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MONETARY POLICY AND THE STATE OF THE ECONOMY

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BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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MONETARY POLICY AND THE STATE OF THE ECONOMY

Thursday, February 17, 2005

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

The committee met, pursuant to call, at 10:04 a.m., in Room 2128, Rayburn House Office Building, Hon. Michael Oxley [chairman of the committee] presiding.

Present: Representatives Oxley, Leach, Baker, Pryce, Castle, King, Lucas, Ney, Kelly, Paul, Gillmor, Ryun, Manzullo, Jones, Biggert, Shays, Miller of California, Tiberi, Kennedy, Feeney, Hensarling, Garrett, Barrett, Harris, Gerlach, Pearce, Neugebauer, Price, Fitzpatrick, Davis of Kentucky, McHenry, Frank, Kanjorski, Waters, Sanders, Maloney, Gutierrez, Velazquez, Watt, Ackerman, Carson, Sherman, Meeks, Lee, Moore of Kansas, Capuano, Ford, Hinojosa, Crowley, Clay, Israel, McCarthy, Baca, Matheson, Lynch, Miller of North Carolina, Scott, Davis of Alabama, Green, Cleaver, Bean, Wasserman Schultz, and Moore of Wisconsin.

The CHAIRMAN. [Presiding.] The committee will come to order.

We are indeed honored again to have Chairman Greenspan, Chairman of the Fed, testify before the committee.

And I thank, Mr. Chairman, you in advance for your testimony and the time that you are going to spend with us today.

Mr. Chairman, we all know that the economy is nearly completely recovered. We have had four strong quarters of GDP growth, and the total number of jobs, a little more than 130 million, is back to its peak from the winter of 2000-2001.

Productivity remains impressive, and the market is strong, with the Dow looking as if it might touch the 11,000 mark again.

Job creation remains robust, and the unemployment rate, at 5.2 percent, is at the same level it stood at in 1997, before the unprecedented period in which it briefly went below 4 percent, a rate few imagine we will ever see again.

So, Mr. Chairman, thanks to the twin injections of liquidity, the President's tax cuts, and the Fed's lowering of short-term interest rates, our American economy has once again shown itself to be resilient enough to withstand multiple shocks.

Aside from our strong current position, there are continued challenges ahead that we will discuss today. Among them are the trade deficit, the budget deficit, and Social Security.

Mr. Chairman, you are perhaps America's most famous budget hawk. You favor lower taxes as long as they are offset by spending cuts. I am sure you welcome the President's initiatives outlined in

his budget and in the State of the Union speech. The President has laid out a cost-cutting program, and he has faced the Social Security problem head on.

President Bush knows that the numbers don't lie, and they are clearly on the side of a need to reform the system.

Mr. Chairman, you led the commission that assisted in significant reform of Social Security under President Reagan in 1983, and I am certain all committee members await your views on this matter. We all know the facts, that in less than 15 years the system starts paying more out than it is paying in, and that if we don't do something quickly the options will be higher taxes, benefit cuts, or some blend of the two.

Chairman Greenspan, I stand in complete agreement with the President, and in important part the answer is personal accounts. From its creation, Social Security was never envisioned as the sole answer to an individual's retirement needs, but as a supplement.

However, now, two-thirds of its recipients rely on Social Security for at least half or more of their retirement income. That isn't good for them, and it isn't good for the country, in my view.

Mr. Chairman, I believe President Roosevelt, who created the Social Security system, felt the same way. As the Wall Street Journal has pointed out, in a speech to Congress in 1935 FDR anticipated the need to move beyond the pay-as-you-go financing method.

Chairman Greenspan, that is two presidents—the Democrat founder of Social Security and the Republican to whom it falls to save the Social Security system—in agreement on the issue of personal accounts.

There will be some heavy lifting to get the system right, of course, and this committee will be in support.

We have an obligation to America and to future generations to address this problem.

So, Mr. Chairman, in the week that baseball reports for spring training, I think we should view this effort as the start of a new season as well, a season in which Congress will step up to the plate with intelligent, long-term reform of Social Security.

We seek to extend the ownership society to all Americans, and let us broaden that concept of ownership to retirement.

With that, I am pleased to yield to the Ranking Member, the gentleman from Massachusetts, Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman.

I am in somewhat less agreement with the President than you are, although I don't wish to be totally in opposition.

And I must say I look forward to supporting the President in his attack on bloated and inefficient and wasteful farm subsidies, and I am sure I will have strong support from these free market conservatives on the other side as we attempt to bring the free market principles to the largest sector of the American economy from which they have long been absent.

With regard to Social Security, I do appreciate the Chairman making it very clear, as others have, that the question of private accounts and the question of the solvency of the system are, in fact, quite separate; that the President himself has acknowledged this.

So, yes, there are questions about solvency. They are separate from private accounts. And I will return to them.

But I want to talk about what I think is the overarching problem in the American economy today. And I want to congratulate the Chairman—there are some advantages to going second when the Chairman testifies, and one is that we don't have to worry about poaching on his right to be the presenter of his own ideas. He testified yesterday in the Senate.

So I am not reluctant to call attention to page five of his testimony today in the last couple of paragraphs.

And I think what we have is a serious problem in America.

The economy has begun again to grow, but it is growing in a way that is exacerbating inequality. We are getting, as the Chairman has noted—although there are some hopes this may improve in the future—fewer jobs for each additional unit of GDP.

We have a failure of wages on the whole to rise proportionate to the economy. We have—although it isn't commented on here, we have discussed it—the lack of health care and the falling away of health care for many people.

Some have said, "Well, don't worry about inequality; that is just a sign of pettiness. As long as everything is getting better, why do you worry about inequality?"

And I want to call attention to the quite profound remarks of Chairman Greenspan on this subject when he talks about the problem that we now have where skilled workers' wages, skilled in terms of this economy, are increasing and we have got a greater differential between people who are skilled and people who aren't.

As he says, "If the skill composition of our work force meshed fully with the needs of our increasingly complex capital stock, wage-skill differentials would be stable—for the past 20 years, the supply of skilled, particularly highly skilled workers has failed to keep up with the persistent rise in demand for such skills. Conversely, the demand for lesser skilled workers has declined."

And this is quite profound.

"In a democratic society," you say, Mr. Chairman, "such a stark bifurcation of wealth and income trends among large segments of the population can fuel resentment and political polarization."

And I think you have pointed to a central problem, and you repudiate those who say don't worry about it. And I think you are right to worry about it, but here is my concern.

You then go on to say that one of the most important tasks for the social stability of this country, as well as our economic future—because as you note, a badly polarized society is going to be one in which efforts to move forward toward economic rationality will be resisted sometimes when they shouldn't be; a new rationality may creep in, an anger, a resistance to economic rationalization.

And what you say is we need to increase the skills of lesser skilled people, reduce the excess of lesser skilled workers, expedite the acquisition of skills by all students both through formal education, by on-the-job training.

I would add that it is also important, since we know this isn't going to happen instantly, that we alleviate the negative effects of this while it happens.

You are quite right to note that resentment will build up.

With all the success we could expect in education and on-the-job training, years will ensue before we make a substantial dent in this.

We have a couple of problems now.

Public policy, particularly recently, has cut back in precisely those areas that alleviate the impact of inequality. We are doing less for those who get less. We are cutting back there.

Similarly, our ability to go forward, the private sector will play a major role in on-the-job training and elsewhere. But no one expects people trying to make a profit to fund all of that.

Some significant part of that is going to have to be funded publicly through education, through community colleges, through payment through on-the-job training.

The problem we have is this. The Chairman said you are a very famous deficit hawk. You may be one of the few consistent deficit hawks left here in the capital because people's deficit hawkishness does appear to ebb and flow according to the programs.

If, however, we maintain the current situation in which we have a high priority on reducing the deficit and we continue in existence all of the tax cuts, then the inevitable consequence is very substantial reductions in public spending.

With defense out of this loop, with homeland security out of this loop, all of the programs that either alleviate the consequences of inequality or help us reduce this skill disparity in the future are under the gun.

And so I fear—this is a question I would address to you—how do we alleviate the effects of this inequality so that you reduce the negative feelings that you correctly point out are a result? And how do we increase our ability to get these skills to people; how do we improve education; how do we improve on-the-job training?

Money is not the only answer. But no one, I think, would say that you can do something of that magnitude in this society without additional resources.

And the dilemma is, if you are going to deal with deficit reduction entirely through reductions in domestic public spending, at the state and local level and at the federal level, I think you have a situation in which the situation which you quite eloquently decry will get worse rather than better. And that is a subject I hope to pursue.

The CHAIRMAN. Gentleman's time has expired.

Now, recognize the chairwoman of the Domestic and International Monetary committee, the gentlelady from Ohio, Mrs. Pryce.

Ms. PRYCE. Thanks, Chairman Oxley.

Welcome, Chairman Greenspan, and thank you for taking the time to discuss with us your insights on monetary policy and many other things I am sure we will hear from you.

I am especially happy to be returning to the committee for these very special opportunities. This will be an exciting and very busy year for us. As you know, the President has outlined an aggressive second-term agenda, which includes Social Security, tax and legal reform.

Social Security is an issue that, if addressed today, could safeguard the future of millions of young people, and, if ignored, could become the biggest shortcoming of a generation.

As you noted yesterday, the existing structure isn't working, and I am sure that this committee will have plenty of questions on this issue, and I look forward to hearing your answers later in the morning.

Last month, the Bureau of Labor Statistics released revised data showing gains of 2.7 million jobs for 20 straight months, with those gains beginning of June of 2003, which was 3 months earlier than previously estimated.

My home state of Ohio, which has been hit hard by manufacturing job loss over the last 2 years, has recently seen an increase in workers returning to the job market, and Ohio is not alone in that recovery. The national unemployment rate ticked down 0.2 percentage points in January, the lowest rate since September of 2001.

Mr. Chairman, reflection on the measured rise in inflation taken by FOMC and the role you had in it, I am particularly interested in hearing you address the role raising rates will have on manufacturing states like Ohio, where the manufacturing sector is a large part of the economy.

Also, I would like to hear how you feel it will affect the housing market, which has been such a stable influence in the economy over the last several years.

I appreciate, Mr. Chairman, your support and encouragement of deregulation and technological innovation. You have said before that continued movement on these fronts, along with maintenance of a rigorous and evolving education system, will drive our economy into the future.

I am particularly interested to hear you speak in more length on the demands put on our education system. You have voiced concern in the past that while our fourth graders outperform their peers around the world in math and science, our eighth graders are about average, and our 12th graders rank near the bottom.

How can this happen?

I hope to discuss with you now and in the future possible reasons for this failure and how best we resolve our education system to graduate more skilled workers and how that will affect our economy.

I am also concerned about the state of financial literacy among all Americans.

I am concerned over the state of our nation's savings rate, something I was glad to hear you address in yesterday's hearing and I hope you discuss further today.

We must grow our economy and not our government, and we must change the current system of Social Security to ensure its solvency for our children.

Through fiscal discipline and by implementing policies that increase the rate of personal savings and retirement security, we can provide financial freedom to all Americans and allow them to take ownership over their families' future and prosperity.

I thank you, Mr. Chairman, for your appearance today. I look forward to your testimony.

And with that, I yield back, Mr. Chairman.

The CHAIRMAN. Thank the gentlelady.

Before I recognize the Ranking Member of the subcommittee, I want to first recognize a good friend, former Ranking Member from the committee, John LaFalce.

Good to have you back, John. And probably looks a little different on that side of the dais.

The gentlelady from New York, Ms. Maloney.

Mrs. MALONEY. Thank you. It is always a pleasure to welcome Chairman Greenspan.

I look very much forward to your testimony on the economy and monetary policy, but I would also like to get your views on some broader issues regarding the sharp turn in economy policy from the late 1990s, when we eliminated the deficit and started to pay down the debt, to now, when once again we see deficits as far as the eye can see and mounting debt.

The state of the economy at present deeply disturbs me. This administration has repeatedly set records for debts and deficits.

In the 1990s, we were looking toward a budget surplus of $5.6 trillion over 10 years. Now we have a budget deficit of over $400 billion, with no end in sight. We have raised the debt limit three times in this administration, and our debt now stands at well over $7 trillion, an unfortunate record.

That means that $26,000 is owed by every man, woman and child in America, the highest it has ever been.

Their newest record is an all-time high trade deficit for last year: nearly $618 billion. The debt and deficit policies of this administration place a severe burden on our economy because we are borrowing huge sums from foreign countries. Some of our allies are warning us that they are approaching the limit of their willingness to buy our debt.

It has gotten to the point where some European bankers who were in Washington, D.C., last week were asking if the dollar will continue to be the reserve currency of the world.

So I want to know, Mr. Greenspan, are you really comfortable with the policies of what I can only call the debt-and-deficit Republicans who are now running our economic policy?

Chairman Greenspan, your testimony explains why the Federal Reserve is likely to continue what it calls its measured policy of interest rate increases, but I would hope that you would take a second look at this policy. I am concerned that we are not seeing the kind of robust job growth we would normally see in a strong economy.

The Bush administration is proud of its job creation over the past 20 months, but when you break it down, we are only gaining 140,000 jobs per month, barely enough to keep pace with normal growth in the labor force.

Most indicators of workers' wages show that they are barely keeping up with inflation, and wages may actually be falling at the lower end of wage distribution. That hardly sounds like an economy that needs to be slowed by interest rate hikes.

On the question of debt, I am sure you cannot be happy with what has happened to the federal budget deficit since 2001. And frankly, Mr. Chairman, you had something to do with that, when

you gave the green light to the administration's tax policies in 2001.

But you have repeatedly said that persistent budget deficits are toxic to the economy and that deficit reduction is one of the best strategies to have for raising national savings and boosting future standards of living. And I completely agree with you on that.

That brings me to the administration's proposal for phasing out Social Security by privatizing it. I know you share the President's philosophy about privatized accounts, but you cannot share his budget arithmetic.

Experts estimate that the creation of privatized accounts would add upwards of $4 trillion to $5 trillion to our national debt in the first 20 years alone. I believe that you told the Senate yesterday that the privatized accounts proposal would do absolutely nothing to address the solvency of Social Security and would do nothing to boost national savings, yet it adds new problems to our debt.

I believe you also said that no one knows how financial markets would respond to all of that debt coming on the market.

So I ask mainly what possible benefit could there be to plunging ahead with such a reckless policy when we already have a deficit and debt problem that is out of control?

As always, I look forward to your testimony.

The CHAIRMAN. The gentlelady's time has expired.

We now turn to the distinguished Chairman of the Federal Reserve. Chairman Greenspan, welcome back to the committee. And we appreciate your spending some time with us. And take as much time as you would like.

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

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I request that the full text of my remarks be included for the record.

The CHAIRMAN. Without objection.

Mr. GREENSPAN. Mr. Chairman and members of the committee, in the seven months since I last testified before this committee, the U.S. economic expansion has firmed; overall inflation has subsided and core inflation has remained low.

Over the first half of 2004, the available information increasingly suggested that the economic expansion was becoming less fragile and that the risk of an undesirable decline in inflation had greatly diminished. Toward midyear, the Federal Reserve came to the judgment that the extraordinary degree of policy accommodation that had been in place since the middle of 2003 was no longer warranted and in the announcement released at the conclusion of our May meeting signaled that a firming of policy was likely.

The Federal Open Market Committee began to raise the federal funds rate at its June meeting, and the announcement following that meeting indicated the need for further, albeit gradual, withdrawal of monetary policy stimulus.

Around the same time, incoming data suggested a lull in activity as the economy absorbed the impact of higher energy prices. Much as had been expected, this soft patch proved to be short-lived. Accordingly, the Federal Reserve has followed the June policy move with similar actions at each meeting since then, including our most

recent meeting earlier this month. The cumulative removal of policy accommodation to date has significantly raised measures of the real federal funds rate, but by most measures it remains fairly low.

The evidence broadly supports the view that economic fundamentals have steadied. Consumer spending has been well maintained over recent months, buoyed by continued growth in disposable personal income, gains in net worth, and accommodative conditions in credit markets. Households have recorded a modest improvement in their financial position over this period, to the betterment of many indicators of credit quality.

For their part, business executives apparently have become somewhat more optimistic in recent months. Capital spending and corporate borrowing have firmed noticeably, but some of the latter may have been directed to finance the recent backup in inventories. Mergers and acquisitions, though, have clearly perked up.

Even in the current, much improved environment, however, some caution among business executives remains. Although capital investment has been advancing at a reasonably good pace, it has nonetheless lagged the exceptional rise in profits and internal cash flow.

As opposed to the lingering hesitancy among business executives, participants in financial markets seem very confident about the future and, judging by the exceptionally low level of risk spreads in credit markets, quite willing to bear risk.

This apparent disparity in sentiment between business people and market participants could reflect the heightened additional concerns of business executives about potential legal liabilities, rather than a fundamentally different assessment of macroeconomic risks.

Turning to the outlook for costs and prices, productivity developments will likely play a key role. The growth of output per hour slowed over the past half year, giving a boost to unit labor costs after 2 years of declines.

Going forward, the implications for inflation will be influenced by the extent and persistence of any slowdown in productivity.

To date, with profit margins already high, competitive pressures have tended to limit the extent to which cost pressures have been reflected in higher prices.

The inflation outlook will also be shaped by developments affecting the exchange rate of the dollar and oil prices. Although the dollar has been declining since early 2002, exporters to the United States apparently have held dollar prices relatively steady to preserve their market share, effectively choosing to absorb the decline in the dollar by accepting a reduction in their profit margins.

However, the recent somewhat quickened pace of increases in U.S. import prices suggests that profit margins of exporters to the United States have contracted to the point where foreign shippers may exhibit only limited tolerance for additional reductions in margins should the dollar decline further.

The sharp rise in oil prices over the past year has no doubt boosted firms' costs and may have weighed on production, particularly given the sizable permanent component of oil price increases suggested by distant-horizon oil futures contracts.

However, the share of total business expenses attributable to energy costs has declined appreciably over the past 30 years, which has helped to buffer profits and the economy more generally from the adverse effect of high oil and natural gas prices.

All told, the economy seems to have entered 2005 expanding at a reasonably good pace, with inflation and inflation expectations well anchored.

On the whole, financial markets appear to share this view.

In particular, a broad array of financial indicators convey a pervasive sense of confidence among investors.

Over the past two decades, the industrial world has fended off two severe stock market corrections, a major financial crisis in developing nations, corporate scandals, and of course, the tragedy of September 11, 2001. Yet overall economic activity experienced only modest difficulties.

Thus, it is not altogether unexpected or irrational that participants in the world marketplace would project more of the same going forward.

Yet history cautions that people experiencing long periods of relative stability are prone to excess. We must thus remain vigilant against complacency, especially since several important economic challenges confront policy-makers in the years ahead.

Prominent among these challenges in the United States is the pressing need to maintain the flexibility of our economic and financial system. This will be essential if we are to address our current account deficit without significant disruption.

Central to that adjustment must be an increase in net national saving. This serves to underscore the imperative to restore fiscal discipline.

Beyond the near term, benefits promised to a burgeoning retirement-age population under mandatory entitlement programs, most notably Social Security and Medicare, threaten to strain the resources of the working-age population in the years ahead.

Real progress on these issues will unavoidably entail many difficult choices.

But the demographics are inexorable and call for action before the leading edge of baby boomer retirement becomes evident in 2008.

Another critical long-term economic challenge facing the United States is the need to ensure that our workforce is equipped with the requisite skills to compete effectively in an environment of rapid technological progress and global competition.

But technology and, more recently, competition from abroad have grown to a point at which the demand for the least-skilled workers in the United States and other developed countries is diminishing, placing downward pressure on their wages. These workers will need to acquire the skills required to compete effectively for the new jobs that our economy will create.

Although the long-term challenges confronting the United States economy are significant, I fully anticipate that they will ultimately be met and resolved.

In recent decades, our nation has demonstrated remarkable resilience and flexibility when tested by events, and we have every reason to be confident that it will weather future challenges as well.

For our part, the Federal Reserve will pursue its statutory objectives of price stability and maximum sustainable employment, the latter of which we have learned can best be achieved in the long run by maintaining price stability.

This is the surest contribution that the Federal Reserve can make in fostering the economic prosperity and well being of our nation and its people.

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

[The prepared statement of Hon. Alan Greenspan can be found on page 59 in the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman.

Let me begin with some questions, as you might guess, the issue du jour, Social Security and Social Security reform, and I think correctly put forward by the President.

You have mentioned, for example, that the baby boomers really start drawing down on Social Security as early as 2008. So it does, I think, hopefully focus our attention on that very real fact and how we deal with it.

This committee, of course, has been very interested in issues like capital formation, savings rates, interest rates, and the like, and you have been very helpful over the time that I have chaired this committee in leading us through some very difficult issues.

One of the issues that I wanted to talk to you about today is the individual accounts and how they—not only how they would be structured, because I think our committee will have a serious interest in how that is accomplished—and secondly, what those individual accounts can do for the economy, and I would be interested in your comments.

It seems to me that given an opportunity to create millions of worker capitalists in this country—to introduce a large segment of the population to issues like compound interest, dollar cost, averaging, building up ownership in one's retirement—is a pretty exciting proposition. What kind of increase would we have, for example, in the pool of capital available to American companies to expand and modernize and be competitive in a global economy?

I saw a study the other day that said if the average worker were to invest half of his account in a stock fund, index fund, and half in a bond index fund, that the creation of those bond index funds and those savings would double the amount of money in the current bond market, which I would assume based on what you have said in the past would have a significant positive impact on interest rates going forward.

I just throw those out to you because too many times I think we get lost in the issue of Social Security, and it is an important issue, but also what the overall effect could be on our country, that is individual citizens, as well as the economy.

And I will just turn you loose on that.

Mr. GREENSPAN. Well, Mr. Chairman, I think the first thing that we have to focus upon is this extraordinary shift that is about to occur, starting in 2008, in which roughly 30 million people are going to leave the labor force over the next 25 years and enter into retirement.

This creates a very significant slowing in the rate of economic growth. When the rate of growth of the working-age population relative to the total goes down—and even with productivity increasing at a reasonably good clip the rate of growth in GDP per capita must slow down.

This is going to cause a confrontation in the marketplace between the desire on the part of retirees to maintain essentially what we call their replacement rate—namely, that a standard of living relative to the standard of living they enjoyed just prior to retirement will be maintained.

If that is done, it will put significant pressure on the working-age-population economic growth, and so we have to find a way to get a larger pie to solve both sides of this.

The advantage of having individual accounts is over a fairly broad spectrum, but the one that I think is most important actually relates to the issue which your Ranking Member mentioned before.

These accounts, properly constructed and managed, will create, as you also point out, a sense of increased wealth on the part of the middle-and lower-income classes of this society, who have had to struggle with very little capital.

And while they do have a claim against Social Security system in the future, as best as I can judge, they don't feel as though it is personal wealth they way they would with personal accounts. And I think that is a quite important issue with respect to this.

The major issue of personal accounts is essentially economic, in the sense that, confronted with the very large baby boom retirement and the economic difficulties associated with it, the structure of essentially a pay-as-you-go system, which is what our Social Security system is, which worked exceptionally well for almost 50, 60 years, that system is not well suited to a period in which you do not any longer have significant overall population growth, and therefore a very high ratio of workers to retirees.

And it is no longer the case, as existed in the earlier years, that life expectancy after age 65 was significant. We have been fortunate in that, for a number of reasons, our longevity has increased measurably.

But it does suggest that if we are going to create the type of standard of living that we need in the future for everybody, we are going to need to build the capital stock, plant and equipment, because that is the only way we are going to significantly increase the rate of productivity growth which will be necessary to supply the real goods and services that the individuals who are retired at that point and the individuals who are activity working would sense their right in this economy.

And if we are going to do that, we have to have a significant increase in national savings, because even though it doesn't exactly tie one to one because there are other ways in which productivity rises, the central core of productivity increase is capital investment. And to have capital investment you need to have savings.

Now, we in the United States have had a very low national or domestic savings rate and have been borrowing a good part of it from abroad to finance our existing capital investment. We are obviously not going to be able to do that indefinitely, which puts even more pressure on building up our domestic savings.

And what this means is that whatever type of structure we have for retirement, it has to be fully funded.

The OASI has $1.5 trillion in the trust fund at this stage. The required full funding is over $10 trillion.

In short, we do not have the mechanisms built into our procedures for retirement and retirement income and pensions which are creating a degree of savings necessary to create the capital assets which are a precondition to get a rate of growth in productivity, given the slow growth in the labor force which we project going forward in order to create enough GDP for everybody.

So my major concern is that the current model, which served us so well for so many decades, is not the type of model we would certainly construct from scratch, and we have to move in a different direction.

And one of the reasons that I think we have to move toward a private individual account system is they, by their nature, tend to be significantly fully funded, even if they are defined contribution plans, because individuals know what they need for the future and they tend to put monies away adequately to create the incomes they will need in retirement.

So I think this is an extraordinarily important problem that exists. And I won't even go on to mention the fact that the Medicare shortfall, so far as the issue of where full funding lies, is several multiples in addition to what we confront in Social Security.

The CHAIRMAN. Thank you, Mr. Chairman.

I think the clocks are not working right. We will have to get a——

Mr. FRANK. Don't fix them that quickly. Wait a few minutes.

The CHAIRMAN. Gentleman from Massachusetts.

Mr. FRANK. I am struck by your last point, Mr. Chairman, because the President has been talking, I think, in exaggerated terms about a crisis in Social Security, and I haven't heard him talk about Medicare. And I welcome your assertion that the Medicare problem is, if I heard you correctly, several magnitudes greater.

And it seems to me we are talking about an ideological agenda. When you put the Social Security issue up front and ignore the Medicare issue, I do not think you are simply following what economic necessity would dictate.

On the question of capital formation, it is a question I would like to ask. We have this problem with the deficit. We have a problem of money being used up.

One of the areas of federal spending growth that is obviously, perhaps, the fastest is in the military budget. Now, some of that is necessary, brought on us by outside enemies. I voted for the war in Afghanistan—not for the war in Iraq. But we have some problems here.

On the other hand—and I cited my eagerness to support conservatives as we defend the administration's effort to dismantle the bloated agricultural system—I also look forward to working alongside intellectually honest fiscal conservatives in supporting proposals to de-fund Cold War weapons that no longer have a major justification. The administration is going to be proposing, I am told, the reduction.

Now, I don't ask you to opine about whether or not the weapons are necessary, but I do solicit your opinion on the economic impact.

To the extent that the Defense Department can identify expensive weapon systems that it believes are no longer of a high priority because they were originally designed with a different enemy in mind, a thermonuclear enemy, to the extent that we could reduce the spending there, what is the effect economically for the country?

Mr. GREENSPAN. Well, it is obvious that hardware expenditures, especially the type that was fairly substantial over the post-World War II period, are a drain on the real resources of the economy.

And clearly, to the extent that we can cut back in any part of the budget, dollar for dollar it reduces the deficit, increases national savings, and does, obviously, contribute to private capital investment—the very critical need which I think we have going forward.

Mr. FRANK. Well, I appreciate that because when it comes to reductions in some of these weapons that the Pentagon will say are unnecessary, I anticipate that some who are in other contexts quite critical of government spending are going to sound like Harry Hopkins and Harold Ickes put together as they talk about the stimulative effect for the economy.

Mr. GREENSPAN. I assume you mean Ickes Sr.

Mr. FRANK. Harold Ickes Sr., yes.

The Harold Ickes of your era, Mr. Chairman.

[Laughter.]

While I am on the subject, as I get into Social Security, one question of great interest to me, Mr. Chairman, and you are a distinguished economic authority. Had you been in the Congress in 1935, would you have voted for Social Security?

Mr. GREENSPAN. I was pretty young at that time.

Mr. FRANK. I understand, Mr. Chairman, but——

[Laughter.]

I said, if you had been there, would you have?

Mr. GREENSPAN. I cannot answer that question.

Mr. FRANK. I didn't think you would be able to, but I do think, frankly, look, we have an economic aspect here and an ideological one. And as we have acknowledged, the need to get to solvency has an economic impact. The question of private accounts has an ideological one. And many of us, frankly, would have no question: We would have voted for that. And I think that is relevant.

Let me go to the question of, leaving aside the ideological questions, I do say, and I appreciate what you said about inequality. I do have to express skepticism that telling workers who are now losing their jobs because of various factors in the economy or whose real wages are not keeping up, telling them, "Do not despair, private accounts are coming, 15 or 20 years from now," will be of less of a morale booster than I think you implied.

But leaving aside the desirability, we do have the question of how you get there. You say in the monetary policy report, on page 12, the entire governors say, "The recent sizable deficits in the unified budget mean the federal government, which had been contributing to the pool of national saving from 1997 through 2000 has been drawing on that pool since 2001," and you have identified sav-

ings, the low savings rate, as a big problem. The single biggest factor in this appears to be the federal government.

Net federal savings dropped from positive 2 percent of GDP in 2000 to a level below negative 3 percent in 2003 and 2004. There has been a swing of 5 percent with regard to national savings, entirely attributable to the federal government.

Here is the problem: clearly we are going to have to borrow to set up private accounts. The administration says it will cost $700 billion or $800 billion in the next 9 years, but obviously that is not the end of it. The estimates from the Democrats on the Budget Committee is $4 trillion.

The administration won't say. Generally, when people won't say it is because they don't like what they would have to say.

You told Senator Sarbanes yesterday I believe that if we had to borrow more than a trillion, that could be problematic. You said over a trillion is large.

Mr. GREENSPAN. I was referring to the 10-year time frame.

Mr. FRANK. Okay.

Mr. GREENSPAN. That was the context.

Mr. FRANK. Let me ask, has the Fed done any kind of costing out of what the cost of the borrowing will be in the period after the 10 years?

Mr. GREENSPAN. No, we haven't. But remember that the critical issue here is how it affects national savings.

Mr. FRANK. The market.

Mr. GREENSPAN. If you move marketable securities from the U.S. government and thereby create a deficit into a private account, but you require that that account not be subject to withdrawal prior to retirement, you effectively insulate the issue of a change.

Mr. FRANK. But as you said yesterday, that depends on the market's perception. And I must say yesterday, as I read your questions——

Mr. GREENSPAN. That is correct.

Mr. FRANK.——you were less assured yesterday. Did something happen overnight?

Mr. GREENSPAN. No. I was about to get to that.

Mr. FRANK. Okay. I don't want the time to run out before you did. The clock seems miraculously to have got fixed after he got through.

[Laughter.]

Mr. GREENSPAN. As I said yesterday, we are not sure to what extent and how much the markets respond. I think that basically the question of moving to private accounts, personal accounts, individual accounts, whatever you want to call them, is necessary largely because I think the existing system——

Mr. FRANK. But you are off my point, Mr. Chairman. I understand that. You have said that. But I am asking you about the impact of the borrowing and the market. And yesterday——

Mr. GREENSPAN. To the extent—to the extent—that that affects national savings, and as I say——

Mr. FRANK. But it is a separate question. You, at least yesterday, said market perception was a problem, and you seemed to indicate that the——

Mr. GREENSPAN. Let me tell you why I am responding in the way I am: The unified budget is a mechanism which only partly reflects the impact of government activity on the economy. It is an exceptionally good one, and covers most issues. But when you are dealing with forced savings of any type, the evaluation is somewhat different.

