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MONETARY POLICY AND THE ECONOMIC OUTLOOK

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before the

JOINT ECONOMIC COMMITTEE
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MONETARY POLICY AND THE ECONOMIC OUTLOOK

Wednesday, June 10, 1998

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

The Committee met, pursuant to notice, at 11:00 a.m., in Room 216, Hart Senate Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

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

Staff Present: Christopher Frenze, Colleen Healy, Juanita Morgan, Robert Keleher, Dan Lara, Joseph Cwiklinski, Paul Merski, Howard Rosen, Robert Stein, and Tami Ohler.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Good morning.

It gives me great pleasure to welcome Federal Reserve Chairman Alan Greenspan this morning before the Joint Economic Committee (JEC). Chairman Greenspan's testimony on the outlook for the economy and monetary policy comes at an important juncture in monetary policy.

As the most recent gross domestic product (GDP) and employment data suggest, the business cycle expansion that began in the second quarter of 1991 continues to produce economic and employment gains today.

The hard work of millions of workers and entrepreneurs across the nation has expanded the economy year after year. To the extent policy factors are relevant, monetary policy has been the main factor in sustaining economic expansion.

As the Federal Reserve gradually reduced inflation over the last six years, interest rates and the unemployment rate have both declined.

The anti-inflationary monetary policy of the Federal Reserve has produced prosperity without inflation. The central error in postwar economic policy – the notion of a tradeoff between inflation and

unemployment – has proven misleading during the last two business cycle expansions.

Low inflation is a foundation of sustained economic and employment growth and it fosters lower, not higher, unemployment.

Credible disflation tends to lower interest rates, reduce uncertainty premiums, stabilize financial markets, and thereby bolster interest rate sensitive sectors of our economy.

Lower inflation promotes efficient operation of the price system and, in many ways, works like a tax cut.

All of these factors contribute to sustaining the economic expansion that we now enjoy. Chairman Greenspan and the Federal Reserve deserve a great amount of credit for gradually reducing inflation and thereby promoting the many economic benefits that have resulted.

Nonetheless, I believe we must be vigilant about inflation, and monetary policy must preempt inflation before it emerges.

Here at the Joint Economic Committee we monitor the usual broad measures general inflation such as the CPI (Consumer Price Index) and the PPI (Producer Price Index), but also we monitor forward-looking indicators of inflation expectations such as commodity prices, bond yields, and the value of the dollar.

Neither the conventional nor forward-looking inflation indicators today justify a change in Federal Reserve policy, in my opinion.

Reportedly some policymakers at the Federal Reserve have favored a rise in interest rates for some time. However, it appears to me that the Federal Reserve has been on the right course, and I commend its leadership for charting the appropriate and prudent policy under uncertain conditions.

Overall, the Federal Reserve policy has been very successful. Current Federal Reserve policy appears consistent with the policy of setting an inflation band of about 0 to 2.5 percent.

This approach has also been successfully adopted by a number of other central banks around the world. This policy of inflation-targeting would be institutionalized, incidentally, under a bill that I have introduced as a foundation for future reform.

The important accomplishments of the Fed under Chairman Greenspan would be locked in so that stable prices and low interest rates could be assured for future generations.

I would yield now to the gentleman from New York for any opening statement he may have, Mr. Hinchey.

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

Opening Statement of Representative Maurice D. Hinchey

Representative Hinchey. Well thank you, Mr. Chairman. Thank you very much for the opportunity to speak here. Thank you very much for scheduling this hearing, and thank you very much for inviting Chairman Greenspan.

Mr. Chairman, it is, as always, a pleasure to see you and I look forward to your testimony.

While I very much respect and appreciate the efforts of the Chairman, and find myself agreeing with him on many things, there is one thing about which I disagree. I believe that monetary policy follows fiscal policy; and that the economic circumstances we are enjoying in the United States currently - record levels of employment and very low levels of unemployment; high levels of job production; and a very strong economy - are a result of the Budget Resolution of 1993 proposed by President Clinton and passed by the Congress. This measure resolved our problem of a growing Federal budget deficit and brought the budget deficit which was more than $290 billion in 1993 into balance. In fact we anticipate some surpluses in the budget this year.

The balanced budget and surpluses have brought us this very strong economy, which has enabled the Federal Reserve to show great restraint in interest rates. Although interest rates are at a fairly low level, in real terms because of our very low inflation rate, I think that they might even be higher than they would be.

I express my appreciation to you, Mr. Chairman, because I understand that you have been under considerable pressure within the Federal Open Market Committee to raise interest rates at recent meetings. According to the smoke signals that emerge from those meetings from time to time, it has been largely your leadership that kept the Fed showing restraint and not raising interest rates.

For that, I think the people of the country should feel a deep sense of gratitude. High interest rates would have derailed this economy, and certainly we would not be feeling the benefits that we are today.

The strength of this economy is beginning to express itself in wage increases for hourly workers. Real wages are beginning to rise, as a result of a number of things, not the least of which is sustained, good, solid productivity which is up a point or two over the last couple of years.

I just came from a Joint Meeting of the Congress over in the House of Representatives where we had the pleasure to listen to the recently-elected President of South Korea, Mr. Kim Dae Jung.

His comments should cause us to reflect on the serious economic crisis that continues to prevail in East Asia. In fact, President Kim Dae Jung mentioned the circumstances of that crisis as it impacts his country, South Korea, in the context of his speech.

Also, the markets in East Asia fell again this morning, in some cases by as much as 4 or 5 percent. This indicates that we have still not felt the full effects of this crisis, and that we would be prudent to anticipate the greater effects of the East Asian economic crisis on our country sometime later this year.

So I hope that you will tell us today that the Fed will continue to show the kind of restraint it has shown under your leadership recently, and that we can continue to anticipate relatively low interest rates. In fact, Mr. Chairman, I believe that the Fed might consider looking at the level of real interest rates and consider possibly even a small decrease.

I thank you very much for your leadership, Mr. Chairman, and I thank you very much for your being here today. I eagerly anticipate your testimony.

Representative Saxton. I thank Mr. Hinchey. Thank you, very much.

Mr. Chairman, we are anxious to hear your testimony this morning. So, sir, the floor is yours.

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

Chairman Greenspan. Thank you, Mr. Chairman, Mr. Hinchey, I am pleased to have the opportunity, as always, to present an update on economic conditions in the United States.

Such an assessment cannot be made in isolation but rather depends critically on what is happening in the rest of the world and how those developments affect the performance of the American economy. In my

previous appearance before this Committee last October, my remarks focused mainly on the turbulence that was then evident in world financial markets and, in particular, on the problems that had emerged in a number of Asian economies. The tentative assessment offered then was that the economies of Asia were in for some trying times, but that the situation did not seem likely to threaten the expansion of this country's economy.

That assessment, I believe, still is essentially correct; however, uncertainties about the degree of restraint that will be coming from abroad remain substantial. Earlier this year the situations in most of the Asian countries seemed to be stabilizing in some respects, but, as the events of the past few weeks have demonstrated, the restoration of normally functioning economies will not necessarily go smoothly. In some cases the adjustments that are needed to improve external balances and to correct existing misallocations of resources have been accompanied by sharp increases in inflation, rising unemployment, abrupt cutbacks in living standards, and increases in uncertainty and insecurity. The heightened social and political pressures that can develop in such circumstances not only introduce added complications into economic policymaking, but also make it even more difficult to foresee how the process of adjustment will play out across the afflicted economies.

That the American economy would be affected to some degree by spillover from the problems in Asia was never in doubt, even though the timing and magnitude of the impact have been difficult to predict with much confidence. Many months ago, businesses in this country began anticipating a worsening of our trade balance with the Asian countries, and the incoming economic data have since confirmed those expectations. Meanwhile, other influences on trade–such as the strength-of-demand growth in the United States and a dollar that has been strong against a wide array of currencies–have persisted. In total, U.S. exports of goods and services turned down in real terms in the first quarter of 1998, the first such decline in four years, and real imports of goods and services continued to rise very rapidly. The combined effect of these changes exerted a drag of two percentage points on the annual growth rate of real GDP last quarter.

Weaknesses in Asia appeared to account for approximately one-half of that deterioration. Not only have export volumes been affected, but producers in both industry and agriculture also are having to adjust to the lower product prices that have come with slower economic growth

abroad and the increase in the competitiveness of foreign producers induced largely by depreciations of their currencies.

But even with substantial drag from the external sector, the U.S. economy has continued to expand at a robust pace. In the first quarter, real GDP grew even faster than it had in 1997. Employment has continued to increase rapidly this year, and the unemployment rate has fallen further, reaching its lowest level since 1970. Incomes have continued to climb, and gains in household and business expenditures have been exceptionally strong. Although the data on hours worked suggest that growth of the economy has likely slowed this quarter from the first quarter's torrid pace, the degree of slowdown remains in question. Evidence to date of a moderation in underlying domestic spending still is sparse.

The strength of domestic spending has been fueled in part by conditions in financial markets. Although real short-term interest rates have been rising, equity prices have moved still higher, credit has been readily available at slender margins over Treasury interest rates, and nominal long-term interest rates have remained near the lowest levels of recent decades. Rapid growth of money this year is a further indication that financial conditions are accommodating strong domestic spending, although we at the Fed still are uncertain how reliable that relationship will prove to be over time.

In short, our economy is still enjoying a virtuous cycle in which, in the context of subdued inflation and generally supportive credit conditions, rising equity values are providing impetus for spending and in turn the expansion of output, employment, and productivity - enhancing capital investment. The hopes for accelerated productivity growth have been bolstering expectations of future corporate earnings and thereby fueling still further increases in equity values.

The essential precondition for the emergence, and persistence, of this virtuous cycle is arguably the decline in the rate of inflation to near price stability. Continued low product price inflation and expectations that it will persist have brought increasing stability to financial markets and fostered perceptions that the degree of risk in the financial outlook has been moving every lower. These perceptions, in turn, have reduced the extra compensation that investors require for making loans to, or taking ownership positions in, private firms.

To a considerable extent, investors seem to be expecting that low inflation and stronger productivity growth will allow the extraordinary growth of profits to be extended into the distant future. Indeed, expectations of per share earnings' growth over the longer term have been undergoing continuous upward revision by security analysts since 1994. These rising expectations have, in turn, driven stock prices sharply higher and credit spreads lower, perhaps to levels that will be difficult to sustain unless economic conditions remain exceptionally favorable - more so than might be anticipated from historical relationships. In any event, primarily because of the rise in stock prices, about $12 trillion has been added to the value of household assets since the end of 1994.

Probably only a few percent of these largely unrealized capital gains have been transformed into the purchase of goods and services into consumer markets, but that increment to spending combined with the sharp increase in equipment investment which has stemmed from the low cost of both equity and debt relative to expected profits on capital has propelled the economy forward. The current economic performance, with its combination of strong growth and low inflation is as impressive as any I have witnessed in my near half-century of daily observation of the American economy.

The consequences for the American worker have been dramatic and, for the most part, highly favorable. A great many chronically under-employed people have been given the opportunity to work, and many others have been able to upgrade their skills as a result of work experience, extensive increases in on-the-job training, or increased enrollment in technical programs. Welfare recipients appear to have been absorbed into the work force in significant numbers.

Government finances have improved as well. The taxes paid on huge realized capital gains and other incomes related to the stock market, coupled with taxes on markedly higher corporate profits, have joined with restraint on spending to produce a unified federal budget surplus for the first time in nearly three decades. April's budget surplus of $125 billion was the largest monthly surplus on record. Widespread improvements also have been evident in the financial positions of state and local governments.

