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MONETARY POLICY AND THE ECONOMIC OUTLOOK

Wednesday, April 17, 2002

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

The Committee met, pursuant to notice, at 10 a.m., in Room 2118, Rayburn House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton, Smith, Dunn, Putnam; Senators Reed, Corzine, Crapo, and Bennett.

Also Present: Representative Sherwood.

Staff Present: Chris Frenze, Bob Keleher, Colleen J. Healy, Darryl Evans, Brian Higginbotham, Patricia Ruggles, and Matthew Salomon.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Good morning. I am pleased to welcome Chairman Greenspan to testify before the Joint Economic Committee (JEC) this morning. We appreciate your appearance here today, Mr. Chairman, to discuss the monetary policy and the improved economic situation that has emerged in recent months.

The economy appears to be recovering from the slowdown that began in the middle of 2000 and turned into to a mild recession in March of 2001. The September 11th terrorist attacks inflicted further economic damage. Nevertheless, in the last quarter of 2001, real GDP increased 1.7 percent, with personal consumption spending surging at a 6.1 percent rate.

In addition, manufacturing output has stabilized and appears to be expanding. Home sales have held up well, and large payroll employment declines have subsided. The liquidation of inventories last year has established the basis for inventory rebuilding later in 2002. Another positive aspect of the current outlook is that good productivity growth has been sustained through the business cycle and appears likely in the future. Economic forecasts generally anticipate a strengthening of economic growth during 2002. Leading market price indicators show no significant threat of inflation in the pipeline.

The recovery has begun, but there are potential weaknesses and vulnerabilities that could affect the depth, breadth and sustainability of the economic rebound. As the Federal Reserve has pointed out, the declines in business profits and investments were important factors in the recession, and these remain problematic. Despite improvement in fourth quarter GDP, investment spending fell sharply. Business and household debt levels are relatively high by historic standards and could restrain growth. In addition, the weakness in the economics of some of our international trading partners limits overseas markets for U.S. production.

Meanwhile, costs imposed by terrorism, the instability in the Middle East and the increase in oil prices provide other potential impediments to faster U.S. growth.

Unfortunately, there are a number of major risks to U.S. economic recovery. Given these risks, the current stance of the Federal Reserve monetary policy seems quite appropriate. The Federal Reserve wisely has shown restraint in not tightening monetary policy as the economic rebound consolidates. With little threat of inflation, there has been no reason for tightening of monetary policy by the Federal Reserve.

Mr. Chairman, before we turn the floor over to you, let me just say that unfortunately there are votes, apparently, scheduled in the Senate, and so our brethren in the Senate are not here yet. We expect them to arrive at the conclusion of their votes. And, in addition, the Members of the House are scattered here and there, and they will be along as well.

I would also just like to ask unanimous consent that Congressman Sherwood, who is not a member of this panel, be invited and permitted to sit at the desk.

Mr. Chairman, thank you again for being with us. We always appreciate your appearance here before the Joint Economic Committee, and of course today is no exception. The floor is yours, sir. We are ready to hear your testimony.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 25.]

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

Mr. Greenspan. Thank you very much, Mr. Chairman. As always, I appreciate the opportunity to appear here to discuss the current state of the economy. This morning, I am speaking for myself and not necessarily for the Federal Open Market Committee (FOMC). I am also excerpting from a rather extended prepared testimony and request that the full text be included for the record.

Representative Saxton. Without objection.

Mr. Greenspan. Mr. Chairman, as we noted in our statement following the Federal Open Market Committee meeting in March, "The economy, bolstered by a marked swing in inventory investment, is expanding at a significant pace. Nonetheless, the degree of strengthening in final demand over coming quarters, an essential element in sustained economic expansion, is still uncertain." Mr. Chairman, little, if anything, has happened since the FOMC meeting to alter that assessment.

This morning I would like to elaborate on some of the forces that are likely to shape activity in the months ahead.

A number of crosscurrents are likely to influence household spending this year. Through much of last year's slowdown, housing and consumption spending held up well and proved to be a major stabilizing force. But because there was little retrenchment during the cyclical

downturn, the potential for a significant acceleration in activity in the household sector is likely to be more limited than in past business cycles.

One important source of support to household spending late last year, energy prices, will likely be less favorable in the months ahead. With the rise in the world price of crude oil since the middle of January, higher energy costs are again sapping the purchasing power of households. To the extent that the increase in energy prices is limited in dimension, with prices not materially exceeding the trading range of recent weeks, the negative effects on spending in the aggregate should prove to be small. However, a price hike that drove oil prices well above existing levels for an appreciable period of time would likely have more far-reaching consequences.

Another factor likely to dampen the growth of consumer spending in the period ahead, at least to some extent, is the change in overall household financial positions. Over the past two years, household wealth relative to income has dropped from a peak multiple of about 6.3 at the end of 1999 to around 5.3 currently. About nine-tenths of the decline in the personal savings rate from 1995 to 1999 can be attributed to the rise in the ratio of wealth to income. And the subsequent decline in that ratio is doubtless restraining the growth of consumption.

Much of the movement in household net worth in recent years has been driven by changes on the asset side of the household balance sheet, but household liabilities have generally moved higher as well. Accordingly, the aggregate household debt service burden, defined as the ratio of a household's required debt payments to their disposable personal income, rose considerably in recent years, returning last year to close to its previous cyclical peak of the mid-1980s, where it has remained.

Neither wealth nor the burden of debt is distributed evenly across households. For example, increased debt burdens appear disproportionately attributable to higher-income households.

Although high-income households should not experience much strain in meeting their debt service obligations, others might. Indeed, repayment difficulties have already increased, particularly in the subprime markets for consumer loans and mortgages. Delinquency rates may worsen as a result of the strains on household finances over the past two years. Large erosions, however, do not seem likely, and the overall level of debt and repayment delinquencies do not as of now appear to pose a major impediment to a moderate expansion of consumer spending going forward.

Although the macroeconomic effects of debt burdens may be limited, we have already observed significant spending restraint among the top fifth of income earners, who accounted for around 44 percent of total after-tax household income last year, presumably owing to the drop in equity prices, on net, over the past two years. The effect of the stock market on other household spending has been less evident.

Perhaps most central to the outlook for consumer spending will be developments in the labor market, which has improved some in recent

months. The pace of layoffs quickened last fall, especially after September 11, and the unemployment rate rose sharply. But layoffs have diminished noticeably in 2002, and payrolls grew again in March. In typical cyclical fashion, the unemployment rate has lagged the pickup in demand somewhat, but it has remained between 5-1/2 and 5-3/4 percent of late after rising rapidly in 2001.

Over the longer haul, incomes and spending are driven most importantly by the behavior of labor productivity, and here the most recent readings have been very encouraging. Output per hour continued to grow last year. Indeed it rose at an annual rate of 5-1/2 percent in the fourth quarter of last year and appears to have posted another sharp advance in the first quarter. No doubt some of the recent acceleration reflects normal statistical noise. More fundamentally, however, some of this pickup probably occurred because businesses have remained cautious about boosting labor input in response to this surprising strength of demand in recent months. But the magnitude of the gains in productivity over the past year provides further evidence of improvement in the underlying pace of structural labor productivity.

In housing markets, low mortgage interest rates and favorable weather have provided considerable support to home building in recent months. Moreover, attractive mortgage rates have bolstered the sales of existing sales homes and the extraction of capital gains embedded in home equity that those sales engender. Low rates have also encouraged households to take on larger mortgages when refinancing their homes.

The ongoing strength in the housing market has raised concerns about the possible emergence of a bubble in home prices. However, the analogy often made to the building and busting of a stock price bubble is imperfect. First, unlike in the stock markets, sales in the real estate market incur substantial transaction costs, and when most homes are sold, the seller must physically move out. Doing so often entails significant financial and emotional costs and is an obvious impediment to stimulating a bubble through speculative trading in homes. Thus, while stock market turnover is more than 100 percent annually, the turnover of home ownership is less than 10 percent annually, scarcely tinder for speculative conflagration.

Second, arbitrage opportunities are much more limited in housing markets than in securities markets. A home in Portland, Oregon, is not a close substitute for a home in Portland, Maine. And the national housing market is better understood as a collection of small local housing markets. Even if a bubble were to develop in a local market, it would not necessarily have implications for the nation as a whole.

These factors do not mean that bubbles cannot develop in housing markets and that home prices cannot decline. Indeed, home prices fell significantly in several parts of the country in the early 1990s. But because the turnover of homes is so much smaller than that of stocks, and because the underlying demand for living space tends to be revised very gradually, the speed and magnitude of price rises and declines observed in markets for securities are more difficult to create in markets for homes.

Technological advances contributing to the gains in productivity that we have achieved over the past year should provide support not only to the household sector, but also to the business sector through a recovery in corporate profits and capital investment.

The retrenchment in capital spending over the past year and a half was central to the sharp slowing in overall activity. These cutbacks in capital spending interacted with and were reinforced by falling profits and equity prices. Indeed, a striking feature of the current cyclical episode relative to many earlier ones has been the virtual absence of pricing power across much of American business as increasing globalization and deregulation have enhanced competition.

Part of the reduction in pricing power observed in this cycle should be reversed as firming demand enables businesses to take back large price discounts. Though such an adjustment would tend to elevate price levels, underlying inflationary cost pressures should remain contained. A lack of pressures in labor markets and increases in productivity are holding labor costs in check, resulting in rising profit margins even with inflation remaining low.

To be sure, over time, the current accommodative stance of monetary policy is not likely to be consistent with maintaining price stability. But prospects for low inflation and inflation expectations in the period ahead mean that the Federal Reserve should have ample opportunity to adjust policy to keep inflation pressures contained once sustained, solid, economic expansion is in view.

