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THE ECONOMIC OUTLOOK

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BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

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JOINT ECONOMIC COMMITTEE

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THURSDAY, JUNE 9, 2005

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

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

Representatives Present: Representatives Saxton, English, Paul, Brady, McCotter, Maloney, Hinchey, Sanchez, and Cummings.

Senators Present: Senators Bennett, DeMint, and Reed.

Staff present: Chris Frenze; Colleen Healy; Bob Keleher; Brian Higginbotham; John Kachtik; Natasha Moore; Jeff Wrase; Chad Stone; Matt Solomon; and Nan Gibson.

OPENING STATEMENT OF HON. JIM SAXTON, CHAIRMAN, A U.S. REPRESENTATIVE FROM NEW JERSEY

Representative Saxton. Good morning. The hearing will come to order.

I am very pleased this morning to welcome Chairman Greenspan before the Joint Economic Committee. Chairman Greenspan's testimony will provide useful insights on the current economic expansion and the potential for further economic progress.

A broad array of standard economic data indicates that the economic expansion is on a solid footing. The U.S. economy grew 4 percent in 2004 and advanced at a 3.5 percent rate in the first quarter of 2005.

A rebound in business investment has played an important role in explaining the pickup of the economy since 2003. Equipment and software investment has also been strong over this period.

The improvement in economic growth is reflected in other economic figures as well. For example, over the last 4 months, 3.5 million jobs have been added to the business payrolls. The unemployment rate stands at 5.1 percent, consumer spending continues to grow, home ownership is at record highs and household net worth is also at a high level.

Meanwhile, inflation pressures appear to be contained. Interest rates remain at historically low levels with long-term interest rates, including mortgage rates, actually declining recently. This decline of long-term interest rates, even as the Fed is increasing short-term interest rates, is very unusual, a topic I would like to discuss later on.

In short, overall economic conditions remain positive. It is clear that an accomodative monetary policy and tax incentives for investment have made important contributions to the improvement of the economy in recent years. Recently released minutes from the Federal Reserve suggest that the central bank expects this economic trend to continue. As always, there are some aspects of the economy that should be monitored quite closely. There appears to be pressures in some local housing markets, but these are unlikely to pose a significant threat to the national economic expansion.

Also, quite importantly, the increase in oil prices has had an impact on certain sectors of the economy, but has not severely undermined overall economic growth. A consensus of Blue Chip forecasters projects that the economic expansion will continue through 2005 and 2006. This is consistent with Federal Reserve forecasts for economic growth through 2006.

In summary, the economic situation is solid and the outlook remains favorable. That is the good news.

At this point I would like to yield to the gentleman from Rhode Island, Senator Reed.

[The prepared statement of Hon. Jim Saxton appears in the Submissions for the Record on page 40.]

OPENING STATEMENT OF HON. JACK REED, RANKING MEMBER, A U.S. SENATOR FROM RHODE ISLAND

Senator Reed. Thank you, Chairman Saxton, and welcome, Chairman Greenspan, I want to thank you for coming here to testify today at a time when there are so many genuine puzzles about the direction of the American economy. Chairman Greenspan, you have been rather upbeat about the economic outlook and let me be the first to say that I hope you're right. However, I am concerned about what continues to be a disappointing economic recovery for the typical American worker. Economic insecurity for workers is widespread as a healthy job recovery is yet to take hold, wages are failing to keep pace with inflation, inequality is growing and private pensions are in jeopardy.

Job growth sputtered again last month when only 78,000 jobs were added, calling into question the strength of the labor market recovery. We still have not seen several consecutive months of solid job gains, which is disappointing 42 months into a recovery.

At this point in the last recovery, the economy had created over 4 million more jobs than we have seen in this recovery and we regularly saw gains of 200,000 to 300,000 and sometimes even 400,000 jobs per month. Employers don't seem to have enough confidence in this recovery to pick up their pace of hiring.

Of course the real disappointment in this recovery is how workers have been left out of the economic growth we have seen so far. Strong productivity growth has translated into higher profits for businesses, not more take-home pay for workers. Since the start of the economic recovery in late 2001, corporate profits from current production have risen by 67 percent. By contrast, employee compensation rose by only 17 percent. Since the economy started generating jobs in June of 2003, the average hourly earnings of production workers in non-farm industries have fallen by 1.4 percent after inflation.

The stagnation of earnings in the face of higher prices for food and medical care is squeezing the take-home pay of workers. I hope that the Federal Open Market Committee is paying close attention to the labor market as they set the direction of monetary policy. Workers have been short-changed so far in this recovery, and I believe that the economy should be able to accommodate some acceleration in wages to catch up to productivity growth without generating undue fears of inflation.

Any wage gains we have seen seem to be concentrated at the top of the earnings distribution while the largest losses are at the bottom. As *The New York Times* noted this week, the distribution of earnings has become so unequal that even the merely wealthy are being left behind in the dust by the small slice of super-rich Americans.

I know, Chairman Greenspan, that you have expressed concern about the widening inequality of income and earnings in the American economy. So this development cannot be encouraging to you.

Another troubling development is how unstable the private pension system is becoming. Data released this week by the Government's Pension Benefit Guaranty Corporation show that the country's 1,108 weakest pension plans had an aggregate shortfall of $353.7 billion at the end of last year, 27 percent more than the previous year. Meanwhile, the PBGC itself is underfunded.

Social Security does face long-term challenges, but at the moment it looks like the strongest leg of our retirement system. Rising national savings is the key to our economic growth, a good way to reduce our record trade deficit and, as your past testimony reflects, the best way to meet the fiscal challenges posed by the retirement of the baby boom generation. Unfortunately, the President's large Federal budget deficits are undermining national saving and leaving us increasingly hampered in our ability to deal with the host of challenges we face.

The President's policy priority for large tax cuts for those who are already well off and private retirement accounts that add to the debt and worsen Social Security solvency would take us in exactly the wrong direction for the future.

Finally, there are real questions about whether today's workers can look forward to a future of economic prosperity or one of continued risk and uncertainty about whether they will have good jobs and the means to provide a comfortable standard of living for their families. Indeed, it is a very real question in the mind of all the people I represent whether they will enjoy the same standard of living that their parents enjoyed before them or are enjoying at this moment, and for the first time in my lifetime there is serious concern that the quality of life—the standard of living in the United States will slip rather than progress forward.

Chairman Greenspan, I look forward to your testimony about the economic outlook and exploring some of these issues with you further in the questioning. Thank you, Mr. Chairman.

[The prepared statement of Hon. Jack Reed appears in the Submissions for the Record on page 50.]

Representative Saxton. Mr. Chairman, thank you again for being with us this morning, and we look forward to your testimony.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. Greenspan. Thank you very much, Mr. Chairman, Senator and Members of the Committee. I am pleased once again to appear before this Committee, as I have done for many a year.

Over the past year, the pace of economic activity in the United States has alternately paused and quickened. The most recent data support the view that the soft readings on the economy observed in the early spring were not presaging a more serious slowdown in the pace of activity. Consumer spending firmed again, and indicators of business investment became somewhat more upbeat. Nonetheless, policymakers confront many of the same imbalances and uncertainties that were apparent a year ago.

Our household savings rate remains negligible. Moreover, only modest, if any, progress is evident in addressing the challenges associated with the pending shift of the baby boom generation into retirement that will begin in a very few years. And although prices of imports have accelerated, we are at best in only the earliest stages of a stabilization of our current account deficit, a deficit that now exceeds 6 percent of U.S. Gross Domestic Product.

A major economic development over the past year has been the surge in the price of oil. Sharply higher prices of oil imports have diminished U.S. purchasing power. The value of petroleum imports rose from 1.4 percent of nominal GDP in the first quarter of 2004 to 1.8 percent in the first quarter of this year. The alternating bouts of rising and falling oil prices have doubtless been a significant contributor to the periods of deceleration and acceleration of U.S. economic activity over the past year.

Despite the uneven character of the expansion over the past year, the U.S. economy has done well, on net, by most measures. Real GDP has grown by 3.7 percent over that period, the unemployment rate has fallen to 5.1 percent and core personal consumption expenditures prices have risen a historically modest 1.6 percent.

But the growth of productivity, though respectable at 2.5 percent over the year ending in the first quarter, is far less than the extraordinary pace of 5.5 percent during 2003.

Excluding a large, but apparently transitory, surge in bonuses and the proceeds of stock option exercises late last year, overall hourly labor compensation has exhibited few signs of acceleration. Thus, the rise in underlying unit labor costs has been mainly the result of the slower growth of output per hour. At the same time, evidence of increased pricing power can be gleaned from the profit margins of non-financial businesses, which have continued to press higher even outside the energy sector. Whether that rise in unit costs will feed into the core price level or be absorbed by a fall in profit margins remains an open question.

Among the biggest surprises of the past year has been the pronounced decline in long-term interest rates in U.S. Treasury securities despite a 2 percentage point increase in the Federal funds rate. This is clearly without recent precedent. The yield on 10-year Treasury notes, currently at about 4 percent, is 80 basis points less than its level a year ago. Moreover, even after the recent backup in credit risk spreads, yields for both investment grade and less-

than-investment grade corporate bonds have declined even more than Treasuries over the same period.

The unusual behavior of long-term interest rates first became apparent almost a year ago. In May and June of last year market participants were behaving as expected. With a firming of monetary policy by the Federal Reserve widely expected, they built large short positions in long-term debt instruments in anticipation of the increase in bond yields that has been historically associated with a rising Federal funds rate. But by summer, pressures emerged in the marketplace that drove long-term rates back down. And in March of this year, market participants once again bid up long-term rates, but as occurred last year, forces came into play to make those increases short lived. There remains considerable conjecture amongst analysts as to the nature of those market forces.

That said, there can be little doubt that exceptionally low interest rates on 10-year Treasury notes, and hence on home mortgages, have been a major factor in the recent surge of home building and home turnover and especially in the steep climb in home prices. Although a bubbling in home prices for the Nation as a whole does not appear likely, there do appear to be at a minimum signs of froth in some local markets where home prices seem to have risen to unsustainable levels.

The housing market in the United States is quite heterogeneous, and it does not have the capacity to move excesses easily from one area to another. Instead, we have a collection of only loosely connected local markets. Thus, while investors can arbitrage the price of a commodity such as aluminum between Portland, Maine and Portland, Oregon, they cannot do that with home prices because they cannot move the houses. As a consequence, unlike the behavior of commodity prices, which varies little from place to place, the behavior of home prices varies widely across the Nation.

Speculation in homes is largely local, especially for owner-occupied residences. For homeowners to realize accumulated capital gains on a residence, a precondition of a speculative market, they must move. Another formidable barrier to emergence of speculative activity in housing markets is that home sales involve significant commissions and closing costs, which average in the neighborhood of 10 percent of the sales price. Where homeowner sales predominate, speculative turnover of homes is difficult.

But in recent years, the pace of turnover of existing homes has quickened. It appears that a substantial part of the acceleration in turnover reflects the purchase of second homes, either for investment or vacation purposes. Transactions in second homes of course are not restrained by the same forces that restrict the purchases or sales of primary residences. An individual can sell without having to move. This suggests that speculative activity may have had a greater role in generating the recent price increases than it has customarily had in the past.

The apparent froth in housing markets may have spilled over into mortgage markets. The dramatic increase in the prevalence of interest-only loans, as well as the introduction of other relatively exotic forms of adjustable rate mortgages, are developments of particular concern. To be sure, these financing vehicles have their appropriate uses. But to the extent that some households may be em-

ploying these instruments to purchase a home that would otherwise be unaffordable, their use is beginning to add to the pressures in the marketplace.

The U.S. economy has weathered such episodes before without experiencing significant declines in the national average level of home prices. In part, this is explained by an underlying uptrend in home prices. Because of the degree of customization of homes, it is difficult to achieve significant productivity gains in residential building despite the ongoing technological advances in other areas of our economy. As a result, productive gains in residential construction have lagged behind the average productivity increases in the United States for many decades. This shortfall has been one of the reasons that house prices have consistently outpaced the general price level for many decades.

Although we certainly cannot rule out home price declines, especially in some local markets, these declines, were they to occur, likely would not have substantial macro-economic implications. Nationwide banking and widespread securitization of mortgages make it less likely that financial intermediation would be impaired than was the case in prior episodes of regional house price corrections. Moreover, a substantial rise in bankruptcies would require a quite significant overall reduction in the national average housing price level because the vast majority of homeowners have built up substantial equity in their homes despite large home equity withdrawals in recent years financed by the mortgage market.

In conclusion, Mr. Chairman, despite some of the risks that I have highlighted, the U.S. economy seems to be on a reasonably firm footing and underlying inflation remains contained. Accordingly, the Federal Open Market Committee in its May meeting reaffirmed that it "believes that policy accommodations can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

Thank you very much. I look forward to your questions.

[The prepared statement of Hon. Alan Greenspan appears in the Submissions for the Record on page 52.]

Representative Saxton. Mr. Chairman, thank you very much for that very thorough statement. I would like to lead off with a question that relates to something that you mentioned early in your testimony, and that is the unusual set of circumstances that we see in the relationship between short-term and long-term interest rates.

Over the last year or so, the Fed has increased short-term interest rates by a quarter point 8 times. And long-term rates, as you pointed out in your testimony, have come down.

There is a chart displayed there that shows the increase in short-term rates and that historically during a period of time such as this, long-term rates would be expected to follow an upward path. However, as the blue line shows, that has not happened. In this case, and as a matter of fact I don't know what the Fed policy is going to be going forward, but if this trend continues those two lines could actually meet at some point. So I have essentially three questions.

In your opinion, what has caused this unusual set of circumstances in the relationship between short-term and long-term rates? Second, what do you think might be the potential effects of it on the economy going forward? Third, does this relationship suggest any negative impact on prices and in our ability to control inflation? Is there anything that from a policy point of view we should begin to look at to correct the situation, if in fact it needs to be corrected? And I would be interested in your thoughts on those questions.

Mr. Greenspan. Well, Mr. Chairman, with respect to your first question, as I have indicated previously in various commentaries, this particular configuration is unprecedented in recent experience. Indeed, it is even more exaggerated than it appears on the chart for a very important reason; namely, that the 10-year note which is I believe what you have plotted up there——

Representative Saxton. Is that correct?

