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before the

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED SEVENTH CONGRESS

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Wednesday, October 17, 2001

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

The Committee met, pursuant to notice, at 10:00 a.m., in Room 311, Cannon House Office Building, Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton, Smith, Dunn, English, Putnam, Stark, Maloney, and Watt. Senators Reed, Bingaman, and Corzine.

Also Present: Representative Don Sherwood.

Staff Present: Chris Frenze, Robert Keleher, Colleen J. Healy, Stephen Thompson, Darryl Evans, Brian Higginbotham, Pat Ruggles, Matthew Salomon, and Diane Rogers.

OPENINGS STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Good morning. I would like to welcome Chairman Greenspan before the Committee to testify on monetary policy and the economic outlook. We appreciate your being with us today, Mr. Chairman. We always look forward to the days when you come and visit with us, and so we look forward to your testimony.

I would also like to take this opportunity to thank Chairman Greenspan for his leadership and the Federal Reserve for the actions undertaken to cushion the effects of the September 11 terrorist attacks. The Federal Reserve's ability to deal with such an unspeakable crime has served the country well, and we are in your debt. It is also encouraging that the American people and the economy have demonstrated amazing resilience in the face of these attacks.

Even before the events of September 11, the available economic data indicated that the economic slowdown that began in the middle of 2000 continued. The weight of real gross domestic product (GDP) growth has slowed quite sharply since the second quarter of 2000, barely remaining positive in the second quarter of this year.

The manufacturing sector has been hard hit, losing over a million jobs since July of 2000. Investment growth has fallen over the last several quarters, and corporate profits are weak.

On the other hand, housing and consumer spending have held up fairly well. In addition, since last January, the Fed has reduced interest rates nine times. Congress has lowered the tax drag on the economy and energy prices are finally declining. Economists expect these factors to lead to an economic rebound in the last half of 2001, but the attacks have led them to forecast a delay in the recovery.

Financial markets and the economy have been disrupted by the terrorist attacks. These attacks have increased uncertainty and caused a widespread reevaluation of risk and security. Delays in higher shipping costs in air and ground transport, additional insurance costs, higher expenses for security personnel and equipment, fortification of buildings and facilities, and other measures, will have the effect of imposing something like a "security tax" on an already vulnerable economy. This burden will undermine the economy and in the short run and could tend to adversely affect both productivity growth and the economy's potential growth rate.

Although the precise amount of the extra burden imposed by these security costs is not known, it appears to be large and is growing by the day. Over the last several weeks, private sector economists have begun to consider this cost issue and the potential impact on an already weak economy.

A logical policy response would be to offset those costs by relieving some of the tax burden on the private sector. Monetary policy helped the economic situation with an easing that began in January. The Fed's policy moves so far this year have certainly provided an economic stimulus, but the lags in monetary policy, as we all know, are long and variable. Given the lack of inflationary pressures, prudent action by the Federal Reserve could continue to contribute to improving the economic outlook.

Again, Mr. Chairman, I want to welcome you, and at this point, turn to the Vice Chairman, Senator Reed, for any comments he may have.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 27.]

OPENING STATEMENT OF SENATOR JACK REED, VICE CHAIRMAN

Senator Reed. Thank you very much, Mr. Chairman. Thank you, Chairman Greenspan for joining us this morning. Your presence here is a reassuring one. And we appreciate that you are here and thank you, Chairman Saxton, for scheduling this hearing on a very critical topic – our economic outlook and appropriate policy responses. In light of the new fiscal realities we face, economic policy needs to be recalibrated. The key to achieving a rapid recovery is to bolster incomes, because when cash-strapped households cut their spending, business' sales suffer, stifling investment. We need to complement existing monetary policy with an economic stimulus package, but one which has its maximum impact in the short run and does not undermine long-term fiscal discipline.

Specifically, the stimulus package should be large enough to have an impact on a $10 trillion economy, such as about $100 billion, one percent of GDP, a figure which I believe you have supported, Chairman Greenspan. The bulk of the stimulus should be felt in the next two or three quarters when the economy is weak. Often or not, economic stimulus in the past has not been implemented until the economy was already recovering.

The stimulus package should be designed to phase out rapidly so that the stimulus measures do not overheat the economy later in recovery.

Thus, permanent tax cuts or new spending that spin out slowly are not attractive candidates, while safety-net programs, such as unemployment insurance, which are designed to be countercyclical, are attractive options. The stimulus package should maximize the amount of short-term economic activity created per dollar of outlays or revenue lost. For example, a tax cut for low- or moderate-income households who would likely spend all of their extra income would be more effective as stimulus than a similarly-sized tax cut for higher income households who are more likely to save a substantial portion of it.

These principles are outlined in greater detail in a new report prepared by the Democratic staff of the Joint Economic Committee, *Economic Stimulus, Principles and Options*, which evaluates the leading proposals in light of their impacts on the economy and the degree to which they have a stimulative effect. This report is available here in the room and also online on our website.

Earlier this year, Chairman Greenspan, you spoke of the need to resist those policies that could readily resurrect the deficits of the past and the fiscal imbalances that followed in their wake. You also testified about the limits of tax cuts as effective tools to stimulate the economy. I would be interested in your thoughts on how the economic stimulus proposals before the House right now deal with these tenets.

We have an important responsibility before us, to undertake fiscal policies that will protect the most vulnerable in our economy, while ensuring that we do not compromise our economic future. It is a challenge we can meet if we stick to policies which put people back to work and generate productive business investment. Again, thank you, Mr. Chairman, for your attendance today.

[The prepared statement of Senator Reed appears in the Submissions for the Record on page 28.]

Representative Saxton. Thank you very much, Senator Reed. Mr. Chairman, we are here to hear what you have to say, and we always, as I said before, value these opportunities. So we would like to hear from you at this time. You may proceed.

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

Mr. Greenspan. Well, thank you very much, Mr. Chairman. I very much appreciate this opportunity to appear before this Committee to discuss recent developments in the United States economy. Despite the tragic events of September 11, the foundations of our free society remain sound, and I am confident that we will recover and prosper as we have in the past. But before the recovery process gets underway, stability will need to be restored to the American economy and to others around the world. Arguably, that stability was only barely becoming evident in the United States in the period immediately preceding the act of terrorism.

Aggregate measures of production, employment and business spending continued to be weak in August. Consumer spending, however, moved higher that month, and appeared to be reasonably well maintained in the first part of September. Industry analysts suggest that motor vehicle sales were running close to August levels, and chain store sales were only modestly lower. New orders for nondefense capital goods stabilized in August. Moreover, the dramatic rate of decline in profits was slowing. To be sure, these signs were tentative, but on the whole, encouraging.

In the days following the attack, the level of activity declined significantly. The shock was most evident in consumer markets, as many potential purchasers stayed riveted to their televisions and away from shopping malls. Both motor vehicle sales and sales at major chain stores fell off noticeably. The airline and travel industries also suffered severe cutbacks. The unprecedented shutdown of American air travel and tightened border restrictions induced dramatic curtailments of production at some establishments with tight, just-in-time supply chain practices, most notably in the motor vehicle industry.

As the initial shock began to wear off, economic activity recovered somewhat from the depressed levels that immediately followed the attacks, though the recovery has been uneven. Markedly increased incentives induced a sharp rebound in motor vehicle sales by the end of the month that has carried apparently undiminished into the first half of October. However, many retailers of other consumer goods report that sales have only partially retraced the steep drops that occurred in mid-September.

Fortunately, air freight is largely back to normal. Overall airline passenger traffic, while above its mid-September lows, was still off considerably in early October from pre-attack levels. Similarly, the hospitality and entertainment industries have overcome some of their earlier difficulties but continue to struggle.

The effect on financial markets of the devastating attack on the World Trade Center was pronounced, as telecommunications and trading capacities were severely impaired. But the markets are mostly functioning normally now, and as in the past, the infrastructure will be rapidly restored.

For a brief time, the terrorist attacks markedly disrupted payment transfers, leaving those counting on receiving payments caught short. Those needs ultimately were met by the Federal Reserve, both through record lending at the discount window and through an extraordinary infusion of funds through open market operations. To facilitate the channeling of dollar liquidity to foreign financial institutions operating in the United States, 30-day currency swap lines were arranged with major central banks, again, in record volumes.