But to answer your question very specifically, to the extent that actual government borrowing tends to impact on interest rates and on the economy, which generally budget deficits do, then I do think we have to constrain them.

Mr. FRANK. Thank you.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from Ohio, Ms. Pryce.

Ms. PRYCE. Thank you, Mr. Chairman.

Social Security is the subject du jour, obviously. I will ask you a question on a different matter, but I also would like to allow you to complete your answer, if you had more to say, about the perception.

I was very intrigued. In your testimony you talked about the perception of wealth, personal perception, then you just made reference to market perception. Is there more you would like to say in response to Mr. Frank?

Mr. GREENSPAN. No. It is just that, as I indicated and the congressman quoted me, for the last 25 years we have had a consistent, ever-increasing concentration of income and wealth in this country. And as I said, that is not conducive to the democratic process or democratic society.

It is crucial to our stability that people all have a stake in this system. And I don't perceive that Social Security is conceived that way. It is very important for people to have a sense of ownership. In other countries, where shifts have been made, there is a lot of anecdotal indications that it made a difference in a lot of places.

Now, I am not saying that the United States is like Chile, for example. It is not. But I think that it is an issue that goes beyond the sheer economics of it.

But because we need to find a better vehicle for providing retirement benefits, and therefore have to move away from the pay-as-you-go structure, and I think essentially into certain private accounts or defined benefit programs or something, because we need the full funding, that it is far more likely that we will get the type of savings, and therefore the type of capital investment that we are going to need in order to meet the promises we have already made to the next generation of retirees going forward.

Ms. PRYCE. All right. Thank you, Chairman.

Now let me shift gears away from Social Security, because I am sure that that will be dominating the day. But I would like to ask your insights into the matter of the interchange and how that is going to be affecting control of monetary policy.

I know that the Fed has an ongoing study and retail payments research project to estimate the number of transactions and the value to the retail system.

But it is a very intriguing concept to me, and I would really like to hear your comments on it, how it affects your control of monetary policy, how it affects consumer prices and the economy, and

if you believe that there is a privacy or identity theft peripheral issue to it.

So I know that this is kind of off the subject du jour, but I would like to hear your insights.

Mr. GREENSPAN. Well, one of the things which has been quite impressive is how the financial system has adjusted to the major increase in information technology and computer technology. And the payment system has gotten extraordinarily complex in all the various different areas.

To be sure, we have had privacy questions emerge, and there has been a significant battle, I may say, between those who create new encryption programs and those who are trying to break them.

I think at the end of the day that the mathematics of encryption are such and the technology is such that we ought to be able to create systems which will be exceptionally difficult to break.

If we are going to get the benefits of the payment system or, as I commented yesterday, the extraordinary potential benefits of information technology in the health care area, we have to create security for privacy. And the only way to do that and still have the availability and use of these technologies is to find adequate encryption.

I think that is something which continues to improve. In my judgment, at the end of the day, it is going to become very difficult as the technology gets more and more complex, actually to break some of these newer, very clever encryption systems.

Ms. PRYCE. Would you like to comment at all on——

The CHAIRMAN. Gentlelady's time has expired.

We are going to try to stay as close to the 5-minute rule——

Ms. PRYCE. Thank you, sir.

The CHAIRMAN.——because we have got so many members to ask questions.

The gentlelady from New York?

Mrs. MALONEY. Thank you, Mr. Chairman.

Mr. Greenspan, the President is drumming up support for his plan by saying that by 2042, "the entire system will be bankrupt."

To the average person, bankrupt would mean that you would be totally out of money, that there would be no benefits at all. Yet, experts say that we will not touch the trust fund until 2018, and even though the trust fund will be used up by 2042, as the law envisioned, there will be plenty of money coming in from payroll taxes, enough to pay for three-quarters of the benefits.

So to say that the entire system is bankrupt in 2042 is not true. It is misleading. Would you agree, yes or no, Mr. Greenspan?

Mr. GREENSPAN. It is certainly true that the amounts of money, cash, that are available would, assuming that the 2042 is the more accurate than the 2052 which CBO is raising, but the point I think that is crucial here is that this is mainly the monies that the Congress is making available.

And I must say, parenthetically, I think the probability were we in fact to run into zero trust fund at that point, that benefits would be cut, approaches zero, as indeed it did in 1983, the last time that happened.

But that is not what the issue is. The issue is not whether or not we have the ability to make payments, but whether we have built up a sufficient trust fund——

Mrs. MALONEY. My question is not that. I question the statement that by 2042 the entire system will be bankrupt. It will not be bankrupt. I agree the trust fund will be gone, but there will still be the money coming in from the payroll taxes, enough to pay, by all accounts, three quarters of the benefits.

Is that true or not?

Mr. GREENSPAN. It is true in dollar terms, but I suspect it may not be true in real terms.

And the reason I am saying that, if we cannot get full funding and the savings required to build up the capital stock in time for 2042's production of goods and services, yes, the individuals may have the cash, but the cash will not buy as much as they think it would be.

The real problem has got to be real resources, and this issue of whether or not the OASI goes bankrupt or not bankrupt is an interesting legal and political question, but it really doesn't get at the economics of the retirement of 30 million additional individuals.

Mrs. MALONEY. That is true, but the point is in 2042, the entire system is not bankrupt.

But I would like to get back to your statements in the Senate yesterday where you pointed out that the President's plan does nothing to solve the solvency challenge of Social Security and it does nothing to improve national savings and it creates new debt that will have trouble being absorbed by the markets.

So, in other words, the President's plan doesn't address the real problems and it creates new ones. The cost for transition has been estimated to be $4 trillion to $5 trillion over 20 years, and this is on top of the deficit and debt that we now have and do not seem to be able to control.

We have the highest debt ever, over $7 trillion; the highest deficit ever, over $400 billion; the highest trade debt ever, over $600 billion.

And my question is, wouldn't you say that for the immediate future, the deficit is more of a problem with our economy than Social Security is, particularly since we do not even have to touch it, the trust fund, or the principal until 2018?

Mr. GREENSPAN. No, I think that the problem starts in 2008.

And I don't disagree with you about the size of some of the numbers, but remember a goodly part of that——

Mrs. MALONEY. Especially, Mr. Greenspan, when you said yesterday in the Senate that the increased debt of over $1 trillion in a 10-year period would be too much for the markets to absorb.

And so, when we have independent analysis and economists saying that it will be $4 trillion to $5 trillion over 20 years, doesn't that cause a tremendous problem on top of the debt and deficits that we already have, yes or no?

The CHAIRMAN. The gentlelady's time has expired.

The Chairman may answer yes or no or expand on that.

Mr. GREENSPAN. All I would say is that when you are getting out that far, there will be lots of adjustments.

It is important in the process of the adjustment that we be very careful not to increase the degree of excess inflationary liquidity in the economy, and adjustments will need to be made.

Mrs. MALONEY. Thank you.

The CHAIRMAN. The gentleman from Louisiana, Mr. Baker?

Mr. BAKER. I thank the Chairman.

And welcome the Chairman back again. It is certainly always a pleasure to hear your thoughts.

I just want to speak briefly as to the concerns about the division that apparently will exist in our country going forward with those accumulating wealth and those without hopeful opportunity.

I believe we have learned a great deal from some of our metropolitan woes across the country. As local governments look for ways to deal with infrastructure problems and meeting social need, they have raised taxes to confiscatory levels, and those with the ability have moved to the suburbs, taking their capital and assets with them, and the spiral downward is only escalated.

I worry that in our rush to solve this problem that with additional federal government regulatory encroachment, with confiscatory tax rates being discussed, that those who have the ability simply will move offshore, taking their investments, their manufacturing, and their jobs elsewhere.

And so, we have, indeed, to have a system where everyone has a stake and a potential to share in the potential outcomes if we are going to work our way through this very difficult financial thicket.

I want to turn, however, to a subject which you and I have talked about over time, and it is not a new concern but one which has taken on significance in light of recent developments.

Two years ago, in the fourth quarter of that year, Fannie Mae disclosed it had a significant problem with what it called its negative duration gap measurement in ceding their own internal risk measurement controls.

The resulting action of the GSE in that instance was simply to go out and acquire additional mortgages to rebalance the portfolio.

I likened it to being the owner of the Hindenburg and deciding to add on a new room.

I have come to the conclusion in view of the GSE's portfolio growth over the last several years that the rate of growth is indeed a concern, and I believe you have in past occasions expressed the possible view that maybe some balance between MBS held and overall portfolio structure might be something that the Congress should examine.

I am wondering if you have, one, the concern about rate of growth. Two, is there a remedy in your mind that would be advisable for us to consider; would you go as far perhaps as establishing a cap? And four, whatever response you give will be very informative and helpful.

As you know, we are in the midst now of constructing legislation on GSE reform, and I frankly would like to include a provision on growth constraints, but I want to make sure that from a financial policy perspective you believe it to be advisable.

Mr. GREENSPAN. Congressman, I have been thinking, as you have, about the nature of this problem for the last several years.

What concerns me is not what Fannie and Freddie have been doing in the securitization area, which they have been exceptionally effective as indeed their competitors as well, have created a very important element within the total financial system.

And so, let me just stipulate that securitization is important and has to be maintained and expanded, if at all possible.

But we have examined the purposes of the so-called huge build up in the portfolios that Fannie and Freddie are holding—and remember that it was very small 10 years ago. This is not something which is implicit in the whole securitization operation; it is an add-on which occurs as best we can judge—and we have tried to think of all other possible purposes—very largely to create increased profits for these organizations.

And the reason that occurs is they have, granted by the marketplace, a significant subsidy which enables them to sell their debentures significantly—at a significantly lower interest rate than their competition. And therefore, no matter what market-based types of issues they use that money to invest in, whether it is their own MBS, other MBS, or other assets, they get an extraordinarily large profit and they have been using that for a major expansion in earnings of those corporations.

We have found no reasonable basis for that portfolio above very minimal needs.

And what I would suggest is that for liquidity purposes they are able to hold U.S. treasury bills in whatever quantity they would choose, that they can't exploit the subsidy with treasury bills, because there is no spread which gives them a rate of return. In turn, they should be limited to $100 billion, $200 billion—whatever the number might turn out to be in the size of their aggregate portfolios.

And the reason I say that is there are certain purposes which I can see in the holding of mortgages which might be helpful in a number of different areas. But $900 billion for Fannie and somewhat less, obviously, for Freddie, I don't see the purpose of it.

And over time—I don't believe that we should have legislation which essentially requires immediate divestiture, but over time, several years, that should be done because these institutions, if they continue to grow, continue to have the low capital that they have, continue to engage in the dynamic hedging of their portfolios, which they need to do for interest rate risk aversion, they potentially create ever growing potential systemic risks down the road. There is no risk now at the moment. It is the time, therefore, to act, to do something to fend off problems, which in my judgment seem almost inevitable as we look forward into the remainder of this decade.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Pennsylvania, Mr. Kanjorski?

Mr. KANJORSKI. Mr. Chairman, over a number of years now, I have been looking forward to your addressing the committee. And I must say that I have always thought that you took a fiscally conservative position of responsibility for the government. And I have a few questions that I would like you to answer in terms of whether I was mistaken or not in that conclusion.

One, am I not correct that 1983 you chaired the Social Security commission?

Mr. GREENSPAN. I did.

Mr. KANJORSKI. At that time, did you prepare and submit to the Congress your recommendations as to how to solve the problem that we are now facing, in the President's word, as a crisis?

Mr. GREENSPAN. The commission did, yes.

Mr. KANJORSKI. And did you see the crisis coming, or did you see the problem, or your fix not solving this problem?

Mr. GREENSPAN. No, we did. We recognized that starting in the year roughly 2010, which you must have realized was a quarter-century later, we perceived that there would be a significant build-up and indeed our mandate was to create over a 75-year period, through 2058, a set of receipts and potential benefits, a tax rate, which is now the 12.25 percent rate, which according to the actuaries of that time would have been enough to carry us through 2058. We are still on track for that forecast.

Mr. KANJORSKI. So you would conclude that—then why is the crisis today? What happened?

Mr. GREENSPAN. The crisis today is largely——

Mr. KANJORSKI. You agree with the President, it is a crisis today.

Mr. GREENSPAN. The word crisis depends on in what terms. We have a very serious problem with the existing structure is what I would stipulate. The terms of how you describe it are far less important than defining what it is.

Mr. KANJORSKI. Okay. You also mentioned in your response, either to the Chairman or the Ranking Member, that as bad a problem as we have with Social Security, it pales in comparison to the immediate problem within the next 10 years of Medicare and Medicaid.

Mr. GREENSPAN. It does.

Mr. KANJORSKI. And I seem to remember that you came before the committee and I asked you a question of fiscal responsibility in July of 2003, because I was starting to get extremely worried about the administration's policies, in every year asking for a tax cut.

Now, am I mistaken in some way to misconstrue that the revenues received by the United States government overwhelmingly come from tax revenues?

Mr. GREENSPAN. They do.

Mr. KANJORSKI. And did you realize that when you were supporting the tax cuts of 2001, 2002 and 2003, that you were substantially reducing the revenues of the United States government in spite of the fact that you knew a major problem or crisis in Social Security exists, that a major problem or crisis in Medicare exists, and that a major problem in Medicaid exists, and you were supporting a policy to reduce the revenues of the United States. Is that correct?

Mr. GREENSPAN. Not quite, because from September 2002 going forward, I strongly supported, and still do, the continuation of PAYGO. Remember, it was in September——

Mr. KANJORSKI. I understand PAYGO is a great concept on budgets, but it doesn't have a hell of a lot to do with revenue. Taxes have to deal with revenue. Do you support——

Mr. GREENSPAN. But, Congressman, you are asking me—let me finish my sentence. I supported the tax cuts that I felt was a very important—and I still do—element in expanding the revenue base of this economy for growth. I stipulated that my support was in the context of a PAYGO rule, which I supported, which had been allowed to lapse at that point.

So if I were voting, but I don't vote, I would have voted to take other actions to offset that because I thought that that type of tax cut was important.

Mr. KANJORSKI. Mr. Chairman, it is also this President's policy to ask this Congress to make permanent the three previous tax cuts of his first 3 years in office, which will continue to reduce revenues of the United States ad infinitum. Do you support making permanent all the taxes that have been cut thus far, and make those permanent in nature?

Mr. GREENSPAN. I can't say all of them. I still support the partial elimination of the double taxation of dividends, but in the context of a full PAYGO system, which I trust the Congress will initiate.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from the first state?

Mr. CASTLE. Thank you, Mr. Chairman.

Chairman Greenspan, actually I have enjoyed the Social Security discussion a great deal. And I want to change subjects here a little bit and talk about one of the other two great problems, Medicare being one. But the other is Medicaid. I did a little research. And there are 50 million people on Medicaid, in some way or other, versus 47 million who are receiving Social Security right now. And their total cost, and as we all know it is part state, part federal, more federal than state, today is about $300 billion. I think we pay out about $471 billion in Social Security.

So you are talking about a program which isn't that much less in terms of its overall economic aspects and individual aspects than Social Security.

But I have also learned that about two-thirds, actually more than two-thirds, about 69 percent of Medicaid doesn't pay for the medical bills of the poor, but it pays for long-term care of the disabled and the seniors, the disabled being even more than the seniors.

You indicated earlier in your testimony that I think it was 30 million people over the next 25 years are going to retire. We know that a percentage of those people at some point become impoverished, either intentionally or unintentionally, and they go into the long-term Medicaid program, which costs upwards of $25,000-plus per year.

I don't have the growth rate this year; I didn't have a chance to get that. But the growth rate of Medicaid expenditures is tremendous.

The President and Secretary Leavitt have indicated that they would like to have flexibility, and maybe there is an assumption because they proposed it before that the President has at least some sort of cap on how much would go into Medicaid if the governors would accept flexibility.

The governors rejected that 2 years ago, out of hand. They don't seem to be much more receptive to it this year. They have a meeting in a couple weeks and I suppose they will take it up again.

But to me, this is just a tremendous economic problem in terms of the issues that you worry about in this country and in terms of where we are going with effect to economic security and balancing our budgets. And it is something that frankly I don't think is discussed enough. If you could, I would love to have you allay my concerns. If you can't, any suggestions you have along these lines or even disagreement with what I just indicated of how great a problem it is, I would encourage speaking about as well.

Mr. GREENSPAN. Well, Congressman, I would say it is part of the broad medical cost problem that is burgeoning in this country.

As I said in the Senate yesterday, I think an important initiative is now under way which is an endeavor to try to get the total medical system fairly quickly into the full information system, meaning that we not only digitalize the whole administrative structure of medical practice, which would have, undoubtedly, a significant cost improvement, but also to, assuming we can get the technology involved in broad information on all patients' history and the various different problems each individual has being made accessible to the appropriate parties with encryption.

What we know at this stage is that there are very diverse procedures involved across the country for various ailments, and the outcomes are quite different. And if you get a fully computerized and knowledgeable system, we will have the capability, and the medical profession will——

Mr. CASTLE. I don't mean to interrupt you, but my concern is in the long-term care and the care for the disabled as much as it is in just medical—because I agree with you completely in terms of what you are saying, but I have a little trouble understanding exactly how that is going to make a great difference in the costs.

Mr. GREENSPAN. I was about to get to that. The issue is we are going to eventually get to a clinical best practice, and it involves the whole sets of procedures that are involved, which is going to be quite different, in my judgment, from what is done today. And I think we are going to have to build up, as quickly as we can, the technology because I don't see how we can make major long-term structural decisions on Medicare of which the issue that you are raising, Congressman, is a critical one because I am fearful if we freeze in a "solution," in quotes, to all of these problems, and we find that this clinical practice is changing fairly dramatically, we are going to find as we have frozen in the system which won't work.

So I can't answer your question specifically, but I will tell you that there is not only that problem, but a long series of other problems, which is manifested in a huge potential expenditure outlook going forward with not only Medicare, but Medicaid, and I must say with medical expenditures generally.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from California, Ms. Waters?

Ms. WATERS. Thank you very much.

Thank you very much for being here today, Chairman Greenspan. I have wanted to center all of my questions on Social Secu-

rity, and I do have one. But I cannot help but raise another question, based on some of the answers you have given already.

As I have sat here, and we have all been reminded of the deficit that we have, the debt that this country is involved with, the trade deficit, the problems Medicaid and Medicare. I would think that you as a fiscal conservative would be sounding the alarm. But you just really shook me up when you stuck to your support for tax cuts.

Now, given that you are defending your position on tax cuts in light of all of these problems, what evidence is there that the revenue base of the country has expanded because of these tax cuts?

Mr. GREENSPAN. Let me just say that the evidence does indicate that the economy was significantly supported by the tax cuts in their initial form. But that, of course, has nothing to do with tax cuts going forward in any material way.

Ms. WATERS. What is the evidence?

Mr. GREENSPAN. The evidence is that the economy has stabilized fairly significantly, and the size of the so-called recession of 2001 was the mildest in the post-World War II period. And there is no question that tax cuts had a role in that.

Ms. WATERS. Did those tax cuts have anything to do with job creation? Or do we have an expanding economy without job creation?

Mr. GREENSPAN. The point at issue is that you don't have jobs unless the economy is expanding.

Ms. WATERS. I understand there is a contradiction in the economy now, and that the jobs have not been created because of these tax cuts.

Mr. GREENSPAN. I find no evidence that that is the case.

Let me just respond to the substance of your question.

Ms. WATERS. Yes.

Mr. GREENSPAN. I am not in favor of tax cuts without the issue of a PAYGO. In other words, I argued a year ago that my support for the tax cuts is in the context of a PAYGO rule. And looking out beyond, say, 2008, the problems we have with the budget deficit are huge. And therefore we need very significant changes to come to grips with those issues.

So I am not saying that we have no problems. Our problems, in my judgment——

Ms. WATERS. No, I understand that, Mr. Greenspan. But if you are saying that tax cuts are okay as long as you understand PAYGO—you got to pay as you go—then that certainly has not happened with this administration. As a matter of fact, the debt has increased, the borrowing has increased since the tax cuts. So you must be very unhappy.

Mr. GREENSPAN. I am telling you that I have always supported PAYGO. I think it has been a mistake to allow PAYGO to lapse. I support PAYGO for both the tax side and the spending side. And I trust that the Congress will reinstitute it——

Ms. WATERS. Okay.

Mr. GREENSPAN.—as expeditiously as possible.

Ms. WATERS. Well, good. And let me just go to my Social Security question.

This administration is redefining Social Security as we know it. They say it is a crisis, and they have got young people all riled up

in this country about the fact that it won't be there for them. And the President has rolled out with the personal accounts aspect of this Social Security redefinition.

What does personal accounts have to do with the solvency of the Social Security system? Could you please explain that to us in very simple, factual language, excluding any speculation, and help us to understand how privatization is going to make the system solvent?

Mr. GREENSPAN. The issue is one not of the President's actual program affecting the long-term shortfall in the OASI trust fund. It does not. I have said that before, I said it yesterday.

Ms. WATERS. I am sorry, I can't hear you.

Mr. GREENSPAN. I said it does not.

Ms. WATERS. The private accounts do not?

Mr. GREENSPAN. Not in and of themselves.

What I am saying is that what we need to do is create a system which the existing system is unable to do; namely, build up a sufficient full funding in a reserve system.

That can only apparently be done by moving to the private sector, because we have been utterly unable in the pay-as-you-go system to create the necessary savings to finance the capital investment that we are going to need for the future to create the goods and services that retirees are going to need.

The CHAIRMAN. Gentlelady's time has expired.

The gentleman from Texas, Mr. Paul?

Dr. PAUL. Thank you, Mr. Chairman.

Mr. Greenspan, yesterday you were quoted as saying it was imperative that the Congress restore fiscal discipline. And of course you have made that point, I think, very often over the years.

I have tried my best to vote accordingly, but sometimes I find myself in a lonely category.

I have found that we have a group here that is quite willing to vote for deficits for domestic programs. Then we have another group that is quite willing to spend for militarism abroad. Then we have another group that likes both.

So if you look around for people who are willing to cut in both areas, it is pretty hard to come by.

But you in the past, in answer to some of my questions, have answered that you believe that central bankers have come around to getting paper money to act, in many ways, just like gold, and therefore there was less of an imperative for a gold standard.

I haven't yet been convinced of that. Take, for instance, the current account deficit. You know, under the gold standard there are a lot of self-adjustments, and we certainly wouldn't have the exchange rate distortions between the renminbi and the dollar under a gold standard.

So I think there are a lot of shortcomings under the paper standard with the current account deficit.

Also, although the argument is made that CPI reflects that there is little or no inflation, if you look at the price of bonds or if you look at the cost of medicine, if you look at the cost of energy, there is a lot of price inflation out there.

And also, if you look at the cost of houses, which are skyrocketing, which then is reflected in tax increases, the consumer is

still suffering from a lot of price inflation that we in many ways in Washington try to deny.

But I think in an effort to discipline the Congress, that the Federal Reserve would have a role to play as well because in many ways the Federal Reserve accommodates the spending because you are capable of buying bonds. And when you buy our debt that we create, you do it with credit out of thin air.

So it is that facility of the monetary system that literally encourages or actually tells the Congress they don't need to be disciplined because there is always this fallback that we don't have to worry, the money is out there, money which would not be available, obviously, under a gold standard.

I would like to quote from a famous economist that sort of defends my position. He says, regarding almost the hysterical antagonism toward the gold standard, "It is one issue which unites statists of all persuasions. Government deficit spending under a gold standard is severely limited.

"The abandonment of the gold standard made it possible for the welcome statists to use the banking system as a means to an unlimited expansion of credit. They have created paper reserves in the form of government bonds."

Further stating, "In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. Deficit spending is simply a scheme for the confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights. If one grasps this, one has no difficulty in understanding the statists' antagonism toward the gold standard."

And, of course, I am sure you recognize those words because this is your argument.

Mr. GREENSPAN. I do.

Dr. PAUL. And I would say that isn't it time that, if we ever get concern about our deficit spending and we consider it a real imperative, why shouldn't we talk about serious monetary reform?

Do you think that the gold standard would limit spending here in the Congress?

Mr. GREENSPAN. First of all, that was written 40 years ago, and I was mistaken in part. I expected things that didn't happen. And, nonetheless, my general view toward the type of gold standard effect remains to this day. My forecast of what was going to happen subsequent to that period has proved, fortunately, wrong.

And as I have said to you in the past, we have tried to manage the Federal Reserve over the years, really since October 1979—because, remember, up to that point we were in some very serious inflationary trouble. Since then I think we have been remarkably successful, in my judgment.

The CHAIRMAN. Gentleman's time has expired.

Mr. GREENSPAN. And while I still think that the gold standard served us very considerably during the 19th century, and mimicking much of what the gold standard does is what we do today, I think in that context so far we have maintained a stable monetary system. And I do not think that you could claim that the central bank is facilitating the expansion of expenditures in this country.

The CHAIRMAN. Gentleman from Vermont, Mr. Sanders?

Mr. SANDERS. Thank you, Mr. Chairman.

And nice to see you again, Mr. Greenspan.

I am not going to waste a whole lot of time talking about the so-called crisis in Social Security because there is not a crisis. Depending on the studies that you look at, Social Security is solvent for either 37 years or 47 years. With minor modifications like doing away with the cap for wealthy people so they could contribute more into the system, it will be good for 50 or 60 years. So I don't think we have to waste a lot of time on that particular crisis.

Let us talk about some real crises facing the American people today. The health care system is clearly disintegrating. We are the only country in the industrialized world without a national health care program. We pay the highest prices in the world for prescription drugs. We have children sleeping out on the streets of America today.

We don't give our veterans the benefits that we promise them. Our middle class in general is in a state of collapse, with millions of workers working longer hours for lower wages. There has been an increase in poverty. The gap between the rich and the poor is growing wider, and the richest 1 percent own more wealth than the bottom 90 percent.

Now, Mr. Greenspan, representing the CEOs of America and the wealthiest people of America, you consistently come in here every year and you tell us how great the economy is doing, and you tell us how great unfettered free trade is. So that is the crisis I want to talk about. Talk about unfettered free trade that you have been supporting for years.

We now have a record-breaking trade deficit of $618 billion. We have a trade deficit with China alone of $160 billion, which has gone up by 30 percent in the last year. There are economists who tell us that trade deficit is going to go up and up and up. People who go Christmas shopping understand that when they walk into a store virtually everything on their shelves is made in China now.

You have the heads of large information technology companies in America who basically are telling us, "Hey, we ain't going to have information technology in America, no long white collar jobs, because in 10 or 20 years China is going to be the information technology center of the world."

Economists tell us we have lost millions of decent-paying jobs. We have lost 16 percent of our manufacturing sector in the last 4 years alone, and we are going to lose more and more white collar jobs to China. And yet year after year people like you come here, "Oh, unfettered free trade, it is just great."

Question, Mr. Greenspan: After record-breaking trade deficits, the loss of blue collar jobs, the beginning hemorrhaging of white collar information technology jobs, the understanding that if we don't change things China is going to be the economic superpower of this world in the next 15 or so years, have you rethought your views on unfettered free trade?

Mr. GREENSPAN. All I can say to you, Congressman, is that in spite of the forecasts of the economists that you are citing, of which I can find a whole slew who will report exactly the opposite, we have nonetheless created the highest standard of living of the major industrial economy in this world.

Mr. SANDERS. Really?

Mr. GREENSPAN. We have.

Mr. SANDERS. Really?

Mr. GREENSPAN. That is what the facts are.

The question of increasing globalization, for which the trade deficit is a symptom, is something we should be pleased about, not concerned about, because a considerable amount of our real wealth creation, our real income creation for a broad spectrum of our society, even including the problem which I happen to agree with on the issue of undesirable increase in wealth concentration, we still have the most prosperous nation in the world.

Mr. SANDERS. Mr. Greenspan, are you telling us that we should see as a positive thing a record-breaking $618 billion trade deficit and the loss of 3 million manufacturing jobs in the last 4 years? That is a positive thing?

Mr. GREENSPAN. Our unemployment rate is 5.2 percent.

Mr. SANDERS. But the new jobs that are being created are low-wage jobs with minimal benefits, and we are losing our good-paying jobs.

Mr. GREENSPAN. That is not factually correct, Congressman.

Mr. SANDERS. Really?

Mr. GREENSPAN. I am sorry. That is not what the facts are.

Mr. SANDERS. Well, you tell—you know, maybe, Mr. Greenspan, one of the problems we have is you talk to CEOs, I talk to working people. And what working people tell me is they are losing good-paying jobs, parents are worried about the fact they are sending their kids to college now for information technology jobs; those jobs are going to China. You are telling me we are creating good-paying jobs with good benefits?

Mr. GREENSPAN. I am telling you——

Mr. SANDERS. I don't believe that.

Mr. GREENSPAN.——that I don't listen to the anecdotal stuff by itself; I look at the statistics. And the statistics tell us that we are getting job expansion fairly much across the board——

Mr. SANDERS. You are not worried about the loss of 3 million manufacturing jobs——

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from Illinios, Ms. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

Welcome, Mr. Chairman. I wanted to switch gears and go to a subject that hasn't been talked about, and that is Basel II. I know that the Federal Reserve has been closely involved in the process of crafting the new Basel accord, and that the final agreement was issued last summer.

However, the implementation has not taken place in this country. And there is still some outstanding concerns about the accord and its impact on the competitiveness of banks that are not required or not capable of complying with the agreement.

What is the Federal Reserve doing to ensure that the banks that are not required to comply with the accord are not put at a disadvantage via the banks that are required to comply?

Mr. GREENSPAN. Well, Congresswoman, remember that there is still a long way to go before we get actual implementation of Basel II. We are doing a considerable amount of research to determine

various areas where certain parts of our banking system may turn out to be competitively disadvantaged, inappropriately.

And as a consequence of that, where it is desirable and purposeful and studies show that, after a considerable amount of forward analysis on the competitive position, we will make adjustments as we proceed, as necessary.

Mrs. BIGGERT. Well, I know that there hasn't been any significant change to the operational risk.

Mr. GREENSPAN. Well, the operational risk issue is one in which we are stipulating that individual banks make their own judgments about what the risks are. That operational risks exist is a critical issue. They do exist.

Mrs. BIGGERT. What about the liability? I think that our U.S. tort law or liability laws are significantly more onerous than those in the E.U. or in Asia.

Mr. GREENSPAN. You are quite right. To the extent that our tort laws are more onerous than others, it is an objective increased risk. In other words, our purpose is to appropriately manage risk. And if in our society we choose to construct a certain type of tort system which has positive values, or we wouldn't have it. It also has negative values. And the negative values is that it does increase certain types of bank risk. And I think we have to recognize that fact. It is a fact. We can't believe it doesn't exist; we can't do it.

