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THE 1994 ECONOMIC REPORT OF THE PRESIDENT: THE ECONOMIC OUTLOOK

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BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

January 31, 1994

Printed for the use of the Joint Economic Committee

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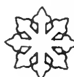

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[Created pursuant to Sec. 5(a) of Public Law 304, 79th Congress]

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THE 1994 ECONOMIC REPORT OF THE PRESIDENT: THE ECONOMIC OUTLOOK

MONDAY, JANUARY 31, 1994

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

The Committee met, pursuant to notice, at 10:30 a.m., in room 2172, Rayburn House Office Building, Honorable David R. Obey (Chairman of the Committee) presiding.

Present: Representatives Obey, Saxton and Cox; and Senators Sarbanes, Robb and Bennett.

Also present: Richard McGahey, Executive Director; William Buechner, Glen Rosselli, Caleb Marshall, Chris Frenze, Larry Hunter and Ed Hudgins, professional staff members.

REPRESENTATIVE OBEY. Good morning. On behalf of the Joint Economic Committee, I would like to welcome our witness this morning, the Chairman of the Board of Governors of the Federal Reserve, Alan Greenspan.

Before we begin, I want to thank Chairman Greenspan for agreeing to testify today. He has to leave to catch an airplane at 1:00 in order to attend a meeting of the Bank for International Settlements in Switzerland. We will do our best to get you out of here by that time. I will dispense with an opening statement and make whatever comments I have in the question period so that we can get right to your testimony.

Mr. Armey, do you or your designee have a brief statement?

REPRESENTATIVE ARMEY. Let me also welcome you, Mr. Greenspan. We are anxious to hear from you.

REPRESENTATIVE OBEY. Please proceed, Mr. Chairman.

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

MR. GREENSPAN. Mr. Chairman, just let me make a minor correction in my destination. I am off to London, not to the Bank for International Settlements. I am fearful that your announcement may create an expectation on their part, and they will wonder what happened to me when I don't show up.

REPRESENTATIVE OBEY. Sorry.

MR. GREENSPAN. In any event, Mr. Chairman, I want to thank you and the Members of the Committee for the invitation to appear before you.

As you know, the Federal Reserve will be meeting later this week and will submit its Semiannual Report on Monetary Policy to the Congress in late February. At that time, I will be in a position to address more specifically our expectations for economic growth and inflation and for monetary policy in 1994.

Under the circumstances, my opening remarks this morning will focus on identifying the major tendencies currently visible in the economy and the broad considerations that will likely be shaping our policy decisions in the weeks and in the months ahead.

As you may recall, in my appearances before this Committee in recent years, I discussed in detail the structural imbalances that I believed were impeding U.S. economic growth. I referred in particular to the enormous strains on the balance sheets of many households and businesses. Those strains, which grew out of the excessive debt expansion of the 1980s, were exacerbated by the subsequent weakness in real estate prices in the early 1990s. Moreover, these difficulties spilled over to the financial intermediaries, which—faced with mounting loan losses and with pressure from the markets and regulators to improve their capital ratios—restricted credit supplies to many small firms and other borrowers.

Considerable progress has been made in correcting these imbalances. Many households and businesses have materially improved their financial positions—as evidenced by the drop in debt-servicing burdens for all sectors and the decline in debt-to-equity ratios for businesses. In addition, banks and other financial institutions, having replenished depleted capital bases, have begun to demonstrate a greater willingness to make loans.

The Federal Reserve, through its deliberately accommodative stance, has played a key role in the restructuring process. But it is important to emphasize that monetary policy must not overstay accommodation: Maintaining the confidence of financial market participants has been crucial for sustaining the declines in inflation expectations and, hence, in long-term interest rates that have facilitated the balance sheet adjustments to date.

The actions taken last year to reduce the federal budget deficit have been instrumental in creating the basis for declining inflation expectations and easing pressures on long-term interest rates. Although we may not all agree on the specifics of the deficit reduction measures, the financial markets are apparently inferring that, on balance, the Federal Government will be competing less vigorously for private saving in the years ahead.

Partly because of these structural adjustments, the foundations of the economic expansion are looking increasingly well-entrenched. Real gross domestic product rose at an annual rate of nearly 3 percent in the

third quarter of 1993, and the advance estimate for the fourth quarter indicated growth of nearly 6 percent at an annual rate. The labor market has also shown signs of notable improvement. Payroll employment rose about 2 million last year, and unemployment dropped appreciably. The unemployment rate for December 1993, at 6.4 percent, was almost a full percentage point below the level of late 1992.

The greater buoyancy in economic activity of late has been evident across the household and business sectors. Housing construction, stimulated by mortgage rates that are the lowest in more than 25 years, has increased markedly; and consumer spending, after hitting a lull in the first quarter of 1993, has posted sizable gains over the past three quarters. Outlays on consumer durable goods have been especially robust, in part to make up for the spending on motor vehicles that was deferred during the 1990-1991 recession and the early expansion period. In addition, the pickup in home sales is bolstering purchases of furniture and appliances.

Business fixed investment was very strong throughout 1993. It rose nearly 15 percent in real terms over the four quarters of the year, and order books for early 1994 are apparently filling rapidly. Stimulated by dramatic innovations in products and extensive price-cutting by the computer manufacturers, real outlays for office and computing equipment have continued to soar as cost-conscious businesses have rushed to exploit the new technologies. And with a favorable outlook for overall business sales, ample profits and cash flows, and relatively low cost of capital, firms have also increased their outlays on more traditional types of equipment. In addition, activity in the nonresidential construction sector finally is recovering from the depressed levels of the past few years.

Business inventories have been expanding only moderately in the aggregate in recent quarters, and stocks generally are lean, especially at manufacturing firms. Should businesses decide that higher levels of stocks are appropriate, we could see production boosted substantially over the next few quarters. Order lead times on the delivery of materials, however, remain low and do not, at least for now, suggest an acceleration in inventory investment.

Although recent economic developments, on the whole, have been favorable, the expansion has remained uneven. In the labor market, firms' efforts to restructure and improve productivity are continuing to restrain hiring, and concerns about job security persist. In addition, employers seem to be relying to an unusual degree on the use of overtime and temporary employees, in part perhaps because of the cost of providing fringe benefits to permanent full-time workers.

Moreover, not all business sectors are faring well. In particular, industries and regions that depend heavily on military spending will continue to experience sizable dislocations and disruptions. Also, many state and local governments are still struggling to reconcile a rising demand for services—especially in education, health and crime prevention and correction—with limited growth in revenues.

Another concern is the weakness in the economies of some of our major trading partners, which has continued to constrain our export performance. Among the industrial countries, Canada and the United Kingdom appear to be emerging from deep slumps. However, signs of near-term improvements in Japan and continental Europe are scant. In Japan, asset deflation and associated financial problems continue to hold back growth; and, in Germany, the far-reaching and costly adjustments associated with unification are still a restraining factor. In reaction to their economies' weak performances, monetary officials in the two countries fostered continued, cautious reductions in interest rates in 1993, as did officials in most other industrial countries. Government budget deficits generally worsened last year because of cyclical factors and, in some cases, endeavors to stimulate demand. This deterioration of budget positions has limited the scope for further fiscal action in most countries.

As for the developing nations, economic conditions in Asia, fueled in part by exceptionally rapid growth in China, remained strong in 1993. In Latin America, however, real growth in Mexico fell to near zero, reflecting the depressing effects of a policy attempting to contain inflationary pressures and, for a time, growing uncertainty about whether the North American Free Trade Agreement would be implemented.

The passage of the NAFTA in November represented a significant achievement for the North American continent. Besides reducing tariff and nontariff barriers on trade, the NAFTA extends liberalization to nontraditional areas, such as financial services and intellectual property. The trade agreement reached in December in the Uruguay Round of the GATT also covers some of these nontraditional areas. Approval by the Congress of the GATT agreement would likely stimulate U.S. exports of high-technology products. More broadly, these agreements are significant because they represent a rejection by the United States and our major trading partners of calls to turn inward in our economic and financial policies.

Interpreting the economic data for the United States over the next few months will be especially complicated. As you know, the Bureau of Labor Statistics is redesigning the household survey of employment. Also, many key indicators of production and spending will be affected by the earthquake in southern California and by the extraordinary weather conditions elsewhere. Nevertheless, although real GDP growth will almost surely slow appreciably from the rapid pace of late 1993, the economic fundamentals appear to be in place for further solid gains in the level of activity in the quarters ahead.

Recent data on prices and wages generally suggest that inflation remained in check through 1993, with the fourth-quarter to fourth-quarter change in the so-called core CPI edging down to 3.1 percent, the lowest reading since the early 1970s. To be sure, the acceleration in domestic economic activity has put some upward pressure on prices of a number of industrial materials, and measures of resource utilization are considerably higher than they were six months ago. Nonetheless,

productivity growth has kept unit labor costs subdued, and the broad measures of inflation have remained well contained.

No doubt, many of the forces that helped restrain inflation in 1993 will continue to do so in 1994. Businesses will almost certainly remain intent on boosting productivity and controlling costs, and competition from abroad will continue to deter price increases—even in markets with limited spare domestic capacity.

History suggests, however, that higher price inflation tends to surface rather late in the business cycle and, hence, is not a good leading indicator of emerging troubles. By the time inflation pressures are evident, many imbalances that are costly to rectify have already developed, and only harsh monetary therapy can restore the financial stability necessary to sustain growth. This situation regrettably has arisen too often in the past.

The challenge of monetary policy is to detect such latent instabilities in time to contain them. Unfortunately, they are rarely visible until relatively far advanced. Moreover, once they are identified, policy actions to counter them take time to have their effects. Thus, the need of monetary policymakers for early indicators of developing problems is evident.

Historically, many such indicators have come from the financial sector: Money supply growth, the slope of the yield curve, quality spreads, and credit flows are among the variables that have helped monetary authorities over the years to act in advance of developing problems.

In recent years, however, as a result of financial innovations and the unusual nature of the most recent business cycle, such indicators have, at times, produced misleading signals. The broad money and credit aggregates, for example, have suggested declining inflation in the United States, but by far more than has actually occurred.

Turning to nonfinancial variables, the degree of slack in the economy is important because it plays a major role in influencing whether inflation is increasing or decreasing. Over the longer haul, however, the level of inflation—that is, the rate of price change—depends crucially on price expectations and not on the degree of slack in the economy.

In the 20 years after World War II, most economists gave short shrift to expectations as a key determinant of inflation. Unemployment and inflation were considered simple tradeoffs. A lower rate of unemployment was thought to be associated with a higher, though constant, rate of inflation. Conversely, a higher rate of unemployment was associated with a lower rate of inflation.

