MONETARY POLICY AND THE STATE OF THE ECONOMY

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CONTENTS

	Page
Hearing held on:	
February 12, 2003	1
Appendix	
February 12, 2003	45

WITNESS

WEDNESDAY, FEBRUARY 12, 2003

Greenspan, Hon. Alan, Chairman, Board of Governors of the Federal Reserve System	5

APPENDIX

Prepared statements:	
Baca, Hon. Joe	46
Davis, Hon. Artur	47
Gillmor, Hon. Paul E.	49
Hinojosa, Hon. Rubén	51
Shadegg, Hon. John	54
Greenspan, Hon. Alan	56

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Hinojosa, Hon. Rubén:	
Introduction of legislation to help Mexican Nationals access the U.S. Banking System	72
Lee, Hon. Barbara:	
"Who Really Gets Home Loans? Year Nine", Executive Summary, California Reinvestment Committee	78
Maloney, Hon. Carolyn:	
State of New York, Office of the State Comptroller letter, January 14, 2003	84
Greenspan, Hon. Alan:	
Monetary Policy Report to the Congress	86
Written response to questions from Hon. Joe Baca	120
Written response to questions from Hon. Judy Biggert	122
Written response to questions from Hon. Luis V. Guiterrez	124
Written response to questions from Hon. Rubén Hinojosa	127
Written response to questions from Hon. Darlene Hooley	133
Written response to questions from Hon. Patrick J. Tiberi	135

MONETARY POLICY AND THE STATE OF THE ECONOMY

Wednesday, February 12, 2003

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

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

Present: Representatives Oxley, Leach, Baker, Bachus, Castle, Royce, Kelly, Paul, Gillmor, Ryun, Biggert, Shays, Shadegg, Miller of California, Hart, Capito, Kennedy, Feeney, Hensarling, Garrett of New Jersey, Murphy, Brown-Waite, Barrett of South Carolina, Harris, Renzi, Frank, Kanjorski, Waters, Sanders, Maloney, Velazquez, Watt, Hooley, Carson, Meeks, Lee, Inslee, Moore, Gonzalez, Capuano, Hinojosa, Lucas of Kentucky, Clay, Israel, Ross, McCarthy, Baca, Matheson, Lynch, Miller of North Carolina, Emanuel, Scott and Davis.

The CHAIRMAN. The committee will come to order. We are pleased to welcome back the Chairman of the—distinguished Chairman of the Federal Reserve, the Honorable Alan Greenspan.

Chairman Greenspan, the committee welcomes you and as always looks forward to your comments. Because of the importance of your message, it is fitting that just two years ago, you were the first witness at the committee's first hearing in this new Congress.

Mr. Chairman, notwithstanding the comments in your prepared statement about the uncertainties posed temporarily by the current situation in the Middle East, we are here to discuss how to further American economic success. For too long the United States economy has been like a starting quarterback in its rookie season. All the fundamentals are there, but we are just not getting the ball across the goal line. Looking at the replay, we are just not sure what went wrong. In an economy that saw record high productivity last year, I believe the third-quarter numbers were the highest in decades, why do we have diminished consumer confidence and so much market volatility that we can see nearly a 1,000-point swing in just a few days?

That said, I think a lot of us are not just the optimists—seeing the light at the end of the tunnel. Once we resolve the situation in the Middle East, many believe that the economy will be free to grow again. I am sure we all hope that comes to pass.

I appreciate your recent comments about the President's jobs and growth plan for the economy. Many have referred to this plan as a short-term stimulus program, but I see it as a bold attempt to

restructure the economy and prepare it for another long period of expansion. Recognizing your important point that any such plan must be paid for, I would like to associate myself with your view that removing the unfair and counterproductive double taxation of dividends is extremely important. Without this kind of long-term thinking, any short-term stimulus program is likely to be both expensive and ineffective in spurring an economic recovery. You are quite measured in your remarks about the effects of removing the double taxation. Mr. Chairman, I hope you are able in the period reserved for questions to elaborate on that issue.

The President and I share the view that economic growth is the best way to ward off deficits, and the best way to spur growth is to keep more money in the hands of the American family. The way you do that is through lower taxes. Although I am never happy to see budget deficits, today's forecast deficits are in terms of the GDP roughly half of what the deficits were some two decades ago. Perspective is important, I think, and I hope that you will provide it to us today.

This committee will also be considering a number of measures important to reinforcing our economic infrastructure. Among them are reform of the bankruptcy laws, ensuring of certainty in the netting of derivatives contracts, reform of the bank deposit insurance system, repeal of some outmoded banking regulations, streamlining of the check processing system, some emergency authority for the Securities and Exchange Commission. These legislative efforts, which would all make the economy even more resilient as well as more efficient, are necessary and will be dealt with swiftly by the committee.

Mr. Chairman, despite a number of uncertainties, our economy has continued to grow, with a 2.4 percent growth rate for last year and an expected rate of more than 3 percent in the current year. That is extraordinary. To be sure, some of the credit goes to you and your masterful handling of monetary policy. Mr. Chairman, thank you for your willingness to return to the committee at a later date to continue our discussion on these and other important matters. And thank you for working with Ranking Member Frank and myself in that regard. We will always benefit from your wisdom this morning and certainly in the future.

The Chair's time has expired, and I yield to the Ranking Member, the gentleman from Massachusetts Mr. Frank.

Mr. FRANK. Mr. Chairman, I want to echo your thanks to the Chairman for agreeing to come back in April. Neither you nor I decided that this should be the second largest committee in the Congress, money being only second to highways in its lure to Members. So we couldn't accommodate everybody, and we do want to do that. And we will be protecting all Members' rights thanks to your and the Chairman's cooperation.

I welcome the Chairman back to what has become an interesting game. Some people when they were younger played capture the flag. The game today is capture the Fed. The question is who can hoist the Chairman to his or her flagpole in the broader debate. And I sympathize, Mr. Chairman, with your unrequested role here, but I appreciate the integrity with which you have addressed this issue in the midst of these political efforts. And essentially as I

read your testimony yesterday, you stayed true to what you have long argued, namely that deficits, and particularly ever-increasing deficits into the future, are a significant negative.

We are in an interesting period in American history. I think from the intellectual standpoint, we are seeing one of the greatest examples of hypocrisy in recent times. The political party that came to power in the Congress in 1995, having signed a contract with the American people, a contract of adhesion, I am afraid, that was going to balance the budget by constitutional amendment, has now basically announced that they were only kidding, that amending the United States Constitution to balance the budget may have seemed like a useful political ploy, but, in fact, they are really not that all concerned about deficits.

There is a certain bifurcation here. The President has announced a new millennium challenge plan for foreign aid, and to qualify that you can't have a budget deficit, but deficits are okay for us. What we are talking about obviously is an ideological effort. I first thought this was hypocrisy, as I said, but I think it is clear that what we are really talking about is bait and switch. We have a political party in power that is now denigrating deficits for the purpose of getting a tax cut through, but if they are successful in getting that through and adding significantly to the deficit not just this year, but on into the future, they will then turn around and rediscover their fear of deficits and use that as a way to oppose legitimate spending on environmental concerns, unemployment compensation, extended health care and other important social needs.

And the fundamental problem we face is this: This President has decided to make a contribution to economic theory which, to me, is unwelcome. That contribution is that you can pay for two wars with three tax cuts. Had the Democrats in 2000 accused the President of planning to have two wars and pay for it with three tax cuts, we would have been accused of the worst kind of unfair campaign tactics, but that is where we are. If, in fact, you go forward with two wars and pay for those two wars with three tax cuts, you then have to, A, announce that deficits are not so bad after all; and B, substantially reduce other important public programs. That is what is important.

The dividend issue is a question which we should be able to consider at some point as to what is an ideal tax structure, but at this point, with another war facing us—and the President's budget calls for a deficit of over 300 billion without the war in Iraq, so those who think the war in Iraq is going to cost us zero and that compensating Turkey and other countries isn't going to cost us anything, we are probably talking about a $400 billion deficit this year. We are talking about a level of deficit which would have gotten us in trouble if we were in the European Union and indefinite increases into the future.

So that is the context in which we operate, and I appreciate it, Mr. Chairman, as I said, what I thought was the fundamental integrity in the face of a lot of political pulling and hauling for you to restate that. There are other issues that obviously we will want to address, but I do think that the context in which we operate—and I want to close with this again, Mr. Chairman—the notion that the Nation can pay for two wars with three tax cuts, war being by

far the most expensive thing you can do and the very expensive aftermath of that war, obviously is the central factor that confronts us. And the Chairman has long believed, as have most economists, that while deficits are not instant death, they are over a long term a negative for the economy. And I very much appreciate the Chairman's consistency in reaffirming that in the face of an awful lot of political praying that he would go the other way.

The CHAIRMAN. The gentleman's time has expired.

The Chair is pleased to recognize Mrs. Biggert, the Vice Chair of the Monetary Subcommittee.

Mrs. BIGGERT. Thank you, Mr. Chairman, and thank you, Chairman Greenspan, for coming before our committee this morning. This is our first hearing in this committee for the 108th Congress, and the fact that you are first, I think, speaks volumes about the great respect that we have for you and the priority we place on your stewardship of our economy.

I know subcommittee Chairman King wanted to join us here today, but unfortunately, he is tied up in another committee with Secretary Powell in discussions concerning Iraq, so I appreciate the opportunity to speak as the subcommittee vice chairman.

It is no secret that we now face some of the most difficult challenges in our Nation's history. On the foreign policy front, there is the prospect of military action against Iraq; North Korea continues to behave like a reckless child in possession of a dangerous toy; and discord remains among Israelis and Palestinians, Indians and Pakistanis, and in and among other nations and groups around the world.

On the domestic front, our Nation's terror alert system remains high, deficits are mounting, economic growth is down, and the markets remain skittish. Yet when we take a close look at the fundamentals of our economy and observe how it has held up over the last 17 months, I think you'd agree that it is anything but down, dead, and buried. Last month the unemployment rate dropped to 5.7 percent, and payroll employment rose to almost 143,000, almost completely reversing December's decline. Interest rates remain low. Manufacturing activity turned up in December. Productivity for all of 2002 grew by 4.7 percent, the strongest showing since 1950, and a big improvement over the 1.1 percent increase posted in 2001.

But even so, we cannot ignore the fact that something is holding the economy back from a more vigorous rebound. And it would be unwise to not discuss the best way to spur consumers and businesses to spend and invest more, spurring growth and ultimately reining in public debt. And that is why we are here today to discuss our Nation's fiscal future and our plan for short-term and long-term economic growth.

Again, thank you Mr. Chairman for joining us. I look forward to your remarks.

The CHAIRMAN. The gentlelady's time is expired.

The Chair is now pleased to recognize the Ranking Member on the Monetary Subcommittee, the gentlelady from New York Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman.

Good morning, Mr. Chairman, and thank you for joining the committee to offer the perspective of the Federal Reserve on the state of our economy.

By practically any measure the economy has deteriorated significantly over the past 2 years. Unemployment has risen from 4.2 percent to 5.7. In New York it has reached 7.5 percent. The stock market has lost $5 trillion in value, lowering the value of ordinary Americans' retirement savings and 401(k)s dramatically. Most dramatically, the Federal balance sheet has suffered through the single greatest about face in our Nation's history.

As an example, the administration's first budget projected at $262 billion surplus for fiscal year 2004. The second budget estimated a deficit in 2004 of $14 billion. Now the administration is projecting a $307 billion deficit for 2004. Overall the original administration's projection has changed by $570 billion for a single year, and the long-term picture is just as bleak. The situation is so dire that, almost in despair, OMB has stopped issuing 10-year projections altogether.

Mr. Chairman, in past statements and just yesterday you have warned eloquently about the negative impact of deficits on our economy. Just last September you said, and I quote, "history suggests that an abandonment of fiscal discipline will eventually push up interest rates, crowd out capital spending, lower productivity growth, and force harder choices upon us in the future," end quote. I share your concern, especially about interest rates, and fear that the administration's new economic plan promoting deficit-expanding tax cuts will lead to increases in mortgages and credit card rates for America's working families. Furthermore the State budgets are hurting, and the new administration's tax proposal will make things worse.

In New York the administration's dividend tax plan will reduce State revenue and increase borrowing costs by $9 billion over the next 10 years, according to New York State comptroller Allen Hevesi. Two years ago the administration pushed through a massive tax cut which it justified with rose-colored revenue projections. Now for the first time in our history, the executive branch is proposing tax cuts and sending our Armed Forces onto the battlefield at the same time.

I fear we are headed toward another round of massive deficit increases, and I look forward to your thoughts this morning. Thank you for joining us.

The CHAIRMAN. Gentlelady's time has expired.

The Chair would ask unanimous consent all Members' statements may be made part of the record. So ordered.

The CHAIRMAN. Mr. Chairman, welcome back to the committee, and we look forward to your statement.

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

Mr. GREENSPAN. Mr. Chairman and Members of the committee, when I testified before this committee last July, I noted that while the growth of economic activity over the first half of the year had been spurred importantly by a swing from rapid inventory drawdown to modest inventory accumulation, that source of impetus

would surely wind down in subsequent quarters, as it did. We at the Federal Reserve recognized that a strengthening of final sales was an essential element of putting the expansion on a firm and sustainable track. To support such a strengthening, monetary policy was set to continue its accommodative stance.

In the event, final sales continued to grow only modestly, and business outlays remained soft. Concerns about corporate governance, which intensified for a time, were compounded over the late summer and into the fall by growing geopolitical tensions. Equity prices weakened further, the expected volatility of equity prices rose to unusually high levels, spreads on corporate debt and credit default swaps deteriorated, and liquidity in corporate debt markets declined. The economic data and the anecdotal information suggested that firms were tightly limiting hiring and capital spending and keeping an unusually short leash on inventories.

By early November, conditions in financial markets had firmed somewhat. But on November 6, with economic performance remaining subpar, the Federal Open Market Committee chose to ease the stance of monetary policy, reducing the federal funds rate 50 basis points to 1-1/4 percent. We viewed that action as insurance against the possibility that the still widespread weakness would become entrenched.

In the weeks that followed, financial market conditions continued to improve, but only haltingly. Mounting concerns about geopolitical risks and energy supplies were mirrored by the worrisome surge in oil prices, continued skittishness in financial markets, and substantial uncertainty among businesses about the outlook. Partly as a result, growth of economic activity slowed markedly late in the summer and in the fourth quarter. Much of that deceleration reflected a falloff in the production of motor vehicles from the near record level that had been reached in the third quarter when low financing rates and other incentive programs sparked a jump in sales. The slowing in aggregate output also reflected aggressive attempts by businesses more generally to ensure that inventories remained under control. Thus far, those efforts have proved successful in that business inventories, with only a few exceptions, have stayed lean.

Apart from the quarterly fluctuations, the economy has largely extended the broad patterns of performance that were evident at the time of my July testimony. Most notably, output has continued to expand, but only modestly. As previously, overall growth has simultaneously been supported by relatively strong spending by households and weighed down by weak expenditures by business. Importantly, the favorable underlying trends in productivity have continued.

One consequence of the combination of sluggish output growth and rapid productivity gains has been that labor markets have remained quite soft. Another consequence of the strong performance of productivity has been its support of household incomes despite the softness of labor markets. Those gains in income combined with very low interest rates and reduced taxes have permitted relatively robust advances in residential construction and household expenditures. The increases in consumer outlays have been financed partly by the large extraction of built-up equity in homes.

While household spending has been reasonably vigorous, we have yet to see convincing signs of the rebound in business outlays. The emergence of a sustained and broad-based pickup in capital spending will almost surely require the resumption of substantial gains in corporate profits. Of course, the path of capital investment will also depend on the resolution of the uncertainties surrounding the business outlook.

The intensification of geopolitical risks makes discerning the economic path ahead especially difficult. If these uncertainties diminish considerably in the near term, we should be able to tell far better whether we are dealing with a business sector and an economy poised to grow more rapidly, our most probable expectation, or one that is still laboring under persisting strains and imbalances that have been misidentified as transitory. If, instead, contrary to our expectations, we find that despite the removal of the Iraq-related uncertainties, constraints to expansion remain, various initiatives for stimulus will doubtless move higher on the policy agenda. But as part of that process, the experience of recent years may be instructive.

As I have testified before this committee in the past, the most significant lesson to be learned from recent American economic history is arguably the importance of structural flexibility and the resilience to economic shocks that it imparts. I do not claim to be able to judge the relative importance of conventional stimulus and increased economic flexibility to our ability to weather the shocks of the past few years, but the improved flexibility of our economy no doubt has played a key role. That increased flexibility has been in part the result of the ongoing success in liberalizing global trade, a quarter century of bipartisan deregulation that has significantly reduced rigidities in our markets for energy, transportation, communication, and financial services, and, of course, the dramatic gains in information technology that have markedly enhanced the ability of businesses to address festering economic imbalances before they inflict significant damage. This improved ability has been facilitated further by the increasing willingness of our workers to embrace innovation more generally.

It is reasonable to surmise that not only have such measures contributed significantly to the long-term growth potential of the economy this past decade, they also have enhanced its short-term resistance to recession. That said, we have too little history to measure the extent to which increasing flexibility has boosted the economy's potential and helped damp cyclical fluctuations in economic activity. Even so, the benefits appear sufficiently large that we should be placing special emphasis on searching for policies that will engender still greater economic flexibility and dismantling policies that contribute to unnecessary rigidity. The more flexible an economy, the greater its ability to self-correct in response to inevitable, often unanticipated, disturbances, thus reducing the size and consequences of cyclical imbalances. Enhanced flexibility has the advantage of adjustments being automatic and not having to rest on the initiatives of policymakers, which often come too late or are based on highly uncertain forecasts.

Policies intended to improve the flexibility of the economy seem to fall outside the sphere of traditional monetary and fiscal policy,

but decisions on the structure of the tax system and spending programs surely influence flexibility, and thus can have major consequences for both the cyclical performance and long-run growth potential of our economy.

As we approach the next decade, we need to focus attention on the necessity to make difficult choices from among programs that, on a stand-alone basis, appear very attractive. Because the baby boomers have not yet started to retire in force, and accordingly the ratio of retirees to workers is still relatively low, we are still in the midst of a demographic lull. But short of an outsized acceleration of productivity to well beyond the average pace of the past seven years or a major expansion of immigration, the aging of the population now in train will end this state of relative budget tranquility in about a decade's time. It would be wise to address the significant pending adjustment and the associated potential for the emergence of large and possibly unsustainable deficits sooner rather than later. As the President's just released budget put it, "The longer the delay in enacting reforms, the greater the danger and the more drastic the remedies will have to be."

Re-establishing budget balance will require discipline on both revenue and spending actions, but restraint on spending may prove more difficult. Tax cuts are limited by the need for the Federal Government to fund a basic level of services, for example, national defense. No such binding limit constrains spending. If spending growth were to outpace nominal GDP, maintaining budget balance would necessitate progressively higher tax rates that would eventually inhibit the growth in the revenue base on which those rates are imposed. Deficits, possibly ever widening, would be the inevitable outcome.

Faster economic growth, doubtless, would make deficits far easier to contain, but faster economic growth alone is not likely to be the full solution to currently projected long-term deficits. To be sure, underlying productivity has accelerated considerably in recent years. Nevertheless, to assume that productivity can continue to accelerate to rates well above the current underlying pace would be a stretch even for our very dynamic economy. So, short of a major increase in immigration, economic growth cannot be safely counted upon to eliminate deficits and the difficult choices that will be required to restore fiscal discipline.

By the same token, in setting budget priorities and policies, attention must be paid to the attendant consequences for the real economy. Achieving budget balance, for example, through actions that hinder economic growth is scarcely a measure of success. We need to develop policies that increase the real resources that will be available to meet our longer-term needs. The greater the resources available—that is the greater the output of goods and services produced by our economy—the easier it will be providing real benefits to retirees in coming decades without unduly restraining the consumption of workers.

These are challenging times for all policymakers. Considerable uncertainty surrounds the economic outlook, especially for the period immediately ahead. But the economy has shown remarkable resilience in the face of the succession of substantial blows. Critical to our Nation's performance over the past few years has been the

flexibility exhibited by our market-driven economy and its ability to generate substantial increases in productivity. Going forward, these same characteristics in concert with sound economic policies should help to foster a return to vigorous growth of the U.S. economy to the benefit of all our citizens.

Mr. Chairman, I have a rather long written statement from which I have excerpted and would appreciate it being included for the record.

The CHAIRMAN. Without objection.

Mr. GREENSPAN. And I look forward to your questions.

The CHAIRMAN. Thank you, Mr. Chairman.

[The prepared statement of Hon. Alan Greenspan can be found on page 56 in the appendix.]

The CHAIRMAN. And let me indicate to the Members that we will strictly adhere to the 5-minute rule so everyone can participate.

The gentleman from Massachusetts.

Mr. FRANK. I would ask all the Democratic Members to read a memo I put on their desk. We had some commitments in terms of order of questioning from last time, and we have the conflict with the hearing with the Secretary of State, so I hope Members—I don't want to take up any more time—would read that memo. We have tried to accommodate. And I want to repeat: The Chairman has very graciously agreed to come back in April for an additional hearing, and any Member that doesn't get a chance to question today will be, as far as we are concerned on this side, up first so that people will get the chance to do that in April.

Thank you again, Mr. Chairman.

The CHAIRMAN. And the Chair will also try to follow that on our side as well.

Mr. Chairman, back when I was in college studying Economics 101, one of the issues at the Federal level was always the issue of double taxation of dividends and a lot of discussion about the fact that it was unfair, that it was a drag on the economy. As you know, the President—one of the major tenets of the President's proposal was to eliminate the double taxation of dividends not as a short-term stimulus, but as a long-term positive change in our Tax Code. Do you think that is a good idea, and if so, what effect, in your estimation, will it have on the economy?

Mr. GREENSPAN. I do, Mr. Chairman. One of the most important experiences, I think, that we have had as analysts in the last several years, as I indicated in my prepared remarks, is the changes that we have observed in the flexibility of the economy and the resilience that that has imparted to our capability of essentially deflecting shocks and largely deflecting major pressures which would have driven us into deep recessions. Indeed, I would have suspected that the 2001 recession would have been far deeper if we did not have the flexibility that we had. And, as I have indicated in my remarks, we have to now start to move, at least in my judgment, if we are going to get increasing economic growth, to increase the flexibility and the resiliency of the system.

One of the areas where we can do considerable good in that regard is to eliminate the double taxation of dividends, because the double taxation has created a bias towards debt rather than equity in our economic system. And one of the concerns that most people

looking at the longer term have is that the notion of flexibility and resilience and great debt leverage do not go hand in hand. So eliminating the double taxation will very significantly alter the way in which investments are financed over time. It won't happen immediately, because it takes a while for the corporate sector to adjust to differing incentives, but I have no doubt it will make some very important contributions to long-term economic growth.

Let me just say parenthetically, Mr. Chairman, while I do not support the elimination of the double taxation of dividends because of short-term stimulus, it does have some short-term stimulus. That is not the reason I am in favor of it. But it probably will increase the level of stock prices and the wealth effect accordingly, and there are some small income effects. But I do think that the emphasis has to be on what the long-term implications of such a policy would be.

The CHAIRMAN. Mr. Chairman, as you know, this committee was deeply involved in the whole corporate scandals issue in the last Congress, culminating in legislation dealing with corporate governance and more accountability. What role, in your estimation, did the debt financing play in some of those corporate scandals, if any?

Mr. GREENSPAN. Mr. Chairman, it is hard to judge without having very specific evidence, but there is no question that in many of the questionable accounting practices which were unearthed prior to the legislation which you were quite instrumental in pushing, we observed that odd forms of debt instruments were crucial to the various different schemes which were involved to, in my judgment, essentially thwart the purpose of accounting, namely, to give a clear picture of whether a corporate strategy is working or not, not to create a set of accounts to spin the stock price of the firm.

The CHAIRMAN. Thank you. My time has expired.

The gentlelady from California Ms. Waters.

Ms. WATERS. Thank you very much, Chairman Greenspan. We thank you for your visit here today. We all await with great anticipation your creative words of wisdom. However, it appears that you have left us with more questions than answers.

I am rather surprised by your rather lengthy discussion of a cash-based accounting versus accrual accounting, where you basically conclude that you do not have the tools by which to come to certain conclusions. Usually you are a lot more definitive than that, and you have always warned us about great deficits and what we should do to avoid deficits and the kind of cuts that we should make. So despite the fact that we may have the most important or the most concise ways to make these decisions, can you tell us in very simple and clear language, when you talk about fiscal discipline, do you include tax cuts along with discussion on the deficit? And will you talk about our need to cut back on this deficit and what tax cuts are doing to that, and talk about the tax cuts that we made in 2001 and the tax cuts in the new stimulus package?

Mr. GREENSPAN. Congresswoman, I testified before the House Budget Committee in September and very strongly recommended that the PAYGO and discretionary cap rules, which, in my judgment, were really quite extraordinarily effective in restraining deficits over the years, be reinstated. As you know, they expired in the

House on September 30 and will be expiring in the Senate sometime in the spring. Those rules effectively limit the capacity to cut taxes without also having either offsetting revenues or cuts in nondiscretionary spending. It also stipulates that expenditure programs are—require the offsets in the other direction.

I do not deny, especially in most recent years when the surpluses arrived, that there was a lot of game-playing with that system, and the reason was that it was originally put in place to constrain deficits. When the surpluses arose, it seemed to everybody that they no longer made any sense, and they were widely evaded and effectively disbanded. I think this is a very bad mistake, and before any actions are taken with respect to the appropriations for the next fiscal year, I certainly trust that these rules, that is, the discretionary caps and PAYGO rules, will be re-established, because what that will do is enforce the necessity to really put forward only the major priorities which this Congress has into legislation, because it is fairly evident that if one merely looks at an array, as I said in my remarks, of free-standing projects, they all look good. They wouldn't have made it, in a sense, to the semifinals if they weren't extraordinarily good projects. The only problem is that there is an aggregate amount of fiscal capacity in any economy, and we are very clearly straining the capacity of the system owing to the inexorable retirement of a very significant part of our population starting at the end of this decade and carrying on, as you know, beyond that.

So, without getting into any of the individual programs, because that is a very crucial and important choice that the Congress must make for the American people, I do say to you that looking at it from the point of view of an economist, looking at what we can afford and what we can't afford, there are limits, and you have to choose what we do within those limits. And while I didn't expect it to be as effective as it was in the years in which it was effective, PAYGO and discretionary caps really did work.

The CHAIRMAN. The gentlelady's time has expired.

The gentleman from Alabama Mr. Bachus.

Mr. BACHUS. Chairman Greenspan, I want to focus on one issue that is not discussed a lot, but which I think is very important, and that is the Fair Credit Reporting Act. The preemption provisions will be expiring at the end of this year. Fair Credit Reporting Act gives us a national credit reporting system with uniform standards. Would you comment on the importance of maintaining a national credit reporting system, the advantages of that, how important you think it is that we reauthorize the Fair Credit Reporting Act? What may be some of the detriment if we don't? Today I think it gives us great flexibility, and we are able to assess credit risk well, and I think it is very beneficial to have this national system for consumers and also for our financial institutions, and obviously will let you comment.

Mr. GREENSPAN. Well, Congressman, 100 years ago when we just had small banks dealing with customers, you knew what the credit quality of your loans was. You knew the families to whom you were lending, you knew the businesses, and you didn't need a data bank. But as we became ever larger and far more complex, and as our financial system, especially that which relates to consumer credit,

became huge in the post-World War II period, there was no other way to handle a fair evaluation of the credit standing of individual borrowers unless it was in one way or another more automated. And we needed to build up some means of history that would essentially enable us to, as bankers say, make judgments without knowing the person personally and not having in front of them a great deal of information, especially because you may not have any way of doing that.

These data systems are essential, in my judgment, to enable consumers to have access to credit. In other words, it is not that long ago when going into a bank and trying to get a consumer loan was just never conceived as an appropriate thing to do. They didn't make consumer loans. That has changed, and it has had a dramatic impact on consumers and households and access to credit in this country at reasonable rates. That system cannot function without data, without credit histories of individual borrowers, and I should certainly hope that it is maintained.

Mr. BACHUS. It is very important that we reauthorize the Fair Credit Reporting Act to our economy?

Mr. GREENSPAN. Yes.

Mr. BACHUS. Thank you.

Let me just close by saying I have read your prepared remarks, the ones you have delivered here today. Let me sort of capsulize maybe one thing I got out of that, and that is that we must reform Medicare and Social Security and do it sooner as opposed to later, and that is of critical importance to our economy and to our financial stability.

Mr. GREENSPAN. When you look beyond the next few years, what strikes you is how significant the retirement of the baby boomers is to our fiscal system. The number of beneficiaries for both Social Security or OASDI and Medicare and Medicaid are really quite startling.

The problems with Social Security, as difficult as they are, and they are difficult, are nonetheless capable of being resolved because the Social Security system has the characteristics of a private defined benefit plan, and we can judge within some range what types of claims on federal resources are required.

Medicare is a wholly different type of institution. Because of the extraordinary gains in technology, the fact that medical care per se is, as economists say, highly inelastic, meaning that you demand it without respect to price, where we have a subsidized third-party payment system, that leaves the estimates of what the size of medical expenditures are in general and Medicare in particular, very difficult to judge, but it is almost open-ended.

And this is why I am very much concerned about having PAYGO in place, because we are going to have to address these systems in a manner which will fit them into the overall resources of the system. That problem, incidentally, exists with or without the President's economic program. In other words, the change in the fiscal state subsequent to, say, 2010 or perhaps 2012, is such that the rate of debt-to-GDP, a measure of the sustainability of our fiscal affairs, goes up quite abruptly, and as, in fact, the President reports in his budget, and indeed so does the Congressional Budget Office, that those rises are unsustainable.

Something has to be adjusted in order to bring the real resources available for our total fiscal affairs in line, and in my judgment, it is none too soon to start that process, to make it phased-in in a manner which doesn't create abrupt problems for either those contributing to Social Security or Medicare trust funds and those receiving the benefits.

The CHAIRMAN. The gentleman's time has expired.

And the gentlelady from California, Ms. Lee.

Ms. LEE. Thank you, Mr. Chairman. I want to thank you and Ranking Member Mr. Frank, and also welcome Mr. Greenspan and say how timely as always your appearance is.

Let me call your attention to a report which was recently issued by the California Reinvestment Committee. This is their ninth annual report as it relates to home lending mortgage practices in California. It concluded that California's most active banks have failed to meet the quality benchmark in each and every instance; secondly, the financial institutions are clearly ailing in their efforts to average California's African American and Latino households; thirdly, that the race and neighborhood of home loan applicants seem to be a factor in how much they will pay for their loan; and finally, the final conclusion was that bank holding companies are profiting from their failure to ensure that borrowers get the best loan product for which they qualify from their own family of companies.

What I wanted to ask you is what would be some of your recommendations to address these very glaring discriminatory outcomes and practices, and how do you think the Federal Reserve can weigh in, if you can or not, because, of course, accumulation of equity in one's home is the primary means of wealth accumulation for the majority of Americans. That is the American dream.

Mr. GREENSPAN. I agree with that, Congresswoman. I think it has been quite a remarkable track record that we have had in this country in expanding home ownership and home equity. And there is no question that if home equity had not existed, we would not have been able to have had the extraordinary degree of extraction of equity that has occurred in recent years and what has accordingly supported the economy, more exactly supported consumption, when business investment was doing so poorly. So clearly it has been housing and mortgage availability which has been a very critical factor in sustaining the economy, which is obviously of crucial importance to the Federal Reserve.

The problems in California are difficult in part because prices are much higher in California, as I recall, than elsewhere, and that makes it quite difficult for first home buyers and minorities to get into home ownership as readily as one would like. And I think what is required in this respect is to find ways in which to enhance the capability of everyone.

There is very little doubt that even though home ownership rates for minorities are still well below those of whites, the gap is, in fact, closing, and we ought to make all sorts of efforts that we can to continue that progress, because as you point out, living in a home and accumulating equity is the way one moves up from the lower-income scales into the middle-income scales. And it strikes

me that whatever can be done should be done to press that forward, as I have said many times in the past.

But the Federal Reserve has only limited capabilities in that regard. We can and do obviously affect mortgage interest rates, and that is a major factor which I think has been quite important in expanding that capability. We will look and I hope we will find other areas which might be helpful, because our general view is that the greater the home ownership in this country, the better.

Ms. LEE. Thank you.

Mr. Chairman, I would like to ask unanimous consent to insert into the record the executive summary of this report by the California Reinvestment Committee.

The CHAIRMAN. No objection.

[The following information can be found on page 78 in the appendix.]

Ms. LEE. Do I have 1 more second?

The CHAIRMAN. You have 38 seconds.

Ms. LEE. Let me just ask you with regard to the elimination of tax on dividends, would you not agree that this dividend exemption could make the low-income housing tax credit, which does give investors a real dollar-for-dollar reduction in taxes and in return, you know, for their investment in housing and other tax matters—you know, for that matter, doesn't that make it less attractive to investors if, in fact, this tax on dividends is enacted, because the low-income housing tax credit we know is—has about run out?

Mr. GREENSPAN. There are lots of impacts of this issue of eliminating the taxation on dividends. The most important thing, however, to keep in mind is that by improving the flexibility of the economy, it almost surely increases the aggregate level of economic activity, of incomes, and probably does contribute to rising incomes all across the income scale when you increase the economy. And generally in the United States, while there are very obvious differences by income group, the data do show that everyone benefits.

And in my judgment, the elimination of the double taxation of dividends will be helpful to everybody. Will it have negative effects in certain parts of the market? For example, state and local governors and mayors have been concerned about the cost of credit of municipal bonds that may actually rise relatively speaking, and there are other people raising similar issues. In my judgment, looking at the whole context, there is no question that this particular program will be, net, of benefit to virtually everyone in the economy over the long run, and that is one of the reasons I strongly support it.

The CHAIRMAN. The gentlelady's time has expired.

The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Chairman Greenspan, welcome. I always enjoy having your perspectives presented to the committee. And for the record, I am not raising a subject that you would be surprised by, although it was raised yesterday in questions in the Senate proceedings relative to mortgage-backed securities, MBS. And I studied your response, and there was an aspect of your answer relative to interest rate risk that caught my eye. I share those views, and I want to give you a little background for my principle question.

The concern over interest rate risk and GSEs is something that I have had continual concern about, and it was first sort of publicly quantifiable in the last quarter of 2002 with the difficulty in managing the negative duration gap numbers. As a consequence of that, I have a related concern to the growth in the number of institutions and the notional amount per institution of GSE securities held by those institutions to meet their Tier 1 capital requirements. It would appear to me that, given the obvious now quantified difficulty in rebalancing asset liability portfolio balance in an interest rate environment, which fortunately has been very stable and moving in the right direction, I might add, if we are to return to an environment where we have a rapid increase in rates, which we all hope does not happen, should there be careful assessment given by the committee to establishing some limit on the amount of GSE securities held by insured financial depositories in order to minimize adverse systemic consequences in an interest rate environment which none of us want to see occur?

As you well know, today there is no such limit despite loan limits on borrowers and all other credit questions, despite limits on the prohibitions on holding triple A rated corporate securities. These appear to be traded without limit, and I am worried about the consequences of the scope today that now appears to exist in many of the insured institutions' portfolios.

Mr. GREENSPAN. Congressman, we are obviously aware of the issue that you are raising. Remember that, at bottom, supervision and regulation in general looks at the safety and soundness of every institution. And while there are various different legal limits and the like, any time there is a concentration of anything, it gets our attention. And the reason basically is that the history of commercial bank defaults, and, in fact, defaults of other institutions, has been too heavily peppered with institutions with concentrations of something. And the trouble is that you could never in advance list all the things that people can think up to get too much of in their balance sheets.

So it is far better to leave it, as far as I can see, in general, to the underlying process that we currently have. But it may be that there are discussions within our staff which I am not aware of that I would just like to quickly double check.

Mr. BAKER. Well, my question really went to the validity of a significant study on the matter, because it appears that the number of institutions and the amount held per institution continues to go up because the number of attractive alternatives for bank investment are fairly limited.

Mr. GREENSPAN. I think that is correct. But I was curious to know whether or not we in fact had done something internally which I had not seen yet.

Mr. BAKER. Terrific. I may follow this up with some correspondence on the matter at a later time.

Mr. GREENSPAN. Why don't you do that, and we will try to be responsive.

Mr. BAKER. Thank you very much.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Kentucky.

Mr. LUCAS OF KENTUCKY. Thank you.

Mr. Chairman, we have a long history as the American people of being real patriots in a time of war. In my view, the old adage of guns and butter still prevails in the larger sense. I think our American people would be willing to make some sacrifices in deference to the war. Given your knowledge of the economy, what would be a reasonable economic sacrifice or other sacrifice for our people to make at this particular troubling time?

Mr. GREENSPAN. Congressman, that question came up in the Senate in a somewhat different form yesterday. Usually when we have been confronted with guns-and-butter-type issues, the ratio of defense expenditures to the GDP has been elevated, and indeed there were limited resources available to do both. And it is well known that in the Vietnam War, mistakes significant mistakes, were made in not recognizing that we were in fact trying to do too much. Fortunately, or unfortunately, depending on one's point of view, the level of defense expenditures to GDP is really quite low at this stage. In fact, only two years ago it was the lowest since before World War II. So we do have a $10 trillion plus economy and about $400 billion in defense expenditures, which by no means is a small amount, but it is not at this stage pressuring on other resources.

