OUTLOOK FOR THE STATE OF THE U.S. ECONOMY IN 1999

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

JANUARY 20, 1999

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OUTLOOK FOR THE STATE OF THE U.S. ECONOMY IN 1999

WEDNESDAY, JANUARY 20, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
January 12, 1999
No. FC–1

CONTACT: (202) 225–1721

Archer Announces Hearing on the Outlook for the State of the U.S. Economy in 1999

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Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on the outlook for the state of the U.S. economy in 1999. The hearing will take place on Wednesday, January 20, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. The sole witness at this hearing will be the Honorable Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

The U.S. economy is currently enjoying its best performance during the post-war period, with a record-sustained period of full employment and low inflation.

The 105th Congress passed bipartisan legislation, the Balanced Budget Act of 1997 (P.L. 105–33) and the Taxpayer Relief Act of 1997 (P.L. 105–34), aimed at reducing the budget deficit and encouraging economic growth. As a result of this bipartisan legislation and the strong performance of the economy, the Federal Government ended fiscal year 1998 with a record $76 billion surplus.

Among the challenges facing the 106th Congress are the approaching insolvency of the Social Security system, a growing Federal tax burden, and the Asian economic crisis. On January 19th, President Clinton is scheduled to give his annual State of the Union address to the nation.

In announcing the hearing, Chairman Archer stated: "The nation's economy continues to be strong, in no small part, due to the bipartisan policies recently passed by the Congress. I'm particularly delighted at our success in turning the Federal budget deficit into a surplus. As the Committee begins this year's efforts to save Social Security, cut taxes, and promote further economic growth, the opinions of Chairman Greenspan on the state of the economy and its future prospects will be especially important. I look forward to hearing his views."

FOCUS OF THE HEARING:

The Committee expects to receive testimony on the state of the economy and the outlook for future economic performance from the Honorable Alan Greenspan, Chairman of the Federal Reserve.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label, by the close of business, Wednesday, February 3, 1999, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments. At the same time written statements are submitted to the Committee, witnesses are now requested to submit their statements on an IBM compatible 3.5-inch diskette in ASCII DOS Text or WordPerfect 5.1 format. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS__MEANS/'.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman ARCHER. The Committee will come to order. The Chair would ask all of our guests to take seats.

Good morning and welcome to our first hearing of the year with our special guest, Chairman of the Federal Reserve Board, Alan Greenspan.

Mr. Chairman, you have not been before our Committee since December 18, 1991. That is too long a period of time.

Mr. GREENSPAN. I observe the economy seems to have done exceptionally well since.

Chairman ARCHER. But you have not been in absentia as this economy has grown, and you have made an enormous contribution to the growth of the economy and the reduction of inflation and unemployment. But welcome back. We are honored to have you with us today. I think you already know of my high regard for you as well as my warm personal friendship with you. We look forward to hearing your views on the economy.

I intend for this to be a very busy and productive year for the Committee on Ways and Means. We look forward to advancing an agenda to secure America's future, and it will be built around four items: Strengthening Social Security, improving education, providing tax relief, and rebuilding our national defense. I would hope that we would be able to add a fifth item, which is paying down the national debt.

This Congress has much to be proud of. The economy is strong and hope is high. More Americans are working now than at any time in the last 29 years. Welfare has turned into workfare. The budget is in surplus and taxes have been cut. We stabilized Medicare and, in a hallmark achievement of this Committee, we protected the people from the IRS.

Last night the President announced his agenda for our Nation and it is truly a busy agenda. It is full of new spending programs. It promises tax increases and it calls for direct government investment in stocks. Sadly, I did not hear of any spending cuts.

The agenda will test our ability to maintain fiscal discipline. Instead of using the surplus to pay down the debt or provide growth-oriented tax cuts, the White House spends every penny of the surplus on more government.

I believe we must maintain fiscal discipline, and that is why I want to use the surplus to save Social Security, cut taxes and pay down the debt. Cutting taxes can achieve two goals. Tax cuts reduce wasteful spending and promote economic growth. The less money people send here, the less money the politicians in both parties will have to waste.

In addition to the tax cuts the House passed last year, I hope we can enact growth-oriented tax cuts this year. It is vital that America's economy remain the engine that helps pull the rest of the world's economies. One look at Brazil and Asia tells us how important growth is. We must maintain economic growth, and cutting taxes appropriately can help get the job done.

To his credit, Secretary Rubin asked the Japanese to cut taxes to foster growth. In America, the Fed cut rates to achieve growth. It is in that spirit that I seek to cut taxes.

Mr. Chairman, you have accomplished much in your career. In a fragile economic time, your hand is steady, guiding our Nation and shaping our economy. You are a man who puts principles before politics and ideas before ambition. That should be the hallmark for every Member of Congress. Again, welcome here today.

Please tell us what you want us to hear. But before that, I am going to recognize Mr. Rangel for any minority views that he might like to make.

[The opening statement follows:]

Statement of Chairman Bill Archer, Representative in Congress from the State of Texas

Good morning.

I'm pleased to welcome everyone to our first hearing of the year, featuring Federal Reserve Chairman Alan Greenspan.

Mr. Chairman, you haven't been before our Committee since December 18, 1991. Welcome back. We're honored to have you here. You already know of my high regard for you and I look forward to hearing your views on the economy.

I intend for this to be a very busy and productive year at Ways and Means. I look forward to advancing an agenda to secure America's future. Our Congressional agenda will be built around four items:

- Strengthening Social Security
- Improving education
- Providing Tax Relief and
- Rebuilding our national defense.

This Congress has much to be proud of. The economy is strong and hope is high. More Americans are working now than any time in the last twenty-nine years. Welfare has turned into workfare, the budget is in surplus, and taxes have been cut. We stabilized Medicare and we protected people from the I.R.S.

Last night, the President announced his agenda for our nation. It's a busy agenda. It's full of new spending programs. It promises tax increases and it calls for direct government investment in stocks. It contains no spending cuts.

This agenda will test our ability to maintain fiscal discipline. Instead of using the surplus to pay down the debt or provide growth-oriented tax cuts, the White House spends every penny of the surplus on more government.

I believe we must maintain fiscal discipline and that's why I want to use the surplus to save Social Security, cut taxes, and pay down the debt.

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To his credit, Secretary Rubin asked the Japanese to cut taxes to foster growth. In America, the Fed cut rates to achieve growth. It's in that spirit that I seek to cut taxes.

Mr. Greenspan, you have accomplished much in your career. In a fragile economic time, your hand is steady, guiding our nation and shaping our economy. You are a man who puts principles before politics and ideas before ambition. Again, welcome here today and say what you want us to hear.

Mr. RANGEL. Thank you, Mr. Chairman. Let me join with you, Chairman Archer, in welcoming Chairman Greenspan here and in thanking you, not only for the Committee Members and the Congress but for the American people, for the leadership that you have demonstrated. We owe you so much for the healthy condition of our economy.

I had really hoped when the Chairman started, that in lauding you, it would have been the beginning of a new era of bipartisanship. And certainly, if I was in the majority with a five-member vote margin, I would have been much kinder to the President than the Chairman appeared to be. But maybe that is why you haven't been to this Committee that often, because you have managed to stay far away from the partisanship that we have in the House. In any event, no matter how much we may differ on this Committee, we all agree that you have done a wonderful job.

Mr. Chairman, while the President has not given us a Social Security bill, he has responded to your request that you have a framework for all of us, Democrats and Republicans, to work with, not only for Social Security and Medicare, but also to encourage savings by our low-income people and, of course, to give incentives for education to make certain that most of our citizens will become productive. Whether you want to give tax cuts at the expense of Social Security is not an issue to discuss at the moment.

Let us join together and welcome Chairman Greenspan for his remarkable leadership. And you can depend that no matter what our differences are, we will still come together to greet you and to follow your leadership.

Thank you, Mr. Chairman.

Chairman ARCHER. Thank you, Mr. Rangel. The Chair accepts your partisan comments.

[The opening statement of Mr. Ramstad follows:]

Statement of Hon. Jim Ramstad, a Representative in Congress from the State of Minnesota

Mr. Chairman, thank you for inviting Chairman Greenspan to address this committee on the state of the economy and the economic outlook for 1999.

We are currently experiencing a nearly unprecedented vibrant economy, with record-length peacetime economic expansion, low unemployment, low inflation, low interest rates and the welcome phenomenon of a budget surplus. A recent poll indicated that 81% of Americans believe our nation is on the right track.

Certainly, America's thriving businesses deserve much of the credit for our current prosperity. But so does sound monetary policy and the bipartisan legislation of the last Congress that restrained spending and stimulated economic growth through tax cuts.

Still, at a time when American families should be reaping the benefits of economic prosperity, too much of their earnings are being eaten by federal taxes. Federal tax revenues are increasing at a rate of 8%—far above America's rate of economic growth. And federal taxes as a percentage of GDP exceed 20%—their highest level since World War II.

Because this committee may be making many decisions this year that will have a lasting impact on our economy—including tax policy, trade and social security reform—I am grateful we will have the benefit of Chairman Greenspan's testimony today.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Greenspan, you may proceed.

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

Mr. GREENSPAN. Thank you. First let me say I thank both of you for your very kind remarks, and I take that as an invitation to have me back somewhat more often, or maybe not after you hear what I have to say today.

Members of the Committee, the American economy through year-end continued to perform in an outstanding manner. Economic growth remained solid and financial markets, after freezing up temporarily following the Russian default, are again channeling an ample flow of capital to businesses and households. Labor markets have remained quite tight, but, to date, this has failed to ignite the inflationary pressures that many had feared.

To be sure, there is decided softness in a number of manufacturing industries, as weakness in many foreign economies has reduced demand for U.S. exports and intensified competition from imports. Moreover, the underutilized production capacity and pressure on the domestic profit margins, especially among manufacturers, are likely to rein in the rapid growth of new capital investment. With corporations already relying increasingly on borrowing to finance capital investment, any evidence of a marked slowing in corporate cash flow is likely to induce a relatively prompt review of capital budgets.

The situation in Brazil and its potential for spilling over to reduce demand in other emerging market economies also constitutes a possible source of downside risk for demand in the United States. So far, markets seem to have reacted reasonably well to the decisions by the Brazilian authorities to float their currency and redouble efforts at fiscal discipline. But followthrough in reducing budget imbalances and in containing the effects on inflation of the drop in value of the currency will be needed to bolster confidence and to limit the potential for contagion to the financial markets and economies of Brazil's important trading partners, including the United States.

While there are risks going forward, to date, domestic demand and hence employment and output in the United States certainly has remained vigorous. Though the pace of economic expansion is widely expected to moderate as 1999 unfolds, signs of an appreciable slowdown as yet remain scant.

But to assess the economic outlook properly, we need to reach beyond the mere description of America's sparkling economic performance of 8 years of record peacetime expansion to seek a deeper understanding of the forces that have produced it. I want to take a few moments this morning to discuss one key element behind our current prosperity—the rise in the value markets place on the capital assets of U.S. businesses.

Lower inflation, greater competitiveness, and the flexibility and adaptability of our businesses have enabled them to take advantage of a rapid pace of technological change to make our capital stock more productive and profitable. I will argue that the process of recognizing this greater value has produced capital gains in equity markets that have lowered the cost of investment in new plant and equipment and spurred consumption. But, while asset values are very important to the economy and so must be carefully monitored and assessed by the Federal Reserve, they are not themselves a target of monetary policy. We need to react to changes in financial markets, as we did this fall, but our objective is the maximum sustainable growth of the U.S. economy, not particular levels of asset prices.

As I have testified before the Congress many times, I believe, at root, the remarkable generation of capital gains of recent years has resulted from the dramatic fall in inflation expectations and associated risk premiums, and broad advances in a wide variety of technologies that produced critical synergies in the nineties.

Capital investment, especially in high-tech equipment, has accelerated dramatically since 1993, presumably reflecting a perception on the part of businesses that the application of these emerging technological synergies would engender a significant increase in rates of return on new investment.

Indeed, some calculations support that perception. They suggest that the rate of return on capital facilities put in place during recent years has in fact moved up markedly. In part this may result from improved capital productivity, that is, the efficiency of the capital stock. In addition, we may be witnessing some payoffs from improved organizational and managerial efficiencies of U.S. businesses and from the greater education, in school and on the job, that U.S. workers have acquired to keep pace with the new technology. All these factors have been reflected in an acceleration of labor productivity growth.

Parenthetically, improved productivity probably explains why the American economy has done so well despite our oft-cited subnormal national saving rate. The profitability of investment here has attracted saving from abroad, an attraction that has enabled us to finance a current account deficit while maintaining a strong dollar. Clearly, we use both domestic saving and imported financial capital in a highly efficient manner, apparently more efficiently than many, if not most, other major industrial countries.

While discussions of consumer spending often continue to emphasize current income from labor and capital as the prime source of funds, during the nineties, capital gains, which reflect the valuation of expected future incomes, have taken on a more prominent role in driving our economy.

The steep uptrend in asset values of recent years has had important effects on virtually all areas of our economy, but perhaps most significantly on household behavior. It can be seen most clearly in the measured personal savings rate, which has declined from almost 6 percent in 1992 to effectively zero today.