Mr. Greenspan [continuing]. Is actually an average, both of long-term rates, meaning, say, a combination of 1-year maturities, 9 and 10 years out, and comparable 1-year short-term rates. If you average them out, you get the 10-year yield. But it means that when the Federal Reserve is raising the Federal funds rate, the short end of the market goes up, and the elements that go into the construction of the 10-year average automatically go up solely because the short-term rates have gone up, which means that the longer term rates—that is, say, from the 5-year maturities—the 1-year maturities 5 years out and longer, have actually gone down more. And if you actually plot those data it is the fastest decline that we have seen in that longer term set of patterns in many decades.

So something unusual is clearly at play here. We have concluded that it is not a U.S. phenomenon because all one needs to do is look abroad and you get very much the same patterns that we see here in the United States. So it is clearly of international origin. There are numbers of hypotheses, frankly all of which are credible to one degree or extent, which people have put forth to explain this. They run anywhere from that the world economy is slowing down to the fact that the degree of and pace of global integration is such as to open up very significant areas of educated, low-cost employment pools in China, India, and in the former Soviet Union. There are vast numbers of people who are skilled, educated, and have a very significant interest in working hard, and they have all come on the market at the same time and have had the effect, as best we can judge, in bringing the cost structure in the world down, which obviously would be reflected in inflation premiums in the low end of the market, which clearly have gone down. I might say both inflation premiums and the real risk premiums as well.

All of these in one way or another probably are part of the explanation. We don't know yet which are the really important ones and probably will not know except in retrospect. But it is a profoundly important phenomenon and really quite different from what one would expect. Its effect on the United States is very clear in the sense that, as I pointed out in my prepared remarks, mortgage rates are lower than they would ordinarily be in a regular cyclical pattern in the United States, and the consequence of that is we

have had a very strong housing market, as I am sure you are all aware.

But certain elements of froth are clearly developing in local markets as a consequence. The low long-term interest rates have also obviously affected other asset values, stock prices, and asset prices elsewhere and has undoubtedly been a factor in the expansion of the economy. How this will all turn out and how we integrate it into the basic underlying monetary policy structure is something we are spending a very considerable amount of time on, making certain we understand this process that is going on as best we can.

Obviously, as you point out in your third question, what may be quite critical here with these lower long-term rates than we ordinarily expect, is to be sure it isn't potentially engendering inflationary forces, and that is something which, needless to say, we are focusing on very extensively, endeavoring to get as much data as we can.

At the moment we are finding little evidence of inflationary pressures on the product side, but it is certainly the case that underlying unit labor costs are rising. There is some evidence, as I indicated in my prepared remarks, that passing through of costs has been easier, but in any event, the overall inflation rate does at this stage remain modest. But we will remain vigilant.

Representative Saxton. Thank you. Let me just follow up, Mr. Chairman. During this period of time when we have seen increased short-term rates and falling long-term rates, the economy, as you note in your statement, seems to be doing reasonably well. You note that the economy has done well on net by most measures as a matter of fact, and you cite standard data on GDP growth, unemployment, and inflation that reflect the ongoing economic expansion.

In addition, Fed projections of economic growth for 2005 and 2006 are generally consistent with the Blue Chip consensus, are they not?

Mr. Greenspan. I believe they are, Mr. Chairman.

Representative Saxton. And your statement also suggests that despite risks to the economic outlook, the economic expansion currently appears to be strong enough to absorb additional tightening of monetary policy without serious damage. Is this a reasonable reference to your remarks? Am I right in saying that?

Mr. Greenspan. I don't wish to go beyond the statements that the Federal Open Market Committee have agreed upon, and the way we have formulated it is basically the way I communicated in the very tail end of my prepared statement.

Representative Saxton. One final item and then we will turn to Senator Reed. In this morning's *Wall Street Journal* there is an article which credits past Fed policy for curbing the effects of the collapse of the stock market and the tech investment bubble in 2000. At the same time, the article suggests that an accommodative Fed policy has instead contributed to a housing bubble.

It seems to me that given the enormous shocks to the economy from the collapse of the stock market and technology bubbles in 2000, that the Fed did the right thing in relaxing monetary policy and in retrospect perhaps could have done that even sooner. The thrust of Fed policy seems to have averted what could have been

a much more serious economic fallout from the popping of the bubbles in 2000.

Looking back, do you believe that the Fed relaxation of monetary policy after the busting of the bubble in 2000 was the best course given the risky conditions at the time?

Mr. Greenspan. I do, Mr. Chairman. We couldn't draw that conclusion at the point we were implementing the policy, because we knew that what we were doing—that is, addressing the consequence of a very severe deflation of a bubble—carried with it potential side effects.

As best we can judge, things have turned out reasonably as we had expected, both positively and negatively. But in our judgment, the positive effects of the policy far exceeded the negative ones. And we decided at that time it was the appropriate policy to initiate, and while it is too soon to judge the final conclusions of how all of this comes out, I think that given the same facts under the same conditions we would have implemented the same policy.

Representative Saxton. I thank you very much, Mr. Chairman. Senator Reed.

Senator Reed. Thank you very much, Chairman Saxton, and thank you, Chairman Greenspan. Let me for a moment focus on several aspects of your testimony, first your very useful comments about the recent spike in employee compensation for the past two quarters. As I understand your testimony, this was attributable generally to a surge in bonuses and stock option exercises that are transitory, is that correct?

Mr. Greenspan. As best we can judge. We don't have actual official data. All we get are the data that are reported under the unemployment insurance system, which accounts for almost 100 percent coverage of wages and salaries. What we do not get is a breakdown in any form which tells us where it is. We have other data which gives us the level of employment by supervised workers and non-supervisory workers and payroll data for non-supervisory workers, so we can infer certain things. And as you pointed out in your earlier remarks, there really is a very substantial difference in the labor market where the 80 percent of the non-supervisory workers' wage increases have been relatively modest, and indeed if you deflate by the Consumer Price Index it is actually negative. I don't like the Consumer Price Index, but you do you get the numbers you are suggesting. What happens, however, is that the 20 percent, which is an issue of the supervisory, skilled and other workers, is reflecting a problem which we have discussed in the past; namely, we have a very significant divergence in our labor market which has consequences we need to address soon rather than later.

Senator Reed. As a follow-up point, Mr. Chairman, so wage compensation is not a significant factor in driving inflation, as you pointed out. If you use the Consumer Price Index deflator it is almost negative. Is that a fair statement?

Mr. Greenspan. That would not be true if you included 100 percent of workers. In other words, wages and salaries per hour overall, even excluding bonuses and stock option realizations, are rising at a reasonably good clip, because the rate of increase in the super-

visory, skilled worker categories is far faster than the numbers you were quoting.

Senator Reed. But essentially what we are seeing, I think unfortunately, is a divergence between highly-skilled, highly-compensated individuals and the rest of the work force. And we have had this discussion before, and I know we all like to think about the better education and better training, et cetera, but in the short run, in the immediate run, what policy options should we pursue to enhance the incomes of most of the workers of America?

Mr. Greenspan. Well, Senator, I don't think there are short-term policies other than the ones we typically use to assuage those who fall into unemployment or policies in the tax area which we endeavor to redistribute income.

The basic problem, as we have discussed previously, as best I can judge, goes back to the education system. We do not seem to be pushing through our schools our student body at a sufficiently quick rate to create a sufficient supply of skilled workers to meet the ever-rising demand for skilled workers, which means that wage rates are accelerating. But the very people who have not been able to move up into the education categories where they become skilled overload the lesser skilled market and cause wages to be moving up, well below average. The consequence, of course, is a divergence and an increased concentration of income.

And as I have often said, this is not the type of thing which a democratic society, a capitalist democratic society can really accept without addressing, and as far as I am concerned the cause is very largely education. It is not the children, because at the 4th grade they are above world average. Whatever it is we do between the 4th grade and the 12th grade is obviously not as good as what our competitors abroad do because we, our children, fall below, well below, the median in the world, which suggests we have to do something to prevent that from happening. And I suspect were we able to do that we will indeed move children through high school and into college and beyond in adequate numbers, as indeed we did in the early post-World War II period, such that we do not get the divergence in income which is so pronounced in the data we currently look at.

Senator Reed. I have other questions, but this argument can be looked at from a different perspective. Back in the 1950s and the 1960s, we had jobs that were producing incomes for families. We had college education costs which were reasonable. We had in some respects better access to health care at more affordable prices so that families could, in fact, save and provide for their children in a way that they can't do today.

But let me move forward. This is a debate that will go forth, I think, further.

You mentioned in response to Chairman Saxton's question this conundrum about interest rates, the yield curve, short-term and long-term rates. But there are some that might see the lack of movement in the long-term rates as a justification for deficits; i.e., deficits don't make a difference, but I think, Mr. Chairman, you have also insisted that deficits do make a difference ultimately for interest rates. Is that true?

Mr. Greenspan. It is, Senator.

Senator Reed. And essentially we have choices before us with respect to these budget deficits. They will, if we don't respond to them, continue to impair national savings and thus our ability to invest in the economy. Is that correct also?

Mr. Greenspan. I believe so.

Senator Reed. And it seems to me at a time where we have to deal with the interest rates to further compound our problems by further reducing taxes, such as the estate tax, would be exactly the wrong direction to pursue. What is your view, Mr. Chairman?

Mr. Greenspan. Well, all I can say is that I have argued before the relevant committees that fiscal policy as it moves into the early part of the next decade is going to run into very severe problems unless we restore PAYGO and other means of restraint on the system. And so I don't want to get involved in any particular policy configurations, but I do think that we have to recognize that something very unusual is about to happen to this country in that we are going to get a huge exodus from the labor force. And remember, the baby boom generation was followed by the baby bust generation, which means that we have relatively fewer workers, on average, ever increasingly as we move into the next decade and beyond to produce the goods and services required, not only for the workers and their families, but for the huge increase in retirees. So we have a very important task out there of creating a level of savings and investment which will make sure that the replacement rate in real terms of retirees enables them to maintain a reasonably adequate standard of living without encroaching on the growth in standard of living of the American work force.

Senator Reed. Just a final point, Mr. Chairman. It seems that we have positioned ourselves adversely to deal with that challenge as we have gone from a surplus to a significant deficit, and that the proposal of the Administration is to further exacerbate the deficit by tax policies. Again that *New York Times* article to me was extraordinarily revealing. It has been estimated that if the President's tax cuts are made permanent, Americans making between $100,000 and $200,000, the new middle class in America if you will, will be paying 5 to 9 percent more in taxes than those making over $1,000,000 a year. That doesn't seem to me to be either good economic policy or good social policy.

Mr. Greenspan. Well, Senator——

Senator Reed. We have to deal with these issues.

Mr. Greenspan. I don't want to comment on individual policies. I have stated before to you—and other committees, on occasion—that I do think that there are parts of the existing recent tax changes, especially with respect to eliminating part of the double taxation of dividends, which I think enhance economic growth, enhance the tax base and increase tax revenues. And that is good economic policy. Having said that, I would argue that all tax and all spending policy should be under PAYGO, which therefore makes them, theoretically at least, hopefully deficit neutral.

Senator Reed. Thank you, Mr. Chairman.

Representative Saxton. I would like to thank Senator Reed for asking the question about the educational component. I think that is extremely important, and I am going to ask my staff to perhaps get with your staff, Mr. Chairman, to explore the details of the

studies that you have referred to, and I thank you for your input on that.

Now that the Ranking Member has completed his questions, we are going to move to Senator Bennett and, as we do, we are going to implement the 5-minute rule in the interest of making sure that all Members have an opportunity to ask questions as well.

Senator Bennett.

Senator Bennett. Thank you, Mr. Chairman.

Chairman Greenspan, I agree with you that we don't really know what is behind the anomaly indicated by the chart that the Chairman put up and there are a number of theories.

I want to suggest another one to you, because I know you believe in the power of markets, that markets send us messages, that many times those of us who are policymakers want to ignore and think we are smarter than the markets. The market is saying something interesting here, and I have heard the various explanations. The one that I want you to consider and perhaps comment on, maybe the markets are being very complimentary to you and the Open Market Committee by saying: we like the way you are handling the challenge of inflation and we like the measured pace, to use your phrase, with which you have adopted the overnight rate increases. And the reason the long-term rates are as low as they are is because we have confidence that inflation is under control.

If that is indeed what the combined wisdom of the market is saying here, it might suggest that when you got to 3.5 in June you stop. Or August, I guess, would be the time that the anticipation is. I know you are far too cagey to respond to the number here because the television cameras are running, but would you comment on the idea that there may be a different kind of message here coming from the marketplace in terms of the way the interest rates are reacting to what the Fed is doing and talking about where you think the ideal overnight rate should be, whether 3 percent, 5 percent, 4 percent, something of that kind in an ideal set of economic circumstances, the target that you could live with?

Mr. Greenspan. Well, Senator, I have commented that it is very difficult to know where that so-called neutral rate is, but we probably will know it when we are there, because we will observe a certain degree of balance which we had not perceived before, which would suggest to us that we are very close to where that rate is. We don't have the statistical ability to forecast where it is or to judge it other than being in place at a certain time and looking at what the specific events are, because that means we don't have to forecast what happens, we just can observe. But if you have to forecast and then observe, it makes it exceptionally difficult.

On the broader question of whether it is a Fed correction or, as it is more generally stated, credibility of central banks throughout the world, we obviously would like to believe it, but the problem with it is, it doesn't give us any information that is useful to us. In other words, if we said that is true, it doesn't tell us what to do. And so, that is for others to judge. My own suspicion is there is less there than meets the eye. But even if I am mistaken on it, it does not help in knowing what to do next.

Senator Bennett. I accept that. My only comment would be that this anomaly, this extraordinary circumstance, might suggest that the golden mean, if I can use that term, is lower than we may have thought in the previous analysis with respect to this.

I would like to focus on one other issue, and that is long-term savings. The savings rate in this country, as you have told us and as we recognized, is lower than it ought to be. That has entered into the debate with respect to how we might deal with the Social Security crisis that we are facing. I agree with you that we are going to have an extraordinary, indeed unprecedented, historical event in the next 20 years. The percentage of Americans of retirement age is going to double in a 20-year period. It has also gone up in an incremental fashion, but it is going to go up in a very sharp upward fashion that has never happened before.

What can we do to stimulate increased savings? Well, I have some suggestions as to what we could do to stimulate increased savings, and one of them is a form of payroll deduction separate and apart from the payroll deduction that goes into Social Security, called the Save For Tomorrow accounts. I think you may be familiar with those.