It was essential in such an environment to meet all appropriate demands for dollar liquidity. As repair of the financial markets and payment infrastructure preceded apace, loans were repaid, open market operations could be scaled back, the unusual swap lines were allowed to expire, and the temporarily bloated balance sheet of the Federal Reserve largely returned to normal.

But even as market functioning and liquidity flows were restored, the potential for heightened uncertainty to damp household and business spending for a time persisted. To cushion these effects, we have eased the stance of monetary policy appreciably since September 11.

We, in the United States, have assumed ourselves to be fairly well-insulated from terrorism or, at most, subject to limited and sporadic episodes similar to those previously observed on a number of occasions in Europe.

We have been aware of the possibility for losses on a much greater scale, but I suspect that those possibilities were deemed so remote that they were never seriously incorporated into most conventional assessments of economic risk.

The shock of the tragedies at the World Trade Center and the Pentagon has reshaped those assessments of risk and required an abrupt realignment of prices in many markets to reflect the expected costs of operating in what we now recognize as a more hostile world. These circumstances pose a difficult challenge for business decisionmaking, not so much because the costs are inordinately large, but because the events, which have potentially substantial consequences, are so uncertain. Insurance deals with this problem by spreading the risk and converting potential large unknown costs into a steady stream of known insurance premiums that facilitates the forward planning so essential to an effective business operation.

Obviously sharp increases in insurance premiums for all forms of businesses are to be expected. Some higher insurance costs, in effect, will be borne implicitly rather than explicitly as firms choose to self-insure, at least in part, rather than lay off all of this risk in the marketplace.

These higher insurance costs, both explicit and implicit, endeavor to anticipate future losses, but in addition, they cover the physical capital and labor resources businesses will be required to devote to enhance security and to increase redundancies as protection against interruption of supplies or production. For example, the degree of comfort businesses have in allowing inventories to shrink to minimal levels in a just-in-time supply chain is lessened. In this regard, increased security threats, not pooled through insurance, have exactly the opposite effect on productivity than that which is gained by an improvement in information technology. In addition to the loss of human life and capital assets, these are important collateral costs associated with the new threats that we now face.

The pronounced rise in uncertainty also has damped consumer spending and capital investment. Households and businesses confronted with heightened uncertainty have pulled back from the marketplace, though that withdrawal has been partial and presumably temporary. The very great economic uncertainties that have arisen in the current environment have also, at least temporarily, resulted in a widening of bond spreads on high-yield instruments.

Markets across our economy will adjust to the altered perceptions of risk that we now confront. Critical to that adjustment process is the behavior of consumers and business people. Behavior is difficult to predict in circumstances such as those we have experienced in the past five weeks. But judging from history, human beings have demonstrated a remarkable capacity to adapt to extraordinarily adverse circumstances, and I expect the same adaptability to become evident in the present situation.

Although it is difficult to determine with any precision, it seems quite likely that a significant repricing of risk has already found its way into our markets as many economic decisions are responding to shifting market signals. But these adjustments in prices and in the associated allocation of resources, when complete, represent one-time level adjustments without necessary implications for our longer-term growth prospects.

Indeed, the exploitation of available networking and other information technologies was only partially completed when the cyclical retrenchment of the past year began. High-tech equipment investment at elevated rates of return will, most likely, resume once very high uncertainty premiums recede to more normal levels. The level of productivity will presumably undergo a one-time downward adjustment as our economy responds to higher levels of perceived risk. But once the adjustment is completed, productivity growth should resume at rates in excess of those that prevailed in the quarter century preceding 1995.

It is worth noting that increased production to enhance security will be counted in measured output without contributing to our standards of living, as was the case during our military buildup of the Cold War. Our productivity measures have always endeavored to capture increased productive efficiency, not increased well-being. We are, in effect, currently using part of our increase in efficiency to supply increased security. Of course, given the heightened risks we face, these investments in security are doubtless quite sound. In any event, such costs are likely to fall short of the costs we incurred for security during the height of the Cold War.

Nobody has the capacity to fathom fully how the effects of the tragedy of September 11 will play out in our economy. But in the weeks ahead, as the initial shock continues to wear off, we should be able to better gauge the ongoing dynamics of how these events are shaping the immediate economic outlook.

For the longer term, prospects for ongoing rapid technological advance and associated faster productivity growth are scarcely diminished. Those prospects borne of the ingenuity of our people and the strength of our system, fortify a promising future for our free nation.

Thank you very much, Mr. Chairman. I look forward to your questions and those of the Committee.

[The prepared statement of Chairman Greenspan appears in the Submissions for the Record on page 30.]

Representative Saxton. Mr. Chairman, thank you very much for sharing those thoughts with us. Let me just take care of a couple of housekeeping measures. Senator Reed has indicated that the Senate is having an important security briefing sometime in the next ten minutes or so, so if some of the Senators disappear, we will understand why. I would also like to ask unanimous consent that Congressman Don Sherwood be permitted to sit on the panel, as he is not a Member of the Joint Economic Committee. Without objection. Thank you.

Mr. Chairman, immediately following the events of September 11, you cautioned policymakers to proceed cautiously, and to take a closer look at economic data that would flow in, in the weeks following September 11. We have begun to see some of that data, and I am wondering if you could comment on what the data covering the period immediately prior to September 11 showed us, and while certainly we don't have a complete picture of the economic situation following the 11th, there is some data that is now available, and would you help us interpret that?

Mr. Greenspan. Well, Mr. Chairman, we interpreted the data that came in at the time before September the 11th, and that information which we have subsequently received for the period before September 11, to indicate that the economy was still weak but showing some signs of stabilization. As I said in my prepared remarks, and I think I said earlier on in my testimony, it was by no means conclusive, but it was certainly encouraging.

Since then, the data are fairly clear as to what is happening, though the interpretation of what it means has yet to fully unfold. That the economy dropped fairly sharply in the days immediately following the attack is confirmed by virtually every measure that we can see, and that it has started to come back is also evident. We see that in the retail area, especially in an uncertain puzzling way, extraordinarily in motor vehicles, because we had a dramatic decline in the middle part of September in motor vehicles. The new incentives came in, and sales came back very sharply in the last 10 days, and from what we can gather, are holding at remarkably high levels in the first half of this month. I say that remarkably in the sense that the discounts which have been put in place, if one looks at previous elasticity of demand in the motor vehicle industry, don't fully account for this upsurge.

So it is a difficult judgment to make. We suspect, as indeed the auto makers suspect, that because the discounts are perceived to be temporary, that a lot of people are moving up sales, and that we would expect a falloff, and indeed the motor vehicle manufacturers are expecting the average for the fourth quarter to be well under the first half of this month.

But outside of the motor vehicle area, things are really quite mixed. Chain store sales are soggy. They have stopped going down, but the evidence that they have turned up in any material way is still quite missing.

Airline travel has come back modestly. It came back reasonably quickly within days after the attack, and load factors rose, but remember, they are load factors after a significant contraction in the number of scheduled flights, which means that the actual revenue passenger miles are still quite significantly below where they were a year ago, and indeed where they were earlier this year.

The entertainment/hotel industry is back to a certain extent – actually occupancy rates have come back, but generally, as I indicated in my prepared remarks, it is evident that there is still a good deal of struggle going on in those areas.

We don't have any real hard evidence on what is happening to capital goods orders, but anecdotal information does suggest that they turned weak late in September and have been weak so far this month.

Home building has been holding up remarkably well, and the starts figures that came out this morning were a continuation of the most previous period of fairly good housing construction. Although again, data on surveys of home builders have indicated that home sales have slipped in recent weeks. It is often difficult to reconcile differing measures of an industry as large and diverse as home building. So until we have more information and it materially works its way through the system, it is not clear what we are seeing. But obviously the home building industry has been a major part of whatever strength we have seen in this economy. And certainly the very high level of turnover of existing homes and the realized capital gains that that engendered in the process has been an important factor in maintaining the level of consumer expenditures for most of this year.

As best we can judge, the closings on existing home sales are still quite high, but we have to remember that there is a lag between actual commitment in purchase and closing, so that we won't really see the impact of what appears to be some softening in existing home sales, as well as new home sales until October data become available, and that may still not capture it fully.

