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ECONOMIC OUTLOOK

Wednesday, November 13, 2002

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

The Committee met, pursuant to notice, at 10:04 a.m., in Room 311, Cannon House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton, Dunn, Stark, Hill, Watt, and Maloney; Senators Reed, Bingaman, Sarbanes, and Corzine.

Staff Present: Chris Frenze, Robert Keleher, Colleen J. Healy, Brian Higginbotham, Pat Ruggles, Chad Stone, Daphne Clones-Federing, Matthew Salomon, Donald Marron, Jeff Wrase, and Dianne Preece.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Good morning. I am pleased to welcome Chairman Greenspan before the Joint Economic Committee (JEC) this morning to testify on the economic outlook. According to a recent Commerce Department release, the economy grew at 3.1 percent in the third quarter of 2002. Consumer spending accounted for much of this performance, though there was a pickup in the rate of investment in equipment and software, its largest since 2000. Overall, however, investment has been quite weak during this expansion. The growth rate of the economy during the first three quarters of 2002 was about 3 percent.

Consumer spending explains much of the result while real nonresidential fixed investment actually fell in the first two quarters of the year, finally eking out a small gain in the third quarter.

In 2002, personal income trended upward and productivity growth has been very strong. Inflation and interest rates remain low, and new home sales have been strong.

In summary, the economy has expanded at a moderate rate so far this year. However, manufacturing activity, which has improved for several months, recently has shown signs of slippage. Overall, payroll employment growth has been soft as employers wait for signs of a faster economy. There is concern that most recently available data may signal a slowing of the economy. Furthermore, the uncertainties involved in the war against terrorism and the international security situation impose additional costs on the economy. While the resilience of the American people and the economy has been remarkable, security costs have exacted a toll on the economic growth.

Given the absence of evidence of inflation currently or in the foreseeable future, the Federal Reserve action last week to reduce the federal funds rate by a half a percentage point to 1-1/4 percent was appropriate. However, a relaxation of monetary policy alone may not be

sufficient to ensure sustained economic expansion. Given the persistent weakness in investment, it would be prudent to consider further changes in tax policy to offset economic uncertainty and improve the prospects for investment growth.

Chairman, thank you for being here. Before we hear from you, we would like to hear from our Vice Chairman, the gentleman, Senator Reed.

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

OPENING STATEMENT OF SENATOR JACK REED, VICE CHAIRMAN

Senator Reed. Thank you very much, Mr. Chairman. It is a pleasure to welcome Chairman Greenspan this morning.

Last week, the Federal Open Market Committee (FOMC) surprised us not by the fact that they lowered interest rates, but by how much they lowered them. That the Fed took such decisive action confirms what many of us have been saying for some time: the economy is in a slump, growth is too slow, too many people are out of work, and things don't seem to be getting better on their own.

I don't know if the Fed's actions will be enough to turn the economy around; I certainly hope they will be for the sake of the American people. But the way things are going now, it looks as if we are headed for a jobless recovery like the one we had after the last recession when the unemployment rate kept rising long after the recession was technically over. Under those circumstances, I think it would be unconscionable if we let the extended unemployment benefits program expire at the end of the year, as it is now scheduled to do.

So, whatever else we think might be necessary to help the economy recover, I hope we can begin by making sure that people who exhaust their regular unemployment benefits in a tough job market are not left out in the cold.

I know Chairman Greenspan's job is to conduct monetary policy, but monetary policy doesn't operate in a vacuum. Sound fiscal policies, like those we pursued in the 1990s, complement monetary policy in creating an environment of attractive interest rates that stimulate investment and productivity growth.

In contrast, large budget deficits, like those we experienced from the early 1980s to the early 1990s, are a drain on national savings that is harmful to long-term growth.

I am afraid that the fiscal discipline of the 1990s is a fading memory, and that we are heading for a repeat of the fiscal mistakes of the 1980s. The 1980s tax cuts were a mistake at the time, but similar policies would be even more of a mistake today. At least in the 1980s, the pressures on the budget from the retirement of the baby boom generation were off in the distant future and there was time to restore fiscal discipline. This time, however, the biggest tax cuts will be kicking in at just about the same time that the baby boom starts retiring.

I hope that in addition to discussing his views on the economic outlook, Chairman Greenspan will spend some time talking about how the choices we make in the coming year about taxes and other fiscal priorities will affect that outlook.

Mr. Chairman, I look forward to your testimony.

[The prepared statement of Senator Jack Reed, Vice Chairman, appear in the Submissions for the Record on page 27.]

Representative Saxton. Thank you very much, Senator Reed.

We again, Mr. Chairman, appreciate you being here with us again. We, Members of this Committee, continue to focus on the economy and have watched with interest a Fed monetary policy as it has worked to ensure continued economic growth without inflation, and we are very pleased to have seen the results of your leadership in this regard. So, we are ready and anxious to hear your remarks this morning, and so at this point, the floor is yours, sir. Thank you for being here.

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

Mr. Greenspan. Thank you very much, Mr. Chairman, and Members of the Committee.

The past year has been both a difficult and a remarkable one for the United States economy. A year ago, we were struggling to understand the potential economic consequences of the events of September 11. At that time, it was unclear how households and businesses would react to this unprecedented shock as well as to the declines in equity markets and cutbacks in investment spending that had already been underway. Economic forecasts were lowered sharply, and analysts feared that even these downward revised projections might be undone by a significant retrenchment in aggregate demand. The American economy, however, proved to be remarkably resilient. In the event, real GDP over the past four quarters grew three percent, a very respectable pace given the blows that the economy endured.

Although economic growth was relatively well-maintained over the past year, several forces have continued to weigh on the economy: the lengthy adjustment of capital spending, the fallout from the revelations of corporate malfeasance, the further decline in equity values, and heightened geopolitical risks.

Over the last few months, these forces have taken their toll on activity, and evidence has accumulated that the economy has hit a soft patch. Households have become more cautious in their purchases, while business spending has yet to show any substantial vigor. In financial markets, risk spreads in both investment-grade and non-investment-grade securities have widened. It was in this context that the Federal Open Market Committee further reduced our target federal funds rate last week.

The consumer until recently has been the driving force of this expansion. Faced with falling equity prices, uncertainty about future employment prospects, and the emergence of the terrorist threats, consumer spending has slowed over the course of the past year, but has not yet slumped as some had earlier feared it might. Tax cuts and extended unemployment insurance provided a timely boost to disposable income, and the deep discounts offered by many businesses on their products were most supportive.

In particular, automotive manufacturers responded to the events of September 11 with cut-rate financing and generous rebates. These incentives were an enormous success in supporting, indeed increasing, the demand for new cars and trucks. Sales surged each time the incentive packages were sweetened, and, of course, fell back a bit when they expired. Some decline in sales was to be expected in recent months after the extraordinary run-up recorded in the summer. However, it will bear watching to see whether this most recent softening is a payback for borrowed earlier strength in sales or whether it represents some weakening in the underlying pace of demand.

Stimulated by mortgage interest rates that are at lows not seen in decades, home sales and housing starts have remained strong. Moreover, the underlying demand for new housing units has received support from an expanding population, in part resulting from high levels of immigration.

Besides sustaining the demand for new construction, mortgage markets have also been a powerful stabilizing force over the past two years of economic distress by facilitating the extraction of some of the equity that homeowners have built up over the years. This effect occurs through three channels: the turnover of the housing stock, home equity loans, and cashouts associated with the refinancing of existing mortgages.

Sales of existing homes have been the major source of extraction of equity. Because the buyer of an existing home almost invariably takes out a mortgage that exceeds the loan cancelled by the seller, the net debt on that home rises by the amount of the difference. And, not surprisingly, the increase in net debt tends to approximate the seller's realized capital gain on the sale. That realized gain is financed essentially by the mortgage extension to the home buyer, and the proceeds, in turn, are used to finance some combination of a down payment on a newly purchased home, a reduction of other household debt, or purchases of goods and services or other assets.