But the experience of the past three decades has demonstrated that what appears as a tradeoff between unemployment and inflation is quite ephemeral and misleading. Over the longer run, no such tradeoff is evident. Attempts to force-feed the economy beyond its potential have led in the past to higher inflation and, ultimately, not to lower unemployment but to higher unemployment as destabilizing forces and uncertainties associated with inflation induced economic contraction.

In that regard, experience both here and abroad suggests that lower levels of inflation are conducive to the achievement of greater productivity and efficiency and, therefore, higher standards of living.

Currently, we have the difficult task of assessing the appropriate time to move away from an extended period of monetary accommodation. The policy was established purposefully, largely to address the balance sheet strains I mentioned earlier. This monetary policy has been effective in that households and businesses are now in a stronger financial position. But the job is not yet complete.

Unfortunately, although we can assess how far the process of repairing balance sheets has proceeded, we do not know how much further it will go, mainly because of the difficulty of gauging desired levels of debt. What is clear, however, as I indicated here a year ago, is that we did not need to complete the job before evidence of faster economic growth would emerge. We have been growing in fits and starts, but smoothing through the data of the past two years we have seen real gross domestic product rise at a respectable 3.4 percent annual rate—sufficient to reignite job creation and significantly reduce unemployment.

A number of questions will have to be addressed by the Federal Open Market Committee. Foremost will be when is the appropriate time to move to a somewhat less accommodative level of short-term interest rates. We will have to make the judgment as to how long we can continue monetary accommodation without sowing the seeds of another bout of inflationary instability accompanied by steeply rising long-term rates. Such an outcome would bode ill for economic growth in 1995 and beyond.

On the other hand, we will also have to judge whether higher rates will slow the necessary completion of balance sheet repair to a point where economic growth is inhibited.

Short-term interest rates are currently abnormally low in real terms. At some point, absent an unexpected and prolonged weakening of economic activity, we will need to move them to a more neutral stance. Such an action would not be taken in order to cut off or limit the economic expansion but rather to sustain and enhance it. The foremost contribution monetary policy can make to achieving higher standards of living in the United States is to provide the stable financial foundation for continued economic growth.

Thank you, Mr. Chairman.

[The prepared statement of The Honorable Mr. Greenspan starts on p.35 of Submissions for the Record:]

REPRESENTATIVE OBEY. Thank you very much, Mr. Chairman. Let me say that last year when you testified before us at a similar time, a number of us— Mr. Sarbanes and I, especially—expressed some concern about what the future activities would be of the Fed. If I can paraphrase Shakespeare, "I come today not to criticize Greenspan but to praise him." I think that you have done a first-rate job in helping to

nurture noninflationary growth over the past year, and I think it has been especially constructive to see that you and the Administration have worked well together, with no appreciable conflicts that might upset the economy or its major players in any way. I want to congratulate you for that. I think you have every right to feel very good about the contribution that you have made towards the standing and the nurturing of that recovery.

MR. GREENSPAN. Thank you very much, Mr. Chairman.

REPRESENTATIVE OBEY. Let me say that there are a number of questions to ask you in a very brief period of time. So, in order to get you out of here in time, I will keep my questions short, and if you will keep your responses short, we shouldn't have any problem.

First of all, I would like to turn to the gas tax. As you know, we provided last year in the budget agreement a 4.3 cent increase in the gasoline tax, which went into effect in October. In September, the price at the pump was $1.15. Because of falling oil prices, the price at the pump is now $1.13½. At this point, given those numbers, I think it is safe to say that at this point the consumer is not experiencing any negative impact on the gas or energy price out of the ledgers, is that correct?

MR. GREENSPAN. That is correct, Mr. Chairman.

REPRESENTATIVE OBEY. Let me ask you about growth. The Blue Chip forecast for the coming year is coming in at around 3 percent. From what you see in the economy, do you believe that is a reasonable assessment?

MR. GREENSPAN. Well, Mr. Chairman, we will be coming forth to the Congress toward the end of next month with our projections for the future, and we have not yet completed the numbers, but, obviously, we are not going to be radically different from that number when we come before this body and produce in some detail our forecasts for the future.

REPRESENTATIVE OBEY. Last year, as you know, growth in the last quarter was very comfortable, but then it was much lower, especially in the first two quarters of 1993, recovering significantly in the last two quarters and providing strong growth. Do you believe we can be absolutely certain that there will not be a recurrence of that pattern with a major dropoff of less than 1 percent growth in the next quarter?

MR. GREENSPAN. Mr. Chairman, any forecaster who says he is absolutely certain about anything is tempting fate beyond any measure that I would like to get involved with. I do think it is true, however, that there is sufficient evidence to suggest that, unlike the period in early 1993, there seem to be underpinnings currently that—while not capable of sustaining growth at near the fourth quarter level, which was a partial aberration—are nonetheless of sufficient credibility to suggest that there is a degree of support in this economy that was absent at this particular time a year ago.

REPRESENTATIVE OBEY. So you think there is a strong underpinning in the economy, but there is certainly not 100 percent——

Mr. Greenspan. There can never be 100 percent certainty. One should never assume, even if the broad spectrum of economists conclude that there is no problem, therefore, they are correct. Economists tend to cluster their forecasts together, and very often that is not an indication of the degree of certainty that they hold.

Representative Obey. Inflation over 1992 was 2.9 percent, correct?

Mr. Greenspan. Yes, sir.

Representative Obey. And for 1993, 2.7 percent?

Mr. Greenspan. Correct.

Representative Obey. With the exception of 1986 when we had a huge drop in oil prices, when is the last time we have had inflation as low as 2.7 percent?

Mr. Greenspan. I would say the more relevant number is what we call the core inflation rate, which abstracts from volatile food and energy prices. And in order to get a comparable number at the level that we had last year, which was roughly 3 percent, slightly higher, you have to go back to the early 1970s.

Representative Obey. In addition, productivity last year was up what amount?

Mr. Greenspan. It was well in excess of 1 percent. We still don't have the data for the fourth quarter, but it looks to be a shade under 2 percent, fourth quarter to fourth quarter.

Representative Obey. And unit labor costs, they rose 1.8 percent?

Mr. Greenspan. Unit labor costs.

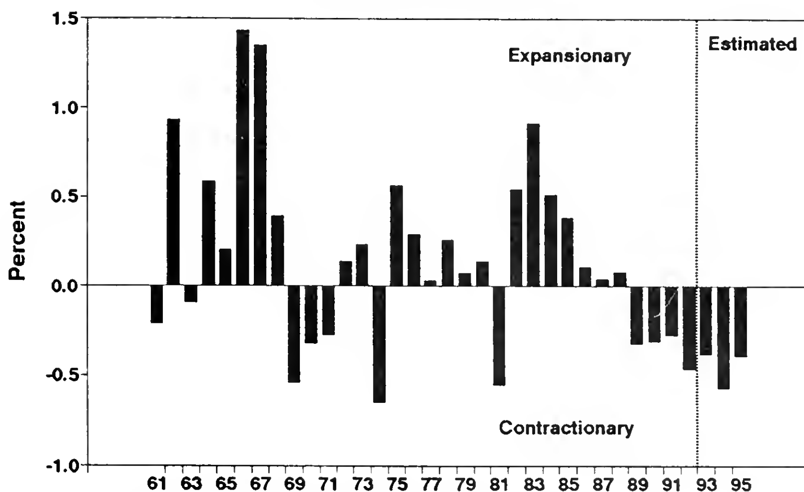
Representative Obey. From third quarter to third quarter.

Mr. Greenspan. Unit labor costs are clearly in the area of roughly 2 percent.

Representative Obey. At this point, there is no appreciable pressure on the wage front that would indicate a significant expansion of inflation, especially given the fact that we are in a world economy and we have significant sluggishness, as you cited, in Europe and Japan?

Mr. Greenspan. There are very marginal elements of evidence of some tightening in certain areas, but they are really at the margin, Mr. Chairman, and overall, I would not disagree with the characterization of the labor market that you just put forward.

Representative Obey. Let me also point out that there is another downward pressure. This chart is meant to demonstrate what the fiscal thrust result is from the federal budget policy, and what it demonstrates is that in past years, you have had some pretty heavy stimulus applied to the economy in the early 1980s (see chart below).



Source: JEC Staff calculations using data from CBO and Federal Reserve.

Obviously, you had some contractionary impact on the economy over the last two or three years, as well. But if you take into account what we did last year on the Budget Act, with the increase in revenues and the reduction in spending on a number of items, a significant portion of that is going to kick in this year. So our Committee staff estimates that the negative fiscal thrust, because of the Budget Act last year, is between 6 and eight-tenths of 1 percent of GDP. That certainly is not an inflationary action, is it?

MR. GREENSPAN. Mr. Chairman, throughout most of last year in discussing the issue of bringing the budget deficit down, I emphasized, to the extent that the budget deficit reduction was credible—meaning that it had long legs —that interest rates in the longer maturities would come down and that you would get a significant offset to the so-called fiscal drag coming from a significant decline in long-term interest rates.

Indeed, what I argued at the time is that the purpose of getting a lower budget deficit was essentially to improve the long-term outlook, and that if the deficit reduction is credible, then the long-term outlook gets discounted upfront. Indeed, that is precisely what is happening. The result is that as the prospective long-term outlook improves, what we get is a financial anticipation that is actually expansionary. And that, in my judgment, is the major reason why we have not had the effects of fiscal drag occurring as a consequence of the reduction in the deficit. But I would emphasize that it matters that those reductions remain credible. It is very easy to lose the gains that have been made in this area.

REPRESENTATIVE OBEY. I agree with that. If you look at the action that we took just on the budget side alone, you could argue that it, in fact, might create a negative impression on the economy. But when you factor in, as you said, the resulting expansion that comes from lower interest rates and confidence in the markets, we are better off in the long term.

I would like to close my ten minutes by making two points. First of all, I would like to congratulate the President for having the courage to tackle the budget issue in a credible way last year. I think we have seen some of the positive results of that. I want to congratulate you for, likewise, playing a very constructive role in seeing to it that the overall mesh and mix of public policy is one that did build a firm, noninflationary growth foundation for the economy.

I would like to say that I know that there has been a considerable number of stories written in the press discussing the fact that you might be entertaining sometime soon at least a small increase in short-term interest rates, and I would like to express a hope that that doesn't occur yet. Because as your statement indicated, absent an unexpected and prolonged weakening of economic activity, we will need to move to a more neutral stance.

I would agree with that, but simply express the view, given the limited number of indicators that inflation is around the corner and given the uneven nature of the recovery of corporate balance sheets and some other problems in the economy, that time, I hope, can be delayed for a few months. Thank you for your appearance here today.