The fact that economic performance strengthened as inflation subsided should not have been surprising, given that risk premiums and economic disincentives to invest in productive capital diminished as

product prices became more stabile. But the extent to which strong growth and high resource utilization have been joined with low inflation over an extended period is nevertheless extraordinary. Indeed, the broadest measures of price change indicate that the inflation rate moved down further in the first quarter of this year even as the economy strengthened. Although declining oil prices contributed to this result, pricing leverage in the goods-producing sector more generally was held in check by rising industrial capacity, reduced demand in Asia that, among other things, has led to a softening of commodity prices, and a strong dollar that has contributed to bargain prices on many imports. Some elements in this mix clearly were transitory, and the very recent price data suggests that consumer price inflation has moved up in the second quarter. But even so, the rate of rise remains quite moderate overall. At this point at least, the adverse wage-price interactions that played so central a role in pushing inflation higher in many past business expansions–eventually bringing those expansions to an end–do not appear to have gained a significant toehold in the current expansion.

There are many reasons why the wage-price interactions have been so well contained in this expansion. For one thing, increases in hourly compensation have been slower to pick up than in most other recent expansions, although, to be sure, wages started to accelerate in the past couple of years as the labor market has become tighter and tighter.

In the first few years of the expansion, the subdued rate of rise in hourly compensation seemed to be in part a reflection of greater concerns among workers about job security.

We now seem to have moved beyond that period of especially acute concern, though the flux of technology may still leave many workers with fears of job skill obsolescence and a willingness to trade wage gains for job security. This may explain why, despite the recent acceleration of wages, the resulting level of compensation has fallen short of what experience of previous expansions would have led us to anticipate given the current degree of labor market tightness. In the past couple of years, of course, workers have not had to press especially hard for nominal pay gains to realize sizable increases in their real wages.

In contrast to the pattern that developed in several previous business expansions when workers required substantial increases in pay just to cover increases in the cost of living, consumer prices have been generally well behaved in the current expansion. Changes this past year in prices

of both goods and services have been among the smallest of recent decades.

In addition, the rate of rise in the cost of benefits that employers provide to workers has been remarkably subdued over the past few years, although a gradual upward tilt has become evident of late. A variety of favors–including the strength of the economy and rising equity values which have reduced the need for payments into unemployment trust funds and pension funds, and the restructuring of the health care sector–have been working to keep benefit costs in check in this expansion. But in the medical area, at least, the most recent developments suggest that the favorable trend may have run its course. The slowing of price increases for medical services seems to have come to a halt, at least for a time, and, with the cost-saving shifts to managed care having been largely completed, the potential for businesses to achieve further savings in that regard appears to be rather limited at this point. There have been a few striking instances this past year of employers boosting outlays for health benefits by substantial amounts.

A couple of years ago - almost at the same time that increases in total hourly compensation began trending up in nominal terms - evidence of a long-waited pickup in the growth of labor productivity began to show through more strongly in the data; and this accelerated increase in output per hour has enabled firms to meet workers' real-wage demands while holding the line on price increases. Gains in productivity usually vary with the strength of the economy, and the favorable results that we have observed during the past two years or so, when the economy has been growing more rapidly, surely overstate the degree of pickup that can be sustained. But evidence continues to mount that the trend has picked up, even if the extent of that improvement is as yet unclear. Signs of a major technological transformation of the economy are all around us, and the benefits are evident not only in high-tech industries but also in production processes that have long been part of our industrial economy.

Not withstanding a reasonably optimistic interpretation of recent productivity numbers, it would not be prudent to assume that rising productivity by itself can ensure a non-inflationary future. Certainly wage increases, per se, are not inflationary. To be avoided are those that exceed productivity growth, thereby creating pressure for inflationary price increases that can eventually undermine economic growth and employment. Because the level of productivity is tied to an important degree to the physical stock of capital, which turns over only gradually,

increases in the trend growth of productivity probably also occur rather gradually. By contrast, the potential for abrupt acceleration of nominal hourly compensation is surely greater. Still, a strong signal of inflation pressures building because of compensation increases markedly in excess of productivity gains has not yet clearly emerged in this expansion. Among nonfinancial corporations, our most reliable source of consolidated costs, trends in in costs seem to have accelerated from their lows, but the rates of increase in both unit labor costs and total unit costs are still quite low.

Nonetheless, as I have noted in previous appearances before Congress, I remain concerned that economic growth will run into constraints as the reservoir of unemployed people available to work is drawn down. The annual increase in the working age population from 16 to 64 years of age, including immigrants, has been approximately 1 percent a year in recent years. Yet employment, measured by the count of persons who are working rather than by the count of jobs, has been rising 2 percent a year since 1995 despite the acceleration in the growth of output per hour. The gap between employment growth and population growth, amounting to 1.2 million a year on average, has been made up in part by a decline in the number of individuals who are counted as unemployed–that is, those persons who are actively seeking work–of approximately 700,000 a year on average, since the end of 1995. The remainder of the gap has reflected a rise in labor force participation that can be traced to a decline of more than 500,000 a year in the number of individuals aged 16 to 64 wanting a job but not actively seeking one. Presumably many of the persons who once were in this group have more recently become active and successful job-seekers as the economy has strengthened, thereby preventing a still further drop in the official unemployment rate. In May the number of persons aged 16 to 64 who wanted to work but who did not have jobs was 9.7 million on a seasonally adjusted basis, slightly more than 5 percent of the working age population. This percentage is a record low for the series which first became available in 1970.

The gap between growth in employment and those of the working age population will inevitably close. What is crucial to sustaining this unprecedented period of prosperity is whether that closing occurs in a disruptive or gradual, balanced manner. The effects of the crisis in Asia will almost certainly damp net exports further, potentially moderating the growth of domestic production and hence employment. The strength of

domestic spending that has been bolstering output growth, and the demand for labor, also could ebb if recent indications of the narrowing in domestic profit margins were to prove to be the forerunner of a reassessment of the expected rates of return on plant and equipment. Reduced prospects for the return to capital would not only affect investment directly, but could also affect consumption as stock prices adjusted to a less optimistic view of earnings' prospects. Finally, the clearly unsustainable rise of inventories that has been evident in recent quarters will be slowing at some point, perhaps abruptly. An easing of the demand for labor would be an expected consequence of a slowdown in either final sales or inventory accumulation. Of course the demand for labor that is consistent with a particular rate of output growth also could be lowered if productivity were to continue to accelerate. And, on the supply side of the labor market, faster growth of the labor force could emerge as the result of delayed retirements or increased immigration.

If developments such as these do not bring labor demand into line with its sustainable supply, tighter economic policy may be necessary to help guard against a buildup of pressures that could derail the current prosperity. Fortunately, fiscal policy has been moving toward restraint to some degree, although recent budgetary discussions do not appear to be focused on extending that tendency. Monetary policy might need to tighten if demand were to continue to exhibit few signs of abating noticeably, thereby threatening to place still further strains on our labor markets.

We at the Federal Reserve, recognizing the powerful forces of productivity growth and global restraint on inflation, have not perceived to date the need to tighten policy in response to strong demand beyond what has occurred through falling inflation's upward pressure on the real federal funds rate, and the modest increase in the nominal rate that we initiated in March of 1997. But we are monitoring the evolving forces very closely to determine whether the recent acceleration of costs, albeit moderate, is likely to prove transitory, or the start of a more worrisome pattern that may well require a response.

In summary, Mr. Chairman, our economy has remained strong this year despite evidence of substantial drag from Asia and, at the same time, inflation has remained low. As I have indicated, this set of circumstances is not what historical relationships would have led us to expect at this point in the business expansion, and while it is possible that we have in a sense moved beyond history, we also have to be alert to the possibility

that less favorable historical relationships will eventually reassert themselves.

That is why we are remaining watchful for signs of potential inflationary imbalances even as the economy continues to perform more impressively than it has in a very long time.

Thank you, Mr. Chairman. I look forward to your questions.

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

Representative Saxton. Chairman Greenspan, we certain appreciate the thoughtful testimony that you have just concluded. Once again, we want to thank you for being here.

I would like to take a few minutes to ask a series of questions. I happen to be of the mind that policymakers ought to try to learn from what has occurred that has been positive, and to try to continue to do those things; and, at the same time, I believe that we should try to identify those things that perhaps have not been so positive and try to avoid them in the future.

Let me begin by asking this:

In my opening statement I said: "To the extent policy factors are irrelevant, monetary policy has been the main factor in sustaining economic expansion.

"Low inflation is a foundation of sustained economic and employment growth, and it fosters lower, not higher, unemployment."

Early in your opening statement–I believe on page 3–you said "The essential precondition for the emergence, and persistence, of this ... cycle is arguably the decline in the rate of inflation to near price stability."

It sounds like you and I have a great deal of common ground in trying to identify what it is that we have been able to accomplish in a positive way.

Now you also mentioned in your statement that there were a number of good things happening in the economy as a result of this period of time through which we have moved through a successful monetary policy, including the lowest unemployment rate in 28 years, an economic recovery in its eighth year, the sixth straight quarter of real GDP growth above 3 percent, and inflation rates that continued to trend downward.

We are certainly all grateful for those things.

The simultaneous occurrence of lower unemployment, healthy economic growth, and lower inflation has puzzled, however, some people. Part of this phenomenon, I believe, can be explained by the Federal Reserve's lower inflation policy which has worked to promote economic growth.

Let me just check off a few of the results, if I may.

One, lower inflation leads to lower interest rates. I think we can all agree on that.

Two, lower inflation helps to reduce uncertainty and risk premiums in interest rates and to stabilize financial markets. Another positive.

Three, lower inflation enables the price system to work better, and therefore, for the economy to operate more efficiently.

Four, in certain respects lower inflation is analogous to a tax cut.

And five, as a result of these factors lower inflation has been good for growth.

Do you agree with those five points? And if you do, could you tell us why you think they are important?

Chairman Greenspan. I do, Mr. Chairman.

Several years ago when inflation seemed to be receding but was still troublesome, it had been the general view of a number of economists and a number of us in the central banking community that low inflation, or approaching stable price conditions, would create a degree of stability in the system overall and, as you point out, lower general risk premiums and uncertainties that would lead to the maximum sustainable economic growth.

What we have learned in the last several years of significant economic growth and continuing fall in the inflation rate is that proposition which was held somewhat tentatively in, say the early 1990s, is now getting increasing confirmation.

And clearly the virtuous circle in which we have found ourselves is an element which suggests that low inflation, or stable prices eventually creates reinforcing elements within an economy, especially working through the financial system, which induces a degree of balance in the system which underlines the technical conditions for maximum sustainable economic growth.

What we have learned most from this period is that a number of our suppositions of an earlier period seem indeed to have been borne out.

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Representative Saxton. Thank you, Mr. Chairman.

Along the same lines, most broad indices of inflation, the CPI, the PPI, and GDP deflators show that inflation continues to trend downward. This is, in my opinion, a result of the Fed policy that we have seen over the past several years.

Isn't this price stability concept proper primary goal for monetary policy?

Chairman Greenspan. I would certainly believe so, Mr. Chairman.

Representative Saxton. Mr. Chairman, as you know, I have introduced a price stability bill using inflation targets. A narrow band of permissible increases in a broad price index measure would be chosen and disclosed by the central bank, by the Fed, as is already the case in a number of other countries.

The definition of "price stability" in terms of inflation targets is a balanced approach that establishes a firm constraint on inflation but permits a good deal of flexibility.

The last time you testified before our Committee you indicated that this approximates what the Federal Reserve is already doing, and it seems consistent with Federal policy.