Home equity loans and funds from cashouts are generally extractions of unrealized capital gains. Cashouts, as you know, reflect the additional debt incurred when refinancings in excess of the remaining balance on the original loan are taken in cash.

According to survey data, roughly half of equity extractions are allocated for the combination of personal consumption expenditures and outlays on home modernization. These data and some preliminary econometric results suggest that a dollar of equity extracted from housing has a more powerful effect on consumer spending than does a dollar

change in the value of common stocks. Of course, the net decline in the market value of stocks has greatly exceeded the additions to capital gains on homes over the past two years. So, despite the greater apparent sensitivity of consumption to capital gains on homes, the net effect of all changes in household wealth on consumer spending since early 2000 has been negative. Indeed, the recent softness in consumption suggests that this net wealth erosion has continued to weigh on household spending.

That said, it is important to recognize that the extraction of equity from homes has been a significant support to consumption during a period when other asset prices were declining sharply. Were it not for this phenomenon, economic activity would have been notably weaker in the wake of the decline in the value of household financial assets.

In the business sector, there has been few signs of any appreciable vigor. Uncertainty about the economic outlook and heightened geopolitical risks have made companies reluctant to expand their operations, hire workers, or buy new equipment. Executives consistently report that in today's intensely competitive global marketplace, it is no longer feasible to raise prices in order to improve profitability.

There are many alternatives for most products, and with technology driving down the costs of acquiring information, buyers today can and do easily shift to a lower-priced seller. In such a setting, firms must focus on the cost side of their operations if they are to generate greater returns to their shareholders. Negotiations with their suppliers are aimed at reducing the costs of materials and services. Some companies have also eschewed the traditional annual pay increment in favor of compensation packages for their rank-and-file workers that are linked to individual performance goals. And, most important, businesses have revamped their operations to achieve substantial reduction in costs.

On a consolidated basis for the corporate sector as a whole, lowered costs are generally associated with increased output per hour. Much of the recent report of improvements in cost control doubtless have reflected the paring of so-called “fat” in corporate operations, fat that accumulated during the long expansion of the 1990s when management focused attention primarily on the perceived profitability of expansion and less on the increments to profitability that derived from cost savings. Managers, now refocused, are pressing hard to identify and eliminate those redundant or nonessential activities that accumulated in the boom years.

With margins under pressure, businesses have also been reallocating their capital so as to use it more productively. Moreover, for equipment with active secondary markets, such as computers and networking gear, productivity may also have been boosted by reallocation to firms that could use the equipment more efficiently. For example, healthy firms reportedly have been buying equipment from failed dot-coms.

Businesses may also have managed to eke out increases in output per hour by employing their existing workforce more intensively. Unlike cutting fat, which permanently elevates the levels of productivity, these gains in output per hour are often temporary as more demanding workloads eventually begin to tax workers and impede efficiency.

But the impressive performance of productivity also appears to support the view that the step-up in the pace of structural productivity growth that occurred in the latter part of the 1990s has not as yet faltered. Indeed, the high growth of productivity during the past year merely extends recent experience. Over the past seven years, output per hour has been growing at an annual rate of more than 2-1/2 percent on average compared with a rate of roughly 1-1/2 percent during the preceding two decades. Although we cannot know with certainty until the books are closed, the growth of productivity since 1995 appears to be among the largest in decades.

Arguably, the pickup in productivity growth since 1995 reflects largely the ongoing incorporation of innovations in computing and communications technologies into the capital stock and business practices. Indeed, the transition to the higher permanent level of productivity associated with these innovations is likely not yet completed. Once the current level of risk recedes, businesses will no doubt move to exploit the profitable investment opportunities made possible by the ongoing advances in technology.

However, history does raise some warning flags concerning the length of time that productivity growth remains elevated. Gains in productivity remained quite rapid for years after the innovations that followed the surge in inventions a century ago. But in other episodes, the period of elevated growth of productivity was shorter. Regrettably, examples are too few to generalize. Hence, policymakers have no substitute for continued close surveillance of the evolution of productivity during this current period of significant innovation.

In summary, Mr. Chairman, as we noted last week, the Federal Open Market Committee continues to believe that an accommodative stance of monetary policy coupled with still robust underlying growth in productivity, is providing important ongoing support to economic activity. However, incoming economic data have tended to confirm that greater uncertainty, in part, attributable to heightened geopolitical risks, is currently inhibiting spending, production, and employment. Inflation and inflation expectations remain contained.

In these circumstances, the Committee believed that the actions taken last week to ease monetary policy should prove helpful as the economy works its way through its current soft spot.

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

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

Representative Saxton. Mr. Chairman, thank you very much for that very insightful statement. I have some questions that have to do with your statement, but let me start on a slightly different note – it is a positive note, actually. Mr. Chairman, when you became chairman back in the late 1980s, inflation was average or was running around 4 percent. Of course, it never remains constant. It was up and down. But basically, the trend was in the 4 percent range. And we have a chart to your right

and our left which shows the inflation trend during the years that you have been chairman. And I just wanted to point this out, because sometimes these kinds of things escape the public.

We see that that line indicating the rate of inflation dropped significantly from the late 1980s until, of course, today, when it is down under 2 percent. I would just like to say for the record and for whoever may be watching or listening, that this was not an accident; this was largely a result of Fed policy. And, as a former realtor, in keeping company with some of my real estate friends, I would notice that when there would be a short-term tightening of monetary policy by the Fed, I would hear grumbles from various parts of the community. But today I don't hear grumbles.

I hear people commending Fed policy for creating a situation in which we can have low, long-term rates. And that is, at least in my view, primarily because of Fed policy and driving inflation, to a large extent, out of the economy. And I would just like to point that out for the record this morning. And if you want to comment on it later, that is fine.

Mr. Greenspan. Mr. Chairman, may I amend that for a moment? I just want to point out that a major change occurred with Chairman Volcker and his colleagues starting in 1979 which came to grips with what was a dangerously expanding inflationary environment. And the really difficult work that occurred to suppress those imbalances occurred under my predecessor and his colleagues. What we did is hopefully try to reinforce it and cement it. And I think that the period going back essentially to the 1979 episode where there was a fundamental change in the way monetary policy was handled, it indicated that the process is something we are increasingly aware of and adjusting to. But to fail to give credit to those in the Federal Reserve who were really on the firing line before I showed up on the scene, I think is not to fully understand the record.

Representative Saxton. I agree with you totally. And that chart points out very clearly that it was in the early 1980s that this trend began. But I think it important that everyone on the Committee and others understand that long-term interest rates to a large degree depend on a low rate of inflation.

I started in the real estate business in 1966. Mortgage rates were six percent. And today, I don't know what they are this week, but I believe they are a little bit under six percent. And that is a great thing for homeowners. Of course, the housing industry has been a large driver, if you will, of the economy, particularly this year. And, in my view, it is in large part because of low interest rates, as a result of low inflation, as a result of Fed policy over the last couple of decades.

Mr. Greenspan. Well, we thank you in any event, sir.

Representative Saxton. Mr. Chairman, in your statement, you talked about the current softening in the economy. We had average GDP growth of about three percent during the first three quarters of the year, and the projected GDP growth for the fourth quarter is about half that, a little bit better than half that, 1.6 percent. And the question arises as to

whether this is a result of some underlying economic problems, or if it is a temporary phenomenon brought about as a result of previous consumer purchases which may have been robust to the point where people purchased earlier what they might have purchased in this quarter and as a result of perhaps some cash resulting from refinancing of homes, resales, et cetera. I think this is an extremely important point. I believe that we have projections next year of more robust growth than 1.6 percent as a result of various surveys. And it seems to be the general thought process, anyway. Can you expand on the temporary nature as opposed to the permanent nature of this downturn that we are experiencing in the fourth quarter of the year?

Mr. Greenspan. Mr. Chairman, as I point out in my written testimony, our best judgment is that we are going through a soft patch that is not something which is a precursor of far more significant weakening. The reason for it, as best we can judge, is a combination of the after effects and still marginally important issues of the decline in stock prices, but increasingly the fallout from corporate governance malfeasance problems, and of course most recently and perhaps most importantly, the geopolitical risks surrounding the negotiations with Iraq.