Mr. Armey, please proceed.

REPRESENTATIVE ARMEY. Thank you.

It seems to me, Mr. Chairman, we have a very confusing set of circumstances. I am always torn between trying to determine whether inflation is too many dollars chasing too few goods or cost-push inflation. I think in the 1970s we had cost-push inflation.

It seems to me right now that we have a lucky set of circumstances. We have the M-1 growing at around 10 percent. It is hard to imagine that we can grow the money supply at that rate and come out with such nominal inflationary impact. Yet that, it seems to me, is compensated by the unusual circumstance in energy costs going down and the fact that businesses are gaining productivity by restructuring their use of labor in order to avoid mandatory fringe benefit costs.

Now, it seems to me that that puts us in the somewhat precarious position, if for some reason energy costs should return to an upswing and business exhausts its ability to minimize per-unit labor costs and gain productivity through those structural adjustments in employment, if Congress were to pass some major new mandate onto business, which also might involve a $250 billion increase in the deficit, it strikes me that the Fed could be forced into a substantial reduction in the rate of increase in the money supply. It seems to me, you make it very clear that there is going to be some tightening.

The question that puzzles you, that you struggle with, is when this will happen. So I guess my point is that, obviously, you have to watch five or six balls in the air at the same time, only a couple of which you can control. Don't you think this would be a particularly important time for Congress to go cautiously into the business of, one, creating new business mandates that would affect labor costs and, two, effecting the major public policy change that could have substantial impact on deficit increase? It strikes me that that would make your job almost impossible if we moved in that direction.

MR. GREENSPAN. First, let me just say that there were technical problems with interpreting M-1 increasing at the 10 percent rate. We have to recognize that some of that is the result of a very substantial acceleration of U.S. currency being shipped abroad, and one must presume that that is not impacting on the liquidity of the domestic system.

But I certainly agree with your concerns with respect to introducing long-term commitments in this economy that will be difficult to finance, because I think we have succeeded—and the Chairman has since alluded to it—that the underlying long-term economic outlook in this country is improving quite measurably. And, indeed, I don't recall as good an underlying base for the long-term outlook that we have today in the last two or three decades.

So I should certainly hope that we are very careful to nurture that extraordinary achievement and try to keep it going so that we can look forward to a continuation of solid economic growth in the years ahead and not run into a degree of financial instability which, historically, has always thrown us into a severe contraction or at least into a major slowdown in economic growth.

REPRESENTATIVE ARMEY. Thank you.

Let me say, Mr. Chairman, again, I admire the work that you do at the Fed. I want to just take a moment to reaffirm my belief that the Fed must be an independent agency in this country, that a separation between monetary and fiscal policy must be held firm, and that the biggest mistake we could make would be to do anything that would in any way abrogate your independence as an agency.

I know that the Fed is a favorite whipping boy in this town, but I have to tell you that I think the Fed does a magnificent job compensating for the failures of fiscal policy, and I want to express my appreciation to you and the other people at the Fed.

MR. GREENSPAN. Thank you very much, Congressman. I appreciate that, and I am sure my colleagues do as well.

REPRESENTATIVE OBEY. Before I call on Mr. Saxton, I want to say that Senator Robb had to leave earlier, and he wanted me to ask you a question, which I doubt very much that you will answer. Following up on the comment that I made to you about the Fed intentions, he wanted to ask whether you would be willing to indicate a trigger point that would result in the Fed's—assuming that it was substantial—raising short-term interest rates?

MR. GREENSPAN. I agree with the Senator's expectation of my willingness to respond to that.

REPRESENTATIVE OBEY. Well, I expected that, but I thought I would, out of courtesy to the Senator, ask the question anyway.

Mr. Saxton, please proceed.

REPRESENTATIVE SAXTON. Thank you, Mr. Chairman.

Mr. Chairman, in your testimony, which was really quite thorough, I thought, you seemed to get to two issues that we have all talked about for years and have tried to deal with for years. One is the deficit and the other is the fine job that you have most recently done, in terms of control of monetary supply, and the job that you have done in monetary policy.

Let me pursue something that Congressman Armey brought up just a moment ago. Early in your testimony, when you were discussing the bringing back into line of business and household debts and you mentioned that banks are again willing to make loans, which are certainly two ills that have come into more balance in recent times, you then went directly to several paragraphs about the deficit. Are those issues related?

MR. GREENSPAN. They are related in the sense that the major problems that we saw emerging when we started to ease in the spring of 1989 had to do with very strained balance sheets. And it was fairly clear, as the months and years wore on, that significant declines not only in short-term interest rates but in long-term interest rates were an essential ingredient for removing that strain and improving the structure of the financial system.

Crucial to that was a necessary reduction in inflation expectations over the longer run. And important to that—in fact, if not largely determinative—is the expectation that the budget deficit on a current services basis, which appeared to be accelerating out of control as we moved into the early years of the next century, be contained. It is only if that process is shown to be under control that inflation expectations will fall adequately. And long-term interest rates, as a consequence, will fall and bring about the remaining elements of improvement that we still foresee are necessary in the balance sheet structure of both households and business and, of course, of the financial institutions as well.

REPRESENTATIVE SAXTON. Thank you, Mr. Chairman.

The concern that I have is that we don't do something in terms of policy to upset what you described as a delicate balance. And I think it is.

Some months ago I asked the Republican staff of this Committee to look at pending policy to try and determine whether we may be headed on the wrong track in regards to, particularly, the President's health-care initiative.

Now, we can talk about the President's health-care initiative in terms of benefits that the public will derive from it, how it will affect medical

health-care delivery, and we can also talk about the finances of it. This study would seem to indicate that the projected monies that are available to pay for this program leave a substantial gap beginning in 1995, if it were to be enacted as it is in 1995, or 1994, and on through the year 2000.

As a matter of fact, depending on certain assumptions, the budget gap in those years could be as high as $1.7 billion, or it could be lower, depending on, again, the assumptions that one makes. Is this something that would have a negative impact on the economic growth, in your view?

MR. GREENSPAN. Mr. Chairman, obviously, anything that is significant change in any major program within this economy has impacts, and Congress and the Administration are, obviously, acutely aware of what economic impacts various different proposals will have on the economy.

These are very complex analytical questions. And even though we at the Federal Reserve try to understand the potential impacts of a lot of the different alternative programs, it is not easy to make realistic judgments as to how they impact on the economy. But I do think that there is a fairly important awareness, certainly, in the Office of Management and Budget, Congressional Budget Office, and a number of other areas of the Administration that are involved in this, that whatever is done has economic consequences, and that has to be a critical consideration of how we move forward in this particular area.

REPRESENTATIVE SAXTON. I certainly don't want to put words in your mouth, but, generally speaking, your testimony indicates that things are somewhat better today because the deficit appears to be shrinking. And, therefore, if Congress did some kind of a policy change relative to health care or any other subject that increases the deficit a substantial amount, it would not be considered to be good for the economy?

MR. GREENSPAN. That is correct. If there is any program out there or any combination of programs that reverse the view held in the financial markets that we are apparently coming to grips with this eroding budget problem, should that occur, the results could be adverse. And I suggest that one of the things that we have learned in the last year is how important it is to remove the expectation from the markets that the budget deficit is a potentially dangerous element in our system. I think a substantial part of the improvement in economic activity and the low rates of inflation can be directly related to a changing financial expectation that we might finally be coming to grips with this very severe problem.

REPRESENTATIVE SAXTON. I thank you, Mr. Chairman.

I would just conclude by saying that I certainly would not expect you to comment on this study, because it would be unfair to do so, but this study does indicate that there could be as much as a $250 billion a year shortfall in the President's plan. We have called this study, "$1 Billion a Day: The Financing Shortfall in President Clinton's Health Care Pro-

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posal." Whether we are right or whether we are wrong about the numbers in this, it is certainly an area of great concern, not only from a health care point of view but from an economic point of view. Thank you very much.

REPRESENTATIVE OBEY. Senator Bennett?

SENATOR BENNETT. Thank you very much, Mr. Chairman.

We have two Messrs. Chairmen here. If I could address Chairman Obey for a minute, I want to thank you for your praise of Chairman Greenspan. I sat here a year ago as a brand-new senator and listened to the things you referred to, where Chairman Greenspan was being told, look, if we don't get a recovery, it is going to be your fault. And now to hear you praise him, I, for one, appreciate your candor and your willingness to do that. I wish Senator Sarbanes had been here to hear it.

REPRESENTATIVE OBEY. I think he would agree.

SENATOR BENNETT. I was present on the Banking Committee when Senator Sarbanes told Chairman Greenspan that the President's proposals were contractionary, and if the Fed didn't get busy and bring about a contrary role and do something to inflate the economy, we were going to be in terrible trouble, and we shouldn't worry about inflation, said Senator Sarbanes. So I am delighted that we are having this kind of love-fest today. I appreciate the attitude Chairman Obey has taken with respect to that.

Now, Chairman Greenspan, there are some who have referred to the bond-market rallies as being demonstrative of expectations that the economy would get worse. Some journalists and commentators have said, "Well, the only reason people are buying bonds is that they expect the economy will get worse and that bonds will be their haven. If they really thought the economy was going to do well, they would get out of the bond market and get into stocks."

Is it your feeling that that is a wise analysis on their part? Or is economic growth generally good for the bond market as well as the stock market?

MR. GREENSPAN. Senator, I don't deny that there are those who have concluded that, and probably a number of investors in long-term Treasury issues as well, because they think the economy is weak. But I think the problem they fail to recognize is that if you have an unduly weak economy in the type of society that we have, the pressures to create inflationary recoveries probably mount in direct proportion to the perception that there is economic weakness. If we are talking about long-term government issues, 10 years, 20 years, 30 years, clearly the expectation of a very significant reflationary endeavor has to be negative to bond prices. And, in that sense, one should argue for the longer term that stable, solid long-term growth is probably more consistent with lower long-term interest rates than a chronic weakening that always has the overhang of a potential significant reflationary set of policies, which

must, of necessity, be adverse to long-term bonds and invariably push long-term interest rates higher rather than lower.

SENATOR BENNETT. I recall in the early 1980s a Treasury auction in which one of my clients was looking at buying a 30-year bond at over 15 percent. Looking back on it, that might be a pretty good instrument to hold today, but that, of course, added to the enormous deficits that we ran in the 1980s when the Federal Government was having to pay 15 percent on a 30-year instrument in order to finance the debt. And, today, what is the rate on a 30-year bond?

MR. GREENSPAN. Yield?

SENATOR BENNETT. Yes, yield.

MR. GREENSPAN. About 6.20 percent.

