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THE ECONOMIC OUTLOOK: MAY 2003

HEARING

before the

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

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JOINT ECONOMIC COMMITTEE

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CONTENTS

OPENING STATEMENT OF MEMBERS

WITNESS

SUBMISSIONS FOR THE RECORD

THE ECONOMIC OUTLOOK: MAY 2003

Wednesday, May 21, 2003

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

The Committee met pursuant to notice at 9:30 a.m., in room 216, Hart Senate Office Building, the Honorable Robert Bennett, Chairman of the Committee, presiding.

Present: Senators Bennett, Sessions, Sununu, Alexander, Collins, Sarbanes and Bingaman; Representatives Saxton, Ryan, Dunn, Putman, Paul, Stark and Hill.

Staff present:: Donald Marron, Jeff Wrase, Chris Frenze, Robert Keleher, Colleen J. Healy, Brian Higginbotham, Melissa Barnson, Drew Glover, Trish Kent, Gary Blank, Rebecca Wilder, Wendell Primus, Chad Stone, Matt Solomon, Daphne Clones, and Rachel Klastorin.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT, CHAIRMAN

Senator Bennett. The Committee will come to order.

We're starting right on time this morning because the Senate is scheduled for a 10:00 vote. And with apologies to our House members who have joined us, we will try to get the opening statements out of the way prior to the 10:00 vote, break so that Senators can come vote, and then return, and hope we can move in as expeditious a manner as possible.

We're pleased to have as our guest today Chairman Alan Greenspan of the Federal Reserve. We always appreciate his views on the current economic situation, as well as his broad perspective on the challenges that we face both as a nation and, increasingly, with the worldwide economy.

Now it's particularly interesting because today will be Chairman Greenspan's first hearing since the most recent meeting of the Federal Open Market Committee (FOMC). Changes in the Fed's statements, as well as substantial consumer and producer price declines in April, have generated many questions about deflation.

And I hope today's hearing will serve as a fair and open forum for exploring some of the potential answers.

In my own view, the deflation questions facing the United States are fundamentally different than they are for some economies currently suffering from this condition, such as Japan. We don't face the same deflation risks. But it's worth raising the issue and talking about it.

We shouldn't take any chances that might come from ignoring it.

The questions about deflation come in the context of a nation that is still awaiting signs that our economy has fully emerged from the recent recession. Many economists predicted months ago that once the fog of war was lifted, and uncertainty resolved, the economy would quickly rebound.

However, economic indicators continue to paint only a murky picture, precluding a confident declaration that the economy has turned the corner and has begun to approach full stride.

For example, far too many Americans are still out of work.

Congress should not wait any longer for brighter signs from the economy. We should send to the President's desk a bold growth and jobs package. And that is in the province of the Ways and Means Committee and the Finance Committee.

I assume that they are doing their work even as we speak.

Final passage of a bold jobs and growth package is an important step, but the next few months will require further activity and in that, Congress has much to do. We will start the discussion today about what tools we should use, in addition to tax cuts, to grow the economy and prepare for the future.

Now some might shrug at the idea of giving serious thought to a foggy future. But, in fact, the future is clearer than some would lead us to believe.

The biggest feature on the horizon, one that we can forecast with almost perfect accuracy, is the aging and the retirement of the Baby Boom generation. In the year 2011, just eight years away, the first of that generation will reach the age of 65. And as these men and women retire, the nation faces the serious challenge of having fewer workers available to support each retiree.

This will put pressure on social security and especially on a system of delivering health care that looks much the same as it did when the younger of the baby boomers still wore diapers.

Part of the answer will be having a fundamentally stronger and larger economy in place when they retire.

So we need to think harder about how we tax capital and how our practice in that area can improve. The tax burden on capital in the United States is higher than imposed by many of our international competitors. Continued high rates of capital taxation would, by discouraging investment and capital formation in the United States, handicap us in our efforts to meet upcoming challenges.

Just last week, 70 Senators voted for a "Sense of the Senate" amendment instructing Committee, as well as the Finance Committee, to consider tax reforms specifically including a Flat Tax. The bipartisan support for this amendment is an encouraging development, suggesting that many members of Congress recognize the need not to just cut taxes, but to reform the tax system.

We must have other weapons besides tax policy in our arsenal if we are to continue to flourish in the decades ahead, and we must consider them. One key strength on which we must draw is our economy's extraordinary flexibility, which has allowed us to weather an unexpected series of shocks over the past few years.

I observe this flexibility in strong financial markets helping to ensure our nation's financial resources are put to their best use. I see this flexibility as well in the vitality and creativity of small and growing businesses.

This is a unique American phenomenon, unduplicated in any other industrialized country. The entrepreneurial spirit, while it springs from a French word, is very much an American creation.

Thanks to the ingenuity of these small business owners who risk their capital, thanks to the eagerness and the ability of workers to adapt to new challenges, thanks to a pension system that has increasingly made workers mobile and allowed them to move from one entrepreneurial activity to another and quickly respond to the opportunities that they have, instead of tying them to a single job for a lifetime.

And thanks to all of these factors, workers are able to go to where they are needed most.

On previous occasions, Chairman Greenspan has emphasized the economy's flexibility as a key to its long-run growth prospects and we look forward to hearing him on this subject again today.

In particular, I would welcome a discussion about the actions we need to take to enhance and build upon the flexibility in order to grow and meet the upcoming challenges.

With that, I will now recognize Mr. Stark, the Ranking Member, for an opening statement. And then Mr. Saxton, the Vice Chairman, for an opening statement.

And I would ask the other members of the Committee if they would forgo their opening statements so that we could move directly to Mr. Greenspan.

Mr. Stark?

[The prepared statement of Senator Bennett appears in the Submissions for the Record on page 47.]

OPENING STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Representative Stark. Thank you, Chairman Bennett, for holding this hearing, and welcome Mr. Greenspan. You're looking chipper after your bout at Johns Hopkins, and I welcome you to the alumni of that auspicious group.

(Laughter.)

I expect that this morning we'll cover a couple other topics. In the first group, I expect we'll talk about the critical issue of how to put people back to work, and get the economy moving again, at a time when interest rates are so low that many of the tools of monetary policy may not serve us well.

In the next category, we have Congress fussing with a Rube Goldberg contraption – tax cuts that still favor the well-to-do and don't seem to have much to do with creating jobs or laying the foundation for sustainable growth.

I hope, Mr. Chairman, that you'll be able to reassure us that the Federal Reserve is committed to getting the economy back to full employment as quickly as possible and tell us about what means that you have, or we have, to do it.

We've lost over 2-1/2 million jobs in the private sector since the current Administration took office and things don't seem to be getting any better.

We haven't seen such persistent job loss since the '30s. The Federal Reserve has said that the balance of risks is tilted towards continued weakness. And I'd be curious to know what the Fed can do to encourage job creation and growth when interest rates, as I said, are already very, very low.

The question is critically important because you may be our last best hope.

When the fiscal policy coming out of Congress seems to be in shambles and the tax cut packages squeeze large tax cuts into a tighter budget. However, if you took off the gimmicks of sun setting, the cost of the tax cut under consideration would still be over the $700 billion that was in the original package.

You've said in the past that you believe the financial markets assumed long ago that the 2001 tax cut would not be allowed to sunset. I doubt if there's any reason to take seriously the sunsets moving through now. These tax cuts will be extended.

So far from being the best policies to get the economy back to full employment as quickly as possible, and enhancing long-term growth, the jobs and growth plans that we're hearing about provides little job-creating fiscal stimulus when it's really needed.

The question is whether we pass the future debt or responsibilities for retirement and health care challenges along to our children and grandchildren just for the sake of some quick tax cuts now.

Treasury Secretary Snow said our economy is soggy. I suppose one reason is that the President and the Republicans continue to believe in trickle-down policies and that's getting everybody kind of damp, but it doesn't see to be offering any real jobs or a growth plan that would get the economy back to full employment.

So we have a preoccupation with tax cuts and very little talk about short-term economic stimulus. And I hope that you could provide us some guidepost as to what we might look forward to in the year ahead.

Thank you for being with us.

[The prepared statement of Representative Stark appears in the Submissions for the Record on page 50.]

Senator Bennett. Mr. Saxton?

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, VICE CHAIRMAN

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

It's a pleasure to join in welcoming Chairman Greenspan once again before the Joint Economic Committee. Thank you for your continuing interest in our Committee.

The latest economic figures indicate that the economy is still expanding, although at a very slow rate, as we all know.

In recent years, the economy has been remarkably resilient, despite terrorism, war and pervasive uncertainty.

However, one of the weakest areas in the expansion has been business investment. And until business investment rebounds, it is my opinion that the economy is not likely to expand at a vigorous rate.

Although it is clear that the persistent weakness in business investment followed the stock market plunge in 2000, it is not possible to know exactly when it will end.

As the New York Fed President has observed, “The effects of the bursting of the stock market have proven to be far more long-term and pervasive than expected.”

Some of these effects are readily seen in the weaknesses in the economic and unemployment conditions that has been apparent for quite some time.

In the last appearance before the Committee last November, Chairman Greenspan stated that the economy was in a “soft patch,” and suggested that when the unusual degree of uncertainty facing the economy was lifted, which certainly existed at the time, the rate of economic growth could be expected to increase.

Although some of the uncertainty may have been reduced, at least some of it still remains. The latest data suggests that the economy is still quite weak.

We all hope that the economy is poised for acceleration in the last half of the year. However, there is little compelling hard evidence that a pick-up in the economic growth is on the horizon.

There has been recovery in business profits and some other indicators, but there have been many other signals of continued economic fragility.

In the economic environment that exists today, it is reasonable to consider adjustments of economic policy. Congress has responded with tax legislation designed to boost investment and create economic growth.

But given the weaknesses and the downward pressures on prices, the Federal Reserve, in my opinion, should implement another incremental easing of monetary policy. If policy is eased and the pace of economic expansion does take off in the second half of the year, monetary policy could readily be adjusted to take this into account.

I might note also that the low short-term interest rates do not prevent the Fed from easing monetary policy. As Chairman Greenspan indicated in the JEC hearing last fall, if short-term interest rates fall close to zero, the Federal Reserve can still lower long-term interest rates or operate in other markets to expand reserves and thereby further ease monetary policy.

The decline in the value of the dollar obviously is a factor to be considered. But it is clear that this decline is not the result of an inflationary monetary policy.

In the absence of inflation, the risks of another easing are low and such a move is already expected in the financial markets and I believe has been factored in by many.

The risks posed by the weaknesses in domestic and international economy appear to exceed the risk that inflation will emerge as a serious problem in the foreseeable future.

Mr. Chairman, thank you for permitting me to make that statement and I look forward to the Chairman's testimony.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 52.]

Senator Bennett. Thank you very much.

Chairman Greenspan, again, we welcome you and look forward to what you have to share with us this morning.

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

Mr. Greenspan. Thank you very much, Mr. Chairman. I very much appreciate the opportunity to testify before this Committee.

As you will recall, when I appeared here last November, I emphasized the extraordinary resilience manifested by the United States economy in recent years – the cumulative result of increased flexibility over the past quarter century. Since the middle of 2000, our economy has withstood serious blows: a significant decline in equity prices, a substantial fall in capital spending, the terrorist attacks of September 11, confidence-debilitating revelations of corporate malfeasance, and wars in Afghanistan and Iraq. Any combination of these shocks would arguably have induced severe economic contraction two or three decades ago. Yet, remarkably, over the past three years, activity has expanded, on balance-- an outcome offering clear evidence of a flexible, more resilient, economic system.

Once again this year, our economy has struggled to surmount new obstacles. As the tensions with Iraq increased early in 2003, uncertainties surrounding a possible war contributed to a softening in economic activity. Oil prices moved close to $40 a barrel in February, stock prices tested their lows of last fall, and consumer and business confidence ebbed. Although in January there were some signs of a post-holiday pickup in retail sales other than motor vehicles, spending was little changed, on balance, over the following three months as a gasoline price surge drained consumer purchasing power and severe winter weather kept many shoppers at home.

Businesses, too, were reluctant to initiate new projects in such a highly uncertain environment. Hiring slumped, capital spending plans were put on hold, and inventories were held to very lean levels. Collectively, households and businesses hesitated to make decisions, pending news about the timing, success, and cost of military action -- factors that could significantly alter the outcomes of those decisions.

The start of the war and its early successes, especially the safeguarding of the Iraqi oil fields, were greeted positively by financial and commodities markets. Stock prices rallied, risk spreads narrowed, oil prices dropped sharply, and the dour mood that had gripped consumers started to lift, precursors that historically have led to improved economic activity. The quick conclusion of the conflict subsequently added to financial gains.

We do not yet have sufficient information on economic activity following the end of hostilities to make a firm judgment about the current underlying strength of the real economy. Incoming data on labor markets and production have been disappointing. Payrolls fell further in April, and industrial production declined as well. Because of the normal lags in scheduling production and in making employment decisions, these movements likely reflect business decisions that, for the most part, were made prior to the start of the war, and many more weeks of data will be needed to confidently discern the underlying trends in these areas.

One reassuring development that has been sustained through this extended period of economic weakness has been the performance of productivity. To the surprise of most analysts, labor productivity has continued to post solid gains. Businesses are apparently continuing to discover unexploited areas of cost reduction that had accumulated during the boom years of 1995 to 2000, when the projected huge returns from market expansion dulled incentives for seemingly mundane cost savings. The ability of business managers to reduce costs, especially labor costs, through investments or restructuring is, of course, one reason that labor markets have been so weak.

Looking ahead, the consensus expectation for a pick-up in economic activity is not unreasonable, though the timing and extent of that improvement continue to be uncertain. The stance of monetary policy remains accommodative, and conditions in financial markets appear supportive of an increased pace of activity. Interest rates remain low, and funds seem to be readily available to credit-worthy borrowers. These factors, along with the ability of households to tap equity accrued in residential properties, should continue to bolster consumer spending and the purchase of new homes.