Improved margins over time and more assured prospects for rising final demand would likely be accompanied by a decline in risk premiums from their current elevated levels toward a more normal range. With real rates of return on high-tech equipment still attractive, the lowering of risk premiums should be an additional spur to new investment.

Recent evidence suggests that a recovery in at least some forms of high-tech investment is under way. But the pickup this year in overall spending on business fixed investment is likely to be gradual.

The U.S. economy has displayed a remarkable resilience over the past six months in the face of some very significant adverse shocks. But the strength of the economic expansion that is under way remains to be clarified. Some of the forces that have weighed heavily on the economy over the past year or so have begun to dissipate, but other factors, such as the sharp increase in world oil prices, have arisen that pose new challenges. As a result, the course of final demand will need to be monitored closely.

Still there can be little doubt that prospects have brightened. Spending in the household sector has held up well, and some signs of improvement are evident in business profits and investment. Fiscal policy continues to provide stimulus to aggregate demand, and monetary policy is currently accommodative. With the growth of productivity well maintained, and inflation pressures largely absent, the foundation for economic expansion has been laid.

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

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

Representative Saxton. Mr. Chairman, thank you very much for the very articulate statement that we have come to expect when you visit with us. We appreciate it very much.

It seems to me, Mr. Chairman, that in recent months there have been many signs that the economic recession that began last March has ended. For example, in the fourth quarter of 2001, growth was positive. The manufacturing sector seems to have bottomed out, and large payroll employment declines seemed to have subsided. So looking at those factors, it would seem to me that the future looks bright.

At the same time, you mentioned in your statement that there are continuing problems or potential problems looming on the horizon, and some that are already with us. You talked about the accumulation of debt. The consumption rebound that took place in the last quarter of last year was quite remarkable, and we are glad that it happened, but it takes away some of the consumption rebound potential for the current period and perhaps for the period ahead.

The investment rebound has not occurred as strongly as we could have hoped. Energy prices continue to be a worry. International sluggishness in some of our trading partners, particularly Japan and Central and South America, is evident, and the costs associated with terrorism continue to be – and will continue to be – a drag on the economy.

So my question is: How do we balance the good with the potential negative factors that we have all talked about here in the last month or so?

Mr. Greenspan. Mr. Chairman, this is a very important question, because one aspect of the dilemma that you raise is the remarkable and unusual divergence between the economic outlook as evaluated by economists on the one hand, and a significant part of the business community on the other. As you know, the latter are showing far less optimism about what is apparently going on than those of us who are evaluating the gross domestic product, the larger aspect of the economy. And what we are observing obviously is that retail sales and consumption generally are holding up, home building is up, and we are seeing a very significant swing from inventory liquidations ultimately to either some degree of small accumulation or at least inventory balance.

What this does is it creates a really quite different view of the economy depending on where you are looking at it from. We add up the so-called net consolidated production of the economy, which is essentially what the gross domestic product is. But, from the business point of view, what they see is a low level of sales, because remember, a goodly part of consumption is coming out of inventory, and a significant decline in profit margins and virtually no pricing power. So,

from that point of view, the lower end of the economy if you want to put it that way, where the business sector largely is functioning, you are getting a continued degree of weakness.

Obviously you cannot have this process going on indefinitely. Either we are going to get a significant increase in production, in profits, in capital investment, which is what our forecast is and what the data, as far as we can judge, seem to portend, or we are going to get real slippage, in which case production will not move materially, nor will profits or investment.

This is an issue which will be resolved within the next two to four months. The odds are very strongly in favor of it being resolved in continued economic growth, resumption of profitability, and capital investment, but clearly there are concerns out there, and there are risks, and you mentioned a few of them, and I think quite correctly.

Representative Saxton. Mr. Chairman, in your statement you referred to monetary policy, and in the same context of that, you said that monetary policy might be adjusted when sustained solid economic expansion is in view.

You have said here that we have laid the basis or the foundation for economic growth, but you haven't said that sustained solid economic expansion is in view. Is that correct?

Mr. Greenspan. It is not sufficiently in view to be comfortable with the outlook. As I indicated in the testimony before the Senate and the House a month ago, what we are aware of is a very strong recovery currently under way as a consequence of the dramatic reduction in the degree of inventory liquidation.

But the crucial issue which I repeat in my testimony today is whether so-called final demand, which has been growing very modestly, continues to grow and indeed accelerates before the very strong impetus coming from the swing in inventories dissipates. We are nowhere near a judgment of that as yet. I mean, we haven't yet gotten to the point in the cycle where we know exactly how that is resolving.

But my impression is that as the quarters go on, things will become obviously very clear in retrospect. Hopefully we will be able to get a reasonably good judgment of what is happening sufficiently in advance. But as I also pointed out in the sentence to which you refer, we are very fortunate in that there is literally no evidence of inflationary pressures building, and that means that the urgency of responding to economic events is less than it would be were we dealing with that other possibility.

Representative Saxton. You anticipated my next question in your response on your statement on inflation. So let me move to one other subject that I feel is very interesting, and then we will go to Mr. Reed.

One of the most positive aspects of economic growth over the last period of time, over the last five years, is based on strong productivity performance, and this was something that I hadn't fully understood, and maybe still don't. But this productivity trend was rooted in earlier

technological innovation and investments, in people, equipment, as well as improved production methods.

The Fed's recent monetary policy report to Congress noted, and I quote, that productivity was impressive. Does it appear that strong productivity growth in recent years has been carried through the business cycle? Do we still see strong productivity, and does this strong productivity performance increase the ability of the economy to continue to grow without inflation?

Mr. Greenspan. It does, Mr. Chairman. One aspect of an evaluation of the effect of the dramatic changes in technology that occurred in application in the second half of the 1990s was the fact that numbers clearly showed growth in output per hour far exceeding those that we had experienced generally in the previous quarter century. And the question that we had was how much of that was merely a cyclical phenomenon, because productivity is pro-cyclical. We wouldn't know until we ran into some cyclical downturn. We have done that, and, if anything, the results are far more impressive than we would have expected.

As I indicated in my prepared remarks, I think some of the numbers we are looking at are statistical noise, meaning it is just the fact that these are very difficult numbers to measure. But even extracting from that, even making all of the adjustments that you want, it is an extraordinary performance, which I must say bodes well for the longer-term outlook of this economy.

Representative Saxton. Well, thank you. That certainly sounds like good news, and we look forward to watching this factor as we move forward.

Mr. Greenspan. I just wanted to say, I just don't believe that we can continue to get the numbers published for the fourth quarter and that will be published for the first quarter indefinitely. The world does not work that well.

Representative Saxton. Yes, sir. Thank you very much.

Mr. Reed, we are glad your votes have subsided for the moment, and the floor is yours.

Senator Reed. Thank you very much, Mr. Chairman, and thank you for calling this hearing. I have a statement which I would like included in the record, with your permission.

Representative Saxton. Without objection.

[The prepared statement of Senator Reed appears in the Submissions for the Record on page 26.]

Senator Reed. Thank you for your testimony and for your colleagues' very adroit use of monetary policy over the last several months to keep us moving forward.

Let me begin with the question. A year ago, Mr. Chairman, you worried that we might be in danger of paying down the national debt too quickly. You suggested we might have to find ways to reduce the

surplus, and many people took this as an endorsement to the President's tax cut. Do you still have that concern?

Mr. Greenspan. No. If you may recall, Senator, the concern I had stemmed from the Congressional Budget Office's (CBO) long-term projection of the current services budget, which exhibited a pattern of growing surpluses, which would imply that by 2006, the Federal Government would have to start to accumulate private or state and local assets because it could no longer run down the debt, in other words, no longer employ the surplus as debt repayment. In fact, the number that they showed was, as I recall, a half a trillion dollars annual surplus.

I had indicated that I thought that accumulation of private assets by the Federal Government was a very undesirable economic policy for a lot of reasons. If I held that position, which I still do, and we are looking at the data that they published, then the question was, how did you get the half-a-trillion-dollar surplus down to zero to prevent the accumulation of assets? And the answer is no matter how you do it, it would be an extraordinary expansion of fiscal policy. It would be a huge stimulus, which may be wholly inappropriate for that particular time.

So I argued that either expenditures ought to be increased, or taxes ought to be cut. I preferred tax cuts, and indeed the bills before the Congress at the time – either the President's or congressional bills, both were adequate to solve the problem of eliminating the surplus by the mid-decade, and indeed we got a significant tax cut, and the problem was solved. So I am no longer concerned about it.

Senator Reed. Might this significant tax cut cause other problems? As you noted, the previous projections were for over $5 trillion of surplus over 10 years, and now these projections have dropped to about 1.7 trillion in less than a year, over just about a year. That is a $4 trillion reduction. And, in fact, the President's recent budgetary proposal would further reduce this projected surplus to less than $500 billion. But are we in danger of running into some of the same problems that we have seen before, which is we run deficits, we put pressure on interest rates, we get back into the fiscal difficulties we had in the 1980s and the 1990s, particularly since now so much of the – of what we must spend money on is not avoidable, the war on terrorism and other major programs?

Mr. Greenspan. No. I think that we have to be very careful about going back into deficit spending, which is very easy to do, and the reason largely, obviously, is that the evidence does indicate that if you start to run substantial deficits, you will begin to move long-term interest rates, and the effect of that on the economy is clearly not favorable.

My judgment is that we have got to come up with a much longer-term focus on fiscal policy. As you know, we have the very major demographic shift that occurs at the end of the decade, and I think what we have to do is decide where we want to be in the year, say, 2013 or somewhere in that area, with respect to the level of debt, the policies of both the unified budget, and also what I would call the accrued budget, which includes the contingent liabilities of the Federal Government, and then, in a sense, having decided where it is sustainable over the longer

run given our demographic changes, work back toward what type of path would be desirable to have in fiscal policy. And my judgment is that it is very unlikely that a very large protracted deficit for the rest of this decade would be where one would want to come out.