So the question is, should we artificially do something? And I think not. I agree with you, I think the American people are remarkable in that respect, and their willingness to sacrifice for the Nation is what has really made us great, and there will be occasions when those issues will re-arise. I do not think, however, that in today's environment that there is any trade-off here that makes any realistic sense.

We used to talk about tax surcharges or various other things in order to finance abnormal expenditures. But that doesn't exist as yet because the scale of our economy has become so large that even as significant an effort as we are embarked upon in the Middle East doesn't put the type of strain which, for example, the Korean War put on our economy and later Vietnam.

Mr. LUCAS OF KENTUCKY. With these record deficits as far as the eye can see, as one of my colleagues said the other day, which was pretty thought provoking, we are sending our young men and women to war, and then if and when this is over—and when it is over, I should say, they are going to come home and their kids and their grandchildren can pick up and pay the debt. It is kind of like double jeopardy.

Mr. GREENSPAN. Actually, it turns out that we do not really have a fiscal problem of moment until we get beyond the end of this decade largely because the underlying growth rate and the structure of interest rates at this stage keep deficits even under the President's program beyond these next two years in areas where the rate of debt-to-GDP does not move up in any way which suggests we are in an unstable system. But when you get beyond this decade, when you get into 2011, 2012, the ratio of debt-to-GDP begins to rise in a very worrisome manner. And as I said in my prepared remarks, because we know that with almost as high a degree of certainty as we can know anything in the area of finance, that it would be far better, as indeed the President's budget suggests, for us to prepare well in advance and phase-in in a manner which does

not require significant discontinuities, because all of a sudden we are retiring a large part of our population from productive endeavors into retirement.

The CHAIRMAN. The gentleman's time has expired.

Could we—I am just trying—could we reset the clock here, the shot clock?

The gentleman from the first State, Mr. Castle.

Mr. CASTLE. It takes me a long time to shoot here. Thank you, Mr. Chairman.

It is always a pleasure to see you. You have already answered the questions about dividend exclusion, and I think I understand where you are coming from, that it makes a great deal of sense but as stimulus from doing it now, this deficit issues, et cetera, that kind of thing. You may not know the answer to this first question, maybe we can go over it quickly. But if you change the taxation on dividends to a finite number, $1,000, $3,000, something of that nature, I mean, as soon as I saw that Bill Gates was going to get, what, over $95 million of Microsoft dividends, I thought that was in trouble as a tax cut. But what if you changed it to a smaller number? Does that—would that still have the effect of having corporations—enough pressure on corporations to change the dividend policies to improve the corporate aspects of this? Or does it have to be a full exclusion, in your judgment? If you have given any thought to that.

Mr. GREENSPAN. I must say to you, I would much prefer it be done fully, because it makes the issue clear and it lets the markets function in an effective way. I think you diminish the effect of the power of what the elimination of the double taxation does by doing it by capping, for example. Capping usually undercuts the economic effect far more than the presumed equity effect that it is employed to address tends to do. So I must say that you diminish the effect.

Mr. CASTLE. And your preference on the corporate—deducting on the corporate level versus the individual?

Mr. GREENSPAN. I would prefer that the deduction be at the corporate level, because it immediately impacts the trade-off between debt and equity. But over the long run I don't think it really very much matters, because if you put the tax credit—or you put the deduction at the investor level, it will not take very long before the pressure to increase dividend payments, and which this is all about, will occur. So whether it happens directly at the corporate level or through pressure coming from investors is more a matter of time than end result.

Mr. CASTLE. Let me turn to housing for a minute. As you know, that is the one part of the economy that has held up, and I am sure you have studied that to a great degree, or you can call it a housing bubble. My first question is, and for those of us fortunate to own the houses but also got into the stock market a little bit late on tech stocks and essentially lost our shirts, this is a matter of some comfort. But there is a lot of discussion now by the pundits out there that we are going to—that the bubble is about to burst and we are going to have a housing problem. I was wondering if you have any thoughts about that, and if you have any thoughts and what would trigger that. I assume higher interest rates are one of the things that could trigger that. But what are your thoughts

about the next few months, even few years, as far as the housing circumstances are concerned?

Mr. GREENSPAN. Well, Congressman, one of the things which is really quite impressive is that when you measure the level of new construction additions of housing units, or housing starts, including mobile home shipments, which are not all that small, what you find is that it barely is in excess of the aggregate increase in occupied households or dwellings or of household formation. What that says is that after making adjustment for change in vacancies, you get an implicit demolition or reduction or replacement of the housing stock. And what is really fascinating is how small that number is, which suggests that we don't have a demand for housing which could all of a sudden slip because, with immigration as it is, having a fairly important impact on the number of new households, net, which are formed and that number not being all that far from the number of new homes that we create, we are effectively not building up a glut of excess housing. And under those conditions, one would presume, even though we have been having some fairly strong gains in home prices, it is our conclusion, without getting into the details of some of the internals of the market place, that it is unlikely that we are confronting a housing bubble.

Certainly the analogy to stock market bubbles is inappropriate. Remember, one crucial thing is that if you sell your house, you have to move. And if you sell your house, there is also a very large transaction cost. That in and of itself prevents the type of speculative housing demand which leads to bubbles and contractions. So while it is not inconceivable—I mean, there are conditions under which that can happen, it has happened in other countries, and it has happened in small geographic areas, but we have such a broad expanse in our country that you cannot arbitrage housing demand in Portland, Maine with Portland, Oregon. And that matters. It is not like the stock market, where there is a single market and everybody is trading with everybody else. The housing market is a highly fragmentized metropolitan area-type market.

Mr. CASTLE. Thank you, Mr. Chairman. Based on that, I will take my house off the market. I am just kidding, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Kansas, Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Mr. Chairman, thank you for being here. Two years ago, we had a $5.6 trillion surplus, and there was discussion around Washington about the dangers of paying down the debt too soon. We don't have that problem anymore. Isn't that correct? That is really a concern we have now, is paying down the debt too soon.

Mr. GREENSPAN. We do not.

Mr. MOORE. Okay. A lot of what we say in the discussion that is here, I think as much as we would like to believe this is science, a lot of this is kind of art, isn't it, trying to figure out what is going to happen in the future, making educated guesses?

Mr. GREENSPAN. If you are talking about the economy in general——

Mr. MOORE. Yes, sir.

Mr. GREENSPAN. ——and the decisions we make?

Mr. MOORE. Yes, sir.

Mr. GREENSPAN. Yes. In fact, the one thing that we know with a great deal of certainty is that the future is of necessity unknown. There are very few things we know for certain, like inventories cannot go below zero. We know basically with some degree of certainty what the number of people will be in the population, say, 20 years of age and over, because they are already born and our experience with immigration and death rates is reasonably well contained, so we can make reasonably good forecasts.

When you are dealing with the broader issues, on what the level of economic growth is going to be, what prices are going to be, what markets are going to be, we are looking at a very complex system. And it can only be handled conceptually if we abstract from that complex system and create models which are much simpler but which we presume will somehow reflect the broader forces in the economy. And the reason why there are differences amongst economists on forecasting is that this process of abstracting for what is the appropriate model to represent what is going on is, as you put it, I think, a state of art, something like that.

Mr. MOORE. You have been here several times in the 4 years I have been in Congress, and you have stated consistently, Mr. Greenspan, that one of your concerns was deficits and the growing national debt, which is now approaching $6.4 trillion. And I think you have been extremely consistent about that, and in fact today you were consistent again, mentioning your concern about deficits. I understand things aren't black and white here and there is a lot of gray area in the middle and that we need to try to sometimes negotiate our way through that gray area and find some compromises, but I think one of the facts that we can state here is, the President has projected for next year, fiscal year 2004 and for the next year after that $300-plus billion deficits and deficits beyond that as well for a while. And I think the other fact that we can certainly state is, as I understand it, the projected interest payment on the national debt for next year is about $174 billion, which is a lot of money by anybody's standards. And I guess my concern is, and you have said here, that in the short run, in the short next few years maybe we are okay. But you have raised a red flag, I think, about what happens beyond 2011, 2012, when the boomers start to retire. How do we reconcile all of this, this $174 billion debt and what I call a debt tax? Because we have to pay it every year as long as we have a national debt. And I don't see that national debt shrinking, and in fact I think it is increasing. So how do we get ready and maneuver our way into this 2011, 2012, and be able to take care of that when we are proposing more tax cuts and some more spending?

I belong to the Blue Dog Coalition, and we try to be consistent like you have, and saying one of the things we need to practice is fiscal responsibility.

Mr. GREENSPAN. I would say there are two things that have to be done. One is to put in place a process which enforces the decision making into making choices. The——

Mr. MOORE. May I interrupt just one minute? Because I would like you to answer this, too, and this is my last question and I will let you just finish then. You mention in your testimony the permanent tax cuts and what that might do to future deficits and debt.

And I would like you, if you would, just to touch on that as well, and I am sorry to interrupt you.

Mr. GREENSPAN. The first thing is to get a process in place which has two aspects to it. One is the PAYGO and discretionary caps which we have done over the last decade or so quite successfully. Second, which would be helpful, is to add an accrual system to our budgetary accounts, which will enable us to be able to anticipate exactly how our obligations are spinning out into cash requirements.

But having done that, all that does for us is tell us what various alternative sets of choices there are. There is a limit to what revenue resources are available which are tied to the GDP. We have done extraordinarily well in that regard in that we have had a major acceleration in productivity, and that has raised the tax base quite considerably, which has enabled very substantial expansion of expenditures which I don't think has been terribly helpful, but the productivity has been crucial.

We can accelerate further, but it is not as though we are back in 1990, when the productivity rate was 1 percent, well below the historical average, and then we moved it up quite appreciably in the latter part of the 1990s, and currently. So our leverage to go higher is limited, and therefore we do have, even under the most optimistic of assumptions, a limit to what our resources are.

We do not, I might just say parenthetically, have the capability of a country which is not at the cutting edge of technology all of a sudden obtaining all sorts of technology and having its productivity growth rate rise sharply, its tax base rise sharply, and have a great fiscal capability. We are at the cutting edge, and history tells us that there are limits to how far we can go, and we must stretch them. In other words, that is the reason I think flexibility is so important.

But this is where the issue of permanent comes in. As a matter of principle, you cannot have permanent anything, either tax levels or spending programs, because it is quite conceivable that if you have either tax rates or entitlements, it is quite possible that the net of those effects may be a larger drain on our real resources than we actually have available. Therefore, I have concluded—and I indicated in my prepared remarks—that we do need triggers or sunset legislation to enable us to adjust in the event that we find that programs previously put in place, either a tax structure or an expenditure program, which combined is in excess of our capability.

So we need far superior fiscal mechanisms far beyond what we used to deal with 40 years ago when everything—virtually everything—was discretionary and all you had to do was make annual appropriations and that was adequate. We now have gravitated to the point where two-thirds of our system is essentially nondiscretionary and on automatic pilot, and we have to make certain that the fiscal vehicle doesn't run off the road because it is a new ballgame. We cannot deal with it the way we did in previous years.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Chairman Oxley.

Chairman Greenspan, welcome. I wanted to ask you about some testimony you made in the Senate last year in April. You said be-

fore the Senate Banking Committee that while deposit insurance contributes to overall short-term financial stability and protection of small depositors, it also induces higher risk-taking, resulting in a misallocation of resources and larger long-term financial imbalances that increase the need for government supervision to protect the taxpayers' interests. You concluded by saying: Any reforms to deposit insurance should be aimed primarily at protecting the interest of the economy overall and not just the profits or market shares of particular businesses, and that it is unlikely that increased coverage, even by indexing, would add measurably to the stability of the banking system today.

I want to ask if your underlying position of skepticism toward the necessity and net benefit of increasing deposit insurance coverage levels has changed drastically, or do you still view an increase in these levels as a solution in search of a specific problem which would warrant creating the resource misallocations and long-term imbalances that you see as inevitably stemming from their increase? In other words, do you believe that large increases in municipal and retirement account coverage are warranted?

Mr. GREENSPAN. All I will say to you, Congressman, is I stand by the testimony that I gave last year, and I have seen nothing of which I am aware to alter the evaluation that we have had with respect to it.

Mr. ROYCE. Well, I thank you for that answer, Chairman Greenspan.

And I thank you, Mr. Chairman.

The CHAIRMAN. Does the gentleman yield back? The gentleman yields back.

Mr. ROYCE. I yield back the balance of my time.

The CHAIRMAN. The gentleman from Texas, Mr. Hinojosa.

Mr. HINOJOSA. Thank you, Mr. Chairman.

Thank you Chairman Greenspan for coming to visit with us. I am not certain whether or not you are familiar with matricular consulars. The matricular consular is a water-sealed photo identification card issued by the Mexican government to Mexican nationals that complete an application form in person at any of the 47 Mexican consulate offices in the United States and submit a certified copy of a birth certificate, present an official picture I.D. issued by any Mexican or U.S. authority, and show proof of residence in the consular's district by presenting a phone, rent, or power bill. Are you familiar with these matricula consulars?

Mr. GREENSPAN. I have read it in the newspapers, but that is the extent of my knowledge.

Mr. HINOJOSA. I come from an area that is trying to increase trade with Mexico. We have millions of Mexican nationals who are working in the United States and need to have the opportunity to open a bank account. At least a third of them do not have a bank account, and many of those individuals are trying to send money back to their families and pay exorbitant amounts to have that done. All this to say that they need a healthy and intelligent alternative to payday lenders, wire transfer services, and check cashers in general. And the question is, should matricula consulars be considered valid forms of ID for the purposes of opening a bank ac-

count. This committee certainly has jurisdiction on that and would like to have your thoughts on it.

Mr. GREENSPAN. Well, Congressman, I don't know enough about the pros and cons of various different alternatives. But I certainly will, if you would like, look into it.

Mr. HINOJOSA. May I send something to you in writing and see if maybe you and your staff could look into it? Because I think we need to think out of the box. I think that we need to make it easy for individuals, particularly Mexican nationals with matricular consulars, to be able to open up bank accounts instead of leaving money in places at home where it can be stolen, or to violence because they are forced to carry such large sums of money with them. I would like to include for the record legislation and a press release on matricula consulars.

Mr. GREENSPAN. Well, why don't you send us a series of questions, and we will try to respond expeditiously to them.

Mr. HINOJOSA. I would be happy to do that. And a last question. As you know, there was some debate last year in this committee as to whether financial institutions, specifically credit unions, should be allowed to be privately insured. And over the past couple of years we have seen an increasing number of credit unions drop their Federal insurance and opt for private insurance. With the strength of all of the Federal insured systems such as the Bank Insurance Fund, the Savings Association Insurance Fund, and the National Credit Unions Share Insurance Fund, is this something that we should be concerned with at this time?

Mr. GREENSPAN. Well, I haven't been aware that the private insurance has taken hold, because, as you recall, our experience over the years with private insurance has not been very impressive. And one of the reasons is that deposit insurance is a very unusual sort of insurance which is very difficult for a private insurer to successfully market without exorbitantly high insurance premiums. And in the past, various different types of insurers found that out to their dismay and bankruptcy, I might say.

I am not aware of the extent to which it has re-emerged in credit unions, but I certainly will be glad to look at it and again respond to you quickly.

Mr. HINOJOSA. Anything we can do to protect the depositors as Congressmen is very important to me, and I would love to get your thoughts on what we should be doing in this committee to improve that, and I thank you for your response.

And thank you, Mr. Chairman.

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

Mr. PAUL. Thank you.

Welcome, Chairman Greenspan. I have a question relating to the speech that you gave at the Economic Club in New York in December, because you introduced your speech with three paragraphs dealing with gold and monetary policy. And you made some very pertinent points about gold, indicating that from the year 1800 to 1929, the price levels were essentially stable under gold. And after we got rid of the gold restraint on the monetary authorities, prices have essentially increased by over tenfold since that time. But you follow that by indicating that inflation, when it was out of control

in 1979, monetary policy changed direction and they were able to take care of inflation, more or less conquer inflation, and that now you are more or less not concerned about inflation, that your concern really is about deflation.

And it was interesting that you brought up the subject of gold, of course, and there is a lot of speculation as to exactly why you did this and what this means. But my question deals with whether or not we should forget about inflation, whether or not this has been dead and buried. Federal Reserve credit for the last 3 months has gone up at the rate of over 28 percent. Inflation is a monetary event, so therefore we have monetary inflation. The median CPI is almost going up at twice the rate as the CPI, close to 4 percent. The Commodity Research Bureau Index is going up, in the last 15 months over 35 percent. Gold is up 36 percent over 18 months or 15 months. Oil is up 60 percent. So we have a lot of inflation. And we have medical care costs skyrocketing, housing costs going up, the cost of education going up, the cost of energy going up. And to assume that we shouldn't be concerned about inflation, all we can do now is print money. I would suggest that this is what we have been doing for 3 years, the monetary authorities. You have lowered the discount rate 12 times, and there is still no signs of good economic growth. So when will you express a concern about an inflationary recession? Because that to me seems like our greatest threat, because that has existed before. We even had a taste of it in the 1970s. We called it stagflation.

So I would like you to comment on that as well as follow up on your comments on just why you might have brought up the subject of gold at the New York speech.

Mr. GREENSPAN. First of all, we have not lessened our concerns about inflation. Indeed, our general presumption is that we seek stable prices, and stable prices mean no inflation nor deflation.

The reason I raised the issue of gold is the fact that the general wisdom during the period subsequent to the 1930s was that as we moved to an essentially fiat money standard, that there was no anchor to the general price level. And indeed, what we subsequently observed is, as you point out, a very marked increase in general price levels, indeed, around the world as we removed ourselves from commodity standards, and specifically gold.

I had always thought that the fiat money system was chronically and inevitably an inflation vehicle, and indeed, said so repeatedly. I have been quite surprised, and I must say pleased, by the fact that central bankers have been able to effectively simulate many of the characteristics of the gold standard by constraining the degree of finance in a manner which effectively has brought down general price levels.

The individual price levels to which you allude are certainly correct. I might say the gold and the oil issue are clearly war-related and not fundamental, but we still are looking at the broadest measures of average inflation, and the best statistics that we have still indicate very low inflation with no evidence of an acceleration. That does not mean, however, that we believe that inflation is somehow inconceivable any time in the future. We will maintain a considerable vigilance on the issue of inflation, and are looking all the time for evidence of an emergence of inflation, which at this

particular time we do not see. But that does not mean that we believe inflation is dead and that we need not be concerned about it. We will continue to monitor the financial system as best we can to make certain that we keep prices stable. They are stable now, and we hope to be able to continue that indefinitely into the future.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Missouri, Mr. Clay.

Mr. CLAY. Thank you, Mr. Chairman.

Mr. Greenspan, thank you for being here. I am somewhat confused by the reports that I read and would like some clarification. You have opposed budget deficits that are to continue for the long term, and you have had an equal distaste for surpluses that you thought would compete in the private markets. You supported the Bush 2001 tax cut, believing that it would control budget surpluses that would continue for years. Maybe the tax cut worked better than expected. We no longer have projected surpluses; all we have now is deficits. The tax cut contributed greatly to this adverse situation with the budget deficits. Presently, without any budget surpluses in sight, we have another tax cut proposed that will push deficits even higher and extend them for untold numbers of years.

My question is, will you state your position on the proposed $1.4 trillion Bush tax cut and inform the committee on its ramifications on the deficit and the national debt?

Mr. GREENSPAN. Well, I have not commented on any of the proposals in general except those which are specifically economic issues, and I have stipulated that I would have hoped that back in September we would have had a PAYGO system continuing and that it would be continuing today. And I would view any proposal that occurs with respect to either taxes or expenditures be first applied through the PAYGO system.

We have been talking about taxes all along, and nobody has mentioned spending. There is an awful lot in the way of spending initiatives out there which, if we had PAYGO rules, would require that they go through the same process to maintain budget neutrality as best we can.

So as far as I am concerned, from the point of view of the central bank, which is interested in the total financial system and is very crucially interested in the level of federal debt and the degree to which it preempts private debt issuance, that is a major issue which is directly in areas which we find important for monetary policy. The question of how you regulate taxes versus expenditures and what expenditures you are having to put forth is something which, as I mentioned before, is, in my judgment, one of the crucial roles of the Congress, because it is the only mechanism that we have which enables the will of the people and their priorities to be constructed in our various budgetary forms.

The President makes recommendations insofar as he can infer what he thinks is the best for the American people. It is the Congress which disposes with the obvious final resolution of the decisionmaking by whether the President signs or vetoes a bill, which you can then override. So that, to me, is a process which we just ought to think about because we are abandoning that.

Mr. CLAY. Well, what do you think about the reversal in fortunes of the U.S. budget as far as us two years ago having a $5.5 trillion

projected surplus and now looking at a projected deficit that grows every day?

Mr. GREENSPAN. Well, one of the reasons that I was in favor of a tax cut two years ago was to prevent the accumulation of private assets by the Federal Government, which I think is a very bad idea and still think it is a very bad idea. Remember, at that time there were a number of tax cuts on the table. It wasn't just the President's tax cut. The issue here is if the President's tax cut didn't pass, another very significant tax cut would have passed, which I would have thought would have been fine, because it was needed to take the surplus off the table, and I think clearly that happened.

What also happened was a major, 50 percent, decline in stock prices which had the effect of very markedly reducing revenues beyond what the Congressional Budget Office had projected when they made that $5.6 trillion surplus projection. They recognized that there were risks in those longer-term forecasts. But in the event it came out to the extreme end of probabilities, it was very unexpected by both the CBO and OMB analysts.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from Illinois, Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Chairman Greenspan, I know that the Fed is very involved with the ongoing Basel negotiations for new risk based capital standards. And as you know, Chairman Oxley and Ranking Member Frank are particularly concerned with the proposed new capital standards for operational risks, and we are going to be looking into this issue in depth in future hearings. And I don't want to ask you to comment specifically on the operational risks section of the rules, but could you please describe to us how the Federal Reserve and other bank regulators are factoring into their Basel positions such factors as the impact of the rules on U.S. banks of all sizes and on the U.S. economy?

Mr. GREENSPAN. I can't comment on exactly how other regulatory authorities will address the Basel II implications. But from the point of view of the United States, for the vast majority of American banks, Basel II is irrelevant. It is a specific set of rules which endeavors to address the fact that we are getting ever-increasingly large global types of international institutions employing very sophisticated risk evaluation techniques and models.

The vast majority of American banks, as you know, are small, are not involved in any of this, and Basel I will, for all practical purposes, continue to be the operative rules for those banks. Even those banks, if they so choose, can apply effectively for regulation under the Basel II procedures, which essentially endeavor to capture the usefulness of these new risk evaluation models, which improve immeasurably the capability of large institutions to contain risk. But in so doing, what the supervision must then turn to is a much more sophisticated approach in evaluating how the risk models are constructed, what the nature of supervision is, and what the nature of disclosure is of these various different types of institutions.

But I want to emphasize we are dealing with a handful of American institutions, and unless and until individual, smaller banks

wish to do the same thing—which they can legally do—it doesn't apply to them.

In one sense, you have to remember that a small commercial bank has very considerable control over its risk management systems. It knows every borrower, as I mentioned before, it knows the history. It is able to get a far more sophisticated evaluation of any individual loan than a very large commercial bank using these mathematical techniques to make a judgment on a loan. I would much prefer to have the small bank appraisal, because you are really looking at the core of what is being done. Because that is not feasible with a very large institution, you have to fall back on more automated types of risk evaluation procedures, which is what they are doing. But there is no way that in any individual loan the quality of judgment that is made on whether that is a good loan or a bad loan can be done better mechanically in the way that these risk management systems do than a small banker fully familiar with the credit history of a particular borrower and knowing what his business is all about can do.

Ms. BIGGERT. So you don't think that a medium-sized bank or a small bank will think that these big banks are getting so much benefit that they either need to consolidate with another bank or that they would need to just voluntarily opt-in to doing the same thing?

Mr. GREENSPAN. I think not. I mean, if indeed you could formalize a credit evaluation through the mathematical techniques which we now have available, which is superior to the capability of an individual banker in a small town making a judgment on the loan, then, yes, I would agree with what you are saying. But that is not what the issue is.

The CHAIRMAN. The gentlelady's time has expired.

The gentleman from Massachusetts, Mr. Frank.

Mr. FRANK. Mr. Greenspan, on the proposal for a tax cut now of $674 billion for the next period, the current tax cut before us, am I correct your position is that it should not be adopted outside of the PAYGO rules, specifically unless you were in the situation where it would take 60 votes in the Senate? Is that a correct understanding of your position?

Mr. GREENSPAN. I would say that I am somewhat distressed that the PAYGO rules were allowed to expire.

Mr. FRANK. So you would not have us adopt a major piece of either the budget or anything else, including a tax cut, until we have reinstated PAYGO?

Mr. GREENSPAN. Tax cut or expenditure program. I would prefer that that had continued and hopefully would put in place before——

Mr. FRANK. It would take 60 votes. So we should not do either expenditure or tax cut decisions this year until they get back to a 60-vote rule in the Senate?

Mr. GREENSPAN. Well, the 60-vote rule still occurs I think through April, as I recall.

Mr. FRANK. Well, but you——

Mr. Greenspan. Yes, the statement that you——

Mr. FRANK. Don't be the Senate Parliamentarian. Be the Chairman of the Fed. In principle, what do you think?

Mr. GREENSPAN. The answer is yes.

Mr. FRANK. Good. Now, that would mean then that any new significant expenditure or new significant tax cut would have to be offset, correct?

Mr. GREENSPAN. Yes, unless obviously emergency issues come up or other various forms of exemption under the procedures that have been involved.

Mr. FRANK. Now, the question I have is this about the $674 billion. You said that the tax cut in 2001 seemed reasonable to you at that level. And what then happened was the economy, picking the stock market, went to the low end of everybody's projection. Is that what you said?

Mr. GREENSPAN. That is correct.

Mr. FRANK. If you were back in 2001 and you knew that the tax—that the projections were to go to the low end, would that have affected the judgment? I mean, it is not anybody's fault. But would that have affected the judgment?

Mr. GREENSPAN. I frankly don't know.

Mr. FRANK. All right. But then let me ask you this question. Having said that clearly the projection of the revenues went to the low end, the tax cut cost us more than we thought it was going to in some ways, doesn't that argue against a further large tax cut now? I mean, having miscalculated doesn't mean we are going to miscalculate again, but if the fiscal picture is considerably worse than people reasonably could have thought it would be, where is the argument for now a further tax cut?

Mr. GREENSPAN. Not necessarily. Because the types of tax cuts we are talking about—let me stay with the double taxation of dividends.

Mr. FRANK. No. I want the whole package.

Mr. GREENSPAN. I will come to the whole——

Mr. FRANK. I only have 5 minutes. Come on.

Mr. GREENSPAN. I understand that. The principle I am trying to raise is that you need to make judgments when you are looking at long-term tax and spending policy; what, for example, the elements of the tax policy do to the GDP and therefore the revenue-raising capacity of the economy. They are not all equal. And I happen to think that the types of programs which have been brought forth which are in the President's program are of the type of——

Mr. FRANK. I am disappointed. I want to be very serious here.

Mr. GREENSPAN. Why are you disappointed? I have——

Mr. FRANK. Because I think what has happened is this. I think when you restated yesterday, quite honestly, your long-held positions on the deficit, and when you disagreed with those who poohpoohed deficits, that got presented in this morning's papers as being critical of the proposal that the President put forward. And my strong impression today is that you are seeking now to find the maximum points of agreement to diminish the impression created that your longstanding positions would be somewhat negative. You will have a chance to answer. I just want to throw in one——

Mr. GREENSPAN. But may I respond to that?

Mr. FRANK. I just want to finish. Let me finish the question.

Mr. GREENSPAN. Sure.

Mr. FRANK. And then I am through. You keep talking, and this is part of the problem. You say, well, we have no problem until 2010 or 2011, and then we have a problem. I mean, that is probably what you are saying. But the world is not divided into two separate wholes. 2008 leads to 2009 and 2010 and 2011. In other words, you are saying Social Security and Medicare will be serious problems for us 10 years from now, but it is irrelevant if we increase deficits between now and then. The more we increase deficits between now and then, the more people who, out of a conservative ideology, want to put pressure to reduce Social Security and Medicare will be able to argue. And I am afraid that is the position I infer from you.

Mr. GREENSPAN. No. The issue basically is this, that if you are going to start with a question of having an aggregate capacity, a revenue capacity in which to fit tax cuts and expenditure increases, then you are dealing with an issue of making choices amongst various different elements if the total of all of the programs you are dealing with exceed, as they always do, the aggregate amount of revenue capacity in the system. What I am saying to you is this: The way you formulated what is attributed to me is incomplete. I am not saying that—let me finish.

Mr. FRANK. Incomplete, but not incorrect.

Mr. GREENSPAN. Well, let me state it, and I don't know whether or not it is incorrect. I am stating to you the following: I am saying you cannot get an effectively full evaluation of whether you should be cutting taxes or making expenditure programs without knowing the impact of that on the revenue base. I don't know what the impact is, but I am basically saying that to make a full judgment about any particular proposal, you need to have a judgment one way or the other of the extent to which it affects the tax base. And, as I said earlier this morning, in my judgment; the elimination of the double taxation of dividends will have a significant although admittedly indeterminate impact on the flexibility of this economy, its growth rate, and therefore its degree of revenue. Not including that in your evaluation of making a judgment of how to balance various elements of taxes and spending I do think is incomplete.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

And Chairman Greenspan, thank you for your testimony today. As part of your testimony, your prepared remarks, I believe you said that if spending growth were to outpace nominal GDP, maintaining budget balance would necessitate progressively higher tax rates that would eventually inhibit the growth in the revenue base on which those rates are imposed.

My question, Mr. Chairman, is, isn't that the recent history of our country if you look back 5, 10, 15 or 20 years, that indeed the growth of government has outpaced the growth in GDP? And if that is true, and this trend continues unabated, given that the average American family has a 40 percent tax burden, almost at its historic high between its local, State, and Federal component, I am curious about your opinion on what the long-term impact will be on our economy and on family income.

Mr. GREENSPAN. Well, Congressman, we are fortunate in the sense that currently the level of debt to the public is at a reasonably low level historically. That is, we came down quite considerably from higher levels and we are now in the low-to mid-30 percent of debt to the public as a percent of the GDP. So we are in the position where the debt load as represented by the amount of debt plus interest—interest being low because interest rates are low—is a great burden on the American public relative to what it has been in previous periods. So it is not—it is not a progression of increasing percents of government expenditures to GDP, because in fact the trend has been largely flat.

As I stipulated in my prepared remarks, there has been a big shift from discretionary spending to nondiscretionary spending, but the numbers have stayed in the area of 18, 20 percent, 21 percent on occasion. So the evidence is that we have not been having government expenditures growing faster than the GDP. It is true that we have had nondefense expenditures growing faster than the GDP and especially nondefense discretionary. But overall the decline in defense expenditures has opened up a much larger capacity for the use of federal revenues for nondefense purposes than we have had in the past.

Mr. HENSARLING. You spoke in your testimony about the desirability of certain budget constraints such as the PAYGO rule sunset provisions. In the President's economic growth package that he has proposed as part of that package is the goal of restraining the growth of government spending to no more than the growth in family income. Let us use for the moment—let us have an overactive imagination and believe that this Congress could actually achieve that goal of restraining government spending to the growth in family income. Do you have a thought of what the long-term impact on the economy would be if we could achieve that budget discipline?

Mr. GREENSPAN. Well, strangely enough, we actually have done that in the sense of the aggregate expenditure because, as I just mentioned before, of the very dramatic decline in defense expenditures, going back say 50 years, we have been able to keep aggregate Federal Government expenditures constant relative to incomes. However, that is going to change. It is inevitably going to change because of the fact, as I mentioned before, with defense as low as it gets, it can't go any lower. And with the retirees after 2010 or 2012, we have a very substantial projected increase in nondefense expenditures.

Mr. HENSARLING. As we see different policies to promote economic growth and obviously a rollback in marginal rates as part of the President's program, we can debate what might happen in the future, but if we look to the past, hasn't the history of our Nation been, in the 1980s, the 1960s and 1920s, that indeed when we roll back these rates that Government revenue and GDP revenue grew?

Mr. GREENSPAN. Would you repeat that again? I didn't quite get it.

Mr. HENSARLING. Isn't the history of our Nation when we roll back marginal rates, as we did in the 1980s, in the 1960s and the 1920s, that revenues to the government actually increased and that GDP grew?

Mr. GREENSPAN. Let us put it this way. It depends on the conditions. It is very rare that you can reduce a tax rate and end up with more revenue. It happens on occasion, but it is not the general case, and I don't think you could argue that in the aggregate sense in any of those particular episodes that it invariably happened. But it is certainly the case that if you have various taxes which inhibit growth and inhibit capital, it is quite possible that reducing those could create a rise in the tax base greater than the cut in taxes and therefore you would get more revenues. That is not the general case, and I think each case has got to be evaluated on its own.

The CHAIRMAN. Gentleman's time has expired. The gentleman from Pennsylvania, Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman. Mr. Chairman, the President in his State of the Union Address just several days ago said we will not pass along our problems to other Congresses, other Presidents or other generations, and that was in the very early part of his speech. And quite frankly, when I heard him say that, I became quite pleased with his intentions as reflected by that statement. But then as he went on to develop his plan for America in his State of the Union Address, and particularly with his tax policies, it seems to me that the President is saying something very interesting. He is saying that the Congress should reduce this double taxation on dividends. And I for one can understand why people would support reduction of any taxes that are possible. And if these are economically retarding-type of taxes to our economy, as your recent answer seemed to indicate, that these are the types of things we can reform or tailor to stimulate the economy long-term but with the intention of not doing away with the revenue source and get out of balance with the budget considerations. But the President's budget reflects the fact that, yes, he wants to make this reduction in dividend taxes and make it up in no other side so that we just basically increase the deficit accordingly. And for a relatively long period of time, certainly as long as the budget projects, the budget will be in deficit and major deficit.

And that brings to my mind—I don't know how long the President can continue to serve, but I think only 6 more years, and I do not see a balanced budget in his projections within those 6 years. This Congress only serves for 2 years, and clearly the President recognizes there will be major deficits for the remaining 2 years. And as we look at a minimum of $300 billion deficit and I think closer probably to $500 billion if you consider the fact that we are taking all of the Social Security overpayment and misdirecting it to operational expenses and not accounting for the expenses of the war, which will be at least $50 billion to $100 billion, I think we can realistically conclude that at the end of this coming year and next year we will be in excess of $500 billion of real deficit. And then our Congress will be over and we will be halfway, or at the end of the President's first term. If he doesn't go on to a second term, there will be a new President and passing that tremendous debt increase on to next generations.

So I have concluded in my own mind, and I am wondering what your conclusion is—wasn't the State of the Union Address and this statement by the President of his policy a rather disingenuous view to put to the American people that you can have this tax cut now,

and as Mr. Frank said, we can fight two wars and give you the third tax cut and there aren't any long-term economic consequences to the economy as a whole and to the fiscal responsibility of the action of the Federal Government as a whole over the next decade or two? What is your position on that?

Mr. GREENSPAN. Congressman, it depends on what the President does next because there is an extraordinarily accurate, in my view, evaluation of the long-term budget outlook in the President's budget, and there is the issue of the sustainability of the budget in the budget document with a fairly sophisticated analysis. So I read the combination of the President's State of the Union plus what is in the President's budget as that there are new policies to come which effectively reconcile the issue that you are concerned about. That is the way I would read it.

Mr. KANJORSKI. Well, you said that we can get control of the fiscal responsibility of the country and the budgetary positions by either not cutting revenue or counterbalancing a loss revenue in the dividend reduction or we can cut spending, and I would tend to think that the emphasis of the President's budget is cutting the expenditure side. But don't you think it is both politically and intellectually disingenuous for this administration and the majority of this Congress to fail now to tell the American people the consequences of cutting these expenditures in order to eventually get to a balanced budget? How can he say we are going to spend more money on education, on health, on the military and all these other expenditures and not be honest telling the American people so that they have a decision process to make? If they want to do away with the double taxation of dividends, they have to be willing to give up the solution of the health problems, the education problems, the military problems of this country.

Mr. GREENSPAN. I can't speak for the President and won't. My impression, basically, is that many of these issues are discussed in some detail in the budget. And I presume that when you see that sort of thing in budgets, it is usually indicating what the thrust of an administration's fiscal policy is. And I would assume that he will make it clear as the time goes on. I have no way of knowing what specifically in each case the particular programs direct to, but he does—there is no doubt in my mind, reading through the budget in full detail, that there is full awareness of all of the various concerns that you raise in the budget document itself.

Mrs. KELLY. [Presiding.] Mr. Garrett?

Mr. GARRETT. Thank you, and I appreciate the opportunity to be with you and ask you a couple of questions today and I will just have two short ones along the lines with regard to the issues on the deficit. We had the opportunity this past week to have some administration officials come before the Budget Committee, and I think they were saying things generally along the line you were when concerns were raised as we look forward on the deficit. And one of the responses we had was similar to what you mentioned just about 5 minutes ago with the comment that things have to be put into perspective as far as the deficit as a percentage of the GDP. But the question that followed on that was, then why was there as much of a concern just 6 or 7 years ago back in the mid-1990s on the deficit if as a percentage of the GDP the deficit was

around at the 2.5 percent level at the same time back then? What is the difference in the factors? Since we are staying constant, as you said, as a percentage, why we should be more concerned back then than we are now?

Mr. GREENSPAN. The crucial issue really gets down to simple arithmetic. If you have debt as a ratio to GDP, say, in the mid-30 percent, which is where it is now, and you have average interest rates as a process, you will find that arithmetically if the ratio of the deficit to the GDP is about 2 percent, that is equivalent to the ratio of debt-to-GDP being constant. As you can see, if the budget is in balance and GDP is rising and the debt by definition is not changing, the ratio of debt-to-GDP will go down. Put it another way, for the debt-to-GDP ratio to be stable, it would be consistent with a modest deficit as a percent of the GDP.

