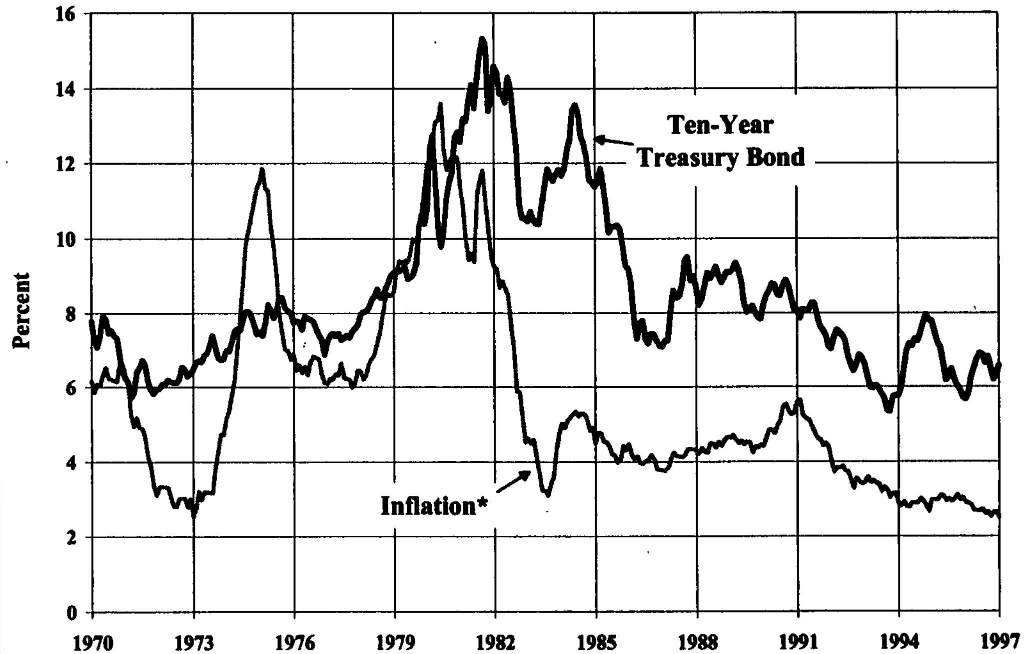
The Federal Reserve, of course, will be weighing these and other influences as it makes future policy decisions. Demand has been growing quite strongly in recent months, and the FOMC, at its meeting next week will have to judge whether that pace of expansion will be maintained, and, if so, whether it will continue to be met by solid productivity growth,

as it apparently has been – official figures to the contrary notwithstanding. Alternatively, if strong demand is expected to persist, and does not seem likely to be matched by productivity improvement, the FOMC will have to decide whether increased pressures on supply will eventually produce the types of inflationary imbalances that, if not addressed early, will undermine the long expansion.

Should we choose to alter monetary policy, we know from past experience that, although the financial markets may respond immediately, the main effects on inflationary pressures may not be felt until late this year and in 1998. Because forecasts that far out are highly uncertain, we rarely think in terms of a single outlook. Rather, we endeavor to assess the likely consequences of our decisions in terms of a reasonable range of possible outcomes. Part of our evaluation is to judge not only the benefits that are likely to result from appropriate policy, but also the costs should be wrong. In any action– including leaving policy unchanged – we seek to assure ourselves that the expected benefits are large enough to risk the cost of a mistake.