Arguably, the average household does not perceive that its saving has fallen off since 1992. In fact, the net worth of the average household has increased by nearly 50 percent since the end of 1992, well in excess of the gains of the previous 6 years. Households have been accumulating resources for retirement or for a rainy day, despite very low measured saving rates.

The resolution of this seeming dilemma illustrates the growing role of rising asset values in support of personal consumption expenditures in recent years. Economists have long recognized a "wealth effect," a tendency for consumption to rise by a fraction of the capital gains on existing assets owned by households, though the magnitude of this effect remains difficult to estimate accurately.

We have some evidence from recent years that all or most of the decline in the saving rate is accounted for by the upper income quintile where the capital gains have disproportionately accrued, which suggests that the wealth effect has been real and significant. Thus, all else equal, a flattening of stock prices would likely slow the growth of spending, and a decline in equity values, especially a severe one, could lead to a considerable weakening of consumer demand.

Some moderation in economic growth, however, might be required to sustain the expansion. Through the end of 1998, the economy continued to grow more rapidly than can be currently accommodated on an ongoing basis, even with higher, technology-driven, productivity growth. Growth has continued to shrink the pool of workers willing to work but without jobs. While higher productivity has helped to keep labor cost increases in check, it cannot be expected to do so indefinitely in ever tighter labor markets.

Despite brisk demand and improved productivity growth, corporate profits have sagged over recent quarters. This is attributable in part to some acceleration in labor compensation, but other factors have been pressing, especially intensified competition and lower prices facing our exporters and those industries competing with imports.

In these circumstances, businesses will feel under considerable pressure to preserve profit margins should labor costs accelerate further, or should the falling prices of commodity inputs, like oil, turn around. But to date, businesses' evident pricing power has been scant. Either that will change and inflation could begin to mount or, if costs could not be recouped, capital outlays might well be cut back.

The recent behavior of profits also underlines the unusual nature of the rebound in equity prices and the possibility that the recent performance of the equity markets will have difficulty in being sustained. The level of equity prices would appear to envisage substantially greater growth of profits than has been experienced of late.

Moreover, the impressive capital gains of recent years would seem also to rest on a perception of relatively low risk in corporate ownership. Risk aversion and uncertainty rose sharply over the late summer and fall of 1998 following the Russian default in mid-August, as evidenced by widening spreads among yields on debt of differing credit qualities and liquidity. The rise in uncertainty increased the discounting of claims on future incomes, and that reduced stock market prices even as the long-term earnings growth expectations of security analysts continued to rise. As risk aversion subsided after mid-October, stock prices returned to record levels.

Markets have doubtless stabilized significantly after the turbulence of last fall, but they remain fragile, as the repercussions of the recent Brazilian devaluation attest. Moreover, our chronic current account deficit has widened significantly, in part reflecting the strength of domestic demand that has accompanied the further accumulation of capital gains. The continued increase in our net external debt and its growing servicing costs clearly are not sustainable indefinitely.

In light of the importance of financial markets in the economy, and of the volatility and vulnerability in financial asset prices more generally, policymakers must continue to pay particular attention to these markets. The Federal Reserve's easing last fall responded to an abrupt stringency in financial markets and the effects that the consequent increased risk aversion was likely to have on economic activity going forward.

We were particularly concerned about higher costs and disrupted financing in debt markets, where much of consumption and investment is funded. We were not attempting to prop up equity prices, nor did we plan to continue to ease rates until equity prices recovered, as some have erroneously inferred.

This has not been, and is not now, our policy or intent. As I have discussed earlier, movements in equity prices can play an important role in the economy which the central bank must take into account. And, we may question from time to time whether asset prices may not embody a more optimistic outlook than seems reasonable, or what the consequences might be of a further rise in those prices followed by a steep decline. But many other forces also drive our economy, and it is the performance of the entire economy that forms our objectives and shapes our actions.

Nonetheless, in the current state of financial markets, policymakers are going to have to be particularly wary of actions that unnecessarily sow uncertainties, undermine confidence, and interfere with the efficient allocation of capital on which our economic prosperity and asset values rest. It is important not to undermine the highly sensitive ongoing process of reallocation of capital from less to more productive uses.

For productivity and standards of living to grow, not only must capital raised in markets be allocated efficiently, but internal cash flow, including the depreciation charges from the existing capital stock, must be continuously directed to their most profitable uses. It is this continuous churning, this so-called creative destruction, that has become so essential to the effective deployment of advanced technologies by this country over recent decades. In this regard, drift toward protectionist trade policies, which are always so difficult to reverse, is a much greater threat than is generally understood.

It is well known that erecting barriers to the free flow of goods and services across national borders undermines the division of labor and standards of living by impeding the adjustment of the capital stock to its most productive uses. Not so well understood, in my judgment, is the impact that fear of growing protectionism would have on profit expectations and hence on the current values of capital assets. Protectionism was a threat to standards of living when capital asset values were low relative to income. It becomes particularly pernicious in an environment, such as today's, when that is no longer the case.

In sum, Mr. Chairman, it has been the ability of our flexible and innovative businesses and work force that has enabled the United States to take full advantage of emerging technologies to produce greater growth and higher asset values. Policy has facilitated this process by containing inflation and by promoting competitiveness through deregulation and an open global trading system. Our task going forward, at the Federal Reserve as well as in the Congress and administration, is to sustain and strengthen these policies, which in turn have sustained and strengthened our now record peacetime economic expansion.

Mr. Chairman, I have excerpted from my full text and would ask that the text be included in the record.

[The prepared statement follows:]

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

The American economy through year-end continued to perform in an outstanding manner. Economic growth remained solid, and financial markets, after freezing up temporarily following the Russian default, are again channeling an ample flow of capital to businesses and households. Labor markets have remained quite tight, but, to date, this has failed to ignite the inflationary pressures that many had feared.

To be sure, there is decided softness in a number of manufacturing industries as weakness in many foreign economies has reduced demand for U.S. exports and intensified competition from imports. Moreover, underutilized production capacity and pressure on domestic profit margins, especially among manufacturers, are likely to rein in the rapid growth of new capital investment. With corporations already relying increasingly on borrowing to finance capital investment, any evidence of a marked slowing in corporate cash flow is likely to induce a relatively prompt review of capital budgets.

The situation in Brazil and its potential for spilling over to reduce demand in other emerging market economies also constitute a possible source of downside risk for demand in the United States. So far, markets seem to have reacted reasonably well to the decisions by the Brazilian authorities to float their currency and redouble efforts at fiscal discipline. But follow through in reducing budget imbalances and in containing the effects on inflation of the drop in value of the currency will be needed to bolster confidence and to limit the potential for contagion to the financial markets and economies of Brazil's important trading partners, including the United States.

While there are risks going forward, to date domestic demand and hence employment and output in the United States certainly has remained vigorous. Though the pace of economic expansion is widely expected to moderate as 1999 unfolds, signs of an appreciable slowdown as yet remain scant.

But to assess the economic outlook properly, we need to reach beyond the mere description of America's sparkling economic performance of eight years of record peacetime expansion to seek a deeper understanding of the forces that have produced it. I want to take a few moments this morning to discuss one key element behind our current prosperity—the rise in the value markets place on the capital assets of U.S. businesses. Lower inflation, greater competitiveness, and the flexibility and adaptability of our businesses have enabled them to take advantage of a rapid pace of technological change to make our capital stock more productive and profitable. I will argue that the process of recognizing this greater value has produced capital gains in equity markets that have lowered the cost of investment in new plant and equipment and spurred consumption. But, while asset values are very important to the economy and so must be carefully monitored and assessed by the Federal Reserve, they are not themselves a target of monetary policy. We need to react to changes in financial markets, as we did this fall, but our objective is the maximum sustainable growth of the U.S. economy, not particular levels of asset prices.

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Indeed, some calculations support that perception. They suggest that the rate of return on capital facilities put in place during recent years has, in fact, moved up markedly. In part this may result from improved capital productivity—that is, the efficiency of the capital stock. In addition, we may be witnessing some payoffs from improved organizational and managerial efficiencies of U.S. businesses and from the greater education—in school and on the job—that U.S. workers have acquired to keep pace with the new technology. All these factors have been reflected in an acceleration of labor productivity growth.

Parenthetically, improved productivity probably explains why the American economy has done so well despite our oft-cited subnormal national saving rate. The profitability of investment here has attracted saving from abroad, an attraction that has enabled us to finance a current account deficit while maintaining a strong dollar. Clearly, we use both domestic saving and imported financial capital in a highly efficient manner, apparently more efficiently than many, if not most, other major industrial countries.

While discussions of consumer spending often continue to emphasize *current income* from labor and capital as the prime sources of funds, during the 1990s, capital gains, which reflect the valuation of expected *future incomes*, have taken on a more prominent role in driving our economy.

The steep uptrend in asset values of recent years has had important effects on virtually all areas of our economy, but perhaps most significantly on household behavior. It can be seen most clearly in the measured personal saving rate, which has declined from almost six percent in 1992 to effectively zero today.

Arguably, the average household does not perceive that its saving has fallen off since 1992. In fact, the net worth of the average household has increased by nearly 50 percent since the end of 1992, well in excess of the gains of the previous six years. Households have been accumulating resources for retirement or for a rainy day, despite very low measured saving rates.

The resolution of this seeming dilemma illustrates the growing role of rising asset values in supporting personal consumption expenditures in recent years. It also illustrates the importance when interpreting our official statistics of taking account of how they deal with changes in asset values.

With regard first to the statistical issues, capital gains themselves are not counted as income, but some transactions resulting from capital gains reduce disposable household income as we measure it, while having no effect on consumption. As a consequence, as capital gains and these associated transactions mount, published saving rates are decreased. For example, reported personal income is reduced when corporations cut back payments into defined-benefit pension plans owing to higher equity prices; however, such reductions do not diminish anticipated retirement income and thus should not lower consumption. And reported disposable income is decreased when households pay taxes on capital gains realizations that would not have been so large in less ebullient markets. However, capital gains tax payments also are highly unlikely to be associated with lower spending because the cash realized from the sale of the asset exceeds the tax, and in most cases the typical household presumably does not perceive of this transaction as reducing available income or financial resources. Together these two effects probably account for an appreciable portion of the reduction in the reported saving rate.

But beyond these statistical issues, there is little doubt that capital gains have increased consumption relative to income from current production over recent years. Economists have long recognized a "wealth effect"—a tendency for consumption to rise by a fraction of the capital gains on existing assets owned by households—though the magnitude of this effect remains difficult to estimate accurately. We have some evidence from recent years that all or most of the decline in the saving rate is accounted for by the upper income quintile where the capital gains have disproportionately accrued, which suggests that the wealth effect has been real and significant. Thus, all else equal, a flattening of stock prices would likely slow the growth of spending, and a decline in equity values, especially a severe one, could lead to a considerable weakening of consumer demand.

Some moderation in economic growth, however, might be required to sustain the expansion. Through the end of 1998, the economy continued to grow more rapidly than can be currently accommodated on an ongoing basis, even with higher, technology-driven productivity growth. Growth has continued to shrink the pool of workers willing to work but without jobs. While higher productivity has helped to keep labor cost increases in check, it cannot be expected to do so indefinitely in ever tighter labor markets.

Despite brisk demand and improved productivity growth, corporate profits have sagged over recent quarters. This is attributable in part to some acceleration in labor compensation, but other factors have also been pressing, especially intensified competition and lower prices facing our exporters and those industries competing with imports. In these circumstances, businesses will feel under considerable pressure to preserve profit margins should labor costs accelerate further, or should the falling prices of commodity inputs, like oil, turn around. But, to date, businesses' evident pricing power has been scant. Either that would change and inflation could begin to mount or, if costs could not be recouped, capital outlays might well be cut back.

The recent behavior of profits also underlines the unusual nature of the rebound in equity prices and the possibility that the recent performance of the equity markets will have difficulty in being sustained. The level of equity prices would appear to envision substantially greater growth of profits than has been experienced of late.

Moreover, the impressive capital gains of recent years would seem also to rest on a perception of relatively low risk in corporate ownership. Risk aversion and uncertainty rose sharply over the late summer and fall of 1998 following the Russian default in mid-August, as evidenced by widening spreads among yields on debt of differing credit qualities and liquidity. The rise in uncertainty increased the discounting of claims on future incomes, and that reduced stock market prices even as the long-term earnings growth expectations of security analysts continued to rise. As risk aversion subsided after mid-October, stock prices returned to record levels.

Markets have doubtless stabilized significantly after the turbulence of last fall but they remain fragile, as the repercussions of the recent Brazilian devaluation attest. Moreover, our chronic current account deficit has widened significantly, in part reflecting the strength of domestic demand that has accompanied the further accumulation of capital gains. The continued increase in our net external debt and its growing servicing costs clearly are not sustainable indefinitely.