At that time you also indicated you were sympathetic to the view that it would be useful to formalize inflation targets in some way.

Would you speak to that point?

Chairman Greenspan. Yes. That inflation reduction and, at the end of the day, price stability is the appropriate goal for the central bank, I have concluded for quite a long period of time, and, as I just mentioned, the evidence is quite supportive of that position.

How one locks that in as official policy is, an important question. And, clearly, while we have not at the Federal Reserve Board or at the Federal Open Market Committee, which is the more relevant group for determining what policy is in the Federal Reserve System - while we have not discussed any of these particular new legislative initiatives in detail - clearly the general consensus of our group is favorably disposed in that direction.

I hesitate to say that we favor it as an institution because I am not in a position to make that statement, but I do think that clearly the

development of many countries to move in that direction has been an indication of the worldwide judgment that this type of policy is helpful.

I should point out, however, that there are a number of technical problems that we have discussed, I believe, in the past with respect to moving in that direction, and it is conceivable to me that we could set up a situation which is too inflexible which would prevent the central bank in some very unusual circumstances to deviate either on the up-side or the down-side from what the ranges that would be promulgated through legislation.

But having said that, I certainly think that the direction in which you are pursuing legislation is a sensible one from my point of view.

Representative Saxton. Mr. Chairman, let me just follow up on two things that you just indicated.

First, you just indicated, I believe, that there are others in the Federal Reserve System who obviously generally agree with the approach that you have taken and have been most cooperative in doing so.

Does that include several Reserve Bank presidents who also support this approach?

Chairman Greenspan. Oh, I was referring to a number of members on the Federal Open Market Committee, both presidents and board members.

Representative Saxton. Also you mentioned policies relative to inflation targeting by other countries.

Is this a general approach that has worked? And have not other countries had successful results in lowering rates of inflation as well as our country?

Chairman Greenspan. It is too soon to tell, Mr. Chairman, and the reason is not that the inflation rates in a number of the countries which have taken on various different types of inflation targeting, it's not that they have failed. Indeed, virtually all of them have succeeded.

The trouble we have, analytically, is that inflation rates have also come down in countries that have not employed that particular type of inflation-targeting device.

So that as far as data proving that there is a major advantage in very specific targeting procedures, that is unlikely to be forthcoming in any definitive way until we are able to demonstrate the countries that are on

that sort of regime do show very much better behavior than those who are not, and it is much too soon to make that judgment.

Representative Saxton. Mr. Chairman, one of the activities that our Committee has taken part in is a study of how we determine what inflation is going to do tomorrow. It is pretty easy to determine what inflation did yesterday by looking at the CPI and the PPI, et cetera.

You are in a pretty tricky business where you have to be able to look a year, a year-and-a-half ahead.

One of the things that we have been able to do is to identify some long-term forward-looking price indicators such as commodity prices, bond yield, and foreign exchange rates to gauge the likelihood of future inflation – which obviously is extremely important in the way you carry out your job.

Given the usefulness of the information from these indicators, is there any reason to discount that they would continue to be good indicators and that we should continue to observe them very carefully?

Chairman Greenspan. We obviously spend a very significant amount of our time endeavoring to create such insights into future economic imbalances, especially inflationary imbalances, so that we have the capability of presumably preempting distortions in the economy and in the financial system before they become difficult.

I think we have to be careful about presuming that there are specific types of indicators which work all the time and will continue to work into the future.

There is no question that a number of the indicators that you mentioned have been useful, and I suspect they will continue to be useful in the future, but I would recommend being careful about relationships.

Because one of the things that we have learned about our really quite unusual technologically-based economy of recent years is its adaptiveness to various different events which it was unable to adapt to previously.

That means that you will often find that indicators which worked exceptionally well in the past do not work, and have not worked in the most recent past.

Obviously I could go through a long list of submodels of what the economy or certain aspects of the economy were supposed to do, which have failed very significantly in the last several years.

The reason, essentially, is that when you move as we are moving into a very high-tech, very sophisticated economy in this country, a number of the relationships which held in the past are somewhat looser, somewhat different, and newer issues are continuously arising.

So it is important to be very careful in not getting ourselves locked into simple sets of relationships, but continuously be re-evaluating what the success of various indicators are and not presume that we will be able to successfully forecast the potential outlook for inflation with a few select but presumably relatively good indicators.

History, especially recent history, has cautioned against a narrow view of inflation forecasting in that regard.

Representative Saxton. Thank you.

Mr. Chairman, it appears to me that currently the markets do not expect an imminent increase in interest rates. If a rate increase were to occur, however, would this not surprise the markets?

And can you speak to how Asian markets might react to an interest rate increase?

Chairman Greenspan. Obviously if markets are not expecting an increase and we move the federal funds' rate up, there will be a surprise, by definition.

What the consequences would be are not easy to determine because it depends very much on the conditions that exist at a time of a movement, whether we are moving up or whether we are moving down.

And that particular evaluation we always make in some detail to try to make some judgment about the repercussions of whatever our monetary policy is apt to do.

I would be hesitant to give you a forecast of how the markets would behave under hypothetical conditions because it depends to a very significant extent on what the state of the markets are at that particular time.

So I am not sure I could really effectively answer that question in words that would be meaningful.

Representative Saxton. Thank you.

Let me just ask one final question. With respect to inflation targets again and their implementation, it would seem to me that given the successful results that we have seen over the past eight years in terms of economic growth coupled with success in controlling inflation, that this

might be a good time to look seriously at how we might institutionalize the concept of the current environment with inflation relatively low.

Actually, is this not the most opportune time to look at this policy in terms of whether or not we somehow want to permanentize it? Understanding, as you have said, that the flexibility that is needed by the Central bank be preserved as well.

Chairman Greenspan. I would agree with that, Mr. Chairman, and we would obviously be available to offer what technical assistance you might require to make certain that in your legislative initiatives that adequate flexibility is maintained for certain types of conditions which might require slight deviations on either side of the bands.

I fully recognize that if you make too many qualifications you might as well forget the guidelines because then they become so full of holes they are meaningless, but there is a balance here which I think can be appropriately struck.

There is just no question that it is far easier to implement this type of policy when in effect markets are behaving in a very benign fashion than it would be if we were dealing with significantly difficult inflationary conditions.

Representative Saxton. I apologize to my friend here to my left. It is your turn next.

I have one final question. I promise this is the last one.

Mr. Chairman, over the years that I have been here in Congress, which are now almost 14, there has been conversation from time to time about good economic growth causing inflation, and then of course inflation spews all kind of venom into the economy and creates recession and unemployment, et cetera.

Something quite astonishing has happened, it seems to me, over the past eight years. That is, that the economy has continued to do well, and inflation has gone down.

We have a chart here over on the side which shows that inflation and unemployment rates have fallen together during this period of time.

There is a theory which is endorsed by some which is generally referred to as the Phillips Curve which says, essentially, that this is not supposed to happen.

Can you comment on this general concept and tell us, in your opinion, why we have seen this great success in terms of both a decrease

in inflation and a decrease in employment over this relatively long period of time?

[The chart entitled, "Inflation and the Unemployment Rate Fall Together Since 1992, " appears in the Submissions for the Record.]

Chairman Greenspan. You are quite right, Mr. Chairman. There was a general thesis, which in fact is still held by a number of people in varying different degrees, which is that inflation behaves inversely with the rate of unemployment. The only problem is that the sign is wrong.

We have a high correlation, as you have demonstrated in your chart, between the unemployment rate and the consumer price index.

The evidence over those years of that very marked shift from our early expectations requires a really major reevaluation of how our economy works under certain circumstances.

We at the Federal Reserve have been spending an inordinately large amount of time endeavoring to try to explain this phenomenon, because it is obviously at the base of policy in all respects.

Analytically one can see it as the fact that unit labor costs have not materially expanded despite the fact that the unemployment rate has fallen so dramatically.

That in turn is evidenced by a rate of growth in productivity which has only been modestly less than the rate of growth in compensation per hour, which has indeed in recent years, as I have mentioned in my prepared remarks, moved pretty much along the earlier expectations.

But there appears to be somewhat of a lower level of wages and total compensation than one would have expected to exist at today's tight labor market from the context of, say, four or five years ago.

And that in turn has got to be explained in some way as to why it is that, as I think is the case, individual workers are seeking job security at the expense of wage increases even in the context of an extraordinarily tight labor market.

And we will not fully understand precisely why this relationship emerged in this particular period until we look at it in retrospect over time. But clearly there have been a number of factors involved.

One is the technologies that arose serendipitously in the post-World War II period, which as I have mentioned in previous testimony before the Congress have apparently created a degree of synergies which increase the potential rate of return on capital investment in the early

1990s, which meant that a substantial increase in investment, especially in high-tech investment, had the capabilities of significantly increasing productivity growth.

And I think, although it is by no means demonstrable clearly at this stage, that when we may look back at that period in retrospect that that indeed will be shown to be the case because it is hard to argue: Why would businesses be continuously investing at the pace they have in recent years if the rates of return were not there?

Clearly, increasing returns are almost surely there. So we do find that technology has been a crucial factor in moving the productivity data and in a sense giving us the type of markets which enable these types of relationships to exist.

Both fiscal policy and monetary policy have been highly supportive of that particular process.

The fact that we have removed the very deleterious effects of budget deficits from the financial markets has been very important, as Mr. Hinchey has pointed out, and unquestionably monetary policy has also been crucial over the last 15 years in creating an environment in which the technologies could be converted into rates of return and investment.

So there were a combination of forces, some of which are probably long-lasting, others of which are transitory, and the transitory ones clearly have got to be the strength of the American dollar which has been an unquestioned factor in holding down import prices and sources of inflation restraint,

And deregulation itself by increasing the globalization pressures on our price structure has also been a material influence.

Finally, there is the fact that the productivity and technological capabilities of our system have become so sophisticated that the lead times on the deliveries of capital equipment have fallen to a point where we are apparently able under pressures of increased demand, especially for goods, to increase capacity very quickly.

This is evidenced by the fact that the number of shortages that exist in our markets have fallen to exceptionally low levels, even in the context of very substantial demand.

So these are some of the issues. A full analysis, a full story, is unlikely to be written except from the point of view of retrospection perhaps five years from today.

Representative Saxton. Thank you, Mr. Chairman.

We are going to move on to Senator Bingaman at this point, and thank you for your very thorough answers.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator Sarbanes. Mr. Chairman, could I simply note you observed earlier you had been here I think 14 years? I just wanted to say that is a good argument against term limits. I just wanted to put that on the record.

Representative Saxton. Well thank you, very much.

OPENING STATEMENT OF SENATOR JEFF BINGAMAN, RANKING MINORITY MEMBER

Senator Bingaman. Thank you for being here, Mr. Chairman. Let me ask you about fiscal policy. You make a statement in your written testimony that fiscal policy has been moving toward restraint to some degree, although recent budgetary discussions do not appear to be focused on extending that tendency. Does it make sense, therefore, given the fragility of this virtuous cycle which you refer to in your testimony, for Congress to be contemplating a significant tax cut at this time?

Chairman Greenspan. Senator, as I testified previously earlier this year to other committees of the Congress, it would be my preference, if it were politically feasible, to actually allow this surplus to run.

Which means that the implication would be that both spending increases and tax cuts would be restrained.

To hold these types of surpluses would, incidentally, reduce the debt, reduce interest payments on the debt, and create a different type of virtuous circle which could very significantly reduce the very high level of interest payments which currently restrict our budgetary policy and require taxes higher than would otherwise be the case. So there is a very strong economist's type argument which I fully subscribe to about letting the surpluses run and allowing the interest charges to fall.

