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S. HRG. 105–417

THE ECONOMIC OUTLOOK AND MONETARY POLICY

HEARING

before the

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

October 29, 1997

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON: 1997

cc 47-280

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-056372-0

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[Created pursuant to Sec. 5(a) of Public Law 304, 79th Congress]

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THE ECONOMIC OUTLOOK AND MONETARY POLICY

Wednesday, October 29, 1997

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

The Committee met, pursuant to notice, at 10:00 a.m., in Room G50 of the Dirksen Senate Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

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

Staff Present: Chris Frenze, Robert Keleher, Colleen J. Healy, Juanita Morgan, Mary Hewitt, Joseph Cwiklinski, Paul Merski, Dan Lara, Howard Rosen, Kerry Sutten, and Amy Pardo.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. The Joint Economic Committee (JEC) hearing will come to order.

I'm pleased to welcome the Federal Reserve Chairman, Alan Greenspan, to testify before the Joint Economic Committee on the economic outlook and monetary policy.

Given the sensitivity of the situation in international financial markets, we recognize that Chairman Greenspan must be somewhat constrained and circumspect in his comments, and for similar reasons, my statement will focus on long-term issues related to monetary policy. I am following this situation with regard to the markets very closely. But, given the volatility in financial markets in recent days, the snap-back of the U.S. equity markets is most encouraging. This highlights the resilience of the economic and financial environment fostered, in my opinion, by Federal Reserve policy relating to price stability.

Two key factors to keep in mind in the current situation are: 1) the underlying strength of the economy and 2) the ability of the leadership of the Federal Reserve to help preserve the kind of growth that we would all like to see.

Economic growth is healthy, and inflation and unemployment are quite low.

In addition, the Federal Reserve demonstrated in 1987 that, when necessary, it can handle market disruptions superbly and eliminate negative fall out on the economy.

In 1987, a decade ago, following the stock market debacle, economic growth actually increased during the fourth quarter of that year.

Currently, the economic outlook for the United States remains very positive.

The business cycle expansion that began in the second quarter of 1991 continues to produce economic and employment gains with no end in sight. It is due to the hard work of millions of American workers and business persons all across our nation.

It is my firm belief that, to the extent that policy factors are relevant to our economic situation today, monetary policy has been the central factor sustaining economic expansion.

As the Federal Reserve gradually squeezed inflation over the last six years, interest rates and unemployment have both declined substantially, and the anti-inflationary monetary policy of the Federal Reserve has paved the way.

The central error in postwar economic policy, the notion of a tradeoff between inflation and employment, has been refuted during the last two business cycles. Low inflation is one of the foundation stones, as a matter of fact, of sustained economic employment and economic growth.

Credible disinflation—that is, lower rates of inflation—tends to lower interest rates, reduce uncertainty and stabilize financial markets in the economy and, thereby, lower inflation promotes efficient operation of the price system, and in many ways works like a tax cut.

That is, as we see inflation come down, followed by lower interest rates, it works as an incentive for business and economic growth.

All of these factors contribute to sustaining the economic expansion. Chairman Greenspan and his colleagues at the Federal Reserve deserve a

great deal of credit for reducing inflation in a gradual manner and, thereby, promoting the many economic benefits that have resulted.

Some seem confused about the coexistence of low inflation and low unemployment. They seek an explanation in a new economy or a new era. But new, revolutionary developments are not necessary to explain the current circumstances.

Rather, old truths will suffice; specifically, low inflation is good for economic growth and works to lower unemployment. They go together.

On the other hand, a loose monetary policy ultimately leads to higher inflation and higher unemployment at the same time, as was demonstrated in the 1970s.

Inflation is not caused by economic growth. As Milton Friedman and F.A. Hayek both noted, inflation is caused by too much money in the system. If the Fed does not expand the monetary supply too rapidly, inflation will not occur.

Only when artificial economic growth is caused by excessive monetary expansion is there reason for concern. Nonetheless, I believe we must be vigilant about inflation and Federal Reserve policy must pre-empt inflation before it emerges.

Here, in the Joint Economic Committee, we monitor the usual price indices—the Consumer Price Index (CPI), the Producer Price Index (PPI), the cost of labor, and so on. But we also look to forward-looking indicators of inflation, 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, in my opinion, at this time.

Overall, the thrust of Federal Reserve policy has been very successful in recent years. Current Federal Reserve policy seems consistent with a policy of setting an inflation band of about zero to 2-1/2 percent. This is a sound approach that has been used successfully and has been adopted by other countries, other central banks around the world.

This policy of inflation-targeting should be institutionalized, and would be under legislation which I have introduced.

The formidable achievements of the Federal Reserve under Chairman Greenspan should be locked in place so that price stability and low interest rates can be preserved for future generations of Americans.

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

Senator Bingaman, that's my opening statement, and I would turn to you, sir, at this point for yours.

Senator Bingaman. Thank you very much.

Representative Saxton. And then we'll hear from the Chairman.

OPENING STATEMENT OF SENATOR JEFF BINGAMAN

Senator Bingaman. Mr. Chairman, thank you very much. Chairman Greenspan, thank you for being here. We welcome you.

I also will try, when we get to the question part, to focus and elicit your insights on some of the more medium and long-term prospects, particularly with regard to any effect we can anticipate on our economy as a result of the turmoil in Asian markets. Is this just a case of the 24-hour Asian flu, or is this a more serious, long-term, fundamental problem to which we need to adjust?

Does the devaluation of Asian currencies raise the prospect of a surge in our trade imbalance? Does it raise the prospect of lower inflation than we would have otherwise expected over the next several months?

And does it put us in a situation where our own dollar is substantially overvalued compared to the Yen and other foreign currencies?

The sort of question I will be anxious to get some insights on is whether the changes that have occurred, particularly concerning the valuation of currencies and anticipated growth rates in the Far East, will cause us to consider whether our own interest rates are too high rather than too low.

All the speculation in recent months has been as to whether we should raise interest rates. I guess the recent events in the Far East at least raise the question with me as to whether, rather than raising them, we should be considering some kind of easing of interest rates in this country.

Those are the kinds of questions I'll be trying to probe with you and, again, thank you for being here.

Representative Saxton. Mr. Chairman, we are very appreciative of the time that you have to spend with us this morning and so, without further ado, we'd like to ask you for your thoughts and your comments at this time.

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

Mr. Greenspan. Well, thank you very much, Mr. Chairman.

I'd just first like to say, speaking for my colleagues, we very much appreciate your opening remarks, and we find your general view as to longer term policies something which clearly engages us in a very important debate.

Mr. Chairman and Committee Members, we meet against the background of considerable turbulence in world financial markets, and I shall address the bulk of my remarks to those circumstances.

We need to assess these developments against the backdrop of a continuing impressive performance of the American economy in recent months. Growth appears to have remained robust and inflation low, and even falling, despite an ever-tightening labor market. Our economy has enjoyed a lengthy period of good economic growth, linked, as you point out, Mr. Chairman, not coincidentally, to damped inflation. The Federal Reserve is dedicated to contributing, as best it can, to prolonging this performance, and we will be watching economic and financial market developments closely and evaluating their implications.

Even after the sharp rebound around the world in the past 24 hours, declines in stock markets in the United States and elsewhere have left investors less wealthy than they were a week ago and businesses facing a higher cost of equity capital. Yet, provided the decline in financial markets does not cumulate, it is quite conceivable that a few years hence we will look back at this episode, as we now look back at the 1987 crash, as a salutary event in terms of its implications for the macroeconomy.

The 1987 crash occurred at a time when the American economy was operating with a significant degree of inflationary excess that the fall in market values arguably neutralized. Today's economy, as I have been suggesting of late, has been drawing down unused labor resources at an unsustainable pace, spurred in part by a substantial wealth effect on demand. The market's net retrenchment of recent days will tend to damp that impetus, a development that should help to prolong our 6-1/2-year business expansion.

As I have testified previously, much of the stock price gain since early 1995 seems to have reflected upward revisions of long-term earnings expectations, which were implying a continuing indefinite rise in profit

margins from already high levels. I suspect we are experiencing some scaling back of the projected gains in foreign affiliate earnings and investors probably are revisiting expectations of domestic earnings growth. Still, the foundation for good business performance remains solid. Indeed, data on our national economy in recent months are beginning to support the notion that productivity growth, the basis for increases in earnings, is beginning to pick up.

I also suspect earnings expectations and equity prices in the United States were primed to adjust. The currency crisis in Southeast Asia and the declines in equity prices there and elsewhere do have some direct effects on U.S. corporate earnings, but not enough to explain the recent behavior of our financial markets. If it was not developments in Southeast Asia, something else would have been the proximate cause for a reevaluation.

While productivity growth does appear to have picked up in the last six months, as I have pointed out in the past, it likely is overly optimistic to assume that the dimension of any acceleration in productivity will be great enough and persistent enough to close, by itself, the gap between an excess of long-term demand for labor and its supply. It will take some time to judge the extent of a lasting improvement.

Regrettably, over the last year, the argument for the so-called new paradigm has slowly shifted from the not unreasonable notion that productivity is in the process of accelerating to a less than credible view, often implied rather than stated, that we need no longer be concerned about the risk that inflation can rise again. The Federal Reserve cannot afford to take such a complacent view of our price prospects. There is much that is encouraging in the recent performance of the American economy, but, as I have often mentioned before, fundamental change comes slowly and we need to evaluate the prospective balance of supply and demand for various productive resources in deciding policy.

Recent developments in equity markets have highlighted growing interactions among national financial markets. The underlying technology-based structure of the international financial system has enabled us to improve materially the efficiency of the flows of capital and payment systems. That improvement, however, has also enhanced the ability of the financial system to transmit problems in one part of the globe to another quite rapidly. The recent turmoil is a case in point. I believe there is much to learn from the recent experience in Asia that can be applied to better the

workings of the international financial system and its support of international trade that has done so much to enhance living standards worldwide.

While each of the Asian economies differs in many important respects, the sources of their spectacular growth in recent years, in some cases, decades, and the problems that have recently emerged, are relevant to a greater or lesser extent to nearly all of them.

Following the early post-World War II period, policies generally fostered low levels of inflation and openness of their economies, coupled with high savings and investment rates, contributed to a sustained period of rapid growth, in some cases, starting in the 1960s and 1970s. By the 1980s, most economies in the region were expanding vigorously. Foreign net capital inflows grew, but until recent years, were relatively modest. The World Bank estimates that net inflows of long-term debt, foreign direct investment, and equity purchases to the Asian Pacific region were only about $25 billion in 1990, but exploded to more than $110 billion by 1996.

A major impetus behind this rapid expansion was the global stock market boom of the 1990s. As the boom progressed, investors in many industrial countries found themselves more heavily concentrated in the recently higher-valued securities of companies in the developed world, whose rates of return in many instances had fallen to levels perceived as uncompetitive with the earnings potential in emerging economies, especially in Asia. The resultant diversification induced a sharp increase in capital flows into those economies. To a large extent, they came from investors in the United States and Western Europe. A substantial amount came from Japan, as well, owing more to a search for higher yields than to rising stock prices and capital gains in that country. The rising yen through mid-1995 also encouraged a substantial increase in direct investment inflows from Japan. In retrospect, it is clear that more investment monies flowed into these economies than could be profitably employed at modest risk.

I suspect that it was inevitable in those conditions of low inflation, rapid growth and ample liquidity that much investment moved into the real estate sector with an emphasis by both the public and private sectors on conspicuous construction projects. This is an experience, of course, not unknown in the United States on occasion. These real estate assets, in turn, ènded up as collateral for a significant proportion of the assets of

domestic financial systems. In many instances, those financial systems were less than robust, beset with problems of lax lending standards, weak supervisory regimes, and inadequate capital.

Moreover, in most cases, the currencies of these economies were closely tied to the U.S. dollar, and the dollar's substantial recovery since mid-1995, especially relative to the yen, made their exports less competitive. In addition, in some cases, the glut of semiconductors in 1996 suppressed export growth, exerting further pressures on highly leveraged businesses.

However, overall GDP growth rates generally edged off only slightly, and imports, fostered by rising real exchange rates, continued to expand, contributing to what became unsustainable current account deficits in a number of these economies. Moreover, with exchange rates seeming to be solidly tied to the dollar, and with dollar and yen interest rates lower than domestic currency rates, a significant part of the enlarged capital inflows into these economies, in particular, short-term flows, was denominated by the ultimate borrowers in foreign currencies. This put additional pressure on companies to earn foreign exchange through exports.