In light of the importance of financial markets in the economy, and of the volatility and vulnerability in financial asset prices more generally, policymakers must continue to pay particular attention to these markets. The Federal Reserve's easing last fall responded to an abrupt stringency in financial markets and the effects that the consequent increased risk aversion was likely to have on economic activity going forward. We were particularly concerned about higher costs and disrupted financing in debt markets, where much of consumption and investment is funded. We were not attempting to prop up equity prices, nor did we plan to continue to ease rates until equity prices recovered, as some have erroneously inferred.

This has not been, and is not now, our policy or intent. As I have discussed earlier, movements in equity prices can play an important role in the economy, which the central bank must take into account. And, we may question from time to time whether asset prices may not embody a more optimistic outlook than seems reasonable, or what the consequences might be of a further rise in those prices followed by a steep decline. But many other forces also drive our economy, and it is the performance of the entire economy that forms our objectives and shapes our actions.

Nonetheless, in the current state of financial markets, policymakers are going to have to be particularly wary of actions that unnecessarily sow uncertainties, undermine confidence, and interfere with the efficient allocation of capital on which our economic prosperity and asset values rest. It is important not to undermine the highly sensitive ongoing process of reallocation of capital from less to more productive uses. For productivity and standards of living to grow, not only must capital raised in markets be allocated efficiently, but internal cash flow, including the depreciation charges from the existing capital stock, must be continuously directed to their most profitable uses. It is this continuous churning, this so-called creative destruction, that has become so essential to the effective deployment of advanced technologies by this country over recent decades. In this regard, drift toward protectionist trade policies, which are always so difficult to reverse, is a much greater threat than is generally understood.

It is well known that erecting barriers to the free flow of goods and services across national borders undermines the division of labor and standards of living by impeding the adjustment of the capital stock to its most productive uses. Not so well understood, in my judgment, is the impact that fear of growing protectionism would have on profit expectations, and hence on the current values of capital assets. Protectionism was a threat to standards of living when capital asset values were low relative to income. It becomes particularly pernicious in a environment, such as today's, when that is no longer the case.

In sum, it has been the ability of our flexible and innovative businesses and work force that has enabled the United States to take full advantage of emerging technologies to produce greater growth and higher asset values. Policy has facilitated this process by containing inflation and by promoting competitiveness through deregulation and an open global trading system. Our task going forward—at the Federal Reserve as well as in the Congress and Administration—is to sustain and strengthen these policies, which in turn have sustained and strengthened our now record peacetime economic expansion.

Chairman ARCHER. Without objection, the Chairman's entire statement will be printed in the record.

I think you have given us a lot to think about. Certainly a very, I think, solid analysis of where we are, and perhaps a few little guidelines in nuance form as to where we might go or what we might do.

I would like to ask your opinion of a major part of the President's proposal for Social Security last night, where he proposed letting the government invest the Social Security Trust Fund surplus in private financial markets. You testified, I believe, last July before the Senate Committee on Banking and Financial Services and were asked about such a proposal in generalities. I believe you said that you thought that would be very dangerous, and added, "I don't know any way you can essentially insulate government decisionmakers from having access to what will amount to very large investments in American private industry."

And so my question to you today is whether you still feel the way you did when you testified before the Senate Committee on Banking and Financial Services as to the wisdom of government-controlled investments in the market?

Mr. GREENSPAN. Mr. Chairman, let me just say first that the notion that the President brought forth last night to effectively keep a very large part of the unified surplus in place in the years ahead is something which I have supported in the past. What I do not support and did not support previously was the investment of government funds, especially Social Security Trust Funds, in private securities, especially equities.

There are really two reasons for that. One is that despite the Herculean efforts of a number of very thoughtful people to try to find ways to insulate the use of those Trust Funds, which would be extraordinarily large—in the trillions of dollars—the ability to insulate that, in my judgment, is virtually impossible.

The political process of which we are all aware, and I would certainly expect that those on the panel know far more about this than I, makes it very difficult not to try to create some form of direction in the way those funds are invested. Indeed, our experience with State and local pension funds very graphically exhibits that.

Indeed numerous studies over the years have shown that the average rate of return on State and local funds is usually 2, maybe 3 percentage points lower on average than private pension funds of comparable nature. There are also studies which suggest that the greater the proportion of trustees who are political appointees on those pension funds, the lower the rate of return. And indeed, I don't think it is very difficult to go through example after example of the endeavors on the part of the political system to employ those funds in ways which are other than what the private market itself will adjust to.

The reason this is important is in fact a reason similar to what I was discussing with respect to the allocation of capital generally. Our extraordinary performance in this country, our ability to adapt to the new technologies in such an effective way, has enabled us to use our capital in an extraordinarily efficient manner, and that flows through directly into higher productivity, higher real wages, and a higher standard of living.

If we are going to take a very substantial part of our savings, and that is what would occur if a substantial part of Social Security Trust Fund was employed in that manner, in my judgment we will lower the capital efficiency of this country. We will lower the thrust of productivity growth and standards of living. So it is not a mere financial accounting issue. It gets down to real goods and services and real standards of living.

Because I do not believe that it is politically feasible to insulate such huge funds from governmental direction, I am fearful that we will use those assets in a way which, one, will create a lower rate of return for Social Security recipients; but of even greater concern, that it will create suboptimal use of our capital resources and those assets which create our standard of living.

Now, to be sure, the President's recommendation is only a small part of Social Security. Had he eliminated the particular private investment characteristic of that program, I would have found what he said with respect to Social Security last night quite important and, in a sense, a definite factor in improving the underlying savings rate in this country, which because of the demographic changes that are occurring, is going to be required if we are to get an overall retirement system, both public and private, functioning in a manner which we have been accustomed to.

Chairman ARCHER. I thank you for that comment. I must say that I don't think any of us fully understands the technical details of the President's proposal yet.

Mr. GREENSPAN. Actually, he did not give any. What he basically stipulated, which was, in my judgment something important, is essentially that rather than allow the surpluses to be dissipated, they are going to be employed of necessity, because that is what will happen if you run a significant unified budget surplus, to reduce the debt to the public. And I am one of those who believes that if we are looking at the long-term stability of capital investment and productivity in this country, if we can significantly reduce the outstanding debt and indeed, in the current environment, create unified budget surpluses, in my judgment that is all to the good.

I do not believe the President said that the surpluses are going to be used to increase benefit payments or anything else of that nature, although he did refer obviously to the use of the non-Social Security part of it. But it is important to distinguish between allowing these surpluses to run and observe their impact on the borrowing from the public, which I think will be very important and positive, and realize that that is an important aspect of trying to increase the national savings rate, which is important.

And I don't want to comment on other aspects of the President's program, but I think we ought to recognize that what this is is not a detailed Social Security program. What it is is a statement that the Social Security system, whether it is privatized or not, ought to move far closer to full funding, because pay-as-you-go Social Security, because of the demographic changes that are in the process of emerging, is not something which can continue to function in the years ahead as it has done so well in the past.

Chairman ARCHER. Well, I certainly agree with that.

Let me state that my position relative to a Social Security solution is that I will oppose government-managed investment in the private sector, for the very reasons that you mentioned and others, although you articulate it probably better than I do.

But I will welcome any suggestions that the President might have relative to the establishment of personal security accounts that will create advanced savings to reduce the drain on the Social Security fund in the outyears. There is a very big difference, in my opinion, between giving individual workers the power to invest their money and having the government control investments.

Let me ask you this question, just as a followup. If in fact we take money out of the Social Security fund, and we don't know yet what percentage the President is going to recommend, and we invest it in the private sector, will we not then be investing in—will we not then fail to invest in government bonds, which means that that debt will have to be owned by the public or the private sector rather than within-house? So we don't change the amount of debt that the Federal Government has as an obligation, do we?

Mr. GREENSPAN. Mr. Chairman, maybe the best way to explain this is to start with the presumption that there is no investment in private securities, and all that is done is allow the unified budget surplus to spill over into the Social Security Trust Fund. That is a bookkeeping, intragovernmental bookkeeping, transaction which has no effect on borrowing from the public, no effect on national savings, and no effect on government savings.

If, however, you use part of those funds to invest in private securities, in effect you are borrowing from the public and investing those funds in private securities. The effect of that is clearly to increase the total debt to the public, but it is offset, presumably dollar for dollar, with new assets that the government has accumulated. So in one sense it doesn't affect the savings rate overall, but it does affect the relationship between private and public savings. But you are quite right, it does require that the debt to the public be higher than it would otherwise be, because of the way our system is set up.

Chairman ARCHER. Well, I learned in 1982, along with you, a lot about Social Security when we served together on the Commission President Reagan created. Based on your overall expertise, as well as your knowledge of Social Security, do you have a preferred approach as to how we should attempt to solve the Social Security problem?

Mr. GREENSPAN. Well, Mr. Chairman, I have always been strongly in favor of a private approach. And the reason I have been is not because of the increased rates of return on private securities, which unless you increase the national savings rate when you do that, is a zero sum game. It merely reduces the rate of return in private pension funds. The reason I favor private funds is that I believe we have a far greater chance of creating full funding and hence higher savings rates through that vehicle than we would through the political system, which I regret exhibits a far higher propensity to spend than to save.

Chairman ARCHER. Given a choice between spending the surplus on more government programs and using it to provide growth-oriented tax cuts, would you have a preference?

Mr. GREENSPAN. Well, as I have said previously, my first preference is to allow the surpluses to run for a while and unwind a good deal of the debt to the public which we have accumulated over the years. Failing that, meaning if my concerns about the propensity to spend are more real than not, I would clearly prefer that if we can't run the surpluses, if we have to get rid of the surpluses, I would far prefer reducing taxes than increasing spending. And, indeed, I don't think it is a close call.

Chairman ARCHER. Thank you very much.

Mr. Rangel?

Mr. RANGEL. Thank you, Mr. Chairman.

We are fortunate that the President was not arrogant enough to give us a bill with details. He recognizes that that responsibility is in the hands of the Congress, and he did what many of us demanded. He gave a framework for us to review and, in a bipartisan way, which I think he stressed last night, to come together with some type of plan that is not a Republican plan nor a Democratic plan, but one that responds to the aging of the baby boomers and longer life expectancy.

You advocate, if we cannot reduce the public debt, that rather than spending more, that we have a tax cut. And there is a lot of talk, especially last night, about a $600 billion tax cut that may be recommended to this Committee.

Given the option of taking the surplus for a tax cut, or following the suggestion that we better prepare the Social Security system for its future obligation to the growing aging population, as well as Medicare, what is your recommendation: follow the framework of the President, to shore up the Social Security system and the Medicare system with the surplus, or move now toward a $600 billion tax cut?

Mr. GREENSPAN. Well, Congressman, as I said before, I prefer letting the surpluses run. And the reason I do is that we have been used to a really quite highly supported pay-as-you-go Social Security system and indeed, a Medicare system. And the reason that the popularity has been really quite impressive is that until very recently the rates of return to individual recipients, meaning the amounts of money that they received as benefits, far exceeded the amount of taxes plus interest they and their employers put in.

As the ratio of workers to retirees decreases, in part because of increased longevity, the ability to continue that process is rapidly diminishing, short of a very large increase in immigration which would offset the retiree-worker ratio.

But if that is not forthcoming, then instead of retirees effectively getting a reallocation of physical resources from current workers, they will have to be able to put in place investments which will return the real resources that they need for retirement because they will not be available from workers in the outyears. There will be just too few of them.

So the only way you can do that, short of an immigration bulge, is to find a way to get increased productiveness in the economy. And the way that we know which is most assuredly going to do that is increased savings effectively invested in real capital-productive assets which will produce the goods and services that the retiree will need in, say, the year 2010, 2030, or thereafter.

So as far as I can see, if one is looking at the long-term focus of the American economy, we do not have any choice but to find a means to replace the pay-as-you-go system, because demographics are immutable and effectively irreversible. And what that tells us is that we cannot go on the way we are. The arithmetic becomes impossible sooner rather than later.

And I might add, that is the reason why our younger generations are turned off on Social Security, because what they see, correctly, is that the rate of return that they will achieve on their payments of taxes and their employers' taxes is very low, especially compared to what you could now get even in a U.S. Treasury bond. That compares with what their parents were able to get, which was really a quite impressive above-market rate of return.

We have to focus on that phenomenon. We have to adjust to it. The fact that we are looking at 10, 20 years out does not mean we can delay, because it is none too soon to start to take action. And, therefore, to keep the savings in place as is being recommended, is the right decision.

Mr. RANGEL. I can see us thinking that way if we had your leadership and that of President Clinton. But in some of our past economic experiences, the market really hasn't responded as positively as recently. What type of guarantees could the individual beneficiary have that the market will be there for them when they retire?

Mr. GREENSPAN. Well, I am not referring so much to the question of whether the market is there. I am talking about the amount of saving that has to be put in place in order to achieve the capital investment. What I am basically saying is, at the current rate of saving and the current expected benefit payments which are embodied in the Social Security legislation, that we will rapidly run into a dilemma where there will be inadequate resources to meet the benefits.

Indeed, that is part of the so-called 2.2 percent gap in the Social Security system that currently exists, or 3.6 percent on a fully, more than 75-year basis. And it is that problem which has got to be addressed sooner rather than later, and it has got very little to do with whether the funds are invested in equities, bonds, government bonds or anything else.