So all in all, I think we are looking at a situation which is by no means as bad as numbers of us were fearful it might turn out to be, but it also has not exhibited a sharp snap back, which has been typical of what happens when you get a major hurricane or natural disaster which breaks down the infrastructure, and has many similar effects to what we have seen since September 11, but which almost never affects demand in any material way or underlying psychology. This clearly has.

Representative Saxton. Well, Mr. Chairman, I think it is fair to say, and I am sure you would agree, that there is a different psychology associated with the events of September 11 than there are with natural disasters. Let me just ask one more quick question, and then we need to proceed to Senator Reed. Beginning in January, Fed policy changed, in that interest rates, Fed funds, were reduced, and in the succeeding months there have been nine reductions, totaling 400 basis points, moving the rate from 6.5 percent to 2.5 percent.

Now, we know from past experience that there is a lag time in the economic benefit that we get from lowering interest rates or the economic effect, I should say, from lowering interest rates. Can you venture any opinion as to when we might begin to see -- or have we already begun to see – the effects of recent Fed policy?

Mr. Greenspan. Mr. Chairman, as best we can judge, we have been seeing a considerable amount of impact from the monetary policy decisions we have taken in the financial markets. You could see them in how it is impacting the term structure of rates, how it is affecting yield spreads, and how it is affecting the degree of liquidity in the system. And all of that is behaving as one would generally expect.

There is a distinction between looking at how effective Federal Reserve policy is and what is happening to the economy. My own judgment is that the impact is probably at least partially responsible for the fact that after a very sharp decline very late last year, the economy, for all practical purposes, has been remarkably flat, and as I put it in earlier testimony, despite the fact of this extraordinarily significant wealth effect contraction late last year, the economy, taking all of the tremendous pressures on it, has nonetheless remained standing.

And I would still characterize that as the case despite the attack on September 11. I don't know to what extent there remains significant amounts of impacts in the pipeline which will work their way through. Those are very difficult judgments to make. As we like to say, the lags are variable, meaning it is an economist's way of saying that the distributions of the impact from policy to impacts on economic activity is not simply definable by a simple distribution which works the same way every time.

All I can say to you is that, as best I can judge, the policies have had a significant impact to date. How much further impact, and when it happens, and in what form, still remains to be seen.

Representative Saxton. Well, thank you, Mr. Chairman. I am hopeful that the Fed will remain open to future rate reductions, particularly if this situation persists, and I know that it is unfair to ask you to comment on that subject, and so I won't. But it is certainly my opinion that what you have done in the past has been particularly effective, and we are hopeful that that policy will continue.

Senator Reed.

Senator Reed. Thank you very much. Thank you, Mr. Chairman. Chairman Greenspan, yesterday the Federal Reserve published data that indicated that manufacturers continue to operate below 75 percent of their capacity, and that producers of high-technology equipment now carry more excess capacity than they ever have before. This raises several questions: First, to what extent will lower interest rates help stimulate investment in this climate? Second, to what extent are business tax incentives likely to stimulate investment when businesses are carrying this excess capacity? Will business respond favorably to investment incentives if consumer demand is low and gets lower, because if not, it raises the possibility that an approach that we most prefer would be to stimulate consumption rather than provide investments – Chairman Greenspan?

Mr. Greenspan. The rate of operation in manufacturing is only one of a number of key variables which determines the level of capital investment. To a very substantial extent, investment is determined at the plant level by plant managers who perceive that a certain piece of equipment will enhance the profitability of that operation independently of what is happening elsewhere in the world.

In other words, there are significant amounts of capital investment which are made for cost-reduction purposes and which are essentially unrelated to the level of output or the rate of operations, and as a consequence of that, we often see fairly significant investment emerging in periods when the rate of operation is quite low. It is, however, very substantially of a cost-saving type, and I think that is the type of outlay which is likely to come back as this economy eventually stabilizes.

You are quite correct in saying that until demand changes, the propensity to expand facilities – new plants, greater expanse of output – is likely to be mooted. But that is a typical pattern that we run into but should not, in any way, dissuade us from endeavoring to produce incentives for capital investment, because even though investment has fallen and may indeed still be falling for all we know because of the attack, it is just as important to slow the rate of decline of that investment as to enhance consumer expenditure growth, because arithmetically, obviously it doesn't matter whether you are slowing the rate of decline or you are raising something else. My own impression is that it is in the investment area where the greatest sensitivity for fiscal stimulus lies.

Senator Reed. Mr. Chairman, implementation of the income tax cut that was recently passed has raised two polar recommendations in the context of the present situation. Some would argue that we should pay for the short-run stimulus gradually over the decades ahead by freezing parts of the tax cut, while others suggest that we accelerate parts of the tax cut that would otherwise not kick in until 2004 or 2006. Could you comment upon these polar views of the world?

Mr. Greenspan. Let me just say in general, Senator, that our economy is extraordinarily complex and our understanding of exactly how it works is changing all the time because the economy itself is changing all the time. And as a consequence of that, the models we develop in order to endeavor to capture the economic impact of fiscal policy differences are not all that robust. We know certain things in general, but I am disinclined to get involved in too much of the details, because I don't think we know as much as we need to know, or at least I don't feel comfortable with the exception of a few types of issues where

I think the evidence tells you that certain things have worked in the past, like temporary expensing has clearly worked in the past, and a temporary investment tax credit has worked in the past.

I might add that neither one of those have any long-term value so far as productivity is concerned, since they merely move capital investment up from what it otherwise would have been, and indeed in the process, do create some degree of uncertainty. And what we find in looking at the various impacts of these fiscal policies is that we get very great differences of opinion amongst analysts, all of whom are looking at least at the same data structure. And the reason is that the economy is constantly changing, and the impact of how various taxes and expenditure programs affect the economy is also changing. That is the reason why there have been significant differences on even interpreting how the previous rebates impacted on the economy to date.

Senator Reed. Thank you very much, Mr. Chairman. Thank you, Chairman Saxton.

Representative Saxton. Thank you very much, Senator Reed. We will now go to the gentleman from Texas, Mr. Smith.

Representative Smith. Thank you, Mr. Chairman. Chairman Greenspan, the high-tech sector is generally considered to be one of the driving forces of the economy. Now, I am wondering what we could do to help the high-tech industry get back on its feet, and specifically would it help, for example, to accelerate depreciation schedules, since, as we know, the shelf life of a computer is probably less than two years now, should we shorten the depreciation from five years to two years or one year?

Secondly, would it help if we increased expenditures for Federal research and development? I am looking for particular things we might do for that particular industry.

Mr. Greenspan. No. I understand the question, and I am saying that what we know about a lot of this is less than we sometimes portray. There is a degree of exactitude in some of these analyses. I notice, for example, that the Congressional Budget Office, OMB, and ourselves, we all come up with estimates of the impact which have got four digits to the right of the decimal point. We know that can't be right.

Certainly the issue of moving towards expensing, I think, is helpful in this regard. My own impression of expenditures, especially on research and development, is that that takes a long lead time.

And I think what is crucially important in this discussion is to make a judgment first.

Are you embarking on a tax policy whose purpose is to basically move production from the future to the present, or are you trying to increase the overall rate of growth of the economy over the long run? What you do in both of those different scenarios is really remarkably different, and I think that once the decision is made that what you are looking at is stimulus, it takes a lot of the other issues of productivity, long-term growth, and all of the associated elements there, and changes the mix completely.

Representative Smith. Thank you.

Chairman Greenspan, one other question goes to your testimony where you said that the level of productivity – something you just mentioned a second ago – will presumably undergo a one-time downward adjustment, but once the adjustment is completed productivity growth should resume at rates in excess of those that prevailed in the quarter century preceding 1995. I am wondering if you have any estimate as to how long that one-time downward adjustment will last; and secondly, it is my understanding that economic growth in the quarter century prior to 1995 has not been as great as economic growth or productivity growth since 1995. Is that correct as well?

Mr. Greenspan. Oh, the latter is definitely the case. The numbers are undergoing all sorts of revisions, but there is no question that the rate of growth in productivity, say between 1995 and the year 2000, was markedly greater than that which occurred for the quarter-century before.