SENATOR BENNETT. Okay. Does not this reflect the very thing you are talking about, that the inflation expectations have gone out of the equation? So, if someone says, if I buy $100,000 worth of bonds today, I will get $100,000 worth of purchasing power some years from now, and, therefore, I can do with a much lower interest rate. Is that a fair analysis?

MR. GREENSPAN. There is a fairly significant inflation expectation still embodied in long-term nominal interest rates and if inflation over the longer term is expected to be less than is currently embodied in those rates, long-term rates will probably fall.

SENATOR BENNETT. And that, of course, produces a tremendous benefit to the deficit. I think the dropping of interest rates in the cost of financing the deficit has had as much to do with bringing the deficit down as some of the things Congress has done.

MR. GREENSPAN. I would think that it is also relevant to what it does to the economy and, therefore, the receipts side of the budget. One can presume that low inflation and low long-term interest rates are consistent, at least from the data that we have seen, with maximum economic growth over the longer term. And since real receipts are related to the level of real economic activity, one must presume that you have an improvement in the deficit outlook from that direction as well.

SENATOR BENNETT. So, by bringing the inflation expectations down, we bring interest rates down, so the government has to pay less to finance the debt. At the same time, we increase economic growth, and there is more revenue out of constant tax rates by virtue of larger economic activity, and we get the best of all possible worlds. Is that a fair summary?

MR. GREENSPAN. That is a fair summary.

SENATOR BENNETT. Therefore, harking back to my earlier comment, your resisting congressional pressure to do something about reinflating the economy was indeed the wise thing to do a year ago, and we are now seeing some of the benefit of that. Have I gone too far in praising you, or will you agree with that as well?

MR. GREENSPAN. I would suggest you put it in escrow, Senator, and pull it out in a year or so and see how it looks.

SENATOR BENNETT. All right. Fine. Thank you very much. I join my colleagues in congratulating you.

I notice in your testimony a rejection of what I understand to be the Phillips curve about inflation and unemployment being offsetting, and I think what you are saying is that we have demonstrated over the last little while that the Phillips curve indeed is not operative, and that those who believe in it should back away from it. Is that also a fair summary?

MR. GREENSPAN. I think that the economics profession, as such, has clearly altered its view from where it was a generation ago on that question.

SENATOR BENNETT. All right. Thank you, Mr. Chairman. I have nothing further.

REPRESENTATIVE OBEY. Mr. Cox.

REPRESENTATIVE COX. Thank you, Mr. Chairman. I am delighted to be present at a hearing wherein the Members of the JEC and the Chairman of the Fed can agree that the Phillips curve is interred, and we are in effect placing flowers upon the grave today.

It is an accomplished fact already, as the Chairman points out. I appreciate very much your plain English description of how this has transpired, first in the 20 years following World War II and then in our experience, subsequently.

You go on to make what I consider to be one of the most important statements in your entire testimony; that attempts to force-feed the economy beyond its potential have led in the past to higher inflation, presumably on the mistaken assumption that the Phillips curve was an iron law, and ultimately not to lower unemployment but to higher unemployment.

Your statement implies that if we could, we would know something about what constitutes force-feeding, what kinds of measures to stimulate demand, for example, and that we also would have in mind some sense of what is the real growth potential of the economy.

I wonder if I could ask you about both, since specifically you state attempts to force-feed the economy beyond its potential have led in the past to higher inflation. I wonder if you could illustrate that with a few historical examples that you would consider to be that type of force-feeding, which lead to higher unemployment in the first place. I would put that question to you.

MR. GREENSPAN. I would just as soon not get into very specific examples, because lots of people were involved in making those decisions as to what was done. It is pretty clear, however, that as we came out of the 1960s and into the 1970s, we began to get a phenomenon that was inconsistent with the Phillips curve that we labeled "stagflation." It did not seem essentially to be consistent with any of our previous notions as to the way the system functioned.

It is an understanding basically of what that process was: How one could have a situation of chronically high unemployment consistent

with chronically high inflation. It is an understanding of that process that has led us to a more general awareness that inflation expectations are a critical variable with respect to the actual performance of the economy, and, more than that, the data are increasingly beginning to suggest, although there is some technical dispute as to how to interpret this, that the rate of inflation is associated inversely with the rate of growth of productivity; meaning that low inflation seems to be consistent with a higher growth rate in productivity than periods of high inflation. What that suggests is that a period of low inflation is conducive to persistent long-term economic growth.

REPRESENTATIVE COX. Well, I certainly have every reason to agree with you, and I appreciate your circumspection in declining to illustrate, with an historical example or two, the kinds of force-feeding in the past that you have described in your testimony.

I wonder, on the second point, whether you might help us grapple with the question of knowing what is the real growth potential of the economy beyond which demands stimulus measures or even supply side measures might be considered to be force-feeding.

Last year, we saw 3.9 percent growth rate. Our historical average of the post-World War II period is about 3.1 percent. Some people are figuring that because of the slow rate of growth in the first half of 1993, even with a strong fourth quarter, it is going to come in lower than the 3.9 percent of 1992.

What is the economy's current growth potential? Should we perhaps adjust ourselves to something less than we have been accustomed to in the post-World War II period as we look ahead to the future?

MR. GREENSPAN. First of all, Congressman, we have had some slowdown in labor force expansion as the demographics of our society have slowed down the rate of growth of the number of people entering the labor force each year, and, of course, that has a significant lowering impact on the long-term rate of growth.

Granted that, the major element that determines the growth over the long term is productivity, or productivity growth, I should say. What we are seeming to observe in the last several years is some acceleration in the long-term growth in productivity, which is, to a substantial extent, the result of the restructuring that we have seen, which has had obviously some significant adverse effects in that it has created a good deal of job insecurity for a number of people in the work force. And that is clearly a darkened cloud in the process, which in general is quite favorable to long-term standards of living.

The Congressional Budget Office estimates that the long-term growth rate is, roughly, 2.5 percent at an annual rate. I want to emphasize, however, that we should be a little careful about taking these numbers of potential growth as though they are rigid, and we should not endeavor to improve on them because there is a considerable amount of gain in productivity that could occur, which we will not be aware of except in retrospect. And so we have to be careful not to look

at economic policy aiming at a fixed growth rate beyond which we are afraid to move.

The important question is that we should endeavor to gain long-term sustainable growth at its maximum level, and that we should be continuously observing the internal structure of the economy, the financial aspects of it, the inflationary aspects of it, to make judgments as to whether we are straining the system.

The issue is not a certain amount of growth, a ceiling that we should not endeavor to go beyond. More importantly, we should try to evaluate as we look at the economy whether it is moving forward in a reasonably solid, nondestabilizing sense—in which case what we are saying is that it is good growth—or whether we are looking at imbalances that are creating the seeds of some major structural change, which would contract the economy and raise the unemployment rate.

So, while it is useful for forecasters and policymakers to have a judgment as to where the growth potential is, as best they can judge, we have to be very careful not to assume that economic policy, whether it is budgetary or monetary policy, takes those numbers as a given and fails to continuously monitor the system to see whether what we are looking at is balance or distortion.

REPRESENTATIVE COX. I appreciate it. As always, you have given not only an answer but a lot more. Thank you.

MR. GREENSPAN. Thank you.

REPRESENTATIVE COX. I yield back. Thank you, Mr. Chairman.

REPRESENTATIVE OBEY. Thank you.

Mr. Greenspan, just a couple of points. Reference was made to Senator Sarbanes by my good friend Senator Bennett. I would simply say that I think Senator Sarbanes was correct in assessing the decisions that were made last year in the federal budget as being contractionary. They were meant to be, because it was felt that that was the only way that we could get a handle on the rising size of the deficit as a percentage of GDP.

I think that all Senator Sarbanes was indicating last year was that if we did not have the properly meshing monetary policy, the result could be an economic nose-dive if we got contractionary policies coming out of both the Federal Reserve and the U.S. Government's fiscal policy. I think that problem has been managed quite well, as I indicated.

Again, I don't want to debate the health-care proposition with my friends here to my left, although they are on my right. I don't want to debate health care today, except I would not want you to draw from comments made here today that staff analysis of the health proposal made by the President has any relationship to reality.

I noticed Senator Mitchell saying a week ago Sunday on Meet the Press, in response to a question from Bob Scheiffer, I think his words were, "The assumptions in the question are at variance with reality." I think the assumptions in the study were at variance with reality.

I don't want to get into that at this point. We will have plenty of time to do that. I think it is useful simply to recite again what has happened on the deficit as a result of that contractionary policy, when viewed narrowly, on the part of the budget. For 1993, President Bush estimated that the deficit would be $331 billion and CBO estimated it would be $310. It wound up being $255. For 1994, CBO estimated on January 1993 that the deficit for fiscal year 1994 would be $291; they now estimate it to be closer to $223, which is a $68 billion improvement. And for 1995, the CBO estimated on January 1, 1993 that the deficit would be $283 billion. They now project it to be $171, which is an improvement of $103 billion. So I think that indicates that things are headed in the right direction.

I would like to return to the Phillips curve comment that your comments have elicited from the Committee here. You indicate that the experience of the past three decades has demonstrated what appears to be a tradeoff between unemployment and inflation is quite ephemeral and misleading. You then cite examples that primarily relate to efforts to move the economy to the upside.

Let me ask, do you not also agree that the Phillips curve linkage on the downside is not also ephemeral, given the integration of the U.S. economy into the world economy to date; given the fact that that means workers, even if conditions in our own economy might dictate some pressures on their part for upward adjustments in wages, which might theoretically be inflationary, are inhibited in their ability to do so because of the integration of the world economy, and because of the fact that they are in competition today with goods around the world produced, in many cases, by low-wage workers? Does that not also mean that we should not assume that just because unemployment gets to a magic level of 6 percent or 5.5 percent that that is an automatic indicator of immediate inflation around the corner?

MR. GREENSPAN. I agree with that, Mr. Chairman. It is a symmetrical conclusion. The evidence clearly suggests that the slack abroad, which has led to low domestic prices abroad, translated into low import price inflation in the United States, especially since the dollar has been stable over the most recent years. So what we do get reflects actions coming from abroad. What we do not pick up, however, is any significant secondary effect from slack abroad having a significant impact on the degree of wage inflation in the United States.

What is clearly the case is that we have been through in the early part of the post-World War II period is a period of low inflation and low unemployment. I mean, there is nothing that suggests that low unemployment means high inflation for precisely the same reason that the reverse is also not true over the long term.

REPRESENTATIVE OBEY. Let me ask, because Mr. Armey and I were both talking about the fact that the BLS will be releasing its unemployment data for this month on the basis of a new survey that reflects a new method of collection of unemployment information, has there been adequate discussions between your people and BLS people that

the Fed clearly understands what the meaning of those numbers will be when they are released this coming week?