Senator Reed. Mr. Chairman, we have seen over the last several weeks and months some encouraging signs about the economy, but one area of continuing concern is the unemployment numbers, which are still hovering around 5.6 to 5.8 percent. There is a possibility that as other factors in the economy improve, we could be in a situation where unemployment lingers at those levels. And are you concerned about a jobless recovery, one in which other indexes will show progress, but unemployment will remain at high levels?

Mr. Greenspan. I am not, Senator. I think that what we have observed currently is a significant recovery underway in the context of very strong gains in output per hour. And the data show not only a rise in output, but a decline in total hours and a decline in employment, which is even more, because as you probably are aware, overtime has gone up, and the average weekly hours have gone up. So what we are observing at this particular stage is the consequence of the economy recovering in the context of very strong productivity growth, which is very favorable.

But what we also were able to observe in the latter part of the 1990s was that this very productive growth enabled the unemployment rate to be driven down quite significantly without any inflationary implications. And if that pattern is still there, it essentially says that that is likely what will happen eventually in the future.

So I am not concerned about chronically elevated levels of unemployment. I think that as this recovery takes hold, those levels will come down, as indeed they did during the latter part of the 1990s.

Senator Reed. Thank you.

One final question, if I may, Mr. Chairman. You argue very eloquently for a longer-term perspective which will take into consideration not just the combined consolidated budget, but our contingent responsibilities, particularly with an aging population. In that context, calls to make the present tax cuts permanent would seem to me to complicate further the resolution of these contingent liabilities particularly.

What is your feeling about making permanent the current temporary or least transitory tax cuts?

Mr. Greenspan. Well, Senator, I can't talk about the politics of this, because clearly the issue from an economic point of view is somewhat different. I don't know of any economist who does long-term forecasting and presumes that the tax cuts will fall off the cliff at the end of the period in which they are statutorily in place.

So my own impression is that the markets assumed that these tax cuts are permanent. In other words, the legal question is a political issue. I don't think it is an economic issue, because I don't know of anyone that seriously believes that the world works the way the legislation stipulated.

Senator Reed. But, if you believe that, that leaves us with, I would suspect, an even greater deficit potential in the future.

Mr. Greenspan. Yes. That is correct.

Senator Reed. Which further complicates the tough problems that we have right now.

Mr. Greenspan. I would agree with that. I think that were I doing a forecast for the long-term unified and, as I call it, accrued budget, I would not make the presumption that the Congress at that particular point is going to act to rescind those taxes in the way the statute now stipulates.

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

Representative Saxton. We are going to go to Mr. Smith.

Before we do, if I may just follow up. Senator Reed, I think appropriately, raised the question of deficit and surplus. But isn't the economic slowdown a major reason for the shift in the 2002 fiscal situation?

Mr. Greenspan. It certainly is, Mr. Chairman.

Representative Saxton. Thank you.

Mr. Smith.

Representative Smith. Mr. Chairman, thank you for holding this hearing.

And, Chairman Greenspan, thank you for being willing to testify.

My first question is about the Patent and Trademark Office, in particular the amount of time required to have a patent approved when requested by businesses today. The average time, as I understand it, is about two years, and the length of time required for patents is expected to increase rather than diminish. It seems to me that this is a real disadvantage to high-tech companies who often produce a product quickly, develop it quickly, and often the product has a short shelf life.

I wanted to ask you if you felt that the length of time required to have a patent approved is a disadvantage to high-tech companies in particular, and harmful to the economy in general?

Mr. Greenspan. Yes, Congressman, I think you are raising a very important question. But it goes beyond patents. It goes into the regulatory pattern – put it this way: It goes into the whole structure of the interface of how government regulates a wide variety of areas, including the time it takes to do a lot of things.

Since it is evident that one aspect of the economy that has emerged in the last six or seven years is a very quickened pace of response as information technology has created a tremendous amount of real-time information systems, all adjustments are happening far more quickly, including the life cycle of a particular innovation, which is the issue that you are raising.

And I am fearful that the tendency to just apply the same old time lags in everything we do is contrary to the new economy, if one wants to use that term, which I hesitate to use, but it is useful in this context.

Representative Smith. Would your comments also apply to depreciation schedules for technology products like computers?

Mr. Greenspan. I don't think so, because I think those are indeed being adjusted to the proper periodicity and the degree of obsolescence. That is handled automatically, or it should be. Obviously to the extent that there are delays in IRS certification of various different types of programs, clearly that would be an issue, but I am not aware that that is a problem.

Representative Smith. Specifically in regard to the depreciation schedule, for instance, for a computer is now five years. It seems to me, given what you have just said about technology, that that is a little too long. We all know that computers are usually out of date within a year or two, and I wanted to ask you as well if you think that those depreciation schedules should be adjusted?

Mr. Greenspan. I really can't say, because I do know that there is a continuous reevaluation of so-called economic life, which is what you are raising, versus let's say IRS or even FASB issues with respect to the depreciation charges.

I think everyone is aware that this issue is out there, and it is being addressed. I don't think that is where a major problem is. I am more concerned about the issues you raise with respect to patents and the long time that it takes, for example, to get new pharmacological innovations through FDA as well.

I mean, these are very tough issues because clearly you don't want to run through a patent evaluation and find that there is truly patent infringement involved. And it takes time to make a judgment as to whether the patent is an innovation, a true one, and obviously it takes time to examine new drugs. So I am not arguing that we should push it merely for the sake of pushing, but I think we ought to be aware of the fact that that process is negative to innovation.

Representative Smith. Thank you.

Chairman Greenspan, one last question. You refer in your testimony to the technological advances contributing to the gains in productivity. One of the most astounding figures I have read recently is that, I think, two-thirds of our economy's increase in productivity gains since 1995 are attributed to information technology, and I wanted to ask you if you think those contributions to the economy by the information technology sector will continue, and if they are as important in the future as they have been in the past.

Mr. Greenspan. Well, it is difficult to make a judgment of what part of the increase in measured output per hour, which we do reasonably well even with all of the statistical noise that is involved in the process, is attributable specifically to information technology per se. We can make reasonable judgments as to what part is attributable to aggregate capital investment input, labor input and what we call overall multifactor productivity, which is a measure of the conceptual improvements that have existed.

But most people are coming out close to the number which you suggested with respect to information technology, and as best we can judge, the overall networking effect and all of the various other aspects which relate to information technology and the broader computer technologies which are associated with it have only partially been exploited. Indeed, as I indicate in my prepared remarks, when you go out and survey purchasing managers, or indeed, corporate executives more generally, you will find that they all perceive that there is a very significant amount of as yet unexploited profits in investments in information technology and in other high-tech areas as well.

So there is no evidence of which I am aware which suggests that this big surge in technology which really starts, as far as applications are concerned, in let's say 1994, 1995, is petering out. Indeed, the productivity numbers which we observed for the last six months are very strongly supportive of the notion that there is a lot out there yet to mine.

Representative Smith. Thank you, Chairman Greenspan.

Thank you, Mr. Chairman.

Representative Saxton. This subject of productivity I find very fascinating, because it seems to me that as we increase workers' productivity, it would tend to have the effect of taking pressure off increased labor costs, which would have the effect, in turn, of taking pressure – taking away certain inflationary pressures. And so this seems to me to be a very important factor in what we have seen over the last decade or two.

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

Representative Saxton. Senator Corzine.

Senator Corzine. Thank you, Chairman Saxton, and I appreciate your holding this hearing. It is always great to get the insights of the Chairman of the Federal Reserve, who has done such an outstanding job in his tenure.

I would like to maybe go back over some of the ground that Senator Reed brought up with a little different angle. There is certainly a political debate about whether we should make permanent the tax cut; as a matter of fact, very strong arguments from the economic side of the House and the administration and others that the current recovery is being hindered because of the sunsetting of the legislation.

I take it from your response to Senator Reed you probably would not believe that anyone is really factoring in that those tax cuts wouldn't be made permanent?

Mr. Greenspan. Let me take a step back.

Every analysis of a corporate investment, as you know, endeavors to project out cash flows into the future off the investment, and part of that analysis is the tax rate you apply. My impression at this particular stage is that most people presume that the tax cut is permanent and that the tax rates will remain as they are postulated in current law.

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If you rescind them, the implication for that project is that the cash flow rate of return, as you know, would go down, so that the argument really gets down to whether companies making investments have effectively assumed that these tax cuts will be permanent or not. If they assumed that they will be permanent and they turn out not to be, then clearly that would be a negative effect.

Senator Corzine. But at least at the moment it is not your assumption in how you are looking at the economy that people are—

Mr. Greenspan. My general impression is that most business investment going forward is making the judgment that those tax cuts are indeed permanent.

Senator Corzine. Okay.

Let me also reiterate if that is, in fact, the case, those tax cuts are permanent, have you or your staff done analyses of what the cost of that tax cut would be in the second 10 years after 2011, and does that really drive at the question of fiscal policy in the context of this long-running demographic challenge that we have as a society?

Mr. Greenspan. Senator, we have not. The only longer-term projections we make are in the Social Security area for purposes of trying to get some sense of what the contingent liabilities are, and, therefore, what the contingent debt obligation of the Federal Government is. I don't think that we go much beyond the next two or three years ourselves. So we rely to a very substantial extent on estimates by CBO and the Office of Management and Budget (OMB) on the grounds that those are very difficult calculations, as you know as well as I, and they have much greater insight into the detail and, I hope, better models than we. So we tend to use their data as a base from which we function.

Senator Corzine. I believe that the estimates that I have seen from those models are an additional $4 trillion of revenue decline in the second decade after 2011. And it is a concern on how our fiscal path will be as we approach that and the demographic bubble at the same time with regard to both Medicare and Social Security.