Representative Smith. So the economic growth you predict is going to be less than what it has is been for the last five or six years. When—

Mr. Greenspan. I would suspect so, certainly. The problem we have is that, as I point out in my prepared remarks, the impact of technology, information technology in the business decision-making process, enabled a very considerable amount of programmed redundancies that had been put into the business structure in years past to endeavor to offset the possibilities of unforeseen events hitting on production to be reduced.

Indeed, the major operations within the plant are always designed to sustain production levels. The type of data we had, say, 15, 20 years ago, required that we have large inventories, backup people, all sorts of redundancies for unforeseen or even unanalyzable events. What information technology did was to so dramatically increase our insights into real-time behavior that we were able to reduce inventory levels, because we knew exactly when a roll of cold-rolled sheet was going to arrive at the loading platform of the plant, and you could schedule your inventory requirements accordingly.

What the events of September 11 did was to introduce a whole new set of uncertainties, which information technology is not going to improve our insight into. And so it is a reversal of some of the forces which engendered the productivity acceleration over the last five years. My impression is that that will work its way through within – it is not years, it is quarters, and even, conceivably, months. But it does reverse part of what we succeeded in doing. My own impression is it is a partial, but by no means, full reversal, and after that adjustment takes place, the fact that we have only partially exploited all of the networking and other forms of technology advancement suggests that once the very high level of uncertainty that now grips everybody is reduced, the perception of above normal rates of return out there for a lot of this type of equipment is going to create a continuation of the degree of networking and advancing that has had such a material effect on productivity in this country.

Representative Smith. Thank you, Chairman Greenspan. Thank you.

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

Mr. Watt, we will turn to you now for your questions.

Representative Watt. Thank you, Mr. Chairman. This obviously is a very, very important subject, but there is also a very important briefing going on in the Senate that Senator Reed and Senator Bingaman had to go to. So what I would like to do, Mr. Chairman, with your permission, is defer to the Senator from New Jersey and let him go so that I can expedite his getting to the briefing also.

Representative Saxton. I would be pleased to recognize at this point Senator Corzine.

Senator Corzine. Mr. Chairman, thank you. Thank you, Congressman Watt, for that courtesy.

Mr. Chairman, first of all, I would like to congratulate the Fed and its, I think, remarkably adept handling of the post-crisis response, the liquidity provision and the return to effective operation of markets and movement of commerce that is underpinned by the financial system. I think you have all done, once again, a remarkable job, and I am complimentary of that.

Also, I think the effort to move rates lower to stimulate the economy, no matter how uncertain that connection is to economic activity, has been a very important ingredient, not only in the recovery that we were looking for prior to September 11, but absolutely necessary afterwards. I have several questions, though, that really go to the – my concern that we live in a world of uncertainty, and the risk of economic recession and its deepening seem to me to be asymmetrically large relative to an overheating and rapid recovery, particularly in a world where additional shocks are at least of some probability. You talked about a snapback that is different than we see in natural disaster circumstances.

I wonder how vulnerable you think our economy is to additional shocks, maybe not of the same dimension, and shouldn't we build in insurance policies in our thinking with regard to stimulus programs that do allow for concern about that? We certainly have threats of that that we live with each other. I would love to hear your comments in that area. And then maybe even more importantly, or at least as importantly, you made a statement which I completely concur with.

Investment is where we get our greatest stimulus, but there is a reality to private sector investment, public sector investment, and whether you believe that investment in public security, public health, public transportation, public infrastructure has some of the same ingredients of improving productivity in our economy with long tails, long after the period in time when the investment is made, to improving economic growth?

Certainly, at least casual economic thinkers might say that the public highway programs that we put in the 1950s ended up having tremendous impact in the long run in the productivity capacity of our economy, and shouldn't we – or I guess I am opining, but shouldn't we be thinking about, as we put together a short-run stimulus program, tying that to long-run productivity in the economy by staying away from pork but involving ourselves in some of those things that might have long tails to them in productivity?

Mr. Greenspan. Senator, with respect to your first question, as you know as well as anybody, and I am sure more than most, when you are in the marketplace, the adjustment process suggests that the changes that occur in risk premiums as a consequence of a major alteration, as we have indeed had on the outlook, partially insulates you against lesser types of events which prior to, say, September 11, could have had some really considerably adverse impact so that there is a discounting in expectation that we will have other events occurring.

Clearly, we don't know the extent to which the markets have discounted or to what level that discounting has occurred, and we probably will not know until we actually see, if at all, a new type of event emerges.

But people, as I said, adjust. Systems are remarkably flexible, and as you know, our economy and our financial system have become quite flexible over the last five, 10 years, and that flexibility in turn has enabled us to absorb shocks which I don't think we could have very readily absorbed in decades past.

So I think we start off at a reasonably good base, but I certainly concur in your concerns that the overall bias to the outlook is clearly biased toward economic weakness, as we have stated innumerable times in our particular post meeting statements of the Federal Open Market Committee.

With respect to the—

Senator Corzine. Mr. Chairman, with – just one quick follow-on. It will take a second. Doesn't that, though, lead us to conclude that whatever we do with regard to stimulus – it is not unlimited. I understand that, but whatever we do, we ought to buy an insurance policy that allows for that degree of uncertainty and stimulus package, and it should be larger rather than smaller; different eyes will look at that in different ways, but that it would lead to a bias that way?

Mr. Greenspan. Well, Senator, I would emphasize that we have to distinguish, as I have noted before, between gross stimulus and net stimulus. We have been, as I indicated earlier, aware of the extent to which the continued extractions of home equity, both as a consequence of the turnover of homes and largely through home equity loans and cash-outs have been a major contributor to the level of consumer spending, and that those extractions in turn have been a function of the level of interest rates, mainly 30-year fixed rate mortgage rates which, as you know, have come down quite appreciably.

One concern that we have to keep in mind is that any stimulus package which augments long-term interest rates will, of necessity, create a lesser degree of expenditure in the households, and the consequence of that is that in any evaluation we make, we have to subtract whatever expectation we perceive would occur as a result of heightened long-term rates from whatever gross stimulus there is.

So I have argued we have to be cautious in looking at what it is we do to make certain that indeed the stimulus we do create is net, on balance, a stimulus. And so I have argued that that requires a degree of caution, and I think that is the appropriate view.

Quickly, with respect to your infrastructure issue, I think there is a problem here where one looks at textbooks on how ideally such infrastructure would be created, and I have no doubt that improved infrastructure does improve the level of private productivity. I am also aware that there is a thing called politics, and over the years I have observed, as I am sure you have, that the propensity to create projects has not always been directly related to enhancing private productivity. And the result of that is that the efficiencies that we see that come off the state and local, and other capital stock, do not very clearly suggest anywhere near the same sort of impact on long-term economic growth that one gets from dollar for dollar in the private sector.

So while I certainly can't argue that infrastructure is irrelevant, I would argue that there are very significant differences, and indeed there are also significant differences in how quickly they can be initiated. I know we go through, or have gone through over the years, endeavors to shorten the lead time of a highway project or public building or something of that nature, and I think history suggests we didn't very readily succeed, that those lead times are still very long, and that we find out that the argument that most economists make that public projects tend to be procyclical rather than countercyclical, in my judgment seems to be confirmed by the evidence.

Representative Saxton. Thank you, Senator.

The gentlelady, Ms. Dunn.

Representative Dunn. Thank you very much, Mr. Chairman.

Welcome, Mr. Chairman. I wanted to follow along the lines that Senator Corzine began and ask you a couple of questions on the stimulus package. I know that you have reviewed it.

There are a lot of controversial elements in the stimulus package, and in your comments you said that we have to determine what our goal is, whether it is an immediate stimulus or long-term growth. I am very interested in pro-growth tax relief. I think the corporate AMT is an example of that, and also the reduction in the capital gains tax, but I guess I would ask you a question.

If you did take politics out of it, and you gave your own opinion and drew up a plan, is there anything missing from the stimulus package, where you change it in any way, so that we could do an overlay of what would be good for long-term growth, as well as what would enter the economy very swiftly?

Mr. Greenspan. Congresswoman, I think that these turn out at the end of the day to actually be quite different sorts of goals. If you are asking me how I would construct a growth package, as I have testified before in the Ways and Means Committee, this Committee, and a series of other Committees of the House and Senate over the years, I have always thought that eliminating the capital gains tax would be a very helpful addition to getting a more efficient capital stock in the economy.