Mrs. BIGGERT. In order to assess the regulatory capital for a global bank, regulators in multiple countries will need to agree on the methodology and assumptions for the models that are going to be used to calculate the capital cover in subsidiaries. What is the Federal Reserve's position on the relative roles of the home and the host supervisors in implementing the new capital framework?

Mr. GREENSPAN. There is actually a committee in Basel, a subcommittee of the Basel Committee on Supervision and Regulation, which is trying to coordinate this very critical issue. From our point of view, for example, because of the extraordinary complexity of a lot of stuff, we are going to have to depend, in many cases, on the supervisory actions on the part of home regulators. That doesn't mean that we don't operate in it.

But what we are trying to do is to make the transition as smooth as possible, so that who has authority, the host regulator or the home regulator, is clearly defined and that it is done so in a way which implements the particular Basel II regulations most effectively.

Mrs. BIGGERT. And then let me just thank you for the work that you have done on financial literacy. I know that you have appeared before the commission and the Federal Reserve is working on that.

We formed a caucus in the House to really address financial literacy and to get out the word on that, too. Representative Hinojosa and I have just started this. And I think we all need to work together to make sure that our young people and adults are going to be able to live a successful life, without financial ruin.

Mr. GREENSPAN. That is a very important endeavor.

Mrs. BIGGERT. Thank you.

The CHAIRMAN. The gentlelady's time has expired.

And let me commend the gentlelady from Illinois and the gentleman from Texas on their work toward that caucus. It is ex-

tremely important, in financial literacy, and I know the Chairman appreciates that as well.

The gentlemen from Illinois, Mr. Gutierrez?

Mr. GUTIERREZ. Thank you very much.

Welcome, Chairman Greenspan.

Tuesday's New York Times indicated that one of the most important factors in maintaining the solvency of the Social Security system is the number of immigrants who are allowed to enter the country legally.

An immigration report authored by a former INS official under President Bush and based on an analysis of data provided by the Social Security Administration concludes that if legal immigration rises by one-third over the next 75 years, the result will be a 10 percent reduction in the Social Security deficit.

However if the number of immigrants declines by one-third, the retirement system shortfall will worsen by the same 10 percent.

The immigration report found that at the present pace new workers entering the United States, that is the pace of new immigrants legally entering our workforce, will contribute $611 billion in 2005 dollars over the next 75 years.

Chairman Greenspan, according to these data, doesn't it make sense that we should reform our immigration system to allow for a regulated, legal flow of workers to come here, build jobs, improve our economy, and strengthen Social Security, so that we can keep the promise we make to our seniors?

And I say that also, but I would like you to think about it in terms of the George Bush Department of Labor says that we will create over the next decade 6 million new low-wage, low-skill, very little training needed for jobs. Over the next 10 years we are going to create these jobs according to that.

And given the fact we have eight, nine, 10, depending on who you want to listen to, undocumented workers—workers, I mean people who are actually working in our economy, do you not think it would be appropriate that we take a look at our immigration policy vis-a-vis our economy and specifically our Social Security issue that we presently are addressing?

Mr. GREENSPAN. Congressman, as I have said before, I am always supportive of expanding our immigration policies. I think that immigration has been very important to the success of this country, and I fully support it.

I am not sure I would want to give the reason that we are creating immigration to support our Social Security system. I think we ought to do it on the grounds that it is good for the country, but not because it helps the Social Security fund, because that then suggests that we find other means to solve the Social Security problem, that we shouldn't be expanding immigration. And I would not support that.

So I would say I support the general issue of increased immigration, but I hope we don't do it for that particular reason.

Mr. GUTIERREZ. And that isn't why. And so I share that with you, Chairman.

Unfortunately, the Congress is not made up of such enlightened 435 people such as yourself. Would it be, I would not have to ask

this question, we could just look at. The fact is that we have a Social Security problem. We know that they enter.

And I guess my question to you is I want to reach that goal that you and I share, that is that immigrants are good for this country. They are good economically, they are good for the United States, and all of the other reasons. I want to reach that goal. Therefore, I have to change the immigration policy of this nation.

In order to change the immigration policy of this nation, because not everyone shares our perspective on immigrants, I have to find new reasons.

So I guess my question to you is, just so that I can say that even the Chairman Greenspan indicates, is it not true that we would add money to our Social Security, given their young age, and would that not help the solvency of Social Security, understanding that that should not be our principal reason for doing it?

Mr. GREENSPAN. You are asking a statistical question. Your numbers, as best I can judge, are accurate.

Mr. GUTIERREZ. Thank you.

Secondly, Congresswoman Kelly and I passed legislation designed to prevent bank examiners from taking a job with a bank they oversaw immediately following that supervision. We did that in the last session.

During our consideration of that legislation, the Office of Government Ethics brought to our attention that most of the criminal conflict of interest statutes, 18 USC Sections 203, 205, 207 and 209, that cover all federal employees, do not in fact apply to employees of the Federal Reserve Banks.

For example, 207 prohibits senior employees from representing a foreign government for 1 year after leaving the U.S. government or representing any party on whose matter they substantially and personally participated in while at their government post. Violation of the statute carries criminal penalties for every federal government employee, including employees of the Federal Reserve Board, but not employees of the Federal Reserve Banks.

I think this is a loophole that should be closed and bring the employees of the FRB Banks under the same laws that apply to every other government employee. Would you agree?

The CHAIRMAN. The gentleman's time has expired.

Mr. GUTIERREZ. He can answer the question.

Mr. GREENSPAN. I will have to—remember that the supervisory authority of the Federal Reserve Banks comes from the Federal Reserve Board. In other words, we at the board have authority under law.

But let me respond to your question a little bit more fully in writing, because I have to go back and look at the statute to be sure I can respond appropriately.

Mr. GUTIERREZ. That is fair.

Thank you very much, Mr. Chairman.

The CHAIRMAN. The gentleman from New Jersey, Mr. Garrett?

Mr. GARRETT. Good morning, or almost afternoon. And I appreciate the opportunity to address some questions to you.

And the issue of Social Security obviously has been pretty well exhausted, I would assume. And I tried to think before I came out

here, is there any other question on Social Security that you have not been asked today or previously while you were on the Hill.

Maybe I should put it that way: Is there any question that no one has asked you yet with regard to Social Security that I can go back and say I got the last question on Social Security?

Mr. GREENSPAN. Congressman, I am sure there is, but I can't think of it.

Mr. GARRETT. Then I feel good, that we are on the same—at least on that aspect we are on the same level.

The question with regard to GSEs was brought a little earlier ago by the Chairman. And just three quick areas that if you could touch on.

You began to touch on the aspect, as far as the problems, as far as the almost trillion dollars in outstanding debt, and you basically focused your talk at that point as far as the regulatory aspect and the need for caps and the regulation aspect of it.

Could you, first of all, maybe just elaborate a little bit on the aspect of if we do nothing on that area what the impact is on the overall market and the economy?

Mr. GREENSPAN. You mean if we do nothing in the GSE areas?

Mr. GARRETT. Yes, right.

Mr. GREENSPAN. The GSEs have a subsidy granted, not by law, but by the marketplace, which therefore gives them unlimited access to capital below the normal competitive rates.

And that therefore, given no limits on what they can put in their portfolios, they can, by merely their initiative, create an ever larger increasing portfolio, which given the low levels of capital, means they have to engage in very significant dynamic hedging to hedge interest rate risks.

If you get large enough in that type of context and something goes wrong, then we have a very serious problem because the existing conservatorship does not create the funds which would be needed to keep the institutions growing in the event of default, which is what the conservatorship is supposed to be and we have no obvious stabilizing force within the marketplace.

So I think that going forward, enabling these institutions to increase in size, and they will once the crisis in their judgment passes. They stopped increasing temporarily.

We are placing the total financial system of the future at a substantial risk. Fortunately, at this stage, the risk is, the best I can judge, virtually negligible. I don't believe that will be the case if we continue to expand in this system.

Mr. GARRETT. That raises the side question then, as you allude to, that, I guess the way I am thinking about it is potentially in the area for the housing market maybe we are—that proverbial bubble that is out there, that they say could someday be down the road that eventually collapses. Could you just touch on that as far as how that would impact on it and where we are going as far as the slight increases that we see in interest rates? Are we getting to that proverbial bubble then, that is potentially out there in the housing market?

Mr. GREENSPAN. I think we are running into certain problems in certain localized areas. We do have characteristics of bubbles in certain areas but not, as best I can judge, nationwide.

And I don't expect that we will run into anything resembling a collapsing bubble. I do believe that it is conceivable that we will get some reduction in overall prices, as we have had in the past, but that is not a particular problem.

Remember that there is a very significant buffer in home equity at this stage because with most of mortgages being of conforming type with a 20 percent down payment, and even when it is less, prices since the homes were bought have gone up on average very considerably, so we have a fairly large buffer against price declines and therefore difficulties which would emerge with homeowners.

Mr. GARRETT. The bubble is about to burst as soon as I buy my house down here in the Washington, D.C., area. I assume it is going to—that is when the market price will start going down again.

But going back to the GSEs. Assuming we take some action with regard to the regulatory nature of them, along the lines that have been suggested, is there some other method that we could also be looking into, a more efficient way to finance mortgages back into the private sector, to open up the private sector to allow them to have a more, if you will, competitive on a same playing field, that they can compete with the GSEs and open up that market so that they—if we are not just purely through the regulatory climate, we are actually allowing them to bring down that effect as well.

Mr. GREENSPAN. I think part of the issue is that the GSEs, as I understand it, essentially define what the issue constitutes conforming loans is. And indeed with their subsidy, they had very significant capability of competitive advantage.

It ought to, in my judgment at least, be made clear within a regulatory structure, which you are about to set up, I trust, that some definition of what constitutes conforming and non-conforming is made fairly clear and an awareness of the fact that we have a viable, a burgeoning market in securitization in non-conforming loans, so that there is a lot of potential competition out there, all of which would be very helpful, in my judgment, to maintain what is really quite a world-class mortgage market in this country.

Mr. GARRETT. Thank you very much.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from New York, Mr. Ackerman?

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

Mr. Chairman, I think I learned today that you are basically unflappable.

I would like to learn a little bit about what you are advising us on the tax cuts. You said that you were in favor of making the tax cuts permanent as long as the Congress invokes the pay-as-you-go or PAYGO rule. Is that——

Mr. GREENSPAN. That is correct, Congressman.

Mr. ACKERMAN. That means, as I understand it, that we have to have spending cuts in the amount of the tax cuts. Isn't that what means?

Mr. GREENSPAN. Spending cuts or increases in other taxes.

Mr. ACKERMAN. So you would make the tax cuts permanent only if we have increases in taxes or spending cuts.

Mr. GREENSPAN. I am basically saying that all such measures in my judgment should pass through the prism of PAYGO. In other words, we have very serious——

Mr. ACKERMAN. But we have to have cuts to make up for the loss in revenue.

Mr. GREENSPAN. I think so. If we look forward into the post-2008 era, we have to make some very major changes to constrain uncontrollable increases in the unified budget deficit. So I think that there are going to have to be extraordinary actions on the part of this Congress.

Mr. ACKERMAN. I am sorry. That is a pretty big test. So you are saying that if we the Congress don't make the offsetting expenditure cuts, that you would not be in favor of making the tax cuts permanent?

Mr. GREENSPAN. Well, I am not in the position to make that judgment. I am just merely stipulating that I think that specifically the tax cuts in reference to the elimination of the partial double taxation of dividends is important to economic growth, and I am basically saying that that is something we should do. But the overriding consideration is to make certain that our deficits don't run away because that will destabilize the whole system.

Mr. ACKERMAN. So things have to balance is what you are saying.

Mr. GREENSPAN. Correct.

Mr. FRANK. Will the gentleman yield?

Mr. ACKERMAN. If I can just finish my thought, Mr. Chairman.

So if things have to balance, that means in order to make the tax cuts permanent, we have to cut things such as agriculture and CDBG and other things, and then find other taxes to increase in order to offset the tax cuts that we made permanent otherwise things wouldn't balance. I don't know where else you would come up with balances. You have to increase other things and decrease other things and come up——

Mr. GREENSPAN. That is correct. No, that is what PAYGO is supposed to do.

Mr. ACKERMAN. So, Chairman Greenspan, it is safe for me to say, opposes making the President's proposed tax cuts permanent unless they go along with increases in other taxes and cutting expenditures that we now have in other programs.

Mr. GREENSPAN. I am not in the position to say yes or no to anybody's proposal. I merely just——

Mr. ACKERMAN. Okay. I will take out the specifics in agriculture and CDBG.

Mr. GREENSPAN. I am basically stipulating that I think that, one, those tax cuts should go forward, and that we should make the changes similar to the changes you are suggesting.

Mr. ACKERMAN. Okay. I just want to understand this clearly. Chairman Greenspan is saying that he opposes making the President's proposed tax cuts permanent——

Mr. GREENSPAN. Congressman, I think I have spoken for myself in this regard. Your choice of words——

Mr. ACKERMAN. Yes, but I am trying to—I am speaking for myself, and I don't—I am trying to understand this.

Mr. GREENSPAN. No, I am trying to say that I am making two propositions here.

Mr. ACKERMAN. I understand you don't want to say you are opposed to anything the President has said. So maybe I should phrase it differently so you don't have to say it that way.

Mr. GREENSPAN. No, I don't want to say I am opposed, because I am not. I want very much for both the tax cuts—that tax cut to be in place and the PAYGO changes to be made. I don't know how else to say it.

Mr. ACKERMAN. In order for that tax cut to comply with PAYGO, the changes to be made have to be one or the other or a combination of other taxes or reducing expenditures. Otherwise that doesn't comply with PAYGO, and Chairman Greenspan would not support unless it complies with PAYGO, which is what you said at the beginning.

Mr. GREENSPAN. That is what I said, yes.

The CHAIRMAN. Gentleman's time has expired.

Mr. ACKERMAN. Thank you very much.

The CHAIRMAN. Gentlelady from New York, Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

Chairman Greenspan, after 9/11 this committee passed the Terrorism Risk Insurance Act to backstop our insurance industry and allow business development to move forward in this country.

For an administrative cost of only $31 million a year, TRIA has provided hundreds of billions of dollars worth of new jobs and investment in our country.

Unfortunately, real estate investment in this country could eventually come to a halt if TRIA is not reauthorized.

This Congress must act or TRIA will expire, forcing millions of Americans to choose between not doing business or losing insurance coverage against terrorism.

Either way, our economy would suffer and terrorism would win a big psychological battle without even firing a shot.

Some members of this House say that TRIA is unnecessary and believe that, without evidence, that private reinsurance is available to cover policies against terrorism.

I asked you a question about that, and in my response to that question I have a letter that you wrote to me on September 16th, 2004, and I quote from that letter:

"Even with TRIA, reinsurance appears to be virtually nonexistent for catastrophic damages from nuclear, biological, chemical and radiologic attacks. These examples suggest that while there would be likely some coverage available in the absence of TRIA, the private market for terrorism insurance would still be quite limited."

And I am quoting from your letter. Do you have conclusive evidence that a robust private market for terrorism reinsurance exists in this country separated from TRIA at this time?

Mr. GREENSPAN. Not to my knowledge, Congresswoman.

This is a very difficult issue, because remember that private markets work exceptionally efficiently in a civilized society in which domestic violence or violence coming from abroad is not a central factor.

You cannot have a voluntary market system and the creation of markets, especially insurance markets, in a society subject to unanticipated violence. And as a consequence, there are certain types of costs, which is what we have the Defense Department protecting us from, which we essentially choose to socialize.

The less of that we have, the better off our society is. There are, nonetheless, regrettable instances in which markets do not work. And while I think you can get some semblance of terrorism insurance, I have not been persuaded that this market works terribly well.

Although I will tell you, numbers of economists and people whom I respect highly, don't agree with what I just told you. They think the markets can be made to work. I have yet to be convinced.

Mrs. KELLY. The GAO also released a report last year indicating that a functioning market for terrorism insurance would not exist if TRIA were allowed to expire.

You further stated to me in this letter that if an efficient pricing mechanism for terrorism risk did not exist—and I am quoting you here—"some level of federal involvement in terrorism insurance may continue to be warranted."

Without a functioning private market for terrorism insurance in the absence of TRIA, do you think government can replace market signals as an arbiter of terrorism insurance prices?

Mr. GREENSPAN. I don't think so.

Mrs. KELLY. Thank you, sir.

Yield back.

Ms. PRYCE. [Presiding.] Recognize Mel Watt.

Mr. WATT. Thank you, Madam Chair.

Secretary Greenspan, I am over here, in case you are looking for me.

Mr. GREENSPAN. I was. Good to see you, Congressman.

Mr. WATT. Good to see you.

I am going to try to understate this because if I said it as aggressively as I feel it, I suspect I would insult you and some other people. So I am just going to make a one-sentence statement about it, and then I am going to move on and ask you a question about something else, not designed to evoke a response.

I would have to say that when I hear you, when I hear the President use as a major justification for this Social Security reform plan that he is trying to look out for black folk, and when I hear you use as a major justification for private accounts that you are somehow trying to look out for poor people, it makes me nauseous.

I am going to leave that alone and move on. If I said it—if I dwelled on that, I would probably throw up.

I am moving on, Secretary Greenspan, because I don't—I mean, I have no interest in getting into a public dispute. I won't be able to restrain myself on that issue. So the best thing I can do on it is move on.

Let me ask a question. You made reference to full funding of Social Security requiring $10 trillion. And I believe you said that there is $1.5 trillion or will be at some point in the trust account.

Mr. GREENSPAN. There is as of now, as best I—roughly that.

Mr. WATT. Okay. Am I clear that the reason there is only $1.5 trillion in the trust account is that substantial amounts have been

borrowed from the trust account and that, in addition to the $1.5 trillion that is there a substantial amount of notes that are due?

Mr. GREENSPAN. No, actually the $1.5 trillion is actually a cumulative difference between receipts, namely, the Social Security taxes, plus interest, minus the cumulative dividend. So it is actually real savings.

Mr. WATT. I am asking you whether there are substantial amounts due from bonds, government-backed securities, into the Social Security trust fund in addition to the $1.5 trillion. That is the question I am asking.

Mr. GREENSPAN. There are no additional assets. Is that what you are referring to?

Mr. WATT. Well, does the federal government owe the trust fund any money?

Mr. GREENSPAN. Not to my knowledge.

Mr. WATT. So that is just a myth. Has the federal government borrowed money out of the Social Security trust fund?

Mr. GREENSPAN. Well, remember that what is involved here is that the——

Mr. WATT. I think that would require either a yes or no answer. Has the federal government borrowed money from the Social Security trust fund or hasn't it?

Mr. GREENSPAN. No.

Mr. WATT. Okay. All right. Then explain why that is not the case.

Mr. GREENSPAN. Basically, what the Social Security trust fund does is it invests in U.S. treasury issues.

I think the question you are raising is a different issue as to whether in fact that particular fund is segregated and allowed to actually increase national savings.

Mr. WATT. No, I am not asking that question at all, Mr. Greenspan. I am asking, does the $1.5 trillion include the amount that the trust has invested in government-backed securities?

Mr. GREENSPAN. That is it. It is $1.5 trillion in U.S. treasury special notes.

Mr. WATT. Okay. All right. Well, that was the only question I was trying to get to.

What——

Ms. PRYCE. The gentleman's time has just expired.

Mr. WATT. Thank you.

Ms. PRYCE. The gentleman from Kentucky, Mr. Davis?

Mr. DAVIS OF KENTUCKY. Thank you, Madam Chair.

Chairman Greenspan, I appreciated very much your remarks this morning on the importance of greatly increasing our national productivity over the long term.

I spent my professional life in the manufacturing sector. Many of the members on the committee, in fact, represent districts that depend on competitive manufacturing and a global economy to sustain our communities.

I was wondering if you could make a comment, from a strategic perspective. You have seen in your distinguished career a great ebb and flow in our international competitiveness, changes in adaptation that we have had to make in various regions of the country to compete, especially with Asia.

I was wondering if you would share with us the points that you feel are most important from a strategic policy standpoint to assure that we have strong, competitive, and adaptive manufacturing in the future.

Mr. GREENSPAN. Congressman, I think that one of the key aspects of the American economy is its increasing integration into a global system. Barriers to cross-border trade are coming down all over the place.

The issue of communications has shrunk the distance that is involved. I should say communication plus transportation has shrunk the distance between peoples around the globe.

And what we are finding is, in the same context that say 150 years ago, we gradually in this country developed—went from local markets to national markets—is that we are going from national markets now to global markets. And we are exceptionally competitive in that regard in the sense that of all the industrial nations in the world, few have gained from globalization as much as we.

The reason for that is we have an exceptionally flexible economic system. We have had bipartisan deregulation since the 1970s of a whole series of different industries. The information technology has created an incredible capability to develop new financial instruments and to develop basically the types of things which enable a system to adjust around the world.

And I think the major focus that we have to maintain is, one, to keep that degree of resilience and flexibility, which means eschew issues of protectionism, regulation, and anything which rigidifies the market's adjustments process which has served us so well in the last decade or so.

Mr. DAVIS OF KENTUCKY. Just as a follow-on, how would you adjust current trade policy to continue to strengthen international exports in manufacturing?

Mr. GREENSPAN. I think that we do that by essentially being competitive, in that we develop skills that create goods and services which customers and the rest of the world want. And we have tended to do that.

The issue of the very large trade and current account deficits we have developed or created is largely because globalization has increased. We used to have, and indeed still have, very significant balance of payments deficits between states in this country. In and of itself, it is not a problem in that if it is done in a market system they self adjust, as ours do all the time. We don't know what our current account balances are between say, New Mexico and Arizona, or any of the states.

There have been occasions when there have probably been severe imbalances. But they correct, and they correct basically because we have a flexible system which enables markets to adjust.

Mr. DAVIS OF KENTUCKY. Thank you, Chairman Greenspan.

I yield back my time.

Ms. PRYCE. All right.

The Chair would like to put members on notice that there is going to be a series of votes at about 12:30 that should last about an hour. So anyone who cares to keep their questioning short so more of us can have at the Chairman, that would be great. But be-

cause the votes will last about an hour, we will adjourn the hearing at the time the votes are called.

And the chair now recognizes Mr. Meeks.

Mr. MEEKS. Thank you.

Thank you, Mr. Chair. I am really somewhat puzzled from some of the answers that I have heard today. Let me just see if I can clear up my own mind.

The first question that I have is, I know the President has described it as a crisis, et cetera, but I don't think I have ever heard what your opinion is. The question on Social Security is it or is it not, in your opinion, a crisis?

Mr. GREENSPAN. It depends on the——

Mr. MEEKS. Yes or no. Is it a crisis or is it not?

Mr. GREENSPAN. Let me be very specific. You have not heard me use that word this morning.

Mr. MEEKS. That is correct, and that is what I am trying to find out from you whether in your opinion——

Mr. GREENSPAN. I did not use it——

Mr. MEEKS.——it is or is not a crisis.

Mr. GREENSPAN. I did not use it yesterday in the Senate. I consider the problem a very serious one, one that has to be addressed, in my judgment, quite soon, and certainly to be in place well before the 2008 leading edge of the baby boom generation retiring.

Mr. MEEKS. So I take that to say, as we sit here today, not 2008, but as we sit here in 2005, that it is not a crisis. It could be a crisis. It may sometime in the future, but as we sit here today, it is not a crisis in your humble opinion?

Mr. GREENSPAN. Well, I don't use the word "crisis" because I think the same—defining what it is very specifically describes what it is. I think it is a very serious issue. It depends on the way you use the word crisis. I have not chosen to use that word. Others might.

Mr. MEEKS. What about Medicare? Is that a crisis?

Mr. GREENSPAN. It is a very serious problem. I mean, again, it has got the same characteristics. And I would not use the word crisis because I don't think that that properly identifies what the nature of the problem is.

Crisis to me usually refers to something which is going to happen tomorrow or is on the edge of going into a very serious change. That is not going to happen in either Social Security or Medicare over the next several years.

Mr. MEEKS. I don't want to get into this privatization stuff either, but let me—Social Security. But let me ask another question then. You know, it seems as though that some say, and I have heard you say, and I believe I heard you say it today, that you believe in these private accounts, that that is a good thing, the private accounts.

Mr. GREENSPAN. I do.

Mr. MEEKS. Okay.

And I have also—I think I heard you say, in reference to Mr. Watt's, one of his questions, that the $1.5 trillion, et cetera, we have not taken it out; the feds haven't borrowed the money. Is that correct?

Mr. GREENSPAN. That is correct.

Mr. MEEKS. All right.

Now, so therefore, when you talk about this solvency problem, it is talking about, in the end, the money that is coming in is not going to be sufficient, but the privacy accounts, allegedly, you are supposed to get a better return on your money as a result, so that is supposed to help. Is that correct, when you have these privacy accounts?

Mr. GREENSPAN. I have not stipulated that increased rates of return are a significant issue in this debate. What I think, it is a question of what type of facility more easily facilitates the type of full funding of these types of programs that we need if we are going to get the savings to create the investment which is going to create the goods and services.

This is not a financial question. This has got to do with, how do we create an adequate amount of real resources for the retirees and the working-age population in 25 years.

Mr. MEEKS. My question then, and then I will just try to yield so more of my colleagues have a chance to ask a question, if the securities market—and I guess people are making it up to be so great—why don't we then, would you recommend, why don't we invest a portion of the trust fund in the market itself and eliminate the individual risk? Why do you have to put the individual at risk? Why don't we just put the money in the trust fund in and eliminate the individual risk?

Mr. GREENSPAN. I am sorry, you mean have the Social Security trust fund invest in——

Mr. MEEKS. In securities.

Mr. GREENSPAN. You could do that, but that still doesn't give it—you still need $10 trillion, not $1.5 trillion. That doesn't solve the funding problem.

Mr. MEEKS. So basically the proposal that I am hearing from the President then, I think we all agree, has nothing to do with the solvency problem, because if you invest the money in these private accounts on an individual basis, it is the same as if you were to have done it within the trust fund, and you don't resolve the solvency problem. So the crises that claims, or the problem that you claim will not go away based upon these private accounts. Is that correct?

Mr. GREENSPAN. The issue is not a solvency question, it is getting adequate amount of savings in the trust fund to finance investment. It is a full funding problem, not a solvency problem.

Ms. PRYCE. The gentleman's time has expired.

The gentleman from Georgia, Mr. Price, is recognized for 5 minutes.

Mr. PRICE. Thank you, Madam Chair. I appreciate that.

It is an honor to be a part of this committee, and it is indeed a privilege to personally witness your wisdom. And I commend you for your dexterity and your persistence in your answers to many of the questions that have come to you today.

I have a comment and then a couple of questions.

I am so pleased to hear you in your written testimony and in your spoken testimony identify 2008 as the pivotal date as it relates to the Social Security issue, for two ones.

One, as you appropriately identified, that is when the baby boomers begin to retire.

The second reason that I believe that needs to be pointed out, and that is that on the wonderful graph of the incoming money as it relates to FICA and when we begin to dip, that is the top of that crest. And then we begin to go down where there is money going out than coming in. So I commend you for that.

And I don't care whether you call it a crisis or a near crisis or a looming crisis, as President Clinton called it in 1998, a rose is a rose is a rose. I think the important issue is that you said clearly, "There is a call for action before the leading edge of the baby boomer retirement becomes evident in 2008," and that is within 3 years.

My question relates to our savings rate as a nation. And it is my understanding that the household savings rate is low as it relates to our history as a nation, and also as it relates to other industrialized nations.

And so I would ask you what your thoughts are on anything that we might do in terms of policy that would positively and significantly affect our savings rate as a nation.

Mr. GREENSPAN. It is one of the most difficult problems government has had, Congressman, in trying to address this particular question. And the reason is that it is not just a question, as we tend to do, create vehicles to save, such as 401(k)s or IRAs or the like, because what we really have to do is to get people to consume less of their income, because that is what savings is. If you don't consume less of your income and you are building up a 401(k), it is essentially saying that you just drew the funds from other forms of savings and you did not increase your aggregate amount of savings.

So the issue really gets down to the question of how do you increase income relative to consumption. And that is not very easy for government to address per se. What we can do is find measures which will augment the growth rate in the economy, create incentives for growth and the like.

But unless you impose some things such as a consumption tax, which economists have argued for, which I suspect has very little support in the Congress, it is difficult to see how you come to grips directly with that issue.

I might add that the consumption tax issue arose essentially because there does not seem to be any other way to directly get at this issue. My suspicion is that the 1 percent savings rate, which is what it has been for the last year, is probably going to be the low point, and we will start to rise from here. But that has been my expectation for a number of years, and I can't honestly wish to guarantee it, because it is a very tricky issue to forecast.

The bottom line, Congressman, is I really can't suggest anything which is significant, practical and usable to address this subject and just hope it cures itself, sooner rather than later.

Mr. PRICE. I appreciate your response, and I am so pleased to hear you talk about the consumption tax, because, as you identified, you have got to have increased income in order—relative to consumption. If the money never gets to your back pocket, it isn't income.

So if I heard you correctly, I understood you to say that, if we were to be able to move to a consumption tax, to a national retail sales tax, that that would in fact have a byproduct of increasing

national savings as you increase the amount of money in individual's pocket.

Mr. GREENSPAN. I would certainly think so, because what you are doing is you are taxing consumption, not income, and as a consequence, as people like to say, if you tax it, you will get less of it. And I think that is probably right.

Mr. PRICE. Thank you, Mr. Chairman.

I yield back.

Ms. PRYCE. Mr. Moore of Kansas?

Mr. MOORE OF KANSAS. Thank you, Madam Chair.

Mr. Chairman, when you talked about the $1.5 trillion in the so-called Social Security trust fund, I think you used the words, "special security notes," or words to that effect. So the fact is, we don't have $1.5 trillion in the fund itself, we have special security notes, correct?

Mr. GREENSPAN. That is correct. The point I am making is, you do have $1.5 trillion of cumulative savings in the national—in other words, it is contributed cumulative, $1.5 trillion, to savings which is part of national savings.

Mr. MOORE OF KANSAS. All right. Is this a marketable special note or fund?

Mr. GREENSPAN. No, it is not. It is not marketable. And it gets converted to a marketable security when Treasury needs to raise funds to pay benefits.

Mr. MOORE OF KANSAS. So at some point this is an obligation, and the full faith and credit of the United States government's behind this, and at some point in the future funds will have to be raised to redeem that, correct?

Mr. GREENSPAN. That is correct.

Mr. MOORE OF KANSAS. Okay. I think there is a lot of maybe misinformation or lack of information in the general public about what actually Social Security is. It is a partial retirement fund, as well as a survivors benefit and a disability benefit. Is that correct, sir?

Mr. GREENSPAN. OASI is separate from the disability fund, but the answer is, you are quite correct.

Mr. MOORE OF KANSAS. But I think there is misinformation and again lack of information about the fact that about a third, or 30 percent of funds that are paid out to Social Security recipients go for survivors and disability and not just retirement or old age. Is that also your understanding?

Mr. GREENSPAN. That is correct. There are disability payments implicit in the OASI fund which relate to disabled children or survivors——

Mr. MOORE OF KANSAS. Right.