I presume I am reading that you are concerned about that coming together of similar issues?

Mr. Greenspan. I am, Senator.

Senator Corzine. Thank you.

Representative Saxton. Senator, thank you very much.

Mr. Chairman, couldn't increased uncertainty about future tax policy undermine economic and business decisions that might produce and have a result of producing a drag on the economy?

Mr. Greenspan. Well, Mr. Chairman, I think that tax policy is a crucial aspect of what the longer term is all about, and I have always argued that we probably would do better with lower corporate tax rates as a general rule. And I have argued that the capital gains tax rate has not been a particularly productive vehicle for raising revenue because these are both charges against capital accumulation, which is such a crucial

aspect of the gains in productivity and economic growth, which we have just been talking about. So it is a very complex subject, as you know far better than I, having been dealing with it up here for many years.

I have nothing really much to add to the discussion.

Representative Saxton. Thank you very much.

Ms. Dunn.

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

Welcome, Mr. Chairman.

I wanted to continue that discussion about tax relief just with a couple of questions. You suggested that most economists and the business community are banking on the tax relief being a permanent change, which pleases me. I like to hear that because I think that adds momentum to our effort—

Mr. Greenspan. Congresswoman, I should say that is my impression. I have never done an actual study. I have spoken to a lot of people, and that is my general expectation.

Representative Dunn. I am happy to hear that.

There are some areas, though, that if unless we make them permanent very quickly, I think will result in no behavioral change.

I bring to your mind the death tax repeal; that if it is not made permanent, I don't see why anybody would have any incentive to change behavior, how they spend money on estate planners and life insurance to provide for an unpredictable event.

What is your thought on what we ought to be doing here with regard to permanency? Ought we to be doing this earlier? Or maybe you can get Senator Corzine's vote now that you have spoken here. But what is your thought on how this should move?

Mr. Greenspan. Well, whatever you do, Congresswoman, I think it has to be clear where the longer-term tax structure in this area is. You cannot do estate planning, as you point out, unless you have a judgment as to what these numbers are. And wherever the Congress comes out, I think it is far more important that it come out clearly and unequivocally and not have an issue pending – an issue which would create a degree of uncertainty, which would make estate planning very difficult to implement.

Representative Dunn. Yes. Thank you.

Are you an advocate or do you believe in the idea of the tax relief providing a bridge during recessionary times for typical folks at home?

Mr. Greenspan. I am sorry, I didn't quite get that.

Representative Dunn. Larry Lindsey has talked in terms of tax relief providing a bridge for people to get through a time of recession; they will have more dollars in their pockets because of tax relief. Are you a believer in that theory?

Mr. Greenspan. Well, he is basically raising the issue of using tax policy as a fiscal policy, which is standard economic procedure. It goes

back many generations. And the issue of countercyclical fiscal policy in many respects had the tax lever as a crucial element in that.

Representative Dunn. And you do believe that?

Mr. Greenspan. Yes, I do.

Representative Dunn. Okay. We have a big problem with unemployment in the Pacific Northwest. Oregon and Washington, for example, continually lag two or three percent behind what is happening in the rest of the nation, and many of the jobs that have been lost – and you will recall the layoffs that are occurring right now, 30,000 layoffs in the Boeing Company alone from their commercial line.

Now that businesses are slowing the pace of the inventory liquidation, do you think that this signals that companies will begin making products again, and, therefore, begin to hire workers back?

Mr. Greenspan. Well, I certainly think that as the expansion takes hold, the answer is very clearly yes. With respect to essentially Boeing and Airbus, the two major players in the world for new commercial aircraft deliveries, the sharp fall-off in demand for airline travel, especially business travel, as you know, is still creating problems for airlines, and Boeing's schedules are reflecting that.

And indeed I would suspect that until we see a restoration of airline travel for business and a reestablishment of profitability in the airlines, it is going to be quite a significant restraint on capital investment for new equipment, and indeed I make the point in my prepared remarks. So it is quite conceivable that the pattern of airline revenue and new orders for equipment will take a somewhat different path overall because that is a special case very significantly impacted by the events of September the 11th and thereafter, whereas the rest of the economy is in somewhat of a different mode with respect to the issue of terrorism and concerns about it.

So, over the longer run, there is no doubt in my mind, as I answered earlier, that the unemployment rates will be coming down in general, and the one thing one can say about the American economy is that it is really far more a single economy than it has been at any time in my recollection. I should put it this way: There are not the significant geographic differences that we used to experience three, four and five decades ago.

Very recently, we are finding that when we survey all of the various different industries, and the various regions of the country, it is remarkable. Throughout, say, 2001, they behaved very much in sync with one another. You would almost replicate the discussions in one area with another, and that is still true to this day. And with the recovery coming back, we are seeing very much the same phenomenon. Everyone is moving together.

So I should think that while there will be differences owing to industrial differences, and the Northwest is clearly a case, over the longer run that is unlikely.

Representative Dunn. Thank you.

Representative Saxton. Thank you very much, Ms. Dunn. Thank you for emphasizing the importance of the need to provide clarity with respect to the inheritance tax. I think that is an extremely important point.

Mr. Sherwood.

Representative Sherwood. Thank you, Chairman Saxton.

Chairman Greenspan, it is always great to hear you. Thank you for coming.

As I listened this morning, if I understand, I think you told us that retail sales are holding up well, and home building is remarkably strong. But the key to the economy is productivity growth, the key that makes us being able to have a good economy without inflation, and as we hear so much about less manufacturing and more service industry in the economy, when we think of productivity, we think of productivity in manufacturing. But obviously you must mean productivity in other sectors as well. Could you chat a little bit about that for us?

Mr. Greenspan. Productivity obviously has been strongest in the manufacturing area. Our data indicate that nonmanufacturing, the whole other area, is also showing significant increases, and there is even the possibility that the gap between manufacturing on the one hand and services and trade and other areas on the other may be more a measurement issue than we realized.

In other words, it is very much more difficult to get the value added, which is the numerator of output per hour, in services than it is to have a physical good where you can see what is happening. And our price data are clearly suboptimal in making those types of calculations.

But the numbers that I have been citing are the overall productivity. In fact, the general numbers that most people use are nonfarm business sector productivity, which is a third manufacturing and about two-thirds nonmanufacturing.

Representative Sherwood. The other issue, you said that unemployment will come down, and I know that there have been – a great deal of the growth and the strength in our economy has been the fact that we had workers available, including noncitizen workers. And after September 11 with us being much more careful at our borders and people having the proper identification for all of the right reasons, is this liable to be a damper on the economy? Do you see that coming?

Mr. Greenspan. Congressman, it is a very difficult issue, because clearly securing our borders is a crucial aspect in the war on terrorism. Nonetheless, we are dealing with the fact that a third of the increase in our labor force is coming from immigrants, and it has enabled us to have a rising number of households, which has been a major factor in why home building has been so powerful a force in the economy.

So I think this is a very important trade-off question here, and it is one of the many issues which the war on terrorism has surfaced and which will have to be confronted by the Congress. There is no easy

answer because clearly the extent to which you enhance one aspect of the problem, you create the potential difficulties for the other.

Representative Sherwood. Thank you.

You said we will know in the next two to four months, if I understood you correctly, what direction certain things are going to take. And if I understood you, you said that a lot of the retail sales are coming now from reducing inventories, and so are you telling us that business will have to make a decision then whether to replace these inventories. I wasn't just sure I understood your two to four month comments.

Mr. Greenspan. Well, the point I was trying to make is that when you are dealing with a situation, as we are today and have been since late last year, where production has been held down very dramatically by inventory liquidation – in other words if you think in terms of consumption as being sort of a level up here, and production being well below, the difference between the two is obviously the amount of goods that are being supplied to consumption out of inventories as distinct from newly produced goods.

But as the level of inventories goes down, clearly it can't go below zero, and so well before zero it has to slow its rate of decline, which means that if consumption is stable, production must rise and supply more of the consumption than it did previously.

And that is the process which we are now going through. As production continues to rise, and since consumption has been relatively stable, we are creating a higher level of demand for people so that you are getting higher incomes, greater employment, more purchasing power, higher profits. And the question basically is whether all of those forces cause demand to kick in at a higher level when the initial thrust coming from the impetus of a reduced rate of inventory liquidation finally dissipates.

It is like a first-stage rocket carrying you off to a certain point and then a second-stage rocket essentially carrying you further. We are in the first-stage rocket, if I may put the analogy in that respect, but we are not yet at the point where its momentum has petered out enough to where we can see significant changes. But what we will learn as the months evolve is whether the increased demand from the increased incomes and profits being created by the shift from inventory liquidation to zero change in inventory, whether that shift creates a demand for goods and services over and above what is currently in place to give us an accelerated pickup in final demand, as we put it.

That is what our forecast is, that is what tends to be the case in our history, but until you actually see it, it is still problematic. You are still not certain. As I say, there is a large degree of uncertainty with respect to this issue out there.

Representative Sherwood. Thank you.

Representative Saxton. Thank you, Mr. Sherwood.

Mr. Putnam.

Representative Putnam. Thank you, Mr. Chairman.

And welcome, Mr. Greenspan.

Over the course of the past 18 months or so, as we have come through this recession, the consumer household spending and home mortgages and auto sales have essentially carried the day. The consequences of that – and, in fact, the Fed report referred to the frenzied refinancing of mortgages. But a consequence of that has been a rise in consumer or household debt. Is that a concern of yours, and what does that bode for future abilities or future room for growth in household spending?

Mr. Greenspan. We have examined that in some detail, Congressman, and we don't sense a serious problem at this stage. We don't expect it to get worse, but even now it is not a big problem.