Mr. RANGEL. Well, the President certainly has given us something to work with, that we have been asking for in a bipartisan way. But the bottom line is that you would rather see the surplus used to reduce our debt, rather than to do the political thing, and that is rush now into a gigantic tax cut.

Mr. GREENSPAN. I don't know whether it is political. I am just telling you what the economics are. The economics, as best I can judge, are best served by moving as quickly as we can to much closer to full funding for our retirement systems. We obviously have it, by definition, in the private sector. We need to now move in that direction in the public sector, because the demographics are making any alternative impossible.

Mr. RANGEL. Thank you.

Chairman ARCHER. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

Chairman Greenspan, we are honored with your presence here today. I have been a longtime admirer from the beginning of my acquaintance with you. I am in awe that you can sit here before us and articulate responses when even a casual comment from you can have international repercussions, so we appreciate profoundly your willingness to do this. I think if I were in your shoes, I would put it all in writing and insist that that is the only way I will respond.

Mr. GREENSPAN. I am willing to do that.

Mr. CRANE. I would like to shift gears just a little bit and ask you about something that is also a major component of our economy and our worldwide economics. I am referring to trade. I am wondering if you could give us an estimate of what portion of the annual growth of our economy do you attribute to international trade?

Mr. GREENSPAN. While it is just a straight statistic where we can try to make judgments as to what the division of labor across the world does to overall standards of living, it is very difficult to put a specific number on it. What we do know with a reasonable degree of certainty is that the dramatic increase in trade worldwide since the end of World War II, which has been far faster than domestic gross product increases, has been instrumental in rising standards of living everywhere.

I think it has been a major factor in the United States, where the open markets have for many, many decades been a major source of business for our exporters, and the imports that press in on us have done two things: First, have given us goods and services at much lower prices than we would otherwise have gotten them, which is the nature of the division of labor; but second, it has also pushed us to a competitive edge which I don't recall seeing in my long career as an economist, and our ability to compete is really impressive.

Like all of us who are involved in business over the years, we don't particularly like competition. I did not like my competitors particularly when I was in the private sector. But I must admit to you that their pressing on me made me do things a lot better and a lot more efficiently. I worked harder and I think I turned out a better product.

That probably is a pretty good description of what this country has become, and I must say to you, it is really something which is impressive in very many ways. The opening up of trade around the world has, in my judgment, been a very important factor in contributing to that impressive performance.

Mr. CRANE. Would you concur, then, that the renewal of the President's fast track negotiating authority is absolutely essential to advancing into the future a healthy economy here at home, but that it has positive consequences worldwide?

Mr. GREENSPAN. I can't comment on whether it is essential, but it is very important. And that one should support it, I have no question whatever. It is all to our advantage to do that.

Mr. CRANE. One other question, since the light is turning yellow already. I think that with the problems that Brazil has most recently experienced, that there are potential parallels to what Mexico went through right after we launched NAFTA. I mean within 6 months of their peso devaluation, as you recall, they had turned that around in Mexico. And I would argue that a big part of that was having that trade relationship with the United States and the prohibition against putting the tariff walls up around their country as a response.

I am wondering if you see parallels between that experience in Brazil, or what do you anticipate might happen down in South America?

Mr. GREENSPAN. Each situation is different. The Brazilian problem is largely a fiscal problem. The Brazilian private economy is a very impressive entity. They have really built up a productive structure and a very sophisticated financial system, but as a consequence of 20 years of military authoritarian rule, they have produced a constitution in 1988 which effectively, in most people's judgment, probably swung the pendulum too much in the other direction, and created innumerable benefits embodied in the constitution which doubtless exceeded the underlying productive capacity of the system to produce.

Ever since then there has been a major endeavor to unwind those excesses, and indeed they are still working on it, and there is an important one that is to be debated and, I believe, voted upon in the Brazil legislature today. So that it is an ongoing process, but it is terribly obvious that there are fiscal problems, largely the very large payrolls in their state governments and a pension fund system, which is what they are voting on today, as well as what turns out to be a very short average maturity of their government debt, which means that marked increases in short-term interest rates flow through to very large increases in interest payments, and that has created a vicious cycle.

They are clearly coming to grips with that issue. It has been very difficult. It has been tough, and it certainly has not been helped by the international financial system, which has run into trouble in the last couple of years, so that the Brazilians are fighting not only their own problems but they have to do it in the context in which the external environment is less beneficent than it was a couple of years ago.

Mr. CRANE. My time has expired. Again, I thank you for sharing so generously your time with the Committee.

Chairman ARCHER. Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman.

Thank you for being with us, Chairman Greenspan.

I have never heard it quite put that way, but it is exactly the situation where you talk about current and especially past retirees getting a return on their investment greater than market return, and part of the problem is we don't have as many people paying in, more people taking money out.

I also agree with your response to the Chairman in regard to the Social Security portion of the President's speech last night because of the unified budget and where the money would be transferred.

My focus for the very short time I have would be on Medicare. As a cochairman of the Medicare Commission we had the pleasure of your presence on April 20, 1998, and it corresponded almost exactly to the comments that you made today about the concerns that you are worried about, one, the interference with the efficient allocation of capital and that it is important not to undermine the ongoing process of the reallocation of capital from less to more productive uses. Your thrust was in commenting about the current Medicare system and that perhaps the incentive structure is not there to do the kinds of productive things that we need to do and that we need to look at structural change.

My concern would be that the President's speech, as opposed to Social Security, was very specific on Medicare taking general revenue sources and proposing to expand benefits—not just try to control the current structure which is going bankrupt but to expand benefits through the addition of the prescription drug argument out of the general fund, increasing the portion of the general fund that goes to Medicare without any of the structural reforms that perhaps would make it a more competitive model, moving from administered prices to more competition.

Do you have some concerns that if the money from the surplus was spent for the Medicare purposes the President outlined that it would not be nearly so conducive as the Social Security portion because we really need to revise structurally Medicare to make it more efficient at the same time that we make sure that money is there for future beneficiaries?

Mr. GREENSPAN. The Medicare issue is a far more complex one than Social Security is. As difficult as we think Social Security is, Medicare is a multiple of complexities. Indeed, as Chairman Archer probably remembers, in the 1982 Social Security Commission we were given the mandate of looking at Medicare if we wanted to, and I thought we disposed of that one as quickly as anything ever has been done. And the reason is it is very tough.

As you remember, the discussion in the Medicare Commission the issue of technology is a terribly crucial one, and it is very difficult to forecast technology. And if you can't forecast technology, it is very difficult to forecast what the actual real dollar burden of the Medicare system is going to be.

So I agree with you in the sense that if you are going to spend funds out of the surplus, you reduce the flexibility of the overall governmental system, if I can put it that way, to address unforeseen Medicare expenses and requirements.

Mr. THOMAS. Do you think that perhaps what we need to do is to examine ways in which we can create a self-corrective mechanism within Medicare to deal with market forces? And certainly, as prices go up, at least you have the comfort that it is a less political administered structure than it is a response to the real needs of the health care marketplace and then it would be a policy decision for us to make as to whether we want to put assets into it at the rate that it would require.

Mr. GREENSPAN. I would agree with that.

Mr. THOMAS. Thank you very much.

Chairman ARCHER. Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman.

Mr. Greenspan, I admire the work that you are doing to ensure a strong economy, but I keep looking at the boats that this tide hasn't lifted. I would like to focus on those who have not benefited from this great, growing economy.

A New York Times article this week said that median family incomes haven't risen since 1970. The average housewife is working 15 more hours a year—15 more weeks a year than she did back in the seventies. Ninety percent of the great stock market gains have gone to the top 10 percent of our households. Sixty percent of Americans don't own any stock. In 20 percent of our counties, unemployment exceeds 8 percent. Fifteen million children live in poverty, even including their participation in social programs. And families headed by females in two out of five quintiles have incomes that have declined markedly since 1983.

So my question is, what must be done to change or improve the private sector or the economy to help the majority of Americans who are observing this economic strength from the sidelines—not participating in it?

While we know, I think, what social programs we can entertain, those are not supported by the majority. What private sector initiatives or changes in the economy could help this portion of the American public?

Mr. GREENSPAN. Mr. Stark, the best way to describe the phenomenon which you are observing is there is just no question that the dispersion of income growth or the dispersion of income distribution has clearly widened quite significantly in the last decade. The last year or two it stopped widening, but there has been a very appreciable change in the income distribution which appears to be highly correlated with technical skills. It is fairly evident that there is a one-to-one correspondence between abilities to interface with this new, advanced technology and the real income that one can earn.

As a consequence of that evident observation, a remarkably large number of people have gone back to school. Indeed, the average age of undergraduates in school full-time has gone up several years. It is really one of the more startling statistics that one can find. Community colleges have burgeoned in size, and on-the-job training has gone up very substantially. The major thrust of this is coming from all income groups pressing one way or another for increased education because what has clearly been the case is that the obverse of this extraordinary churning in the capital stock to which I was referring is that people who are dealing with that capital stock, which means just about everybody, feel insecure; that is, things are changing in a very rapid way, and you get a sense that it is tough to deal with the new technologies, and so they are pressing very hard for higher levels of education and capacity and ability. In my judgment, that is by far the most effective means to bring all of our population into the high-tech age and the high-tech values.

Lacking education I don't see how we can do it, and, as a consequence, education, especially on-the-job training, is important. There are even in many of the technologically advanced corporations little universities in which they take the lower skilled people and teach them exactly how to function in that complex arena. It has induced a really significant increase in their incomes, and I would suggest that anything you can do to enhance that is clearly the most effective way that I know of to bring a not insignificant part of our population which is not doing all that well into the mainstream of the high-tech area.

Mr. STARK. Would the economy be able to absorb a lot more people who would acquire such skills?

Mr. GREENSPAN. Absolutely. There is no doubt that if those people gained increased skills, you create a change in the capital structure. You change incentives so the type of capital equipment you purchase to take advantage of the fact that those skills are there.

Mr. STARK. Thank you.

Chairman ARCHER. Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

And, Chairman Greenspan, I am very pleased that you spent so much time this morning in your dialog and in the question and answer period in talking about the future of Social Security. I was not aware that you were on that special Commission some years ago back in the early eighties with Chairman Archer, but that certainly makes you a tremendous resource in our trying to wade through the ways of saving Social Security.

Looking at Social Security on a global basis in other countries, I would say there is a meltdown going on. There is a global crisis in other countries, even though there are a few that are doing better than we are. Overall, I think there is a global crisis on the question of Social Security and our various retirement programs all over the globe and especially in Europe.

In trying to develop some of the ideas for solutions, I was pleased to see that you do favor some type of privatization, although you do not support the President's plan. In fact, I don't see a lot of support for what the President put out last night. However, I would give the President high marks for having opened up the dialog on privatization, because I think that was a very necessary step that he took, and I think it is going to be very useful.

But what I want to question you on for just a moment is the effect that it would have on the markets, assuming that we set it up in a situation, maybe not exactly as the Chilean model but somewhat, so that the management of these programs is far divorced from and removed from the Federal Government but run by the private sector under some very strict guidelines set forth by the Congress. What effect will this type of investment have upon the marketplace? And if you could expand your answer into what effect would it have when people start pulling their assets out of those programs, such as the baby boomers which will come in large quantities at a future date to buy annuities or to come up with some other device for distribution for retirement income?

Mr. GREENSPAN. Mr. Shaw, it really gets down to the question of the impact on equity prices. I assume you are talking about the level of stock prices?

Mr. SHAW. Yes, sir.

Mr. GREENSPAN. That occurs as a consequence of who holds the claims because if you think in the broadest sense the overall market value of stocks in this country should be a reflection of the productive capabilities of the assets that companies have for which there are claims. While one can make arguments that who holds the stock may affect the value of the overall structure of American industry, as a first approximation, it does not. The technological capability of American industry does not depend upon who the shareholders are. If that is the case, then you have to get to the question as to what is it about the nature of the shareholding that will somehow alter what the stock values are.

One of the things we do know is that if there is less volatility in stocks, whatever the capital value capability of the corporations are, if stocks fluctuate less and are more stable and appear less risky, leaving out their trend, that would assume, other things equal, stock prices would be higher.

The issue of what would happen if a significant part of our equities were held by the Social Security Trust Funds is indeterminate on the question of their impact on stock prices, even leaving aside the issue I raised before about the possibility that would be misallocation of capital if you did that. The reason I say this is, on the one hand, clearly a constant flow of funds from the Social Security Trust Fund would be an element of support in the short run and, with other things equal, would tend to probably balance out some of the fluctuations.

But it is not clear that other areas of holdings would not accelerate volatility, in part because of the types of issues that you raised, and I don't think there has been enough thought given about that particular phenomenon. I am reasonably sure that the general presumption is that a significant amount of holdings of equities in the Social Security Trust Funds will significantly increase the level of stock prices. I am reasonably sure that notion is false.

Mr. SHAW. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Houghton.

Mr. HOUGHTON. Thank you, Mr. Chairman.

Thank you, Mr. Greenspan. I am delighted to have you here.