If, however, it turns out that it is very difficult politically to hold these types of surpluses and the politics are such that spending becomes the major thrust of trying to reduce the deficits, then I will become a very strong advocate of tax cuts in lieu of that, because that could be really quite detrimental to long-term prosperity of this country, especially when we consider what our fiscal requirements are going to start to be as the baby boomers retire around the year 2010 and thereafter.

Senator Bingaman. So you would prefer we neither raise spending nor cut taxes?

Chairman Greenspan. For the time being.

I am a strong advocate of cutting taxes, and I remain a strong advocate because I think that one can enhance economic growth materially in that regard.

However, this is a very unusual circumstance which we have at this particular moment which would enable us to accumulate very large surpluses which would have a major long-term positive effect on our fiscal affairs.

And also, to the extent that allowing the fiscal processes to work towards surplus, as I indicated in my prepared remarks, it also acts to hold down what could be a set of pressures in the current economy which are creating demand increases which are very difficult to contain in our clearly significantly ever-tighter labor markets.

Senator Bingaman. Shifting to the global economy, let me ask about the continued weakening of the yen.

The United States currently has a very large trade imbalance with Japan, as well as with much of the rest of the world. Our trade deficit is growing and is expected to reach around $200 billion this year. All indications I have seen are that the yen is continuing to weaken, making it more difficult for U.S. producers to export to Japan, and making it more difficult for exports from other countries in the Pacific region to compete against Japanese exports to the United States and other markets.

In the long term, are these large U.S. trade deficits sustainable? Is the continued weakening of the yen something we can tolerate, or alternatively, is it helpful to us?

Chairman Greenspan. Well, Senator, I have chosen to allow our economic policy establishment to focus all notions with respect to the exchange rate of the dollar with the Treasury Department, and it is Secretary Rubin who is our spokesman, and we have all chosen not to comment on individual currency relationships, allowing him to do it in our name, so to speak.

Let me just respond to what I think is the more important question, which is the issue of the chronic longer-term deficits which clearly this country is experiencing, and experiencing in the context of an obviously strong demand for U.S. dollar claims throughout the world.

So in effect we are having no difficulty at this stage financing that current account deficit.

Over the longer run, it is difficult to perceive that going on indefinitely. At some point you just cannot continuously maintain a deficit on your current account.

At the Fed, we have been looking, fairly extensively at this particular process and trying to understand how it is going to eventually emerge.

We have not yet concluded a set of principles or a set of policies which we think are worth recommending to address this issue, but we do think it is one of the long-term issues which confronts this country.

Senator Bingaman. Am I correct in thinking that the monetary policy currently being adopted and implemented by the Federal Reserve does not take this long-term trade imbalance into account? Is this a new factor which you are beginning to take into consideration?

Chairman Greenspan. The long-term imbalance is not something which we directly employ for purposes of current monetary policy, because it is long-term–and I mean an exceptionally long-term problem; I am talking 5, 10, 15, years - who knows what the time frame is - and it closely interrelates with the issue of the American dollar as the reserve currency in the world. And all I can say to you is that while we do not factor such notions into our current policy deliberations, I think it would be a mistake to fail to recognize that it is a fundamentally unsustainable position, and that at some point, in some manner, we are going to have to address that to bring us back to balance.

Senator Bingaman. I would like to ask one further question. One of the responsibilities the Federal Reserve has is to oversee and, as I understand it, approve mergers of financial institutions. A series of proposed mergers of major U.S. banks have been announced over the last few weeks and months. What kind of criteria do you use when considering these mergers? For example, there are people in my state of New Mexico who are concerned that consumers are not being seriously considered in all this merger activity. They feel that these mergers are primarily driven by a desire to increase shareholder value and increase the price of bank shares. They believe consumers are being left out.

I would be interested in knowing to what extent you and your colleagues consider these consumer concerns and to what extent should they be considered?

Chairman Greenspan. Well we are required by law to look at that under the Community Reinvestment Act.

Let me just say that I do not really believe that there is any banker who seriously contemplates the view that he can maintain profitability without his customers, because it is they who give him his value-added and his earnings.

So that the whole thrust of banking activity, whether it is expansion, de novo banking, mergers, acquisitions and the like, all have at the end of the day a focus on where their profits are going to be coming from, and that invariably is either market-related events which ultimately are determined by consumers or a direct relationship with consumers.

So that to the extent that bankers–or individuals who are merging organizations–disregard the needs of their customers, the shareholders are going to suffer. Indeed, there have been innumerable cases in which that has been the case.

Representative Saxton. Senator Sessions?

OPENING STATEMENT OF SENATOR JEFF SESSIONS

Senator Sessions. Thank you.

Mr. Chairman, I remember early last year when you were here for my first Committee hearing. And I asked you if you agreed with business persons from Germany, Japan and England who had inquired about the health of our economy as opposed to theirs, and concluded it was less taxes, less regulation and a greater commitment to the free market, that has made our economy as strong as it is. I think you agreed that that was a good analysis of the strength of our economy.

I think this commitment has existed to varying degrees, for some time, maybe since 1980 and President Reagan, and it is producing some good things for the entire world.

I just noted one of your comments recently, in which you concluded that, "only free market systems–that is the American model–exhibit the flexibility and robustness to accommodate human nature and harness rapidly advancing technology, and to consistently advance living standards."

I think you have also suggested that the Japanese model of business/government partnerships is not healthy.

I wanted to mention this because about an hour ago, President Kim of Korea spoke to the Joint Congress, and said:

"The cause of our economic problems in Korea is quite clear. My predecessors did not practice democracy and a free market economy. In fact, there was too little democracy, too much collusion with big business, and too much government-directed finance. Corruption prevailed. Imprudent borrowing weakened our nation's banks and businesses."

I wonder if you think he is correct, and if he is in fact agreeing with your analysis?

Chairman Greenspan. I would be more inclined to say I agree with his analysis.

(Laughter.)

Senator Sessions. Well I think you suggest in your remarks that it is possible we might be going beyond history a bit here. In *The Economist* recently there was an article suggesting that we were perhaps going into a great new century of increased productivity.

If that is true, is it possible that wages could continue to rise at the current level if productivity keeps apace with it?

Should we be not too quick to dampen some of the good things that appear to be happening?

Chairman Greenspan. Well insofar as monetary policy is concerned, it is our policy to endeavor to keep this stable, expanding economy going.

What type of policies are required to do that are not overly clear at all times. To the extent that we take actions in any direction, preemptive or otherwise, the reason we are doing it is to facilitate the movement into the 21st Century of a strong economy.

So it is clearly the basis of policy at the Federal Reserve, and I would think pretty much every major central bank of which I am familiar, to facilitate strong economic growth, recognizing that a necessary condition for that is a non-inflationary or stable price level environment.

Senator Sessions. I think you have certainly provided us with the framework for this growth. It has been a marvelous thing, indeed, and we are definitely in your debt for that.

With regard to trade, Senator Bingaman wrote an article which was even published in the *Mobile Press Register*, expressing some concern

about the trade deficit. This is something that we do not talk about in this Congress very much.

Yet, as you noted, the deficit continues to expand. With China, the U.S. trade deficit is 4:1, as I understand. They buy one dollar from us for every four dollars we buy from them.

I would like to ask you, should the political process to begin to put some pressure on to reverse those trends, or at least narrow that trade gap? Because it would seem to me this gap is not only bad for us, it is bad for China.

Chairman Greenspan. Frankly, I would hope not. And the reason I say that is that markets are very sophisticated, increasingly so, and they adjust over time.

The crucial question that we have to put on the table is whether we are talking about a jobs question. And I should think that the evidence of the last several years should put to rest the question as to whether trade deficits create unemployment.

We are having very great difficulty finding people to work, so that the whole labor force has been effectively absorbed in the context of a very large trade deficit.

I do think the trade deficit, as I indicated to Senator Bingaman before, is an issue, but it is a financial issue.

It is an issue of the nature of financing them and the structure of relationship between economies. But the one thing that we have to be careful about is to recognize that trade is very beneficial to standards of living.

We have seen a dramatic rise in trade in the post-World War II period, cross-border trade. It has been unquestionably a factor in enhancing standards of living everywhere it has occurred, including the United States, and that increasing division of labor and comparative advantage, as economists like to say, with respect to the trade area, are things we should endeavor to enhance, not restrict.

We are often going to find that there are periods when our bilateral deficits with individual countries are very large in either direction. And I would hope that we do not get overly concerned because markets tend to readjust.

To the extent that we try to block the trade patterns, we create potential problems for our standards of living, and I think that would be a terrible mistake.

Senator Sessions. Well, I can understand your concern, and I think the world has certainly benefitted from free trade. It does appear to me that many nations, and China is a good example, are interfering with progress, to their own detriment and to our detriment also, with restrictions that restrain trade. I think it would be good if they could be encouraged to be more open, and that it would benefit both our nations; would you not agree?

Chairman Greenspan. I absolutely agree with that. I think that it is always to the advantage of an individual country to lower its barriers, irrespective of what one's trading partners do.

It is better if both of us lower our barriers. It is by far worse if we raise ours, largely because the notion that the issue of trade is always a negotiated, bilateral question, I think, misses the point of the advantage of trade.

It is certainly to our advantage to keep our markets open, irrespective of what happens to others, but if we can talk them into lowering their barriers, they will benefit and we will benefit more. But the notion that unless we can strike a deal, which has essentially been the general philosophy of our trade negotiations over the decades, that unless we can strike a deal, we should not do it, I think is a mistake.

And I would certainly agree with you with respect to trying to encourage our trading partners to be more open. It is in their interest to do so.

Senator Bennett (Presiding). Thank you.

Senator Sarbanes?

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

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

Chairman Greenspan, I join with my colleagues in welcoming you back before the Committee. I have two or three questions I want to try to put very quickly.

First of all, along with many Members, I was at the address to the Joint Meeting of the Congress by President Kim Dae Jung of the Republic of Korea. That is an amazing story, of course.

He spent six years in prison, 10 years in exile under house arrest, his life endangered on many occasions. The U.S., of course, and he acknowledged it this morning, was instrumental on more than one occasion in helping to protect his life.

And he made a very moving address, I thought. One of the things he said, and I quote him, when he turned to the economic situation, he said, "With the IMF's strong support we are aggressively and successfully promoting restructuring of our economy to the level of other advanced countries. In a sense, the IMF is to international finance what the Federal Reserve is to your nation's financial system, the lender of last resort.

The IMF may well have to play again a critical role in averting and stabilizing future economic crises, and the IMF deserves continued support."

Now, frankly, I do not think we should have to have foreign leaders come in and tell us that. It seems to me that we are sort of freely falling down on the job by not getting this replenishment of the resources of the IMF, and I think that even more so in the view of subsequent weakenings now that are taking place with respect to the world economy in various regions.

Would you agree that the need to act on the IMF replenishments is, in fact, sharpened or increased over what it was when we first addressed that situation?

Chairman Greenspan. I have been a supporter of that increase, as you know, from the point of initiation, and I continue to support it.

The notion which I registered very early on is that the chances are that additional funds would not be needed, but in the event that they are, the urgency of that need could create a very serious problem if it is not forthcoming.

Therefore, even though the probabilities of having to need funding beyond what the IMF is now capable of doing are relatively small, the consequences of needing it and not having it, I think, are creating too large a risk for policy.

I happen to agree with a number of the people who argue that there should be significant changes in the way the IMF is structured, and I think that that certainly should be the case when we fully begin to understand how the new high tech international, global financial system is functioning.