The economy as such is not evidently significantly out of balance. That is, we do not have excess inventories. We do not have, as best we can judge, a debilitatingly large overhang of capital stock from overbuilding of plant and equipment. We don't have the usual internal weaknesses that presage an economy going down in a cumulative manner. What we do have is a very large degree of uncertainty both as a consequence of corporate governance and as a consequence of geopolitical risks, and they are creating some significant hesitation, mainly in the business sector, but presumably at least in part amongst consumers as well.

Our judgment is when this uncertainty is lifted, when this risk premium essentially is restored to normal, as it will be, that the number of the activities which are basically built in to the type of market economy that we have will take force and begin to increase the rate of growth. And while I obviously cannot speak for other forecasters around the country, you are quite right that the general consensus is for a gradual pick-up in the rate of growth next year. That, I suspect, pretty much rests on presumption that that overhang of uncertainty is lifted.

Representative Saxton. Thank you, Mr. Chairman. Last week, there was some surprise, as you know, with the 50 basis point rate reduction. The widely anticipated amount would have been about half that. Can you elaborate on why the 50 basis point reduction rather than what we may have expected?

Mr. Greenspan. As I think I mentioned to this Committee before, in evaluating monetary policy it is important to recognize that we very often, in trying to evaluate alternate policies, ask ourselves the question: what are the consequences if we take policy A and we are wrong relative to being wrong on taking policy B?

In the current period, what we are observing is a gradual erosion of economic activity which occurred sometime in the summer. Remember, most of the GDP growth in the third quarter is largely from sharp increases in July, and in some cases, early August. But it has been softening since then. Our best judgment, and indeed, the data to date confirmed that this is a gradual, not a cumulative decline. But there is a probability, small as it may be, that we may be wrong, that this may be the beginning of something more than appears most likely. And because the probability of the emergence of inflationary pressures now seems so remote that the insurance premium, if I may put it that way, for going down 50 basis points – which would be the right policy, if, indeed we are wrong in our expectation that we are going through a soft patch which will unwind very quickly – if we are wrong on that, then the 50 basis points was the right policy. If we turn out to be right on that, as we expect we will on the outlook, then clearly we will reverse the policy at some point in the future, because you cannot stay at one and a quarter federal funds rate indefinitely without ultimately engendering inflationary pressures.

But all of the evidence that we have on the question of pricing power in this economy suggests that there is very little evidence that any pressures will reemerge in a timeframe which is too short for us to respond sufficiently adequately to fend it off.

So, it was our conclusion that even though the expectation of a significant decline is – I should say, the probability of a significant acceleration is quite small, the cost of taking out insurance against it was so low that it, in effect, tilted the decision to 50 basis points.

Representative Saxton. Thank you very much. Let me explore just one other subject. We talked about inflation earlier. The subject of deflation has become a topic of conversation recently. I have a two-part question. The first part is, very simply, do you see deflation as a danger in the near or in any term? And secondly, should the Fed find itself in an environment where interest rates are very low, perhaps near zero, and cannot be lowered when an easier policy is called for, what alternative policy tools or guides is the Fed prepared to use?

Mr. Greenspan. Mr. Chairman, our view is that we are quite a far distance from deflationary forces taking hold. We have been looking at this process for quite a long period of time. In fact, we even had seminars several years ago examining the various possibilities of what seemed most inconceivable to us in the early postwar period; namely, that with a fiat money system, you could engender a deflationary environment. But we have seen that that is clearly possible, and we have examined it in some considerable detail, both with respect to Japan, the results of which we issued as a public analysis, and obviously looked at it in fairly considerable detail with respect to the United States.

Theoretically, clearly it is a concern, and indeed, we are watching it about as closely as we can because there is an asymmetry between the impact of inflation and deflation, and it is somewhat easier to contain

inflation than to contain deflation, and our view is that price stability is the optimum position, as I have mentioned to you before.

So, yes, we are looking at it. Our conclusion is that we are not close to a deflationary cliff. If we ever get to that point, remember, we are not limited with respect to purchasing only the assets which affect the overnight federal funds rate. We, in the past, have engaged in purchasing assets all along the maturity spectrum of the yield curve. And, indeed, during World War II and until the accord with the Treasury in 1951, the Federal Reserve essentially pegged the long end of the Treasury market, accumulating at some points some very significant amounts of Treasury issues.

So if we ever got to the point – and I must say to you I find it extraordinarily remote that that will happen – and we got to the point where we could no longer lower the target federal funds rate, we could, nonetheless, increase the liquidity of the system by moving out on the maturity schedule as far out as we wanted, and as a consequence there is virtually no meaningful limit to what we could inject into the system were that necessary. But let me reemphasize. This is an academic exercise and academic evaluation. We have seen no evidence at this point that we are close to a dangerous point with respect to deflation, but we are very consciously aware that we cannot allow that to creep up on us unseen, so we put a lot of resources in examining and reevaluating this conclusion all the time.

Representative Saxton. Another, perhaps, way of saying that would be that we have established this level of inflation at or slightly below 2 percent, and there is no evidence that it is either going to increase or decrease any time soon.

Mr. Greenspan. I think that is an excellent summary, Mr. Chairman.

Representative Saxton. Thank you.

At this point I would like to turn to Senator Reed for whatever questions he may have.

Senator Reed. Thank you very much, Mr. Chairman. And thank you, Chairman Greenspan, for your always thoughtful testimony.

In the 1990s, you were the staunchest advocate for fiscal discipline, reminding us that the relationship between a growing budget deficit and adverse impact on investment, national savings, and ultimately economic growth. But has anything in your thinking changed about that relationship?

Mr. Greenspan. It has not, Senator.

Senator Reed. One of the issues that I raised with respect to my statement was the impending baby boom retirement dilemma. And with some of the tax cuts that have already been passed, it seems to me we have weakened our ability to respond to that predictable and inevitable challenge. Some of the numbers that have been generated by the Democratic staff of this Committee suggest, for example, that if we simply took half of the revenue lost by making permanent last year's tax cuts over the next 75 years, we could cover all the shortfalls in Social

Security system based upon the demographic challenge. Do you think we are in a vulnerable position to deal with this baby boom crisis as it approaches?

Mr. Greenspan. Senator, as I have testified before other Committees of the Congress recently, my view is that with the Federal Government commitments becoming increasingly longer term, and involved in either various different types of entitlement programs or long-term tax programs, our focus of necessity must be extended. There are very few things that anyone can forecast with a degree of certainty out 8, 9, 10 years.

The one we can is that the ratio of retirees to workers is going to rise quite materially and have a very significant impact on the federal budget process in the year 2010 and beyond. I think it is essential that we construct a fiscal policy structure; that we have in place an ongoing, continuous evaluation of what the budget will look like as the years go on, fully recognizing how difficult forecasting is.

But it is essential to get a sense of where the long-term is going, and as a consequence of that, as I have said many times in the past, we ought to have much more in the way of sunsetting of legislation, really automatically reviewing legislation to see whether it is fitting into various priorities which the Congress and the administration have set out over the longer term. And, indeed, it is those priorities which will determine what those economic revenue resources are employed for.

But once you have done that, once you have got a system in place which, say, has methods of reevaluation through sunsetting or triggering devices which create changes in the path of either an entitlement program or tax programs, owing to some contingency that might or might not arise, unless you do that, you do not have a focus on what the longer-term fiscal outlook is.

And, as best I can judge, we should get back to our discretionary caps and PAYGO rules and a structure which, even though I thought was unlikely to be effective years ago, has been. It is really quite impressive how well Congress' approach to the very large budget deficits in previous decades were finally addressed. And, indeed, it wasn't until we got surpluses that the system broke down.

I think it is essential that we restore the positions that we had previously. And the reason I think this is terribly important is that unless we know where we are going and answer questions with respect to taxes, expenditures of various different forms for short-term stimulus – and indeed, we may need short-term stimulus at some point – we have no sense of what the implications of those actions are over the long term.