MR. GREENSPAN. There has been very extensive discussions between our two agencies. The Commissioner came over and visited with us a while back and went over in some considerable detail what the data were showing. We have had very considerable staff contacts on an ongoing basis, and when the new data come out, I am sure we will be in close contact with the Bureau of Labor Statistics to see whether or not we can infer precisely what the changes are as they affect the economy.

REPRESENTATIVE OBEY. Thank you. My five minutes are up in this round.

Mr. Armey?

REPRESENTATIVE ARMEY. Thank you. I don't want to belabor these points, but the fact is that the Clinton budget plan was enacted in August 1993 and the fiscal year ended about a month and a half later. So I don't think we ought to detract from the Federal Reserve's role in this matter by claiming, in any way, that the fiscal policy of the current Administration had any impact on fiscal 1993. It just simply did not; no more than any other Presidency's impact.

I have to tell you, Mr. Chairman, I am distressed. We went through a trauma in the 1960s with President Johnson insisting on an integration of the Fed being more closely under the jurisdiction of the Executive Branch of government. This specter seems to be rising again, and I have no doubts that those of you in the Fed will understand the importance of this. But it strikes me that one of the most dangerous things that we could do to the future stability of the American economy would be to pursue any number of the plans that are out there, which essentially compromises your jurisdiction and independence over monetary policy.

So I would, again, aside from all we might talk about who did what and how it got done, I do want to affirm that there is at least one stalwart champion of the Federal Reserve's independence, who has enough of an institutional memory on this subject to still thank God that William McChesney Martin got away from the Texas barbecue with his hide, and the fact is that the Nation has survived ever since that time without suffering the foibles of the compounding of Executive Branch jurisdiction on both fiscal and monetary policy.

I know I do have a chance to have another round, but I do know that Mr. Wayne Angell is leaving. I hope for your sake, the sake of the Fed, the sake of the Nation, that we can find somebody of his strength, understanding and character to join the Fed in his absence.

But let me again thank you. Milton Friedman is my hero, and there are few things that I have ever disagreed with the professor on, but one is his comment that if you cannot find something bad to say about the Fed, don't say anything at all. I find the Fed, to a degree, less than most institutions in this town, is worthy of that kind of compliment.

So my hat is still off to you. I appreciate the good work you do and the diligence by which you maintain the surveillance over our money supply, and I want to thank the Fed for its contribution to the current sustained recovery from the modest recession that we experienced a few years back. Thank you.

MR. GREENSPAN. Thank you very much, Congressman.

I want to say for my colleagues, we are going to miss Wayne Angell. Unless you work on a day-by-day basis with him, you are not very clear what contribution he has made, but he is a man of extraordinary integrity and conceptual insight. And I must say that I personally will miss him and trust that his endeavors in the future are as productive as his tenure at the Federal Reserve has been.

REPRESENTATIVE OBEY. Mr. Saxton.

REPRESENTATIVE SAXTON. Mr. Chairman, late in your testimony you talked about indicators that occur in the economy, that the business cycle may be turning perhaps in a negative way, and you also indicated that oftentimes by the time we recognize those indicators—I have forgotten the term you used—drastic measures have to be taken to make corrections.

I guess my question is, what are those indicators today, what do they look like, and how does monetary policy currently reflect what is happening with those indicators?

MR. GREENSPAN. I am sorry, would you repeat that for me? I didn't quite get it, Congressman. Which indicators are you referring to?

REPRESENTATIVE SAXTON. The indicators that are inherent in the economy, which you referred to——

MR. GREENSPAN. You mean the various financial indicators?

REPRESENTATIVE SAXTON. Yes, sir.

MR. GREENSPAN. Well, clearly money supply growth—meaning M2, which is the conventional measure that we have been using for a number of years —has still not moved back on track. You may recall a year or so ago that I argued something very abnormal was occurring, that we were getting a divergence in nominal gross domestic product, which was rising more rapidly than the projected gross domestic product from the money supply. Well, that gap has not closed. It is still fairly wide. And the evidence is that even though the growth in M2 is within the ranges we postulated a year ago, it clearly was adjusted to those ranges because we saw the relationships had gone off track.

I might say that the fact money supply is growing in the lower part of our ranges is a measure of the fact that it is still off track.

So far as the slope of the yield curve is concerned, we moved to an extraordinary, probably historic, spread between short- and long-term interest rates a number of months back in 1993. In other words, we had a very severe tilt with the long end of the market high and the short-end low. It has tilted back a little bit, but it is still at a very historically high slope.

So the change is not large, but there has been some change in those indicators with respect to economic activity, but they are still not working all that well.

CONGRESSMAN SAXTON. Do you contemplate changes in monetary policy that would tend to act as a correction mechanism?

MR. GREENSPAN. I don't think we would introduce particular monetary policy actions to address ourselves to those particular indicators, because, remember, they are symptoms of what is going on in the system, and we want to see what they are doing. In other words, as Congressman Armey mentioned earlier, we were getting divergent readings with respect to our various different measures of money supply, which was creating somewhat differing views as to what the degree of liquidity was in the system.

These are all measures of the temperature of the economy, if I may put it that way. And the last thing we want to do is to try and find policies that somehow play with the thermometer rather than the patient, which we are trying to deal with.

So we are displeased with the fact that a number of those very useful early indicators of emergent troubles have gone astray, but we suspect that they may come back at some point and be as useful as they have been in the past. But I am disinclined to say at the moment that one can infer as much now as in the past from the data.

REPRESENTATIVE SAXTON. Thank you.

Thank you, Mr. Chairman.

REPRESENTATIVE OBEY. Mr. Bennett?

SENATOR BENNETT. I see Senator Sarbanes has come in. I probably should defer to him. Having raised his name without his presence, I better let him defend himself before I go on further.

REPRESENTATIVE OBEY. Why don't you go ahead and let him organize his notes.

SENATOR BENNETT. All right. I need to be appropriately differential to him, since it looks as though he is going to be Chairman of the Banking Committee later on, which I serve on.

If I might, Chairman Greenspan, take advantage of your presence to return to one of my hobby horses and get you to comment, in the atmosphere of the soundness of the economy, on the issue of the capital gains tax. What would happen to the economy if Congress were to make some changes in the capital gains tax, which is now at historic highs? I understand revenue from capital gains is at relatively low levels, considering the amount of economic activity that is going on.

President Bush proposed to increase the revenue from capital gains tax by lowering the rate, thereby freeing up a number of investments that otherwise are staying as they are in order to avoid the historic high rate for capital gains. Others have suggested indexing capital gains; that is saying that there would be a zero rate on inflationary growth in capital gains, but not the existing rate on the real growth.

Of course, you have expressed your preference for a zero rate across the board, which if you and I were running the world is what we would have. I don't think that is politically possible. I think history has demonstrated that.

Could you comment on the other two possibilities: Either lowering the rate to something in the neighborhood that President Bush proposed; or indexing capital gains so that that which is taxed is only real gain rather than inflationary gain?

MR. GREENSPAN. Senator, on the indexing, I think that it is appropriate to view a realized capital gain as composed of two elements: One, the underlying general inflation rate in the economy, which has nothing to do with the particular investment that was taken by the investor; and the actual realized gain over and above that.

I don't think it is proper to have a tax that essentially reflects the degree of laxness in governmental economic policy that leads to inflation. If one is going to tax capital gains—and as I have indicated previously I have a long-held belief that that is not a useful means of achieving revenue in an economy—but if one is going to tax them, it strikes me that an individual investor should not be taxed on the fact that inflation has occurred as a consequence of actions over which he had no control.

So I would argue strongly, if one does have such a tax, that at least the rate be imposed on the actions over which the person being taxed has control, and not taxed because there was, say, a less than responsible policy that engendered a degree of inflation that affected the value of the property that he has.

SENATOR BENNETT. Do you have any numbers that would indicate what effect that would have on the economy, if we were to move to an indexed capital gains? Would we be better off now?

MR. GREENSPAN. No, Senator, I do not, but my general view is that it could be nothing but positive.

SENATOR BENNETT. That is my general view as well. I have heard people say, "Well, if you change the tax on capital gains, everybody would simply shift income from ordinary income to capital gains income and thereby avoiding the tax." I have been in business a lot of years and I have never figured out how to do that.

Do you have any strategies for shifting income, or any understanding of how people could shift their income, from regular income to capital gains income?

MR. GREENSPAN. There are innumerable strategies that used to exist. My judgment is that many of them have been eliminated in recent legislation, but, in any event, when I was in the private sector and I looked at all of these vehicles, it always struck me that it was the lawyers and the accountants who really got the value added and not the taxpayer who figured ways around that. So I have never been able to really find a means by which you can very significantly avoid the tax structure, and

that is especially the case, incidentally, with the statutes as they currently exist.

SENATOR BENNETT. I see.

Thank you, Mr. Chairman.

REPRESENTATIVE OBEY. Mr. Cox?

REPRESENTATIVE COX. Thank you, Mr. Chairman.

There is another theory, I understand, about why some people are shifting into capital assets, particular financial assets, and I would like to have you comment upon it, if you would. Those of us who are trying to track what it is the Fed is doing have noticed that while M2 has been expanding relatively slowly over the last year, indeed over the last 13 weeks, both averages around 2.5 percent, that the monetary base has been growing much more rapidly during the last 52 weeks, in the area of 10 percent growth. Recently, some slower growth, around 5 percent; but over the 52-week period, ending right about now, 10 percent.

Some analysts have expressed concern that the rapid growth in this so-called high-powered money is not going into M2 but rather into the securities market, and as a result, they fear, in financial asset inflation, inflation that does not show up in the CPI because it is not going into M2. If this scenario is accurate, the analysis goes, the bubble could pop; we would see a break in the market, sudden rapid increase in M2, and a knife-edge inflation burst. Could this theory be real? How would you respond to those analysts who put it forward?

MR. GREENSPAN. First of all, we have examined the issue of the lead elements involved in the monetary base, and we have not been able to find significant use for the monetary base. Certainly M2, except for its most recent period, has been a rather useful indicator, and I feel somewhat chagrined that we have lost some of the potency of it.

But as I said earlier, remember that the monetary base includes currency—which is, to a large extent, reflecting a substantial flow abroad—and reserve balances—which, to a very large extent, reflect transaction deposits, which legally require reserve balances. The very large mortgage refinancings that we have seen in the last year or so have boosted the transaction deposits because there were escrow accounts that were associated with those mortgage refinancings. That has meant that we have had a much larger increase in M1 than would otherwise have been the case. That M1 is largely immobilized. Nonetheless, it still requires reserve balances, and therefore the monetary base has shown some fairly significant momentum.

