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CONDUCT OF MONETARY POLICY

HEARING

BEFORE THE

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U.S. HOUSE OF REPRESENTATIVES

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CONDUCT OF MONETARY POLICY

Wednesday, July 17, 2002

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to call, at 10:10 a.m., in Room 2128, Rayburn House Office Building, Hon. Michael G. Oxley [chairman of the committee] presiding.

Present: Representatives Oxley, Leach, Roukema, Bereuter, Baker, Castle, King, Royce, Lucas of Oklahoma, Kelly, Paul, Bachus, Barr, Gillmor, Cantor, Weldon, Ryun, Shays, Miller, Grucci, Hart, Capito, Ferguson, Rogers, Tiberi, LaFalce, Frank, Kanjorski, Waters, Sanders, Maloney of New York, Bentsen, Maloney of Connecticut, Carson, Sherman, Sandlin, Lee, Inslee, Schakowsky, Moore, Gonzalez, Capuano, Ford, Hinojosa, Lucas of Kentucky, Gutierrez, Watt, Crowley, Clay and Ross.

The CHAIRMAN. The committee will come to order.

Pursuant to the Chair's prior announcement, the Chair will recognize himself and the ranking minority member for 5 minutes each for opening statements and the Chair and ranking minority member of the Subcommittee on Domestic Monetary Policy for 3 minutes each. All members' opening statements will be made part of the record.

The Chair now recognizes himself for a brief opening statement.

Chairman Greenspan, welcome back to the committee. We look forward to your remarks regarding the current economic environment.

As you well know, the situation appears far different from when you were the first witness called before this new committee some 18 months ago. It is now apparent that, even then, the United States economy was sliding into a recession, a recession that next week's release of GDP figures should tell us was short, maybe only a solitary quarter's worth, but the results of which, nonetheless, had a real impact on American families and workers.

Among the questions we all are interested in are these: When will the recovery start in earnest? How will we know we are in the recovery? What can we all do, Congress certainly, but everyone in this country, to encourage and speed the recovery? I think we also will want to hear your views on whether it is possible it avoid going through this time of adjustment again any time soon.

Many of the committee believe that more timely and accurate reporting of economic data would help the business sector adjust to changing economic times and, therefore, avoid some of the gyrations the economy occasionally executes.

In the past, you have noted how the information and technology revolution of the last decade can aid in this effort. But, primarily, Mr. Chairman, I think we would like to hear you talk about the mixed messages we are getting about the current shape of the economy.

We have heard from many economists that the fundamentals of the economy are good. As a matter of fact, you mentioned that yesterday. Consumer spending has remained strong, and the dollar has settled to parity with the Euro, which one would expect would rapidly spur U.S. exports, while turning demand for comparable goods inward.

Mr. Chairman, you mentioned a lot of these figures in your prepared statement, and I know you agree with me that they are promising. I note that you have raised your forecast of economic growth for the current year by a half percentage point, from a maximum of 3.25 to a maximum of 3.75 percent, and have estimated growth for the next year to be in the 4 percent range. Those are good numbers in any circumstance but especially good news right now.

But to paraphrase a well-known and widely respected economic theorist, all of this plays out against a surge of irrational pessimism about our equity markets. Buffeted by reports of accounting misdeeds, the markets have plummeted, decreasing personal wealth and retirement incomes and dampening investor enthusiasm.

We are now in what might be termed a crisis of confidence. Plainly, without the confidence of investors, a free market economy such as ours cannot remain robust. Efforts by this committee and more recently by the White House and Senate to set new standards for corporate governance will go a long way towards restoring that confidence. However, I think we all would be interested in hearing your views on what else might be done in that arena so that the United States economy can remain the envy of the world for its strength and resilience.

The current environment brings to mind a passage in our recent history. A couple of decades ago, massive corporate restructurings caused a great deal of economic discomfort. It was a painful time, and many feared we would be permanently damaged by it. In fact, we learned that those restructurings left American businesses strong and lean and better suited for international competition than any other, and the ultimate result was two strong decades of growth as the rest of the world inexpertly took up American style restructuring.

I wonder, Mr. Chairman, if we will not see the rest of the world in the next year or two embark on a reexamination of its own asset valuation and accounting standards and another long cycle in which U.S. business, again strong and lean, leads the way in growth.

Of course, Mr. Chairman, there are other issues on which we would like to hear your opinion. Will the European financial services action plan create an economy that is truly competitive with the United States, or one that is better suited than ours to compete? What can be done to help Argentina and Brazil and other emerging markets grow their way to health? Do you have any early

projections on the effects on the economy of the proposed Free Trade Agreement of the Americas? And what will be the shape of international trade in 5 years or a decade and how can U.S. businesses best prepare themselves to compete?

Your thoughts on all these matters will be greatly appreciated, not only by this committee but indeed by all Americans.

I thank you again for your appearance with us today; and, with that, I am pleased to yield to the gentleman from New York, Mr. LaFalce.

Mr. LAFALCE. Thank you very much, and welcome, Chairman Greenspan. This may be my final opportunity to address you in this setting, and I want you to know that it has been one of the great privileges of my public career to have worked with you these many years as Chairman of the Federal Reserve Board.

Mr. GREENSPAN. Thank you very much.

Mr. LAFALCE. Chairman Greenspan, in reporting on the state of the economy today, I expect you will highlight recent events in the global economy. In particular, I would note that an important country in the Americas finds itself in the midst of a financial crisis. After struggling to meet its sovereign debt obligations, this country is now confronting widespread corruption in the business sector. Charges of inappropriate business dealings have reached the President and key officials in his government. The IMF has weighed in with criticism of the government's irresponsible fiscal policy and inadequate corporate governance standards. The head of the nation's central bank, while widely respected domestically and internationally, finds his advice on at least one important policy issue ignored by the President. Foreign investors have watched events in the country unfold with alarm and have begun to pull their money out, causing the currency to decline significantly. And yet, just a few years earlier, this country was envied for its miracle economy.

Argentina? No. Brazil? No. Mexico? No.

Of course, I am talking about the United States of America.

For years, the United States had been the guiding light for an unassailable faith in free markets. Deregulation, smaller government and the wisdom of the marketplace had become watchwords that many urged other countries to follow as a model. In fact, we are now so accustomed to considering how best to deregulate, many seem unable or at least most unwilling to enact appropriate regulations for the private sector in the face of widespread and costly corporate abuses of the public's trust.

Many of us in Congress have tried to put a human face on the toll that the corporate scandals have taken. It is not hard to do. Thousands of long-time employees at Enron and WorldCom have lost their jobs and their life savings in one fell swoop. But each of these individual job losses adds up to an economy-wide problem that is no longer isolated to Houston, Texas, or Mississippi. Oftentimes in these monetary policy hearings we push you to step away from the macroeconomic issues to address the human side of things, but today I do believe it is important and useful to consider what will happen to our economy at large as a result of the corporate fraud disclosures.

My concern is at least twofold. First, that we could be entering a protracted period of little or no economic growth as we struggle

by fits and starts to restore confidence in our markets. And restoration of confidence is so essential for not only do economies move markets but today markets often move economies, up, down or sideways.

Secondly, and very importantly, by mid-August, the CEOs and CFOs of the top 1,000 publicly traded corporations in America must certify to the accuracy and reliability of their companies' financial statements. I fear this may precipitate hundreds of restatements of earnings. This might well have a downward impact on the market and the economy.

Mr. Chairman, I am anxious to hear your views on the impact corporate fraud is having on the economy and what impact it could have, both by mid-August and in the months ahead, particularly if consumers and investors continue to express doubt in the ability of elected officials and corporate leaders to respond to the problem.

In my view, the potential ramifications are widespread. As I mentioned earlier, we have begun to see a depreciation in the dollar resulting in part from a loss of confidence amongst foreign investors. While a moderately weaker dollar will provide a substantial benefit to our exporters, a rapid decline in the dollar could bring with it a host of other problems and surely make your job significantly more difficult.

These macroeconomic factors matter because, ultimately, they will affect the human side of our economy. The difference between economic growth of 4 percent and 1 percent is the difference between an economy that produces tens of thousands of new jobs and one that does not and the difference between an economy in which workers' wages grow and one in which they stagnate.

Last week, in perhaps an all-too-candid moment, President Bush wondered out loud just how important the corporate scandals really are. Well, my answer, Mr. President, is that they are very, very important; and it is time that we all begin to respond to them with meaningful remedies.

I mentioned earlier, Mr. Chairman, that your advice has been ignored by the President, and on that I was referring to your support for the expensing of stock options. I am pleased that Coca Cola, the Washington Post and Bank One have followed your and Warren Buffet's sage and prudent advice. This is just one of the meaningful remedies we should all be able to agree upon in short order, so I hope today's hearing will serve, amongst other things, to highlight the economic necessity and urgency of corporate reforms.

I thank the Chair.

The CHAIRMAN. The gentleman's time has expired.

The Chair now recognizes the Chairman of the Subcommittee on Domestic Monetary Policy, the gentleman from New York, Mr. King.

Mr. KING. It is a pleasure to have you here this morning, especially at this particularly critical moment in our Nation's economic history. I notice that the Dow is up almost 200 points, and Congressman Bereuter just cautioned me not to say anything that could upset that, so I will try to restrain my remarks.

Mr. Chairman, I was in some ways gratified by your statement yesterday before the Senate about how the economy is fundamentally sound, that inflation appears to be under control, productivity

is increasing, the housing industry is strong, and unemployment seems to be at least stable.

At the same time, however, though, because primarily of the corporate scandals, there is almost a total disconnect between the fundamental strengths of the economy and the showing of the stock market; and, as Congressman LaFalce said, this has a real human impact. We are talking about real people—people about to retire, people that have their entire life savings in their 401(k)s, looking towards their retirement years, and they are faced with a terrible crisis.

So I would really again—in your testimony today, I look forward to if you can give us some estimate as to when you think we will be coming out of this, just how important it is that we at a very early stage pass very effective reforms and legislation as far as cracking down on corporate corruption and also to address issues such as the fact that the Euro is now at a parity with the dollar. Is that a threat to us or an opportunity? What does that auger for the future?

Also, how much of an impact do you believe that just the threat of future terrorist attacks is going to have on the economy as far as holding it back and holding it down? How significant will that be?

With all of these, Mr. Chairman, when you were talking about yesterday the fundamental strength of the American economy, I think one item you omitted was your service as Chairman of the Federal Reserve. I think that has done as much as anything to bring about the stability and strength which is going to bring us through this period, and I want to commend you for your years of service, the work you have done and also for coming before our committee at least twice every year, your constant communications with us, but, most importantly, the note of reassurance you send to markets both here and throughout the world.

Mr. Chairman, with that I yield back the balance of my time.

The CHAIRMAN. Chairman Greenspan, we are pleased to welcome you back to the committee.

Mr. LAFALCE. Mr. Chairman, I would like to yield Mrs. Maloney's 3 minutes for an opening statement in her absence to the distinguished gentleman from Arkansas, Mr. Ross.

The CHAIRMAN. The gentleman is recognized for 3 minutes.

Mr. ROSS. Thank you, Mr. Chairman, and thank you ranking member, and good morning to you, Chairman Greenspan. I look forward to your testimony here this morning.

Before I address corporate governance, I would like to simply stress I am confident in the long run our economic system will overcome its current challenges. Despite our immediate difficulties, I have the highest confidence in our system of free markets. Over time, it has proven preeminent in generating economic growth, jobs and rewarding innovation. We have been through other market declines and corporate scandals, including insider trading and major banking collapses during the 1980s. Times now demand strong leadership and meaningful reform.

On Monday, the President delivered a speech in Alabama where he blamed our current economic problems on a hangover from the binge in the 1990s. I agree with the President that we experienced

what I call a bubble in the stock market, with some high-tech and telecom stocks rocketing to unsustainable capitalizations, but I strongly disagree with his characterization of the decade. The 1990s were a decade of unparalleled prosperity. The economy experienced an unmatched period of growth, government surpluses, strong financial markets and full employment.

The Clinton administration put us on the path to fiscal responsibility in 1993; and, Chairman Greenspan, you and your colleagues at the Fed formulated and implemented the monetary policies during the 1990s and deserve credit. I wonder if you agree with the President's characterization of the 1990s, and I hope you will tell the committee whether the Fed contributed to the excesses to which the President referred.

Rather than blame the 1990s, it is more reasonable to point to the business cycle. It is unfortunate that the downturn in the cycle has coincided with a staggering reversal in our government's balance sheet resulting from the Bush tax plan. The White House now acknowledges a $165 billion deficit this year, with expected deficits through 2005.

Rather than pointing the finger toward the past, I blame our current situation on the crisis of confidence brought on by the corrupt business practices of those in the corporate world. I think we have got to take the necessary steps to restore faith and confidence to our markets, specifically our stock markets.

Despite these challenges, I am optimistic about the future, and I am pleased that I can have you here with us today to share your thoughts on the unstable economy, as I call it. We have got to find ways, Mr. Chairman, to restore confidence, what I call restore small town values to the corporate world.

The CHAIRMAN. The gentleman's time has expired.

Chairman Greenspan, again welcome back to the committee. You may proceed with your opening statement.

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

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

Over the four and one-half months since I last testified before this Committee on monetary policy, the economy has continued to expand, largely along the broad contours we had anticipated at that time. Although the uncertainties of earlier this year are not yet fully resolved, the U.S. economy appears to have withstood a set of blows—major declines in equity markets, a sharp retrenchment in investment spending, and the tragic terrorist attacks of last September—that in previous business cycles almost surely would have induced a severe contraction. The mildness and brevity of the downturn, as I indicated earlier this year, are a testament to the notable improvement in the resilience and flexibility of the U.S. economy.

But while the economy has held up remarkably well, not surprisingly the depressing effects of recent events linger. Spending will continue to adjust for some time to the declines that have occurred in equity prices. In recent weeks, those prices have fallen further on net, in part under the influence of growing concerns about cor-

porate governance and business transparency problems that evidently accumulated during the earlier rapid run-up in these markets. Considerable uncertainties—about the progress of the adjustment of capital spending and the rebound in profitability, about the potential for additional revelations of corporate malfeasance, and about possible risks from global political events and terrorism—still confront us.

Nevertheless, the fundamentals are in place for a return to sustained healthy growth. Imbalances in inventories and capital goods appear largely to have been worked off, inflation is quite low and is expected to remain so, and productivity growth has been remarkably strong, implying considerable underlying support to household and business spending as well as potential relief from cost and price pressures.

In considering policy actions this year, the Federal Open Market Committee has recognized that the accommodative stance of policy adopted last year in response to the substantial forces restraining the economy likely will not prove compatible over time with maximum sustainable growth and price stability. But, with inflation currently contained and with few signs that upward pressures are likely to develop any time soon, we have chosen to maintain that stance, pending evidence that the forces inhibiting economic growth are dissipating enough to allow the strong fundamentals to show through more fully.

As has often been the case in the past, the behavior of inventories provided substantial impetus for the initial strengthening of the economy. However, as inventories start to grow more in line with sales in coming quarters, the contribution of inventory investment to real GDP growth should lessen. As a result, the strength of final demand will play its usual central role in determining the vigor of the expansion. While final demand has been increasing, the pace of forward momentum remains uncertain.

Household spending held up quite well during the downturn and through recent months and thus served as an important stabilizing force for the overall economy. Spending was boosted by ongoing increases in incomes, which in turn were spurred by strong advances in productivity as well as by legislated tax reductions and, in recent months, by extended unemployment insurance benefits.

Monetary policy also played a role by cutting short-term interest rates, which helped lower household borrowing costs. Particularly important in buoying spending were the very low levels of mortgage interest rates, which encouraged households to purchase homes, refinance debt and lower debt service burdens, and extract equity from homes to finance expenditures. Fixed mortgage rates remain at historically low levels and thus should continue to fuel reasonably strong housing demand and, through equity extraction, to support consumer spending as well.

But those sources of strength probably will be tempered by other influences. Because consumer and residential expenditures did not decline during the overall downturn, there is little pent-up demand to be satisfied. Moreover, the declines in household wealth that have occurred over the past couple of years should continue to restrain spending in the period ahead. Still, despite concerns about economic prospects, equity valuations, terrorism and geopolitical

conflicts, consumers do not appear to have retrenched in retail markets. Indeed, consumers responded strongly to the new interest rate incentives of motor vehicle manufacturers this month. Early reports indicate a significant improvement in sales over June.

By contrast, business spending has been depressed. The recent economic downturn was driven, in large measure, by the sharp fall-off in the demand for capital goods that occurred when firms suddenly realized that stocks of such goods were excessive. Overall, the level of real business fixed investment plunged about 11 percent between its quarterly peak in the final months of 2000 and the first quarter of this year.

With the adjustment of the capital stock to desired levels now evidently well advanced, business fixed investment may be set to improve. A recovery in this category of spending is likely to be gradual by historical standards and uneven across sectors. Still, firms should respond increasingly to the expected improvement in the outlook for sales and profits, low debt financing costs, the heightened incentives resulting from partial expensing tax provisions legislated earlier this year, and especially the productivity enhancements offered by continuing advances in technology.

Indeed, despite the recent depressed level of investment expenditures, the productivity of the U.S. economy has continued to rise at a remarkably strong pace. The magnitude of the recent gains would not have been possible without ongoing benefits from the rapid pace of technological advance and from the heavy investment over the latter half of the 1990s in capital equipment incorporating such advances.

Despite these encouraging developments regarding the longer-term protects prospects for the economy, financial markets have been notably skittish of late, and business managers remain decidedly cautious. In part, these attitudes reflects the lingering effects of the shocks that our economy endured in 2000 and 2001.

Also contributing to the dispirited attitudes among many corporate executives is the intensely competitive business environment facing their firms. Increased competition, while producing manifold benefits for consumers and for the economy as a whole, clearly makes individual firms' operations more difficult.

Those businesses where heightened competition has engendered a loss of pricing power have sought ways to raise profit margins by employing technology to lower costs and improve efficiency. In the United States, as a consequence of the interaction of monetary policy, globalization and cost-reducing productivity advances, price inflation has fallen in recent years to its lowest level in four decades, as has the recent growth of nominal GDP and consolidated corporate revenues.

In part because nominal corporate revenues, although no longer declining, are growing only tepidly, managers seem to remain skeptical of the evidence of an emerging upturn. Profit margins do appear to be coming off their lows registered late last year, but, unsurprisingly, the recovery in economic activity from a shallow decline appears less vigorous than in the past. The lowest sustained rates of inflation in 40 years imply that nominal growth in sales and profits looks particularly anemic. Reflecting concerns about the

strengths of the recovery, managers continue to limit capital spending to only the most pressing needs.

Given the key role of perceptions of subdued profitability in the current period, it is ironic that the practice of not expensing stock option grants, which contributed to the surge in earnings reported to shareholders from 1997 to 2000, has imparted a deceptive weakness to the growth of earnings reported to shareholders in recent quarters. According to estimates by Federal Reserve staff, the value of stock option grants for the S&P 500 corporations fell about 15 percent from 2000 to 2001, and grant values have likely declined still further this year. Moreover, options grants are presumably being replaced over time by cash or other forms of compensation, which are expensed, contributing further to less robust growth in earnings reported to shareholders from its trough last year.

In contrast, the measure of profits calculated by the Department of Commerce for the National Income and Product Accounts is designed to gauge the economic profitability of current operations. It excludes a number of one-time charges that appear in shareholder reports and, importantly, records options as an expense, albeit at the time of exercise. National Income and Product Account profits have increased sharply since the third quarter of last year, partly reflecting the dramatic jump in productivity and decline in unit labor costs.

The difficulties of judging earnings trends have been intensified by revelations of misleading accounting practices at some prominent businesses. The resulting investor scepticism about earnings reports has not only depressed the valuation of equity shares, but it also has been reportedly a factor in the rising risk spreads on corporate debt issued by the lower rung of investment-grade and below-investment grade firms, further elevating the cost of capital for these borrowers.

To sum up, Mr. Chairman, the U.S. economy has confronted very significant challenges over the past year or so. Those problems, however, led to only a relatively brief and mild downturn in economic activity, reflecting the underlying strengths and increased resiliency that the economy has achieved in recent years. The effects of the recent difficulties will linger for a bit longer, but as they wear off and absent significant further adverse shocks, the U.S. economy is poised to resume a pattern of sustainable growth. Our prospects for extending this performance over time can be enhanced through implementation of sound monetary, financial, fiscal and trade policies.

Thank you, Mr. Chairman. I have rather extended written remarks and request they be included for the record. I look forward to your questions.

The CHAIRMAN. Without objection, the entire statement will be made part of the record, Mr. Chairman.

[The prepared statement of Alan Greenspan can be found on page 49 in the appendix.]

The CHAIRMAN. The Chair would announce there is a vote on the floor, and it would be the wish of the Chair to recess the committee for 10 minutes. Then we will proceed with the questions for the Chairman.

The committee stands in recess for 10 minutes.

[Recess.]

The CHAIRMAN. The committee will reconvene.

Mr. Chairman, we thank you for your remarks. It is now time to get into the question period. The Chair will recognize himself for 5 minutes for that purpose.

Mr. Chairman, during the 1990s and just until recently, there was a lot of talk about the wealth effect, of course we have changed from a Nation of savers to investors. I saw a recent poll the other day that some 70 percent of people consider themselves investors in one way or another.

During that run-up, the wealth effect was cited as an example of why people felt better about themselves, felt more secure in their retirement.

The obvious question is now that the, if you will, the bubble has burst, are you seeing the opposite effect from the wealth effect, and how is that affecting our overall economy?

Mr. GREENSPAN. For a long period of time prior to the mid-1990s, the ratio of net worth to household income was within a relatively narrow range. In the latter part of the 1990s, that ratio rose quite significantly as a consequence both of the very dramatic rise in stock prices but also in home values. As a consequence of that, and the various techniques which we have to determine what creates consumer expenditures, we concluded that a substantial part of the rise in consumption expenditures did reflect essentially the wealth effect. Either borrowing off increasing wealth and spending it or in essentially a sense of having a lot of assets, people drew down some of their liquid assets and spent it on goods and services.

Now that it is reversed, we are getting essentially the reversal of the upside with a few major qualifications.

First, it has not been true in the equity people have had in homes, and indeed, that has continued to rise. And because most of the evidence which we have indicates that the propensity to spend out of increased home wealth is much greater than increased stock market wealth, even though the aggregate value of the decline in stock market wealth since the peak in the early part of 2000 is far in excess of the increase in home equity wealth since then, it is not by any means a swamping of the impact on consumer expenditures from this dramatic decline in stock market values.

So, yes, we have had a reversal of the wealth effect, but it has been very significantly tempered by the continued existence of growth in home equities.

Secondly, it matters where in the income scale you are. The data that we have suggest very disproportionate amounts of equity stock wealth is in the upper 20 percent of households arrayed by income and that a significantly larger impact from home wealth is in the lower groups. So that there is a complexity of factors here which net has reduced consumption expenditures from what they otherwise would have been. But so long as home wealth, the value of homes and the equity we have in them continues to increase, that is clearly going to significantly temper the impact that the decline in stock prices has had.

The CHAIRMAN. Let me ask you a specific question regarding the issue of corporate accountability and transparency. The bill that

the House passed in April contained two provisions in terms of transparency. The one provision was that if a corporate insider was to sell his stock, that under current law, as you know, it would be up to potentially 40 days before he would have to report. The bill that passed the House would require that that be done in real time, essentially the second day from that sale, therefore providing more information to the stockholders when it might appear the corporate insiders were bailing out.

The second provision was that, should a corporation discover a material change in their business, that is, they lost a major customer, had a major settlement, that kind of thing, that that, too, would have to be made available via the Internet in real time.

In a general sense I think all of us support the concept of transparency. Do you think it is a good idea that in today's world in terms of the ability to transfer information that quickly, that those two provisions are beneficial?

Mr. GREENSPAN. Well, Mr. Chairman, the only qualification I would make rests on the issue of whether in the process you are making available competitively valuable information, whether it is proprietary information, and I don't know the answer to that. But I would suggest to you that while clearly transparency, especially of the type you are referring to, is of value, it is important that what we do not do is that we enforce directly or indirectly the disclosure of proprietary information which is a valuable property right and a valuable asset for individual companies and, indeed, a very crucial element in the proper functioning of a free market system.

The CHAIRMAN. Thank you. My time has expired. The gentleman from New York Mr. LaFalce.

Mr. LAFALCE. Thank you, Mr. Chairman.

Chairman Greenspan, I would like to in my limited time address two questions to you. First deals with the certification by CEOs and CFOs of the accuracy and reliability of their financial statements. This is something that President Bush did call for in March, but as far as I understand, it was just a call for CEOs to do this voluntarily. There was no suggestion that there be legislation to require it, nor that the SEC promulgate regulations to require it.

I offered amendments both within the committee and on the House floor, and they were voted down on a party-line vote. But the SEC did require it recently of the roughly top 1,000 publicly traded corporations in America, and I expect those certifications to be in to the SEC by, I believe, August 14th.

I don't know what is going to happen. I am concerned that it may be coupled with a significant number of earnings restatements. Every earning restatement I have ever seen has been revised downward rather than upward. That is interesting, isn't it? Given the fact that accounting is an art, why is it that all the restatements are restatements down?

I am just wondering if there is any contingency planning going on with the Federal, with the SEC, the SROs, et cetera, for the eventuality of what the potential impact might be.

My second question is—I just want to get it in—is I have long believed I have always supported FASB when FASB said we ought to require the expensing of stock options. And it was only because

of the unbelievable pressure that certain Members of Congress exerted upon FASB, basically threatening them with extinction, that they decided not to go forward with the expensing of options as a requirement and simply recommended it, the recommendation that almost no corporations in America—I think two—complied with, until a week ago when we did get following your advice Coca Cola, Washington Post and Bank One.

I would like you to explain your rationale for the expensing of stock options and your evaluation of the contribution that its absence has had upon the overvaluation, the bubble and the bursting of the bubble, et cetera.

Mr. GREENSPAN. Well, first, Congressman, let me say that I have always been under the impression that one of the reasons the SEC moved in the direction that it did with respect to certification was, in fact, conversations with the Administration and, I would presume, as the result of the President's request. The initial notion of doing that is actually Paul O'Neill, the Secretary of the Treasury's view of what would be required. And when I first heard it, I thought that it cut right to the core of what the nature of the problem was. It is clear that he convinced the President, and my impression, but I don't know for certain, is that the SEC was following essentially previous conversations and I wouldn't say instructions from the President—obviously he doesn't do that—but clearly influenced by the President's position.

With respect to the issue of stock option grants, the—.

Mr. LAFALCE. The second part of that question is, you know, do you have any contingency plans, any expectations?

Mr. GREENSPAN. Oh, of course, yes. I do believe there are going to be significant restatements, and I agree with you that the number that are going to be restated up won't take you very long to read. I am not terribly concerned about any impact because remember, what is involved here is that if we get a lot of restatements, and I presume we may very well, I am not sure that is all bad. Indeed what it is suggesting is that the issue which really gripped everybody for a number of years, to manage your earnings so that you could affect the stock price, is going to disappear. And indeed, I think it is very much disappearing.

Mr. LAFALCE. I hope you are right. I suspect you are.

Let me just ask this, though: Do you think we should extend that from the top 1,000 corporations to all publicly traded corporations?

Mr. GREENSPAN. I don't think it is necessary mainly because—

Mr. LAFALCE. How about desirable?

Mr. GREENSPAN. Well, my main concern is that you don't want to overload the SEC, and the vast proportion of any of the issues that would come up which should concern us from the economy's point of view are covered pretty much by the SEC requirement.