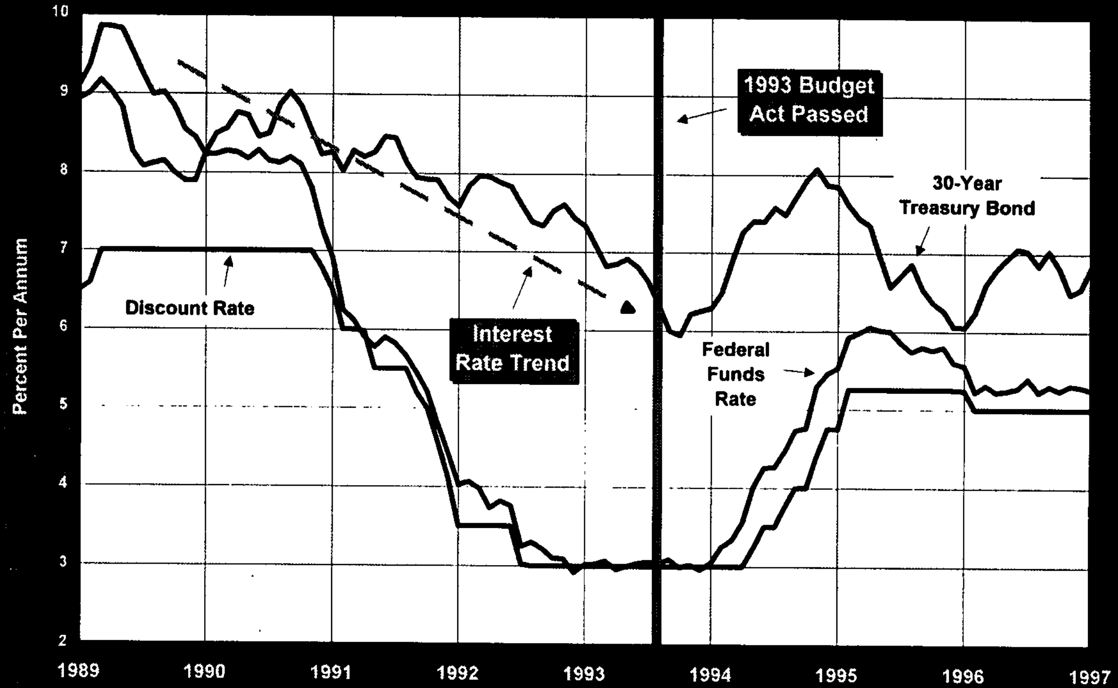
In closing, I would like to note that the current economic expansion is now entering its seventh year. That makes it already a long upswing by historical standards. And yet, looking ahead, the prospects for sustaining the expansion are quite favorable. The flexibility of our market system and the vibrancy of our private sector remain examples for the whole world to emulate. We will endeavor to do our part by continuing to foster a monetary framework under which our citizens can prosper to the fullest possible extent.

Inflation vs. Long-Term Interest Rates



Source: Federal Reserve Bank of St. Louis.

* CPI Core Rate year-over-year percent change with monthly data.



Source: Federal Reserve Bank of St. Louis.

Chart 1

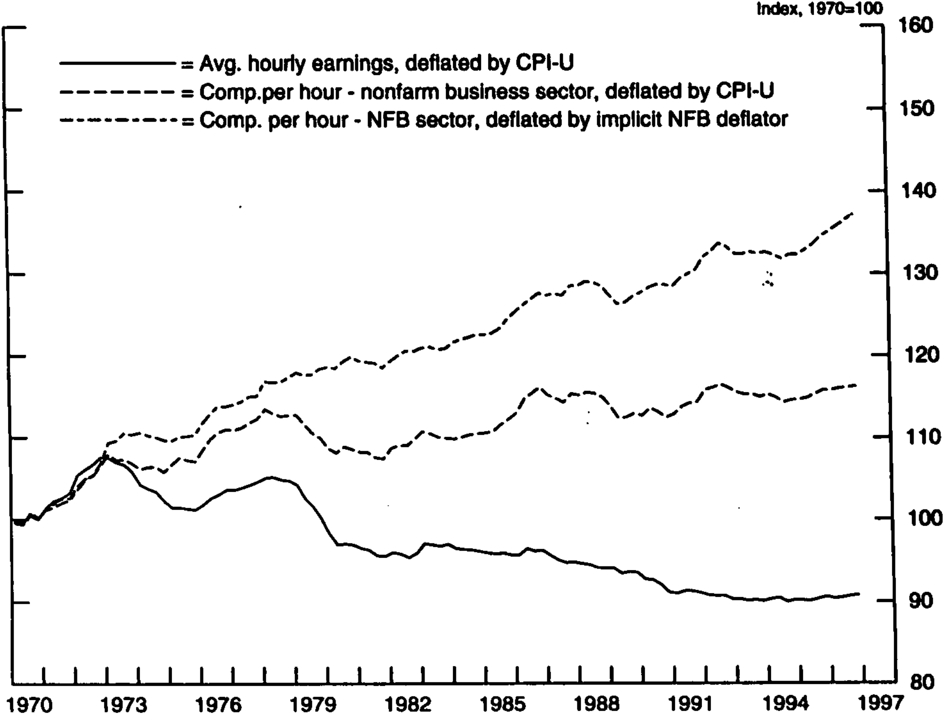
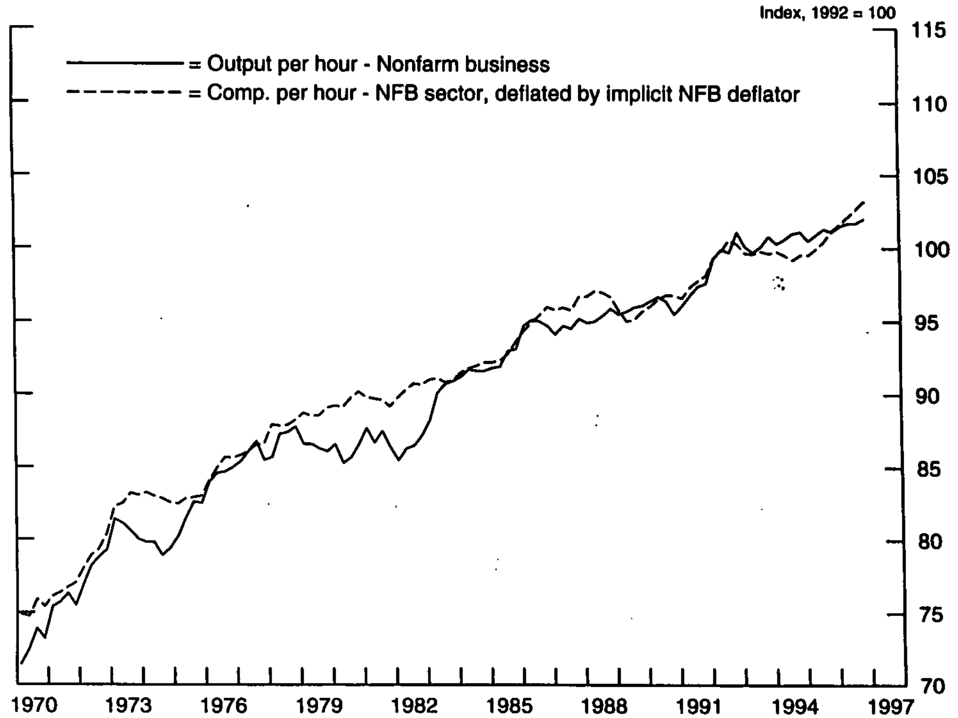