What I hope we do not do is engage in actions which, in retrospect, we could have avoided if we thought through the consequences of what it would be doing to the budget.

So I am merely suggesting that it is the process which needs to be significantly improved. And I don't think it takes very much time. All of the data are readily available. Congress could construct a 12-year forecast

of the outlook and set in place numerous mechanisms to adjust it if it is going wrong, I would say within two weeks. It is not a project that requires effort. It requires decisions. But the data that are required to make those decisions are readily available. And unless and until that is done, in my judgment, it is very difficult to answer questions about what form of stimulus, if you chose to do that, would be the most appropriate, because it is important to know what the long-term implications of all those actions are.

Senator Reed. Mr. Chairman, from your response, you suggest that one of the saving graces in the last two years has not only been the budget rules, but fixed terms for tax proposals or for entitlement proposals. And it seems that the proposal now to make these tax cuts permanent flies in the face of those sunset provisions you lauded. Is that your view?

Mr. Greenspan. No, not necessarily. Indeed, I would suspect with respect to the question of the permanence of the most recent tax cuts, I think the markets are assuming that they are permanent, largely because they don't believe it is credible that when the deadline approaches that the Congress will not reenact the levels. So, that is not an issue as far as I am concerned. I know that there is a presumption that if you make those tax cuts permanent, it will add stimulus to the economy. I doubt it. I think that the market has already presumed that they are permanent, and the only thing that probably could have a negative effect later on is when the markets find out they may be wrong. But that is not a short-term issue.

Senator Reed. What are the markets assuming about Social Security?

Mr. Greenspan. That we don't have a policy. That something will have to happen at some point. And, I guess if there is such a thing as a market that is viewing these things, it hopes for the best.

Senator Reed. Let me turn to another aspect of the proposed permanency of the tax cut. It seems to me that as a way to stimulate consumption, it is not the most appropriate response since most of the benefits are heavily weighted to the very wealthiest Americans. And I think, just in terms of sheer numbers, there are more low-income Americans that will consume and they won't benefit from the next round of tax cuts. And if the theory is to stimulate the investment by increasing national savings, then you run into the dilemma of the deficit which will be engendered by the tax cuts.

So in terms of a policy to get the economy going, it seems to fail on both not being particularly tuned in to consumption nor particularly respectful of long-term national savings and investment.

Mr. Greenspan. Well, Senator, I don't want to get involved in the individual items of policy with respect to potential stimulus. But let me just make one point. Some of the work that we have been doing suggests that the swings in consumption in the upper quintile of American households is really quite a significantly important element within the aggregate total of personal consumption expenditures.

So the general view that there is not significant spending up there, and that therefore you don't get the stimulus, I am not sure is accurate. We are not exactly sure that our data are correct, but it certainly is moving in that direction.

Senator Reed. Well, that would depend, I think, – the presumption is that the marginal propensity to consume is inversely related to income. Is that presumption being undercut?

Mr. Greenspan. Well, the marginal propensity to consume has always been thought to be very much higher in the lower income groups than in the upper income groups, and I think that is correct, but I have a suspicion that the differences are much less. In short, remember, we are not talking about the average consumption; we are talking about the marginal consumption. And there is even a hypotheses which some people have that it may be close to a constant. I don't think that, but I don't think that it is a very significantly larger – it is not a huge difference.

Senator Reed. Let me turn to one final point, Mr. Chairman. That is, in the November meeting, not only did you cut rates, but you also reverted to a neutral bias which I understand assumes that there is an equal likelihood of a pickup in inflation or a slowdown in GDP growth. And that – which raises the possibility at least of an additional rate cut. But then in your response to the Chairman, you suggested that you see these, the overnight rates going up eventually. Can you help explain?

Mr. Greenspan. Well, remember that balance of risks is essentially the judgment of where the economy is going, where its balance of risks is in the context of monetary policy. Because remember, we stipulated that with respect to our goals of policy. The way we view that – and I must say it is how I view it, because remember, there are other members of the FOMC who are voting on this, but they don't all say why they are voting so I cannot really tell – but basically, our view is that the economy's most likely projection is to come out of this soft spot and to start accelerating. In the context of the intermediate period, we view that the risks are balanced, especially because we have moved the funds rate down significantly. So all we are basically saying is that the barrier to lowering it further is higher, but it does not mean that should economic events emerge that require us to move it, we will not be inhibited by judgments that we made about the balance at an earlier period.

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

Representative Saxton. Thank you.

Senator Bingaman.

Senator Bingaman. Thank you very much.

Thank you, Mr. Chairman, for your testimony. As I understand your answer to the last few questions, you believe that it may be necessary to engage in some type of short-term stimulus at some point, but not at this point. Is that accurate?

Mr. Greenspan. I am in the process of thinking about that, and I cannot say to you, Senator, that I have come to a firm conclusion. It is the case that while the economy is softening or stagnant, if you want to put

it that way, there is no evidence, at least up to the moment, that it is accelerating on the down side. Indeed, the longer we go through a period of just sort of sluggishness, the closer we get to the risk premiums beginning to fall, and investment beginning to rise.

So, if I were to assume that the outlook is exactly what the most probable path is, then I would say no additional stimulus is necessary. But then you get to the question of, what happens if you are wrong? And it is that type of problem which I am trying to confront, and I don't really have a judgment at this stage which I feel comfortable with.

Senator Bingaman. Well, in order to guard against that risk, you – the Federal Reserve lowered – interest rates a full half-point in order, as I understand your earlier testimony, partly in order to guard against the risk that the upturn that you expect will not be there as expected. Would it make sense for the Congress and the administration to be going forward with a stimulus package on the same theory, that is, that we – in order to be safe, we ought to put more stimulus into the economy?

Mr. Greenspan. It would be if you could make the statement that the costs of that program were as deminimus as it is in monetary policy, because we can reverse and we don't see any real significant dangers of inflationary pressures emerging. The reason I would like to see a structure for the federal budget in place and agreed upon by both the administration and the Congress as a pattern of where we are going is I think it would enable us to answer that question far more efficiently with respect to fiscal policy as I think we can do with respect to monetary policy.

In other words, we believe that we can be significantly ahead of the curve in any inflationary set of pressures that might emerge, and therefore we can readily reverse and contain any negative effects from stimulus policy that we put in place. Until you have a longer-term framework for fiscal policy, I am not sure you can make that judgment either way. And until that you are capable of making the judgment of what is the premium cost of the insurance, then I think it is difficult to make a judgment as to whether to buy that insurance.

Senator Bingaman. I also understood you to say that if we determine a set of stimulus proposals are appropriate, that making the tax cut permanent is not a significant part of stimulating the economy in the short term, as you see it.

Mr. Greenspan. That would be my judgment, Senator.

Senator Bingaman. Let me ask about the current account deficit. As I understand the statistics now, our current account deficit is larger as a share of our gross domestic product than it has ever been. Is that a cause for concern? Is that a factor that you consider in establishing monetary policy or that we should consider in trying to pass provisions relative to fiscal policy?

Mr. Greenspan. Senator, the reason for this chronic and growing chronic deficit is that our propensity to import goods and services relative to our income is much higher than those of our trading partners. And so

if the world economy is such that everyone would be growing at the same rate in their gross domestic product, we would have an ever-increasing share of imports relative to others. In other words, the ratio of imports to GDP in the United States would be continuously rising where it probably wouldn't be rising as much in other countries.

That means that our exports would fall short relative to our imports, and it has, and continuously increased the current account deficit. In short, the rise in GDP abroad induces less exports from the United States than the increases in the GDP in the United States induces imports from abroad. And that has been going on, as best we can judge, for decades. The differential propensity to import has narrowed some, but not enough to prevent this from continuing.

I have argued for a very long period of time that this cannot go on. It cannot go on because clearly as our current account deficit continues, the net debt to foreigners of necessity rises and the servicing costs of that debt rises. And without getting into the arithmetic of what the problems are, it becomes an ultimately unsustainable process. So it has to give at some point.