Mr. LAFALCE. The economy is one thing, and a human person with all his or her investments is another. And if all were required and then did have random, this might better serve the public interest. That is why I think it is necessary to have not just the top 1,000, but all 17,000 publicly traded corporations have the certification.

Mr. GREENSPAN. If they did it voluntarily, it would be fine, but I would hate to have to administer something of that dimension.

I am fearful that the resources that inevitably would go in that direction would impede the much smaller group, which you really need to oversee in that respect.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Iowa Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

Market economies obviously are based on confidence. And when you have corporate governance problems, whatever, we have the confidence erodes. And so the question I think many people in the market are asking is that if Congress moves forthrightly to tighten the law, if the executive demonstrates a willingness to serve as a referee and insists that the law be abided by, then is the market drop that we have seen an aberration, or is it simply a natural correction? Would you care to comment on that?

Mr. GREENSPAN. It is very difficult to answer that question. I know that there are a lot of people who are focusing on it very sharply and a number of people who are paid very large salaries to answer that question. And I regret to say the answers I have heard I have not felt convincing one way or the other. Clearly—well, the bottom line is I really don't know, and that is about as much as I can say about it.

Mr. LEACH. Let my say you are paid a small salary, but the assumption is you know more about it than those that are paid a large salary. But thank you.

Mr. GREENSPAN. Let me just say this: I do know what I don't know.

Mr. LEACH. That is what distinguishes you from Members of the United States Congress.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Massachusetts Mr. Frank.

Mr. FRANK. Mr. Chairman, I am struck by the emphasis both in the report, the monetary report, and your statement about what appears to be your concern that we are moving from surplus to deficit at the Federal level with the negative consequences. I mean, you talked a lot about and I think there was a consensus that one of the great things about the recent period was that we saw a strong growth in the economy at a time when the Federal Government was, in fact, moving from deficit to surplus, and that, in fact, that offered a basis for things going forward.

Now, here's the problem. You say, and I appreciate this, because there has been some debate about what has caused the move from surplus to deficit, and I appreciate your mentioning there were several factors, because people try to sometimes talk about—they try to give a monofactor analysis, but I note for instance in the monetary policy report you say receipts have remained subdued. Individual tax payments are running well below last year's pace. This weakness reflects general macroeconomic conditions, the legislative changes in tax policy, and the declining stock prices. And similarly in your statement you say at page 13, talking about this move, the necessary rise in expenditures related to the war on terrorism and enhanced homeland security has also played a role, as have the tax reductions legislated last year.

Now, in a less superheated political world, noting that reducing tax rates reduces revenues would not be considered a significant statement, but it is, and I think it is important and I appreciate your acknowledging that one of the contributing factors to the move from surplus to deficit, as you say both in the statement and the report, are the tax cuts of 2001.

The problem we have, I think, is this: As you say, there have been some unanticipated results, although some of us did say it was a mistake to do a tax cut of that magnitude, assuming that you were going to have a high level of economic activity going forward. No one anticipated the mass murders of September 11th and the need to spend money. After doing the tax reductions in 2001, we experienced the tragedy of September 11th, those murders, and we have committed ourselves to spending probably hundreds of billions of dollars over the next few years, as you know, increasing expenditures.

Given that there is not a reason—and you have acknowledged that—you have not acknowledged because you have been a leader in this, you have pointed out that the move from surplus to deficit has very real negative consequences for the economy both in the ability of the Federal Reserve to help with monetary policy and with the economy in general.

You acknowledge that the tax reductions of 2001 are one of several reasons why this is happening. We also have a consensus to spend much more money at the Federal level. Indeed you mention in the report, the monetary policy report, that outlays in the first 8 months of 2002 were up 14 percent particularly when you correct for the drop in the interest rates and the payment of the deficit. None of those, to my recollection, were over the President's objection. So outlays were up 14 percent in part because of September 11th. Taxes are cut. We have got to spend more money. We are going from surplus to deficit with negative macroeconomic consequences. Yes, you called for some spending restraints, but should a reexamination of the tax cut go forward?

I guess my question would be if we had known what was going to happen on September 11th, and we had known what the economy would be doing, would it have been prudent to have reduced taxes by as much as we did in 2001?

Mr. GREENSPAN. Well, it is turning out that the tax cut is a two-edged sword in that respect. One, obviously it reduces the surplus and adds to the deficit. It is not a very large part of that. It is part of it. But because it happened to turn out to occur just when a pickup in consumer expenditures would be quite helpful—.

Mr. FRANK. Let me say this, Mr. Greenspan: Yes, it was fortuitous that it happened at that point, more than fortuitous, but now we are talking about going forward where the great bulk of the tax cut is before us with those negative consequences.

Mr. GREENSPAN. I understand that Congressman. The answer that I gave to the Senate yesterday is, I think, the appropriate one. In looking at our whole fiscal affairs, we are confronted with a major shift in the last several decades from budgets which we could focus on and enact within a very short time frame. In other words, there was very little in the way of very long-term commitments in the budget. What has happened to our budget is it has become not

a 1- or even a 2-year budget any longer; it has become a long, 10 maybe 15-year budget. And my own view is that we do not put enough in the way of analysis of evaluating the full impact of both receipts and outlays as we go into the future and make determinations.

Mr. FRANK. But isn't this then imprudent—you want us to change that part about the budget. Maybe others will agree. But isn't it not imprudent to reduce revenues before you succeed in making those changes, or at least isn't that the consequence that it has a contributing consequence to the deficits?

The CHAIRMAN. The gentleman's time has expired. You may respond.

Mr. GREENSPAN. I think you have to look at both sides, both receipts and expenditures.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Nebraska Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman.

Chairman Greenspan, thank you for helping us again wrestle with these problems. My constituents and people across America are really angry with corporate governments, the failures, the abuses there. They want people to go to prison who are guilty of violating the law. Their retirement accounts, their education accounts are devastated, and they want those prisons not to be just country club prisons.

In your statement you say even a small increase in the likelihood of large possible criminal penalties for egregious behavior of CEOs can have a profoundly important affect on all aspects of corporate governance. And then later, just a few paragraphs later, you say, I recognize that I am saying that the state of corporate governance to a very large extent reflects the character of the CEO, and that that is a very difficult issue to address. Although we may not be able to change the character of corporate officers, we can change the behavior through incentives and penalties.

Then you discuss the kind of responsibilities and the way that that governance direction would come from statutory direction, from Congress, or from regulation and flexibility and rulemaking, and then also from supervisory activities of nongovernmental organizations like the New York Stock Exchange.

What are your thoughts and guidance to us about what is the proper role for regulation versus strict statutory action in the current environment that we face?

Mr. GREENSPAN. Congressman, I think the principle has got to be based on how one evaluates what it is you are trying to regulate. We, for example, at the Federal Reserve are acutely aware that the financial system is under continuous change year by year as it evolves, hopefully in a positive direction. We accordingly don't have a fixed set of supervisory and regulatory standards. We are continuously revising them so that they match the changes that are going on in the financial system. It would be a mistake, for example, for what we do to be hard-wired into statute.

And so then I would say the principle that I would apply here is whether or not what you are writing into law specifically is something you expect to be applicable, say, 30 years from today. Principles should be in the law, but empowerment of, for example,

the Securities and Exchange Commission is the major vehicle here to effectuate the changes that need to be made so that they can do it by rulemaking, but rulemaking which can change as the circumstances change, but it is rulemaking under the empowerment of legislation enacted by the Congress. It is a very difficult balance, but one that I think is very important to adhere to, and that clearly refers to those issues which should not be under federal regulatory structures one way or the other and should be in the private sector most effectively.

Mr. BEREUTER. Since I seem to have a minute, people look at a corporate leader who systematically deceived the public, the stockholders, investors, and they see at this moment a huge mansion complex being constructed in Florida, and they think, as I do, we ought to go after those assets. So what do you think about disgorgement and the need for congressional action on that subject?

Mr. GREENSPAN. Well, that is an issue of enforcement about which I don't know terribly much. But, obviously fraud is theft. It is indistinguishable from going into a bank and stealing something. And our free market capitalist system cannot function in an environment in which fraud and misrepresentation are critical elements because trust is so essential to making that system work.

This is something which we have to address. How we do it and to what extent we impose severe criminal remedies is an issue which I don't have any particular view on, but that it should be forceful and effective I have no doubt.

Mr. BEREUTER. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Pennsylvania Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Greenspan, in the last several weeks consumer confidence has shown some shift. Of course, that was one of the two pillars that have been sustaining our economy over the last 18 months: the consumption of personal items. I would therefore like you to address the level of personal debt and whether or not its high amount could impinge on the ability for consumer confidence to rise and consumption to continue. Then, interlace that answer with this discussion that we are hearing now about the potential of a real estate bubble. We have also had real estate as the second leg sustaining the economy which has been significantly high and to a large extent almost beyond understanding in a continuing growth pattern.

Is it possible that the real estate bubble exists in the country as the stock market bubble existed? If the real estate bubble disappears—and real estate adjustments occur—and consumer confidence continues to go down, what do you foresee for the American economy over the next 18 months to 2 years?

Mr. GREENSPAN. Well, first of all, Congressman, let me say that it is certainly the case that the surveys of consumer confidence have gone down, and the reasons they have gone down are many, but consumer spending in retail markets has not. And indeed our interest is actually in what people do, not what they say. Indeed, as I point out in my written text, at the same time that the indexes of consumer confidence fell, there has been a big surge in motor ve-

hicle sales in the early weeks of July, so that I think we have to be aware that on occasion, as good as these measures are of consumer confidence, they often don't necessarily represent what people are going to do where we care what they are going to do as far as the economy is concerned.

On the issue of debt, a goodly part of the rise in debt is mortgage debt, but that mortgage debt has not been going up faster than the rise in the market value of homes. Indeed it has been going up less, and that actual new equity is still increasing. So a goodly part of the rise in debt is merely a reflection of the significant rise in home ownership and the rise in the market value of homes, which to a large extent is a function of, one, the low interest rates; two, the shortage of buildable land; and three, and importantly, the incredible rise in immigration. A third of the rise in the household formation is from immigration, and that has been a major factor holding the price level of homes up.

We have looked at the bubble question, and we have concluded that it is most unlikely mainly because, we have a very diverse real estate market throughout the country. You have so many different areas which don't arbitrage one another as do stock prices, and the transaction costs in homes is very high. You cannot readily sell a home without a fairly large cost, and perhaps, even more importantly, you have to move, so that the type of underlying conditions that creates bubbles is very difficult to initiate in the housing market. It is actually easier in England where they have had bubbles because it is a smaller geographical area. But we see no evidence that a national bubble in home values which would then collapse and create the type of problems you correctly identify is likely to happen. Indeed, I might say the evidence of the last few months is that the acceleration in prices which we saw earlier is beginning to phase down so that it is not an issue on the table at the moment. It is theoretically a concern. We do watch it. If it changes, obviously we would try to conceive of actions we could take to change it, but that is not an issue that we think needs to be addressed by policy at this stage.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from New Jersey Mrs. Roukema.

Mrs. ROUKEMA. Thank you. I thought that Mr. King was going to be next. But in any case—well, in any case I do want to congratulate and extend my congratulations to you, Mr. Chairman, because of your wisdom and knowledge on these subjects. We always look forward to your leadership. It has been excellent.

There have been a couple of questions here. As I understand it, you do support the question of expensing of stock options, and that is supportable. And that is certainly in the Senate bill, but not adequately covered in our bill here. But let me ask you how that relates as—I heard your answer to Mr. Bereuter on that subject, but how that relates with what you had stressed in your testimony about the transparency issue. Now, the question is, I think you said, do not force directly or indirectly proprietary information. How does that work out? How does that transparency work out, whether it is stock options or whatever, in real terms, and how do we deal with the SEC and be sure that they are empowered as regulators under this new legislation?

Mr. GREENSPAN. Congresswoman, I think that the issue that has been really with us for half a century or more is the trade-off of transparency in the regulatory process and the need to maintain proprietary information. Clearly the IRS has got a very major issue there. But it is also true in all regulation. We have at the Fed, for example, information which we do not divulge publicly and cannot because it is proprietary, and if it were divulged, it would undercut the competitive position of individual institutions.

So I think it is something which is really done reasonably well in this country. Over the years we have managed to know where the dividing line is, and while there are on occasion clearly egregious breaches of that, it is not the standard practice. I am not concerned that as we move into other areas that are involved in legislation both from this Committee and from the Senate Committee that we will not—address that issue at an appropriate time.

Mrs. ROUKEMA. Is it presently addressed, or does it have to evolve through the conference, this consideration?

Mr. GREENSPAN. I don't know the detail of the specific statutes and the empowerments you give, for example, to the SEC and others. So I really can't answer that, but I believe that as the staffers write up final legislation, that will address those issues, and I have got every confidence that it will be addressed.

Mrs. ROUKEMA. Certainly will be tracking that and hoping that we will be addressing those issues of tracking it through with both bills.

I thank you, Mr. Chairman, and I do again congratulate you for your wisdom and your leadership. Thank you.

The CHAIRMAN. The gentlelady's time has expired.

The gentleman from Vermont Mr. Sanders.

Mr. SANDERS. Thank you, Mr. Chairman, and nice to you see you again, Mr. Greenspan.

I think, as usual, you and I look at the world a little bit differently. And my line of questions are two: I am going to talk about the crisis and confidence; and I want to talk about our trade policy and how that relates to the ostensibly strong foundations of the economy which you have talked about.

It seems to me when the average American looks out in the world, he or she has every right to have a crisis of confidence in the ruling class of this country, the people who control our economy, and to a large degree through their campaign contributions control what goes on in the White House and in the Congress. It is not just Enron and WorldCom and Xerox. The fact is that over the last 5 years 1,000 corporations have restated their earnings, and you have just indicated to us that you think more may come. In other words, these leaders, these country club executives, have lied to their investors and to the American people.

But it goes beyond financial misstatements. Many of these companies cheat on their taxes, they bulldoze the IRS because they have 10 well-paid accountants trying to take advantage of every loophole, while the middle class pays their taxes. Many of these companies are now running to Bermuda to disown their obligations to the American taxpayer at all. We are looking at profitable corporations which have surpluses in their pension funds, cutting back on the pensions of workers who have worked for those companies

for 20 or 30 years, and, while profitable, cut back on their health care benefits of their retirees. We are looking at these companies who denounce the Federal Government every day, but then they run to Washington for their corporate welfare, largest corporations in America who are taking their jobs abroad. They line up here and get their corporate welfare. And meanwhile in order to cover their behinds, they contribute hundreds and hundreds of millions of dollars to both political parties, so they are not held accountable.I want you to talk about that in a moment.

The second issue I would like you to talk about is trade. You are an advocate of free trade. You have told the American working people how great it is. Let's open up all the markets.

Today we have a $426 billion trade deficit, including an $8 billion trade deficit with China. Over the last 4 years we have lost over 2 million factory jobs, representing 10 percent of the manufacturing work force in my own State alone. We haven't been as low in manufacturing as 33 years ago. This is going on all over the country.

So I want you to tell American workers why deregulation and free trade is so great when we have lost millions of decent-paying jobs while American companies are selling out working families and moving to China and to Mexico. And I want you to tell us how a $426 billion trade deficit suggests a potentially strong economy.

Those are my two questions: crisis of confidence and the wonderful trade policies that we have.

Mr. GREENSPAN. First of all, I am not going to obviously have time to address all the issues that you raised, but let me just say that one, the issue of restatement of earnings is not an issue of lying. And the reason it is not is that there are quite legitimate differences with respect to how a number of different items are treated. There are difficult questions with respect to how one judges what the particular average rate of return, for example, on defined benefit pension plans will be, and that will have a significant effect on what the earnings estimate—.

Mr. SANDERS. Were WorldCom and Enron lying?

Mr. GREENSPAN. Let me finish. We are no longer dealing with, as we used to maybe a century and a half ago, a situation where bookkeeping was essentially a measure of the cash that came in and the cash that went out, and the difference was your profit. Today we have got very complex problems of forecasting what happens to balance sheets and what the values of those balance sheets are. And there is quite a legitimate difference of opinion among very skilled and professional accountants as to how you handle these various things. And they are essentially based on forecasts, different people's forecasts. So if you restate your earnings, it doesn't necessarily mean at all that you lied, it means that you misjudged. And that is a different issue.

On the question of trade, I have argued, and I think the evidence is really very impressive, that the dramatic increase in globalization during the post-World War II period has been a major factor in rising living standards throughout the world for those countries engaged in trade, and especially for the United States. The number you quoted is the current account deficit. That is not the trade deficit and is not in and of itself a measure of anything bad, because what that means is that that much money is coming

into the United States on the part of those who want to invest here.

Mr. SANDERS. Do you think the loss of 10 percent of our manufacturing base in the last 4 years is not bad?

The CHAIRMAN. The gentleman's time has expired. The chairman may respond.

Mr. GREENSPAN. First of all, the production level of manufacturing remains high. We have got fewer people in manufacturing because productivity is so good. But they have shifted to other jobs.

Mr. SANDERS. Lower-paying jobs.

Mr. GREENSPAN. No, the real average income of the American worker has been rising for several years at a fairly—.

Mr. SANDERS. It has substantially—.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Delaware, Mr. Castle.

Mr. CASTLE. Thank you, Mr. Chairman.

Going back if we can, Chairman Greenspan, to some of the earlier issues on the corporate aspects of all of this, in your report, which is I think relatively optimistic and talks about sustainable growth, you indicate that things are perhaps not as bad as the stock market is. And you have—a wise man earlier said something about irrational exuberance a few years ago, and we seem to have gone to some sort of rational pessimism, may be on our way to irrational pessimism, and I am trying to figure out why.

My judgment is the whole corporate behavior has become a very significant issue in how people look at the stock market, the uncertainty which is there; not the corporate production, but what they are doing in the corporations. And like a lot of other members here, we hear this at home, but we are just personally concerned, too, about the whole issue of corporate malfeasance, which we have heard about right at that table a few times; the greed which exists; the issue of stock options, which I would like to come back to; the accounting and auditors; the analyst recommendations, which I would like to come back to, which to me are all roiling these markets, are really having a huge input.

It is because the average investors who ultimately make up the mutual funds and ultimately are very important in terms of the future of the economy and capitalism of this country, just don't quite understand what is happening. They are looking to us for some direction and action. And, frankly, they are probably looking to those who have the bully pulpit, and the President is another, and a few others in this country, to try to help straighten this out. I think we need to bring some certainty to it.

And that is why I want to come back to stock options. Mr. LaFalce talked about this a little bit also as well. We can't have Warren Buffet on every corporate board in the country. That would be a nice thing if we could, by the way, but we can't. So therefore I don't think all of them are going to convert to some sort of expensing of stock options. But I am really concerned about this. Stock options right now appear as footnotes. They are nonentries. They are not expensed at all, which you, I think, have stated repeatedly is probably not a very good way to do it.

On the other hand, to allow the corporations to do it on their own, with still lack of clarity as to what we are looking at, bothers

me too. I don't have a problem with stock options per se, but I have a real problem with the accountability of what is happening with them. It just seems to me that somebody, maybe it is not Congress, maybe it is FASB, maybe it is somebody else, but somebody needs to look at a methodology for the use of stock options. I realize there are different kinds of stock options, different years of issuance and that kind of thing. But somebody needs, in my judgment, to do this if we are going to have a concrete understanding of what is happening corporately out there.

I just like—I know where your views have been on that, but it just bothers me that we are going to leave it up to the corporations.

Mr. GREENSPAN. Well, first of all, I think that the evidence is becoming increasingly overwhelming that both the economic and the accounting principles that we apply necessitate the expensing at the point of stock option grant and evaluating it in a manner which effectively reflects market values. I will go into the issue if somebody wants me to, but it is something which was sort of vague 5, 10 years ago. It is no longer vague. There has been a very major debate going on, and the evidence as best I can judge is dramatically clear that expensing is the right way, and I will be glad to debate that.

Mr. CASTLE. To me it is extraordinarily real. It really does impact earnings.

Mr. GREENSPAN. It affects earnings. The question is what you really want to do is get the correct earnings; that is, you want to know whether you are using more real resources to produce output or less real resources. And the only way to do it is a proper accounting.

My impression, and obviously I don't know this, is that if you leave it to FASB and you don't interfere with what they are going to do, they will get it right. If in fact it turns out that they do not, and Congress or the SEC wants to revisit the issue, then it would be an appropriate time to do it. I don't think that one need worry about that at this stage.

Mr. CASTLE. I just think we need firm guidance. Hopefully it will happen that way.

Mr. GREENSPAN. What I do think is going to happen is that—we have already seen Coca Cola and the Washington Post Company, but there are a very large number of companies whose actual stock option grants are relatively small—they, in my judgment, are all going to start to expense. For example, the Coca Cola stock price went up, not down, after they announced it. And I think that is going to be the general experience.

The early event is going to be a major move on the part of those in which it doesn't matter very much, and then the market's pressure will start to move on everybody, even if FASB doesn't do anything. But I do believe that FASB will, and my own impression is that it is probably unnecessary at this stage for the Congress to be involved in that technical an issue which can be handled and should be handled in the normal private sector, by normal private sector means, with SEC oversight.

The CHAIRMAN. The gentleman's time has expired. The gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY OF NEW YORK. Thank you, Mr. Chairman. Earlier today during your opening statement, the New York delegation was meeting with the FEMA director to discuss recovery efforts. And I do want to thank you for the work of the New York Federal Reserve, which produced a study of the economic effects of the tragedy on our city, which I asked to you produce at your last appearance before this body. Thank you.

Mr. Chairman, yesterday you mentioned infectious greed as one of the underlying problems facing our economy, corporate America, and the markets. I don't disagree that greed is playing a role in the mounting scandals, but I am not convinced that this is such a new phenomenon. Certainly the desire to accumulate personal wealth is not a new motivation for business people, and we have been through corporate scandals before, including insider trading and major S&L banking collapses during the 1980s. Greed certainly played a role in these episodes, which were resolved after government responded by punishing criminals and putting in place new financial service reforms. Times now demand a strong leadership from government and meaningful reform.

Yesterday the Senate unanimously approved the Sarbanes accounting legislation. I hope that this body will do the same.

This Monday in Alabama, the President went so far as to blame our current economic problems on, quote, ″a hangover and binge,″ end quote, in the 1990s. I agree with the President that we experienced a bubble in the stock market as some high-tech and telecom stocks rocketed to unsustainable capitalizations, but I strongly disagree with his characterization of this decade. In my view, the 1990s were a decade of unparalleled prosperity, the longest and the best in my lifetime. The economy experienced an unmatched period of growth, government surpluses, strong financial markets, and full employment.

The Clinton administration, along with Bob Rubin and others, put us on the path to fiscal responsibility in 1993. And Chairman Greenspan, you and your colleagues at the Fed formulated and implemented the monetary policies during the 1990s and accordingly deserve credit.

I wonder if you agree with the President's characterization of the 1990s? To me it was a period of well-thought-out policies that reduced the deficit, balanced the budget, and made meaningful investments in education and health care for the American people. Do you agree with the President's characterization of the 1990s?

Mr. GREENSPAN. Well, I am not sure that I read what he said the way you are, Congresswoman. I think the issue he is raising is the fact that there are certain aspects of the 1990s which were characterized by the fact that huge values in the stock market began to impact the way the economy functions and created certain distortions which, as you point out, in the past unwound.

Greed is not an issue of business, it is an issue of human beings. And as I tried to point out in my prepared remarks, what occurred was the dramatic increase in the market capitalization of equities which, regrettably in part resulted because of the failure to expense stock options, created distortions and a bubble which eventually must burst, and it did. And that has, as I pointed out in my re-

marks, lingering effects which take time to work their way through.

My own judgment is that the issue of corporate malfeasance being driven by endeavors, as I put it, to harvest part of that huge increase in market capitalizations is over. There is none of it left to do the types of things people were doing. And we will see the lingering effects of that in the restatements of earnings that we talked about earlier, and we will see that in some of the impacts of the declining level of stock prices on consumer expenditures, as I mentioned in my prepared remarks.

But I didn't read the President's remark as stipulating that the 1990s were not a decade of rapid growth and productivity, of major improvements in standards of living and great technological advances. Indeed, the dot-coms which went under, went under because they did not have value added. But a lot of them are still around. They have produced major advances in technology and improved our standards of living. So I think—.

Mrs. MALONEY OF NEW YORK. And I am sure you would agree—

The CHAIRMAN. Time of the gentlelady has expired. The gentleman from New York Mr. King.

Mr. KING. Thank you, Mr. Chairman.

Chairman Greenspan, if I could follow up on your latest answer on the question of corporate corruption, the fact of whether or not it is working its way out of the system. I would ask you two questions; one on that issue. We have seen other countries where the issue of crony capitalism has been so embedded that it takes an economy years to recover from it. You seem to believe that the corruption in this country, as serious as it may be in the corporations, is not that entrenched, and that specific legislation with severe penalties will eliminate it or at least remove it considerably.

How can you be that confident that the corruption has not entrenched itself and is not so deep-rooted that it could take many years for it to recover?

Secondly, if I could, just as a follow up question, the whole issue of the Euro versus the dollar, as what you see the impact of the parity now between the Euro and the dollar. Is that a threat, is it a challenge, how is that going to work, you know, play itself out in years to come as far as an impact on our economy?

Mr. GREENSPAN. The reason I am reasonably sure about the fact that the malfeasance that we have observed and documented in very great detail has not cut to the core of the system is that fact that we have got a remarkably efficient and productive economy. You cannot reconcile this dramatic increase in productivity which we have been seeing in recent years, in fact concurrently, with a goodly part of the type of corporate malfeasance which is concerning us. It has had an effect. It has an effect on the margins and it would have an effect if it were carried forward and continued indefinitely.

But that is not going to happen, because I think a goodly part of the tinder, the huge capital gains tinder which created a goodly part of the attraction to do things which people ordinarily wouldn't do, that is gone. And as far as I can see, the underlying structure of the economy, its underlying efficiency, has not been materially impacted. If it were, we wouldn't see the type of productivity num-

bers, the type of efficiencies that have emerged in recent years. So we are very fortunate in that regard.

It could have been different, but the evidence does not suggest that the malfeasance really cut to the core of the system. It did create a very significant problem with respect to that part of corporate governance which relates to the allocation of gains, or financial gains between shareholders on the one hand and corporate managers on the other. And that, in my judgment, very much needs to be addressed. Fortunately, that has not had a major impact on the underlying efficiency of the corporate system, and in that regard, that part of corporate governance has with all of its difficulties apparently continued to work well.

Mr. KING. I asked the question about the Euro and the dollar, the parity.

Mr. GREENSPAN. As I mentioned in the Senate yesterday, the particular ratio, which is what an exchange rate is, when it is set is arbitrary. It could just as easily be half the number or 20 times the number. So the particular question of the 1.00 issue is an arbitrary issue which has no economic or financial significance. The change in the ratio clearly does matter, obviously. That affects the relative purchasing power of currencies. But the absolute number that is used to measure that is an arbitrary choice, and needs to be.

Mr. KING. How about the question of the Euro being strengthened and the dollar being weakened? What impact do you see that having?

Mr. GREENSPAN. Well, as I said in my prepared remarks, issues of that nature are left to be discussed by the Secretary of the Treasury in this government. We have found that it is far better that there be a single voice on those issues in international finance. I would like to adhere to that.

Mr. KING. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Texas, Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman Greenspan, it is always good to see you here. In reading your testimony, you lay out a prognosis that you expect to see economic growth, fairly significant or fairly good economic growth through the remainder of this year and into the next year. But you also talk about a number of considerable uncertainties. And if you read through your testimony, one could argue that it lacks any exuberance at all, which is of course your trademark, but one could argue that perhaps it is even a little more tampered down than normal.