I have two questions. First of all, about the current account deficit, trade deficit, how serious do you think that is? And then, second, you talked about the objective—your objective as the maximum sustainable growth of the U.S. economy. And I worry about the delicate balance between international sources, commodity prices, savings, what the U.S. Government does, what business does. What are these things we, as Members of the House, ought to worry about when you talk about promoting flexibility and competitiveness and the atmosphere of churning and creative destruction?

Mr. GREENSPAN. With respect to the current account balance, the problem we have there is the fact that because the American dollar has been held in such high esteem and because it has become the major currency that is held in the private sector as well as in the public sector as a reserve balance, it means that we can run a chronic significant current account deficit. Because the other side of the accounting for the fact that imports of goods and services exceed exports of goods and services is an inflow of capital, and if that capital is not coming in, you cannot maintain the gap. That it has come in for years now is an indication that our perceived policies are sound and that the dollar is sound and that it is a stable, noninflationary system in which foreigners are effectively investing.

The problem that we run into, unfortunately, is that, as our net foreign debt rises, that the amount of interest we must pay, and indeed dividends as well, continues to rise and that process itself creates a type of situation that if at some point foreigners stop wanting to continue to accumulate dollars it creates a major reverberation back on the American economy which has to adjust.

We have seen no evidence of that phenomenon arising. We know it as a problem only in the abstract and the arithmetic of the issue is that the rise in the net debt cannot continue indefinitely. The question is, what does that mean? Where is the end of that rise? It is a question we have addressed ourselves to in some considerable detail. We have not yet been able to answer it effectively.

Mr. HOUGHTON. Well, it is important, isn't it, that we maintain our position of having the world's premiere reserve currency?

Mr. GREENSPAN. It is important. It is not essential. In other words, there is a great deal of discussion as to whether the new euro will make significant inroads into our share of the overall reserve assets held by both private and public sectors abroad. My suspicion is that unless they find that they run into more problems than it seems at this stage they are about to run into, some erosion of our undisputed huge share has got to occur.

My own suspicion, and I must say I am speaking with very little evidence because I don't know how you fully answer this question, is that it is only going to be modest.

Mr. HOUGHTON. Thank you.

Chairman ARCHER. Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

Thank you very much, Chairman Greenspan, for being here. We appreciate your testimony.

I was brought back about 17 years when you were chair of the Greenspan Commission, and it required a lot of leadership in the spring of 1983 to solve that problem. Because you came up with some rather difficult things: Deferral for 6 months, the CPI for senior citizens which picked up $40 billion, as I recall, and obviously a small payroll tax increase at that time. After you had come up with your report, there was some tentativeness because you didn't have unanimity at that time.

And the Chairman then, Chairman Dan Rostenkowski, and obviously Speaker O'Neill and Jim Baker got together and you and Senator Dole and, I believe, Senator Moynihan got together and they all committed not to trash the proposal that was coming out. They all said, let's step back and see if we can resolve this. Because everybody understood how difficult this issue is. And I would hope we would learn by that experience.

I just want to mention two things. You mentioned two reasons why we shouldn't be in the equity market. One was the lower rate of return for beneficiaries and, obviously, the misallocation of capital issue. Those are two major, significant issues. It is my understanding, however, that public pension funds—public pension funds are about 10 percent of the market. And you agree.

At this time, the President's proposal is just about 4 percent of the market, 25 percent of the 60 percent of the surplus or 62 percent of the surplus, that is significant from some perspectives. Others have suggested that is probably not enough. You can get a greater rate of return.

It is my understanding that in the public pension programs you do get a greater return than you do through Social Security by the government bond. Is that correct?

Mr. GREENSPAN. That is correct.

Mr. MATSUI. Even though it is 3 percent lower than the private investment in the equity markets, it is still greater than Social Security?

Mr. GREENSPAN. Yes, it certainly is.

Mr. MATSUI. And so that it does provide some level of benefit for Social Security recipients even though it is not as great as if it were in the market on an individual basis.

Second, the misallocation of capital, that is very important, I think, because obviously public pension programs are creating some disruption in the marketplace. Certainly if the Federal Government went in, it could create disruption in the marketplace, but I suppose whenever government programs get into the market or the economy, there is another purpose.

For example, we spent trillions of dollars over the last decade or two on the defense budget. And I supported the defense budget over the years, particularly in the eighties through President Reagan because we were seeing the Soviet threat, the East-West conflict and, obviously, it provided some level of benefit. And the Berlin wall dropped in 1989, so we actually won the cold war. So those expenditures actually provided a big benefit.

But if you go back to the Michigan study and you go back to other studies, if one put aside that goal of our confrontation with the Soviet Union, one would come to the conclusion that perhaps that effort was a misallocation of capital. Is that correct? Because, after all, you could have used those trillions of dollars in the R&D market, you could have used it for productive pursuits, perhaps through consumer technology advances.

Mr. GREENSPAN. In that particular context it is important to separate certain aspects of a society. I would scarcely argue that our military programs were market efficient. I think that the Congress has gone over them in great detail and——

Mr. MATSUI. If I could understand—I don't mean to interrupt, but you are saying they were not efficient?

Mr. GREENSPAN. They were not.

Mr. MATSUI. You said it the other—I just wanted to make sure I understood it.

Mr. GREENSPAN. I am sorry. On the contrary, government procurement is a centrally planned system. It may exist in a private market, in a free, democratic system, but it has got all the characteristics of Gosplan. And Gosplan, the Soviet system of central planning, was allegedly a very efficient means which they thought would function.

You have got to put the policing power aside. You do not endeavor to apply market efficiency criteria to that particular function of a society except in a more general way. I might say it is a necessary condition for the market system to function. I would never argue that it should be integrated with it.

Mr. MATSUI. If I could just conclude, and perhaps you can respond to this.

There is no question in my mind that much of government spending—Federal, local, State—creates a misallocation of resources. Because, obviously, if you have a free-peer market, you are probably going to get the greatest efficiency. The problem is that for Social Security we perhaps have a different goal. We have an additional goal besides market purity, and that obviously is to protect the safety net.

I believe that 40 percent of the American public currently is in the market, but 60 percent is not in the market. And you recall that Mr. Levitt said that you have got to be somewhat cautious about this because there may be some difficulties regarding that 60 percent in terms of investment risk. You saw what happened in Great Britain. And certainly other forms of government will have to come in if, in fact, those folks misuse their Social Security benefits in the equity market.

Mr. GREENSPAN. I don't deny there are problems there, and I agree with Arthur Levitt on a number of the issues but not all of the issues he raises.

But let's remember that, unless savings increase, the mere fact of getting a higher rate of return from equities in the Social Security Trust Funds of necessity means that there will be comparable losses and returns in the private sector, very largely in private pension fund rates of return. And if you think of the total retirement system, public and private, the use of equities in the public system in lieu of U.S. Treasury securities is a zero sum game. It does not increase the overall rate of return to the system as a whole. And unless and until one can demonstrate that the net national savings increases, the form in which it is invested becomes irrelevant.

And my argument is with the problems that it creates for corporate governance and for capital allocation questions. It strikes me that there is really no strong evidence to suggest any positive aspects of moving Social Security funds into equities. And I find it very difficult to find rational arguments taking into consideration the whole system for that particular initiative.

Mr. MATSUI. Thank you.

Chairman ARCHER. The gentleman's time has expired.

Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman.

Mr. Greenspan, I would like to follow up on some comments you made earlier; and to make sure I understand you. You have a very strong concern, as I do, about one of the proposals of the President last night in which he would take part of the Social Security surplus and invest it in the stock market and under a situation in which the government, the Federal Government, would own those investments within the stock market and the potential detriment that that can do as opposed to perhaps taking a portion of this and having individuals be able to own those investments.

And my specific question has to do with one of the presenters in the recent White House Conference on Social Security, Martin Feldstein, who has developed a reform plan that combines an investment-based system of personal retirement accounts with the traditional tax-financed Social Security which he believes can eliminate the need for an increase in the payroll tax or decrease in Social Security benefits. The required personal retirement account deposit of 2 percent covered earnings could be financed by the projected budget surpluses and the future increases in corporate tax revenues that result from the personal retirement account savings.

And my question, Chairman Greenspan, are you familiar with this proposal and would you give us your thoughts about this type of approach?

Mr. GREENSPAN. My recollection is that what makes his system work is the mandatory 2 percent additional savings which creates additional capital which in turn creates additional assets and higher GDP. So, in effect, he is funding the increase in his system.

There are a number of economists who would take an exception with him on whether some of his assumptions about how much productivity there would be are realistic or not, but I do think that the general approach that he is taking is something which is one that requires considerable detailed evaluation by the Congress.

Mr. HERGER. Thank you again.

And then, just to again follow up with the first part of my statement, do I understand that you do have very serious concern about the Federal Government actually taking money and then owning stocks in the private sector?

Mr. GREENSPAN. Everyone is concerned about that. The difference is whether or not it can be insulated from the political system.

There are those who are arguing for a special type of board which would be technically independent of the political system in a way in which the Federal Reserve is supposed to be independent of the political system. I guess I have been around this town too long to seriously believe that, with that huge pot of funds sitting out there, the pressure is there to find means to employ it for means other than direct budgetary expenditures. In other words, if you have a particular project and you are restrained by budget caps, there are a lot of alternate ways in which you do it by regulation, mandation of actions on the private sector, and this would be an additional one. This would be a means of obtaining funds without a particular effect on unified budget, and hence PAY–GO and all the other rules are not relevant.

Mr. HERGER. Thank you again, Mr. Chairman. I share those same concerns. I think they are well taken. And I also appreciate your thoughts on the other—that perhaps it would be very advantageous for us to begin considering at least taking a portion of this money in which the individual taxpayer and citizen would own these stocks as opposed to the Federal Government owning them. Thank you very much.

Chairman ARCHER. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Chairman Greenspan, here I am. Let me talk about some specifics, as I understand it, as to what the President has proposed, because I am interested in your thoughts on the specific amount.

You stated earlier there are to be trillions of dollars invested, but the way I read the publication that I presume is from the White House, the President only proposes investing directly from the government about $680 billion over the next 15 years in the stock market. So, given that number that is far short of several trillion dollars, do you still have the same concerns about investing by the government?

Mr. GREENSPAN. If we start down that road, I will venture to say the number will turn out to be substantially larger than the number the President is using.

Mr. MCCRERY. Well, I understand the slippery slope theory, but let's assume——

Mr. GREENSPAN. Let me just go back and say even that number I find is large. Let me say it is not so much a tradeoff of benefits versus costs. I am, frankly, just hard-pressed to find any benefits there are in doing it if indeed it is a zero sum game in which, if you do not increase the national saving, the mere investment of public funds in American equities does not change saving. And all it would do would essentially imply a swap of the U.S. Treasury issues held by the Social Security Trust Fund with equities in the private sector. So that those government low-yielding instruments must end up in the private sector, probably in the private pension funds.

It is not a question of whether a small amount is good. I am just not finding reasons to even say that a negligible part is of value. I cannot find a logical reason to do it.

Mr. MCCRERY. Well, Chairman Greenspan, I am sure you could find economic fault with many of the things that the Congress does, but, unfortunately, we are constrained by politics and by the desire of the public to have a sound Social Security system. And the President's proposal, let's give it some due. From an economic theory standpoint you are correct, but from the standpoint of solving the immediate problem of money in the Social Security system, it does help to solve that particular problem. So—and I am kind of playing devil's advocate here because I do want to get your frank reaction to what we will hear from the President's side.

Let me move on now to your suggestion that we need to fully fund Social Security, and you said that you think we have a better chance to fully fund it through a private system rather than a public system. We could fully fund it, couldn't we, by just increasing payroll taxes? That would be fully funding it, wouldn't it?

Mr. GREENSPAN. That is correct, Congressman.

Mr. MCCRERY. And you are opposed to that?

Mr. GREENSPAN. I would be opposed to it on the grounds that doing it in the private sector is better. But if you ask me is it feasible to fully fund the Social Security system by increasing taxes and therefore increasing government savings and which, in turn, would increase national savings, the answer is yes.

Mr. MCCRERY. That would be one way to fund it, even though you think it is not the most desirable way to do it.

Mr. GREENSPAN. Yes.

Mr. MCCRERY. Would you elaborate a little bit on how we can fully fund the Social Security system privately?

Mr. GREENSPAN. Well, let's talk about the Social Security system in the general sense of benefits that are now being created under current law. The question of fully funding those benefits is what the crucial issue is. And I agree with what you just said, it can be done in a number of ways. It can be done in the public sector. It can be done in the private sector. It is my view that it is far more feasible to do it in the private sector.

The crucial issue, however, is that we have to do that. Now, I am not saying we need absolute full funding but a very substantial increase in funding is required largely because the arithmetic of the pay-as-you-go system against the demographic changes in the population makes the system immediately vulnerable to the types of problems which would require a huge increase in taxes if we don't come to grips with it relatively soon.

Mr. MCCRERY. Well, Mr. Chairman, my time is up. If we get another round—you didn't answer my question. I wanted you to elaborate on how it could be fully funded in the private sector. So if you could give that some thought.