The pressures on fixed exchange rate regimes mounted as foreign investors slowed the pace of new capital inflows and domestic businesses sought increasingly to convert domestic currencies into foreign currencies, or, equivalently, slowed the conversion of export earnings into domestic currencies. The shifts in perceived future investment risks led to sharp declines in stock markets across Asia, often on top of earlier declines or lackluster performances.

To date, the direct impact of these developments on the American economy has been modest, but it can be expected not to be negligible. U.S. exports to Thailand, the Philippines, Indonesia, and Malaysia— the four countries, incidentally, initially affected—were about 4 percent of total U.S. exports in 1996. However, an additional 12 percent went to Hong Kong, Korea, Singapore, and Taiwan, economies that have been affected more recently. Thus, depending on the extent of the inevitable slowdown in growth in this area of the world, the growth of our exports will tend to be muted. Our direct foreign investment in, and foreign affiliate earnings reported from, the economies in this region as a whole have been a smaller share of the respective totals than their share of our exports. The share is, nonetheless, large enough to expect some drop-off in those earnings in the period ahead. In addition, there may be indirect effects on the American

real economy from countries such as Japan that compete even more extensively with the economies in the Asian region.

Particularly troublesome over the past several months has been the so-called contagion effect of weakness in one economy spreading to others, as investors perceive, rightly or wrongly, similar vulnerabilities. Even economies, such as Hong Kong, with formidable stocks of international reserves, balanced external accounts, and relatively robust financial systems, have experienced severe pressure in recent days.

One can debate whether the recent turbulence in Latin American asset values reflect contagion effects from Asia, the influence of developments in U.S. financial markets, or home-grown causes. Whatever the answer, and the answer may be all of the above, this phenomenon illustrates the interdependencies in today's world economy and financial system.

Perhaps it was inevitable that the impressive and rapid growth experienced by the economies in the Asian region would run into a temporary slowdown or pause. But there is no reason that above-average growth in countries that are still in a position to gain from catching up with the prevailing technology cannot persist for a very long time. Nevertheless, rapidly developing free-market economies periodically can be expected to run into difficulties because investment mistakes are inevitable in any dynamic economy. Private capital flows may temporarily turn adverse. In these circumstances, companies should be allowed to default, private investors should take their losses, and government policies should be directed toward laying the macroeconomic and structural foundations for renewed expansion; new growth opportunities must be allowed to emerge. Similarly, in providing any international financial assistance, we need to be mindful of the desirability of minimizing the impression that international authorities stand ready to guarantee the liabilities of failed domestic businesses. To do otherwise could lead to distorted investments and could ultimately unbalance the world financial system.

The recent experience in Asia underscores the importance of financially sound domestic banking and other associated financial institutions. While the current turmoil has significant interaction with the international financial system, the recent crises would arguably have been better contained if long-maturity property loans had not accentuated the usual mismatch between maturities of assets and liabilities of domestic financial systems that were far from robust to begin with. Our unlamented savings and loan crises comes to mind.

These are trying days for economic policy makers in Asia. They must fend off domestic pressures that seek disengagement from the world trading and financial system.

The authorities in these countries are working hard, in some cases with substantial assistance from the IMF, the World Bank, and the Asian Development Bank, to stabilize their financial systems and economies.

The financial disturbances that have afflicted a number of currencies in Asia do not at this point, as I indicated earlier, threaten prosperity in this country. But we need to work closely with their leaders and the international financial community to assure that their situations stabilize. It is in the interest of the United States and other nations around the world to encourage appropriate policy adjustments and, where required, provide temporary financial assistance.

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. Dr. Greenspan, thank you very much for a very thorough and articulate statement involving the situation that we find ourselves in.

Mr. Chairman, during your statement you mentioned at some length the situation involving the Asian developing countries. And if I interpreted what you said correctly, you indicated that what we're seeing is, hopefully, perhaps probably, temporary in nature in terms of a setback.

We also know that despite the recent volatility shown in the U.S. stock market, that economic growth appears to be solid and that unemployment and inflation remain quite low.

Given the economic fundamentals and given the analysis that you have just related to us regarding the Asian developing countries, shouldn't we expect the outlook for the economy to be quite positive in the foreseeable future?

Mr. Greenspan. You're talking about the American economy?

Representative Saxton. Yes, sir.

Mr. Greenspan. Yes. Indeed, it's very difficult to come to a conclusion, looking at the data that continue to come in, that this economy cannot continue to grow in a solid and, hopefully, noninflationary manner.

I indicated in my testimony that, as things now stand, the repercussions from the difficulties in Asia, while they do impact upon our

exports, and they doubtless impact on some of the prices that domestic producers charge in this country, which have additional marginal effects, that impact is relatively modest.

Our concern is that the contagion that has occurred be contained. And the reason for that is that, with the evolution of what really is an extraordinarily dynamic international financial system, which has emerged really in the last decade or less, there is a new pattern of flows of capital which have become extraordinarily large. And while these flows are clearly required to facilitate the expansion of international trade in goods and services and standards of living, they are something new that we have to focus on and understand.

As in all open economies and all free markets, people don't bat 1000 percent in their investment judgments, they make mistakes, hopefully fewer than the correct decisions, but they do make mistakes. And periodically, that is going to cause retrenchments. They should be temporary. They should be a pause, and as the mistakes are liquidated, and growth picks up again, new products will emerge, economies will become better, standards of living will rise.

That is the process on which we in the United States should be very focused to assure it continues in a balanced manner because we are one of the major recipients of the benefits of that effective international financial system.

Representative Saxton. Mr. Chairman, let me just follow up. I don't want to be repetitive. I did refer to this in my opening statement.

But with regard to our domestic economy, you have made it a central focus of your Chairmanship and of the Federal Reserve policy to focus on a part of our economy that we generally refer to as inflation or price stability.

In recent congressional testimony, you stated that low inflation, "was a cause of a good economy." You said, "Continued low levels of inflation and inflationary expectations have been a key support for healthy economic performance. They have helped to create a financial and economic environment conducive to strong capital spending and long-range planning generally, and so, to sustain economic expansion.

Consequently, the Federal Open Market Committee believes it is crucial to keep inflation contained in the near-term and ultimately, to move toward price stability."

This seems to me to be a concept that's extremely important in our economy today.

Doesn't this suggest that lower inflation leads to lower interest rates and that lower interest rates lead to economic expansion, in much the same way that some of us like to think about lower taxes leading to economic growth?

Isn't this all kind of, sort of the same policy?

Mr. Greenspan. I think so, Mr. Chairman. Especially as we are experiencing month after month of low inflation and observing the concurrent strength that is being exhibited by the economy, statisticians are going to find increasingly that the relationship between low inflation, on the one hand, and increasing productivity on the other, is going to become an ever-tighter relationship. I suspect, although at this particular stage we can't prove definitively, that strong economic growth which persists indefinitely requires low inflation as a necessary condition.

If that is the case, then the notion that we would allow inflation to reemerge in this country and undercut what has been one of the most successful economic expansions that I've experienced in my working life, would be a very tragic event.

And as I've stated innumerable times before this Congress, the policy of the Federal Reserve has to be to sustain low inflation and price stability if our objective is maximum, long-term sustainable growth.

Representative Saxton. Mr. Chairman, the central banks in the United Kingdom, Canada and Sweden have adopted formally a policy of targeting inflation. And as you know, I have introduced a price stability bill mandating the use of inflation targets.

A narrow band of permissible increases in a broad price index measure would be chosen and disclosed by the central bank, as is already the case in the nations that I mentioned and quite a few others.

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.

This seems to be consistent with recent Fed policy pursuant to your Chairmanship.

Is this kind of definition of price stability a promising approach? Obviously following on your comments of a few minutes ago, I would

think so. And do you see—obviously, you're not going to be the Chairman forever and I'm not going to be in this seat forever.

Some people may be happy about this seat. I'm not sure—

Mr. Greenspan. I can assure you there are a lot who would feel the same about this seat.

(Laughter)

Representative Saxton. I'm curious. It appears that this economic theory is valid. It appears that it has worked in other countries. It appears that during this decade—let me put it that way—it has worked in this country.

Is it something that you believe that as policymakers, we might pursue to formalize in some way?

Mr. Greenspan. Mr. Chairman, the answer from my point of view is yes, as I've indicated, other Members, including Senator Mack, who has had a bill which is not dissimilar to yours.

There is a dispute within the economics profession and, indeed, within the Federal Reserve itself, about the proper balance between the question of the focus on inflation and employment.

My impression is that we may be resolving that dispute merely by the accumulation of evidence that inflation is such a crucial factor in the sustaining long-term employment growth.

This is a debate which would be very valuable to engage in the Congress, and it would be quite useful to get numbers of peoples' views on the particular aspects of your bill because I think it's only in that way that it can be put on the table and thoroughly debated.

But I certainly agree with the general thrust of your remarks and I must say, I, personally, would probably be a fairly strong supporter of the thrust that you're initiating.

Representative Saxton. Thank you, Mr. Chairman. Yes, you're right. Senator Mack and I have worked together on this approach with certain adjustments in our legislation from time to time.

But it has been rewarding to work with the Senator, actually following his leadership to some extent, with regard to this subject.

We have a chart over on the side here which demonstrates the result, or at least a parallel occurrence.

[The chart appears in the Submissions for the Record.]

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The yellow line on the chart, which goes back about a decade, shows what has happened with inflation as measured by the CPI, which obviously shows a downward path. And the rate of unemployment, demonstrated by the red line, shows a very similar downward path.

And so it's very encouraging to see that these policies relative to inflation targeting and squeezing inflation out of our economy have produced the positive kinds of effect that both employers and workers alike have benefitted from.

As I mentioned a few minutes ago, and I'll ask this one last question on this subject and then leave it at that, I mentioned that many central banks in other countries have successfully adopted these inflation policies. Most of these countries have significantly lowered their inflation rates since introducing their targets.

And I'm glad to know that you believe that this is the kind of policy that we should pursue as well.

Let me just ask this question. What do you believe are the primary lessons to be learned from the international experience with inflation-targeting?

Are they similar to ours?

Mr. Greenspan. You're quite correct in what you state that those who have put on inflation targets have seen lower inflation. It's not unequivocal though in the sense that many others who haven't put on inflation targets have also seen lower inflation.

So it's only when we begin to see divergences between countries that you can get a really significant test as to the extent to which the inflation targets themselves create other collateral policies which actually foster lower inflation or price stability.

Representative Saxton. Just as a follow up, when you mentioned that we perhaps have not formally put on inflation targets, but certainly, informally, the thrust of the Fed over the last decade has been to do just that, perhaps in an informal way.

Would you agree with that?

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

Representative Saxton. Thank you very much.

Senator Bingaman, I've completed my line of questioning for now, and we'll turn to you.

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

Chairman Greenspan, thank you for your statement. On several previous occasions over the last year or so, I think you indicated your belief that equity markets were overpriced. Have recent or current circumstances led you to change that view?

Mr. Greenspan. Well, I never actually said they were overpriced. What I did say is that the various elements which were being implicitly projected by the level of stock prices had, in my judgment, a less than 50-50 probability of occurring.

It's always a very tricky question to determine whether stock prices are overvalued or not. All you can really do is infer what a particular level of stock prices implies about the expected growth rate in earnings, or what economists call the equity premium in markets, that is, the yield spread over the long run of what a stock will yield over a riskless debt instrument.

All you can say is whether or not the implicit growth rates of earnings—and we do have data on security analysts' forecasts—are reasonable or unreasonable and, very specifically, whether the equity premiums are within a reasonable range so far as history is concerned.

As I've said previously, I've thought that the significant upward revisions in long-term earnings growth implied a very beneficent outlook for earnings.

There's been some adjustment in that recently and clearly, to that extent, I would have to conclude that things are less out of line, certainly, than they would have been, in my judgment.

I would hesitate to give you a view as to exactly where the probabilities lie because, as I pointed out in my prepared remarks, we are finally beginning to see some evidence in the data that productivity growth—which is crucial in that whole notion of earnings growth—is exhibiting some elements of acceleration.

Whether it is temporary or not, it's reflecting some of the longer-term forces which I outlined in earlier testimonies. It is as yet too soon to tell, and we probably won't be able to tell for a while.

But it's very encouraging that the productivity numbers look as they do because it's essentially that which has enabled us to produce an economy with fairly solid growth without inflation showing any significant re-emergence.

Senator Bingaman. What about imports? Would we also see a reduction or downward pressure on inflation in this country as a result of substantial increases in imports from that part of the world?