Mr. GREENSPAN. But there is also, of course, an additional fund, which is the disability insurance fund, which is for disability solely.

Mr. MOORE OF KANSAS. And I have heard your statements, Mr. Chairman, about the President's proposal for partial private accounts, and you have said generally you support those. And I am a little confused, because I heard you say that—I think, correct me if I am wrong, I think that I read that you said that if we had to borrow $2 trillion you wouldn't be supportive of something like

that; if we had to borrow $1 trillion, you might support that. Is that correct, sir?

Mr. GREENSPAN. I said that because of the difficulty of making judgments as to how markets would behave when you are moving funds out of the U.S. treasury into a private account, even though it is forced savings—meaning, you can't do anything with it—and from a technical point you have not changed the national savings rate, have not changed the balance of supply and demand of securities, and have not therefore presumably affected the price level of bonds, there is still the issue of how that is perceived by the marketplace, which is not all that easy to make a judgment on.

My general concern is that if we knew for sure that the contingent liabilities that now exist are viewed in the private marketplace as similar to the real debt of the federal government, then technically moving funds in a carve-out of the way that the President is talking about would have no effect on interest rates, no effect, indeed, which would then be an accounting system which would be based on accrued receipts.

The problem is caused by the fact that we are running unified budget——

Mr. MOORE OF KANSAS. Moving aside from the interest rates concern right now, which I understand is a huge concern, if we were to borrow $2 trillion or $1 trillion right now—and I am saying right now, over the next several years—to finance these partially private accounts and divert money out of present retirement benefits being paid to Social Security recipients, wouldn't that just pass a debt along to our children and grandchildren? And is that fair?

Mr. GREENSPAN. Well, the question is, remember that, at least as I understand the President's program, which has not been produced sufficiently as yet, that is offset by potential benefits to be paid or scheduled to be paid at a later time. So taking the full context of a particular individual's period, then the debt in that regard does not change over the long run.

Mr. MOORE OF KANSAS. I understand. But we can have the best intentions in the world, and when the President talked to Congress about the Medicare program it was $400 billion, now it is $754 billion.

Ms. PRYCE. Gentleman's time has expired.

Mr. MOORE OF KANSAS. Projections don't always work. Isn't that correct, sir?

Mr. GREENSPAN. That is, of course, correct.

Mr. MOORE OF KANSAS. Thank you.

Ms. PRYCE. Mr. Barrett is recognized for 5 minutes.

Mr. BARRETT. Thank you, Madam Chairman.

Mr. Chairman, I was concerned about your testimony on the differences in wages from skilled and non-skilled workers. And I have seen the result in my rural district in South Carolina.

I know that education is an important tool when we are talking about trying to lessen the differences between the skilled and the unskilled. But is there anything else we can do, other than education, to help balance the two?

Mr. GREENSPAN. The issue of education is so critical to this that it overwhelms, in my judgment, all alternate policies to address

this issue. Now, you have to include in education, obviously, on-the-job training, even education which is not even formal.

And the essential reason is that what makes our country competitive is in my judgment two things. One, it is our Constitution, which creates a rule of law which people want to invest in. And two, it is what is in the heads of our children, because they are the future of the people who will staff our increasingly complex capital stock.

I am not sure what else there is to do, because the job is very large in the issue of education and I would not divert resources to anything other than that, if the purpose is to address and resolve this particular issue.

Mr. BARRETT. Thank you, Mr. Chairman.

Thank you, Madam Chairman.

Ms. PRYCE. Mr. Capuano is recognized for 5 minutes.

Mr. CAPUANO. Thank you, Madam Chair.

Thank you, Mr. Chairman.

Mr. Chairman, I just want to just point out a couple little facts. You have repeatedly stated how strongly you support the PAYGO rules.

And just as a point of information, the last vote this Congress had on those was November of 2002, as they were expiring, and only 19 members of the House voted to continue those rules. Of those 19 members, three of them are on this panel today. They include myself, Congresswoman Waters and Congresswoman Lee.

Now, my guess is that, if you don't know the rollcalls, most people wouldn't have expected the three of us to have voted to continue the PAYGO rules.

But I guess the reason I say that is, I agree with you. I think it is fair to have the PAYGO rules in the context of you get what you pay for, period. Be honest. Without the PAYGO rules, we run a dishonest accounting system. As far as I am concerned, for all intents and purposes this government is bankrupt.

Fair enough. We lost. I think we have to get over it. I don't think they are going to come back. With only 19 votes on the floor, I don't think they are going to come back.

So for me, though I agree with you 100 percent that the PAYGO rules were good and we should readopt them, they are not going to get readopted. And therefore, we have to look, how else to we do it? How else do we get back some fiscal sanity; in my opinion, it is fiscal honesty.

Every time you have come before this committee since I have been on it, you state your support for tax cuts for the wealthiest amongst us. I respectfully disagree. I understand your position. I am not going to challenge you on it. I don't think you are about to change. But clearly your opinion is that the tax cuts for the wealthiest amongst us are more important than programs.

Because if you have it on a system, you only have revenues and expenditures, we haven't cut back our expenditures as much as you would need to balance our budget, and especially when we cut our revenues, so therefore we have an imbalance. We have a deficit.

And if we are not going to change our expenditures, which we haven't, we shouldn't change our revenues, I would argue. And I understand that we disagree.

So I just wanted to make that clear: The PAYGO rules—maybe I am wrong, but they were killed in 2002. There is no real serious talk that I have heard of to bring them back, though if you can generate that talk, I will support you.

But what I do want to talk about is, okay, here we are. We haven't got PAYGO rules. We have deficits for as long as we can see, climbing deficits, dangerous deficits. I know you don't use the word "crisis," but I would, relative to deficits.

Now we have a proposal in front of us for whatever the program might be, it happens to be Social Security today, but whatever it might be, that might require this government to borrow trillions of dollars. I am not going to try to get you on any of these, because you are too good at avoiding answers you don't want to answer. You didn't answer it yesterday, I don't expect you are going to answer it today as to what the impact of that $2 trillion borrowing might be on today's market.

But I do want to ask you, based on your own testimony, not your testimony, but the report that is in front of us, the table on page 13 clearly indicates something that is a fact, but the table is not new to me, but it is interesting. Since the year 2000, the percentage of treasury securities held by foreign investors as a share of the total treasuries held has gone up above 45 percent, has increased by 45 percent in just 4 years. Regardless of additional borrowing, do you find that troubling? Do you think that is good, bad or indifferent?

Mr. GREENSPAN. I find it difficult to make a judgment for the following reason: The reason that they are investing in the United States is they find our U.S. treasury instruments the safest instruments in the world. And in one sense, I am pleased by the fact that that is the view of the rest of the world.

As we are becoming increasingly global, there is going to be a great deal of cross-border investment, and everybody's portfolio is going to have a very big chunk of foreign something.

Mr. CAPUANO. So then these foreign investors think that we are a good investment. So therefore there is no reason to believe that the market today would think that the payments coming due to the Social Security trust fund wouldn't be paid.

Mr. GREENSPAN. There is no response in the market at this particular stage that I am aware of.

Mr. CAPUANO. Good.

And would it be unreasonable or reasonable to presume, to add these two things together, that if we were to go out for an additional $2 trillion worth of borrowing, that, based on statistics today, is it reasonable to presume that 45 percent of that or 50 percent of that would be bought by foreign investors?

Mr. GREENSPAN. It is conceivable that it might be more than that.

Mr. CAPUANO. So, therefore, if we are going to mortgage our children's future in Social Security——

Ms. PRYCE. The gentleman's time has expired.

Mr. CAPUANO.——we would be doing it to the Chinese, the Japanese, the Saudis and everybody else around the world except ourselves.

Thank you, Mr. Chairman.

Ms. PRYCE. Mr. Jones is recognized for 5 minutes.

Mr. JONES. Madam Chairman, thank you.

Mr. Greenspan, I would like to pick up on what my friend from Massachusetts was speaking to. And you are a very learned man. We all have great respect for you, whether we agree or disagree. But I just have to believe with this debt of this nation, the deficit of this nation, that there is going to come a time—and maybe we won't be here—but there is going to come a time, if we don't get a handle on this, we are going to be in deep, deep trouble.

This is my question: If Japan owns over $700 billion of the U.S. debt, mainland China and Hong Kong together hold over $250 billion of U.S. debt, Mr. Chairman, the question is, if this deficit continues to rise, and it looks like we are not going to do what needs to be done to hold it from rising, what would be the impact on U.S. financial markets if Japan or China were to stop buying U.S. treasury bonds?

This might be a hypothetical, but I would appreciate if you would give us your opinion.

Mr. GREENSPAN. Yes. We have looked into that question, and I think that we have concluded that the effect of foreign borrowing of U.S. treasury instruments has lowered long-term interest rates a modest amount. And therefore, if they were to choose to stop buying or to sell, it would raise interest rates, but, again, by a modest amount.

And the reason for this is that U.S. treasury securities, as big as they are, and as important as they are, are only a fraction of the competing securities around the world, which is what this market is.

It is a worldwide market. And in a sense, it is a market in which interest rates in various different localities and for various different instruments are all arbitraged.

And so if there is a significant purchase or sale of U.S. treasury security, it is sort of dispersed on the other parts of the market at the same time, so that the adjustment is not particularly great.

But the issue you raise is a much deeper one. If we run into serious trouble with respect to our deficit, it is not a question of whether foreigners will buy or not buy our securities, it is whether Americans will buy or not buy our securities. And that to me is where the critical issues lies.

We are looking at a gulf in our unified budget for all sorts of reasons, of which Medicare is the largest one, in the period as we get into the next decade. And unless we address that issue now, well in advance of its occurring, I am not sure that we are going to be able to get an appropriate handle on it before it creates serious problems down the road.

Mr. JONES. Mr. Chairman, I agree with you totally about the deficit. And thank you so much for being here today.

I had a second question, but I want my colleagues to have equal time as I have. So I yield back my time. Thank you.

Ms. PRYCE. Thank you, Mr. Jones.

Mr. Crowley is recognized.

Mr. CROWLEY. Thank you, Madam Chair.

And thank you, Mr. Chairman, for being here once again before our committee.

Mr. Chairman, I want to bring the issue back again to Social Security. In your view, is it possible to create private accounts, that my Republican colleagues would like to do, as the President would like to do as well, without substantially borrowing for the transition that would have to take place? And if so, how would you do that?

Mr. GREENSPAN. The only way to do it is to essentially either borrow, raise taxes or cut other spending.

Mr. CROWLEY. So the President's options are—and I will just repeat them—would either be a massive tax increase on the American public—we are talking about massive, anywhere between $1 trillion and $2 trillion, or twice what the IRS took in tax revenues last year. And I believe you stated yesterday that anything over $1 trillion is considered—$1 trillion is large, a large tax increase on the American public. That was A.

B, there would be a huge, potentially huge cut to benefits to both current and future, I am assuming, retirees, including the disabled, as well as the dependent children, which is a real possibility.

But those benefit cuts would have to come to today's retirees, as I mentioned before, almost immediately in order to pay the $1 trillion to $2 trillion in borrowing that is needed for the Social Security privatization plan. Or—and this, I think, is the most egregious—massive new deficits.

And in essence my colleagues on the other side, I think very effectively, use the issue of the death tax politically incredibly well, and I think cornered us in many respects.

What I think is even more immoral and more egregious is the fact—I have two children, 4 and 5, and, quite frankly, I am expecting a third child, although I don't think my wife expected me to say that on national television.

But if you take the fact that my children today owe $26,000, theoretically, in national debt, each, as we all do, my unborn child to be, once it comes out of the womb, will have a price tag of $30,000 that he or she will have to pay—you know, we are all going to die some day, and maybe we are going to need the death tax benefit to pay for our birth tax.

And I think that is the most egregious thing about what we are doing to ourselves with this mess of deficit that we are putting our children and our children's children into fiscal disability in the future. Can you comment on that?

Mr. GREENSPAN. Congressman, the problem we have is that there is this yawning, unfunded future liability. This issue is going to emerge, no matter what solution you are talking about, because we are short of funds. The $1.5 trillion in the OASI fund is just not adequate.

And the problem that we are going to confront is somewhere along the line, you are going to have to increase taxes or reduce spending somewhere, if we are going to keep the deficit under control.

Mr. CROWLEY. Mr. Chairman, I appreciate—I am going to yield back in just a moment. Let me just say, I believe in personal responsibility. That is not just a Republican adage, Democrats believe that as well. I do believe that we have to contribute, ourselves, to our own personal retirement.

And building up ownership in the retirement, as I think the Chairman mentioned earlier in his opening statement or in his opening question to you, I believe in that. I think we all have to contribute in some way toward that.

But Social Security was one leg of the stool, or the chair or the table, in that vein.

I am 42 years of age. I still don't think about Social Security. I am not even thinking about retiring. But I also know that I have to do other things in order to retire, to save for my retirement. And that includes making sound fiscal choices.

And I think part of that is investing in the stock market, is in 401(k) plans, is in other pensions, et cetera, et cetera.

I think that you are right that we will have to do something, this is a problem that will have to be addressed. It certainly is not a crisis. And I don't think that it has really borne well for the President or my colleagues on this side to present it as a crisis.

It is a problem we all should try to, and I think will work to solve. But I think it goes beyond just Social Security. It is about retirement and what we have to do to the American public to understand that it is about personal responsibility, they need to be engaged in this, and it is not just a problem of Social Security.

And I yield back the balance of my time.

Ms. PRYCE. Thank you.

The gentleman from Pennsylvania, Mr. Fitzpatrick, is recognized.

Mr. FITZPATRICK. Thank you, Madam Chair.

Mr. Chairman, I want to go back to the issue of workforce investment, following up on Mr. Barrett's question earlier.

Even though the unemployment rate has dropped to 5.2 percent, there are many men and women in my district in Pennsylvania who are still looking for jobs and whose job skills miss the skill requirements of the jobs that are actually available in Pennsylvania and across the nation.

And I am a new member of Congress, and find out now, I have been visited already by the community colleges from my district. I have heard from my technical high schools. There are a number of federal programs out there investing in education and workforce investment.

I was wondering, Mr. Chairman, if you have any thoughts, or even recommendations on better coordination of education funding to better meet the needs of the next generation of Americans, so that they will be prepared to take the jobs that are actually available?

Mr. GREENSPAN. Congressman, I think we have two problems in the area of education. One is to solve the dilemma that one of your colleagues mentioned earlier, namely that in the fourth grade our students seem to rank average or somewhat above average in math and science relative to the rest of the world, but by the twelfth grade, we are down quite low, in the lowest quartile, as I recall. In other words, we are not doing something that the rest of the world does to bring forward the skills of fourth graders through the end of high school. And we have got to address that, because it is a really crucial problem.

Secondly, within the types of institutions generally where we seem to be getting the most leverage is the community college, in

the sense that people are going back to school, and as you probably, I am sure, are aware, a significant proportion of enrollees in community colleges are in their 30s. It is not just the young kids, just coming out of high school. And they are going back to pick up the skills which they need to compete in the world.

And I think the dramatic growth that we have seen in community colleges suggests that the demand is there for exactly the type of education, which is an education usually very specific to a specific profession, it is not a generic education, which is what the 4-year college tends to do. And that seems to have been quite effective.

We do have the problem, as I have indicated before, that we have not solved this question of matching skills with the requirements of our capital stock, but it is clear that where we are making progress apparently, or at least doing the right thing, is in advancing our community colleges.

Mr. FITZPATRICK. Thank you, sir, for your thoughts and for your service to our nation. I appreciate it.

I yield back my time.

Ms. PRYCE. Thank you.

Mr. Clay is recognized.

And let me just say, there has been a vote called, and this will be the last question of the day.

And you may proceed.

Mr. CLAY. Thank you, Madam Chairman.

Chairman Greenspan, I am concerned about the deficit, and you have voiced concerns numerous times about deficit spending also. There are those who champion tax cuts without regard for future budget consequences. Those who championed the tax cuts of 2001 repeatedly cited the benefits to the economy of that tax cut.

Of course, there were those of us who said that most of the cuts were unfunded mandates of a sort and would result in deficits.

The CBO has released new data that show that the changes enacted since January 2001 have increased the deficit by $539 billion. They also say that in 2005, the cost of tax cuts enacted over the past 4 years will be over three times the cost of increases in domestic spending.

Mr. Chairman, what are your concerns about this huge deficit? And do you still view the tax cuts as being beneficial to the economy? Where do you suggest we go from here? And if you could, elaborate.

Mr. GREENSPAN. Well, Congressman, I want to emphasize that our critical first priority is to get the long-term deficits under control.

In that context, you do have room—or should have room, as we will indeed have room—to, one, increase spending on certain programs, and reduce taxes on others. You can't go, with the huge budget that we have, you can't think in terms that everything goes in the same direction. That is not the way the Congress should or does adjust the priorities of the nation.

So I think that I would say the first priority is to assure that deficits are under control. After that, I think the resources that we use and in what form we use them are judgments that the Congress has to make.

I personally think that we would be well served by having significant elimination of the double taxation on dividends because I think that is a crucial aspect of economic growth, which obviously has an effect on the revenue base. But others can disagree others can have different ideas, but that is where I come from.

Mr. CLAY. But on that point, do we then go through the budget and slice programs that are wasteful, or do we not make the 2001 tax cuts permanent, or do we target middle-income Americans and give them some financial help?

Mr. GREENSPAN. That is the choice of the Congress. I mean, the point is, the wonderful thing about our system is we have elected representatives who have to make these judgments. And if they don't reach you, somebody else made them, and they are easy decisions. You only get the tough ones.

Mr. CLAY. Thank you for your response.

I appreciate it, Madam Chair.

Ms. PRYCE. Thank you, Mr. Clay.

And thank you, Chairman Greenspan, for your service to our country and for your time that you spent with this committee today. It is very much appreciated, and we will welcome you back in about 6 months.

With that being said, the chair notes that some members may have additional questions for this panel or this witness which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to this witness and to place their response in the record.

Hearing nothing further, this hearing is adjourned.

[Whereupon, at 12:52 p.m., the committee was adjourned.]

A P P E N D I X

February 17, 2005

Opening Statement

Chairman Michael G. Oxley
House Financial Services Committee

Semi-Annual Report on Monetary Policy
February 17, 2005

Good morning, Chairman Greenspan. Thank you in advance for your testimony and for the time you will spend with us today.

Mr. Chairman, we all know that the economy has nearly completely recovered. We've had four strong quarters of GDP growth, and the total number of jobs — a little more than 130 million — is back to its peak from the winter of 2000-2001. Productivity remains impressive, and the market is strong with the Dow looking as if it might touch the 11,000 mark again. Job creation remains robust, and the unemployment rate, at 5.2 percent, is at the same level it stood at in 1997 before the unprecedented period in which it briefly went below 4 percent — a rate few imagine we ever will see again.

So, Mr. Chairman, thanks to the twin injections of liquidity — the President's tax cuts and the Fed's lowering of short-term interest rates — our American economy has once again shown itself to be resilient enough to withstand multiple shocks.

Aside from our strong current position, there are continued challenges ahead that we will discuss today. Among them are the trade deficit, the budget deficit, and Social Security.

Mr. Chairman, you are perhaps America's most famous budget hawk. You favor lower taxes as long as they are offset by spending cuts. I'm sure you welcome the President's initiatives outlined in his budget and in the State of the Union speech.

The President has laid out a cost-cutting program, and he has faced the Social Security problem head-on. President Bush knows that the numbers don't lie, and they are clearly on the side of a need to reform the system.

Mr. Chairman, you led the commission that assisted in significant reform of Social Security under President Reagan, and I am certain all Committee members await your views on this matter. We all know the facts — that in less than 15 years the system starts paying more out than it is paying in, and that if we don't do something quickly, the options will be higher taxes, benefit cuts or some blend of the two.

Mr. Chairman, I stand in complete agreement with the President an important part the answer is personal accounts. From its creation, Social Security was never envisioned as the sole answer to an individual's retirement needs, but as a supplement. However, now, two-thirds of its recipients rely on Social Security for

half or more of their retirement income. That isn't good for them, and it isn't good for the country, in my view.

Mr. Chairman, I believe President Franklin Roosevelt, who created the Social Security system, felt the same way. As the Wall Street Journal has pointed out, in a speech to Congress in 1935, FDR anticipated the need to move beyond the pay-as-you-go financing scheme.

Chairman Greenspan, that's two Presidents—the Democrat founder of Social Security and the Republican to whom it falls to save the Social Security system—in agreement on the issue of personal accounts. There will be some heavy lifting to get the system right, of course, and this Committee will be in support. We have an obligation to America and to future generations to address this problem.

So, Mr. Chairman, in the week that baseball reports for spring training, I think we should view this effort as the start of a new season as well — a season in which Congress will step up to the plate with intelligent, long-term reform of Social Security. We seek to extend the ownership society to all Americans, and let's broaden that concept of ownership to retirement.

With that, I thank you again Mr. Chairman, and yield to the gentleman from Massachusetts.

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THE HONORABLE JOE BACA
STATEMENT FOR THE RECORD
APPEARANCE, BEFORE THE FULL COMMITTEE, OF FEDERAL
RESERVE CHAIRMAN ALAN GREENSPAN

Chairman Oxley and Ranking Member Frank:

I am pleased to be here today, and to welcome Chairman Greenspan before the committee. I ask unanimous consent that my statement be included in the record.

I understand that, based on seniority, it will not be possible to ask questions of Chairman Greenspan until the next time he comes before the committee, so I would like to outline some areas of concern. Perhaps the Chairman can touch upon these issues the next time we meet.

1. Government spending appears to be severely underestimated.

I would be interested to know the Chairman's view on the administration's submission of spending plans that underestimate the cost of the war and Social Security reform, including the costs of establishing private accounts, which I understand would be substantial.

I also understand that many of the costs of the President's programs will not be realized until after he leaves office. I am concerned at the impact that may have on the market, and I would like the Chairman's comment on how he thinks that might affect the overall health of the U.S. economy.

I am also concerned at the ballooning costs of Medicare under the Republicans' prescription drug plan. Rather than reforming the system, it appears the Republicans have kept in place a regime that enriches the drug companies, while saddling our nation with yet more debt. I would be interested in the Chairman's comment on the effect of these Medicare costs on the well being of the American economy.

2. We have entered an era of soaring deficits.

Combined with spending on the war, and Bush tax cuts for the top 1% of wage earners, these policies have taken an $86 billion surplus in fiscal 2000 to a record $412 billion deficit last year. It appears that at some point, these deficits could have a bad impact on our economy, and so I would be

interested in the Chairman's view of whether he believes we are headed on the right track, economically.

I am concerned that, as a percentage of the nation's gross domestic product, the 2004 Bush deficit was larger than that under the Clinton administration. I understand that, at the time, Congressional Republicans were very critical of that deficit. I am wondering if Chairman Greenspan had those concerns at that time, and whether he thinks they are warranted in today's climate.

3. This appears to be a bad climate for workers, maybe permanently so.

I am also concerned that the economy continues to stall under this administration, and that it is a bad climate for workers. For example, the share of the eligible adult population participating in the labor market is the lowest it has been since May 1988. The Labor Department's job creation report showed just 146,000 new jobs last month, far fewer than the 200,000 expected.

I would like the Chairman's comment on whether he thinks those numbers are cause for concern, and whether this is some sort of permanent facet of the American economy.

I know that from the perspective of my district and workers, it appears that this economy is one in which the wealthy are getting wealthier, and the poor are seeing their jobs shipped overseas.

Have we entered an era in which middle class prosperity and dreams have been replaced by harsh international markets? Where big corporations make money, but shed jobs?

4. We are entering an era of soaring trade deficits.

I am also concerned about the trade deficit, which is one measure of the fact that less and less goods are being made in America. According to projections by private economists, the trade deficit could widen from 6 percent of gross domestic product (in 2004) to 8 percent in 2008, and even higher in 2010. I am wondering if the Chairman is optimistic that this trend will reverse.

5. Is the "American Century" over?

I would like to know what the long-term implications of the above are to the health of our economy. I would like to believe that the "American Century" – in which America stood tall and proud, and we had a robust middle class – is not over, but it appears that Europe and Asia are overtaking us. I am wondering if the chairman has some insight about this.

Will the American bubble burst at some point, as international investors flee our capital markets? Is there a place for the American worker in today's society? Can we continue to have faith in America, and the worth of an American dollar?

These questions are especially important as we continue to face questions about how we can provide for the well being of our retirees and others in our society. I want to make sure that the world we leave for our children and grandchildren is a sound one.

Thank you.

February 17, 2005

Opening Statement by 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

Thank you, Mr. Chairman, for holding this important hearing and thank you, Chairman Greenspan, for coming before us this morning to present your report on the current state of our economy.

When we heard testimony from Chairman Greenspan one year ago our discussions centered on the problems of a recovering economy, however, today it is a welcome change to be focused on the future of a nearly recovered economy.

Under Chairman Greenspan's distinguished stewardship our economic expansion has continued and current forecasts predict continued growth and stability with expected Gross Domestic Product (GDP) growth for 2005 around 3.5 percent and for 2006 about 3.4 percent. Inflation, is also expected to be approximately 2.5 percent this year, and 2.2 percent in 2006.

In the first month of 2005 alone, 146,000 new jobs were created with a total of over 2.7 million new jobs created in our economy since May 2003. Our national unemployment rate has also been reduced to 5.2%, the lowest rate since September of 2001. Since the national peak in June 2003, unemployment rates have fallen across all levels of education, race, and age.

Chairman Greenspan, in addition to your report this morning on the state of our economy and monetary policy, I would welcome any further comments you can share on the impending crisis we face if reforms are not made to our current Social Security system.

Again, thank you Mr. Chairman for coming before us this morning. I look forward to an informative session.

OPENING STATEMENT
CONGRESSMAN PETER T. KING
before the
HOUSE FINANCIAL SERVICES COMMITTEE

"Monetary Policy Report of Chairman Alan Greenspan"

Welcome Chairman Greenspan. It is a pleasure to have you back before this Committee and I look forward to your insightful report on the state of the economy.

It is evident that the U.S. economy has rebounded from the 2000-2001 recession that was exacerbated by the 9/11 terrorist attacks and corporate scandals. The employment situation is encouraging with 20 straight months of job creation and more than 2.7 million jobs added to our economy since August 2003. The unemployment rate is currently lower than the average rate during the 70s, 80s, and 90s. Housing starts remain strong, recently reaching the highest level of new construction in nearly 21 years. The Federal Open Market Committee should be commended for its measured approach in ensuring the continued strength of our economy.

While there is much to be optimistic about, we still face challenges as we move forward. With the approaching retirement of the baby boom generation, I am concerned about the state of Social Security. At the outset of this program, Social Security had 16 workers supporting every retiree; now there are 3 for every retiree; and soon there will be only 2 workers for every retiree. The time to reform Social Security is now so we can ensure that younger generations are provided for.

Mr. Chairman, I am interested to hear your perspective on the state of Social Security and your suggestions for confronting this issue.

Once again, I look forward to your testimony.

For release on delivery
10:00 a.m. EST
February 17, 2005

Statement of

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

February 17, 2005

Mr. Chairman and members of the Committee, I am pleased to be here today to present the Federal Reserve's Monetary Policy Report to the Congress. In the seven months since I last testified before this Committee, the U.S. economic expansion has firmed, overall inflation has subsided, and core inflation has remained low.

Over the first half of 2004, the available information increasingly suggested that the economic expansion was becoming less fragile and that the risk of an undesirable decline in inflation had greatly diminished. Toward midyear, the Federal Reserve came to the judgment that the extraordinary degree of policy accommodation that had been in place since the middle of 2003 was no longer warranted and, in the announcement released at the conclusion of our May meeting, signaled that a firming of policy was likely. The Federal Open Market Committee began to raise the federal funds rate at its June meeting, and the announcement following that meeting indicated the need for further, albeit gradual, withdrawal of monetary policy stimulus.

Around the same time, incoming data suggested a lull in activity as the economy absorbed the impact of higher energy prices. Much as had been expected, this soft patch proved to be short-lived. Accordingly, the Federal Reserve has followed the June policy move with similar actions at each meeting since then, including our most recent meeting earlier this month. The cumulative removal of policy accommodation to date has significantly raised measures of the real federal funds rate, but by most measures, it remains fairly low.

The evidence broadly supports the view that economic fundamentals have steadied. Consumer spending has been well maintained over recent months, buoyed by continued growth in disposable personal income, gains in net worth, and accommodative conditions in credit markets. Households have recorded a modest improvement in their financial position over this period, to the betterment of many indicators of credit quality. Low interest rates and rising

incomes have contributed to a decline in the aggregate household financial obligation ratio, and delinquency and charge-off rates on various categories of consumer loans have stayed at low levels.

The sizable gains in consumer spending of recent years have been accompanied by a drop in the personal saving rate to an average of only 1 percent over 2004--a very low figure relative to the nearly 7 percent rate averaged over the previous three decades. Among the factors contributing to the strength of spending and the decline in saving have been developments in housing markets and home finance that have spurred rising household wealth and allowed greater access to that wealth. The rapid rise in home prices over the past several years has provided households with considerable capital gains. Moreover, a significant increase in the rate of single-family home turnover has meant that many consumers have been able to realize gains from the sale of their homes. To be sure, such capital gains, largely realized through an increase in mortgage debt on the home, do not increase the pool of national savings available to finance new capital investment. But from the perspective of an individual household, cash realized from capital gains has the same spending power as cash from any other source.

More broadly, rising home prices along with higher equity prices have outpaced the rise in household, largely mortgage, debt and have pushed up household net worth to about 5-1/2 times disposable income by the end of last year. Although the ratio of net worth to income is well below the peak attained in 1999, it remains above the long-term historical average. These gains in net worth help to explain why households in the aggregate do not appear uncomfortable with their financial position even though their reported personal saving rate is negligible.

Of course, household net worth may not continue to rise relative to income, and some reversal in that ratio is not out of the question. If that were to occur, households would probably

perceive the need to save more out of current income; the personal saving rate would accordingly rise, and consumer spending would slow.

But while household spending may well play a smaller role in the expansion going forward, business executives apparently have become somewhat more optimistic in recent months. Capital spending and corporate borrowing have firmed noticeably, but some of the latter may have been directed to finance the recent backup in inventories. Mergers and acquisitions, though, have clearly perked up.

Even in the current much-improved environment, however, some caution among business executives remains. Although capital investment has been advancing at a reasonably good pace, it has nonetheless lagged the exceptional rise in profits and internal cash flow. This is most unusual; it took a deep recession to produce the last such configuration in 1975. The lingering caution evident in capital spending decisions has also been manifest in less-aggressive hiring by businesses. In contrast to the typical pattern early in previous business-cycle recoveries, firms have appeared reluctant to take on new workers and have remained focused on cost containment.

As opposed to the lingering hesitancy among business executives, participants in financial markets seem very confident about the future and, judging by the exceptionally low level of risk spreads in credit markets, quite willing to bear risk. This apparent disparity in sentiment between business people and market participants could reflect the heightened additional concerns of business executives about potential legal liabilities rather than a fundamentally different assessment of macroeconomic risks.