We have looked very closely at whether we can use the monetary base as an indicator in the same way that we have used M2 over the years. That is, it is certainly the case that you can find sub-periods in which the use of the monetary base seems to coincide with the growth of nominal gross domestic product with a significant lag. And this is largely what a number of these analysts are showing. The trouble is, when you carry it back in time, the relationship falls apart.

It is important not necessarily that monetary relationships are generic through a whole particular period, but if you are choosing a specific sub-period, you have to be able to argue that the particular choice for that period is relevant and the broader period is not. We have not been able to draw that distinction with respect to the monetary base as a useful tool, and especially since we have altered the base over which reserves are calculated relative to deposits.

We do get a narrow effect coming from the fact that transaction balances are involved here, and we are no longer reserving a much broader element of the deposit base in the system.

I don't know whether this appropriately responds to your questions, Mr. Cox, but that is essentially where we have been coming out.

REPRESENTATIVE COX. It certainly is satisfactory on the point, at least for the time being, whether the monetary base might confidently be used as a predictor. It leaves some question, I suppose, definitionally unanswered as to whether we can measure in any way the spread between M2 and the monetary base that might have disproportionately found its way into financial assets.

MR. GREENSPAN. We have looked at that in some considerable detail—about how the household and the business sectors are restructuring their balance sheets with respect to how various different elements in the monetary system behave. Indeed, one of the things on which we have done an extraordinary amount of work, subsequent to the difficulties we have had with M2 as an indicator, is looking at all such relationships that you indicate, and we have found some.

We have found, for example, that if you take M2 and add mutual funds, you get a more stable relationship recently. Unfortunately, the trouble with that is mutual funds' values are affected by the prices of the assets that they have, and that can very significantly distort what the measure of liquidity would have. As a consequence, we are still working to find better relationships than we currently have.

I am finding it, I must say, rather frustrating that we are not able to do as much as I would like to do. But that has not deterred us from trying to understand in far more detail the various processes of what the economy is doing for which these various financial indicators were used as a proxy. If we cannot have the proxy, it means that we have to look in far more considerable detail at how the system is working.

It makes it more difficult for us to understand the processes of economic growth and contraction in inflation and instability, but it does not mean that we have lost control of how we do our job. It just makes it more difficult. It takes more effort and more focus, and it means we cannot use a number of the simpler indicators, which we found so useful in the past. It does not mean that we cannot know what is going on and how our policies affect the economy. It just means that we have to work in a far more detailed manner looking at far more elements within the system in a far broader context than we had been able to do 5, 6, or 10 years ago.

REPRESENTATIVE COX. Well, I certainly appreciate that, and I hope for my part that some of these analysts are wrong.

I also thank the Chairman and want to recognize the time limitation, so I will not put any more questions. I would like to add at the conclusion of my time that there has been some question raised about the validity of the assumptions that went into the JEC staff report on the President's health care plan. I think it would do us all well to take a look at that report because the assumptions, all with respect to revenues, are favorable to the Administration. They are all based on static analyses, and they assume, for example, that the CBO predictions about growth in GDP actually come true; that is, health care on balance will have no unfavorable impacts on business activities, despite the mandates and the taxes and so on.

They assume that wages and salaries remain at their historic 49 percent share of GDP, so the act would have no unfavorable impacts on wages and employment. In a footnote to this report, it is pointed out that if these favorable assumptions do not materialize—as people like Martin Feldstein suggest they will not—rather than looking at $3.5 billion shortfall in financing for this health-care proposal, we will be looking at significantly worse numbers, because, for example, as Feldstein points out, the health-care tax increases will reduce 1997 wages by $115 billion, and therefore depress federal tax revenue that year by a total of $49 billion.

So my colleague, Mr. Saxton, was citing numbers that are at least taking the report at face value. The most favorable numbers that we can come up with, using all of the Administration's own assumptions, if we use other people's assumptions, the picture looks worse still.

I thank the Chairman.

REPRESENTATIVE OBEY. Let me simply say before I turn it over to Senator Sarbanes, I am sure the study will receive all the attention it deserves.

Mr. Greenspan, before I turn you over to Senator Sarbanes——

MR. GREENSPAN. You make that sound as though I am being fed to the lions.

REPRESENTATIVE OBEY. No, I just want to make sure he gets his shot at you before you leave for your plane.

I do want to observe that I hope you keep in mind the fact that while the growth number that was announced in the last quarter last week was very impressive, I think even more impressive was the fact that the inflation numbers, which were also part of the report were very encouraging. In fact, apparently because of those inflation numbers, the 30-year Treasury prices actually rallied, and they are doing that somewhat again today as well, which is good news. I can't help but put in context what that GDP deflator looks like historically. As you can see, we have not had a year with the GDP deflator as low as it is today, going all the way back to 1964. It almost made it once in the 1980s, but

not quite. So I think, in historical terms, the performance looks awfully good.

MR. GREENSPAN. In fact, Mr. Chairman, that 1980 number is the 1986 figure that had the significant oil price drop, which had an extraordinary impact on it.

I do think what is interesting about the data that are coming out is the importance of looking beyond the Consumer Price Index to get an essential judgment as to the total inflation level. In that sense, it is not so much the GDP deflator *per se,* but some of the other components like domestic purchases with fixed weights, which essentially is the Consumer Price Index plus elements purchased by the business community and others. This shows a lower rate of inflation than the CPI, because there are very considerable downward pressures coming from computer prices that feed into the business sector. And it is not only in personal computers that that is occurring.

In that regard I think what the markets are responding to is this broader measure of inflation, essentially the one that is reflecting the degree of stability, or lack thereof, in the economy, and as a consequence of that, there has been, I think, increasing awareness that these broad measures are important to understanding the degree of inflation in the total system.

They all measure different things, incidentally, and we have to be careful not to assume that they are all looking at the same thing. For example, the Domestic Purchases Index is closely related to the Consumer Price Index, whereas, the GDP deflator—the one you show there, which is, I assume, the implicit deflator—has only the cost structure in the domestic economy and strips out the effects that occur as a consequence of import prices changing; whereas the fixed weight Domestic Purchases Index does reflect this broader impact. That is largely what is depicted in the chart that you showed us today.

REPRESENTATIVE OBEY. I understand.

Senator Sarbanes?

SENATOR SARBANES. Thank you very much, Chairman Obey.

Mr. Chairman, I have been listening to these answers with some concern, not so much by the substance ... I gather you are about to leave and get on an airplane. Could I inquire what kind of timeframe——

MR. GREENSPAN. I actually have until 1:00.

REPRESENTATIVE OBEY. However, Senator, you do not get all that time.

SENATOR SARBANES. But I assume I will get time that equalizes me with my colleagues?

REPRESENTATIVE OBEY. I will recognize you for 15 minutes, because the others had a 10-minute opening round and a 5-minute follow up.

SENATOR SARBANES. All right. First of all, let me say at the outset, just to set the stage, Chairman Obey, that I want to welcome, as I know others have done, Chairman Greenspan before the Committee. It is

always a pleasure to have him here and to have an opportunity to exchange views with him.

I cannot understand the kind of wailing and gnashing of teeth I am hearing over the fact that the economic ship is off course. All the reports that are coming in now—we had the CBO report the other day—indicate that this economic ship is on course.

My own view is that the policy on everybody's part ought to be "Steady as she goes." I think that means that the Congress, of course, needs to stay with the discipline of the fiscal policy that was enacted in the measure passed last August, and I would hope it would also mean that the Fed would stay with its monetary policy and not move it around at this point.

Now, last February in the Humphrey-Hawkins report, the Board of Governors came to the Congress and said, and I quote:

> With regard to fiscal policy, credible action to reduce the perspective size of future federal budget deficits could yield a very direct and meaningful payoff in the form of lower long-term interest rates.

Apparently Senator Bennett made some comments, but it is quite true about what I pointed out, along with Chairman Obey last year, was that if we were confronted with this problem of trying to address a federal budget deficit that was on an upward trend line, so much so in fact that as a percentage of GNP, it was growing, and that was seen as a very important thing to accomplish.

Even though we were confronting significant unemployment, it was asserted to us, as I have just read from the Humphrey-Hawkins report, and more generally, if we could put in a credible deficit reduction program, it would bring a response on the financial and monetary side, which would give us better interest rates to work with and that the sectors of the economy sensitive to the interest rates would then respond.

So, while you were restraining the economy through your fiscal discipline, you would get some impetus for growth in the economy through the response to an accommodating monetary policy. My own view is that that is what has happened, actually. And I think this package that was put together has been working pretty well. In fact, it has been working so well that there has now been a revision of the deficit reduction goals, or projections, I should say, so that they are even more forthcoming than they were when we put the package in place.

So I am very concerned with keeping this economic ship on course. I know that does not come as a surprise to you, but I wanted to say that by way of preface to some questions I want to put.

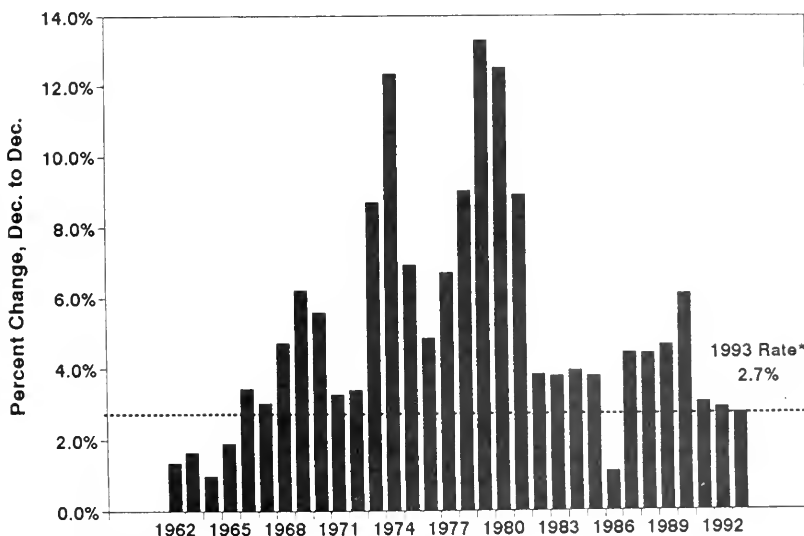
First of all, my understanding is that the inflation performance rate last year was 2.7 percent; is that correct?

MR. GREENSPAN. Yes, sir.

SENATOR SARBANES. That is the lowest inflation rate—this is the CPI inflation rate—the lowest inflation rate since 1965, with one exception. The one exception being——

MR. GREENSPAN. 1986.

SENATOR SARBANES. Yes, 1986. That is reflected in this chart (see chart below). This is the inflation rate for last year, and as we can see, it is lower than any year going back to 1965, with the exception of this year in the mid-1980s when we had a sharp break in oil prices. Am I correct in that analysis?