Mr. GREENSPAN. I would just basically—well, let me say that is a 15-minute discussion.

Chairman ARCHER. The gentleman's time has expired.

Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Chairman Greenspan, thank you for your testimony here today. And in your testimony you pointed out that it is well known that removing barriers to free flow of goods and services across national borders affects positively the standard of living, and I don't think anyone would disagree with that, and protectionism should be avoided as much as we can.

We have a situation in this country where Japan and Russia and Korea are dumping their steel product in this country, and I was wondering if your admonition against trade barriers extends to the Commerce Department and our trade ambassador taking actions to try to ameliorate that problem?

Mr. GREENSPAN. I am very chagrined about what has happened to the steel industry. I was, in a sense as a youngster, brought up in the industry. That was my major specialty. So I know the industry exceptionally well. It has had a remarkable record in this country.

The trouble, unfortunately, is that it has gotten smaller and smaller, and, as you are probably aware, total employment is now at probably a little over 200,000, when it was many multiples of that 15 or 20 years ago.

There is just no doubt that increased imports have had a significant impact. My recollection is that hot-roll sheet prices have gone down really quite dramatically. It has not gotten to the point yet where there are industrywide losses; that is, many mills are still doing reasonably well although their earnings are down, but they are still quite positive, and they are not doing all that badly. U.S. Steel is still in the black. Bethlehem Steel is not. So it is a tough situation for them.

The dilemma that trade policy has is how do you help the 10,000 or so U.S. steelworkers who have been laid off as the market has weakened? How do you help people who are confronted with these very difficult types of problems?

My own view is that you need very generous, basic support for the workers. You have to be very careful about imposing quotas or other types of things which will create retaliation and undercut our whole trading system. This is one of the really very tough problems that any trade negotiator has to recognize. You have real hardship, and there is no question that it is there.

I remember once I went up to Homestead outside of Pittsburgh, and I remember when it was really the biggest plant in the world. It was really something to behold, and now there is nothing there to speak of. And that is a real tragedy, and we have to address that the best we can, but recognize that we are dealing with a very small segment of the American economy. We have to be very careful in addressing the problems of these industries not to undermine the capacity of the broad system to function.

So I am glad I am not in the position where I have to make those types of choices. I think they are pretty tough.

Mr. COYNE. Well, Homestead is in my district; and, as you point out, 10,000 steelworkers have lost their jobs as a result of this dumping problem in the country; and the Commerce Department has had an initial finding of violations.

And the only question I had for you, do you think we should let other nations dump their steel in here at less than what it costs to produce there or should we take some actions against that kind of practice?

Mr. GREENSPAN. There is a very difficult problem of what their cost structures are. For example, I defy anyone to tell me what Russian steel costs. Their books cannot be in shape to find out what their marginal cost is. I know enough about pricing in the industry to know that the notion that you're pricing under cost is a very tricky issue because the fixed cost levels in producing steel are very high.

All I can say to you is that whatever it is we do, if we start to block the free flow of goods and services, it doesn't stop there. The consequences of introducing increased protectionism in that area is very costly for the Nation as a whole, and I suggest that we do everything we can to try to assuage the real and serious problems that both the industry has and the individual workers have but not beyond the point where it creates a serious trade problem for us. That is a shortsided view of the way the world should work, and I trust we will not go in that direction.

Mr. COYNE. Thank you.

Chairman ARCHER. Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman, for holding this hearing; and thank you, Mr. Greenspan, for appearing before the Committee today.

The Federal tax burden as a percent of GDP is the highest it has been since World War II; and I would like to get your comments on if you agree that the tax burden is too high and, if you do, what types of tax cuts should we be considering and what types of tax relief or tax cuts should we be staying away from?

Mr. GREENSPAN. The issue of whether it is too high is a tricky problem for an economist, but there are those who are concerned about it. There is no question, however, that the numbers are large—it is over 21 percent of the GDP at this stage.

All of the change that has occurred in recent years shows up in the individual income tax receipts, and even though we don't yet have the statistics of income for 1997—I am not even sure we have 1996 data yet—it appears, looking at the nature of what we see in the tax receipt data, that a very substantial part of it is related to the rising stock market in two ways. One, there has been a substantial increase in capital gains taxes, but probably far more important, as I think we are all acutely aware, there has been a really major shift in the form of compensation which exists mainly for management and middle management in the way of stock options, in the way of bonuses, and in the way of all sorts of things which relate to the value of the stock of the company. And so even though it is not capital gains, it is clearly a stock market related issue.

Second, there has been a fairly dramatic rise in the turnover of existing homes which is not unrelated to the stock market itself. The commissions that are involved in that area are really bolstering taxable income, mainly at the higher marginal tax rates, so that we clearly see a fairly substantial stock market related directly and indirectly increase in revenues, and it depends on where the stock market goes how substantial those revenues will be. But remember that a goodly part of that occurs as a consequence of a rise in stock prices; unless they continue to rise at near the rate they have, one must presume that the tax base is going to be lowered.

My own view with respect to taxation is the lower, the better. I have always argued for lower marginal tax rates because that is where the incentive structure is. I have argued for lower capital gains taxes. Indeed, I have always been of the presumption that capital gains taxes are a poor way to raise funds because of their negative impact on capital investment. These taxes have a greater negative effect than any measure of the value of the receipts that you as a consequence create. So I would say in some sense a marginal tax rate reduction and capital gains tax reduction have always been in my judgment what is useful in this country.

The question of whether the burden overall is too high is difficult to make at this stage if we are getting such terrific capital efficiency. I do think, however, that we could still improve it further if we did move the marginal rates lower.

Mr. CAMP. Thank you very much.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Mr. Chairman; and thank you, Chairman Greenspan, for being here today as well as the masterful job you have done with monetary policy.

I just want to follow up the question my colleague from Michigan asked. With inflation hovering around 2 percent—and thank you for keeping inflation in check—and growth in GDP at 3 to 4 percent, we have seen about an 8-percent growth rate in Federal tax revenues, and you certainly explained the reason. As a follow up, some are suggesting a substantial reduction in the rates. And, again, thank you for your advocacy, which you reiterated today, for lower marginal rates as well as capital gains cuts which we have done in part.

What would be your reaction? Would you support, say, the proposal being touted currently for a 10 percent across-the-board reduction in rates?

Mr. GREENSPAN. Congressman, as I said at the beginning, my first preference is to allow the surplus to run, because I think that the benefits to the economy through the effects on increasing saving are a very important priority for this country. If it turns out that that is politically infeasible, then I would say that some form of tax cut is a far superior way than spending the money, and a 10 percent across-the-board tax decrease strikes me as a relatively simple way to do that.

Mr. RAMSTAD. Given the factors—the inflationary factor at 2 percent, the economy growing at an annual rate of 3 to 4 percent, from an economic standpoint, obviously, this would be a sound move. And you don't see the two as being incompatible certainly, that is, using x percent of the surplus projected, 10-year surplus, to apply to Social Security and at the same time providing the tax cut that you responded to?

Mr. GREENSPAN. That is an issue the Congress has got to make a judgment on. I don't think that there is any reasonable amount of insight that economists can give you over and above what we have just been discussing to make that judgment.

Mr. RAMSTAD. The insight you have just provided has been very helpful, and we appreciate that.

I want to ask you with my remaining time about the year 2000 computer problem. Certainly we recognize that the Y2K computer problem affects primarily the aggregate supply side of the economy, and I know monetary policy affects mostly the aggregate demand side, but is the Federal Reserve prepared—and I think this is an important question—prepared in case of a Y2K disruption in case it has feedback effects? Has the Federal Reserve dealt with this adequately and are you ready if we have, God forbid, a recession or a big hit to the economy because of problems with the Y2K computer problem of the type some are predicting?

Mr. GREENSPAN. We obviously are spending a considerable amount of time and resources to make sure that, one, the Federal Reserve System as a whole with all of our payment systems, all of our interconnects to the individual banking systems is what we call Y2K compliant, and we are pretty much convinced that we are going to be OK.

We are also increasingly optimistic that the American banking system is moving quickly in the direction of being able to interface with us and with their clients in a manner which will be, I would say, pretty much effective.

There clearly are going to be mistakes out there which I am not able to anticipate largely because a computer program is really unforgiving of mistakes. You could have 1,000 lines which are perfect and then the next line has got a comma in the wrong place and it is gone.

What we need to recognize is that while we probably have got a believably good shot that the internal U.S. systems Y2K problems are under control, we cannot be sure about our interface with the rest of the world. As a consequence of that and as a goodly part of the international flows that are involved with automatic computer digital type of interfaces, it is conceivable to us that some problems could emerge.

We have not only clearly tried to fix whatever we can see in the current system but we are also increasingly beginning to address the issue of what if, and the what if can come in many different forms. I am reasonably certain that we will be about as prepared as one can be prepared for the unknown, but it is unknown. There is nobody I know who has the capability to know precisely how this is all going to come out. We have never seen anything like this, and all we can do is to try to think of all the possible negative outcomes, both prior to January 1 and subsequent, and at the moment I would say I personally am quite impressed with what we and our colleagues at the Reserve banks are doing in this regard.

Mr. RAMSTAD. Thank you, Mr. Chairman, Chairman Greenspan.

Chairman ARCHER. Mr. Chairman, I think in deference I should ask you what your schedule is for the remainder of the day so we can plan as to how we proceed from this point.

Mr. GREENSPAN. I can go on certainly for a half-hour to 45 minutes if you——

Chairman ARCHER. If that is suitable to you, we will just continue for 30 to 45 minutes.

Mr. Levin.

Mr. LEVIN. Thank you. Thank you. You are a highly respected figure. You deserve to be. I think one of the problems is that you don't please anybody all the time and so people kind of hear you selectively. If they like your advice, they take it. If they don't, they can skip along.

Mr. GREENSPAN. I have observed that.

Mr. LEVIN. So let me be clear as to your advice. You said your first preference is to let the surplus run. And that is a higher preference, for example, as you see it than a substantial, across-the-board tax cut?

Mr. GREENSPAN. That is correct.

Mr. LEVIN. You less prefer large spending increases.

Mr. GREENSPAN. That is not a preference.

Mr. LEVIN. All right. OK. That is clear.

Now, just quickly, where does Medicare—addressing Medicare fit into your preference list?

Mr. GREENSPAN. Congressman, that is one of the most difficult problems that we face. As I said before, one of the reasons it is exceptionally difficult is that, one, we are so increasingly technologically oriented in that area that we need to get some judgment as to what the technology is doing, and second, we are really quite limited in understanding what types of new major advances in pharmacology and the electronic means of surveillance of the human body and——

Mr. LEVIN. Let me ask you, where should we put this preference?

Mr. GREENSPAN. I was about to get to another issue which I think is really at the base of it. What we try to do in our society is allow people to make judgments of how they wish to allocate their real incomes, and the American people have very clearly chosen increasingly to put it into medical services.

When I was very young, I remember the doctor used to show up and he would give you two aspirin and say, call me in the morning, and that was high-tech medicine. Now our capabilities of doing things are just awesome, and if everybody got everything that was technologically possible, we would probably be eating up half the gross domestic product.

There is clearly an issue implicit in the way we handle ourselves in the medical services area. The crucial issue is that there is one form or another of rationing that goes on, and rationing of medical services, I think, is anathema to the average person. So we have this very crucial dilemma, granted the capability of actually expending huge resources in a positive manner. That is, we probably can improve the quality of health of everyone to a certain degree, considerably more than we do at this stage, with the expenditure of a huge amount of resources.

I don't know the way in which one can properly make those balanced judgments. Here the Congress has, in my judgment, the most difficult of choices, because you are trading human life against other values in life. If we knew a great deal more about the technologies' future, you could probably be in a far better position to make the——

Mr. LEVIN. Let me quickly ask you, on trade we hear you caution. I don't think that is the same as inaction. But let me ask you about the government investment of funds. By the way, if it is done privately, I don't see how it increases the savings rate any more than if the government does it.

Mr. GREENSPAN. It would do so only at this particular point if the additional savings were mandated.

Mr. LEVIN. So let me ask you this, then: The Federal Reserve Board is insulated from political pressures considerably, is it not?

Mr. GREENSPAN. To an extent. The only thing that we are insulated from is a countermanding of the decisions that we make under law in the Federal Open Market Committee.

Mr. LEVIN. Why can't we do, I guess you have to answer this quickly, the same in terms of a government investment?

Mr. GREENSPAN. Congressman, that is what people are recommending. It is just that I find it very difficult to believe that it is feasible. There are people whom I respect, whose judgment I respect, who disagree with that. It is not an economic judgment. I guess it is a political judgment. It is a question of how our system works.

I guess I have just seen too many Presidents in my lifetime who, when confronted with a problem in the Federal budget, meaning a lack of resources and a huge pot of money sitting out there, would be unable to resist moving in that direction. I just don't believe they would. A majority of both houses can create laws that can overturn anything that is done to set up such sort of a Federal Reserve Board type related reserve fund.

Look, your judgment on this has got to be superior to mine. You have been involved in all sides of the political process for a good number of years. That is my judgment. If you think it is wrong, clearly your judgment would be superior in that regard.