And you talk about a number of issues, the fact that—you talk about considerable uncertainties. You talk about business investment being questionable, final demand uncertain, business investment gradual by historical standards and uneven, no surge in household spending. Adverse publicity regarding accounting practices would affect the actions of managers; which, from what I have seen in my sector, in the energy sector, shoring up of balance sheets rather than engaging in new capital investment.

You raise concerns about fiscal policy that Mr. Frank also talked about yesterday. We had the President's budget director before the

Budget Committee, and he at the end of the day more or less said, yes, we are in a unified or in an on-budget deficit for the next decade, without question, and the prospect of paying down all public debt and curtailing your open market activities are no longer a concern.

And my question to you—well—and on top of that, we have seen a dramatic outflow of foreign investment in U.S. equities over the last month or so, somewhere between 30 or $40 billion, I think, in one article that I read. The dollar, which I realize you don't want to comment on, has declined relative to other currencies.

So let me ask you this, a concern that I have. I have two questions for you. One is you can paint, obviously, a picture that we are going to have good economic growth and ultimately things will come back into fore and business demand and aggregate demand will increase. But on the other hand, is there a possibility that we see a further decline in the dollar, a further outflow of foreign investment, a rise in the Federal budget deficit for long-term costs like homeland security and the like, and a bear market in the U.S. equity markets that could result in a down period for the U.S. economy? Not necessarily a double dip, but should we be concerned that ultimately interest rates will have to come up to defend the dollar and that that tampers down investments?

The second thing I would ask, a little bit unrelated, is the House and Senate will soon go to conference on the Oxley and Sarbanes bills. One of the key differences between those bills is the structure of a new oversight entity for the auditing industry. In your testimony, you talk about the breakdown in the bulwarks of those who we relied on, including auditors, in corporate investment practices. There is a difference as to whether or not this new entity ought to be separate and apart or at least on a par with the Securities and Exchange Commission or it should be a subset and under the auspices of the SEC. And would you be willing to give us your guidance, as one who has spent a great deal of time in regulatory financial regulatory affairs, as to what sort of structure we might look for to oversee public accounting?

Mr. GREENSPAN. With respect to the first question, I think the problem we have is that the economy did not go down very much, and therefore, the usual characterization of a recovery, one which is surging and often growing at a 5- to 7 percent annual rate, is not there, and should not be there, can't be there. Because we didn't go down, we can't go up. So what we have is an economy that will tend to increasingly move from being somewhat below potential growth up to potential growth as the lingering effects of the shocks we have seen over the last couple of years begin to dissipate.

That is what the evidence suggests to us is by far the most probable outcome that we perceive. And the pieces seem to be falling into place day by day. We are not getting a big surge in anything, we are not getting a surge in consumer spending, in capital spending, we are not getting a surge in the economy, but we don't expect to see that.

Are there problems in the economy? There are always uncertainties. But as best we can judge, the outline of the forces that we thought would drive the economy earlier this year, indeed when I

was testifying before you in February, pretty much have come about in the way we expected them, and at this moment we are still on path.

Yesterday, for example, the Federal Reserve issued its estimate of the June industrial production index, which was up quite significantly, and as I mentioned earlier we are seeing in the retail markets, especially motor vehicles, clearly evidence that the consumer has not retrenched in any material way.

So, I would say overall, there are always elements within a complex economy such as ours which suggest that things are not going straight up, and indeed they are not, and I hope they all do not, because if we are ever in a period of that, we are usually out of balance.

So, I just would repeat what I have been saying in the last couple of days, namely, that we are poised for a reasonably good expansion. It will not be an expansion of the order of magnitude that we have seen coming out of past recessions.

The CHAIRMAN. The gentleman's time has expired. If the Chairman would respond to the second question from the gentleman from Texas regarding the Independent Oversight Board, if he chooses to?

Mr. GREENSPAN. I have seen in general discussions of the various different ways of coming at these issues. I don't know enough about the consequences of both to really give you a thoughtful judgment. There are others who are more knowledgeable than I.

My general view is that the approach of both Houses is coming to grips with the nature of the problem, but on the specific value of one approach versus the other, I am not sufficiently knowledgeable about to give you anything useful with respect to resolving some of these questions.

The CHAIRMAN. The gentleman from Alabama, Mr. Bachus.

Mr. BACHUS. Thank you. Chairman Greenspan, I reviewed your testimony from yesterday. You talked at length about the importance of capital investment to maintaining a strong economy, to maintaining business viability, to maintaining high productivity.

Now, my question relates to how do we spur that investment?

The Fed has lowered the Fed funds rate 11 times this year. It is at an astonishing 1.75 percent. Yet during this time, long-term rates, like the 10-year T bill, have stayed fairly stable and fairly high.

How can the Fed, or what can the Fed do to push down long-term rates to free up business capital, because that is how most capital is financed, is longer term rates?

Mr. GREENSPAN. It is certainly the case that long-term rates in below investment grade issues have moved up during this period as the risks have moved up. But investment grade, and specifically A and AA rates and mortgage rates, which are very important, have come down. So it is a mixed case.

I don't think it is the issue of debt or long-term interests rates which are inhibiting capital investment. It is the perceived issue of subdued profitability.

The way I look at this economy is profitability is gradually being restored and margins are gradually opening up. As that process continues, and indeed as we see it in, as I mentioned in my pre-

pared remarks, those types of profit estimates which endeavor to exclude all of the one-shot charges, one-time charges, the profitability of American business is improving. As that continues, it will impact on the propensity to invest, whereas now, as I mentioned in my prepared remarks, capital investment seems to be at a level that meets only the most basic needs. That will inevitably change as we begin to see profitability moving up, as we begin to see the longer-term outlook emerge more clearly.

So, our projection is for these markets to open up and improve, and it is just a question of time.

Mr. BACHUS. Let me ask you another question. You are the chairman of a top Federal regulator, so you, obviously, appreciate how regulators affect it.

The Securities Exchange Commission is the top Federal regulator of accountants, of publicly traded companies, of security markets. First of all, I am sure you are aware that they have two vacancies on the five-member board, and two people are serving as recess appointees. I saw where Laura Unger, former board member, recently said serving as a recess appointee is like serving with one arm tied behind you.

Would you be concerned, if you were chairman of the SEC, with having 40 percent of your board unfilled and another 40 percent serving as recess appointees? Does that compromise their ability?

Mr. GREENSPAN. Oh, I think it inhibits your ability to function as best you can, certainly.

Mr. BACHUS. So it is a major problem in addressing some of the problems we have had recently?

Mr. GREENSPAN. I would certainly agree that the sooner that can be resolved, the better.

Mr. BACHUS. And you consider it critical that those vacancies be filled?

Mr. GREENSPAN. Well, I don't want to use the word "critical." I mean, the SEC functions because it has a very effective staff, and most of the operations that occur, that are important in the SEC, are staff-driven. So it is not as though they are undercut from being an effective regulator. But if you don't have the Commission effectively in place, it means a lot of things you ordinarily should be able to do, you are not able to do.

Mr. BACHUS. You are aware with the Federal Reserve, if you don't have a certain number of members, actually certain actions can't be taken and certain actions can be thrown out legally. In fact, the Federal court recently did that.

Mr. GREENSPAN. Absolutely.

Mr. BACHUS. I appreciate your testimony. I appreciate the job you have done. I saw all the compliments in the Senate yesterday, and it was very touching. They said you raised the market 200 points. I noticed right after you left it fell back down. So we may want you to just continue to talk all day.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Texas, Mr. Gonzales.

Mr. GONZALEZ. Thank you very much, Mr. Chairman. Again, welcome, Chairman Greenspan. It is good to see you. I have a couple of simple questions. It is really about timelines and the importance of Congress acting.

We have already indicated that we have a reporting period pursuant to Chairman Pitt's request for the affirmation of the financial statements, and I guess that is August 15, and we anticipate, we are just anticipating, that there may be some restatements and that people will attribute that or will attribute reasons that may not be accurate. It could be a change in regulation, it could be interpretation, and not necessarily that someone was cooking the books, trying to misrepresent facts and figures. But, nevertheless, I think that we need to prepare ourselves for that.

Coupled with ongoing investigations of other large corporations.

I would venture to guess that it is incumbent on Congress to act quickly—we will be in recess in August when this happens. So could do you see that there is some value in acting quickly before we recess for August when it comes to the corporate governance legislation that is pending and going to conference? That is the first question.

The second one has to do with options. I think you pointed out the pitfalls and the negatives associated with options. But in our discussions, especially with individuals representing the high-tech industries and the importance that options play in that particular industry, we are not talking about Coca-Cola, we are not talking about Bank One, we are not talking about Boeing, but I don't see any of the high-tech industries rushing in and agreeing with you on the expensing of options.

Can you go ahead and tell me what the benefits are associated with options, and what can we do to still retain the benefits that options provide these corporations?

Thank you.

Mr. GREENSPAN. With respect to your first question, Congressman, I don't perceive a need for Congress to move expeditiously in this regard. The reason is that, as I indicated in my prepared remarks, and indeed in testimony yesterday before the Senate, the frenzy that has occurred—the frenetic activities in corporations endeavoring to manage their earnings to meet various different goals, to drive their stock price—that is largely over, and indeed it will be over shortly.

We will get some restatements. I hope we get restatements. indeed, because a lot of people began to think that the name of corporate governance was how do you manage earnings to satisfy stock prices.

Now, that is nonsense. That is not what corporate governance is all about.

I think that is over. And indeed, if I were convinced that you didn't need to do anything ever, then I would say Congress can just go home and forget about it. The trouble, unfortunately, is that the shock of what has happened will keep malfeasance down for a while, but human nature being what it is and memories fade, it will be back, and it is important that at that time appropriate legislation be in place to inhibit activities that we would perceive to be inappropriate.

But I do think it needs to happen in a manner which is deliberative, rather than rushed, because there is nothing that anyone is going to do out there that you need to stop people from doing. Most of them are so traumatized at this point that the thought of doing

anything other than preserve cash is not something which is first on their agenda.

If you wait too long, you probably lose the window of opportunity, but I don't think there is a need to move forward especially before the August recess, but I think you do have to move before everybody loses interest in the subject.

With respect to the issue of stock options, there is no question that a number of the high-tech companies could not have made it without issuing stock options in lieu of cash, because they didn't have cash.

The argument has got nothing to do with whether you issue stock options; it is whether you account for them. In other words, a very significant number of dot-com companies reported earnings which really did not exist. What they effectively did is that they used a very significant amount of labor resources to produce new goods and services, but didn't count them as any cost, so you get an artificial view that there is profit, meaning that you produced more than you used up than in fact was the case.

I have no argument against new high-tech companies giving stock options. Indeed, it is a very useful and very beneficial mechanism to get people engaged in a company. I am only arguing that when you do it, you represent the earnings of the company correctly, and indeed don't try to fool the people whom you are giving stock options to, that the company is worth a lot more than it is.

So, it is more a question of proper reporting, not in the issue of whether or not you should issue stock options.

Expensing stock options says nothing about whether they are desirable to do or whether you can legally do them. On the contrary, they are desirable to do, they do have benefits, but the income ought to be recorded appropriately so that people know how valuable the company is.

Mr. GONZALEZ. Thank you very much.

Mr. KING. [Presiding.] The gentleman from California, Mr. Royce.

Mr. ROYCE. Chairman Greenspan, welcome. Last week in this committee, we had testifying here on the $308 billion restatement of earnings at WorldCom, an individual named Jack Grubman. He is a securities analyst at the underwriting firm of Salomon Smith Barney. He is also one of the individuals who helped hype that company's market capitalization to over $190 billion, which I think is about 600 times what it is today.

In his testimony, in response to our questions, he admitted that no one could sit here on Wall Street today and deny to anybody on this committee that banking is not a consideration in the compensation of analysts at a full-service firm.

I think he was the best paid on Wall Street, and I think his compensation was in the neighborhood of $20 million a year.

There used to be this firewall between security analysis and investment banking within firms in order to protect investors from the inherent conflict of interest that could arise when employees of a given firm simultaneously raised capital for companies and then go out and advise investors. I think his testimony really makes clear that today analysts are promoting deals at sales road shows is basically an adjunct of their firm's investment banking in order

to make up for the loss leader, which is the securities research, at the underwriting firm.

Now, the New York Stock Exchange has written new rules that are supposed to be in place by November, and those rules are supposed to bar analyst compensation tied to investment banking deals, they are supposed to make it difficult for analysts to discuss specific stocks on the air, to require the monitoring of communications between researchers and deal makers, and to require disclosure of the firm's ratios of buy, hold and sell ratings to the public.

I don't know that that is possible. It seems to me that the only way to fix this, if you really want to return to what used to be called that "Chinese wall", is to forbid analysts from any involvement in investment banking deals whatsoever.

I was going to ask you for your opinion of the potential for mingling of securities research and investment banking, the potential that that creates a conflict of interest where these particular stocks are hyped, where that gives rise to irrational exuberance in certain stocks or certain sectors of the market, and my question is, do these regulations by the New York Stock Exchange effectively address this situation? And if not, how can this problem be more effectively addressed by us in Congress, since we are going into conference right now on CARTA legislation.

I thank you very much for your thoughts on that.

Mr. GREENSPAN. Congressman, first of all, I would like to state that the market value of research is based on its credibility. Over the years it has become quite apparent that there is an upward bias in security analysts' forecasts of earnings that estimated over the last 15 years as averaging about 5 percent per and up. In other words, it is a fairly significant—.

Mr. ROYCE. It is compounding.

Mr. GREENSPAN. It is a fairly significant change. It is not so much that what you are getting are analysts who are fudging the numbers, but there is a tendency on the part of brokerage firms to hire people who are optimistic. So you get that sort of built-in bias, even though everyone is telling it exactly the way it is. So that the question really is can you regulate that?

I think not. I think the New York Stock Exchange's endeavor to do it is the best that probably can be done. But there has been a major loss in the market value of stock market research, if I can put it in a business sense. It is to everybody's interest who is endeavoring to get involved in that activity to try to give the perception that, indeed, there is a Chinese wall; not only is there a Chinese wall, but there is objective valuation.

As you know, a number of the firms which do this no longer put in buy recommendations. They merely grade various different companies, A, B, C, D, E, F, or whatever, and leave it at that. I think what is going to happen here are changes which will get us back to where research is going to be useful. I am very doubtful that there is legislation that can do that. This is too technically a difficult issue to legislate, and I would leave it to the private sector to handle it.

My judgment is that they will do as good a job as can be done, but I say at the end of the day, the presumption that you are going to get what you really would want in this respect, independent se-

curity analysts working only for the purpose of doing forecasts of earnings, selling it as a commercial product, it will not happen, because the market apparently is not there.

The only place it exists is within a number of large institutional investors who hire specific analysts to do that, and they do it right.

Mr. ROYCE. Well, there are some independent research firms out there, Charles Schwab and so forth. I wonder if the market will evolve in that direction?

Mr. GREENSPAN. There are a few. I certainly hope so. If the demand is there, it will. I doubt very much any legislative vehicle on the part of the Congress can actually expedite or improve on that process.

Mr. KING. The time of the gentleman has expired.

The Chair recognizes the gentleman from Massachusetts, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Chairman, since we started this morning, the market started out at up 208 at 10 o'clock. It is now up only 77, so every word we say is apparently losing somebody some money. So I will try to keep this very boring and try not to excite anybody.

But I do have similar questions that I have asked you in the past. I read the policy report and I read the numbers and I know what the Fed does and I know that what you do is all macroeconomic, and I appreciate that, and I don't think there is anybody better at it than you.

But from my level, the impact of macro on micro is critical. For instance, you mentioned earlier that equity has increased quicker than mortgage debt, and I appreciate. It has in my home as well. My home is worth a lot more today than I bought it for. But the problem is I cannot access that equity, because I could not pay the monthly mortgage on accessing it. So therefore, though the equity is there, my personal level, that is great, it makes me look good on paper, I can't touch that money. No bank in their right mind would give me the mortgage that my house is worth. So that is the micro part of it. The macro part is it is this and looks good, but the micro part is nobody can get to it.

Again, I would encourage you and others who look at these things to really look at how it impacts individual investors and individual people, because it is really critical. It is the same thing with the unemployment rate and other issues that are in these reports on a regular basis.

That goes to one of the questions I want to ask you. I really only have two questions, and I hope both are boring. One of them, I have heard you very clearly on the stock options. I could not agree with you more. I totally agree with you, and it actually came as a little displeasure that others don't. So be it.

There is also another item that strikes me as something that inflates the bottom line of corporations, and I think some of the transparency is there, but again, similar to stock options, I think some of the access to the wealth is not there, and that is when it comes to the reporting of investment increases in pension funds.

Many corporations, you know better than I do, when the pension funds that they have related to for their employees, when they invest in something and that investment goes up, they report that in-

vestment increase as profit. Now, my guess is that some of the best and more independent analysts could weed through that, but my guess is that my mother could not. That being the case, I think that is problematic.

I would ask if you think that my analysis is, again, not point for point correct, but on board, and, if so, would you share that concern, or are you comfortable with the current situation?

Mr. GREENSPAN. Well, I think we have to separate defined contribution plans, which clearly belong to the individual who has shares in them, and defined benefit pension plans, which are essentially an obligation on the part of the corporation to make a fixed payment, a fixed annuity to the employee at the point of retirement.

There is a legal obligation which the corporation has to meet that. The existence of the pension fund does not, in any way, change that obligation. So what happens is that corporations, in order to make certain that they can meet their legal obligations, will build up a pension fund to a size which enables them to pay off retirement benefits as they occur.

Periodically what does happen is that they become overfunded. That is, either the stock market went up or they inadvertently put in more than they actually need, and under certain conditions, that is capable of being drawn out and the entries are reversed, and it does show up in corporate profits in some form or another.

But I think the important issue here is that the pension fund in no way affects the obligation, as I understand it, of the individual corporation. If the fund went down and they lost a great deal of money, they are still obligated to pay the pension.

Mr. CAPUANO. In some pension funds I would agree with you. Again, I would ask you to look at that in some point of the future and let us know, let me know, whether you are satisfied with current reporting requirements relative to pension fund items.

The only other question I have for you, I was just reading some news clips this morning—.

Mr. KING. The gentleman's time has expired.

Mr. CAPUANO. May I just ask this last one question, two seconds. Since 1998, apparently 77 percent of the mergers and acquisitions that have occurred in this country have occurred by the acquisition by foreign companies of American companies. I am just wondering if you are comfortable with that trend?

Mr. GREENSPAN. Well, that is another way of looking at the fact that foreigners view investment in the United States as superior to investment anywhere else in the world. One of the reasons why we have had such a huge increase of funds flowing into the United States, some of which are so-called direct investment, is that people perceive that this is the best place in the world to invest. So what they are doing is that they are buying existing companies. We are creating new ones and we keep selling them to foreigners.

So it is, in a sense, a measure of what people perceive that this country is capable of doing.

Mr. KING. The gentlewoman from New York, Mrs. Kelley.

Mrs. KELLY. Thank you.

Mr. Greenspan, in reading your testimony at yesterday's hearing in the Senate, you observed that you felt that the most important

part of the legislation that we would do here would be to raise the penalties for malfeasance. Tell me, do you think that increasing the ability for individuals to sue corporations for inaccuracies in their statements is a proper goal for this kinds of legislation?

Mr. GREENSPAN. I think not. I don't see that that has any particular economic advantage. The issue is a technical one and a complex one and should be really under the aegis of the Securities and Exchange Commission, and they should be taking the actions which are required to redress the inaccuracies, mistakes, malfeasance and the like.

I don't see any particular benefit in resolving the types of problems we are confronted with by increasing the ability of people to sue. I mean, we have an existing structure. I think that the major expansion that will occur has got to be in the ability of the empowerment of the SEC to do these various different things. I don't think you gain anything by increasing the ability to sue the company. Because remember that it is shareholders suing other shareholders. That is what it is.

Mrs. KELLY. Thank you. There has been a tremendous attempt to politicize this issue, and I would be interested in seeing what you feel about the potential for Congress to overreach and possibly do more harm than good in some respects with this legislation that we are looking at, and, if so, would you be willing to outline some of the areas where you feel there is a need for us to proceed with great caution?

Mr. GREENSPAN. I am not sufficiently knowledgeable about the details of either the bill that has been passed in this House versus the one that was passed on Monday in the Senate. They both address the problems that I think need to be addressed. They have technical differences and these are a lot of changes, but I can't argue that I am sufficiently knowledgeable about the impact of a lot of those things, so that my comments I don't think are very worthwhile in that regard.

Mrs. KELLY. One final question, sir. I understand that today the news came out that construction on new homes dipped by 3.6 percent. Although apparently the permits for future projects have gained, this could represent a blip perhaps in the housing market, and if we experience a loss in value of housing, how readily will that translate into harm to our economy, and does this give the Board pause in any consideration of raising interest rates?

Mr. GREENSPAN. First of all, I think the data that came out today were pretty much in line with what our forecasts were. Indeed, almost exactly in line with it. There is no evidence that one can see that the fairly significant strength in the housing market is, in any way, impeded. Indeed, as you point out, permits, which are in a certain sense as important as the housing starts data in evaluating the market, were firmer.

Mrs. KELLY. My question was whether or not the Board would be looking at raising interest rates?

Mr. GREENSPAN. I know what your question was.

Mrs. KELLY. And you didn't answer.

Mr. GREENSPAN. I was hoping the chairman might find that the time ran out. I tried to address that as best I could within my prepared remarks, Congresswoman.

Mrs. KELLY. Thank you. I yield back.

Mr. KING. I remind all members that Chairman Greenspan has to leave by 1 o'clock today, so I ask them to stay within the 5 minute limit.

The gentleman from New York, Mr. Crowley.

Mr. CROWLEY. Thank you for the time. Thank you, Mr. Greenspan. Good to see again. Thank you for coming before the committee again. I have a couple of quick questions.

One question deals with an issue I asked the last time I had an opportunity to ask a question of you, and it dealt with consumer confidence. We have seen a little over a decade of tremendous growth, high double digit earnings, percentage earnings in the last decade, tens of millions of people who have known nothing but growth have all of a sudden had a bucket of ice cold water dumped on their heads. Many of them are in the middle of their careers, maybe a little over 12 years in their careers, and they are halfway through, getting ready, set their retirement at 40 years of age, and now realize they have a little more work to do in their lives in all likelihood.

What are your thoughts about how to restore the confidence, not only of those folks who are directly engaged in the market and it is their livelihood directly, but for those tens of millions of investors who now, I think, have gotten the real jolt, not having lived through maybe more difficult times, and looking to someone like yourself, who, in all likelihood, not knowing exactly how old you are, has probably lived through more difficult times.

What advice do you have for those people who work directly within the market, and for those tens of millions of people, blue collar men and women who never have been invested before, who have become invested?

On the issue of the development of tax havens, corporate tax havens as well, I would like to know what your position is. The Democratic members of the Appropriations Committee, approved a provision that would prohibit government contracts from being issued to companies that have reincorporated overseas, specifically, to avoid paying their full taxes. It is my understanding that that language is coming under attack now, and the administration is also attacking that, the attempt to close that loophole.

We have seen a great deal of fleecing going on here in the States with American companies, and some of those companies are attempting to go offshore to avoid paying taxes. I wonder what your thoughts are on that attempt to avoid to pay corporate tax in lieu of the fact that we have gone from a $5 trillion surplus in just under 2 years of seeing no end to the massive deficits in just less and year and a half maybe during this administration.

Then lastly, you mentioned stock options before. Do you believe that it should be imposed by market or by government in terms of the accounting of those options?

I will leave it to you.

Mr. GREENSPAN. Well, Congressman, I have indicated that I would far prefer that the issue of accounting principles be privately determined. I don't think anybody believes that you can legislate the principles of accounting, and that would obviously include how

one handles such technical questions of various different types of stock options and various different types of forms of compensation.

On the issue of the difficulties that a lot of people are going through—and indeed they are, and as you correctly point out, I have been looking at ups and downs for a very long period of time and I prefer the ups—we do have, however, in this country increasing evidence that the flexibility and resiliency of the economy that has emerged in the 1990s largely as a result of the technology advances, but also of increasing deregulation of various areas in our economy which were creating bottlenecks in the flexible movement of markets and prices and people and capital, and that has apparently had a very important positive effect on the longer term, and we are indeed seeing almost on a day-by-day basis its repercussions.

As I said earlier, the longer-term outlook for this economy is really very, very impressive. When we do our short-term forecasts, we essentially move into our longer-term outlook, so to speak. What that is, in effect, telling us as we do it is that things are gradually improving. And while we are all seeing the downside of stock prices and the various difficulties that emerge as a consequence, it is a two-way street, and that street will change. It always has. There is nothing fundamental in the economy that appears to be a longer-term deterioration. When we had that sort of valuation, you had a much more deep-seated set of problems than we have today.

So I think that the longer term is, if anything, better than I have seen it in a very long period of time, and while that might not be something which can console people who have been through some very rough times in the financial markets recently, it is an issue that suggests that in the long term, this will pass.

Mr. CROWLEY. The tax havens?

Mr. GREENSPAN. I think you have to be very careful. This is a very tricky issue, and it is a tricky issue because when you impose taxes in this country which do not exist elsewhere, there will be a tendency for people to try to move where the tax burden is least. If you are going to have a free market system, you have to have freedom of movement. I think without having looked at the detail of this problem more than at a level necessary to come to a real judgement, I do know enough to know that it is not always as simple as it looks; if you start to change the tax code at the border, you have consequences which, as far as the economy is concerned, I think you have to be careful about.

So, I can't give you any specific advice on how to handle this particular problem. It is just that it is very easy to try to block people from taking actions. I am not sure that that helps in the long run. I am not sure that that advice is helpful, but that is the best I can do.

Mr. KING. The gentleman's time has expired.

The gentleman from Texas, Dr. Paul.

Dr. PAUL. Thank you, Mr. Chairman. Welcome, Chairman Greenspan. I have listened carefully to your testimony, but I get the sense I may be listening to the chairman of the board of Central Economic Planning rather than the Chairman of a Board that has been entrusted with protecting the value of the dollar.

I have, for quite a few years now, expressed concern about the value of the dollar, which I think we neglect here in the Congress, here in the committee, and I do not think that the Federal Reserve has done a good job in protecting the value of the dollar. It seems that maybe others are coming around to this viewpoint, because I see that the head of the IMF Mr. Koehler, has expressed a concern and made a suggestion that all the central bankers of the world need to lay plans for the near future to possibly prop up the dollar. So others have this same concern.

You have in your testimony expressed concern about the greed factor on Wall Street, which obviously is there, and you implied that this has come out from the excessive capitalization, excessive valuations, which may be true. But I think where you have come up short is in failing to explain why we have financial bubbles. I think if you have fiat money and excessive credit, you create financial bubbles, and you also undermine the value of the dollar, and now we are facing that consequence.

We see the disintegration of some of these markets. At the same time, we have potential real depreciation of the value of our dollar. We have pursued rampant inflation of the money supply since you have been chairman of the Federal Reserve. We have literally created $4.7 trillion worth of new money in M-3. Even in this last year with this tremendous burst of inflation of the money supply, it has gone up, since last January, over $1 trillion. You can't have anything but lower value of that unit of account if you keep printing and creating new money.

Now, I would like to bring us back to sound money, and I would want to quote an eminent economist by the name of Alan Greenspan who gives me some credibility on what I am interested in. A time ago you said, "in the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value without gold. This is the shabby secret of the welfare state that tirades against gold. Deficit spending is simply a scheme for the hidden confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights."