MR. GREENSPAN. That is correct, Senator.

SENATOR SARBANES. So on the inflation front, that is really a very, very good performance. I mean, it is the best performance in almost 30 years, with one exception.

Now, I also understand that the Bureau of Labor Statistics has done some studies published in the *Monthly Labor Review,* which suggests that the inflation figure of 2.7 percent could actually overstate the actual inflation rate by as much as half a percentage point. Are you familiar with those studies?

MR. GREENSPAN. I am, Senator. In fact, our view is that we suspect the adjustment may be even more than that.

SENATOR SARBANES. And is that based on some studies that the Fed staff has done?

MR. GREENSPAN. Yes, the Fed staff and a number of economists in the private sector who have been looking at these data in some detail.

SENATOR SARBANES. Now, if those studies are accurate—because time is limited, I will not probe into the factors of those studies, although, Mr. Chairman, at some point, it might be helpful for us to do a hearing that would do that—but if those studies are on track, then it is quite possible that we are really dealing with an inflation rate more around 2 percent than 2.7 percent. Would that be correct?

MR. GREENSPAN. Yes, sir. That is a CPI inflation rate. The point I was making earlier with Chairman Obey is that if one looks at the broader inflation rate, it is probably less than that.

SENATOR SARBANES. Even less than that?

MR. GREENSPAN. Yes. I have said on many occasions in testimony before the Congress that I thought we were not all that far from price stability. Indeed, I think history does suggest that while we are not there yet, clearly, we have made considerable progress in that direction, as those data show.

SENATOR SARBANES. There are some who think that if you get growth of any significant degree and duration, you are going to get an increase in labor cost. I would like to ask about that because it is not quite clear to me that the old connection that was posited between those two factors exists. First of all, you have a fairly good productivity performance. Would you agree with that?

MR. GREENSPAN. I do.

SENATOR SARBANES. Second, we are now more integrated into an international economy, so as you get slow growth in Europe, high unemployment and low wages in developing Third World countries, all of which, of course, put their products into the international trading regime. Does that not also act as a pressure or a restraint on an increase in labor costs here?

MR. GREENSPAN. It works in that sense, if you are asking: Does an increased degree of imports that has occurred in this country where inflation rates are being suppressed by excess capacity abroad, does that impact on the price levels in the United States? The answer to that is yes. Import prices have been rising at a fairly subdued pace and have contributed to a not insignificant part of the decline in overall inflation as reflected in the Consumer Price Index. But I think we do have to be a little careful about presuming that one is dealing wholly with an international market where the effects of high unemployment in one area are fully transmitted into the United States. The evidence we have suggests that that is a relatively minor effect. And we have not been able to find, other than through the direct effect on import prices, a major impact on domestic wages or domestic prices as a consequence over that phenomenon.

SENATOR SARBANES. I was struck by a column written recently by Hobart Rowan in which he pointed out that there are many pressures on wages in the United States, including plentiful imports from abroad,

where labor is in excess supply, double-digit unemployment in Europe and low wages in Third World countries.

Just to address this notion, if you begin to restore employment and bring down the unemployment rate and therefore begin to tighten up the labor market somewhat, it is inevitably going to lead to rising inflation. I think that lays the basis for the inflation dimension that I want to address.

MR. GREENSPAN. Let me add one thing, Senator. Remember that most of this process seems to be working through the goods components of imports. And the evidence, as far as I can judge, that we are getting spillover effects in the services area from abroad is inconclusive on that question.

SENATOR SARBANES. The other point, on the commodity indices, I gather that the raw materials used in industry and manufacturing actually are declining that index.

MR. GREENSPAN. I am sorry, is what?

SENATOR SARBANES. Raw materials for industry and manufacturing are declining?

MR. GREENSPAN. No. As I indicate in my prepared remarks, there is some evidence that they have been firming of late. That is a consequence of the fact that there has been some pickup in orders and demand and the degree of domestic industrial production slack has gone down, and there is some relationship that exists with respect to those particular prices and the levels of industrial activity, which seem to be working now as they have in the past.

SENATOR SARBANES. I will stand corrected. I understood that the index based largely on farm prices rose steadily during 1993. Of course, we had the flood in the Midwest and drought in the Southeast that impacted food prices, and which are hopefully one-time occurrences and will not repeat themselves in 1994.

I understood the other index, based primarily on prices of industrial raw materials, fell during most of 1993.

MR. GREENSPAN. I think you can find, if you want to dissect the producers' price index, that there are elements that are going up and going down.

In general, prices have been remarkably stable. We have seen, for example, some pickup in some of the domestic raw materials prices. For example, steel scrap prices have risen quite significantly. Lumber prices have risen. My recollection is that cement has risen. There are a number of them. They are not sufficiently broad-based to stipulate that there is a major expansion coming from the commodities' side by any means.

SENATOR SARBANES. I will close on this by quoting from this morning's *Wall Street Journal,* which says:

> Treasuries were pushed higher across the board Friday on word that inflation pressures were minimal in the fourth quarter.

Soon after, in the morning, the Commerce Department reported fourth-quarter gross domestic product figures prices began soaring. Profit taking by midafternoon took some of the glow off the gains, but, nonetheless, the market put in an impressive performance. The Commerce Department reported the fixed-price deflator rose at a rate of 2.2 percent, and the implicit-price deflator, a measure of consumer consumption patterns, rose at a rate of only 1.3 percent.

Now, let me turn to the growth figures. What I am concerned about is this talk about, quote, a preemptive strike. Now, a preemptive strike, the way it is being defined, is something that would be done without any rational base, without any figures with which to work off, at least as some asserted. I am not attributing this to you, Mr. Chairman, but I am talking about some others who talk about it.

In effect, they say, "Well, these figures are all very good." In fact, they are the best figures, as I have outlined, in 30 years. Everywhere you look, you can find a little tightening here and a little tightening there. But, as you have said this morning, it is basically stable. Yet, you get people coming along saying, well, now, we have to have a preemptive strike. Yes, we know all of those figures, and I can't cite you something that warrants it, but we want to move in in anticipation. Of course, you can do anything on that basis. I mean, all you have to do is to conjure up a scenario, then you anticipate it, and then you do your preemptive strike.

Now, let me ask you this question. Last year at this time, do you recall what the Blue Chip forecasters were predicting for the growth of the economy?

MR. GREENSPAN. You mean for basically——

SENATOR SARBANES. For 1993.

MR. GREENSPAN. You mean the end of January, or thereabouts?

SENATOR SARBANES. Yes.

MR. GREENSPAN. By then, they were revising growth down significantly. I have forgotten what the numbers were, but since you obviously have them there—at least, I hope you do—I would not want to guess what you can tell me.

SENATOR SARBANES. My understanding is 3 percent.

MR. GREENSPAN. Well, that is not too far from what actually happened.

SENATOR SARBANES. No. We got eight-tenths of a percent in the first quarter.

MR. GREENSPAN. Oh, you were talking about the first quarter. I thought you were talking about the year as a whole.

SENATOR SARBANES. They were projecting that the growth experienced in the fourth quarter of 1992 would slow, but would slow to about 3 percent in the first quarter of 1993.

MR. GREENSPAN. Yes.

SENATOR SARBANES. Of course that did not happen. It slowed to eight-tenths of a percent. Then, in the next quarter, it went to 1.7 percent, I believe.

MR. GREENSPAN. Well, it depends. It is an interesting question about the second quarter. If you come at it from gross domestic income, which is a conceptually equivalent view of the second quarter, you get a somewhat higher figure, and there were more indications of strength in the second quarter than the gross domestic product showed. But, clearly, it was subdued, and acceleration did not occur in any meaningful sense until we got into the second half of 1993.

SENATOR SARBANES. The information I have is that last year in the January 1993 issue of *Blue Chip Economic Indicators,* they predicted that economic growth in the first half of 1993 would be roughly 3 percent. Instead, we had average growth in the first half of barely 1 percent.

Now, the only reason I bring this history lesson forward is because I want to stay on the steady-as-she-goes course in order to get a good reading—or a much better reading than I have at this point—about where the economy is going to be going in 1994. A lot of the kick that is coming to the economy now, at least as I perceive it, is coming from interest-sensitive sectors of the economy. Would you agree with that, Mr. Chairman?

MR. GREENSPAN. I think that is correct. Yes.

SENATOR SARBANES. As a worthy accommodation on the monetary side, in response, I think, to doing a fiscal policy, which you have urged on us over the years. I think that is fair to say, is it not?

MR. GREENSPAN. It is, indeed.

SENATOR SARBANES. I do not necessarily want to tie you down to the exact quantity or the components of it, but in the macro sense, we moved in that direction last August. This a creditable way in which you have been advising us to do for quite some time. Is that a fair statement?

MR. GREENSPAN. That is correct, sir.

SENATOR SARBANES. All right. Now, I am concerned that this growth continue on a fairly steady basis, and my own view is that we are not anywhere near far enough into 1994 to be sanguine on that point. I will just leave that as an observation.

My time is almost up, but I want to close with one point. The Open Market Committee meets on Thursday and Friday of this week?

MR. GREENSPAN. That is correct, Senator.

SENATOR SARBANES. On Friday, the Commissioner will be before us to report the unemployment rate determined on a new basis, as you know. That figure may jump around. We are not really sure what is going to happen. There are new survey techniques, greater use of the computer. An alteration in the sampling pattern is being done. Has all of that been explained to the members of the Open Market Committee?

MR. GREENSPAN. We have had extensive discussions with the Bureau of Labor Statistics on the details, and we have communicated clearly to the Board and to the Presidents and, I would presume, to the staffs of the various Federal Reserve Banks who are involved in this. So we are about as knowledgeable at this moment as one can be with the very large uncertainties, with respect to shifting from one sample procedure to another, which will inevitably create some difficulties in interpretation.

I would certainly presume that since we are meeting after those data are released, our staff will go over in some detail with the members of the FOMC as to what they can infer from those data and what the contacts we had with BLS, with respect to them, suggest.

SENATOR SARBANES. Well, I only make this point to urge a certain amount of caution or prudence in reacting or interpreting these figures, just as I assume you would want us in the Congress to exercise some caution and prudence in responding to these figures until we fully understand exactly what they mean. They may be different in a significant way from the figures we have been dealing with, and, until one can digest all of that, it ought not to be the basis for change in policy.

So, Mr. Chairman, I conclude as I began. I think the economic ship is on course. I think steady as she goes is the lesson all of us should draw from the current situation. Thank you very much.