Have you any feel, or any opinion, as to what would happen if there was a more formal kind of payroll deduction across the economy aimed at increased personal savings? And if that was successful, Save For Tomorrow has been successful in the firms that have used it. If that was successful across the economy would that have a beneficial effect if we saw the savings rate of everybody start to go up?

Mr. Greenspan. Well, Senator, the only new evidence we have, if I can put it that way, with respect to savings concerns the suggestion that if right now an employee has to opt in on a 401(k), for example, there is some evidence to suggest that if the 401(k) is automatic unless the employee opts out, that we may find that there is a significantly larger amount of savings that is being created.

Senator Bennett. That is an aspect of the Save For Tomorrow account.

Mr. Greenspan. Yes, I understand that, so there is some evidence to suggest that there is something valid in that general proposition. I am a little gun-shy on the issue of inducing savings in this country because I have seen just too many vehicles promising to do something important, and as you know we have ended up with a very low savings rate.

So it is clearly the market that is generating the vast amount of the savings flows, the expansion and contraction, and I am reasonably certain that if we get a significant increase in savings, in household savings for example, it is more likely to be reflective of a slowdown in the rate of mortgage increases rather than any of the other variables that we are using. But I would say that anything which does promise to increase savings is a very worthwhile endeavor because, as I said before, the slow growth that is implicit in the labor force starting 2006, 2010, and thereafter, if it is going to produce enough goods to meet all the retirees' needs as well as those of workers themselves, has got to have a significant pickup in output per hour growth. And that historically has been associ-

ated with increased capital investment, which in turn requires mainly domestic savings to finance it since we cannot count indefinitely on foreign savings doing that.

Therefore, anything which increases domestic savings has a double effect in one respect on the longer term outlook, because it will displace the potential loss of foreign savings and contribute to a level of savings that will be required to maintain a viable society with a very large number of retirees.

Representative Saxton. Senator Bennett, thank you for bringing up that extremely important subject of savings. It is something that is on all of our mind, and thank you for bringing that up.

Mrs. Maloney.

Representative Maloney. Thank you, Mr. Chairman, Ranking Member, and welcome, Mr. Greenspan. As you indicated in your testimony, the American economy is resilient and I expect that we will continue to experience a cyclical recovery in the economy. But I did not hear much in your statement about the longer run imbalances associated with our failure to address the problem with the large Federal deficits, the largest trade deficit in our history and the largest debt ever in our history, over $7.6 trillion, and like Senator Bennett, I am concerned about our national savings. And, as you both indicated, our national savings is quite low as a share of our national income. And aren't large Federal budget deficits one of the main reasons why?

Mr. Greenspan. They are, Congresswoman.

Representative Maloney. We are financing an increasing share of our net national investment with foreign borrowing rather than our own saving, and as you indicate we can only depend on our own domestic savings and not on more foreign borrowing, but aren't we financing an increasing share of our net national investment with foreign borrowing rather than our own saving?

Mr. Greenspan. Well, the significant increase in foreign borrowing or, to be more exact, the significant increase in the amount of financing of our domestic consumption that is coming from abroad, a very considerable amount of it is not debt, but when it is not United States debt, when it is not the United States that is borrowing, it is foreigners who want to invest here. So it is a mixed issue, but however you look at it, it is not something on which we can depend indefinitely.

Indeed, our net debt on foreign income is rising quite significantly year after year and the service cost, that is of course quite substantial. So we can't count on that going on indefinitely and if we are going to cite the level of capital stock that is necessary to meet the requirement of, say, 2020, 2030, we are going to have to get a much higher level of savings than we have and in the process we are going to have to create capital assets which induce a very significant rise in productivity growth.

Representative Maloney. Doesn't that mean, this increasing share of net national investment with foreign money—doesn't that mean that most of the benefits from that investment will accrue to our foreign creditors rather than increasing standards of living here in the United States for our citizens?

Mr. Greenspan. Congresswoman, it will depend wholly on what, of course, are net claims on U.S. residents, because obviously to the

extent that we borrow or even get equity capital from abroad, we have got to pay the servicing costs of that. When you have a very large net foreign debt, a significant amount of domestic production is essentially owned by foreigners. Indeed the income from production goes abroad and is not available to domestic residents of the United States, so that the issue is essentially what is the level of net claims against U.S. residents as a share of GDP, that being the best measure, as I can see, to measure the type of problem you are raising.

Representative Maloney. Can you talk with the Committee about what would happen to interest rates and investment if foreigners were no longer willing to accept our IOUs?

Mr. Greenspan. Well, I don't think that is going to be an issue anywhere of significance, because there is always a question, what do they do with their other resources? But having said that, we at the Federal Reserve have looked at a very special part of that problem, which is the large accumulation of U.S. Treasury issues in foreign accounts.

What we have concluded is that because of the extraordinary depth of the U.S. Treasury market, even as large as the holdings are of those abroad, their impact on the Treasury interest rate level is still rather modest. The reason why is that U.S. Treasuries complete with a huge block of other debt instruments throughout the world—both dollar dominated instruments, and of course a very large block of foreign currency denominated issues.

As a consequence, even were the net accretion of U.S. Treasuries on foreign accounts to cease, its impact, I think, would be evident, but not serious.

Representative Saxton. I thank the gentlelady for the questions.

We will move now to Senator DeMint.

Senator DeMint. Thank you, Mr. Chairman.

Thank you, Mr. Chairman for being here today. I appreciate very much the confidence that your steady hand has given to our economy over many years.

Today you have described a short-term economic situation as steady, as sound. But reading between the lines, and I think about what you have said about a long-term scenario, I think if we contemplated that for a few moments, it seems very alarming.

You have described a situation in which over the next 10 or 20 years, we will have the largest decrease in workforce and increase in retirement that we have ever faced as a Nation. You have also said at the same time that the workforce that we are leaving behind is well below an ability to compete in the international market as we are training them today.

As I look at where we are headed, it seems very close to Europe; a little older society, moving toward heavy social benefits, raising taxes to pay for it; a real burden on the economy. I mean, is it fair to say that there should be a greater sense of urgency on this panel and in Congress in dealing with our education situation, our entitlements?

With this massive change in front of us, it seems to me there should be a greater sense of urgency on how to deal with this and avoid the situation that many European nations are in. I know that

is a very broad question to answer, but if you could give us any direction there, I would appreciate it.

Mr. Greenspan. As I have testified previously, before a number of committees in the House and the Senate, as best I can judge, especially with respect to Medicare, because of the huge prospective increase in the number of beneficiaries, which will invariably occur and our inability to have any real particular judgment of what the trend in healthcare per beneficiary is going to be in the years out into the future, there is a not insignificant probability that we have already committed under existing law and presumed demographics far more in real resources than we can actually deliver without significantly undermining the very base of the economic system.

I think that unless we start to address this issue sooner rather than later, the markets will force it on us, and that is usually an unhappy circumstance. So I think that the extent of entitlements that have been created in the system have not been properly evaluated with respect to whether, in fact, the implicit real resources, which those commitments require, fit into a reasonable expectation of what the structure of the American economy is able to produce, especially as you put it in the context of a labor force, which may not have the skills that are required to create a level of goods and services output that will be necessary to maintain reasonable standards of living, not only of the working population, but of this huge increase in retirees.

Senator DeMint. Thank you.

Representative Saxton. Thank you.

Mr. Hinchey.

Representative Hinchey. Mr. Chairman, thank you very much. Good morning, Chairman Greenspan, it is a pleasure to see you and thank you for being here. I just wanted to make an observation about the baby boom generation and the retirement of that baby boom generation and the maintenance of those programs. It seems to me that there are more children in secondary schools in America today than ever before in history.

Our job is to create and maintain fiscal and monetary policies that are going to insure that when they get out into the workforce, they will have an abundance of good-paying jobs in order for programs like Social Security and Medicare to be sustained. That is really what our job is, isn't it, Mr. Chairman?

Mr. Greenspan. I would say that if we all are successful in doing that, it is a job well done.

Representative Hinchey. You pointed out in your testimony and in your response to questions that we are at a moment of conflicting economic circumstances, kind of a convergence of those conflicting circumstances. Since June, the Central Bank has reduced short-term interest rates by 2 points.

Mr. Greenspan. Increased.

Representative Hinchey. Increased, rather, right. Thank you. Increased short-term interest rates by 2 points, but at the same time, the 10-year Federal Reserve bond has gone down by roughly about 80 basis points, now, under 4 percent.

So the economic and financial world, as you pointed out, I think very, very correctly, is indeed changing. My question is, does the unusual behavior of the global bond market signal economic weak-

ness, because that is what we are hearing from other predictors, from Wall Street, particularly?

Mr. Greenspan. Well, it is one of the possible hypotheses. There is no question that growth is slowing in a goodly part of the world. But this has been a characteristic of the world economy ever since we started to seriously proceed toward advanced globalization, which is what I would say occurs when you begin to get not only trade imports and exports, expanding relative to the GDP which has been occurring for the last 50 years, but, more importantly, in addition, get savers willing to reach beyond their natural borders to invest abroad, which is a phenomenon which has arisen in a material way only in the past decade.

What that has done is to alter the way the world's economy functions. In so doing, I think we are getting a goodly part of backing and filling and adjustments of all sorts in which you find that instead of the economy going very smoothly forward, it goes in little cycles.

Hence it is often misread as though we are about to tilt into a recession. I think in that respect, it is important to try to cut through some of this. If that is the case, then the hypothesis that it is a weak world economy, which has been driving down long-term interest rates, is probably not correct. Indeed, it can't explain the fact that rates were going down in 2004 when we had the fastest growth worldwide in a very long period of time.

The idea of weakness—there is a certain credible ring to it. But when you begin to look at the details of the argument, it becomes less persuasive.

Representative Saxton. Mr. Hinchey, thank you very much for the questions.

We are going to move now to Mr. Paul.

Representative Paul. Thank you, Mr. Chairman.

Mr. Greenspan, I have a short question, hopefully, and then a follow-up. You talked frequently about the conundrum that was mentioned already today about the interest rates not being as low as one would anticipate. I am wondering why this is such a conundrum in the sense that this could well represent just the flattening of a yield curve, which is well-known and established and generally presages a recession, and the fact that you have mentioned that this is different in that it is worldwide. Could this not be a bad omen, that it is just a flattening of a yield curve and presages a coming recession?

Mr. Greenspan. Well, the flattening of the yield curves which get engendered as a consequence of ever-tightening monetary policy are usually in the context of rising short-term rates and rising long-term rates.

Most importantly, in the context of where they are perceived to be precursors of economic decline, it essentially commercial banks, which are the main forces of intermediation in the economy. Because obviously, if short-term rates are rising and long-term rates are holding steady or falling, and because the maturity of annual bank assets is somewhat longer than the maturity of their liabilities, if you raise short-term interest rates and lower long-term interest rates, you get a squeeze in the commercial banking system

and a pulling back of loans, which has usually been in the past a precursor of a significant decline in economic activity.

Representative Paul. Thank you. My second question has to do with debt. You have frequently talked about us having too much debt and too many deficits here in the Congress. But I am really concerned about it when you look at the unfunded liabilities of Medicare, the problems we face with Social Security, and now we have evidence that our private pension funds backed up by the U.S. Government probably have the characteristics of a Ponzi scheme similar to Social Security and that their reporting requirements have not required that they report their true assets, but just their cash-flow.

But we have a current deficit which you talk about frequently, and also a foreign debt that is into the trillions of dollars. I just wonder if we might not be fooling ourselves about our prosperity. Because if I could borrow a lot of money, if I could borrow $1 million every year, I would have pretty good prosperity and eventually it would come to an end.

So a Nation probably has an end point as well. I think this has been magnified by the fact that the efficiency of the central banker, which you have explained that you have gotten fiat money to act as if it is gold, and in some ways, I think that is true, that people do accept our money, and that this encourages us to have more deficit, it encourages us to buy more than we pay for, buy more than we save, and contribute to the current account deficit.

So it is the combination of the monetary system and the acceptance of our money that has contributed this huge debt. But most people say, most economists recognize that there is a limit to how far we can go on the accumulation of this debt.

It is almost a Catch 22. The more efficient we are in convincing the world to take our money, the worse the problem gets, and the bigger the bubble. Instead of borrowing that money to build our manufacturing base, which we are not, everybody knows that is dwindling, we are using it for consumption. So why is it that we should be reassured that our prosperity is sound and we don't have to worry about paying this debt back?

Mr. Greenspan. Well, I think we have learned very early-on in economic history that debt in modest quantities does enhance the rate of growth of an economy and does create higher standards of living, but in excess, creates very serious problems.

First of all, I would think that one way to address the question you are raising with respect to unfunded liabilities is that we need to do a good deal more of accrual accounting in the Federal Government, which will automatically pick that up and get a realistic size of what we are dealing with. But there is no question that the amount of debt that is out there has to be serviced, and so that debt per se can not grow indefinitely.

But if we can grow indefinitely and sustainably, if we assure a means of servicing that debt, which is essentially what we try to do, but we may not be doing it as well as we should and have in the past, we have not always done it well.

Let me just make one final remark, because I didn't want to leave the implication with respect to the yield curve as though I

am concerned that the potential tilting of the yield curve is precursing a significant economic weakness.

What is different, in the past when commercial banking was our key form of financial intermediation, is we have created many more means of intermediation, so that even if the commercial banks pull away, as they did indeed in the very early 1990s, like 1990–1991, we have alternate means of financing. Indeed, with the increase of technologies and the broader globalization, I would hesitate to read into an actual downward tilt of the yield curve as meaning necessarily what it invariably meant 30, 40 years ago.

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

We are going to return to Mr. Hinchey. I think I may have shorted him on his time. Mr. Hinchey. You are recognized for 2 additional minutes.

Representative Hinchey. Well, thank you very much, Mr. Chairman.

Mr. Greenspan, I think you are absolutely correct, a modest amount or reasonable amount of debt carefully applied and intelligently invested does lead to strong growth.

But the question is, how can it be carefully applied and intelligently invested? I think that part of the Federal debt that we hold, which is approaching $8 trillion, is neither of those things.

You said a few moments ago that you continue to support the President's tax cuts. But the President's tax cuts have not only contributed to the huge debt and the annual budget deficits that we are experiencing, but they are also making it very difficult for us to meet other obligations.