The recent declines in energy prices are another positive factor in the economic outlook. The price of West Texas intermediate crude oil dropped back to below \$26 per barrel by the end of April, but as indications of a delay in the restoration of Iraqi oil exports became evident and geo-political risks crept back in, prices have risen to near \$30 a barrel – a worrisome trend if continued. Nonetheless, the price of crude oil is still about \$10 per barrel below its peak in February. This decline has already shown through to the price of gasoline in May. Some modest further declines in gas prices are likely in coming weeks, as marketers' profit margins continue to back off their elevated levels of March and April to more normal levels.

In contrast, prices for natural gas have increased sharply in response to very tight supplies. Working gas in storage is presently at extremely low levels, and the normal seasonal rebuilding of these inventories seems to be behind the schedule, which we typically perceive during the fall and winter months. The colder-than-average winter played a role in producing today's tight supply situation as did the inability of heightened gas well drilling to significantly augment net marketed production. Canada, our major source of gas imports, has little room to expand shipments to the United States. Our limited capacity to import liquified natural gas effectively restricts our access to the world's abundant supplies of natural gas. The current tight domestic natural gas market reflects the increases in demand over the past two decades. That demand has been spurred by myriad new uses for natural gas in industry and by the increased use of natural gas as a clean-burning source of electric power.

On balance, recent movements in energy prices seem likely to be a favorable influence on the overall economy. In the short run, lower energy bills should give a boost to the real incomes of households and to business profits. To be sure, world energy markets obviously remain susceptible to politically driven supply disruptions, as has been evident recently from the events in Venezuela and Nigeria. But, even taking account of these risks, futures market project crude oil prices to fall over the longer run, consistent with the notion that current prices are above the long-term supply price of oil.

As has been the case for some time, the central question about the outlook remains whether business firms will quicken the pace of investment now that some, but by no means all, of the geopolitical uncertainties have been resolved.

A modestly encouraging sign is the backlog of orders for nondefense capital goods excluding aircraft, which has been moving up in recent months. Moreover, recent earnings reports suggest that the profitability of many businesses is on the mend. That said, firms still appear hesitant to spend and hire, and we need to remain mindful of the possibility that lingering business caution could be an impediment to improved economic performance.

One new uncertainty in the global economic outlook has been the outbreak of severe acute respiratory syndrome – SARS – in Southeast Asia and elsewhere. This epidemic has hit the economies of Hong Kong and China particularly hard, as tourism and business travel has been severely curtailed and as measures to contain the spread of the virus have held down retail sales.

To date, the effects of SARS on the U.S. economy has been minimal. Airlines have obviously suffered another serious blow, and some U.S. multinational corporations are reporting reduced foreign sales.

But the effects on other industries have been small. Initially, there had been some concern that SARS would disrupt the just-in-time inventory systems of U.S. manufacturers. Many of those systems rely on components from Asia, and any disruption in the flow of these goods has the potential to affect production in the United States. So far, however, U.S. manufacturing output has not been noticeably affected.

In recent months, inflation has dropped to very low levels. As I noted earlier, energy prices already are reacting to the decline in crude oil prices, and core consumer price inflation has been minimal. Inflation is now sufficiently low that it no longer appears to be much of a factor in the economic calculations of households and businesses. Indeed, we have reached a point at which, in the judgment of the Federal Open Market Committee, the probability of an unwelcome substantial fall in inflation over the next few quarters, though minor, exceeds that of a pick-up in inflation.

Mr. Chairman, the economic information received in recent weeks has not, in my judgment, materially altered the outlook. Nonetheless, the economy continues to be buffeted by strong cross currents. Recent readings on production and employment have been on the weak side, but the economic fundamentals – including the improved conditions in financial markets and the continued growth in productivity – augur well for the future.

Thank you, and I look forward to your questions.

[The prepared statement of Mr. Greenspan appears in the Submissions for the Record on page 54.]

Senator Bennett. Thank you very much.

Mr. Saxton has to leave. He has an assignment on the House floor. So with the permission of my colleagues, I will go out of order and recognize Mr. Saxton to ask the first question and take the first round.

Representative Saxton. Thank you very much.

Let me just ask two questions. Last November, when you were here, Mr. Chairman, we discussed the downward pressure on prices and options available to the Federal Reserve to combat it.

Yet, some still seem to believe that low, short-term interest rates limit the potency of monetary policy. As I pointed out in my statement, the last time you were here, you shed some light on that subject.

Could you explain how the Fed could address unwelcome downward pressures on prices through the purchase of long-term Treasury securities?

Mr. Greenspan. As I and a number of my colleagues have stated recently, we have chosen to act solely in overnight funds, essentially addressing the reserve balances of the banks. There are a number of reasons why we did that, but the point at issue is that there is no legal requirement that we do, nor indeed an economic one.

And should it turn out that, for reasons which we don't expect, but we certainly are concerned may happen, the pressures on the short-term markets drive the federal funds rate down close to zero, that does not mean that the Federal Reserve is out of business on the issue of further easing and expansion of the monetary base.

We, indeed, as you point out, can merely move out on the yield curve because, as you are well aware, even though short-term rates are something slightly over one percent, longer-term rates are significantly above that. And we do have the capability, should that be necessary, of clearly moving out on the yield curve, essentially moving longer-term rates down and in the process, expanding the monetary base and the degree of monetary stimulus.

And since there is such a significant amount of potential in that longer maturity structure, we see no credible possibility that we will at any point, irrespective of what is required of us, run out of monetary ammunition to address problems of deflation or anything similar to that which disrupts our economy.

Representative Saxton. Thank you. Mr. Chairman, in your remarks, you talked a good deal about energy prices. In regard to oil prices in particular, I note from our studies that oil prices have not been moving in a straight line.

Beginning in about March, we saw oil prices begin to come down significantly and then they ticked back up. And following that tick in March or April, they continued on down and then ticked back up.

And then after that second tick back up, they continued to come down, and now they've ticked back up.

And so, I would interpret this as the general direction of oil prices and energy prices becoming lower.
Is that a good interpretation?

Mr. Greenspan. That's certainly what the commodity markets are suggesting, namely, the futures markets.

The initial sharp reaction on the down side occurred when it became evident not that the war would necessarily not be associated with significant problems in the oil fields, but that whatever happened, the uncertainty of the mere time frame as to when the war would begin was removed and there was a general expectation of once the war started, it would end quickly. And as a consequence of that, markets of crude oil fell very sharply.

Then when the oil fields became clearly under control, and the expectation of the resumption of Iraqi crude exports became evident, prices worked their way lower, for fear that there would be some form of glut.

When it became evident, as I mentioned in my prepared remarks, that Iraqi exports were not coming back very quickly -- they were coming back, obviously, but not at the pace that the markets had assumed -- markets have backed up. And when I last looked, they were somewhat below $30 a barrel for West Texas intermediate crude.

Representative Saxton. Thank you very much, Mr. Chairman. And Mr. Chairman, thank you for permitting me to go out of order.

Senator Bennett. We appreciate your attendance and your participation.

Mr. Stark?

Representative Stark. Thank you, Mr. Chairman. Thank you, Mr. Greenspan.

In the conclusion of your remarks, it sounds to me that you're suggesting that the main problem facing the economy is weak demand which leads to sluggish growth and high unemployment.

You say recent readings on production and employment have been on the weak side.

And you also seem to suggest that our long-term growth prospects are okay. You say continued productivity augurs well for the future.

That seems to leave us with the shorter-term stimulus for demand as what's left for us to do in the policy field, to see whatever we can do to get full employment as quickly as we can without increasing long-term debt by too much.

Is that the dilemma that faces us as policy-makers? What can we do to stimulate a short-term demand without borrowing excessive amounts of money?

That's my question. It seems to me that is what's left for us to do.

Mr. Greenspan. Congressman, I think that the first decision that any policymaker in this environment has got to make a judgment about is, one, whether the economy is turning and whether its potential pace on turn and thereafter is enough to obviate the need for further stimulus.

Clearly, we at the Federal Reserve perceive monetary policy as the primary tool in this government for short-term stimulus.

It has been the general conclusion of economists over the years that the difficulty in timing fiscal policies merely because of our congressional structure and the particular procedures which you're far more aware of than I, makes it difficult to calibrate fiscal policy in a timely manner. And therefore, most economists have generally eschewed in recent years the use of fiscal policy as short-term stimulus.

Now it turned out with the 2001 tax cut that, indeed, the actual implementation of the tax cut did come at a time when it seemed to be propitious for short-term stimulus, and that has apparently revived some views about the use of fiscal policy as short-term stimulus. And there are arguments, I must say, in favor of it.

I still think that monetary policy should take the lead in the short run, largely because we can move on twenty minutes' notice, and ten minutes', if necessary, where that is obviously not feasible in the fiscal realm.

Having made the judgments, then the question is: to do what? And there is the obvious problem of short-term fiscal stimulus, which you could arrange; in other words, you can get a very significant short-term surge, perhaps in retail sales, with a very marked short-term decline in taxes, for example.

The problem is that if you succeed, the difficulty is that it is short-term and it tends to fade. And if it creates levels of production which reduce unemployment as a consequence, over time, it reverses, and it's not a longer-term phenomenon. And therefore, you have to make the judgments as to whether fiscal stimulus should be directed at consumption or investment. My own view is I would much prefer the latter because I've always perceived fiscal stimulus as an intermediate- to longer-term policy tool.

But these are judgments that very thoughtful economists disagree on. There's not a uniform view that you'll get a collective wisdom on in these areas.

Representative Stark. Well, as a thoughtful economist, let me ask you – and here's the question – faced with perhaps capacity at 60, 70 percent, wherever it is. We have excess capacity–

Mr. Greenspan. In manufacturing.

Representative Stark. And faced with high unemployment and an expiration of unemployment benefits, for example, what are the pros and the cons of extending unemployment benefits to a couple of million people. Wouldn’t that send them right out to Wal-Mart to buy the shoes and food that they need and give us at least a short-term boost, with some social benefits?

Mr. Greenspan. Mr. Stark, I've always been of the opinion and stated before this Committee previously that our unemployment insurance system seems to work rather well. It is not overly generous, which would induce the type of increased levels of structural unemployment which we see in other countries which have these types of structures. But unemployment insurance here is essentially restrictive because it's been our perception that we don't want to create incentives for people not to take jobs.

But when you're in a period of job weakness where it is not a choice on the part of people whether they're employed or unemployed, then, obviously, you want to be temporarily generous. And that's what we have done in the past and I think it's worked well.

With respect to the immediate future, I don't have a judgment on any particular program, but I would suggest that if you go forward with additional extensions, I would be careful to keep the extensions relatively short and renew them again if necessary because we're not quite clear at this stage what the path of short-term economic activity is. A number of major economic forecasters have forecasts for the third quarter, which is just about in front of us, of four percent growth at an annual rate. And that is a relatively long list.

Now, anybody with a little arithmetic will tell you that this economy has to start to move fairly quickly to get there.

Representative Stark. I don't know if you know how happy you've made Chairman Bennett and myself, but by saying two 13-week periods instead of one 26, just think. We get to announce twice, and get twice the accolades for doing it.

(Laughter.)

What a great idea. Thank you, Mr. Chairman.

Senator Bennett. We get to argue about it twice.

(Laughter.)

There are roughly five minutes left on the vote on the Senate floor. For those that are watching the clock in the back, it is 13 minutes slow.

(Laughter.)

So we won't do that.

I will turn the gavel over to Mr. Ryan, who is the most senior Republican here, and encourage the House members to remain and continue the questioning while the Senators go over and save the Republic, or whatever it is that we do while we vote.

(Laughter.)

Mr. Ryan, Mr. Putnam was the first member of the House to show up, if you want to honor the early bird rule. And if you want to wait until we get up and use your vast power to question yourself, that's up to you.

Representative Ryan. (presiding). That means I get to ask questions last, if I want to honor the early bird rule.

(Laughter.)

Mr. Putnam?

Representative Stark. Do the right thing.

(Laughter.)

Representative Putnam. I thank the distinguished elder Chairman for anchoring the 20- and 30-somethings of the House caucus.

(Laughter.)

Mr. Chairman, I want to address briefly the issue of the housing sector. The consumer confidence has been all over the map, but appears to be on the rise right now. A great deal of our reliance on the fundamentals of the economy thus far as we have gone through this soft patch have been as a result of continued consumer spending and the money that they have been able to extract from the value of their home and continued strong real estate prices.

What is your outlook for the continued explosion of refinancing and the extraction of equity from the housing market and the continued strong home sales for the remainder of this year?

Mr. Greenspan. First, let me stipulate that while cash-outs, extraction of monies in the process of refinancing, have become a very big number in recent quarters, they still fall short of the equity extraction that occurs as a consequence of the sales of existing homes when, obviously, the seller of a home cancels a mortgage which is much smaller than the mortgage taken out by the buyer. And the difference between those two numbers is, by definition, the increase in debt on that home and the extraction of equity, essentially, by the seller.

Having said that, it's important to recognize that a goodly part of the extraction of equity has been an ongoing issue related to a very high level of existing home sales, which has not deviated very much, as you well know, in recent quarters.

What has changed is a very extraordinary shift in the way the mortgage market functions. We had a huge surge in refinancings late last year as the mortgage rate, say, the fixed 30-year mortgage rate, fell significantly below the average coupon on existing mortgages, meaning that the gap was widening and therefore, the presumption would be, as indeed it was, that a very large number of refinancers would come into the market and we had a huge number of refinancings and very large cash-outs. That number dipped a bit in the first quarter. But in recent weeks, it's come back up again.

Refinancings in the second quarter look to be very large. The cash-outs, however, are not as large relative to refinancings as they've been; that is, there's some evidence that, while the refinancings have gone up dramatically in order to reduce the average coupon, we have not seen a major increase in cash-outs as a result.