Chairman ARCHER. The gentleman's time has expired.

Mr. Johnson.

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman. Welcome again. In the past you have testified that you expect a correction in the stock market, and I guess it hasn't happened exactly like you had forecast. I wonder, since the prices of high-tech stocks have really zoomed and there aren't any real profits in those companies yet, especially the Internet ones, what your forecast is now, and how is that going to affect some private investment that we might formulate for fixing Social Security?

Mr. GREENSPAN. I am not sure I want to get involved in individual types of stocks and their valuation. As I said in my prepared remarks, I made a few comments with respect to what I think the historical relationship of values are, as best we can judge them. I know of no one who would argue at this stage that at minimum we are not at the higher levels of valuation.

I guess that is about as far as I want to go at this particular stage. There are lots of ways in which markets can evolve for lots of different reasons. I chose my words as closely as I could in my formal remarks, and I would just as soon not go beyond that.

Mr. JOHNSON OF TEXAS. You mentioned the Y2K problem and the fact that there is no assurance that internationally it is going to work out. You are fairly confident that we are OK, U.S.-wise, and yet our interrelationship internationally is pretty intertwined at this point. How do you expect that to affect—I mean, already you saw a bump when Brazil deflated and it came right back up. And this morning even there was a bump at 10:30. Believe it or not, when you started testifying it went down and it is back up.

How do you account for that in the long term?

Mr. GREENSPAN. I would just as soon not try to.

Mr. JOHNSON OF TEXAS. OK. You are pretty honest, as a matter of fact. I appreciate that.

Do you think that our tax system sufficiently rewards risk-taking and entrepreneurship? And if we lowered taxes, I think you intimated it ought to increase the dollars available to make the economy stay strong.

Mr. GREENSPAN. Our tax system relative to the rest of the world is not bad, but there is no doubt in my mind that it could be improved upon. I do think that lowering marginal tax rates specifically and lowering the capital gains tax rate, in my judgment, would enhance the ability to increase incentives and capital investment in this country.

Mr. JOHNSON OF TEXAS. Thank you very much.

Chairman ARCHER. Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman.

Mr. Chairman, I want to stay on this track because I really am intrigued with your comments on how the surplus should be used. I wanted to ask you further, if a portion of the surplus is returned to the people in the form of tax relief, and you have talked about marginal rate reductions and capital gains, could you discuss for me your analysis or your impression or your thoughts on how lowering the death tax, the inheritance tax, would affect the economy, the growth side of the economy? Mr. Tanner and I are cosponsoring a rate reduction, 5 percent a year, and I am interested in your thoughts.

Mr. GREENSPAN. Which tax are you referring to?

Ms. DUNN. What is your analysis of how lowering the rates on the death tax or inheritance tax would affect the growth of our economy?

Mr. GREENSPAN. I have seen a lot of studies on that and I have found them all inconclusive, so I have nothing really substantive to add. Clearly, when we had a very substantial part of our population on the farm, the issue of inheritance taxes was a really debilitating problem for the transfer of the property from one generation to the next. The fact that our inheritance taxes throughout a substantial part of our history were either zero or very low, I thought enhanced a goodly part of the development of this country.

I can't say that I feel as strongly currently as I would have, say, in an earlier period. But my general view is, it is not terribly obvious to me that the amounts of money which we raise through the inheritance tax, which is really quite small, is economically positive. In my own judgment, it is probably otherwise, but I can't honestly cite evidence which I would consider to be conclusive in that regard.

Ms. DUNN. What about your thoughts on corporate capital gains reduction?

Mr. GREENSPAN. Well, I would put the capital gains tax reduction on both individual and corporate earnings.

Ms. DUNN. Let me move to a different topic that affects my State, Washington State, almost more than any other State in the Union. That is the fact that our exports have been reduced to Japan over 31 percent in the last year. We are very concerned about this. As the second highest exporting State in the Nation, it has a huge effect on us. Japan is seen as driving the economy in Asia, and I would like to have your thoughts on whether you believe that the Japanese, as they have made their corrections in their own economy, if you think that they are responding adequately to restore their economy and the economy of Asia?

Mr. GREENSPAN. As I have said publicly, I am hopeful that the Japanese will address the issue of their ailing banking system with a great deal more alacrity than has been the case of late.

The problem that occurred in Japan and still exists is a very dramatic decline in the value of real estate assets when the so-called real estate bubble burst in 1990. Real estate is the major collateral for the banking system in Japan, and the immediate result was a very major increase in nonperforming loans, which could have been addressed very early on in a manner similar to what we did with the RTC when the savings and loan debacle hit us. Had they done that, in my judgment, they would have cleared up a corrosive force that was spreading in their banking system and they now would probably have an economy which is doing a good deal better than it is.

The problem in Japan is that their financial intermediation is very largely commercial banking, as differentiated from the United States where we have a very significant capital market as well. The result of that is the increasing problems within the Japanese banking system have induced a major credit crunch in Japan. The problem has gotten so bad that Japanese banks have to pay a significant premium in the London market for borrowing in yen relative to British and American banks, for example, which tells you that it is a credit-risk problem of very major dimensions and that unless and until they resolve their banking problems, it strikes me that the economy's ability to come back in a vigorous manner is going to be delimited.

So I should say that there are lots of things that have to be done to reinvigorate the Japanese economy, but unless they address the nonperforming loan problem in a significant manner, which I have always argued has got to be handled in a manner similar to our RTC, I think that the credit crunch will continue to hobble economic growth there.

Chairman ARCHER. Mr. Jefferson.

Mr. JEFFERSON. Thank you, Mr. Chairman.

You say in your testimony, among other things, that it is important not to undermine the highly sensitive ongoing process of reallocation of capital from less to more productive uses through enactment of various policies that may sow uncertainties, undermine confidence and so on. Do you have any particular prospective policies in mind that might result in that sort of problem, that the Congress should refrain from being involved with?

Mr. GREENSPAN. I did not quite get the——

Mr. JEFFERSON. In your testimony, at the end you say that it is important not to undermine the highly sensitive ongoing process of reallocation from less to more productive uses. And previous to that you say that policymakers are going to have to be particularly wary of actions that unnecessarily sow uncertainties.

So my question is, did you have any particular actions in mind that you might see on the horizon, that the Congress might be contemplating or policymakers might be contemplating, that might cause this concern for you?

Mr. GREENSPAN. Let me just address the broad allocation problem because the thing which has struck me about the way our markets have evolved is that the technology has enabled us to unbundle risks in a manner which it has never been capable before. Individual consumers and investors have been able to differentiate between various products.

For example, you now can go out to buy a car and you can get all different types of special vehicles which we never were able to get before. Remember, several generations ago Henry Ford said, you know, “I will give you any type of car you want so long as it is black.” And we have changed that. We have gotten very sophisticated.

The technology has essentially created a major ability to reallocate capital in positive ways. There are a number of things that we can do to enhance it from the governmental point of view. My major concern would be, for example, that we be careful not to raise the minimum wage, and the reason I say that is that all the evidence that I have seen suggests that the people who are most needy of getting on the lower rungs of the ladder of our income scales, developing the skills and getting the training, are unable to earn the minimum wage and, as a consequence, cannot get started.

We have to be very careful about thinking that we can somehow raise standards of living by mandating an increase in the minimum wage rate. As a consequence of that, the need to keep our labor markets as flexible as possible and the ability to get the training to move up the ladder has got to be unimpeded because we cannot have a sophisticated capital market or a sophisticated system overall unless we have a flexible wage market.

I would say in that respect if there is any single thing that we could do which would help over and above a number of other things that have been discussed today, I would say be careful about moving the minimum up inordinately. My own preference would be to lower it and in fact even eliminate it, because I think it does more damage than good. But I recognize I am in a significant minority on that question.

Mr. JEFFERSON. This issue of fully funding the Social Security system, Mr. McCrery asked about it, and I was intrigued by your comment in your testimony on that issue. He talked about fully funding it through the public sector and you intimated a preference to having it done through the private sector. You also said it would take a long time to answer that private sector question.

But nonetheless, I don't know what you had in mind, and I would like to know if you could provide something of an answer as to how the private sector might be an answer to fully funding the Social Security retirement system?

Mr. GREENSPAN. It is going to be very difficult. The issue I come at is that it needs to be done. That is statement number one, and I infer that from the clear and growing evidence that we are not going to be able to meet the demands of the goods and services that retirees, who are going to be in hugely increasing numbers, are going to require upon retirement.

So I start off with the proposition that we have no alternative but to go to some form of increased funding or full funding. The more difficult question is how to do that, and clearly you can do it in a number of ways. You can raise Social Security taxes, which I think would be a problem in the labor market or you could significantly increase the average age of Social Security entitlement to more effectively link it to life expectancy. Indeed, I think what we should be doing is have the number of years that one is in retirement remain proportional to the number of years which one works and contributes to the fund. As it stands now, the ratio of retired years to working years is increasing and that is arithmetically unsustainable.

There are also a number of things we can do with bend points in the benefit programs. There are a number of things we could do to flatten out benefits without materially affecting the levels of benefits in a large way, which would have a very major effect on the underfunding that currently goes on. So can it be done costlessly? The answer is absolutely not.

Mr. JEFFERSON. These solutions you talk about are all within the public domain. The private sector domain is the one which is the most confusing as to an obvious answer, and there are some suggestions as to where an answer might be.

Chairman ARCHER. Will the gentleman suspend for 1 minute? In deference to the fact that there are other Members that need to try to get their 5 minutes in, perhaps the Chairman can give you that in writing or in some other way. I hate to cut any Member off, but I want as many Members as possible to be able to inquire.

Mr. GREENSPAN. Write me a note and I will be very glad to——

Chairman ARCHER. I fear the answer might be rather lengthy.

Mr. Collins.

Mr. COLLINS. Mr. Chairman, thank you.

Chairman Greenspan, please bear with me. I am probably the only one on this Committee that will speak at a slower pace than you do. There are two areas that I want to refer to and follow up with a question.

You mentioned Brazil and their economy and the fact that government actions have led to a point that government liabilities probably and do exceed potential revenues for the Government of Brazil. I think you may be referring to some programs that redistribute income. I see the United States as having that same potential problem, based on government entitlement programs that have been created over the years. One in particular is Medicare. And I agree with you that Medicare is a more significant problem for us to deal with than Social Security.

But I want to refer to Social Security and the fact that we have a pay-as-you-go system. In other words, the workers today are paying the payroll tax to meet the benefits of those who are receiving the Social Security checks. You mentioned current retirees and how their returns on the investment that they made from those payroll taxes over the years are much better. Actually, many of them have received back in 3 to 5 years more than they actually had reduced or deducted in payroll tax.

But then I want to go to my generation. I was born in 1944. I thought I was the beginning of the baby boom generation but I learned last night it was 1946. But at the White House in the Social Security summit in December, information was shared that my generation probably will have to draw benefits for a period of some 19 years before we get to a point of breaking even, based on increased taxes and the higher earnings limit that have been put in place for Social Security taxes.

But then we look at the next generation behind me, the younger people. You referred to the fact that they, as has been said before, believe more in UFOs than they do that they will ever receive a Social Security check, because the same information that was shared with us at the summit on Social Security at the White House was the possibility of younger people never living long enough to even get a return on all of their investment through the payroll tax.

That is the reason I think we need to focus on that generation and generations behind them, as to whether or not we are going to establish a true retirement program for them or we can continue with this socialized insurance program we have today called Social Security. I think we need to focus on the fact that they need a true retirement program, and I think it will do several things.

First, it will phase out the pay-as-you-go system that you said needs to end. Second of all, I think it will increase individual savings and overall savings rates. It will make more funds available for capital investments. And I think that it has the potential of reducing the payroll tax in the outyears, which I think will be very important and significant to younger generations, rather than having to increase the payroll tax to meet the current socialized insurance program.

My question to you is very similar to what Mr. Jefferson was leading into. When you talk about the importance of not undermining the highly sensitive ongoing process of reallocation of capital from less to more productive uses for productivity and standards of living to grow, not only must capital be raised and markets be allocated efficiently but internal cash flow, including the depreciation charges for existing capital, must be changed. Are you suggesting that we revise the current depreciation schedules based on the new current high-tech equipment that is used so much?

You mentioned the medical field. I am in the trucking business. There is quite a difference today in the current truck market than there was 20 years ago when I went into it. A lot of it is high-tech. That is true throughout the industry, computers and all. Should we revise the depreciation schedules more in line with the life expectancy of that equipment and usage of it than we currently do?

Mr. GREENSPAN. It is very difficult to get a depreciation schedule which essentially replicates the economic lives of the various different types of equipment that we have. Over the years there has been considerable endeavor on the part of the Congress to restructure depreciation schedules to be more closely aligned to the expected average lives.

One of the troubles, however, is that because of this continuous change in the structure of capital, it is hard to keep up. I don't know at this particular stage, not having seen any studies—but I am sure there are studies—of to what extent the most recent set of depreciation guidelines as they exist in the Internal Revenue Code, which go back a number of years now, still apply to what the real world capital asset turnover is.