Mr. Greenspan. I would doubt if we're going to see substantial increases in imports, per se. We'll see some because, obviously, with their exchange rates lower, they can price at a lower level into American markets but it is unlikely that there will be any really significant increase in imports. They do affect the world price level for a lot of different commodities, and to that extent, it probably does filter in here.

But remember that, unlike other economies which are more manufacturing goods-related, we are increasingly a service economy. Of the business sector product, manufacturing is roughly a third or less of what we produce in the way of overall goods and services.

And as a consequence of that, we're dealing with a situation in which we see a fairly constrained price level for goods in this country. In other words, the CPI for commodities only is rising far less than the elements of the CPI which comprise services.

To the extent that we are getting the types of imports and import price effects, it impacts largely, not wholly, on goods only and, therefore, is not a profoundly important impact. It does work at the margins. And it's important for numbers of individual companies, but I would be quite surprised if it turned out to be anything other than a marginal effect.

Senator Bingaman. In the 1980s, there was a period during which I thought, at the time, the dollar seemed to be overvalued relative to other currencies. Many of our companies had great difficulty maintaining their market shares in world markets because of the very high value of the dollar, particularly relative to the yen.

Are we in danger of having another period like that now, with the devaluation of the East Asian currencies that's already occurred and with the strong dollar that we already have?

Mr. Greenspan. I would doubt it very much, Senator.

The period just prior to February 1985, which is when we reached the peak value of the dollar vis-a-vis the other currencies, was really quite a distorted financial period.

We had a number of things going on—including, as you may recall, a very large federal government deficit—that doesn't exist today. So I would be far more relaxed on that question at this particular time. I don't

deny that we have to monitor movements in exchange rates because, as the economy becomes increasingly more internationally oriented, our exchange rate does have an increasing impact on everybody, but I don't perceive of any distortions arising which would create the type of concerns that you express.

Senator Bingaman. My last question is regarding interest rates and Fed policy on interest rates.

Do you see the recent events, which you described at length in your statement, increasing the prospects that the Fed would look in the future to lowering interest rates rather than to raising them? Or do you still think the concern would be about a need to raise interest rates?

Mr. Greenspan. Senator, I don't know of any way I can answer that question without getting myself in trouble.

(Laughter)

Senator Bingaman. I just thought I'd ask.

(Laughter)

Representative Saxton. Senator Bingaman, thank you very much.

I was intrigued particularly by the question you asked relative to the relative value of currency. It obviously is a concern that many of us have had. We're comforted, to a large degree, by the Chairman's comments.

I turn now to the gentleman from Texas, Mr. Thornberry.

OPENING STATEMENT OF REPRESENTATIVE MAC THORNBERRY

Representative Thornberry. Thank you, Mr. Chairman.

Chairman Greenspan, I think in many ways one of the most striking things to many of us about the events of this week is the interdependence of the economies of various nations.

And you talk in your statement about the contagion effect being particularly troublesome.

In some ways, one wonders whether this interdependence is, in part, taking our ability to shape our economy out of our own hands. Maybe the decisions of the Fed, the decisions of Congress, have less importance as decisions and things that happen in other countries play a bigger role.

I'm wondering if you have suggestions about structural or policy changes that we should look at to at least try to prevent the downside of that phenomenon from impacting on our economy.

And I think all of us are troubled if we see instances of rumors or hints or other kinds of factors other than underlying economic fundamentals playing such a tremendous role as they can in the volatility of these markets.

And certainly, suggestions you have on how we focus on the things that matter and try to discount the things that don't matter I think would be helpful to us.

Mr. Greenspan. Mr. Thornberry, we are moving toward a world in which the major changes in technology, as I mentioned earlier, are going to alter the way that we look at how we do business, the way we produce goods and services, and we have to adjust to that.

Our choice is really this: We or anybody else can put barriers around your country. We can insulate ourselves fully, even if we wanted to, from all the contagion effects and from all of the other problems. We could do that. The cost would be a very dramatically lower standard of living. We would, in effect, have stagnation.

The alternative is to address this really dramatic, dynamic, international system and capture the really quite impressive benefits that it offers. And as I indicated earlier, we in the United States are probably at the cutting edge of where those benefits are.

There is a cost and the cost is that we're running against potential types of errors which get magnified. The point you raise is exactly right. We shouldn't make the choice to go back, but instead make going forward as productive and as least subject to crisis as possible.

We're not going to be able to fully remove fluctuations and crises from the market. That's in the nature of markets. They sometimes are in turmoil. That's the result of the fact that you cannot bat 1000 percent in investment decisions.

I don't mean portfolio or stock investments. I mean in whether you build a building here or a plant there.

Because of that, there are periodic periods of turmoil. We should accept that as essentially normal, but make certain that we have mechanisms in the international financial system which contain them and prevent the contagion from spilling over and altering what is just a normal, ongoing correction into something far worse.

We at the Fed and our colleagues at the Treasury have been spending quite a good deal of time focusing on precisely this issue in recent years

and especially, obviously, in the most recent period. I don't know if we'll come up with exactly the right answers. I don't know that, in conjunction with the very considerable discussions we were having with our counterparts abroad, we're going to get down to the bottom line and get it exactly right. But we are trying and, I must say, I am somewhat encouraged about the progress that's been made in recent years on this issue.

Representative Thornberry. One of the key points you make somewhat related to that is that, essentially, we have to let investors take their losses and move on. But one of the things we have to do is minimize the impression that international authorities stand ready to bale people out.

There are have been some former cabinet secretaries that have recently called, for example, for the IMF to be abolished, that it has outlived its usefulness, at least in its current form.

How ready is the international financial system to deal with the way that things are now and the direction that they are going?

And do you have suggestions for us about improvements, modernization, updating of at least our role in some of those institutions?

Mr. Greenspan. It's becoming ever more apparent that the problems that give us the most concern in the international sphere turn out to be largely domestic problems, meaning the crises which we have experienced in recent years seem to almost invariably end up with some problem in the domestic banking industry.

That suggests to us that what is quite important is to get a far better infrastructure in the international financial system by finding ways to assure that banking and finance generally are put in a very sound and secure manner, which is not the case in a large number of countries.

Learning that lesson suggests to us that, indeed, the International Monetary Fund does have a role. It's a new role. It's not the one which the Bretton Woods conference created. And those who argue that that role is gone are quite correct.

It turns out that we do need some international presence of the type that the IMF has put into place. If we focus on a new role for a new institution, there's no reason why it cannot be the International Monetary Fund, as, indeed, it has been in recent years as they have shifted their focus in a manner which—while we may not always agree with them in everything they do—in general, that focus has been productive.

Representative Thornberry. Thank you.

Representative Saxton. Thank you very much, Mr. Thornberry.

If I may, at this point, for the Members, we are, because of the number of folks who have fortunately come this morning, we are operating pursuant to the five-minute rule. And the little green and red lights there are indicators of expirations, unfortunately, of time.

So if we could all try to keep our questions to five minutes, it would be appreciated, I'm sure, by everyone here.

Let me turn now to the gentleman from New York, Mr. Hinchey.

OPENING STATEMENT OF REPRESENTATIVE MAURICE D. HINCHEY

Representative Hinchey. Well, thank you very much, Mr. Chairman. And Mr. Greenspan, thank you very much for being here and thank you for your statement.

I found it very interesting and very revealing, and in spite of its sort of Darwinian overtones with regard to the world markets, particularly those in the Far East, I think very, very helpful, as you always are when you appear before either this Committee or one of the other committees, and I very much appreciate that.

I also want to express my appreciation to you for the moderate approach that you seem to have taken within the Committee meetings.

As near as we can decipher the minutes coming out of the meetings, you seem to have been a force arguing against some of the other Members of the Committee in their interest in wanting to raise interest rates.

You seem to have been wanting to calm that down. And to the extent that that is the case, I want to express my appreciation to you for that.

The irony, of course, is that, just a few weeks ago when you were before—I think it was the Senate Budget Committee at that time—you made some statements that were construed to mean that there may be some cause for raising interest rates. And of course, that caused the market to drop by 100 points the next day.

So I am particularly, in the context of what we've seen recently, fascinated about this total devotion to price stability when, it seems to me, that others in the world now are talking about the need to stimulate growth.

We know that we have had the benefits of this economic expansion now since sometime around the end of 1992, and the effects of it have been very, very beneficial.

But those benefits have not expressed themselves universally within our society.

Corporate profits are up by 60 percent. Yet, wages in that period of time, which affects most of the people in this country, are up by only 1-1/2 percent.

So the fixation on price stability at the expense of growth is one that I find just absolutely remarkable.

I would appreciate your views on that, particularly in light of what you seem to have said in response to some of the questions that were raised earlier, that there seems to be a need to focus more attention on price stability and less on full employment, and the effects that full employment would bring to our economy.

Mr. Greenspan. Mr. Hinchey, I am increasingly of the view that there is no important trade off here over the longer run, and I think most economists would agree with that.

Would it be nice or desirable if, instead of the growth rate we have—whatever it is and however it is measured—it is twice what it is? Obviously.

I don't think that's the question. The question that we must confront is whether in fact the existing economic expansion, which is about as solid as any I've seen, has drawn down the number of people who, are unemployed officially because they report to the Bureau of Labor Statistics, that they had sought a job in the previous month, and also the not unsubstantial number of people who are technically outside of the labor force, but say they want a job.

The sum total of those two groups has been falling very dramatically in the last year or so and is now at levels which are lower relative to their populations than at any time as far back as the data go.

This has had some very positive effects on this economy. It has created levels of job skills for people who would not have been able to achieve them otherwise. It has assisted welfare reform immeasurably.

It has all different types of advantages which we can cite, including significant recent increases in real wages and a definite slowing in the degree of income inequality which we have discussed previously.

It is terribly important for us to make sure that this recovery continues and continues in a solid way. I think the greatest threat to it at the moment, as I've argued in previous fora, is the onset of inflation, which could destabilize the system, create unemployment, and effectively reverse much of the benefits that have occurred.

If I thought that deflation were emerging and, indeed, was a threat to the recovery that we're looking at, I would say that would be something that we should be focused on just as resolutely. It's just that the analysis at this stage suggests that that is not the case. It could be the case, and it's not something which I would dismiss out of hand.

We talk about price stability, not anti-inflation policy. If you want to be anti-inflation, the best way to be anti-inflation is to have your prices go down 20 percent a year.

That is not what price stability means. We believe that we should be as forceful against the emergence of deflation as inflation.

It just happens that, at this particular time, the concerns which grab our attention as a result of the analysis of the various forces that are going on in the economy stress that it is inflation, not deflation, which is a crucial element which serves as the major threat to this expansion.

Representative Hinchey. Well, of course, there is inevitably going to be disagreement about that. And there are many economists who disagree, as I disagree heartily with what you just said.

I think that we are on the verge of a situation where, in fact, it may be deflation that is the enemy.

Inflation today, as you know, is half of what it was just last year. There is no indication of inflation anywhere in the economy. And it was argued recently at your Committee meeting that interest rates now are high by historical standards, higher than they need to be.

And it seems to me that we ought to be looking more at how to share the benefits of this economy with more and more people, how to get the economy to grow at a faster rate.

I'm particularly concerned in the context of the global economy. It has been projected that our growth rate next year—that is, the United States' growth rate—may fall to as low as 1-1/2 percent.

If the problems in the Far East persist, as they give indications they may, as the Europeans continue to struggle with the need to complete the requirements of the Maastrich Treaty and lower their deficits below 7

percent of GDP, I wonder where this world economy is going, unless we begin to concentrate our efforts on the need to promote more growth than we currently have, and to involve more of our people in the benefits of that growth.

I would love to hear your comments on that.

Mr. Greenspan. Well, I would certainly like to see as much benefit as we can get and I'd like to see as much growth as we can get.

The question is a factual issue as to where threats are. None of us can forecast the future with accuracy. We're all making judgments about what probabilities are, and some of us have far more experience in certain areas than others.

Some of us—and I'm talking about within the Federal Reserve— are arguing points not dissimilar to the points that you're making. That's part of the basic discussion.

I don't know what I can say, other than the fact that most of us at the Federal Reserve disagree with the position that you're taking. Is it a respectable position? Certainly. If we see the types of forces that you're seeing, we'll change. The point is that we don't see them. It's not because we're not looking very forcefully. I do not deny that there are a lot of economists out there who are raising these issues. It's one of the more interesting, difficult problems analytically that we have, insofar as monetary policy is concerned. But it's a really very fortunate problem. We're looking at how to continue what has really been a very successful economic expansion.