I have been arguing for years that it cannot go on and it will stop. It has continued, and the reason it has continued is that the investment opportunities in the United States have continued to improve relative to the rest of the world, so that what is occurring is a very massive flow of investment funds into the United States. And indeed, when the dollar is rising, that is basically saying that the demand for dollars coming from the inflow from abroad for investment is greater than the so-called ex ante demand of importers to purchase foreign currencies to finance their imports.

And indeed, during the period when our current account deficit was rising very rapidly, it was also a period when the dollar was strengthening, which tells us that the current account deficit was rising because of the inflow of capital, meaning that the inflow of capital was basically creating a situation in which as the exchange rate rose, it would tend to create an ever-increasing capability of importing goods and services relative to exports.

So it is a type of situation that we know cannot exist indefinitely. We know it most certainly relates to the issue of differential growth rates in the economy.

My own guess is that it will eventually simmer down because our propensity to import will continue to decline and eventually match the rest of the world, in which case it will bring the deficit down, but I have been wrong on this for years. I have been waiting. I am still waiting. I expect to be waiting five years from now.

Representative Saxton. Senator Bingaman, some of our other panel Members have to leave, and so if we can, we probably have time for a second round.

So, Mr. Hill.

Representative Hill. Thank you, Mr. Chairman.

Mr. Chairman, thank you for being here this morning. The debate in Congress is somewhat centered on the importance of eliminating the deficit. Back in the 1990s, you thought that eliminating the deficit in terms of monetary policy was more important than cutting deficits.

You know, there are those who say that the debt is not a problem, that the proportion to the GDP – of the debt to the GDP is what is important. What is your view on the deficit? What is more important?

Mr. Greenspan. Well, I do think that it is certainly the case that the debt to the public has come down significantly as a share of the GDP, and that clearly has been very helpful and probably an important factor in bringing down long-term interest rates.

But remember, we have very large contingent liabilities, something in the area of $10 trillion, more than $10 trillion, I expect. To a large extent, the expectation that the payments already accrued to people in the work force for Social Security may not be paid, that is what contingent means.

Now, unless I am sitting on Mars, that makes no sense to me. The probability that more than a very small fraction of those contingent liabilities will not, in fact, have the same status of debt to the public seems noncredible to me, so that in looking at our overall fiscal situation, we should be looking at not only the debt to the public, but the very extraordinarily expanding contingent liabilities which the federal government has been taking on in recent decades. And unless we factor that into our view of how to handle our budget, I think we are missing what the basic, underlying economic forces are.

If they are truly contingent liabilities and are quite subject to revision by the Congress, then indeed they should stay that way, but the vast, overwhelming proportion of those liabilities, in my judgment, are no less real than those of the debt issuance to the public currently.

So, as I indicated earlier to Senator Reed, I think it is important for our unified budget system, which is what we deal with in the Congress and we deal with in its impact directly on the economy, to have a long-term structure to enable us to evaluate it. But I think increasingly we are going to find that it is going to be very important to have a consistent set of accounts which result from contingent liabilities arising where the contingencies are truly in quotes.

Representative Hill. Well, let me be specific then, because we in Congress have to make decisions about the tax cuts versus the deficit. Should we delay the tax cuts that have not gone into effect yet for reasons of making sure that we get control of the deficit?

Which is more important, controlling the deficit or delaying the tax cuts?

Mr. Greenspan. Well, first of all, I have stated my personal views. I believe to maintain sound fiscal policy, it is important to constrain outlays, in which case you have a much lower-level of taxation, which I think is important for economic growth.

When you get to individual programs, as I have said previously, I happen to think that it is probably unwise to unwind the long-term tax cut, because I think it is already built into the economic system, and in so doing, there are potential adverse consequences which I don't think are desirable.

But having said that, we are dealing with a situation in which Congress has got to look at all of the various elements within the budget and make judgments of what the Congress' priorities are. There is no infinite amount of resources available, and the demands on budget processes always exceed the resources available. There is no alternative to making decisions with respect to individual priorities.

If you ask me as an individual citizen, as an economist, I will give you my views, but I don't have any votes in the Congress, which is probably fortunate for the country. But these judgments have got to be made.

The only thing I can emphasize is the fact of what the economic impact of various different alternatives are likely to be over the longer run. But within that framework, these are value judgments which must be made by the Congress acting for the American people. No one else, other than the administration and the Congress, has given that—

Representative Hill. Thank you, Mr. Chairman. I know Senator Sarbanes needs to get going.

Representative Saxton. The gentleman from Maryland, Senator Sarbanes.

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

I want to follow along on that very fine line of questioning that Congressman Hill was just engaged in. In every previous recession, we have repeatedly extended the unemployment insurance benefits. Now, you spoke a moment ago about constraining outlays, but what is your view on extending unemployment insurance benefits when we are in a slow economic time and the job market is not picking up and people have been laid off? That is an immediate problem we face here.

Mr. Greenspan. Senator, the unemployment insurance system has been fairly restrained and I think quite sensibly as a general policy, and the reason basically is that economists and others do worry that if you have too generous an unemployment system, you will tend to create levels of unemployment that are higher than necessary and get numbers of people whose incentives to work will be reduced.

But when you get into a period where jobs are falling, then the arguments that people make about creating incentives not to work are no longer valid and hence, I have always argued that in periods like this the economic restraints on the unemployment insurance system almost surely ought to be eased to recognize the fact that people are unemployed because they couldn't get a job not because they don't feel like working.

That is clearly the case now and is likely to be the case in the immediate future.

Senator Sarbanes. Thank you. I have two or three questions. I will run through them very quickly, because I would like to try to cover all of these issues. In your last appearance before the JEC in April, I submitted a question for the record concerning our international trade deficit and growing foreign indebtedness. I would like to quote from your response and then ask a further question on this issue, and it follows along with what Senator Bingaman was asking just a short while ago.

In your written response, you emphasize that private investors have been responsible for virtually all of the capital inflow that was increasing the value of the dollar – this is back in April now – and you said it is difficult to predict how long global investors will continue to place their funds disproportionately in U.S. assets.

"To this point, the United States has had little apparent difficulty in attracting funds from abroad. The fact that the foreign exchange value of the dollar has drifted higher on balance during the past few years suggests that incipient net private financial inflows are at least equal to the deficit on the current account. Private foreign purchases of U.S. securities alone have either met or exceeded the entire current account deficit during the past 3 years."

Now, as I look at the figures, it seems the situation has changed after your April response. In fact, in 2001, the balance on current account was minus $393 billion, an incredible figure when you think about it. Only $5 billion was foreign official assets in the United States, net foreign official assets.

But in the second quarter of this year, foreign governments accounted for $47 billion in net capital inflow, almost 40 percent of $123 billion current account for the quarter. So there is, I think, a rather dramatic shift that took place since that last question was put to you and we had your response.

Do you take a different view of the situation when foreign governments are intervening so extensively to support the dollar and effectively suppressing their own currency, which seems to be happening? What is your take on this rather marked shift that has transpired?

Mr. Greenspan. Well, I can't say more than to confirm your numbers. That is correct, there has been a very significant accumulation on the part of reserve balances held in the United States for foreign official agencies.

I can't respond to the issue of the exchange rate because, as you know, it is the general agreement within this government that only the Secretary of the Treasury can comment directly on the exchange rate and I would like to stay away from that issue except to confirm the fact that nothing you have said I find at variance with the facts.

Senator Sarbanes. Some are commenting now that the Fed has gone so low on the interest rates that its ability to deal in the future with a further softening economy, if that should happen, has been undercut or

curtailed or minimized. They draw an analogy with the Japanese situation.

I would be interested in how you address that question. You are now down to 1.25 percent; and you know, we still have some room, but not a lot of room. And what is your response to this current that is now appearing in a fair amount of commentary, that the Fed is losing its capability to address economic slowdown?

Mr. Greenspan. Senator, we are far from that. I think that there is an implication in the notion that we are getting close to our capability that we are restricted solely to overnight funds, but our history as an institution indicates that there have been innumerable occasions when we have moved out well beyond the short-term assets and invested quite significantly in longer-term U.S. treasuries.