In your testimony and in response to questions, you emphasized the importance of education and we all, I am sure, agree with you on that. If we are going to be competitive in the future, we have to have the best educational system training the best people in the world.

But because of this debt and because of these huge budget deficits, the Federal Government is defunding education, all across the board, and that is particularly true of higher education, making it much more expensive and much more difficult for people to go to college. The cutbacks in Medicare and Medicaid are causing problems for local and State governments, thereby causing them to raise the price of education. In my State, for example, the Governor has increased the cost of public education at the New York State University system by enormous amounts over the course of the last several years.

Aren't we in some kind of a conflict here that we need to resolve? Do you still support the tax cuts and do you believe that those tax cuts should be made permanent?

Mr. Greenspan. Mr. Hinchey, I have said on numerous occasions that I support the tax cuts in the context of PAYGO. I support a lot of programs directly and indirectly, but only if they don't affect the deficit. The only way that is true is if they are passed under PAYGO.

Now the problem is that I—and I suspect all—the Members of Congress who have a vote, which I don't have, have a lot of priorities. There is a physical amount of resources which is available to make them real. We have to choose between a whole series of

things we all perceive to be of value. Indeed, numbers of bills that have come up in the Congress would not have come up if a large number of the House or the Senate didn't believe it was a worthy cause. But if you put them all together, it is very obvious that you have a large number of worthy causes, but not enough resources to meet them.

Representative Hinchey. But we have cut our resources, we have cut our resources dramatically, and this Government has abandoned PAYGO. Since the Government has abandoned PAYGO, should we make the tax cuts permanent?

Mr. Greenspan. All I will say is I will repeat what I have said. I have always approved of and have always made fiscal policy choices and recommendations only in the context of PAYGO.

Representative Saxton. Thank you very much, Mr. Chairman. We are now going to move to Ms. Sanchez.

Representative Sanchez. Thank you very much, Mr. Chairman, thank you very much for being here today. I am a Blue Dog Democrat. As you know, one of our policies is to try to institute PAYGO as much as possible here in the Congress. You know, I live my life under PAYGO, I have only one outstanding loan and that would be a mortgage.

I don't owe anybody any money—and I think that is a good way. I think the biggest problem that the United States has is a large debt and a large deficit situation going on, a structural problem that is going to be very difficult to get ourselves out of. So I have a question with respect to PAYGO, because you keep coming back to it. I think we should switch to PAYGO.

I mean, if you were in Congress, what sort of—how would you get to PAYGO? We have entitlements. We had a Medicare part D plan that was passed that was supposed to be $400 billion over 10 years. It is $1 trillion and growing, who knows how that is going? We had tax cuts, which the President's own comptroller said that the tax cuts are responsible for 70 percent of the deficit that is going on. What that means is there is less revenue coming in.

Some had thought if we did tax cuts somehow we would get more revenue, because people would invest more—and it doesn't seem like that really happened. We have defense spending going up, $1.5 billion a week in Iraq alone. You know, we don't know how long we are going to be there.

Then we have discretionary spending, education, transportation, research, healthcare. You know I like to spend on investment. I took out loans to go to college, as did the rest of my family members. I think that is a good place, if you are going to be spending.

You are concerned about the haves and have-not problem and the gap growing wider. You are concerned about education, as you told us. Yet the President's policies have been to cut Head Start, to shortchange No Child Left Behind by $9 billion, to cut funds at the community college level, to cut student loans.

Where would you go to PAYGO? What would you do? What tax cuts would you keep—I know you don't like to get into individual policies. But, you know, when you say you have got to get back to PAYGO Congress, what do you mean by that?

Mr. Greenspan. Well, let me try to be as explicit as I dare.

We have passed a large number of bills on the outlay side, and we have instituted a tax structure on the receipt side. They don't balance. But it is very clear that a majority of both Houses and the President of the United States, whoever it was at the particular time, thought that all of these items on both sides of the ledger were things that were of value to the American people, but that some of them are not possible, which means that choices must be made between very goods and only lesser goods.

In other words, what is missing in the process is choosing between things that people think are of value. I have seen very little in the way of interest in curtailing anything. There is a constituency out there for tax cuts. There is a constituency out there for expenditure increases, and very little constituency for balancing the budget—although I must say the Blue Dogs come as close as any part of the Congress to being in that particular area.

But as I recall, when I first came to Washington in the 1970s, there was at least an awareness that balancing the budget was a critical issue. Indeed, we have carried out of the 1974 Act, from which PAYGO—actually, PAYGO comes out of the combination of the 1974 and the 1990 Acts. But we constructed a system which essentially seemed to work. We have abandoned it, and I think that we have got to find a way to construct a system which enforces the issue of choosing between A and B.

Right now, everybody wants A and B. Unless you repeal the laws of arithmetic, it won't work.

Representative Sanchez. Let me ask you another question. This is with respect to housing, because I represent Orange County, California, probably the hottest housing market right now, where the mean value of a resale 1,500-square-foot 40-year-old home is running about $600,000.

You say in your testimony that you do not think—you say these declines, were they to occur, would not likely have substantial macro-economic implications. You are talking about maybe a decline in housing in certain markets.

You know, when I look at what is going on in Orange County, I see interest-rate only loans, lots of them. I see ARMs that people are just beginning to understand are going to choke them in the next year or two. I see a lot of people who took equity out of homes that grew with the housing boom, but which they are not—if housing stops—they are not going to be able to recover out of that.

How can you say, when the brightest spot in the economy has been housing and refinance, how can you say that you don't believe that if there is a slowdown, even in some of these markets, that it will have substantial macro—it will not have substantial macro-economic implications?

Mr. Greenspan. It really gets to the question of what I mean by "substantial." Clearly, if you get a flattening out of prices, not even a decline, and you gradually reduce the realized capital gains and the unrealized capital gains on homes, equity extraction, which is a very significant contributor to personal consumption expenditures, will go down. I have no doubt that as this boom begins to basically diffuse, we will see the rate of increase in mortgage debt largely driven by equity extraction, slow down.

Since a significant part of personal consumption expenditures—and I might say home modernization—are financed by equity extraction, one would presume one will also be observing a slowing in consumption expenditures. Higher savings, but slower economic growth, at least as far as the consumer is concerned.

The reason I don't suspect that there will be substantial macro-economic effects is that I envisage, as it is occurring, capital investment will begin to take up the slack and growth will continue to a greater or lesser extent.

So I am really not saying that it has no local effect. I mean, remember what happened to Silicon Valley, which is just up the State from you. It had a really severe local effect. But it was not a national macro-economic effect.

What I was referring to was basically not that it would have no effect, but I don't perceive it on net to be a major macro-economic effect.

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

We will go now to Mr. Brady.

Representative Brady. Thank you, Mr. Chairman, I thank Chairman Greenspan. I would like to ask two questions related to the deficit, one trade and one our Federal financial deficit. You have spoken frequently about the growing role of international trade in the U.S. economy, about the savings to consumers, the opportunity to raise the standards of living, and a repeated note of caution about the trade deficit.

We have a relatively open economy, yet we find when our companies try to compete around the world, we often run into strong tariff barriers and non-tariff barriers around the world. How important is it that we pursue a trade agenda and trade agreements, like with Central America, that lower those trade barriers for U.S. producers of goods and services?

Mr. Greenspan. Congressman, I think it is exceptionally important. The major reason is that a very substantial amount of American prosperity is the consequence of an opening up of the world trading system over the last 50 years. Everybody has benefited from the increasing globalization, net—and I mean net. I do not deny that as you get globalization and the churn of the economy, there are winners and losers. But the number of winners are far in excess of the number of losers. The resources that are created in the process can help take care of those who are on the wrong side of the tradeoff.

However, a very major part of our current standard of living rests on our position in the global markets. If we start to retreat from that, I think we will find that we are very significantly impaired with respect to living standards. Competition is not something anybody likes.

I didn't like it when I was in the business community. I thought my competitors were always unfair, and I wished they would go elsewhere. But at the end of the day, I realized that they made me work harder, do better and be more successful. It is a tough thing to think in terms of, but that is what our problem is.

The facts are, the more we liberalize trade, the more we expand it, the higher are our standards of living. While we might prefer

to be quiescent and not engage in so much competition, we can do that. But there is a cost. That cost could be very significant.

Representative Brady. Thank you, Chairman. I will just thank you. That was very revealing.

On our Federal deficit, I am convinced after 9 years in Congress, if Congress were a manufacturing plant, we would manufacture spending, that is what we are good at doing. If we want to manufacture savings and efficiency, we have to retool the plant, change the process that we go about reaching our budget each year and controlling spending.

In the past you have supported a sunset process where at the Federal level we require agencies and programs to justify their existence or face consolidation, streamlining or, in some cases, elimination—the goal being to eliminate the duplication of services, to eliminate obsolete agencies, to find a more thoughtful way really of getting the bang for the buck up here.

Do you still support a sunset mechanism of some type, as a tool, one tool, to help reach that efficiency?

Mr. Greenspan. I certainly do, Congressman. One of the reasons is, as you point out, it is exceptionally effective mechanism to force a review of an ongoing program, whether it is an entitlement or any other form of program. I think we would find, that even though there is a general, conventional wisdom, that this country is extraordinarily split 50/50, we would find that the vast majority of programs that are now on the books would very readily be renewed without any question.

But enough of them would not be, and that could create fairly considerable avenues of budget savings which we don't seem to be able to create these days. As you say, it is only one tool. I mean, there are triggers, there are sunsets, there are a variety of other things, along with PAYGO, which, as far as budget process is concerned, I think would give us a far more sensible structure. But I have always envisaged sunset as being the crucial issue because every agency, every program should be reviewed.

Another Member of your Committee, Senator Sarbanes, many years ago, asked me when I was raising this issue, does that include the Federal Reserve? I said absolutely, Senator. If we cannot convince the Congress that we should still be here, we shouldn't be.

Representative Brady. Thank you, Chairman, very much. Thank you, Chairman Saxton.

Representative Saxton. Thank you. We will move now to my friend, Mr. Cummings.

Representative Cummings. Thank you, Mr. Chairman.

Chairman Greenspan, you know they say that when you speak, to paraphrase the investment commercial, everybody listens. I am hoping that they listen to some of the most powerful words I have heard from you. Those were your comments on education and how important education is and how we need to bring our children and our young people up so that they can take on these jobs that you talked about.

I am just wondering, if we have a situation where in many parts of our country where 50 percent, sometimes as much as 60 percent, of young people are dropping out of school, then you have a number of students who will get a diploma, but can barely read the diploma

itself. Even though we may—let us assume that the things that we are doing now to try to help these young people become all that God meant for them to be, taking into account all that you said about the people retiring and the problems that we have with our public education system, looking into your crystal ball—what do you see for our future?

In other words, you are talking about something that is going to take a little while to reverse, I mean, to get back on track. So those kids who may be in the—we saw in the State of Maryland some good great developments with our recent test scores. But we are talking about kids in elementary school.

So I am just wondering what do you see?

Mr. Greenspan. Well, I wish my crystal ball were as clear as I would like it to be. But let me just put a little perspective on this issue. I have been dealing on a day-by-day basis with the American economy and the American institution since 1948.

Every decade or so we look forward and it looks awful. There is no way that the United States is going to continue to survive in the state that we have been in. We, somehow by some means, seem to recreate ourselves. I think it is one of the extraordinary aspects of our country that the Constitution and the culture that derived from it is creating a dynamism that we seem to have which one way or the other we seem, when confronted with problems, to get them resolved.

With all of that experience of that happening all of these years, my inclination is just to assume. I don't know how it is going to happen, but we will do it. The trouble I have is that we only seem to do it when we are forced into a crisis.

I trust that we have the capability of being able to see something in the future, which is reasonably certain to happen, namely the demographic shifts in retirement and the problems that are now emerging in our schools. We know what will happen if we don't address both of those questions.

I should hope that instead of waiting till we are at the edge where we have to really get to work to resolve them, we can do them in advance where less effort and less resources and less angst would be required. I trust we will be able to address what we see as real problems in the next decade, in this decade, rather than waiting for them to come right up to our door.

Representative Cummings. Just, very quickly, on the pension situation, Chairman Greenspan, with companies turning to the Pension Benefits Guarantee Corporation, and it seems like many anticipate there will be a stream of companies coming, not having sufficient funds to pay off these pensions. How do you suggest that problem be addressed?

Mr. Greenspan. It is. Let me just start off with what an economist or an accountant would say about how you can fund, with no risk, a pension fund at relatively little risk.

Since you can project the liabilities, really the amounts of payout that your workforce when they retire will require, you know that cash-flow needs on a yearly basis, going out 30, 40, sometimes 50 years.

If you invested on the asset side of your balance sheet in U.S. Treasuries, which matured in the periods when you knew you

would have your cash-flow, you would have a riskless system. But that is very expensive in the sense that you don't get the interest rates or the dividends that most private pension funds get.

So what we are dealing with here is that to the extent that pension funds are invested in other than risk-free instruments, risks are being taken. It is perfectly sensible to do that, when you realize, for example, stocks over the very long term yield more than U.S. Treasuries with a reasonable degree of accuracy. There is a tendency to have not all U.S. Treasuries in your portfolio.

However, it is important to recognize that all of that is risk, and the question is somebody has to bear that risk in the event of failure. It is either the employees, corporate shareholders, or now with the Pension Benefit Guarantee Corporation, the American taxpayer. I think we have to recognize what it is we are doing when we are setting up a pension fund.

If there are risks involved, they should be identified, and the question is in the event of a problem, who bears the cost? Historically, it was always either the shareholders of the corporation or the beneficiaries. Now that we have got a very big slug of possibilities that the American taxpayer is going to have to pay for it. The Congress will have to judge how far you want to carry this.

Representative Cummings. Thank you.

Representative Saxton. Thank you very much, Mr. Cummings. Mr. McCotter, would you have a question at this point?

Representative McCotter. No, thank you.

Representative Saxton. Thank you. Let me just say where we are in terms of time. We have been informed we will have a vote on the House floor sometime between 11:40 and 12:00 or a little bit after. So if it is all right with you, Mr. Chairman, we will begin a second round and try to do it quickly. When the time comes for us to go to vote, we will go to vote, and we will adjourn the hearing at that point.