So the question isn't whether or not in the past we were concerned or not concerned. There were many times in the past when we weren't concerned when we should have been concerned. It is really a question of moving forward in time. If you take the President's program as it stands, you have modest deficits after the next two years, which are consistent with a level of debt-to-GDP, which is not significantly different from where it is now. But as we go beyond the turn of the decade, expenditures rise quite significantly and the ratio of debt-to-GDP begins to move up. And when that begins to happen, you have an unstable system with consequences which are difficult to judge, and it is that period which has to be addressed.

And one of the reasons I have said it is none too soon to start thinking about the path of how we get there is that it is a fairly significant change that occurs as the baby boomers retire.

Mr. GARRETT. Thank you very much, and the other portion of the question is the spending side, which I guess you alluded to a couple of minutes ago. You were saying we have sort of bottomed out on the defense side and then leaving a smaller percentage as far as the discretionary side, and we are within the 4 percent figure that we mentioned over here.

Mr. GREENSPAN. What I am basically saying is the fact that over the past 50 years the ratio of expenditures-to-GDP has been constant, has masked a trend towards nondefense expenditures as a percent of GDP which has actually been rising quite significantly. And the problem was, even without September 11, we probably would have found that the ratio of spending-to-GDP was going to start to rise, not a great deal, but at least start to rise. And the trend is changing because the defense budget has gone from a fairly significant percent of GDP down to 3 or 4 percent.

Mr. GARRETT. Where we should be concerned is on the mandatory side, especially in light of the administration's proposal where we are significantly adding on to that portion of the budget?

Mr. GREENSPAN. Yes, we should be concerned about anything which is mandatory.

Mr. GARRETT. Thank you.

Mrs. KELLY. Mr. Sanders?

Mr. SANDERS. Thank you, Madam Chairman, and thank you very much, Chairman Greenspan, and I look forward to working with

you as the ranking Member of the Financial Institution Subcommittee.

Mr. Greenspan, I always enjoy your presentation, because frankly I wonder what world you live in. It is not a world in which you engage with working people who are struggling harder than ever to keep their heads above water, with workers who have lost their jobs, with elderly people who can't afford prescription drugs. And maybe, and I say this respectfully, you might want to stop going to all the black tie dinners and hanging out with the CEOs and come and talk to the middle class working families of this country, because I think if you do that you are going to find that your world view and your economic approach is dead wrong and has caused devastating impacts for millions of people.

Mr. Greenspan, you have been pushing for years for unfettered free trade, for energy deregulation, which has given us Enron, for huge tax breaks for the richest people in this country. You have opposed any increase in the minimum wage, and in fact the last time you were here you told us you didn't even believe in a minimum wage. Your policies call for massive cutbacks in government programs, such as Social Security, Medicare, Medicaid, veterans needs, affordable housing and education. In my view, your policies have been one of the reasons why the middle class in this country is being decimated, why more and more Americans are being pauperized and why the gap between the rich and poor is growing wider. In my view, you owe millions of Americans who have lost their jobs or who today are working longer hours for low wages an apology, and it is high time you rethought your extreme right wing ideology. In your position, you are supposed to represent all Americans and not just the wealthy and the CEOs of large corporations.

Mr. Greenspan, let me introduce you to some reality. Since January, 2001, 1.7 million jobs have been lost and we have 8.5 million Americans today who are unemployed. In 2001, 1.3 million Americans slipped below the official poverty line. Over the last few years, trillions of dollars have been lost on the stock market and millions of workers today in this country have got to work beyond the time they originally planned to retire. In the last 2 years the U.S. has had the highest rate of bankruptcy cases in history. In 2001, the number of Americans without health insurance rose by 1.4 million, and that number continues to rise. Today as a result of the policies being proposed by the Bush administration, it is likely that millions of workers are going to see a significant reduction in the pensions that they had been promised by their employers.

Now you in your testimony talked about expanding, quote-unquote, the liberalized global economy, which you call an ongoing success. This year we are going to have a $400 billion trade deficit, including a $100 billion trade deficit with China. In the last 2 years we have lost 2 million decent paying manufacturing jobs. At 16.5 million manufacturing jobs, we are at the lowest ebb position we have been in in 40 years, and you tell us that that is an ongoing success. If we have more successes like that, we are not going to have any manufacturing jobs in America.

Mr. Greenspan, as you know, we have the most unfair distribution of wealth and income of any industrialized country. The richest 1 percent of the population own more wealth than the bottom

90 percent, and yet you here today tell us that you think it is a good idea to provide more tax breaks to the wealthiest people by doing away with the tax on dividends. The fact is that under that proposal people earning more than a million dollars would get an average tax break of $27,000 a year while those making less than $75,000 will get an average break of $42. Why do you advocate tax breaks for the richest people when we already have the greatest gap between the rich and poor of any industrialized country?

And what particularly disturbed me about your testimony is that at a time when millions of elderly people today cannot afford prescription drugs, can't afford to heat their homes, you are advocating by monkeying with the CPI major cuts not only for our seniors but for our veterans.

Mrs. KELLY. Mr. Sanders, your time is up.

Mr. SANDERS. Can you respond why you want to cut back on your Social Security?

Mrs. KELLY. Mr. Sanders, your time is up.

Mr. SANDERS. I would like the same time.

Mrs. KELLY. Mr. Sanders, we have been working with the 5-minute rule. Everyone knew about that. Mr. Greenspan, if you would like to answer that question.

Mr. GREENSPAN. I don't wish to cut back on Social Security, I just merely wish to enforce the law. The law stipulates that the cost-of-living adjustment is what should be applied to all tax and certain social insurance programs. I am stipulating, as I did in my remarks, that the new chain-weighted Consumer Price Index is a far superior means of measuring the cost of living.

Mr. SANDERS. Because it would cut back?

Mr. GREENSPAN. Do you wish——

Mrs. KELLY. Mr. Sanders, please do not interrupt Mr. Greenspan.

Mr. GREENSPAN. If you wish to increase Social Security, you can do so through statute. I am merely raising a technical question of trying to adjust to how the statute that you have passed is best administered.

Mrs. KELLY. Mr. Murphy.

Mr. MURPHY. Thank you, Madam Chairman, and thank you, Chairman Greenspan. First a question on check truncation issues. The committee intends to consider legislation this year to modernize the check processing system. As you know, legislation known as Check 21 is based upon a proposal the Federal Reserve originally submitted to Congress in December 2001. Can you share with the committee your perspective on the legislation and what savings in operational efficiencies do you expect to flow from its enhancement?

Mr. GREENSPAN. Congressman, we strongly support check truncation because we think it would very significantly improve the process of payments within our financial system. You may recall that we had some fairly significant problems right after September 11 as a consequence of air traffic problems and the ability to move checks through the system in an adequate manner. Had we had check truncation at that time, it would have made it a far easier problem to resolve. We think it is a significant advance in our pay-

ment system and we hope that the Congress would address that issue as expeditiously as you can.

Mr. MURPHY. Thank you. Another category has to do with the impact of the economy upon the States. A number of States are facing fiscal problems and talking among themselves about cutbacks in services and spending as well as raising taxes. What are your views on these fiscal problems of the States and how do you see that impacting the economy as a whole?

Mr. GREENSPAN. Well, as many people have noted, the substantial deficits in the general reserve of states are quite significant. And with the exception of Vermont, as I recall, all states are required to maintain a balanced budget, which means essentially that a substantial amount of either expenditure cuts or tax increases are taking place within the states so that by the end of the fiscal year, June 30 in most cases, the law has been adhered to. The question of endeavoring to be of assistance to the States has to recognize that any aid that can come from the Federal Government would have to come not for the current fiscal year because there is no way to get monies that quickly, but for subsequent years. And so the question is some of the states by the actions they will be taking in this fiscal year will, with very stringent changes, have successfully solved their problem so that when you go to fiscal 2004 and beyond they may no longer have a problem which would need to be addressed with federal funds.

Doubtless some states, even if they bring their general fund to balance in the current fiscal year, nonetheless have problems in 2004 and beyond, in which case then the question of federal transfers to those states is on the table. And again, we are looking at a PAYGO issue, and I think appropriately so. So it is not an issue which can be readily resolved, as I see it, currently, because so much will have already taken place before the first dollar can be transferred to the states, and by then it probably would be too late unless they wished to reverse tax increases or programs they have canceled.

Mr. MURPHY. One final quick question. Some have said that if we do a dividend tax cut that it would make States' bonds look less attractive and might have some impact upon raising those interest rates. Could you comment about what your thoughts are about that?

Mr. GREENSPAN. I think that is probably accurate. The size is difficult to judge. As I said in a similar question in the Senate yesterday, it raises a very interesting question as to whether or not the double taxation of dividends has effectively been subsidizing municipal finance in the sense of giving them a fairly improved status in the financial markets, in which case you would argue the elimination is taking away the subsidy. The other side is that if we are trying to maintain the state and local financial systems, the elimination of the double taxation does have an impact of a negative sort. I am not sure it is very large, but I don't know because I have never seen an actual realistic evaluation to know how significant it is. I think it is correct that it has some effect, but whether it is minor or significant I frankly do not know.

Mrs. KELLY. Mrs. Maloney.

Mrs. MALONEY. Thank you, Madam Chairwoman, and thank you, Chairman Greenspan, for your testimony today. I would like to follow up on the gentleman's question on the impact of the administration's economic plan on the States. And I have an analysis that New York State Comptroller Alan Hevesi has done on the impact and I request permission to place it into the record.

Mrs. KELLY. So moved.

[The following information can be found on page 84 in the appendix.]

Mrs. MALONEY. In his analysis he describes the administration's dividend plan more or less as the gift that keeps on taking, and he estimates or believes that it will reduce New York State tax revenue and increase borrowing costs in New York State alone by $551 million this year and by $9 billion over the next 10 years. He estimates that the impact on New York City will be $160 million in 2003 and $3.3 billion over the next 10 years.

In your statement earlier, you mentioned that some of these States would solve their problems this year, but clearly the only way they can solve these problems is to cut back on programs that are particularly important to lower income people in a bad economy or increase taxes. And nationally in his estimates he put forward in his letter to the New York delegation, he estimates that the cumulative State deficits are now between $60 billion and $85 billion. And my question is, do you think the impact of the administration's plan on State budgets both from the revenue side and on the borrowing costs, because tax favored municipal bonds could lose some of their appeal, this is really going to place a tremendous burden on our States in a time when they are confronting tremendous challenges?

Mr. GREENSPAN. Congresswoman, unless I am mistaken, the reason why the loss of revenues occurs in the states is because they use adjusted federal gross income as the base to apply the state income tax rate. It strikes me that perhaps what some of the states may want to do is alter that. In other words, what is occurring in the process is a reduction in state taxes because there is a lesser amount of income which occurs because it is tax free. So it may very well be that the solution to this is for the states to recognize that they don't wish to cut taxes and they can alter the rates accordingly or alter the employment of the adjusted gross income that is applied on the federal form in a manner which doesn't get this flow-over effect. And I would suspect that a number of states are going to do that.

Mrs. MALONEY. Well, they can, but still overall as the Comptroller points out, it is a tremendous impact on State budgets when they are facing huge budget gaps.

Getting back to the deficits that are galloping forth, are you concerned that the increases in the deficits will push up interest rates and increase mortgage, car and credit card rates for working families?

Mr. GREENSPAN. I am, Congresswoman. I think that what has been an extraordinarily important prop to this economy through its very stressful two or three years has been low mortgage interest rates, which have not only maintained the fairly pronounced level of residential construction, but have also, in conjunction with the

rise in the prices of homes, facilitated a fairly substantial extraction of equity from homes, which has been the means of financing the fairly large part of consumer expenditures over the years. Clearly if mortgage interest rates were to move up in any material way I think we would find that that would have a marked impact on, obviously, house turnover, which is a major factor in extraction of equity, and clearly on refinancings and the cash-outs which are associated with them.

So, yes, I am concerned about long-term interest rates specifically, but mortgage rates in particular, rising.

Mrs. MALONEY. And we seem to be going in that direction.

Mrs. KELLY. Excuse me, but your time is up, Mrs. Maloney. It appears to be my turn to ask questions, Mr. Greenspan, so I am going to ask you a question that says—tells you I am reintroducing my business checking legislation in this Congress and I expect the House is going to pass that fairly quickly. I take it that the Fed is still behind in supporting my legislation?

Mr. GREENSPAN. We certainly are.

Mrs. KELLY. It is my understanding that one of the issues that has held up the legislation in the Senate was the intent of some of the Members to add language to the bill to give State chartered industrial loan companies the ability to also pay interest on demand accounts. We hear arguments that these institutions are well regulated by the State and Federal Deposit Insurance Corporation. There has been a great deal of debate on this point, but I want to get it on the record.

Mr. Chairman, why should we oppose efforts to allow the industrial loan companies to pay interest on NOW accounts held by the businesses?

Mr. GREENSPAN. Basically because if you make that shift, they become full commercial banks, and because of their exemption under the Bank Holding Company Act they can be purchased by commercial enterprises. Now it has been my impression that the purpose of Gramm-Leach-Bliley was to limit the extent of the mixing of banking and commerce and to draw a line in a specific way, which has been very difficult. At the moment we don't have that problem with industrial loan companies who are doing reasonably well, but we would have if that amendment came into place and it would significantly alter the intention of Gramm-Leach-Bliley. So it has been our impression that it is not appropriate for the legislation going forward.

Mrs. KELLY. I want to make sure that I am clear about this. If an industrial loan company in a State like Utah is given the ability to pay interest on NOW accounts that are held by businesses in the State of Utah, why does the Fed oppose the State's intent?

Mr. GREENSPAN. Why don't I ask our General Counsel to—why don't you come up here—give you a legal—make sure he gets it right. This is Virgil Mattingly, our General Counsel.

Mrs. KELLY. Excuse me. Sir, would you please just give us your name for the record?

Mr. MATTINGLY. My name is Virgil Mattingly. I am General Counsel to the Federal Reserve, and I think the Chairman has accurately answered the question. Right now the only federal restriction on industrial loan companies is on their ability to offer ac-

counts that function as demand deposits to commercial entities. If they were to be given the authority to offer business NOWs or checking accounts to corporations, they would have all of the powers of an insured bank. In other words, they would be a substitute for an insured bank. Industrial loan companies have an exemption from the Bank Holding Company Act, which means they can be acquired by commercial entities, and several in Utah are owned by commercial entities. And as the Chairman indicated, the mixing of banking and commerce would be inconsistent with the Gramm-Leach-Bliley Act, which was recently passed by a previous Congress.

Mrs. KELLY. Thank you very much. Mr. Greenspan, I was interested in reading your testimony in front of the Senate yesterday, especially the line where you said the ability of economists to assess the effects of tax and spending programs is hindered by an incomplete understanding of the forces influencing the economy. Nice statement. And in light of what Mr. Sanders said, I would like to invite you to come and take a look at what the forces of the economy have done to New York. New York State has not completely recovered from 9/11. I know that you know where my district is. I know you have come to my district. I invite you back so you can take a look and perhaps meet with some of the people. I hope you will answer in the affirmative, but I am not going to put you on the spot and force you to answer that question now.

With that I yield the rest of my time and call on Mr. Inslee.

Mr. INSLEE. Thank you. Mr. Chairman, I always enjoy your presentation for different reasons than my friend Bernie Sanders, and the reason I enjoy it is because you have been consistent through time and through administrations in reminding us of the importance of fiscal discipline and pointing out the dangers to the United States economy, in jobs, in interest rates of these deficits. And I want to tell you that your continued reminding of us is very consistent with what people are telling me back home.

I represent a district just north of Seattle, and I have to tell you what I hear on the streets and in the grocery stores right now. People believe that there is a certain madness that has descended on Washington, D.C., and they are very, very angry, and what they are angry about is that they have seen us work through these deficits during the 1990s that they were continually concerned about, saw us make some progress on that, and now seen us have a $7 trillion swing from projections of surpluses in February to now these big multi-billion dollar deficits, and they are mad about it for three reasons.

One, they understand the baby boom phenomenon. They understand this intrinsic gut level belief that we should be saving for the future when the baby boomers retire. Two, they understand what you have said, they like low interest rates and they understand it doesn't do any good to have big tax cuts or big spending if it results in higher interest rates on their homes and their cars. And three, they are starting to hear about the debt tax. They are starting to hear about the fact that 12 or 14 percent of all the money they pay in income taxes go to service the Federal debt. They don't like it. They think that is waste, fraud and abuse. So they really appreciate the message you have of fiscal discipline and responsibility.

But I want to ask, the reason they are angry is they think a madness is descending because others have fallen off the fiscal discipline wagon here, and others have changed their tune.

I want to read a quote from John Snow, November 13, 1995. It says a balanced Federal budget is the best choice to ensure a bright future for the Nation's economy. That was then. Now we hear representatives of the administration, a quote from Mitch Daniels, January this year, said we have returned to an era of deficits, but we ought not to hyperventilate about this issue. If Mr. Daniels was here I would tell him people are breathing hard, not hyperventilating, and they are very angry about this. And I guess the question I have is, is there any economic justification for people who for decades have been telling America that they believe in balanced budgets, for decades telling us we had to have fiscal responsibility, for years been hectoring members of the other political party about this issue, is there any economic reason that has changed those fundamental characteristics of Federal deficits?

Mr. GREENSPAN. Congressman, there is a big dispute on the question of the extent to which various different types of tax cuts engender their own revenue increases. The extreme form, as you know, is the argument that if you cut taxes, the level of revenues will not change, and there are certain circumstances in which you can demonstrate that that is the case. That has been broadly generalized in many respects and it is a question of fact. It is not an issue of whether or not one has some ideological view of the way the world works. It is either true or false, and so it is a factual question. And the trouble is that it is difficult to basically corral all of the facts to make definitive cases in which all individuals agree. In recent years, there has been considerable evaluation and thinking on this particular question, and I think a number of people have changed their view or moved from views of the fact that there were no tax programs which could significantly improve revenues. You cut taxes, revenues go down. Some people have revised their views on that issue, and that is the reason you are getting the results that you are getting.

Mr. INSLEE. Have you—I hear what you are saying, but I want to make sure I understand. What I understand you are telling the Congress is that whatever you do, if you are going to cut taxes, whatever you are going to do on spending, it is a negative for the U.S. Economy to run long-term Federal deficits? Is that a basic statement that you believe in?

Mr. GREENSPAN. That is correct.

Mr. INSLEE. And do I hear you saying to us——

Mrs. KELLY. Excuse me, Mr. Inslee, your time is up.

Mr. INSLEE. It is a great question for April.

Mrs. KELLY. Mr. Kennedy.

Mr. KENNEDY. Thank you, Mr. Chairman, in trying to characterize the world that you live in, I think the gentleman from Vermont—an outline, that he lives in a bitterly partisan world and I applaud your patience in enduring that shrill attack. In the world that I have lived in, in my time period prior to coming to Congress here, I was in the common sense job creation world. And as a former chief financial officer, I have had the opportunity to struggle with that and understand and applaud your bringing up the fact

that the Tax Code really gives too much of an incentive to debt versus equity and also applaud the fact that you acknowledge that removing this double taxation on dividends would give us a better balance that would make our economy more flexible to attack, less likely to have a financial structure of a business, cause layoffs and other things that are harmful to businesses. So I acknowledge and agree with your statements on that.

I would also like to say, though, as a former chief financial officer and a CPA that has lived in this job creating world, I also agree with what you are saying on accrual accounting. We in government don't allow major businesses to practice cash accounting. We require them to do accrual accounting. We don't allow any businesses to intermingle their pension funds with their operating businesses like we have done for years. And as you outlined very well in your testimony, the need to look at our world on an accrual basis, my first question to you is what can we do? Who would we ask to do what to get to more of an accrual view of the world?

Mr. GREENSPAN. Since the Congressional Budget Office is a creature of the Congress, you could request of them that they develop effective accrual accounting systems. As I say in my prepared remarks, on the outlay side we are pretty much there. We do know the accrued benefits for Social Security and I think probably can calculate it for Medicare and many of the other programs that you related. We have more difficulty on the deferred tax side because what we do know is there is a very large block of retirement accounts out there which become taxable on withdrawal, and hence those are appropriately measurable as deferred assets of the Federal Government. And clearly, if we have changes in the accrued benefits and the accrued revenues, we obviously have constructed an accrual system which in combination with the cash system enables us to understand how various appropriations and authorizations made for eventual spending by the Congress spin out through the cash accounts and how they affect the debt to the public and what the level of contingent debt is, net, to the public over and above the little under $4 trillion in debt to the public which now exists.

Mr. KENNEDY. And I strongly agree with our need to do that approach, and you outline the difficulty in forecasting the revenue. Part of that difficulty is a reliance on capital gains tax, which are highly variable depending on which way the market is going. And the reason we face a deficit today is, as you mentioned, the dramatic falloff in evaluation. If we addressed also the capital gains tax, wouldn't that not only be a very positive thing for our economy but really allow us to have a more predictable and more dependable view of revenues for the long-term future?

Mr. GREENSPAN. I am sorry, do what with the capital gains?

Mr. KENNEDY. Either reduce it, eliminate it and not to have such a heavy reliance on it in our future revenue streams.

Mr. GREENSPAN. I commented many times in the past, Congressman, that I think the capital gains tax is a very poor means of raising revenues. It imposes costs on capital which are far larger than the equity revenue effects, which, in my judgment, are the sole purpose of doing that. I would much prefer that we did not tax capital

in the way that we did. I think it is counterproductive to aggregate economic growth.

Mr. KENNEDY. And my last question is if we looked out into the future and we address these long-term needs to reform and make sure that we have a balance on our long-term entitlement pass, would we see a positive impact in our economy today for addressing those here and now as opposed to letting them fester for another decade?

Mr. GREENSPAN. To the extent that the market perceives that those long-term changes were real, are going to happen, then clearly they would be discounted in the prices of securities today.

Mr. KENNEDY. Thank you.

Mrs. KELLY. Mr. Watt?

Mr. WATT. Thank you, Mr. Chairman, for being here. I just have two very quick questions, which hopefully won't take my full time, and I apologize if they have been asked while I was out of the room. On pages 7 and on the following pages of your written testimony, you spend quite a bit of time talking about some of your concerns about our whole budget process and the way we account, which is a continuation of the discussion you were just having with my colleague.

First of all, I just want to be clear, do you have a position on dynamic scoring? And if so, what is it?

Mr. GREENSPAN. In principle, Congressman, dynamic scoring is the way in which we should be estimating the impact of revenues and expenditure programs. It is theoretically doable, but it is very difficult to get general agreement on the type of model that is required to estimate the secondary effects over and above so-called static scoring. If we could get the general agreement on how dynamic scoring would be done with respect to various different types of programs, then it would be useful because the Congress would know what the various costs of various programs are in which everyone would agree that those are the data. But as I have testified before, it is very difficult to get a model which everybody agrees is the ideal model, meaning the one in the context of earlier remarks. Abstraction is a very complex reality.

Mr. WATT. So if they accepted your model, you would have supported it? If they didn't accept your model, you probably wouldn't support that?

Mr. GREENSPAN. Congressman, I trust they wouldn't accept my model because I know how flaky any model is, mine included. I fall back to what I would call a less desirable means of evaluating programs, which is so-called static scoring. I would like to see us be able to develop dynamic scoring. It is conceptually superior as a means of doing it. I just don't see how we are going to do it, but I hope we can try.

Mr. WATT. Second question, on page 14 of your written testimony, you say something that I am having a little trouble understanding. You say, "So short of a major increase in immigration, economic growth cannot be safely counted upon to eliminate deficits." the reverse of that is will—the implication is a dramatic increase in immigration might have some positive impact on growth. Can you just tell me what you mean by that so I will have a clear understanding of it?

Mr. GREENSPAN. It is precisely what you just indicated. The level of immigration in this country, which is a third to a half of our increase in households, has been a major factor in the increase in the population, the increase in the labor force, the increase of employment. And aggregate economic output is basically output per person times the number of people, and if you accelerate immigration, you will expand the labor force and increase the GDP, increase aggregate wages and salaries, increase contributions to social insurance, increase individual income tax payments, and in a sense the whole revenue base goes up accordingly.

Mr. WATT. Well, I could go on and on with that, but I won't deal with that. I appreciate it. Those are the two questions that I wanted clarification on. I appreciate your response, and I yield back the balance of my time.

Mrs. KELLY. I would remind the people in the committee who are remaining Mr. Greenspan must leave at 1 o'clock, so we are going to try to get everybody in. But you must keep your questions succinct and the answers short. With that, Mr. Shays.

Mr. SHAYS. Thank you, Mr. Greenspan. Thank you for being here and thank you for your service to our country. I would like to ask you some questions on derivatives and on the GSEs. For the last several Congresses, we have attempted to pass bankruptcy reform legislation, and included in those efforts were provisions to improve the netting out process of certain financial contracts. Could you please describe your views on these netting provisions and what level of importance would you attach to them?

Mr. GREENSPAN. We have had very considerable success in developing a sophisticated financial system in recent years, which has been a major factor in American economic growth. A not insignificant part of that has been derivatives, which in earlier legislation were able to be netted out in a manner in which bankruptcy courts could essentially make a determination of who owed what to whom under various different circumstances. Because of changes that have occurred in recent years, this needs to be addressed again, and it is terribly important that individuals are able to net out various differing derivative obligations owed to them or owed by them in a manner which could facilitate a much less risky bankruptcy procedure.

So in my judgment, it is crucially important that the changes that we have been discussing about netting be moved through as expeditiously as possible either tied to the bankruptcy laws or essentially as a free-standing piece of legislation. It is important largely because the ability to net out clarifies a very significant element of uncertainty in who owes what to whom under various different stressful conditions.

Mr. SHAYS. Thank you. When you were before the Senate Banking Committee you made reference to GSEs as legally private corporations that should be handled the way private corporations are handled. As you are aware, there is legislation to repeal the GSEs' exemption from this Nation's securities laws and subject them to the SEC disclosure standards imposed on every other publicly-traded company. Now I know you can't endorse legislation, but would you basically say that GSEs should be handled the way private corporations are handled in general?

Mr. GREENSPAN. Yes, I would.

Mr. SHAYS. Just one last question, should there be two-tier treatment for capital gains or would you prefer to just see one-tier treatment; in other words, short-term gain versus long-term gain?

Mr. GREENSPAN. It is a complex question. I said previously my view of the capital gains taxes is it is counterproductive.

Mr. SHAYS. If we are going to have this counterproductive tax though, would you prefer——

Mr. GREENSPAN. I prefer short-term and long-term gains being separated.

Mr. SHAYS. Be separate.

Mr. GREENSPAN. Yes.

Mr. SHAYS. I yield back the balance of my time.

Mrs. KELLY. Mr. Meeks?

Mr. MEEKS. Thank you, Madam Chair.

Mr. Chairman, let me just follow up on Congressman Watt, because I was also intrigued by the statement on page 14. Conversely, you know, the administration has put into effect the policy to sharply curtail or maybe even to discourage because of protecting our borders, et cetera, immigration. So would you say that by us now curtailing immigration, that that is a factor, whether it be significant or otherwise, in our slowing economy?

Mr. GREENSPAN. Well, obviously the less immigration we have, the less employment, the less GDP. And I might say that the fact that so many people are pounding on our doors to get into this country is a very significant vote of confidence in what type of economic society we have created here. And my view is that immigration throughout our history has been a very important part of the dynamism and the growth that we have had in this country. And my view is that limits should be less than they are.

Mr. MEEKS. Let me ask another question, and I am going to try to be brief. I hope I can squeeze somebody else in, so I will just have this one question. Right now oil prices are starting to again go through the roof, and they are rising dramatically. And of course concerns about when we go to war with Iraq, it just seems that that is inevitable. The political instability in Venezuela, again, that is driving oil prices crazy. If the war hypothetically were to last, say, a year, how much of an inflationary effect would it have on our economy, and would the Feds see the need to increase the Fed fund rate to fight the inflation?

Mr. GREENSPAN. Well, Congressman, it depends very much on what happens both to Venezuela and to Iraqi crude oil production. As you know, the Venezuelan production has been cut to a third. It is rising now, but it is still well below where it was. And both of these countries' capacity are about three million barrels a day. If there is a substantial shortfall which is not made up by the other Gulf states, for example, Saudi Arabia being the obvious important one, then we are up against problems of making judgments as to how much leeway there is between aggregate capacity worldwide on crude oil production and what consumption is.

Fortunately, in the period immediately ahead, worldwide consumption is in the seasonal decline. Starting in April, May, and June, you get a much lower level of oil consumption, which means that if we had a shutdown, its effect on price would be modest. But

if it went on, as you point out, for a year, it could be troublesome in how it was handled.

Mr. MEEKS. I yield back.

Ms. KELLY. Thank you.

Mr. GREENSPAN. I should say, I find it unlikely. A year under any scenario seems to me far beyond anything I could conceive of. So the more likely scenario is a much shorter one, obviously.

Ms. KELLY. Thank you.

Mr. Chairman, we are very pleased and we do thank you for your willingness to come here and be with us today. We have run out of time. The Chair notes that some Members may have additional questions, and they may wish to submit those in writing. So without objection, the hearing record will remain open for ten days for Members to submit written questions to these witnesses and to place their responses in the record.

Chairman Greenspan, you are excused with the committee's great thanks and appreciation for your time. And——

Mr. FRANK. I would——

Ms. KELLY. Mr. Frank?

Mr. FRANK. Madam Chair, I do note that we do all want to get together and do this again sometime.

Ms. KELLY. This hearing is adjourned.

[Whereupon, at 1:01 p.m., the committee was adjourned.]

A P P E N D I X

February 12, 2003

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February 11, 2003
Opening Statement for the Record
Congressman Joe Baca

Mr. Chairman,

Thank you Chairman Oxley, Congressman Frank, and my new colleagues on the Financial Services Committee. I am excited to serve on this committee, and I look forward to working closely with members on both sides of the aisle.

Americans are facing an uncertain future. Jobs are becoming scarce, states are experiencing a severe financial crisis, and we are standing at the threshold of war. People throughout our nation are pleading with the Federal Government to help provide answers to many tough questions.

In my district, crime is becoming more rampant, unemployment more pervasive, and concerns about Homeland Security more prevalent. People from my district have come to my office door and begged me not to send their sons and daughters off to a war that they don't understand, a war that has yet to be justified. If we make the difficult decision to send our troops to Iraq, we need to provide our nation with firm answers to the many questions that surround this military action. Financing is a critical question that needs to be addressed. The President's budget does not address how the country will pay for war. He has proposed tax cuts without a discussion about the necessary sacrifices that accompanies war. We have not heard what price our nation will pay should we occupy a nation that we have chosen to invade.

Today, we call upon Chairman Greenspan to answer some of the imperative financial questions that this Administration is failing to answer. We must ask him how it is possible to endorse a tax cut that will ultimately benefit the wealthiest people of this nation, while failing to address the needs of the working class. We must ask him if a tax cut is the wisest decision during a time of ballooning deficit. We must ask him how we will pay for war. Hopefully, the Chairman will be able to fill in the colossal information gap that the Administration is failing to close. I thank him for his time today, and I thank the Committee for allowing me the opportunity to submit remarks and questions.

Sincerely,

Joe Baca

JOE BACA, Congressman
43rd Congressional District

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OPENING STATEMENT OF REP. ARTUR DAVIS
Federal Reserve Board's Semiannual Monetary Policy Report to the Congress
Before the Committee on Financial Services
February 12, 2003

Mr. Chairman, Mr. Frank, members of the Committee on Financial Services, good morning and thank you for the opportunity to share my thoughts on the Federal Reserve Board's conduct of domestic monetary policy and the impact that the President's proposed budget will have on the creation of that policy.

This issue is not wanting for attention these days with all the news coverage the President's FY 2004 budget has received. In fact, it would surprise many to learn that there is any aspect of his budget proposal that has not been scrutinized. But, one aspect of this debate has gone unnoticed, even by those affected – the impact a large budget deficit and the corresponding rise in long-term interest rates will have on our ability as a nation to assist those who have been left out of the economic prosperity of the Twentieth Century.

These are the rural poor, the residents of the nation's Delta Black Belt region; 14 states located predominately in the southeastern and central region of the country. The area is characterized by unemployment that doubles the national average, by poverty that consistently exceeds 30 percent, by double-digit rates of teenage pregnancy, by schools that struggle on starvation budgets, and by inadequate access to healthcare. Still reeling from a two decade long erosion of its job base and still burdened by a legacy of racial and economic discrimination, this region has been left out of the economic growth and prosperity experienced by the rest of the country. It is the poorest region in the United States, a slice of Third World demographics in our own backyard.

As we sit here today and discuss what policy actions the Federal Reserve Board plans to take to address the $2.1 trillion deficit the Administration's tax cuts – $1.5 trillion over the next ten years – will engender, let us not forget the real world implications of that policy. Chairman Greenspan noted this past September that, "History suggests that an abandonment of fiscal discipline will eventually push up interest rates, crowd out capital spending, lower productivity growth, and force harder choices upon us in the future." [Sept. 12, 2002.] For the residents of the Black Belt that means even higher unemployment, continued dwelling in substandard housing, continued loss of medical facilities, and no money to renovate or rehabilitate schools that are, literally, falling apart.

Unfortunately, there is no need to exaggerate these terms. Currently, one-quarter of rural Americans spend more than 30 percent of their income on housing, including 2.1 million rural households that spend more than half their incomes and 2.5 million that spend between 30 and 50 percent of their incomes. This year, when the deficit created by the Administration's tax cuts is projected to be only $304 billion, the President proposed, eliminating the programs that affect their quality of life, including the Department of Housing and Urban Development's Office of Rural Housing. These cuts also reduce funding for the Rural Housing Services Section 515 rental housing direct loans program

by 37 percent (from $114.1 million in FY2002 to $71 million in FY2004) and prohibit the use of these funds for new construction. Devastating cuts with a dramatic impact in just the first year.

Consider what happens to our commitment to rural areas in the out-years, when the country is facing a $2.1 trillion deficit. Exactly what Chairman Greenspan anticipated: we will be faced with the harsh choice between assisting them and digging the larger economy out of its deficit hole. This is an illusory choice because the country's economic future depends on its fastest growing region – the South – and the economic future of the South depends on our capacity to invigorate the part of that region that has been left behind.

Ladies and gentlemen of the Committee I ask you, as we proceed with our discussion of interest rates, inflation, and money supplies to keep in mind that ours is not a theoretical discussion. The President's budget choices have serious consequences; consequences which will take the form of exploding deficits, rising long-term interest rates and an increased burden on the people who are already overburdened and under-equipped to absorb the impact.

February 12, 2003

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

I would like to thank you, Mr. Chairman, for holding this important hearing and Chairman Greenspan for making himself available to the committee.

Given our current uncertain economic climate and slowed growth during the last Fiscal Year, I am especially interested today to hear your expectations for the future.

As the President emphasized in the explanation of his proposed jobs and growth package, the fundamental elements of our economy have remained strong. This can be clearly observed in the housing market. However, our overall economy is not immune to external factors. We all witnessed the crippling impact a deterioration of investor confidence, triggered by an event such as the September 11th attacks, can have on our financial markets.

I would appreciate any elaboration you could give us on your remarks from yesterday, regarding the affect of current geopolitical risks on the timetable for economic recovery and specifically, increased capital investment and hiring.

Increased unemployment is an important issue for constituents in every congressional district and I sincerely hope the prediction of a .3 percent decrease to 5.7 at the end of this year is surpassed.

If I understood you correctly, it is really the uncertainty of the global geopolitical climate that has negatively impacted our markets and any action our government could take to bring greater stability in the global arena would prove beneficial.

Before the Banking, Housing, and Urban Affairs Committee in the Senate, you also reiterated your position in support of the elimination of the double taxation of dividends

and I am interested to hear any further explanation you could share on its constraint on the flexibility of our economy.

I fully understand that fiscal policy is not, nor should it be, in your area of responsibility but feel that we could all benefit from your theoretical knowledge and expertise in evaluating this issue.

Thank you again for testifying before our committee and sharing your opinions with us today.

Opening Statement of Congressman Rubén Hinojosa
House Financial Services Committee
Humphrey Hawkins Hearing
February 12, 2003

Mr. Chairman and Ranking Member Frank,

Thank you very much for holding this important hearing so that we may hear the testimony of Mr. Greenspan on monetary policy and the state of the economy.

I want to use my time here today to raise for my colleagues and Mr. Greenspan's attention and policy consideration what the media and economic indicators have been telling us since this economic downturn began -- and that is that housing has been one of the few and consistent bright spots that has kept this recession from dipping perilously low.

I raise this because, at a time when we are all struggling for answers on how to get our nation's economy moving again, it is as important to focus on what needs to be fixed and what is functioning well and should not be disturbed.

We should be very cautious in how we approach the nation's housing policy, particularly with respect to the government-sponsored enterprises -- Fannie Mae and Freddie Mac.

I read with interest some of the newspaper accounts of Mr. Greenspan's testimony before the Senate Banking Committee yesterday, and Mr. Greenspan was asked about the role the SEC should play in the registration of the GSE's securities. I would like the record to reflect that just last summer this Committee received testimony from Treasury Undersecretary Peter Fisher emphasizing the Administration's position that Fannie Mae and Freddie Mac did not need to register their mortgage-backed securities as long as they registered their equity securities under the 1934 Act.