Turning to the outlook for costs and prices, productivity developments will likely play a key role. The growth of output per hour slowed over the past half year, giving a boost to unit labor costs after two years of declines. Going forward, the implications for inflation will be

influenced by the extent and persistence of any slowdown in productivity. A lower rate of productivity growth in the context of relatively stable increases in average hourly compensation has led to slightly more rapid growth in unit labor costs. Whether inflation actually rises in the wake of slowing productivity growth, however, will depend on the rate of growth of labor compensation and the ability and willingness of firms to pass on higher costs to their customers. That, in turn, will depend on the degree of utilization of resources and how monetary policymakers respond. To date, with profit margins already high, competitive pressures have tended to limit the extent to which cost pressures have been reflected in higher prices.

Productivity is notoriously difficult to predict. Neither the large surge in output per hour from the first quarter of 2003 to the second quarter of 2004, nor the more recent moderation was easy to anticipate. It seems likely that these swings reflected delayed efficiency gains from the capital goods boom of the 1990s. Throughout the first half of last year, businesses were able to meet increasing orders with management efficiencies rather than new hires. But conceivably the backlog of untapped total efficiencies has run low, requiring new hires. Indeed, new hires as a percent of employment rose in the fourth quarter of last year to the highest level since the second quarter of 2001.

There is little question that the potential remains for large advances in productivity from further applications of existing knowledge, and insights into applications not even now contemplated doubtless will emerge in the years ahead. However, we have scant ability to infer the pace at which such gains will play out and, therefore, their implications for the growth of productivity over the longer run. It is, of course, the rate of change of productivity over time, and not its level, that influences the persistent changes in unit labor costs and hence the rate of inflation.

The inflation outlook will also be shaped by developments affecting the exchange value of the dollar and oil prices. Although the dollar has been declining since early 2002, exporters to the United States apparently have held dollar prices relatively steady to preserve their market share, effectively choosing to absorb the decline in the dollar by accepting a reduction in their profit margins. However, the recent somewhat quickened pace of increases in U.S. import prices suggests that profit margins of exporters to the United States have contracted to the point where the foreign shippers may exhibit only limited tolerance for additional reductions in margins should the dollar decline further.

The sharp rise in oil prices over the past year has no doubt boosted firms' costs and may have weighed on production, particularly given the sizable permanent component of oil price increases suggested by distant-horizon oil futures contracts. However, the share of total business expenses attributable to energy costs has declined appreciably over the past thirty years, which has helped to buffer profits and the economy more generally from the adverse effect of high oil and natural gas prices. Still, although the aggregate effect may be modest, we must recognize that some sectors of the economy and regions of the country have been hit hard by the increase in energy costs, especially over the past year.

Despite the combination of somewhat slower growth of productivity in recent quarters, higher energy prices, and a decline in the exchange rate for the dollar, core measures of consumer prices have registered only modest increases. The core PCE and CPI measures, for example, climbed about 1-1/4 and 2 percent, respectively, at an annual rate over the second half of last year.

All told, the economy seems to have entered 2005 expanding at a reasonably good pace, with inflation and inflation expectations well anchored. On the whole, financial markets appear

to share this view. In particular, a broad array of financial indicators convey a pervasive sense of confidence among investors and an associated greater willingness to bear risk than is yet evident among business managers.

Both realized and option-implied measures of uncertainty in equity and fixed-income markets have declined markedly over recent months to quite low levels. Credit spreads, read from corporate bond yields and credit default swap premiums, have continued to narrow amid widespread signs of an improvement in corporate credit quality, including notable drops in corporate bond defaults and debt ratings downgrades. Moreover, recent surveys suggest that bank lending officers have further eased standards and terms on business loans, and anecdotal reports suggest that securities dealers and other market-makers appear quite willing to commit capital in providing market liquidity.

In this environment, long-term interest rates have trended lower in recent months even as the Federal Reserve has raised the level of the target federal funds rate by 150 basis points. This development contrasts with most experience, which suggests that, other things being equal, increasing short-term interest rates are normally accompanied by a rise in longer-term yields. The simple mathematics of the yield curve governs the relationship between short- and long-term interest rates. Ten-year yields, for example, can be thought of as an average of ten consecutive one-year forward rates. A rise in the first-year forward rate, which correlates closely with the federal funds rate, would increase the yield on ten-year U.S. Treasury notes even if the more-distant forward rates remain unchanged. Historically, though, even these distant forward rates have tended to rise in association with monetary policy tightening.

In the current episode, however, the more-distant forward rates declined at the same time that short-term rates were rising. Indeed, the tenth-year tranche, which yielded 6-1/2 percent last

June, is now at about 5-1/4 percent. During the same period, comparable real forward rates derived from quotes on Treasury inflation-indexed debt fell significantly as well, suggesting that only a portion of the decline in nominal forward rates in distant tranches is attributable to a drop in long-term inflation expectations.

Some analysts have worried that the dip in forward real interest rates since last June may indicate that market participants have marked down their view of economic growth going forward, perhaps because of the rise in oil prices. But this interpretation does not mesh seamlessly with the rise in stock prices and the narrowing of credit spreads observed over the same interval. Others have emphasized the subdued overall business demand for credit in the United States and the apparent eagerness of lenders, including foreign investors, to provide financing. In particular, heavy purchases of longer-term Treasury securities by foreign central banks have often been cited as a factor boosting bond prices and pulling down longer-term yields. Thirty-year fixed-rate mortgage rates have dropped to a level only a little higher than the record lows touched in 2003 and, as a consequence, the estimated average duration of outstanding mortgage-backed securities has shortened appreciably over recent months. Attempts by mortgage investors to offset this decline in duration by purchasing longer-term securities may be yet another contributor to the recent downward pressure on longer-term yields.

But we should be careful in endeavoring to account for the decline in long-term interest rates by adverting to technical factors in the United States alone because yields and risk spreads have narrowed globally. The German ten-year Bund rate, for example, has declined from 4-1/4 percent last June to current levels of 3-1/2 percent. And spreads of yields on bonds issued by emerging-market nations over U.S. Treasury yields have declined to very low levels.

There is little doubt that, with the breakup of the Soviet Union and the integration of China and India into the global trading market, more of the world's productive capacity is being tapped to satisfy global demands for goods and services. Concurrently, greater integration of financial markets has meant that a larger share of the world's pool of savings is being deployed in cross-border financing of investment. The favorable inflation performance across a broad range of countries resulting from enlarged global goods, services and financial capacity has doubtless contributed to expectations of lower inflation in the years ahead and lower inflation risk premiums. But none of this is new and hence it is difficult to attribute the long-term interest rate declines of the last nine months to glacially increasing globalization. For the moment, the broadly unanticipated behavior of world bond markets remains a conundrum. Bond price movements may be a short-term aberration, but it will be some time before we are able to better judge the forces underlying recent experience.

This is but one of many uncertainties that will confront world policymakers. Over the past two decades, the industrial world has fended off two severe stock market corrections, a major financial crisis in developing nations, corporate scandals, and, of course, the tragedy of September 11, 2001. Yet overall economic activity experienced only modest difficulties. In the United States, only five quarters in the past twenty years exhibited declines in GDP, and those declines were small. Thus, it is not altogether unexpected or irrational that participants in the world marketplace would project more of the same going forward.

Yet history cautions that people experiencing long periods of relative stability are prone to excess. We must thus remain vigilant against complacency, especially since several important economic challenges confront policymakers in the years ahead.

Prominent among these challenges in the United States is the pressing need to maintain the flexibility of our economic and financial system. This will be essential if we are to address our current account deficit without significant disruption. Besides market pressures, which appear poised to stabilize and over the longer run possibly to decrease the U.S. current account deficit and its attendant financing requirements, some forces in the domestic U.S. economy seem about to head in the same direction. Central to that adjustment must be an increase in net national saving. This serves to underscore the imperative to restore fiscal discipline.

Beyond the near term, benefits promised to a burgeoning retirement-age population under mandatory entitlement programs, most notably Social Security and Medicare, threaten to strain the resources of the working-age population in the years ahead. Real progress on these issues will unavoidably entail many difficult choices. But the demographics are inexorable, and call for action before the leading edge of baby boomer retirement becomes evident in 2008. This is especially the case because longer-term problems, if not addressed, could begin to affect longer-dated debt issues, the value of which is based partly on expectations of developments many years in the future.

Another critical long-run economic challenge facing the United States is the need to ensure that our workforce is equipped with the requisite skills to compete effectively in an environment of rapid technological progress and global competition. Technological advance is continually altering the shape, nature, and complexity of our economic processes. But technology and, more recently, competition from abroad have grown to a point at which demand for the least-skilled workers in the United States and other developed countries is diminishing, placing downward pressure on their wages. These workers will need to acquire the skills required to compete effectively for the new jobs that our economy will create.

At the risk of some oversimplification, if the skill composition of our workforce meshed fully with the needs of our increasingly complex capital stock, wage-skill differentials would be stable, and percentage changes in wage rates would be the same for all job grades. But for the past twenty years, the supply of skilled, particularly highly skilled, workers has failed to keep up with a persistent rise in the demand for such skills. Conversely, the demand for lesser-skilled workers has declined, especially in response to growing international competition. The failure of our society to enhance the skills of a significant segment of our workforce has left a disproportionate share with lesser skills. The effect, of course, is to widen the wage gap between the skilled and the lesser skilled.

In a democratic society, such a stark bifurcation of wealth and income trends among large segments of the population can fuel resentment and political polarization. These social developments can lead to political clashes and misguided economic policies that work to the detriment of the economy and society as a whole. As I have noted on previous occasions, strengthening elementary and secondary schooling in the United States--especially in the core disciplines of math, science, and written and verbal communications--is one crucial element in avoiding such outcomes. We need to reduce the relative excess of lesser-skilled workers and enhance the number of skilled workers by expediting the acquisition of skills by all students, both through formal education and on-the-job training.

Although the long-run challenges confronting the U.S. economy are significant, I fully anticipate that they will ultimately be met and resolved. In recent decades our nation has demonstrated remarkable resilience and flexibility when tested by events, and we have every reason to be confident that it will weather future challenges as well. For our part, the Federal Reserve will pursue its statutory objectives of price stability and maximum sustainable

employment--the latter of which we have learned can best be achieved in the long run by maintaining price stability. This is the surest contribution that the Federal Reserve can make in fostering the economic prosperity and well-being of our nation and its people.

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March 1, 2005

The Honorable Alan Greenspan
Chairman
The United States Federal Reserve Board
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Chairman Greenspan:

Mr. Chairman, thank you for appearing before the Financial Services Committee on February 17, 2005. I appreciated your insight into the state of the U.S. economy as well as the need for Social Security reform. Because of time constraints, I did not have the opportunity to ask you about the Regulation B proposal to Title II of the Gramm-Leach-Bliley Act currently under consideration by the Securities and Exchange Commission. This proposed regulation will impact the delivery of brokerage services by financial institutions and is something that the Financial Services Committee has been monitoring closely. I am concerned that, as drafted, this regulation will impair the ability of banks and savings associations to continue to provide the traditional banking services that Title II permitted institutions to continue to pursue. Would you comment on how this proposed regulation could affect financial institutions?

Our Committee wrote a comment letter to the SEC on this issue recommending that the Commission engage with the banking regulators to develop a more workable regulation. To your knowledge, have there been any inter-agency discussions on Regulation B?

I will look forward to your responses to these questions.

Yours truly,

Michael G. Oxley
Chairman

MGO/km

For use at 10:00 a.m., EST
Wednesday
February 16, 2005

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

February 16, 2005

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

Submitted pursuant to section 2B of the Federal Reserve Act

February 16, 2005

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 16, 2005

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 February 16, 2005, pursuant to section 2B of the Federal Reserve Act

Monetary Policy and the Economic Outlook

The year 2004 was marked by continued expansion in economic activity and appreciable gains in employment. With fiscal policy stimulative, monetary policy accommodative, and financial conditions favorable, household spending remained buoyant and businesses increased investment in capital equipment and inventories, despite the restraint imposed by sizable increases in oil prices. Labor market conditions improved significantly, albeit at an uneven pace, and productivity rose notably further. Consumer price inflation moved higher with the surge in energy prices, but core consumer price inflation (that is, excluding food and energy) remained well contained, and measures of expected inflation over longer horizons held steady or edged lower.

Although economic activity had increased substantially in 2003, the expansion nevertheless appeared somewhat tentative as 2004 opened, in large measure because businesses still seemed to be reluctant to boost hiring. Over the course of the spring, however, it became clearer that the expansion was solidifying. Businesses added appreciably to their payrolls, boosted investment in equipment and software, and started restocking inventories. While household spending growth softened somewhat, residential construction expanded rapidly. Rising energy prices boosted overall consumer price inflation, and core inflation moved up as well. In response to positive economic news and higher inflation during this period, market participants came to anticipate that monetary policy tightening would begin sooner than they had expected, and interest rates increased considerably. With the economic expansion more firmly established and slack in labor and product markets somewhat diminished, the Federal Open Market Committee (FOMC) at its June meeting began to reduce the substantial degree of monetary accommodation that was in place.

The gradual removal of monetary policy stimulus continued in the second half of the year as the economy expanded at a healthy clip on balance. Around midyear, some measures of growth in activity softened, partly because of the drain on income and the rise in business costs created by higher oil prices. The expansion of consumer spending slowed in the spring, and the pace of hiring and gains in industrial production dropped back notably during the summer. Equity prices and longer-term interest rates moved lower over this period as well. In the event, the slowdown in household spending growth proved short lived. Both hiring and increases in factory output stepped up again in the autumn, and these gains were extended early this year. With profits healthy and financial conditions still supportive, capital spending increased at a brisk pace throughout the year. Over the final quarter of 2004, short-term interest rates rose further as monetary policy was firmed at each FOMC meeting, but long-term interest rates were largely unchanged. Equity prices rose appreciably in the fourth quarter, and the dollar depreciated against most other major currencies. The FOMC increased the target federal funds rate 25 basis points again at its meeting this month, bringing the cumulative tightening over the past year to 1½ percentage points.

The fundamental factors underlying the continued strength of the economy last year should carry forward into 2005 and 2006, promoting both healthy expansion of activity and low inflation. Monetary policy is still accommodative, and financial conditions more generally continue to be advantageous for households and firms. Profits have been rising briskly, and corporate borrowing costs are low. Household net worth has increased with the continued sharp rise in the value of real estate assets as well as gains in equity prices, and this will likely help support consumer demand in the future. Absent a significant increase in oil prices from current levels, the drag from last year's run-up should wane this year. The lagged effects of the decline in the exchange value of the dollar since the autumn and sustained foreign economic growth are likely to boost the demand for U.S. exports. The prospects for the expansion of aggregate supply also appear to be quite favorable. Gains in structural labor productivity should continue, although not necessarily at the pace of recent years. Economic growth will likely be sufficient to generate notable increases in employment, although any reversal of the decline in labor force participation observed since 2001 would tend to hold up the unemployment rate. Core consumer price inflation has remained low since the larger increases posted in the early months of 2004, and long-term inflation expectations have been similarly well contained. With some slack likely remaining in labor and product markets at present and with the indirect effects of higher oil and import prices diminish

ing, the prospects for inflation staying low are good. A favorable economic outcome is, of course, not assured, but at the most recent FOMC meeting the Committee again assessed the risks to both output and inflation as balanced. The Committee also reaffirmed that it is prepared to respond to events as necessary in its pursuit of price stability.

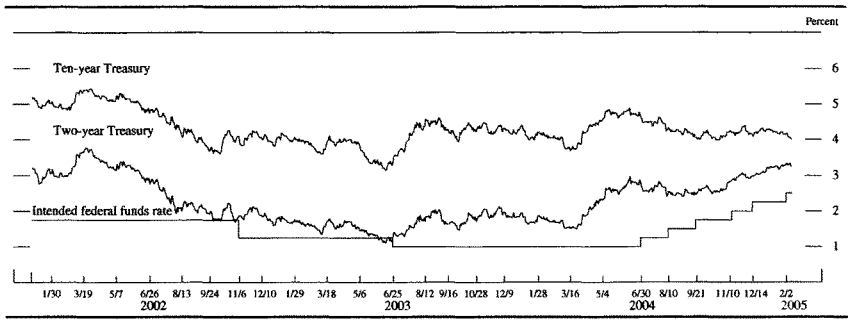
Monetary Policy, Financial Markets, and the Economy in 2004 and Early 2005

In early 2004, against the backdrop of stimulative fiscal and monetary policy, continued rapid growth in productivity, and supportive financial market conditions, business outlays appeared to be firming significantly and household spending remained strong. The FOMC became more confident that the economic expansion was likely gaining traction and that the risk of significant further disinflation had been greatly reduced. In these circumstances, it recognized that a highly accommodative stance for monetary policy could not be maintained indefinitely. Nonetheless, the Committee was concerned about the persistently slow pace of hiring and viewed underlying inflation pressures as likely to remain subdued. Accordingly, the Committee left its target for the federal funds rate unchanged at 1 percent at its January and March meetings. However, beginning in January, it modified the language of its policy statement to gain greater flexibility to tighten policy should circumstances warrant by indicating that monetary policy accommodation would eventually have to be removed. At the same time, the Committee suggested that it could be patient in undertaking such actions.

By the time of the May and June FOMC meetings, incoming economic data pointed to a broader and more firmly established expansion, with continued strength in housing markets and business fixed investment. Also, the employment reports for March, April, and May had indicated strong and widespread gains in private nonfarm payrolls, and previous reports for January and February were revised upward significantly. Overall consumer price inflation in the first quarter was faster than it had been a year earlier, and core inflation also increased, in part because of the indirect effects of higher energy prices. The Committee maintained its target for the federal funds rate at 1 percent in May, but on the basis of the evolving outlook for economic activity and prices, it revised its assessment of risks to indicate that the upside and downside risks for inflation had moved into balance. The Committee also stated that monetary policy accommodation could "be removed at a pace that is likely to be measured" to communicate its belief, given its economic outlook, that policy would probably soon need to move toward a more neutral stance, though probably not at a rapid pace. The Committee retained this language at the June meeting while raising its target for the federal funds rate from 1 percent to 1¼ percent and noting that it would "respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

The information that the Committee had received by the time of its August meeting indicated that economic growth had softened somewhat earlier in the summer. Although the housing market had remained strong and business outlays had continued to be healthy, consumer spending growth had slowed significantly, and industrial production had begun to level off. Also, the June and July labor market reports revealed that employment growth

Selected interest rates



NOTE. The data are daily and extend through February 9, 2005. Treasury rates are constant-maturity yields based on the most actively traded securities. The dates on the horizontal axis are those of FOMC meetings.
SOURCE. Department of the Treasury and the Federal Reserve.

had slowed considerably. At the same time, core consumer price inflation had moderated in May and June even though sizable increases in food and energy prices continued. However, the Committee believed that the softness in economic activity was caused importantly by higher prices of imported oil and would prove short lived. With financial conditions remaining stimulative, the economy appeared poised to grow at a pace sufficient to trim slack in resource utilization. In that regard, given the unusually low level of the federal funds rate, especially relative to the level of inflation, policymakers noted that significant cumulative policy tightening would likely be needed to meet the Federal Reserve's long-run objectives of price stability and sustainable economic growth. The Committee's decision at the meeting to raise its target for the federal funds rate 25 basis points, to 1½ percent, and to maintain its assessment of balanced risks with respect to sustainable growth and price stability was largely anticipated by financial markets. However, market participants revised up their expectations for the path of the federal funds rate, reportedly because the announcement conveyed a somewhat more optimistic outlook for the economy than many had anticipated.

By the time of the September FOMC meeting, available information suggested that the economy had regained momentum. Real consumer spending bounced back sharply in July after a weak second quarter, and incoming data on industrial production indicated a modest strengthening. Housing activity had increased further, and business outlays had picked up significantly in the second quarter. In addition, the labor market showed signs of improvement in August, as the unemployment rate edged down and nonfarm payrolls grew moderately. Core consumer price inflation slowed in June and July, and a decline in energy prices from record levels pushed down readings on headline inflation. Although the Committee acknowledged that higher oil prices had damped the pace of economic activity around midyear, it nonetheless saw the expansion as still on solid footing. Consequently, the Committee agreed to increase its target for the federal funds rate another 25 basis points, to 1¾ percent; to reiterate its view that the risks to price stability and to sustainable growth were balanced; and to repeat its indication that the removal of policy accommodation would likely proceed at a "measured" pace. The reaction in financial markets to the policy rate decision and the accompanying statement was muted.

The information in hand at the time of the November FOMC meeting generally suggested that the economy had continued to expand at a moderate rate despite the restraint that higher oil prices imparted to real incomes and consumer confidence. Consumer and business spending stayed firm, and the housing market remained buoyant. However, industrial production was about unchanged, and the news on job growth was uneven—lackluster increases in nonfarm payrolls in September were followed by robust expansion in October. Inflation measures were moderate, although up somewhat from one year earlier. On balance, the Committee saw the economy as growing at a pace that would reduce margins of slack in the utilization of resources. The Committee also judged that inflationary pressures would likely be well contained if monetary policy accommodation were gradually withdrawn. The Committee's decision to raise its target for the federal funds rate from 1¾ percent to 2 percent with minimal change in the language in the accompanying statement was largely anticipated by financial markets and elicited little reaction.

At its December meeting, the Committee viewed available information as continuing to indicate that the pace of the economic expansion was sufficient to further reduce the underutilization of resources, despite elevated oil prices. Consumer spending remained solid, investment spending was strong, and manufacturing production showed modest growth. Also, employment gains in October and November were consistent with gradual improvement in the labor market. Meanwhile, core inflation, while above the unusually low rates of late 2003, remained subdued. Accordingly, the Committee voted to raise its target for the federal funds rate 25 basis points, to 2¼ percent, and to retain the previous statement that the removal of policy accommodation would likely be "measured." Investors had largely anticipated the policy rate decision, but a few market participants had reportedly speculated that the Committee would signal increased concern about inflationary pressures. In the absence of any such signal, implied rates on near-dated futures contracts and longer-term Treasury yields declined a few basis points after the release of the December statement.

Also at its December meeting, the Committee considered an accelerated release of the minutes of FOMC meetings. The Committee's practice had been to publish the minutes for each meeting on the Thursday after the next scheduled meeting. The Committee believed that, because the minutes contain a more nuanced explanation of policy decisions than the statement released immediately after each meeting, publishing them on a timelier basis would help market participants interpret economic developments and thereby better anticipate the course of interest rates. Earlier release would also provide a context for the public remarks of individual FOMC members. It was also recognized, however, that financial markets might misinterpret the minutes at times and that earlier release might adversely affect the Committee's discussions and, perhaps, the minutes themselves. After weighing these considerations, the Committee voted unanimously to publish the FOMC minutes three weeks after the day of the policy decision.

The information that the Committee reviewed at its February 2005 meeting indicated that the economy had continued to expand at a steady pace. The labor market showed signs of further improvement, and consumer spending and the housing market remained robust. Industrial production accelerated, particularly at the end of 2004, and growth of business fixed investment was solid in the fourth quarter. Core inflation stayed moderate, and measures of inflation expectations remained well anchored. Given the solid economic expansion and limited price pressures, the Committee voted to continue its removal of policy accommodation by raising its target for the federal funds rate from 2¼ percent to 2½ percent and to essentially repeat the language of the December statement. Futures market quotes indicated that investors had already priced in a 25 basis point increase in the target federal funds rate at the meeting, and market participants reportedly expected no substantive changes to the accompanying statement. Accordingly, the reaction in financial markets to the announcement was minimal.

Economic Projections for 2005 and 2006

Federal Reserve policymakers expect the economy to expand moderately and inflation to remain low in 2005 and 2006.[1] The central tendency of the forecasts of real GDP growth made by the members of the Board of Governors and the Federal Reserve Bank presidents is 3¾ percent to 4 percent over the four quarters of 2005. The civilian unemployment rate is expected to average about 5¼ percent in the fourth quarter of 2005. For 2006, the policymakers project real GDP to increase about 3½ percent, and they expect the unemployment rate to edge down to between 5 percent and 5¼ percent. With regard to inflation, FOMC participants project that the chain-type price index for personal consumption expenditures excluding food and energy (core PCE) will increase between 1½ percent and 1¾ percent both this year and next—about the same as the 1.6 percent increase posted over 2004.

1. As a further step to enhance monetary policy communications, Federal Reserve policymakers will now provide economic projections for two years, rather than one, in the February Monetary Policy Report.

Economic and Financial Developments in 2004 and Early 2005

The economy proved to be sufficiently resilient to maintain solid growth and moderate core inflation in 2004 even as higher oil prices drained consumers' purchasing power and boosted firms' costs. Real GDP rose 3¾ percent last year after having increased 4½ percent in 2003. Activity was supported by continued robust advances in household spending. In addition, capital spending by businesses increased notably. Labor market conditions improved significantly, though at an uneven pace over the course of the year. Private payrolls, which turned up in late 2003, rose 170,000 per month last year, on average, and the unemployment rate declined below 5½ percent by year-end and to 5¼ percent in January 2005—the lowest rates since 2001.

Consumer price inflation was driven higher last year by the sharp rise in energy prices. Although core consumer price inflation moved up somewhat from unusually low levels recorded in 2003, it remained well contained. Price increases were restrained by continuing, though diminishing, slack in labor and product markets, which tended to offset the effects of higher energy and commodity prices, as well as the weaker dollar, on firms' overall costs. In addition, solid productivity gains implied that unit labor costs rose only modestly, even if up from the declines in the preceding two years. The decline in crude oil prices, on balance, since October points to some easing of cost pressures on firms from that source in the period ahead.

Several forces likely contributed to last year's impressive economic performance in the face of the sizable

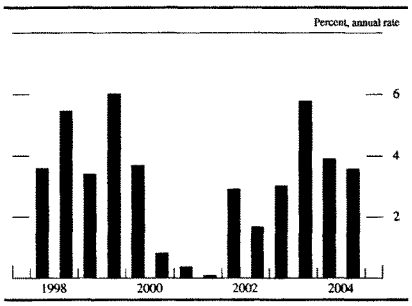
Economic projections for 2005 and 2006

Percent

Indicator	Memo 2004 actual	Federal Reserve Governors and Reserve Bank presidents			
		2005		2006	
		Range	Central tendency	Range	Central tendency
Change, fourth quarter to fourth quarter[1]					
Nominal GDP	6.2	5–6	5½–5¾	5–5¾	5–5½
Real GDP	3.7	3½–4	3¾–4	3¼–3¾	3½
PCE price index excluding food and energy	1.6	1½–2	1½–1¾	1½–2	1½–1¾
Average level, fourth quarter					
Civilian unemployment rate	5.4	5–5½	5¼	5–5¼	5–5¼

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

Change in real GDP

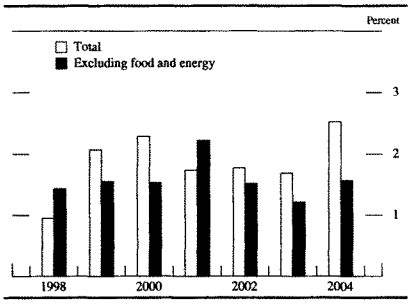


NOTE. Here and in subsequent charts, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period.
SOURCE. Department of Commerce, Bureau of Economic Analysis.

adverse oil shock. The growth of real output continued to be undergirded by gains in structural labor productivity. Moreover, fiscal policy remained stimulative last year through the combination of the lagged effect of earlier cuts in personal tax rates, the rise in defense spending, and perhaps also the partial-expensing tax incentives for business investment. Monetary policy was highly accommodative in the early part of the year and remained accommodative, though progressively less so throughout the year, and credit remained readily available at favorable terms. Consumer demand was also boosted by the strong increases in asset values during the past two years.

Financial conditions remained stimulative last year even as market participants revised up their expectations for the near-term path of monetary policy. Interest rates on longer-term Treasury securities remained low, risk spreads on corporate bonds narrowed, and commercial banks eased terms and standards on business loans. In this environment, household debt again increased briskly. The borrowing needs of nonfinancial businesses were damped by their strong cash flows. Equity values rose, especially toward the end of the year. At the same time, the exchange value of the dollar declined, on net, over the year as market participants apparently focused on the financing implications of the large and growing U.S. current account deficit.

Change in PCE chain-type price index



NOTE. The data are for personal consumption expenditures (PCE).
SOURCE. Department of Commerce, Bureau of Economic Analysis.

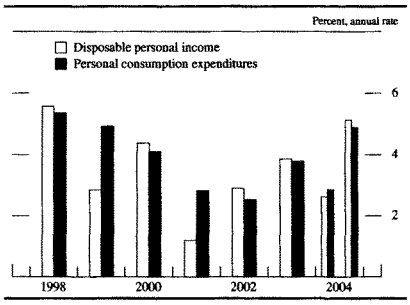
The Household Sector

Consumer Spending

Consumer spending grew substantially last year. Personal consumption expenditures (PCE) advanced nearly 4 percent in real terms, about the same as the increase in 2003. Sales of new motor vehicles remained brisk, on average, at 16¾ million units. Excluding motor vehicles, consumer spending on most categories of durable and nondurable goods rose rapidly, as gains in real expenditures for food and clothing both exceeded 5 percent; however, spending on computing equipment increased less in 2004 than in preceding years, and consumers responded to the high cost of gasoline and heating fuel by cutting back on real spending for these items. Real outlays for services also increased rapidly last year, and medical services posted especially large gains.

Real disposable personal income (DPI) rose nearly 4 percent last year, but this figure is exaggerated by Microsoft's $32 billion special dividend payment in December (the bulk of which is estimated to have accrued to U.S. households). If this one-time event is excluded from the calculation, real DPI rose only 2¾ percent in 2004, well below the increase posted in 2003. Faster job growth helped to support increases in

Change in real income and consumption



SOURCE. Department of Commerce, Bureau of Economic Analysis.

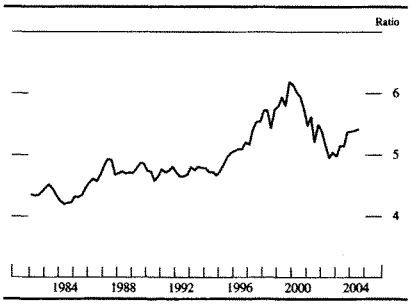
households' incomes last year in nominal terms, and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), which brought lower personal tax rates forward into 2003, led to larger refunds and smaller final payments in the spring of 2004. However, real income gains were held down, as higher oil prices siphoned off household purchasing power.

With the growth of real consumption spending outpacing that of real income through most of last year, the personal saving rate moved lower, from 1½ percent, on average, in 2003 to only ½ percent in the third quarter of last year. (The fourth-quarter surge in income associated with the Microsoft dividend payments pushed the saving rate back up to 1¼ percent, but this increase will likely be reversed early this year as dividend income falls back. Because the company's share price declined in step with the dividend payouts, the dividends had no effect on shareholders' overall financial resources and so probably had little effect on consumption.)