Let me also point out that surveys by the Federal Reserve indicate that equity extraction from homes, especially in refinancings, tend to be very significantly employed to repay other debt. First of all, they're a major source of repayment on home equity loans. But they have also shown up as a major factor in reducing the burden of consumer debt.

So, all in all, it's turned out that the technology, which obviously is at the base here of where this refinancing is coming from, has changed the financing of the housing market in a rather fundamental way and it has made it a vehicle for liquefying household wealth. And it's been a major factor in consumer activity. And I might say to you that my suspicion is that it's going to increase rather than decrease as a factor in the American consumer markets as home ownership continues to increase.

Representative Putnam. That technology that you referred to has fueled an historic growth in productivity across all sectors of the economy. And you have been an eternal optimist about the continued ability of our economy to produce productivity gains.

Does that situation then yield another jobless recovery where these continued productivity gains will not put more people back to work as we emerge from this soft patch?

Mr. Greenspan. No, Congressman. It does, however, raise the hurdle of what the rate of increase in GDP must be in order to get employment rising because, clearly, the arithmetic is straight-forward.

Productivity is essentially the rate of growth in GDP minus the rate of growth in hours. And in the most recent period, what we've seen is a modest, sluggish increase in real GDP and a decline in hours.

And one could argue that if productivity were weak, American business would have to employ more people to meet the demands of the market place, weak as it is.

As it's turning out, what we are finding is that American business is increasingly being able to meet what has been a tepid rise in sales with an ever-lower work force, which means either the use of technology or restructuring in manners which employ improved productivity.

We should never look at productivity growth as anything negative because that's where standards of living come from. That's where real wealth comes from. That's what indeed has made this economy the most extraordinarily productive in the world. But it does raise the hurdle of what the growth rate overall must be if we're going to keep our labor force employed.

Representative Putnam. I thank the Chairman very much.

Representative Ryan. Mr. Hill?

Representative Hill. Mr. Chairman, thank you for being here this morning.

Listening to your testimony, you made the statement that monetary policy should lead in terms of stimulating the economy, that a short-term stimulus package – and I'm assuming you mean through tax cuts – tends to fade.

Mr. Greenspan. Unless it is an incentivizing investment. Then it's a different deal.

Representative Hill. The tax cuts that were proposed in the House, as a member of the House, I voted against because I believe that deficits matter. And I think that the tax cuts are only contributing to the deficit problem that we have.

On February the 13th of this year, you said, and I quote: "Contrary to what many have said, when the deficit goes up, it does affect long-term interest rates. It does have a negative impact on the economy."

We're about to make some decisions in Congress, maybe this week, about whether or not we should have a tax cut. Now in my view, we shouldn't because it contributes to the debt.

What's your view? What should we do?

Mr. Greenspan. I think what is required in doing any sort of analysis is to, on the one hand, try to evaluate the gross positive impact from any fiscal program, one, for example, that is budget-neutral, on the one hand, and one which may be contributing to budget deficits.

If it's the latter, then the issue I was raising with respect to interest rates is that, in order to get the net impact, plus or minus, it's important to reflect the fact that, indeed, changes in the longer-term fiscal outlook are very clearly a factor in the level of long-term interest rates today.

And as a consequence, if you engage in a program which significantly alters the long-term deficit outlook to a point that long-term rates are raised, it may or may not be curtailing economic output.

Let's put it this way. It requires an analysis of what the extent of the curtailment in economic output would be as a consequence of higher long-term interest rates to net it against the gross incentive flows and productive flows that occur from some form of long-term tax cut program.

The point I was making is that deficits do matter, and that in any evaluation of a program, what happens to deficits is an integral part of the analysis.

Representative Hill. I want to make sure that I heard you right. Did you say that any kind of tax cut should be revenue-neutral?

Mr. Greenspan. Not necessarily revenue. Budget-neutral.

In other words, I must admit that in the debate that's been going on on the issue of fiscal policy, it really is a debate between whether or not deficits are increased by spending or by tax cuts.

I'm waiting to hear the third stool – I was going to say the third foot and I was wondering what kind of an animal this is.

(Laughter.)

But what is missing here and was never missing in previous discussions is restraint on spending. I am increasingly of the view that the huge surpluses which we created in our budget which were wonderful things to observe have severely undercut fiscal restraint, the type of restraint that existed before the surpluses emerged.

And as the Chairman indicated, we are looking at the potentials of a significant demographic problem as we look beyond 2011. It's something which requires a really very close look at the size of the commitments for spending that we're making. And I think that I would very much like to see that issue addressed far more than it is.

And I must say, the silence is deafening.

Representative Hill. I couldn't agree with you more, Mr. Chairman. I've got the red light on me just now, so maybe I'll ask another question later.

But thank you for your answer.

Representative Ryan. Although it's very tempting to want to follow up on what Mr. Hill just said, I shall recognize Mr. Paul.

Representative Paul. Thank you, Mr. Chairman.

Good morning, Mr. Greenspan. I have two questions. One is generalized and it deals with the dollar system and the monetary system that you're required to operate.

And then one more specific, a factor that affects the strength of the dollar.

But the big debate now in financial circles is the weak dollar, whether it's good or bad, versus what a strong dollar should do to us, or for us.

And I would like to suggest that there should be another alternative, rather than arguing a temporary case for a strong dollar to help us, which it seemed to in the latter part of the 1990s, versus whether the weak dollar will now help us on our exports.

Rather than this manipulation of the value of the dollar, I would hope some day that we would talk about a stable dollar, one that does not fluctuate so readily.

We deal in the world today with fluctuating exchange rates and all currencies are inflated at different rates, and nobody advocates that we have 50 different currencies in this country. That would be totally chaotic.

And yet, the world is required to operate. And there's no soundness to it, no restraint on the monetary authorities.

And the other challenge that we have to look at some day is whether or not we should continue to accept this notion that we can achieve positive central economic planning through the monopoly control of money and credit in setting of interest rates, which is really contradictory to capitalism.

And I think that that's where part of our problem is.

The Austrian economists – Mises and Hayek and Rothbar – have argued that this is the source of our problem, that the manipulation of interest rates too low causes the boom and then, eventually, the bust has to come. And we see this over and over again.

But we talk about productivity and other events that are important, but we fail to talk about the initial cause of the mal-investment – the over-capacity, which then requires the correction.

Because we operate the reserve currency of the world, we have the advantage of others taking our money and our dollars and holding them. But, currently, the expectations are that our current account deficit may soar to $600 billion next year.

And we do know throughout history, and most economists agree, that these current account deficits cannot be maintained, that it will eventually lead to a weaker dollar and higher interest rates.

So I think you're under the gun. In one sense, you want to stimulate the economy with low interest rates, which weakens the dollar. At the same time, the weak dollar will eventually push up the interest rates.

My question there is, when do you think – or do you think that we will ever talk once again about sound, stable currency?

And the other question is more specific, because even though what the Fed does in the creation of new money is the key element, other things do have factors – the jaw-boning and the so-called speculators. For a day or two, they have an effect, but they really can't change it.

Jaw-boning doesn't work.

Ultimately, in 1979, interest rates had to go to 21 percent to restore some order to the dollar.

But you talked about the war and the supposed benefits after the war was over and after it started. But I think what has not been recognized is the ongoing foreign policy of our adventurism and our plans, really – those same people that planned and argued the case for Iraq, are arguing the case for Syria and they're arguing the case for Iran.

At the same time, we don't have our allies close to us. We don't have people pouring in the dollars like we did in the 1990s.

So that in itself has a subjective relationship to the perceived value of the dollar. And I want to know whether or not you think that element in foreign policy today specifically has affected the future perceptions of what the dollar's value is going to be?

Mr. Greenspan. Dr. Paul, first let me address the last question first.

As I think you may remember, we in the United States government have made a decision in which the value of the American currency will be discussed only by our chief economic spokesman, who is the Secretary of the Treasury.

And we at the Fed have adhered to that for quite a long period of time and think it's important to have one voice speaking on that issue.

With respect to the more general question about the issue of sound, stable currencies, this, as you know, is a very fundamental debate amongst economists.

You point out quite correctly that there is a single currency in the 50 states of the United States. The reason why we are able to function in a manner which others are not is that an exchange rate that is a unit-specific currency tends to bring together all of the imbalances in an economy in the exchange rate's price.

In other words, at the border, the exchange rate essentially rebalances all of the imbalances between two contiguous countries or as it might have been in the United States, between two states.

If you lock the currency in and you cannot adjust the currency at the border, then the adjustments must occur in capital flows or in labor flows, the only two other ways in which you can get the major adjustments that are required between two disequilibrium economies.

The advantage of the United States is that because we've stripped out all barriers to interstate commerce, essentially – I should say most – we are able to get equilibria adjusted solely through capital and labor market flows and we have a fixed currency.

The reason why it is not at this moment feasible in a lot of other areas of the world is that capital and labor flows are not adequate to pick up the full adjustment process. And an endeavor to fix exchange rates in the face of imbalances induces financial breakdowns as have occurred.

Representative Paul. May I just interject?

I'm not talking about fixing these rates. I'm talking about a single currency that could be universalized.

Mr. Greenspan. That's the algebraic equivalent of fixing the rates. In other words, if you lock in legally all rates, it's irrelevant what you call the currency in one nation and another. It's the lock that matters. And if you have, for example, as we did, the gold standard, which for a very substantial period of time was the single currency of the world, it didn't matter what you called the other currencies because they were all locked in in units of gold.

And so, the notion of a stable world currency requires a degree of flexibility in capital and labor flows which we have not yet achieved.

Representative Paul. Thank you.

Senator Bennett. Mr. Chairman, the press has made a great deal out of your use of the word "deflation" the last time you appeared before the Congress.

Mr. Greenspan. Did I use the word deflation?
I thought I said—

Senator Bennett. You kind of danced around it, but that's the way it came across.

Mr. Greenspan. It was my interpreter.

(Laughter.)

Senator Bennett. It was your interpreter. All right.

(Laughter.)

I'd like to put the word right smack in the middle of the table and give you an opportunity to talk about it, so that we can address the speculation, sometimes wild speculation that has gone on in many of the columns that say that we are on the verge of becoming Japan, if we are not in fact Japan.

Greenspan warns of deflation. And we're looking at ten years of falling prices and sluggish economy and all of the rest of that.

Can you just take that particular topic and deal with it in a way that we hope, or I hope, will put some of these specters to rest?

Mr. Greenspan. It's a very serious issue, an issue which we at the Federal Reserve are paying extensive attention to. And the reason is basically, and this indeed follows on naturally from my conversation with Congressman Paul, with the elimination of the gold standard in the 1930s and the development essentially of worldwide fiat currencies, almost no economists believed that you could create deflation with fiat currencies because the ultimate supply of those currencies, by definition, comes from government fiat.

We went through most of the post-World War II period with the expectation that fiat currencies were essentially inflation-ridden and that the major focus of central banks was to suppress inflation. The notion that deflation would emerge just never entered our minds until the Japanese demonstrated to us otherwise.

As a consequence of that, not having had any experience in the modern world with dealing with deflation and fiat currencies, our knowledge base was virtually nonexistent in the sense that we know how to deal with inflation. Inflation obviously is something that for a half-century we've been struggling with. We know how to suppress it. We know the consequences of suppressing it. We know the impact of various monetary policy decisions on the levels of output growth and unemployment. So we are familiar with the mechanism. It's not that we can very easily and automatically just suppress inflation. It has been a struggle of very great dimensions for most central banks in the world.

What's happened now is that since I guess the middle of the 1990s, we're beginning to see that it is possible for deflation to exist with a fiat currency. And in a way, I suspect it's a credit to central banks, which essentially have restrained the expansion of credit enough that many aspects of the gold standard which induced deflationary patterns in past periods, have been replicated in our monetary systems, and that, frankly, is quite good.

We at the Federal Reserve recognize that deflation is a possibility. Indeed, we now have been putting very significant resources in trying to understand, without actually seeing it happen, what this phenomenon is all about.

We cannot say that in the marketplace that there is a severe increasing concern of deflation. Indeed, the various expectations of price by both business and consumers has been relatively flat for recent years. And the so-called TIPS inflation premium – that is, the implicit forecast of the consumer price index which is embodied in our TIPS Treasury yields – has not changed much over the last three or four years. So this is not something which the markets are beginning to sense is about to erupt and something which we must address.

Nonetheless, even though we perceive the risks as minor, the potential consequences are very substantial and could be quite negative. So we have created fairly significant resources to try to address this problem, increasing our knowledge of what actually happens, what's the process, and what tools are necessary to fend it off. I think we've made very substantial progress in that intellectual endeavor.

We do, obviously, have the problem that we've never dealt with this before. We know as a consequence of that, when we don't deal with something, we have a large element of uncertainty, which strangely we do not have with the implementation of policies against inflation because we've dealt with it over so many decades.

We believe that because, in the current environment, the cost of taking our insurance against deflation is so low, that we can aggressively attack some of the underlying forces, which are essentially weak demand. And indeed, we have done that since we started a very aggressive easing of monetary policy in early 2001.

So long as the costs of engaging disinflation are so low, we have moved fairly considerably, and in statements we have made, specifically, as you point out, the statement that we made at our last FOMC meeting,

to recognize this not as an imminent, dangerous threat to the United States, but a threat that, even though minor, is sufficiently large that it does require very close scrutiny and
maybe – maybe – action on the part of the central bank.

Senator Bennett. Thank you very much. I'm told that there is another ten-minute vote that started at 10:32.

So, Mr. Ryan, you're back in charge.

Representative Ryan. (presiding). Thank you, Mr. Chairman.

I believe Ms. Dunn is up.

Representative Dunn. Thank you very much. Thank you, Mr. Ryan, my more senior member. It's delightful to meet you and to have you in charge of this panel.

It's nice to see you, Mr. Chairman.