But gold always has always had to be undermined if fiat money is to work, and there has to be an illusion of trust for paper money to work. I think this has been happening for thousands of years. At one time the kings clipped coins, then they debased the metals, then we learned how to print money. Even as recently as the 1960s, for us to perpetuate a myth about our monetary system, we dumped two-thirds of our gold, 500 million ounces of gold, on to the market at $35 an ounce, in order to try to convince people to trust the money.

Even today, there is a fair amount of trading by central banks in gold, the dumping of hundreds of tons of gold, loaning of gold, for the sole purpose of making sure this indicator of gold does not discredit the paper money, and I think there is a definite concerted effort to do that.

My questions are twofold relating to gold. One, I have been trying desperately to find out the total amount of gold either dumped and sold on the markets by all the central banks of the world, or loaned by the central banks of the world. This is in hundreds and

hundreds of tons. But those figures are not available to me. Maybe you can help me find this.

I think it would be important to know since all central banks still deal with and hold gold, whether they are dumping or loaning or buying, for that matter. But along this line, I have a bill that would say that our government, our Treasury, could not deal in gold and could not be involved in the gold market, unless the Congress knows about it.

That, to me, seems like such a reasonable approach and a reasonable request, but they say they don't use it, so therefore, we don't need the bill. If they are not trading in gold, what would be the harm in the Congress knowing about handling and dealing with this asset, gold?

Mr. GREENSPAN. Well, first of all, neither we nor the Treasury trades gold. My impression is that were we to do so, we would announce it. It is certainly the case that others do. There are data published monthly or quarterly which show the reported gold holdings in central banks throughout the world, so you do know who holds what.

The actual trading data, I don't think is available, although the London Gold Exchange does show what its volume numbers are, and periodically individual central banks do indicate when they are planning to sell gold, but they all report what they own. So it may well be the case that you can't find specific transactions, I think, but you can find the net results of those transactions, and they are published. But as far as the United States is concerned, we don't do it.

The CHAIRMAN. [presiding.] The gentleman's time has expired. The gentleman from California, Mr. Sherman, is recognized.

Mr. SHERMAN. Thank you. It is good for you to be back again. As before, I may have some questions I will ask you to submit answers to in writing, because my questions exceed the amount of time. I was looking back at our February exchange, and I noted that I said that I was amazed that the dollar still sells for more than the Euro. I am amazed that the dollar is not selling for a lot less than the Euro, given our incredibly high and continuing trade deficit. But perhaps we are headed toward a glide path. I would ask you a question about that, but I am not sure that you want to comment.

First, I want to thank you for the incredible wisdom of holding off on any new regulations allowing commercial banks into the real estate-brokerage business. I hope I am confident that that wisdom will continue well into next year.

I also want to thank you for not echoing the comments of others. Others have said that home prices today show irrational exuberance, and I note that that was not your conclusion.

One thing that concerns me is that the whole world is way faster, especially in getting information. We used to wait for a weekly magazine. Now we log on to the Web. But in one area, it hasn't gotten any faster. You still get only annual audited financial statements. Putting aside whether the audits do us any good and we are striving to create audits worthy of the name, would it make sense for us to have semi-annual audits of our 1,000 largest companies? I don't know if you would like to respond.

Mr. GREENSPAN. I think that the internal audit system is almost universally overseen by outside auditors, and in a sense, the quarterly statements that come out, whether audited or not, are within a set of guidelines. So I am not sure you pick up very much except additional expense in doing that.

If there are individual companies or industries where, say, earnings fluctuate a great deal or there is great complexity, maybe. But I am not sure what the advantages would be, frankly.

Mr. SHERMAN. So you don't see a major difference in investor reliability between a reviewed financial statement and an audited financial statement?

Mr. GREENSPAN. I would say our recent history answers that question, unfortunately.

Mr. SHERMAN. Turning to stock options, one of the basic fundamental premises of an accounting system is comparability. We used to be able to compare Coke with Pepsi. We still can as consumers, but as investors, we no longer can. I know you are opposed to having the government write financial statements, but perhaps you could comment on the incredible timidity of the Financial Accounting Standards Board, that long ago issued a statement saying the right thing to do is to expense stock options. But, oh, gee, we are not going to make you do it.

I wonder whether some government board or some other entity might come up with a better approach to knowing what the right thing is, but actually requiring it, and I would join you in saying just because stock options should be expensed, doesn't mean they are bad. Right now a company recognizes an expense when they pay for employee health care or coffee or salaries, and we are all in favor of salaries and health care, and they are expensed when they are given to employees, and obviously stock options should be as well.

But what do you think of an accounting standards board that knows what the right thing to do is, but doesn't do it, and do you think that this voluntary approach by Coke, while a good step, doesn't just confuse the whole comparability issue?

Mr. GREENSPAN. No, I have been in business forecasting for a long time to know when I see a trend. I see one. We will have, as best I can judge, expensing of stock options fairly generally within a reasonable period of time.

If I am wrong on that, I will acknowledge that I was wrong and that maybe additional actions are required. But I doubt it. I think if you leave it to the FASB at this particular point, my impression is that it will come out right.

The CHAIRMAN. The gentleman's time has expired. The gentleman from New York, Mr. Grucci.

Mr. SHERMAN. I will submit additional questions in writing.

The CHAIRMAN. Without objection.

Mr. GRUCCI. Over the course of the last several weeks or so, the last couple of months, consumers have lost and investors have lost their confidence in the market, but they certainly haven't lost their confidence in the economy. The economy seems to be solid. As you reported here today, it seems to be moving in the right direction. But they have lost their support for the cornerstone of our econ-

omy, which is our stock market. It is just absolutely shameful that the acts of a few have tainted the many.

I would like to know your thoughts regarding your talk about strengthening the actions taken against those who would use their influence, use their power, use their position to hide, to shade, to jade the truth. At the same time, making personal gains for themselves.

What would your thoughts be about having a standard or statute similar to that of RICO that if indeed someone was found to be guilty of something of that magnitude, not only would they be facing a jail term, but they would also be the facing the possibility of being stripped clean of all of their assets, having those assets converted back into cash and given back to the people whose children's education funds were lost and their retirement funds lost people who watched their entire life savings being wiped out.

Do you think that would be a strong deterrent to prevent the future actions of some of these corporate executives?

Mr. GREENSPAN. Congressman, as I indicated in my prepared remarks, I think actually a relatively small shift in emphasis will have a very large impact. I don't know enough about the criminal justice system to give any real views as to what works and what doesn't work and what is appropriate or not. All I am aware of is that the incentive structure was distorted and needs to be redressed. I think that can be done within a relatively modest set of changes. But then, again, I can't say for sure, because, as I said, I am not sufficiently familiar— I am not a lawyer, I am certainly not a criminal lawyer—to know exactly what type of inhibitions are required to achieve certain types of results.

Mr. GRUCCI. Nor am I a lawyer, sir. But it would seem to me if I stood the risk of losing everything, it might give me a moment of pause before I cooked the books a little.

A second thought I had that I would like your opinion on, you have certainly expressed your support for expensing stock options. By doing so, do you see that having a chilling effect on the market in the sense that once you reevaluate the company, people would take a moment of pause to see how that all shakes out? In doing so, would that have a negative effect on the investors in the market, and if you do think it does, for how long do you think it might?

Mr. GREENSPAN. My general impression is no, because I think it is pretty apparent that reality is not changing. It is just the way books are kept. The most recent experience has really indicated that the confidence that investors have had in the books, if I may put it that way, has deteriorated to a significant extent, so that by definition, if you don't have confidence in the number you are looking at, if you change it, you are not going to have very much confidence in that either.

So I think as we move toward a much better structure of reporting, which truly endeavors to measure what is really profitable as distinct from sort of fictional bookkeeping profit, the better off we are.

It is far more important to get back to reality, to get back to sound bookkeeping, as quickly as we can, and the net effect on the markets and the market values is going to be, on net, positive not negative.

Mr. GRUCCI. Lastly, along that same thought, what would happen to the value of the company? Would it be overburdened if the options were never exercised? Would the company be unfairly burdened?

Mr. GREENSPAN. You mean if it had options which were vested, but not exercised?

Mr. GRUCCI. Yes, correct.

Mr. GREENSPAN. Not really. We are talking about basically a relationship between new shareholders and existing shareholders. You know, the aggregate amount of the market value of the firm doesn't change when you trade the stock. So really, the question of whether you have vested options which are exercised or not doesn't have a material effect. It has an impact on the potential value of the existing shares because those shares would be diluted.

Whether you exercise or not probably doesn't really matter at the end of the day.

The CHAIRMAN. The gentleman's time has expired. The Chair would like to inquire of the Chairman, I understand you have to leave by 1, is that correct?

Mr. GREENSPAN. I do indeed.

The CHAIRMAN. If we could do a couple minutes for the members, if the Chairman would—.

Mr. GREENSPAN. Then obviously I will be glad to answer whatever questions in writing.

The CHAIRMAN. I think that would be more fair, if we can try to divvy up the time.

The gentleman from Tennessee for 2 minutes.

Mr. FORD. Thank you, Mr. Chairman.

Welcome. A couple of questions, Chairman Greenspan, and I will try to be very quick. One, the last time you were here, a year and a half ago, I asked a question regarding the challenges that so many of our States are facing, 45 to 50 of them now, are facing with these budget shortfalls.

Your remarks yesterday before the Senate Banking Committee suggested that the fundamentals are in place for this economy, it may take a little longer, the recovery or the growth may not be as robust as we enjoyed during the nineties.

My question is, the fiscal challenges facing the States, what kind of contractionary impact, if at all, will it have on the national economy? If I might be so bold, your response last time suggested not much. You talked about elasticity and inelasticity of revenue streams for States versus the Federal Government. My question at that time was motivated by these remarkable projections, surplus projections.

My, my, my, how a year and a half can change things. We talked about retiring this debt. It doesn't look like we are going to do it as quickly as we once did. That is my first question, sir.

The second, third and fourth deal with, I know you indicated corporate government reform is not something in your estimation that needs to be done before the August recess, or I should say it is not urgent. But, as you know, there are a few differences between what we passed here in the House and what the Senate passed.

I would love to give you a chance to respond to the first question and just give you the three areas where I think the differences are

the most significant; one being leveling the playing field and the kind of ensuring the independence of analyst advice, forcing them to disclose ownership of stocks that they cover as well as business relationships that may exist with companies. Two, these auditor committees, ensuring that in many ways—or the independence of outside auditors. In a lot of ways—as you know, both bills prohibit auditors from performing internal audit work, as well as consulting on the formation of financial systems designs. But the Senate bill goes further and allows audit committees of corporate boards to have to sign off on any other type of non-audit work.

I am curious to know your thoughts on that. I will wait for the last one if I have more time.

The CHAIRMAN. The gentleman doesn't have any time. The Chairman may respond.

Mr. GREENSPAN. I will be glad to respond to that in writing.

[The following information was subsequently submitted by Chairman Greenspan.]

> [You have raised three questions. In your first question about the fiscal challenges facing State governments, as you have noted, in most States (and some localities) revenue collections have fallen short of policymakers' expectations for at least a year. So far, the response in State budgets has been a fairly small slowing in spending and some relatively minor tax increases, as has been typical in past cyclical downturns. As a result, the overall balance of State and local budgets has declined, which tends to have an expansionary effect on aggregate demand.
>
> Regarding your question about the appropriateness of independent analyst advice, I believe that stronger regulatory oversight, combined with market discipline, is working to improve the information content of analyst reports and recommendations. In May, the SEC approved new regulations that had been proposed jointly by the National Association of Securities Dealers and the New York Stock Exchange. These regulations mandate increased disclosure of potential conflicts of interest and prohibit compensation practices believed to impair the objectivity of analysts' advice. In addition, brokerage firms must include in research reports the distribution of their "buy," "sell," and "hold" ratings, so that investors can see whether the firm is typically optimistic. Even before these rules received SEC approval, many brokerage firms had adopted key features of the proposed rules in response to market pressure. In light of these positive developments, the Sarbanes-Oxley Act—appropriately, in my view—leaves the oversight of analysts in the hands of the SEC.
>
> Regarding your question about independence of outside auditors, enhancing the independence of outside auditors is an important and necessary part of the corporate reform agenda. This key issue was addressed by the Sarbanes-Oxley Act, which prohibits an outside auditor from providing eight specified non-audit services, For an outside auditor to provide other non-audit services, advance approval by the company's audit committee is now required.

In coming months, the SEC will be writing regulations to implement these provisions of the Sarbanes-Oxley Act.]

The CHAIRMAN. I thank the gentleman. We want to move on. The gentleman from Louisiana, Mr. Baker.

Mr. FORD. You are going to abbreviate everyone's time?

The CHAIRMAN. Yes.

Mr. BAKER. Thank you, Mr. Chairman. Rarely is a there a singular cause for any identifiable problem, especially in complex financial markets, but in the words of quarterly earnings reports and expectations, you either beat the street or you die, and that is little incentive for corporate management to look toward long-term corporate value growth.

To some extent, the development of and release of pro forma returns I think are intended to diffuse the volatility resulting from quarterly reports.

In response to Chairman Oxley earlier today as to the effects of potential real time material fact disclosure, you expect some concern about the protection of proprietary information, which I share. However, if you were to take the elements of the quarterly earnings contents and require that model to be utilized on a day-to-day requirement by management, it would seem to me that moving that reporting system to an hour or daily basis as opposed to waiting for the 90-day volatility would eliminate the potential for the broad swings we see now in the marketplace.

Other than possible tax incentives or holding periods for ownership of stock, are there any other mechanisms or manners in which you think the committee could act to incentivize long-term corporate management building of value?

Mr. GREENSPAN. I have thought about that, and I really would like to respond to the extent that I can after I give it some more thought, because it is a very tricky and very important question, if I may.

Mr. BAKER. You have another 30 seconds. Thank you, Mr. Chairman.

[The following information was subsequently submitted by Chairman Greenspan.]

[Regarding your question about long-term incentives for corporate management, stock options and other forms of equity-based compensation, if properly constructed and accounted for, can be effective tools to strengthen the incentives of corporate management to build the long-term value of the firm. There are two issues to be addressed. First, the failure to expense stock options has distorted reported earnings and weakened the link between a firm's true condition and its ability to raise investment capital. This link is crucial for channeling our economy's limited supply of investment capital to its most productive uses. Second, stock options, as currently structured, are typically based on the absolute, not relative, performance of the firm's stock. In periods when stock prices are rising across the economy, absolute-performance options will reward managers whose companies are merely keeping pace with, or indeed are even lagging somewhat behind, the overall market. Relative-performance options would pro-

vide a stronger incentive, by only rewarding those managers whose actions result in their stock outperforming a benchmark stock index.

In recent weeks, a number of companies have announced that they will voluntarily expense the cost of their employee stock options, and the Financial Accounting Standards Board is currently considering changes to disclosure requirements for option expenses. Given these developments, I believe that legislative action in this area would be inappropriate at this time.]

The CHAIRMAN. The Chair would indicate that under an arrangement with Chairman Greenspan, he had to leave at 1 o'clock. Let me say to the members who have been so patient that the Chair would note the presence of those members and would recognize them first when the next appearance by Chairman Greenspan. That is about as fair as I can be. We will take names, and we will appreciate the participation of the members at that time.

Chairman Greenspan, once again, thank you very much for appearing before us today. Some of our members may have additional questions. The committee record will remain open for 30 days so that members may submit additional questions.

Without objection, the committee stands adjourned.

[Whereupon, at 1:00 p.m., the committee was adjourned.]

A P P E N D I X

July 17, 2002

July 17, 2002

Opening Statement for Congressman Paul E. Gillmor
House Financial Services Committee, Full Committee Hearing to receive the testimony of the Chairman of the Federal Reserve Board of Governors on Monetary Policy and the State of the Economy

I would like to begin by thanking you, Chairman Greenspan, for coming before our committee this morning to make your semi-annual report to Congress.

Our economy has certainly been through many fluctuating periods of growth and decline since your last report and our markets are unfortunately still faced with decreased investor confidence as a result of recent corporate scandals. However, I was heartened by your positive statements on the future health of our economy, yesterday, before our counterpart in the Senate.

The ongoing revelations regarding corporate accounting fraud and misleading disclosures have exposed an underlying problem in this country's corporate culture. But just as our economy has shown its resilience in weathering past shocks to our markets, such as the terrorist attacks last September, a pattern of growth will return and the fundamentals of our economy have maintained their strength. Unemployment numbers are dropping and reports on new factory orders continue to show increases.

As you know, the House of Representatives acted swiftly in its investigation and consideration of a legislative solution to the systemic problems allowing recent corporate abuses by passing the Corporate and Auditing Accountability, Responsibility, and Transparency Act on April 24, 2002. This week, the Senate has responded to the House proposal with its own bill and I was very interested in your comments on that proposal at

yesterday's Senate hearing and hope you can speak more specifically to the House proposal this morning. Both congressional chambers are committed to expeditiously reaching agreement on a compromise proposal for signature into law by the President, as Congress has a significant role to play in restoring investor confidence in American corporations.

I applaud your position on the expensing of stock options. The current situation permits companies to report misleading earnings, and unfortunately, many are doing exactly that. Certainly, further federal regulations are not necessary to direct all needed reforms and I will be particularly interested to hear any further comments you may have on whether this issue requires congressional action or should be left to the Financial Accounting Standard Board (FASB) for consideration. I would also like to take this opportunity to commend the Coca-Cola Company's recent decision to voluntarily count stock options as an expense and hope that other publicly traded corporations will follow their lead.

Again, I would like to thank you for coming before us today and look forward to your learned remarks.

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Statement of Congressman Steve Israel
Hearing to Receive the Monetary Policy Testimony of the
Chairman of the Federal Reserve Board of Governors
Committee on Financial Services
United States House of Representatives
July 17, 2002, 10:00 a.m.

Traditionally, this Committee asks the Chairman of the Federal Reserve about interest rates, the state of the economy and what we can do about it. Does the economy need a stimulus? Should interest rates be raised or lowered? What role does the return of deficits have on investments?

These are all critical questions. But what this country faces today is not a problem with monetary or fiscal policy; it is not a question of merely tweaking the markets. It is about the very structure of our entire financial system. Chairman Greenspan appears before us today amidst the greatest shock to confidence in our financial system since the 1970's, and possibly all the way back to the Great Depression.

Mr. Chairman, the retirements of millions of American families are at risk. There was a time in this country when people depended upon their savings, an employer sponsored traditional pension plan and Social Security. Stock investments make up a larger portion of personal savings and pensions than ever before. And while risk is a part of the system, American investors had a reasonable right to expect that a company's annual report was based on real numbers, that the analysts told the truth and that regulators were enforcing the law.

Well, as we all know now, that was not true. At too many companies the accounting practices seemed more like the plot of *The Producers* than Accounting 101. Just like in *The Producers*, the accountants were hired by the executives they were auditing. And it turns out that analysts frequently were pushing stocks on unsuspecting investors not because they were good stocks but because they were making money off the sale. Our regulators were either asleep on the job or overworked, overburdened and underpaid. In any case, the situation is intolerable. Absolutely intolerable, and has created the near panic that is sweeping the stock market, and individual investors all across America who depended on investments for their retirement income.

My constituents work hard and play by the rules. They don't get to inflate their bank balances when applying for a loan and they certainly don't get to move out of the country when they decide their taxes are too high. Companies seem to be playing by a different set of rules and it is resulting in the delayed retirements for millions of senior Americans, and the destruction of dreams and plans for scores of millions of others.

Mr. Chairman, every one of us wants to fix this problem. But the fact of the matter is that the horse has left the barn. The exchanges, the regulators, the self-regulatory organizations, the lawyers, the accountants, the analysts, and yes, this Committee and this Congress failed. It will not be easy to restore confidence. We need to stop talking and start acting. Our nation's workers and retirees are depending on us.

I look forward to hearing what Chairman Greenspan will add to this discussion.

For release on delivery
10:00 a.m. EDT
July 17, 2002

Statement of

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

House of Representatives

July 17, 2002

I appreciate this opportunity to present the Federal Reserve's Monetary Policy Report to the Congress.

Over the four and one-half months since I last testified before this Committee on monetary policy, the economy has continued to expand, largely along the broad contours we had anticipated at that time. Although the uncertainties of earlier this year are as yet not fully resolved, the U.S. economy appears to have withstood a set of blows—major declines in equity markets, a sharp retrenchment in investment spending, and the tragic terrorist attacks of last September—that in previous business cycles almost surely would have induced a severe contraction. The mildness and brevity of the downturn, as I indicated earlier this year, are a testament to the notable improvement in the resilience and flexibility of the U.S. economy.

But while the economy has held up remarkably well, not surprisingly the depressing effects of recent events linger. Spending will continue to adjust for some time to the declines that have occurred in equity prices. In recent weeks, those prices have fallen further on net, in part under the influence of growing concerns about corporate governance and business transparency problems that evidently accumulated during the earlier rapid runup in these markets. Considerable uncertainties—about the progress of the adjustment of capital spending and the rebound in profitability, about the potential for additional revelations of corporate malfeasance, and about possible risks from global political events and terrorism—still confront us.

Nevertheless, the fundamentals are in place for a return to sustained healthy growth: Imbalances in inventories and capital goods appear largely to have been worked off; inflation is quite low and is expected to remain so; and productivity growth has been remarkably strong, implying considerable underlying support to household and business spending as well as potential relief from cost and price pressures. In considering policy actions this year, the Federal

Open Market Committee has recognized that the accommodative stance of policy adopted last year in response to the substantial forces restraining the economy likely will not prove compatible over time with maximum sustainable growth and price stability. But, with inflation currently contained and with few signs that upward pressures are likely to develop any time soon, we have chosen to maintain that stance pending evidence that the forces inhibiting economic growth are dissipating enough to allow the strong fundamentals to show through more fully.

As has often been the case in the past, the behavior of inventories provided substantial impetus for the initial strengthening of the economy. Manufacturers, wholesalers, and retailers took vigorous steps throughout 2001 to eliminate an unwanted buildup of stocks that emerged when final demand slowed late in 2000. By early this year, with inventory levels having apparently come into better alignment with expected sales, the pace of inventory reduction began to ebb, and efforts to limit further drawdowns provided a considerable boost to production. The available evidence suggests that, in some sectors, liquidation may be giving way to a rebuilding of inventories. However, as inventories start to grow more in line with sales in coming quarters, the contribution of inventory investment to real GDP growth should lessen. As a result, the strength of final demand will play its usual central role in determining the vigor of the expansion. While final demand has been increasing, the pace of forward momentum remains uncertain.

Household spending held up quite well during the downturn and through recent months, and thus served as an important stabilizing force for the overall economy. Real consumer outlays and spending on residential construction each rose about 3 percent over the course of 2001, even as the growth of real GDP fell off to only ½ percent. Household spending was boosted by ongoing increases in incomes, which in turn were spurred by strong advances in productivity as

well as by legislated tax reductions and, in recent months, by extended unemployment insurance benefits.

Monetary policy also played a role by cutting short-term interest rates, which helped lower household borrowing costs. Particularly important in buoying spending were the very low levels of mortgage interest rates, which encouraged households to purchase homes, refinance debt and lower debt service burdens, and extract equity from homes to finance expenditures. Fixed mortgage rates remain at historically low levels and thus should continue to fuel reasonably strong housing demand and, through equity extraction, to support consumer spending as well. Indeed, recent sizable increases in home prices, which reflect the effects on demand of low mortgage rates, immigration, and shortages of buildable land in some areas, have significantly increased the equity in houses that homeowners can readily tap through home equity loans and mortgage refinancing.

But those sources of strength probably will be tempered by other influences. As we noted in February, because consumer and residential expenditures did not decline during the overall downturn, there is little pent-up demand to be satisfied. Consequently, a surge in household spending early in this recovery is unlikely. Moreover, the declines in household wealth that have occurred over the past couple of years should continue to restrain spending in the period ahead. Still, despite concerns about economic prospects, equity valuations, terrorism, and geopolitical conflicts, consumers do not appear to have retrenched in retail markets. Indeed, consumers responded strongly to the new interest rate incentives of motor vehicle manufacturers this month. Early reports indicate a significant improvement in sales over June.

By contrast, business spending has been depressed. The recent economic downturn was driven, in large measure, by the sharp falloff in the demand for capital goods that occurred when firms suddenly realized that stocks of such goods—both those already in place as well as those in inventory—were excessive. The resulting declines in the production of capital goods were particularly sizable in the high-tech sector. Monthly shipments of computers and peripherals, for example, fell by about 40 percent from their peak in 1999 through their trough in 2001. Sales by communications equipment producers slumped just as sharply. Outside the high-tech sector, production also declined. Assemblies of commercial aircraft slowed abruptly. In addition, the construction of office and industrial buildings fell off noticeably. The collapse of many Internet firms and the difficulties of the high-tech sector more generally led to a significant drop in the demand for office space that was exacerbated as the economic slowdown widened beyond the tech sector. Overall, the level of real business fixed investment plunged about 11 percent between its quarterly peak in the final months of 2000 and the first quarter of this year.

With the adjustment of the capital stock to desired levels now evidently well advanced, business fixed investment may be set to improve. A recovery in this category of spending is likely to be gradual by historical standards and uneven across sectors. For example, an upturn in production of semiconductors and computers has been under way now for nearly a year, but with significant overcapacity still prevailing in some segments of the telecom industry, investment in communications equipment is likely to remain subdued for some time to come. Overall capital expenditures should strengthen with time. In particular, firms should respond increasingly to the expected improvement in the outlook for sales and profits, low debt financing costs, the

heightened incentives resulting from the partial expensing tax provisions legislated earlier this year, and especially the productivity enhancements offered by continuing advances in technology.

Indeed, despite the recent depressed level of investment expenditures, the productivity of the U.S. economy has continued to rise at a remarkably strong pace. In the nonfarm business sector, output per hour is currently estimated to have soared at an average annual rate of about 7 percent over the fourth quarter of 2001 and first quarter of 2002, and the available evidence points to continued gains last quarter—though not at the frenetic pace of the preceding half year. In part, these increases in productivity reflect the very cautious attitudes of managers toward hiring. But the magnitude of the recent gains would not have been possible without ongoing benefits from the rapid pace of technological advance and from the heavy investment over the latter half of the 1990s in capital equipment incorporating such advances.

Despite these encouraging developments regarding the longer-term prospects for the economy, financial markets have been notably skittish of late, and business managers remain decidedly cautious. In part, these attitudes reflect the lingering effects of the shocks that our economy endured in 2000 and 2001. Particularly given the dimensions of those shocks, some persistent uncertainty and concern are not surprising.

Also contributing to the dispirited attitudes among many corporate executives is the intensely competitive business environment facing their firms. Increased competition, while producing manifold benefits for consumers and for the economy as a whole, clearly makes individual firms' operations more difficult. Past deregulation and, more recently, the enhanced speed and efficiency of information flows resulting from technological advances are strengthening competition domestically. In addition, globalization is intensifying competition in

a broad range of markets and damping pricing power across developed and developing nations alike.

Those businesses where heightened competition has engendered a loss of pricing power have sought ways to raise profit margins by employing technology to lower costs and improve efficiency. In the United States, as a consequence of the interaction of monetary policy, globalization, and cost-reducing productivity advances, price inflation has fallen in recent years to its lowest level in four decades, as has the recent growth rate of nominal GDP and consolidated corporate revenues.