Mr. Chairman, you have pointed out some good news. Real GDP growth is paced over 3 percent, and that is expected to continue into 2006. Housing and real estate remains strong—and as a matter of fact, at near record levels. Payroll employment is up 3.5 million jobs over the last 24 months. The unemployment rate is at 5.1 percent, which is a historic low, particularly when compared to the averages of the 1970s, 1980s and 1990s and inflationary pressures appear to be contained.

All of this has happened and continues to be a good picture, in spite of the fact that we today see oil prices well over $50 a barrel. If someone had told me in 2003, when oil prices were at $30 a barrel, that the economy would have continued to expand with oil prices at $50 a barrel, I would have had great doubts. In spite of this, we have continued to see good growth.

I would just ask you, in spite of the fact that oil prices are in nominal dollars, far in excess of what they were in the late 1970s and early 1980s, adjusted for inflation, today oil prices are significantly below what they were in the late 1970s and 1980s. Can you expand on this and help us understand what is happening here in the economy, in spite of the fact that we have historically high oil prices in today's dollars, measured in nominal terms?

Mr. Greenspan. I think one of the important issues to focus on is the fact that when oil prices go up or, more exactly, when gasoline and oil prices, for example, in the United States go up, we don't curtail consumption in any measurable way. However, as time goes on, you get a change in the motor vehicle stocks, use of gasoline, so that while people don't curtail the amount of miles they travel, over the longer run, as prices stay high they start to buy increasingly fuel-efficient cars.

So while the consumption levels don't get impacted right away with a rise in oil prices, whether it is gasoline or in the case of home heating oil whether insulation is put in the home—over the longer run it does. What we find is that there is a fairly significant response in consumption, both in the United States and worldwide, over the longer run when oil prices go up.

So that the effect has been over the years, as we have moved from, for example, the late 1960s, early 1970s, when oil prices really began to move, we have seen a very dramatic decline over the long run in the ratio of oil consumption to real GDP, indicating that the structure of the American economy, its capital assets that consume energy and specifically petroleum-based products, that capital structure becomes ever more energy efficient, because it turns over toward more energy efficient-type capital, whether it be passenger cars or capital equipment.

We are now confronted with an issue where presumptions have changed. The earlier presumption was that the longer-term price will go back to what used to be termed normal, which was $20 a barrel. We no longer perceive that that is going to occur, even though the evidence of a long-term decline in the ratio of oil to GDP continues and the evidence of increasing fuel efficiency in cars is occurring.

I think that the significant increase in the long-term futures prices for crude oil 6, 7 years out, in recent years, is suggestive of the fact that the markets do not believe that after we go through a price bulge, which then ultimately gets reversed because consumption settles down, that is not going to happen now.

Future prices have gone up for the year, to the year 2011, for example, they are up quite significantly from what they were. The reason why that has happened, as best I can judge, is more political than economic. The reserves of crude oil, as you know, are largely concentrated in OPEC countries where to a very substantial extent, national oil companies have evolved and have become monopolies in their countries and are having considerable difficulty in choosing whether the cash revenues go for domestic uses and the budgets in those countries, or are plowed back into drilling, not just to increase the oil reserves, but the capacity to produce oil from those reserves.

We are having significant shortages in the growth of long-term crude oil capacity availability, which seems to be falling short of what our projections of oil use over the longer run will be, and that has created an increase in expectations of shortages in the long run, and it is the reason why prices are up. We also have significant problems, I might add, with capital expenditures and capital availability for world refining as well.

So the international oil system is changing. We are able to function and be able to grow economically, especially in the United States, because we find ever more sophisticated ways to remove petroleum and energy as a cost in our production structures.

As a consequence, we have managed to find ways around these ever higher increases in prices. I think we will continue to do so. But there is no question that if the real price of oil were what it was back in the early 1970s, our rate of growth and our current standard of living in the United States would clearly be lower today than it currently is.

Representative Saxton. Thank you, Mr. Chairman.

Senator Reed.

Senator Reed. Thank you, Mr. Chairman.

Chairman Greenspan, you have identified two contemporary challenges to our economy, principally the housing bubble and also the trade deficit, which has to be financed. With respect to the housing bubble, you suggest that it is really a froth.

By the way, I have this image of thousands of Ph.D. students in economics running to a thesis advisor and changing the topic from exuberance, irrational exuberance, to housing froth. So that is happening as we speak.

But the housing bubble may be something because of the nature of housing and the localized implications. That is not serious. But financing our deficits, and dependence upon foreign central banks, could be the most significant challenge we face, given the fact that if there is a moment's lack of confidence in our economy or our decisionmaking, if they feel that our deficit projections would continue to be unremitting and without any type of break, there would be a tendency, obviously, to move out of dollars.

In fact, there was a stutter in the market several weeks or months ago when the South Koreans seemed to be moving. Is that to you a most significant challenge, and how long do we maintain this co-dependency?

I mean, we are hooked on their central bank money. They are seeing it as a way to continue to give us money to buy their products. How long can we maintain this, in my view, unstable co-dependency?

Mr. Greenspan. The expanding dispersion of current account balances which, as you know, are a big chunk of the deficit side, is a function of the degree of globalization.

The increasing tendency of domestic savers to invest outside of their country necessarily implies that the dispersion of current account balances will increase. The dispersion of current account balances is not necessarily a problem, provided that you do not, as a consequence, build up very significant levels of debt is a consequence of chronic deficits.

If you move between a surplus and a deficit, it is no real problem. But what our concern has got to be, especially in the United States, is if we continue to build up net claims against U.S. residents, which must be serviced.

That, I suspect, will get resolved, because the markets will not allow that to happen. The prices will change, terms of trade will change, interest rates will change. At the end of the day, exchange

rates will change one way or the other, which will effectively create changes in these balances.

But the thing which should concern us is more that which the markets cannot adjust, which is the Federal budget deficit. There is a policy question. I would focus on that as being the major issue which I think we have to worry about, because I believe that if we maintain the degree of flexibility in our economy that we have achieved in recent years, and which enabled us to absorb 9/11's economic impact, the bubble of the markets in 2000, the corporate scandals and their aftermath, it is the flexibility of the American economy, which has enabled us to do that.

I do think that so long as we continue that, and avoid protectionism, which would undermine it, I am not worried about how the international system will restructure itself. But we cannot count on the international system or the markets as such to solve our budget deficit problem. That is an issue of choice and an issue which is quite difficult, and I think must be addressed.

Senator Reed. Well, I agree with you, Mr. Chairman, we made those choices in the early 1990s, we raised taxes and we cut expenditures. Do you think there is any other way we can deal with this deficit other than by pursuit of those two courses?

Mr. Greenspan. Not that I am aware of.

Senator Reed. Thank you very much.

Representative Saxton. Thank you, Mr. Chairman and Senator Reed.

Senator Bennett.

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

As I look around the world, I become more discouraged than I am about the United States. Japan seems to be unable to come out of their now decade-long recession. I spend time with Europeans now to a greater degree than I used to, and any country in Europe would kill to have our numbers, our productivity numbers, our GDP growth numbers, our unemployment numbers; they are behind us in every category. And their demographic challenge is greater than ours.

We, at least, have immigration to help us deal with the challenge. The retirement end. They don't, to the extent that we have, they are below replacement level. Their population is shrinking. One statistic that struck me: in the Second World War, Germany had 70 million population, today they have 80 million, whereas we had what—140 million in the Second World War, and we are now closing in on 290 million. The European Union in the next 30 years will become smaller than the United States populationwise. We will grow, they will not.

Basically, we are carrying the rest of the world on our shoulders in this situation.

We can talk about our deficit problem, we can talk about the foreign money we depend on, but as you indicated in an answer to a previous question, a large part of the reason the foreign money is coming here is because it feels safer here than any other place. You can you address this whole question of what we have to do in the overall context of dealing with globalization, it is a reality. It cannot be repealed. I agree were you absolutely, that we must pass CAFTA, and we must pass other free trade agreements in an effort

to get the greatest efficiency and benefit out of globalization that we can.

Protectionism would be a disaster. But other than that, comment on the overall international situation that we face in the next 10 to 15 years.

Mr. Greenspan. Well, Senator, a while back, I had to deliver a memorial lecture on Adam Smith and was required as a consequence to read *The Wealth of Nations* again, which I must say, I hadn't read for 50 years. And it was obviously different. Somebody came in and rewrote it one way or another because it seemed so modern in so many of its insights. The major insight is, I think, the serious question of what does create the wealth of nations? What is it about the United States that which gives us a special status? And, I think the way I would put it is first, it is not our real resources as such, although we, over the generations, have had a considerable amount of oil, copper, ore, iron ore and the like.

But it is fundamentally our Constitution, because the Constitution is structured in a manner which protects property rights better than anywhere else in the world. And one of the reasons why businesses have flocked here, why they have invested here, is that they know that in the event of adjudication they get a fair trial. And that our Constitution protects them.

The second major issue that has always been relevant to the United States is the nature of the people and their education and what they have in their heads. And we have managed, up until very recently, to maintain a very high level of skills. It became obviously most manifest in World War II when the kids who came out of the war were able to put together an automotive engine in 20 minutes where the rest of the world had not yet even gotten close. And we maintained that all the way through the 1960s, the 1970s. We are running into problems now. They are not overwhelming yet.

But I am concerned about the quality of our workforce that we have got to make certain can have the skills that will be required of us in the next generation. As I said to your Congressman colleague from Maryland, I have been around long enough to have considerable expectation that we will figure it out at some point. Over the years, I have been through too many hanging-over-the-edge-of-cliffs scenarios about whether we would do it or not, but we managed to. I think it would be very useful to anticipate sometime in the future what we are going to have to do and do it sooner rather than later.

Representative Saxton. Thank you very much.

Mrs. Maloney.

Representative Maloney. Thank you, Chairman Greenspan, for your truly insightful testimony today. You mentioned you just read Adam Smith. Well, have you read *The World Is Flat* by Thomas Friedman? And do you have any comments.

Mr. Greenspan. Well, the picture on the cover of his book is so revealing. I don't know if you remember what it is. It is the galleons going off the cliff and falling off the region of the earth. I found it sufficiently riveting to go find out what is in the book. And I think it is an interesting book and I think I haven't read it in full detail, but I have read parts of it.

There are big issues out here, which I think we are all trying to come to grips with. This is a different world. I mean, it is a world in which we all are economically related. When I first started in business and had to forecast the American economy, I did not have to avert to what was going on in the rest of the world because it didn't matter that much to what the GDP—or then the GNP—would be for the United States. But now, unless you start with what is going on in the rest of the world, you don't have a clue with what is going to happen here. And I think books like Tom Friedman's and others trying to delve into this have got good things and bad things in them, but I think we are all learning a great deal about how the world works. And I think it is helpful.

Representative Maloney. You commented to Senator Reed's focus on the deficits that it is a tremendous problem, and I would like to ask, wouldn't we see a sharp increase in interest rates and a decline in investment if we continued to run large Federal budget deficits?

Mr. Greenspan. Well, Congresswoman, the real problem that I have is that if you take what I perceive is likely increases in outlays, as you move into the next decade and beyond, you begin to create potentially unstable deficit situations in which deficits increase, the debt increases, the interest on that debt increases, both because interest rates go up and because the debt itself goes up, and that increases the deficit still more, and a number of the econometric scenarios that we run in that context do not reach equilibrium very easily so that we have a major task in front of us.

Representative Maloney. Thank you. You also mentioned today several times and advocated as for a pay-as-you-go policy for all of our Federal budget decisions. And that would also include budget decisions concerning tax cuts becoming permanent, would it not?

Mr. Greenspan. It would.

Representative Maloney. It would. OK. And currently that is not the policy of the Administration, and have you talked to members of the Administration and tried to persuade them of the need for pay-as-you-go rules for all of our budget decisions?

Mr. Greenspan. I have tried to persuade lots of people in this town, sometimes with success, more often than not, lesser success.

Representative Maloney. But we always listen to you, Mr. Chairman, we may not agree, but we always listen to you with great attention. And I really need more evidence to be convinced that we have a robust economic recovery, particularly for the typical American worker. And how would you characterize the behavior of payroll employment over the most recent cycle? Wouldn't you say that it took an unusually long time just to erase the jobs deficit created by the 2001 recession and that we are still well behind the pace of job creation typically seen in past economic recoveries? And, related to that, how would you characterize the unemployment? I know that it has edged down to 5.1 percent in May. But aren't we still waiting for labor force partnership participation to bounce back from the effect of the recession?

Mr. Greenspan. Well, remember, one way of looking at the fact that employment significantly lagged the recovery in the economy earlier in this decade is we had an extraordinary rise in produc-

tivity growth. Indeed, looking back at the figures, even though the economy was relatively weak very early-on in the decade, productivity started to pick up, which was very unusual and as we moved through 2002 and 2003, as I pointed out in my prepared remarks, productivity growth continued to expand, and hence raised the overall standard of living of the American economy. And that therefore, is the source of the delayed recovery in employment.

But employment, obviously, is coming back. The unemployment rate is down to quite low levels historically. It is certainly the case that the participation rate of the labor force has been moving down, although it's flattened out very recently. A goodly part of that is merely the demographics that as you move through cohorts which generally have lower labor force participation, the average comes down and that is one of the things that we are looking at.

But even making adjustment for the demographic shifts, there is a tendency for people to desire to work less than they did historically. A lot of them are going to school. And it is not only the kids. I mean, there is a very significant increase in enrolment at community colleges which have average ages of enrollments, 30, 35 and more.

Representative Maloney. My time is up, thank you very much.

Representative Saxton. I thank the Gentlelady. I just would remind the Gentlelady that today's unemployment rate is 5.1 percent, which is, as the Chairman has just pointed out, is historically low. To be more specific, during the 1970s, the average unemployment rate was 6.2 percent. During the 1980s, it was averaged at 7.3 percent. During the 1990s, it averaged 5.8 percent. And so 5.1 percent doesn't appear to me to be too bad. And I think we need to look at this in that context, and hopefully, it will be reduced even more. But in terms of the last three decades, we are doing pretty well.

Representative Maloney. Well, I thank the Chairman for pointing that out to me and would like to comment that it was lower in 2000. Thank you so much.

Representative Saxton. Again during the 1990s, the unemployment rate averaged 5.8 percent. Historical facts will bear that out.

Mr. Paul.