I have a few questions that I would like to submit to you in writing. They have to do with the WTO and how United States tax laws could potentially put our exports at a disadvantage.

I would appreciate your comments as I submit those questions on how we can find an approach as we iron out the FSC-ETI-WTO problem that will result in some incompatibility with the obligations that I certainly feel to some of my employers, who are United States-based manufacturers.

So, with your approval, I'll get those questions to you.

I do have a couple of questions and, depending on time and your testimony, a few others that have popped up as my colleagues have asked you questions.

You mentioned in your statement on page four that geo-political uncertainties have been resolved.

So one question that I have because of my involvement as vice-chairman of the Homeland Security Committee on the House side, is whether uncertainties here at home are having an effect on the economy?

Mr. Ridge, as you well know, has just raised the threat level to orange. Has the economy adjusted since 9/11 to the threat to homeland security, or is there some underlying drag on business investment that's caused by security warnings that are issued by the government?

Mr. Greenspan. Congresswoman, this is a very difficult question to get a handle on because we don't have enough history. We don't have any hard data.

As you're aware, the financial markets took a very severe shock as a result of September the 11th. And we were most concerned about the stability of the system and pumped in huge amounts of reserves and engaged in many different activities to make sure that we could stabilize the system.

One concern that we had was that a follow-up of terrorism would occur two, three, four weeks after September the 11th, and we were worried about the fragility of the system at the time.

In retrospect, that did not happen. And indeed, nothing has happened since in the United States. Nonetheless, there's got to be some residual overhang in longer-term expectations. But it is very difficult to ferret it out of the financial data.

So one can conclude that, yes, it seems most likely that there's got to be some residual concern, but it is not, at least as of the moment, of an order of magnitude which becomes a major factor in economic or, for that matter, homeland security policy, so far as the economy is concerned.

Representative Dunn. Thank you. Do you think that the time is right for us to undertake fundamental tax reform?

I ask you that because the complexity in the code continues to be greater and greater, no matter which way we look, whether it's in our discussion of the decrease of taxes on dividends or the capital gains tax treatment of assets or the difficulties with our trading partners as to how we treat exports coming from our country, or the treatment of certain assets that are based on the type of ownership of those assets.

It is just simply a continuing problem that we run into with the complexity of the code.

Is there a way to fix this code, do you think, without fundamental tax reform?

Mr. Greenspan. We did: 1986-1987. The problem is not in fixing the code. We know how to do that. We probably could improve it immensely, but the trouble is, what do you do after you've fixed it because there seems to be a propensity in our process to re-employ all sorts of variations to changes in the tax code to obtain one public policy purpose after another. And we end up apparently where we started.

So if you ask me, would I like to see tax reform? Most certainly. There is no doubt that our tax system is rife with incentive-stifling regulation, taxation burdens of all forms.

I thought we had made a major breakthrough in the 1986 Act. And I'm discouraged because if we find a way to create a major improvement in the tax structure, which undoubtedly is overburdened with unbelievable detail, do we have a mechanism, either politically or statutorily, which can freeze the structure, or at least in part?

Representative Dunn. One more question?

Representative Ryan. We're going to do a second round.

Representative Dunn. Great. Thank you, Mr. Chairman.

Representative Ryan. Thank you, Mr. Chairman. I would like to maybe pick up where Ms. Dunn left off. And that is, in '86, we did do a fairly comprehensive tax reform.

Then the rest of the world followed suit with their own versions of tax reform, lowering their tax rates on capital.

Now, since 1986, we find that when we examine the U.S. Tax Code, that we actually tax capital on most instances, but especially in dividends, higher than any other industrialized country in the OECD.

And so, when we take a look at the fact that capital is being taxed higher than the other OECD nations, I would argue, and I would like to ask your opinion on this, that that is pushing capital overseas, away from the U.S., to lower tax jurisdictions.

So when we take a look at what we're about to do here in Congress on tax policy, as early as tomorrow, the House will bring up a bill that has a tax cut. And this is a tax cut that we budget for in our budget resolution.

It's not revenue-neutral in the pristine sense that we raise taxes for every dollar that we cut taxes, but we do have this included in our budget resolution, which does get us onto a glide path to balancing the budget within the next ten years.

The key proponent of actually doing that, though, is that we grow our economy.

And when we take a look at tax policy that actually reduces the tax rate on capital, that actually increases the after-tax rate of return on investments, the bill we're passing tomorrow I think does just that.

It accelerates the marginal income tax rate cuts that are scheduled to take place in 2006, up to this year, retroactive to January 1st of this year.

So all the rate cuts come in right now. That's the tax rate that small businesses pay.

Right now, and a lot of people don't know this, but small businesses, like Sub S corporations, sole proprietorships, actually pay a higher tax rate than large corporations do.

With this tax bill, that will be made lower to 35 percent.

The tax bill we're also passing hopefully tomorrow in the House brings the capital tax rate down to 15 percent and the dividends tax rate down to 15 percent for the rest of the decade.

What I'd like to ask you, Mr. Chairman, is, number one, even Keynesians might argue in a deflationary environment, that tax cuts are a good idea at this time. Do you believe that tax cuts that seek to lower the price of capital, that seek to encourage investment, are a good thing at this time?

And number two, are these particular tax cuts – lowering the tax rates on dividends, capital gains, and marginal income tax rates across the board – are good tax cuts that actually do encourage investment?

Mr. Greenspan. First, Congressman, let me just repeat a cliche which happens to be true, namely, that capital doesn't pay any taxes. Only people pay taxes. What happens is that you impose taxes on organizations which then deflect them elsewhere, but at the end of the day, all taxes are paid by people.

I've always argued that this is a very inefficient way of organizing revenues within a government and that we are far better to gain our taxes directly rather than putting them on capital because all it does is slow down the growth of economic activity and the revenue base from which the revenues actually occur.

And I've argued over the years for the elimination, where we possibly could, of taxes on capital. And I, as you probably are aware, have always argued for the elimination of the capital gains tax. And the reason is I think it's an extraordinarily inefficient tax, an inefficient means of raising revenue in the sense that, by imposing itself on capital, it reduces the growth rate in the economy.

Now, having said what I just said, I need not answer the rest of the questions that you raised.

Representative Ryan. I think you did. Thank you, Mr. Chairman. One last question.

The crowding out argument seems to take a lot of hold these days, which is that deficits, as we have right now, are propping up interest rates.

But if one looks at other data, say Japan, where their GDP and deficit ratios are far higher than ours, where their long-term interest rates are extremely low, current data showing that the deficit exists is growing, but our long-term rates are low, seem to suggest that this crowding out argument doesn't really hold much water given the data that we have available here in the U.S. and across the world.

What are your thoughts on that?

Mr. Greenspan. I think the argument that it doesn't hold in Japan is accurate, but that therefore it doesn't hold in the United States is false. And the reason I say that is that the evidence that we have very clearly and very robustly, as economists like to say, indicates that interest rates are a function of the long-term expected deficit. We indeed have just published a study which is really quite difficult to get around if you're statistician. The numbers are pretty robust.

The reason why it doesn't show up in Japan is cultural. There is an extraordinary propensity on the part of Japanese households and others to hold only yen-denominated assets. And very little of the huge debt of Japan is held outside of Japan. Indeed, the only areas that I'm aware of are in index bond funds which are required effectively to essentially diversify their bond holdings.

But because of that, what you get is a very low interest rate because if you take the savings propensities of the Japanese people, which are commendable, especially compared to ours, they actually press interest rates down.

In the United States, that is not the case.

If there was a very significant part of Japanese, yen-denominated government debt – JGB (Japanese Government Bonds), so to speak – held by foreigners, you would find interest rates were very much higher in Japan than they currently are.

Representative Ryan. Your statement on the distinction between America and Japan, does that hinge based upon the size of the deficit relative to the size of the economy?

Mr. Greenspan. It's largely a reflection of very different cultures. We do not have a culture where people, as patriotic as they may be, will hold on to dollar-denominated assets if they can do better elsewhere.

Representative Ryan. But the crowded-out effect on U.S. is determined by, not the nominal size of the debt or deficit, but the relative size of the debt or deficit relative to the size of the economy.

Mr. Greenspan. That is correct. It is related to the relative size of the deficit essentially to either the GDP or net aggregate flows.

Representative Ryan. Thank you. I yield back to the Chairman.

Senator Bennett. Thank you very much.

Senator Alexander?

Senator Alexander. Thank you, Mr. Chairman. Chairman Greenspan, excuse our going in and out.

I have two questions.

One is – and I'd like to illustrate them by circumstances in Tennessee. The first has to do with natural gas.

If I were one of your interpreters and I were listening to your comments today, I'd say, somewhat encouraging would be the news. Except the big red flag that I noticed in your testimony has to do with natural gas.

You spent some time talking about it, even though you said, on balance, energy prices are more favorable overall in the economy.

I feel the same way in my role as chairman of the Energy Subcommittee. I hear a lot about natural gas. For example, Tennessee Eastman hires 8,000 to 10,000 people in Tennessee, for their chemical company. They came in the other day when natural gas prices went way up. They took a six-percent management pay cut and a three-percent pay cut for several thousand employees just to keep from laying off people. So it affected jobs.

And as I look at the next winter, based upon the very factors you talked about, things don't look much better for natural gas prices, and that could have a profound impact on costs of many of our major manufacturers, and that could result either in lay-offs or the movement of jobs overseas.

So I wondered if you wanted to say more about your thought about the long-term effect of natural gas prices on jobs and the economy, and if you had any suggestions for policy that we ought to consider as members of Congress.

Mr. Greenspan. Senator, I am quite surprised at how little attention the natural gas problem has been getting because it is a very, very serious problem.

It's partly the result of the new technologies that have been employed in the areas of drilling technologies and the whole exploratory procedures which have evolved over the last decade or so. Seismic surveillance has improved the rate of so-called wildcat successful wells by double. I should say it's more than seismic issues. It's basically the new technologies.

The end result is that we are so good that the new findings of natural gas reservoirs are drained by half in the first year. And as a consequence, even though we do a considerable amount of drilling, and there's been a fairly substantial rise in natural gas drilling rigs, just to keep up with the drain is a major problem in itself.

Unlike oil, which, when we run into a problem, we can import, we cannot do that in natural gas. And the major reason is, not that there is not a huge amount of gas in the world. In fact, as has been pointed out, it is really quite abundant. The only way to get it to the United States, other than Canada and Mexico, is to bring it in with cryogenic liquified natural gas carriers, which have created a major environmental problem. We have very few vehicles which enable us to tap the world natural gas market. And the reason essentially is our capacity to bring in natural gas in cryogenic form is extremely limited.

If, on the one hand, we have encouraged, as we have, very significant growth in domestic demand for natural gas, but are very readily constrained by our ability to increase supply, then something has got to give. And what is giving, of course, is price. And price – now it's \$6 per million BTU – is pressing down, as you well point out, on a number of industries which rely very heavily on natural gas. And I don't think we've yet seen the implications of this, but they are going to arise and if it's coming to your subcommittee, I suspect you're going to find a number of people are going to start to watch very closely because this is an issue that we have not addressed and we have, I'd say, contradictory federal policy.

Senator Alexander. Mr. Chairman, can I ask one more question?

Senator Bennett. Sure.

Senator Alexander. Chairman Greenspan, you've talked about, here and earlier, about the strength of our flexible economy and the importance of competitiveness.

We now have about 900 auto parts suppliers in our state. Most of them buy steel. Most of them have seen a 25 to 30 percent increase in the price of the steel they buy since the steel tariffs came in.

I wondered what comment you might have or what effects you might have seen of the Section 201 safeguard steel tariffs on the economy as a result over the last several months, and whether you think those tariffs are a good idea.

Mr. Greenspan. Well, I testified at the various different hearings not on that issue directly, but inevitably the question came up. I expressed and continue to express considerable chagrin at endeavoring to create severe limitations on imports of steel. I think we'd be better off without them. And I hope that they will eventually be dispensed with.

I do not deny that, apparently, a number of structural advances have occurred in the old, traditional coke oven, blast furnace steelworks, and rolling mill integrated operations, and we've squeezed them down quite considerably and even addressed the legacy costs, which are so important with those types of institutions.

But I think, over the long run, we have to be very careful to recognize that artificially increasing the price of steel in the United States has included, and will continue to induce, individual steel users to move abroad if they can, out from under the high tariffs that are involved here.

I think there have been job losses here on the part of steel users. There clearly have been job losses in steel. And I think it's a very tricky problem which I don't deny is not readily resolvable.

But I do think over the longer run, we should, as quickly as we can, take those tariffs off and open up the market to competitive forces, which I think is what this country is all about.

Senator Alexander. We often hear about the job losses in foundries. We don't as often hear about the job losses at 900 auto parts suppliers employing 150,000 people, just in one state, who are looking to keep costs low, and if they're not low, they move the jobs to Mexico.

Thank you, Mr. Chairman.

Senator Bennett. Thank you. Chairman Greenspan, as I was coming back over from the last vote, I was asked by a representative of the press what I thought about the current status of the jobs and growth package as it is emerging from the conference committee between the House and the Senate.

And I was able to say with complete candor, I don't have the slightest idea what the current shape is. Any information I have about the shape of it is 24 hours old, and in this atmosphere, that might as well be last year.

So the press representative enlightened me and said it now looks as if the House is on top and the House version will prevail, and how do you feel about that?

And this also is a very easy answer. I said I prefer the Senate version. Being a Senator, that comes very normally.

But that stimulates me to take advantage of your being here to discuss the question of long-term tax structure.

I accept wholeheartedly your comment about the time lag between actions on fiscal policy and the economy. I've supported the elimination of the taxation on dividends on the grounds that it is a long-term, intelligent thing to do in order to make the economy more flexible and more responsive long-term.

And even if it doesn't have a short-term kick, it will help us over the long-term.

Now, apparently, the House has taken the position that dividends ought to be taxed as if they were capital gains at a 15-percent level and they're reducing the effective capital gains taxes to 15 percent.