In part because nominal corporate revenues, although no longer declining, are growing only tepidly, managers seem to remain skeptical of the evidence of an emerging upturn. Profit margins do appear to be coming off their lows registered late last year, but, unsurprisingly, the recovery in economic activity from a shallow decline appears less vigorous than in the past. The lowest sustained rates of inflation in forty years imply that nominal growth in sales and profits looks particularly anemic. In contrast, in the 1950s and early 1960s, the last period of stable prices, populations and employment were growing considerably faster than the recent pace so that growth in nominal GDP, consolidated corporate sales, and profits was seen as still quite respectable. Reflecting concerns about the strength of the recovery, managers continue to limit capital spending to only the most pressing needs.

Given the key role of perceptions of subdued profitability in the current period, it is ironic that the practice of not expensing stock-option grants, which contributed to the surge in earnings reported to shareholders from 1997 to 2000, has imparted a deceptive weakness to the growth of earnings reported to shareholders in recent quarters. As stock market gains turned to losses a

couple of years ago, the willingness of employees to accept stock options in lieu of cash or other forms of compensation apparently diminished. According to estimates by Federal Reserve staff, the value of stock option grants for the S&P 500 corporations fell about 15 percent from 2000 to 2001, and grant values have likely declined still further this year. Moreover, options grants are presumably being replaced over time by cash or other forms of compensation, which are expensed, contributing further to less robust growth in earnings reported to shareholders from its trough last year.

In contrast, the measure of profits calculated by the Department of Commerce for the National Income and Product Accounts is designed to gauge the economic profitability of current operations. It excludes a number of one-time charges that appear in shareholder reports, and, importantly, records options as an expense, albeit at the time of exercise. Although this treatment of the cost of options is not ideal, it is arguably superior to their treatment in shareholder reports, where options are generally not expensed at all. NIPA profits closely approximate those obtained from reports submitted for tax purposes, and, for obvious reasons, corporations tend not to inflate taxable earnings. Consequently, NIPA profits have been far less subject to the spin evident in reports to shareholders in recent years. NIPA profits have increased sharply since the third quarter of last year, partly reflecting the dramatic jump in productivity and decline in unit labor costs.

The difficulties of judging earnings trends have been intensified by revelations of misleading accounting practices at some prominent businesses. The resulting investor skepticism about earnings reports has not only depressed the valuation of equity shares, but it also has been reportedly a factor in the rising risk spreads on corporate debt issued by the lower rung of

investment-grade and below-investment grade firms, further elevating the cost of capital for these borrowers. Businesses concerned about the impact of possible adverse publicity regarding their accounting practices on their access to finance could revert to a much heavier emphasis on cash generation and accumulation. Such an emphasis could slow new capital investment initiatives.

The recent impressive advances in productivity suggest that to date any impairment of efficiency of U. S. corporations overall has been small. Efficiency is of course a key measure of corporate governance. Nonetheless, the danger that breakdowns in governance could at some point significantly erode business efficiency remains worrisome. Well-functioning markets require accurate information to allocate capital and other resources, and market participants must have confidence that our predominately voluntary system of exchange is transparent and fair. Although business transactions are governed by laws and contracts, if even a modest fraction of those transactions had to be adjudicated, our courts would be swamped into immobility. Thus, our market system depends critically on trust—trust in the word of our colleagues and trust in the word of those with whom we do business. Falsification and fraud are highly destructive to free-market capitalism and, more broadly, to the underpinnings of our society.

In recent years, shareholders and potential investors would have been protected from widespread misinformation if any one of the many bulwarks safeguarding appropriate corporate evaluation had held. In too many cases, none did. Lawyers, internal and external auditors, corporate boards, Wall Street security analysts, rating agencies, and large institutional holders of stock all failed for one reason or another to detect and blow the whistle on those who breached the level of trust essential to well-functioning markets.

Why did corporate governance checks and balances that served us reasonably well in the past break down? At root was the rapid enlargement of stock market capitalizations in the latter part of the 1990s that arguably engendered an outsized increase in opportunities for avarice. An infectious greed seemed to grip much of our business community. Our historical guardians of financial information were overwhelmed. Too many corporate executives sought ways to "harvest" some of those stock market gains. As a result, the highly desirable spread of shareholding and options among business managers perversely created incentives to artificially inflate reported earnings in order to keep stock prices high and rising. This outcome suggests that the options were poorly structured, and, consequently, they failed to properly align the long-term interests of shareholders and managers, the paradigm so essential for effective corporate governance. The incentives they created overcame the good judgment of too many corporate managers. It is not that humans have become any more greedy than in generations past. It is that the avenues to express greed had grown so enormously.

Perhaps the recent breakdown of protective barriers resulted from a once-in-a-generation frenzy of speculation that is now over. With profitable opportunities for malfeasance markedly diminished, far fewer questionable practices are likely to be initiated in the immediate future. To be sure, previously undiscovered misdeeds will no doubt continue to surface in the weeks ahead as chastened CEOs restate earnings. But even if the worst is over, history cautions us that memories fade. Thus, it is incumbent upon us to apply the lessons of this recent period to inhibit any recurrence in the future.

A major focus of reform of corporate governance, of course, should be an improved functioning of our economy. A related, but separate, issue is that shareholders must perceive that

corporate governance is properly structured so that financial gains are fairly negotiated between existing shareholders and corporate officeholders. Shareholding is now predominately for investment, not corporate control. Our vast and highly liquid financial markets enable large institutional shareholders to sell their shares when they perceive inadequacies of corporate governance, rather than fix them. This has placed de facto control in the hands of the chief executive officer. Shareholders routinely authorize slates of directors recommended by the CEO. Generally, problems need to become quite large before CEOs are dislodged by dissenting shareholders or hostile takeovers.

Manifestations of lax corporate governance, in my judgment, are largely a symptom of a failed CEO. Having independent directors, whose votes are not controlled by the CEO, is essential, of course, for any effective board of directors. However, we need to be careful that in the process, we do not create a competing set of directors and conflicting sources of power that are likely to impair a corporation's effectiveness. The functioning of any business requires a central point of authority.

In the end, a CEO must be afforded full authority to implement corporate strategies, but also must bear the responsibility to accurately report the resulting condition of the corporation to shareholders and potential investors. Unless such responsibilities are enforced with very stiff penalties for non-compliance, as many now recommend, our accounting systems and other elements of corporate governance will function in a less than optimum manner.

Already existing statutes, of course, prohibit corporate fraud and misrepresentation. But even a small increase in the likelihood of large, possibly criminal penalties for egregious behavior of CEOs can have profoundly important effects on all aspects of corporate governance

because the fulcrum of governance is the chief executive officer. If a CEO countenances managing reported earnings, that attitude will drive the entire accounting regime of the firm. If he or she instead insists on an objective representation of a company's business dealings, that standard will govern recordkeeping and due diligence. It has been my experience on numerous corporate boards that CEOs who insist that their auditors render objective accounts get them. And CEOs who discourage corner-cutting by subordinates are rarely exposed to it.

I recognize that I am saying that the state of corporate governance to a very large extent reflects the character of the CEO, and that this is a very difficult issue to address. Although we may not be able to change the character of corporate officers, we can change behavior through incentives and penalties. That, in my judgment, could dramatically improve the state of corporate governance.

Our most recent experiences clearly indicate, however, that adjustments to the existing structure of regulation of corporate governance and accounting beyond addressing the role of the CEO are needed. In designing changes to our regulatory framework, we should keep in mind that regulation and supervision of our financial markets need to be flexible enough to adapt to an ever-changing and evolving financial structure. Regulation cannot be static or it will soon distort the efficient flow of capital from savers to those who invest in plant and equipment. There will be certain areas where Congress will choose to provide a specific statutory direction that will be as applicable thirty years from now as today. In other cases, agency rule-making flexibility under new or existing statutes is more appropriate. Finally, there are some areas where private supervision would be most effective, such as that of the New York Stock Exchange, which requires certain standards of governance for listing.

Above all, we must bear in mind that the critical issue should be how to strengthen the legal base of free market capitalism: the property rights of shareholders and other owners of capital. Fraud and deception are thefts of property. In my judgment, more generally, unless the laws governing how markets and corporations function are perceived as fair, our economic system cannot achieve its full potential.

* * *

A considerable volume of market commentary in recent weeks has suggested that concerns about earnings prospects and the proliferating revelations of serious governance and accounting issues have contributed not only to lower equity prices but also to a decline in the foreign exchange value of the dollar. And some of that commentary has extrapolated the trend of dollar weakness. As you know, the Secretary of the Treasury speaks for our government on exchange rate policy. But, given the recent intense interest in the future course of the dollar, I would like to raise a technical issue and a flag of caution regarding those forecasts—or, for that matter, any forecast of exchange rates. There may be more forecasting of exchange rates, with less success, than almost any other economic variable.

The reason that it is so difficult is that an exchange rate is a very complex price that balances, on the one hand, the demand for, for example, dollars stemming from the demand for dollar investments and for U.S. exports against, on the other hand, the demand for foreign currencies by U.S. investors desiring to acquire foreign assets and by U.S. importers of foreign goods and services. Hence, exchange-rate movements depend on shifting perceptions of the relative returns from investing in different countries and on the myriad influences on relative tendencies to import and export. The net effect of these factors over any future time period is

extraordinarily difficult to assess in advance. Although measures such as real interest rate differentials, differential rates of productivity gains, and chronic external deficits are often employed to explain exchange rate behavior, none has been found to be consistently useful in forecasting exchange rates even over substantial periods of one or two years.

Our ability to attract foreign capital in coming years will help facilitate the increases in investment that will promote continued gains in productivity and standards of living. But policymakers should also recognize the important role that prudent fiscal policy can play in promoting national saving and maintaining conditions conducive to investment and continued strong growth of productivity. Beginning in the late 1980s, impressive progress was made in reining in federal expenditures and restoring a better balance between spending and revenues. The lower federal deficits and, for a time, the realization of surpluses contributed significantly to improved national saving and thereby put downward pressure on real interest rates. This, in turn, enhanced the incentives of businesses to invest in productive plant and equipment.

Recently, however, some of those gains have been given up. To a degree, the return to budget deficits has been a result of temporary factors, especially the falloff in revenues and the increase in outlays associated with the economic downturn. Those influences should tend to reverse over the next year or two, other things equal, although the decline in revenues reflecting the drop in capital gains realizations, including those on options is unlikely to be fully reversed. And the necessary rise in expenditures related to the war on terrorism and enhanced homeland security has also played a role, as have the tax reductions legislated last year. Unfortunately, there are also signs that the underlying disciplinary mechanisms that formed the framework for federal budget decisions over most of the past fifteen years have eroded. The Administration and

the Congress can make a valuable contribution to the prospects for the growth of the economy by taking measures to restore this discipline and return the federal budget over time to a posture that is supportive of long-term economic growth.

To sum up, the U.S. economy has confronted very significant challenges over the past year or so. Those problems, however, led to only a relatively brief and mild downturn in economic activity, reflecting the underlying strength and increased resiliency that the economy has achieved in recent years. The effects of the recent difficulties will linger for a bit longer but, as they wear off, and absent significant further adverse shocks, the U.S. economy is poised to resume a pattern of sustainable growth. Indeed, the central tendency of Federal Reserve policymakers' forecasts is for expansion of real GDP over the four quarters of 2002 of 3-1/2 to 3-3/4 percent, somewhat above the rates anticipated in our February report. Economic growth is projected to be solid again next year, with real output rising 3-1/2 to 4 percent. Monetary policymakers anticipate that these gains should be sufficient to bring the unemployment rate down to 5-1/4 to 5-1/2 percent by the end of next year. Inflation is expected to be subdued throughout, with prices for personal consumption expenditures increasing at only a 1-1/2 to 1-3/4 percent rate. Our prospects for extending this performance over time can be enhanced through implementation of sound monetary, financial, fiscal, and trade policies.

For use at 10:00 a.m., EDT
Tuesday
July 16, 2002

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

Pursuant to section 2B of the Federal Reserve Act

July 16, 2002

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 16, 2002

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to section 2B of the Federal Reserve Act.

Sincerely,

Alan Greenspan, Chairman

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Monetary Policy Report to the Congress

Report submitted to the Congress on July 16, 2002, pursuant to section 2B of the Federal Reserve Act

MONETARY POLICY AND THE ECONOMIC OUTLOOK

The pace of economic activity in the United States picked up noticeably in the first half of 2002 as some of the powerful forces that had been restraining spending for the preceding year and a half abated. With inventories in many industries having been brought into more comfortable alignment with sales, firms began boosting production around the turn of the year to stem further runoffs of their stocks. And while capital spending by businesses has yet to show any real vigor, the steep contraction of the past year or so appears to have come to an end. Household spending, as it has throughout this cyclical episode, continued to trend up in the first half. With employment stabilizing, the increases in real wages made possible by gains in labor productivity and the effects of a variety of fiscal actions have provided noticeable support to disposable incomes. At the same time, low interest rates have buoyed the purchase of durable goods and the demand for housing. Growth was not strong enough to forestall a rise in the unemployment rate, and slack in product and labor markets, along with declining unit costs as productivity has soared, has helped to keep core inflation low. The exceptionally strong performance of productivity over the past year provides further evidence of the U.S. economy's expanded capacity to provide growth over the longer haul.

The Federal Reserve had moved aggressively in 2001 to counter the weakness that had emerged in aggregate demand; by the end of the year, it had lowered the federal funds rate to 1-3/4 percent, the lowest level in forty years. With only tentative signs that activity was picking up, the Federal Open Market Committee (FOMC) decided to retain that unusual degree of monetary accommodation by leaving the federal funds rate unchanged at its January meeting. Confirmation of an improvement in activity was evident by the time of the March meeting, and the FOMC moved toward an assessment that the risks to the outlook were balanced between its long-run goals of price stability and maximum sustainable economic growth, a view maintained through its June meeting. The durability and strength of the expansion were recognized to depend on the trajectory of final sales. The extent of a prospective strengthening of final sales was—and still is—uncertain, however, and with inflation likely to remain contained, the Committee has chosen to maintain an accommodative stance of policy, leaving the federal funds rate at its level at the end of last year.

The economy expanded especially rapidly early in the year. As had been anticipated, much of the first quarter's strength in production resulted from the efforts of firms to limit a further drawdown of inventories after the enormous liquidation in the fourth quarter of 2001. With respect to first-quarter sales, purchases of light motor vehicles dropped back from their extraordinary fourth-quarter level, but other consumer spending increased substantially. Housing starts, too, jumped early

in the year—albeit with the help of weather conditions favorable for building in many parts of the country—and spending on national defense moved sharply higher. All told, real GDP is now estimated to have increased at an annual rate in excess of 6 percent in the first quarter.

Economic activity appears to have moved up further in recent months but at a slower pace than earlier in the year. Industrial production has continued to post moderate gains, and nonfarm payrolls edged up in the second quarter after a year of nearly steady declines. However, several factors that had contributed importantly to the outsized gain of real output in the first quarter appear to have made more modest contributions to growth in the second quarter. Available data suggest that the swing in inventory investment was considerably smaller in the second quarter than in the first. Consumer spending has advanced more slowly of late, and while the construction of new homes has expanded further, its contribution to the growth of real output has not matched that of earlier in the year.

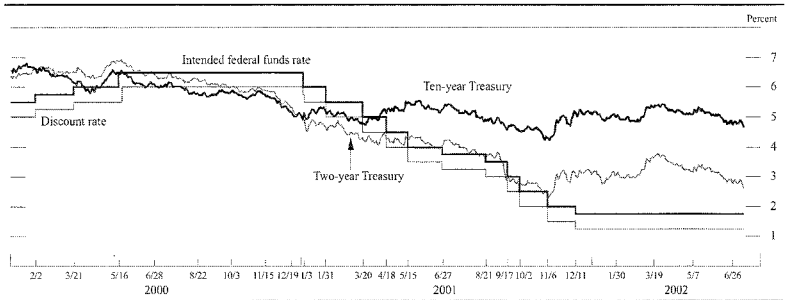
Notable crosscurrents remain at work in the outlook for economic activity. Although some of the most recent indicators have been encouraging, businesses still appear to be reluctant to add appreciably to workforces or to boost capital spending, presumably until they see clearer signs of improving prospects for sales and profits. These concerns, as well as ongoing disclosures of corporate accounting irregularities and lapses in corporate governance, have pulled down equity prices appreciably on balance this year. The accompanying decline in net worth is likely to continue to restrain household spending in the period ahead, and less favorable financial market conditions could reinforce business caution.

Nevertheless, a number of factors are likely to boost activity as the economy moves into the second half of 2002. With the inflation-adjusted federal funds rate barely positive, monetary policy should continue to provide substantial support to the growth of interest-sensitive spending. Low interest rates also have allowed businesses and households to strengthen balance sheets by refinancing debt on more favorable terms. Fiscal policy actions in the form of lower taxes, investment incentives, and higher spending are providing considerable stimulus to aggregate demand this year. Foreign economic growth has strengthened and, together with a decline in the foreign exchange value of the dollar, should bolster U.S. exports. Finally, the exceptional performance of productivity has supported household and business incomes while relieving pressures on price inflation, a combination that augurs well for the future.

Monetary Policy, Financial Markets, and the Economy over the First Half of 2002

The information reviewed by the FOMC at its meeting of January 29 and 30 seemed on the whole to indicate that economic activity was bottoming out and that a recovery might already be under way. Consumer spending had held up remarkably well, and the rates of decline in manufacturing production and business purchases of durable equipment and software had apparently moderated

Selected interest rates



NOTE. The data are daily and extend through July 10, 2002. The dates on the horizontal axis are those of scheduled FOMC meetings and of any intermeeting policy actions.

toward the end of 2001. In addition, the expectation that the pace of inventory runoff would slow after several quarters of substantial and growing liquidation constituted another reason for anticipating that economic activity would improve in the period immediately ahead. Nonetheless, looking beyond the near term, the FOMC faced considerable uncertainty about the strength of final demand. Because household spending had not softened to the usual extent during the recession, it appeared likely to have only limited room to pick up over coming quarters. Intense competitive pressures were thought to be constraining the growth of profits, which could damp investment and equity prices. At the same time, the outlook for continued subdued inflation remained favorable given the reduced utilization of resources and the further passthrough of earlier declines in energy prices. Taken together, these conditions led the FOMC to leave the stance of monetary policy unchanged, keeping its target for the federal funds rate at 1-3/4 percent. In light of the tentative nature of the evidence suggesting that the upturn in final demand would be sustained, the FOMC decided to retain its assessment that the more important risk to achieving its long-run objectives remained economic weakness—the possibility that growth would fall short of the rate of increase in the economy's potential and that resource utilization would fall further.

When the FOMC met on March 19, economic indicators had turned even more positive, providing encouraging evidence that the economy was recovering from last year's recession. Consumer spending had remained brisk in the early part of the year, the decline in business expenditures on equipment and software appeared to have about run its course, and housing starts had turned back up. Industrial production, which had been falling for nearly a year and a half, increased in January and February as businesses began to meet more of the rise in sales from current production and less from drawing down inventories. Indications that an expansion had taken hold led to noticeable increases in broad stock indexes and in long-term interest rates. But the strength of the recovery remained unclear. The outlook for business fixed investment—which would be one key to

the strength of economic activity once the thrust from inventory restocking came to an end—was especially uncertain, with anecdotal reports indicating that businesses remained hesitant to enter into major long-term commitments. While the FOMC believed that the fiscal and monetary policies already in place would continue to stimulate economic activity, it considered the questions surrounding the outlook for final demand over the quarters ahead still substantial enough to justify the retention of the current accommodative stance of monetary policy, particularly in light of the relatively high unemployment rate and the prospect that the lack of price pressures would persist. Given the positive tone of the available economic indicators, the FOMC announced that it considered the risks to achieving its long-run objectives as now being balanced over the foreseeable future.

By the time of the May 7 FOMC meeting, it had become evident that economic activity had expanded rapidly early in 2002. But the latest statistical data and anecdotal reports suggested that the expansion was moderating considerably in the second quarter and that the extent to which final demand would strengthen was still unresolved. Business sentiment remained gloomy as many firms had significantly marked down their own forecasts of growth in sales and profits over coming quarters. These revised projections, along with the uncertainty surrounding the robustness of the overall economic recovery, had contributed to sizable declines in market interest rates and weighed heavily on equity prices, which had dropped substantially between the March and May meetings. The outlook for inflation had remained benign despite some firming in energy prices, as excess capacity in labor and product markets held the pricing power of many firms in check, and the apparent strong uptrend in productivity reduced cost pressures. In these circumstances, the FOMC decided to keep the federal funds rate at its accommodative level of 1-3/4 percent and maintained its view that, against the background of its long-run goals of price stability and sustainable economic growth, the risks to the outlook remained balanced.

Over the next seven weeks, news on the economy did little to clarify questions regarding the vigor of the ongoing recovery. The information received in advance of the June 25-26 meeting of the FOMC continued to suggest that economic activity had expanded in the second quarter, but both the upward impetus from the swing in inventory investment and the growth in final demand appeared to have diminished. In financial markets, heightened concerns about accounting irregularities at prominent corporations and about the outlook for profits had contributed to a substantial decline in equity prices and correspondingly to a further erosion in household wealth. But some cushion to the effects on aggregate demand of the decline in share prices had been provided by the fall in the foreign exchange value of the dollar and the drop in long-term interest rates. Although the FOMC believed that robust underlying growth in productivity, as well as accommodative fiscal and monetary policies, would continue to support a pickup in the rate of increase of final demand over coming quarters, the likely degree of the strengthening remained uncertain. The FOMC decided to keep unchanged its monetary policy stance and its view that the risks to the economic outlook remained balanced.

Economic Projections for 2002 and 2003

The members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, expect the economy to expand rapidly enough over the next six quarters to erode current margins of underutilized capital and labor resources. The central tendency of the forecasts for the increase in real GDP over the four quarters of 2002 is 3-1/2 percent to 3-3/4 percent, and the central tendency for real GDP growth in 2003 is 3-1/2 percent to 4 percent. The central tendency of the projections of the civilian unemployment rate, which averaged just under 6 percent in the second quarter of 2002, is that it stays close to this figure for the remainder of the year and then moves down to between 5-1/4 percent and 5-1/2 percent by the end of 2003.

Support from monetary and fiscal policies, as well as other factors, should lead to a strengthening in final demand over coming quarters. Business spending on equipment and software will likely be boosted by rising sales, improving profitability, tax incentives, and by the desire to acquire new capital embodying ongoing technological advances. Improving labor market conditions and a robust underlying trend in productivity growth should further bolster household income and contribute to an uptrend in spending. In addition, the liquidation of last year's inventory overhangs has left businesses in a position to begin rebuilding stocks as they become more persuaded that the recovery in final sales will be sustained.

Most FOMC participants expect underlying inflation to remain close to recent levels through the end of 2003. Core inflation should be held in check by productivity gains that hold down cost increases, a lack of pressure on resources, and well-anchored inflation expectations. Overall inflation, which was depressed last year by a notable decline in energy prices, is likely to run slightly higher this year. In particular, the central tendency of the projections of the increase in the chain-type index for personal consumption expenditures over the four quarters of both 2002 and 2003 is 1-1/2 percent to 1-3/4 percent, compared with last year's pace of 1-1/4 percent.

Economic projections for 2002 and 2003
Percent

Indicator	Federal Reserve Governors and Reserve Bank presidents	
	Range	Central tendency
	2002	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4½–5½	4¾–5¼
Real GDP	3–4	3½–3¾
PCE chain-type price index	1¼–2	1½–1¾
Average level, fourth quarter		
Civilian unemployment rate	5½ –6¼	5¾–6
	2003	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4½–6	5–5¾
Real GDP	3¼–4¼	3½–4
PCE chain-type price index	1–2¼	1½–1¾
Average level, fourth quarter		
Civilian unemployment rate	5–6	5¼–5½

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

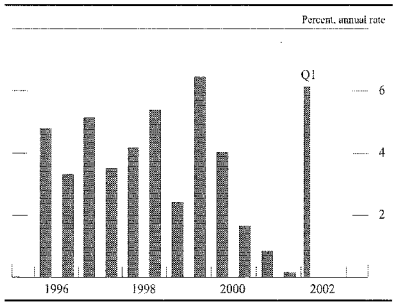
ECONOMIC AND FINANCIAL DEVELOPMENTS IN 2002

The pace of economic activity picked up considerably in the first half of 2002 after being about unchanged, on balance, in the second half of 2001. Final sales advanced modestly as substantial gains in household and government spending were partly offset by weak business fixed investment and a widening gap between imports and exports. In addition, inventory liquidation slowed sharply as businesses stepped up production to bring it more closely in line with the pace of final sales. The increase in real GDP was particularly rapid early in the year, with the first-quarter gain elevated by a steep reduction in the pace of the inventory run-off, a surge in defense spending, and a weather-induced spurt in construction. Real GDP is currently estimated to have risen at an annual rate of just over 6 percent in the first quarter and appears to have posted a more moderate gain in the second quarter.

Private payroll employment declined through April, and at mid-year the unemployment rate stood somewhat above its average in the fourth quarter of 2001. Core inflation—which excludes the direct influences of the food and energy sectors—remained subdued through May, held down by slack in resource utilization and continued sizable advances in labor productivity. Overall inflation was boosted by a surge in energy prices in March and April, but energy prices have since retreated a bit. Inflation expectations remained in check in the first half of this year.

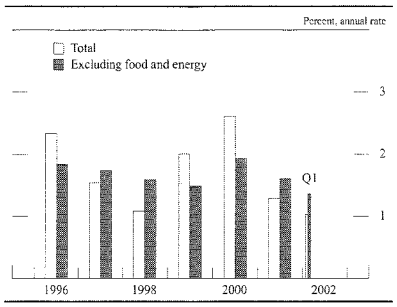
As judged by declines in most interest rates over the first half of the year, financial market participants have marked down their expectation of the vigor of the economic expansion. Interest rates, along with most equity indexes, rose noticeably toward the end of the first quarter in reaction to generally stronger-than-expected economic data. But Treasury yields and equity prices more than rolled back those increases on renewed questions about the strength of the rebound in the economy,

Change in real GDP



NOTE. Here and in subsequent charts, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period.

Change in PCE chain-type price index



NOTE. The data are for personal consumption expenditures (PCE).

including growing uncertainty regarding prospective corporate profits and concerns about escalating geopolitical tensions and about the governance and transparency of U.S. corporations. Private demands on credit markets moderated in the first half the year, as businesses substantially curbed their net borrowing. For the most part, this reduction reflected further declines in business investment, a pickup in operating profits, and a return to net equity issuance. But, in addition, lenders became more cautious and selective, especially for borrowers of marginal credit quality.

Market perceptions that the recovery in the United States might turn out to be less robust than anticipated also put downward pressure on the foreign exchange value of the dollar as measured against the currencies of our major trading partners, especially during the second quarter of 2002. Central banks in some foreign countries, including Canada, tightened policy as growth firmed. The euro-area economy recovered modestly during the first half, and some brighter signs were evident in Japan. In contrast, the dollar strengthened on balance against the currencies of our other important trading partners; in particular, the Mexican peso lost ground, and financial markets reacted to political and economic problems in several South American countries.

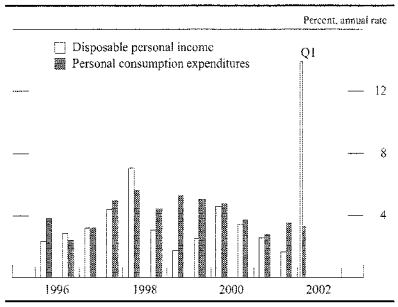
The Household Sector

Household spending began the year on a strong note and continued to rise in the second quarter. Further gains in disposable income have supported a solid underlying pace of spending. The decline in stock prices in the first half of 2002 reduced household wealth, and the debt-service burden remained high, but financial stress among households to date has been limited.