I have also been inclined to seek to eliminate the double taxation of dividends, and I have even played with the notion of significantly expanding Subchapter S corporation limits to effectively do that at least for small business or larger small businesses.

Those, however, do not in my judgment have any real short-term impact. They project over a longer period, and I think are important factors. And were I constructing long-term growth packages, as I have testified in the past, that is the direction that I would go, but I would scarcely consider them as short-term stimulus, because the evidence, as best as I can read it with all of the caveats I have said previously about how difficult it is to get really good figures on those impacts, is there is very little evidence to suggest that you get a bang-for-the-buck type of impact in these particular types of projects.

I don't deny that you can combine these. I am just basically saying they really do quite different things; and in my judgment, I think we ought to be clear on what it is that we are endeavoring to do.

Representative Dunn. Do you fear that by lowering the capital gains rate we are going to impact the stock market?

Mr. Greenspan. I would not at this stage worry about how you impact the stock market, pro or con. That is going to happen no matter what you do. The focus should be on the economy, and if it is good for the economy, either in the long run or the short run, depending on what your policy is, in my judgment, that is what I think ought to be the determining factor.

Representative Dunn. Let me ask you another question on consumer confidence, since we know it is very important.

I have found it a substantial measurement of the economy, but it is interesting how it has stayed with us so long since a year ago; and I am wondering if there is anything that we can be doing now to increase consumer confidence. If you had your druthers, what would you see coming out of our piece of how we affect the economy, or what should we be concerned about and careful about?

Mr. Greenspan. My answer would be somewhat similar to my view about whether you focus on the stock market or you focus on the economy. I think that it is important for policy to focus on real events. And I find that every time we try to influence people's view of the way they view those real events, we usually find we end up with a lot of unanticipated consequences. Consumer confidence is a rational reaction to people's view of how they see their own daily job, the markets in which they deal, what they see on television and the like.

People make judgments based on what is going on in the real world. I think policy ought to focus on what is going on in the real world. And if we do the right things, consumer confidence will take care of itself.

Representative Dunn. Thank you.

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

We will now return to Mr. Watt, who was kind enough to yield to Senator Corzine.

Representative Watt. Thank you, Mr. Chairman. And I will try to be brief, because I know we are going over a lot of the same things over and over again.

I have been listening intently to your suggestions about some things that probably won't work in the stimulus, and also picking up some things that you think will; and I am wondering if you had some druthers about this, what things do you think would work as an effective stimulus, that would have some short-term bang and not the longer-term detriment that you have expressed concern about?

Mr. Greenspan. Well, the data that we come up with basically suggest that some form of temporary expensing comes out probably as having the most immediate impact of the amount of dollars – of budgetary dollars – that are expended. But let me just emphasize what I said previously, this is not a net increment to long-term growth, it is merely moving it up.

Representative Saxton. May I just interrupt to make a quick announcement?

There is a vote on. Mr. Smith has gone to vote. He is going to come back. When he gets back, I am going to go vote. So judge for yourselves whether you want to go earlier or later. But we are not going to stop.

Mr. Greenspan. I don't know enough about some of the various different versions, nor does our analysis give us hard conclusions. The Congress has to act on specific legislation. You don't have the choice not to make those decisions.

Representative Watt. That is why I am not asking you to comment on any particular package. I am asking you what you think will work. Temporary expensing will work. I am not trying to guide you anywhere.

Mr. Greenspan. I understand that.

I wish I could be more responsive to your question and give you a laundry list of things that work. I feel uncomfortable doing that because I think that the – there are only a very few items which show up in the data in a robust manner. Everything else is sort of—

Representative Watt. Well, I was trying to keep from giving you my own bias on this and give you a clean slate to start from. But, if you read your testimony, on page one, you started off talking about motor vehicle sales, chain store sales. Those are consumer-oriented things.

Would you think that something that put some emphasis in this stimulus package on consumer demand would be important?

Mr. Greenspan. The data do show that people tend to spend a share of whatever tax cuts they get. It depends, however, very critically on whether they perceive them to be permanent changes in their after-tax income or a one-shot effect.

And what is most interesting about the most recent rebates is that there were differences of opinion amongst economists as to how that would be viewed. And in retrospect, it turns out that from what surveys we have been able to see, people spent a relatively small part of those tax cuts, but they did spend some. And there is no question that if you reduce individual income taxes, you will get some impact on consumer markets. What is unclear, however, is how much.

Representative Watt. I think I will yield back, Mr. Chairman. I am not getting very far here.

Mr. Greenspan. I tried to be as vague as I could, Congressman.

Representative Watt. I appreciate the vagueness. We are all struggling with this and not doing very well at coming up with specific proposals.

Although I guess I should conclude by saying that it is hard to stimulate production unless you have some demand for production that is being stimulated. I have always been kind of a supporter of the trickle-up theory rather than the trickle-down theory, but my colleagues here have heard me say that before.

Representative Saxton. Thank you very much, Mr. Watt. And we too appreciate your questions.

Mr. Putnam.

Representative Putnam. Thank you, Mr. Chairman. Welcome, Chairman Greenspan.

As the low man on the totem pole who is going to be around to feel the impacts of some of these things for the long term, let me shift gears, if I may, to the macro.

We are currently running approximately a $52 billion unified budget surplus. What will be the – what are your thoughts on the short-term and long-term implications of the Federal Government going back into a deficit situation before the end of this quarter?

Mr. Greenspan. I think you have to distinguish the immediate short-term problems which confront us and which are quite difficult and require different things than we would want to have accomplished over the longer run.

But we still have out there very significant demographic shifts that are in the process of occurring as the baby-boomers retire, and as the ratio of retirees to workers goes up quite appreciably as we get into the next decade and beyond.

And what that requires is that we engender a higher level of investment in the economy in order to produce a level of goods out there which will take care of both the retirees, who are much larger in number, and yet enable the working part of our society to gain increased real wages from gains in productivity.

So we need that higher level of investment to engender the productivity, which implies we need a higher level of national savings to finance it. And that suggests that the very large drains on private savings that the federal government was involved with for so many decades, prior to the surpluses as they arose, is not helpful at all.

We are going to need as much private savings as we can get; and even some public savings is not bad if we cannot get it in the private sector. But going to government deficits is clearly something which, over the longer run, we should endeavor to avoid as best we can, because of the changing commitments and demographics that are out eight, 10, 12 years from now.

Representative Putnam. Will the – will there be a short-term impact to the markets should that deficit spending occur this quarter, or has that already been factored into the climate?

Mr. Greenspan. Treasury publishes a daily Treasury statement which gives you a reasonably good shot at what is happening to the surplus or deficit on a unified budget account almost on a daily basis. And I can assure you that everybody who is involved in the markets reads those data very closely so that they know what is going on. It is not something which is going to fool them or come up as a big surprise.

There are in many respects just as good analysts of the U.S. budget in the private sector as there are in the government, in the administration, or in the Congressional Budget Office (CBO).

Representative Putnam. I have no doubt about that.

Much of your optimism in your prepared remarks about the future returns to productivity were based upon the productivity of the information technology sector. Are there other sectors of the economy that you are equally optimistic about productivity gains in, that would contribute to a rapid recovery?

Mr. Greenspan. Well, Congressman, I think we are dealing with a very different type of economy than we had 30 or 40 years ago. We have moved toward a globalization which essentially means that the degree of specialization we have all embarked upon is not only enhanced in our domestic economy, but the ever-increasing interaction we have in a global context has created a higher degree of productivity amongst all of our trading partners, including ourselves especially.

So I think that we have got to be aware of the huge demands that demographics are going to impose upon us and look for innovative ways of getting higher degrees of productivity to finance that. And one way is to continue the degree of globalization – opening up markets, opening up trade, opening up the movement of people across national boundaries; and indeed, as I have argued on many occasions in the past, to have a reasonable immigration policy in this country which would go along with that.

I think the events of September 11 have made it very difficult in many of these respects in the short run, and I would hope that we are capable of reaching beyond them, adjusting to them, and continuing on what I consider to be really quite a positive element in the long-term changes that have been occurring in the American economy.

Representative Putnam. Thank you very much, Mr. Chairman.