This past January, the SEC, the Treasury Department and OFHEO produced a study outlining the additional disclosure these entities deem appropriate going forward. As an outgrowth of those recommendations, and consistent with what I have seen as Fannie Mae's on-going efforts to be as transparent to investors as possible, beginning April 2003, Fannie Mae will disclose new information about the mortgages in its mortgage-backed securities including six additional elements of information.

The elements and a detailed description of the information that will be provided for each, and I quote, are:

Original loan-to-value ratios -- Fannie Mae will provide the relationship between the mortgage's unpaid principal balance at the time of loan origination and a measure of the property's value at time of origination, expressed as a percentage ratio.

Standardized credit scores of borrowers -- Fannie Mae will include credit-scoring data (numerical values that rank a borrower according to his or her credit risk at a given point in time).

Loan purpose -- Fannie Mae will disclose whether a loan was used to purchase the home or refinance an existing home.

Occupancy type -- Fannie Mae will disclose how the borrower will use the property. The disclosure will identify whether the home is owner-occupied, an investment property or a second home.

Property type -- Fannie Mae will describe the type of property by identifying the number of separate dwellings that comprise the single-family property. The disclosure will identify whether the property is a "one unit" property or a "2-4 unit" property.

Servicer -- Fannie Mae will identify the entity that services the mortgages in the pool. The company currently identifies the seller of the loans, which usually is the originator, and will continue to identify the seller in addition to the servicer.

Mr. Chairman, clearly these GSEs are striving to remain responsive to Congressional demands, increase transparency to an investing public and are still very much focused on their mission as prescribed by Congress and regulated by HUD. On this last point, earlier this month, Fannie Mae announced that for the 9th consecutive year they exceeded all of HUD's statutory housing requirements for 2002.

As you know, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires Fannie Mae and Freddie Mac to meet annual percent-of-business housing goals established by HUD for three categories: low- and moderate-income, underserved, and special affordable.

For 2002, Fannie Mae exceeded the regulatory goals in each category.

Preliminary results for Fannie Mae's 2002 business activity show that: low- and moderate-income households (those with incomes less than or equal to 100% of an area's median income) represented over 51.6% of the units the company financed (compared with a HUD goal of 50% for the year); underserved areas accounted for over 32.7% of the units that Fannie Mae financed (the company's HUD goal was 31% for the year); and special affordable housing (low- and very low-income households living in both single-family and multifamily residences) accounted for 21.3% of total units financed in 2002 (HUD's goal was 20%). Fannie Mae delivered $7.2 billion in multifamily special affordable financing against a HUD goal of $2.85 billion.

Clearly, Mr. Chairman, these private companies, engaged in an important public mission, are an important part of our economy, and I look forward to continuing to work with them to increase affordable financing opportunities across the country. We beed to

remember that Fannie Mae and Freddie Mac have played an important role in keeping the housing market going since the stock market bubble burst in 2000. Any actions we take to harm them or any other part of the housing market could damage the one positive aspect of our economy.

Opening Statement
Financial Services Committee
Federal Reserve Board's Semiannual Monetary Report to Congress
February 12, 2003
Congressman John Shadegg

Thank you, Chairman Oxley. First, I would like to take a moment to welcome Chairman Greenspan and thank you for your testimony before this committee. I believe that, with the added uncertainty of war with Iraq and the continued sluggishness of the economy, your expertise will offer us guidance in ways to improve and promote economic growth.

I would like to emphatically state my support for President Bush's economic growth proposal, especially the plan to eliminate the double taxation of corporate dividends. I was pleased by the release of the President's budget which holds the increases in discretionary spending at four percent, a level equal to the percentage that the average family's income is expected to grow this year. As the President stated in his State of the Union Address, "(f)ederal spending should not rise any faster than the paychecks of American families."

As Members of Congress, we should approach the government's budget with the same common sense we apply to our family finances – but with an additional acute sense of responsibility. Shaping the federal budget is a duty entrusted to us by the citizens that elect us, and we should exercise it with care because it is not *our* money, but revenue generated by the hard work of taxpaying Americans. Like a family, the government's fixed expenditures should go toward funding the basics, like defense and critical infrastructure.

It is our responsibility this year to focus on *restraining* the growth in spending, particularly in areas that are already funded at very high levels. Almost every government agency is doing better than the American family. Over the past five years the median household income has increased by nineteen percent, while the government's budget has increased an incredible forty percent.

Let me provide you with an example: for the past five years, the National Institutes of Health (NIH) has received an extraordinary flow of money from the federal government, including annual budget increases on the order of fifteen percent. If Congress approves NIH's budget request for Fiscal 2003, the Institute's budget will exceed $27 billion – *double* the level it was funded at in 1998. To frame this in terms of family finances, ask yourself: has your salary *doubled* in the last four years?

We cannot continue the largesse of years past – tightening the purse strings is a necessary course of action. Curtailing discretionary spending is essential if we are to allocate government funds for other, more immediate priorities.

Moreover, it is important to understand what it means to "cut" funding at this time when the country is choosing between essential and non-essential spending. A budget *increase* of less than the prior year is not a spending "cut." And critics who characterize a four percent increase as a "cut" should not be taken seriously. It is time for the federal government to start doing what every family must do: separating discretionary "wants" from critical spending "needs" and learning to live within a responsible budget.

I would like to focus on another responsibility this Congress will have in the coming months: improving and expanding the economic growth of the United States. We must quickly pass the President's growth package. This will yield tax relief for every American who pays income taxes by accelerating rate reductions.

I support the President's plan to treat all investors equally in our tax laws, and I was pleasantly surprised by your testimony yesterday to the Senate Banking Committee in which you stated that the President's proposal to eliminate the taxation of corporate dividends was "long-term good corporate policy." This is a view I am sure you will reiterate several times today.

As we all know, shareholders are currently taxed twice on earnings distributed by corporations as dividends: first, when revenue is reported as corporate profit (a thirty-five percent tax) and, second, when it is distributed as dividends. Depending on the taxpayer's income bracket, such double taxation can result in effective rates exceeding sixty percent. An investor in the twenty-seven percent tax bracket, for example, receives less than forty-eight cents for each dollar earned as dividend income. As a result, only about twenty-percent of companies today even pay dividends. Elimination of double taxation of dividends would properly incentivize companies to distribute wealth back to shareholders. It is simply good tax policy to encourage companies to return wealth to investors - the true owners of companies.

Tax relief and sensible short and long-term pro-growth policies are worthwhile achievements irrespective of economic stimulation. The President's plan harnesses these policies in a manner that creates an immediate boost as well. It is time for partisan bickering and the rhetoric of class warfare to take a backseat to the work of passing an economic stimulus package that benefits all Americans. Congress owes a duty to those we represent to pass a strong stimulus package that creates jobs by encouraging investment and consumption and, in the long-term, lays the foundation for sensible fiscal policy by correcting flaws in our tax code.

Thank you again Mr. Chairman for the testimony you are about to give.

For release on delivery
10:00 a.m. EST
February 12, 2003

Statement by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

House of Representatives

February 12, 2003

Mr. Chairman and members of the committee, I am pleased this morning to present the Federal Reserve's semiannual Monetary Policy Report to the Congress. I will begin by reviewing the state of the U.S. economy and the conduct of monetary policy and then turn to some key issues related to the federal budget.

When I testified before this committee last July, I noted that, while the growth of economic activity over the first half of the year had been spurred importantly by a swing from rapid inventory drawdown to modest inventory accumulation, that source of impetus would surely wind down in subsequent quarters, as it did. We at the Federal Reserve recognized that a strengthening of final sales was an essential element of putting the expansion on a firm and sustainable track. To support such a strengthening, monetary policy was set to continue its accommodative stance.

In the event, final sales continued to grow only modestly, and business outlays remained soft. Concerns about corporate governance, which intensified for a time, were compounded over the late summer and into the fall by growing geopolitical tensions. In particular, worries about the situation in Iraq contributed to an appreciable increase in oil prices. These uncertainties, coupled with ongoing concerns surrounding macroeconomic prospects, heightened investors' perception of risk and, perhaps, their aversion to such risk. Equity prices weakened further, the expected volatility of equity prices rose to unusually high levels, spreads on corporate debt and credit default swaps deteriorated, and liquidity in corporate debt markets declined. The economic data and the anecdotal information suggested that firms were tightly limiting hiring and capital spending and keeping an unusually short leash on inventories. With capital markets inhospitable and commercial banks firming terms and standards on business loans, corporations relied to an unusual extent on a drawdown of their liquid assets rather than on borrowing to fund their limited expenditures.

By early November, conditions in financial markets had firmed somewhat on reports of improved corporate profitability. But on November 6, with economic performance remaining subpar, the Federal Open Market Committee chose to ease the stance of monetary policy, reducing the federal funds rate 50 basis points, to 1¼ percent. We viewed that action as insurance against the possibility that the still widespread weakness would become entrenched. With inflation expectations well contained, this additional monetary stimulus seemed to offer worthwhile insurance against the threat of persistent economic weakness and unwelcome substantial declines in inflation from already low levels.

In the weeks that followed, financial market conditions continued to improve, but only haltingly. The additional monetary stimulus and the absence of further revelations of major corporate wrongdoing seemed to provide some reassurance to investors. Equity prices rose, volatility declined, risk spreads narrowed, and market liquidity increased, albeit not to levels that might be associated with robust economic conditions. At the same time, mounting concerns about geopolitical risks and energy supplies, amplified by the turmoil in Venezuela, were mirrored by the worrisome surge in oil prices, continued skittishness in financial markets, and substantial uncertainty among businesses about the outlook.

Partly as a result, growth of economic activity slowed markedly late in the summer and in the fourth quarter, continuing the choppy pattern that prevailed over the past year. According to the advance estimate, real GDP expanded at an annual rate of only ¾ percent last quarter after surging 4 percent in the third quarter. Much of that deceleration reflected a falloff in the production of motor vehicles from the near-record level that had been reached in the third quarter when low financing rates and other incentive programs sparked a jump in sales. The slowing in aggregate output also reflected aggressive attempts by businesses more generally to ensure that inventories

remained under control. Thus far, those efforts have proven successful in that business inventories, with only a few exceptions, have stayed lean—a circumstance that should help support production this year. Indeed, after dropping back a bit in the fall, manufacturing activity turned up in December, and reports from purchasing managers suggest that improvement has continued into this year. Excluding both the swings in auto and truck production and the fluctuations in non-motor-vehicle inventories, economic activity has been moving up in a considerably smoother fashion than has overall real GDP: Final sales excluding motor vehicles are estimated to have risen at a 2¼ percent annual rate in the fourth quarter after a similar 1¾ percent advance in the previous quarter and an average of 2 percent in the first half.

Thus, apart from these quarterly fluctuations, the economy has largely extended the broad patterns of performance that were evident at the time of my July testimony. Most notably, output has continued to expand, but only modestly. As previously, overall growth has simultaneously been supported by relatively strong spending by households and weighed down by weak expenditures by businesses. Importantly, the favorable underlying trends in productivity have continued; despite little change last quarter, output per hour in the nonfarm business sector rose 3¾ percent over the four quarters of 2002, an impressive gain for a period of generally lackluster economic performance. One consequence of the combination of sluggish output growth and rapid productivity gains has been that the labor market has remained quite soft. Employment turned down in the final months of last year, and the unemployment rate moved up, but the report for January was somewhat more encouraging.

Another consequence of the strong performance of productivity has been its support of household incomes despite the softness of labor markets. Those gains in income, combined with very low interest rates and reduced taxes, have permitted relatively robust advances in residential

construction and household expenditures. Indeed, residential construction activity moved up steadily over the year. And despite large swings in sales, underlying demand for motor vehicles appears to have been well maintained. Other consumer outlays, financed partly by the large extraction of built-up equity in homes, have continued to trend up. Most equity extraction—reflecting the realized capital gains on home sales—usually occurs as a consequence of house turnover. But during the past year, an almost equal amount reflected the debt-financed cash-outs associated with an unprecedented surge in mortgage refinancings. Such refinancing activity is bound to contract at some point, as average interest rates on outstanding home mortgages converge to interest rates on new mortgages. However, fixed mortgage rates remain extraordinarily low, and applications for refinancing are not far off their peaks. Simply processing the backlog of earlier applications will take some time, and this factor alone suggests that refinancing originations and cash-outs will be significant at least through the early part of this year.

To be sure, the mortgage debt of homeowners relative to their income is high by historical norms. But as a consequence of low interest rates, the servicing requirement for the mortgage debt of homeowners relative to the corresponding disposable income of that group is well below the high levels of the early 1990s. Moreover, owing to continued large gains in residential real estate values, equity in homes has continued to rise despite sizable debt-financed extractions. Adding in the fixed costs associated with other financial obligations, such as rental payments of tenants, consumer installment credit, and auto leases, the total servicing costs faced by households relative to their incomes are below previous peaks and do not appear to be a significant cause for concern at this time.

While household spending has been reasonably vigorous, we have yet to see convincing signs of a rebound in business outlays. After having fallen sharply over the preceding two years,

new orders for capital equipment stabilized and, for some categories, turned up in nominal terms in 2002. Investment in equipment and software is estimated to have risen at a 5 percent rate in real terms in the fourth quarter and a subpar 3 percent over the four quarters of the year.

However, the emergence of a sustained and broad-based pickup in capital spending will almost surely require the resumption of substantial gains in corporate profits. Profit margins apparently did improve a bit last year, aided importantly by the strong growth in labor productivity.

Of course, the path of capital investment will depend not only on market conditions and the prospects for profits and cash flow but also on the resolution of the uncertainties surrounding the business outlook. Indeed, the heightening of geopolitical tensions has only added to the marked uncertainties that have piled up over the past three years, creating formidable barriers to new investment and thus to a resumption of vigorous expansion of overall economic activity.

The intensification of geopolitical risks makes discerning the economic path ahead especially difficult. If these uncertainties diminish considerably in the near term, we should be able to tell far better whether we are dealing with a business sector and an economy poised to grow more rapidly—our more probable expectation—or one that is still laboring under persisting strains and imbalances that have been misidentified as transitory. Certainly, financial conditions would not seem to impose a significant hurdle to a turnaround in business spending. Yields on risk-free Treasury securities have fallen, risk spreads are narrower on corporate bonds, premiums on credit default swaps have retraced most of their summer spike, and liquidity conditions have improved in capital markets. These factors, if maintained, should eventually facilitate more-vigorous corporate outlays.

If instead, contrary to our expectations, we find that, despite the removal of the Iraq-related uncertainties, constraints to expansion remain, various initiatives for conventional monetary and

fiscal stimulus will doubtless move higher on the policy agenda. But as part of that process, the experience of recent years may be instructive. As I have testified before this committee in the past, the most significant lesson to be learned from recent American economic history is arguably the importance of structural flexibility and the resilience to economic shocks that it imparts.

I do not claim to be able to judge the relative importance of conventional stimulus and increased economic flexibility to our ability to weather the shocks of the past few years. But the improved flexibility of our economy, no doubt, has played a key role. That increased flexibility has been in part the result of the ongoing success in liberalizing global trade, a quarter-century of bipartisan deregulation that has significantly reduced rigidities in our markets for energy, transportation, communication, and financial services, and, of course, the dramatic gains in information technology that have markedly enhanced the ability of businesses to address festering economic imbalances before they inflict significant damage. This improved ability has been facilitated further by the increasing willingness of our workers to embrace innovation more generally.

It is reasonable to surmise that, not only have such measures contributed significantly to the long-term growth potential of the economy this past decade, they also have enhanced its short-term resistance to recession. That said, we have too little history to measure the extent to which increasing flexibility has boosted the economy's potential and helped damp cyclical fluctuations in activity.

Even so, the benefits appear sufficiently large that we should be placing special emphasis on searching for policies that will engender still greater economic flexibility and dismantling policies that contribute to unnecessary rigidity. The more flexible an economy, the greater its ability to self-correct in response to inevitable, often unanticipated, disturbances, thus reducing the

size and consequences of cyclical imbalances. Enhanced flexibility has the advantage of adjustments being automatic and not having to rest on the initiatives of policymakers, which often come too late or are based on highly uncertain forecasts.

Policies intended to improve the flexibility of the economy seem to fall outside the sphere of traditional monetary and fiscal policy. But decisions on the structure of the tax system and spending programs surely influence flexibility and thus can have major consequences for both the cyclical performance and long-run growth potential of our economy. Accordingly, in view of the major budget issues now confronting the Congress and their potential implications for the economy, I thought it appropriate to devote some of my remarks today to fiscal policy. In that regard, I will not be emphasizing specific spending or revenue programs. Rather, my focus will be on the goals and process determining the budget and on the importance, despite our increasing national security requirements, of regaining discipline in that process. These views are my own and are not necessarily shared by my colleagues at the Federal Reserve.

* * *

One notable feature of the budget landscape over the past half century has been the limited movement in the ratio of unified budget outlays to nominal GDP. Over the past five years, that ratio has averaged a bit less than 19 percent, about where it was in the 1960s before it moved up during the 1970s and 1980s. But that pattern of relative stability over the longer term has masked a pronounced rise in the share of spending committed to retirement, medical, and other entitlement programs. Conversely, the share of spending that is subject to the annual appropriations process, and thus that comes under regular review by the Congress, has been shrinking. Such so-called discretionary spending has fallen from two-thirds of total outlays in the 1960s to one-third last year, with defense outlays accounting for almost all of the decline.

The increase in the share of expenditures that is more or less on automatic pilot has complicated the task of making fiscal policy by effectively necessitating an extension of the budget horizon. The Presidents' budgets through the 1960s and into the 1970s mainly provided information for the upcoming fiscal year. The legislation in 1974 that established a new budget process and created the Congressional Budget Office required that organization to provide five-year budget projections. And by the mid-1990s, CBO's projection horizon had been pushed out to ten years. These longer time periods and the associated budget projections, even granted their imprecision, are useful steps toward allowing the Congress to balance budget priorities sensibly in the context of a cash-based accounting system.[1] But more can be done to clarify those priorities and thereby enhance the discipline on the fiscal process.

A general difficulty concerns the very nature of the unified budget. As a cash accounting system, it was adopted in 1968 to provide a comprehensive measure of the funds that move in and out of federal coffers. With a few modifications, it correctly measures the direct effect of federal transactions on national saving. But a cash accounting system is not designed to track new commitments and their translation into future spending and borrowing. For budgets that are largely discretionary, changes in forward commitments do not enter significantly into budget deliberations, and hence the surplus or deficit in the unified budget is a reasonably accurate indicator of the stance of fiscal policy and its effect on saving. But as longer-term commitments have come to dominate tax and spending decisions, such cash accounting has been rendered progressively less meaningful as the principal indicator of the state of our fiscal affairs.

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[1] Unfortunately, they are incomplete steps because even a ten-year horizon ends just as the baby boom generation is beginning to retire and the huge pressures on social security and especially Medicare are about to show through.

An accrual-based accounting system geared to the longer horizon could be constructed with a reasonable amount of additional effort. In fact, many of the inputs on the outlay side are already available. However, estimates of revenue accruals are not well developed. These include deferred taxes on retirement accounts that are taxable on withdrawal, accrued taxes on unrealized capital gains, and corporate tax accruals. An accrual system would allow us to keep better track of the government's overall accrued obligations and deferred assets. Future benefit obligations and taxes would be recognized as they are incurred rather than when they are paid out by the government.[2]

Currently, accrued outlays very likely are much greater than those calculated under the cash-based approach. Under full accrual accounting, the social security program would be showing a substantial deficit this year, rather than the surplus measured under our current cash accounting regimen.[3] Indeed, under most reasonable sets of actuarial assumptions, for social security benefits alone past accruals cumulate to a liability that amounts to many trillions of dollars. For the government as a whole, such liabilities are still growing.

Estimating the liabilities implicit in social security is relatively straightforward because that program has many of the characteristics of a private defined-benefit retirement program. Projections of Medicare outlays, however, are far more uncertain even though the rise in the beneficiary populations is expected to be similar. The likelihood of continued dramatic innovations in medical technology and procedures combined with largely inelastic demand and a subsidized third-party payment system engenders virtually open-ended potential federal outlays unless

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[2] In particular, a full set of accrual accounts would give the Congress, for the first time in usable form, an aggregate tabulation of federal commitments under current law, with various schedules of the translation of those commitments into receipts and cash payouts.

[3] However, accrued outlays should exhibit far less deterioration than the unified budget outlays when the baby boomers retire because the appreciable rise in benefits that is projected to cause spending to balloon after 2010 will have been accrued in earlier years.

constrained by law.[4] Liabilities for Medicare are probably about the same order of magnitude as those for social security, and as is the case for social security, the date is rapidly approaching when those liabilities will be converted into cash outlays.

Accrual-based accounts would lay out more clearly the true costs and benefits of changes to various taxes and outlay programs and facilitate the development of a broad budget strategy. In doing so, these accounts should help shift the national dialogue and consensus toward a more realistic view of the limits of our national resources as we approach the next decade and focus attention on the necessity to make difficult choices from among programs that, on a stand-alone basis, appear very attractive.

Because the baby boomers have not yet started to retire in force and accordingly the ratio of retirees to workers is still relatively low, we are in the midst of a demographic lull. But short of an outsized acceleration of productivity to well beyond the average pace of the past seven years or a major expansion of immigration, the aging of the population now in train will end this state of relative budget tranquility in about a decade's time. It would be wise to address this significant pending adjustment sooner rather than later. As the President's just-released budget put it, "The longer the delay in enacting reforms, the greater the danger, and the more drastic the remedies will have to be."[5]

Accrual-based revenue and outlay projections, tied to a credible set of economic assumptions, tax rates, and programmatic spend-out rates, can provide important evidence on the

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[4] Constraining these outlays by any mechanism other than prices will involve some form of rationing--an approach that in the past has not been popular in the United States.

[5] Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2004*, Washington, D.C.: U.S. Government Printing Office, p. 32.

long-term sustainability of the overall budget and economic regimes under alternative scenarios.[6] Of course, those projections, useful as they might prove to be, would still be subject to enormous uncertainty. The ability of economists to assess the effects of tax and spending programs is hindered by an incomplete understanding of the forces influencing the economy.

It is not surprising, therefore, that much controversy over basic questions surrounds the current debate over budget policy. Do budget deficits and debt significantly affect interest rates and, hence, economic activity? With political constraints on the size of acceptable deficits, do tax cuts ultimately restrain spending increases, and do spending increases limit tax cuts? To what extent do tax increases inhibit investment and economic growth or, by raising national saving, have the opposite effect? And to what extent does government spending raise the growth of GDP, or is its effect offset by a crowding out of private spending?

Substantial efforts are being made to develop analytical tools that, one hopes, will enable us to answer such questions with greater precision than we can now. Much progress has been made in ascertaining the effects of certain policies, but many of the more critical questions remain in dispute.

However, there should be little disagreement about the need to reestablish budget discipline. The events of September 11 have placed demands on our budgetary resources that were unanticipated a few years ago. In addition, with defense outlays having fallen in recent years to their smallest share of GDP since before World War II, the restraint on overall spending from the

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[6] In general, fiscal systems are presumed stable if the ratio of debt in the hands of the public to nominal GDP (a proxy for the revenue base) is itself stable. A rapidly rising ratio of debt to GDP, for example, implies an ever-increasing and possibly accelerating ratio of interest payments to the revenue base. Conversely, once debt has fallen to zero, budget surpluses generally require the accumulation of private assets, an undesirable policy in the judgment of many.

downtrend in military outlays has surely run its course—and likely would have done so even without the tragedy of September 11.

The CBO and the Office of Management and Budget recently released updated budget projections that are sobering. These projections, in conjunction with the looming demographic pressures, underscore the urgency of extending the budget enforcement rules. To be sure, in the end, it is policy, not process, that counts. But the statutory limits on discretionary spending and the so-called PAYGO rules, which were promulgated in the Budget Enforcement Act of 1990 and were backed by a sixty-vote point of order in the Senate, served as useful tools for controlling deficits through much of the 1990s. These rules expired in the House last September and have been partly extended in the Senate only through mid-April.

The Budget Enforcement Act was intended to address the problem of huge unified deficits and was enacted in the context of a major effort to bring the budget under control. In 1990, the possibility that surpluses might emerge within the decade seemed remote indeed. When they unexpectedly arrived, the problem that the budget control measures were designed to address seemed to have been solved. Fiscal discipline became a less pressing priority and was increasingly abandoned.

To make the budget process more effective, some have suggested amending the budget rules to increase their robustness against the designation of certain spending items as "emergency" and hence not subject to the caps. Others have proposed mechanisms, such as statutory triggers and sunsets on legislation, that would allow the Congress to make mid-course corrections more easily if budget projections go off-track—as they invariably will. These ideas are helpful and they could strengthen the basic structure established a decade ago. But, more important, a budget framework

along the lines of the one that provided significant and effective discipline in the past needs, in my judgment, to be reinstated without delay.

I am concerned that, should the enforcement mechanisms governing the budget process not be restored, the resulting lack of clear direction and constructive goals would allow the inbuilt political bias in favor of growing budget deficits to again become entrenched. We are all too aware that government spending programs and tax preferences can be easy to initiate or expand but extraordinarily difficult to trim or shut down once constituencies develop that have a stake in maintaining the status quo.

In the Congress's review of the mechanisms governing the budget process, you may want to reconsider whether the statutory limit on the public debt is a useful device. As a matter of arithmetic, the debt ceiling is either redundant or inconsistent with the paths of revenues and outlays you specify when you legislate a budget.

In addition, a technical correction in the procedure used to tie indexed benefits and individual income tax brackets to changes in "the cost of living" as required by law is long overdue. As you may be aware, the Bureau of Labor Statistics has recently introduced a new price index—the so-called chained CPI. The new index is based on the same underlying data as is the official CPI, but it combines the individual prices in a way that better measures changes in the cost of living. In particular, the chained CPI captures more fully than does the official CPI the way that consumers alter the mix of their expenditures in response to changes in relative prices. Because it appears to offer a more accurate measure of the true cost of living—the statutory intent—the chained CPI would be a more suitable series for the indexation of federal programs. Had such indexing been in place during the past decade, the fiscal 2002 deficit would have been $40 billion smaller, all else being equal.

At the present time, there seems to be a large and growing constituency for holding down the deficit, but I sense less appetite to do what is required to achieve that outcome. Reestablishing budget balance will require discipline on both revenue and spending actions, but restraint on spending may prove the more difficult. Tax cuts are limited by the need for the federal government to fund a basic level of services—for example, national defense. No such binding limits constrain spending. If spending growth were to outpace nominal GDP, maintaining budget balance would necessitate progressively higher tax rates that would eventually inhibit the growth in the revenue base on which those rates are imposed. Deficits, possibly ever widening, would be the inevitable outcome.

Faster economic growth, doubtless, would make deficits far easier to contain. But faster economic growth alone is not likely to be the full solution to currently projected long-term deficits. To be sure, underlying productivity has accelerated considerably in recent years. Nevertheless, to assume that productivity can continue to accelerate to rates well above the current underlying pace would be a stretch, even for our very dynamic economy.[7] So, short of a major increase in immigration, economic growth cannot be safely counted upon to eliminate deficits and the difficult choices that will be required to restore fiscal discipline.

By the same token, in setting budget priorities and policies, attention must be paid to the attendant consequences for the real economy. Achieving budget balance, for example, through actions that hinder economic growth is scarcely a measure of success. We need to develop policies that increase the real resources that will be available to meet our longer-run needs. The greater the resources available—that is, the greater the output of goods and services produced by our

[7] In fact, we will need some further acceleration of productivity just to offset the inevitable decline in net labor force, and associated overall economic, growth as the baby boomers retire.

economy—the easier will be providing real benefits to retirees in coming decades without unduly restraining the consumption of workers.

* * *

These are challenging times for all policymakers. Considerable uncertainties surround the economic outlook, especially in the period immediately ahead. But the economy has shown remarkable resilience in the face of a succession of substantial blows. Critical to our nation's performance over the past few years has been the flexibility exhibited by our market-driven economy and its ability to generate substantial increases in productivity. Going forward, these same characteristics, in concert with sound economic policies, should help to foster a return to vigorous growth of the U.S. economy to the benefit of all our citizens.

PRESS RELEASE – PRESS RELEASE – PRESS RELEASE

HINOJOSA INTRODUCES LEGISLATION TO HELP MEXICAN NATIONALS ACCESS THE U.S. BANKING SYSTEM

For Immediate Release
February 20, 2003

Contact: Israel Rocha
(202) 225-2531

Washington, DC - Congressman Rubén Hinojosa (TX-15) today announced that he had introduced legislation to help Mexican nationals access the U.S. Banking System. H.R. 773, the "21st Century Access to Banking Act" will allow Mexican nationals with specialized identification, otherwise known as ***matricula consulars***, issued by Mexican Consulates to gain access to U.S. financial institutions for the purposes of opening accounts. Hinojosa introduced the legislation on February 13, 2003. Since its introduction, the bill has already garnered the support of 14 cosponsors.

"Opening a bank account is often impossible for Mexican nationals who lack the generally required 2 forms of identification. As a consequence, Mexican nationals are often forced to use expensive check-cashing services to cash payroll checks and wire services to send money to relatives in Mexico. In addition, these same "unbanked" Mexican nationals have had to carry large sums of cash, which has increasingly made them targets of crime," said Hinojosa.

HR 773 will make several key reforms to the U.S. Patriot Act of 2001, legislation introduced to safeguard our U.S. Banking System against terrorism. The key reforms include: **(1)** authorizing U.S. financial institutions to accept matricula consulars as valid identification for the purposes of opening bank accounts; **(2)** bringing unbanked individuals into the U.S. Banking System; and **(3)** allowing for more efficient regulation of currency in the United States.

Background on Matricula Consulars:

The matricula consular is a water-sealed photo identification card issued by the Government of Mexico to Mexican nationals who complete an application form in person at any of the 47 consulate offices of the Government of Mexico within the United States. Applicants must submit a certified copy of a birth certificate, present an official picture ID issued by any Mexican or U.S. authority, and show proof of residence in the consular district by presenting a phone, rent or power bill. The matricula consular contains a serial number, the individual's name, date and place of birth, the United States address of such individual, as well as the card's date of issuance and expiration. Mexican consulate offices in the United States are also developing a telephone verification service that will allow financial institutions and other persons to confirm the authenticity of any matricula consular.

The issuance of matricula consulars began in 1871, and they have been issued for more than 131 years in Mexican consulates around the world. Accepting matricula consular as a form of identification allows Mexican nationals to enter the financial mainstream and provides banks and other financial institutions with a new, fast-growing market.

####

.....
(Original Signature of Member)

108TH CONGRESS
1ST SESSION

H. R. _____

IN THE HOUSE OF REPRESENTATIVES

Mr. HINOJOSA introduced the following bill; which was referred to the Committee on _____

A BILL

To amend section 5318 of title 31, United States Code, to authorize financial institutions to accept matricula consular issued in the United States as a valid form of identification.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "21st Century Access to Banking Act".

1 **SEC. 2. FINDINGS.**

2 The Congress finds the following:

3 (1) As financial institutions more carefully
4 scrutinize identifying documents presented by for-
5 eign nationals seeking to open new accounts, they
6 are increasingly accepting the matricula consular as
7 the primary form of identification for Mexican citi-
8 zens residing in the United States.

9 (2) The matricula consular is a water-sealed
10 photo identification card issued by the Government
11 of Mexico to Mexican nationals who—

12 (A) complete an application form in person
13 at any of the 47 consulate offices of the Gov-
14 ernment of Mexico within the United States;
15 and

16 (B) submit a certified copy of a birth cer-
17 tificate, present an official picture ID issued by
18 any Mexican or U.S. authority, and show proof
19 of residence in the consular district by pre-
20 senting a phone, rent, or power bill.

21 (3) The card known as the matricula consular
22 contains a serial number, the individual's name, date
23 and place of birth, the United States address of such
24 individual, as well as the card's date of issuance and
25 expiration.

1 (4) Mexican consulate offices in the United
2 States are also developing a telephone verification
3 service that will allow financial institutions and
4 other persons to confirm the authenticity of any
5 matricula consular.
6 (5) Accepting matricula consular as a form of
7 identification allows Mexican immigrants to enter
8 the financial mainstream and provides banks and
9 other financial institutions with a new, fast-growing
10 market.
11 (6) Opening a bank account is often impossible
12 for Mexican nationals who lack the generally re-
13 quired 2 forms of identification and as a con-
14 sequence, they often use expensive check-cashing
15 services to cash payroll checks and wire services to
16 send money to relatives in Mexico and carry large
17 sums of cash, which has increasingly made them tar-
18 gets of crime.
19 (7) Institutions located in areas with large His-
20 panic populations have established a variety of pro-
21 grams to meet the needs of this growing segment of
22 the population, including the maintenance of bilin-
23 gual automated teller machines, the employment of
24 bilingual staff, and the establishment of loan pack-

1 ages and business banking services geared to His-
2 panic businesses.
3 (8) The acceptance of the matricula consular
4 issued by consulates of the Government of Mexico as
5 a form of identification is consistent with the pro-
6 posed customer identification verification regulations
7 prescribed under section 5318(l) of title 31, United
8 States Code.

9 **SEC. 3. ACCEPTANCE OF MATRICULA CONSULAR FOR IDEN-**
10 **TIFICATION AND VERIFICATION OF CUS-**
11 **TOMERS WHO OPEN ACCOUNTS AT FINAN-**
12 **CIAL INSTITUTIONS.**

13 (a) IN GENERAL.—Paragraph (6) of section 5318(l)
14 of title 31, United States Code, is amended to read as
15 follows:
16 "(6) MATRICULA CONSULAR.—Subject to regu-
17 lations prescribed under this subsection, a matricula
18 consular issued in the United States by a duly au-
19 thorized consular officer of the Government of Mex-
20 ico shall be a valid form of identification of the indi-
21 vidual to whom the card is issued for purposes of
22 this subsection.".
23 (b) EFFECTIVE DATE OF REGULATIONS.—The Sec-
24 retary of the Treasury shall prescribe such regulations in
25 final form as may be necessary to give effect to the amend-

1 ment made by subsection (a) before the end of the 90-
2 day period beginning on the date of the enactment of this
3 Act.

.California Reinvestment Committee

Who Really Gets Home Loans? Year Nine

(Executive Summary)

Prepared by: Kevin Stein
Associate Director
California Reinvestment Committee
2002

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Executive Summary

Who Really Gets Home Loans? Year Nine investigates whether California's largest banks and mortgage companies are meeting the single-family home loan needs of the state's traditionally underserved residents. This report looks at whether banks are able to meet the demand for home purchase loans in California, and explores the relationship between race and the cost of credit.

In analyzing home lending patterns for the state's top lenders, the California Reinvestment Committee ("CRC") finds that three key trends emerge:

1. **There is Unequal Access to Prime Home Purchase Loans**
2. **People of Color Pay More for Home Loans**
3. **A Two Tier System of Credit Exists Within Larger Financial Institutions**

Key Findings

The California Reinvestment Committee analyzed 2001 Home Mortgage Disclosure Act (HMDA) data for the most active California banks and bank-affiliated mortgage lenders, looking at lending patterns in Los Angeles, Oakland, Sacramento, San Diego, and Fresno. The results show that African American and Latino households are less likely to obtain prime home purchase loans; pay more for their home purchase, home improvement and refinance home loans; and often don't get the most appropriately priced loan products from financial corporations that own BOTH prime AND subprime lenders.

Prime lending refers to lending geared to borrowers with good credit profiles, usually with lower interest rates and costs. Subprime lending refers to lending that is said to be targeted to credit impaired borrowers and which often includes higher interest rates, up front loan costs, and fees.

1. Unequal Access to Prime Home Purchase Loans

First, CRC analyzed patterns of home purchase lending to African American and Latino households by each the fifteen largest bank and bank-affiliated prime lenders in the state. Lender performance was evaluated against CRC's Equality Benchmark. The Equality Benchmark compares home loan activity to the proportion of African American and Latino households in each of the five cities reviewed. Lenders earned Equality Benchmark points for taking applications from or originating home purchase loans to African American and Latino households in percentages that equal or exceed the proportion of these groups in each of the five cities surveyed.

Analysis of home lending patterns in the year 2001 shows that major bank lenders are doing a poor job of serving African American and Latino households in California:

- **1/3 Lenders Earned No Equality Benchmark Points.** Five of the most active fifteen prime lenders surveyed received no (0) points in the Equality Benchmark analysis, out of a possible twenty (20) points. These five institutions failed to achieve the Equality Benchmark for applications taken from, and originations to, African American and Latino

borrowers in all five cities. These failing lenders are: Citibank, Countrywide Home Loans, Union Bank, United California Bank, and Bank of the West.

- **Fresno, San Diego and Los Angeles Experience Greatest Inequities.** Lending inequities were greatest in Fresno and San Diego under the Equality Benchmark analysis. Lenders there met or exceeded the benchmark only 10% of the time, earning six (6) points out of a possible sixty (60) points available in each city. Disparities were only slightly better in Los Angeles, where lenders met the benchmark 11.7% of the time, earning only seven (7) Equality Benchmark points. Major bank lenders are not conducting adequate outreach to the African American and Latino communities in any of these cities.

- **African Americans Continue to Face the Greatest Barriers.** Bank lender failure was most striking in regard to serving African American home loan applicants. In all five cities combined, the most active fifteen bank and bank-affiliated prime lenders together scored a mere four (4) points out of a possible one hundred fifty (150) under the Equality Benchmark analysis. No lender met the Equality Benchmark for outreach or lending to African Americans in Sacramento or San Diego. African American loan seekers in California continue to have the greatest difficulty accessing credit.