At least that's what I gather from my source in the 4th estate who shoved the microphone in my mouth as I got on the elevator.

Could you comment for us on the relative wisdom of these two approaches, the question of reducing taxation on dividends and the concept of tying dividend taxation to capital gains taxation, and where should the appropriate rate be on capital gains and so on?

I've been given a quote here from Robert Lucas, who has a Nobel Prize, who says that eliminating capital income taxation would increase the capital stock by about 35 percent, leading to, his quote, “the largest, genuinely free lunch that I have seen in 25 years in this business.”

Do you agree with Mr. Lucas, or do you defer on that? What are your comments about the whole question of how capital should be taxed?

Representative Hill. Mr. Chairman, I apologize for interrupting, but I have to leave. Senator Kennedy has a written statement that he would like to enter into the record, if that's okay.

Senator Bennett. Without objection, it shall be entered.
[The prepared statement of Senator Kennedy appears in the Submissions for the Record on page 58.]

Representative Hill. Thank you.

Mr. Greenspan. I can't comment on the 35 percent, but I think the sign is right.

I do believe that, as I've indicated previously, and repeated today, that taxation of capital, per se, is misguided in the sense that it ultimately falls on individuals, and that we ought to direct the tax to people who pay it, rather than allow indirect incidence of taxation to flow to many people and inadvertently tax them without their being aware that they're being taxed.

As I said, I don't know whether the 35-percent number is correct, but I'm sure he's correct in the direction, and anything we can do to remove taxation on capital will enhance the revenue base and probably do more to incomes of middle- and lower-income Americans than any other tax type of vehicle we would impose.

The major problem, as I mentioned to Congresswoman Dunn, is we could get—

Senator Bennett. I apologize for not having been here to hear that.

Mr. Greenspan. It was an interesting conversation because she's raising much the same issues that you are.

And I said, we did that in 1986, to a greater or lesser extent. The problem is that we always creep back. And I was wondering that it's fine to get a tax reform bill, but is there any way in which we can guarantee that it doesn't get revised, because we seem to revise them very rapidly going back?

I would just as soon not get involved in the individual discussions on particular things because I'm 48 hours behind schedule.

(Laughter.)

Senator Bennett. I thought I could drag you into that.

(Laughter.)

But, very appropriately, you refused to enter the thicket. So I congratulate you on that.

Do any of the Members of the Committee have a second round, want to participate in a second round? All right. Let's see.

Senator Sununu, we welcome you, and it's now your turn.

Senator Sununu. Thank you, Mr. Chairman. And I do apologize to both Chairmen. We have a Foreign Relations mark-up that proceeds a pace.

Mr. Chairman, you talked about the experience in Japan. You also talked about cultural differences and investment practices.

Two questions about Japan.

First, to what extent do you think that those cultural differences, differences in investment practices, contributed to or lessened the severity of Japan's problem with deflation?

And second, what did you learn from the experience of Japan?

Mr. Greenspan. Well, it's hard to know about the deflation issue, but I will just tell you what I've been telling my Japanese colleagues, both privately and publicly. And they agree. And the issue is the following: That in order for economies to grow, you need to have obsolescent capital move out, usually through depreciation charges, into cutting-edge technologies. That's the way productivity grows. That's the way economies grow.

Japan did exceptionally well for 40 years because they never had to confront the problem which is a serious problem today, namely, discharging people and causing companies to go bankrupt, both of which very significantly induce a loss of face, which is culturally unacceptable in Japan. For 40 years, the number of bankruptcies were negligible and they had lifetime employment because their growth rate was so spectacular and their ability to recover from the ashes of World War II was quite remarkable. They now have the second largest economy in the world.

As soon as they slowed down, as they inevitably had to slow down, having become as large as they were, they ran into the problems of creative destruction. And they are culturally having difficulties addressing those issues. And the result is that banks are very reluctant to take collateral and sell it because that would bankrupt the borrower, or discharge people. And unless and until they address this issue, in my judgment, they're going to have serious difficulties.

I raised this with many senior people in Japanese government and one of them said to me, very succinctly, you have it exactly right, but you don't understand. Your solution is not the Japanese way.

And it is not. And I think there has to be some mechanism which they find to resolve these issues. They understand them. It is not a great mystery to anybody what is the problem they have. And they are working very diligently, as best as I can judge, to find ways in their culture to solve the problems that confront them.

Senator Sununu. And those obstacles to moving obsolete capital, specifically, the reluctance to discharge or to deal with the large amount of debt that sits on the books of some banks, as well as cultural dislike for the bankruptcy process, do both of those fit into that category?

Mr. Greenspan. Remember that a very significant part of the loans that are made by Japanese banks are collateralized by real estate or by other types of business assets. So long as the collateral is held in the bank, the individual borrower can function as though it had full control of the collateral.

If, however, the loan is to be written off, the collateral has to be sold, which means that you take the building away from the company or you do other things with respect to their assets, which effectively throws them into bankruptcy. And that's been a very reluctant activity on the part of Japanese banking.

Senator Sununu. I apologize if you've already addressed this issue specifically, but could you comment on the current strength of the dollar and whether or not it's appropriately valued?

Mr. Greenspan. No, Senator, I cannot.

(Laughter.)

And the reason I cannot, as I indicated to your colleagues, we in the United States Government have a pact in which all conversations with respect to the value of the dollar are in the bailiwick of our chief financial officer, chief economic spokesman, the Secretary of the Treasury.

Senator Sununu. Do you think the Secretary is doing a good job?

(Laughter.)

Mr. Greenspan. I do. I do. He's a very capable individual.

Senator Sununu. Thank you. The European Central Bank (ECB), could you comment about their current policies and the degree to which their current monetary supply – do you feel that it's appropriately loose or tight?

Mr. Greenspan. Here, again, you raise issues which—

Senator Sununu. There's a pact between central bankers as well?

I'm sorry.

(Laughter.)

I apologize for not having the list of pacts in front of me. I understand.

(Laughter.)

Mr. Greenspan. We central bankers talk to each other a great deal and give each other advice. We work very well together and I think very effectively as the G-10 Governors in Basel.

I have been very reluctant, and I think that it is just not appropriate for individual central banks to comment on the policies of others when we know how hard it is basically to do our jobs. And I don't know as much about Europe or the European financial system by a very significant order of magnitude as my colleagues at the ECB.

Senator Sununu. In your testimony, you discussed the current earnings reporting cycle and indicated that there has been some good news there.

Has there been any news, positive or negative, that has surprised you in the current cycle of earnings reports?

Mr. Greenspan. The earnings are doing better than I would have anticipated. The second quarter is still, of course, open. But the current estimates are, even though the GDP in the second quarter is going to be quite soft, earnings are pretty flat, they're not going down. In other words, productivity is essentially showing through into significant improvements in profit margins and in earnings.

Senator Sununu. What do you think are the specific factors that are driving those productivity gains? Again, you mention in your testimony the surprising continued strength of productivity growth.

Are there any specific factors that you feel have been driving productivity over the last six to 12 months?

Mr. Greenspan. Well, as I point out in my prepared remarks, I think the best explanation of where that is coming from is the result of a very significant amount of accumulated inefficiencies that developed from 1995 to 2000, as a consequence of capital investments being very largely focused on market-expanding activities. And those are the types of capital investments which offer very large potential rates of returns, if they work.

Very little was done, as best I can judge, in endeavoring to approach cost-cutting, which is usually very effective, but it's not a huge rate of return. And I think that over the latter part of the 1990s, a lot of inefficiencies through inadvertence built up, and now managements are going back and exploiting those backlogs of inefficiencies, and they show up as significant improvements in productivity.

Senator Sununu. When you talk about—

Senator Bennett. We're going to have a second round, Senator. And Senator Sessions is next.

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

Senator Sessions. Thank you, Senator.

Mr. Greenspan, just to follow up on that productivity thing, some commentators I note in papers indicate that it does cause at times lay-off of employees.

But would you share with us your thoughts as to why it's good in the long run?

Mr. Greenspan. Well, it is certainly the case, Senator, that when underlying productivity growth is at a higher rate than it had been, you need a higher rate of growth of GDP in order to create jobs.

But because productivity per se is the base by which we measure the growth in standards of living and the effectiveness of an economy, clearly, the greater the degree of productivity growth, the better.

That does mean that it does raise the barrier of what we are required to create with respect to GDP growth if we're going to employ our labor force appropriately.

Senator Sessions. I know you mentioned in your written remarks the oil prices and the relatively prompt conclusion of the war in Iraq, and the prices have fallen.

We have – the conventional wisdom is that falling energy prices are a positive indicator for the economy. Would you share your thoughts on that?

Mr. Greenspan. Well—

Senator Sessions. If you haven't already.

Mr. Greenspan. No. In fact, there's an issue that you're raising that I think is probably worthwhile re-emphasizing.

We import a considerable amount of our oil. And as a consequence, when the price falls, we in fact get, for that imported amount of oil, both crude and products, a net benefit – that is, the American people get a net benefit. For energy which is produced solely domestically, it's merely a transfer of incomes from producers to consumers and back and forth.

But the one thing that is distinct about oil is that it's one of our major sources of energy for which imports are a very big issue.

Senator Sessions. I've felt pretty strongly, that when the amount of wealth spent to import oil and energy is a big deal for the American economy.

So that argues, I guess, pretty clearly that conservation, domestic production, and efforts to contain the world price are the kind of policies that could have a significant impact on the economy.

And the fact that you're paying a greater amount for fuel as a result of a world price, it's like a tax on the American people for which they get no benefit.

Would that be fair to say?

Mr. Greenspan. I think it's perfectly accurate to put it the way you just did, Senator.

Senator Sessions. I'm concerned that we're not going to meet our power generation plans and goals without reactivation of nuclear energy in this country. France is now 80 percent of their power. We have the plants that are operating in the United States setting records for safety and efficiency.

Do you have any thoughts about the role of nuclear power, both for the environmental benefits of clean air and containing the demand on natural gas?

Mr. Greenspan. Well, obviously, the big problem with nuclear power is disposal of waste. But if we can resolve that issue, the advantages of nuclear power are very considerable. And indeed, as you point out, Senator, the technology has improved very measurably over the post-World War II period and safety is, as you point out as well, has clearly been a very formidable issue.

There is no energy production which is risk-free, no matter what we do. The point at issue is to reduce the level of risk to the lowest levels that we can. And I do think that we ought to be spending more time at least looking and contemplating the issue of nuclear power, especially since, as I mentioned in the discussion with Senator Alexander, natural gas is a real serious problem.

And the reason basically is that we don't have the capability of importing very substantial amounts of it from other than Canada and Mexico, and we don't do much with Mexico. In fact, it's basically the other way around.

So I think that if we're going to continue to expand our energy base, we're going to have to be starting to look at nuclear power as a potential reservoir of new sources of energy which are not available by other means.

Senator Sessions. Thank you.

Senator Bennett. Thank you. Well, we will have a second round.

And according to my list, Congressman Paul, you're up.

Representative Paul. Thank you, Mr. Chairman.

I wanted to follow up on your comments about not being able to—

Senator Bennett. I'll monitor the time a little more emphatically in the second round than I did the first time.

Representative Paul. Earlier, we were talking about your ability to talk about the value of the dollar and what it should be.

I find that rather ironic. The Federal Reserve is in charge of the monetary system and you as Chairman have a lot to say about what monetary policy is and how much money will be printed and created and what interest rates will be.

We find it bit ironic that you can't comment on the value of the dollar and we defer to Treasury.

Now Treasury can play a role, of course, by intervening in the exchange markets, but that's very temporary.

But I understand the policy and we don't expect you to change that. But, in a way, you're really in charge and it's too bad that we can't get comments about the dollar.

I did want to remind you about following up on the question about foreign policy, how foreign policy anticipation of what we might be doing around the world might affect fiscal and monetary policy and trade policy, how that might affect perceptions of the dollar and whether or not that's important.

But on the currency issue, I'm still not interested in going back to fixed currency rates such as the Bretton Woods agreement. That's not my interest. Because even then, Henry Hazlitt, I remember, wrote very correctly back then that Bretton Woods would break down, and it certainly did break down. It didn't work with that so-called gold exchange standard.

But if you have achieved what you hope you have achieved, and that is, that central banks have done such a good job in managing paper money, that it's starting to act like a gold standard. Now that would be an historic achievement, you realize that, because it has not been done in 6,000 years of recorded history.

History is on my side of this argument in that paper money doesn't work very well. Paper money ends badly. We may be seeing some signs today around the world that paper money is a very shaky system.

But a more specific question dealing with that, in a return to commodity money, at least on a voluntary basis, if we have a Third World nation that destroys its currency and they don't have the advantages that we have politically, if they destroy their currency and they want to link their currency to gold because they know history, they're not allowed to do it.

The IMF prevents them from doing it. There's an IMF rule that says that you can't do it.

So wouldn't this be a good time for us to become more neutral and not antagonistic towards gold and say to the IMF and to our position, that if you choose to go back and get stability and soundness to your currency with a linkage to gold, we ought to permit that?

Mr. Greenspan. Well, I believe a country has the capability of doing that. I'm not sure what the rule is in the IMF. But if they were going to link their currency to gold and they believed that was going to stabilize the system, they wouldn't need the IMF.

Representative Paul. But there's a prohibition if they want to stay in the IMF with that.

What about the foreign policy question?

Mr. Greenspan. I don't see how I can answer that without breaching the agreement about not talking about the currency.

I don't know how to phrase an answer to your question without implicitly doing that.

Representative Paul. Okay. I yield back.

Senator Bennett. Ms. Dunn?

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

Mr. Greenspan, I was intrigued by a report in the newspaper a few days ago that had to do with Iraq's being encouraged by the United States to leave the oil cartel and, in effect, flood the market with oil.

I don't know if you read that. But if you did, do you have any comment on the effect of that and whether that's a possibility that could be worked out, and what its positive aspects or any aspects would be on the United States?