Consumer Spending

Real consumer expenditures increased at an annual rate of 3-1/4 percent in the first quarter. Demand for motor vehicles dropped from an extraordinary fourth-quarter pace, but purchases remained supported in part by continued large incentive packages. Outlays for other goods and services advanced smartly in the first quarter. In the second quarter, the rate of increase in consumer spending looks to have eased somewhat. Motor vehicle purchases were little changed, and most other major categories of consumer spending likely posted smaller gains than earlier in the year.

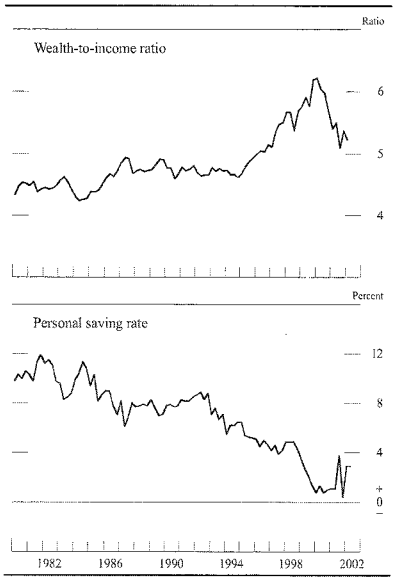
Change in real income and consumption



Real disposable personal income moved sharply higher in the first quarter and appears to have risen a little further in the second quarter. Wages and salaries have

increased only moderately this year. But tax payments have fallen markedly; last year's legislation lowered withheld tax payments again this year, and final payments this spring on tax obligations for 2001 were substantially below last year's level (likely related at least in part to a decline in capital gains realized last year). All told, real disposable income increased at an annual rate of 8 percent between the fourth quarter of last year and May. However, household net worth has likely fallen further because the negative effect of the decline in stock prices has been only partly offset by an apparent continued appreciation in the value of residential real estate. According to the flow of funds accounts, by the end of the first quarter, the ratio of household net worth to disposable income had reversed close to two-thirds of its run-up in the second half of the 1990s; this ratio has undoubtedly registered additional declines since the end of March. Consumer sentiment improved over the first several months of the year, with indexes from both the Conference Board and the Michigan Survey Research Center reversing last fall's sharp deterioration. However, both indexes have given up some of those gains more recently.

Wealth and saving



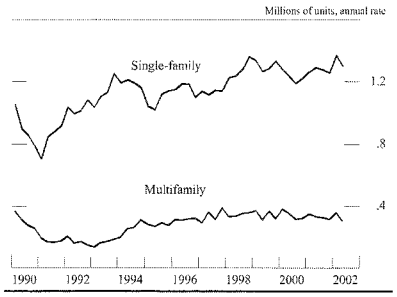
NOTE. The data are quarterly. The wealth-to-income ratio is the ratio of household net worth to disposable personal income and extends through 2002:Q1. The personal saving rate extends through 2002:Q2; the reading for that quarter is the average for April and May.

The personal saving rate increased in the first half of this year, as the decline in wealth over the past two years likely held down consumer spending relative to disposable personal income. In May, the saving rate stood at 3 percent of disposable income, up from an average of 1-1/2 percent over 2001. Movements in the saving rate have been very erratic over the past year, reflecting cyclical factors, the timing of tax cuts, and adjustments in incentives to purchase motor vehicles.

Residential Investment

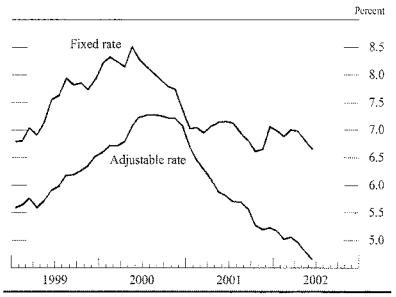
Real residential investment increased at an annual rate of about 15 percent in the first quarter and the level of activity appears to have remained robust in the second quarter. The first-quarter surge was spurred partly by unseasonably warm and dry winter weather, which apparently encouraged builders to move forward some of their planned construction. At the same time, underlying housing activity has been supported by the gains in income and

Private housing starts



NOTE. The data for 2002:Q2 are the averages for April and May; the data for earlier periods are quarterly.

Mortgage rates



NOTE. The data, which are monthly and extend through June 2002, are contract rates on thirty-year mortgages.
SOURCE. Federal Home Loan Mortgage Corporation.

confidence noted above, and, importantly, by low interest rates on mortgages. In the single-family sector, starts averaged an annual rate of 1.35 million units over the first five months of the year—up 6-1/2 percent from the already buoyant pace registered in 2001. Sales of existing homes jumped in early 2002 after moving sideways during the preceding three years; sales of new homes have also been running quite high in recent months.

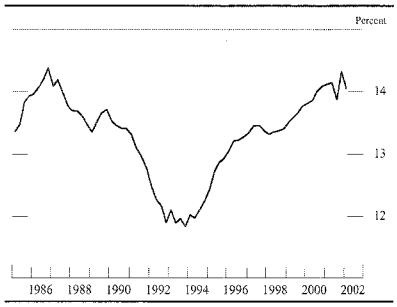
Home prices have continued to move up strongly. For example, over the year ending in the first quarter, the constant-quality price index for new homes rose 5-1/4 percent, and the repeat-sales price index for existing homes was up 6-1/4 percent. Despite these increases, low mortgage rates have kept housing affordable. Rates on thirty-year conventional fixed-rate loans averaged less than 7 percent in the first half of this year, and rates on adjustable-rate loans continued the downtrend that began in early 2001. The share of median household income required to finance the purchase of a median-price house is close to its average for the past ten years and well below the levels that prevailed in the 1970s and 1980s.

In the multifamily sector, housing starts averaged 340,000 units at an annual rate over the first five months of the year, a pace close to the average of the previous five years. However, conditions in this market have deteriorated somewhat during the past year. In the first quarter, the vacancy rate for apartments spiked to the highest level since the late 1980s, and rents and property values were below year-earlier readings.

Household Finance

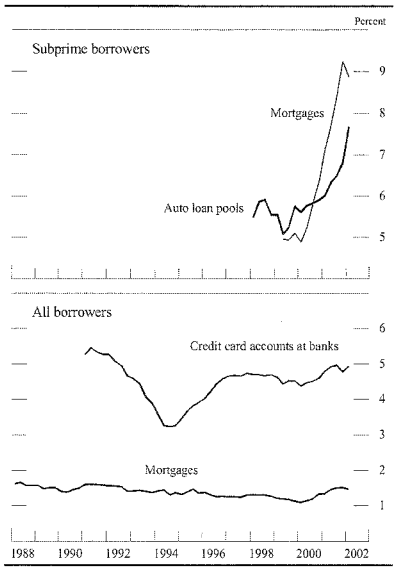
As it did last year, household debt appears to have expanded at more than an 8 percent annual rate during the first half of 2002. Although consumer credit (debt not secured by real estate) has increased, the bulk of the expansion in household debt has come from a sizable buildup of home

Household debt service burden



NOTE. The data are quarterly and extend through 2002:Q1. Debt burden is an estimate of the ratio of debt payments to disposable income; debt payments consist of the estimated required payments on outstanding mortgage and consumer debt.

Delinquency rates on selected types of household loans

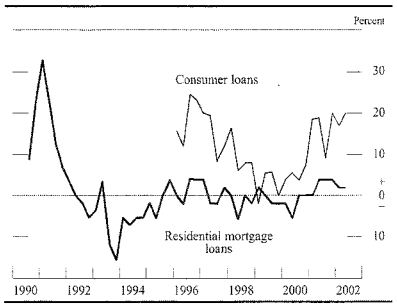


NOTE. The data are quarterly and extend through 2002:Q1.
SOURCE. For auto loans, Federal Reserve staff estimates based on data from Moody's Investors Service; for mortgages, the Mortgage Bankers Association and LoanPerformance; for credit cards, bank Call Reports.

mortgage debt. Refinancing activity has fallen below last year's record pace, but it has remained strong as households have continued to extract a portion of the accumulated equity in their homes.

The aggregate household debt-service burden—the ratio of estimated minimum scheduled payments on mortgage and consumer debt to disposable personal income—although still elevated, has moved little this year. The effect of the fast pace of household borrowing on the debt burden has been offset by lower interest rates and the brisk growth in disposable income. On balance, indicators of credit quality do not suggest much further deterioration in the financial condition of households. While delinquency rates for subprime borrowers have risen further for auto loan pools and have stayed high for mortgages, mortgage delinquencies for all borrowers have changed little, and delinquencies on credit card

Net percentage of domestic banks tightening standards on consumer loans and residential mortgage loans



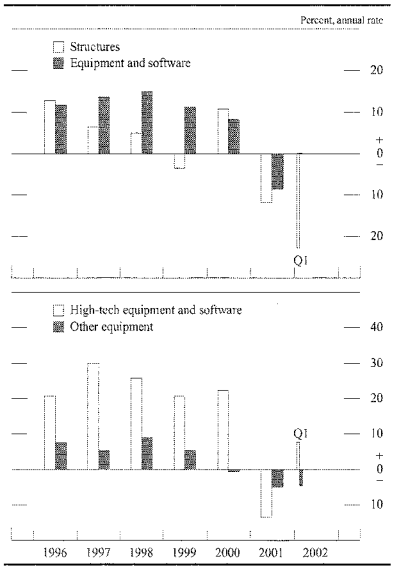
NOTE. The data are based on a survey generally conducted four times per year; the last reading is from the April 2002 survey. Net percentage is the percentage reporting a tightening less the percentage reporting an easing.
SOURCE. Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices.

accounts at banks have not risen significantly since the mid-1990s. The number of personal bankruptcy filings also has essentially moved sideways this year, albeit at a historically high rate. Lenders have apparently reacted to these indicators of household credit quality by tightening standards for consumer loans, as reported on the Federal Reserve's Senior Loan Officer Opinion surveys. Standards for mortgage loans, however, have changed little, and, on the whole, credit appears to have remained readily available to the household sector.

The Business Sector

Spending in the business sector appears to have bottomed out recently, but a strong recovery has not yet taken hold. Real business fixed investment, which declined sharply last year, fell again in the first quarter, but seems to have firmed in the second quarter. Excess capacity in some sectors and uncertainty about the pace of the economic expansion are likely still restraining equipment demand, but rising output, improving corporate profits, and continuing technological advances appear to be working in the opposite direction. Many businesses have worked off their excess stocks, and the substantial inventory runoff that began in the first quarter of last year seems to be drawing to a close. The combination of higher profits and weak investment spending has led to a drop in borrowing by the nonfinancial business sector thus far this year.

Change in real business fixed investment



NOTE. High-tech equipment consists of computers and peripheral equipment and communications equipment.

Fixed Investment

Real business spending on equipment and software (E&S) was little changed in the first quarter after having dropped sharply last year. In the high-tech category, real expenditures moved up in the first quarter after a double-digit decline in 2001. Outlays for computers posted large gains in inflation-adjusted terms in both the fourth and first quarters; many businesses apparently postponed computer replacement over much of last year but now

seem to be taking advantage of ongoing technological progress and the associated large declines in prices. In contrast, real expenditures for communications equipment were little changed in the first quarter after having plunged by one-third during 2001. Excess capacity in the provision of telecom services is continuing to weigh heavily on the demand for communications equipment. Business outlays for software edged down in real terms in the first quarter.

Real spending on transportation equipment dropped in the first quarter. Outlays for aircraft shrank dramatically as the reduction in orders after last year's terrorist attacks began to show through to spending. Outlays for motor vehicles fell sharply early in the year owing to weakness in the market for heavy trucks and a reported reduction in fleet sales to rental companies related to the downturn in air travel. Real E&S spending outside of the high-tech and transportation categories moved up in the first quarter after sizable declines in the three preceding quarters. This pattern probably reflects the deceleration and subsequent acceleration in business output, which is an important determinant of spending in this category.

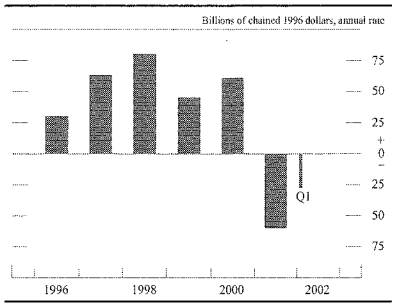
In the second quarter, real E&S spending likely rose, borne along by increases in sales and a rebound in profits. Incoming data on orders and shipments suggest that real outlays for high-tech equipment advanced and that expenditures for other nontransportation equipment also rose. Spending on aircraft probably contracted further, but orders for heavy trucks surged this spring, as some companies reportedly shifted purchases forward in anticipation of stricter emissions requirements that are scheduled to take effect in the fall. Because of lags in the ordering and building of new equipment, the provision for partial expensing in the Job Creation and Worker Assistance Act passed by the Congress in early March will likely bolster investment spending gradually.

Real outlays for nonresidential structures registered a very large decline in the first quarter after having slipped appreciably in 2001. Outlays for office and industrial structures, lodging facilities, and public utilities dropped substantially. Vacancy rates for offices jumped in the first quarter to their highest level since the mid-1990s; in addition, rents and property values were noticeably below their levels one year earlier. Vacancy rates have risen dramatically in the industrial sector as well. Construction of drilling structures also contracted sharply in the first quarter, thereby continuing the downtrend that began in the middle of last year in the wake of the decline in the prices of oil and natural gas from their peaks a few quarters earlier. Incoming data point to further declines in spending for nonresidential structures in the second quarter.

Inventory Investment

Businesses ran off inventories at an annual rate of nearly $30 billion in the first quarter. This drawdown followed a much larger liquidation—at an annual rate of roughly $120 billion—in the fourth quarter, and the associated step-up in production contributed almost 3-1/2 percentage points to the first-quarter increase in real GDP. Book-value data on inventories outside of the motor vehicle sector point to a further slackening of the drawdown more recently. Since last fall, inventory-sales

Change in real business inventories



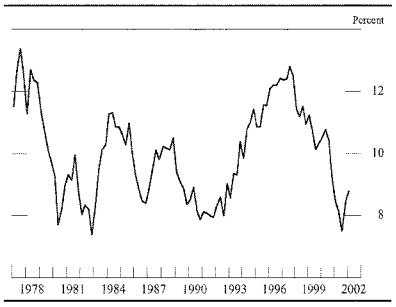
ratios have more than reversed the run-up that occurred as the economy softened. Currently, inventories do not appear to be excessive for the economy as a whole, although industry reports suggest that overhangs persist in a few areas. In contrast to inventories in other sectors, motor vehicle stocks increased in the first half of this year, as automakers boosted production in order to rebuild stocks that had been depleted by the robust pace of sales in late 2001. Motor vehicle inventories were no longer lean as of the middle of this year.

Corporate Profits and Business Finance

The economic profits of the U.S. nonfinancial corporate sector grew 5 percent at a quarterly rate in the first quarter of this year after a surge of 13-3/4 percent in the fourth quarter of 2001. The corresponding ratio of profits to sector GDP has edged up to 8-3/4 percent, reversing a portion of the steep decline registered over the preceding few years but remaining well below its peak in the mid-1990s. Early indicators point to further profit gains in the second quarter.

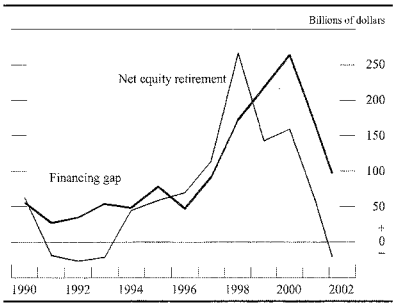
The rise in profits since late 2001, combined with weak capital expenditures and low share repurchase and cash-financed merger activities, have helped keep nonfinancial corporations' need for external funds (the financing gap) below the average of last year. In addition, corporations have

Before-tax profits of nonfinancial corporations as a percent of sector GDP



NOTE. The data are quarterly and extend through 2002:Q1. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.

Financing gap and net equity retirement at nonfarm nonfinancial corporations

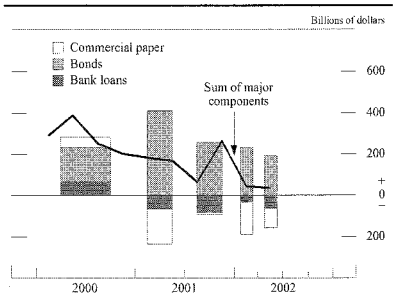


NOTE. The data are annual through 2001; the final observation is for 2002:Q1 at an annual rate. The financing gap is the difference between capital expenditures and internally generated funds. Net equity retirement is the difference between equity retired through share repurchases, domestic cash-financed mergers, or foreign takeovers of U.S. firms and equity issued in public or private markets, including funds invested by venture capital partnerships.

turned to the equity markets to raise a portion of their needed external funds: Corporations have sold more new equity than they have retired this year—the first period of net equity issuance in nearly a decade. They have used much of these funds to repay debt. As a result, the growth of nonfinancial business debt appears to have slowed considerably in the first half of 2002 after rapid gains in preceding years.

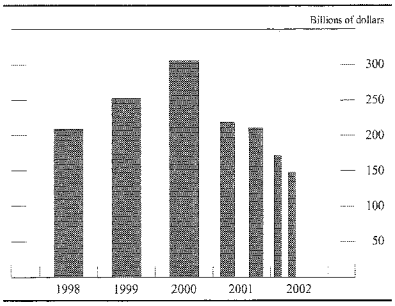
Much of the growth in nonfinancial business debt this year has been concentrated in the corporate bond market (though issuance has not been quite so strong as in 2001), as firms have taken advantage of historically attractive yields. Many corporations have used the proceeds of their bond offerings to pay down commercial and industrial (C&I) loans at banks and commercial paper. In recent months, however, net corporate bond issuance has slowed, and the contraction in short-term funding appears to have moderated.

Major components of net business financing



NOTE. Seasonally adjusted annual rate for nonfarm nonfinancial corporate business. The data for the sum of major components are quarterly. The data for 2002:Q2 are estimated.

Nonfinancial commercial paper outstanding



NOTE. The data are period-end figures and extend through 2002:Q2.

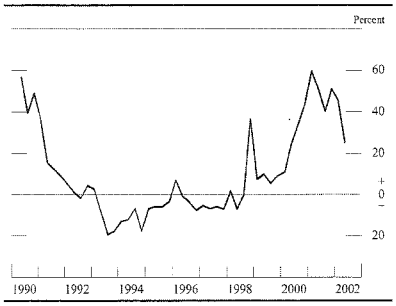
About one fifth of total bond offerings over the first half of 2002 have been in the speculative-grade market. This fraction is about unchanged from last year but still well below the proportions seen in the latter half of the 1990s, and speculative-grade bond offerings have been concentrated in the higher quality end of that market. Troubles in the two largest sectors of the market—telecommunications and energy—have continued to weigh on issuance this year.

Although many businesses have apparently substituted bond debt for shorter-term financing by choice, others, especially investment-grade firms in the telecommunications sector, have done so by necessity: They were pushed out of the commercial paper market or otherwise encouraged by investors and credit-rating agencies to curb their reliance on short-term sources of financing to limit the associated rollover risk. Indeed, commercial paper outstanding ran off sharply in February and early March, when several companies that were perceived as having questionable accounting practices were forced to tap bank lines to pay off maturing

commercial paper. With lower-quality borrowers leaving the market in the face of elevated risk spreads, commercial paper outstanding shrank nearly 30 percent in the first half of the year after a sizable decline in 2001.

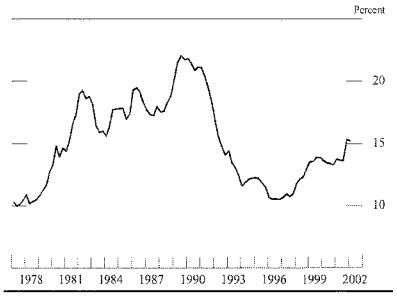
Some firms that exited the commercial paper market turned, at least temporarily, to banks as an alternative. Nonetheless, on net, commercial and industrial loans at banks have declined this year, reflecting borrowers' preference for lengthening the maturity of their liabilities and the overall reduction in the demand for external financing, noted earlier. To a more limited extent, a somewhat less receptive lending environment probably also weighed on business borrowing at banks. In particular, banks continued to tighten terms and standards on C&I loans on net over the first half of this year, although the fraction of banks that reported having done so fell noticeably in the Federal Reserve's Senior Loan Officer Opinion survey in April. Banks have also imposed stricter underwriting standards and higher fees and spreads on backup lines of credit for commercial paper over most of 2001 and early 2002; banks cited increased concerns about the creditworthiness of issuers and a higher likelihood of lines being drawn down.

Net percentage of domestic banks tightening standards on commercial and industrial loans to large and medium-sized firms



NOTE. The data are based on a survey generally conducted four times per year; the last reading is from the April 2002 survey. Large and medium-sized firms are those with annual sales of $50 million or more. Net percentage is the percentage reporting a tightening less the percentage reporting an easing.
SOURCE. Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices.

Net interest payments of nonfinancial corporations relative to cash flow



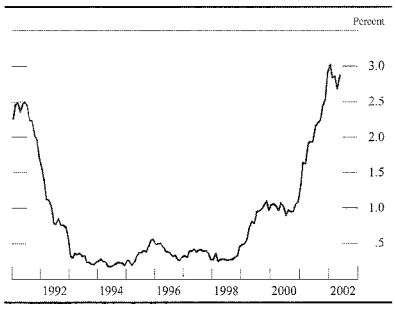
NOTE. The data are quarterly and extend through 2002:Q1.

Indicators of credit quality still point to some trouble spots in the nonfinancial business sector. The ratio of net interest payments to cash flow has trended up since the mid-1990s for the nonfinancial corporate sector as a whole, with increases most pronounced for weaker speculative-grade firms. The default rate on outstanding corporate bonds has remained quite elevated by historical standards. By contrast, although the delinquency rate on C&I loans at banks has risen a bit further this year, it has stayed well below rates observed in the early 1990s.

In part, however, this performance may be attributable to more aggressive loan sales and charge-offs than in the past. It may be that problems have risen more for large firms than for smaller ones, as the increase in C&I loan delinquencies over recent quarters was limited to large banks, where loans to larger firms are more likely to be held. Credit rating downgrades continued to outpace upgrades by a substantial margin, as was the case in the last quarter of 2001. Spreads of corporate bond yields over those on comparable Treasuries have remained high by historical standards and have risen considerably across the credit-quality spectrum for telecom firms. Corporate bond spreads also widened, though to a much smaller extent, for a few highly rated firms in other industries owing to concerns about their accounting practices.

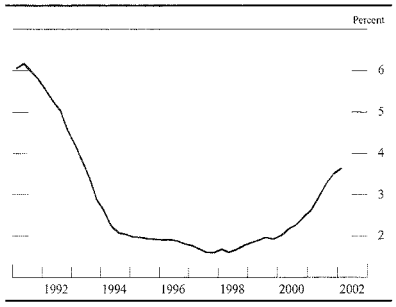
After having surged late last year, growth in commercial mortgage debt dropped back in the first half of this year amid a sharp decline in construction activity. Issuance of commercial mortgage backed securities (CMBS), a major component of commercial mortgage finance, has been especially weak. Nonetheless, investor appetite for CMBS has apparently been strong, as yield spreads have narrowed this year. Delinquency rates on CMBS pools, which had been rising during the early part of the year, seem to have stabilized in recent months, and delinquency rates on commercial mortgages held by banks and insurance companies have remained near their historical lows.

Default rate on outstanding bonds



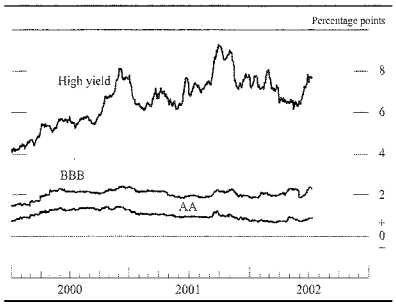
NOTE. The default rate is monthly and extends through May 2002. The rate for a given month is the face value of bonds that defaulted in the twelve months ending in that month divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the twelve-month period.

Delinquency rates on commercial and industrial loans at banks



NOTE. The data, from bank Call Reports, are quarterly, seasonally adjusted, and extend through 2002:Q1.

Spreads of corporate bond yields over the ten-year Treasury yield



NOTE. The data are daily and extend through July 10, 2002. The spreads compare the yields on the Merrill Lynch AA, BBB, and 175 indexes with the yield on the ten-year off-the-run Treasury note.

The low level of risk spreads for CMBS suggests that concerns about terrorism insurance have not been widespread in the market for commercial mortgages, and responses to the Federal Reserve's Senior Loan Officer Opinion survey in April indicate that most domestic banks required insurance on less than 10 percent of the loans being used to finance high-profile or heavy-traffic properties. Nonetheless, that fraction was much higher at a few banks, and some credit-rating agencies have placed certain CMBS issues—mainly those backed by high-profile properties—on watch for possible downgrade because of insufficient terrorism insurance.

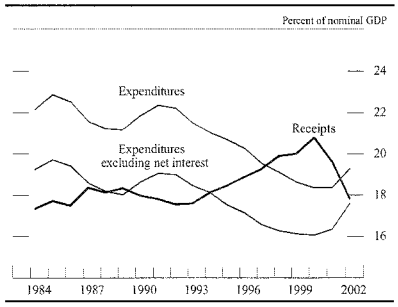
The Government Sector

The federal unified budget moved into deficit in fiscal 2002 after having posted a substantial surplus in fiscal 2001. The deterioration reflects a sharp drop in tax collections (resulting in part from the effects of the economic downturn, the decline in stock prices, and legislated tax cuts) and unusually large supplemental spending measures. As a consequence, federal debt held by the public increased in the first half of the year after rapid declines during the previous several years. The budgets of states and localities have also been strained by economic events, and many state and local governments have taken steps to relieve these pressures.

Federal Government

Over the first eight months of fiscal year 2002 (October through May) the unified budget recorded a deficit of $147 billion, compared with a surplus of $137 billion over the same period of fiscal year 2001. Nominal receipts were 12 percent lower than during the same period of fiscal 2001, and daily Treasury data since May suggest that receipts have remained subdued. Individual tax payments are running well below last year's pace; this weakness reflects general macroeconomic conditions, the legislated changes in tax policy, and the decline in stock prices and consequent reduction in capital gains realizations in 2001. The extent of the weakness was not widely anticipated—this spring's nonwithheld tax payments, which largely pertain to last year's liabilities, generated the first substantial negative April surprise in revenue collections in a number of years. Corporate tax payments

Federal receipts and expenditures



NOTE. The budget data are from the unified budget; through 2001 they are for fiscal years (October through September), and GDP is for Q3 to Q3. For 2002, the budget data are for the twelve months ending in May, and GDP is for 2001:Q1 to 2002:Q1.

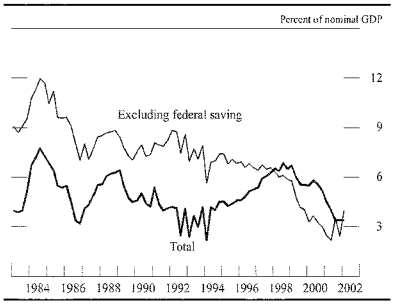
have also dropped from last year's level because of weak profits and the business tax provisions included in the Job Creation and Worker Assistance Act of 2002.

Nominal federal outlays during the first eight months of fiscal 2002 were 10 percent higher than during the same period last year; excluding a drop in net interest payments owing to the current low level of interest rates, outlays were up 14 percent. The rate of increase was especially large for expenditures on income security, health, and national and homeland defense. Real federal expenditures for consumption and gross investment, the part of government spending that is a component of real GDP, rose at an annual rate of roughly 11-1/2 percent in the first calendar quarter of 2002 as defense spending surged. The available data suggest that real federal expenditures for consumption and gross investment increased further in the second quarter.