2. African American and Latino Borrowers Pay More for Home Loans

A new dimension has been added to the battle for equal access to credit in California. For years, communities of color struggled to access loans to buy homes. Now, traditionally underserved communities in California are also being flooded with loan opportunities, but it is high cost, subprime credit which they can ill afford and often do not deserve based on their credit profiles. As subprime lending disproportionately impacts borrowers and communities of color, the California Reinvestment Committee views this as a civil rights, fair lending, and economic justice issue. The amount paid for a loan should not vary depending on where you live or what you look like.

CRC looked at the aggregate home lending of the fifteen largest bank lenders and compared it to that of the largest fifteen subprime lenders in the state. The disparities in lending demonstrate that banks are failing to adequately serve African American and Latino households in California in comparison to their higher cost subprime lending peers.

- **African Americans Not Served by Prime Lenders.** Subprime lenders were twice as likely to accept a home loan application from African American applicants as the most active prime lenders in all five of the survey cities. For example, in the city of Los Angeles, the most active subprime lenders took in 16.9% of their home loan applications from African Americans, compared to 6.2% for the most active prime lenders. If applications from certain groups are low, it is because lender outreach efforts and focus on these groups is minimal. The same held true for originations – the most active subprime lenders in Los Angeles made 12.7% of their loans to African Americans, compared to 5.5% of loans from the most active prime lenders going to African Americans. In contrast, whites represented 62.6% of prime loan originations in LA.

- **Latinos Not Served by Prime Lenders**. Subprime lenders took a greater percentage of applications, and made a greater percentage of home loans to Latino borrowers than did their prime counterparts in four of the survey cities: Los Angeles, Sacramento, San Diego, and Fresno. In Sacramento, for example, subprime lenders saw 23.3% of applications and 27.9% of all home loans go to Latino households, as compared to 15.7% and 15% for bank and bank affiliated lenders. In contrast, whites represented 54.8% of prime loan applications and 57.5% of prime loans originated in Sacramento.

3. A Two Tier System of Credit Exists *Within* Financial Corporations

Finally, CRC examined the lending records of large financial corporations that own, or will own, BOTH a low cost prime lender AND a high cost subprime lender. Three of the country's largest banks offer sub-prime mortgages through an affiliated company. These banks are: Citibank, National City, and Washington Mutual. Additionally, mortgage companies Countrywide Home Loans and H&R Block Mortgage offer subprime loans both through the mortgage company and through their subprime affiliates, Full Spectrum Lending and Option One, respectively. Finally, HSBC is purchasing major subprime lender Household International. Each of these larger institutions must develop more responsible lending practices and ensure that home loan applicants get the best loan product for which they qualify.

CRC analyzed the lending patterns of these companies and found that a two tier system of credit exists *within* large financial services corporations, with the banks and prime lenders available to serve white borrowers, and the subprime mortgage companies serving African Americans and Latinos.

- **Prime Affiliates Not Serving People of Color**. In each of the five cities surveyed, subprime affiliates took in a greater percentage of applications from, and originated a greater percentage of loans to, their African American and Latino customers than did their bank affiliated prime lenders. Often, the disparities were large. In Fresno, 42% of these subprime home loan applications were from Latino households, compared to 23.6% of the home loan applications of their prime affiliate lenders. In San Diego, these subprime lenders made 9.7% of all home loans to African American borrowers, while their six prime lending affiliates made only 2.8% of home loans to African American borrowers.

- **2 Tier Lending: Citibank and Citimortgage/Citifinancial and Travelers Bank and Trust**. In four out of five of the survey cities - Los Angeles, Sacramento, San Diego and Fresno – Citigroup's subprime subsidiaries reached more African American and Latino Californians than their lower cost prime lending counterparts. In Los Angeles, for example, Citibank made 4.1% of its loans to African Americans, 10.2% to Latinos, and 62.1% to whites; while subprime lender Travelers Bank and Trust, FSB made 7.5% of its loans to African Americans, a striking 59.8% to Latinos, and only 15.8% to whites.

- **2 Tier Lending: H&R Block/Option One**. In each of the five cities, subprime lender Option One Mortgage had a much larger share of the African American and Latino

market than did its prime lending affiliate, H&R Block Mortgage. Option One is seeking a thrift charter, yet many of its borrowers in California may be getting higher cost subprime credit than they deserve because Option One does not refer qualified home loan applicants to H&R Block for lower cost mortgage products.

- **2 Tier Lending: HSBC/Household.** In each of the five cities, Household International and its subprime lending subsidiaries are reaching more African American and Latino Californians than is HSBC. HSBC, a major mortgage lender in California with no significant branch presence, is purchasing the troubled and alleged predatory lender, Household.

Recommendations

In light of these disturbing findings, CRC recommends the following:

- **Meet the Equality Benchmark.** Financial institutions must set serious lending goals to ensure that lending performance mirrors the racial and income demographics of this diverse state. Specifically, applications from and loans to African American and Latino households should approximate the proportion of these households in California's communities. Washington Mutual, for example, was one of the largest lenders in the state, yet it was only able to secure a score of one (1) point out of a possible twenty (20) points achievable, under the Equality Benchmark analysis.

- **Strengthen outreach and marketing.** Prime lending banks and mortgage companies must focus outreach and marketing efforts on people and neighborhoods of color. Research suggests that higher cost loans are often made through the use of aggressive marketing tactics by subprime lenders and brokers. Bank lenders need to do a better job of competing with subprime lenders by making their low cost prime products accessible to underserved communities. Regulators do not, but must begin to, examine the marketing efforts of prime lenders and their subprime affiliates to make sure that communities of color are not targeted for higher cost products. Heightened regulatory scrutiny is especially needed with a corporation such as Wells Fargo Home Mortgage which hides its substantial subprime lending activities by reporting these loans together with its prime loans, so the public cannot distinguish one from the other.

- **Expand branch presence.** Meaningful access to low cost products depends on branch access and presence. Financial institutions must open full service branches in underserved neighborhoods if they are serious about expanding their market share in emerging communities. HSBC has four branches serving upper income clients in California, while at the same time it proposes to purchase and retain 177 Household Finance and Beneficial branches that will offer higher cost products to California's diverse population. In CRC's experience, banks can best reach new markets and communities by being part of them.

- **Offer best loan products.** Financial institutions must make their best and lowest cost loan products available to all qualified applicants through all lending channels, including the bank, prime lending unit, or subprime affiliate. What a borrower looks like or where she lives still determines whether she will get a loan, and how much it will cost her. An African American loan seeker with excellent credit should not have to pay more for a loan because the only lenders located and marketing in her neighborhood are subprime. This is a fair lending issue. Citigroup recently acknowledged that over 17,000 of its subprime borrowers could qualify for a prime loan, yet Citigroup has failed in its efforts to get these customers into the lower cost loans that they deserve. Such borrowers, often people of color, are paying too much for their home loans. Citigroup and other large corporations with both prime and subprime lenders profit while their customers pay more.

- **Community Reinvestment Act (CRA) beyond bank branches.** CRC notes two related and disturbing trends: banks purchasing subprime lenders, and corporations seeking bank charters as a tool to support their prime and subprime mortgage efforts. In both cases, the result is a merging of bank and non bank activities with no corresponding expansion of community reinvestment obligations. Financial institutions should not be allowed to play corporate games that enable them to circumvent the CRA, making profits nationally but investing only in one community.

  For example, Countrywide Home Loans is one of the largest lenders nationally, yet has no CRA responsibilities. Its parent, Countrywide Credit Industries, owns Treasury Bank in Virginia. Treasury Bank recently opened four "branches" in the San Fernando Valley. Countrywide maintains that these branches, complete with "Countrywide Bank" signs, bank staff, and assistance in opening bank accounts, are not branches and therefore Countrywide has no CRA responsibility beyond its one Treasury Bank office in Virginia.

  Similarly, Option One, a huge subprime lender which does significant business nationally, is seeking a savings and loan charter through its H&R Block affiliate. Block, which engages in problematic Tax Refund Anticipation Loans, has no real CRA plan other than its subprime lending through Option One. Block proposes also to limit its CRA activities, such as they are, to one lone assessment area where its one branch will sit. Such institutions are feeding off communities, while failing to reinvest deposits and profits back into these neighborhoods.

ALAN G. HEVESI
COMPTROLLER

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ALBANY, NEW YORK 12236

STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

January 14, 2003

Honorable Carolyn Maloney
2331 Rayburn House Office Bldg.
Washington DC 20515-3214

Dear ~~Congresswoman Ma~~loney:

I am writing to inform you about the impact on New York State and New York City of President Bush's proposal to eliminate taxes on most corporate dividends. According to an analysis done by my Office, the proposal will reduce State tax revenues and increase State borrowing costs by $551 million in 2003, $2.55 billion over the next four years and $9 billion over the next 10 years. The impact on New York City will be $160 million in 2003, $841 million over the next four years and $3.3 billion over the next 10 years. And the City of Yonkers will lose $230,000 in 2003, $1 million over the next four years and $2.9 million over the next 10 years.

This comes at a time when New York State and its local governments already face huge budget gaps. A representative of Governor Pataki recently told the *New York Times* that the State faces a gap of as much as $2.5 billion for the year ending March 31 and another $10 billion for the following fiscal year. My Office estimates that New York City could face a gap of more than $3 billion for next year.

New York is not alone in being injured by the President's proposal. Forty-one of the 50 states will lose an estimated $4.5 billion in tax revenues in the first year alone, according to the Center for Budget and Policy Priorities. This comes at a time when States are facing budget gaps totaling between $60 billion and $85 billion for next year.

We had hoped that the federal government would come to the aid of the states, and especially New York, which has been hurt by the combined impact of a national economic recession and the 9/11 attack. Instead, the President's plan would add to the already serious state and local fiscal crisis.

I urge the members of the New York Congressional delegation of all parties to join with Senators and Representatives from around the country to see that no state or city is injured by this proposal. If a personal income tax cut is agreed to at the federal level, we urge you to insist it take a form that does not automatically damage State finances.

Please feel free to contact me or Val Grey, of my staff, at 518-473-4333 if you have any questions about our analysis or need further data.

Sincerely,

Alan G. Hevesi

AGH:DN:eje

For use at 10:00 a.m., EST
Tuesday
February 11, 2003

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

February 11, 2003

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 11, 2003

Letter of Transmittal

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
Washington, D.C.
February 11, 2003

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

Contents

	Page
Monetary Policy and the Economic Outlook	1
Economic and Financial Developments in 2002 and Early 2003	5

Monetary Policy Report to the Congress

Report submitted to the Congress on February 11, 2003, pursuant to section 2B of the Federal Reserve Act

Monetary Policy and the Economic Outlook

The economy of the United States has suffered a series of blows in the past few years, including the fall in equity market values that began in 2000, cutbacks in capital spending in 2001, the horrific terrorist attacks of September 11, the emergence of disturbing evidence of corporate malfeasance, and an escalation of geopolitical risks. Despite these adversities, the nation's economy emerged from its downturn in 2001 to post moderate economic growth last year. The recovery was supported by accommodative monetary and fiscal policies and undergirded by unusually rapid productivity growth that boosted household incomes and held down business costs. The productivity performance was also associated with a rapid expansion of the economy's potential, and economic slack increased over the year despite the growth in aggregate demand.

After turning up in late 2001, activity began to strengthen more noticeably early last year. Sharp inventory cutbacks in 2001 had brought stocks into better alignment with gradually rising final sales, and firms began to increase production in the first quarter of 2002 to curtail further inventory runoffs. Moreover, businesses slowed their contraction of investment spending and began to increase outlays for some types of capital equipment. Household spending on both personal consumption items and housing remained solid and was supported by another installment of tax reductions, widespread price discounting, and low mortgage interest rates. By midyear, the cutbacks in employment came to an end, and private payrolls started to edge higher.

Although economic performance appeared to be gradually improving, the tentative nature of this improvement warranted the continuation of a highly accommodative stance of monetary policy. Accordingly, the Federal Open Market Committee (FOMC) held the federal funds rate at 1¾ percent through the first part of the year. In March, however, the FOMC shifted from an assessment that the risks over the foreseeable future to its goals of maximum sustainable growth and price stability were tilted toward economic weakness to an assessment that the risks were balanced.

Around midyear, the economy began to struggle again. Concerns about corporate governance came to weigh heavily on investors' confidence, and geopolitical tensions, especially the situation in Iraq, elevated uncertainties about the future economic climate. Equity prices fell during the summer, liquidity eroded in corporate debt markets, and risk spreads widened. Businesses once again became hesitant to spend and to hire, and both manufacturing output and private payrolls began to decline. State and local governments struggled to cope with deteriorating fiscal positions, and the economies of some of our major trading partners remained weak. Although the already accommodative stance of monetary policy and strong upward trend of productivity were providing important support to spending, the Committee perceived a risk that the near-term weakening could become entrenched. In August, the FOMC adjusted its weighting of risks toward economic weakness, and in November, it reduced the targeted federal funds rate 50 basis points, to 1¼ percent. The policy easing allowed the Committee to return to an assessment that the risks to its goals were balanced. With inflation expectations well contained, this additional monetary stimulus seemed to offer worthwhile insurance against the threat of persistent economic weakness and substantial declines in inflation from already low levels.

On net, the economy remained sluggish at the end of 2002 and early this year. The household sector continued to be a solid source of demand. Motor vehicle sales surged at year-end on the tide of another round of aggressive discounting by the manufacturers, other consumer outlays trended higher, and activity in housing markets remained exceptionally strong. Concerns about corporate governance appeared to recede somewhat late last year, in part because no new revelations of major wrongdoing had emerged. However, the ongoing situation in Iraq, civil strife in Venezuela that has curtailed oil production, and tensions on the Korean peninsula have sustained investors' uncertainty about economic prospects and have pushed prices higher on world oil markets. Faced with this uncertainty, businesses have been cautious in spending and changed payrolls little, on net, over December and January.

Mindful of the especially high degree of uncertainty attending the economic outlook in the current geopolitical environment, the members of the FOMC believe the most likely outcome to be that fundamentals will support

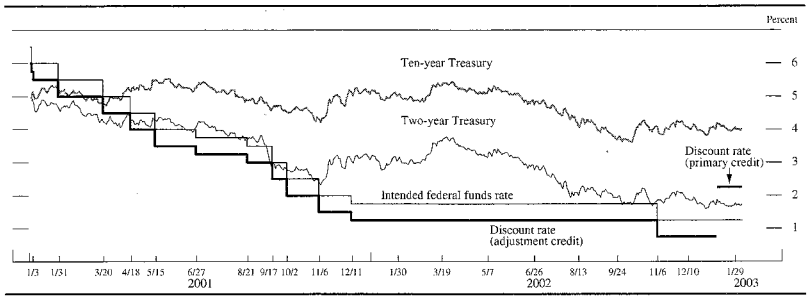
a strengthening of economic growth. Business caution is anticipated to give way over the course of the year to clearer signs of improving sales. Inventories are lean relative to sales at present, and restocking is likely to provide an additional impetus to production in the period ahead. The rapid expansion of productivity, the waning effects of earlier declines in household wealth, and the highly accommodative stance of monetary policy should also continue to boost activity. Although state and local governments face budgetary problems, their restraint is likely to offset only a part of the stimulus from past and prospective fiscal policy actions at the federal level. In addition, the strengthening economies of our major trading partners along with the improving competitiveness of U.S. products ought to support demand for our exports. Taken together, these factors are expected to lead to a faster pace of economic expansion, while inflation pressures are anticipated to remain well contained.

Monetary Policy, Financial Markets, and the Economy over 2002 and Early 2003

As economic growth picked up during the early months of 2002, the FOMC maintained its target for the federal funds rate at 1¾ percent. A sharply reduced pace of inventory liquidation accounted for a significant portion of the step-up in real GDP growth, but other indicators also suggested that the economy was gaining momentum. Reductions in business outlays on equipment and software had moderated significantly after dropping precipitously in 2001, and consumer spending was well maintained by sizable gains in real disposable personal income. Residential construction activity was spurred by low home mortgage interest rates. The improvement in economic conditions sparked a rally in equity markets late in the first quarter and pushed up yields on longer-term Treasury instruments and investment-grade corporate bonds; yields on speculative-grade bonds declined in reaction to brighter economic prospects and the perceived reduction in credit risk. Meanwhile, surging energy prices exerted upward pressure on overall inflation, but still-appreciable slack in resource utilization and a strong upward trend in private-sector productivity were holding down core price inflation.

At both its March and May meetings, the FOMC noted that the apparent vigor of the economy was importantly attributable to a slowdown in the pace of inventory liquidation and that considerable uncertainty surrounded the outlook for final sales over the next several quarters. The Committee was especially concerned about prospects for a rebound in business fixed investment, which it viewed as key to ensuring sustainable economic expansion. Although the decline in investment spending during the first quarter of 2002 was the smallest in a year, gloomy business sentiment and large margins of excess capacity in numerous industries were likely to hamper capital expenditures. According to anecdotal reports, many firms were unwilling to expand capacity until they saw more conclusive evidence of growing sales and profits. At the same time, however, the FOMC noted that, with the federal funds rate unusually low on an inflation-adjusted basis and considerable fiscal stimulus in train, macroeconomic policies would provide strong support to further economic expansion. Against this backdrop, the Committee at the March 19 meeting judged the accommodative stance of monetary policy to be appropriate and announced that it considered the risks to achieving its long-run objectives as being balanced over the foreseeable future, judgments it retained at its meeting in early May.

Selected interest rates



NOTE. The data are daily and extend through February 5, 2003. The dates on the horizontal axis are those of scheduled FOMC meetings and of any intermeeting policy actions. On January 9, 2003, the Federal Reserve changed the main credit program offered at the discount window by terminating the adjustment credit program and beginning the primary credit program.

The information reviewed at the June 25–26 FOMC meeting confirmed that the economy was expanding but at a slower pace than earlier in the year. As expected, the degree of impetus to economic activity from decelerating inventory liquidation had moderated. Residential investment and consumer spending also had slowed appreciably after surging earlier in the year. The most recent data on orders and shipments suggested a small upturn in business spending on equipment and software, but the improvement in capital spending appeared to be limited, unevenly distributed across industries, and not yet firmly indicative of sustained advance. Industrial production continued to increase, and the unemployment rate declined somewhat.

In financial markets, investors and lenders had apparently become more risk averse in reaction to the mixed tone of economic data releases, growing geopolitical tensions, further warnings about terrorist attacks, and additional revelations of dubious corporate accounting practices. In concert, these developments pushed down yields on longer-term Treasury securities, while interest rates on lower-quality corporate bonds rose notably, and equity prices dropped sharply. Although the economy continued to expand and the prospects for accelerating aggregate demand remained favorable, downbeat business sentiment and skittish financial markets rendered the timing and extent of the expected strengthening of the expansion subject to considerable uncertainty. In these circumstances, the FOMC left the federal funds rate unchanged to keep monetary policy very accommodative and once again assessed the risks to the outlook as being balanced.

By the time of the August 13 FOMC meeting, it had become apparent that economic activity had lost some of its earlier momentum. Turbulence in financial markets appeared to be holding back the pace of the economic expansion. Market participants focused their attention on the lack of convincing evidence that the recovery was gaining traction and the possibility that more news of corporate misdeeds would surface in the run-up to the Securities and Exchange Commission's August 14 deadline for the certification of financial statements by corporate executives. Although the cumulative losses in financial wealth since 2000 were restraining expenditures by households, very low mortgage interest rates were helping to sustain robust demand for housing. Moreover, the financial resources made available by a rapid pace of mortgage refinancing activity, in combination with attractive incentives offered by auto manufacturers, supported other consumer spending. The Committee continued to judge the prevailing degree of monetary accommodation as appropriate to foster a solid expansion that would bring the economy to fuller resource utilization. At the same time, the Committee recognized the considerable risks to that outlook and the potential adverse consequences for economic prospects from possible additional deterioration of financial conditions. The members noted, however, that a further easing of monetary policy, if it came to be viewed as appropriate, could be accomplished in a timely manner. In light of these considerations, the FOMC opted to retain a target rate of 1¾ percent for the federal funds rate, but it viewed the risks to the economy as having shifted from balanced to being tilted toward economic weakness.

When the FOMC met on September 24, data indicated that economic growth had picked up in the third quarter, on average, buoyed in part by a surge in motor vehicle production. The uneventful passing of the mid-August deadline for recertification of corporate financial statements briefly alleviated investors' skittishness in debt and equity markets. However, the most timely information suggested that some softening in economic activity had occurred late in the summer. Those economic reports, along with a darker outlook for corporate profits and escalating fears of a possible war against Iraq, led market participants to revise down their expectations for the economy. Equity prices and yields on both longer-term Treasury and private securities moved sharply lower in early autumn. In the Committee's view, heightened geopolitical tensions constituted a significant additional source of uncertainty clouding the economic outlook. Still, fundamentals suggested reasonable prospects for continued expansion. Accordingly, the FOMC left the federal funds rate unchanged at the close of the September meeting but also reiterated its view that the risks to the outlook were weighted toward economic weakness.

The information reviewed at the November 6 meeting indicated a more persistent spell of below-par economic performance than the FOMC had anticipated earlier. With home mortgage rates at very low levels, residential construction activity remained high. But consumer spending had decelerated noticeably since midsummer under the combined weight of stagnant employment and declining household wealth resulting from further decreases in equity prices. Worries about the potential for war against Iraq, as well as persistent concerns about the course of economic activity and corporate earnings, were apparently engendering a high degree of risk aversion among business executives that was constraining capital spending and hiring. Despite a weakening in the exchange value of the dollar, sluggish economic growth among major trading partners spelled difficulties for U.S. exports, and a rebound in foreign output seemed more likely to follow than to lead a rebound at home. Moreover, economic slack that was larger and more persistent than previously anticipated ran the risk of reducing core inflation appreciably further from already low levels. Given these considerations, the Committee lowered its target for the fed-

eral funds rate 1/2 percentage point, to 1 1/4 percent. The relatively aggressive adjustment in the stance of monetary policy was deemed to offset the potential for greater economic weakness, and the Committee accordingly announced that it judged risks to the outlook as balanced with respect to its long-run goals of price stability and sustainable economic growth.

When the FOMC met on December 10, overall conditions in financial markets had calmed considerably. Indicators of production and spending, however, remained mixed. The manufacturing sector registered large job losses in the autumn, and industrial production continued its slide, which had begun around midyear. A more vigorous rebound in business fixed investment was not evident, and indeed the recent data on orders and shipments and anecdotal reports from business contacts generally signaled continued softness in capital spending. Very low home mortgage interest rates were supporting residential construction activity, but consumption expenditures were sluggish. On balance, the Committee's view was that in the absence of major shocks to consumer and business confidence, a gradual strengthening of the economic expansion was likely over the coming quarters, especially given the very accommodative stance of monetary policy and probable further fiscal stimulus. The FOMC left the federal funds rate unchanged and indicated that it continued to view the risks to the outlook as balanced over the foreseeable future.

By the time of the FOMC meeting on January 28–29, 2003, it had become apparent that the economy had grown only slowly in the fourth quarter of last year, but little evidence of cumulating weakness appeared in the most recent data, and final demand had held up reasonably well. The escalation of global tensions weighed heavily on business and investor sentiment. Firms apparently were remaining very cautious in their hiring and capital spending, and equity prices had declined on balance since the December meeting. But yield spreads on corporate debt—especially for riskier credits—narrowed further, and longer-term Treasury yields declined slightly. Although the fundamentals still pointed to favorable prospects for economic growth beyond the near term, geopolitical developments were making it especially difficult to gauge the underlying strength of the economy, and uncertainties about the economic outlook remained substantial. Against this background, the Committee decided to leave the federal funds rate unchanged and stated that it continued to judge the risks to the outlook as balanced.

Economic Projections for 2003

An unusual degree of uncertainty attends the economic outlook at present, in large measure, but not exclusively, because of potential geopolitical developments. But Federal Reserve policymakers believe the most probable outcome for this year to be a pickup in the pace of economic expansion. The central tendency of the real GDP forecasts made by the members of the Board of Governors and the Federal Reserve Bank presidents is 3 1/4 percent to 3 1/2 percent, measured as the change between the final quarter of 2002 and the final quarter of this year. The full range of these forecasts is 3 percent to 3 3/4 percent. Of course, neither the central tendency nor the range is intended to convey the uncertainties surrounding the individual forecasts of the members. The civilian unemployment rate is expected to end the year in the 5 3/4 percent to 6 percent range.

Apart from the geopolitical and other uncertainties, the forces affecting demand this year appear, on balance, conducive to a strengthening of the economic expansion. Monetary policy remains highly accommodative, and federal fiscal policy is and likely will be stimulative. However, spending by many state and local governments will continue to be restrained by considerable budget difficulties. Activity abroad is expected to improve this year, even if at a less robust pace than in the United States; such growth together with the improving competitiveness of U.S. products should generate stronger demand for our exports. Furthermore, robust gains in productivity, though unlikely to be as large as in 2002, ought to continue to promote both household and business spending. Household purchasing power should be supported as well by a retreat in the price of imported energy products that is suggested by the oil futures market. And the adverse effects on household spending from past declines in equity wealth probably will begin to wane.

A reduction of businesses' hesitancy to expand investment and hiring is critical to the durability of the expansion, and such a reduction should occur gradually if geopolitical risks ease and profitability improves. Inventories are relatively lean, and some restocking ought to help boost production this year, albeit to a much smaller extent than did last year's cessation of sharp inventory

Economic projections for 2003

Percent

Indicator	Memo 2002 actual	Federal Reserve Governors and Reserve Bank presidents	
		Range	Central tendency
Change, fourth quarter to fourth quarter[1]			
Nominal GDP	4.1	4 1/2–5 1/2	4 3/4–5
Real GDP	2.8	3–3 3/4	3 1/4–3 1/2
PCE chain-type price index	1.9	1 1/4–1 3/4	1 1/4–1 1/2
Average level, fourth quarter			
Civilian unemployment rate	5.9	5 3/4–6	5 3/4–6

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

liquidations. In addition, the continued growth of final sales, the tax law provision for partial expensing of equipment purchases, replacement demand, and a more hospitable financial environment should induce many firms to increase their capital spending. The growth of investment likely will be tempered, however, by the persistence of excess capital in some areas, notably the telecommunications sector, and reductions in business spending on many types of new structures may continue this year.

Federal Reserve policymakers believe that consumer prices will increase less this year than in 2002, especially if energy prices partly reverse last year's sharp rise. In addition, resource utilization likely will remain sufficiently slack to exert further downward pressure on underlying inflation. The central tendency of FOMC members' projections for increases in the chain-type price index for personal consumption expenditures (PCE) is 1¼ percent to 1½ percent this year, lower than the actual increase of about 2 percent in 2002.

Economic and Financial Developments in 2002 and Early 2003

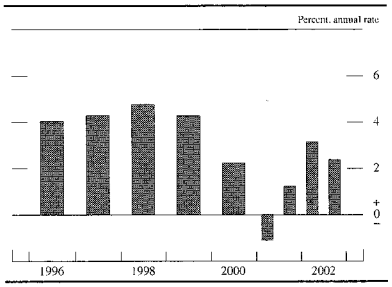
In 2002, the United States economy extended the upturn in activity that began in late 2001. Real GDP increased 2¾ percent over the four quarters of last year, according to the advance estimate from the Commerce Department. However, the pace of activity was uneven over the course of the year, as concerns about emerging economic and political developments at times weighed heavily on an economy already adjusting to a succession of shocks from previous years.

Economic conditions improved through the first part of the year. Household spending on both personal consumption items and housing remained solid, businesses curtailed their inventory liquidation and began to increase their outlays for some types of capital equipment, and private employment started to edge higher. But the forward momentum diminished noticeably later in the year when concerns about corporate governance put a damper on financial markets and geopolitical developments boosted oil prices and added to the uncertainty already faced by businesses about the economic outlook. In the summer, equity prices fell, risk spreads widened, and liquidity eroded in corporate debt markets. Businesses' caution was reflected in their reluctance to substantially boost investment, restock inventories, or add to payrolls. Responding to these developments, as well as some weakening in demand from abroad, manufacturers trimmed production during the fall. Employment at private businesses declined again, and the unemployment rate rose to 6 percent in December. However, despite the modest pace of last year's overall recovery, output per hour in the nonfarm business sector grew 3¾ percent over the year—an extraordinary increase even by the standards of the past half decade or so.

Signals on the trajectory of the economy as we enter 2003 remain mixed. Some of the factors that had noticeably restrained the growth of real GDP in the fourth quarter of last year—most especially a sharp decline in motor vehicle production—are not on track to be repeated. Moreover, employment leveled off on average in December and Janaury, and readings on industrial production have had a somewhat firmer tone of late. Nevertheless, the few data in hand suggest that the economy has not yet broken out of the pattern of subpar performance experienced over the past year.

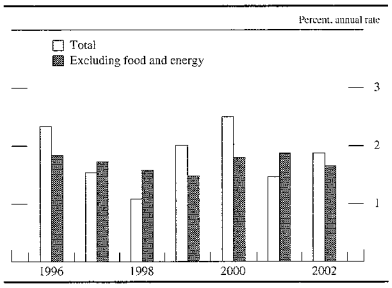
Consumer price inflation moved up a bit last year, reflecting sharply higher energy prices. Excluding the prices of food and energy items, the price index for per-

Change in real GDP



NOTE. Here and in subsequent charts, except as noted, annual changes are measured from Q4 to Q4, and change for a half-year is measured between its final quarter and the final quarter of the preceding period.

Change in PCE chain-type price index



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

sonal consumption expenditures increased 1¾ percent, about ¼ percentage point less than in 2001; this deceleration most likely resulted from continued slack in labor and product markets, robust gains in productivity, and somewhat lower expectations of future inflation.

The Household Sector

Consumer Spending

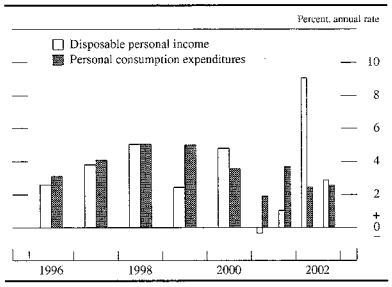
Consumer spending grew at a moderate pace last year and, on the whole, continued to be an important source of support for overall demand. Personal consumption expenditures rose 2½ percent in real terms, near the 2¾ percent increase in 2001 and down from the more than 4 percent average growth over the preceding several years. Sales of new motor vehicles fell only a little from the extremely high levels of late 2001; outlays were especially strong during the summer and late in the year, when manufacturers were offering aggressive price and financing incentives. Growth of spending on other durable goods was well maintained last year as well, although the gains were smaller than is often seen early in an economic recovery; in contrast to the situation in many previous cycles, spending on durable goods did not decline sharply during the recession and so had less cause to rebound as the recovery got under way. Apart from outlays on durable goods, spending for most categories of consumer goods and services increased at a moderate rate last year.

That moderate rate of aggregate consumption growth was the product of various crosscurrents. On the positive side, real disposable personal income rose nearly 6 percent last year, the fastest increase in many years. Strong productivity growth partially offset the effects of stagnant employment in restricting the growth of household income, and the phase-in of additional tax reductions from the Economic Growth and Tax Relief Reconciliation Act of 2001 boosted household purchasing power appreciably. In addition, high levels of mortgage refinancing allowed homeowners to reduce their monthly payments, pay down more costly consumer credit, and, in many cases, extract equity that could be used to support other spending. On the negative side, household wealth again moved lower last year, as continued reductions in equity values outweighed further appreciation of house prices. By the end of the third quarter, according to the Federal Reserve's flow-of-funds accounts, the ratio of household net worth to disposable income had reversed nearly all of its run-up since the mid-1990s.

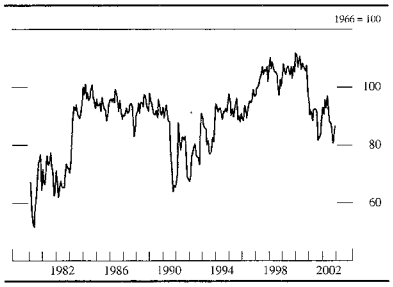
Consumer confidence, which had declined during most of 2001 and especially after the September 11 attacks, picked up in the first half of last year, according to both the Michigan Survey Research Center (SRC) and Conference Board surveys. However, confidence retreated over the summer along with the drop in equity prices, and by early this year, consumer confidence again stood close to the levels of late 2001. These levels of consumer confidence, though at the bottom of readings of the past several years, are nevertheless above levels normally associated with recession.

The personal saving rate, which has trended notably lower since the early 1980s, moved above 4 percent by late last year after having averaged 2¼ percent in 2001. The saving rate has been buffeted during the past two years by surges in income induced by tax cuts and by spikes in spending associated with variations in motor vehicle incentives. But, on balance, the extent of the increase in the saving rate has been roughly consistent with a gradual response of consumption to the reduction in the ratio of household wealth to disposable income.

Change in real income and consumption

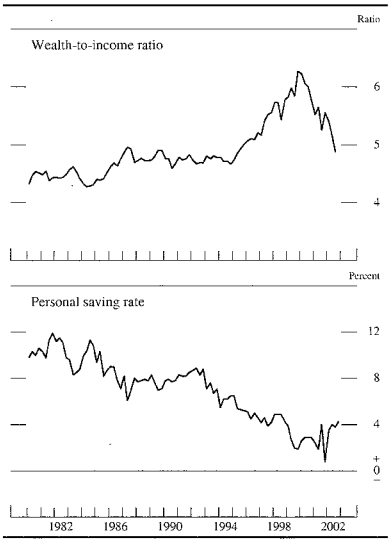


Consumer sentiment



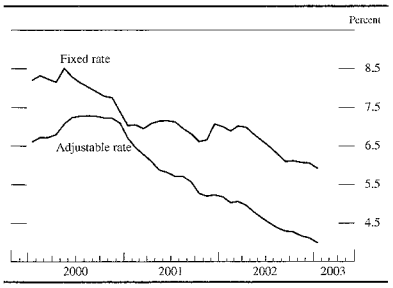
SOURCE. University of Michigan Survey Research Center.

Wealth and saving



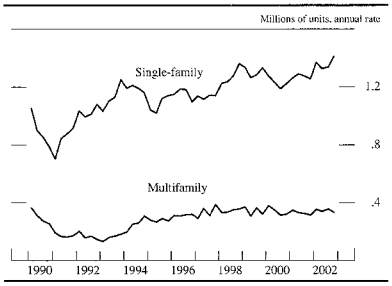
NOTE. The data are quarterly. The wealth-to-income ratio is the ratio of household net worth to disposable personal income and extends through 2002:Q3; the personal saving rate extends through 2002:Q4.

Mortgage rates



NOTE. The data, which are monthly and extend through January 2003, are contract rates on thirty-year mortgages.
SOURCE. Federal Home Loan Mortgage Corporation.

Private housing starts



NOTE. The data are quarterly.

Residential Investment

Real expenditures on residential investment increased 6 percent in 2002—the largest gain in several years. Demand for housing was influenced by the same factors affecting household spending more generally, but it was especially supported by low interest rates on mortgages. Rates on thirty-year fixed-rate mortgages, which stood at around 7 percent in the first months of the year, fell to around 6 percent by the autumn and dipped below that level early this year—the lowest in thirty-five years. Not surprisingly, attitudes toward homebuying, as measured by the Michigan SRC, remained quite favorable.

Starts of new single-family homes were at 1.36 million units last year, 7 percent above the already solid pace for 2001. Sales of both new and existing homes were brisk as well. Home prices continued to rise but at a slower rate than in 2001, at least according to some measures. The repeat-sales price index for existing homes rose 5½ percent over the four quarters ended in 2002:Q3, a slowing from the 8¾ percent increase over the comparable year-earlier period. The constant-quality price index for new homes rose 4½ percent last year, but this increase was close to the average pace over the past few years. At the same time, measures of house prices that do not control for the mix of homes sold rose considerably more last year than in 2001, a difference indicating that a larger share of transactions were in relatively expensive homes.

In the multifamily sector, starts averaged a solid 345,000 units last year, an amount in line with that of the preceding several years. However, the pace of building slowed a little in the fall. Apartment vacancy rates moved notably higher last year and rent and property values declined; these changes suggest that the strong demand for single-family homes may be eroding demand for apartment space.

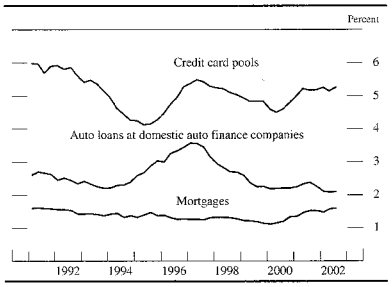
Household Finance

Households continued to borrow at a rapid pace last year; the 9¼ percent increase in their debt outstanding was the

largest since 1989. Low mortgage interest rates helped spur both very strong home purchases and refinancing of existing loans, which together increased home mortgage debt 11½ percent. Refinancing activity was especially elevated in the fourth quarter, when fixed mortgage interest rates dipped to around 6 percent. Torrid refinancing activity helps explain last year's slowdown of consumer credit, which is household borrowing not secured by real estate: A significant number of households reportedly extracted some of the equity from their homes at the time of refinancing and used the proceeds to repay other debt as well as to finance home improvements and other expenditures. According to banks that participated in the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices in October, the frequency and size of cash-out refinancings were substantially greater than had been reported in the January 2002 survey. Although automakers' financing incentives and attractive cash rebates stimulated a substantial amount of consumer borrowing, the growth rate of consumer credit in 2002, at 4¼ percent, was more than 2½ percentage points below the pace in 2001.