Mr. Greenspan. I didn't read the articles closely, but I glanced at them. I wasn't aware that that's official policy, as far as I know.

Representative Dunn. Yes, I don't think it's official policy. But there was some – I don't know if it's leakage or not – but that was a potential policy.

Mr. Greenspan. Well, there are lots of people who hold that view. But lots of people hold lots of views.
I'm not sure—

Representative Dunn. Well, if it's official policy or not, could you speak briefly to the effects that that would have on the United States?

Mr. Greenspan. Well, remember, as the President has said, the oil belongs to the Iraqi people. Their judgment as to whether or not they wish to remain in OPEC or not remain in OPEC or deal with it one way or the other I think is an issue which they eventually, meaning those who are in control of the oil, are going to have to make.

Representative Dunn. Let me ask you about a comment that you made on page five of your testimony. Airlines have obviously suffered another blow due to the SARS outbreak and effects.

What do you think is the future of the airline industry?

Mr. Greenspan. I am statutory Chairman of the Loan Board and have been successful in delegating all my authorities to Governor Gramlich, who I think has done a far better job than I could have done on this issue.

As a consequence, I have not looked at the airline industry in great detail. I have economist's views about what should happen. But that really gets to the issue of the degrees of deregulation. In other words, remember that we significantly deregulated essentially the revenue side of the airline industry following the mid-'70s to very great effect. We augmented airline travel by a huge amount.

I think, however, we're still involved with many of the regulatory structures that existed prior to deregulation on all other aspects of airlines. And I think they're running into trouble where, as somebody said, the net earnings of the airline industry since the turn of the last century is zero. And that tells you that, structurally, something is askew here and we need to address this in a manner which makes them far more valuable.

The technologies are just remarkable. It's hard to believe that an industry that sophisticated is unable to make an adequate rate of return. But they're not able under existing sets of regulations.

Representative Dunn. A few months ago, some of the members of the airline industry were making comments that nationalization of the airline industry was a possibility.

Do you think that's a possibility?

Mr. Greenspan. I certainly hope not.

Representative Dunn. Thank you.

Senator Bennett. Senator Alexander?

Senator Alexander. Mr. Greenspan, I want to suggest a concept here and see whether it makes any sense as you look at the economy and try to make judgments.

I've been thinking that since September 11, that we've had imposed upon us in our country a sort of terrorism tax that would be composed of a variety of different costs. The actual costs of security, for example.

The costs that come from the loss of productivity as people watch television or do other things worrying about terrorism.

The costs that come from a lack of consumer confidence as people become nervous and postpone decisions.

You mentioned a little earlier the lack of business confidence as some business people are nervously postponing decisions.

I wonder if you've tried to put in one bucket all of these costs that have come as a result of the terrorism attack on 9/11 and since then, and apply that to the economy we have today. And I wonder what the economy would be like if we took the costs of the terrorism tax out of the picture.

It seems to me it would be a booming economy.

Mr. Greenspan. It's very difficult to judge, Senator. What we do know is, in the period immediately subsequent to September the 11th, a number of us endeavored to try to add up numbers of the type that you're talking about, both qualitatively and quantitatively, and we concluded that it's a rather large burden.

The problem, however, is looking from here in retrospect, it's difficult to find it in the aggregate figures. In other words, productivity is better than we expected. The degree of flexibility of our economy and resilience is better than we would have expected.

In short, while one would certainly have to argue, because there's no way to avoid it, that there's got to be some costs, dead-weight cost on businesses and on households from this, it is not easy for an economist to extract it from the macro-data. In other words, the economy is not behaving in a manner which suggests that these costs are overwhelmingly depressing.

It could be. I could certainly conceive of a situation in which we find that. It's just not evident in the data base.

Senator Alexander. So instead of jumping to a conclusion – well, common sense tells us, as you just indicated, that there are bound to be –

Mr. Greenspan. Got to be.

Senator Alexander. – some significant costs. Whether you walk into an airport or whatever.

But rather than jump to the conclusion that had it not been for 9/11, the economy would be booming, I guess another possibility would be that the strength of the country has found ways to compensate for that in other words and adjusted and maintained the strength that otherwise we wouldn't have been challenged to maintain.

Mr. Greenspan. Senator, I think that this raises the much broader question about governmental policy, which goes through fiscal policy, through homeland security, and the like. And it's to recognize, as we've discussed this morning, how important the issue of improved resilience and flexibility of the American economy has been to our society.

We've had huge deregulation in the last 25 years. We have major globalization, which improved competition. Technology very markedly improved real-time auditing of business imbalances and prevented them from festering and creating serious difficulties.

And it strikes me that one lesson we should be learning from all of this is that if we're trying to improve the economy, one of the best ways we can do so is to improve the flexibility and hence, the resilience, of the economy so that, irrespective of the types of shocks which are evident in the last several years, there's a base there which can fend them off.

It's better not to catch a cold than to have to fight it off after you've got it.

I haven't tried to do the arithmetical exercise, but I would suspect that the returns that we would get if we tried to estimate, for example, what the American economy would look like today if it did not have all the improvements that I just mentioned, we would find the GDP, in my judgment, down very significantly. And the macroeconomic impact of flexibility – in other words, what is the consequence of flexibility on GDP growth – I think we would find the numbers to be exceptionally large, and indeed, probably dwarfing many of the expected outputs from some of the initiatives we've been talking about today.

Senator Alexander. Thank you.

Senator Bennett. Senator Sarbanes?

Senator Sarbanes. Well, thank you very much, Mr. Chairman. And I apologize that I wasn't able to be here earlier and I apologize to Mr. Greenspan.

I started out this morning, I had three committees meeting at the same time. My initial reaction to that was not to go to any of them.

(Laughter.)

But I then concluded that that would be a dereliction of duty. So I'm trying to work through the list as best I can.

Senator Bennett. The Senator just confessed something of which all senators are guilty at some point or other.

(Laughter.)

Senator Sarbanes. Chairman Greenspan, we're obviously pleased to have you back before us. I'm going to put forward two or three quick questions.

First of all, I know that you've already addressed the unemployment insurance issue earlier. But you previously indicated that there are periods where the context is such that the restraints on the unemployment insurance system ought to be eased.

I guess I have a very simple question to put to you. We are in a period in which the unemployment rate continues to go up, the long-term unemployed now are at the highest level they've been in almost 20 years.

We're now facing the issue here of extending unemployment benefits. The average duration of unemployment has now gone to 19.6 weeks, which is the highest since January of 1984.

Would you regard this as a situation in which the economic context is such that we ought to consider extending these unemployment insurance benefits?

Mr. Greenspan. Senator, in answer to the question earlier, what I did say, after repeating what you've heard me say in the past about the unemployment insurance system which is that we have one far superior than any other that I've seen around the world in the sense that it does not encourage people not to take jobs.

Senator Sarbanes. It's pretty stringent in some respects in that regard.

Mr. Greenspan. Exactly. And I think that because it is stringent, in normal periods, that one should recognize that people who lose jobs not because they did anything and can't find new ones, you have a different form of problem, which means that you have to allow the unemployment system to be much broader and, indeed, that's what we tend to do.

I do, however, argue that we have to be careful about creating permanent temporary extensions, if I may put it that way.

And I was suggesting to your colleagues that should you be going forward in an extension, that it's far more important to have a short extension and, if necessary, just repeat it at a later time, because it is at this stage unclear as to whether we're at a fulcrum of a fairly significant economic recovery, which would make the necessity of a long-term adjustment in the unemployment insurance system moot.

Senator Sarbanes. On the trade deficit question, of course we now have this fall in the value of the dollar. How long can we go on running these large trade deficits and building up these very significant claims abroad on our productive capacity?

Mr. Greenspan. Senator, as you well know, the issue of how much you can build up net claims against American residents is a large function of the willingness of foreigners to hold and seek those claims. And indeed, what we have found over the years is that when the exchange rate for the dollar is rising, it of necessity means that there is a greater demand for dollars. And that's what occurred during a significant part of the 1990s.

But the obvious problem that you raise is, over the very long run, the ratio of accumulated claims against the United States, more specifically, those which relate to debt, create interest charges which in turn are part of the current account deficit, which means that it is quite possible to get into an unstable equilibrium, and that's an issue which economists have discussed quite significantly with respect to the United States.

And as I think I've mentioned to you, Senator, I've been raising this issue for years and forecasting a major contraction eventually of the current account deficit, and I raise it every five years.

Senator Sarbanes. Yes.

Mr. Greenspan. And I've been wrong every five years.

(Laughter.)

Senator Sarbanes. I know. But if we ever hit it, it almost would be like falling off the cliff, would it not?

Mr. Greenspan. No, I would think not, largely because the stock of dollar assets is so huge, and the ability to move them around is fairly limited, that adjustments don't occur off the cliff -- in other words, the question is, what do the holders do with those assets?

They're so heavily involved in dollar-denominated claims that, while obviously they can move out of them, and would, there are limits to how fast these things tend to move.

Senator Sarbanes. Can I put one more question, Mr. Chairman?

Senator Bennett. Surely.

Senator Sarbanes. Thank you. Kevin Hassett, an economist at the American Enterprise Institute, whom the *Post* reports has close Administration ties, wrote the following analysis of the dividend tax cut the Senate adopted last week. And I quote him:

"Think for a moment of the likely wacky effects of such a plan. With dividend tax rates dancing like fairies for the next few years, firms will have difficulty setting dividends and shareholders will have even more difficulties figuring out what current dividends signal about future prospects.

"Since the elimination of dividend tax is only temporary, investors must evaluate the risk that dividend taxes will come back. If they do, then the cash flows to investors from owning stock will plummet, as will the value of shares.

"Under such circumstances, it is undeniable that government policy significantly increases the fundamental risk of stocks. It would be hard to imagine that this would be good for the stock market or the economy.

"Clearly, this is one of the most patently absurd tax policies every proposed."

Now I was going to ask you your opinion of this comment. But we've run out of time and, having had a chance to introduce the quote in the course of my question, I'll yield back now to the Chairman so that the Committee can proceed.

(Laughter.)

Senator Bennett. Thank you very much.

Mr. Ryan?

Representative Ryan. Thank you. I have a question regarding Iraq. But I'll just pause for a second to continue the Kevin Hassett quote, which is that he spoke very glowingly of the House version of the tax bill, which is what the House will be voting on probably tomorrow. And it's my understanding that the Senate may be voting on it as early as Friday.

So if you look at Hassett's analysis, he thought that the reduction of the dividend tax rate down to 15 percent for the rest of the decade was right on the money.

So, with that, Mr. Chairman, I want to ask you about post-war Iraq.

If you take a look at the Iraqi economy, which is hopefully coming together, one of the chief problems and big challenges facing Iraq is to have a currency that is a reliable store of value on which they can build back their economy.

And if you look at the currencies circulating in Iraq, you would almost argue that it is effectively a dollarized economy already.

And given that we are now talking about investing billions of taxpayer dollars into the construction, reconstruction of post-war Iraq, one way that we could actually save money for American taxpayers, but also invest in Iraq, is to effectively dollarize, help Iraqis dollarize and share a fraction of our seigniorage with the Iraqi government.

I'd like to get your reaction on a proposal to dollarize the Iraqi economy, allow them to dollarize their economy, get a fraction of our seigniorage, and with that proposal would be a very, very explicit statement that any actions of the Federal Reserve or the U.S. Government policy will not take into account or any consideration conditions in Iraq.

So make sure we de-link our policy, our monetary policy-making with any other country that chooses to dollarize. But in the case of Iraq, who essentially is using dollars right now, give them some of our seigniorage. And the money we make on printing more dollars that they would then be using.

What is your reaction to that proposal?

Mr. Greenspan. Well, Congressman, actually, the so-called Swiss dinars, as well as the Sudan dinars, are circulating and, indeed, are critical to the total currency system.

But very clearly, it's important that a sound currency be instituted. There are innumerable financial analysts from our Government and elsewhere working with the Iraqi people and the Iraqi central bank to move in a direction of a sound currency, because you cannot have an economy grow without a means by which the division of labor can function. And unless you have a sound currency, people won't trade with one another because they don't know what they're getting with respect to paper.

It's not yet a problem. Remember that the Iraqi economy was essentially a planned economy under Saddam, not earlier. And the capitalist institutions which are so crucial to a development are still moribund there. So that it's going to require a considerable amount of effort. But there are a lot of people giving a lot of thought, constructive thought, to how to handle this issue. And I think whether or not the issue of dollarization comes up will ultimately be determined by the judgment of those Iraqis who ultimately will be part of the government which will make those decisions.

Representative Ryan. Obviously, laying a strong foundation is critical for their economy to grow, and taking out the uncertainty that accompanies new currency or new currency regimes is clearly a goal worth achieving.

Do you believe that we should consider if they ask us to share a small fraction of our seigniorage with the Iraqis?

Mr. Greenspan. We always consider such issues. Indeed, it as you well know has occurred on innumerable other occasions.

The question of sharing seigniorage is easily said, but very difficult to calculate. It's a lot more difficult. The question is – I don't want to get into the details of it—

Representative Ryan. I understand.

Mr. Greenspan. —but in principle, it's fairly obviously a valuable operation. Making it work is something else again.

Representative Ryan. Thank you.

Senator Bennett. Thank you very much.

All members of the Committee are encouraged to submit written questions. Many have indicated that they have those. We appreciate your response to those, Mr. Chairman.

If I could ask just one last question.

Some people are concerned that lower interest rates could interfere with the functioning of money markets. Money market funds, for example, might have a negative net return if interest rates fall to 75 or 50 basis points.

In other words, can you really go to zero? Do you have a comment on this?

Mr. Greenspan. Well, as you can imagine, the Federal Reserve staff has focused on this issue in some considerable detail. We have pretty much concluded where the key points of difficulties are and in what types of funds and in what types of instruments held by money market mutual funds, which is where the critical problems arise.