Chart 2



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Chairman Greenspan subsequently submitted the following in response to Congressman Hinchey:

Chart 1 presents three alternative measures of real (that is, inflation adjusted) remuneration to workers.[1] The solid line, is the series that is cited at the hearing--average hourly earnings of production or nonsupervisory workers on private nonfarm payrolls, which is published by the Bureau of Labor Statistics (BLS) deflated by the consumer price index for urban consumers (CPI-U), which is also published by the BLS. As can be seen, this series has been on a persistent downtrend for more than two decades. However, several problems with the series suggest that it is not an accurate measure of real remuneration nor should it be expected to track closely movements in productivity over time.

First, as noted in a recent study by the BLS, average hourly earnings is likely biased down because it is based on a sample that probably does not reflect the universe of all nonfarm payroll jobs.[2] Second, it omits a sizable portion of the workforce because it does not include nonproduction and supervisory workers. Third, the average hourly earnings data exclude employer-provided benefits, which have become an increasingly important part of workers' pay packages. The dashed line on the chart shows compensation per hour, which is also a BLS series, deflated by the CPI-U. This series covers wages and salaries of non-production and production workers as well as supplements to wages and salaries (benefits). In addition, the series does not have the downward bias known to exist for average hourly

1. For expositional purposes, all series have been indexed so that 1970 equals 100.

2. Katharine B. Abraham, James R. Spletzer, and Jay C. Stewart, "Divergent Trends in Alternative Real Wage Series," Bureau of Labor Statistics, October 19, 1995 (mimeo).

earnings. As can be seen, on balance, this series has drifted up slowly over the past two decades or so.

Although compensation per hour deflated by the CPI-U is a better measure of real remuneration than real average hourly earnings, it still is not appropriate for comparisons with productivity trends. For this type of analysis, both productivity and real remuneration should be based on deflation by the same price index; otherwise one is, in a sense, comparing statistical apples and oranges. On chart 1, the line with the long and short dashes is such a measure of real remuneration: compensation per hour deflated by the deflator for nonfarm business sector output.[3] This series has displayed a clear uptrend over the past quarter century. Chart 2 compares this series with productivity (output per hour) in the nonfarm business sector. As can be seen, these two series have tracked each other quite well over the past 25 years. Although they diverge periodically, the gaps between them always close over time.

3. The deflator for nonfarm business sector output is published by the Department of Commerce, Bureau of Economic Analysis.

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