Low interest rates were one factor that helped to support consumption growth—especially for durable goods—despite comparatively slow gains in real income. Higher household wealth was also an important force that propelled consumer spending last year. According to the Federal Reserve's flow of funds accounts, the ratio of household net worth to disposable income rose sharply in 2003, as corporate equity values rebounded and home prices continued to rise. Moreover, although equity values were little changed, on net, through much of 2004 before rising notably in the final quarter, home prices continued to rise throughout the year, and the wealth-to-income ratio moved up further; by the third quarter (the most recent period for which the complete wealth data are available), the ratio had reversed nearly half its decline since the stock market peak in 2000. Because wealth feeds through into household spending over a period of several quarters, the wealth increases in both 2003 and 2004 were important in supporting consumer spending last year. The rise in house prices, together with continued low interest rates, also led consumers to extract additional equity from their homes, in particular through home equity loans. Such actions provided many households with a readily available and relatively low-cost source of funds for financing consumption.

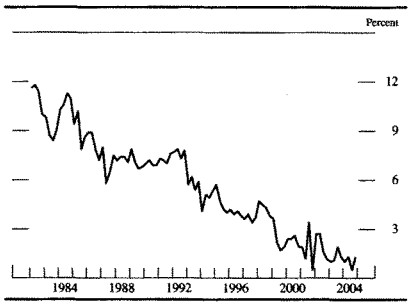
Consumer confidence, which had improved in 2003, remained at generally favorable levels last year, according to surveys by both the Michigan Survey Research Center (SRC) and the Conference Board. Confidence tended to dip at times during the year when energy prices were moving up most rapidly, but it recovered soon after those episodes.

Wealth-to-income ratio



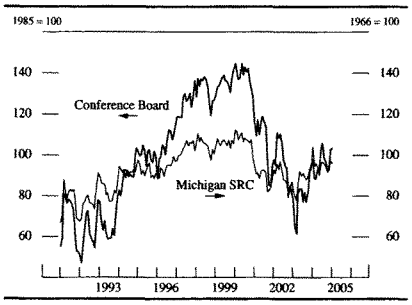
NOTE. The data are quarterly and extend through 2004:Q3. The wealth-to-income ratio is the ratio of household net worth to disposable personal income.
SOURCE. For net worth, Federal Reserve Board, flow of funds data; for income, Department of Commerce, Bureau of Economic Analysis.

Personal saving rate



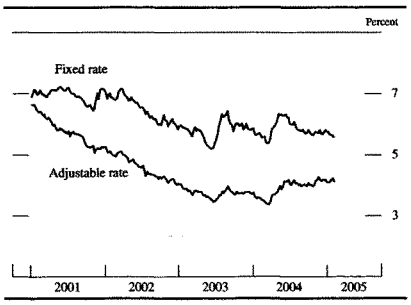
NOTE. The data are quarterly and extend through 2004:Q4.
SOURCE. Department of Commerce, Bureau of Economic Analysis.

Consumer sentiment



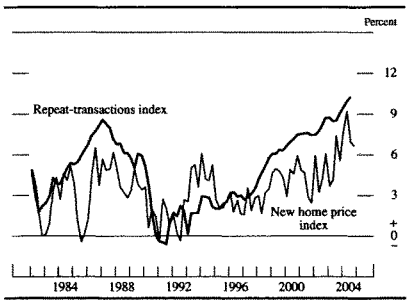
NOTE. The data are monthly and extend through January 2005.
SOURCE. The Conference Board and University of Michigan Survey Research Center.

Mortgage rates



NOTE. The data, which are weekly and extend through February 9, 2005, are contract rates on thirty-year mortgages.
SOURCE. Federal Home Loan Mortgage Corporation.

Change in house prices



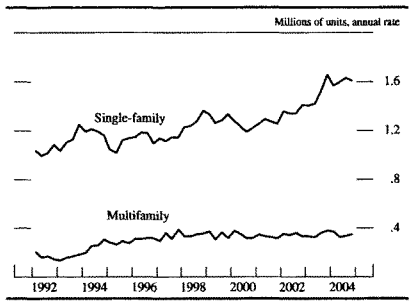
NOTE. The repeat-transactions index includes purchase transactions only and extends through 2004:Q3. The new home price index extends through 2004:Q4. Change is over four quarters.
SOURCE. For repeat transactions, Office of Federal Housing Enterprise Oversight; for new home prices, Department of Commerce, Bureau of the Census.

Residential Investment

Residential investment remained robust last year. Real expenditures increased 5¾ percent in 2004—the third straight year of strong gains. Demand for housing was influenced by the same factors that affected household spending more generally, but it was especially supported by nominal mortgage interest rates that have remained near their lowest levels since the late 1960s. Rates on thirty-year fixed-rate mortgages fluctuated between about 5½ percent and 6¼ percent over the past two years; they edged up to the high end of that range during the spring but dropped back to under 6 percent by the end of summer and now stand below 5¾ percent.

In the single-family sector, housing starts amounted to 1.6 million units last year, a rate faster than the already rapid pace of 1.5 million units started in 2003. In the multifamily sector, starts totaled a solid 350,000 units last year, a figure in line with that of the preceding several years. Sales of both new and existing single-family homes hit new highs last year, and home prices moved up sharply. The repeat-transactions price index for existing homes (limited to purchase transactions only), which is published by the Office of Federal Housing Enterprise Oversight, climbed more than 10 percent over the four quarters ending in the third quarter of last year (the latest quarter for which data are available) and is up a cumulative 65 percent since 1997, when it started to rise notably more rapidly than overall inflation. These price increases have also outstripped by a wide margin the increases in household incomes and rents. Another nationwide price index, the Census Bureau's constant-quality price index for new homes, rose only 6¾ percent last year. Because this index does not adjust for the location of new homes within metropolitan areas, and because new homes constitute only a small fraction of the overall housing stock, this index is probably a less reliable indicator of overall home values than is the repeat-transactions index.

Private housing starts

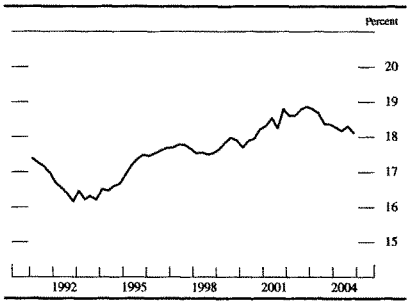


NOTE. The data are quarterly and extend through 2004:Q4.
SOURCE. Department of Commerce, Bureau of the Census.

Household Finance

Household debt is estimated to have increased about 9¾ percent in 2004, a touch less than in the previous year. Mortgage debt again paced this advance. The brisk expansion of mortgages reflected continued strong activity in housing markets and rising house prices. However, the growth rate of mortgage debt did not quite match that registered in 2003. Refinancing activity fell off

Household financial obligations ratio

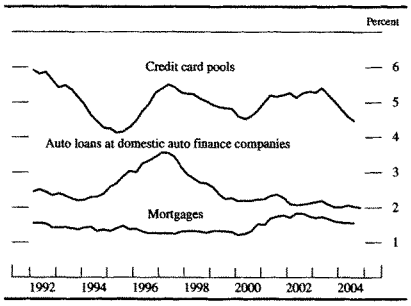


NOTE. The data are quarterly and extend through 2004:Q4. The final observation, 2004:Q4, is a projection. The financial obligations ratio equals the sum of required payments on mortgage and consumer debt, automobile leases, rent on tenant-occupied property, homeowners' insurance, and property taxes, all divided by disposable personal income.

sharply last year, as the pool of outstanding mortgages with interest rates above current market rates shrank considerably. Mortgages with adjustable interest rates, including hybrids that feature both fixed and adjustable interest rate components, were increasingly popular in 2004. Consumer credit continued to expand at a moderate pace by historical standards, restrained in part by the substitution of other forms of debt, such as home equity loans. Higher interest rates on some consumer loans and credit cards in the second half of 2004 may have also damped the growth of consumer credit.

Relatively low interest rates and further gains in disposable personal income limited pressures on household balance sheets in 2004. Measures of aggregate household financial obligations and debt service, which capture pre-committed expenditures relative to disposable income, were little changed last year, on balance, though they remained high by historical standards. Nevertheless, measures of household credit quality either held steady or improved during the course of the year. The latest available data indicate that delinquency rates on credit card loans, consumer loans, and residential mortgages at commercial banks declined, while those on auto loans at captive finance companies were about unchanged at a low level. Household bankruptcy filings ran below the elevated levels of 2003, although they stayed generally above the rates posted in earlier years.

Delinquency rates on selected types of household loans



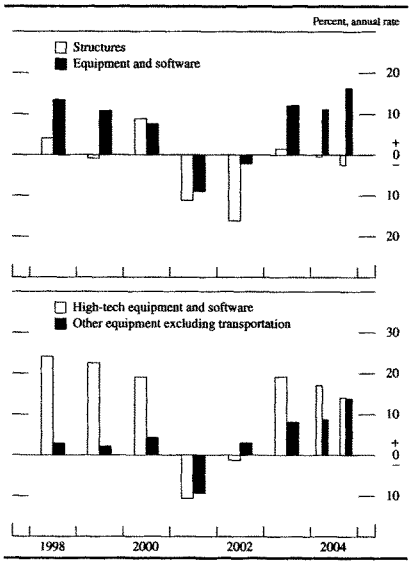
NOTE. The data are quarterly. The rates for credit card pools and mortgages extend through 2004:Q3; the rate for auto loans extends through 2004:Q4.
SOURCE. For credit cards, Moody's Investors Service; for auto loans, Big Three automakers; for mortgages, Mortgage Bankers Association.

The Business Sector

Fixed Investment

Business fixed investment rose robustly for a second consecutive year in 2004. Real spending on equipment and software (E&S) increased 13½ percent, about as much as in 2003, as firms' final sales continued to increase, profits and cash flow rose further, and many businesses

Change in real business fixed investment



NOTE. High-tech equipment consists of computers and peripheral equipment, software, and communications equipment.
SOURCE. Department of Commerce, Bureau of Economic Analysis.

reported a need to replace or upgrade existing equipment and software. Although many firms had little need to seek outside financing given their flush cash situation, those that did generally found financial markets to be receptive—interest rates remained low and other terms and conditions stayed relatively favorable. The partial-expensing tax incentives, which covered new equipment and software installed by the end of 2004, boosted profits and cash flow and may have also stimulated some investment spending.

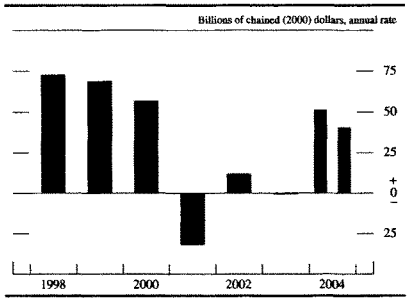
Increases in E&S spending were fairly widespread across categories of capital goods. Spending on high-technology equipment increased 15½ percent last year after having risen 19 percent in 2003; these gains followed two years of declines. Although the pattern of spending was uneven over the four quarters of 2004, for the year as a whole, business outlays for computing equipment rose 25 percent in real terms, while spending on software and communications equipment posted increases of 13 percent and 10 percent respectively. Outside of the high-tech sector, business spending on aircraft moved lower for the third consecutive year, as airlines continued to struggle with a highly competitive market environment and high fuel prices. In contrast, business outlays on motor vehicles rose substantially last year, with the demand for trucks exceptionally strong. Investment in equipment other than high-tech and transportation goods—a category that includes industrial machinery and a wide range of other types of equipment—moved up 11 percent last year, the most in more than ten years.

In contrast to the rebound in equipment spending, real outlays in the nonresidential construction sector were about unchanged for a second year in 2004 and have yet to recover from their sharp downturn during 2001 and 2002. In the office sector, where construction increased rapidly in the late 1990s, spending has remained especially weak; vacancy rates for these properties, although down a touch over the past year, are still quite elevated. Construction of industrial buildings has also remained low as a result of high vacancy rates. In contrast, demand for new retail and wholesale properties has been firmer, reportedly a reflection of the steady increases in consumer spending, and outlays for these types of buildings moved higher last year. In addition, investment in the drilling and mining sector rose last year in response to high prices for natural gas.

Inventory Investment

Businesses added appreciably to inventories last year for the first time since running down their holdings sharply in 2001. As economic activity strengthened during 2002 and 2003, many businesses chose to operate with inventories that were increasingly lean relative to sales. In 2004, when stocks had become quite spare—even after taking into account the ongoing improvements in inventory management that have allowed firms to economize on stockholding—and businesses had apparently grown more confident in the durability of the recovery, businesses accumulated $45 billion of inventories (in real terms), according to preliminary data. The step-up in the pace of stockbuilding contributed about ¼ percentage point to GDP growth last year.

Change in real business inventories



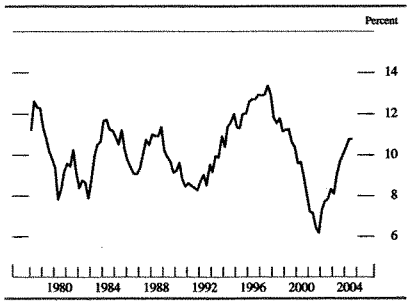
SOURCE. Department of Commerce, Bureau of Economic Analysis.

Corporate Profits and Business Finance

Strong growth of corporate profits again allowed many firms to finance capital spending with internal funds last year. As a result, nonfinancial business debt rose at only a moderate pace. Net equity issuance dropped further into negative territory in 2004, and on balance nonfinancial corporations are estimated to have raised no net funds in credit and equity markets. However, short-term business debt, including commercial paper and commercial and industrial (C&I) loans, expanded last year after three years of contraction, and commercial mortgage debt continued to increase rapidly. The credit quality of businesses remained strong.

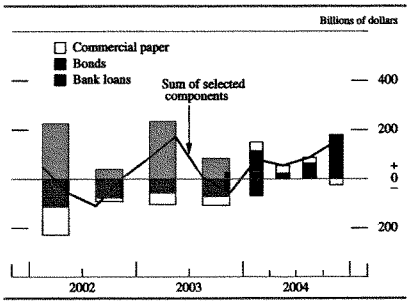
Corporate profits held up well in 2004 after surging in the previous year. The ratio of before-tax profits of nonfinancial corporations to that sector's gross value added increased for a second consecutive year. In the fourth quarter of 2004, operating earnings per share for S&P 500 firms were nearly 20 percent above their level four quarters earlier. Analysts' earnings forecasts began to moderate somewhat in the second half of 2004 after several months of strong upward revisions.

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



NOTE. The data are quarterly and extend through 2004:Q3. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.
SOURCE. Department of Commerce, Bureau of Economic Analysis.

Selected components of net business financing



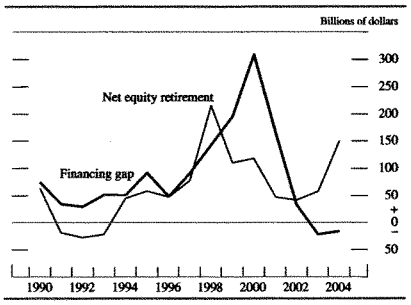
NOTE. Seasonally adjusted annual rate for nonfinancial corporate business. The data for the sum of selected components are quarterly. The data for 2004:Q4 are estimated.
SOURCE. Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

In equity markets, net issuance of shares by nonfinancial firms turned more negative in 2004. Although initial public offerings rebounded from the sluggish pace of the past two years, ample profits and sizable cash holdings helped boost share retirements from mergers and repurchases.

Net corporate bond issuance was sluggish in 2004, as firms evidently relied heavily on their considerable profits to fund investment in fixed capital and inventories. The timing of gross bond issuance was influenced by interest rate movements during the year, as firms took advantage of occasional dips in longer-term yields to issue bonds. Firms reportedly used a large portion of the proceeds to pay down existing debt, although some companies used the funds raised in the bond market to repurchase equity shares or to finance mergers.

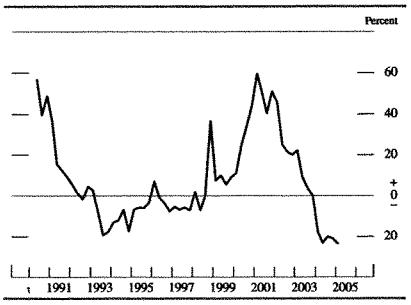
Short-term business borrowing revived in 2004 after a prolonged contraction. Commercial paper outstanding turned up in the first half of the year, although it flattened out over the second half. Business loans at banks rebounded over the course of last year. According to results from the Federal Reserve's Senior Loan Officer

Financing gap and net equity retirement at nonfinancial corporations



NOTE. The data are annual; 2004 is based on partially estimated data. 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.

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



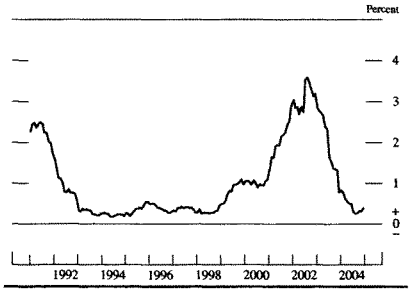
NOTE. The data are based on a survey generally conducted four times per year; the last reading is from the January 2005 survey. Large and medium-sized firms are those with annual sales of $50 million or more. Net percentage is the percentage reporting a tightening less the percentage reporting an easing.
SOURCE. Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices.

Opinion Survey on Bank Lending Practices, commercial banks eased terms and standards on business loans during the course of 2004 in response to the improved economic outlook and to increased competition from other banks and nonbank lenders. Survey responses also indicated an increase in demand for C&I loans that reflected firms' need to fund rising accounts receivable, inventories, capital expenditures, and merger activity. Concerns over loan quality seemed to diminish further in 2004, as spreads on leveraged deals in the syndicated loan market edged down from already low levels.

Corporate credit quality remained solid in 2004 amid strong earnings, low interest rates, and a further buildup of already substantial cash positions on firms' balance sheets. The delinquency rate on C&I loans declined further, and the twelve-month trailing default rate on corporate bonds fell to historically low levels before edging up late in the year. Net upgrades of bonds by Moody's Investor Service for both investment- and speculative-grade nonfinancial firms increased last year.

The stock of commercial mortgage debt outstanding grew at a rapid pace in 2004. Some firms reportedly continued to find mortgages an attractive source of long-term funding. The expansion of commercial mortgage credit helped propel issuance of commercial-mortgage-backed securities (CMBS) to near-record levels. Delinquency rates on commercial mortgages on the books of banks and insurance companies remained low throughout the year, and those on loans backing mortgage securities fell. Considerable gains in commercial real estate prices increased owners' equity and largely kept pace with the sizable increase in mortgage debt obligations. Yield spreads of CMBS over comparable Treasury securities remained moderate.

Default rate on outstanding corporate bonds



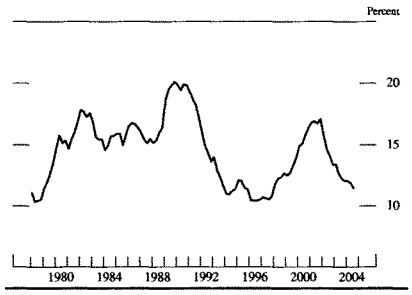
NOTE. The data are monthly and extend through December 2004. The rate for a given month is the face value of bonds that defaulted in the twelve months ending in that month divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the twelve-month period.
SOURCE. Moody's Investors Service.

The Government Sector

Federal Government

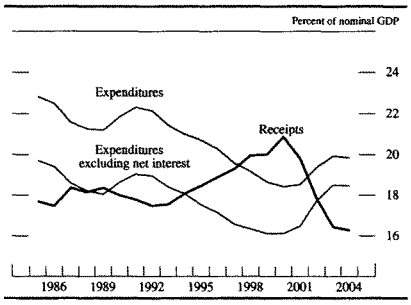
The federal budget position deteriorated slightly further in 2004, as spending increases and further tax reductions offset the effects of stronger economic growth on revenues. The unified budget deficit widened from $378 billion in fiscal 2003 to $412 billion in fiscal 2004. As a share of GDP, the federal unified deficit stood close to 3½ percent in both years. Receipts increased 5½ percent in fiscal 2004 after two years of declines. Corporate receipts surged more than 40 percent, or $58 billion, reflecting the improvement in corporate profits; individual tax receipts—restrained by JGTRRA, which pulled for

Net interest payments of nonfinancial corporations as a percent of cash flow



NOTE. The data are quarterly and extend through 2004:Q3.
SOURCE. Department of Commerce, Bureau of Economic Analysis.

Federal receipts and expenditures



NOTE. The budget data are from the unified budget and are for fiscal years (October through September); GDP is for the year ending in Q3.
SOURCE. Office of Management and Budget.

ward reductions of personal tax rates that had been scheduled for the second half of the decade—rose only about 2 percent. Overall federal receipts increased less rapidly than nominal GDP, and the ratio of receipts to GDP edged down to 16¼ percent, the lowest level in more than forty years.

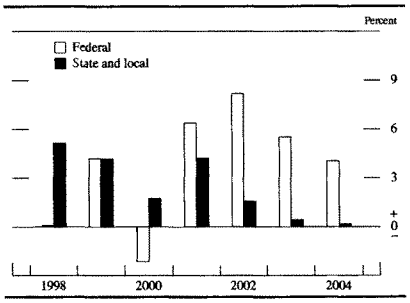
Meanwhile, nominal federal outlays increased about 6 percent in fiscal 2004. Spending for national defense increased especially sharply, but spending also increased notably for Medicare and Medicaid. Debt service costs, which fell sharply from 1997 through 2003 as a result of reduced debt and declining interest rates, edged higher last year. Federal government purchases of goods and services—the part of spending that is counted in GDP—rose about 4 percent in real terms in 2004 after larger increases in the preceding two years. (Government spending on items such as interest payments and transfers is excluded from GDP because these items do not constitute a direct purchase of final production.)

Regarding legislative initiatives, two new tax bills were enacted in the fall of 2004. First, the Working Families Tax Relief Act extended through 2010 a variety of personal tax reductions that had previously been set to expire earlier. Second, the American Jobs Creation Act replaced the exclusion of extraterritorial income (which the World Trade Organization had declared an illegal export subsidy) with numerous other tax reductions for domestic manufacturers and U.S. multinationals. The first bill is expected to have a ten-year budget cost of around $150 billion, while the second bill was scored as being revenue neutral. As for federal spending in fiscal 2005, the regular appropriations bills provided for sizable increases in spending on defense and homeland security and for modest increases in nondefense discretionary expenditures. In addition, emergency legislation passed in the autumn provided disaster aid for victims of hurricanes and for ranchers and farmers affected by drought conditions.

The recent sizable deficits in the unified budget mean that the federal government, which had been contributing to the pool of national saving from 1997 through 2000, has been drawing on that pool since 2001. Net federal saving—essentially the unified budget balance adjusted to the accounting practices of the national income and product accounts (NIPA)—dropped from positive 2 percent of GDP in 2000 to a level below negative 3 percent of GDP in 2003 and 2004. Personal saving moved lower over this period as well, while business net saving rose with the rebound in corporate profits. In all, net national saving edged up in 2004 but remained near its postwar lows. Because net national saving has fallen increasingly short of net domestic investment over the past several years, the inflow of foreign funds needed to finance that investment has risen. The growing inflow of foreign capital is mirrored in the widening of the nation's current account deficit. Over time, the low national saving rate could eventually slow the rise in living standards either by increasing the burden of servicing U.S. foreign debt or by impinging on domestic capital formation.

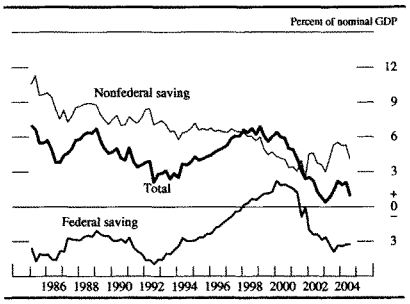
The growth rate of Treasury debt moderated slightly last year after increasing substantially in 2003. Nonetheless, federal debt held by the public as a percentage of GDP continued to edge higher over the course of 2004 and currently stands at about 36½ percent. To help finance substantial budget deficits, the Treasury issued a considerable volume of bills as well as two-, three-, five-, and ten-year nominal notes. In addition, the Treasury expanded its borrowing program in 2004 by adding semiannual auctions of twenty-year inflation-protected bonds and five-year inflation-protected notes.

Change in real government expenditures on consumption and investment



SOURCE. Department of Commerce, Bureau of Economic Analysis.

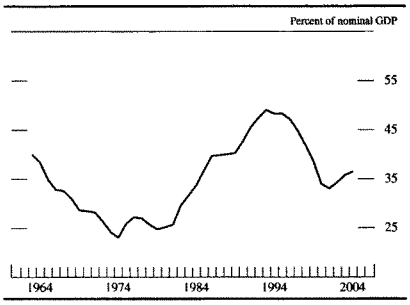
Net saving



NOTE. The data are quarterly and extend through 2004:Q3. Nonfederal saving is the sum of personal and net business saving and the net saving of state and local governments.

SOURCE. Department of Commerce, Bureau of Economic Analysis.

Federal government debt held by the public

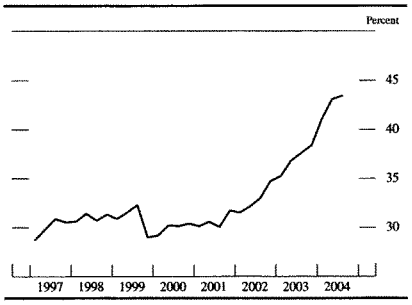


NOTE. Through 2003, the data for debt are year-end figures, and the corresponding value for GDP is for Q4 at an annual rate; the final observation is for 2004:Q3. Excludes securities held as investments of federal government accounts.

Various indicators suggested a continued strong appetite for Treasury securities among foreign investors last year. Indirect bidding at Treasury auctions, which includes bidding by the Federal Reserve Bank of New York on behalf of foreign official institutions, remained robust, and Treasury securities held in custody at the Federal Reserve Bank of New York on behalf of such institutions increased just over $200 billion in 2004. Also, data from the Treasury International Capital System showed a substantial increase in holdings of Treasury securities by foreign official and private investors, particularly those in Japan. The proportion of Treasury securities held by foreign investors is estimated to have risen to a record 43½ percent by the third quarter of 2004.

Treasury debt reached its statutory ceiling late last year. To cope with the constraint, the Treasury temporarily resorted to accounting devices, suspended issuance of state and local government series securities, and postponed a four-week bill auction. In mid-November, Congress raised the debt ceiling from $7.4 trillion to $8.1 trillion, and the Treasury subsequently resumed normal financing operations.

Treasury securities held by foreign investors as a share of total outstanding



NOTE. The data are quarterly and extend through 2004:Q3.

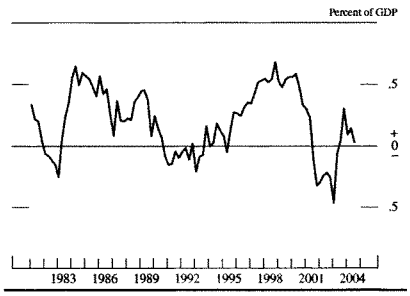
State and Local Governments

Pressures on the budgets of state and local governments have eased as economic activity has strengthened. Tax receipts have been spurred by the increases in household income, consumer spending, and property values. As a result, many states seem to be on track to meet balanced budget requirements in the current fiscal year (which ends June 30 for all but a few states) without using as much borrowing or other extraordinary measures as in recent years. Nevertheless, a number of states still must deal with lingering fiscal problems, particularly depleted reserve funds, the expiration of temporary tax hikes, and rising Medicaid costs. In addition, several states still face serious structural imbalances in their budgets.

Real expenditures by state and local governments as measured in the NIPAs remained about flat for a second year in 2004. Real spending on current operations rose less than 1 percent last year, while real investment spending declined. However, even as they were holding the line on spending increases, states and localities were able to resume net hiring in 2004 after having left employment about unchanged in 2003.

Net issuance of debt by state and local governments edged down from the rapid pace set in 2003, as improved budget positions permitted some contraction in short-term debt. Advance refunding offerings were again strong dur

State and local government net saving



NOTE. The data, which are quarterly, are on a national income and product account basis and extend through 2004:Q3. Net saving excludes social insurance funds.

SOURCE. Department of Commerce, Bureau of Economic Analysis.

ing the year, as states and municipalities took advantage of low long-term interest rates and moderate credit spreads. Credit quality of tax-exempt borrowers improved in 2004. Rating upgrades of tax-exempt bonds outpaced downgrades, especially later in the year.

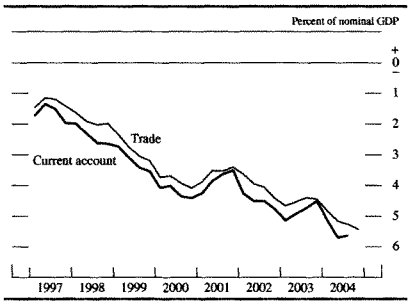
The External Sector

After narrowing in 2003, the U.S. current account deficit widened again last year and was $660 billion (annual rate), or 5.6 percent of GDP, in both the second and third quarters. Much of this widening reflected a considerable increase in the deficit on goods and services trade, as a marked rise in imports more than offset solid increases in exports. The trade deficit expanded from $500 billion during the fourth quarter of 2003 to more than $650 billion, on average, during the second half of 2004.

International Trade

Real exports of goods and services rose an estimated 5½ percent in 2004 despite a deceleration in the fourth quarter. In the first half, exports were supported by the lagged effect of the fall in the dollar's value in 2003. Strong expansion of foreign economic activity also helped boost exports in the first half, but that stimulus diminished in the second half of the year when foreign growth slowed. For the year as a whole, exports of industrial supplies and capital goods posted solid growth. Exports to Canada, Mexico, and western Europe rose smartly in 2004, whereas exports to Japan were relatively weak. Real exports of services increased about 3½ percent through 2004 as a whole.

U.S. trade and current account balances



NOTE. The data are quarterly. The trade data extend through 2004:Q4 and the current account data extend through 2004:Q3.
SOURCE. Department of Commerce.

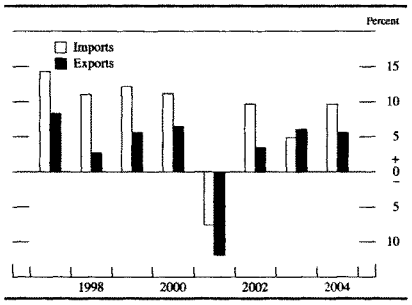
After increasing at an annual rate of almost 6 percent in the first half of 2004, prices of exported goods moved up at just a 2½ percent rate in the second half. This deceleration was due in large part to a reversal of the run-up in the prices of agricultural products that had occurred in late 2003 and early 2004. Better harvests last year returned prices of agricultural products to levels near those that had prevailed before the spike.

Solid growth in income in the United States spurred growth of real imports of 9½ percent in 2004. The increase primarily reflected higher imports of goods that occurred despite a notable rise in their prices. Real oil imports expanded almost 10 percent in 2004. Imports of capital equipment increased throughout the year, but imports of consumer goods suffered a period of weakness through the middle of the year before rebounding in the fourth quarter. Imports of services moved up only 1¾ percent in 2004.