We haven't completed our studies yet fully. And I don't want to prejudge where we go. But there is obviously a question that you have significant impacts as you move short-term rates down through where the margins of money market mutual funds are.

And the question essentially rests as to what happens when you do that? We're spending some considerable time examining that issue.

Senator Bennett. Thank you. You'll be making a publication, or do we ask you that question again at some point?

Mr. Greenspan. I frankly do not – that question has not been addressed at this particular stage. But obviously, when we come to conclusions, I would presume that we would share it with you.

Senator Bennett. Very good.

Senator Sarbanes. Mr. Chairman?

Senator Bennett. Yes.

Senator Sarbanes. Could I just comment?

I see there's an article in the *New York Times* a couple of days ago headlined, "Surprise – The Fed Isn't Just Greenspan."

(Laughter.)

And I just want to say, I think that Chairman Greenspan has consistently been aware of that fact and has made extended efforts devoted to trying to develop a consensus on issues, and we certainly have also been aware of it here.

But it was an interesting story and certainly an interesting headline.

Thank you.

Senator Bennett. Mr. Chairman, as usual, you have enlightened us and handled the various questions deftly and appropriately.

We appreciate your willingness to appear before the Committee and for your service.

The hearing is adjourned.

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

[Whereupon, at 11:55 a.m., the hearing was concluded.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF SENATOR ROBERT F. BENNETT, CHAIRMAN

Good morning and welcome to today's hearing. We are pleased to have as our guest today Chairman Alan Greenspan of the Federal Reserve. We always appreciate his views on the current economic situation, as well as his broad perspective on the challenges we face as a nation.

Today is Chairman Greenspan's first hearing since the most recent meeting of the Federal Open Market Committee of the Federal Reserve. Changes in the Fed's statements, as well as substantial consumer and producer price declines in April, have recently generated many questions about deflation. I hope today's hearing will serve as a fair and open forum for exploring some of the potential answers.

In my own view, the deflation questions facing the United States are fundamentally different than they are for some economies currently suffering from this condition, such as Japan. We don't face the same deflation risks. But we shouldn't take any chances.

The questions of deflation come in the context of a nation still awaiting signs that our economy has fully emerged from the recent recession. Many economists predicted months ago that once the so-called "fog of war" was lifted and uncertainty resolved, the economy would rebound. However, economic indicators continue to paint only a murky picture, precluding a confident declaration that the economy has turned the corner and begun to approach full stride. For example, far too many Americans are still out of work.

Congress should not wait any longer for brighter signs from the economy. We should send to the president's desk a bold jobs and growth package now.

Final passage of a bold jobs and growth package is an important step, but the next few months will not be a time for us to sit on our laurels. Congress has much work to do. Let's start the discussion today about what tools we should use, in addition to tax cuts, to grow our economy and prepare for the future.

Some might shrug at the idea of giving serious thought to a foggy future, but the fact is, the future is much clearer than some would have us believe. The biggest feature on the horizon – one that we can forecast with an almost perfect accuracy – is the aging and the retirement of the Baby Boom generation. In the year 2011, now just eight years away, the first of that generation will reach the age of 65. As these men and women retire, the nation faces a serious challenge, with fewer workers available to support each retiree. This trend will put pressure on Social Security and especially on a system of delivering health care that looks much the same as it did when the younger of the Baby Boomers still wore diapers. Part of the answer will be having a fundamentally stronger and larger economy in place when they retire.

We need to think harder about how we tax capital and how our practice in that area can improve. The tax burden on capital in the U.S. is higher than imposed by many of our international competitors. Continued high rates of capital taxation could, by discouraging investment and capital formation in the U.S., handicap us in our efforts to meet upcoming challenges.

Just last week 70 Senators voted for a “Sense of the Senate” amendment instructing the Joint Economic Committee and the Senate Committee on Finance to consider tax reforms, including a Flat Tax. The bipartisan support for the amendment is an encouraging development suggesting many Members of Congress recognize the need to not just cut taxes, but to reform our tax system.

Yet, we must have more weapons than tax policy in our arsenal if we are to continue to flourish in the decades ahead. One key strength on which we must draw is our economy’s extraordinary flexibility, which has allowed us to weather an unexpected series of shocks over the past few years.

I observe this flexibility in strong financial markets helping to ensure our nation’s financial resources are put to their best use. I see this flexibility, as well, in the vitality and creativity of small and growing businesses, which quickly arise to meet new needs. Thanks to the ingenuity of these small business owners who risk their capital; thanks to the eagerness and ability of workers to adapt to new challenges; thanks to a pension system that has increasingly made workers mobile and allowed them to quickly respond to new opportunities instead of tying them to a single job for a lifetime: thanks to all of these factors, workers can go to the places they are needed the most. On previous occasions, Chairman Greenspan has emphasized the economy's flexibility as a key to its long-run growth prospects. Today, I invite him to add concreteness to his observation. In particular, I welcome a discussion about the particular actions we can take to enhance and build upon the flexibility to grow and meet the coming challenges.

Welcome again, Chairman Greenspan. We look forward to your testimony.

PREPARED STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Thank you Chairman Bennett for holding this hearing. I would like to welcome Chairman Greenspan here today.

I expect we will explore topics ranging from the sublime to the ridiculous. In the first category, we face the critical issue of how to put people back to work and get the economy moving again when interest rates are so low that the traditional tools of monetary policy are no longer effective. In the latter category—the ridiculous—we have the Congress pretending that a Rube-Goldberg contraption of a tax cut that mostly favors the well-to-do has anything to do with creating jobs and laying the foundation for sustainable growth.

Let me talk a little about the first topic. I hope, Chairman Greenspan, that you will be able to reassure us that the Fed is committed to getting the economy back to full employment as quickly as possible, and that you have the means to do it. We have lost 2.7 million private sector jobs since President Bush took office, and things aren't getting better. We haven't seen such persistent job loss since the 1930s. The Federal Reserve has said that the balance of risks is tilted toward continued weakness, but what can the Fed do to encourage job creation and growth when interest rates are already very low?

That question is critically important because you may be our last best hope when the fiscal policy coming out of the Congress is a shambles. Using a variety of gimmicks, both the House's $550 billion and the Senate's $350 billion tax cut packages squeeze large tax cuts for the wealthy into tighter budget constraints. Without those gimmicks, the true costs of these "more affordable" tax cuts are comparable to the President's original $726 billion package.

Chairman Greenspan, you have said in the past that you believe the financial markets assumed long ago that the 2001 tax cuts would not be allowed to sunset and that they would be made permanent. Is there any reason to take seriously the sunsets in the 2003 tax cuts moving through Congress now?

Far from being the best policies to get the economy back to full employment as quickly as possible while enhancing its long-term growth prospects, Republican "jobs and growth" plans provide little job-creating fiscal stimulus now when it is really needed, even as they drain national saving through swollen deficits. Their plans weaken our ability to address fundamental future retirement and health care challenges and merely pass along the responsibilities to our children and grandchildren, all for the sake of more tax cuts that primarily benefit the richest of households.

The American economy is “soggy,” according to Treasury Secretary John Snow. One reason is that the President and the Republican Congress continue to pursue trickle-down policies, instead of offering a real jobs and growth plan that would get the economy back to full employment quickly without undermining long-term growth.

The Republicans’ preoccupation with tax cuts leads them to propose inadequate policies for short-term economic stimulus, which would be better achieved by extending unemployment benefits and providing aid to the states.

I look forward to your testimony here today Chairman Greenspan.

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, VICE CHAIRMAN

It is a pleasure to join in welcoming Chairman Greenspan before the Joint Economic Committee once again.

The latest economic figures indicate that the economy is still expanding, although at a slow rate. In recent years, the economy has been remarkably resilient despite terrorism, war, and pervasive uncertainty. However, one of the weakest areas in the expansion has been business investment, and until business investment rebounds the economy is not likely to expand at a vigorous rate.

Although it is clear that the persistent weakness in business investment followed the stock market plunge in 2000, it is not possible to know exactly when it will end. As the New York Fed President has observed, the "effects of the bursting of the stock market have proven to be far more long term and pervasive than expected." Some of these effects are readily seen in the weakness in economic and employment conditions that has been apparent for some time.

In his last appearance before this Committee last November, Chairman Greenspan stated that the economy was in a "soft patch," and suggested that when the unusual degree of uncertainty facing the economy was lifted, the rate of economic growth could begin to increase. Although some of this uncertainty may have been reduced, at least some of it still remains. The latest data suggest that the economy is still quite weak.

We all hope that the economy is poised for acceleration in the last half of the year. However, there is little compelling hard evidence that a pick-up in economic growth is on the horizon. There has been a recovery in business profits and some other indicators, but there are many other signals of continued economic fragility. In this economic environment, it is reasonable to consider adjustments in economic policy. Congress has responded with tax legislation designed to boost investment and economic growth.

Given the economic weakness and the downward pressures on prices, the Federal Reserve should implement another incremental easing of monetary policy. If policy is eased and the pace of economic expansion does take off in the second half of the year, monetary policy could readily be adjusted to take this into account. However, if the economy continues to sputter along for another six months, the Fed may have missed its opportunity.

The decline in the value of the dollar obviously is one factor to be considered, but it is clear that this decline is not the result of an inflationary monetary policy. In the absence of inflation, the risks of another easing move are low, and such a move is already expected in the financial markets. The risks posed by the weakness in the domestic and international economy appear to exceed the risk that inflation will emerge as a serious problem in the foreseeable future.

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

Mr. Chairman, I appreciate the opportunity to testify before the Joint Economic Committee. As you will recall, when I appeared here last November, I emphasized the extraordinary resilience manifested by the United States economy in recent years–-the cumulative result of increased flexibility over the past quarter century. Since the middle of 2000, our economy has withstood serious blows: a significant decline in equity prices, a substantial fall in capital spending, the terrorist attacks of September 11, confidence-debilitating revelations of corporate malfeasance, and wars in Afghanistan and Iraq. Any combination of these shocks would arguably have induced a severe economic contraction two or three decades ago. Yet remarkably, over the past three years, activity has expanded, on balance--an outcome offering clear evidence of a flexible, more resilient, economic system.

Once again this year, our economy has struggled to surmount new obstacles. As the tensions with Iraq increased early in 2003, uncertainties surrounding a possible war contributed to a softening in economic activity. Oil prices moved up close to $40 a barrel in February, stock prices tested their lows of last fall, and consumer and business confidence ebbed. Although in January there were some signs of a post-holiday pickup in retail sales other than motor vehicles, spending was little changed, on balance, over the following three months as a gasoline price surge drained consumer purchasing power and severe winter weather kept many shoppers at home.

Businesses, too, were reluctant to initiate new projects in such a highly uncertain environment. Hiring slumped, capital spending plans were put on hold, and inventories were held to very lean levels. Collectively, households and businesses hesitated to make decisions, pending news about the timing, success, and cost of military action – factors that could significantly alter the outcomes of those decisions.

The start of the war and its early successes, especially the safeguarding of the Iraqi oilfields, were greeted positively by financial and commodities markets. Stock prices rallied, risk spreads narrowed, oil prices dropped sharply, and the dour mood that had gripped consumers started to lift, precursors that historically have led to improved economic activity. The quick conclusion of the conflict subsequently added to financial gains.

We do not yet have sufficient information on economic activity following the end of hostilities to make a firm judgment about the current underlying strength of the real economy. Incoming data on labor markets and production have been disappointing. Payrolls fell further in April, and industrial production declined as well. Because of the normal lags in scheduling production and in making employment decisions, these movements likely reflect business decisions that, for the most part, were made prior to the start of the war, and many more weeks of data will be needed to confidently discern the underlying trends in these areas.

One reassuring development that has been sustained through this extended period of economic weakness has been the performance of productivity. To the surprise of most analysts, labor productivity has continued to post solid gains. Businesses are apparently continuing to discover unexploited areas of cost reduction that had accumulated during the boom years of 1995 to 2000 when the projected huge returns from market expansion dulled incentives for seemingly mundane cost savings. The ability of business managers to reduce costs, especially labor costs, through investment or restructuring is, of course, one reason that labor markets have been so weak.

Looking ahead, the consensus expectation for a pickup in economic activity is not unreasonable, though the timing and extent of that improvement continue to be uncertain. The stance of monetary policy remains accommodative, and conditions in financial markets appear supportive of an increased pace of activity. Interest rates remain low, and funds seem to be readily available to creditworthy borrowers. These factors, along with the ability of households to tap equity accrued in residential properties, should continue to bolster consumer spending and the purchase of new homes.

The recent declines in energy prices are another positive factor in the economic outlook. The price of West Texas intermediate crude oil dropped back to below $26 per barrel by the end of April, but as indications of a delay in the restoration of Iraqi oil exports became evident and geopolitical risks crept back in, prices have risen to near $30 a barrel – a worrisome trend if continued. Nonetheless, the price of crude oil is still about $10 per barrel below its peak in February. This decline has already shown through to the price of gasoline in May. Some modest further declines in gas prices are likely in coming weeks, as marketers' profit margins continue to back off from their elevated levels of March and April to more normal levels.

In contrast, prices for natural gas have increased sharply in response to very tight supplies. Working gas in storage is presently at extremely low levels, and the normal seasonal rebuilding of these inventories seems to be behind the typical schedule. The colder-than-average winter played a role in producing today's tight supply situation as did the inability of heightened gas well drilling to significantly augment net marketed production. Canada, our major source of gas imports, has little room to expand shipments to the United States. Our limited capacity to import liquified natural gas effectively restricts our access to the world's abundant supplies of natural gas. The current tight domestic natural gas market reflects the increases in demand over the past two decades. That demand has been spurred by myriad new uses for natural gas in industry and by the increased use of natural gas as a clean-burning source of electric power.