As I recall, starting with the beginning of World War II, we at the Federal Reserve essentially contained long-term rates – in a sense pegged them at 2.5 percent. Indeed, for all maturities over 25 years, we were pegging rates at 2.5 percent, and on certain conditions, especially right after World War II, we accumulated long-term Treasuries in very large relative quantities. So we do have the capability, if we were required to do so, to go well beyond any activities related solely to overnight rates.

Now, that would be a material change in policy, and it is not something we would do without very considerable deliberation. But the notion that we are somehow statutorily or otherwise restricted is clearly incorrect, and we do have quite significant capabilities to do a lot more than is implied by the 1.25 federal funds rate.

Senator Sarbanes. Mr. Chairman, what are we to make of the fact that the Europeans, the EU, which has a growth rate under the U.S. growth rate, but yet they are pegging their interest rates at a significantly higher level than the U.S. is doing?

And then, of course, you have this dysfunction almost. Shouldn't they be trying to move their economies up faster if we are going to get a worldwide movement in that direction? Of course, I haven't even brought in the Japanese situation, the world's second largest economy and the economic stagnation which exists in Japan, but what is your take on the European approach to this question?

Mr. Greenspan. Well, the legal mandate of the European Central Bank is different from ours, and their basic requirement is to maintain a stable currency and low inflation. And as a consequence of that, their trade-offs and priorities are different from ours, and it is not self-evident which of the two regimes is the most appropriate. I do think we are going to learn in this period whether in fact their particular approach or ours is the more appropriate one.

There is less difference, however, than I think appears on the surface, and there is certainly less difference in the general views of where the economies are moving. But it is true that there are actual differences currently in our postures, and there are arguments on both sides. We

obviously believe our arguments, or we would be doing the same thing they are doing.

Senator Sarbanes. What do you think of this argument from a chief economist of one of the Munich banks who says, all of the economic arguments are in favor of cutting rates today, speaking about the Europe Central Bank, that they will have to do it in the next month or two.

"Mr. Hufner and other critics said that in holding the line now, the European banks seem motivated less by economical calculation than by the desire to avoid looking like a handmaiden of the Fed. It is never a good thing when the Fed cuts rates on a Wednesday and the ECB cuts them on a Thursday, Mr. Hufner said. It gives them the image of a junior partner which they don't want to have."

What is your reaction to that?

Mr. Greenspan. My reaction is, knowing my counterparts in the ECB and in Europe generally, that is not a fair description of their motives or their attitudes. Indeed, we coordinate on many occasions. We differ, and I am not going to argue that we are right and they are wrong.

Look, their economy is almost as large as ours.

Senator Sarbanes. That's right.

Mr. Greenspan. And monetary policy is not an easy activity. There is very considerable room for differences of opinion, but the presumption that their motives are that they don't want to be a handmaiden of the Federal Reserve strikes me as a bit ludicrous.

Senator Sarbanes. Thank you.

Representative Saxton. Thank you, Senator Sarbanes. Good question.

Mr. Chairman, several Members here have talked – or have asked about your take on unwinding the 2001 tax cuts. I just want to make sure that we are clear. Would you just state for the record in as clear a way as you can where you stand as an economist on repealing the tax cuts that were passed last year?

Mr. Greenspan. Well, Mr. Chairman, as I indicated, because I believe that the markets presume that the tax cuts are permanent and that, as a consequence, making them permanent would therefore have no stimulative effect on the economy, it is also the case that if you were to rescind them, the markets would adjust negatively, in my judgment and I have not been in favor of doing that, as I indicated in past testimony before the Congress.

Representative Saxton. Thank you.

Mr. Chairman, some months ago when you visited with us in a forum similar to this, you described a period of economic growth to come in two phases, the first phase being generated or pushed forward by consumer activity and the second phase then being pushed forward by investment activity. And you commented then that investment activity had not yet kicked in, and I suspect that the same situation – at least it appears to me that the same situation exists today.

What is it that government, either the Congress or the administration, can do or that the Fed can do to help stimulate investment activity?

Mr. Greenspan. As I indicated earlier, Mr. Chairman, my impression is that the underlying long-term investment opportunities are in place, but they are being inhibited by very large uncertainties relative to corporate governance first and then, more importantly, the geopolitical risks. When and if – or I should say – when those uncertainties are removed, then the underlying incentives will be adequate with the existing degree of cash flow and profitability, in my judgment, to engender a marked improvement in capital investment.

There is very little that I can perceive that policy per se can do which really matters all that much to address the issues of geopolitical risks. I think that thanks to Senator Sarbanes and Congressman Oxley, we have got a bill in place which is, I think, helpful, but with respect to the corporate governance issue, that is going to take a while to work out. So I am not sure what one does in this regard except to try to maintain the economy as best we can until these uncertainties are lifted, as they will be.

Representative Saxton. Well, thank you.

One of the other issues that I believe is having an effect on – negative effect on the economy is the change in the so-called wealth effect. We've obviously experienced a bear market; as a result, asset price declines have occurred, and those asset price declines can have an adverse impact on households and consumption and business and investment, as well as the public sector.

What are the key ways a bear market in stocks can effect the economy? In what sectors are the adverse effects, let us say, the most prominent? And given the significance of these adverse effects, should the Fed pay attention or respond to sharp asset price movements?

Mr. Greenspan. Well, Mr. Chairman, the effects on household consumption are reasonably well documented in the sense that what we find when there are significant capital gains on stocks held by households is that they tend to spend a portion of those capital gains and hence, the published savings rate – which, remember, is savings excluding capital gains as a ratio to income excluding capital gains – tends to fall.

In other words, I should put it this way: in addition to consumption out of income, you have consumption out of capital gains, which is financed largely by borrowing.

Clearly, when stock prices or other asset prices fall, you get less consumption financed by capital gains, and it has a negative overall impact on the economy and similarly, the impact of declining stock prices tends to affect long-term values in an economy and, hence, also impacts on capital investment. We don't target asset prices per se, but what we do endeavor to respond to is the way asset prices affect the economy; and that is the way in which monetary policy is impacted by changes in the stock market or in housing prices.

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

We are going to move now to Mr. Stark.

Representative Stark. Thank you, Mr. Chairman.

Thank you, Mr. Greenspan. I would like to just ask – I know you don't like hypotheticals, but I have to ask anyway.

As you know, we have a President who has somewhat of an obsession, it appears, to plunge us into a war, and on the assumption that we will be there 1 or 2 years at $100-$130 billion a year in a conflict and perhaps another year or 2 policing it, 2 to 4 billion bucks a month by a variety of estimates. So let us say over 4 years we would spend somewhere between $200 and $300 billion on a war effort in Iraq.

I have no concept of what that might or might not do to oil prices if you—

Mr. Greenspan. In fact, that is very significantly on—

Representative Stark. What would that do to the economy? We obviously would have to borrow, because they are not going to raise taxes. What would you advise the President if he asked you what would this – what effect would this have on our economy?

Representative Saxton. If I may break in for just one moment here, we have got a vote on, and since I am the only person from my side of the aisle here, I am going to have to go vote at some point here in the next 10 minutes or so. So if we can—

Representative Stark. Fine.

Mr. Greenspan. I will try to answer quickly.

First of all, let me just say that the numbers you quote are clearly very much on the high side of normal estimating procedures of what a reasonable length of time of a war would create. Also it is important to remember that the actual level of defense expenditures as a percent of the GDP has come down very significantly through most of the post-World War II period and especially, obviously, since Vietnam. So in that regard, there is a much larger private sector to absorb these particular costs.

Nonetheless, these are numbers – your numbers, if I put them that way – that if it gets to that level, these are not de minimus, and I think we have to address them accordingly.

I would be very doubtful if the impact on the economy is more than modest, largely because this is not Vietnam or Korea. With Korea, it had a really monumental effect, basically because the economy was so much smaller than it is today, and the size of the operations are not all that much different.

So it is a concern, but not an overriding one, Congressman.

Representative Stark. Thank you.

Representative Saxton. Thank you. Senator Corzine.