One of the reasons is that a goodly part of the increase in debt is mortgage debt, and mortgage debt to a very substantial extent is supported by the market value of houses. And indeed, despite the fact that there has been a very dramatic increase in mortgage debt, the equities within homes continues to rise, and this is especially the case for the lower four-fifths of households calibrated by income, because, as I point out in my prepared remarks, a goodly part of the debt increase is in the upper quintile, which is almost a half of overall consumption. So I would think that while we do see that the debt service levels, that is, the amount of amortization plus interest as a ratio to income, are up at pretty high levels, there is a significant capability in most households, especially those which own homes with equity in them, to employ home equity loans or, in cases of refinancing, so-called refinancing cashouts where you take out more cash out of the process. And what that enables a lot of households to do is pay down their installment debt, their credit card debt, and indeed they have done so.

Now, clearly there are segments of our society, however, which don't have large equity positions in homes, and we do see that in some subprime lending, in both consumer and mortgage lending, delinquencies have indeed gone up. And we are probably likely to see further erosion because these types of things tend to lag behind the economy.

And indeed, I should have mentioned earlier with respect to the discussion of unemployment, there is a tendency for unemployment itself to be a lagging indicator, which is clearly a factor in which you get delinquencies and difficulties in household debt carrying into the recovery period, into its early stages, because it takes time for that process to work its way through.

But the bottom line is that having looked at this as best we can, we don't perceive it as a significant impediment to an expansion in consumer expenditures.

Representative Putnam. A number of private economists have indicated, as has the government, that IRS refunds are up perhaps as high as 26 percent over last year. Does this give the consumer some additional breathing room, and will this have a stimulative effect, as this economist

from Goldman Sachs predicts, as a high level of tax refunds to increase personal income levels by as high as three billion a month?

Mr. Greenspan. Well, remember those refunds are only up to a point, and then they fall off. It is hard to know what people expect with respect to refunds and when they spend them, but there is no question that they do have an effect. But clearly as you get to April the 15th, that begins to peter off, because a good deal of refunds have occurred prior to the April 15th date. Some of them go beyond, but a goodly part of that is already in train.

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

Representative Saxton. Mr. Chairman, we promised we would finish this hearing in a timely fashion to try to accommodate your schedule. If you have time, sir, Mr. Corzine has one final question.

Senator Corzine. Mr. Chairman, we were talking earlier about a certainty and clarity, and one of the things that I think that we have talked about before in other hearings is change of circumstances should lead or often leads to change in policy considerations, just as you suggested; that if we were going to have to have a paydown of the debt and potential investment by governmental authorities, that would imply one policy versus one where deficits might impinge on the ability of the economy to save and have productive growth.

It strikes me that we are not showing the flexibility in fiscal policy that I think I have heard you endorse with regard to changing circumstances that might be. We do have a war today, a war on terrorism that has changed our spending needs, and while there is a need for clarity with regard to tax policy, I presume there is a need for clarity with regard to spending on education, special education, or spending on cleaning up the environment, or spending with respect to – or at least building up of reserves or potential capacity to pay for our Medicare expenses in future years, or Social Security for that matter.

So I am curious whether you think we are showing enough flexibility with regard to our fiscal policy strategies, which certainly wouldn't reflect how the Federal Reserve has managed monetary policy over a few years. And clarity is a two-sided coin. It is not just with taxes. I would suppose it is also with the resources that come with expenditures. I would love to hear your comments on that.

Mr. Greenspan. In principle there is no question that we have to do it, and we have to try to do it as best we can. In practice we have very considerable difficulties.

Senator Corzine. We have to have flexibility in our policies.

Mr. Greenspan. Yes. In practice we have considerable difficulties, largely because our forecast capabilities are not up as yet to the tasks, and one of the reasons is that if you are dealing, for example, with a $2 or $2½ trillion budget, and you have receipts and outlays roughly the same, as you know, very small changes in the balance of these very large aggregates engender very significant swings in unified budget surpluses and deficits.

And I think that you know the fan chart that CBO shows with respect to its probabilities is a good representation of what their history has been. And it is not that they are inadequate forecasters, they are pretty good as far as the profession is concerned, but it is an inherently very difficult exercise.

And so I think as part of this flexibility question, you have got a very important question of making judgments of what the probabilities of various different outlooks are and then making judgments. But that you have to do it, there is no question. That you have to be flexible, because events are changing by their nature is no question.

I just merely raise the issue of how good our capabilities are in implementing policy. Monetary policy is easy in that regard. We only have to make judgments, technically speaking, 20 minutes in advance before we can implement a policy. But you obviously cannot do that with fiscal policy. There are very long leads and lags and very long projections.

And my impression is that we probably would be wise to spend more time thinking about this problem because it is going to become a very serious issue as the years go on, if for no other reason than one of the easiest things to forecast is the demographics which are going to hit us, and I don't get the impression that we yet have the technical capability to come at this in a manner which is as effective as I think we are going to eventually need.

Senator Corzine. Could you just comment also, though, on the clarity of expenditures, investments in education, et cetera, and contrast – or at least in comparison to clarity with regard to tax policy?

Mr. Greenspan. Clarity to tax policy, you say. Well, I don't know. Clarity to me means basically you have a long-term strategy, you know where you are going, and you have a policy of getting there.

And I think one of the interesting issues that the Congress has to confront is trying to make judgments as to, let's say for example, an education policy, which policies work and which don't. And so there is a diagnosis of the problem, which I think is still in very significant debate within the society, and until we come to a conclusion of what works and what doesn't work, it is hard to get a fiscal policy which embodies that.

So there are important issues here of a conceptual nature that have got to be resolved. Over the years we have had many such arguments. We have to a greater or lesser extent resolved them. I think that is probably one of the things which is a major strength of this country.

Senator Corzine. Thank you.

Representative Saxton. Mr. Chairman, thank you.

Mr. Chairman, you just made reference to fiscal and monetary policy and its effect on influencing economic growth.

How effective were – how effective were the implementation of fiscal and monetary policies in 2001 in offsetting the recession, in your opinion?

Mr. Greenspan. In the most recent period?

Representative Saxton. Yes.

Mr. Greenspan. Both worked probably better than they usually work. That is, of necessity, all policy implies a forecast. We like to pretend that these are mechanical procedures which one can implement without making forecasts, but that is not factually the way the world works. And I think, for better or worse, the timing of policies has largely been, in my judgment, reasonably good in this respect.

Representative Saxton. How well timed were the policy moments in 2001?

Mr. Greenspan. With respect to? How was it in 2001? I thought that both tax and monetary policy turned out to be reasonably well calibrated.

Representative Saxton. Thank you.

One final question with regard to forecasting inflation. It doesn't appear that – at least from the statistical evidence that we have available – that there is any real problem with inflation currently, nor does it appear that there is a problem in the foreseeable future. But given the current economic situation, what indicators in the coming months would tend to be the most helpful in evaluating risks of future inflation?

Mr. Greenspan. Well, all of the analysis that we make from the point of view of a central bank is to endeavor to make those judgments. You don't look at any individual indicator, because that doesn't really help you because it keeps changing. You try to understand the process. You try to understand what are the broad forces, both domestically and globally, which are making the economy move. One aspect of that analysis is an evaluation of potentially building inflationary pressure.

So I would not say that there is a single statistic which would tell us that sufficiently in advance. Obviously, the price indexes themselves are what we are measuring. But they are very lagging indicators, and you can't really make useful judgments looking in the rear view mirror, if I may put it that way.

Representative Saxton. Thank you very much.

Senator Bennett has arrived, Mr. Chairman.

The Chairman is on a kind of a tight leash, Senator, so we welcome your questions, but hope you will keep that in mind.

Senator Bennett. Thank you very much. I will try to abide by that admonition.

Mr. Chairman, it has been pointed out to me at least one body of opinion rather necessarily casting it as a fact, but one body of opinion, is that since the dollar is now the de facto reserve currency of the world, if not the dominant currency in the world, you are not only the central bank for the United States, you have become the central banker for the rest of the world. And I know you didn't sign up for that, but there are many people who give you that particular responsibility.

I would like to get your views on the question of world liquidity. Many people say Japan is in a serious deflation, there is a liquidity crisis in Europe, and that while we may have statistically enough liquidity in the economy in the United States, on a worldwide basis there is a liquidity problem, and that somehow you have to be involved in that.

And while you are pondering that one, I will pose the second and somewhat related question. As we come out of this recession, we must face the reality of world overcapacity in a number of industries. Steel is the most obvious, but there are a number of industries where there is a significant overcapacity, and, of course, overcapacity tends to dampen economic recovery when you are coming out of a recession circumstance.

So could you address those two related questions and – the amount of money available in the rest of the world, and the impact of that on our economy, and then the amount of overcapacity in the rest of the world.

Mr. Greenspan. Senator, I am not concerned about the issue of world liquidity largely because to a very substantial extent the system creates liquidity as is necessary. The central banks of the world obviously are crucial at the ultimate level of liquidity creation, and here one finds very little evidence that there is any particular problem. I mean, you can look at the European community, there's certainly no difficulty from a liquidity point of view. I trust there is none in the United States, nor do I perceive one in Japan, for example, or elsewhere. One of the reasons is that markets work to create—

Senator Bennett. If I could just – Japan is in a deflation, isn't it, from your view; is it not?

Mr. Greenspan. Well, Japan is beginning to show signs of stabilization as a consequence of the fact that the United States and Europe are beginning to firm. So to be sure there has been a very serious deflationary problem in Japan, but there are the first inklings that that is beginning to stabilize.

I don't wish to say that they don't have significant problems, which they clearly do, but I wouldn't perceive this as a particularly major issue if the rest of the world is beginning to move.