Prices of imported non-oil goods increased at an annual rate of just over 4 percent in the first half of 2004, but the pace slowed to 2 percent in the second half. This step-down largely reflected a deceleration in the prices of industrial supplies, driven by a leveling off of nonfuel commodity prices at the elevated levels reached in March. Declines in the prices of foods offset continued price increases for metals.

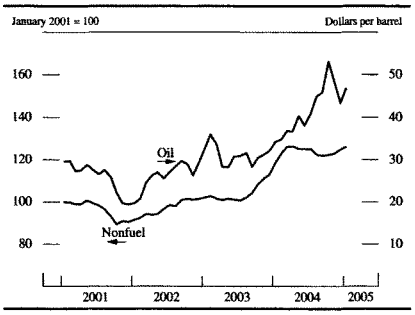
The spot price of West Texas intermediate (WTI) crude oil moved up during most of 2004 and surged temporarily to a record high of $55 per barrel in October. Since then, it has fluctuated somewhat below that peak but still at levels well above $33 per barrel, the price at which it started 2004. Oil prices were driven up by intensified concerns that oil supply would not keep pace with surprisingly strong global demand. Oil consumption in China grew nearly 15 percent in 2004, pushing that economy past Japan as the world's second-largest consumer. As oil prices rose, OPEC increased its oil production,

Change in real imports and exports of goods and services



SOURCE. Department of Commerce and Federal Reserve staff estimates

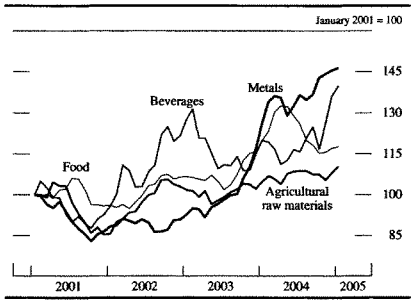
Prices of oil and of nonfuel commodities



NOTE. The data are monthly and extend through January 2005. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is an index of forty-five primary-commodity prices.
SOURCE. For oil, *Wall Street Journal;* for nonfuel commodities, International Monetary Fund.

diminishing the cartel's estimated spare capacity to historically low levels. Increased OPEC production damped particularly the rise in prices of heavier, more sulfurous grades of crude oil but had less effect on prices of lighter grades like WTI. Supply disruptions also played a role in the run-up of oil prices. In October, Hurricane Ivan extensively damaged oil and gas production facilities in the Gulf of Mexico, boosting the price of WTI relative to other grades of crude oil. Sabotage of production and distribution facilities in Iraq hindered oil exports from that country, which remain below pre-war levels. In Nigeria, ethnic violence and community protests shut down some production. Russian oil output, however, continued despite the breakup of Yukos, formerly Russia's largest oil company. Late in the year, oil prices declined from their October highs, as production recovered in the Gulf of Mexico and OPEC added new capacity. The price of the far-dated NYMEX oil futures contract (currently for delivery in December 2011) rose about $10 per barrel during 2004, possibly reflecting expectations of greater oil demand in Asian emerging-market economies. The far-dated futures contract averaged about $38 per barrel in January 2005, while the spot price of WTI averaged about $48 per barrel.

Prices of major nonfuel commodities



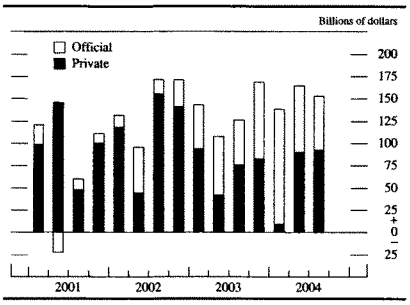
NOTE. The data are monthly and extend through January 2005. The metals category includes aluminum, copper, and iron ore; food includes cereals, vegetable oils and protein meals, seafood, and meat; agricultural raw materials consists of timber, cotton, wool, rubber, and hides; beverages consists of coffee, cocoa beans, and tea.
SOURCE. International Monetary Fund.

The Financial Account

In 2004, the U.S. current account deficit was financed once again largely by foreign purchases of U.S. bonds. Foreign official inflows picked up further last year and were especially strong in the first quarter, reflecting sizable bond purchases by Asian central banks. Private foreign purchases of U.S. bonds rebounded in 2004 from a slight decline in 2003, with especially large purchases coming late in the fourth quarter. In contrast, foreign demand for U.S. equities weakened further in 2004, although this also picked up late in the year. Net purchases of foreign securities by U.S. investors remained strong in 2004, with most of the strength coming in the second half of the year.

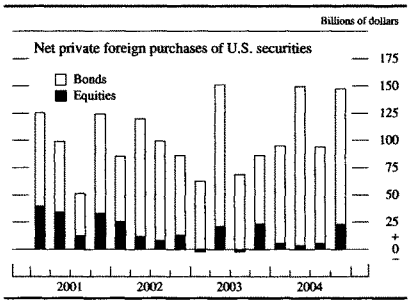
U.S. direct investment abroad continued at a strong pace, as reinvested earnings remained sizable. Direct investment into the United States rebounded in the first three quarters of 2004 from its anemic pace in 2003; global mergers and acquisitions revived, and reinvested earnings picked up. Overall, net direct investment outflows continued over the first three quarters of 2004 but at a lower pace than in 2003.

U.S. net financial inflows



SOURCE. Department of Commerce.

U.S. net international securities transactions



SOURCE. Department of Commerce and the Federal Reserve Bank of New York.

Net inflows of portfolio capital exceeded net outflows of direct investment and represented the financial counterpart to the U.S. current account deficit. These net financial inflows imply a further decline in the U.S. net international investment position, which began 2004 at a reported level of negative $2.4 trillion (22 percent of GDP).

The Labor Market

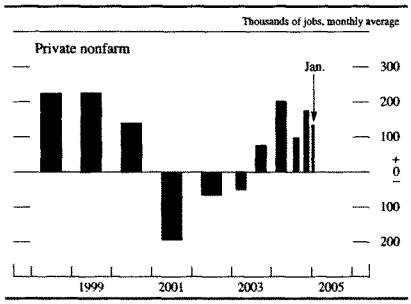
Employment and Unemployment

The labor market improved notably in 2004. Private payrolls, which began to post sustained increases in late 2003, rose an average of 170,000 per month last year. Progress was not steady over the course of the year, however. Employment growth stepped up sharply in the spring to a pace of almost 300,000 per month in March, April, and May; net hiring then dropped back to subpar rates of about 100,000 per month in June through September. In the four months since then, increases in private payrolls have averaged 165,000 per month.

The improved pace of hiring was widespread, as all major industry groups contributed to faster employment growth relative to that of the latter part of 2003. The largest gains were in professional and business services and health services. The construction sector also posted substantial gains. In the manufacturing sector—where employment had declined almost continuously since early 2000—payrolls increased in the spring when overall employment was rising sharply but were about unchanged, on net, over the second half of the year. Employment gains in retail trade and in food services were also brisk over the first half of the year but tapered off in the second half. Meanwhile, state and local governments added substantially to their payrolls last year, especially for education, but civilian employment in the federal government edged lower.

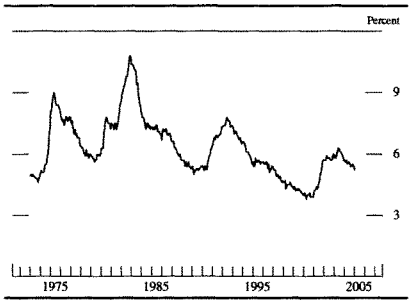
The unemployment rate fell from near 6 percent in late 2003 to less than 5½ percent by late last year; joblessness fell further in January 2005, to 5¼ percent. The decline in the unemployment rate over the past year reflected both the pickup in hiring and a labor force participation rate that remained surprisingly low. From 2001 through 2003, the participation rate declined by more than would have been predicted on the basis of past relationships with indicators of labor demand, and in 2004, when the pace of hiring increased, the participation rate leveled off but failed to rise. These considerations suggest that there may be a persistent component to the recent softness in participation. However, participation had been quite strong through 2000, when the labor market was extremely tight, and the fact that participation turned down

Net change in payroll employment



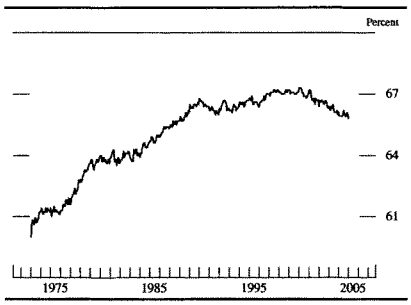
SOURCE. Department of Labor, Bureau of Labor Statistics.

Civilian unemployment rate



NOTE. The data are monthly and extend through January 2005.
SOURCE. Department of Labor, Bureau of Labor Statistics.

Labor force participation rate



NOTE. The data are monthly and extend through January 2005.
SOURCE. Department of Labor, Bureau of Labor Statistics.

at the same time that labor demand weakened suggests that at least some of the recent low participation is cyclical. To the extent that some of this low participation proves to be transitory, the resumption of more-rapid labor force growth will limit the speed at which employment gains further push down the unemployment rate.

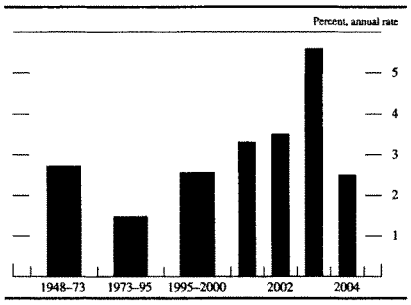
Productivity and Labor Costs

Labor productivity rose solidly again last year. Output per hour in the nonfarm business sector increased an estimated 2½ percent over the year. This increase was somewhat below the outsized 4 percent average pace of increase from 2001 through 2003. Those earlier huge productivity gains were not associated with especially large accumulations of new capital equipment, as had been the case during the late 1990s; instead, to a large degree, the gains seem to have been related to more effective use of capital equipment that had been acquired earlier and to one-time organizational innovations induced by firms' earlier reluctance to commit to increased hiring. Still, last year's 2½ percent increase in productivity was impressive by long-run standards: It was in line with the pace of the late 1990s and well above rates that had prevailed during the preceding two decades.

Increases in hourly labor compensation remained moderate last year. As measured by the employment cost index (ECI), which is based on a quarterly survey from the Bureau of Labor Statistics, hourly compensation in private nonfarm businesses increased 3¾ percent in 2004, a bit less than in 2003. An alternative measure is compensation per hour in the nonfarm business sector as derived from compensation data in the NIPAs. This measure of hourly compensation rose 3½ percent last year, an increase similar to that in the ECI but substantially less than the 5½ percent rise in 2003.

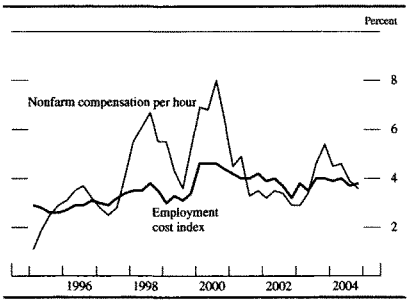
As has been the case for several years, the cost of employee benefits rose considerably more than did wages and salaries last year. The benefits component of the ECI increased nearly 7 percent, while the wages and salaries component posted a much more moderate 3 percent increase. The rise in hourly wages and salaries was about the same as increases in the preceding two years; although probably boosted by last year's higher rate of price inflation, wages were likely held down by the continued, though diminishing, labor market slack and also by employers' attempts to offset continued large increases in benefits costs. Health insurance costs continued to rise rapidly. As measured by the ECI, employers' costs of health insurance, which account for about 6 percent of

Change in output per hour



NOTE. Nonfarm business sector.
SOURCE. Department of Labor, Bureau of Labor Statistics.

Measures of change in hourly compensation



NOTE. The data are quarterly and extend through 2004:Q4. 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.
SOURCE. Department of Labor, Bureau of Labor Statistics.

overall compensation costs, rose 7 percent last year after having increased more than 10 percent per year in 2002 and 2003.

Prices

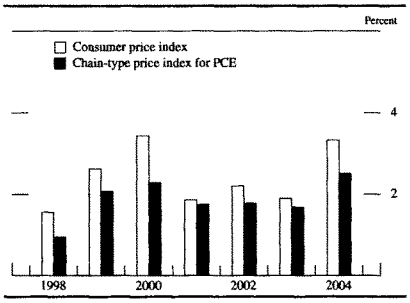
Overall consumer prices rose notably more in 2004 than they did in 2003, and the sharp increase in energy prices accounted for much of the step-up. The chain-type price index for personal consumption expenditures (PCE) rose 2 1/2 percent last year, compared with an increase of 1 3/4 percent in 2003. The increase in PCE prices excluding food and energy was considerably smaller—only 1 1/2 percent, up a little more than 1/4 percentage point from the increase in 2003. Inflation as measured by the market-based component of core PCE prices—which excludes a collection of erratic prices that are unobservable from market transactions and which the Bureau of Economic Analysis began to publish early last year—was in line with overall core PCE inflation last year. The core consumer price index (CPI) rose about 2 percent last year after having increased 1 1/4 percent in 2003. (The CPI differs from PCE prices in a number of respects, but one factor that boosted CPI inflation relative to PCE inflation last year was a difference in the way the two indexes measure the prices of medical services, especially physicians' services, which rose much more rapidly in the CPI than in the PCE index.) The rise in core consumer prices was largest in the early months of 2004: Core PCE prices increased at an annual rate of nearly 2 percent over the first half of the year and then decelerated to a 1 1/4 percent rate of increase in the second half.

The price index for GDP was less affected by last year's rise in energy prices than was the PCE measure; much of the energy price increase was attributable to the higher prices of imported oil, which are excluded from GDP because they are not part of domestic production. GDP prices increased 2 1/4 percent last year, 1/2 percentage point faster than in 2003. In addition to the rise in PCE prices (excluding the influence of imported oil), GDP prices were affected by a sizable increase in construction prices for residential and nonresidential structures.

The jump in consumer energy prices in 2004 was driven by the run-up in crude oil prices. The prices of both gasoline and fuel oil increased approximately 30 percent over the year, and higher oil costs accounted for the bulk of the increase. Prices of natural gas, which can often substitute for fuel oil in the industrial sector, rose notably as well last year despite the restraining influence of ample inventories. Electricity prices, which tend to reflect fuel costs with a lag, also moved higher through most of the year but dropped back some near year-end.

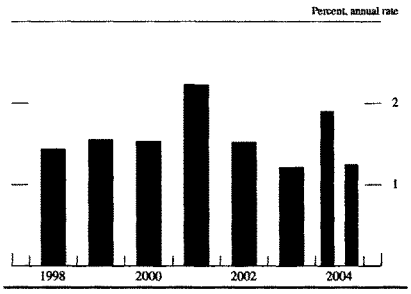
Consumer food prices rose around 3 percent for a second consecutive year in 2004. Exports of beef dropped

Change in consumer prices



SOURCE. For consumer price index, Department of Labor, Bureau of Labor Statistics; for chain-type measure, Department of Commerce, Bureau of Economic Analysis.

Change in PCE prices excluding food and energy



SOURCE. Department of Labor, Bureau of Labor Statistics.

Alternative measures of price change

Percent

Price measure	2002	2003	2004
Chain-type			
Gross domestic product	1.6	1.7	2.4
Gross domestic purchases	1.8	1.8	2.9
Personal consumption expenditures	1.8	1.7	2.5
Excluding food and energy	1.5	1.2	1.6
Market-based PCE excluding food and energy	1.4	1.0	1.6
Fixed-weight			
Consumer price index	2.2	1.9	3.4
Excluding food and energy	2.0	1.2	2.1

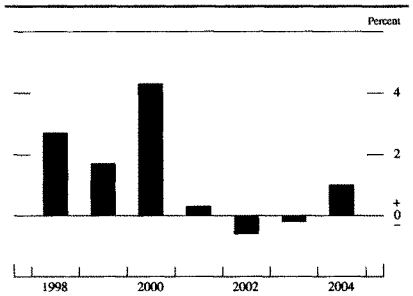
NOTE. Changes are based on quarterly averages of seasonally adjusted data.
SOURCE. For chain-type measures, Department of Commerce, Bureau of Economic Analysis; for fixed-weight measures, Department of Labor, Bureau of Labor Statistics.

sharply last year when most of the largest importing countries placed restrictions on U.S. beef after a case of mad cow disease was discovered. Nevertheless, domestic demand was sufficiently strong to support consumer meat prices last year. Fruit and vegetable prices trended sideways through most of the year but then rose sharply in the fall because of crop damage associated with the series of hurricanes that hit the Southeast in August and September. In addition, prices for food away from home, which are driven more by labor costs than by raw food prices, increased more rapidly last year than in 2003.

Core consumer prices were influenced by a variety of forces last year. Price increases were likely restrained by continuing slack in labor markets and in some product markets, but businesses faced considerable pressure from several sources of increased costs. First, the indirect effects of the large jump in energy prices fed through to businesses throughout the economy and were especially important for firms in energy-intensive industries, such as those that produce plastics and fertilizers. Second, prices were up sharply for a number of other industrial commodities, including lumber and a variety of metals. These price increases reflected strengthening economic activity abroad as well as in the United States. Although these non-oil commodities represent a small part of businesses' overall costs, some businesses likely felt the pinch of sustained price increases in these areas. Third, the declining exchange value of the dollar boosted import prices, including those of many inputs to production. Finally, the deceleration in labor productivity boosted unit labor costs after two years of declines; nevertheless, last year's 1 percent rise in unit labor costs was quite modest.

Taken together, these influences left their clearest mark on the prices of goods rather than services. Core goods prices were about unchanged, on average, last year, but this period of stability followed a period of unusually large

Change in unit labor costs



NOTE. Nonfarm business sector.
SOURCE. Department of Labor, Bureau of Labor Statistics.

TIPS-based inflation compensation

NOTE. The data are daily and extend through February 9, 2005. Based on a comparison of the yield curve for Treasury Inflation-Protected Securities (TIPS) to the nominal off-the-run Treasury yield curve.

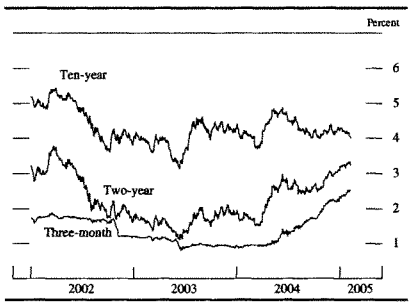
declines in 2003. In particular, the prices of new motor vehicles leveled off after falling notably in 2003, and the prices of used vehicles reversed some of their sharp 2003 declines. Prices of non-energy PCE services rose about 2 percent in 2004—a smaller increase than in 2003.

Last year's rise in inflation showed through to short-term measures of expected inflation, but longer-term measures remained stable. According to the Michigan SRC, households' median expectations for inflation over the next year moved up considerably in the spring as inflation was rising, but then they eased back and ended the year near 3 percent—up from around 2½ percent in late 2003. In contrast, the median expectation for inflation over the next five to ten years held about steady near 2¾ percent throughout this period. Inflation compensation as measured by spreads between yields on nominal Treasury securities and inflation-indexed securities—another indicator of expected inflation, albeit one that is also influenced by perceptions of inflation risk and perhaps also by the development of the market for inflation-indexed debt—showed a similar pattern. Inflation compensation over the next five years moved up about ½ percentage point during 2004, to 2½ percent, while compensation at the five- to ten-year horizon edged lower, on net, over the year.

U.S. Financial Markets

Domestic financial conditions were supportive of economic growth in 2004. Interest rates on longer-term Treasury securities remained low, corporate risk spreads fell, and stock prices, on balance, registered gains. These developments occurred even as market participants revised up their expectations for the path of the federal funds rate. At the beginning of 2004, futures market quotes

Interest rates on selected Treasury securities



NOTE. The data are daily and extend through February 9, 2005.
SOURCE. Department of the Treasury.

implied that investors expected a 1¾ percent target for the federal funds rate at year-end, 50 basis points below the target actually established at the FOMC meeting in December 2004. Consistent with the revision in policy expectations, yields on two-year Treasury notes increased about 1¼ percentage points in 2004. Yields on longer-dated Treasury securities, however, ended the year essentially unchanged. Despite the run-up in oil prices, equity prices registered solid gains in 2004 after rising sharply the year before. Risk spreads on investment-grade corporate debt declined a touch, and those on speculative-grade debt fell more noticeably. Moreover, banks appreciably eased terms and standards for lending to businesses.

Interest Rates

Most market interest rates rose, on balance, over the first half of 2004, particularly at shorter maturities. The FOMC's decision at its January meeting to shift from a statement that monetary policy could remain accommodative for "a considerable period" to an indication that it could be "patient" in removing policy accommodation prompted a rise in market interest rates. In early February and March, yields fell substantially in response to employment reports that indicated tepid job growth. Prices of federal funds and Eurodollar futures contracts implied that investors placed only small odds on an increase in the target funds rate before late 2004 and that they envisioned only moderate monetary policy tightening thereafter. Longer-term interest rates and the expected path for the federal funds rate were considerably marked up later in the spring in response to data suggesting a pickup in aggregate demand and hiring, readings on core inflation that came in above expectations, and rising oil prices. In the statement released after its May meeting, the Committee indicated that policy accommodation was likely to be removed at a "measured" pace. At its June meeting, the Committee raised the target for the federal funds rate from 1 percent to 1¼ percent, but it continued to assess the risks to sustainable growth and to price stability as balanced and reiterated the "measured pace" language. Interest rates across the term structure declined somewhat immediately after the announcement, reportedly because some market participants had expected the FOMC to mention upside risks to growth or inflation in its statement.

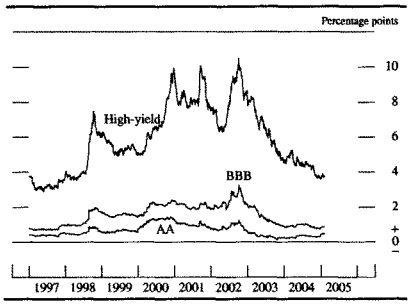
Chairman Greenspan's congressional testimony in July on monetary policy, which suggested that recent softness in consumer spending would likely prove short lived, sparked a jump in yields on Treasury securities. However, interest rates subsequently moved lower, on balance, as incoming data pointed to weaker spending and employment than investors had expected as well as to more-subdued core inflation. Apart from the August employment report, which seemed to hint that the economy was emerging from its "soft patch," incoming economic news remained somewhat lackluster through the end of the third quarter. However, investors reportedly viewed FOMC statements and comments by FOMC officials as more sanguine on near-term prospects for the economy than they had expected. In particular, the release of the minutes from the August FOMC meeting, which referenced the probable need for "significant cumulative tightening," prompted investors to mark up their expectations for the near-term path of monetary policy.

Short-term Treasury yields rose a bit further over the fall in association with actual and expected policy tightening, but long-term Treasury yields were little changed on net. Investors' expectations for the path of monetary policy firmed a bit more in the fourth quarter in response to higher-than-anticipated inflation and remarks from Federal Reserve officials that were reportedly interpreted as suggesting that an imminent pause in the tightening cycle was unlikely.

As the economic expansion gathered momentum and measures of corporate credit quality improved, investors' perception of risk seemed to diminish, and their willingness to bear risk apparently increased. Risk spreads on investment-grade corporate debt over comparable Treasuries ended the year slightly below their levels at the end of 2003. Spreads of speculative-grade yields declined further after narrowing sharply during 2003.

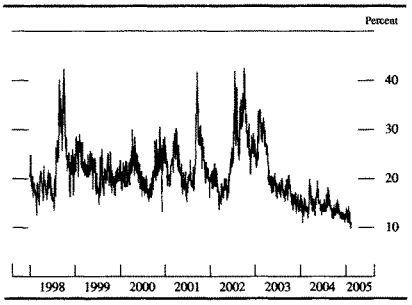
In early 2005, market participants boosted their expectations for the path of the federal funds rate, partly in response to the publication of the minutes of the December FOMC meeting, which investors reportedly interpreted as pointing to greater concerns about infla

Spreads of corporate bond yields over comparable off-the-run Treasury yields



NOTE. The data are daily and extend through February 9, 2005. The high-yield index is compared with the five-year Treasury yield, and the BBB and AA indexes are compared with the ten-year Treasury yield.
SOURCE. Merrill Lynch AA and BBB indexes and Merrill Lynch Master II high-yield index.

Implied S&P 500 volatility



NOTE. The data are daily and extend through February 9, 2005. The series shown is the implied thirty-day volatility of the S&P 500 stock price index as calculated from a weighted average of options prices.
SOURCE. Chicago Board Options Exchange.

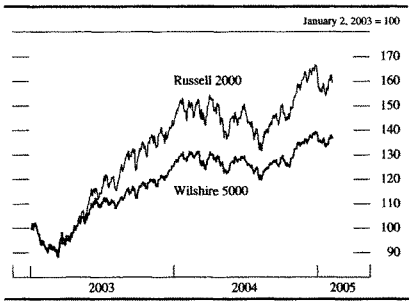
tion than had been expected. Short- and intermediate-term Treasury yields rose along with expectations for the path of monetary policy, but longer-term yields edged lower. Yields on investment- and speculative-grade corporate bonds largely moved with those on comparable Treasury securities, and hence risk spreads remained at low levels.

Equity Markets

After surging as much as 30 percent in 2003, broad stock market indexes climbed modestly over the first half of 2004. The boost to equity prices from robust earnings reports and analysts' upward revisions for future profits during this period was offset in part by rising interest rates in the second quarter, worries about geopolitical developments, and sharply higher oil prices. Stock prices dipped early in the second half in response to softer economic data, further concerns about energy prices, and guidance from corporations that pointed to a less optimistic trajectory for earnings than investors had reportedly been expecting. However, as oil prices pulled back toward the end of 2004 and news on the economy improved, stock prices rebounded to post solid gains for the year. The increases were led by stocks with comparatively small market capitalizations; the Russell 2000 index climbed 17 percent in 2004 to a record high. The S&P 500 and the technology-laden Nasdaq advanced about 9 percent and 8½ percent respectively. To date in 2005, equity prices have edged lower, on balance, as investors have responded to a rebound in oil prices, lackluster earnings reports, cautious guidance for future profits, and indications of continued monetary policy tightening.

Expected volatility implied by options prices for both the Nasdaq 100 and the S&P 500 declined further in 2004 from already low levels. The difference between the earnings–price ratio and the real ten-year Treasury yield—a crude measure of the premium investors require for holding equity shares—changed little, on balance, remaining close to its average value over the past two decades but above its level during the late 1990s.

Stock price indexes

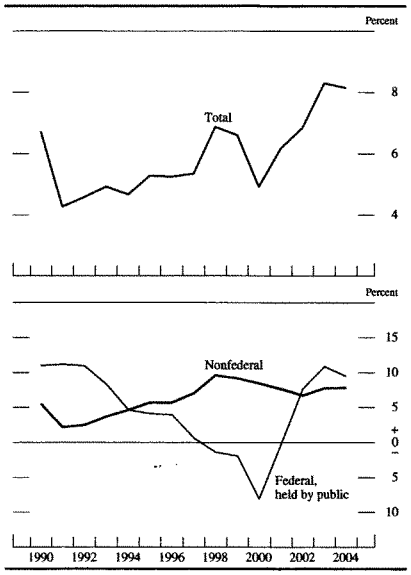


NOTE. The data are daily and extend through February 9, 2005.

Debt, Bank Credit, and M2

The aggregate debt of domestic nonfinancial sectors is estimated to have increased about 7¾ percent in 2004,

Growth of domestic nonfinancial debt



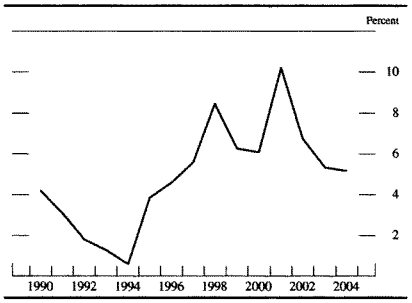
NOTE. For 2004, change is from 2003:Q4 to 2004:Q3 at an annual rate. For earlier years, the data are annual and are computed by dividing the annual flow for a given year by the level at the end of the preceding year. The total consists of nonfederal debt and federal debt held by the public. Nonfederal debt consists of the outstanding credit market debt of state and local governments, households, nonprofit organizations, and nonfinancial businesses. Federal debt held by the public excludes securities held as investments of federal government accounts.

somewhat faster than nominal income but a bit slower than the pace set the year before. Household and federal debt expanded rapidly. Borrowing by nonfinancial businesses was moderate, although it picked up in the fourth quarter.

Commercial bank credit rose about 9 percent in 2004, a larger advance than in the previous year. Expansion of mortgage and home equity loans on banks' books remained strong, as activity in the housing market stayed robust while mortgage originations shifted somewhat toward adjustable-rate products. After several years of runoffs, business loans began to grow in the second quarter of the year. According to survey evidence, commercial banks eased terms and standards on business loans as the economic outlook improved and competition from other banks and nonbank lenders intensified. Also, banks reported a pickup in demand for business loans that was said to be driven by customers' needs to fund rising accounts receivable, inventories, capital expenditures, and mergers. After adjusting for certain reclassifications of securities as loans, the growth of consumer loans on banks' books remained sluggish. Despite reports of increased competition among banks and nonbank intermediaries, bank profits were again strong in 2004. Banks experienced further improvements in asset quality and, as a result, reduced their provisions for loan losses.

M2 grew at a pace roughly in line with that of nominal GDP during the first half of 2004. A resurgence of mortgage refinancing spurred by the first-quarter decline in mortgage rates likely boosted liquid deposit growth, as proceeds from refinancing were temporarily held in deposit accounts pending disbursement to the holders of mortgage-backed securities. M2 growth slowed in the second half of the year in response to a drop in mortgage refinancing activity and the increased opportunity cost of holding M2 assets, as returns available on market instruments rose more than those on M2 components. For example, yields on retail money market mutual funds moved up more slowly than did short-term market interest rates, and assets of money funds accordingly continued to shrink. Small time deposits, which had contracted over the previous three years, resumed expansion in the second half of the year, as their yields began to rise in association with the increase in other market rates. Currency grew at its slowest rate since 2000, apparently reflecting sluggish demand by both domestic and foreign holders. On balance, M2 growth from the fourth quarter of 2003 to the fourth quarter of 2004 was about $5^1/_4$ percent. The velocity of M2 rose 1 percent, on net, roughly in line with the historical relationships among money, income, and opportunity cost.

M2 growth rate



NOTE. The data are annual and extend through 2004. M2 consists of currency, traveler's checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds.

International Developments

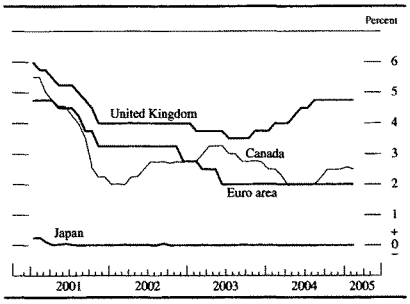
Foreign economic activity expanded in 2004 at a faster pace than in the preceding three years. The pickup in growth was widespread—global manufacturing and trade rebounded across industrial and emerging economies, in part because of strong demand from the United States and China. In the second half of the year, trade and foreign GDP growth slowed, partly as a result of higher oil prices and the appreciation of some foreign currencies against the dollar. The run-up in oil prices and other commodity prices contributed to higher, though still moderate, inflation across industrial and emerging economies.