But for the moment, we have an unstable international financial environment, and this is not the time to take the types of risks that I think would be taken were we to fail to augment the quotas that are implicit in the bill that is being proffered by the Administration.

Senator Sarbanes. Well, Secretary Rubin has indicated that he and other finance ministers are going to look at the international financial architecture, and they are prepared to do that. But it seems to me, in the meantime, you do not remodel your emergency room at a time when it is kind of overrun with patients.

So, it seems to me we have to address the current situation that confronts us. I make this prediction: I think those that are not supporting these replenishments, if, in fact, we really hit a crisis and there are not the resources with which to deal with it, will be falling all over themselves to get to the floor of their chambers in order to support replenishments.

But at that time, it may be too late. I am of the view that if the IMF is perceived as having sufficient resources, it makes it less likely rather than more likely that they will have to use them because it injects and element of confidence into the marketplace.

I wanted to ask about statistics, economic statistics. The agencies that produce those, the BEA, the BLS, and the Census, have major initiatives to try to catch up with where the economy is - software, financial institutions, telecommunications, non-wage compensation - and also to address the statistical discrepancy between measured income and measured output.

Now, we are dealing - we are trying, obviously, to maintain a restrained fiscal policy and to carry forward these surpluses. We are not talking about a lot of money in terms of the budgets of these agencies and in terms of what is needed to upgrade the statistical infrastructure.

So, I guess - my question is, what is your view on supporting these statistical initiatives in the current budget climate? What is the benefit to us from really sharpening up our statistics so we have a better view of what is happening?

Chairman Greenspan. Senator, I, as you know, am often very reluctant to spend anything on anything.

(Laughter.)

This happens to be one of the areas where I believe the payoff is of sufficiently large magnitude where very small amounts of money can have very large potential rewards.

I think you correctly identify what the nature of the problem is, is that we have developed a very sophisticated set of statistics for manufacturing and for industry for things which one can see, feel, measure, in a quantitative sense. And we have had a census of manufacturers going back very early into the beginnings of our republic.

We have very little that is meaningful and useful in the areas which are moving most rapidly, which are the service areas, largely the business-related service areas and largely those which are related to high tech.

We have got very little in the way of measurement for very large growing segments of our economy, and we have huge detail in certain old industries which I doubt very much if anybody even reads anymore, and I think that that balance should be redressed, and I think that it could be redressed very profitably with very little money.

Senator Sarbanes. Thank you.

I want to turn now to an observation about the current economic situation. You indicate in your statement that the current performance, with a combination of strong growth and low inflation, is as impressive as any you have witnessed in your nearly half-century of daily observations of the American economy.

I must say, I do think we have a very strong economy. Of course, we have these economic problems in Asia which appear to be deepening, and, to some extent, affecting other regions. We have already had a sharply deteriorating trade deficit, and we have these rapid inventory accumulations by U.S. businesses which may lead to a slowing in production later in the year.

Now the Fed has not raised the rates, but of course with the drop in inflation the real rates have gone up, and you acknowledge that, of course, in previous testimony before the Congress, that there had been what you called a passive tightening of monetary policy.

In fact, the real funds rate now is up over the past year-and-a-half by two percentage points, at its highest level since before the last recession. Real long-term interest rates as measured by AAA corporate bonds are also at a very high level.

I looked at the FOC minutes for the March meeting. On the one hand, the FOMC decided at that meeting to shift from a neutral stance, the one they adopted in December, to leaning toward higher rates.

On the other hand, it made these comments:

They said: "The economy might well continue to accommodate relatively robust economic growth and a high level of resource use for an extended period without a rise in inflation.

Members believe that... I am quoting from the minutes, "Members believe that a preemptive move to head off inflation was premature or perhaps even unwarranted, and in the view of some, a tightening mood was not inevitable."

Now, we do not yet have the May 19th minutes of the Open Market Committee, so we do not know whether that bias was retained--the bias towards higher interest rates-was retained at the last meeting.

I just want to make this observation. In fact, it keys off of something that you have in your statement. I think the benefits of this sustained economic growth are just really being felt throughout the economy. I think workers at the middle and lower end of the scale are finally beginning to see improvements in their living standards while inflation continues to decline.

I think sustained economic growth is absolutely essential to make progress in addressing the difficult problems confronting the urban areas of our country.

In fact, in your own statement you are saying, and I now quote it, "The consequences for the American worker have been dramatic and, for the most part, highly favorable. A great many chronically under-employed people have been given the opportunity to work, and many others have been able to upgrade their skills as a result of work experience, extensive increases in on-the-job training, or increased enrollment in technical programs. Welfare recipients appear to have been absorbed into the work force in significant numbers."

I just want to underscore that very strongly.

I think the economy has to work in a very positive fashion over a sustained period of time before we really begin to see its benefits in these what are otherwise difficult pockets of under-employment or unemployment in our society.

I think we are now seeing some of those benefits, as you have indicated here in your statement. People are being trained. They are being put to work. Job opportunities are there.

We are fortunate that, as we try to implement the welfare program, we are doing it in this economic context. So I very much hope that the Fed will stay on course.

I obviously do not favor taking the rates up. I think the economy is working very well. I never have understood, when the economy is working so well, why we just do not stay on course.

I mean, all of these efforts – even these efforts to change the statutes to sort of redefine the responsibility of the Fed I do not agree with.

You know, obviously we are doing pretty well here under the existing statutes and existing policy making, partly on the part of the Fed, and I think also on the part of the President and the Congress with respect to fiscal policy.

So I very much hope that the members of the Open Market Committee will keep this particular point in mind.

I know they talk about tightening labor markets, but tightening labor markets bring some important benefits with them because they draw into the labor market and into the mainstream people who have been outside of it and excluded. And when they are outside and excluded, they constitute a burden on the society. Whereas, if we can get them into the labor market, and into the mainstream, they help to carry the burden of the society. So it is a complete reversal of the problems, and it is another addition to the virtuous circle that you made reference to before.

Thank you, Mr. Chairman.

Representative Saxton. Thank you very much, Senator.

Senator Sarbanes. I do not know if you wanted to respond to that.

Chairman Greenspan. Well I will be glad to respond, because I think you know my response, since we have had this discussion at length, I think, that I certainly agree that what we want to do in this economy is to continue what is really an unprecedented degree of prosperity with some major benefits that are accruing to all aspects of our nation.

The question really is: How does one do that?

It is, as we have pointed out in numerous discussions, quite possible that under certain conditions in order to keep that prosperity going the appropriate policy is to raise rates.

So it is not a question of the goal; it is a tactical question of how does one maintain an ongoing, balanced economic system?

There are occasions when that can be done only in the context of a tightening financial system, because there are innumerable scenarios, which I could outline, which could describe a burgeoning financial scenario which ultimately has in it the seeds of its own destruction.

And it is that which we would like very much to avoid because we have seen the great progress that has occurred in our markets as a consequence of the current prosperity, and we would like very much to see that continued.

Senator Sarbanes. Well let me just close with this observation.

Representative Saxton. If you can make it quickly.

Senator Sarbanes. I will be very quick, Mr. Chairman.

Representative Saxton. Thank you.

Senator Sarbanes. By holding the rate constant at a time when the inflation rate has been dropping, in effect the Fed has raised real interest rates. So monetary policy has tightened even though you have not changed the rate.

Chairman Greenspan. That is correct.

Representative Saxton. The Chairman has to leave us at one o'clock, which is about 25, 24 minutes from now, so what we will do is, there are three more folks who would like to ask questions.

Senator Bennett will be first, and we will try to limit each questioner to eight minutes.

Senator?

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT

Senator Bennett. Thank you, Mr. Chairman. I will try not to take that much time. Chairman Greenspan, it is always a delight to have you. As I have said before, either you are getting clearer or I am beginning to finally understand you, because each time I learn more from your appearance here.

(Laughter.)

I interpret what you are saying in your testimony as being a bit of a warning to us that the business cycle has not been repealed.

Chairman Greenspan. I would say that would be one of the lessons, yes.

Senator Bennett. We have had now 15 years of very good economy, interrupted by one recession, relatively mild–although it did not seem so at the time–but looking back on it in historic terms there was a nine-month down period, but if you allow for that exception, we have gone on for 15 years.

P.E. ratios are close to an all-time high on the Stock Market. In your testimony you say we have added something like $12 trillion in unrealized net worth–unrealized capital gains–and that is all wonderful.

I hope it is not tulip time. I hope it is not unrealized and unrealizable, as people start to try to sell it, as the Dutch discovered in the tulip panics when, at a time, statistically, everybody was tremendously wealthy because they owned tulip bulbs.

You know my obsession now that has manifested itself in the chairmanship that the Senate has conferred upon me in the new committee with respect to the year 2000, and year 2000-related technology problems.

As I look at the year 2000 and see the problems that could occur in our economy–and I am absolutely convinced there will be problems in our economy; the only question is how big they will be and where they will hit, but there will be serious problems in our economy as a result of the year 2000 computer problem–but as I look around the world, I think these problems in the United States will be mild compared to the problems that we will discover in foreign countries.

And particularly right now we are thinking about Asia. The Japanese economy is in some difficulty at the moment, and the Japanese are singularly ill-prepared to deal with the year 2000 problem.

They are saying to us: Well, our problem is not as great as yours because we do not use as many computers as you do. And that may or may not be the case.

I do remember going into businesses in Japan, when I owned a business in Japan, and being a little startled to see them using an abacus to keep track of their daily receipts while they were, at the same time, selling electronic calculators to the United States by the boat- load.

But nonetheless, I wonder if anyone at the Fed has tried to give any kind of quantification as to what the impact on the United States will be if all of a sudden large portions of the European economy, and I think almost all of the Asian economy, drop off the chart in January of 2000

because of their inability to deal with the computer interruption that will come as a result of the Y2K problem.

Chairman Greenspan. This is one of the most unusual problems I think that economists have had to confront in a very long period of time because it is a single event without any history associated with it.

It refers to a degree of complexity in the way business organizations are put together which are very difficult to make transparent.

I know, as I think I have mentioned to you previously, how complex some of the problems will be because I was one of those people who wrote some of the programs which are creating the problems today, and I know that I did not document them in the way in which even I, if I were to see the program today, could figure out what was done.

We all, 20, 30 years ago, assumed that no one in their right minds would keep those old programs in place by the year 2000, and it never entered our minds that the issue would even remotely emerge.

Senator Bennett. You underestimated the power of inertia.

Chairman Greenspan. I am afraid you are absolutely correct, and I trust that that lesson was well learned, but I am not sure.

We do not know what the impact will be because we know, even if the vast majority of problems are eliminated, systems are very unforgiving. Computer programs, software programs, do not allow for single mistakes. You cannot be "approximately" correct. You are either right. Or you are wrong.

And if the program is wrong, the system in one form or another breaks down.

As you imply, even were we in the United States to fully expurgate our computer systems of these obsolete programs, we still have a very substantial interaction with the rest of the world and it is very tough to know precisely what the status of all of the various different computers are both in Europe and in Asia and elsewhere.

As a consequence, as I am sure you are aware, there has been a very considerable amount of activity moving forward in a number of international fora to see whether this issue could be pushed forward, and certainly, Senator, your efforts have been very helpful in this regard and we very much appreciate that.

The bottom line is: We really do not have the analytical capability to make judgments as to what the size of the problem is for the economy as a whole.

Obviously it is a negative. Whether it is a small negative or a significant negative, I know of no way in which we can make that judgment in a manner which we would have confidence in the forecast.

I think it is important for us to put the resources in place that will bring down the probability that it will create a significant problem, that is, that we put as much resources as we can maintain effectively in reducing the probability that we are running into a problem.