That is a far more desirable debate than how does one catch up to a crisis when you're behind the curve and you can't figure out what the consequences of what you're doing are.

So, to be sure, there is a debate here. There are good arguments on both sides, but, because neither group can forecast the future with certainty, the award to whom is accurate cannot be given in advance.

But reality will confront us eventually, and the answer to your question will come out unequivocally one way or the other.

(Laughter)

Representative Hinchey. Thank you, sir.

Representative Saxton. Mr. Hinchey, Maurice, thank you very much. A discussion of economics would not be complete without differing points of view and we appreciate your articulating your point of view.

I'd just like to take a moment to once again refer to the chart here to show that, at least from an economic unemployment rate point of view, as inflation has come down, so, too, has the rate of unemployment, quite dramatically.

And while we'd all like to see higher wages, certainly, that's the American way and the American dream, we hope we'll get to that as we proceed through this period of expansion.

The gentleman from Illinois, Mr. Ewing.

OPENING STATEMENT OF REPRESENTATIVE TOM EWING

Representative Ewing. Chairman Greenspan, thank you for your comments. Thank you for the time you're spending with us at this very important time financially here in America.

I want to change the questioning just a little bit, first, by saying that this week's market movement impacted the Dow Jones futures contracts traded on the Chicago Board of Trade in Illinois and the S&P 500 traded on the Chicago Mercantile Exchange.

Both exchanges initiated trade-halting procedures on Monday.

In your opinion, do you believe the circuit breaker on the futures exchange worked as intended?

Mr. Greenspan. Mr. Ewing, I think there are going to be a number of doctoral theses written on this subject in the years ahead because this is the first real test that we have seen. I can probably, with some confidence, conclude that the results will be inconclusive.

(Laughter)

And the reason is that there are a lot of different forces involved. There are strong arguments on both sides of this. My own personal view has never been wholly friendly to circuit-breakers or stopping markets because I'm always concerned as to how in the world are you going to get them started again. But that view is countered by many who claim that, indeed, there are significant benefits.

There have been recent surveys about the effects of innumerable various related types of activities. As you know, there are limits on the Chicago Board of Trade on all the agricultural commodities and the like. We do have program trading alterations, as you know, when the Dow Jones Industrial Average moves 50 points in either direction. The analyses of these have not been conclusive one way or the other.

So I'm not sure we're going to find very much unanimity on this issue. I think you're going to find that most brokers, most traders would prefer that you kept the markets open. You'll also find others who would not.

As I said, I come out more on the side of leaving markets open and letting them trade. But I suspect the average of these views probably is right smack in the middle.

Representative Ewing. You might feel, then, that by halting this trading that we have limited liquidity. That's one of the arguments.

Mr. Greenspan. That's one of the purposes, actually. It's actually to slow the process down and the presumption is that people who are going to be rashly running to sell or to buy would have second thoughts and would change them.

The problem is that there are others who, when you shut markets down, have claustrophobia and decide that, all of a sudden, they want to get out, and as soon as you open the door, they're gone. So it's a question of which force is the most dominant to determine which price effect occurs.

Representative Ewing. We currently have a prohibition on trading individual stock futures. Had individual stock futures been traded this week, would there have been a negative, positive or indifferent effect on the market?

Mr. Greenspan. Mr. Ewing, that's almost a question like monetary policy. Anything I can say on that issue will create more enemies out of friends, and vice-versa, and I don't have enough friends.

So that I think I'd better stay put.

(Laughter)

As you know, there is a very strong view in the New York Stock Exchange against that and a very strong view in the futures markets for it.

It's an argument that I probably, as a private citizen, would love to get involved in. But I see no necessity as a central banker to have to answer that question.

Representative Ewing. Well, I'll try and throw a softball.

There is legislation in both the Senate and the House that would free up the regulations of our futures markets with the concern that we need to be competitive in the world markets.

Would you have a comment on that? That legislation is stalled, I think, really in both houses as far as moving this year.

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Mr. Greenspan. Yes. Which particular part of the legislation are you referring to?

Representative Ewing. Well, the pro-market provisions of the legislation, which allow the markets to operate with less regulation, such as some of the foreign markets are doing.

Mr. Greenspan. Yes. This is the CFTC legislation?

Representative Ewing. Yes, that's correct.

Mr. Greenspan. I've been supportive of that, and I think that it gets to a lot of complex legal issues with respect to what constitutes a derivative, what constitutes a future, and who has regulatory authority as between the CFTC and the Securities and Exchange Commission.

I have been concerned that we not too rigorously define these things in a manner which would undercut the so-called over-the-counter market in derivatives, which is a very important force developing in this international financial system, which I discussed earlier, and which is crucial to the continued expansion of international trade.

So I'm personally quite supportive of those measures because I think that to get these issues clarified and get a broader capability of competition going is in this nation's interest.

Representative Ewing. Thank you very much.

Representative Saxton. Thank you, Mr. Ewing.

We'll turn now to the gentlelady from New York, Mrs. Maloney.

OPENING STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY

Representative Maloney. Thank you, Mr. Chairman.

Welcome, Mr. Greenspan, and thank you for your leadership.

You mentioned earlier that you believed that we need an international presence like the IMF to help stabilize markets in Asia.

Do you believe that the American government should be increasing its participation in the IMF? Should we be loaning more to the IMF to help with this particular problem?

And secondly, will the Fed be making swap loans, federal loans, available to the Asian countries?

Mr. Greenspan. We have supported Treasury's initiatives with respect to elements specifically in the function 150 categories in the budget

and in its initiatives with respect to our relationships with the International Monetary Fund and the World Bank. We have not been involved in the Federal Reserve with swap arrangements, as you are aware.

I can't say where or what we might do in the future. I would say, however, that were we or the Treasury to be involved in any such assistance, it would be because it was perceived to be in the interest of the United States.

In fact, I think the law effectively requires that.

Representative Maloney. Following up on Senator Bingaman's question on possible actions for future inflation.

Yesterday, the Bureau of Labor Statistics reported that the employment cost index, the average cost of employing a worker, rose 8/10ths of a percent in the third quarter of 1997, which amounts to a rise of 3 percent over the last 12 months.

A wire story said yesterday that this news, and I quote, "isn't good for the Federal Reserve. Fed Chairman Greenspan said recently that trends in the labor market indicate the labor market has been on an unsustainable track."

And you brought that up in your testimony today.

Meanwhile, research from many sources, including a September 1997 article from the Federal Reserve Bank of New York and a 1993 article by a Federal Reserve researcher, are very inconclusive about whether a rise in wages leads or follows increases in product prices.

The Federal Reserve Board of New York's research concludes that the increase in the wages of workers in production industries—that is, not in the service sector—is not related to inflation.

Would you clarify your position on this issue? Are you using the employment cost index as a primary signal of future inflation?

Mr. Greenspan. No. And, as I recall the New York Federal Reserve Bank issue, they were referring to the question of whether or not you can use wages as a statistical indicator of future inflation. I think that most of the econometric analysis of this creates all sorts of problems because it's a simultaneous process at work.

The issue that I have been raising is a question of what the facts are. The facts are that the rate of growth in employment over recent years has been such that we have had to dig ever increasingly into a group of people who are not working but want a job, to the point, as I mentioned earlier,

that the sum total of the unemployed plus those who are not in the work force but would like a job, has gotten increasingly lower.

I am merely drawing the obvious arithmetical problem that if that trend continues, something has to give. We do at some point run into some pressures. And one can very appropriately argue that inflation can begin without any wage pressure at all—for example, if oil prices are spiked higher, that will engender inflation. It may pull up wages because of the required escalators in a number of different contracts.

Alternatively, you can create a scenario in which, indeed, it is an increase in wages if they rise faster than the rate of productivity that is a force creating inflation.

Nominal wage increases, per se, without advertence to what the corresponding increase in productivity is will tell you little, if anything, about the inflation process. So the question really gets down to the difference between wages and productivity.

I am merely saying that—which is what the facts, in my judgment, irrevocably communicate—you just cannot continuously reduce the level of people who are willing to work without either running out of that group of people or well before then, finding that in order to induce other people to work, the wage structure must go up.

If that goes up in line with productivity, it is not inflationary. If it goes up more than productivity, meaning unit labor costs go up, it begins to put pressure on prices.

It's very difficult to get out of that analysis. The question is, which causes what under what conditions? And I will say that it varies.

I wouldn't argue that wage increases, per se, cause inflation, nor would I argue that inflation causes wage increases. I think it's an interactive process and you need far more information to know what the outcome is likely to be.

Representative Saxton. Thank you very much, Ms. Maloney.

For those who may be casual observers of the Joint Economic Committee, we get our name, Joint Economic Committee, because, you noted, Senator Bingaman, the Ranking Member, is a Senator.

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

We also have another Senator, a very thoughtful gentleman from the State of Utah, Mr. Bennett.

Senator, you may ask your questions.

OPENING STATEMENT OF SENATOR ROBERT BENNETT

Senator Bennett. Thank you, Mr. Chairman.

Chairman Greenspan, we won't force you to sit there while we debate economics back and forth among ourselves. But I can't resist making a comment.

I ran a business during the great inflation of the late 1970s. I remember a political commentator said it's the only time in history where the president's approval rating was lower than the prime rate.

(Laughter)

I have had the experience of borrowing money at 21 percent. And I also ran a business during the time of sustained growth of the kind you have described here. I found it much easier to create jobs during the time of sustained growth than when I had to go to the bank and borrow money at 21 percent.

So I think you ought to stay firm on your position with respect to the importance of price stability and the importance of sustained growth as the way to solve the unemployment problem, rather than some of the other nostrums that might be suggested to you within the Fed.

I have several questions, the first one having to do with what's happening in the economy right now and the impact on the federal budget.

We were told that we were going to have a $124 billion deficit this year. It's going to come in now at something less than $100 billion shy of that, which is very good news.

The President takes credit for it, as I would if I were President.

(Laughter)

We Republicans give you the credit for it, as naturally we would do if we don't hold the presidency.

(Laughter)

I think probably the real hero here is neither the Congress, nor the Fed, nor the President, but the economy itself that is growing at a rate that nobody really had foreseen, and that's always good news.

We're going to be faced with the challenge in the Congress next year, if we don't have a recession, of dealing with the unexpected and, for all of us, except possibly Strom Thurmond, unexperienced—

(Laughter)

—circumstance of a budget surplus. And we will argue mightily among ourselves as to what to do with that money. Some say, give it back to the taxpayers. Some say, raise spending in social programs. Some say, pay down the debt.

Do you have any views as to what we might do with the surplus?

Mr. Greenspan. As I testified before the House Budget Committee earlier this month, I thought that it would be quite useful to allow, at least in the beginning, the surplus to in fact occur.

(Laughter)

Meaning, indeed, it just reduces the level of debt to the public. If, as I said earlier, we are beginning to become far more secure in our view that low inflation brings down inflation premiums and long-term interest rates, and that, in turn, is a major factor in economic growth of the sustainable type, then it's pretty obvious that to the extent that we are reducing the federal debt to the public, we're also likely lowering the inflation premiums embodied in long-term rates.

It's quite conceivable to me that if we allow at least a significant part of this excess of receipts over outlays to end up as a reduction in the debt, we may find that we have created a very effective economic policy.

And while I, as you know, am strongly in favor of cutting marginal tax rates, and have even argued beyond what most people are willing to argue—namely, that the capital gains tax ought to be eliminated—I, nonetheless, believe that we've built up a very substantial amount of debt in this country, and I'm not one of those who believes that that is irrelevant to what the inflation premium is in interest rates or in the growth of the economy.

So I would be cautious about dispensing something we don't have yet. And if it turns out that we get it, it's not the worst thing in the world to lag a little bit in responding in a way to dispense with it.

There is no urgency to take action if we inadvertently fall into a surplus because receipts turn out to be even still higher than we've been projecting.

I grant you, it's a wonderful pot of money for many different types of projects, but that is something that the Congress is going to have to make a judgment on.

Senator Bennett. Thank you. I have exactly the same instincts, that the surplus should go to pay down the debt.

And much as I am in favor of reduced tax rates, too, I think we do that by restructuring the whole tax code.

I think it is an abomination, even though I voted for the latest addition to it that makes it even more impenetrable.

And just note, Mr. Chairman, Chairman Greenspan and I have a ritual that has gone on ever since I've been in the Congress.

At some point, I always ask him what he thinks the appropriate rate is for capital gains. And he solemnly tugs his cheek and says, I think it probably ought to be zero.

And we've gotten it down to the point where he did it automatically, without having the question here today, and I'm grateful.