REPRESENTATIVE OBEY. Mr. Chairman, I want to thank you for coming. You are out of here in time to catch your plane, and I would simply echo the last comment of Senator Sarbanes and hope you have a good trip. Thank you very much.

MR. GREENSPAN. Thank you very much, Mr. Chairman.

[Whereupon, at 12:40 p.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF THE HONORABLE MR. GREENSPAN

Mr. Chairman and members of the Committee, as you know, the Federal Reserve will be meeting later this week and will submit its semiannual report on monetary policy to the Congress in late February. At that time, I will be in a position to address more specifically our expectations for economic growth and inflation and for monetary policy in 1994. Under the circumstances, my opening remarks this morning will focus on identifying the major tendencies currently visible in the economy and the broad considerations that will likely be shaping our policy decisions in the weeks and months ahead.

As you may recall, in my appearances before this Committee in recent years, I discussed in detail the structural imbalances that I believed were impeding U.S. economic growth. I referred in particular to the enormous strains on the balance sheets of many households and businesses. Those strains, which grew out of the excessive debt expansion of the 1980s, were exacerbated by the subsequent weakness in real estate prices in the early 1990s. Moreover, these difficulties spilled over to the financial intermediaries, which—faced with mounting loan losses and with pressure from the markets and regulators to improve their capital ratios—restricted credit supplies to many small firms and other borrowers.

Considerable progress has been made in correcting these imbalances. Many households and businesses have materially improved their financial positions—as evidenced by the drop in debt-servicing burdens for all sectors and the decline in debt-to-equity ratios for businesses. In addition, banks and other financial institutions, having replenished depleted capital bases, have begun to demonstrate a greater willingness to make loans.

The Federal Reserve, through its deliberately accommodative stance, has played a key role in the restructuring process. But it is important to emphasize that monetary policy must not overstay accommodation: Maintaining the confidence of financial market participants has been crucial for sustaining the declines in inflation expectations and, hence, in long-term interest rates that have facilitated the balance sheet adjustments to date. The actions taken last year to reduce the federal budget deficit have been instrumental in creating the basis for declining inflation expectations and easing pressures on long-term interest rates. Although we may not all agree on the specifics of the deficit reduction measures, the financial markets are apparently inferring that, on balance, the federal government will be competing less vigorously for private saving in the years ahead.

Partly because of these structural adjustments, the foundations of the economic expansion are looking increasingly well-entrenched. Real gross domestic product rose at an annual rate of nearly 3 percent in the third quarter of 1993, and the advance estimate for the fourth quarter indicated growth of nearly 6 percent. The labor market has also shown signs of notable improvement. Payroll employment rose about 2 million last year, and unemployment dropped appreciably; the unemployment rate for December 1993, at 6.4 percent, was almost a full percentage point below the level of late 1992.

The greater buoyancy in economic activity of late has been evident across the household and business sectors. Housing construction, stimulated by mortgage rates that are the lowest in more than 25 years, has increased markedly; and consumer spending, after hitting a lull in the first quarter of 1993,

has posted sizable gains over the past three quarters. Outlays on consumer durable goods have been especially robust, in part to make up for the spending on motor vehicles that was deferred during the 1990-91 recession and the early expansion period. In addition, the pickup in home sales is bolstering purchases of furniture and appliances.

Business fixed investment was very strong throughout 1993. It rose nearly 15 percent in real terms over the four quarters of the year, and order books in real terms over the four quarters of the year, and order books for early 1994 are apparently filling rapidly. Stimulated by dramatic innovations in products and extensive price-cutting by the computer manufacturers, real outlays for office and computing equipment have continued to soar as cost-conscious businesses have rushed to exploit the new technologies. And with a favorable outlook for overall business sales, ample profits and cash flows, and relatively low cost of capital, firms have also increased their outlays on more traditional types of equipment. In addition, activity in the nonresidential construction sector finally is recovering from the depressed levels of the past few years.

Although recent economic developments, on the whole, have been favorable, the expansion has remained uneven. In the labor market, firms' efforts to restructure and improve productivity are continuing to restrain hiring, and concerns about job security persist. In addition, employers seem to be relying to an unusual degree on the use of overtime and temporary employees, in part perhaps because of the cost of providing fringe benefits to permanent full-time workers.

Moreover, not all business sectors are faring well. In particular, industries and regions that depend heavily on military spending will continue to experience sizable dislocations and disruptions. also, many state and local governments are still struggling to reconcile a rising demand for services—especially in education, health, and crime prevention and corrections—with limited growth in revenues.

Another concern is the weakness in the economies of some of our major trading partners, which has continued to constrain our export performance. Among the industrial countries, Canada and the United Kingdom appear to be emerging from deep slumps. However, signs of near-term improvements in Japan and continental Europe are scant. In Japan, asset deflation and associated financial problems continue to hold back growth, and in Germany, the far-reaching and costly adjustments associated with unification are still a restraining factor. In reaction to their economies' weak performances, monetary officials in the two countries fostered continued, cautious reductions in interest rates in 1993—as did officials in most other industrial countries. Government budget deficits generally worsened last year because of cyclical factors—and, in some cases, endeavors to stimulate demand. this deterioration of budget positions has limited the scope for further fiscal action in most countries.

As for the developing nations, economic conditions in Asia, fueled in part by exceptionally rapid growth in China, remained strong in 1993. In Latin America, however, real growth in Mexico fell to near zero, reflecting the depressing effects of a policy attempting to contain inflationary pressures and, for a time, growing uncertainty about whether the North American Free Trade Agreement (NAFTA) would be implemented.

The passage of the NAFTA in November represented a significant achievement for the North American continent. Besides reducing tariff and nontariff barriers on trade, the NAFTA extends liberalization to nontraditional areas, such as financial services and intellectual property. The trade agreement

reached in December in the Uruguay Round of the GATT also covers a some of these nontraditional areas. Approval by the Congress of the GATT agreement would likely stimulate U.S. exports of high-technology products. More broadly, these agreements are significant because they represent a rejection by the United States and our major trading partners of calls to turn inward in our economic and financial policies.

Interpreting the economic data for the United States over the next few months will be especially complicated. As you know, the Bureau of Labor Statistics is redesigning the household survey of employment. Also, many key indicators of production and spending will be affected by the earthquake in Southern California and by the extraordinary weather conditions elsewhere. Nevertheless, although real GDP growth will almost surely slow appreciably from the rapid pace of late 1993, the economic fundamentals appear to be in place for further solid gains in the level of activity in the quarters ahead.

Recent data on prices and wages generally suggest that inflation remained in check through 1993. With the fourth-quarter to fourth-quarter change in the so-called core GPI edging down to 3.1 percent, the lowest reading since the early 1970s. To be sure, the acceleration in domestic economic activity has put some upward pressure on prices of a number of industrial materials, and measures of resource utilization are considerably higher than they were six months ago. Nonetheless, productivity growth has kept unit labor costs subdued, and the broad measures of inflation have remained will contained.

No doubt, many of the forces that helped restrain inflation in 1993 will continue to do in 1994. Businesses will almost certainly remain intent on boosting productivity and controlling costs, and competition from abroad will continue to deter price increaes—even in markets with limited spare domestic capacity.

History suggests, however, that higher price inflation tends to surface rather late in the business cycle and, hence, is not a good leading indicator of emerging troubles. By the time inflation pressures are evident, many imbalances that are costly to rectify have already developed, and only harsh monetary therapy can restore the financial stability necessary to sustain growth. This situation regrettably has arisen too often in the past.

The challenge of monetary policy is to detect such latent instabilities in time to contain them. Unfortunately, they are rarely visible until relatively far advanced. Moreover, once they are identified, policy actions to counter them take time to have their effects. Thus, the need of monetary policymakers for early indicators of developing problems is evident.

Historically, many such indicators have come from the financial sector: Money supply growth, the slope of the yield curve, quality spreads, and credit flows are among the variables that have helped the monetary authorities over the years act in advance of developing problems. In recent years, however, as a result of financial innovations and the unusual nature of the most recent business cycle, such indicators have, at times, produced misleading signals. The broad money and credit aggregates, for example, have suggested declining inflation in the United States—but by far more than has actually occurred.

Turning to nonfinancial variables, the degree of slack in the economy is important because it plays a major role in influencing whether inflation is increasing or decreasing. Over the longer haul, however, the level of inflation—that is, the rate of price change depends crucially on price expectations, and not on the degree of slack. In the twenty years after World War II, most economists gave short shrift to expectations as a key determinant of inflation. Unemployment and inflation were considered simple tradeoffs. A lower rate of unem-

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ployment was thought to be associated with a higher, though constant, rate of inflation; conversely, a higher rate of unemployment was associated with a lower rate of inflation.

But the experience of the past three decades has demonstrated that what appears as a tradeoff between unemployment and inflation is quite ephemeral and misleading. Over the longer run, no such tradeoff is evident. Attempts to force-feed the economy beyond its potential have led in the past to higher inflation and, ultimately, not to lower unemployment, but to higher unemployment, as destabilizing forces and uncertainties associated with inflation induced economic contraction. In that regard, experience both here and abroad suggests that lower levels of inflation are conducive to the achievement of greater productivity and efficiency and, therefore, higher standards of living.

Currently we have the difficult task of assessing the appropriate time to move away from an extended period of monetary accommodation. The policy was established purposefully, largely to address the balance sheet strains I mentioned earlier. This monetary policy has been effective in that households and businesses are now in stronger financial condition. But the job is not yet complete. Unfortunately, although we can assess how far the process of repairing balance sheets has proceeded, we do not know how much further it will go, mainly because of the difficulty of gauging desired levels of debt. What is clear, however, as I indicated here a year ago, is that we did not need to complete the job before evidence of faster economic growth would emerge. We have been growing in fits and starts; but smoothing through the data of the past two years, we have seen real GDP rise at a respectable 3.4 percent annual rate—sufficient to reignite job creation and significantly reduce unemployment.

A number of questions will have to be addressed by the Federal Open Market Committee. Foremost will be when is the appropriate time to move to a somewhat less accommodative level of short-term interest rates. We will have to make the judgment as to how long we can continue monetary accommodation, without sowing the seeds of another bout of inflationary instability accompanied by steeply rising long-term rates. Such an outcome would bode ill for economic growth in 1995 and beyond. On the other hand, we will also have to judge whether higher rates could slow the necessary completion of balance sheet repair to a point where economic growth is inhibited.

Short-term interest rates are currently abnormally low in real terms. At some point, absent an unexpected and prolonged weakening of economic activity, we will need to move them to a more neutral stance. Such an action would not be taken in order to cut off or limit the economic expansion, but rather to sustain and enhance it. The foremost contribution monetary policy can make to achieving higher standards of living in the United States is to provide the stable financial foundation for continued economic growth.

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