Even though households took on a large amount of mortgage debt last year, extraordinarily low mortgage rates kept the servicing requirement for that debt (measured as a share of homeowners' disposable income) well below its previous peak levels. Moreover, reflecting large gains in residential real estate values, equity in homes has continued to increase despite sizable debt-financed extractions. The combined influence of low interest rates and the sizable gain in disposable personal income also kept the total servicing costs faced by households—which in addition to home mortgage payments include costs of other financial obligations such as rental payments of tenants, consumer installment credit, and auto leases—relative to their incomes below previous peaks. Against this backdrop, broad measures of household credit quality deteriorated very little last year, and signs of financial stress were confined mainly to the subprime segment of the market. Delinquency rates on home mortgages inched up, while those on auto loans at finance companies were flat. Delinquency rates on credit cards bundled into securitized asset pools remained close to those of recent experience.

Delinquency rates on selected types of household loans



NOTE. The data are quarterly and extend through 2002:Q3.
SOURCE. For mortgages, the Mortgage Bankers Association; for auto loans, the Big Three automakers; for credit cards, Moody's Investors Service.

The Business Sector

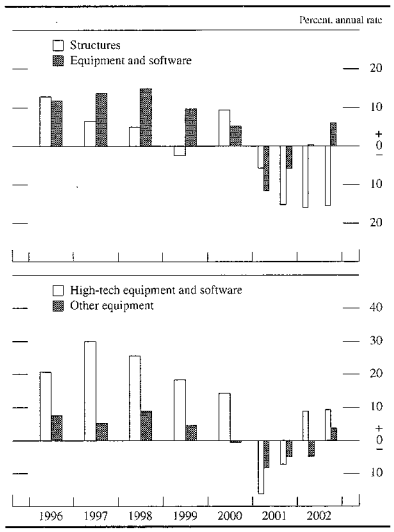
Overall business fixed investment moved lower last year, although the decline was not nearly so precipitous as in 2001. Outlays for equipment and software edged up, but spending on structures fell sharply. Financing conditions worsened over the summer, with equity prices declining, initial public offerings (IPOs) drying up, credit market spreads widening, and banks tightening up somewhat on credit standards in the wake of increased reports of corporate malfeasance. In addition, geopolitical concerns increased firms' already heightened uncertainty about the economic outlook. These factors contributed to an apparent deterioration in business confidence, and businesses still have not felt any great urgency to boost investment appreciably. For similar reasons, although firms slowed their rate of inventory liquidation last year, they have yet to undertake a sustained restocking.

Fixed Investment

After dropping sharply in 2001, real spending on equipment and software rose 3 percent last year. Spending on high-technology equipment, one of the hardest-hit sectors in 2001, showed signs of uneven improvement. The clearest rebound was in computing equipment, for which spending rose 25 percent in real terms; this gain fell short of the increases posted in the late 1990s but far more than reversed the previous year's decline. Software investment also turned positive, rising 6 percent after declining about 3 percent in 2001. By contrast, real outlays for communications equipment were reported to be up only slightly in 2002 after plummeting 30 percent in 2001.

Business spending on aircraft fell sharply last year. Airlines were hit especially hard by the economic downturn and by the reduction in air travel after the September 11 attacks; although expenditures for new aircraft held up through the end of 2001 because of the very long lags involved in producing planes, shipments of planes slowed greatly thereafter. Meanwhile, business outlays on motor vehicles edged up last year. Demand for autos and light trucks by rental companies weakened sharply along with the drop in air traffic that occurred after September 11 but recovered gradually over the course of last year. Purchases of medium and heavy trucks fell off overall,

Change in real business fixed investment



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

despite the fact that demand for heavy (class 8) trucks was boosted by spending in advance of the implementation of more-stringent environmental regulations.

Investment in equipment other than high-tech and transportation goods moved modestly higher through most of last year, as real outlays for industrial machinery and a wide range of other equipment gradually strengthened through the summer. Although spending edged lower again in the fourth quarter, investment in non-high-tech, nontransportation equipment increased 3½ percent for the year as a whole.

Spending on equipment and software was supported last year by low interest rates, which helped hold down the cost of capital, as did the tax provision enacted in March 2002 that allows partial expensing of new equipment and software purchased before September 11, 2004. Moreover, modest increases in final sales together with replacement demand no doubt spurred many firms to make new capital outlays. Nevertheless, some sectors, most notably telecommunications, probably still had excess holdings of some forms of capital. Concerns about corporate malfeasance, which had become more intense over the spring and summer, weighed heavily on financial markets and raised the cost of capital through reduced share prices and higher yields on the bonds of lower-rated firms. In addition, uncertainty about the geopolitical situation, including the possible consequences for oil prices of an outbreak of war with Iraq, likely made many firms reluctant to commit themselves to new expenditures. In all, businesses have been, and appear to remain, quite cautious about undertaking new capital spending projects.

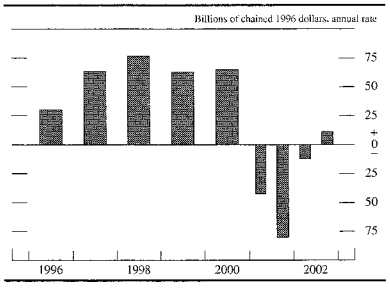
Real business spending for nonresidential structures declined sharply for a second year in 2002. Outlays for the construction of office buildings and industrial buildings were especially weak. Vacancy rates for such buildings increased throughout the year, and property values and rents moved lower. Construction of new hotels and motels also fell considerably, reflecting the weakness in the travel industry. By contrast, spending on other commercial buildings, such as those for retail, wholesale, and warehouse space, moved only a little lower last year.

A number of factors likely account for investment in structures having been much weaker than investment in equipment. Structures depreciate very slowly, so businesses can defer new outlays without incurring much additional deterioration of their capital stock. And unlike investment in equipment, spending on structures is not eligible for partial expensing. According to some analysts, concerns about additional acts of terrorism (and, until late in the year, the lack of insurance to cover such events) may also have had a damping effect on some types of construction, particularly large "trophy" projects.

Inventory Investment

The sharp inventory runoffs that characterized the economic downturn, together with gradually rising final sales, implied that, by early last year, stocks were in much better alignment with sales than had been the case during 2001. Accordingly, businesses lessened the pace of inventory liquidation early in the year and by summer

Change in real business inventories



had turned to some modest restocking. However, firms appeared to have exerted tight control over production and inventories; with prospects for the strength of the recovery having diminished in the second half of the year, businesses quickly cut production, and inventories only edged up in the fourth quarter, according to incomplete and preliminary data. In all, total inventories were about unchanged last year compared with a liquidation of more than $60 billion in 2001, and this turnaround contributed 1 percentage point to the growth of real GDP over the year. At year-end, inventory-to-sales ratios in most sectors stood near the low end of their recent ranges.

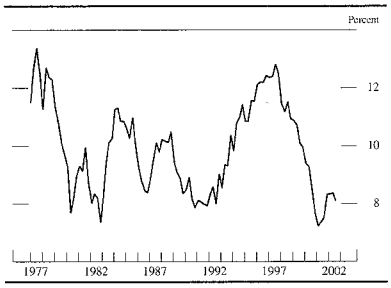
In the motor vehicle industry, last year's very strong sales were matched by high levels of production, and the stock of inventories, especially for light trucks, appeared at times to be higher than the industry's desired levels. Nevertheless, the surge in sales late in the year helped to pare stocks, and dealers ended the year with inventories of light vehicles at a comfortable level.

Corporate Profits and Business Finance

The profitability of the U.S. nonfinancial corporate sector improved from its lows of 2001 but relative to sector output remained at the low end of the range experienced over the past thirty years. Economic profits of nonfinancial corporations—that is, book profits adjusted for inventory valuations and capital consumption allowances—rebounded in late 2001 and were little changed through the third quarter of last year. The sluggish expansion of aggregate demand and the lack of pricing power associated with intense competitive pressures were the main factors that held down profits in 2002. Also playing a role, especially in the manufacturing sector, were costs arising from underfunded defined-benefit pension plans. Reflecting the pause in economic growth, earnings reports for the fourth quarter indicate that profits may have dropped some late in the year.

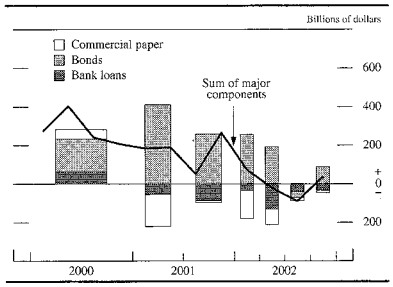
A dearth of expenditures on fixed capital and moribund merger and acquisition activity were the chief culprits behind the sluggish pace of nonfinancial corporate borrowing last year. Also important was the propensity of some firms to draw on liquid assets—which began the year at high levels—rather than to seek external financing. Consequently, debt of the nonfinancial corporate sector expanded only 1½ percent, a rate slower than the already subdued pace in 2001. The composition of business borrowing was dominated last year, as it was in 2001, by longer-term sources of funds. Robust demand for higher-quality corporate debt on the part of investors, combined with the desire of firms to lock in low interest rates, prompted investment-grade corporations to issue a large volume of bonds during the first half of 2002. With funding needs limited, investment-grade issuers continued to use the proceeds to strengthen their balance sheets by refinancing higher-coupon bonds and by paying down short-term obligations such as bank loans and commercial paper. Buoyed by declining yields, gross issuance of below-investment-grade bonds for the most part also held up well during the first half, although this segment of the market was hit hard after revelations of corporate malfeasance, as investors shunned some of the riskiest issues; issuance was especially weak in the beleaguered telecom and energy sectors, which continue to be saddled with overcapacity and excessive leverage. Despite falling share prices, seasoned equity offerings were also well maintained over the first half of the year, in part because of the decision of some firms—especially in the telecom and energy sectors—to reduce leverage. IPOs, by con-

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



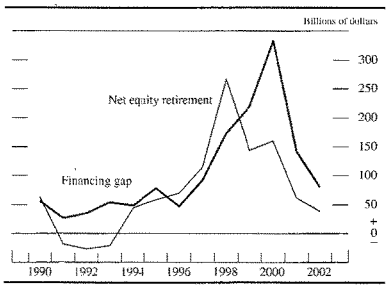
NOTE. The data are quarterly and extend through 2002:Q3. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.

Major components of net business financing



NOTE. Seasonally adjusted annual rate for nonfarm nonfinancial corporate business. The data for the sum of major components are quarterly. The data for 2002:Q4 are estimated.

Financing gap and net equity retirement at nonfarm nonfinancial corporations

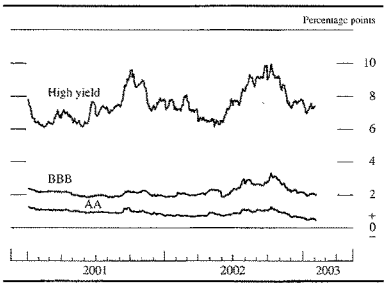


NOTE. The data are annual; 2002 is based on partially estimated data. The financing gap is the difference between capital expenditures and internally generated funds. Net equity retirement is the difference between equity retired through share repurchases, domestic cash-financed mergers, or foreign takeovers of U.S. firms and equity issued in public or private markets, including funds invested by venture capital partnerships.

trast, were sparse. The evaporation of cash-financed mergers and acquisitions and desire by firms to conserve cash kept equity retirements at their slowest pace since 1994.

Over the summer, investors grew more reluctant to buy corporate bonds because of concerns about the reliability of financial statements, deteriorating credit quality, and historically low recovery rates on defaulted speculative-grade debt. Macroeconomic data suggesting that the economic recovery was losing momentum and widespread company warnings about near-term profits pushed yields on speculative-grade debt sharply higher. Risk spreads on investment-grade bonds also widened appreciably in the third quarter, as yields in that segment

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



NOTE. The data are daily and extend through February 5, 2003. The spreads compare the yields on the Merrill Lynch AA, BBB, and 175 indexes with the yield on the ten-year off-the-run Treasury note.

of the corporate bond market declined less than those on Treasury securities of comparable maturity. Investors' aversion to risk was also heightened by mounting tensions with Iraq; by early autumn, risk spreads on junk-rated bonds reached their highest levels in more than a decade. Gross bond issuance both by investment-grade and below-investment-grade firms fell off markedly, and the amount of redemptions was large. By the third quarter, net issuance of bonds by nonfinancial corporations had turned negative for the first time since the early 1950s. Trading conditions in the corporate bond market deteriorated during this period, as bid–asked spreads reportedly widened in all sectors. With share prices dropping and stock market volatility increasing, issuance of seasoned equity nearly stalled in the summer and early autumn. IPOs were virtually nonexistent amid widely publicized investigations into the IPO allocation process at large investment banks.

A smattering of more upbeat news about the economy in mid-autumn and the absence of major revelations of corporate wrongdoing sparked a rally in equity prices and rekindled investors' appetite for corporate debt. Over the remainder of the year and during early 2003, risk spreads narrowed considerably on investment-grade corporate bonds—especially for the lowest rated of these issues—and even more on speculative-grade bonds, although they remained high by historical standards. In the meantime, liquidity in the corporate bond market generally improved. A brightening of investor sentiment caused a rebound in gross bond issuance, with firms continuing to use bond proceeds to refinance long-term debt and to pay down short-term debt. Rising stock prices and reduced volatility also allowed seasoned equity issuance to regain some ground in the fourth quarter. The improved tone in corporate debt markets carried over into early 2003. Gross corporate bond issuance continued at a moderate pace, and despite the drop in stock prices in the latter half of January, seasoned equity issuance has been reasonably well maintained. IPO activity and venture capital financing, however, remained depressed.

The heavy pace of bond issuance, sagging capital expenditures, and diminished merger and acquisition activity allowed firms to pay down large amounts of both business loans at banks and commercial paper last year. The runoff in business loans that started in early 2001 intensified in the first half of 2002. At the same time, commercial paper issuers that were perceived as having questionable accounting practices encountered significant investor resistance, and most of these issuers discontinued their programs. Bond rating agencies stepped up the pressure on firms to substitute longer-term debt for shorter-term debt and thereby reduce rollover risk. In addition, banks raised the total cost of issuing commercial paper by tightening underwriting standards and boost-

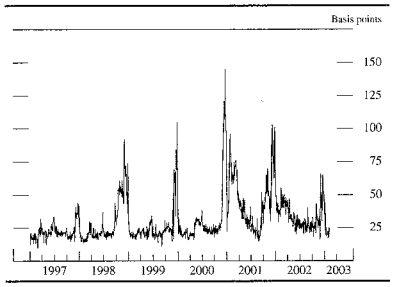
ing fees and spreads on the associated backup lines of credit—especially for lower-rated issuers. In doing so, respondents to the April Senior Loan Officer Opinion Survey on Bank Lending Practices cited heightened concerns about the deterioration of issuers' credit quality and a higher probability of lines being drawn. Many commercial paper issuers either turned to longer-term financing or dropped out of the credit markets altogether, and the volume of nonfinancial commercial paper outstanding shrank about one-fourth during the first six months of the year after having dropped one-third in 2001.

The volatility that gripped equity and bond markets around midyear, however, did not spill over to the commercial paper market. Quality spreads in the commercial paper market were largely unaffected, in part because many of the riskiest issuers had already exited the market, while others had strengthened their cash positions and significantly reduced rollover risk earlier in the year. Indeed, because of difficulties in the corporate bond market, some nonfinancial firms turned temporarily to the commercial paper market to obtain financing, and the volume of outstanding paper rose in July after a lengthy period of declines. Over the remainder of the year, business loans at banks and commercial paper outstanding contracted rapidly, as inventory investment remained negligible, and firms continued to take advantage of relatively low longer-term interest rates by issuing bonds.

A decline in market interest rates and improved profitability helped reduce the ratio of net interest payments to cash flow in the nonfinancial corporate sector last year. Even so, many firms struggled to service their debt, and corporate credit quality deteriorated markedly. The trailing average default rate on corporate bonds, looking back over the preceding twelve months, was already elevated and climbing when WorldCom's $26 billion default in July propelled the average rate to a record level. The amount of nonfinancial corporate debt downgraded by Moody's Investors Service last year was more than fourteen times the amount upgraded. At less than 25 percent, the average recovery rate in 2002 on all defaulted bonds—as measured by the price of bonds at default—was at the low end of recovery rates over the past decade. Delinquency rates on business loans at commercial banks rose noticeably before stabilizing in the second half of the year, and charge-off rates remained quite high throughout 2002.

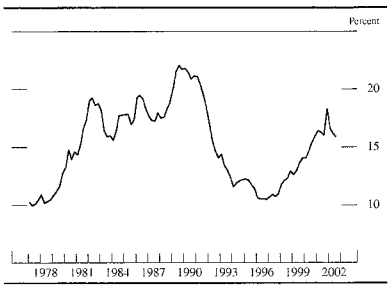
After expanding rapidly in 2001, commercial mortgage debt grew much more slowly during the first quarter of last year, as business spending on nonresidential structures fell. Despite the continued contraction in outlays on nonresidential structures, commercial mortgage debt accelerated over the remainder of the year, apparently because of refinancing to extract a significant por-

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



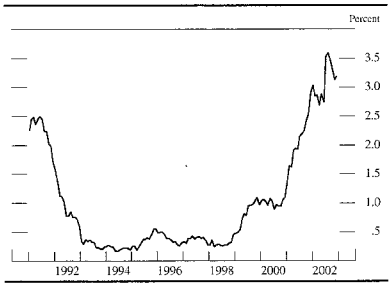
NOTE. The data are daily and extend through February 5, 2003. The series shown is the difference between the rate on A2/P2 nonfinancial commercial paper and the AA rate.

Net interest payments of nonfinancial corporations relative to cash flow



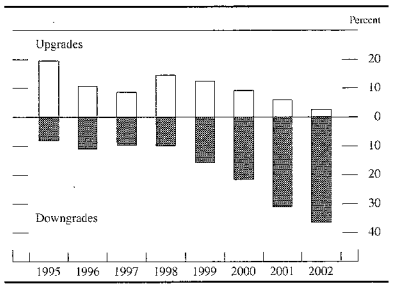
NOTE. The data are quarterly and extend through 2002:Q3.

Default rate on outstanding bonds



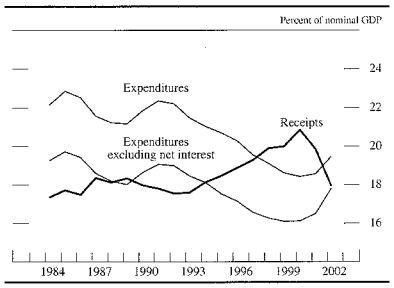
NOTE. The default rate is monthly and extends through December 2002. The rate for a given month is the face value of bonds that defaulted in the twelve months ending in that month divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the twelve-month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

Ratings changes of nonfinancial corporations



NOTE. Data are at an annual rate. Debt upgrades (downgrades) are expressed as a percentage of par value of all bonds outstanding.
SOURCE. Moody's Investors Service.

Federal receipts and expenditures



NOTE. The budget data are from the unified budget and are for fiscal years (October through September); GDP is for Q3 to Q3.

tion of equity from existing properties. The issuance of commercial-mortgage-backed securities (CMBS), a key source of commercial real estate financing in recent years, was well maintained in 2002. Even as office vacancy rates rose, the quality of commercial real estate credit remained stable last year. Commercial banks firmed standards on commercial real estate loans in 2002, on net, and delinquency rates on commercial real estate loans at banks stayed at historically low levels. Delinquency rates on CMBS leveled off after increasing appreciably in late 2001, and forward-looking indicators also do not suggest elevated concerns about prospective defaults: Yield spreads on CMBS over swap rates remained in the fairly narrow range that has prevailed over the past several years.

The Government Sector

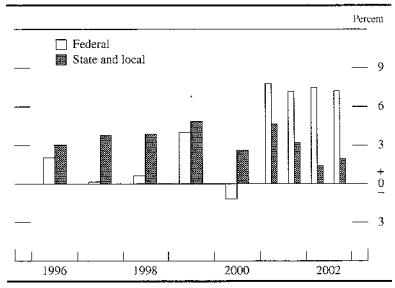
Federal Government

Despite modest economic growth, the federal budget position deteriorated sharply in 2002. After running a unified budget surplus of $127 billion in fiscal 2001, the federal government posted a deficit of $158 billion in fiscal 2002—and that deficit would have been $23 billion larger if not for the shifting of some corporate tax payments from fiscal 2001 to fiscal 2002. After adjustment for that tax shifting, receipts declined 9 percent in fiscal 2002: A $50 billion drop in corporate payments stemmed largely from tax provisions enacted in the 2002 stimulus bill (especially the partial-expensing provision on investment), and a decline in individual tax payments of $136 billion was largely attributable to a drop in capital gains realizations and to lower tax rates that were enacted in the 2001 tax bill.

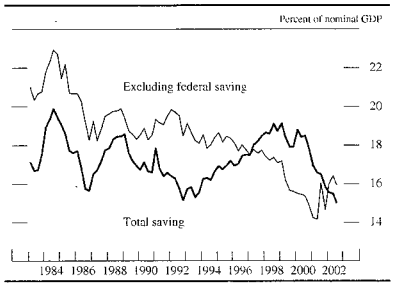
Meanwhile, federal outlays increased nearly 8 percent in fiscal 2002 and 11 percent excluding a decline in net interest expenses. Spending increased notably in many categories, including defense, homeland security, Medicaid, and income security (which includes the temporary extended unemployment compensation program). Federal government consumption and investment—the part of spending that is counted in GDP—rose more than 7 percent in real terms in 2002. (Government spending on items such as interest payments and transfers are not counted in GDP because they do not constitute a direct purchase of final production.)

The turn to deficit in the unified budget means that the federal government, which had been contributing to national saving since 1997, began to reduce national saving last year. The reversal more than offset an increase in saving by households and businesses, and gross national saving declined to 15 percent of GDP by the third quarter of last year—the lowest national saving rate since the 1940s.

Change in real government expenditures on consumption and investment



National saving



NOTE. The data are quarterly and extend through 2002:Q3.

After it reentered the credit markets as a significant borrower of net new funds in the second half of 2001, the Treasury continued to tap markets in volume last year. Federal net borrowing was especially brisk over the first half of the year. With federal debt rapidly approaching its statutory borrowing limit, the Secretary of the Treasury declared a debt ceiling emergency on May 16 and identified about $80 billion worth of accounting measures that could be used to create financing room within the existing $5.95 trillion limit. The Secretary's announcement and subsequent employment of one of these devices—in which Treasury securities held in government trust funds were temporarily replaced by Treasury IOUs not subject to the debt ceiling—had little effect on Treasury yields, as market participants were apparently confident that the ceiling would be raised in time to avoid default. And indeed, the Congress approved legislation raising the statutory borrowing limit to $6.4 trillion on June 27. With its credit needs remaining substantial, the Treasury continued to borrow heavily over the second half of 2002. The increase in the Treasury's net borrowing last year caused the ratio of publicly held debt to nominal GDP to rise for the first time since 1993.

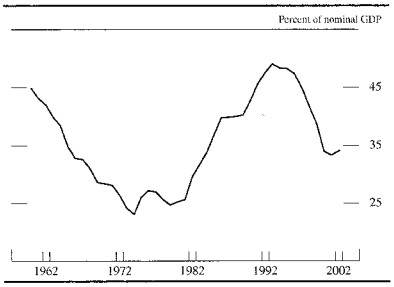
State and Local Governments

State and local governments have continued to struggle in response to sluggish growth of receipts. In the current fiscal year (which ends June 30 for most states), most state governments are reported to be facing significant shortfalls. Although a variety of strategies may be available for the purpose of technically complying with balanced-budget requirements, including tapping nearly $20 billion in combined rainy-day and general fund balances and turning to the capital markets, many states will be forced to boost revenues and hold the line on spending.

Real expenditures for consumption and gross investment by state and local governments rose less than 2 percent in 2002—the smallest increase in ten years. The slowdown in spending growth was widespread across expenditure categories and included notably smaller increases in outlays for construction. Employment in the state and local sector continued to rise in 2002, but at a slower rate than in recent years.

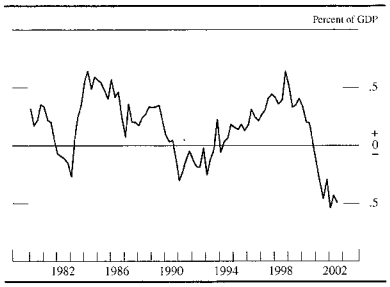
Debt of the state and local government sector expanded last year at the fastest pace since 1987. Governments used the proceeds to finance capital spending and to refund existing debt in advance. Net issuance of short-term municipal bonds was also well maintained, as California

Federal government debt held by the public



NOTE. Through 2001, the data for debt are year-end figures and the corresponding value for GDP is for Q4 at an annual rate; the final observation is for 2002:Q3. Excludes securities held as investments of federal government accounts.

State and local government current surplus or deficit



NOTE. The data, which are quarterly, are on a national income and product account basis and extend through 2002:Q3. The current surplus or deficit excludes social insurance funds.

and some other states facing fiscal difficulties turned to shorter-term borrowing while fashioning more permanent solutions to their budget problems. Worsening budget situations contributed to some deterioration in municipal credit quality last year. Credit-rating downgrades outpaced upgrades by a significant margin, and the yield spread of BBB-rated over insured AAA-rated municipal bonds rose significantly over the second half of 2002.

The External Sector

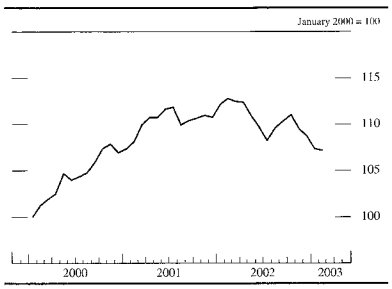
The U.S. current account deficit widened again in 2002 after a brief respite during the cyclical slowdown in 2001. Two-thirds of the expansion of the deficit last year was attributable to a decline in the balance on goods and services, although net investment income also fell sharply as receipts from abroad declined more than payments to foreign investors in the United States. The broad exchange value of the dollar peaked around February 2002 after appreciating about 13 percent in real terms from January 2000; in early February 2003 it was down about 5 percent from the February 2002 level.

Trade and the Current Account

Both exports and imports rebounded in 2002 as the cyclical downturn of the previous year was reversed and spending on travel recovered from the post–September 11 slump. As is often the case, the amplitude of the recent cycle in trade has been greater than that of real GDP. In 2001, stagnant real GDP in the United States and abroad was coupled with declines of 11½ percent in real exports and 8 percent in real imports. Last year, moderate growth of both foreign and domestic real GDP was exceeded by gains of 5 percent and 9 percent, respectively, in our real exports and imports. The faster growth of imports relative to exports over the past two years was consistent with the historical pattern in which the responsiveness of imports to income is greater in the United States than in the rest of the world. Although the dollar depreciated on balance last year, the lagged effects of its prior appreciation over the two previous years contributed to the faster growth in imports relative to exports in 2002.

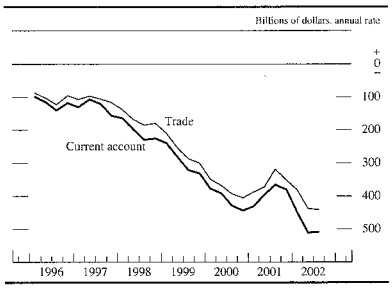
Real exports of goods posted a strong gain in the second quarter of 2002 after six consecutive quarters of decline. However, as output growth slowed abroad, exports decelerated in the third quarter and then fell in the fourth quarter. On balance, exports of goods rose about 2 percent over the course of the year, reversing only a small portion of the previous year's decline. Not surprisingly, the increase in goods exports in 2002 was concen-

U.S. dollar real exchange rate, broad index



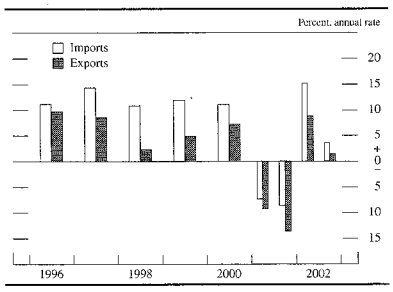
NOTE. The data are monthly. The last observation is the average of trading days through February 5, 2003. Exchange rates are adjusted for inflation with the consumer price index and are in foreign currency units per dollar. The broad index is a weighted average of the foreign exchange values of the U.S. 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.

U.S. trade and current account balances



NOTE. The data are quarterly and extend through 2002:Q3.

Change in real imports and exports of goods and services

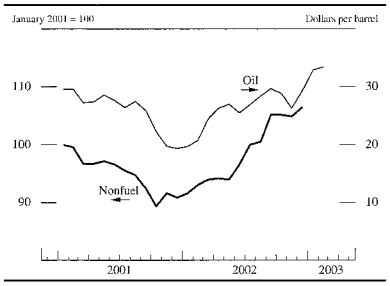


trated in the destinations where GDP growth was strongest—Canada, Mexico, and several developing Asian economies. A gain of 12 percent in real exports of services in 2002 more than reversed the previous year's decline and reflected both a pickup in tourism and an increase in other private services. Export prices turned up in the second quarter after a year of decline and continued to rise at a moderate pace in the second half.

The very rapid growth of real imports of goods in the first half of last year was a reaction to the revival of U.S. activity, and they gained about 9 percent over the year. The particularly large gains in imports of consumer goods and automotive products reflected the buoyancy of U.S. consumption expenditures. Imports of most major categories of capital goods also increased on balance over the year. However, as with exports, import growth was considerably stronger in the first half of the year than in the second. This pattern likely reflected the deceleration in U.S. GDP, along with the effects of some depreciation of the dollar. In addition, there may have been some shifting of import demand from later in the year to the earlier months as it began to appear more likely that labor contract negotiations at West Coast ports would not go smoothly.[1] Imports of services more than reversed their 2001 decline over the course of the year, and gains were recorded for both travel and other private services. Prices of non-oil imports turned up in the second quarter after declining over the preceding four quarters, as a result of the weaker exchange rate and a turnaround in prices of internationally traded commodities.

The spot price of West Texas intermediate crude oil climbed above $35 per barrel in early 2003, its highest level since the beginning of 2000. Oil prices had fallen to around $20 per barrel during 2001 amid general economic weakness, but they began rising in February and March of last year in response to both improving global economic activity as well as a production-limiting agreement between OPEC and several major non-OPEC producers. Even though production in a number of OPEC and non-OPEC countries in fact exceeded the agreed limits last year, heightened tensions in the Middle East along with severe political turmoil in Venezuela continued to put upward pressure on prices. The pressure intensified late in the year as a strike in Venezuela that began on December 2 virtually shut down that country's oil industry, and Venezuelan oil production was still well below pre-strike levels in early 2003. Concern over a possible war with Iraq, along with a very low level of crude oil inventories in the United States, has helped to keep spot prices high. Also in response to the heightened tensions, the price of gold shot up about 30 percent over the past year.

Prices of oil and of nonfuel commodities



NOTE. The data are monthly; the last observation for oil is the average of trading days through February 5, 2003; the last observation for nonfuel commodities is December 2002. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is a weighted average of thirty-nine primary-commodity prices from the International Monetary Fund.

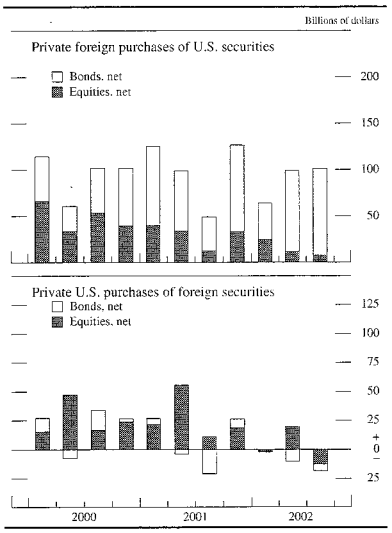
The Financial Account

The increase in the current account deficit in 2002 was about equal on balance to the stepped-up foreign official purchases of U.S. assets, as changes in the components of private capital flows were offsetting. Private foreign purchases of U.S. securities were about $360 billion at an annual rate through November, a volume similar to last year's total. However, there was some shift in the composition of flows away from equities and toward Treasury securities. This shift may have reflected the damping of equity demand caused by slower economic growth and continued concern about corporate governance and accounting. Over the same period, purchases by private U.S. investors of foreign securities declined nearly $100 billion. Accordingly, the net balance of private securities trading recorded a sharp increase in net inflows.

In contrast, net foreign direct investment inflows fell about $70 billion between 2001 and 2002. Foreign investment in the United States and investment abroad by U.S. residents both declined, but the decline in flows into the United States was considerably larger, as merger activity slowed and corporate profits showed little vigor. U.S. direct investment abroad held up fairly well in 2002, a result largely reflecting retained earnings.

1. The dispute between the Pacific Maritime Association and the International Longshore and Warehouse Union eventually led to an eleven-day port closure in late September and early October that ended when President Bush invoked the Taft-Hartley Act. Although the monthly pattern of trade was influenced by the closure, the overall level of imports for the year does not appear to have been much affected.

U.S. international securities transactions



SOURCE. Department of Commerce and the Federal Reserve Board.

The Labor Market

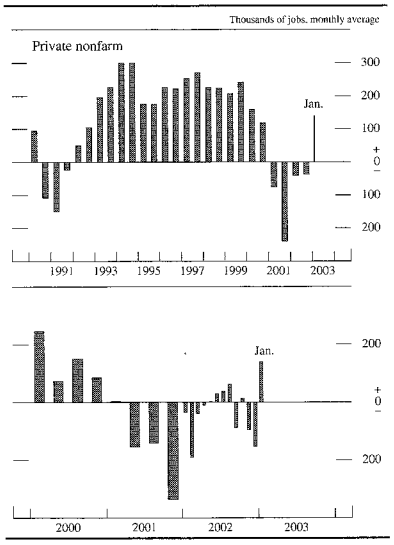
Employment and Unemployment

Labor markets appeared to stabilize last spring after the sharp deterioration of 2001 and early 2002. Employment on private payrolls, which had declined an average of 160,000 per month in 2001, leveled off in the spring and moved slightly higher over the summer. But labor demand weakened again as the economy softened later in the summer, and private employment declined about 80,000 per month on average in the last four months of the year. Private payrolls rebounded nearly 150,000 in January, though the magnitude of both the especially sharp decline in December and the rebound in January likely was exaggerated by difficulties in adjusting for the normal seasonal movements in employment during these months.

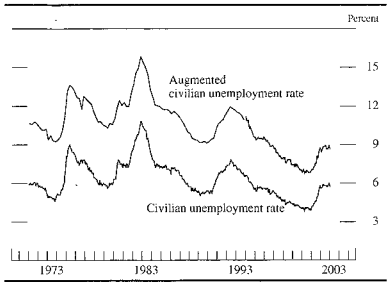
The manufacturing sector continued to be the weakest segment of the labor market; even during the spring and early summer, when the overall labor market seemed to be improving, factory payrolls contracted on average. Declines in factory employment were more pronounced—at about 50,000 per month—toward the end of the year. Employment at help-supply firms and in wholesale trade—two sectors in which activity closely tracks that of manufacturing proper—rose over the summer but also turned down again later in the year. And employment in retail trade, though quite erratic, leveled off over the summer before declining further in the fall. However, employment in services other than help supply grew reasonably steadily throughout the year and rose nearly 50,000 per month after March; health services and education services contributed more than half of those job gains. The finance and real estate sectors also added jobs last year, probably because of the surge in mortgage refinancings and high levels of activity in housing markets. Last year's job losses in the private sector were partially offset by an increase in government employment that averaged about 20,000 per month; the increase resulted mostly from hiring by states and municipalities, but it also reflected hiring in the fall by the Transportation Security Administration.

Overall employment moved lower, on net, and the unemployment rate increased a little less than 1/2 percentage point over the year, to 6 percent, before dropping back to 5.7 percent in January 2003. The unemployment rate probably has been boosted slightly by the federal temporary extended unemployment compensation program. By extending benefits for an additional three months, the pro-

Net change in payroll employment



Measures of labor utilization



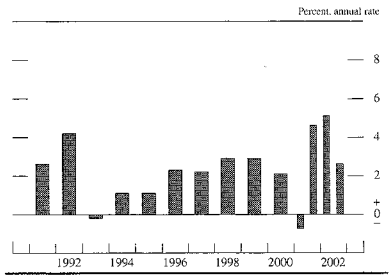
NOTE. The data extend through January 2003. The civilian rate is the number of civilian unemployed divided by the civilian labor force. The augmented rate adds to the numerator and the denominator of the civilian rate the number of those who are not in the labor force but want a job. The small break in the augmented rate in January 1994 arises from the introduction of a redesigned survey. For the civilian rate, the data are monthly; for the augmented rate, the data are quarterly through December 1993 and monthly thereafter.

gram allows unemployed individuals whose regular benefits have expired to be more selective in accepting job offers and provides them with an incentive not to withdraw from the labor force. In addition, as would be expected in a still-weak labor market, the labor force participation rate moved lower last year.

Productivity and Labor Costs

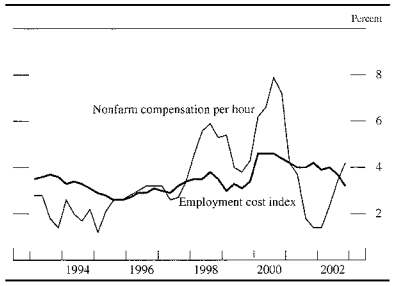
Labor productivity rose impressively in 2002. Output per hour in the nonfarm business sector increased an estimated 3¾ percent from the fourth quarter of 2001 to the fourth quarter of 2002. Labor productivity typically suffers in an economic downturn as businesses reduce hours worked by proportionally less than the decline in output; conversely, productivity typically rebounds early in an expansion as labor is brought back toward fuller utilization. During the most recent downturn, however, productivity held up comparatively well, a performance that makes last year's surge all the more impressive. Indeed, productivity rose at an average annual rate of nearly 3 percent over the past two years, faster than the average pace of increase during the late 1990s.