Representative Smith. [Presiding.] The gentleman from Pennsylvania, Mr. English, is recognized for his questions.

Representative English. Thank you, Mr. Chairman.

I wanted to thank you, Mr. Chairman, for coming before us to testify at such a critical time. In your testimony, you focus on the need to restore stability to the American economy, and I am delighted to see you particularly focus some of your remarks on the problems in the insurance sector.

May I ask, in your view, given the actuarial difficulties that writers of insurance policies are currently experiencing, is there a necessary and appropriate role for the Federal Government in the area of reinsurance in policies that would cover terrorism in public?

Mr. Greenspan. Congressman, I think so. And I think so for a very important reason which relates to the nature of markets.

A free, open market is one in which you have voluntary exchange to mutual advantage. And the notion of hostile activities is wholly detrimental to the functioning of that type of environment because part of an expansionary economy is one in which people are making commitments or reaching out, taking risks. And what hostile environments do is induce people to withdraw, to disengage, to pull back.

So it is quite conceivable that you could get a level of general hostility that would make viable market functioning very difficult. And in that regard, one can look toward the police power of the state as a means by which you try to extract or subdue that violence to allow markets to function.

So I can conceive of situations in which the insurance requirements of, say, terrorist attacks are so large that the premiums that would be required to effectively enable private insurance companies to insure against all of those risks and still get a rate of return on their capital – I can conceive of situations where those premiums would be so large as to inhibit people from actually taking out that insurance. And, therefore, you are led to what is a very unusual conclusion, that the viability of free markets may, on occasion, when you are dealing with a degree of violence, require that the costs of insurance are basically reinsured by the taxpayers – as indeed they are, for example, in Great Britain and in Israel and in other countries which have run into problems quite similar to ours.

So even though I recognize that there are very significant difficulties in reconciling free markets and government reinsurance, in this very unusual circumstance, they are indeed compatible.

Representative English. I appreciate that guidance, and I think that is a sound and wonderful analysis.

Further on that point, will security costs, in your view, hinder productivity increases significantly over the long term?

On the other hand, is it possible that a public-private drive to enhance network security could actually promote growth in America's technology sector?

Mr. Greenspan. I don't know enough to answer that question. It is a very interesting issue. I don't think we know enough to make a judgment.

Representative English. Well, that is – Mr. Chairman, if I have stumped you, then I feel I have really made my day.

On another issue, given recent international events, and what many are calling a global economic slowdown, should we expect a round of currency devaluations abroad, and what impact is that likely to have on the United States' manufacturing sector?

Mr. Greenspan. I don't think so, Congressman, because remember that exchange rates are bilateral. They really represent a valuation of the currency of one country versus another. And if we are all being impacted equally, as we are effectively by the events of September 11, that in and of itself should not have a material impact. And, indeed, currencies have been one of the very few stable financial prices that we have seen in periods since September 11.

Representative English. Thank you, Mr. Chairman. And this has been truly wonderful testimony.

And I thank you, Mr. Chairman, for your indulgence.

Representative Smith. Thank you, Mr. English. I think I should point out to Chairman Greenspan that you are going to miss a vote in order to ask him questions.

Chairman Greenspan, I am going to take advantage of the absence of other Members and a slight prerogative of the temporary chair to ask you one more question, if I may.

This goes to a column that you may have read in today's paper by Robert Novak. I think he made the point, that I recall, that monetary policy alone may not be enough to restart the economy. And I was going to ask you if you thought Congress's expectations, perhaps the public's expectations were too high for what the Fed could do. Or do you think – that gives you an open question, I guess.

Mr. Greenspan. I think it is important to put in general perspective what policy in general can do.

There is a view out there, Congressman, that fiscal and monetary policy can prevent any recession from occurring. And I find that very puzzling, because the implication obviously is that the only recessions that we get are as a consequence of the failure of policy. Because if policy never failed, then presumably, we would never have a recession. But that runs into a very difficult statistical problem.

Prior to 1913, there was no central bank. And prior to 1913, let's just say World War I to generalize it, I don't think the words "fiscal policy" had any meaning to anybody. And so for all practical purposes, for the period from, let's say, 1835 when the Second Bank of the United States went out of business and the First World War, there was effectively no economic policy to speak of in this country.

But we had an awful lot of recessions, and something else must have been causing them.

And what was obviously causing them is, in fact, what is the major problem today, people. Human psychology is a remarkably unchangeable phenomenon as you go from one generation to the next. We tend to overextend and contract. And what fiscal and monetary policy can do is to ameliorate that process. But the presumption that we have the capability of eliminating that, I think presumes that we have greater control over how humans think and how they behave than indeed is clearly the case.

So I would always argue that monetary policy is effective. Fiscal policy, under certain conditions is effective. But under no conditions would I ever argue that perfect monetary and fiscal policy will eliminate the business cycle. It will not.

Representative Smith. Thank you, Chairman Greenspan.

I wanted to follow up on a question I asked you a few minutes ago during the first round that was in reference to your testimony this morning about a one-time downward adjustment.

Did I understand you to say earlier that you expected that downward adjustment to last only a few months, or do you feel that it will last longer than that?

Mr. Greenspan. I think the question is that markets are now adjusting to the fact that we need more redundancies in the system; that is, you need more back-up facilities. There is greater risk of events which we can no longer effectively assume away. And the consequence of that is you have an elevated level of input without changing output, and so you get a one-shot adjustment.

Whether that occurs in months or over several quarters, I think it is very difficult to say. Clearly it occurs over a time frame. But it is – as I pointed out in my prepared remarks, exactly the reverse of what we gained from the advent of information technology capabilities, which to a major extent improved our ability to make decisions on a real-time basis with real-time information, which means that you had a lesser requirement for redundancies than in the past.

So I didn't mean to imply that it will be over in two months or something like that, but it is not a period of three years.

Representative Smith. I understand. Thank you, Chairman.

One last question: This goes to the economic stimulus package that you have been asked about several times today. I noticed in your answer a few minutes ago to Congresswoman Jennifer Dunn's questions that not one of the suggestions you made for long-term economic growth was actually in the economic stimulus package, for instance, cutting the capital gains tax.

Do you think we are on the right track with that economic stimulus plan, by limiting it just to the short term, or should we also consider some long-term growth components that are not presently in that economic stimulus package?

Mr. Greenspan. Congressman, that is a judgment that Congress has to make. As an economist I can tell you, to the extent that we know much about this, what the various impacts and what the relationships are in all sorts of combinations. Obviously, you always want to be in the position to do as much as you can to promote long-term economic growth, and especially in the context of the demographics which I mentioned previously. That is an important issue that we do have to keep in mind.

But I think that unless we are clear in our own views as to what it is that is being done between short-term stimulus, which by definition has very little long-term carryover, or long-term policies, which by definition have very small short-term stimulus, I am not sure that one benefits any way that I am aware of by mixing the two.

That is what I am saying. But that is a policy judgment which the Congress has got to make. I mean, there are arguments against what I just said. And one can make these arguments. One can say that it is better to have a mixture of both, and that may be right. But I say, if you do that, be very clear that is indeed exactly what you are doing.

Representative Smith. Thank you, Chairman Greenspan. I don't have any further questions.

I don't see the other Members present. I know that Chairman Saxton is on his way back from the House floor, and I hope you will be able to wait a couple of minutes for him to be able to thank you in person for appearing today. And I hate to stall, but I do expect him to walk in the door any minute.

Let me just ask finally, Chairman Greenspan, if you have anything else you would like to add to what you have already said, that you think will be useful for Members of Congress to know.

Mr. Greenspan. I think I have made the major points that I thought would be useful.

Representative Smith. Let my see if we have any other questions. Hold on for a second.

The gentlewoman from New York.

Representative Maloney. I am from the great city and state of New York. I am glad to welcome another New Yorker and to thank him very much for his leadership during this crisis. I would like to start with a New York question.

The insurance support program that Congress and the President have talked about, if you could comment on it. We are seeing a credit contraction that is going on that may worsen if that challenge is not addressed.

Secondly, in your comments today and yesterday, the Federal Reserve published data that indicate that production is way down, that manufacturers are operating at below 75 percent of their capacity and that producers of high-tech equipment are now carrying more excess capacity than ever before.