Federal saving, which equals the unified budget surplus adjusted to conform to the accounting practices followed in the national income and product accounts, has fallen considerably since the middle of last year. Net federal saving, which accounts for the depreciation of government capital, turned negative in the first quarter of this year. At the same time, the net saving of households, businesses, and state and local governments has moved up from its trough of last year. On balance, net national saving as a share of GDP has held roughly steady in the past several quarters after having moved down sharply since 1999.

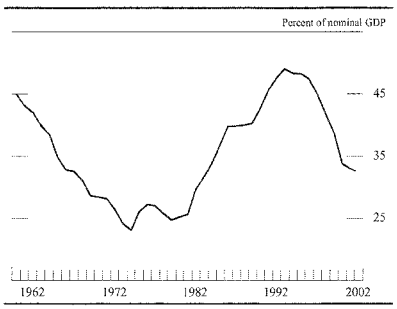
Federal debt held by the public, which had been declining rapidly over the past few years, grew at a 3-1/4 percent annual rate in the first quarter of 2002 and is estimated to have increased considerably more in the second quarter. The ratio of federal government debt held by the public to nominal GDP fell only slightly in the first quarter following several years of steep declines. In response to the changing budget outlook, the Treasury suspended its buyback operations through mid-August and increased the number of auctions of new five-year notes and ten-year indexed securities.

Net national saving



NOTE. The data are quarterly and extend through 2002:Q1.

Federal government debt held by the public



NOTE. Through 2001, the data for debt are year-end figures and the corresponding value for GDP is for Q4 at an annual rate; the final observation is for 2002:Q1. Excludes securities held as investments of federal government accounts.

During the second quarter, the Treasury took unusual steps to avoid breaching its statutory borrowing limit of $5.95 trillion. In early April, it temporarily suspended investments in the Government Securities Investment Fund—the so called G-fund of the Federal Employees' Retirement System. Incoming individual nonwithheld tax receipts later that month allowed the Treasury to reinvest the G-fund assets with an adjustment for interest. Late in May, the Treasury declared a debt ceiling emergency, which allowed it to disinvest a portion of the Civil Service Retirement and Disability Fund, in addition to the G-fund, to keep its debt from breaching the statutory limit. At the time of the declaration, the Treasury indicated that disinvestments from these two funds, combined with other stopgap measures, would be sufficient to keep it from breaching the debt ceiling only through late June. The Congress approved legislation raising the statutory borrowing limit to $6.4 trillion on June 27.

State and Local Governments

Slow growth of revenue resulting from the economic downturn has also generated a notable deterioration in the fiscal position of many state and local governments over the past year. In response, many states and localities have been trimming spending plans and, in some cases, raising taxes and fees. In addition, many states have been dipping into rainy-day and other reserve funds. Together, these actions are helping to move operating budgets toward balance.

Real consumption and investment spending by state and local governments rose at an annual rate of 4-1/4 percent in the first quarter, but available data suggest that outlays were little changed in the second quarter. Outlays for consumption items seem to have held to only moderate increases in the first half of this year, a step-down from last year's more robust gains. Investment spending rose briskly in the first quarter and retreated in the second quarter; this pattern largely reflects the contour of construction expenditures, which were boosted early in the year by unseasonably warm and dry weather.

Debt growth in the state and local government sector has slowed so far in 2002 from last year's very rapid pace. States and localities have continued to borrow heavily in bond markets to finance capital expenditures and to refund existing obligations, including short-term debt issued last year. The overall credit quality of the sector has remained high despite the fiscal stresses associated with the recent economic slowdown, and yield ratios relative to Treasuries have changed little this year, on net.

The External Sector

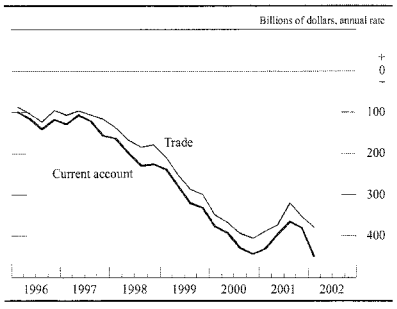
Stronger growth in the United States contributed to a widening of U.S. external deficits in the first quarter of this year. The United States has continued to receive large net private financial inflows in 2002, but both inflows and outflows have been at lower levels than in recent years.

Trade and the Current Account

The U.S. deficit on trade in goods and services widened about $27 billion in the first quarter, to nearly $380 billion at an annual rate, as a surge in imports overwhelmed a slower expansion of exports. U.S. net investment income decreased $33 billion to a slight deficit position after recording modest surpluses in all four quarters last year. The U.S. deficit on other income and transfers widened about $9 billion, to nearly $70 billion at an annual rate. The U.S. current account, which is the sum of the above, recorded a deficit in the first quarter of $450 billion at an annual rate, 4.3 percent of GDP and nearly $70 billion larger than the deficit in the fourth quarter of 2001.

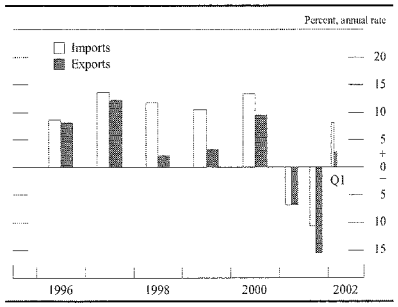
Real exports of goods and services increased 3 percent at an annual rate in the first quarter, after five quarters of decline. This improvement resulted from a very large step-up in service receipts, as payments by foreign travelers moved back up to near pre-September 11 levels and other private service receipts increased as well. The real value of exported goods contracted in the first quarter, but at only a 3-1/2 percent annual rate. Goods exports had declined much more steeply in the previous three quarters under the effects of slower output growth abroad, continued appreciation of the dollar, and plunging global demand for high-tech products. The better performance in the first quarter of 2002 included a markedly slower rate of decline of machinery exports and a small increase in exported aircraft. While exports of computers continued to fall, exports of semiconductors rose for the first time in nearly two years. Export prices continued to edge down in the first quarter.

U.S. trade and current account balances



NOTE. The data are quarterly and extend through 2002:Q1.

Change in real imports and exports of goods and services

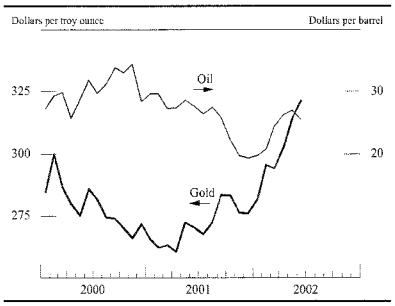


NOTE. Change for the half-year indicated is measured from the preceding half-year, and the change for 2002:Q1 is from 2001:Q4. Imports and exports for each period are the average of the levels for component quarters.

U.S. real imports of goods and services expanded in the first quarter at an 8 percent annual rate. As was the case with exports, a substantial part of the increase came from larger service payments related to increased travel abroad by U.S. residents. Reflecting the rebound in U.S. economic activity, imports of real goods rose at about a 4 percent pace in the first quarter of 2002, the first increase in four quarters, as a decline in oil imports was more than offset by a substantial increase in imports of other goods. Growth of non-oil imports was led by increased imports of computers, autos, and consumer goods. The price of imported non-oil goods declined at about a 2-1/4 percent annual rate, in line with its trend in 2001; prices fell for a wide range of capital goods and industrial supplies.

Declining demand during the second half of last year put the price of West Texas intermediate (WTI) crude oil in December 2001 at around $19 per barrel, its lowest level since mid-1999. Unusually warm winter weather in the United States—along with low prices—helped keep the value of oil imports at a very low level in the first quarter. But oil prices began to rise in February and March as global economic activity picked up and as OPEC reduced its production targets in an agreement with five major non-OPEC producers (Angola, Mexico, Norway, Oman, and Russia). Oil prices remained firm in the second quarter around $26 per barrel amid turmoil in the Middle East, a one-month suspension of oil exports by Iraq, disruption of supply from Venezuela, and increasing global demand. The price of gold also has reacted to heightened geopolitical tensions and moved up more than 13 percent over the first half of 2002.

Prices of oil and gold

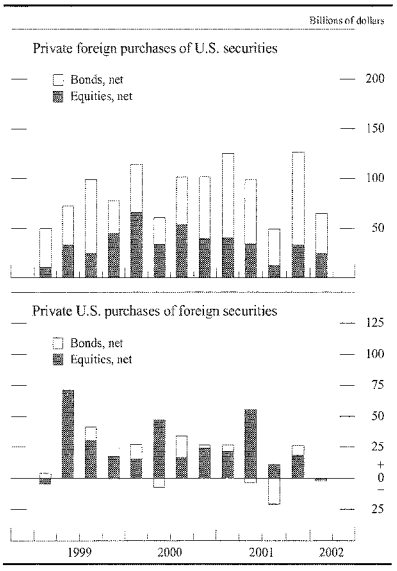


NOTE. The data are monthly. The oil price is the spot price of West Texas intermediate crude oil. The gold price is the price in London.

The Financial Account

The shift in the pattern of U.S. international financial flows observed in the second half of 2001 continued into the first quarter of this year. Influenced by increased economic uncertainty, questions about corporate governance and accounting, and sagging share prices, foreign demand for U.S. equities remained weak. Foreign net purchases of U.S. bonds slowed; although purchases of corporate bonds continued to be robust, demand for agency and Treasury bonds slackened. Nonetheless, because U.S. net purchases of foreign securities also fell off, the contribution of net

U.S. international securities transactions



SOURCE. Department of Commerce and the Federal Reserve Board.

inflows through private securities transactions to financing the U.S. current account deficit remained at a high level. Preliminary and incomplete data for the second quarter of 2002 suggest a continuation of this pattern.

Slower economic activity, both in the United States and abroad, and reduced merger activity caused direct investment inflows and outflows to drop sharply late last year. Direct investment inflows, which were strong through the first half of 2001, plummeted in the second half. U.S. direct investment abroad stayed at a high level through the third quarter but then fell sharply. Both inflows and outflows remained weak in the first quarter of 2002. Available data point to a pickup of capital inflows from official sources during the first half of 2002, as the recent weakening of the foreign exchange value of the dollar prompted some official purchases.

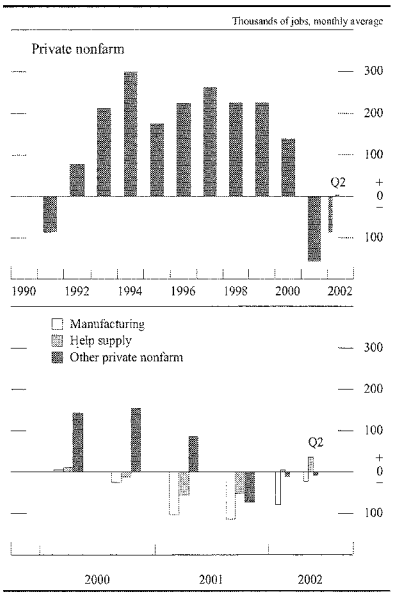
The Labor Market

Labor markets weakened further in the first few months of the year; they now appear to have stabilized but have yet to show signs of a sustained and substantial pickup. Growth of nominal compensation slowed further in the first part of the year after having decelerated in 2001. With productivity soaring in recent quarters, unit labor costs have fallen sharply.

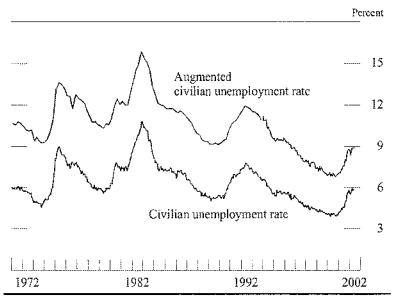
Employment and Unemployment

After having fallen an average of nearly 160,000 per month in 2001, private payroll employment declined at an average monthly rate of 88,000 in the first quarter and was about unchanged in the second quarter. Employment losses in the manufacturing sector have moderated in recent months, and employment in the help supply services industry—which provides many of its workers to the manufacturing sector—has increased. These two categories, which were a major locus of weakness last year, gained an average of 11,000 jobs per month over the past three months, compared with an

Net change in payroll employment



Measures of labor utilization



NOTE. The data extend through June 2002. The civilian rate is the number of civilian unemployed divided by the civilian labor force. The augmented rate adds to the numerator and the denominator of the civilian rate the number of those who are not in the labor force but want a job. The small break in the augmented rate in January 1994 arises from the introduction of a redesigned survey. For the civilian rate, the data are monthly; for the augmented rate, the data are quarterly through December 1993 and monthly thereafter.

average loss of 76,000 jobs per month in the first quarter of the year and 163,000 jobs per month over 2001.

Apart from manufacturing and help supply, private payrolls fell 12,000 per month in the first quarter and declined 8,000 per month in the second quarter. In the second quarter, hiring in construction fell by the same amount as in the first quarter. Retail employment declined somewhat after rising a bit in the first quarter, and the employment gain in services other than help supply was slightly smaller than in the first quarter. However, employment losses in several other categories abated in the second quarter.

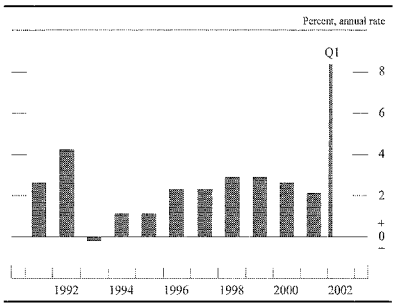
The unemployment rate in the second quarter averaged 5.9 percent, up from a reading of 5.6 percent in both the fourth quarter of last year and the first quarter of this year. The higher unemployment rate in recent months is consistent with weak employment gains, and it probably was boosted a bit by the federal temporary extended unemployment compensation program. Because this program provides additional benefits to individuals who have exhausted their regular state benefits, it encourages unemployed individuals to be more selective about taking a job offer and likely draws some people into the labor force to become eligible for these benefits.

Productivity and Labor Costs

Labor productivity has increased rapidly in recent quarters. After rising at an average annual rate of around 1 percent in the first three quarters of last year, output per hour in

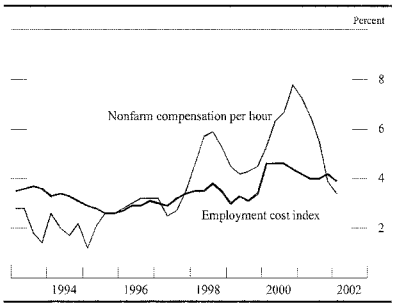
the nonfarm business sector jumped at an annual rate of 5-1/2 percent in the fourth quarter of last year and 8-1/2 percent in the first quarter of this year. Productivity likely continued to rise in the second quarter, albeit at a slower pace. Labor productivity often rises briskly in the early stages of economic recoveries, but what makes the recent surge unusual is that it followed a period of modest increases, rather than declines. In earlier postwar recessions, productivity deteriorated as firms retained more workers than may have been required to meet reduced production needs. The strength in productivity growth around the beginning of this year suggests that employers may have doubted the durability of the pickup in sales and, therefore, deferred new hiring until they became more convinced of the vigor of the expansion. Smoothing through the recent cyclical fluctuations, productivity advanced at an average annual rate of close to 3-1/2 percent between the fourth quarter of 2000 and the first quarter of this year. Although this pace is unlikely to be sustained, it further bolsters the view that the underlying trend in productivity has moved up since the first half of the 1990s.

Change in output per hour



NOTE. Nonfarm business sector.

Measures of change in hourly compensation



NOTE. The data extend through 2002:Q1. For nonfarm compensation, change is over four quarters; for the employment cost index (ECI), change is over the twelve months ending in the last month of each quarter. Nonfarm compensation is for the nonfarm business sector; the ECI is for private industry excluding farm and household workers.

The employment cost index (ECI) for private nonfarm businesses increased just under 4 percent during the twelve months ended in March of this year, after rising about 4-1/4 percent in the preceding twelve-month period. The recent small step-down likely reflects the lagged effects of the greater slack in labor markets and lower consumer price inflation. The wages and salaries component and the benefits component of the ECI both decelerated by 1/4 percentage point relative to the preceding year. The slowing in benefits costs occurred despite a 2-1/2 percentage point pickup in health insurance cost inflation, to a 10-1/2 percent rate of increase.

Nominal compensation per hour in the nonfarm business sector—an alternative measure of compensation based on the national income and product accounts—rose 3-1/2 percent during the year ending in the first quarter. This rate represented a sharp slowing from the 7-1/4 percent pace recorded four quarters earlier, which likely had been

boosted significantly by stock options; stock options are included in this measure at their value when exercised. The deceleration in this measure of compensation is much more dramatic than in the ECI because the ECI does not include stock options. The moderate increase in nominal compensation combined with the spike in productivity growth led unit labor costs to drop at an annual rate in excess of 5 percent in the first quarter, after a decline of 3 percent in the fourth quarter.

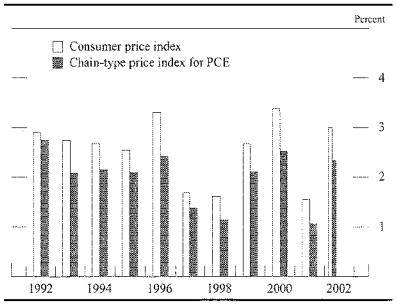
Information about the behavior of compensation in more recent months is limited. Readings on average hourly earnings of production or nonsupervisory workers suggest a further deceleration in wages: The twelve-month change in this series was 3-1/4 percent in June, 3/4 percentage point below the change for the preceding twelve months.

Prices

A jump in energy prices in the spring pushed up overall inflation in the first part of 2002, but core inflation remained subdued. The chain-type price index for personal consumption expenditures (PCE) increased at an annual rate of 2-1/4 percent over the first five months of the year, compared with a rise of just over 1 percent for the twelve months of 2001. Core PCE prices rose at an annual rate of just over 1-1/2 percent during the first five months of this year, which was the pace recorded for 2001.

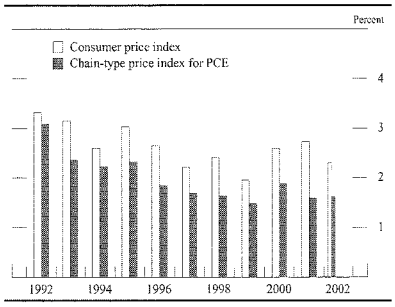
Energy prices rose sharply in March and April but have turned down more recently. Gasoline prices spiked in those two months, as crude oil costs moved higher and retail gasoline margins surged. Since April, gasoline prices have, on balance, reversed a small part of this rise. Natural gas prices stayed low in early 2002 against a backdrop of very high inventories; however, these prices have, on average, moved higher in more recent months. Electricity prices have dropped this year, a

Change in consumer prices



NOTE. Change for 2002 is from December 2001 to May 2002 at an annual rate; changes for earlier periods are from December to December.

Change in consumer prices excluding food and energy



NOTE. Change for 2002 is from December 2001 to May 2002 at an annual rate; changes for earlier periods are from December to December.

move reflecting deregulation of residential prices in Texas as well as lower prices for coal and natural gas, which are used as inputs in electricity generation. All told, energy prices increased at an annual rate of 20 percent over the first five months of the year, reversing a little more than half of last year's decline.

Consumer food prices increased at an annual rate of 1-1/2 percent between December and May. A poor winter crop of vegetables pushed up prices early this year, but supplies subsequently increased and prices came down. In addition, consumer prices for meats and poultry, which began to weaken late last year, remained subdued this spring.

Core inflation was held down over the first five months of the year by continued softness in goods prices, including a significant decline in motor vehicle prices. Non-energy services prices continued to move up at a faster pace than core goods prices, although the very sizable increases in residential rent and the imputed rent of owner-occupied housing have eased off in recent months. The rate of increase in core consumer prices has been damped by several forces. One is the lower level of resource utilization that has prevailed over the past year. Core price increases were also held down by declines in non-oil import prices and the lagged effects of last year's decline in energy prices on firms' costs. In addition, inflation expectations have stayed in check: The Michigan Survey Research Center index of median expected inflation over the subsequent year has rebounded from last fall's highly unusual tumble, but its average in recent months of 2-3/4 percent is below the average reading of 3 percent in 2000.

Like core PCE inflation, inflation measured by the core consumer price index (CPI) has remained subdued. However, the levels of inflation corresponding to these two alternative measures of consumer prices are markedly different: Core PCE inflation was about 1-1/2 percent over the twelve months ended in May, while core CPI inflation was about 2-1/2 percent. This gap is more than 1/2 percentage point larger than the average difference between these inflation measures during the 1990s (based on the current methods used to construct the CPI instead of the official published CPI). The larger differential arises from several factors. First, the PCE price index (unlike the CPI) includes several components for which market-based prices are not available, such as checking services provided by banks without explicit charges; the imputed prices for these components have increased considerably less rapidly in the past couple of years than previously. Second, the substantial acceleration in shelter costs since the late 1990s has provided a larger boost to the CPI than to the PCE price index because housing services have a much larger weight in the CPI. Third, PCE medical services prices—which are largely based on producer price indexes rather than information from the CPI—have increased more slowly than CPI medical services prices over the past couple of years.

The chain-type price index for gross domestic purchases—which captures prices paid for consumption, investment, and government purchases—rose at an annual rate of roughly 1 percent in the first quarter of 2002, putting the four-quarter change at 3/4 percent. This pace represents a marked slowing relative to the 2-1/4 percent rise in the year-earlier period, owing to both a drop in energy prices (as the decline in the second half of 2001 was only partly offset by the increase this

Alternative measures of price change
Percent

Price measure	2000 to 2001	2001 to 2002
Chain-type		
Gross domestic product	2.3	1.4
Gross domestic purchases	2.2	.7
Personal consumption expenditures	2.4	.7
Excluding food and energy	1.9	1.3
Fixed-weight		
Consumer price index	3.4	1.2
Excluding food and energy	2.7	2.5

NOTE. Changes are based on quarterly averages and are measured from Q1 to Q1.

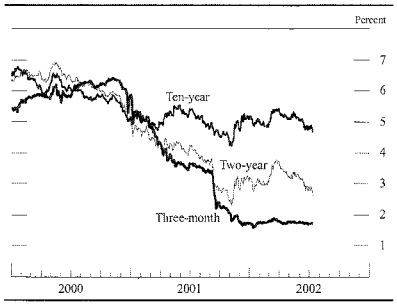
spring) and more rapid declines in the prices of investment goods such as computers. The GDP price index rose at an annual rate of 1-1/4 percent in the first quarter and was up almost 1-1/2 percent relative to the first quarter of last year. The GDP price index decelerated somewhat less than the index for gross domestic purchases, in part because declining oil prices receive a smaller weight in U.S. production than in U.S. purchases.

U.S. Financial Markets

Market interest rates have moved lower, on net, since the end of 2001, as market participants apparently viewed the ongoing recovery as likely to be less robust than they had been expecting late last year. Such a reassessment of the strength of economic activity and associated business earnings, along with worries about the accuracy of published corporate financial statements, weighed heavily on major equity indexes, which dropped 12 to 31 percent. The debt of the nonfinancial sectors expanded at a moderate pace, but lenders have imposed somewhat firmer financing terms, especially on marginal borrowers.

Households' preferences for safer assets, which had intensified following last year's terrorist attacks, diminished early in 2002, as evidenced by strong flows into both equity and bond mutual funds. Equity fund inflows lessened in May and turned into outflows in June, however, as concerns about the strength and accuracy of corporate earnings reports mounted. But the net shift toward longer-term assets this year appears to have contributed to a significant deceleration in M2, which has also been slowed by reduced mortgage refinancing activity and a leveling out of the opportunity cost of holding M2 assets.

Rates on selected Treasury securities



NOTE. The data are daily and extend through July 10, 2002.

Interest Rates

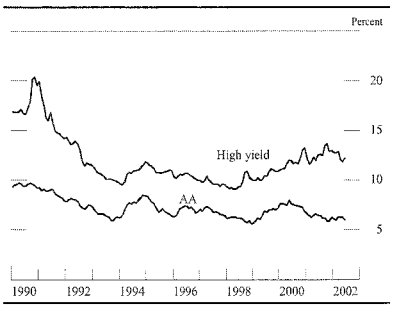
Uncertain about the robustness of the economic recovery, the FOMC opted to retain its accommodative policy stance over the first half of 2002, leaving its target for the federal

funds rate at 1-3/4 percent. Market participants, too, have apparently been unsure about the strength of the recovery, and shifts in their views of the economic outlook have played a significant role in movements in market interest rates so far this year. During the first quarter of the year, news on aggregate spending and output came in well above expectations, and Treasury coupon yields rose between 35 and 65 basis points. The second quarter, however, brought renewed concerns about the economic outlook, compounded by sharp declines in equity prices. In recent months, Treasury coupon yields have more than reversed their earlier increases and are now 40 to 50 basis points below their levels at the end of 2001.

Survey measures of long-term inflation expectations have been quite stable this year, implying that real rates changed about as much as nominal rates. The spread between nominal and inflation-indexed Treasury yields, another gauge of investors' expectations about inflation, has moved over a relatively wide range since the end of 2001, but, on net, it has edged up only slightly. Even the small widening of this spread likely overstates a shift in sentiment regarding future price pressures in the economy. In mid-February, the Treasury reassured investors that it would continue to issue indexed debt, an announcement that was reinforced in May when the Treasury made public its decision to add one more auction of ten-year indexed notes to its annual schedule of offerings. This reaffirmation of the Treasury's commitment to issue indexed securities may have pulled indexed yields down by bolstering the actual and expected liquidity of the market.

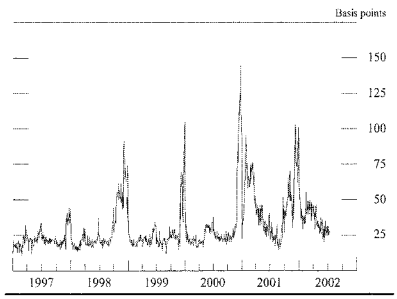
Yields on longer-maturity bonds issued by investment-grade corporations have stayed close to their lows of the past ten years, but speculative-grade yields remained near the high end of their range since the mid-1990s. Spreads relative to Treasury yields have widened most recently for both investment- and speculative-grade bonds as concerns about corporate earnings reporting intensified. Such concerns have also played a prominent role in the commercial paper market, especially early

Corporate bond yields



NOTE. The data are monthly averages and extend through June 2002. The AA rate is calculated from bonds in the Merrill Lynch AA index with seven to ten years remaining maturity. The high-yield rate is the yield on the Merrill Lynch 175 high-yield index.

Spread of low-tier CP rates over high-tier CP rates

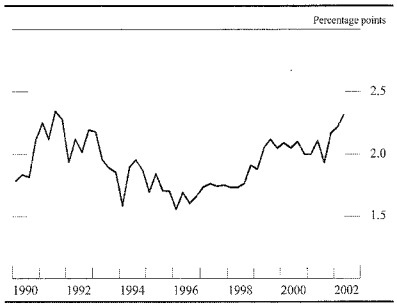


NOTE. The data are daily and extend through July 10, 2002. The series shown is the difference between the rate on A2/P2 nonfinancial commercial paper and the AA rate.

this year, when investors, who had become increasingly worried about accounting scandals, imposed high premiums on lower quality borrowers. Subsequently, however, many such borrowers either left the commercial paper market or reduced their reliance on commercial paper financing, and the average yield spread on second-tier commercial paper over top-tier paper has narrowed considerably.