Change in output per hour



NOTE. Nonfarm business sector.

Measures of change in hourly compensation



NOTE. The data extend through 2002: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.

Very likely, the rapid pace of last year's productivity growth was due in part to the special circumstances that developed after the September 11 attacks. Businesses cut labor substantially in late 2001 and early 2002 amid widespread fear of a sharp decline in demand; when demand held up better than expected, businesses proved able to operate satisfactorily with their existing workforces. Moreover, the fact that this step-up in productivity was not reversed later in the year suggests that at least a portion of it is sustainable. The recent rapid growth in productivity may derive in part from ongoing improvements in the use of the vast amount of capital installed in earlier years, and it may also stem from organizational innovations induced by the weak profit environment.

Indicators of hourly compensation sent mixed signals last year. The rise in the employment cost index (ECI) for hourly compensation in private nonfarm businesses, 3¼ percent, was 1 percentage point lower than the increase in 2001. Compensation increases likely were damped last year by the soft labor market and expectations of lower consumer price inflation. The wages and salaries component and the benefits component of the ECI both posted smaller increases last year. The deceleration was less pronounced for the benefits component,

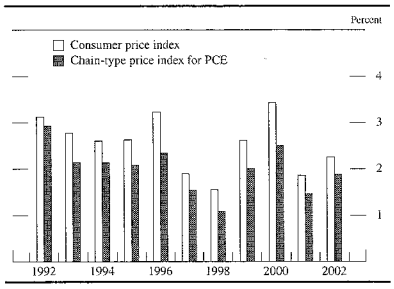
however, which was boosted by further large increases in employers' health insurance costs. According to the ECI, health insurance costs, which constitute about 6 percent of overall compensation, rose 10 percent last year after having risen about 9 percent in each of the preceding two years.

An alternative measure of compensation costs is compensation per hour in the nonfarm business sector, which is derived from information in the national income and product accounts. According to this measure, hourly compensation rose 4¼ percent last year—a little more than the increase in the ECI and up from a much smaller increase in 2001. One important difference between these two measures of compensation is that the ECI omits stock options, while nonfarm compensation per hour captures the value of these options upon exercise. The very small increase in the latter measure in 2001 likely reflects, in part, a drop in option exercises in that year, and the larger increase in 2002 may point to a firming, or at least to a smaller rate of decline, of these exercises.

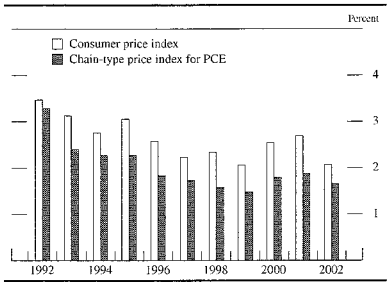
Prices

The chain-type price index for personal consumption expenditures (PCE) rose about 2 percent last year, compared with an increase of 1½ percent in 2001. This step-up in consumer price inflation resulted from a jump in energy prices. Outside of the energy sector, consumer price inflation was pushed lower last year by continued slack in labor and product markets as well as by expectations of future inflation that appeared to be lower in 2002 than in most of 2001. The increase in PCE prices excluding food and energy, which was just 1¾ percent, was about ¼ percentage point less than in 2001. 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 higher prices of imported oil, which

Change in consumer prices



Change in consumer prices excluding food and energy



are not included in GDP because they are not part of domestic production. On net, GDP prices rose only 1¼ percent last year, a deceleration of ¾ percentage point that reflected not just the deceleration in core consumer prices but also considerably smaller increases for prices of construction.

The upturn in consumer energy prices in 2002 was driven by a jump in crude oil prices. Gasoline prices increased some 25 percent from December 2001 to December 2002; prices of fuel oil increased considerably as well. By contrast, consumer prices of natural gas posted only a modest rise after declining sharply in 2001, and electricity prices moved lower. More recently, the rise in crude oil prices since mid-December, together with cold weather, has increased the demand for natural gas and has led to higher spot gas prices; the higher spot prices for both oil and gas are likely to be boosting consumer energy prices early this year.

The PCE price index for food and beverages increased only 1½ percent last year; the increase followed a 3 percent rise in 2001 that reflected supply-related price increases for many livestock products including beef, poultry, and dairy products. But livestock supplies had

Alternative measures of price change

Percent

Price measure	2001	2002
Chain-type		
Gross domestic product	2.0	1.3
Gross domestic purchases	1.3	1.6
Personal consumption expenditures	1.5	1.9
Excluding food and energy	1.9	1.7
Chained CPI	1.2	1.9
Excluding food and energy	1.8	1.6
Fixed-weight		
Consumer price index	1.9	2.3
Excluding food and energy	2.7	2.1

Note. Changes are based on quarterly averages and are measured to the fourth quarter of the year indicated from the fourth quarter of the preceding year.

recovered by early last year, and a drought-induced selloff of cattle herds last summer pushed prices still lower.

The prices of goods other than food and energy items decelerated sharply last year. Prices for apparel, new and used motor vehicles, and a wide range of other durable goods all declined noticeably and, on average, at a faster pace than in 2001. Price increases for services were much larger than for goods and slowed less from the previous year. Both tenants' rent and the imputed rent of owner-occupied housing—categories that account for a sizable share of services—rose significantly less last year than they did in 2001. But many other services prices posted increases in 2002 that were about the same as in 2001. Information on medical prices was mixed. According to the CPI, the price of medical services continued to accelerate, rising 5½ percent last year. But the increase in the PCE measure of medical services prices was less than 3 percent, a smaller increase than in 2001. One reason for this difference is that the prices of services paid for by Medicare and Medicaid are included in the PCE index but not in the CPI (because services provided by Medicare and Medicaid do not represent out-of-pocket costs to consumers and so are outside of the CPI's scope), and Medicare reimbursement rates for physicians were reduced last year.

Despite the acceleration in medical prices in the CPI but not in the PCE price index, the CPI excluding food and energy decelerated notably more than did the core PCE price index between 2001 and 2002. The two price measures differ in a number of respects, but much of last year's greater deceleration in the CPI can be traced to the fact that the CPI suffers from a form of "substitution bias" that is not present in the PCE index. The CPI, being a fixed-weight price index, overstates increases in the cost of living because it does not adequately take into account the fact that consumers tend to substitute away from goods that are rising in relative price; by contrast, the PCE price index does a better job of taking this substitution into account. Last year, the Bureau of Labor Statistics began to publish a new index called the chained CPI; like the PCE price index, the chained CPI does a more complete job of taking consumer substitution into account, but it is otherwise identical to the official CPI. In 2001, an unusually large gap between increases in the official CPI and the chained CPI arose, pointing to very large substitution bias in the official CPI in that year. This gap narrowed in 2002, indicating that substitution bias declined between the two years. (Final estimates of the chained CPI are not yet available; the currently available data for both 2001 and 2002 are preliminary and subject to revision.)

Survey measures of expected inflation generally ran a little lower in 2002 than in 2001. According to the Michigan SRC, median one-year inflation expectations plummeted after the September 11 attacks, but by early 2002, expectations returned to the 2¾ percent range that had prevailed during the previous summer. These expectations gradually moved lower over the course of last year and now stand around 2½ percent. Meanwhile, the Michigan SRC's measure of five- to ten-year inflation expectations remained steady at about 2¾ percent during 2002, a rate a little lower than the 3 percent inflation expectations that had prevailed through most of 2001.

U.S. Financial Markets

Developments in financial markets last year were shaped importantly by sharp declines, on net, in equity prices and most long-term interest rates and by periods of heightened market volatility. In contrast to 2001, when the Federal Reserve eased the stance of monetary policy eleven times, last year saw one reduction in the intended federal funds rate—in early November—and interest rates on short-term Treasury securities had moved little until then. Longer-term interest rates, by contrast, were more volatile. Investors' optimism about future economic prospects pressured longer-term Treasury bond yields higher early in 2002. But as the year progressed, that optimism faded when the economy failed to gather much momentum, and longer-term Treasury yields ended the year appreciably lower. Softer-than-expected readings of the economic expansion, a marked deterioration in corporate credit quality, concerns about corporate governance, and heightened geopolitical tensions made investors especially wary about risk. Lower-rated firms found credit substantially more expensive, as risk spreads on speculative-grade debt soared for most of the year before narrowing somewhat over the last few months. Even for higher-quality firms, risk spreads widened temporarily during the tumultuous conditions that prevailed in financial markets over the summer. In addition, commercial banks tightened standards and terms for business borrowers, on net, in 2002, and risk spreads on business loans remained in an elevated range throughout the year. Increased caution on the part of investors was particularly acute in the commercial paper market, where the riskiest issuers discontinued their programs.

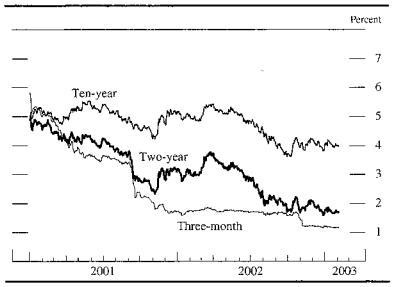
Federal borrowing surged last year, while private borrowing was held down by the significantly reduced credit needs of business borrowers. Declines in longer-term interest rates during the first half of the year created incentives for both businesses and households to lock in lower debt-service obligations by heavily tapping corporate bond and home mortgage markets, respectively. While mortgage borrowing remained strong, businesses sharply curtailed their issuance of longer-term debt during the second half of 2002 amid the nervousness then prevailing in the financial markets.

Interest Rates

Reflecting an unchanged stance of monetary policy over most of last year, short-term market interest rates moved little until early November, when the FOMC lowered the target federal funds rate ½ percentage point, and other short-term interest rates followed suit. Yields on intermediate- and long-term Treasury securities, by contrast, declined as much as 1½ percentage points, on net, in 2002. Longer-term interest rates began last year under upward pressure, as signs that the economy had bottomed out started to nudge rates higher in the final weeks of 2001. Positive economic news pushed interest rates up appreciably further during the first quarter of 2002. The increase in longer-term interest rates was consistent with the sharp upward tilt of money market futures rates, which suggested that market participants expected that the FOMC would almost double the intended level of the funds rate by year's end. However, as readings on the strength of the economic expansion came in on the soft side, investors substantially trimmed their expectations for policy tightening, and yields on longer-term Treasury securities turned down in the spring.

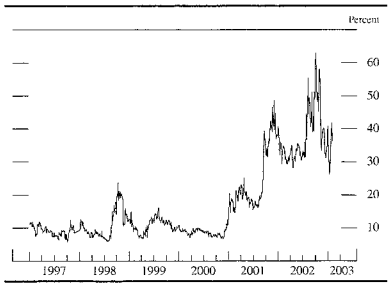
The slide in longer-term Treasury yields intensified over the summer amid weaker-than-expected economic data, heightened geopolitical tensions, fresh revelations of corporate malfeasance, and disappointing news about near-term corporate profits. In concert, these developments prompted investors to mark down their expectations for economic growth and, consequently, their anticipated path for monetary policy. A widespread retrenchment in risk-taking sent yields on speculative-grade corporate bonds sharply higher and kept those on the lower rungs of investment grade from declining, even as longer-term nominal Treasury yields fell to very low levels by the end of July.

Interest rates on selected Treasury securities



NOTE. The data are daily and extend through February 5, 2003.

Implied volatility of short-term interest rates

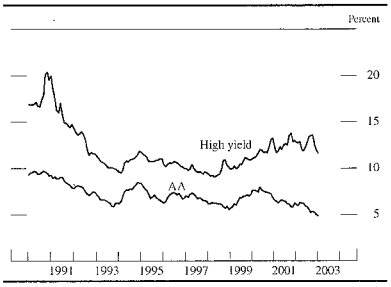


NOTE. The data are daily and extend through February 5, 2003. The series shown is the implied volatility of the three-month eurodollar rate over the coming four months, as calculated from option prices.

The uneventful passing of the Securities and Exchange Commision's August 14 deadline for officers of large companies to certify corporate financial statements somewhat assuaged investors' anxieties about corporate governance problems. But subsequent news suggesting that the economy was losing momentum and a flare-up in tensions with Iraq further boosted demand for Treasury securities. The FOMC's decision at the August meeting—to leave the intended federal funds rate unchanged but to judge the balance of risks to the outlook as weighted toward economic weakness—pulled the expected path of the funds rate lower, and longer-term Treasury yields sank to forty-year lows in early autumn. A high degree of investor uncertainty about the future path of monetary policy was evidenced by implied volatilities of short-term interest rates derived from option prices, which soared to record levels in early autumn. The size of the FOMC's November cut in the target federal funds rate and the shift to balance in its assessment of risks surprised market participants, but the policy easing appeared to lead investors to raise the odds that the economy would pick up from its sluggish pace. Generally positive economic news and rising equity prices over the remainder of the year also bolstered confidence and prompted market participants to mark up the expected path for monetary policy and push up longer-term Treasury yields.

Yields on higher-quality investment-grade corporate bonds generally tracked those on Treasuries of comparable maturity last year, although risk spreads on these instruments widened moderately over the summer and early autumn before narrowing over the remainder of the year. Interest rates on below-investment-grade corporate debt, by contrast, increased for much of last year, as spreads over Treasuries ballooned in response to mounting concerns about corporate credit quality, historically

Corporate bond yields



NOTE. The data are monthly averages and extend through January 2003. The AA rate is calculated from bonds in the Merrill Lynch AA index with seven to ten years remaining maturity. The high-yield rate is the yield on the Merrill Lynch 175 high-yield index.

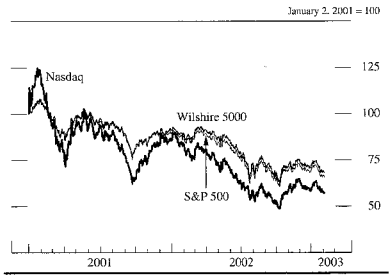
low recovery rates on defaulted bonds, and revelations of improper corporate governance; credit risk spreads widened in all speculative sectors but especially in telecom and energy. By the summer, investors' retreat from risk-taking had widened bid–asked spreads in the corporate bond market enough to impair trading. Risk spreads on speculative-grade bonds narrowed considerably over the year's final quarter and in early 2003, though they remain elevated by historical standards; risk spreads for the weaker speculative-grade credits remain exceptionally wide, as investors evidently anticipate a continued high level of defaults and low recovery rates.

Equity Markets

Equity prices were buffeted last year by considerable fluctuations in investors' assessments of the outlook for the economy and corporate earnings and by doubts about the quality and transparency of corporate balance sheets. Net declines in stock prices in 2002 exceeded those posted during either of the preceding two years. Worries about the pervasiveness of questionable corporate governance and a deterioration in the earnings outlook—especially in the technology sector—depressed equity prices in early 2002. The positive tenor of economic data, however, managed to outweigh those concerns, and stock prices staged a rally halfway through the first quarter, with the gains tilted toward "old economy" firms. But the rebound was short lived. Share prices started to tumble in early spring across all sectors as weaker-than-expected economic data eroded investors' confidence in the strength of the economic expansion. These developments were reinforced by first-quarter corporate earnings reports that, though mostly matching or exceeding investors' expectations, painted a bleak picture of prospective sales and profits.

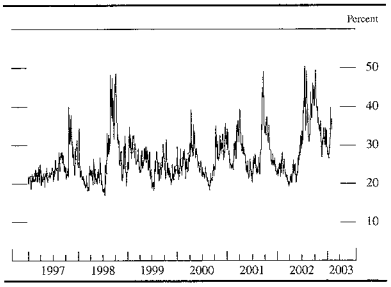
Over the spring and summer, accounting scandals, widespread warnings about near-term corporate profitability, and heightened geopolitical tensions intensified the slide in stock prices. Particularly large declines in share prices were posted for technology firms, whose prospects for sales and earnings were especially gloomy. Equity prices were boosted briefly by the uneventful passing of the August 14 deadline to certify financial statements, but they quickly reversed course on continued concerns about the pace of economic growth and corporate earnings and the escalating possibility of military action against Iraq. By early October, equity indexes sank to their lowest levels since the spring of 1997, and implied stock price volatility on the S&P 100 surged to its highest reading since the stock market crash of 1987.

Major stock price indexes



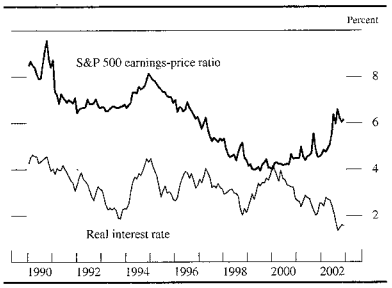
NOTE. The data are daily and extend through February 5, 2003.

Implied S&P 100 volatility



NOTE. The data are daily and extend through February 5, 2003. The series shown is the implied volatility of the S&P 100 stock price index as calculated from the prices of options that expire over the next several months.
SOURCE. Chicago Board Options Exchange.

S&P 500 forward earnings-price ratio
and the real interest rate



NOTE. The data are monthly and extend through December 2002. The earnings-price ratio is based on I/B/E/S consensus estimates of earnings over the coming year. The real rate is estimated as the difference between the ten-year Treasury rate and the five-year to ten-year expected inflation rate from the FRB Philadelphia survey.

The drop in stock prices widened the gap between the expected year-ahead earnings-price ratio for the S&P 500 and the real ten-year Treasury yield—one simple measure of the equity premium—to levels not seen since the mid-1990s.

Share prices turned around in late October, as the third-quarter corporate earnings reports were not as weak as investors had originally feared. Equity prices were also given a boost in early November by the larger-than-expected monetary policy easing, and the rally was sustained over the remainder of the year by the generally encouraging tone of economic data. Greater confidence among investors in the economic outlook also helped bring down the implied volatility on the S&P 100 significantly by year-end, although it remains at an elevated level by historical standards. Despite the fourth-quarter rebound, broad equity indexes were down, on net, about 20 percent in 2002, while the tech-heavy Nasdaq lost more than 30 percent.

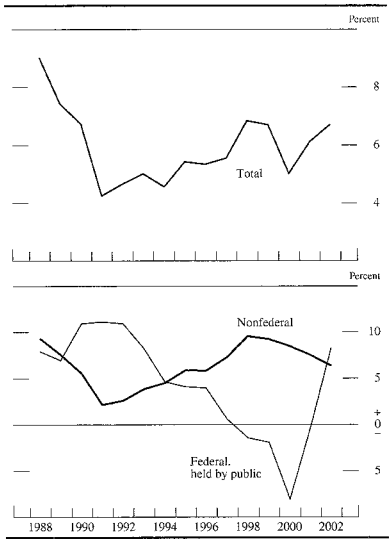
The decline in equity prices during the first three quarters of 2002 is estimated to have erased more than $3½ trillion in household wealth, a loss of nearly 9 percent of total household net worth, although the fourth-quarter rise in stock prices restored about $600 billion. Still, the level of household net worth at the end of last year was more than 40 percent higher than it was at the start of the bull market in 1995. Equity prices maintained their upward momentum during the first half of January 2003 but then fell sharply amid the looming prospects of military action against Iraq and a still-gloomy outlook for corporate earnings. Broad stock price indexes have lost almost 5 percent this year; however, solid fourth-quarter earnings from many prominent technology companies helped brighten investors' sentiment regarding that sector, and the Nasdaq is down about 3 percent this year.

Debt and Financial Intermediation

A deceleration of business borrowing slowed growth of the debt of nonfederal sectors about 1 percentage point in 2002, to 6½ percent. By contrast, the decline in interest rates last year kept borrowing by households and state and local governments brisk. At the federal level, weak tax receipts and an acceleration in spending pushed debt growth to 7½ percent last year after a slight contraction in 2001.

For the year as a whole, corporate borrowing was quite weak, mainly because of sagging capital expenditures, a drying up of merger and acquisition activity, and a reliance on liquid assets. Although businesses tapped bond markets in volume over the first half of the year, subsequent concerns about the reliability of financial statements

Change in domestic nonfinancial debt

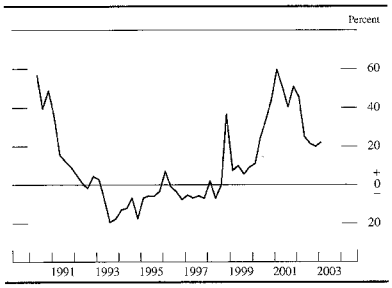


NOTE. For 2002, change is from 2001:Q4 to 2002:Q3 at an annual rate. For earlier years, the data are annual and are computed by dividing the annual flow for a given year by the level at the end of the preceding year. The total consists of nonfederal debt and federal debt held by the public. Nonfederal debt consists of the outstanding credit market debt of state and local governments, households, nonprofit organizations, nonfinancial businesses, and farms. Federal debt held by the public excludes securities held as investments of federal government accounts.

and the quality of corporate governance and deteriorating creditworthiness ruined investors' appetite for corporate debt in the summer and early autumn. Households, by contrast, flocked to the mortgage markets to take advantage of low mortgage rates throughout the year, and strong motor vehicle sales supported the expansion of consumer credit. For depository institutions, the net effect of these developments was an acceleration of credit to 6½ percent last year, 2 percentage points above the pace of 2001. The growth of credit at thrift institutions moderated, though the slowdown can be attributed for the most part to a large thrift institution's conversion to a bank charter. The growth of credit at commercial banks accelerated to 6¾ percent—a significant increase from the anemic pace in 2001; the pickup was driven by large acquisitions of securities, especially mortgage-backed securities, as well as a surge in home equity and residential real estate lending.

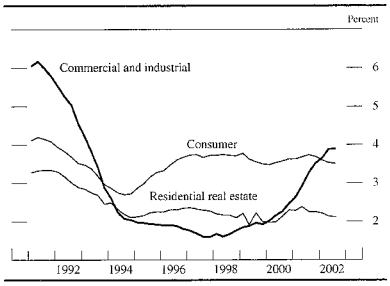
By contrast, business lending at commercial banks dropped 7 percent last year after falling almost 4 percent in 2001; last year's decline kept overall loan growth for 2002 to about 5 percent. In the October Senior Loan Officer Opinion Survey on Bank Lending Practices, respondents noted that the decline in commercial and industrial (C&I) lending since the beginning of the year reflected not only the limited funding needs of creditworthy borrowers that found bond financing or a runoff of liquid assets more attractive, but also a reduction in the pool of creditworthy borrowers. Over the course of last year, banks reported some additional net tightening of standards and terms on C&I loans, mainly in response

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 2003 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.

Delinquency rates on selected types of loans at banks

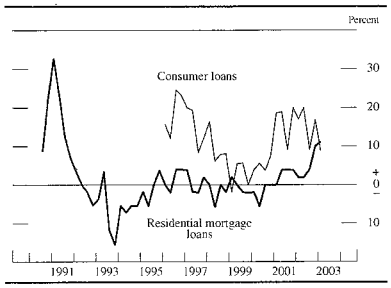


NOTE. The data, from bank Call Reports, are quarterly, seasonally adjusted, and extend through 2002:Q3.

to greater uncertainty about the economic outlook and rising corporate bond defaults, although the proportions of banks that reported doing so declined noticeably. Direct measures of loan pricing conditions from the Federal Reserve's quarterly Survey of Terms of Business Lending also indicated that banks were cautious lenders last year, as the average spread of C&I loan rates over market interest rates on instruments of comparable maturity remained wide, and spreads on new higher-risk loans declined only slightly from the lofty levels that prevailed over the first half of the year. Although bank lenders were wary about business borrowers, especially toward lower-rated credits, they did not significantly constrict the supply of loans: Most small firms surveyed by the National Federation of Independent Businesses in 2002 reported that they experienced little or no difficulty satisfying their borrowing needs.

Loan quality at commercial banks improved overall last year. Loan delinquency rates edged down through the third quarter of 2002—the latest period for which Call Report data are available—in response to better performance of residential real estate and consumer loans and a stable delinquency rate on C&I loans. Despite the improvement in consumer loan quality, domestic banks imposed somewhat more stringent credit conditions when lending to households, according to the survey on bank lending practices. Moderate net proportions of surveyed institutions tightened credit standards and terms for credit card and other consumer loans throughout last year. The net fraction of banks that tightened standards on residential mortgage loans rose late in the year to the highest share in the past decade, but nonetheless remained quite low. Commercial banks generally registered strong profit gains last year, although steep losses on loans to energy and telecommunications firms significantly depressed profits at several large bank holding companies. Despite

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

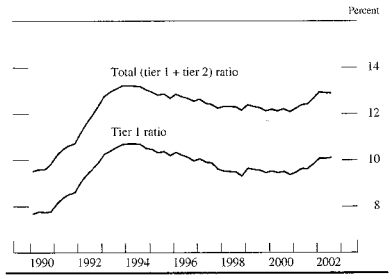


NOTE. The data are based on a survey generally conducted four times per year; the last reading is from the January 2003 survey. Net percentage is the percentage reporting a tightening less the percentage reporting an easing.
SOURCE. Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices.

the increased rate of provisioning for loan losses, the banking sector's profitability stayed in the elevated range recorded for the past several years, as a result of the robust fee income from mortgage and credit card lending, effective cost controls, and the relatively inexpensive funding offered by inflows of core deposits. As of the third quarter of last year, virtually all assets in the banking sector were at well-capitalized institutions, and the substitution of securities for loans on banks' balance sheets helped edge up risk-based capital ratios.

The financial condition of insurance companies, by contrast, worsened notably last year. Both property and casualty insurers and life and health insurers sustained significant investment losses from the decline in equity prices and the deterioration in corporate credit quality. However, these negative pressures were offset somewhat by the continued strong growth of insurance premiums, and both sectors of the insurance industry stayed fairly well capitalized in 2002.

Regulatory capital ratios of commercial banks



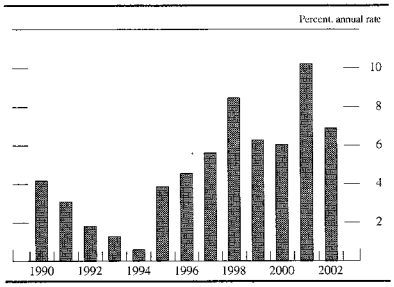
NOTE. The data, which are quarterly and extend through 2002:Q3, are ratios of capital to risk-weighted assets. Tier 1 capital consists primarily of common equity and certain perpetual preferred stock. Tier 2 capital consists primarily of subordinated debt, preferred stock not included in tier 1 capital, and a limited amount of loan-loss reserves.

Monetary Aggregates

The broad monetary aggregates decelerated noticeably last year after surging in 2001. Short-term market interest rates, which had declined swiftly during 2001, were stable over the first half of the year; deposit rates, in a typical pattern of lagged adjustment, continued to fall. Consequently, the opportunity cost of holding M2 assets increased, especially for its liquid deposit (checking and savings accounts) and retail money fund components, thereby restraining the demand for such assets. After decelerating in the first half of the year, M2 rebounded significantly in the second half, because of a surge in liquid deposits and retail money market mutual funds. The strength in both components partly reflected elevated volatility in equity markets against the backdrop of a still-low opportunity cost of holding such deposits. In addition, another wave of mortgage refinancing boosted M2 growth during this period. (Refinancings cause prepayments to accumulate temporarily in deposit accounts before being distributed to investors in mortgage-backed securities.) All told, over the four quarters of the year, M2 increased 7 percent, a pace that exceeded the expansion of nominal income. As a result, M2 velocity—the ratio of nominal GDP to M2—declined for the fifth year in a row, roughly in line with the drop in the opportunity cost of M2 over this period.

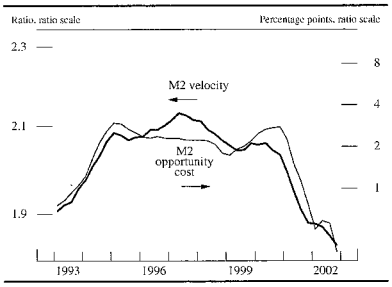
Reflecting in part the slowing of its M2 component, M3—the broadest money aggregate—expanded

M2 growth rate



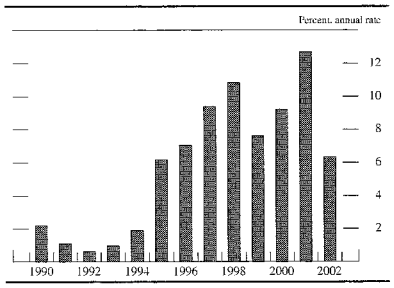
NOTE. M2 consists of currency, travelers checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds.

M2 velocity and opportunity cost



NOTE. The data are quarterly and extend through 2002:Q4. The velocity of M2 is the ratio of nominal gross domestic product to the stock of M2. The opportunity cost of holding M2 is a two-quarter moving average of the difference between the three-month Treasury bill rate and the weighted average return on assets included in M2.

M3 growth rate



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

6½ percent in 2002, a pace well below the 12¾ percent advance posted in 2001. Growth in M3 was also held down by a sharp deceleration of institutional money funds, as their yields dropped to close alignment with short-term market interest rates. This effect was only partly offset by the pickup in needs to fund bank credit, which resulted in an acceleration in the issuance of managed liabilities, including large time deposits. M3 velocity continued to decline in 2002.

New Discount Window Programs

On October 31, 2002, following a three-month public comment period, the Board of Governors approved changes to its Regulation A that established two new types of loans to depository institutions—primary and secondary credit—and discontinued the adjustment and extended credit programs. The new programs were implemented on January 9, 2003. The seasonal credit program was not altered.

The primary reason for adopting the new programs was to eliminate the subsidy to borrowing institutions that was implicit in the basic discount rate, which since the late 1960s had usually been set below market interest rates. The subsidy required Federal Reserve Banks to administer credit extensions heavily in order to ensure that borrowing institutions used credit only in appropriate circumstances—specifically, when they had exhausted other reasonably available funding sources. That administration was necessarily somewhat subjective and consequently difficult to apply consistently across Reserve Banks. In addition, the heavy administration was one factor that caused depository institutions to become reluctant to use the window even in appropriate conditions. Also, depository institutions were concerned at times about being marked with a "stigma" if market analysts and counterparties inferred that the institution was borrowing from the window and suspected that the borrowing signaled that the institution was having financial difficulties. The resulting reluctance to use the window reduced its usefulness in buffering shocks to the reserve market and in serving as a backup source of liquidity to depository institutions, and thus undermined its performance as a monetary policy tool.

To address these issues, the Board of Governors specified that primary credit may be made available at an above-market interest rate to depository institutions in generally sound financial condition. The above-market interest rate eliminates the implicit subsidy. Also, restricting eligibility for the program to generally sound institutions should reduce institutions' concerns that their borrowing could signal financial weakness.

The Federal Reserve set the initial primary credit rate at 2.25 percent, 100 basis points above the FOMC's target federal funds rate as of January 9, 2003. The target federal funds rate remained unchanged, and thus the adoption of the new programs did not represent a change in the stance of monetary policy. In the future, the primary credit rate will be adjusted from time to time as appropriate, using the same discretionary procedure that was used in the past to set the adjustment credit rate. The Federal Reserve also established procedures to reduce the primary credit rate to the target federal funds rate in a national emergency, even if key policymakers are unavailable.

Institutions that do not qualify for primary credit may obtain secondary credit when the borrowing is consistent with a prompt return to market sources of funds or is

necessary to resolve severe financial difficulties. The interest rate on secondary credit is set by formula 50 basis points above the primary credit rate. The rate was set initially at 2.75 percent. Because secondary credit borrowers are not in sound financial condition, extensions of secondary credit usually involve some administration.

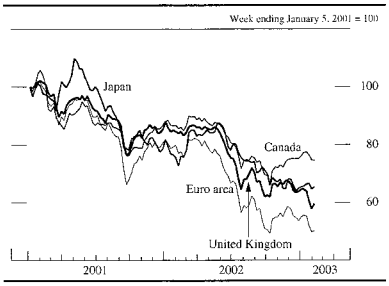
International Developments

The international economy rebounded in 2002 after a stagnant performance in 2001, but recovery was uneven in both timing and geographical distribution. Growth abroad picked up sharply in the first half of last year, as a strong rally in the high-tech exporting economies in developing Asia was joined by robust growth in Canada and, to a lesser extent, Mexico. Japan also posted respectable growth in the first half, largely as a result of a surge of exports. However, performance in the euro area remained sluggish, and several South American economies experienced difficulties, with full-fledged crises in Argentina and Venezuela and mounting concerns about prospects for Brazil. As the U.S. economy decelerated in the second half, the rapid pace of recovery slowed in developing Asia and in Canada, while performance remained lackluster in much of the rest of the world.

Monetary policy actions abroad also diverged across countries in 2002 as authorities reacted to differing economic conditions. In Canada, official interest rates were raised in three steps by July amid concerns that buoyant domestic demand and sharply rising employment would ignite inflationary pressures. Monetary authorities in Australia and Sweden also increased policy rates in the first half of the year. However, as economic conditions weakened around the world in the second half, official interest rates were held constant in Canada and Australia and were lowered in Sweden. Monetary policy was held steady throughout 2002 in the United Kingdom, where growth was moderate and inflation subdued, but official interest rates were lowered 25 basis points, to 3.75 percent, in early February 2003 in response to concerns about the prospects for global and domestic demand. The European Central Bank (ECB) held rates constant through most of the year, as inflation remained above the ECB's 2 percent target ceiling, but rates were lowered 50 basis points in December as the euro area's already weak recovery appeared to be stalling. Japanese short-term interest rates remained near zero, while authorities took some limited further steps to stimulate demand through nontraditional channels. Monetary policy was tightened in both Mexico and Brazil in response to concerns about the inflationary effects of past currency depreciation.

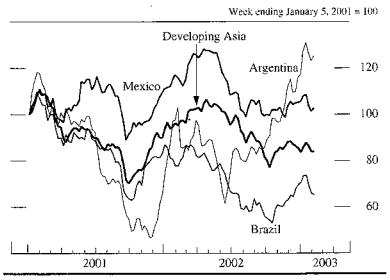
Yield curves in the major foreign industrial countries steepened and shifted up in the first quarter of 2002 in response to generally favorable economic news, but later they flattened out and moved back down as the outlook deteriorated. Similarly, equity prices in the major foreign industrial economies held up well early in the year but then declined along with the U.S. stock market and ended the year down sharply from the previous year. The performance of the stock markets in the emerging-market economies was mixed. Share prices in Brazil and Mexico fell sharply in the second and third quarters but then showed some improvement toward the end of the year. In the Asian emerging-market economies, equity prices rose in the first half of 2002 on a general wave of optimism, especially in the high-technology producing economies; equity prices began to decline around midyear as global demand softened but posted modest rebounds late in the year.

Equity indexes in selected foreign industrial countries



NOTE. The data are weekly. The last observations are the average of trading days through February 5, 2003.

Equity indexes in selected emerging markets



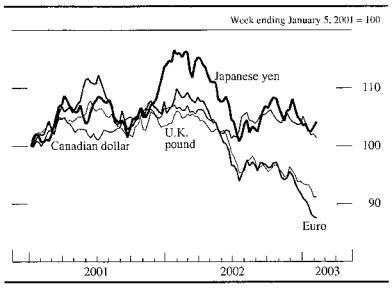
NOTE. The data are weekly. The last observations are the average of trading days through February 5, 2003.

The foreign exchange value of the dollar continued its mild upward trend into the early part of 2002, as it appeared that the United States was poised to lead a global economic recovery. However, the dollar weakened sharply in the late spring and early summer amid deepening concerns about U.S. corporate governance and profitability. Around that time market analysts also appeared to become more worried about the growing U.S. current account deficit and its potential negative influence on the future value of the dollar. The dollar rebounded somewhat around midyear as growth prospects for other major economies, particularly in the euro area, appeared to dim; the dollar dropped back again late in the year as geopolitical tensions intensified, and continued to depreciate in early 2003. In nominal terms the dollar has declined about 5 percent on balance over the past year, with depreciations against the currencies of the major industrial countries and several of the developing Asian economies partly offset by appreciation against the currencies of several Latin American countries.

Industrial Economies

The Canadian economy recorded the strongest performance among the major foreign industrial countries last year despite some slowing in the second half. The strength, which was largely homegrown, reflected robust growth of consumption and residential construction as well as an end to inventory runoffs early in the year. The expansion was accompanied by very rapid increases in employment and utilization of capacity, and the core inflation rate breached the upper end of the government's 1 percent to 3 percent target range near the end of the year. The Canadian dollar appreciated against the U.S. dollar in the first half of the year, but it dropped back somewhat in the second half as the economy slowed; by the end of the year it was up only slightly on balance. The Canadian dollar has moved up somewhat more so far this year.

U.S. dollar exchange rate against selected major currencies



NOTE. The data are weekly. Exchange rates are in foreign currency units per dollar. Last observations are the average of trading days through February 5, 2003.