And so I would like to ask really a three-part question in response to that and in response to some of the things you said today.

With so much excess capacity, how effective are lower interest rates in stimulating interest in this environment, and would it be stimulative to reduce taxes on business capital investment at a time of such excess capacity or to do what you were talking about before, the temporary expensing when we have such excess capacity?

And thirdly, you mentioned that you had looked at the results of some of the tax cuts, and that people spend a share of the taxes that they get. But there is one proposed tax cut that I can assure you that everyone will spend, every single cent, that is the rebate for the lowest income people. They will spend it. They need to spend it. Would that in any way stimulate and help the economy?

And I would like to end with the New York question. Every time the mayor speaks nationally, Mayor Giuliani, he responds to really the outpouring of support from across this country; and he says, "If you want to help New York, come to New York, spend money, go to our restaurants and invest in our city, help us get back on our feet."

And when you talk to the industry leaders, whether it is Broadway, they have closed 11 total shows. But those that are open, they say people aren't buying long-term tickets, they are coming from New Yorkers that are reacting patriotically or someone gives a grant that lets a whole group of people that are helping the recovery go.

Many restaurants are closing or they have gone to half-price. And would the stimulus of a rebate or a tax deduction for going to New York and spending money help not only New York, but around the country. If you look at the two industries that are hurt the most – our airlines and our tourism; the President has said, "Go to Disneyland" – would not a rebate or a deduction, offered to families to do such, would that not help stimulate?

And I might add also, I feel in New York, families, individuals are feeling tremendous pressure, tension, sadness and possibly a stimulus or a support for them to spend time with their families on something that is enjoyable might not only help the financial, but the mental health of the country at this point.

Thank you again for all that you have done. I think you really reacted with great leadership and appropriately and have helped instill a confidence in Americans, and we appreciate it.

Mr. Greenspan. Well, thank you very much.

Representative Saxton. [Presiding.] Thank you, Ms. Maloney. I appreciate it.

Representative Maloney. He didn't answer my question. I gave him five, and he hasn't answered even one of them. And three of them were New York-specific.

Representative Saxton. Thank you. I thought that you were having an exchange.

Representative Maloney. No.

Mr. Greenspan. As you know, I was born in New York and lived there for a very long period of my life. And the one thing that characterizes that city is a sense, rightly or wrongly, that everything is sort of advanced and wonderful with respect to new technologies and new entertainment, the highest level of civilization, the best chefs, everything. We always thought that that was the quintessential New York, that anyone else who could put a baseball team on the field that could beat the New York Yankees deserved a little press, but not much.

What has happened, and I think you pointed it out, Congresswoman, there has been a subdued sense in the city. And until that subdued sense unwinds and we get back to some of the spirit that I experienced all of my life, until that comes back, we will have a subdued city. But it is not going to stay that way for long. New Yorkers don't know how to be subdued. And it is one of the problems which I think sort of puts us in conflict with a lot of other of our colleagues around the country.

But what I thought was utterly remarkable is the support that the city got from the rest of this nation, and that is – in that sense, I was both proud to be a native New Yorker and proud to be an American.

Representative Maloney. But, you didn't answer my questions. On the insurance support program, that has –

Mr. Greenspan. I did, in part, answer that earlier.

Representative Maloney. You did?

Mr. Greenspan. Let me just say very briefly, I think that the type of program that the administration is coming up with seems, to me, in the right ball park. It is coming at an issue which is inherently a very difficult one.

Representative Maloney. I will read the transcript. I was running back and forth.

But also the rebate for the lowest income residents, would that happen—

Mr. Greenspan. I didn't want to comment very specifically on a lot of the different elements that are involved in various different packages. All I would say to you is, what evidence we have suggests that while it is certainly the case that – as you pointed out earlier, that we are operating at a low operating rate, that capital investment would seemingly not be stimulated by that.

It is true that expansion of new facilities is doubtless retarded by the fact that the operating rates are low, but a goodly part of capital investment is cost savings. And cost savings, especially in this type of environment, is actually created by incentives. And if we can have a significant amount of capital investment, which would be important, even though it is not of the capacity-expanding type, as far as the level of economic activity is concerned, there is really no difference between whether you are building a new plant or you are putting in a piece of equipment which reduces your cost. I think the latter would be where most of the improvements in investment are likely to take place.

Representative Maloney. You spoke strongly for the temporary expensing. But when production is so low and people are not buying, how does the temporary expensing—

Mr. Greenspan. Because they are endeavoring to reduce their costs. And the reduction of costs is a particularly important issue when, indeed, demand is low; that is really all you can do to improve your profitability. That is what people tend to do.

Representative Maloney. Thank you very much.

Representative Saxton. Mr. Chairman, we have been through all of the Members on the Committee today and you have responded very well – thank you very much – to our questions. We appreciate that very much.

We are going to have another vote here in a few moments and so rather than to move forward with another round of questions, I think we will say thank you and we will go get our voting done.

And your optimism in terms of us returning to normal and the fading impact, we hope, of the incidents of September 11, that is good news to us and to the American people. So we thank you for bringing your message here to share with us today. And we look forward to seeing you again in the future.

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

Representative Saxton. The hearing is adjourned.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

I would like to welcome Chairman Greenspan before the Committee to testify on monetary policy and the economic outlook. We appreciate your appearance here today, and look forward to your testimony.

I would also like to take this opportunity to thank Chairman Greenspan for his leadership and the Federal Reserve for the actions undertaken to cushion the effects of the September 11 terrorist attacks. The Federal Reserve's ability to deal with such an unspeakable crime has served the country well, and we are in your debt. It is also encouraging that the American people and economy have demonstrated amazing resilience in the face of these attacks.

Even before the events of September 11, the available economic data indicated that the economic slowdown that began in the middle of 2000 continued. The rate of real GDP growth has slowed quite sharply since the second quarter of 2000, barely remaining positive in the second quarter of this year. The manufacturing sector has been hard hit, losing over 1 million jobs since July of 2000. Investment growth has fallen over the last several quarters, and corporate profits are weak.

On the other hand, housing and consumer spending have held up fairly well. In addition, since last January the Fed has reduced interest rates nine times, Congress has lowered the tax drag on the economy, and energy prices are declining. Many economists had expected these factors to lead to an economic rebound in the last half of 2001, but the attacks have led them to forecast a delay in the recovery.

Financial markets and the economy have been disrupted by the terrorist attacks. The attacks have increased uncertainty, and caused a widespread reevaluation of risk and security. Delays and higher shipping costs in air and ground transport, additional insurance costs, higher expenses for security personnel and equipment, fortification of buildings and facilities, and other measures will have the effect of imposing something like a "security tax" on an already vulnerable economy. This burden will undermine the economy in the short run, and could tend to adversely affect both productivity growth and the economy's potential growth rate.

Although the precise amount of the extra burden imposed by these security costs is not known, it appears to be large and growing by the day. Over the last several weeks private sector economists have begun to consider this cost issue and its potential impact on an already weak economy. A logical policy response would be to offset these costs by relieving some of the tax burden on the private sector.

Monetary policy has addressed the economic situation with an easing that began last January. The Fed's policy moves so far this year have certainly provided economic stimulus, but the lags in monetary policy are long and variable. Given the lack of inflationary pressures, prudent action by the Federal Reserve could also contribute to improving the economic outlook.

Prepared Statement of Senator Jack Reed, Vice Chairman

Thank you, Chairman Greenspan, for coming to testify before us. Thank you, too, Mr Chairman Saxton, this opportunity to discuss and debate our economic outlook and appropriate policies.

In light of the new fiscal realities we face, economic policy needs to be recalibrated. The key to achieving a rapid recovery is to bolster incomes, because when cash-strapped household cut their spending, business sales suffer, stifling investment. We need to complement existing monetary policy with an economic stimulus package – but one that has its maximum impact in the short run and does not undermine long-term fiscal discipline. Specifically:

- <u>The stimulus package should be large enough to have an impact on a $10 trillion economy</u>, up to about $100 billion (1 percent of GDP), a figure which I believe you have supported, Chairman Greenspan.
- <u>The bulk of the stimulus should be felt in the next two or three quarters when the economy is weak</u>. More often than not, economic stimulus in the past has not been implemented until the economy was already recovering.
- <u>The Stimulus package should be designed to phase out rapidly, so that the stimulus measures do not overheat the economy later in recovery</u>. Thus permanent tax cuts or new spending that spin out slowly are not attractive candidates, while safety net programs (such as Unemployment Insurance), which are designed to be counter-cyclical, are.
- <u>The stimulus package should maximize the amount of short-term economic activity created per dollar of outlays or revenue lost</u>. For example, a tax cut for low- or moderate-income households who are likely to spend nearly all of the extra income is more effective as stimulus than a similarly sized tax cut for higher-income households who are more likely to save a substantial portion of it.