And then, at that point, hope for the best–because I am not sure what our alternatives are.

As you know, we are spending, and will spend, a great deal of money in the United States–we estimate $50 billion–to put our systems into shape where the probability of difficulties arising are moved to as low a level as we can conceivably move them.

We do not have judgments about the rest of the world.

Senator Bennett. I would just comment that I think your $50 billion is probably low based on what I am finding out. My concern is: If the business cycle has not been repealed and we are getting increasingly due for some kind of a downturn, it is coming right at the same timing as the Y2K and it may be that the Y2K problem will exacerbate something that is already being baked into the cake simply in terms of the historic precedent.

Thank you, Mr. Chairman.

Representative Saxton. Senator, thank you very much for your effort in sticking to our time constraints.

Mr. Hinchey?

Representative Hinchey. Mr. Chairman, I will try to do the same.

Thank you, Chairman Greenspan, for your excellent testimony. It was very incisive and thoughtful and I very much appreciated listening to you and reading it while you were speaking.

We know that economies are very fragile things, and even good economies seem to be particularly fragile. They can be influenced by outside factors very easily.

Prior to our current good economic times, we experienced two decades of economic problems. In the 1970s, it was characterized by

increasing energy prices. In fact, there were periods during the 1970s when the chart that the Chairman has produced for us could have gone, and in fact did go in the opposite direction.

We had periods of rising unemployment and rising inflation concurrently, circumstances that were almost unique in the American experience at least in this century.

In the 1980s we had economic difficulties characterized by huge budget deficits which came about as a kind of a corrupted Keynesian economics where we saw huge public expenditures in the military sector, and enormous competition for funds and increasing interest rates during that time.

It is only recently that our economy has turned around, and we know from experience that this can be reversed again.

In this time of budget surpluses and low unemployment, I think that–well, I would like to hear what you have to think, really, because that is far more important than what I think.

Is it possible for us to sustain lower levels of unemployment in periods of budget surplus than it would be in more conventional periods?

And might we not be in a period when we can more comfortably, without fearing inflation, have lower levels of unemployment and more full employment?

Chairman Greenspan. I would say other things equal, Congressman, the ability to sustain low unemployment levels is easier with a surplus of significant dimensions than with a deficit of significant dimensions.

Representative Hinchey. Well, yes, Mr. Chairman. I could have given that answer, but that is not the answer that I am looking for.

I had hoped that the Chairman of the Federal Reserve would have given a much more detailed answer than that.

Could we not realistically expect to be in a period in which we can sustain lower levels of unemployment, longer levels of full employment, while experiencing lower inflation since the budget is in surplus?

Chairman Greenspan. Yes. No, I do not wish to be facetious, Congressman. I think that it is a simple relationship in the sense that, other things equal, it is better to have a degree of fiscal restraint in the system when inflationary pressures are potentially there, when labor markets and product markets are exceptionally tight.

I am not certain you can go terribly far beyond that general statement because the issues then become far more complex.

Representative Hinchey. All right. Well, let me introduce another complexity then. We are seeing in the present circumstance some very serious problems in East Asia.

You mentioned it in your testimony. It has been mentioned in the context of statements and questions here from the members of the panel.

The most optimistic outlooks of the economists and the political leaders in those countries suggest that they will not be pulling out of their recessions until sometime in the second half of next year.

Is it not reasonable to expect that the full brunt of the crisis in East Asia has yet to express itself in the American economy and may yet express itself sometime later this year or in the first part of next year?

Chairman Greenspan. Well as I said in my prepared remarks, I do expect that further pressure from the international sector for the United States is to be expected in the period ahead.

There is no question that we have seen some very severe contractions in economic activity in Southeast Asia. The key question is whether or not they will continue to fall or whether they will stabilize.

In other words, they can be exceptionally low and unemployment rates can be exceptionally high, but if they stabilize at that level then one would presume that the trade accounts in the United States relative to Southeast Asia would stabilize.

The very difficult question to try to answer is whether or not it is stabilizing or whether it is continuing to go down.

Representative Hinchey. Well what is your estimate of it? It would seem to me that it is not stabilizing; that it is in fact some distance from stabilizing.

Chairman Greenspan. It is hard to tell. In other words, what we have at this stage relevant to actual data is that we do not yet see a general stabilization.

Our data, remember, are largely for the first quarter and not very much for the current quarter. As of the first quarter there was a significant decline pretty much across the spectrum of Southeast Asia.

We would expect that to stabilize. When, is the crucial question. But at the point it stabilizes, the presumption at that point is that the maximum impact on the United States has been reached.

We do not know where that is yet, and we are putting a good part of analysis into trying to see whether we can fine-tune the data in a manner to really be able to make those judgments.

Representative Hinchey. But that stabilization lies yet ahead?

Chairman Greenspan. It may be happening now, but data do not as yet show it; or, it is in the future. All I will say to you is: The data that we have, which relate to say April and earlier, do not yet show a degree of stabilization.

Representative Hinchey. In fact we are seeing rising inventories in this country, a growing trade deficit, and increased weakness in certain aspects of the manufacturing sector–for example, the announcement just recently by Motorola that they were laying off 15,000 workers.

Motorola is one of the most prominent high-tech manufacturers in the United States. That would seem to me to have some relationship perhaps to the East Asian phenomenon.

And also the layoffs announced by General Motors may have some relationship to the East Asian phenomenon in that automobile prices in Asia are dropping precipitously.

Chairman Greenspan. Are you referring to General Motors here, or there?

Representative Hinchey. Here.

Chairman Greenspan. But the layoffs were mainly because of the strikes, or at least that—

Representative Hinchey. Well, yes, that is part of it, but that does not explain all of those layoffs. There were 10,000 and then 15,000.

Chairman Greenspan. There is no question that we are seeing impacts from Asia. You can see it, as you point out, in some of the inventory backups that are occurring. Clearly you can see it in the decline in export demand. And a goodly part of backing up of inventories in a lot of different areas are directly attributable to Southeast Asia. I mean, oil and high-tech, especially semiconductor electronic inventory accumulation which has been substantial very recently, is clearly in part a reflection of the weakness in Southeast Asia.

Representative Hinchey. Just finally I would like to emphasize what was said by Senator Sarbanes a few moments ago. The fact is that, as you agree, real interest rates are higher than they were last year and the year before. They are because of declining inflation and the stability of

the interest rates thanks again, I think, to your leadership on the Federal Reserve.

But that is something that we have to keep in mind. Because real interest rates are high, and I believe that they are making it more difficult for us to deal with the influence of the East Asian crisis.

Chairman Greenspan. Mr. Hinchey, I think the ultimate test of whether interest rates are too high is whether interest sensitive areas of the economy are under stress. And it's hard to find that at this stage.

In other words, certainly housing demand has really been quite impressive by any set of standards. Indeed, it's stronger than we would have expected by any of the models that we pick up and interest rates are a crucial issue in that regard.

Passenger car and truck sales are also related, so we do have a number of areas in the economy of quite significant importance which one would assume would be markedly restrained if interest rates were grabbing. And we see very little evidence of that at this particular stage.

Representative Hinchey. Thank you, Mr. Chairman.

Representative Saxton. The gentleman's time has expired.

Mr. Sanford, why don't you take your remaining time.

OPENING STATEMENT OF REPRESENTATIVE MARK SANFORD

Representative Sanford. Well, if we've got to end at 1:00, I would want to yield some of my time to Ms. Maloney. Do we have to end, we do have to end at 1:00, don't we?

Chairman Greenspan. Can I say, my first meeting is with my own colleagues, and I will just keep them waiting if necessary.

Representative Sanford. I'll cut my time down to four minutes.

I was going to ask a question about, is the Phillips Curve dead? Is irrational exuberance dead? Is human nature dead? And then finally a question on the IMF.

I will boil it down just to two questions.

One on is irrational exuberance dead?

And if you look at the most recent numbers, it suggests that there's more money in our mutual fund industry than is in fact in our banking system. Therefore, one of my earlier colleagues had suggested that if things turned south, inasmuch as that was the case, and you look at that

kind of contraction on people's balance sheets, would your hands be tied to an extent in warding off a downturn?

Chairman Greenspan. Well there's been a general increase over recent years in the proportion of our households which own equities. There's been a major shift, obviously as you point out, towards mutual funds, but actually there's been a reduction of direct holding of stocks by households.

So there's been a shift. Nonetheless, the increase in prices has just ballooned the total household balance sheet, and obviously the so-called wealth effect that we can clearly pick up in consumer markets works in both directions.

And in the event that there's been a marked decline in wealth ultimately you're going to see that in the consumer markets, so we are aware of that. We try to keep on track as best we can.

Representative Sanford. Second question under the category of is human nature dead. I think you wisely pointed out in your testimony about the budget, that recent budgetary discussions do not appear to be focused on extending the tendency towards restrained spending growth.

The highway bill would probably be an example of that.

But what I was wondering about is if you think about how this place works, when there's been discussion of Social Security, there seems to be a controversy about whether there should be individual personal savings accounts, if there's reform of Social Security, versus a collective investment account.

And given the way Washington is a very human institution, I've got real questions about the wisdom of a collective account.

What are your thoughts?

Chairman Greenspan. Well I've testified previously that the availability of individual accounts will create a much higher likelihood that our retirement system, both private and public, will be fully funded.

The major problem I have with our existing pay-as-you-go system is that it doesn't reflect the fact that when you're trying to create a retirement fund, you need real resources because people consume real goods and services on retirement, and finance is merely a facilitator to create the resources that will be available for both workers and for retirees at a particular point in time.

And I've always argued that the full funding procedures that are involved in the private sector are far more likely to create the real goods that are required, and therefore anything which will move our Social Security retirement system old age and survivors' benefits to a fully-funded system I think is very helpful.

And to the extent that we can move to equivalent private accounts, I think that would work clearly in that direction.

Representative Sanford. Thank you, Mr. Chairman.

Representative Saxton. Thank you.

Ms. Maloney, the Chairman has graciously agreed to stay for a few more minutes and so if you would like to use the remaining time?

OPENING STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY

Representative Maloney. I thank Chairman Greenspan for staying.

Recently I heard President Clinton talk about meeting, when he first came to office in '93, with many economists who told him that if the unemployment rate fell below 5 percent or 5.5 percent, that we would have inflation.

Well, we are now at what is it? 4.3 and .1 percent inflation, and I'd like to hear your comment on that very briefly.

And unfortunately, my great State of New York has not followed the national trend of lower unemployment. The national trend is 4.3 percent, but in New York City, we have a 9 percent.

Should we see that as an opportunity for economic growth for employment in New York City?

Could you comment on that?

[The prepared statement of Representative Maloney appears in the Submissions for the Record.]

Chairman Greenspan. Well, the issue has been summarized in what we call the NAIRU, which is an attempt to try to find the unemployment rate at which inflation is neither accelerating or decelerating.

And if that rate were 5.5 percent or even close to 6 percent, as many economists had presumed a decade or more ago, then one would never expect of course to see this particular chart.

Whenever the facts are alien to one's presumptions of what the structure of the economy is supposed to be, one has to go back and re-look at what the underlying elements in the model are.

I have been always quite uncomfortable about the notion that there is such a thing as a national NAIRU, that is, a particular unemployment rate that has the effect of stabilizing the rate of inflation. However, I do think it can exist in a metropolitan area, where people can compete with one another, move back and forth.

I have great doubts at whether or not it's an assumption that is stable when you go to a nation as a whole. And I think there are going to be a number of doctoral theses that will be written in the years ahead to try to reconcile what the relationship is between the views that were held in, say, the 1980s and what the data shown in this particular chart suggests.