Representative Paul. Thank you, Mr. Chairman, I would like to follow up on Chairman Saxton's question about the oil prices. You said that the discounting of future high oil prices is probably more political than economic, and I would like to suggest that possibly there are some economic factors. You know in the 1970s, we faced a somewhat similar problem. We had a lot of inflation, and yet we had political turmoil which helped push oil prices up. But we were also living after the decade of the 1960s where we were financing the Vietnam War as well as the Great Society programs and that led to a whole decade of stagflation and significant inflation.

And most individuals now recognize that general price inflation simply is a reflex of money policy and it is not a result of political turmoil, although, the political turmoil can contribute to higher prices. And today certainly we have political turmoil in the Middle East. We see oil pipelines being burned almost on a daily basis,

and that, I would agree, certainly contributes to this anticipation that there will be future price increases in oil.

But, it also, we talk a lot of about increase and demand and I would recognize that that has something to do with the demand coming from China and other far eastern countries that would put pressure on the oil prices. But that the one factor that we essentially never talk about nor recognize is the monetary factor that maybe we still have some old fashioned inflation around. We have some house pricing inflation. We have medical care cost inflation. And we have educational cost inflation. And we also know that one true characteristic of monetary inflation when it translates into price inflation, it is never uniform. Some prices go down. Some prices go up, but you still can have inflation; you can have prices of houses going up with computer prices and TV pricing going down.

So I am suggesting that quite possibly the markets are saying to us in the Congress that we are discounting Congress's inability to handle the deficit, and therefore putting more pressure on the monetary authorities to do what they do. And that is, accommodate deficits and eventually inflate just as we do to accommodate the deficits of the 1960s, and contributed to the 1970s. Why couldn't a case be made that there is a monetary factor in here or would you still stick to the argument that you will say no, there is no economic factor, it is all political factor that anticipates higher prices of oil in the next decade or so?

Mr. Greenspan. Well, with regard to the political factors I was referring to, I am not sure I made myself clear. It was not so much the violence and terrorism that is involved, but the fact that very few of these nationalized oil companies will allow foreign oil companies to come in and drill and increase their productive capacity. In Mexico, for example, its constitution prohibits foreign involvement in its underlying crude oil reserves.

The issue of monetary policy is potentially a significant inflationary force as we have discussed before on numerous occasions. The history of fiat monies, which is what we have, tends to be chronically inflationary. At the current time, money supply growth is really quite modest. And I think it is modest around the world, and I think the reason is that a large number of us recognize that the inflation is a very deleterious force in a market economy, and that if we feed inflationary forces, we ultimately undermine the economy. The argument that we at the Fed make is that our statutory requirement is to maintain maximum sustainable growth, but we perceive the necessary condition of that to be a non-inflationary monetary policy.

Representative Paul. Thank you.

Representative Saxton. Thank you very much.

Mr. Hinchey.

Representative Hinchey. Thank you very much, Mr. Chairman, Chairman Greenspan it is always more than a pleasure and also always instructive to listen to you. I very much appreciate the opportunity to be here with you today.

Mr. Greenspan. Thank you.

Representative Hinchey. As you point out, whenever you put into place a program or a policy, it is always prudent to periodically

review that policy or program to see that it still makes sense and that it is performing as you anticipated it might.

We have an economic policy in place today which has been in place now for about 4½ years, and we have an opportunity to evaluate the outcomes and to see what it is doing for us. We talk about growth in the economy and that seems pretty significant. Unquestionably, that growth seems strong and solid. But it doesn't seem to be affecting everyone. For example, in the last 4½ years, there are now 4 million more Americans without health insurance. That number is up to 45 million now, and there are tens of millions more who have inadequate health insurance. There are about 1.3 million more Americans living in poverty than there were 4½ years ago. And the median annual income of middle class families is down by $1,400 over the course of that period.

In the private sector, we still have not produced the number of private sector jobs that would bring us back to the number of private sector jobs that we had 4½ years ago. The benefits of our economy are increasingly flowing to a smaller number of people. In fact, a recent analysis by *The New York Times*, for example, indicates that about less than 1/10th of 1 percent of the population are getting not just the lion's share of the benefits, but most of the entire pride's share of the benefits.

If we are going to maintain a kind of social equality, or the social opportunities at least that we have had throughout our history, don't you think that we need to re-examine this policy and begin to do something different so that more people can begin to benefit from the enormous opportunities that exist in this country? Instead of having just a tiny fraction of people get all the benefits, shouldn't we be trying to share them more equitably? Aren't there things we need to be doing better?

Mr. Greenspan. I didn't read *The New York Times* article in detail, but it is a fact that the concentration of income has increased for reasons I discussed before. I do think it is important to recognize that to the extent that that occurs, it is not helpful for a democratic society, especially one of the breadth and heterogeneity of this type of society.

I have looked at the various different things that can be done. And I have concluded that with education reforms necessary, whatever that means, because I don't know enough about how to teach children in a way that would prevent them from falling to the bottom of the barrel by the time they go from 4th grade to 12th grade.

But I do know that that is both the necessary and sufficient condition to solving the problem that you are most concerned about. I am not sure what a whole series of other programs would succeed in doing. I am reasonably certain if we don't solve the education problem, whatever else we do isn't going to help very much.

Representative Hinchey. I am really talking now about the monetary and fiscal policies that we are pursuing. For example the huge tax cuts.

Mr. Greenspan. The problem I am concerned about is on a pretax level. You will get the same numbers.

Representative Hinchey. The ones I am concerned about are at a post-tax level.

Mr. Greenspan. I understand that. What I am trying to say——

Representative Hinchey. Because if you have these huge tax cuts, which take enormous amounts of money out of the Treasury, put them into the hands of just a tiny fraction of the American people, and just let them do with it what they want, they will not invest that money into society. If you had a tax cut, for example, that was more equitable, that was distributed more equitably among the middle class, then you would see more investment going back into the society. You talk about education. Because of the fact that we are running these huge budget deficits now as a result of the tax cuts and other actions—the war in Iraq, for example—we can't afford to invest more in education. Now the Administration is arguing that we can't afford Social Security. We can't afford Medicare, we can't afford education. They are cutting back on Pell Grants. They are cutting back on other means of funding education.

So if we are not putting enough money into education then you have classrooms that are overcrowded. You have educational conditions that are actually depriving young people of the education that they should have. We are not using our resources equitably, intelligently, we are using them in ways that are reckless and radical and putting them into the hands of a tiny fraction of the American people rather than having those resources spread in a more, not just egalitarian, but at least more democratic way.

Mr. Greenspan. Well, it is a factual issue here that leaving aside the question of equity, those monies come back into investment. In other words, unless you consume your income, it is going back into financing investment.

Representative Hinchey. But Mr. Chairman, the investments are going to buy an island in the South Pacific or buy a factory in China or buy some kind of information distribution system in India. That is where they're going. They are not coming back into our economy.

Mr. Greenspan. I think you would find if you actually had the full detail, those would be extraordinarily small proportions of what actually gets invested. Look, the truth of the matter is, I don't want to argue the other side of the question of equity, because I don't necessarily disagree with that. But there is no question that this standard of living is unmatched. And it is unmatched for everybody. Everybody has got a car. And the cars that people have today are so superior to what they were 50 years ago it is unimaginable.

So, you can look at the system and say it has got a lot of problems. And sure it does. It always has. But, you can't get around the fact that this is the most extraordinarily successful economy in history. And while we may not distribute the resources in the way that you or maybe I would think is necessarily appropriate, the fact is it is still a very successful economic system. And what we are going to find is that over the years, if we resolve the education problems, I think we will find that everybody is getting very significant advances.

If we were in such poor shape why do so many people want to come to this country?

Coming to this country, taking the lowest paying jobs which are several multiples of what they can make at home. We have got to be doing something which is not bad.

Representative Saxton. Thank you very much, Mr. Greenspan. Mr. McCotter has joined us and we are going to move to him for a question.

Representative McCotter. Thank you, Mr. Chairman. You had spoken about having to dust off your Adam Smith. I guess I have to dust off my civics book when I get home, because it was always my understanding that taxation occurred with the consent of the governed. The tax cuts are not taken from the Treasury and placed in the hands of the few unless at first they are taken from the hands of the people who earned them and then stuffed into the Federal Treasury. And it can only be done with their consent. So maybe we have a difference of opinion. I will go check and see whether I am right or not.

Speaking of the consent of the governed, in economic models as you rightly pointed out, in the past we only had to focus on the United States of America, what is good for GM is good for the country, and so forth.

At this point in time, given the globalization of much of the economic sectors, do any economic models take into account the different natures of the governments involved in global trade?

Mr. Greenspan. Different what?

Representative McCotter. The different type of government. For example, let's use two examples. The United States of America is a free republic. It has an entrepreneurial system and, say, somebody like the People's Republic of China, which is a communist government, it is a totalitarian state.

Do economic models anywhere account for the different natures of the governments? For example, we can discuss where we would rightly or wrongly invest, in education or elsewhere, but we have to do it through the consent of the governed and through consensus in the Congress and then express incentivize. We cannot command and control an economic sector or our economic decisions. We have a free market. We can help. We can hurt. We cannot command and control.

How does a free republic with the entrepreneurial free market system engage with a communist country which is a totalitarian state which has a command and control structure which we cannot follow? Do economic models take these into account? My concern is that over time, as we look at this, is that economists tend to look at market forces. Not the aberrations in market forces that can be caused by a totalitarian government, whereby an economic policy will not be determined by an aggregation of individual decisions made throughout a free market, but at the behest and the command of a dictatorial government.

Do any economic models take this into account or do we simply assume that perhaps these totalitarian states can be treated as a dichotomy between their government and perhaps a system that they are employing economically at a given time?

Mr. Greenspan. Econometric models don't. In fact, they presuppose a market economy and are not sufficiently sophisticated in their mathematical constructions to say they differentiate between differing types of market capitalism. There are huge differences in economic development, depending on whether or not you have a rule of law, whether you have property rights, what type of govern-

ment you have, is it representative, is it republic, is it democratic in its nature? That is a part of economics which I wouldn't call modeling, but it is called development economics, and what they try to figure out is, as did Adam Smith, what causes the wealth of nations? And there the conclusions come out fairly clearly. Namely that when you have, if you want to call it a model, you actually had an experiment in central planning versus market forces for 40 years with East Germany and West Germany in which they came out of the same culture, language, everything similarly. The only thing that was fundamentally different was their political structure. And when the end of the 40 years, the experiment came to an end and we looked. East Germany's standard of living was a third of West Germany's.

So you can, in a sense, get a model, if you want to call it that, to produce those results. But, it is very rare that that occurs. And the only time I know they would use models in central planning was the Gosplan in the Soviet Union which was very sophisticated and didn't work.

Representative McCotter. And bring this up to my concern over time whether or not there is a lot of faith in the permanent normalization in trade relations with the People's Republic of China has been that you will get democracy following economic opportunity if we continue to trade with China on this basis, if we drop human rights as a criteria, if we allow them access to our markets and we go back and forth is that somehow they will magically realize that the vanguard of the proletariat is no longer needed to run the lives of their people.

My concern is not that we have soon a past model, such as the Soviet Union or East Germany. My concern is that we may be seeing a different hybrid of a totalitarian government. We may be seeing a totalitarian government that will allow a limited amount of economic opportunity without any political freedom whatsoever, without any real democracy whatsoever. And as a resident of the United States, I asked the question because my concern is that we tend to think that what we have here in the free republic through democracy and through an entrepreneurial economy is somehow entitled to us rather than simply an experiment in democracy which, as some of us know, did not work out too well in the ancient Athenian city-state very long. And that as Russia goes backwards with their economic models and China continues down the path, we are basically, as an article of faith, hoping that China does the right thing and becomes more like us in the next 20 years, rather than even bother to entertain the notion if we continue to trade with them in the manner that we are trading with them and dealing with them, that somehow in the next 20 years, we might start looking a lot more like them. So that is why I asked the question, but as always, I enjoy engaging with you, Mr. Chairman.

Mr. Greenspan. Thank you.

Representative Saxton. Thank you very much.

Ms. Sanchez.

Representative Sanchez. Thank you, Mr. Chairman.

Mr. Chairman, what I want to go back to, what I see over time, your concern of this, I hate to call it as the haves and have-nots, but the widening and disparity of what is going on, and to a large

extent, you talked today at length about how education may be one of those big issues that makes the widening, or the gap that is occurring.

I ask because I come from the fifth wealthiest county in the Nation, Orange County, California. And yet, the Rockefeller Foundation about 5 months ago issued a report that said that the city that was the worst place to be poor is Santa Ana, California. That is the county seat of Orange County. And then when I look at the percent of giving rates, charitable giving, county-by-county in the Nation, Orange County is pretty low on the list as a percent. And when we see where it gives, a lot of the giving that we are seeing in my area goes to the arts.

So I am looking at the policy or what is it that is creating this disparity and one of the issues that comes up is this whole issue of the estate tax. And to tell the truth, that has come up in different forms, I have voted one way or the other depending on whether or not I think this will work.

As a Blue Dog, we tried to put in a proposal that would basically have no tax all the way up to 97 percent of all households in the United States. But that didn't go through. The House recently passed an estate tax that said there will be no estate tax. I want to ask you because one of the arguments that people used in trying to sway some of us to vote one way or the other was this other whole issue of if you don't tax with an estate tax, then people will not put their monies into charitable types of institutions. They won't make the Carnegie Foundation. They won't make these foundations that in turn come back and do education on a more broad base, or invest in research on a more broad base.

What do you think about eliminating completely the estate tax versus something of, you know, trying to eliminate it from most, but not the very top 2 percent of estate tax estates? What is your opinion on that?

Mr. Greenspan. I don't have a view on that particularly. I think that there is a great deal of literature as to whether or not Americans contribute to charities because of the graduated income tax or not at all. I mean, obviously, through very significant charitable contributions and bequeathing of very large trusts for charitable distributions, before the income tax, we obviously had Carnegie and Rockefeller, and a variety of other major contributors. But it is an analytical question as to the impact of the estate tax or indeed the income taxes on charitable giving, and I am not sufficiently familiar with the conclusions of that. I don't really have a position on it.

Representative Sanchez. Aside from this education gap, what do you think might be other policies that we, the Federal Government, have instituted that are creating this widening of the gap between those who have the low paying service jobs and those who have the creative, technological-type jobs?