Senator Corzine. Thank you, Mr. Chairman. And it is good to see Chairman Greenspan. I apologize for being tardy.

I guess I have a question that follows on what Chairman Saxton asked about. You have repeated a number of times that the market already expects that tax cuts, or a market economy has built in these tax cuts, and they will have whatever impact they have. What presumes, or has built into it, an assumption, or at least an unasked question, whether these are the optimal tax cuts for stimulating the economy?

There may very well be a reasoned argument for freezing these and having other tax cuts if you thought fiscal policy needed to be part of the mix of stimulating the economy. And then, second of all, isn't there also built into market and economic expectations that we have issues with how we fund Social Security and our Medicare systems in the future, that are also weighing at some level, someplace in people's expectations, real problems, that come and do some offsetting with regard to those tax cuts?

So on both of those issues I guess the simple question is, do we have the optimal mix for stimulating the economy with regard to the tax cuts?

I could go through a whole checklist, and we don't have time, but don't we also have the countervailing force that we have serious problems with long-run fiscal considerations that weigh against some of those stimulative effects of a tax cut?

Mr. Greenspan. Well, Senator, I agree with the substance of your remarks, and indeed that is the reason why I said earlier that prior to addressing any of these subjects, it is important for the Congress and the administration to have a long-term budget structure which we continuously update and evaluate so that we have a mechanism to make judgments as to whether we do have an optimal mix – optimal in the sense of either value judgments relative to priorities within the overall budget choice process or with respect to the economy. Unless we have got a way of knowing how we are going to phase into the almost inevitable rise in retirees as a ratio to workers, say 9, 10 years from now, I don't know how you answer these questions. You have no structure against which to make alternate evaluations.

Indeed, you may well be right: is the existing tax structure optimal in the longer term for what we have to deal with? The answer is, I don't know if you can answer that question without getting what the other alternative possibilities are. And I argued, I think, certainly before you came in, Senator, that we have all the data. You could put together a full 12-15-year budget with triggers, sunsetting, all of the mechanisms required to make sure it phases in and make fundamental judgments.

It is not that we are missing any information. It is that we are missing deliberations and choices, and unless and until those are made and put into a fiscal structure, I don't see how you can answer the question you raise, which is the reason I say, prior to addressing these things, that we need to get the process back to where it was. We need to reestablish the basic caps on discretionary spending, on PAYGO, introduce new things like triggers or other things which give us a vehicle to function with.

Senator Corzine. I could support everything you are saying, Mr. Chairman, but I think what people hear when it is singularly focused on whether the tax cut is built into the expectations of the economy, to the

decision-making, that that sounds like – at least to some ears, that that is an endorsement of that, without taking into consideration all these other issues that are operating at the same time.

Mr. Greenspan. Well, I am giving my judgment, as I indicated previously. Fortunately, I don't have the vote that you do and the Congress does, because I am not sure the world would be better off, but the issue here is that from what I know at this moment, all other things equal, I think it would be a mistake to do that.

But it is conceivable that a structure maybe in which you can literally say, what are the alternatives, and indeed if we could do it some other way, is this superior? It is perfectly credible that I would say, yes, that is a superior procedure.

Senator Corzine. One 15-second question. I heard you mention, earlier, corporate accountability, some of the other issues that have overlaid confidence in the economy, certainly confidence in markets. You continue to believe that some of the confusion and implementation of the corporate accountability efforts is a concern to the economy and the marketplace in general?

Mr. Greenspan. I would say that—

Senator Corzine. Starting with personnel, but the inability to get in place some of the reforms that we have talked about because those things are predicative.

Mr. Greenspan. Actually, Senator, I don't think so. I think that as the stock market came down and the bubble burst and the – as I put it – infectious greed automatically disappeared because there was nothing to be greedy about, everything changed. I think we have gone to very major improvements in corporate accounting. I believe numbers of issues that we are concerned about are readily being resolved. I think we need Sarbanes-Oxley not immediately for current procedures, but for the future, because none of the activities which were so rampant – and I would say disgraceful, if I may put it that way – several years ago are taking place today.

The actions of conservatism that we all took for granted 20 years ago are coming back and, indeed, are probably largely in place. We no longer have audit committees which sit there and do nothing. They have become scrupulous. We no longer have CEOs who are requesting their auditors to give them a better set of numbers than they deserve, if I may put it that way. Things have changed.

So is there an urgency to do all of this? No. Is it important that it be done? Absolutely.

Representative Saxton. Mr. Chairman, Chairman Greenspan, thank you for being with us today. We appreciate your indulgence and thank you also for being willing to answer and comment on such a broad range of questions, everything from spending to tax policy, of course, monetary policy and all the other issues that we talked about today. Thank you for being with us, and we will look forward to seeing you in the future. And our best.

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

[Whereupon, at 12:34 p.m., the Committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

I am pleased to welcome Chairman Greenspan before the Joint Economic Committee this morning to testify on the economic outlook.

According to a recent Commerce Department release, the economy grew at a 3.1 percent rate in the third quarter of 2002. Consumer spending accounted for much of this performance, though there was a pick-up in the rate of investment in equipment and software, its largest since 2000. Overall, however, investment has been quite weak during this expansion.

The growth rate for the economy during the first three quarters of 2002 was about 3 percent as well. Consumer spending explains much of this result, while real nonresidential fixed investment actually fell in the first two quarters of the year, finally eking out a small gain in the third quarter. In 2002, personal income has trended upward, and productivity growth has been very strong. Inflation and interest rates remain low, and new home sales have been strong.

In summary, the economy has expanded at a moderate rate so far this year. However, manufacturing activity, which had improved for several months, recently has shown signs of slippage. Overall payroll employment growth has been soft, as employers wait for signs of faster recovery. There is concern that the most recently available data may signal a slowing of the economy.

Furthermore, the uncertainties involved in the war against terrorism and in the international security situation impose additional costs on the economy. While the resilience of the American people and economy has been remarkable, security costs have exacted a toll on economic growth.

Given the absence of evidence of inflation currently or in the foreseeable future, the Federal Reserve action last week to reduce the federal funds rate by half a percentage point to 1.25 percent was appropriate. However, a relaxation of monetary policy alone may not be sufficient to ensure sustained economic expansion. Given the persistent weakness in investment, it would be prudent to consider further changes in tax policy to offset economic uncertainty and improve the prospects for investment and growth.

PREPARED STATEMENT OF SENATOR JACK REED, VICE CHAIRMAN

It's a pleasure to welcome Chairman Greenspan this morning. Last week the Federal Open Market Committee surprised us – not by the fact that they lowered interest rates, but by how much they lowered them. That the Fed took such decisive action confirms what many of us have been saying for some time: the economy is in a slump. Growth is too slow, too many people are out of work, and things don't seem to be getting better on their own.

I don't know if the Fed's actions will be enough to turn the economy around. I certainly hope they will be for the sake of the American people. But the way things are going now, it looks as if, at best, we are headed for another jobless recovery like the one we had after the last recession, when the unemployment rate kept rising long after the recession was technically over. Under those circumstances, I think it would be unconscionable if we let the extended unemployment benefits program expire at the end of the year as it is now scheduled to do. So whatever else we think might be necessary to help the economy recover, I hope we can begin by making sure that people who exhaust their regular unemployment benefits in a tough job market are not left out in the cold.

I know Chairman Greenspan's job is to conduct monetary policy. But monetary policy doesn't operate in a vacuum. Sound fiscal policies, like those we pursued in the 1990s, complement monetary policy in creating an environment of attractive interest rates that stimulate investment and productivity growth. In contrast, large budget deficits like those we experienced from the early 1980s to the early 1990s are a drain on national saving that is harmful to long-term growth.

I am afraid that the fiscal discipline of the 1990s is a fading memory and that we are headed for a repeat of the fiscal mistakes of the 1980s. The 1980s tax cuts were a mistake at the time, but similar policies would be even more of a mistake now. At least in the 1980s, the pressures on the budget from the retirement of the baby boom were off in the distant future and there was time to restore fiscal discipline. This time, however, the biggest tax cuts will be kicking in at just about the same time that the baby boom starts retiring.