On balance, recent movements in energy prices seem likely to be a favorable influence on the overall economy. In the short run, lower energy bills should give a boost to the real incomes of households and to business profits. To be sure, world energy markets obviously remain susceptible to politically driven supply disruptions, as has been evident recently from the events in Venezuela and Nigeria. But, even taking account of these risks, futures markets project crude oil prices to fall over the longer run, consistent with the notion that current prices are above the long-term supply price of oil.

As has been the case for some time, the central question about the outlook remains whether business firms will quicken the pace of investment now that some, but by no means all, of the geopolitical uncertainties have been resolved. A modestly encouraging sign is the backlog of orders for nondefense capital goods excluding aircraft, which has been moving up in recent months. Moreover, recent earnings reports suggest that the profitability of many businesses is on the mend. That said, firms still appear hesitant to spend and hire, and we need to remain mindful of the possibility that lingering business caution could be an impediment to improved economic performance.

One new uncertainty in the global economic outlook has been the outbreak of severe acute respiratory syndrome (SARS) in Southeast Asia and elsewhere. This epidemic has hit the economies of Hong Kong and China particularly hard, as tourism and business travel have been severely curtailed and as measures to contain the spread of the virus have held down retail sales.

To date, the effects of SARS on the U.S. economy have been minimal. Airlines have obviously suffered another serious blow, and some U.S. multinational corporations are reporting reduced foreign sales. But the effects on other industries have been small. Initially, there had been some concern that SARS would disrupt the just-in-time inventory systems of U.S. manufacturers. Many of those systems rely on components from Asia, and any disruption in the flow of these goods has the potential to affect production in the United States. So far, however, U.S. manufacturing output has not been noticeably affected.

In recent months, inflation has dropped to very low levels. As I noted earlier, energy prices already are reacting to the decline in crude oil prices, and core consumer price inflation has been minimal. Inflation is now sufficiently low that it no longer appears to be much of a factor in the economic calculations of households and businesses. Indeed, we have reached a point at which, in the judgment of the Federal Open Market Committee, the probability of an unwelcome substantial fall in inflation over the next few quarters, though minor, exceeds that of a pickup in inflation.

Mr. Chairman, the economic information received in recent weeks has not, in my judgment, materially altered the outlook. Nonetheless, the economy continues to be buffeted by strong cross currents. Recent readings on production and employment have been on the weak side, but the economic fundamentals – including the improved conditions in financial markets and the continued growth in productivity – augur well for the future.

PREPARED STATEMENT OF SENATOR EDWARD M. KENNEDY

I commend Chairman Bennett, for his leadership in holding this hearing on the nation's economic outlook, and I join in welcoming Federal Reserve Chairman Greenspan to our Committee.

Many of us in Congress have continuing concerns about the Administration's economic policy and its responses to the challe3nges facing our troubled economy. Unemployment is still on the rise, climbing to 6.0 percent in April. Almost 9 million men and women are unemployed. The economy has lost nearly 3 million jobs since President Bush took office, and there is no end in sight. Workers have lost their job security, and as layoffs mount, they live in fear of being the next to be let go.

Those looking for a job are finding it increasingly difficult to find one. The number of long-term unemployed has tripled. The average time it takes an unemployed worker to find a new job is the longest in 19 years. The crisis in state budgets across the country is making all these problems worse.

When President Bush took office, it was estimated that the cumulative budget surplus for the next ten years would be $5.6 trillion. Now, the Congressional Budget Office says the budget deficit will grow to 4 trillion dollars, with more than three-quarters of that amount directly attributable to the Bush tax cuts. Mr. Greenspan has cautioned that further tax cuts which are not offset could drive up long-term interest rates and make the economic outlook even darker.

It is ironic that the Administration which is so fervently pursuing more tax cuts is at the same time urgently requesting the largest increase in the debt limit ever proposed. It's no wonder that more than 450 economists – including 10 Novel Prize winners – have signed a statement criticizing the President's proposal as an ineffective short-term stimulus that worsens the long-term budget outlook.

Obviously, Congress is sharply divided on these issues. I continue to hope that we can reach a fair compromise that will genuinely help the economy, and benefit all our citizens too. But so far, there seems to be little chance of that.

I look forward to Chairman Greenspan's testimony today. Hopefully it may serve the stimulus that all of us in Congress need to do the right thing!

JENNIFER DUNN

UNITED STATES
HOUSE OF REPRESENTATIVES

May 20, 2003

The Honorable Alan Greenspan
Chairman
Board of Governors
Federal Reserve System
Washington, DC

Dear Mr. Chairman:

The accompanying questions are submitted in connection with your appearance before the Joint Economic Committee. Because they relate to a matter to arise in the near future before the House Committee on Ways and Means, on which I serve, I would appreciate your prompt response.

Thank you for your attention.

Best regards,

Jennifer Dunn

JENNIFER DUNN
Member of Congress

JD/ps
Enclosure

Questions submitted by Representative Dunn:

1. The territorial tax systems in Europe seem to provide an inherent advantage in their treatments of exports. Do you think there is a way to provide comparable treatment for US exports without running afoul of WTO? What is the best way to do this?

2. From a broader perspective, is there something fundamentally wrong in how we impose taxes that has led to the problem? For example, I noted that the Undersecretary of Commerce for International Affairs, Grant Aldonas, said recently that he would raise the issue of direct vs. indirect taxation within the WTO. Is that the best approach to resolving this problem?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 2D5S1

June 3, 2003

The Honorable Jennifer Dunn
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

I am enclosing my responses to the written questions that you submitted following my recent testimony before the Joint Economic Committee.

A copy also has been sent to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Chairman Greenspan subsequently submitted the following in response to written questions received from Congresswoman Jennifer Dunn in connection with the Joint Economic Committee hearing of May 21,2003:

1. The territorial tax systems in Europe seem to provide an inherent advantage in their treatment of exports. Do you think that there is a way to provide comparable treatment for U.S. exports without running afoul of WTO? What is the best way to do this?

The worldwide and territorial systems are two methods of corporate taxation. In a purely "worldwide" or "residence-based" system, the home country taxes the income of companies based there, regardless of where the income is earned. In contrast, a purely "territorial" system taxes the corporate income earned within the home country; income earned in other countries (i.e. , foreign-source income) is not taxed by the home country.

In practice, existing systems of taxation contain elements of both methods, but the U.S. system is primarily worldwide, while some European countries utilize a largely territorial system. The impression that a territorial system provides inherent advantages to exporters may stem from the ways in which the two types of systems attempt to deal with the problem of double taxation, whereby a firm could be subject to taxes on the same income in two different countries. WTO rules state that countries are permitted to adopt measures to avoid double taxation. Such measures generally differ between worldwide and territorial systems.

Regarding comparable treatment for U.S. exports, the United States could of course adopt a European-style territorial system, assuming that all of the key aspects of such a system are incorporated. However, rather than focusing on one specific form of international transaction, i.e., exports, it may be useful to think more broadly about the principles that should be embodied in the corporate tax code. Ideally, any changes in the system of taxation would aim to minimize distortionary effects and encourage the most efficient international allocation of resources.

2. From a broader perspective, is there something fundamentally wrong in how we impose taxes that has led to the problem? For example, I noted that the Undersecretary of Commerce for International Affairs, Grant Aldonas, said recently that he would raise the issue of direct vs. indirect taxation within the WTO. Is that the best approach to resolving the problem?

Indirect taxes are based on expenditures and include levies such as sales taxes and value-added taxes. Direct taxes are based on income and include, for example, taxes on corporate income. Countries generally use a mix of these two types of taxes. For example, the United States has both indirect taxes (such as state sales taxes) and direct taxes (on wages and corporate income).

WTO rules incorporate a distinction between indirect and direct taxes. There is debate regarding the degree to which the disparate treatment of direct and indirect taxes is warranted. Under WTO rules, while indirect taxes are border-adjustable, direct taxes (such as on corporate income) are generally not adjustable at the border. Thus, value added taxes (VAT) are not collected on European exports, just as state sales taxes are not collected on U.S. exports. VAT is collected on European imports, just as state sales taxes are collected on the final sale of U.S. imports, Such "border adjustments " are consistent with a destination principle for the VAT, whereby taxes are levied based on the location of consumption.

The distinction in the treatment of direct and indirect taxes is reportedly going to be part of the Doha negotiations under the WTO, consistent with (b):(15) of Section 2102 of the Trade Act of 2002. Such international discussions could be useful in terms of alleviating any tensions between trading partners over this matter. It is important to note that European countries generally impose direct taxes, with a corporate income tax burden often comparable to or in some cases higher than in the United States. Given that European countries are subject to the same WTO rules as is the United States, any changes in these rules would apply to both the United States and Europe.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 2D5S1

June 16. 2003

The Honorable Ron Paul
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am enclosing my responses to the written questions that you submitted following my recent testimony before the Joint Economic Committee.

A copy also has been sent to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Chairman Greenspan subsequently submitted the following in response to written questions received from Congressman Ron Paul in connection with the Joint Economic Committee hearing of May 21, 2003 :

A.) Mr. Chairman, you mentioned a concern regarding an "unwanted severe decrease in inflation." This prompts three questions. First, is the definition for the word inflation you are using here "an increase in prices" or is it the more historically accurate definition of inflation, namely "an increase in the supply of currency?"

Next, assuming you are defining inflation as an increase in prices, do you realize that people generally would view an increase in their purchasing power as a positive thing?

Finally, when you speak of "unwanted severe decrease in inflation," is this the same thing as the "deflation" you referenced?

Inflation is generally defined as a sustained increase in the aggregate price level To be sure, inflation is almost always a monetary phenomenon, and, as you are well aware, its origins typically are found in too much money chasing too few goods.

With respect to your question concerning purchasing power, I certainly agree that people will view increases in their purchasing power as a positive development. However, an environment of a falling aggregate price level does not necessarily translate into enhanced household purchasing power. If falling prices eventually lead to falling wages and profits, there may be no increase at all in household purchasing power. Moreover, if this process were to further include an impingement on businesses' operating margins, firms could cut employment and production with attendant negative consequences for overall economic activity.

A) "substantial fall in inflation" means just that. Obviously, with a sufficiently large fall, inflation would give way to deflation.

B) You stated that "non-incentivizing attempts at short-term stimulus by way of fiscal policy tends to fade and in fact reverse itself." By implication, you are suggesting that monetary policy does not face the same pitfall. What evidence can you present to suggest that the mal-investment caused by monetary policy is not every bit as detrimental as are the "reverses" you suggest arise from fiscal policy-based interventions into the market?

As I noted in my appearance, fiscal stimulus directed at consumption can succeed for a time at boosting aggregate economic activity. However, because stimulus of this variety has only indirect and partial effects on investment and aggregate supply, some of the initial impetus to activity can eventually be reversed should increases in demand exceed those of supply. Fiscal stimulus directed at boosting capital formation over the intermediate to longer term has the advantage of augmenting both demand and the economy's productive capacity. an outcome that yields more sustainable increases in economic activity.

I do not believe that appropriate monetary policy results in misallocation of investment and capital. To the contrary, a successful monetary policy aimed at achieving stable prices provides the environment most conducive to long-term planning by businesses and households and to the effective operation of our free-market system. This outcome, in turn, provides a solid foundation for the promotion of maximum sustainable growth of the economy.

C) You suggested that fiscal policy is not a good way to stimulate short-term economic growth because of the congressional budgetary system. In comparing this with monetary policy, you suggested that the Federal Reserve was a better vehicle of economic planning because it could react "in 20 minutes." Mr. Chairman, given the myriad of failed attempts at central planning particularly in the recently completed century, can you comment upon your evident belief that our nation's Founders were wrong for giving us a system that would in fact not allow for the government to interfere in the economy “at the drop of a hat?”

Furthermore, you suggested that economists are divided on the issue but tend to support your view of monetary policy as the effective way to intervene in the economy. Is it true to suggest that the "divide" is between those who support the idea of government intervention (and your position with regard to the effectiveness of monetary policy as a tool for planning), and those who are more supportive of unrestricted and unplanned markets?

Congress effectively put us on a fiat money standard in the 1930s. That requires actions on the part of government or its designee, the central bank, to set the size of the central bank's balance sheet. It is even an act of government intervention to choose to leave the balance sheet unchanged, as well, of course, as to change it through intervention in the money market.

The time frame in which monetary policy can be formulated and implemented is much shorter than that for fiscal policy. As a consequence, in most circumstances, monetary policy is better positioned than fiscal policy to respond to the short-term fluctuations in output and inflation that are often associated with business cycle developments. Fiscal policy typically addresses the longer-term objectives of encouraging national saving, promoting capital formulation, and minimizing tax-related distortions in economic behavior. In any event, neither monetary policy nor fiscal policy should be employed for purposes of central planning. As you point out, the last century provided ample evidence of the futility of such efforts and the destructive consequences that inevitably follow. In the case of monetary policy, the pursuit of price stability allows our free-market system to support the achievement of maximum sustainable growth.

D.) You stated that capital and labor flows are the alternative ways to attain what you see as the benefits of a fluctuating currency. Is it not true that the corollary is accurate (i.e., that fluctuating currencies provide a disincentive to capital and labor flows and hence incentivize inefficient applications of both labor and capital)?

Economic analysis stresses the importance of flexible prices in guiding markets to achieve the most efficient use of resources, and, because exchange rates are a particular set of prices, this general conclusion applies to them just as it does to other prices. Factor movements, that is, labor migration and capital flows, can substitute for price flexibility and in time achieve an efficient international allocation of resources under a system of fixed exchange rates. However, it is usually the case that the necessary re-allocation of economic resources in response to changing fundamentals in the international economy can be accomplished by means of a change in exchange rates. Therefore, rather than providing a disincentive to capital and labor flows, freely fluctuating exchange rates should be seen as reducing the need for some factor flows (especially labor migration), and in so doing exchange rate fluctuations can lower the transition costs of changing resource allocation patterns and promote the efficient allocation of economic resources .