The Japanese economy recorded positive growth during 2002, although it was not enough to fully reverse the decline in output that occurred in 2001. Despite about 10 percent appreciation of the yen against the dollar in 2002, Japanese growth was driven largely by exports, with smaller contributions from both increased consumption and a slower pace of inventory reduction. In contrast, private investment continued to decline, although not as sharply as in 2001. Labor market conditions remained quite depressed, and consumer prices continued to fall. Little progress was made on the serious structural problems that have plagued the Japanese economy, including the massive and growing amount of bad loans on the books of Japanese banks. A new set of official measures that aims at halving the value of bad loans within two and a half years was announced in the fall, but the details of this plan are still not fully specified. In September, the Bank of Japan announced a plan to buy shares from banks with excessive holdings of equity, which would help to reduce bank exposure to stock market fluctuations. Because the transactions are to occur at market prices, there would be no net financial transfer to the banks. Near the end of last year the Bank of Japan (BOJ) raised its target range for bank reserves at the BOJ from ¥10–15 trillion to ¥15–20 trillion, increased the monthly amount of its outright purchases of long-term government bonds, and broadened the range of collateral that can be used for market operations. In December the monetary base was up about 20 percent from a year earlier, a rise partially reflecting the increased level of bank reserves at the BOJ. However, the twelve-month rate of base money growth was considerably below the 36 percent pace registered in April. Broad money growth remains subdued.

Economic performance in the euro area was quite sluggish last year. Although exports were up sharply, growth in consumption was modest, and private investment declined. The area's lackluster economic performance pushed the unemployment rate up by several tenths of a percentage point by the end of the year. Economic weakness was particularly pronounced in some of the larger countries—Germany, Italy, the Netherlands, and, to a lesser extent, France. In contrast, growth in Spain and some of the smaller euro-area countries—Ireland, Portugal, Finland, and Greece—was much more robust. Headline inflation jumped to a bit above 2½ percent early in the year, owing to higher food and energy prices and in small part to the introduction of euro notes and coins. Increased slack in the economy, however, together with the 15 percent appreciation of the euro by the end of the

year, helped to mitigate inflation concerns, and the ECB lowered its policy interest rate in December. The euro continued to appreciate in early 2003.

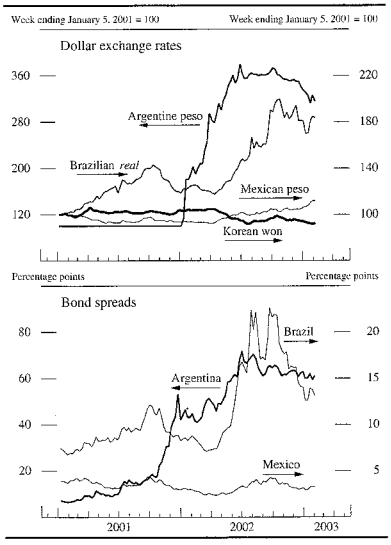
Economic growth in the United Kingdom held up better than in the other major European countries last year, and sterling strengthened about 10 percent versus the dollar. However, the expansion remained uneven, with the services sector continuing to grow more rapidly than the smaller manufacturing sector. Despite tight labor markets, inflation remained a bit below the Bank of England's target of 2½ percent for most of the past year. A sharp rise in housing prices has, however, raised some concern about the possibility of a real estate price bubble. The British government announced its intention to complete a rigorous assessment of its criteria for joining the European Monetary Union (EMU) by the middle of this year and, if they are met, to hold a referendum on entry.

Emerging-Market Economies

The Brazilian economy posted a surprisingly strong rebound in 2002 despite a major political transition and accompanying turbulence in financial markets. The Brazilian *real* depreciated sharply between May and October, and sovereign bond spreads climbed to 2,400 basis points as it became increasingly likely that Luiz Inácio Lula da Silva (Lula), the Workers' Party candidate, would win the presidential election. Given some of the past stances of the party, this possibility fueled concerns among foreign investors about a potential erosion of fiscal and monetary discipline. In response to the sharp deterioration in financial conditions facing Brazil, a $30 billion IMF program was approved in September 2002, $6 billion of which was disbursed by the end of the year. However, financial conditions improved markedly after Lula won the election in late October and appointed a cabinet perceived to be supportive of orthodox fiscal and monetary policies, including greater central bank independence. By January 2003 the *real* had reversed about one-fourth of its previous decline against the dollar, and bond spreads had fallen sharply. However, the new administration still faces some major challenges. In particular, serious concerns remain over the very large quantity and relatively short maturity of the outstanding government debt. In addition, last year's currency depreciation fueled a rise in inflation that has prompted several increases in the monetary policy interest rate. In January the government raised the upper bound of its inflation target range for this year to 8.5 percent from 6.5 percent, although the target for next year was lowered at the same time to 5.5 percent from 6.25 percent.

Argentine GDP contracted further in 2002 after declining 10 percent in 2001. The currency board arrangement that had pegged the peso at a one-to-one rate with the dollar collapsed early last year; the peso lost nearly three-fourths of its value by late June, and sovereign bond spreads spiked to more than 7,000 basis points. By early 2002, the banking system had become effectively insolvent as a result of the plunging peso, the weak economy, and the government's default on debt that the banks held mostly involuntarily. Confronted with this situation, the government forced the conversion of the banks' dollar-denominated assets and liabilities to pesos and also mandated the rescheduling of a large share of deposits. As a result of these and other measures, confidence in the banking system, already shaken, was further impaired. Financial and economic conditions eventually stabilized in the second half of the year, but there are no signs yet of a sustained recovery. The government also defaulted on obligations to multilateral creditors in late 2002 and early 2003. In January, Argentina and the International Monetary Fund reached agreement on a $6.6 billion short-term program that will go to meeting Argentina's payments to the IMF at least through the elections expected

Exchange rates and bond spreads for selected emerging markets



NOTE. The data are weekly. Exchange rates (top panel) are in foreign currency units per dollar. Bond spreads (bottom panel) are the J.P. Morgan Emerging Market Bond Index (EMBI+) spreads over U.S. Treasuries. Last observations are the average of trading days through February 5, 2003.

in the spring and also to clearing its overdue obligations to the multilateral development banks.

Venezuela experienced extreme economic and political turmoil over the past year. In February 2002 the central bank abandoned the bolivar's crawling peg to the dollar, and the bolivar depreciated sharply. Opponents of President Hugo Chavez mounted a short-lived coup in April and declared a national strike in early December. The strike brought the already-weak economy to a standstill, and output in the key oil industry plummeted. The strike abated in early February in all sectors but oil. In response to the strike, Chavez increased his control of the state-owned oil company and oil production began rising in early 2003, but it was still well below pre-strike levels. With the exchange rate plunging in late January, the government suspended currency trading for two weeks before establishing a fixed exchange rate regime and some restrictions on foreign currency transactions.

One of the few bright spots in Latin America last year was the Mexican economy. Boosted by the U.S. recovery, growth was moderate for the year as a whole despite some late slowing. However, financial conditions deteriorated somewhat after midyear as market participants reevaluated the strength of the North American recovery. Mexican stock prices slid about 25 percent between April and September, and sovereign bond spreads widened nearly 200 basis points to around 430 basis points over the same period. Nevertheless, the Mexican economy did not appear to be much affected by spillovers from the problems elsewhere in Latin America; bond spreads dropped sharply between October and the end of the year to around 300 basis points, a level considerably lower than elsewhere in the region. The peso depreciated about 12 percent against the dollar over the course of last year. The decline fueled an increase in twelve-month inflation to more than 5½ percent by year-end. The acceleration put inflation above the government target rate of 4½ percent and well above the ambitious 3 percent target set for 2003. In response to increasing inflation, the Bank of Mexico has tightened monetary policy four times since September 2002. The peso has continued to depreciate in early 2003, and bond spreads have moved back up a bit.

The Asian emerging-market economies generally performed well in 2002, although there were significant differences within the region. Outside of China, the strongest growth was recorded in South Korea, which benefited in the first half of the year from both an upturn in global demand for high-tech products and a surge in domestic demand, particularly consumption. However, consumer confidence deteriorated at the end of the year as tensions over North Korea intensified; the uneasy situation, as well as the substantial existing consumer debt burden, pose significant risks to growth in consumption this year. The Korean won appreciated sharply against the dollar between April and midyear in response to improving economic conditions; it then dropped back in late summer and early fall as perceptions about the strength of the global recovery were adjusted downward. However, the won turned back up against the dollar late last year.

The performance of the ASEAN-5 economies—Indonesia, Malaysia, the Philippines, Singapore, and Thailand—also was generally robust in 2002, although the overall softening in global demand in the second half of the year was evident there as well. The second-half slowing in production was particularly pronounced in Singapore, which is heavily dependent on exports of high-technology products. Taiwan, another high-technology producer, also showed a significant deceleration in output between the first and second halves of the year. Both of these economies experienced some mild deflation in 2002, although prices turned up toward the end of the year.

Although the Hong Kong economy did not show as much improvement as most other emerging Asian economies in the first half of last year, it recorded very strong growth in the third quarter. Nevertheless, prices continued to fall for the fourth consecutive year. The mainland Chinese economy, which again outperformed the rest of the region in 2002, enjoyed surging investment by the government and by foreign investors as well as robust export growth. The Chinese economy continued to experience mild deflation last year.

Chairman Greenspan submitted the following in response to written questions received from Congressman Joe Baca in connection with the House Financial Services Committee hearing of February 12, 2003:

It is clear to me that the only thing that has been keeping this economy afloat is the low interest rates offered to consumers. Because the FED has kept interest rates so low, working families have been able to afford purchasing homes and cars at reasonable rates despite the poor economy. They also have been able to benefit form these low rates by refinancing their homes causing a nationwide refinancing boom. Economists estimate that the boom has put $420 billion dollars into homeowner's pockets in the past two years. With the value of the dollar falling, deficits rising, and Bush's tax cuts eliminating federal revenue, is the FED going to be able to continue the low interest rate trend? Won't increasing interest rates have a devastating effect on consumers and more importantly working families?

The level of interest rates is unusually low at the present time because of the various factors inhibiting overall spending which, in turn, have resulted in relatively sluggish growth of the economy. As you point out, that low level of interest rates has been an important force in maintaining economic growth. Significant upward pressures on market interest rates, should they occur, are likely to reflect stronger spending propensities, particularly by businesses, and a related expansion in credit demands. Because significantly higher market interest rates are likely to occur only in the context of stronger economic conditions, they associated increases in incomes should enable households to expand their expenditures. In addition, as you note, many households (as well as businesses) have taken the opportunity to strengthen their balance sheets by locking in very low long-term rates, and thus the exposure of these households to rising interest rates is reduced.

States all across the country are currently experiencing significant budgetary problems and the Administration has refused to help. California alone faces a $36 billion dollar budget deficit, the largest state deficit in U.S. History! The Administration has turned its back on the states and has refused to fund critical programs, such as TANF and No Child Left Behind, while mandating that the states meet federal mandates. Estimates indicate that the proposed tax cuts are going to cost states $23 billion dollars in the short term and $41 billion over ten years. Isn't it true that States, because of Federal fiscal policy, are going to be put in the position of drastically raising taxes in order to stay alive? Isn't Bush's plan that proclaims to help working families really harming them because ultimately families are going to be hit by increased income, property, and sales tax at the state level?

Most of the effect of the President's tax cut plans on state revenues would derive from the proposed removal of dividends received by individuals from the federal individual income tax base. This could affect state revenues because most states, including California, use adjusted gross income reported on federal income tax returns as the base for the calculation of state income tax liability and (under current law) dividends are included in federal adjusted gross income. In this situation, states that do not wish to cut taxes could consider altering their tax rates or altering their use of adjusted gross income from the federal form in a manner that avoids the potential reductions in revenues.

Chairman Greenspan submitted the following in response to written questions received from Congresswoman Judy Biggert in connection with the House Financial Services Committee hearing of February 12, 2003:

Mr. Greenspan, what are your views concerning the adequacy of existing laws and regulation governing bank tying? Are you aware of any convincing evidence that illegal tying occurs? What steps is the Federal Reserve taking to ensure that commercial banking companies do not engage in illegal anti-tying activities?

Banks are subject to a variety of laws that prohibit them from tying products and services in a manner that harms customers or lessens competition. Section 106 of the Bank Holding Company Act Amendments of 1970, prohibits a bank from extending credit or varying the terms of credit on the condition that a customer purchase another product or service from the bank or its affiliates, with certain exceptions. Banks are also subject to the anti-tying provisions of the federal antitrust laws, which prohibit a company with market power in one product from using that market power to require a customer to purchase a second product.

In addition, to the extent that this conduct involves a bank reducing the price of credit to benefit an affiliate's investment banking business, it may violate section 23B of the Federal Reserve Act, which requires that transactions involving a bank and its affiliate be on market terms. Finally, in certain circumstances, this practice may, by reducing the bank's income for the benefit of an affiliate, be an unsafe and unsound banking practice.

The Board's examination procedures and practices include supervisory efforts to ensure compliance with section 106, other banking statutes and safe and sound banking practices. For example, the Board's Supervision Manuals governing Bank Holding Company and State Member Bank Examinations provide for compliance reviews of a bank holding company and state member bank that include evaluation by examiners of the institution' program for compliance with section 106. The Board and the other federal banking agencies have also issued guidance directing banks and bank holding companies to implement and maintain appropriate systems and controls to promote compliance with the anti-tying provisions. That guidance addressed the need for specific policies and procedures addressing tying prohibitions, training materials and programs that provide examples of prohibited practices and sensitize employees to the concerns raised by tying, compliance systems, and management involvement in reviewing training, audit, and compliance programs related to tying. *See, e.g.,* FRB Bank Holding Company Supervision Manual § 3500.0; OCC Insurance Activities Handbook, Federal Prohibitions on Tying (June 2002); OCC Bulletin 95-20 (April 14, 1995).

In addition to examining for compliance with this agency guidance, the Board investigates allegations of illegal tying and initiates appropriate actions to remedy any violations of the anti-tying provisions that are found. Currently, the Board, in conjunction with the Office of the Comptroller of the Currency, is conducting a special targeted review of compliance with the anti-tying provisions in light of reports described in the press. This review includes a review of the anti-tying training and compliance programs, marketing programs, training materials and adequacy of internal audits for compliance with the bank's internal policies and procedures at several of the country's largest banks. These efforts are ongoing, and we have not yet completed our evaluation of the information we have gathered thus far. If the Board finds banks offering credit on an impermissible basis, we will take appropriate supervisory action to assure compliance with the law and to terminate unsafe and unsound banking practices.

To date, the agencies have not found that commercial banks are manipulating the pricing of credit to build investment banking market share. Clearly, banking organizations that have credit relationships with customers hope to sell them the bank's full range of products and services. As you know, banking organizations are permitted to package certain services because some tying arrangements are permissible under statutory and regulatory exceptions and some customers may request that the bank package services. In both cases, interested customers have the choice of whether to enter into these arrangements.

Chairman Greenspan submitted the following in response to written questions received from Congressman Luis V. Gutierrez in connection with the House Financial Services Committee hearing of February 12, 2003:

Mr. Chairman, in light of recent events and our current economic condition, could you please address the importance of immigrants to our nation's economic health?

During our last Full Committee hearing on Monetary Policy and the State of the Economy, you discussed how much the country has benefitted from the fact that we draw people from all over the world.

You also commented on immigrants' "willingness to do the types of work that make this economy function."

Could you please explain if anything has changed?

And also, could you further clarify why exactly immigrant labor is so important to our economy?

To take it a step further, the Labor Department estimates that the total number of jobs requiring only short-term training will increase from 53.2 million in 2000 to 60.9 million by 2010, a net increase of 7.7 million jobs.

The amount of native workers currently available and able to fill jobs that require short-term training continues to fall because of an aging workforce and rising education levels.

What would the ramifications be for U.S. businesses and our overall economic and fiscal health if the immigrant population in this country was to be rapidly reduced?

Also, would it be logical from an economic perspective to have a system in place that would legalize immigrants currently living in this country without documentation to ensure that we can adequately fill these jobs in the future?

Immigration has been an important demographic factor in the expansion of the U.S. economy in recent years. The Bureau of the Census estimates that in March 2002, the working-age (16 and older) civilian noninstitutional population of the United States

included 30 million foreign-born individuals; 45 percent of them had entered this country since 1990.

Using these estimates from the Bureau of the Census, we can infer that the net change in our foreign-born population accounted for roughly 40 percent of the increase in our working age population between 1990 and 2002. In percentage terms, that amounts to roughly 1/2 percentage point of the 1.1 percent per year increase in the working-age population over that period. The increase in our working-age population is one of the factors that, when combined with labor productivity, determine that rate at which our longer-run economic potential expands. That is, because aggregate output is basically output per worker times the number of workers, a rise in immigration that boosts the labor force will increase the potential growth rate of the economy. In addition, new immigrants add to aggregate income and spending, and, thus, aggregate demand; they also contribute to the revenue base of state and local governments through such channels as individual tax payments and contributions to social insurance.

Based on the boost to our working-age population, a rough estimate of the importance of immigration is that it has contributed about 1/2 percentage point annually to the rate of expansion of our aggregate productive potential in recent years. Of course, that is a simple, static estimate. If the immigration of the 1990s had been less than it was, the demand for workers may have set in motion changes in the labor force preferences among our native working-age population or in business decisions to substitute capital for labor in order to boost their productivity, which might have offset a portion of the output lost through the slower rise in the population.

Because U.S. labor markets typically exhibit a great deal of flexibility, they have been successful in absorbing the sizable and diverse influx of immigrants that we have seen in recent years. Indeed, those recent immigrants have filled jobs that span a wide range of occupations and that require a spectrum of skills and training. While about one-third of them have less than a high school education, a just slightly lower proportion of new immigrants who entered over the period from 1990 to 2002 had, by 2002, completed a bachelor's or advanced degree.

Chairman Greenspan submitted the following in response to written questions received from Congressman Rubén Hinojosa in connection with the House Financial Services Committee hearing of February 12, 2003:

Q.1. Chairman Greenspan, what impact would the Bush Administration's proposal for the elimination of double taxation of dividends have on municipal bonds? Some have said that it would decimate them, consequently harming cities around the nation at a time when cities and the states need more help than harm.

A.1. Investors hold municipal bonds because they provide the opportunity to earn interest income that is free from federal taxation. In this regard, marginal tax rates determine the attractiveness of municipal bonds relative to taxable bonds. Because dividends represent a small fraction of total taxable income, eliminating personal taxes on dividends would affect the marginal tax rate for only a small number of investors. Thus, any shift from municipal bonds to taxable bonds likely would be limited, which would prevent the interest rates on municipal debt from rising substantially.

Investing in equities is another alternative to holding municipal bonds. If personal taxes on dividends were eliminated, some investors would sell municipal bonds to purchase equities. However, equities are not a close substitute for the relative safety and stability of municipal bonds. Given the greater risk inherent in equities, I suspect that most investors would make only small adjustments in their holdings of equities relative to municipal bonds, which also would tend to limit the effect of the dividend tax proposal on municipal bond yields.

Q.2. Mr. Greenspan, as you are likely aware, the House Financial Services Committee will be holding hearings on the Fair Credit Reporting Act this year. Included in that Act are seven exceptions, one of which allows affiliates to share customer information. What would happen to the U.S. economy if the exceptions to the Fair Credit Reporting Act were allowed to expire after January 1, 2004? Do you support the extension of these exceptions?

A.2. The flow of information on the characteristics of customers, both businesses and individuals, and changes in information technology in recent years, have improved the efficiency, innovativeness and competitiveness of our markets. This information has enabled producers and marketers to fine-tune production schedules to the ever greater demands of our consuming public for diversity and individuality of products and services.

For example, the emergence of credit scoring technologies, which rely on the availability of information about the financial experiences of individuals, has proven useful

in expanding access to credit for us all, including for lower-income populations and others who have traditionally had difficulty obtaining credit. It has also enabled financial institutions to offer a wide variety of customized insurance, credit and other products. In addition, newly devised derivative products have enabled financial institutions to unbundle risk in ways that enable those desirous of taking on that risk (and potential reward) to do so, and those that choose otherwise, to be risk averse.

Limits on the flow of information among financial market participants, or increased costs resulting from restrictions that differ based on geography, may lead to an increase in the price or a reduction in the availability of credit, as well as a reduction in the optimal sharing of risk and reward. As a result, I would support making permanent the provision currently in the Fair Credit Reporting Act (FCRA) that provides for uniform federal rules governing various matters covered by the FCRA and would not support allowing different state laws in this area.

Q.3. Chairman Greenspan, I am not certain whether or not you are familiar with matricula consulars. A matricula consular is a water-sealed photo identification card issued by the Mexican government to Mexican nationals that complete an application form in person at any of the 47 consulate offices in the U.S. and submit a certified copy or a birth certificate, present an official picture ID issued by any Mexican or U.S. authority, and show proof of residence in the consular district by presenting a phone, rent or power bill. The card contains a serial number, the individual's name, date and place of birth, U.S. address, as well as the card's date of issuance and expiration. Mexican consulate offices are also developing a telephone verification service that will allow banks to confirm a matricula card's authenticity for the purposes of identification. Accepting matricula consular as a form of identification allows Mexican immigrants to enter the financial mainstream and provides banks with a new, fast-growing market. Opening a bank account is often impossible for Mexican nationals who lack the generally required two forms of identification. Consequently, they often use check-cashing services to cash payroll checks and wire services to send money to relatives in Mexico, both services imposing exorbitant fees. Hispanic immigrants also carry large sums of cash, which has increasingly made them targets of crime. 20% to 30% of my constituents are unbanked. Matricula consulars are important to helping move some of my constituents away from expensive wire services and into the traditional U.S. financial services sector. Many individuals believe these cards may satisfy the personal identification requirements of Section 326 of the Patriot Act currently under review by the Treasury Department. Do you have a position on the use of these cards? If not now, would you please respond as soon as possible because this issue will impact many individuals and banks across the country.

A.3. As with the use of any government-issued identification card that facilitates access to financial services, a case can be made for the potential benefits it offers, as well as for the possibility of problems it presents.

Any mechanism that improves the process--identifying and verifying customers--that financial institutions must undertake when opening account relationships can benefit the banking industry, the individual consumer, and the overall economy. Systematic identification systems that offer reliable verification of prospective account holders increase opportunities for financial institutions to expand their customer base and standardize their processes for opening accounts. Increased opportunities to participate in mainstream banking systems can improve a consumer's ability to access more competitive or responsive services. Such effects can improve banking market operations by increasing overall competition and efficiency.

However, as with the provision of any banking service, there is a degree of risk associated with the acceptance of alternate forms of identification. Certainly, concerns of fraud in relation to the issuance of such identification cards are valid, and measures must be taken to reduce an institution's exposure to the possibility of fraud. To mitigate risk, the Federal Reserve expects financial institutions to conduct due diligence to assess their risks of liability associated with all of their accounts, including those opened based on matricula consulars.

Q.4. Mr. Chairman, according to a recent article, a new coalition of nine national housing lobbies have expressed concern that the Bush Administration's proposal to eliminate taxation of stock dividends would undermine the country's most successful program producing and rehabilitating affordable housing. The low-income housing tax credit gives investors a dollar-for-dollar reduction in taxes in return for investing in such housing. The article contends that the dividend exemption could make all tax credits less attractive to investors and could move investment from tax-exempt government bonds to dividend-paying stocks. The group includes the National Association of Home Builders, the National Association of Realtors, the Mortgage Bankers Association of America, Fannie Mae and Freddie Mac. What are your views on this contention?

A.4. As I mentioned in my answer to Q.1, I believe that eliminating the double taxation of dividends would result in, at most, only a small increase in the interest rates on tax-exempt bonds. In addition, low-income housing tax credits would remain a valuable tax shield--except for those investors who receive the bulk of their income in the form of dividends. Thus, I would not expect the Administration's proposal to have severe adverse effects on the nation's affordable housing programs. Nonetheless, if the dividend tax proposal became law, the Congress would need to monitor whether the funding for such

programs remained at desired levels. If necessary, the Congress could adjust the structure of the programs to offset declines in the current sources of funding.

Q.5. The dividend paying stocks in the S&P 500 lost on average 18.4 percent last year. When the proposal for complete elimination of dividend taxes is promoted as highly beneficial to senior citizens investing in dividend-paying stocks is the risk associated with encouraging greater stock investment a concern?

A.5. As a point of clarification, the Administration's proposal would end the double taxation of dividends; it would not completely eliminate taxes on dividends. Currently, much corporate income that is paid out to individuals as dividends is taxed first at the corporate level, and then a second time at the individual level when shareholders are taxed on the dividends they receive. The Administration's proposal would eliminate only the second level of taxation.

As you note, stocks--including those that pay dividends--are subject to considerable investment risk, and prudent investing requires that this risk be taken into account at all times. Nonetheless, for most investors, stocks are a valuable part of a well-diversified portfolio. The appropriate portfolio allocation depends largely on the individual's investment horizon and risk tolerance, although tax considerations do play a role as well. If the double taxation of dividends were eliminated, some investors--including senior citizens--could well decide to allocate a larger share of their portfolio to stocks. However, the incentive to do this would vary across investors and could well be modest overall. One point to note is that investments held in retirement accounts, such as 401(k)s or IRAs, already enjoy tax-deferred accumulation. Thus, the dividend tax proposal would not affect the tax status of assets held in these accounts. Second, even for stocks held outside such accounts, the tax savings from eliminating personal taxes on dividends would be fairly small. Currently, the dividend yield for the S&P 500 is less than 2 percent. Hence, reducing the personal tax rate on dividends from (say) 30 percent to zero would boost the after-tax return on stocks by only 0.6 percentage point--probably not enough to prompt a major shift toward equity holdings.

Q.6. Mr. Greenspan, I serve on this Committee as well as on the House Education and Workforce Committee, where I am now Ranking Member on the Select Education Subcommittee. On the Education Committee, I have devoted a considerable amount of time trying to ensure that my constituents, who live in one of the poorest districts in the country, gain access to as many educational programs as possible. Now that I serve on this Committee, I also want to focus on ensuring that my constituents become financially literate and have access to as many financial literacy programs as necessary. The FDIC has a wonderful program in both English and Spanish, known as Money Smart, that targets

adults. It is being disseminated in my District. Several large banks, such as Wells Fargo and Bank of America have implemented financial literacy programs that are now being used in schools for K-12 programs. Additionally, the independent bankers in Texas are attempting to encourage the Texas State legislature to include financial literacy programs as a requirement for graduation from high school. What is your opinion of such programs, and how can the Federal Reserve help to provide financial literature to both school children and adults seeking such information? Education is the key to success.

A.6. Indeed, education is the key to success, and the value of an educated consumer of financial services cannot be underestimated. Knowledgeable consumers are empowered to make decisions that can optimize their financial situation and improve their future economic well being. Further, informed consumers are critical to efficient market operation, as consumers' choices promote competition among providers and ensure that the prices and terms of products are appropriate. I have, in fact, testified on the importance of financial education at hearings held by the Senate Committee on Housing, Banking and Finance on February 5, 2002, and spoken on the issue at the Federal Reserve's biennial Community Affairs Research Conference on April 6, 2001.

The Federal Reserve System has been devoting considerable resources to facilitate financial training in conjunction with the providers of such programs throughout the country. In its twelve Community Affairs and Public Information Offices, such efforts often take the form of hosting train-the-trainer workshops, highlighting effective local and regional programs in their newsletters, and conducting outreach to both identify information needs and to connect community groups with existing resources. For example, the Federal Reserve Board hosted a national community organization when it provided training on its financial education curriculum to community educators in February 2002. Some Federal Reserve Banks have also developed products to support educators and consumers in responding to financial training needs. In particular, the Federal Reserve Bank of Dallas offers "Building Wealth," a publication available in English and Spanish that provides an overview of the fundamental principles of personal financial management. The web-based version of this product also includes a calculator that enables users to develop a budget that factors in savings strategies to further short- and long-term asset building goals. More recently, the Federal Reserve Board has hosted several informational seminars for its employees highlighting consumer financial issues, such as purchasing a home, managing debt, and developing holiday spending budgets.

Given the increased interest in, as well as the proliferation of, financial education programs in recent years, the Federal Reserve Board has also been seeking ways to promote the measurement of the effectiveness and the identification of methods of efficient delivery of such programs because both programs and their appropriate delivery to the targeted audience are important to successful outcomes. In preparation for the 2003

Community Affairs Research Conference, a call for papers was published requesting, in part, studies that explore the efficacy of financial counseling and educational programs. A panel of researchers will be presenting the findings of their analyses at this conference to be held March 27-28 in Washington, D.C. The Board has also recently entered into a partnership with the Department of Defense to develop instruments to gauge the effectiveness of financial education provided as part of military training programs. In an effort to better understand issues related to the consumption of financial services, the Board's Division of Consumer and Community Affairs staff have published papers addressing various aspects of consumers' financial behavior, including money management and checking account ownership. An article providing an overview of the research, practices, and possible policy implications related to financial education programs was published in the November 2002 issue of the Federal Reserve Bulletin.

Given the importance that the Federal Reserve places on facilitating information flows to improve the operation of banking markets, we will continue to seek ways to appropriately and effectively promote and support financial training and education for consumers. This spring we plan to launch a major communications effort to heighten the visibility and importance of financial education.

Chairman Greenspan submitted the following in response to written questions received from Congresswoman Darlene Hooley in connection with the House Financial Services Committee hearing of February 12, 2003:

In my home state of Oregon, we are facing an enormous economic crunch similar to what is being experienced in some other states. Because of a loss in state revenue caused by the downturn in the economy, the state government is finding itself virtually in a precarious position. A loss of revenue, compiled by the rising unemployment, businesses closing, and a drop in consumer spending, has had the effect of limiting Oregon's ability to provide government services precisely when those services are in the most demand. As one example, the State is now considering reducing the number of school days in a calendar year as a way of trimming education costs. Furthermore, state and local governments since 9/11 have been forced to devote their already scarce resources towards improving local homeland security. In Salem, Oregon alone, the government has spent nearly $300,000 for security improvements.

Mr. Chairman, given this strain on state resources, I am very interested to know if you could speculate as to the impact of the President's tax cut plan on the revenue of State Governments?

Most of the effect of the President's tax cut plans on state revenues would derive from the proposed removal of dividend payments from the federal individual income tax base. This could affect state revenues because most states, including Oregon, use adjusted gross income reported on federal income tax returns as the base for the calculation of state income tax liability, and (under current law) dividends are included in federal adjusted gross income. In this situation, states that do not wish to cut taxes could consider altering their tax rates or altering their use of adjusted gross income from the federal form in a manner that avoids the potential reduction in revenues.

Mr. Chairman, you have said repeatedly in past testimony that, "all things being equal, a declining level of federal debt is desirable." At this time, it is estimated that there will be a federal deficit in the neighborhood of $307 billion for FY 2004, while just two years ago it was estimated that there would be a surplus of $262 billion for the same year. In your opinion, at what point, all things being equal, would a rising level of federal debt become undesirable?

Undesirable consequences of deficits (or, equivalently, rising debt levels) do not begin at any particular point. In general, increases in the deficit result in higher long-term interest rates which, in turn, discourage private borrowing and investment. However, if

deficits are allowed to become too large, there is the additional concern that fiscal system will become unsustainable--that is, higher debt service outlays engendered by growing debt may result in a cycle of ever-higher deficits and debt-service outlays relative to GDP. Such instability would not occur as long as deficits do not result in a rising debt-to-GDP ratio. The path of the debt-to-GDP ratio currently being projected by CBO and the Office of Management and Budget for the next several years is about flat; that is, the deficits do not yet pose a significant instability concern. But as we go beyond the turn of the decade, a very significant acceleration in payments to beneficiaries of both Social Security and Medicare will hit the budget and, in the absence of other budget adjustments, produce deficit-to-GDP ratios that would not be consistent with long-run fiscal sustainability.

A) Has the Federal Reserve ever issued a solicitation to the private sector for the national provision of services now performed by its Check Relay Network? If so, what were the results? If not, please explain why the Federal Reserve would not make such a solicitation.

The Federal Reserve Banks (Reserve Banks) provide check clearing services to the banking industry that are designed to facilitate the prompt collection and return of checks. To accomplish this task, the Reserve Banks have always contracted with private-sector air and ground couriers to transport millions of paper checks daily, six days a week, between Reserve Bank offices and to present or return checks to depository institutions.

During the 1970s, the Reserve Banks did issue a solicitation for and contracted with a single vendor for the weekday air transportation of the checks they collected. The Reserve Banks ended this business relationship when the carrier consistently was unable to meet the Reserve Banks' business requirements, including the failure to meet delivery deadlines. The problem directly resulted from the carrier placing a higher priority on completing its commercial bank customers' check deliveries than on those for the Reserve Banks. To reduce the potential for competing customer priorities for the same vendor equipment, the Reserve Banks began using vendors that were able to provide equipment that would be strictly devoted to meeting the Reserve Banks' deadlines.

Today, the transportation of checks between Reserve Bank locations is coordinated by the Federal Reserve Bank of Atlanta through its Check Relay office. The Atlanta Reserve Bank uses a competitive bidding process to contract for air and ground transportation services. Through the contracting process, broad-based requests for proposals (RFPs) for both air and ground courier services have been open to bids from both national providers and small, regional firms. The RFPs reflect the different business requirements for the Federal Reserve Banks' weekday and weekend check transportation needs.

For weekend transportation, the three-day span from Friday through Sunday night provides greater flexibility for processing checks and reduces the time-critical nature of the weekend delivery windows. This timing allows those routes to be served more easily by commercial air and ground carriers with multiple customers, while still meeting the Federal Reserve Banks' business requirements. This has allowed Check Relay to issue a solicitation for and contract with a single vendor to provide all weekend air and ground deliveries.

As further background on weekday operations, Check Relay manages a network involving about 50 private-sector aircraft that make an average of 200 flights each weekday evening. The air network is configured into geographic regions (termed "color zones"), with five regional "hub" cities facilitating the rapid delivery of items between Reserve Bank offices located within the same zone and to hubs in the other zones. Weekday

transportation is configured for two, six-hour delivery windows in this hub and spoke arrangement, which reflects the predominantly regional nature of the Federal Reserve Banks' check business. In addition to the air transportation component, ground operators based at hub airports load and unload aircraft and provide some ground transportation to and from Federal Reserve Bank offices.

During the last round of bids for weekday transportation, Check Relay sent RFPs to 220 companies of all sizes and in all sectors of the airfreight industry, including Airnet Systems, Inc. Companies were invited to bid on one or more of the network's routes. As a result of that competitive bidding process, seven private-sector firms currently provide weekday services for one or more of these routes. Although all contracts are not subject to rebidding at the same time, there are no restrictions that prohibit a single vendor from bidding on and, if successful, providing transportation services for all the weekday routes.

In addition, as part of its efforts to identify alternative transportation options, Check Relay issued a request for information in 2002 that asked a large number of vendors of air transport services, including Airnet Services, Inc., how the network might be managed better to improve its efficiency. No responses were received.

B) Has the Federal Reserve ever performed a comparative analysis exploring the merits of continuing to maintain the Check Relay Network versus those of a single private sector provider performing the same service under its supervision? If so, what were the results? If not, please explain why the Federal Reserve would not perform such an analysis.

Check Relay management continually evaluates alternative means of transporting the checks that the Reserve Banks collect. As part of that evaluation process, Check Relay must balance possible reductions in check transportation costs against maintaining check service quality and the potential cost of check float. The analysis has included extensive discussions with national carriers regarding possible check transportation alternatives that could meet the Reserve Banks' business requirements.

An important aspect of the Reserve Banks' requirements is that strict deadlines exist both for regional and national check transportation, in order to provide adequate clearing services nationwide. To date, national freight carriers (such as UPS or Federal Express) have not shown an ability to meet both these regional and national needs in a sufficiently robust manner to support the Reserve Banks' clearing activities.

To minimize cost and improve the availability of funds for withdrawal, it is imperative that checks be transported on time each night. A missed connection because of a plane's late arrival can result in a full-day delay in the collection of the checks on that plane. Such delays also create float, which can be a significant cost to the Reserve Banks,

depending upon the face value of the checks being carried and the prevailing interest rates. On average, the Check Relay network carries approximately $15 billion worth of checks each day. At the current federal funds rate of 1.25 percent, the potential cost to the Reserve Banks for every billion dollars worth of those checks that are delayed one day because of a late delivery is more than $33,000. If the federal funds rate were 4.59 percent, which was the average federal funds rate over the past ten years, a one-day delay would cost almost $126,000 per billion dollars of checks. In addition, the Federal Reserve relies upon accurate, daily estimates of this float to conduct its open market operations. Given these concerns and the level of service required, the Reserve Banks have found that effective, responsive, and efficient management of contracted couriers, their routes, and nightly flight plans is an important key to timely transportation of checks. The Check Relay function has consistently met these expectations on behalf of the Reserve Banks.

Although discussions with the nationally integrated carriers have led to some companies making bids for weekday routes and the weekend service, no specific proposals for having one company provide all transportation services have emerged from either those discussions or from the competitive bidding process that would sufficiently meet the Reserve Banks' business requirements. The Reserve Banks have sought advice and recommendations from outside consultants and transportation experts regarding how the Check Relay network could be improved. These outside experts have found the existing network approach appropriate for transporting checks, although they have suggested minor changes that have improved the efficiency of its operations even further. As mentioned in the answer to question A, Check Relay did not receive any responses to its 2002 request for information that asked a large number of vendors of air transport services how the network might be managed better to improve its efficiency.

C) The Federal Reserve traditionally has provided transportation service only from one Federal Reserve Bank to another in connection with check processing. Has the Federal Reserve ever marketed its transportation services to private sector banks other than from one Reserve Bank to another.

The Reserve Banks use private-sector air and ground couriers to transport checks between Reserve Bank offices and to present or return checks to depository institutions. In some cases, depository institutions may use those same couriers to deposit checks with the Reserve Banks. The Reserve Banks provide information regarding the availability of these transportation options to depository institutions. The Reserve Banks do not provide, however, any service that would permit a depository institution to ship checks directly to another depository institution.

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