Mr. Greenspan. Congresswoman, I don't think we need to do anything else. If we succeed in solving the education issue, I think we have got it solved. Remember, we came out of World War II with the GI Bill of Rights, and a lot of technological capability, what the technologies were back at the end of World War II. And we had, for several decades, a very rapidly growing economy and,

no increasing concentration of income. In other words, all wage levels moved the same. You are not going to eliminate the differential wage levels because those are skill-based.

But what we need to eliminate is the ever gradual spreading of those wages which we now see and there are lots of ways you can come out at it, but all I can say is that if you can solve the education problem you don't have to do anything else. And if you don't solve it, nothing else is going to matter all that much.

Representative Sanchez. Thank you Mr. Chairman. Thank you.

Representative Saxton. Thank you, Ms. Sanchez.

Mr. Chairman, we have got to go vote, and we want to thank you for being here with us this morning. We are pleased with the news that you bring us today. And, I want to thank you also for emphasizing the concern that you have with regard to the educational issues in our society. I think that is extremely important. I sit here in this room, actually on the Armed Services Committee, and one of the things that we are reminded about from time to time is the shortage of engineers that work in various capacities that provide for expertise in the area of defense, national security. These are important issues and I agree with you that we need to recognize them and work on them. Thank you again for being here with us this morning and we look forward to seeing you again in the future.

Mr. Greenspan. Thank you, Mr. Chairman.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

Submissions for the Record

CONGRESS OF THE UNITED STATES

JOINT ECONOMIC COMMITTEE

CHAIRMAN JIM SAXTON

PRESS RELEASE

For Immediate Release
June 9, 2005

STATEMENT OF CHAIRMAN JIM SAXTON

Press Release #109-24
Contact: Christopher Frenze
Executive Director
(202) 225-3923

Economic Outlook

WASHINGTON, D.C. – I am pleased to welcome Chairman Greenspan before the Joint Economic Committee today. Chairman Greenspan's testimony will provide useful insights on the current economic expansion and the potential for further economic progress.

A broad array of standard economic data indicates that the economic expansion is on a solid footing. The U.S. economy grew 4 percent in 2004, and advanced at a 3.5 percent rate in the first quarter of 2005. A rebound in business investment has played an important role in explaining the pick-up in the economy since early 2003. Equipment and software investment has been strong over this period.

The improvement in economic growth is reflected in other economic figures as well. Over the last 24 months, 3.5 million jobs have been added to business payrolls. The unemployment rate stands at 5.1 percent. Consumer spending continues to grow. Homeownership has hit record highs. Household net worth is also at a high level.

Meanwhile, inflation pressures appear to be contained. Interest rates remain at historically low levels, with long-term interest rates, including mortgage rates, actually declining recently. This decline of long-term interest rates, even as the Fed is increasing short-term rates, is very unusual.

In short, overall economic conditions remain positive. It is clear that accommodative monetary policy and tax incentives for investment have made important contributions to the improvement in the economy in recent years. Recently released minutes from the Federal Reserve suggest that the central bank expects this economic strength to continue.

As always, there are some aspects of the economy that should be monitored closely. There appears to be speculative pressures in some local housing markets, but these seem unlikely to pose a significant threat to the national economic expansion. The increase in oil prices has had an impact on certain sectors of the economy, but has not severely undermined overall economic growth.

The consensus of Blue Chip forecasters projects that the economic expansion will continue through 2005 and 2006. This is consistent with Federal Reserve forecasts for economic growth through 2006. In summary, the current economic situation is solid, and the outlook remains favorable.

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Congress of the United States

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

Washington, DC 20510–6602

June 22, 2005

The Honorable Alan Greenspan
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Chairman Greenspan:

I would like to thank you for your recent testimony on the Economic Outlook before the Joint Economic Committee. Your testimony addressed a number of compelling and timely issues, and the printed record of the hearing will be an invaluable resource.

I would appreciate your addressing the attached four questions for the record.

Also, a copy of the June 9, 2005, hearing transcript is enclosed. Please have a member of your staff return the corrected transcript, together with your answers to the submitted questions, to my Executive Director, Christopher Frenze, Joint Economic Committee, 433 Cannon Office Building, Washington, D.C. 20515. Should your staff have any questions, please call Chris at (202) 225-3923.

Thank you and I look forward to your response.

Sincerely,

J. Saxton

Jim Saxton
Chairman

Questions Submitted for the Record
Chairman Saxton for Chairman Greenspan
June 22, 2005

- Economists have established a connection between movements in the yield spread (i.e., the difference between the long-term bond yield and the fed funds rate) and the thrust of monetary policy. As the yield spread widens, policy becomes easier and becomes tighter as the spread narrows or inverts. Such an empirical relation has been identified by a number of researchers, including several within the Federal Reserve System. Further, the Conference Board uses this spread as one of its most reliable components in its index of leading economic indicators.

  On the other hand, some policymakers and researchers seem to contend that the recent decline in the long-bond yield is an independent source of policy stimulus. An example of this is provided by the recent reduction in the long bond yield that stimulated the real estate sector. In this view, **in situations when the yield spread narrows in part due to a decline in the long bond yield, the spread does not measure** the same degree of monetary policy restrictiveness. Recently, for example, as the Fed narrowed the spread by increasing the fed funds rate and an accompanying fall in the long-bond yield took place, a given narrowing of the spread was not seen as restrictive as earlier was believed. According to this view, in these circumstances, it is possible that the monetary authorities could misinterpret heretofore important policy indicators.

  At our recent JEC hearing, you indicated that the decline of the long-bond yield may be stimulative. In that context,

  (1) Could you comment on the above interpretation?
  (2) In our current circumstances, do you view a reduction in the long-bond yield as stimulative or restrictive?
  (3) Could you expand on your previous discussions of this topic?

- During the June 9 Joint Economic Committee hearing, I asked you about a *Wall Street Journal* article published that morning that included criticism of the Fed for its handling of the conditions arising from the 2000 bursting of the stock market and technology bubbles. The article contended that in addressing the macroeconomic fallout of the bubbles that popped in 2000, the Fed helped create a housing bubble that is still expanding. In response to my question, you effectively defended the Fed's actions. However, could you expand on the potential risks to the macroeconomic situation had the Fed not acted as it did in easing monetary policy?

- Oil prices have increased significantly to levels above $50/b. In assessing the economic effects of these oil price increases, the earlier experience of the U.S. still influences many. Historically, the U.S. has experienced a number of supply-restrictive episodes; prices increased largely because of restrictive supply. The oil price supply shocks of the 1970s, for example, caused prices to increase sharply and adversely impacted the real sectors of most economies.

  Currently, we are again experiencing significant increases in oil prices. Today, however, there are a number of reasons to believe that those oil price hikes may not impact the real economy as severely as earlier episodes of the 1970s did. Consider, for example, the following:

  - ✓ The economy is more energy-efficient today.
  - ✓ The **real** price of oil has not increased to the degree that it did in the 1970s.
  - ✓ Recent price hikes have (for the most part) been the result of increases in demand, and therefore, the product of healthy economies rather than supply-side shortages.

  In view of these considerations, what is the Fed's latest thinking on the following:
  (1) the economic affects of our current oil price increases?
  (2) the future of the price of oil?

- A consensus view among monetary policy makers is that monetary policy should not be used to respond to, manage, or attempt to "burst" an asset price "bubble." Rather, monetary policy should be used to provide for overall, macroeconomic price stability, not asset price stability in one particular sector. Should a "bubble burst" and adversely affect the macroeconomy, then the monitoring authority can and should respond.

  - ✓ Given this view, is there any **regulatory policy tool** that can be used to moderate lending in "frothy" sectors that fuel asset price inflation?

  - ✓ Is there a "regulatory substitute" that can help to minimize asset price bubbles?

  - ✓ Is the recent **Interagency Credit Risk Management Guidance for Home Equity Lending** such an attempt?

  - ✓ Is this **Guidance** an example of some "**regulatory suasion**" to help with this problem?

  - ✓ What **regulatory options** does the Federal Reserve have to better manage or influence asset price bubbles?

  - ✓ What are the most risky lending practices currently contributing to the froth in the housing sector?

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

ALAN GREENSPAN
CHAIRMAN

July 11, 2005

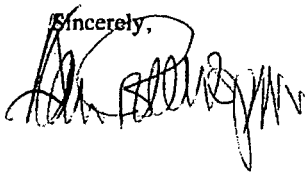
The Honorable Jim Saxton
Chairman
Joint Economic Committee
Washington, D.C. 20510

Dear Mr. Chairman:

I am enclosing for the record my responses to your additional questions following the Committee's hearing of June 9, 2005, on the Economic Outlook.

Please let me know if I can be of further assistance.

Sincerely,



Enclosure

Chairman Greenspan subsequently submitted the following in response to written questions received from Chairman Saxton in connection with the hearing before the Joint Economic Committee on June 9, 2005:

• Economists have established a connection between movements in the yield spread (i.e., the difference between the long-term bond yield and the fed funds rate) and the thrust of monetary policy. As the yield spread widens, policy becomes easier and becomes tighter as the spread narrows or inverts. Such an empirical relation has been identified by a number of researchers, including several within the Federal Reserve System. Further, the Conference Board uses this spread as one of its most reliable components in its index of leading economic indicators.

On the other hand, some policymakers and researchers seem to contend that the recent decline in the long-bond yield is an independent source of policy stimulus. An example of this is provided by the recent reduction in the long bond yield that stimulated the real estate sector. In this view, in situations when the yield spread narrows in part due to a decline in the long bond yield, the spread does not measure the same degree of monetary policy restrictiveness. Recently, for example, as the Fed narrowed the spread by increasing the fed funds rate and an accompanying fall in the long-bond yield took place, a given narrowing of the spread was not seen as restrictive as earlier was believed. According to this view, in these circumstances, it is possible that the monetary authorities could misinterpret heretofore important policy indicators.

At our recent JEC hearing, you indicated that the decline of the long-bond yield may be stimulative. In that context,

(1) Could you comment on the above interpretation?
(2) In our current circumstances, do you view a reduction in the long-bond yield as stimulative or restrictive?
(3) Could you expand on your previous discussions of this topic?

Although the slope of the yield curve can at times be a useful indicator, there are several points to bear in mind.

- First, the slope of the yield curve has flattened considerably over the past year, but currently it is about in its average range for the last twenty years.
- Second, a sharp flattening of the yield curve is not a foolproof indicator of economic weakness. Indeed, the yield curve narrowed sharply over the period 1992-1994 even as the economy was entering the longest sustained expansion of the postwar period.

- Third, researchers have developed a number of statistical models relating the slope of the yield curve to future GDP growth. Based on recent readings of the slope of the yield curve, such models typically project continued moderate expansion of GDP for the foreseeable future.

The decline in long-term nominal bond yields observed over the past year appears to have reflected, at least in part, in lower real interest rates. Lower real interest rates reduce the cost of borrowing for households and businesses and support the prices of many other assets. Thus, the decline in long-term yields, other things equal, is stimulative. However, interest rates both affect, and are affected by, a wide range of other variables. Consequently, movements in bond yields should not be assessed in isolation but need to be interpreted in the context of overall domestic and foreign economic and financial developments.

- **During the June 9 Joint Economic Committee hearing, I asked you about a *Wall Street Journal* article published that morning that included criticism of the Fed for its handling of the conditions arising from the 2000 bursting of the stock market and technology bubbles. The article contended that in addressing the macroeconomic fallout of the bubbles that popped in 2000, the Fed helped create a housing bubble that is still expanding. In response to my question, you effectively defended the Fed's actions. However, could you expand on the potential risks to the macroeconomic situation had the Fed not acted as it did in easing monetary policy?**

The Federal Reserve aggressively eased monetary policy over the course of 2001, beginning early that year, in response to factors that were tending to weaken the U.S. economy. Those factors initially included a considerable slump in capital spending in the wake of the shakeout in the technology sector, a substantial inventory correction, a slowing of economic growth abroad, and the effects on consumer spending of the sharp decline in equity prices. Later in the year, those influences were compounded by the adverse economic effects of the terrorist attacks on September 11.

In the event, the United States experienced a recession during 2001, albeit one that was neither especially severe nor prolonged in comparison with other downturns in the post-World-War-II period. Absent the monetary stimulus applied promptly by the Federal Reserve in 2001, that recession could have been considerably deeper and more costly for our nation. The sharp reduction in money market interest rates resulting from our monetary policy actions fostered a considerable easing of broader financial market conditions. Longer-term interest rates fell particularly notably, reaching their lowest levels in decades. The drop in yields provided substantial support to interest-sensitive spending--especially housing, but probably to expenditures on consumer durables and business investment as well. Without the more accommodative financial conditions, this pickup in interest-sensitive spending would presumably have been greatly damped--or may not have

occurred at all--and the result could have been a much more severe economic downturn. Moreover, it is worth recalling that, even as events turned out, inflation appeared to be in the process of falling to uncomfortably low levels--and possibly so low that the ability of monetary policy to help stabilize the economy could have been impaired.

• **Oil prices have increased significantly to levels above $50/b. In assessing the economic effects of these oil price increases, the earlier experience of the U.S. still influences many. Historically, the U.S. has experienced a number of supply-restrictive episodes; prices increased largely because of restrictive supply. The oil price supply shocks of the 1970s, for example, caused prices to increase sharply and adversely impacted the real sectors of most economies.**

Currently, we are again experiencing significant increases in oil prices. Today, however, there are a number of reasons to believe that those oil price hikes may not impact the real economy as severely as earlier episodes of the 1970s did. Consider, for example, the following:

- ✓**The economy is more energy-efficient today.**
- ✓**The real price of oil has not increased to the degree that it did in the 1970s.**
- ✓**Recent price hikes have (for the most part) been the result of increases in demand, and therefore, the product of healthy economies rather than supply-side shortages.**

In view of these considerations, what is the Fed's latest thinking on the following:
(1) The economic affects of our current oil price increases?
(2) The future of the price of oil?

The spot price of West Texas Intermediate crude oil currently is trading around $60 per barrel. The high price reflects the significant global demand for crude oil as well as the limited ability of oil-producing nations to expand their production in the short run. Far-dated futures prices, which reflect the market's expectations of prices six years hence, are around $55 per barrel. The small expected decline from current prices reflects the market's view that the supply-demand balance for oil will not change appreciably over the medium term.