(Laughter)

Representative Saxton. Thank you very much, Senator Bennett.

Senator Sarbanes?

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator Sarbanes. Well, thank you, Mr. Chairman.

Chairman Greenspan, welcome.

Mr. Greenspan. Thank you.

Senator Sarbanes. I regret very much that I missed the spina bifida roast that took place here last night here in town, because I understand Andrea Mitchell gave us a lot of clues on how to interpret your comments.

Unfortunately, I wasn't there so I didn't have the benefit of it. But they tell me C-SPAN carried it and maybe we'll study very carefully what Andrea had to say and we'd be in a better position to interpret you when you come before the Committee.

Mr. Greenspan. I guess—

Senator Sarbanes. You don't have to respond to that if you don't want to.

(Laughter)

Mr. Greenspan. I felt an obligation to, but I appreciate not having to.

(Laughter)

Senator Sarbanes. I'm sure the context for today's hearing is quite different than what you anticipated when you accepted the Committee's invitation to testify.

And of course, a lot of the focus has been on developments in the stock market over the past few days.

However, I wanted to go beyond these immediate events and talk a bit about the underlying condition of the U.S. economy because it seems to me that looking beyond the developments of the past few days, the basic condition of the U.S. economy continues to be exceptionally good, and I think you indicated as much in the course of your testimony here.

Growth has been steady, unemployment low and inflation is declining.

Let me repeat that—inflation is declining.

In the first nine months of this year, the Consumer Price Index is up at only 1.8 percent annual rate, well below the 3-percent rate that we were bragging about last year and which was, I think, the lowest in some 25 years.

In fact, this is really a very impressive performance, as we can see, with this year's performance over there on the far right. And we have to go back into the mid-1960s to have anything comparable.

Now, even if we exclude food and energy, and I'm not going to show that chart, but the core inflation is up at only a 2.2 percent annual rate. Producer prices are essentially unchanged over the last year.

[The chart appears in the Submissions for the Record.]

This is 1990-91, and that's where we are today, which I think is a pretty spectacular performance.

And the thing that my colleague, Congresswoman Maloney, touched on, which was unit labor costs, are only up 2.2 percent, consistent with the rate of inflation.

This is the unit labor cost performance.

So all of those, I think, are pretty dramatic examples of the context of a declining inflation rate we're now experiencing.

The point I want to get at is that, given this, the Fed's current posture of holding the federal funds rate constant at 5-1/2 percent—you took it up, I think, last March.

Was it a quarter of a point?

Mr. Greenspan. That's correct, Senator.

Senator Sarbanes. Means that real interest rates are actually rising. And I think it's very important to think in these terms because there's a

tendency to see the Fed's holding the rate, the nominal rate, at a constant level, as not representing action on the monetary front.

But if, in fact, the inflation rate is declining and the nominal rates are held constant, you're going to get an increase in real interest rates.

And that's shown in this chart, which shows that the real fund rates are on the increase. This is 1994 back here, and we fund rate is now moving up, as it shows at the far right of the chart.

[The chart appears in the Submissions for the Record.]

In fact, the real fund rates are at the highest level since June of 1990, a month before the recession began, the 1990 recession, '90-'91.

And what we have and what I'm concerned about, I don't want to see happen again, is the real interest rates were taken up quite high in '89, higher than they are now.

Subsequent to that, we had a recession. You brought the real interest rates down, as that chart indicates. Now you're taking them back up again.

And I'm concerned that they not go back to the point where they trigger another economic slowdown and throw us back into a recession.

The fact of the matter is what appears as a passive position on the part of the Fed with respect to interest rates—namely, holding them at a phenomenal level—has been in real terms a restrictive monetary policy.

A recent *New York Times* article entitled, "Fed Policy on Rates Seems Tough After All," focuses on this often overlooked fact, and I'd like to insert that article into the record.

[The article, "Fed Policy on Rates Seems Tough After All," appears in the Submissions for the Record.]

In fact, the article points out that the minutes of the August meeting of the Federal Open Market Committee released earlier this month acknowledged the role of high real interest rates as a constraint on the economy.

The Fed itself acknowledged that, and I quote from the minutes: "The level of real short-term interest rates was relatively high by historical standards, provided some assurance that the current stance of policy would not accommodate a significant increase in underlying inflationary pressure."

I emphasize this point because before the events of the past few days increased speculation that the Fed might have to raise interest rates soon

to offset inflationary pressures. That kind of speculation had started the press.

Now the press, most observers believe the past few days make the outlook for an imminent rate hike less likely.

But I want to emphasize the point that there is still no evidence of inflationary pressures, and that in fact, the Fed has been pursuing a restrictive monetary policy characterized by rising real interest rates.

Isn't it reasonable to focus on the real interest rates? Or at least doesn't the point need to be made—

Mr. Greenspan. Yes, Senator.

Senator Sarbanes. —that if the Fed holds rates constant and the inflation rate declines, in fact, the real interest rates are going up?

Mr. Greenspan. Real short-term rates.

Senator Sarbanes. Right.

Mr. Greenspan. Yes. Indeed. Translating that statement, however, into an issue of the degree of tightness of policy requires that you evaluate what's happening within the economy, especially in the interest-sensitive areas of the economy.

If monetary policy were perceived as severely restrictive, we would see the whole structure of interest-sensitive areas of the economy—housing, motor vehicles, and a number of other interest-sensitive areas—showing signs of contraction. We don't see that at this particular stage.

Were we to see that, then we would say that it's pretty clear that the level of real short-term rates is beginning to grip.

As a first approximation, it is the right thing to do to take a look at the historic relationship of the current real federal funds rate and history to get a sense of where we are in a general way.

But that is inadequate as a measure to conclude the degree of restraint that we're imparting on the system.

It merely says that if we begin to get in areas where it looks as though, on a historical basis, the short-term real federal funds rate is high, then that accelerates our looking at other areas of the economy which interest rates affect, both in the financial system and elsewhere.

As you know, money supply growth has been somewhat stronger than we would have projected, which suggests that there is no particular

restraint going on in the banking system. And when we asked very specifically in our senior loan officer survey how the banks are behaving relative to customers, we don't pick up any significant degree of restraint there, either.

It's an issue which, I grant you, requires a considerable degree of focus, but we want to begin to see signs that that level of the interest rates is, indeed, creating a significant slowdown.

The one area which I want to emphasize, however, is the issue which we're always confronted with, namely, that there is a significant lead time between the actions that we take as manifested in the real federal funds rate and its impact on the economy. So to argue the other side of the issue partially, merely seeing concurrent evidence that there is no effect, is not in itself necessarily conclusive. It is an important fact, however, that we ought to evaluate.

Senator Sarbanes. Yes. Well, Mr. Chairman, in this article that I've submitted for the record—

Representative Saxton. Senator, if you would—obviously, your five minutes has long since passed, and we have other Members who are waiting patiently.

So if you would conclude, we'd appreciate it.

Senator Sarbanes. I'd just make this observation.

Between the Fed's quarter-point increase and the sharp decline in inflation this year, that the federal funds rate is up from 2.22 percent in February to 3.28 percent. It's gone up by more than a point in less than a year's time.

Now, when the bite will come, I don't know. But I think it's important that we get it out in the public and recognize that when the Fed holds interest rates constant and inflation is declining, the Fed, in effect, is tightening because real interest rates are rising under that circumstance.

Thank you, Mr. Chairman.

Representative Saxton. Thank you. The gentleman from Louisiana, Mr. McCrery.

OPENING STATEMENT OF REPRESENTATIVE JIM MCCRERY

Representative McCrery. Thank you, Mr. Chairman.

Chairman Greenspan, I want to shift gears here for just a minute and talk about trade.

Does the recent turbulence in the Asian currencies and the Asian markets underscore, in your opinion, the need for our president to engage in trade negotiations under fast-track authority?

Mr. Greenspan. I think that the evidence in the post-World War II period has been fairly conclusive that the quite marked expansion in trade—I'm not talking only about the United States so much as everybody—has really had a pronounced, positive impact on rising standards of living. We are a very major player, obviously, in the world trading system. I think we benefit immeasurably from it.

Previous presidents have very readily been able to obtain fast-track authority to negotiate for very obvious reasons. You just cannot negotiate if you're not the final negotiator. And I think that it is very important that the President be accorded fast-track authority, not necessarily because it reflects individual negotiations or the like, but I think it's the right thing to do because it's really in the interest of this country to be in the forefront of expanded trade. One vehicle which enables us to do that is to have a negotiating authority for the President which enhances his capability to obtain increased opening up of markets where we would otherwise be constrained.

Representative McCrery. Thank you. And now, I'd like to get back to Senator Bennett's question about the surplus.

I'd like for you to expand a little bit on your answer. In answering the Senator's question, you said that while it would be nice to lower the tax rates and even go to a zero capital gains rate, we've built up a substantial debt and it's probably in our interest to address that sizable debt.

But, in fact, if the current debt was all we had to worry about, I would be much more inclined to use some of the surplus, or perhaps all of the surplus, to reduce tax rates or even spend the money on transportation infrastructure or other needs.

But, as I look down the path into the next century, I see that the current debt is not the only thing we need to worry about.

Could you expand upon that? Does that have something to do with your inclination to spend the surplus, so to speak, to buy down the current debt?

Mr. Greenspan. It certainly does, Congressman. One of the few things we can forecast in the future is the structure of our population. Under existing law, the social security system, as you know, creates a trend in benefits which accelerates very significantly starting in the latter part of the first decade of the 21st Century, and that continues to move at a very rapid pace.

As things now stand, unless we either create a chronic surplus in the non-social security area, or significant changes in social security, we are going to run unified budget deficits which are going to be exceptionally difficult to finance. How one tracks into that period, which accelerates pretty fast, is going to really matter.

So if we are in a position where we're coming into the year, say 2007, with a significant surplus, we'll eat into that surplus very quickly in the subsequent 10 years.

So it's going to really matter whether or not you come in at a low level, either a small deficit or a small surplus, or a significant surplus, as to how easy the transition is going to be. There is no way to get around that problem and it's by no means too early to start to think about trying to resolve it because it's only 10 years away.

Ten years for this type of problem is a very short period. If we don't address it now, the political consequences are going to be terribly destabilizing to the society because you're going to force a wrench between the younger people in our society at that time and those who are in the process of retiring.

I know of nothing which could do more damage to the structure of this society than have that type of confrontation emerge, and it will, unless we can confront this issue sufficiently far in advance and enact legislation today which becomes effective then. It's far easier, as you well know, to do something now which doesn't affect anybody for 10 years than to do something which affects them tomorrow.

Representative McCrery. Yes, sir. You mentioned the effect that the aging of our society is going to have on the social security system.

You didn't mention, but well could have, the Medicare system and the Medicaid system as well.

Mr. Greenspan. You're quite right. I forgot to mention that and that's, in a certain sense, from a statistical point of view, an even greater threat to the budget.

Representative McCrery. One last comment, Mr. Chairman. And that is that, again, echoing Senator Bennett's comments, I think maybe we could have it both ways.

If we junked the current tax code and went to a different tax system, we might be able to have a zero capital gains rate, a tax system that would promote growth, and at the same time, use the surplus to buy down the public debt.

Thank you.

Representative Saxton. I thank the gentleman from Louisiana.

I'd now like to turn to the Senator from Florida and thank him for his patience and waiting so long for his opportunity to question the Chairman.

Senator Mack was, incidentally, as everyone here knows, the Chairman of the Joint Economic Committee in the 104th Congress.

So it's good to be back here with you today, Connie.

OPENING STATEMENT OF SENATOR CONNIE MACK, VICE CHAIRMAN

Senator Mack. Thank you, and I appreciate your kind comments earlier this morning with respect to the work that we've done together on trying to focus on the issue of price stability as being the primary goal of the Fed.

I've enjoyed working with you and appreciate your leadership.

Mr. Chairman, I think, frankly, most of the questions that I had in my mind have been raised here this morning already, but I think that I can focus a question or two back on what has been on the minds of the American people the last couple of days, and raise a question from this perspective.

Given the experience with Mexico a few years ago, and I remember in our discussions about that, it really raised for the first time, the significance of the interdependence among nations from a financial and economic perspective.

I think it's probably fair to say that what's happened in Asia is another example of that interdependence.

What it raises in my mind is, are there new obligations or responsibilities of the Fed, of the Treasury, of international financial institutions, to deal with this greater dependence that we share now with other nations and other economies?

It may be too early to conclude what that should be. If that's the case, I would be interested in what you think the proper forum would be to begin the discussions of the development—if necessary, the development of ideas about the roles that the Fed should play, or that the Treasury should play, and other international financial institutions?