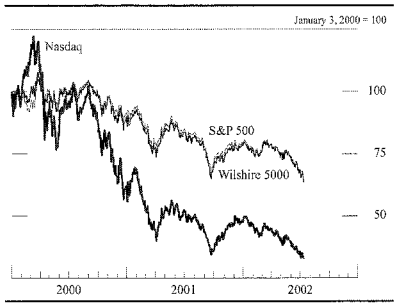
Interest rates on car loans have changed little, on net, this year, and mortgage rates have moved lower. However, according to the Federal Reserve's Survey of Terms of Business Lending, interest rates on C&I loans at domestic banks have moved a bit higher this year, as banks have raised the spread of the average interest rate on business loans over the target federal funds rate. The wider spread reflects higher risk premiums on C&I loans to lower-quality borrowers; spreads for higher-quality borrowers have changed little on net.

Spread of average business loan rate over the intended federal funds rate



NOTE. The data are for loans made by domestic commercial banks and are based on a survey conducted in the middle month of each quarter; the final observation is for 2002:Q2.
SOURCE. Federal Reserve Survey of Terms of Business Lending.

Major stock price indexes

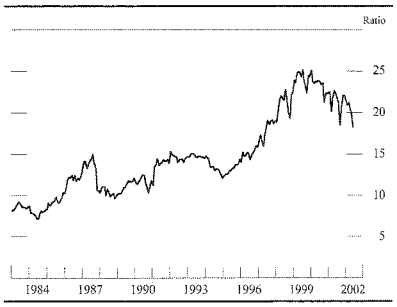


NOTE. The data are daily and extend through July 10, 2002.

Equity Markets

After falling in January in reaction to pessimistic assessments of expected business conditions over the coming year—especially in the tech sector—stock prices rebounded smartly toward the end of the first quarter on stronger-than-expected macroeconomic data. Most first-quarter corporate earnings releases met or even exceeded market participants' expectations, but many firms included sobering guidance on sales and earnings prospects in those announcements. These warnings, combined with mounting questions about corporate accounting practices, worries about threats of domestic terrorism, and escalating geopolitical tensions, have taken a considerable toll on equity prices since the end of March. On net, all major equity indexes are down substantially so far this year. Share prices in the telecom and technology sectors have performed particularly poorly, and, on July 10, the Nasdaq was 31 percent lower than

Price-earnings ratio for the S&P 500



NOTE. The data are monthly and extend through June 2002. The ratio is based on I/B/E/S consensus estimates of earnings over the coming twelve months.

at the end of 2001. The Wilshire 5000, a broad measure of equity prices, fell 18-1/2 percent over the same period, returning to a level 40 percent below its historical peak reached in March 2000.

Declining share prices pulled down the price-earnings ratio for the S&P 500 index (calculated using operating profits expected over the coming year). Nonetheless, the ratio remained elevated relative to its typical values before the mid-1990s, suggesting that investors continued to anticipate rapid long-term growth in corporate profits.

Monetary Policy Instruments

At its March 19 meeting, the FOMC assessed the priorities, given limited resources, it should attach to further studies of the feasibility of outright purchases for the System Open Market Account (SOMA) of mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA-MBS) and the addition of foreign sovereign debt securities to the list of collateral eligible for U.S. dollar repurchase agreements by the System. As noted in the February and July 2001 Monetary Policy Reports to the Congress, such alternatives could prove useful if outstanding Treasury debt obligations were to become increasingly scarce relative to the necessary growth in the System's portfolio, and the FOMC had requested that the staff explore these options. Noting that many of the staff engaged in these studies were also involved in contingency planning, which had been intensified after the September 11 attacks, the FOMC decided to give the highest priority to such planning. Federal budgetary developments over the past year meant that constraints on Treasury debt supply would not become as pressing an issue as soon as the FOMC had previously thought. Still, given the inherent uncertainty of budget forecasts, the likely significant needs for large SOMA operations in coming years, and the lead times required to implement new procedures, the FOMC decided that the exploratory work on the possible addition of outright purchases of GNMA-MBS should go forward once it was possible to do so without impeding contingency planning efforts.

The Federal Reserve also addressed possible changes to the structure of its discount window facility. On May 17, 2002, the Federal Reserve Board released for public comment a proposed amendment to the Board's Regulation A that would substantially revise its discount window lending procedures. Regulation A currently authorizes the Federal Reserve Banks to operate three main discount window programs: adjustment credit, extended credit, and seasonal credit. The proposed amendment would establish two new discount window programs called primary credit and secondary

credit as replacements for adjustment and extended credit. The Board also requested comment on the continued need for the seasonal program but did not propose any substantive changes to the program. The proposal envisions that primary credit would be available for very short terms, ordinarily overnight, to depository institutions that are in generally sound financial condition at an interest rate that would usually be above short-term market interest rates, including the federal funds rate; currently, the discount rate is typically below money market interest rates. The requirement that only financially sound institutions should have access to primary credit should help reduce the stigma currently associated with discount window borrowings. In addition, because the proposed discount rate structure will eliminate the incentive that currently exists for depository institutions to borrow to exploit a positive spread between short-term money market rates and the discount rate, the Federal Reserve will be able to reduce the administrative burden on borrowing banks. As a result, depository institutions should be more likely to turn to the discount window when money markets tighten significantly, enhancing the window's ability to serve as a marginal source of reserves for the overall banking system and as a backup source of liquidity for individual depository institutions. Secondary credit would be available, subject to Reserve Bank approval and monitoring, for depository institutions that do not qualify for primary credit. The proposed amendment is intended to improve the functioning of the discount window and the money market more generally. Adoption of the proposal would *not* entail a change in the stance of monetary policy. It would not require a change in the FOMC's target for the federal funds rate and would not affect the overall level of market interest rates. The comment period on the proposal ends August 22, 2002. If the Board then votes to revise its lending programs, the changes likely would take place several months later.

Debt and Financial Intermediation

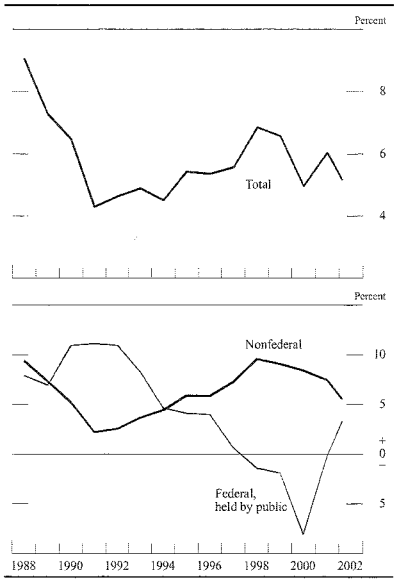
Growth of the debt of domestic nonfinancial sectors other than the federal government is estimated to have slowed during the first half of 2002, as businesses' needs for external funds declined further owing to weak capital spending, continuing inventory liquidation, and rising profits. In addition, growth in consumer credit moderated following a surge in auto financing late last year. On balance, nonfederal debt expanded at a 5-1/2 percent annual rate in the first quarter of the year after growing 7-1/2 percent in 2001. In contrast, the stock of federal debt held by the public, which had contracted slightly in 2001, grew 3-1/4 percent at an annual rate in the first quarter and expanded further in the second quarter, as federal tax revenues fell short of expectations and government spending increased substantially. The sharp rise in federal debt outstanding followed a few years of declines.

The proportion of total credit supplied by depository institutions over the first half of the year is estimated to have been near its lowest value since 1993. Although banks have continued to acquire securities at about the same rapid pace observed in 2001, the shift in household and business preferences toward longer-term sources of credit greatly reduced the demand for bank loans. As noted, banks' loans to businesses ran off considerably, as corporate borrowers turned to the bond market in volume to take advantage of favorable long-term interest rates. Growth of real estate loans

slowed markedly this year, partly as outlays for nonresidential structures declined, but growth of consumer loans was fairly well maintained. With some measures of credit quality in the business and household sectors still pointing to pockets of potential strain, loan-loss provisions remained high at banks and weighed on profits. Nonetheless, bank profits in the first quarter stayed in the elevated range observed over the past several years, and virtually all banks—98 percent by assets—remained well capitalized.

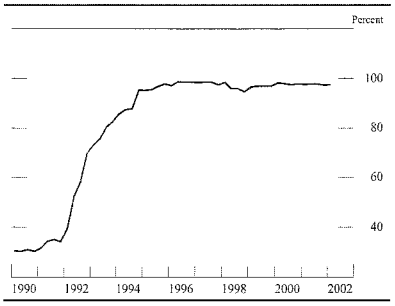
Among nondepository financial intermediaries, government-sponsored enterprises (GSEs) curtailed their net lending (net acquisition of credit market instruments) during the first quarter of the year, but available data suggest that insurance companies more than made up for the shortfall. The GSEs appeared to continue to restrain their net lending in the second quarter, in part as yields on mortgage-backed securities, which are a major component of their holdings of financial assets, compared less favorably to yields on the debt they issue. Net lending by insurance providers in the first quarter was especially strong among life insurance companies, which experienced a surge in sales late last year in the aftermath of the September 11 terrorist attacks. Net lending by the GSEs amounted to 14 percent of the net funds raised by both the financial and nonfinancial sectors in the credit markets in the first quarter of 2002, and the figure for insurance companies was 10 percent; depository credit accounted for 13 percent of all net borrowing over the same period.

Change in domestic nonfinancial debt



NOTE. For 2002, change is from 2001:Q4 to 2002:Q1 at an annual rate. For earlier years, the data are annual and are computed by dividing the annual flow for a given year by the level at the end of the preceding year. The total consists of nonfederal debt and federal debt held by the public. Nonfederal debt consists of the outstanding credit market debt of state and local governments, households, nonprofit organizations, nonfinancial businesses, and farms. Federal debt held by the public excludes securities held as investments of federal government accounts.

Percent of all U.S. commercial bank assets at well-capitalized banks

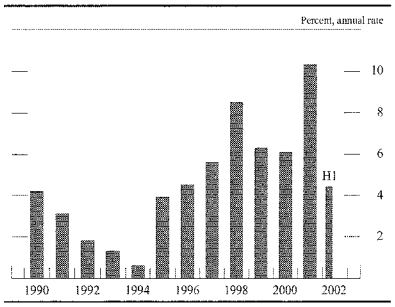


NOTE. The data are quarterly and extend through 2002:Q1. Capital status is determined using the regulatory standards for the leverage, tier 1, and total capital ratios.

Monetary Aggregates

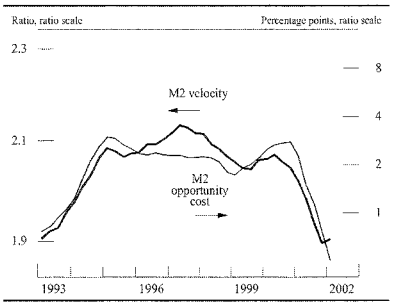
The broad monetary aggregates decelerated considerably during the first half of this year. M2 rose 4-1/2 percent at an annual rate after having grown 10-1/4 percent in 2001. Several factors contributed to the slowing in M2. Mortgage refinancing activity, which results in prepayments that temporarily accumulate in deposit accounts before being distributed to investors in mortgage-backed securities, moderated over the first half of this year. In addition, the opportunity cost of holding M2 assets has leveled out in recent months, so the increase in this aggregate has been more in line with income. Because the rates of return provided by many components of M2 move sluggishly, the rapid declines in short-term market interest rates last year temporarily boosted the attractiveness of M2 assets. In recent months, however, yields on M2 components have fallen to more typical levels relative to short-term market interest rates. Lastly, precautionary demand for M2, which was high in the aftermath of last year's terrorist attacks, seems to have unwound in 2002, with investors shifting their portfolios back toward longer-term assets such as equity and bond mutual funds. With growth in nominal GDP picking up significantly this year, M2 velocity—the ratio of nominal GDP to M2—rose about 1-1/2 percent at an annual rate in the first quarter of 2002, in sharp contrast to the large declines registered throughout 2001.

M2 growth rate



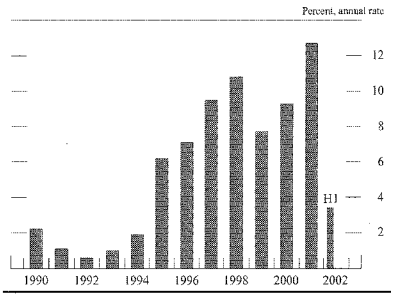
NOTE. M2 consists of currency, travelers checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds.

M2 velocity and opportunity cost



NOTE. The data are quarterly and extend through 2002:Q1. The velocity of M2 is the ratio of nominal gross domestic product to the stock of M2. The opportunity cost of holding M2 is a two-quarter moving average of the difference between the three-month Treasury bill rate and the weighted average return on assets included in M2.

M3 growth rate



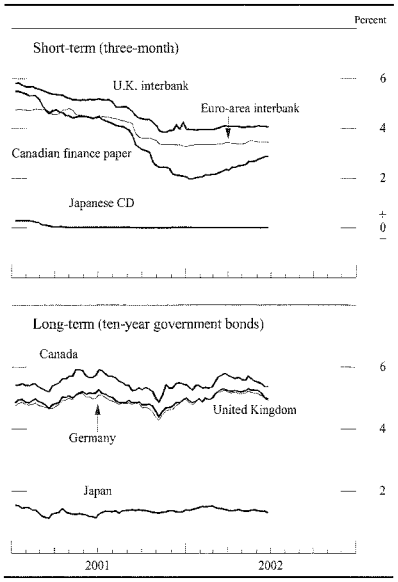
NOTE. M3 consists of M2 plus large-denomination time deposits, balances in institutional money market funds, repurchase-agreement liabilities (overnight and term), and eurodollars (overnight and term).

M3—the broadest monetary aggregate—grew 3-1/2 percent at an annual rate through the first six months of the year after rising 12-3/4 percent in 2001. Most of this deceleration, apart from that accounted for by M2, resulted from the weakness of institutional money market funds, which declined slightly, after having surged about 50 percent last year. Yields on these funds tend to lag market yields somewhat, and so the returns on the funds, like those on many M2 assets, became less attractive as their yields caught up with market rates.

International Developments

Signs that economic activity abroad had reached a turning point became clearer during the first half of 2002, but recovery has been uneven and somewhat tepid on average in the major foreign industrial countries. Improving conditions in the high-tech sector have given a boost to some emerging-market economies, especially in Asia, but several Latin American economies have been troubled by a variety of adverse domestic developments. Foreign financial markets became increasingly skittish during the first half of the year amid worries about global political and economic developments, including concerns about corporate governance and accounting triggered by U.S. events. Oil prices reversed a large part of their 2001 decline.

Foreign interest rates



NOTE. The data are weekly and extend through July 5, 2002.

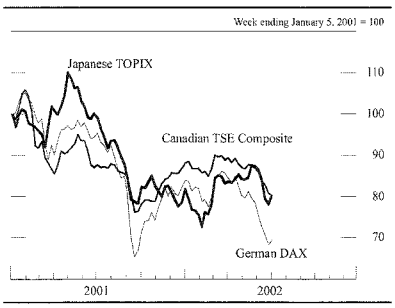
During the first half, monetary authorities in some foreign countries where signs of recovery were most evident and possible future inflation pressures were becoming a concern—Canada, Australia, New Zealand, and Sweden, among others—began to roll back a portion of last year's easing, raising expectations that policy tightening might become more widespread. However, policy was held steady at the European Central Bank (ECB) and the Bank of England. The Bank of Japan (BOJ) maintained short-term interest rates near zero and kept balances of bank deposits at the BOJ at elevated levels. Yield curves in most foreign industrial countries became a bit steeper during the first

quarter as long-term rates rose in reaction to news suggesting stronger U.S. growth and improving prospects for global recovery. Since then, long-term rates have edged lower, on balance, in part as investors shifted out of equity investments. Foreign equities performed well in most countries early in the year, but share prices in many countries have fallen since early in the second quarter—in some cases more steeply than in the United States. The broad stock indexes for the major industrial countries are down since the beginning of the year, except in Japan, where stock prices, on balance, are about unchanged. High-tech stocks have been hit especially hard.

During the first quarter of 2002, the foreign exchange value of the dollar (measured by a trade-weighted index against the currencies of major industrial countries) appeared to react primarily to shifting market views about the relative strength of the U.S. recovery and its implications for the timing and extent of future monetary tightening. Despite some fluctuations in this period, the dollar stayed fairly close to the more than sixteen-year high reached in January. In the second quarter, however, the dollar trended downward as earlier market enthusiasm about U.S. recovery dimmed. Concerns about profitability, corporate governance, and disclosure at U.S. corporations appeared to dampen the attraction of U.S. securities to investors, as did worries that the United States was particularly vulnerable to the consequences of global geopolitical developments. With U.S. investments perceived as becoming less attractive, the financing requirements of a large and growing U.S. current account deficit also seemed to emerge as a more prominent negative factor. The dollar has lost more than 9 percent against the major currencies since the end of March and is down, on balance, more than 8 percent so far in 2002. In contrast, the dollar has gained about 2 percent this year, on a weighted-average basis, against the currencies of our other important trading partners.

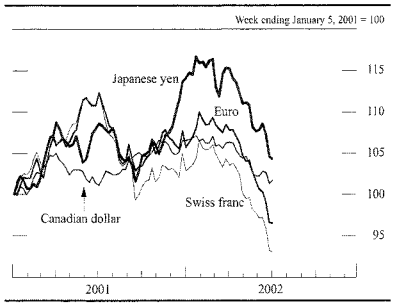
The dollar's exchange rate against the Japanese yen was quite volatile in the first half and, on balance, the dollar has fallen more than 10 percent since the beginning of the year. Although Japan's domestic economy continued to struggle with deflation and severe structural problems, including

Foreign equity indexes



NOTE. The data are weekly and extend through July 5, 2002.

U.S. dollar exchange rate against selected currencies



NOTE. The data are weekly and extend through July 5, 2002. Exchange rates are in foreign currency units per dollar.

mounting bad loans in the financial sector and growing bankruptcies, some indicators (including strong reported first-quarter GDP, a firming of industrial production, and a somewhat better reading on business sentiment in the BOJ's second-quarter Tankan survey) suggested that a cyclical recovery has begun. The yen's rise occurred despite downgradings of Japan's government debt by leading rating services in April and May and several episodes of intervention sales of yen in foreign exchange markets by Japanese authorities in May and June. Japanese stock prices, which had fallen to eighteen-year lows in early February, turned up later as economic prospects became less gloomy. At midyear, the TOPIX index was about where it was at the start of the calendar year.

After declining in the final quarter of 2001, euro-area GDP appears to have increased in the first half, though at only a modest rate. Exports firmed and inventory destocking appeared to be winding down, but consumption remained weak. The pace of activity varied across countries, with growth in Germany—the euro area's largest economy—lagging behind. Despite lackluster area-wide growth, concerns about inflation became increasingly prominent. For most of the first half, euro-area headline inflation persisted at or above the ECB's 2 percent target limit, partly on higher energy and food price inflation; even excluding the effects of those two components, inflation picked up somewhat during the period. Inflation concerns also were fanned by difficult labor market negotiations this spring, but the strength of the euro may blunt inflationary pressures to some extent. The new euro notes and coins were introduced with no noticeable difficulties at the beginning of the year, but the euro drifted down against the dollar for several weeks thereafter. Since then, however, the euro has reversed direction and moved steadily higher. On balance, the dollar has lost nearly 11 percent against the euro so far in 2002.

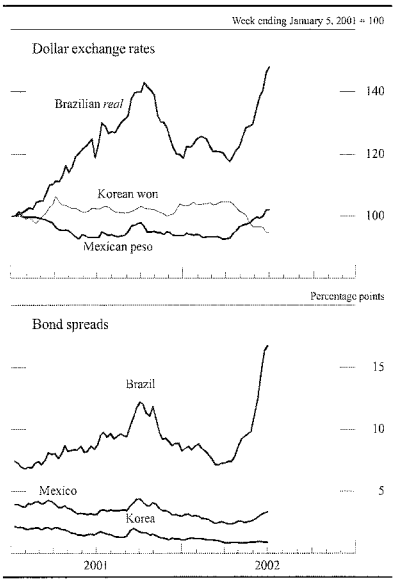
The United Kingdom seemed to weather last year's slump better than most industrial countries, as strength in consumption counteracted weakness in investment and net exports, though growth did weaken in the last quarter of 2001 and into the first quarter of 2002. Notable increases in industrial production and continued strength in the service sector indicate that growth picked up in the second quarter. Household borrowing has increased briskly, supported by rapid increases in housing prices, and unemployment rates remain near record lows. At the same time, retail price inflation has remained below the Bank of England's 2-1/2 percent target. Sterling has fallen nearly 5 percent against the euro since the beginning of the year, while it has gained more than 6 percent against the dollar. Elsewhere in Europe, the exchange value of the Swiss franc has been driven up by flows into Swiss assets prompted in part by uncertainties about global political developments. The Swiss National Bank eased its official rates in May to counteract this pressure and provide support for the Swiss economy.

Economic recovery appears to be well under way in Canada. Real GDP increased 6 percent at an annual rate in the first quarter, and other indicators point to continued strong performance in the second quarter. Canadian exports—particularly automotive exports—benefitted early in the year from the firming of U.S. demand, but the expansion has become more widespread, and employment growth has been strong. Although headline consumer price inflation has remained in the bottom half

of the Bank of Canada's target range of 1 percent to 3 percent, core inflation has crept up this year. In April, the Bank of Canada increased its overnight rate 25 basis points, citing stronger-than-expected growth in both the United States and Canada, and it increased that rate again by the same amount in June. The Canadian dollar, which had been at a historically low level against the U.S. dollar in January, moved up quite steeply in the second quarter and has gained about 5 percent for the year so far.

The Mexican economy was hit hard by the global slump in 2001 and especially by the weaker performance of the U.S. economy. Mexican exports stabilized early this year as U.S. activity picked up, and other indicators also now suggest that the Mexican economy is beginning to recover. In February, despite the weak level of activity at the time, the Bank of Mexico tightened monetary policy to keep inflation on track to meet its 4-1/2 percent target for 2002, and the Mexican peso moved up a bit against the dollar during February and March. In April, with inflation apparently under control, the central bank eased policy, and since then the peso has moved down substantially. Against the dollar, the decline since the beginning of the year has amounted to almost 7 percent. After rising through April, Mexican share prices also fell sharply, leaving them at midyear about unchanged from their end-2001 levels.

Selected emerging markets



NOTE. The data are weekly and extend through July 5, 2002. Exchange rates (top panel) are in foreign currency units per dollar. Bond spreads (bottom panel) are the J.P. Morgan Emerging Market Bond Index (EMBI+) spreads over U.S. Treasuries.

Financial and economic conditions deteriorated significantly in Argentina this year. The Argentine peso was devalued in January and then allowed to float in early February; since then, it has lost more than 70 percent of its value versus the dollar. The peso's fall severely strained balance sheets of Argentine issuers of dollar-based obligations. Various stop-gap measures intended to restrict withdrawals from bank accounts and to force conversion of dollar-denominated loans and deposits into peso-denominated form put banks and depositors under further stress. Meanwhile, economic activity has continued to plummet, and the government has struggled to gain support for reforms that would address chronic fiscal imbalances. Since late 2001, the government has been servicing its

obligations only to its multilateral creditors, and spreads on Argentina's international debt have soared to more than 65 percentage points.

In recent months financial markets elsewhere in the region have become more volatile. Brazilian markets have been roiled by political uncertainties related to national elections coming in the fall. Attention has focused on vulnerabilities associated with Brazil's large outstanding stock of debt, much of which is short-term. Since April, the value of the *real* against the dollar has fallen nearly 20 percent, and Brazilian spreads have widened substantially. Several other South American countries, including Uruguay and Venezuela, also have been beset by growing financial and economic problems.

Asian economies that rely importantly on exports of computers and semiconductors (Korea, Singapore, Malaysia, and Taiwan) have grown quite vigorously so far this year, a buoyancy reflecting in part the recent turnaround of conditions in the technology sector and stronger U.S. growth. The currencies of several countries of this group have moved up against the dollar. In Korea, the expansion has been more broad-based, as domestic demand was fairly resilient during the recent global downturn and has remained firm. China, which is less dependent on technology exports, has continued to record strong growth as well. Other countries in the region also have started to recover from steep slowdowns or contractions in 2001, although Hong Kong has continued to be troubled by the collapse of property prices. Most stock markets in the region have recorded gains so far this year.

Chairman Greenspan subsequently submitted the following in response to written questions received from Congresswoman Jan Schakowsky following the July 17, 2002, hearing before the Committee on Financial Services:

Pending Bank Merger

I want to ask you about a pending merger that if approved will have an extremely negative impact on my constituents and people around the country. Cincinnati BancGroup, which is associated with Check'n Go the nation's second largest payday lender, wants to acquire Bank of Kenney so they can originate payday loans throughout Illinois at 57 locations. This is a ploy to avoid state regulations that curtail predatory payday lenders. By becoming a state-chartered bank, Check'n Go will be able to offer payday loans without being concerned about payday lending laws in Illinois and elsewhere.

This merger raises significant safety and soundness problems because payday lenders are notorious for making loans without ability to pay. Payday lenders like Check'n Go should not be given the same privileges as banks.

I strongly recommend that you reject Cincinnati BancGroup's acquisition of Bank of Kenney. Can you tell me if you will allow the merger and if you will at the very least grant a public hearing before making a final determination?

The Board is still reviewing Cincinnati BancGroup's application to acquire the Bank of Kenney. Your comments will be made part of the record and considered by the Board in connection with the application. The Board has requested additional information from the applicant, and no decision will be made regarding the disposition of the application or the requests for a public meeting until that additional information has been received and evaluated. In its review of the application, the Board is required to consider financial, managerial, and competitive factors, as well as the effect of the proposal on the convenience and needs of the communities to be served by the Bank of Kenney, including a review of the bank's performance under the Community Reinvestment Act. The Board will also consider the proposal's compliance with relevant state law.

Corporate governance:

I want to thank you for your continued leadership on the stock option expense issue. Investors, pension holders, and workers will have more accurate information if corporations list stock options as an expense. The abuse of stock option plans has undermined the stability of our financial markets. It is all too clear that executive stock option plans contributed to WorldCom's bankruptcy and the failure of other publicly held companies such an Enron.

Stock options have also helped push the ratio of executive pay to average worker pay from 41 to 1 in 1980 to 419 to 1 in 1998. I think we need to limit executive stock option plans. Top executives on average receive 20% of stock option plans. Do you support limiting executive stock option plans to 10% of a company's stock and 1% to any individual?

Do you support preventing executives from retaining less than 75% of their restructured stock options for as long as they are with their company?

A number of companies in recent months have responded to investor demands and announced plans to count as an expense the value of stock options granted to employees. Recent actions and statements by the International Accounting Standards Board and Financial Accounting Standards Board also have added to the pressure on companies to expense stock options.

The expensing of employee stock options, and thus the explicit recognition of their costs on the income statement, is likely to cause firms to more closely evaluate the size and structure of option packages awarded to executives and other employees. It is my opinion that once companies recognize stock option expenses, they will have ample incentive to structure option packages in ways to align the interests of management and shareholders. General Electric, Coca-Cola, and Amazon are among the companies that have recently announced that they will expense options and have indicated that the expensing of all types of options now gives them greater flexibility to offer option packages that provide better

incentives. Also, in response to increased investor scrutiny, companies are reviewing their policies regarding stock ownership by executives. Such policies include executive sales of shares received from exercising stock options and whether executives should hold substantial stock positions for as long as they are with their company.

07:08pm From-Rep.Schakowsky 202-226-5468 T-204 P.002/002 F-210

CLO: #G - 58
CCS: 02- 3465
RECVD: 7/29/02

July 17, 2002
Financial Services Committee Hearing
Congresswoman Jan Schakowsky
For Record

The Honorable Alan Greenspan, Chairman, The Federal Reserve

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