We used to get a clear signal from Chairman Greenspan about the importance of fiscal discipline and the pre-eminence of deficit reduction and paying down the public debt over tax cuts as the way to stimulate investment and growth. But that signal has gotten a little garbled in the past two years. I hope that in addition to discussing his views on the economic outlook, Chairman Greenspan will spend some time talking about how the choices we make in the coming year about taxes and other fiscal priorities will affect that outlook.

Mr. Chairman, I look forward to your testimony.

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

The past year has been both a difficult and a remarkable one for the United States economy. A year ago, we were struggling to understand the potential economic consequences of the events of September 11. At that time, it was unclear how households and businesses would react to this unprecedented shock as well as to the declines in equity markets and cutbacks in investment spending that had already been under way. Economic forecasts were lowered sharply, and analysts feared that even these downward-revised projections might be undone by a significant retrenchment in aggregate demand. The United States economy, however, proved to be remarkably resilient: In the event, real GDP over the past four quarters grew 3 percent – a very respectable pace given the blows that the economy endured.

Although economic growth was relatively well maintained over the past year, several forces have continued to weigh on the economy: the lengthy adjustment of capital spending, the fallout from the revelations of corporate malfeasance, the further decline in equity values, and heightened geopolitical risks. Over the last few months, these forces have taken their toll on activity, and evidence has accumulated that the economy has hit a soft patch. Households have become more cautious in their purchases, while business spending has yet to show any substantial vigor. In financial markets, risk spreads on both investment-grade and non-investment-grade securities have widened. It was in this context that the Federal Open Market Committee further reduced our target federal funds rate last week.

The consumer until recently has been the driving force of this expansion. Faced with falling equity prices, uncertainty about future employment prospects, and the emergence of the terrorist threat, consumer spending has slowed over the course of the past year but has not slumped as some had earlier feared it might. Tax cuts and extended unemployment insurance provided a timely boost to disposable income. And the deep discounts offered by many businesses on their products were most supportive.

In particular, automotive manufacturers responded to the events of September 11 with cut-rate financing and generous rebates. These incentives were an enormous success in supporting – indeed increasing – the demand for new cars and trucks. Sales surged each time the incentive packages were sweetened and, of course, fell back a bit when they expired. Some decline in sales was to be expected in recent months after the extraordinary run-up recorded in the summer. However, it will bear watching to see whether this most recent softening is a payback for borrowed earlier strength in sales or whether it represents some weakening in the underlying pace of demand.

Stimulated by mortgage interest rates that are at lows not seen in decades, home sales and housing starts have remained strong. Moreover, the underlying demand for new housing units has received support from an expanding population, in part resulting from high levels of immigration.

Besides sustaining the demand for new construction, mortgage markets have also been a powerful stabilizing force over the past two years of economic distress by facilitating the extraction of some of the equity that homeowners had built up over the years. This effect occurs through three channels: the turnover of the housing stock, home equity loans, and cash-outs associated with the refinancing of existing mortgages. Sales of existing homes have been the major source of extraction of equity. Because the buyer of an existing home almost invariably takes out a mortgage that exceeds the loan canceled by the seller, the net debt on that home rises by the amount of the difference. And, not surprisingly, the increase in net debt tends to approximate the sellers' realized capital gain on the sale. That realized capital gain is financed essentially by the mortgage extension to the homebuyer, and the proceeds, in turn, are used to finance some combination of a down payment on a newly purchased home, a reduction of other household debt, or purchases of goods and services or other assets.

Home equity loans and funds from cash-outs are generally extractions of unrealized capital gains. Cash-outs, as you know, reflect the additional debt incurred when refinancings in excess of the remaining balance on the original loan are taken in cash.

According to survey data, roughly half of equity extractions are allocated to the combination of personal consumption expenditures and outlays on home modernization. These data and some preliminary econometric results suggest that a dollar of equity extracted from housing has a more powerful effect on consumer spending than does a dollar change in the value of common stocks. Of course, the net decline in the market value of stocks has greatly exceeded the additions to capital gains on homes over the past two years. So despite the greater apparent sensitivity of consumption to capital gains on homes, the net effect of all changes in household wealth on consumer spending since early 2000 has been negative. Indeed, the recent softness in consumption suggests that this net wealth erosion has continued to weigh on household spending. That said, it is important to recognize that the extraction of equity from homes has been a significant support to consumption during a period when other asset prices were declining sharply. Were it not for this phenomenon, economic activity would have been notably weaker in the wake of the decline in the value of household financial assets.

In the business sector, there have been few signs of any appreciable vigor. Uncertainty about the economic outlook and heightened geopolitical risks have made companies reluctant to expand their operations, hire workers, or buy new equipment. Executives consistently

report that in today's intensely competitive global marketplace it is no longer feasible to raise prices in order to improve profitability.

There are many alternatives for most products, and with technology driving down the cost of acquiring information, buyers today can (and do) easily shift to the low-price seller. In such a setting, firms must focus on the cost side of their operations if they are to generate greater returns for their shareholders. Negotiations with their suppliers are aimed at reducing the costs of materials and services. Some companies have also eschewed the traditional annual pay increment in favor of compensation packages for their rank-and-file workers that are linked to individual performance goals. And, most important, businesses have revamped their operations to achieve substantial reductions in costs.

On a consolidated basis for the corporate sector as a whole, lowered costs are generally associated with increased output per hour. Much of the recent reported improvements in cost control doubtless have reflected the paring of so-called "fat" in corporate operations – fat that accumulated during the long expansion of the 1990s, when management focused attention primarily on the perceived profitability of expansion and less on the increments to profitability that derive from cost savings. Managers, now refocused, are pressing hard to identify and eliminate those redundant or nonessential activities that accumulated in the boom years.

With margins under pressure, businesses have also been reallocating their capital so as to use it more productively. Moreover, for equipment with active secondary markets, such as computers and networking gear, productivity may also have been boosted by a reallocation to firms that could use the equipment more efficiently. For example, healthy firms reportedly have been buying equipment from failed dot-coms.

Businesses may also have managed to eke out increases in output per hour by employing their existing workforce more intensively. Unlike cutting fat, which permanently elevates the levels of productivity, these gains in output per hour are often temporary, as more demanding workloads eventually begin to tax workers and impede efficiency.

But the impressive performance of productivity also appears to support the view that the step-up in the pace of structural productivity growth that occurred in the latter part of the 1990s has not, as yet, faltered. Indeed, the high growth of productivity during the past year merely extends recent experience. Over the past seven years, output per hour has been growing at an annual rate of more than 2-1/2 percent, on average, compared with a rate of roughly 1-1/2 percent during the preceding two decades. Although we cannot know with certainty until the books are closed, the growth of productivity since 1995 appears to be among the largest in decades.

Arguably, the pickup in productivity growth since 1995 reflects largely the ongoing incorporation of innovations in computing and communications technologies into the capital stock and business practices. Indeed, the transition to the higher permanent level of productivity associated with these innovations is likely not yet completed. Once the current level of risk recedes, businesses will no doubt move to

exploit the profitable investment opportunities made possible by the ongoing advances in technology.

However, history does raise some warning flags concerning the length of time that productivity growth remains elevated. Gains in productivity remained quite rapid for years after the innovations that followed the surge in inventions a century ago. But in other episodes, the period of elevated growth of productivity was shorter. Regrettably, examples are too few to generalize. Hence, policymakers have no substitute for continued close surveillance of the evolution of productivity during this current period of significant innovation.

In summary, as we noted last week, “The [Federal Open Market] Committee continues to believe that an accommodative stance of monetary policy, coupled with still-robust underlying growth in productivity, is providing important ongoing support to economic activity. However, incoming economic data have tended to confirm that greater uncertainty, in part attributable to heightened geopolitical risks, is currently inhibiting spending, production, and employment. Inflation and inflation expectations remain well contained.” In these circumstances, the Committee believed that the actions taken last week to ease monetary policy should prove helpful as the economy works its way through this current soft spot.