Mr. Greenspan. Senator, I think that's a very important issue. What technology is doing is positioning the United States and, indeed, all of our trading partners, such that we all affect each other increasingly more than in the past.

In other words, if you take the ratio of trade to gross domestic product, it's rising. The ratio is rising quite significantly, meaning, in effect, that, on average, both exports and imports for everybody are becoming ever more important with to each of us.

To the extent, therefore, that difficulties arise in individual countries, we're all affected. There's a contagion effect which is not unrelated to this increasing globalization. It therefore is incumbent upon all of us to recognize that and to try to take actions which effectively restrain the consequences of mistakes, but more importantly, find means to prevent them from happening. We have an unofficial forum at this stage which is a continuous interaction within the United States, for example, between those agencies which are related to this question—mainly, the Fed and the Treasury—but also the State Department and, the White House. Obviously, the trade representative is a crucial operator in this regard as well.

There's a general interest here in which we endeavor to find the appropriate interface with our trading partners. What the ultimate project should be is hard to say. The one thing you have to be very careful about is the one thing we don't want which is some super-national financial or trade authority which has impacts on the sovereignty of the individual nations.

What we want—indeed, what I think is evolving—is a voluntary association where we meet as the G-7 or the G-10 or in the Bank for International Settlements or other grouping, in which we discuss various bilateral, multilateral issues which are of interest to all of us, and it is not

a zero-sum game. In other words, if it were a zero-sum game, then we would be at loggerheads with each other because your gain is my loss and vice-versa.

What we have found, however, is that there is a net positive sum. We all benefit and therefore, we all have a very strong interest in seeing that trade proceeds and that the international financial system, whose basic function is to facilitate that, functions in its most effective manner.

Senator Mack. What I hear you saying is that there is a natural evolution taking place within the present institutions that, at least for the time, are addressing these issues, and at the present time, seem to be adequate to deal with these various crises that come up.

That's point one.

One additional question to raise is having to do again with Asia.

I think that the stock market, in a sense, is kind of reflecting a process that most investors went through. I raise the question about how significant an effect the actions in Asia will have on our markets. As they went through that process, the market turned around because the conclusion was it's a relatively small impact on the American economy and the American markets.

But the question I have, and then I'll conclude, is what effect will this Asian problem have on Japanese financial institutions, which I understand presently, are experiencing some fairly significant difficulties, and how can that or will that have an effect on the U.S.?

Mr. Greenspan. Well, as you point out, Senator, they are having problems and have been ever since the collapse in property prices in Japan.

And not unlike many of the smaller Asian nations who have had real estate collateral as significant elements within their banking system, the Japanese have been struggling with that problem and working to solve it with some success in recent years.

But they have found, as we found during our credit crunch, when we had the same thing, as you may remember, back in 1990-91 that real estate is a relatively small part of most economies, but it ends up as a significant part of the collateral in the banking system, which impacts the whole system.

To the extent that Japanese banks are involved in lending on property in a number of these different Asian areas, and they are to a certain extent,

then clearly, unless and until that issue gets resolved, it would have more of a negative effect on them than on us.

Obviously, they are aware of that and we're all aware of the significance of property values throughout Asia.

To the extent that it impacts negatively on Japan, which is such a potent factor in Asia, obviously it impacts us, as, indeed, difficulties with any of our major trading partners creates problems for us. So that, as far as we're concerned, it is not an issue that we look on without interest or concern. We are interested and we are concerned and we would like to see the issue resolved as quickly as possible to reduce all of the latent risks that have emerged in this contagion problem that I discussed in my prepared testimony.

There's an awful lot of work that's moving forward on that, and I just wish to emphasize that, while we may not be directly involved in a lot of it, we do have a significant interest that it gets resolved effectively because if it does not, then the impact on us becomes immeasurably larger.

Senator Mack. Thank you, Mr. Chairman. Thank you.

Representative Saxton. Thank you very much, Senator Mack.

We're going to move now to the gentleman from South Carolina, Mr. Sanford.

But before we do, let me just announce that Mr. Sanford will be our last participating questioner this morning because of scheduling considerations. And so, Mr. Sanford, we're anxious to move on and hear your questions at this point.

[The prepared statement of Senator Connie Mack appears in the Submissions for the Record.]

OPENING STATEMENT OF REPRESENTATIVE MARK SANFORD

Representative Sanford. Thank you, sir.

I have but two questions, Mr. Chairman. I noticed here in the second page of your testimony that provided the decline in financial markets does not culminate, we'll look back at it in many of the same ways we look back at, for instance, 1987.

My question, is: doesn't it have to culminate, either because of the length of this expansion, which I understand to be very close to a

post-World War II record in terms of length of time on expansion. Or, if not for that reason, because there are no magic eras.

I don't know if you saw an article a couple weeks ago, in the *New York Times* or the *Washington Post*. It talked about technological advancement. And while much of the earnings projections were based on technological advancement within our society, the article pointed out that technological advancement is a relative thing. For instance, while telephones were a tremendous technological advance at the time, and now computers are, relative to our economy, they are not life-changing and that, therefore, there is no magic technological new eras.

If either of those two happen, does that mean that we go back to the markets culminating, and if that happens, what does that mean?

Mr. Greenspan. I read that article, as I recall. I thought it was quite interesting and I think there's a substantial element that is important to recognize.

However, the issue isn't whether we're dealing with an explosive new technology far greater than in the past. Indeed, as I think that article points out, productivity growth in the 1960s was significantly higher than it is today, and that's factually the case.

The issue that is involved here is: are we going back to an ever-increasing globalization which we really haven't experienced for 100 years? We had a very substantial free world system at the end of the 19th Century and then, especially after World War I, it began to get narrower and narrower and then, with the Depression, we all just shut our doors. And then we had Smoot Hawley and everybody pulled in their horns and it was an autarchic society.

We're reversing that and I think it's tremendously beneficial. And in that regard, the technology changes are impacting to a greater extent on financial areas and, indeed, changing the basic structure of finance.

So, these are really quite unusual changes, and in the sense that, if you go back to, say, the Mexican crisis of the early 1990s, its impact was nowhere near the more recent impact, largely because now we're dealing with a far more open world system. And I think that changes the scorecard, so to speak, in an appreciable manner.

Representative Sanford. Okay. My second question was unrelated, and that one goes back to what Mr. McCrery was raising on the issue of Social Security.

And that is, I guess two related questions.

One is, will we in fact run a budget surplus? In other words, Washington may proclaim this year or next year that we've run a surplus. Do you think that we will really have a surplus given the way that some of the money is moved around within the unified process?

Mr. Greenspan. Yes.

Representative Sanford. We introduced today a bill on Social Security. What do you think might be the right prescription for saving Social Security?

Mr. Greenspan. First of all, there are many different definitions of surplus. It depends what it is you're focusing on. We at the Federal Reserve are very focused on the issue of what is the amount of new debt issued to the public? That is effectively the unified budget deficit. And so far as financial policy is concerned, that's the crucial measure.

Representative Sanford. But at some point, don't the financial markets begin to take into effect the contingent liability?

Mr. Greenspan. Yes, I was about to raise that and that's a very interesting and very important point.

We have something on the order of contingent liabilities in our existing social security system of $9 trillion.

Now it's not exactly the same sort of commitment that, say, a U.S. Treasury bond is. That debt, by any of our customs or any of our laws, is irrevocable. We will pay interest and we will pay it off.

The contingent liability, however, on the social security system is a somewhat lesser type of obligation in that the Congress has the legal authority to alter the pattern of both receipts and outlays in the future and change that number.

So it doesn't have exactly the same force.

What we don't know and are very interested in is how the markets view that because, as you know, there are lots of questions about how to reform social security and one of them is to go the Chilean direction, which essentially would have "recognition bonds," which would mean, effectively, that that $9 trillion would go into nonmarketable securities owned by individuals—and probably they would be zero-coupon bonds or something of that nature.

Now, how that impacts on the financial markets dollar for dollar, vis-a-vis the regular debt that we publish, we don't really know. We suspect, obviously, that it is less, but we don't know how much less.

If it were a small number, we wouldn't care. But it's $9 trillion. And a small part of $9 trillion is a very large number.

So that is an issue which we are puzzled about, and you're quite right to raise the issue of a different form of measure of surplus.

If you put the contingent liabilities in, then we are running a deficit. And the question is, it's a different definition. It means something different. And I wouldn't say that it is necessary for the Congress to have a single definition. There are multiple purposes which the Congress addresses and you could very readily want certain things handled in different ways.

But this whole question of Social Security reform has raised a large number of issues which we really haven't focused on and really had better do sooner, rather than later.

Representative Sanford. Thank you, sir.

Representative Saxton. I thank the gentleman from South Carolina for his questions.

Mr. Chairman, thank you for being with us here today. In particular, I'd like to thank you for your candid discussion relative to the Fed perspective, or your perspective at least, of issues involving inflation and price stability.

I thought that was very enlightening.

I'd also like to thank you for your willingness to discuss today's economy and the economy as you see it, the prospects for the economy in the future, as well as social security and other matters.

Thank you very much for being with us today.

Mr. Greenspan. Thank you, Mr. Chairman.

Representative Saxton. The Committee stands adjourned.

[Whereupon, at 12:03 p.m., the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

I am pleased to welcome Federal Reserve Chairman Alan Greenspan to testify before the Joint Economic Committee on the economic outlook and monetary policy.

Given the sensitivity of the situation in international financial markets, we recognize that Chairman Greenspan must be constrained and circumspect in his comments, and for similar reasons my statement will focus on longer term issues related to monetary policy.

Two key factors to keep in mind in the current situation are the underlying strength of the economy and the able leadership of the Federal Reserve. Economic growth is healthy, and inflation and unemployment are quite low. In addition, the Federal Reserve demonstrated in 1987 that when necessary it can handle market disruptions superbly, and eliminate negative fallout on the economy. Economic growth actually increased in the fourth quarter of 1987. Currently, the outlook for the U.S. economy remains very positive.

The business cycle expansion that began in the second quarter of 1991 continues to produce economic and employment gains with no end in sight. This business cycle expansion is due to the hard work of millions of workers and business persons across this nation. To the extent policy factors are relevant, monetary policy has been the central factor sustaining the economic expansion.

As the Federal Reserve gradually squeezed 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 paved the way to prosperity without inflation. The central error in postwar economic policy—the notion of a tradeoff between inflation and unemployment—has been refuted 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 his colleagues at the Federal Reserve deserve a great amount of credit for reducing inflation in a gradual manner and thereby promoting the many economic benefits that have resulted.

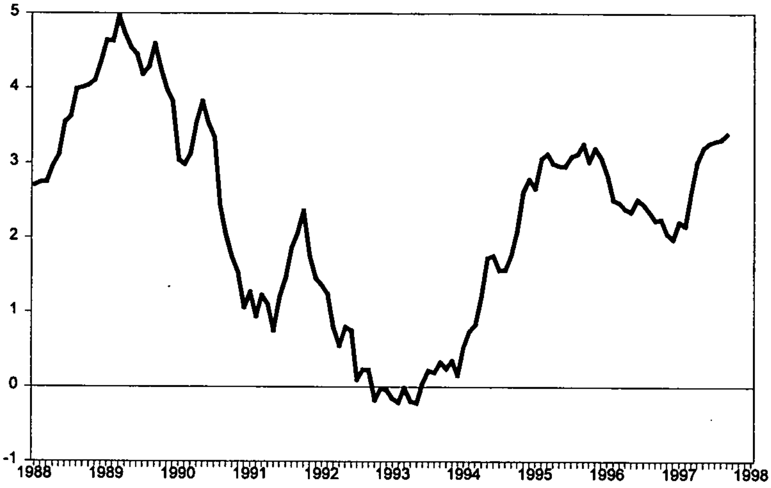
Some seem confused about the coexistence of low inflation and low unemployment. They seek an explanation in a "new economy" or a "new era." But new, revolutionary developments are not necessary to explain current circumstances. Rather, old truths will suffice; specifically, low inflation is good for economic growth and works to lower unemployment. On the other hand, a loose monetary policy ultimately leads to higher inflation and higher unemployment, as was demonstrated in the late 1970s.