On the issue of overcapacity, that is a problem, Senator, which I think we always have one way or the other. And clearly steel has become the poster child of overcapacity, largely because it tends to become an industry which many emerging nations perceived as evidence of industrialization, and we created a very substantial amount of capacity, some of it quite obsolete and some of it extraordinarily high-cost.

And as you know, Secretary O'Neill, who was involved in endeavoring to, as a private citizen, bring down excess aluminum reduction plant capacity over the years, is trying to obtain similar sorts of adjustments in world steel capacity, and I would say that it is important that he succeed or that – I should put it more generally – that he and his colleagues who are involved in these discussions make significant headway, because it is important to rationalize the industry.

Senator Bennett. But overall you think that the overcapacity problem in the world is not going to dampen our recovery from the recession?

Mr. Greenspan. I think not. I think that it always does, but not to a great extent. A more relevant concern is obviously the communications capacity problem where a goodly part of high-tech investment is being impeded due to an endeavor to absorb a good deal of the excess which has been put in place. That will impede the recovery some, but not over the longer run. We managed to move capital from obsolescent overcapacity in industries into cutting-edge uses quite effectively.

Senator Bennett. Thank you, Mr. Chairman. I recognize that my time is up.

I would like to pursue with Chairman Greenspan the issue of data-sharing and the quality of economic statistics. Maybe we can have that dialogue in another venue. But I know that he is a leader in trying to get good economic information, and I have an interest in information-sharing, and we will pursue that at another time when we don't have the time constraints.

[The written question to Chairman Greenspan from Senator Bennett, together with the written response appears in the Submissions for the Record on page 38.]

Representative Saxton. Thank you, Senator Bennett.

Mr. Chairman, we would like to thank you and your staff for being here with us today. We appreciate it very much. We appreciate your message also that the foundation seems to have been set for an economic recovery, and that there are still, however, continuing concerns that we need to watch very carefully in terms of a number of factors that may play as a drag on economic performance.

So thank you for being with us. We appreciate it again, and we look forward to seeing you again in the future. Thank you.

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

Representative Saxton. The hearing is adjourned.

[Whereupon, at 11:35 a.m., the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

I am pleased to welcome Chairman Greenspan to testify before the Joint Economic Committee this morning. We appreciate your appearance today to discuss monetary policy and the improved economic situation that has emerged in recent months.

The economy appears to be recovering from the slowdown that began in the middle of 2000, and turned into a mild recession in March of 2001. The September 11 terrorist attacks inflicted further economic damage. Nonetheless, in the last quarter of 2001, real GDP increased 1.7 percent, with personal consumption spending surging at a 6.1 percent rate.

In addition, manufacturing output has stabilized and appears to be expanding, home sales have held up well, and large payroll employment declines have subsided. The liquidation of inventories last year has established the basis for inventory rebuilding later in 2002. Another positive aspect of the current outlook is that good productivity growth has been sustained through the business cycle and appears likely in the future. Economic forecasts generally anticipate a strengthening of economic growth during 2002. Leading market price indicators show no significant threat of inflation in the pipeline.

The recovery has begun, but there are potential weaknesses and vulnerabilities that could affect the breadth and sustainability of the economic rebound. As the Federal Reserve has pointed out, the declines in business profits and investment were important factors in the recession, and these remain problematic. Despite the improvement in fourth quarter GDP, investment spending fell sharply. Business and household debt levels are relatively high by historic standards and could restrain growth.

In addition, the weakness in the economies of some of our international trading partners limits overseas markets for U.S. production. Meanwhile, costs imposed by terrorism, the instability in the Middle East, and the increase in oil prices provide other potential impediments to faster U.S. growth. Unfortunately, there are a number of major risks to the U.S. economic recovery.

Given these risks, the current stance of Federal Reserve monetary policy seems appropriate. The Federal Reserve wisely has shown restraint in not tightening monetary policy as the economic rebound consolidates. With little threat of inflation, there has been no reason for a tightening of monetary policy by the Federal Reserve.

PREPARED STATEMENT OF SENATOR JACK REED, VICE CHAIRMAN

Thank you. I want to commend Chairman Saxton for holding this hearing and to welcome Federal Reserve Chairman Greenspan.

The past year and a half have proven to be quite challenging, both for economic forecasters and for policymakers. You and your colleagues at the Federal Reserve began to take aggressive action to head off economic weakness early last year and ended up cutting short-term interest rates 11 times over the course of the year. You also responded quickly to inject liquidity into the financial system at the time of the September 11 attacks. In other words, Chairman Greenspan, I think you have conducted monetary policy quite reasonably over this period.

I wish we in the Congress had been as wise in our fiscal policy decisions. In any case, the economy may be on the road to recovery, but the budget outlook was left in shambles by the tax cut, the recession, and the terrorist attacks. And, in that order, I might add. The Senate Budget Committee's analysis of CBO data show that more than 40 percent of the decline in the baseline of 2002-2011 surpluses since last January is due to the tax cut and associated debt service costs, with lesser percentages attributable to weaker economic conditions, increased spending to fight terrorism, and other technical budget adjustments.

This change in our budget outlook has important implications for our economy. As you pointed out earlier this year, Chairman Greenspan, the reduced prospects for paying down our national debt were a factor in keeping long-term interest rates from falling as much as we might have expected when the Fed cut short-term rates. And if the experience of the 1980s is any guide, a large tax cut that eats into our national saving will keep interest rates high and produce an unbalanced expansion with low rates of investment even as we climb back to full employment.

The consequences of not having surpluses to fund our national priorities are severe. I am worried, for example that even as the recovery gets underway, labor markets will remain soft for the most vulnerable in our society – less skilled and minority workers. Budgetary pressures have led the President to propose tax cuts in job training programs, which are precisely the sort of programs we will need to help less-skilled workers join in the recovery.

So Chairman Greenspan, I am encouraged with how the economy has been performing recently, at least relative to the discouraging forecasts we had been seeing. With the economy picking up while inflation remains moderate, I hope the Federal Reserve can afford to wait before it begins to unwind its year-long series of rate cuts. I will be interested in hearing your views on the short-term outlook.

But I am discouraged by the longer-term fiscal outlook. I would be interested in your views about whether the deterioration of the budget outlook is a threat to our long-term growth prospects, especially as we look beyond the current budget window to the years when the retirement of the baby boom generation will put increasing pressure on the budget.

I don't think we can just grow our way out of the current budget situation, but I wonder what you think.

Again, thank you for coming, and I look forward to your testimony.

I appreciate the opportunity to appear before the Joint Economic Committee to discuss the current state of the economy.

As we noted in our statement following the Federal Open Market Committee meeting in March, "The economy, bolstered by a marked swing in inventory investment, is expanding at a significant pace. Nonetheless, the degree of strengthening in final demand over coming quarters, an essential element in sustained economic expansion, is still uncertain." Little, if anything, has happened since the FOMC meeting to alter that assessment.

This morning I would like to elaborate on some of the forces that are likely to shape activity in the months ahead.

As I just noted, the behavior of inventories currently is the driving force in the near-term outlook. Stocks of goods in many industries were drawn down significantly last year, and preliminary data suggest that the pace of liquidation tapered off markedly in the first quarter. This development is important because the reduction in the rate of inventory liquidation has induced a rise in industrial production.

The pickup in the growth of activity, however, will be short-lived unless sustained increases in final demand kick in before the positive effects of inventory investment dissipate. We have seen encouraging signs in recent months that underlying trends in final demand are strengthening, but the dimensions of the pickup are still not clear.

* * *

A number of crosscurrents are likely to influence household spending this year. Through much of last year's slowdown, housing and consumption spending held up well and proved to be a major stabilizing force. But because there was little retrenchment during the cyclical

downturn, the potential for a significant acceleration in activity in the household sector is likely to be more limited than in past business cycles.

One important source of support to household spending late last year--energy prices--will likely be less favorable in the months ahead. With the rise in world crude oil prices since the middle of January, higher energy costs are again sapping the purchasing power of households. To the extent that the increase in energy prices is limited in dimension--with prices not materially exceeding the trading range of recent weeks--the negative effects on spending in the aggregate should prove to be small. However, a price hike that drove oil prices well above existing levels for an appreciable period of time would likely have more far-reaching consequences.

In assessing the possible effects of higher oil prices, the inherent uncertainty about their future path is compounded by the limitations of the statistical models available to analyze such price shocks. When simulated over periods with observed oil prices spikes, these models do *not* show oil prices consistently having been a decisive factor in depressing economic activity. Yet, coincidence or not, all economic downturns in the United States since 1973, when oil became a prominent cost factor in business, have been preceded by sharp increases in the price of oil. This pattern leads one to suspect that the responsiveness of U.S. gross domestic product to energy prices is far more complex and may be quite different when households and businesses are confronted with abnormal price hikes. Macroeconometric models typically are specified as linear relationships, and they reflect average behavior over history. These models cannot distinguish between responses to outsized spikes and normal price fluctuations and thus may not capture the effect of sudden and sizable shifts in oil prices on the economy.

Another factor likely to damp the growth of consumer spending in the period ahead, at least to some extent, is the change in overall household financial positions over the past two years. Household wealth relative to income has dropped from a peak multiple of about 6.3 at the end of 1999 to around 5.3 currently. Econometric evidence suggests that wealth is an important determinant of spending, explaining about one-fifth of the total level of consumer outlays. Indeed, about nine-tenths of the decline in the personal saving rate from 1995 to 1999 can be attributed to the rise in the ratio of wealth to income, and the subsequent decline in that ratio is doubtless restraining the growth of consumption.

Much of the movement in household net worth in recent years has been driven by changes on the asset side of the household balance sheet. But household liabilities have generally moved higher as well. Accordingly, the aggregate household debt service burden, defined as the ratio of households' required debt payments to their disposable personal income, rose considerably in recent years, returning last year to close to its previous cyclical peak of the mid-1980s, where it has remained.