These high oil prices are having an effect on the U.S. economy. Consumer price inflation has moved up along with the higher crude oil prices. This has reduced households' purchasing power and adversely affected spending. Businesses too seem to have reassessed the profitability of some investment projects in the light of significantly higher energy costs. Based on econometric estimates done by the Board staff, the increase in oil prices since the end of 2003 probably has shaved roughly 1/2 percentage point off of real GDP growth last year, and they look to restrain growth this year by approximately

3/4 percentage point. Aside from these "headwinds," the U.S. economy seems to be coping pretty well with the run-up in crude oil prices.

• **A consensus view among monetary policy makers is that monetary policy should not be used to respond to, manage, or attempt to "burst" an asset price "bubble." Rather, monetary policy should be used to provide for overall macroeconomic price stability, not asset price stability in one particular sector. Should a "bubble burst" and adversely affect the macroeconomy, then the monitoring authority can and should respond.**

- ✓**Given this view, is there any regulatory policy tool that can be used to moderate lending in "frothy" sectors that fuel asset price inflation?**
- ✓**Is there a "regulatory substitute" that can help minimize asset bubbles?**
- ✓**Is the recent Interagency Credit Risk Management Guidance for Home Equity Lending such an attempt?**
- ✓**Is this Guidance an example of some "regulatory suasion" to help with this problem?**
- ✓**What regulatory options does the Federal Reserve have to better manage or influence asset bubbles?**
- ✓**What are the most risky lending practices currently contributing to the froth in the housing sector?**

Bank regulatory policies are neither designed nor used to influence asset prices in particular sectors of the economy. Rather, their purpose is to ensure adequate bank risk management and thereby strengthen the safety and soundness of individual banking firms, foster a resilient banking system, and protect FDIC-insured deposits. To be sure, bank regulatory policies can be influenced by macroeconomic and broad market developments. Macroeconomic and market trends and risks may induce action to modify regulations, particularly if banks do not appear to be taking appropriate account of such developments in the measurement and management of their own risks.

With respect to regulatory options or "regulatory substitutes" to address asset price bubbles, some observers have suggested increasing margin requirements to counter perceived speculation in equities markets. Even if one presumes that a bubble in this market can be identified before it bursts, however, such an approach is unlikely to succeed. Only a small fraction of equity is purchased using credit. Moreover, money is fungible, so that if an attempt were made to limit the amount of credit that could be used for a

particular purpose, say, the purchase of securities, it is highly likely that some investors who would be constrained by such a regulation would find ways to channel credit from other sources to effect the desired purchases--for example, by funding more of the security purchase with funds ostensibly borrowed for other purposes, such as mortgage or consumer loans.

The recent Interagency Credit Risk Management Guidance for Home Equity Lending was not a regulatory effort to combat a housing price bubble, nor was it an example of regulatory suasion aimed at asset prices. Rather, it was a response to indications that some banks were not appropriately managing risks in the home equity area. The regulatory system is not designed to influence or control asset bubbles, but rather to ensure that bubbles, should they develop, do not lead to unsafe lending practices. Although the guidance was not aimed at affecting asset prices directly, it may nevertheless affect market conditions through changes in the availability of credit for some riskier households.

As I indicated in my testimony, there does not appear to be a "bubble" in home prices for the nation as a whole, but there are signs of "froth" in some local markets where home prices seem to have risen to unsustainable levels. It is not clear whether lending practices have contributed to these local conditions. After all, the mortgage market is national in scope, while rapid price increases have been in particular areas. The Interagency Credit Risk Management Guidance for Home Equity Lending listed a number of product, risk management, and underwriting risk factors and trends that suggested that some financial institutions may not fully recognize the risk embedded in home equity loan portfolios. These factors include interest-only features on some loans, loans with limited or no documentation of borrowers' financial condition, high loan-to-value and debt-to-income ratios, greater use of automated valuation models, and increased use of loan brokers or other third parties to generate transactions. These factors have not necessarily had a material effect on housing prices. The possibility that home prices may be unsustainably high does, however, contribute to the risks associated with such lending, since it may suggest that the value of some loans' collateral may be vulnerable to declines. Indeed, the guidance indicated that financial institutions should perform stress tests of their key portfolio segments, including evaluations of the effects of declines in home values.

SEN. JACK REED (RI)
RANKING DEMOCRAT

SEN. EDWARD M. KENNEDY (MA)
SEN. PAUL S. SARBANES (MD)
SEN. JEFF BINGAMAN (NM)
REP. CAROLYN B. MALONEY (NY)
REP. MAURICE HINCHEY (NY)
REP. LORETTA SANCHEZ (CA)
REP. ELIJAH E. CUMMINGS (MD)

Congress of the United States
Joint Economic Committee
Democrats

109TH
CONGRESS

804 HART SENATE OFFICE
BUILDING
WASHINGTON, DC 20510-6602
202-224-0372
FAX 202-224-5568
www.jec.senate.gov/democrats

CHAD STONE
STAFF DIRECTOR

Opening Statement
Senator Jack Reed
Joint Economic Committee Hearing
June 9, 2005

Thank you, Chairman Saxton. I want to welcome Chairman Greenspan and thank you for testifying here today at a time when there are so many genuine puzzles about the direction of the American economy.

Chairman Greenspan, you have been rather upbeat about the economic outlook, and let me be the first to say that I hope you're right. However, I am concerned about what continues to be a disappointing economic recovery for the typical American worker. Economic insecurity for workers is widespread as a healthy jobs recovery has yet to take hold, wages are failing to keep pace with inflation, income inequality is growing, and private pensions are in jeopardy.

Job growth sputtered again last month when only 78,000 jobs were added, calling into question the strength of the labor market recovery. We still have not seen several consecutive months of solid job gains, which is disappointing 42 months into a recovery. At this point in the last recovery, the economy had created over four million more jobs than we have seen in this recovery, and we regularly saw gains of 200,000 to 300,000 and sometimes 400,000 jobs per month. Employers don't seem to have enough confidence in this recovery to pick up their pace of hiring.

Of course, the real disappointment in this recovery is how workers have been left out of the economic growth we have seen so far. Strong productivity growth has translated into higher profits for businesses not more take home pay for workers. Since the start of the economic recovery in late 2001, corporate profits from current production have risen by 67 percent. By contrast, employee compensation rose by only 17 percent. Since the economy started generating jobs in May 2003, the average hourly earnings of production workers in nonfarm industries have fallen by 1.4 percent after-inflation. The stagnation of earnings in the face of higher prices for gasoline, food, and medical care is squeezing the take home pay of workers.

I hope that the Federal Open Market Committee is paying close attention to the labor market as they set the direction of monetary policy. Workers have been shortchanged so far in this recovery, and I believe that the economy should be able to accommodate some acceleration in wages to catch up to productivity growth without generating undue fears of inflation.

Any wage gains we have seen seem to be concentrated at the top of the earnings distribution, while the largest losses are at the bottom. As the *New York Times* noted this week, the distribution of earnings is also becoming so unequal that "Even the merely wealthy are being left behind in the dust by the small slice of super-rich Americans." I know,

Chairman Greenspan, that you have expressed concern about widening inequality of income and earnings in the American economy, so this development cannot be encouraging to you.

Another troubling development is how unstable the private pension system is becoming. Data released this week by the government's Pension Benefit Guaranty Corp. (PBGC) show that the country's 1,108 weakest pension plans had an aggregate shortfall of $353.7 billion at the end of last year -- 27 percent more than the previous year. Meanwhile, the PBGC itself is under-funded. Social Security does face long-term challenges, but at the moment it's looking like the strongest leg of our retirement system.

Raising national saving is the key to our economic growth, a good way to reduce our record trade deficit, and, as your past testimony reflects, the best way to meet the fiscal challenges posed by the retirement of the baby boom generation. Unfortunately, the President's large federal budget deficits are undermining national saving and leaving us increasingly hampered in our ability to deal with the host of challenges we face. The President's policy priorities of large tax cuts for those who are already well off and private retirement accounts that add to the debt and worsen Social Security's solvency would take us in exactly the wrong direction for the future.

Finally, there are real questions about whether today's workers can look forward to a future of economic prosperity or one of continued risk and uncertainty about whether they will have good jobs and the means to provide a comfortable standard of living for their families.

Chairman Greenspan, I look forward to your testimony about the economic outlook, and exploring some of these issues further with you in the questioning.

###

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

Chairman Saxton, Vice Chairman Bennett, and Members of the Committee, I am pleased to appear once again before the Joint Economic Committee.

Over the past year, the pace of economic activity in the United States has alternately paused and quickened. The most recent data support the view that the soft readings on the economy observed in the early spring were not presaging a more-serious slowdown in the pace of activity. Consumer spending firmed again, and indicators of business investment became somewhat more upbeat. Nonetheless, policymakers confront many of the same imbalances and uncertainties that were apparent a year ago.

Our household saving rate remains negligible. Moreover, modest, if any, progress is evident in addressing the challenges associated with the pending shift of the baby-boom generation into retirement that will begin in a very few years. And although prices of imports have accelerated, we are, at best, in only the earliest stages of a stabilization of our current account deficit—a deficit that now exceeds 6 percent of U.S. Gross Domestic Product (GDP).

A major economic development over the past year has been the surge in the price of oil. Sharply higher prices of oil imports have diminished U.S. purchasing power. The value of petroleum imports rose from 1.4 percent of nominal GDP in the first quarter of 2004 to 1.8 percent in the first quarter of this year. The alternating bouts of rising and falling oil prices have doubtless been a significant contributor to the periods of deceleration and acceleration of U.S. economic activity over the past year.

Despite the uneven character of the expansion over the past year, the U.S. economy has done well, on net, by most measures. Real GDP has grown by 3.7 percent over that period, the unemployment rate has fallen to 5.1 percent, and core personal consumption expenditure prices have risen a historically modest 1.6 percent. But the growth of productivity, though respectable at 2½ percent over the year ending in the first quarter, is far less than the extraordinary pace of 5½ percent during 2003. Excluding a large but apparently transitory surge in bonuses and the proceeds of stock option exercises late last year, overall hourly labor compensation has exhibited few signs of acceleration. Thus, the rise in underlying unit labor costs has been mainly the result of the slower growth of output per hour. At the same time, evidence of increased pricing power can be gleaned from the profit margins of nonfinancial businesses, which have continued to press higher even outside the energy sector. Whether that rise in unit costs will feed into the core price level or will be absorbed by a fall in profit margins remains an open question.

Among the biggest surprises of the past year has been the pronounced decline in long-term interest rates on U.S. Treasury securities despite a 2-percentage-point increase in the Federal funds rate. This is clearly without recent precedent. The yield on ten-year Treasury notes, currently at about 4 percent, is 80 basis points less than its level of a year ago. Moreover, even after the recent backup in credit risk spreads, yields for both investment-grade and less-than-investment-grade corporate bonds have declined even more than Treasuries over the same period.

The unusual behavior of long-term interest rates first became apparent almost a year ago. In May and June of last year, market participants were behaving as expected. With a firming of monetary policy by the Federal Reserve widely expected, they built large short positions in long-term debt instruments in anticipation of the increase in bond yields that has been historically associated with a rising Federal funds rate. But by summer, pressures emerged in the marketplace that drove long-term rates back down. In March of this year, market participants once again bid up long-term rates, but as occurred last year, forces came into play to make those increases short lived. There remains considerable conjecture among analysts as to the nature of those market forces.

That said, there can be little doubt that exceptionally low interest rates on ten-year Treasury notes, and hence on home mortgages, have been a major factor in the recent surge of homebuilding and home turnover, and especially in the steep climb in home prices. Although a "bubble" in home prices for the Nation as a whole does not appear likely, there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels.

The housing market in the United States is quite heterogeneous, and it does not have the capacity to move excesses easily from one area to another. Instead, we have a collection of only loosely connected local markets. Thus, while investors can arbitrage the price of a commodity such as aluminum between Portland, Maine, and Portland, Oregon, they cannot do that with home prices because they cannot move the houses. As a consequence, unlike the behavior of commodity prices, which varies

little from place to place, the behavior of home prices varies widely across the Nation.

Speculation in homes is largely local, especially for owner-occupied residences. For homeowners to realize accumulated capital gains on a residence—a precondition of a speculative market—they must move. Another formidable barrier to the emergence of speculative activity in housing markets is that home sales involve significant commissions and closing costs, which average in the neighborhood of 10 percent of the sales price. Where homeowner sales predominate, speculative turnover of homes is difficult.

But in recent years, the pace of turnover of existing homes has quickened. It appears that a substantial part of the acceleration in turnover reflects the purchase of second homes—either for investment or vacation purposes. Transactions in second homes, of course, are not restrained by the same forces that restrict the purchases or sales of primary residences—an individual can sell without having to move. This suggests that speculative activity may have had a greater role in generating the recent price increases than it has customarily had in the past.

The apparent froth in housing markets may have spilled over into mortgage markets. The dramatic increase in the prevalence of interest-only loans, as well as the introduction of other relatively exotic forms of adjustable-rate mortgages, are developments of particular concern. To be sure, these financing vehicles have their appropriate uses. But to the extent that some households may be employing these instruments to purchase a home that would otherwise be unaffordable, their use is beginning to add to the pressures in the marketplace.

The U.S. economy has weathered such episodes before without experiencing significant declines in the national average level of home prices. In part, this is explained by an underlying uptrend in home prices. Because of the degree of customization of homes, it is difficult to achieve significant productivity gains in residential building despite the ongoing technological advances in other areas of our economy. As a result, productivity gains in residential construction have lagged behind the average productivity increases in the United States for many decades. This shortfall has been one of the reasons that house prices have consistently outpaced the general price level for many decades.

Although we certainly cannot rule out home price declines, especially in some local markets, these declines, were they to occur, likely would not have substantial macro-economic implications. Nationwide banking and widespread securitization of mortgages make it less likely that financial intermediation would be impaired than was the case in prior episodes of regional house price corrections. Moreover, a substantial rise in bankruptcies would require a quite-significant overall reduction in the national housing price level because the vast majority of homeowners have built up substantial equity in their homes despite large home equity withdrawals in recent years financed by the mortgage market.

In conclusion, Mr. Chairman, despite some of the risks that I have highlighted, the U.S. economy seems to be on a reasonably firm footing, and underlying inflation remains contained. Accordingly, the Federal Open Market Committee in its May meeting reaffirmed that it ". . . believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."