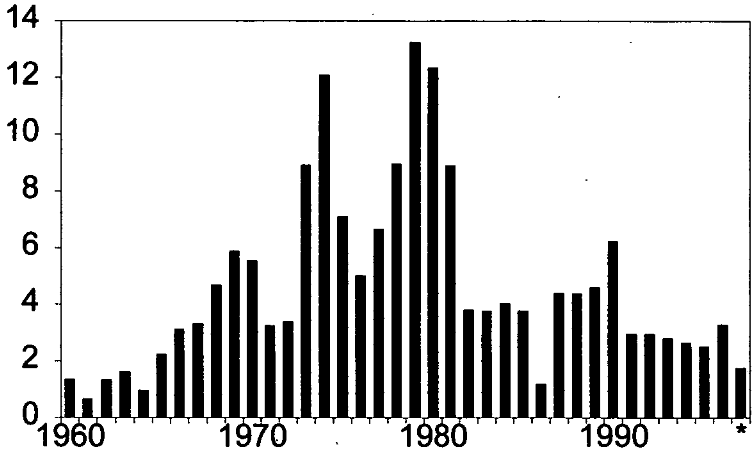
Inflation is not caused by economic growth. As Milton Friedman and F.A. Hayek noted, inflation is a monetary phenomenon. If monetary policy is not overly expansionary, there will not be inflation. Only when artificial economic growth is caused by an inflationary monetary policy is there reason for concern.

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 price index measures but also forward-looking indicators of inflation 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.

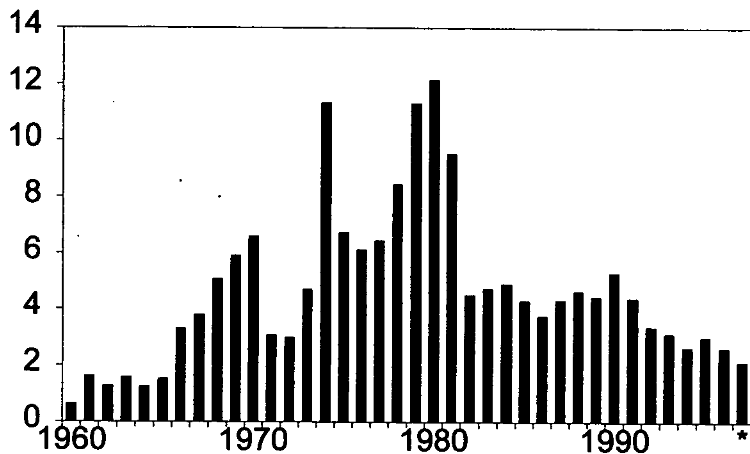
Overall, the thrust of Federal Reserve policy has been very successful in recent years. Current Federal Reserve policy seems con-sistent with a policy of setting an inflation band of about 0 to 2.5 percent. This is a sound approach that has also been successfully adopted by a number of other central banks around the world.

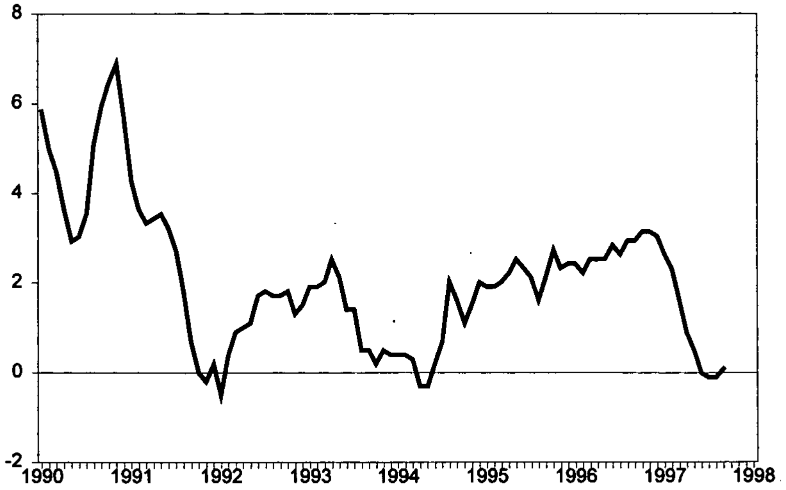
This policy of inflation targeting would be institutionalized under legislation I have introduced. The formidable achievements of the Federal Reserve under Chairman Greenspan should be locked in so price stability and low interest rates can be assured for future generations.


Real Fed Funds Rate
Fed Funds Rate Minus 12-Mo Change CPI
5
4
3
2
1
0
-1
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998



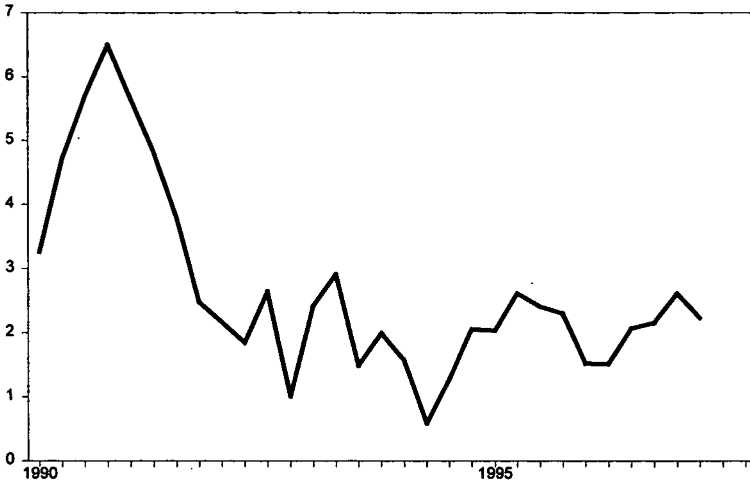
Consumer Price Inflation
Percent Change, December-to-December
14
12
10
8
6
4
2
0
1960
1970
1980
1990
*


Core Inflation
Percent Change, December-to-December
14
12
10
8
6
4
2
0
1960
1970
1980
1990
*


Producer Prices, Finished Goods
12-Month Percent Change
8
6
4
2
0
-2
1990
1991
1992
1993
1994
1995
1996
1997
1998
Source: Department of Labor

Unit Labor Costs, Nonfarm Business

Percent Change from Year Ago



PREPARED STATEMENT OF ALAN GREENSPAN, CHAIRMAN

We meet against the background of considerable turbulence in world financial markets, and I shall address the bulk of my remarks to those circumstances.

We need to assess these developments against the backdrop of a continuing impressive performance of the American economy in recent months. Growth appears to have remained robust and inflation low, and even falling, despite an ever tightening labor market. Our economy has enjoyed a lengthy period of good economic growth, linked, not coincidentally, to damped inflation. The Federal Reserve is dedicated to contributing as best it can to prolonging this performance, and we will be watching economic and financial market developments closely and evaluating their implications.

Even after the sharp rebound around the world in the past twenty-four hours, declines in stock markets in the United States and elsewhere have left investors less wealthy than they were a week ago and businesses facing higher equity cost of capital. Yet, provided the decline in financial markets does not cumulate, it is quite conceivable that a few years hence we will look back at this episode, as we now look back at the 1987 crash, as a salutary event in terms of its implications for the macroeconomy.

The 1987 crash occurred at a time when the American economy was operating with a significant degree of inflationary excess that the fall in market values arguably neutralized. Today's economy, as I have been suggesting of late, has been drawing down unused labor resources at an unsustainable pace, spurred, in part, by a substantial wealth effect on demand. The market's net retrenchment of recent days will tend to damp that impetus, a development that should help to prolong our six-and-a-half-year business expansion.

As I have testified previously, much of the stock price gain since early 1995 seems to have reflected upward revisions of long-term earnings expectations, which were implying a continuing indefinite rise in profit margins from already high levels. I suspect we are experiencing some scaling back of the projected gains in foreign affiliate earnings, and investors probably also are revisiting expectations of domestic earnings growth. Still, the foundation for good business performance remains solid. Indeed, data on our national economy in recent months are beginning to support the notion that productivity growth, the basis for increases in earnings, is beginning to pick up.

I also suspect earnings expectations and equity prices in the United States were primed to adjust. The currency crises in Southeast Asia and the declines in equity prices there and elsewhere do have some direct effects on U.S. corporate earnings, but not enough to explain the recent behavior of our financial markets. If it was not developments in Southeast Asia, something else would have been the proximate cause for a re-evaluation.

While productivity growth does appear to have picked up in the last six months, as I have pointed out in the past, it likely is overly optimistic to assume that the dimension of any acceleration in productivity will be great enough and persistent enough to close, by itself, the gap between an excess of long-term demand for labor and its supply. It will take some time to judge the extent of a lasting improvement.

Regrettably, over the last year the argument for the so-called new paradigm has slowly shifted from the not unreasonable notion that productivity is in the process of accelerating, to a less than credible view, often implied rather than stated, that we need no longer be concerned about the risk that inflation can rise again. The Federal Reserve cannot afford to take such a complacent view of our price prospects. There is much that is encouraging in the recent performance of the American economy, but, as I have often mentioned before, fundamental change comes slowly and we need to evaluate the prospective balance of supply and demand for various productive resources in deciding policy.

Recent developments in equity markets have highlighted growing interactions among national financial markets. The underlying technology-based structure of the international financial system has enabled us to improve materially the efficiency of the flows of capital and payment systems. That improvement, however, has also enhanced the ability of the financial system to transmit problems in one part of the globe to another quite rapidly. The recent turmoil is a case in point. I believe there is much to be learned from the recent experience in Asia that can be applied to better the workings of the international financial system and its support of international trade that has done so much to enhance living standards worldwide.

While each of the Asian economies differs in many important respects, the sources of their spectacular growth in recent years, in some cases decades, and the problems that have recently emerged are relevant to a greater or lesser extent to nearly all of them.

Following the early post-World War II period, policies generally fostering low levels of inflation and openness of their economies coupled with high savings and investment rates contributed to a sustained period of rapid growth, in some cases starting in 1960s and 1970s. By the 1980s most economies in the region were expanding vigorously. Foreign net capital inflows grew, but until recent years were relatively modest. The World Bank estimates that net inflows of long-term debt, foreign direct investment, and equity purchases to the Asia Pacific region were only about $25 billion in 1990, but exploded to more than $110 billion by 1996.

A major impetus behind this rapid expansion was the global stock market boom of the 1990s. As that boom progressed, investors in many industrial countries found themselves more investors in man heavily concentrated in the recently higher valued securities of companies in the developed world, whose rates of return, in many instances, had fallen to levels perceived as uncompetitive with the earnings potential in emerging economies, especially in Asia. The resultant diversification induced a sharp increase in capital flows into those economies. To a large extent, they came from investors in the United States and Western Europe. A substantial amount came from Japan, as well, owing more to a search for higher yields than to rising stock prices and capital gains in that country. The rising yen through mid-1995 also encouraged a substantial increase in direct investment inflows from Japan. In retrospect, it is clear that more investment monies flowed into these economies than could be profitably employed at modest risk.

I suspect that it was inevitable in those conditions of low inflation, rapid growth and ample liquidity that much investment moved into the real estate sector, with an emphasis by both the public and private sectors on conspicuous construction projects. This is an experience, of course, not unknown in the United States on occasion. These real estate assets, in turn, ended up as collateral for a significant proportion of the assets of domestic financial systems. In many instances, those financial systems were less than robust, beset with problems of lax lending standards, weak supervisory regimes, and inadequate capital.

Moreover, in most cases, the currencies of these economies were closely tied to the U.S. dollar, and the dollar's substantial recovery since mid-1995, especially relative to the yen, made their exports less competitive. In addition, in some cases, the glut of semiconductors in 1996 suppressed export growth, exerting further pressures on highly leveraged businesses.

However, overall GDP growth rates generally edged off only slightly, and imports, fostered by rising real exchange rates, continued to expand, contributing to what became unsustainable current account deficits in a number of these economies. Moreover, with exchange rates seeming to be solidly tied to the dollar, and with dollar and yen interest rates lower than domestic currency rates, a significant part of the enlarged capital inflows, into these economies, in particular short-term flows, was denominated by the ultimate borrowers in foreign currencies. This put additional pressure on companies to earn foreign exchange through exports.

The pressures on fixed exchange rate regimes mounted as foreign investors slowed the pace of new capital inflows, and domestic businesses sought increasingly to convert domestic currencies into foreign currencies, or, equivalently, slowed the conversion of export earnings into domestic currencies. The shifts in perceived future investment risks led to sharp declines in stock markets across Asia, often on top of earlier declines or lackluster performances.