Neither wealth nor the burden of debt is distributed evenly across households. Hence, the spending effects of changes in these influences also will not be evenly distributed. For example, increased debt burdens appear disproportionately attributable to higher-income households. Calculations by staff at the Federal Reserve suggest that the ratio of household liabilities to annual after-tax income for the top fifth of all households ranked by income rose from about 1.1 at the end of 1998 to 1.3 at the end of 2001. The increase for the lower four-fifths was not quite half as large

Although high-income households should not experience much strain in meeting their debt-service obligations, others might. Indeed, repayment difficulties have already increased, particularly in the subprime markets for consumer loans and mortgages. Delinquency rates may well worsen as a delayed result of the strains on household finances over the past two years. Large erosions, however, do not seem likely, and the overall levels of debt and repayment delinquencies do not, as of now, appear to pose a major impediment to a moderate expansion of consumption spending going forward.

Although the macroeconomic effects of debt burdens may be limited, we have already observed significant spending restraint among the top fifth of income earners--who accounted for around 44 percent of total after-tax household income last year--presumably owing to the drop in equity prices, on net, over the past two years. The effect of the stock market on other households' spending has been less evident. Moderate-income households have a much larger proportion of their assets in homes, and the continuing rise in the value of houses has provided greater support for their net worth. Reflecting these differences in portfolio composition, the net worth of the top fifth of income earners has dropped far more than it did for the remaining four-fifths over the two-year period.

As a consequence, excluding capital gains and losses from the calculation, as is the convention in our national income accounts, personal saving for the upper fifth, which had been negative during 1999 and 2000, turned positive in 2001. By contrast, the average saving rate for the lower four-fifths of households, by income, was generally positive during the second half of the 1990s and has fluctuated in a narrow range in the past few years. Accordingly, most of the change in consumption expenditures that resulted from the bull stock market and its demise

reflected shifts in spending by upper-income households. As I noted earlier, the restraining effects from the net decline in wealth during the past two years presumably have not, as yet, fully played out and could exert some further damping effect on the overall growth of household spending relative to that of income.

Perhaps most central to the outlook for consumer spending will be developments in the labor market, which has improved some in recent months. The pace of layoffs quickened last fall, especially after September 11, and the unemployment rate rose sharply. But layoffs have diminished noticeably in 2002, and payrolls grew again in March. In typical cyclical fashion, the unemployment rate has lagged the pickup in demand somewhat, but it has remained between 5-1/2 and 5-3/4 percent of late, after rising rapidly in 2001.

Over the longer haul, incomes and spending are driven most importantly by the behavior of labor productivity. And here the most recent readings have been very encouraging. Typically, labor productivity declines when output is cut back and businesses are reluctant to proportionately reduce their workforces. However, output per hour continued to grow last year. Indeed, it rose at an annual rate of 5-1/2 percent in the fourth quarter of last year and appears to have posted another sharp advance in the first quarter. No doubt, some of the recent acceleration reflects normal statistical noise. More fundamentally, some of this pickup probably occurred because businesses have remained cautious about boosting labor input in response to the surprising strength of demand in recent months. But the magnitude of the gains in productivity over the past year provides further evidence of improvement in the underlying pace of structural labor productivity. This development augurs well for firms' ability to grant wage increases to their employees without putting upward pressure on prices.

In housing markets, low mortgage interest rates and favorable weather have provided considerable support to homebuilding in recent months. Moreover, attractive mortgage rates have bolstered the sales of existing homes and the extraction of capital gains embedded in home equity that those sales engender. Low rates have also encouraged households to take on larger mortgages when refinancing their homes. Drawing on home equity in this manner is a significant source of funding for consumption and home modernization. The pace of such extractions likely dropped along with the decline in refinancing activity that followed the backup in mortgage rates that began in early November. Mortgage rates have gone back down again in recent weeks and are at low levels. This should continue to underpin activity in housing, but with perhaps less spillover to consumption more generally.

The ongoing strength in the housing market has raised concerns about the possible emergence of a bubble in home prices. However, the analogy often made to the building and bursting of a stock price bubble is imperfect. First, unlike in the stock market, sales in the real estate market incur substantial transactions costs and, when most homes are sold, the seller must physically move out. Doing so often entails significant financial and emotional costs and is an obvious impediment to stimulating a bubble through speculative trading in homes. Thus, while stock market turnover is more than 100 percent annually, the turnover of home ownership is less than 10 percent annually--scarcely tinder for speculative conflagration. Second, arbitrage opportunities are much more limited in housing markets than in securities markets. A home in Portland, Oregon is not a close substitute for a home in Portland, Maine, and the "national" housing market is better understood as a collection of small, local housing markets. Even if a

bubble were to develop in a local market, it would not necessarily have implications for the nation as a whole.

These factors certainly do not mean that bubbles cannot develop in house markets and that home prices cannot decline: Indeed, home prices fell significantly in several parts of the country in the early 1990s. But because the turnover of homes is so much smaller than that of stocks and because the underlying demand for living space tends to be revised very gradually, the speed and magnitude of price rises and declines often observed in markets for securities are more difficult to create in markets for homes.

* * *

The technological advances contributing to the gains in productivity that we have achieved over the past year should provide support not only to the household sector but also to the business sector through a recovery in corporate profits and capital investment.

The retrenchment in capital spending over the past year and a half was central to the sharp slowing in overall activity. These cutbacks in capital spending interacted with, and were reinforced by, falling profits and equity prices. Indeed, a striking feature of the current cyclical episode relative to many earlier ones has been the virtual absence of pricing power across much of American business, as increasing globalization and deregulation have enhanced competition. Business managers, with little opportunity to raise prices, have moved aggressively to stabilize cash flows by trimming workforces. These efforts have limited any rise in unit costs, attenuated the pressure on profit margins, and ultimately helped to preserve the vast majority of private-sector jobs. To the extent that businesses are successful in boosting profits and cash flow, capital spending should begin to recover more noticeably.

Part of the reduction in pricing power observed in this cycle should be reversed as firming demand enables businesses to take back large price discounts. Though such an adjustment would tend to elevate price levels, underlying inflationary cost pressures should remain contained. A lack of pressures in labor markets and increases in productivity are holding labor costs in check, resulting in rising profit margins even with inflation remaining low. Although energy-using companies will experience some profit pressures as recent increases in spot oil prices become imbedded in contracts, these effects should be limited unless oil prices increase appreciably further.

To be sure, over time, the current accommodative stance of monetary policy is not likely to be consistent with maintaining price stability. But prospects for low inflation and inflation expectations in the period ahead mean that the Federal Reserve should have ample opportunity to adjust policy to keep inflation pressures contained once sustained, solid, economic expansion is in view.

Improved profit margins over time and more assured prospects for rising final demand would likely be accompanied by a decline in risk premiums from their current elevated levels toward a more normal range. With real rates of return on high-tech equipment still attractive, the lowering of risk premiums should be an additional spur to new investment. Reports from businesses around the country suggest that the exploitation of available networking and other information technologies was only partially completed when the cyclical retrenchment of the past year began. Many business managers still hold the view, according to a recent survey of purchasing managers, that less than half of currently available new and, presumably profitable, supply-chain technologies have been put into use.

Recent evidence suggests that a recovery in at least some forms of high-tech investment is under way. Production of semiconductors, which in the past has been a leading indicator of computer production, turned up last fall. Expenditures on computers rose at a double-digit annual rate in real terms in the fourth quarter. But investment expenditures in the communications sector, where overcapacity was substantial, as yet show few signs of increasing, and business investment in some other sectors, such as aircraft, hit by the drop in air travel, will presumably remain weak in 2002. On balance, the recovery this year in overall spending on business fixed investment is likely to be gradual.

* * *

The U.S. economy has displayed a remarkable resilience over the past six months in the face of some very significant adverse shocks. But the strength of the economic expansion that is under way remains to be clarified. Some of the forces that have weighed heavily on the economy over the past year or so have begun to dissipate, but other factors, such as the sharp increase in world oil prices, have arisen that pose new challenges. As a result, the course of final demand will need to be monitored closely.

Still, there can be little doubt that prospects have brightened. Spending in the household sector has held up well, and some signs of improvement are evident in business profits and investment. Fiscal policy continues to provide stimulus to aggregate demand, and monetary policy is currently accommodative. With the growth of productivity well maintained and inflation pressures largely absent, the foundation for economic expansion has been laid.

Congress of the United States

JOINT ECONOMIC COMMITTEE

(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)

Washington, DC 20510–6602

April 25, 2002

The Honorable Alan Greenspan
Chairman
Board of Governors of the Federal Reserve System
Twentieth Street and Constitution Avenue, N.W.
Washington, DC 20551

Dear Chairman Greenspan:

It was a pleasure to speak with you at the Joint Economic Committee hearing of April 17, 2002 and to hear your thoughts on monetary policy and the state of the U.S. and world economies. Since I had only limited time to get your thoughts at the hearing, I appreciate the opportunity to follow-up with a few questions that can be included in the record.

As I briefly mentioned at the end of the hearing, I believe that opportunities exist to improve the quality of the economic statistics that federal agencies collect, process, and disseminate. As you know, these statistics – on production, income, employment, productivity, etc. – play an important role, not only in the development of economic policy, but also in the decision-making of many businesses and consumers.

It recently came to my attention that statutory constraints might be limiting the quality of economic statistics. As you know, the responsibility for economic statistics is spread across many separate agencies, most notably the Bureau of Economic Analysis (BEA), the Bureau of Labor Statistics (BLS), and the Bureau of the Census. The data gathering efforts of these agencies sometimes overlap. For example, both the BLS and the Census collect data about business establishments.