So it is one of the more important questions of economic analysis that I think economists are going to have to confront in the years ahead.

Representative Maloney. Mr. Greenspan, this morning, the Russian stock market was down 6.2 percent, the closing prices on the Asian markets were all lower with Taiwan down 5 percent, Hong Kong down 4.9 percent, Korea down 4.3 percent, Singapore down 4.4 percent, and Thailand down 5.2 percent.

And for the first time, we are beginning to hear from China that the Japanese yen's weakness is beginning to bother them.

Under these conditions, Mr. Chairman, should the United States central bank refrain from sending any signals about higher federal fund rates at this point, given the falling in these markets?

Chairman Greenspan. It's fairly apparent that when we formulate monetary policy with the underlying goal of maintaining maximum sustainable growth in the United States, we are required to evaluate not only what's going on in this country, but what's going on elsewhere, because the interactions are increasingly more sophisticated and the activities of the new international financial system are creating evermore interrelationships amongst economies around the world.

So that clearly what exchange rates are do matter to us in one form or another.

How we function or what we say always, at least I hope always, does endeavor to embody in it a judgment as to what consequences in markets will be of the types of statements we make or do not make.

Representative Maloney. Well under these conditions, Mr. Greenspan, what are the economic effects on the United States' economy of failing to fund the International Monetary Fund?

Chairman Greenspan. Well, I've commented to a similar question to Senator Sarbanes, and I will just sort of summarize my views, which are that even though I would agree with a number of the criticisms that are being made of the IMF and the potential need to change some of its structure, we are confronted at this particular stage with an international financial system which is quite sensitive and, I would say, under real stress in certain particular areas.

At this particular point, failing to fund the IMF strikes me as the wrong position to take because even though it is quite likely that under most reasonable expectations of the future, the IMF currently has adequate resources to fund what it needs to fund, there is a small but I suspect at the moment growing probability that they may need more, and if it is not forthcoming, I would say that the consequences of the shortfall could be far more difficult than we would imagine.

And I think that while the risks may not be large, the consequences, if we are wrong, are too large, in my judgment, to fail to replenish the funds as is required.

Representative Maloney. Thank you, Mr. Greenspan.

And finally, I'd like to refer to two articles that were in the *New York Times* recently.

One talked about our jobs surging by 300,000 last month and unemployment at 4.3 percent, then in the same paper and practically on the same page, there was a short, one-paragraph article reporting that the Federal Reserve announced that consumer borrowing grew by $5.5 billion in April following a revised $2 billion increase in March.

The increases in both months were higher than expected.

What is your analysis of an apparent contradiction, Mr. Greenspan, in that more Americans are working than ever. There are more jobs being created, lowest unemployment in my lifetime, yet they continue, Americans continue to build up increasing amounts of consumer debt.

And actually, as we have this hearing, there is a bill on the Floor of Congress right now on bankruptcy, much of which is because of the ease of Americans gaining more consumer debt.

But why are we doing this?

Why are we now getting more money, we're all employed, yet we are building up more debt?

Chairman Greenspan. Well, I think the numbers you're referring to were percents, are they not?

Be that as it may, it's not relevant here.

Consumer credit actually serves a very useful purpose for a vast proportion of American households. And even when they are employed, even when they are financially well off, they—

Representative Maloney. But why is it galloping forward so fast?

Chairman Greenspan. It's not, I was about to get to that - it really is not. If you take a look at the basic measures of the burden of consumer debt - the actual amounts of monthly payments relative to income - the figures are not historically high. If anything, what really has to be explained is why consumer credit is growing so slowly. Part of that answer is that home equity loans are increasing at a fairly substantial pace because a lot of people are now using home equity loans as a substitute for consumer credit.

But even when you combine all of that, as large as the numbers are, and as impressive as the growth is, it still is not at a level which I would consider particularly burdensome.

So unless and until we get to that point, I don't think that problem exists.

I do think the issue you raise with respect to bankruptcy is a very crucial one. I don't think that, however, it is the consequence of an excessive amount of credit being proffered by the banking or the finance company systems which are largely the elements of the financial system which create consumer credit.

So there are lots of problems that we are concerned about in the financial system, and it is conceivable that we may get quite concerned about excessive consumer credit expansion, but we are not there at this particular moment, because we don't think the data exhibit elements of concern.

Representative Saxton. Mr. Chairman, I would like to just thank you very much for the time that you've spent with us today.

I'm a firm believer that when policymakers, members of the business community and the American people generally gain a deeper

and better understanding of our economy and our economic process, that we'll all be able to deal with it in a better way.

The information that you have shared with us this morning has been very valuable in that regard and we thank you very much.

We'll look forward to seeing you again in the future.

The hearing is adjourned.

[Whereupon, at 1:10 p.m., the hearing 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 this morning before the Joint Economic Committee (JEC). Chairman Greenspan's testimony on the outlook for the economy and monetary policy comes at an important juncture in monetary policy.

As the most recent GDP and employment data suggest, the business cycle expansion that began in the second quarter of 1991 continues to produce economic and employment gains. The hard work of millions of workers and entrepreneurs across this nation has expanded the economy year after year. To the extent policy factors are relevant, monetary policy has been the main factor sustaining the economic expansion.

As the Federal Reserve gradually reduced inflation over the last six years, interest rates and the unemployment rate have both declined. The anti-inflationary monetary policy of the Federal Reserve has produced prosperity without inflation. The central error in postwar economic policy – the notion of a tradeoff between inflation and unemployment – has proven misleading during the last two business cycle expansions. Low inflation is a foundation of sustained economic and employment growth and it fosters lower, not higher, unemployment.

Credible disinflation tends to lower interest rates, reduce uncertainty premiums, stabilize financial markets and thereby bolster interest rate sensitive sectors of the economy. Lower inflation promotes efficient operation of the price system and, in many ways, works like a tax cut. All of these factors contribute to sustaining the economic expansion. Chairman Greenspan and the Federal Reserve deserve a great amount of credit for gradually reducing inflation and thereby promoting the many economic benefits that have resulted.

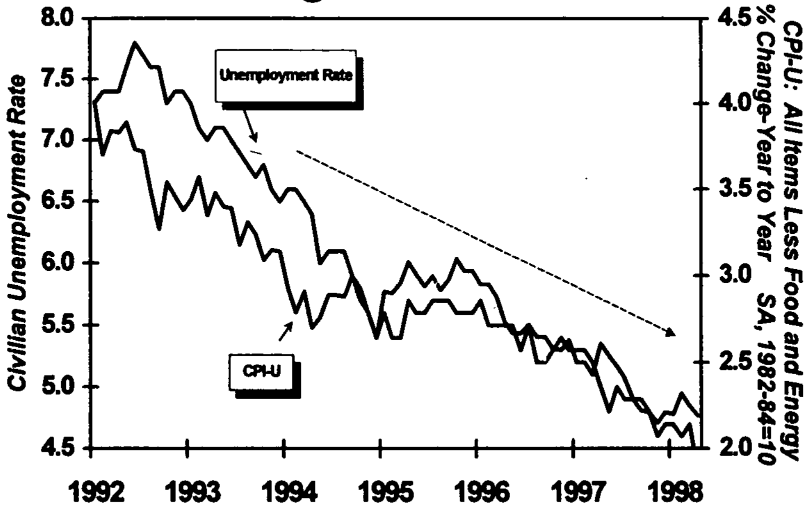
Nonetheless, I believe we must be vigilant about inflation, and monetary policy must pre-empt inflation before it emerges. Here at the Joint Economic Committee we monitor the usual broad measures of general inflation but also forward-looking indicators of inflation expectations such as commodity prices, bond yields, and the value of the dollar. Neither the conventional nor forward-looking inflation indicators justify a change in Federal Reserve policy at this time.

Reportedly, some policymakers at the Federal Reserve have favored a rise in interest rates for some time. However, I think the Federal Reserve has been on the right course and I commend its leadership for charting the appropriate and prudent policy under uncertain conditions.

Overall, recent Federal Reserve policy has been very successful. Current Federal Reserve policy appears consistent with a policy of setting an inflation band of about zero to 2.5 percent. This approach has also been successfully adopted by a number of other central banks around the world.

This policy of inflation targeting would be institutionalized under a bill I have introduced as a foundation for future reform. The important accomplishments of the Federal Reserve under Chairman Greenspan would be locked in so that stable prices and low interest rates can be assured for future generations.

Inflation and the Unemployment Rate Fall Together since 1992



Source: St. Louis Federal Reserve Board and JEC calculations.

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 have the opportunity to present an update on economic conditions in the United States.

Such an assessment cannot be made in isolation but rather depends critically on what is happening in the rest of the world and how those developments affect the performance of the American economy. In my previous appearance before this Committee last October, my remarks focused mainly on the turbulence that was then evident in world financial markets and, in particular, on the problems that had emerged in a number of Asian economies. The tentative assessment offered then was that the economies of Asia were in for some trying times but that the situation did not seem likely to threaten the expansion of this country's economy.

That assessment, I believe, still is essentially correct, although uncertainties about the degree of restraint that will be coming from abroad remain substantial. Earlier this year, the situations in most of the Asian countries seemed to be stabilizing in some respects, but, as the events of the past few weeks have demonstrated, the restoration of normally functioning economies will not necessarily go smoothly. In some cases, the adjustments that are needed to improve external balances and to correct existing misallocations of resources have been accompanied by sharp increases in inflation, rising unemployment, abrupt cutbacks in living standards, and increases in uncertainty and insecurity. The heightened social and political pressures that can develop in such circumstances not only introduce added complications into economic policymaking but also make it even more difficult to foresee how the processes of adjustment will play out across the afflicted economies.

That the American economy would be affected to some degree by spillover from the problems in Asia was never in doubt, even though the timing and magnitude of the impact have been difficult to predict with much confidence. Many months ago, businesses in this country began anticipating a worsening of our trade balance with the Asian countries, and incoming economic data have since confirmed those expectations. Meanwhile, other influences on trade--such as the strength of demand growth in the United States and a dollar that has been strong against a wide array of currencies--have persisted. In total, U.S. exports of goods

and services turned down in real terms in the first quarter of 1998, the first such decline in four years, and real imports of goods and services continued to rise very rapidly. The combined effect of these changes exerted a drag of 2-1/2 percentage points on the annual growth rate of real GDP last quarter. Weaknesses in Asia appear to account for approximately one-half of that deterioration. Not only have export volumes been affected, but producers in both industry and agriculture also are having to adjust to the lower product prices that have come with slower economic growth abroad and the increase in the competitiveness of foreign producers induced largely by depreciations of their currencies.

But even with substantial drag from the external sector, the U.S. economy has continued to expand at a robust pace. In the first quarter, real GDP grew even faster than it had in 1997. Employment has continued to increase rapidly this year, and the unemployment rate has fallen further, reaching its lowest level since 1970. Incomes have continued to climb, and gains in household and business expenditures have been exceptionally strong. Although the data on hours worked suggest that growth of the economy has likely slowed this quarter from the first quarter's torrid pace, the degree of slowdown remains in question. Evidence to date of a moderation in underlying domestic spending still is sparse.

The strength of domestic spending has been fueled, in part, by conditions in financial markets. Although real short-term interest rates have been rising, equity prices have moved still higher, credit has been readily available at slender margins over Treasury interest rates, and nominal long-term interest rates have remained near the lowest levels of recent decades. Rapid growth of money this year is a further indication that financial conditions are accommodating strong domestic spending, although we still are uncertain how reliable that relationship will prove to be over time.