To date, the direct impact of these developments on the American economy has been modest, but it can be expected not to be negligible. U.S. exports to Thailand, the Philippines, Indonesia, and Malaysia (the four countries initially affected) were about 4 percent of total U.S. exports in 1996. However, an additional 12 percent went to Hong Kong, Korea, Singapore and Taiwan (economies that have been affected more recently). Thus, depending on the extent of the inevitable slowdown in growth in this area of the world, the growth of our exports will tend to be muted. Our direct foreign investment in, and foreign affiliate earnings reported from, the economies in this region as a whole have been a smaller share of the respective totals than their share of our exports. The share is, nonetheless, large enough to expect some drop-off in those earnings in the period ahead. In addition, there may be indirect effects on the U.S. real economy from countries such as Japan that compete even more extensively with the economies in the Asian region.

Particularly troublesome over the past several months has been the so-called contagion effect of weakness in one economy spreading to others as investors perceive, rightly or wrongly, similar vulnerabilities. Even economies, such as Hong Kong, with formidable stocks of international reserves, balanced external accounts and relatively robust financial systems, have experienced severe pressures in recent days. One can debate whether the recent turbulence in Latin American asset values reflect contagion effects from Asia, the influence of developments in U.S.

financial markets, or home-grown causes. Whatever the answer, and the answer may be all of the above, this phenomenon illustrates the interdependencies in today's world economy and financial system.

Perhaps it was inevitable that the impressive and rapid growth experienced by the economies in the Asian region would run into a temporary slowdown or pause. But there is no reason that above-average growth in countries that are still in a position to gain from catching up with the prevailing technology cannot persist for a very long time. Nevertheless, rapidly developing, free-market economies periodically can be expected to run into difficulties because investment mistakes are inevitable in any dynamic economy. Private capital flows may temporarily turn adverse. In these circumstances, companies should be allowed to default, private investors should take their losses, and government policies should be directed toward laying the macroeconomic and structural foundations for renewed expansion; new growth opportunities must be allowed to emerge. Similarly, in providing any international financial assistance, we need to be mindful of the desirability of minimizing the impression that international authorities stand ready to guarantee the liabilities of failed domestic businesses. To do otherwise could lead to distorted investments and could ultimately unbalance the world financial system.

The recent experience in Asia underscores the importance of financially sound domestic banking and other associated financial institutions. While the current turmoil has significant interaction with the international financial system, the recent crises would arguably have been better contained if long-maturity property loans had not accentuated the usual mismatch between maturities of assets and liabilities of domestic financial systems that were far from robust to begin with. Our unlamented savings and loan crises come to mind.

These are trying days for economic policymakers in Asia. They must fend off domestic pressures that seek disengagement from the world trading and financial system. The authorities in these countries are working hard, in some cases with substantial assistance from the IMF, and the World Bank, and the Asian Development Bank, to stabilize their financial systems and economies.

The financial disturbances that have afflicted a number of currencies in Asia do not at this point, as I indicated earlier, threaten prosperity in this country, but we need to work closely with their leaders and the international financial community to assure that their situations stabilize.

It is in the interest of the United States and other nations around the world to encourage appropriate policy adjustments, and where required, provide temporary financial assistance.

PREPARED STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY

Chairman Greenspan,

After Monday's market scare... All the world is watching you—to see if you will exhibit some tell tale signs—as to what will happen next!

As we saw Monday—the policy we create is crucial to every American. Millions of people take part in the process either directly, or through their pension funds. They have invested a major part of their wealth in our nations's businesses because they have as justified confidence in the future of our economy.

To put the recent stock market instability in its proper perspective, the U.S. economy is too large to be sidetracked by unexpected gyrations in financial markets, that have no true basis in the economic conditions of this country. In other words, unexpected gyrations are frightening. And, given the health of our nation's economy, they seem unnecessary.

We must also remember that in this new technological era, information may be transmitted around the world faster than it can be analyzed. Panic is too often the result of disinformation. And once again, our high tech accomplishments become a liability.

I must say I am curious to know... how a somewhat "low tech" NEW policy worked—in your opinion. The so-called circuit breakers that were put into place in 1987 "seemed" to serve their purpose well. Traders seemed to appreciate the breathers. But there's been some controversy—and I'm hoping you can tell us today what you think.

Mr. Greenspan, keeping in mind all of the difficulties that need to be balanced, I'd like to express my support in pursuing a monetary policy which has helped to foster sustained non-inflationary growth of the U.S. economy ever since the recession of 1990 and '91.

I have full faith in the excellent leadership of President Clinton, the officials of the United States Treasury, the Securities and Exchange Commission, the Commodities Futures Trading Commission, and of course, the Federal Reserve under your leadership. I know everyone will play a constructive role to reassure the public, and when, appropriate, to minimize any harmful effects of the recent instability in the financial markets.

PREPARED STATEMENT OF SENATOR CONNIE MACK

Thank you Chairman Greenspan for appearing before this Committee. I always look forward to hearing your views on monetary policy and the economy.

With continued turmoil in many foreign economies (particularly in Southeast Asia) it is comforting to know that the U.S. economy is fundamentally sound and growing. Our currency is stable and strong.

A great deal of the economic stability we may take for granted today is the result of sound monetary policy and low inflation. Under Chairman Greenspan's guidance, the Federal Reserve has done an excellent job of focusing on stable monetary policy that is so essential for strong economic growth. There is no doubt that Mr. Greenspan's solid leadership has produced confidence and certainty in the U.S. economy.

The current positive growth and inflation statistics should not lure us into complacency. The Federal Reserve should remain focused on price stability—and Congress should remain focused on balancing the budget and lowering the record high tax burden.

I believe the best way to guarantee continued growth is to remove the fiscal burdens that have been placed on this economy. Over the years, major tax hikes, excessive regulations, and increased government spending have taken their toll on the economy and the American family. Total taxes (that's federal, state and local) take up almost one-third of the U.S. economy. That means that for every eight-hour workday, the average taxpayer works nearly three of those hours just to pay their taxes! That's just plain wrong.

The Taxpayer Relief Act was a good first step toward letting people keep more of their own money. Just four years after President Clinton raised taxes by $240 billion, this package of relief will reverse about one-third of that 1993 increase. And we shouldn't stop there. More tax relief and the eventual overhaul of our tax system, in my opinion, will add even more growth and opportunity to our economy.

The Federal Reserve has done an outstanding job with monetary policy and controlling inflation. Now it's time for Congress and the Administration to do their part, by pursuing a pro-growth fiscal policy and following through on balancing the budget and providing additional tax relief. With lower taxes, price stability, and a balanced budget, American families will flourish.

I welcome Chairman Greenspan and I'm anxious to hear his analysis.

PREPARED STATEMENT OF SENATOR SAM BROWNBACK

Mr. Chairman, thank you for the opportunity to provide some opening remarks before the Committee today. You have done an admirable job as Chairman of the Committee and I look forward to continue working with you and the Committee in the years to come.

Mr. Greenspan, I presume you have had a very busy couple of days and I am pleased that you are able to take time to offer your testimony today. As I am sure everyone in this room must know, the financial markets around the world experienced a serious compression this past week. Initially triggered overseas in the Asia markets, the effect of Hong Kong's freefall has reached into the markets of all industrialized countries.

I would hope that this compression would alleviate the fear that our economy is currently too vibrant and needs to be brought into check—a supposition that was prevalent among many economists only a few short months ago. The speculative bubble has quite evidently popped, thus making pre-emptory action to prevent inflation from taking hold virtually unnecessary in my opinion.

More fundamentally, I believe that our economy—and by that I mean our financial markets—needs to have the elbow room necessary to allow it to continue growing at a steady pace. While increases in interest rates slow inflationary pressures they can sometimes stifle economic growth and slow the expansion of our economy as well. Additionally, I believe that, given the recent compression, interest rates should not rise beyond their current levels—a belief that I assume you now share.

Beyond the current seemingly temporary worldwide compression of our financial markets I would like to turn to another topic of critical importance to U.S. monetary policy and future economic growth in America.

Mr. Greenspan, you have used the interest rates controlled by the Federal Reserve very effectively in combating against inflation. You have worked hard and very successfully in keeping inflationary pressures at bay and preventing the ravages of inflation from taking hold on our economy by effectively taking pre-emptory steps. I commend you for this fine work. In fact, it is to you that many in Congress owe some of the credit for our current economic situation. Of course, the business cycle is very robust in itself, more than the politicians in Washington, to be given the credit for our current economic expansion. The American economy is really responsible for our economic growth.

As you may know, monthly, the Joint Economic Committee hears testimony from Katharine Abraham at the Bureau of Labor Statistics on the "Employment Situation." And as you also know, unemployment levels have been at record lows for much of the year. This is a situation that, given some of the faulty economic theories prevalent in the academy only a few short years ago, would have been thought impossible based on the then ardent belief in the Phillips Curve and its implications for monetary policy. We now know, based on years of evidence that the link thought to have existed between inflation and unemployment presumably explained in the Phillips Curve is virtually nonexistent.

Correspondingly, I believe that our monetary policy should now focus on the only thing it can realistically achieve—a low level of inflation.

The evidence clearly seems to indicate that much of our current economic growth is the result of greater price stability along with a very robust business cycle.

Therefore, I believe that legislation charging the Federal Reserve with the goal of inflation control will do much to return our economy and our monetary policy to a situation of increased stability. It is time to eliminate the goal of low unemployment from the charge given to the Federal Reserve.

By doing this we will give the Federal Reserve the ability to set monetary policy without having to worry about artificial unemployment targets that are rarely met anyway. The whole nation of codifying Keynesian theory into law by placing unemployment targets in monetary policy is a notion that has been shown to be false. From earlier testimony before this Committee, I know that you share some of these concerns.

Mr. Greenspan, I look forward to your testimony today and will yield back the balance of my time to the Chairman.

NYT 10/5/97

MARKET WATCH

JONATHAN FUERBRINGER

Fed Policy On Rates Seems Tough After All

The Federal Reserve's policy-making committee met last week and, again, did not raise interest rates — a move that, for some, is evidence that the central bank is prolonging its "experiment" with inflation and growth.

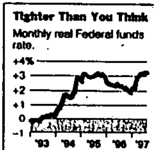
Look closely, though, and you find that the Fed is not being so experimental, after all. Adjusted for inflation, the Fed's short-term interest-rate target is keeping the economy on a tighter leash than many people realize.

Those who are worried say the Fed, by not raising interest rates, is ignoring the traditional view that strong growth with low unemployment inevitably leads to rising wages and prices. But at the same time, analysts agree that it would be very hard politically for the Fed to raise interest rates now with no sign of an inflation threat.

In fact, though, it is the very absence of inflation that is making Fed policy more restrictive than it may appear.

The Fed's short-term interest-rate target is the Federal funds rate, the interest charged on overnight loans between banks. At present, the nominal Fed funds rate is 5.5 percent, last increased in March, when the Fed raised it one-quarter of a point.

But interest rates adjusted for inflation are a better measure of the drag that the Fed is putting on the economy, because they reflect real costs to the borrower. And after subtracting the Consumer Price Index increase for the last 12 months, the real Fed funds rate is 3.28 percent. Between the Fed's quarter-point increase and the sharp decline in inflation this year, that is up from 2.22 percent in February. While the economy is growing faster than last year, the price index is up only 1.6 percent at an annual rate through August, half the 3.3 percent of 1996.



To see how restrictive these real short-term rates are, look at February 1994, when the Fed began a yearlong series of increases in the nominal Federal funds rate, to 6 percent from 3 percent. At the time, the real, inflation-adjusted rate was an average of nine-hundredths of 1 percent for the last 12 months — or almost zero — according to James E. Glassman, senior United States economist at Chase Manhattan Bank. The Fed's credit policy was very easy.

By the time the Fed finished that round of tightening in February 1995, the real Fed funds rate had risen to 3.14 percent; the average for the next 12 months was 3.01 percent. While much tighter, it was not as restrictive as this August's 3.28 percent.

"It's hard to find indications that the Fed's policy is too easy," Mr. Glassman said.

Alan Greenspan, the chairman of the Federal Reserve and the focus of speculation about a conversion in thinking at the central bank, allowed that the real Fed funds rate was pretty high last February. It "might be at a level that will promote continued non-inflationary growth," he told Congress, "especially considering the recent rise in the exchange value of the dollar."

This trust in a high real Fed funds rate was reiterated at the August meeting of Fed policy makers. In the just-released minutes of that session, they said they left the nominal Fed funds rate unchanged because the real rate was "high by historical standards and provided some assurance that the current stance of policy would not accommodate a significant increase in underlying inflationary pressures."

[illegible] because the Fed is already tight, future i[illegible]eases should not have to be big. And if the economy slows some, maybe there will be none at all.

ISBN 0-16-056372-0