It has been suggested to me that the statistical agencies could realize significant gains – in the quality of their published data, the cost of preparing it, and the burden that data collection places on respondents in the private sector – if they could share some of their underlying data with each other. Their ability to do so, however, is greatly limited by statutory barriers that, in essence, prohibit such sharing.

These statutes have a worthy goal – protecting the confidentiality of the respondents who provide information to the government. I have been advised, however, that under reasonable statutory changes, it should be possible to maintain or even strengthen the current level of confidentiality while allowing data sharing only for statistical purposes.

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Chairman Greenspan

Given the Federal Reserve's prominent role as both a consumer and a producer of economic statistics, I would appreciate your thoughts on these issues. In particular:

- Would data sharing among the leading statistical agencies improve the quality of economic statistics?
- Would data sharing among the leading statistical agencies, and any resultant improvements in economic statistics, assist the Federal Reserve in its activities, such as:
  - o producing its own economic statistics (e.g., industrial production);
  - o analyzing and understanding trends in key economic measures, such as output, employment, prices, or productivity;
  - o conducting monetary policy; and
  - o supervising and regulating banking institutions?
- Would increased data sharing among the statistical agencies raise any concerns for the Federal Reserve about respondent confidentiality?

To the extent that you can provide specific examples in response to any of these questions, that would be very helpful.

Should you have any questions about these inquiries, please do not hesitate to contact me or Donald Marron (202-224-3922), my Principal Economist at the Joint Economic Committee.

Thank you for interest and assistance.

Sincerely,

Robert F. Bennett
United States Senator

RFB:dbm

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

May 8, 2002

The Honorable Robert F. Bennett
United States Senate
Washington, D.C. 20510

Dear Senator:

Thank you for your letter of April 25 in which you asked for my views on removing certain statutory barriers to the sharing of business data among the Bureau of the Census, the Bureau of Labor Statistics (BLS), and the Bureau of Economic Analysis (BEA). Under a recent proposal, data would be shared for the purpose of updating statistical sample frames, improving sample coverage, providing consistent classifications of establishments and companies into industries, and reconciling significant differences between existing data produced by the three agencies.

As I have remarked on many occasions, high quality economic statistics are an important input for decisionmaking by households, businesses, and policymakers. We are fortunate that the statistical systems in the United States, both public and private, are among the best in the world and, indeed, in many respects set the world standard. But even a world standard can be made better.

One important outcome of data sharing would be the coordination of establishment lists. Currently, the BLS and the Census Bureau maintain separate lists of establishments that they use for sampling purposes. These establishment lists are derived from two different sets of administrative records. The Census Bureau uses tax records, and the BLS uses records from the unemployment insurance system. In a dynamic economy such as ours, where new establishments are being created every day, the statistical agencies have a difficult job making sure that the lists used for their sampling frames provide an up-to-date and complete representation of the current industrial structure. If legislation allowing the sharing of business data were enacted, the Census Bureau and the BLS would be able to compare their lists in order to improve the depth and breadth of their samples. Such improved coverage would help make the data collected by agencies more representative of the economy and, accordingly, more reliable.

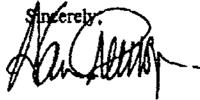
The Honorable Robert F. Bennett
Page Two

The establishment lists that both agencies maintain include a code that identifies the industry associated with the primary output of the establishment. These codes are based on the North American Industry Classification System (NAICS). One problem is that the two lists may identify the same establishment with different NAICS codes. As a result, for example, the detailed industry data on shipments from a Census Bureau survey may not cover the same establishments as the detailed industry data on employment collected by the BLS. To the extent that these misclassifications occur, detailed industry estimates of productivity will be invalid. My understanding is that problems of this type do, in fact, exist. Thus, another benefit of the proposed legislation is that it would allow the statistical agencies to cross-validate their establishment lists.

Improving the consistency and reliability of economic information across statistical agencies would benefit all data users. To illustrate, at the Federal Reserve we look closely at data such as shipments and employment at the detailed industry level for our economic analysis and as part of our industrial production statistical program. This work would certainly be enhanced by improvements in the quality of the underlying source data.

The American statistical system is an extremely important national resource, and I applaud efforts to improve that system.

Sincerely,



PAUL S. SARBANES
MARYLAND

309 HART SENATE OFFICE BUILDING
WASHINGTON, DC 20510
202-224-4524

United States Senate
WASHINGTON, DC 20510-2002

Dear Chairman Greenspan,

An article published on Tuesday, April 16th, in the Wall Street Journal reported that, "The U.S. may not be nearly as big an international debtor as generally thought, because official data overstate how much it owes to foreigners, a Federal Reserve study has found." Even if this is correct, it is fair to say that the U.S. external debt is extraordinarily large and growing.

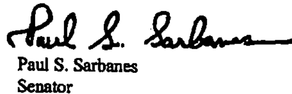
Foreigners held $9.4 trillion in U.S. assets at the end of 2000 (the most recent official data). At the same time, Americans held $7.2 trillion in assets abroad. That left us with a net asset position of $2.2 trillion (market value) – 22 percent of our GDP. Even if the estimates made in the recent Fed study are correct, the net negative international position was still 16 percent of GDP and rising rapidly. In 2001, the U.S. ran another deficit of $417 billion in the current account, probably increasing U.S. external debt by another 4 percent of GDP.

With our imports running 35 percent larger than our exports, our exports must grow 35 percent faster than our imports just to keep the trade balance from widening. Trade economists tell us that, when U.S. income goes up 10 percent, our imports rise about 18 percent, but when income abroad rises 10 percent U.S. exports rise by only about 11 or 12 percent. The consensus of economists calls for U.S. growth to outpace foreign growth again this year.

All this points to the almost certain result that the trade deficit will resume going up again this year after a one year respite because of the recession.

Whether the official numbers or the Fed researchers numbers are correct about the current level of our net asset position, the ratio of our net position to GDP is rising rapidly. How long does the Federal Reserve expect the current account to be roughly 4 percent or more of GDP? How much does the Federal Reserve expect the net asset to GDP ratio to rise over the next 5 years? Over the next 10 years? What are the conditions necessary to stabilize this deteriorating situation?

Sincerely,



Paul S. Sarbanes
Senator

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

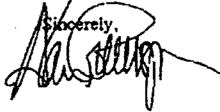
April 26, 2002

The Honorable Paul S. Sarbanes
United States Senate
Washington, D.C. 20510

Dear Senator:

I am pleased to enclose my response to the question you submitted following the April 17 hearing before the Joint Economic Committee. I have also forwarded a copy to the Committee for inclusion in the hearing record.

Sincerely,



Enclosure

Chairman Greenspan submitted the following in response to a written question received from Senator Sarbanes in connection with the Joint Economic Committee hearing of April 17, 2002:

Current Account Deficit

An article published on Tuesday, April 16th, in the Wall Street Journal reported that, "The U.S. may not be nearly as big an international debtor as generally thought, because official data overstate how much it owes foreigners, a Federal Reserve study has found." Even if this is correct, it is fair to say that the U.S. external debt is extraordinarily large and growing.

Foreigners held $9.4 trillion in U.S. assets at the end of 2000 (the most recent official data). At the same time, Americans held $7.2 trillion in assets abroad. That left us with a net asset position of $2.2 trillion (market value) – 22 percent of our GDP. Even if the estimates made in the recent Fed study are correct, the net negative international position was still 16 percent of GDP and rising rapidly. In 2001, the U.S. ran another deficit of $417 billion in the current account, probably increasing U.S. external debt by another 4 percent of GDP.

With our imports running 35 percent larger than our exports, our exports must grow 35 percent faster than our imports just to keep the trade balance from widening. Trade economists tell us that, when U.S. income goes up 10 percent, our imports rise about 18 percent, but when income abroad rises 10 percent U.S. exports rise by only about 11 or 12 percent. The consensus of economists calls for U.S. growth to outpace foreign growth again this year.

All this points to the almost certain result that the trade deficit will resume going up again this year after a one year respite because of the recession.

Whether the official numbers or the Fed researchers numbers are correct about the level of our net asset position, the ratio of our net position to GDP is rising rapidly. How long does the Federal Reserve expect the current account to be roughly 4 percent or more of GDP? How much does the Federal Reserve expect the net asset to GDP ratio to rise over the next 5 years? Over the next 10 years? What are the conditions necessary to stabilize this deteriorating situation?

As noted in the question, our imports have exceeded our exports by a growing amount over the past several years resulting in a widening current account deficit. Our ongoing current account deficit is also, by definition, a measure of the portion of our net

investment in domestic plant and equipment that is financed with foreign funds, both debt and equity. The impressive productivity performance of the U.S. economy during this period has motivated global investors (both U.S. and foreign) to place their funds disproportionately in U.S. assets because of the expectation of higher returns on these relatively more productive assets. During the past six years, about 40 percent of the total increase in our capital stock in effect has been financed, on net, by saving from abroad

It is difficult to predict how long global investors will continue to place their funds disproportionately in U.S. assets. One cannot help but be impressed with how well productivity has held up in the face of the abrupt slowing of the economy in late 2000 and in 2001. While the recovery in spending on business fixed investment is likely to be only gradual, if the recent more-favorable economic developments gather momentum, uncertainties will diminish, risk premiums will fall, and the pace of capital investment embodying new technologies will increase. To this point, the United States has had little apparent difficulty in attracting funds from abroad. The fact that the foreign exchange value of the dollar has drifted higher, on balance, during the past few years suggests that incipient net private financial inflows are at least equal to the deficit on the current account. Private foreign purchases of U.S. securities alone have either met or exceeded the entire current account deficit during the past three years. In addition, foreign direct investment into the United States has swollen in recent years.

But the current account deficit, as you acknowledge, is also a measure of the increase in the level of net claims, primarily debt claims, that foreigners have on our assets. As the stock of such claims grows, an ever-larger flow of interest payments must