Monetary policy in many foreign economies tightened over the course of 2004. Citing high rates of capacity utilization and mounting inflationary pressures, the Bank of England raised its target interest rate 100 basis points but has been on hold since August amid signs that housing prices and consumer spending are cooling. After cutting official interest rates earlier in the year, the Bank of Canada raised rates in the fall in response to diminishing slack in the economy. The Bank of Mexico tightened policy throughout the year to resist rising inflation, and Chinese authorities made monetary policy more restrictive to rein in soaring investment demand. In the euro area and Japan, central banks kept policy interest rates unchanged in 2004.

Foreign equity price indexes recorded moderate net gains last year after larger increases in 2003. Equity markets started the year strong, but prices declined in the spring as interest rates rose. The run-up in oil prices between July and October appeared to weigh on foreign equity prices, but the subsequent decline in oil prices helped support a rise in equity prices late in the year. Foreign long-term interest rates declined, on net, during 2004. Rates rose in the second quarter as new data (including reports from the United States) that showed faster growth and higher inflation led market participants to expect more-aggressive monetary tightening. However, foreign long-term interest rates slipped after midyear, when foreign growth slowed and foreign currencies appreciated against the dollar. Over the first half of the year, spreads on internationally issued sovereign debt of emerging-market economies over U.S. Treasuries moved up somewhat from low levels, but spreads more than reversed those increases in the second half.

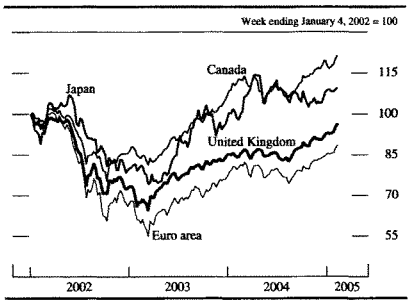
The path of the exchange rate was uneven over the course of 2004. The dollar rose slightly in the first half of

Official interest rates in selected foreign industrial countries



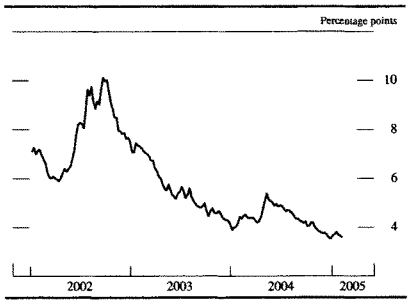
NOTE. The data are as of month-end; the last observation for each series is the average of trading days through February 9, 2005. The data shown are the call money rate for Japan, the overnight rate for Canada, the refinancing rate for the euro area, and the repurchase rate for the United Kingdom.

Equity indexes in selected foreign industrial countries



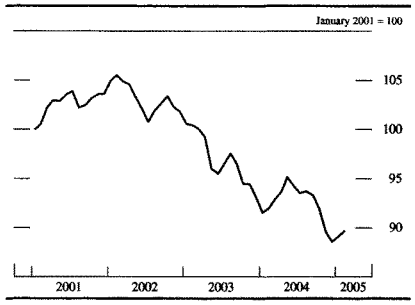
NOTE. The data are weekly. The last observation for each series is the average of trading days through February 9, 2005.
SOURCE. Bloomberg L.P.

Spread on internationally issued sovereign debt of emerging-market economies



NOTE. The data are weekly averages. The last observation is the average of trading days through February 9, 2005. The series shown is the spread of the yield of certain dollar-denominated sovereign debt instruments of emerging-market economies over U.S. Treasury securities; over the period shown, the index encompassed nineteen countries.
SOURCE. J.P. Morgan Emerging Market Bond Index Plus (EMBI+).

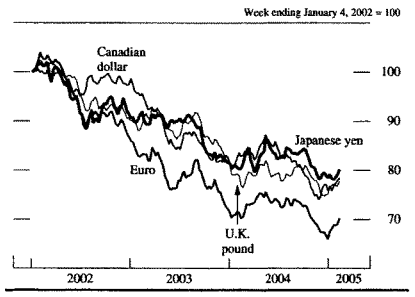
U.S. dollar nominal exchange rate, broad index



NOTE. The data are monthly and are in foreign currency units per dollar. The last observation is the average of trading days through February 9, 2005. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.

the year on perceptions that monetary policy would tighten more quickly in the United States than abroad. Beginning in September, however, the dollar resumed the depreciation that had started in 2002, as market participants focused on the financing implications of the large and growing U.S. current account deficit. In 2004, the dollar depreciated about 7 percent, on net, against the euro, the U.K. pound, and the Canadian dollar. The dollar declined 4 percent, on net, against the Japanese yen and 13 percent against the Korean won, but some other Asian central banks, most notably the People's Bank of China, kept their currencies stable against the dollar. So far in 2005, the dollar has rebounded, with market commentary focusing on the positive differential between U.S. economic growth and that in Europe and Japan.

U.S. dollar exchange rate against selected major currencies



NOTE. The data are weekly and are in foreign currency units per dollar. The last observation for each series is the average of trading days through February 9, 2005.
SOURCE. Bloomberg L.P.

Industrial Economies

After increasing strongly in the first quarter, Japanese GDP growth stagnated in the remainder of 2004. Growth in exports and business investment slowed over the year, and government investment contracted. However, corporate profits and balance sheets improved, and labor market conditions also brightened, with the job-offers-to-applicants ratio rising to a twelve-year high. Consumer prices continued to decline in 2004, though only slightly. In contrast, higher commodity prices helped push twelve-month wholesale price inflation up to 2 percent late in the year, its highest rate since 1990. The yield on the ten-year bellwether government bond rose from its June 2003 record low of about 1/2 percent to nearly 2 percent in mid-year before retreating to about 1 1/2 percent recently. After making substantial sales of yen for dollars in the first quarter, Japanese authorities ceased intervention in mid-March and remained on the sidelines even as the yen appreciated significantly against the dollar in the fall.

Economic conditions in the euro area firmed during the first half of 2004 but weakened in the second half. Private consumption and investment spending continued to rise, but export growth slowed after midyear. German GDP growth slowed to a crawl in the second half, as German consumer spending remained anemic, held down by a weak labor market and low consumer confidence. In contrast, French GDP growth was strong in the fourth quarter. The euro-area unemployment rate has been near 9 percent since rising to that level in early 2003. Inflation for the euro area remained just above the European Central Bank's medium-term goal of less than, but close to, 2 percent.

With the exception of a slowdown in the third quarter, economic expansion in the United Kingdom stayed strong during 2004, largely because of the brisk growth of consumption and government spending. Labor markets remained tight in 2004; the unemployment rate ticked down to its lowest level in almost three decades, and labor earnings posted solid gains. Consumer price inflation over the twelve months ending in December was 1 1/2 percent, below the central bank's official target rate of 2 percent. Housing price rises slowed sharply from rapid rates and were muted during the second half of 2004. Household net mortgage borrowing declined to a level 20 percent below its 2003 peak.

The Canadian economy expanded at a healthy pace throughout 2004. Sizable gains in consumption and investment boosted output throughout the year. Export growth, supported by demand from the United States, was

strong in the first half of the year but stagnated in the second half as U.S. manufacturing growth slowed and the Canadian dollar's appreciation hurt Canadian trade. The unemployment rate declined moderately over the year, and employment posted strong gains. Consumer price inflation has settled at about 2 percent, the midpoint of the Bank of Canada's inflation target range, whereas inflation excluding food, energy, and indirect taxes declined to around 1½ percent by year-end.

Emerging-Market Economies

Growth of real GDP in China remained very robust in 2004, supported by strong domestic demand and exports. The Chinese government took steps early in the year to slow investment spending, curbing investment approvals and lending. Investment growth slowed significantly but remained rapid. At the same time, indicators of personal consumption spending strengthened, and Chinese exports and imports continued to soar in 2004. Consumer price inflation peaked at a twelve-month change of more than 5 percent in July but has fallen since then to less than 3 percent, as food prices have moderated. Inflation excluding food is only about 1 percent.

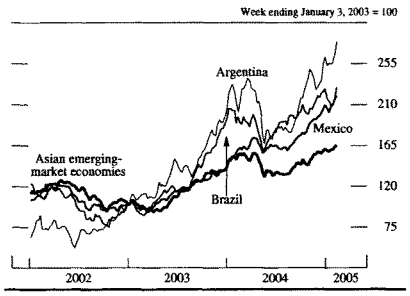
Supported by exports to China, economic growth in other Asian emerging-market economies was generally strong in 2004. Economic expansion in Korea remained heavily dependent on external demand because high levels of consumer debt continued to weigh on consumption spending. Inflation across emerging Asia, though still moderate, was pushed up by higher energy prices and strong aggregate demand.

The Mexican economy grew rapidly in the first half of the year in response to strong demand from the United States. In the third quarter, Mexican GDP growth slowed somewhat, as manufacturing exports stagnated, but domestic demand remained buoyant. Increases in energy and food prices pushed up twelve-month consumer price inflation to more than 5 percent, above the Bank of Mexico's target range of 2 percent to 4 percent. Monetary policy tightened throughout the year, and inflation began to fall near year-end. Oil revenues boosted the Mexican public-sector fiscal surplus and allowed Mexican government spending to provide stimulus while still meeting fiscal targets.

In Brazil, economic activity continued to expand robustly in 2004. Domestic demand was supported by the monetary loosening that occurred in the second half of 2003 and early 2004. Export growth was boosted by demand for commodities and the recovery in Argentina. Brazilian asset prices declined through May on expectations that higher global interest rates would make it more difficult for the Brazilian government to finance its debt, but stock prices have moved up sharply since May, and the currency has appreciated. Concerns over inflation pressures have prompted the central bank to tighten monetary policy since September.

In Argentina, the economic recovery picked up steam last year, as exports were supported by strong demand for commodities. The country continues, however, to grapple with difficult structural problems. After more than three years in default, the government launched a debt swap in January with the goal of restructuring more than $80 billion in defaulted bonds.

Equity indexes in selected emerging-market economies



NOTE. The data are weekly. The last observation for each series is the average of trading days through February 9, 2005. The Asian emerging-market economies are China, Hong Kong, India, Indonesia, Malaysia, Pakistan, the Philippines, Singapore, South Korea, Taiwan, and Thailand; the index weight for each of these economies is its market capitalization as a share of the group's total.

SOURCE. For Argentina, Brazil, Mexico, Bloomberg L.P.; for Asian emerging-market economies, Morgan Stanley Capital International (MSCI) index.

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

April 6, 2005

ALAN GREENSPAN
CHAIRMAN

The Honorable Michael G. Oxley
Chairman
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

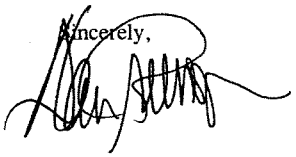
Thank you for your letter of March 1, 2005, concerning the Securities and Exchange Commission's (SEC) proposed Regulation B. The proposed regulation would implement the exceptions for banks from the definition of "broker" in the Securities Exchange Act of 1934 that were adopted by Congress in the Gramm-Leach-Bliley Act (GLB Act). The exceptions in the GLB Act were designed and intended to allow banks to continue to effect securities transactions for their customers as part of their traditional trust, fiduciary, custodial and other bank functions.

Regulation B, if implemented, would significantly disrupt the normal functions and customer relationships of banks that the GLB Act was intended to protect and preserve. Moreover, the regulation would impose substantial and unnecessary costs on banks and their customers and limit customer choice by preventing or discouraging banks from providing certain services that customers have come to expect and demand from their banking institution. The Board believes these results would not occur if the exceptions in the GLB Act are implemented in a manner consistent with the statute's language and purpose.

In October 2004, the Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency submitted a joint comment letter to the SEC on proposed Regulation B that sets forth in detail the banking agencies' concerns with the proposed regulation. Since filing the comment letter, Board members and staff have discussed these concerns with the SEC and its staff.

I hope this information is helpful.

Sincerely,



Chairman Greenspan subsequently submitted the following in response to written questions received from Congressman William Lacy Clay in connection with the February 17, 2005, hearing before the House Financial Services Committee:

Chairman Greenspan, I am concerned about the deficit and you have voiced concerns numerous times about deficit spending also. There are those who champion tax cuts without regard for future budget consequences. Those whom championed the tax cuts of 2001 repeatedly cited the benefits to the economy of that tax cut. Of course there were those of us who said that most of the cuts were unfunded mandates of a sort and would result in deficits. The Congressional Budget Office (CBO) has released new data that show that the changes enacted since January 2001 have increased the deficit by 539 billion. They also state that in 2005, the cost of tax cuts enacted over the past four years will be over three times the cost of increases in domestic spending.

Mr. Chairman, what are your concerns about this huge deficit and do you still view the tax cuts as being beneficial to the economy? Where do you suggest we go from here? Please elaborate.

As I stated in my testimony before the House Budget Committee on March 2, 2005, "The likelihood of escalating unified budget deficits is of especially great concern because they would drain an inexorably growing volume of real resources away from private capital formation over time and cast an ever-larger shadow over the growth of living standards. . . . Raising national saving is an essential step if we are to build a capital stock that by, say, 2030 will be sufficiently large to produce goods and services adequate to meet the needs of retirees without unduly curbing the standard of living of our working-age population."

Difficult choices on both sides of the ledger--spending and taxes--will be required. As I noted in my statement on March 2, "Addressing the government's own imbalances will require scrutiny of both spending and taxes. However, tax increases of sufficient dimension to deal with our looming fiscal problems arguably pose significant risks to economic growth and the revenue base. The exact magnitude of such risks is very difficult to estimate, but, in my judgment, they are sufficiently worrisome to warrant aiming, if at all possible, to close the fiscal gap primarily, if not wholly, from the outlay side."

As for how to address the situation, a good first step, as I argued March 2, would be to reinstate the lapsed budget rules with regard to PAYGO and discretionary spending caps. "Reinstating a structure like the one provided by the Budget Enforcement Act would signal a renewed commitment to fiscal restraint and help restore discipline to the annual budgeting process. Such a step would be even more meaningful if it were coupled with the adoption of a set of provisions for dealing with unanticipated budgetary outcomes over time. . . .The original design of the Budget Enforcement Act could also be enhanced by addressing how the strictures might evolve if and when reasonable fiscal balance came into view."

We have gone from a projected surplus to these astronomical deficits mostly because of the tax cuts already enacted. The cuts already in effect, for the most part, benefit the upper 2% of American taxpayers. Most of the tax cuts that were advertised to the middle class voter as being a direct benefit to them such as the "marriage penalty" and the "death tax" have not been in effect yet. Also the permanent cuts have not been put into law as of yet. The upper 2% of the population are enjoying prosperity. The middle class and working America are suffering from the effects of the slow trickledown that may not reach them. How do you suggest that we in Congress address this?

Do you agree that the order of the tax cuts should have been different? If you agree please be detailed and specific in your reply. If you do not agree then please elaborate on that position.

As elected representatives of the people, the Congress and the President have the responsibility of establishing priorities among the many possible competing uses of the nation's resources. In that context, however, it is crucial that a framework be established putting the nation on a trajectory toward a sustainable fiscal future. For the reasons outlined in my response to the preceding question, and in light of the impending retirement of the baby-boom generation, the need to confront the overall issue of our fiscal situation is growing ever more important.

Last year when you were here you defended the shipping of jobs overseas as beneficial to the economy. In fairness, you did say that the benefit would be long term. We have seen that the loss of tax bases in several states and municipalities have been seriously damaged. Social Security also is suffering from the loss of revenue from the job losses.

Do you still hold to the position that the shipping of jobs overseas is beneficial to the middle class American worker? Please explain in light of the plight of the unemployed, no more unemployment benefits, loss of health insurance, and underemployment for many of those who are back in the workforce. How does this benefit them? In responding please consider that domestic programs that were in place to address this are being eliminated.

As I have stated on previous occasions, history clearly shows that our economy is best served by full and vigorous engagement in the global economy. The competitive environment inherent in this engagement has helped to provide American consumers with lower prices, higher quality, and access to a wider range of goods and services than would otherwise be possible. More generally, our long-standing commitment to free trade and a competitive global marketplace has helped to lift our standard of living to a level unparalleled for so large a population. And, over the long sweep of American generations, we have not experienced a net drain of jobs to other nations; the unemployment rate in the United States has averaged less than 6 percent since World War II with no apparent trend.

That said, the oft-expressed concern that the United States is losing jobs to lower-wage economies represents a real unease among many individuals. Moreover, there is no doubt that those who have lost jobs as a consequence of this process are not readily consoled by the beneficial effects for the economy as a whole. But the protectionist policies that are sometimes proposed in response to these concerns would tend to make matters worse rather than better. To be sure, the pace of competition would undoubtedly slow and tensions might appear to ease for a time. Before long, however, our standard of living would begin to stagnate and perhaps even decline as a consequence. And, if foreign countries were to retaliate, we would surely lose jobs.

Instead, we need to increase our efforts to ensure that as many of our citizens as possible have the opportunity to capture the benefits that flow from free and open trade. Policies to put the current economic expansion on a solid footing represent a part of this process, and as output continues to expand, we have reason to be confident that new jobs will take the place of the old ones as they always have. We also need to further open markets here and abroad to allow our workers to compete effectively in the global marketplace. But an especially critical element in creating opportunity is the provision of rigorous education and training for all members of society. Doing so will not eliminate the pain for those who lose their jobs. But it does promise to reduce the length and cost of such economic dislocation.

We have a housing crisis in America. Yet we are cutting the budget in HUD, sending some of the programs of HUD to the Department of Commerce and to the Department of the Treasury. Additionally there is consideration of partially privatizing the GSEs.

Do you think that cutting Community Development Grants (CDBG), sending housing programs to these other agencies, and somewhat gutting HUD will benefit housing? What is your opinion on these proposals?

As I state below, homeownership is an important public policy objective. Congress and the Administration should decide the best method of pursuing this objective in the context of evaluating other objectives, along with the relative costs and benefits of any given policy.

Do you see the privatization of Fannie Mae and Freddie Mac as beneficial to our housing crisis?

I believe the current intent of the Congress is to use the housing-related GSEs to promote homeownership, particularly among lower income families. This is a worthy objective. Property ownership promotes important economic and societal goals. In particular, market economies require a rule of law. A society without state protection of individual rights, especially the right to own property, cannot build private long-term assets, a key ingredient for a growing modern economy. The wide acceptance of the public to the rule of law in a market economy is greatly promoted by a wide dispersion of property ownership

across households. Congress should focus Fannie Mae and Freddie Mac on securitizing home mortgages, which would promote homeownership without creating potential systemic risks to our financial system.

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

ALAN GREENSPAN
CHAIRMAN

April 5, 2005

The Honorable Luis V. Gutierrez
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am writing in response to one of the questions that you asked during the February 17th hearing on the Federal Reserve's Monetary Policy Report. In particular, you asked whether certain conflict-of-interest provisions in the federal criminal code that currently apply to employees of the U.S. government should be extended to cover employees of the Federal Reserve Banks.

The Federal Reserve System has a unique public-private structure that was designed to reflect and facilitate the System's broad and diverse missions. At the center of the System is the Board of Governors, which establishes policy for the System as a whole. It is the Board, for example, that has statutory responsibility for establishing reserve requirements, supervising and examining banking organizations, implementing many of the nation's banking and consumer protection laws, and establishing the rules governing the operation of the discount window and the payments system. The Board also has general supervisory authority over the Reserve Banks. The Board is an independent agency within the federal government and its employees are fully subject to the criminal conflict-of-interest provisions in Title 18 that apply to all other government employees.

The Reserve Banks, on the other hand, are not government agencies. Under the Federal Reserve Act, the Reserve Banks operate under a bank charter and are privately owned by the member banks within their respective districts. The shareholding member banks elect two-thirds of the board of directors of each Reserve Bank. Moreover, the Reserve Banks operate and function in many respects like a commercial bank for other banks and depository institutions. The Reserve Banks, for example, distribute coin and currency, provide check clearing and collection services, operate the Fedwire and automated clearinghouse funds transfer systems, and provide net settlement services to other institutions and clearing organizations. In fact, the vast majority of Reserve Bank employees support these commercial-type functions and the Federal Reserve is required by law to price these services in a manner comparable to a private business firm. See 12 U.S.C. § 248a. The Reserve Banks perform examinations of banking organizations under authority that is granted to the Board of Governors and then delegated by the Board to the Reserve Banks. These examinations are conducted in accordance with policies established by the Board of Governors.

The Honorable Luis V. Gutierrez
Page Two

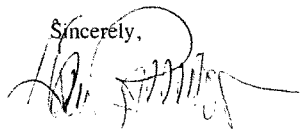
Because the Reserve Banks are not government agencies, Reserve Bank employees may not participate in the retirement, thrift or health plans available to federal employees. They are not part of the civil service and do not have the protections afforded government employees under various civil service acts.

It is thus entirely consistent with their status as outside the government that Reserve Bank employees are not subject to the criminal conflict-of-interest provisions in sections 203, 205, 207 and 209 of Title 18 that apply to U.S. government employees. Reserve Bank employees, however, are subject to ethics requirements that mirror in many respects those applicable to government employees. All Reserve Bank employees, for example, are subject to a comprehensive Uniform Code of Conduct that prohibits employees from, among other things, using their Bank position for personal gain, participating personally and substantially in a particular matter in which the employee (or certain related interests) have a financial interest, and communicating with a former Bank employee about a particular matter (such as a bank examination) in which the former employee participated while employed by the Bank.

To ensure awareness of, and promote compliance with, these restrictions, each Reserve Bank has an ethics officer who is responsible for counseling and training employees concerning their ethical obligations. Reserve Bank ethics officers confer frequently with each other and with the Board's ethics staff to discuss conflicts of interest and other ethics issues and to coordinate training and compliance efforts. Reserve Bank employees file financial disclosure forms annually and, in the case of supervision and regulation employees, information from the forms is used to generate assignment restriction lists. The Board's ethics officer also conducts on-site reviews of each Reserve Bank's ethics program to confirm that all necessary elements are present and functioning effectively. Taken together, these requirements and programs have been effective in preventing and addressing conflicts of interests and in ensuring high ethical standards at the Reserve Banks. Board staff recently provided your staff with a variety of materials relating to the rigorous ethics program maintained and enforced at the Reserve Banks.

For these reasons, I believe it would be unnecessary and inappropriate to extend the criminal conflict-of-interest statutes to cover employees of the Reserve Banks. I hope this information is helpful.

Sincerely,



Chairman Greenspan subsequently submitted the following in response to written questions received from Congresswoman Barbara Lee in connection with the February 16, 2005 hearing before the House Committee on Financial Services:

1) How can we justify giving most major banks an "Outstanding" or "Satisfactory" (CRA) rating when they provide on average only one percent of conventional home loans to African Americans?

This question was also the subject of correspondence between us in 2002. As I noted in my letters to you of February 26 and July 16, 2002, the CRA statute does not focus either on race or ethnicity and, as written, does not contemplate the agencies' focusing solely, or even primarily, on lending of any particular type to minorities. Rather, the statute refers to an institution's helping to meet the credit needs of its entire community, including low- and moderate-income areas. Consequently, under the current CRA regulations, examiners pay particular attention to an institution's record of meeting credit needs of low- and moderate-income neighborhoods and borrowers.

As I also noted in my 2002 letters, the regulations direct examiners to take into account, when assigning a bank a CRA rating, any failure by the bank to comply with laws prohibiting discrimination in lending on the basis of race, ethnicity, and other prohibited factors. Fair lending violations can adversely affect an institution's CRA rating, since such violations may indicate that an institution is not serving its entire community.

You express particular interest in how mortgage and small business credit can be made available to more African Americans. I strongly share your view that increased minority homeownership is a desirable goal for our nation. For most households, homeownership represents a significant financial milestone and is an important vehicle for ongoing savings. The Federal Reserve can best promote expanded homeownership by pursuing the objectives of monetary policy that Congress has set out in the Federal Reserve Act--maximum employment, stable prices, and moderate long-term interest rates. With people employed to the greatest sustainable degree, and with long-term interest rates moderate and thus affordable, homeowners and potential homebuyers of every race and ethnic background are better able to qualify for, and to service, home mortgages. The Federal Reserve can also contribute to increased homeownership through the diligent enforcement of the fair lending laws, a responsibility we take very seriously; through outreach and training efforts of our Community Affairs programs; and, of course, through administration of the CRA.

Small business is also an important vehicle for significant numbers of minority families to accumulate assets. It is essential that the opportunity to start an enterprise is open to anyone with a viable business concept. I agree we must seek ways to promote the creation and expansion of viable firms by lowering barriers to funding and financial

services. Discrimination distorts the distribution of output, raising costs, reducing real output, and slowing national wealth accumulation. Removing non-economic distortions that arise as a result of discrimination can generate higher returns to human capital and other productive resources. Failure to recognize the profitable opportunities represented by minority enterprises not only harms these firms, it harms the lending institutions as well. Accordingly, the nation must make further progress in establishing business relationships between the financial services sector and the rapidly growing number of minority- and women-owned businesses. The Community Affairs Officers of the Federal Reserve System have facilitated such relationships, and will continue to do so.

2) How do you feel about the current revisions, particularly on the part of the Office of Thrift Supervision, that seem to be inspiring a race to the bottom in terms of our CRA standards?

I am pleased to note that the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation recently decided to propose for public comment identical revisions to their CRA regulations. The proposed revisions primarily concern the CRA evaluations and obligations of banks with assets between $250 million and $1 billion. The revisions would exempt those banks from their current obligation to report data on small-business, small-farm, and community-development loans; those types of loans would continue, however, to be considered in CRA evaluations of such banks. Under the proposed revisions, those banks would be evaluated under a two-part test (lending and community development) instead of the three-part test now applied to them (lending, investment, and service). The proposal is intended to reduce some burdens on community banks while more effectively encouraging them to address local community development needs. The proposal is out for public comment until May 10.

As you observe, the Office of Thrift Supervision has taken a somewhat different approach. Nevertheless, I hope that in the longer term all four agencies will have fully consistent regulations.

3) How does the agencies' interpretation of what banking activities trigger an institution's CRA obligations relate to the Community Reinvestment Act's call for banks to meet the convenience and needs of the communities in which they are chartered to do business?

Specifically, how can the regulatory agencies allow banks to evade CRA responsibilities in areas where banks have most of their depositors and customers, open accounts, and sell products? And how does this view reflect changes in banking that have occurred over the last few decades?

The issue you raise is the extent to which an evaluation of a bank's CRA lending, which is generally limited to the bank's lending in the communities where it has deposit-taking facilities such as branches, should be expanded to consider lending in other communities in which the bank takes deposits or sells services. Institutions' increasing reliance on nontraditional channels to make loans and take deposits (examples you cite are the Internet, nonbranch offices, and agents or employees of affiliated nonbank companies), however, means some institutions make a large proportion of their loans and take some of their deposits outside areas in which they have deposit-taking facilities.

The four CRA-responsible agencies jointly addressed that issue in a February 2004 Federal Register notice. The agencies indicated that the current regulations are flexible enough to permit CRA evaluations to address institutions that make a substantial portion of their loans remote from their deposit-taking facilities. The agencies further indicated:

> "Although limitations in the current definition of 'assessment area' might grow in significance as the market evolves, we believe any limitations are not now so significant or pervasive that the current definition is fundamentally ineffective. Moreover, none of the alternatives we studied seemed to improve the existing definition sufficiently to justify the costs of regulatory change. Many of the alternative definitional changes to assessment area we reviewed were not feasible to implement, and some of them raised fundamental questions about the scope and purpose of CRA and entail political judgments that may be better left to elected officials in the first instance."

Chairman Greenspan subsequently submitted the following in response to written questions received from Chairwoman Deborah Pryce in connection with the House Financial Services Committee hearing of February 17, 2005:

Since 2001, the Federal Reserve Board has had an ongoing study showing the level of growth in electronic payments in the United States and undertaken the *Retail Payments Research Project* to estimate the annual number and value of retail payments in the United States.

Clearly the information in this study has some very significant policy implications. Will you review these and other issues related to the Federal Reserve's role in the oversight of and competition in the electronic payment system just as you have done in the paper check payment system?

Will the Federal Reserve develop a plan for oversight, disclosure, regulation if necessary, to ensure that the Federal Reserve's role in electronic payments is preserved and that off-line and on-line debit and credit transactions are cost-effective and efficient for consumers, businesses and our economy? Who will have responsibility for that important portfolio?

I have learned about the conference being hosted by the Federal Reserve Bank of Kansas City, "Interchange Fees in Credit and Debit Card Industries: What Role for Public Authorities?" I applaud this discussion of the role of the Federal Reserve in the oversight of interchange fees, particularly in light of the recent Federal Reserve Payments study showing electronic payments surpassing check payments for the first time; and recent reports (by Boston Consulting Group/Nilson) indicating that U.S. merchant-paid interchange exceeded $33 billion in the last year--the highest interchange in the world. Do you also intend for the Board of Governors to also review this issue?

The Federal Reserve System seeks to promote efficiency, competition, and equity in the nation's payment system primarily in three ways. First, the Federal Reserve Board regulates certain aspects of the payment system. This regulatory authority is not comprehensive but rather is limited to specific matters as authorized by specific statutes. For example, the Expedited Funds Availability Act and the more recent Check Clearing for the 21st Century Act provide the Board with regulatory authority for certain aspects of the nation's check collection system. The Electronic Fund Transfer Act provides the Board with authority to regulate some aspects of electronic payments, such as disclosure requirements, limits on consumer liability, and error resolution procedures. The Board's regulatory authority does not currently encompass regulating the interchange fees

established by payments networks for off-line and on-line debit and credit card transactions.

Second, the Federal Reserve closely monitors the evolution of the nation's existing payment systems to assess whether changes are needed in Board regulations or in Reserve Bank payment services and to formulate legislative recommendations, if necessary. This monitoring would include legal and market developments related to interchange fees for debit and credit card transactions.

Third, the Federal Reserve Banks provide wire transfer, automated clearinghouse (ACH), and check clearing services to depository institutions. Private-sector organizations compete with the Federal Reserve Banks in providing similar services, and the Monetary Control Act requires the Federal Reserve to charge fees for these services that reflect the full cost--including imputed costs and profit--of providing them. Under Board policy, the Federal Reserve Banks would not introduce a new service or major service enhancement unless the service is expected to achieve full cost recovery over the long run and to yield a clear public benefit, and is one that the private sector cannot be expected to provide with reasonable effectiveness, scope, and equity. Any consideration of expanding the Federal Reserve's role in providing electronic payment services would require careful analysis of the market for electronic payment services, including a discussion of any perceived market failure that might justify public-sector intervention. Because of the low marginal costs and evident economies of scale in electronic payments, a large volume base is critical to profitability and a significant public-sector presence in such a market might reduce private-sector incentives for development.

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