In short, our economy is still enjoying a virtuous cycle, in which, in the context of subdued inflation and generally supportive credit conditions, rising equity values are providing impetus for spending and, in turn, the expansion of output, employment, and productivity-enhancing capital investment. The hopes for accelerated productivity growth have been bolstering expectations of future corporate earnings and thereby fueling still further increases in equity values.

The essential precondition for the emergence, and persistence, of this virtuous cycle is arguably the decline in the rate of inflation to near price stability. Continued low product price inflation and expectations that it will persist have brought increasing stability to financial markets and fostered perceptions that the degree of risk in the financial outlook has been moving ever lower. These perceptions, in turn, have reduced the extra compensation that investors require for making loans to, or taking ownership positions in, private firms.

To a considerable extent, investors seem to be expecting that low inflation and stronger productivity growth will allow the extraordinary growth of profits to be extended into the distant future. Indeed, expectations of per share earnings growth over the longer term have been undergoing continuous upward revision by security analysts since 1994. These rising expectations have, in turn, driven stock prices sharply higher and credit spreads lower, perhaps to levels that will be difficult to sustain unless economic conditions remain exceptionally favorable--more so than might be anticipated from historical relationships. In any event, primarily because of the rise in stock prices, about $12 trillion has been added to the value of household assets since the end of 1994. Probably only a few percent of these largely unrealized capital gains have been transformed into the purchase of goods and services in consumer markets. But that increment to spending, combined with the sharp increase in equipment investment, which has stemmed from the low cost of both equity and debt relative to expected profits on capital, has propelled the economy forward. The current economic performance, with its combination of strong growth and low inflation, is as impressive as any I have witnessed in my near half-century of daily observation of the American economy.

The consequences for the American worker have been dramatic and, for the most part, highly favorable. A great many chronically underemployed people have been given the opportunity to work, and many others have been able to upgrade their skills as a result of work experience, extensive increases in on-the-job training, or increased enrollment in technical programs. Welfare recipients appear to have been absorbed into the work force in significant numbers.

Government finances have improved as well. The taxes paid on huge realized capital gains and other incomes related to the stock market, coupled with taxes on markedly higher corporate profits, have joined with restraint on spending to produce a unified federal budget surplus for

the first time in nearly three decades. April's budget surplus of $125 billion was the largest monthly surplus on record. Widespread improvement also has been evident in the financial positions of state and local governments.

The fact that economic performance strengthened as inflation subsided should not have been surprising, given that risk premiums and economic disincentives to invest in productive capital diminish as product prices become more stable. But the extent to which strong growth and high resource utilization have been joined with low inflation over an extended period is nevertheless extraordinary. Indeed, the broadest measures of price change indicate that the inflation rate moved down further in the first quarter of this year, even as the economy strengthened. Although declining oil prices contributed to this result, pricing leverage in the goods-producing sector more generally was held in check by rising industrial capacity, reduced demand in Asia that, among other things, has led to a softening of commodity prices, and a strong dollar that has contributed to bargain prices on many imports. Some elements in this mix clearly were transitory, and the very recent price data suggest that consumer price inflation has moved up in the second quarter. But, even so, the rate of rise remains quite moderate overall. At this point, at least, the adverse wage-price interactions that played so central a role in pushing inflation higher in many past business expansions--eventually bringing those expansions to an end--do not appear to have gained a significant toe-hold in the current expansion.

There are many reasons why the wage-price interactions have been so well-contained in this expansion. For one thing, increases in hourly compensation have been slower to pick up than in most other recent expansions, although, to be sure, wages have started to accelerate in the past couple of years as the labor market has become tighter and tighter.

In the first few years of the expansion, the subdued rate of rise in hourly compensation seemed to be, in part, a reflection of greater concerns among workers about job security. We now seem to have moved beyond that period of especially acute concern, though the flux of technology may still leave many workers with fears of job skill obsolescence and a willingness to trade wage gains for job security. This may explain why, despite the recent acceleration of wages, the resulting level of compensation has fallen short of what the experience of previous expansions would have led us to anticipate given the current degree of labor market tightness. In the past couple of years, of course, workers

have not had to press especially hard for nominal pay gains to realize sizable increases in their real wages. In contrast to the pattern that developed in several previous business expansions, when workers required substantial increases in pay just to cover increases in the cost of living, consumer prices have been generally well-behaved in the current expansion. Changes this past year in prices of both goods and services have been among the smallest of recent decades.

In addition, the rate of rise in the cost of benefits that employers provide to workers has been remarkably subdued over the past few years, although a gradual upward tilt has become evident of late. A variety of factors--including the strength of the economy and rising equity values, which have reduced the need for payments into unemployment trust funds and pension plans, and the restructuring of the health care sector--have been working to keep benefit costs in check in this expansion. But, in the medical area at least, the most recent developments suggest that the favorable trend may have run its course. The slowing of price increases for medical services seems to have come to a halt, at least for a time, and, with the cost-saving shift to managed care having been largely completed, the potential for businesses to achieve further savings in that regard appears to be rather limited at this point. There have been a few striking instances this past year of employers boosting outlays for health benefits by substantial amounts.

A couple of years ago--almost at the same time that increases in total hourly compensation began trending up in nominal terms--evidence of a long-awaited pickup in the growth of labor productivity began to show through more strongly in the data; and this accelerated increase in output per hour has enabled firms to meet workers' real wage demands while holding the line on price increases. Gains in productivity usually vary with the strength of the economy, and the favorable results that we have observed during the past two years or so, when the economy has been growing more rapidly, surely overstate the degree of pickup that can be sustained. But evidence continues to mount that the trend has picked up, even if the extent of that improvement is as yet unclear. Signs of a major technological transformation of the economy are all around us, and the benefits are evident not only in high-tech industries but also in production processes that have long been part of our industrial economy.

Notwithstanding a reasonably optimistic interpretation of the recent productivity numbers, it would not be prudent to assume that rising productivity, by itself, can ensure a non-inflationary future. Certainly

wage increases, per se, are not inflationary. To be avoided are those that exceed productivity growth, thereby creating pressure for inflationary price increases that can eventually undermine economic growth and employment. Because the level of productivity is tied to an important degree to the physical stock of capital, which turns over only gradually, increases in the trend growth of productivity probably also occur rather gradually. By contrast, the potential for abrupt acceleration of nominal hourly compensation is surely greater. Still, a strong signal of inflation pressures building because of compensation increases markedly in excess of productivity gains has not yet clearly emerged in this expansion. Among nonfinancial corporations, our most reliable source of consolidated costs, trends in costs seem to have accelerated from their lows, but the rates of increase in both unit labor costs and total unit costs are still quite low.

Nonetheless, as I have noted in previous appearances before Congress, I remain concerned that economic growth will run into constraints as the reservoir of unemployed people available to work is drawn down. The annual increase in the working-age population (from 16 to 64 years of age), including immigrants, has been approximately 1 percent a year in recent years. Yet employment, measured by the count of persons who are working rather than by the count of jobs, has been rising 2 percent a year since 1995 despite the acceleration in the growth of output per hour. The gap between employment growth and population growth, amounting to about 1.2 million a year on average, has been made up, in part, by a decline in the number of individuals who are counted as unemployed--those persons who are actively seeking work--of approximately 700,000 a year, on average, since the end of 1995. The remainder of the gap has reflected a rise in labor force participation that can be traced to a decline of more than 500,000 a year in the number of individuals (age 16 to 64) wanting a job but not actively seeking one. Presumably, many of the persons who once were in this group have more recently become active and successful job-seekers as the economy has strengthened, thereby preventing a still sharper drop in the official unemployment rate. In May, the number of persons aged 16 to 64 who wanted to work but who did not have jobs was 9.7 million on a seasonally adjusted basis, slightly more than 5-1/2 percent of the working-age population. This percentage is a record low for the series, which first became available in 1970.

The gap between the growth in employment and that of the working-age population will inevitably close. What is crucial to sustaining this unprecedented period of prosperity is whether that closing occurs in a disruptive or gradual, balanced manner. The effects of the crisis in Asia will almost certainly damp net exports further, potentially moderating the growth of domestic production and hence employment. The strength of domestic spending that has been been bolstering output growth and the demand for labor also could ebb if recent indications of a narrowing in domestic profit margins were to prove to be the forerunner of a reassessment of the expected rates of return on plant and equipment. Reduced prospects for the return to capital would not only affect investment directly but could also affect consumption as stock prices adjusted to a less optimistic view of earnings prospects. Finally, the clearly unsustainable rise of inventories that has been evident in recent quarters will be slowing at some point, perhaps abruptly. An easing of the demand for labor would be an expected consequence of a slowdown in either final sales or inventory accumulation. Of course, the demand for labor that is consistent with a particular rate of output growth also could be lowered if productivity were to continue to accelerate. And, on the supply side of the labor market, faster growth of the labor force could emerge as the result of delayed retirements or increased immigration.

If developments such as these do not bring labor demand into line with its sustainable supply, tighter economic policy may be necessary to help guard against a buildup of pressures that could derail the current prosperity. Fortunately, fiscal policy has been moving toward restraint to some degree, although recent budgetary discussions do not appear to be focused on extending that tendency. Monetary policy might need to tighten if demand were to continue to exhibit few signs of abating noticeably, thereby threatening to place still further strains on our labor markets. We at the Federal Reserve, recognizing the powerful forces of productivity growth and global restraint on inflation, have not perceived to date the need to tighten policy in response to strong demand, beyond what has occurred through falling inflation's upward pressure on the real federal funds rate and the modest increase in the nominal rate that we initiated in March of 1997. But, we are monitoring the evolving forces very closely to determine whether the recent acceleration of costs, albeit moderate, is likely to prove transitory or the start of a more worrisome pattern that may well require a response.

In summary, Mr. Chairman, our economy has remained strong this year despite evidence of substantial drag from Asia, and, at the same time, inflation has remained low. As I have indicated, this set of circumstances is not what historical relationships would have led us to expect at this point in the business expansion, and while it is possible that we have, in a sense, moved "beyond history," we also have to be alert to the possibility that less favorable historical relationships will eventually reassert themselves. That is why we are remaining watchful for signs of potential inflationary imbalances, even as the economy continues to perform more impressively than it has in a very long time.

PREPARED STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY

Mr. Chairman, over the past several months the business community has been focused on the financial crisis in Asia. While we observe the problems in these other countries, the overriding question has been how the problems there would affect the economy here, in the U.S.

So far the news has been quite good. For the past two months the unemployment rate in this country has been 4.3%... the lowest rate in 30 years. The inflation rate as measured by the change in the Consumer Price Index was an incredibly low 0.2%, in first quarter of 1998. And growth in the gross domestic product was a strong 4.8 percent, also in the first quarter.

There are some concerns which are beginning to appear. U.S. exports to Asia have drastically declined, leading to a trade deficit in March of $13 billion. Exports to Asia have dropped about 15% compared to the same period last year. And as exports have weakened, industrial production has stalled. The result of this decline on the Asian market, Factory output, much of which relies on exports, has been flat since the beginning of this year.

So have we escaped the consequences of the "Asian Contagion"? While the economy appears to be strong it is unclear that we have yet to withstand the brunt of the effects. Obviously, Chairman Greenspan, you take these criteria into account when determining monetary policy. But those of us in Congress do have a role to play. As you know there is a faction in Congress that believes we should not refund the International Monetary Fund. I have supported the Administration in their efforts to fund the IMF, but I hope that you will discuss what the consequences on the U.S. economy may be if we fail to provide the $18 billion for the IMF and turned our backs on this international organization.

While the economy is strong, we must not consider our economic policy in a vacuum.

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