These principles are outlined in greater detail in a new report prepared by the Democratic Staff of the Joint Economic Committee. The report, *Economic Stimulus: Principles and Options*, evaluates the leading proposals in light of their impacts on the economy and the degree to which they have a stimulative effect. The report is available online at <www.senate.gov/~jec>.

Earlier this year, Chairman Greenspan, you spoke of the need to "resist those polices that could readily resurrect the deficits of the past and the fiscal imbalances that followed in their wake." You also testified about the limits of tax cuts as effective tools to stimulate the economy. I would be interested in your thoughts on how the economic stimulus proposal before the House right now deals with these tenets.

We have an important responsibility before us – to undertake fiscal policies that will protect the most vulnerable in our economy while ensuring that we do not compromise our economic future. It is a challenge we can meet, if we stick to policies which put people back to work and generate productive business investment.

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

I appreciate this opportunity to appear before the Committee to discuss recent developments in the United States economy. Despite the tragic events of September 11, the foundations of our free society remain sound, and I am confident that we will recover and prosper as we have in the past.

But before the recovery process gets under way, stability will need to be restored to the American economy and to others around the world. Arguably, that stability was only barely becoming evident in the United States in the period immediately preceding the act of terrorism.

Aggregate measures of production, employment, and business spending continued to be weak in August. Consumer spending, however, moved higher that month and appeared to be reasonably well maintained in the first part of September. Industry analysts suggest that motor vehicle sales were running close to August levels, and chain store sales were only modestly lower. New orders for nondefense capital goods stabilized in August. Moreover, the dramatic rate of decline in profits was slowing. To be sure, these signs were tentative but, on the whole, encouraging.

In the days following the attack, the level of activity declined significantly. The shock was most evident in consumer markets, as many potential purchasers stayed riveted to their televisions and away from shopping malls. Both motor vehicle sales and sales at major chain stores fell off noticeably. The airline and travel industries also suffered severe cutbacks.

The unprecedented shutdown of American air travel and tightened border restrictions induced dramatic curtailments of production at some establishments with tight just-in-time supply chain practices, most notably in the motor vehicle industry.

As the initial shock began to wear off, economic activity recovered somewhat from the depressed levels that immediately followed the attacks, though the recovery has been uneven. Markedly increased incentives induced a sharp rebound in motor vehicle sales by the end of the month that has carried apparently undiminished into the first half of October. However, many retailers of other consumer goods report that sales have only partially retraced the steep drops that occurred in mid-September. Fortunately, air freight is largely back to normal. Overall airline passenger traffic, while above its mid-September lows, was still off considerably in early October from pre-attack levels. Similarly, the hospitality and entertainment industries have overcome some of their earlier difficulties but continue to struggle.

The effect on financial markets of the devastating attack on the World Trade Center was pronounced, as telecommunications and trading capacities were severely impaired. But the markets are mostly functioning normally now, and as in the past, the infrastructure will be rapidly restored.

For a brief time, the terrorist attacks markedly disrupted payment transfers, leaving those counting on receiving payments caught short. Those needs ultimately were met by the Federal Reserve, both through record lending at the discount window and through an extraordinary infusion of funds through open-market operations. To facilitate the channeling of dollar liquidity to foreign financial institutions operating in the United States, thirty-day currency swap lines were arranged with major central banks, again in record volumes. It was essential in such an environment to meet all appropriate demands for dollar liquidity. As repair of the financial markets and payment infrastructure proceeded apace, loans were repaid, open-market operations could be scaled back, the unusual swap lines were allowed to expire, and the temporarily bloated balance sheet of the Federal Reserve largely returned to normal.

But even as market functioning and liquidity flows were restored, the potential for heightened uncertainty to damp household and business spending for a time persisted. To cushion these effects, we have eased the stance of monetary policy appreciably since September 11.

We in the United States have assumed ourselves to be fairly well-insulated from terrorism or, at most, subject to limited and sporadic episodes similar to those previously observed on a number of occasions in Europe.

We have been aware of the possibility for losses on a much greater scale. But I suspect that those possibilities were deemed so remote that they were never seriously incorporated into most conventional assessments of economic risk.

The shock of the tragedies at the World Trade Center and the Pentagon has reshaped those assessments of risk and required an abrupt realignment of prices in many markets to reflect the expected costs of operating in what we now recognize as a more hostile world. These circumstances pose a difficult challenge for business decisionmaking, not so much because the costs are inordinately large, but because the events, which have potentially substantial consequences, are so uncertain. Insurance deals with this problem by spreading the risk and converting potential large unknown costs into a steady stream of known insurance premiums that facilitates the forward planning so essential to an effective business operation.

Obviously, sharp increases in insurance premiums for all forms of businesses are to be expected. Some higher insurance costs, in effect, will be borne implicitly rather than explicitly, as firms choose to self-insure, at least in part, rather than lay off all of this risk in the marketplace.

These higher insurance costs, both explicit and implicit, endeavor to anticipate future losses. But in addition, they cover the physical capital and labor resources businesses will be required to devote to enhanced security, and to increased redundancies as protection against interruption of supplies or production. For example, the degree of comfort businesses have in allowing inventories to shrink to minimal levels in a just-in-time supply chain is lessened. In this regard, increased security threats, not pooled through insurance, have exactly the opposite effect on productivity than that which is gained by an improvement in information technology. In addition to the loss of human life and capital assets, these are important collateral costs associated with the new threats that we now face.

The pronounced rise in uncertainty also has damped consumer spending and capital investment; households and businesses, confronted with heightened uncertainty, have pulled back from the marketplace, though that withdrawal has been partial and presumably temporary. The very great economic uncertainties that have arisen in the current environment have also, at least temporarily, resulted in a widening of bond spreads on high-yield instruments.

Markets across our economy will adjust to the altered perceptions of risk that we now confront. Critical to that adjustment process is the behavior of consumers and business people. Behavior is difficult to predict in circumstances such as those we have experienced in the past five weeks. But judging from history, human beings have demonstrated a remarkable capacity to adapt to extraordinarily adverse circumstances. And, I expect the same adaptability to become evident in the present situation.

Although it is difficult to determine with any precision, it seems quite likely that a significant repricing of risk has already found its way into our markets, as many economic decisions are responding to shifting market signals. But these adjustments in prices and in the associated allocation of resources, when complete, represent one-time level adjustments, without necessary implications for our longer-term growth prospects.

Indeed, the exploitation of available networking and other information technologies was only partially completed when the cyclical retrenchment of the past year began. High-tech equipment investment at elevated rates of return will, most likely, resume once very high uncertainty premiums recede to more normal levels.

The level of productivity will presumably undergo a one-time downward adjustment as our economy responds to higher levels of perceived risk. But once the adjustment is completed, productivity growth should resume at rates in excess of those that prevailed in the quarter-century preceding 1995.

It is worth noting that increased production to enhance security will be counted in measured output without contributing to our standards of living, as was the case during our military buildup of the Cold War. Our productivity measures have always endeavored to capture increased productive efficiency, not increased well-being. We are, in effect, currently using part of our increase in efficiency to supply increased security. Of course, given the heightened risks we face, these investments in security are, doubtless, quite sound. In any event, such costs are likely to fall short of the costs we incurred for security during the height of the Cold War.

Nobody has the capacity to fathom fully how the effects of the tragedy of September 11 will play out in our economy. But in the weeks ahead, as the initial shock continues to wear off, we should be able to better gauge how the ongoing dynamics of these events are shaping the immediate economic outlook.

For the longer term, prospects for ongoing rapid technological advance and associated faster productivity growth are scarcely diminished. Those prospects, born of the ingenuity of our people and the strength of our system, fortify a promising future for our free nation.

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