If indeed it turns out that it is a significant issue, I would say that if you have a depreciation code which is debilitating to the investment structure, you are going to inhibit the appropriate allocation of capital. And indeed I would say that should be addressed. I must say, though, I don't know anything particular that I have seen which suggests that, but I do think it is something worthy of study if it has not been particularly done in some detail recently.

Chairman ARCHER. Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman.

Chairman Greenspan, your testimony here is timely and deeply appreciated. I want to follow up directly on Mr. Collins' question. I am very interested in the remarks in your testimony about the fact that growth has been fed, at least in part, by investment in capital stock. I wonder, as a followup, if Congress were to decide to scrap depreciation completely and go to a system of expensing, what sort of impact would you expect that to have on economic growth?

Mr. GREENSPAN. The first thing it would do is provide a very significant tax cut, clearly, and increased cash flows historically have always had the impact of increasing capital investment. If you take a step back and say how did the system work when we didn't have any corporate tax at all, clearly the incentive structure was different from the way it is today.

I think the question you have to ask is, if you are going to give a significant tax cut which would be implicit in that, whether it is better focused in the depreciation area or at marginal tax rates. At this stage I am not sufficiently up to date on all of the discussions that have existed on this question recently to be able to give you a thoughtful judgment on it.

Mr. ENGLISH. Then in that case, Mr. Chairman, on another topic, recently the U.S. taxpayer has been called on, either directly or through multilateral institutions such as the IMF, to act as a lender of last resort to stabilize the rapidly devaluing currencies around the world. These devaluations are fairly clearly the result of failed micro- and macroeconomic policies of the countries involved, and it seems that despite tens of billions of dollars of lending, devaluations have been occurring in any case, although admittedly in a much more orderly fashion. These devaluations obviously put some of our sectors, steel as an example, at something of a competitive disadvantage.

Now setting aside for a moment the very real concern of moral hazard with these lending policies, many of us are concerned that our taxpayers have been put in the position of subsidizing foreign economies which in turn subsidize our competitors. Do you feel it would be appropriate to in some manner to tie our loans to specific progress in receiving countries opening their markets to U.S. exports and the elimination of direct or indirect tariff barriers?

Mr. GREENSPAN. That is a goodly part of what the IMF has been endeavoring to do. The issue of whether they have done it successfully is another question. There is just no doubt that it should be in the interest of the United States to open up world markets because the other side of our protectionism is other people's protectionism, and that should be as anathema to us as any we engender ourselves. So anything which opens up markets is to the mutual advantage of all trading partners.

I would think that that is our policy in the sense that in all aspects of the foreign economic policy of the United States, as I understand it, it is an essential goal. I don't think that it has been compromised in a very significant extent, though I do grant you that there are particular instances when I would say that it is otherwise.

Mr. ENGLISH. Thank you Mr. Chairman. I yield back the balance of my time.

Chairman ARCHER. Chairman Greenspan has now generously given us a little over 2½ hours of his time. The Chair is going to suggest that, with Mr. Greenspan's permission, that we will take one additional Member on the Minority side and one additional Member on the Majority side and then conclude this hearing this morning.

Mr. Doggett.

Mr. DOGGETT. Thank you for your very insightful comments. Am I correct that if the choice is between letting the surpluses buildup or enacting a tax cut, even a so-called growth-oriented tax cut, that your belief is unequivocal that we ought to build the surplus and reject the tax cut?

Mr. GREENSPAN. That is correct, Congressman. At this particular stage, with the economy doing as well as it is and with investment moving forward as facilely as it is, the need for additional fiscal stimulus from the tax side, which we may need at some future time—and I am very supportive of that—we don't need as far as I can see at the moment. The advantages that I perceive that would accrue to this economy from a significant decline in the outstanding debt to the public and its virtuous cycle on the total budget process is a value which I think far exceeds anything else we could do with the money.

Mr. DOGGETT. There has also been, as you are well aware, so much dissatisfaction with the Internal Revenue Code that some have advanced the notion that what this Congress ought to do is just set an arbitrary date and kill the sucker. My question is, what economic consequences or reaction of the financial markets should we as Members of Congress consider in deciding whether to set a day, say, December 31, 2002 or 2003, and to declare that the Internal Revenue Code is dead without having previously enacted a replacement Code?

Mr. GREENSPAN. That is the toughest question I have been asked all morning.

Obviously if you do not have a Code in place to replace it, and I am one of those who have great sympathy for those who want to make lots of changes in that Code, it is not a good idea. That does not mean that one should not move in the direction of significant alterations, but this is a process question as to whether in fact, which is the reason it is a tough question, you throw out the Code and you are going to have to focus one's attention to get a new one by the effective date. That concentrates the mind and probably is a great incentive to doing that. Whether you want to take that risk is not a judgment I am going to make.

Mr. DOGGETT. If we stay within the existing budget caps adopted under the Balanced Budget Act, is more investment in effective education and job training likely to produce increased labor productivity and thereby our national economic growth rate?

Mr. GREENSPAN. I agree with those who have difficulty finding relationships between the quality of the education that we engender in this society and the amount of cash that we direct to it. Structural changes—indeed, some of the issues that the President raised last night I thought were to the point—are more relevant than the issue of cash.

Mr. DOGGETT. Thank you so much. I yield back.

Chairman ARCHER. The Chair is always pleased whenever a Member yields back any time. Thank you so much.

Mr. Chairman, before I recognize Mr. Portman, who will be the last inquirer, let me be sure to crystallize your responses as I understand them. And frankly, I thought I understood them before you even appeared today because you and I have talked about this before.

Your number one preference for the surplus would be to let it stay in place and neither spend it nor give tax reduction.

Mr. GREENSPAN. That is correct.

Chairman ARCHER. Because leaving it there effectively reduces the national debt every year?

Mr. GREENSPAN. And has significant positive economic consequences as a result.

Chairman ARCHER. And I understand that. But knowing the proclivities of democracy and the Congress particularly, it is very unlikely that that will happen, and I think history is a pretty good barometer of that. And in the event that it does not happen and you had to choose between a tax reduction and simply new spending programs, what would you choose?

Mr. GREENSPAN. Tax reduction.

Chairman ARCHER. I just wanted to make that clear, because I understood you to say that this morning.

Mr. Portman.

Mr. PORTMAN. I want to commend Chairman Archer for holding the hearing and for allowing not only the Members of this panel but the public to hear your insights. I have found it fascinating. We have learned a lot today.

Trying to summarize your prescription for the future, I would say it is that net increased savings effectively invested in productive assets should be our goal. On Social Security and retirement savings generally, I would like to get your input. You probably know more about it than anybody, having chaired the Greenspan Commission and having thought about it now in the larger perspective of our country's economic growth into the next century.

Often we treat Social Security reform in isolation and don't focus as much on the other two legs of the so-called three-legged stool, personal savings, IRAs, and then employer-sponsored plans. And in fact, last year and the year before there were more benefits paid through the employer based pension system than there were in Social Security benefits. So it is an important part, critical part of our overall retirement savings.

My concern is, retirement savings is not growing nearly fast enough. In fact it is flat in many areas. Among smaller businesses, as you probably know, with 25 or fewer employees, only 19 percent now offer any kind of pension plan, 401(k), profit sharing or any other vehicle. Congress has done a pretty good job on the personal savings side, particularly with the Roth IRA and some other vehicles. But we tend to focus on Social Security in isolation, a bit on the personal savings side, and we have left the employer-sponsored plans without effective simplification and effective expansion that we should indeed be providing.

I know that you are not necessarily in a position to talk about specific legislation today, but I would like to hear from you as to what you think about ideas to indeed expand the pension system through simplification, so that smaller businesses can get involved without the same cost burdens and liabilities attached to the current system; and, second, through increasing the ability of people to set money aside and increasing the ability for employers to match those funds by increasing contribution limits. I wonder if you would care to comment on that kind of a proposal?

Mr. GREENSPAN. Congressman, I agree with you that basically we tend to focus on Social Security as though it is independent of the overall means of retirement incomes for the population as a whole. Indeed, what we find is that retirees over a broad segment of our society have multiple forms of resources to carry them through their retirement, although there is not a insignificant proportion of the elderly who have only Social Security.

But I do think it is important to recognize that the same forces which are creating problems for the public sector, Social Security, are also the identical problems that are focused on the private sector; namely, that we are going to have to increase the aggregate amount of resources for our retirement population because it is becoming so large and will become larger. The presumption that it can all be financed through the public Social Security system, I think, is a mistake. We ought to look at all various segments of retirement funding. I have no question that there is probably a significant possibility for major improvements in our private retirement system laws which so affect employer contributions and employer capabilities of setting up various different types of funds.

Mr. PORTMAN. Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman ARCHER. The Chair regrets and apologizes to all the Members who have not been able to inquire. At the same time, Chairman Greenspan has been most generous with his time today.

We are extremely grateful for your coming to visit with us at the beginning of this new Congress. Again, my compliments to you for the marvelous work that you have done over the years. We expect nothing but the best from you in the years ahead.

Mr. GREENSPAN. Thank you very much Mr. Chairman.

Chairman ARCHER. Thank you. The Committee will stand adjourned. We do have another hearing tomorrow morning.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

[A submission for the record follows:]

Statement of National Association of Manufacturers

INTRODUCTION

Over the last eighteen months, there have been a series of shocks to the world economy. The main ones were the recession in Asia, which started in the summer of 1997, followed by a similar collapse in Russia. There is now a serious risk of the same type of scenario in Latin America. Further, the world economy will be hit by the Y2K problem in less than a year.

Through it all, the American economy has continued to hold up. This reflects both some key underlying strengths—mainly high productivity—and the fact that the Federal Reserve has cut interest rates. So far, the United States seems to be riding out the global storm, albeit at the expense of large trade deficits. Given the threat that the recession overseas will worsen, it would be a good idea to take out some insurance, and cut taxes. To this end, we recommend a cut of 10 percent in personal and corporate tax rates.

GLOBAL SHOCKS

The 1997 recession in Asia was the largest shock that has hit the world economy since the Gulf War. The crisis was largely unanticipated, and involved a massive flight of capital from the region. In 1996, net private capital inflows into the Pacific Basin (South Korea, Indonesia, Malaysia, Thailand and the Philippines) came to $93 billion. In 1997, the net private capital outflow was $12.1 billion, a swing of $105 billion, equal to 11 percent of the GDP of these countries. The collapse was not only unanticipated, it was much deeper than expected.

The situation in Asia was worsened by the fact that Japan underwent its second recession in a single decade. Japan's initial slide into recession occurred in 1992–93, coming in the wake of the collapse of the Nikkei and a decline in real estate values. Macroeconomic policy was too tight at the time, slowing the recovery. The government has been slow to enact stimulative measures, relying more on public works, rather than demand-expanding tax cuts. As a result, Asia is likely to remain in recession in 1999, and emerge only slowly in the year 2000.

The second shock that hit the world financial system was the collapse in Russia in the summer of 1998. The causes were similar in some ways to Asia: there was a massive flight of capital, leaving Russia short of foreign exchange. As a result, Russia defaulted on its foreign debt and underwent a disorderly devaluation.

THE THREAT IN LATIN AMERICA

The most serious threat at the current time is that a similar crisis could take place in Latin America. The focal point is Brazil, which was forced to devalue on January 13. Last summer, Brazil was hit by the crisis in Russia, and began to suffer the same kind of capital flight. In only two months, Brazil's foreign exchange reserves dropped by nearly $30 billion (from $70 billion in July). This created the preconditions for an Asia-style implosion. As of November 13, a $42 billion IMF rescue package has been announced for Brazil. However, this does not seem to have stabilized the situation.

One aspect of the problem is that Brazil still has a budget deficit of more than 7 percent of its GDP. The size of the deficit has led to fears that at some point it may be financed by money creation, leading to a return to high inflation. Fiscal restraint will be difficult because it will slow the economy and lead to greater unemployment in the short run. A further aspect of the problem is that Brazil's inflation rate has been driven in part by a series of devaluations. This country chose to try to stabilize its exchange rate in part to be able to control inflation. However, the exchange rate could not be maintained. In the short term, the United States and other Western countries need to make additional credit available to Brazil. In the long run, the success of the Brazilian stabilization program will depend on whether they are able to reduce their budget deficit, and keep devaluations orderly.

If Brazil were to go into recession, this would inevitably drag down much of Latin America. The Southern Cone countries—Argentina and Chile—are currently stable, but would undergo downturns if the Brazilian market contracted. Venezuela also seems politically unwilling to retrench, and may try to reflate. As a result, Latin America could be in for a period of stagnant growth and possibly higher inflation.

This would not be favorable for the United States. Brazil represents only 2 percent of the American export market, but Latin America (less Mexico) represents more than 10 percent. Adding in Mexico, the Latin American region comprises 20 percent of U.S. exports. Stagnant growth in Latin America would further slow the American economy, particularly in trade-sensitive manufacturing sectors that have already been hurt by the recession in Asia.

It would also not be favorable in a geopolitical sense. If Latin America were to collapse, this would leave North America and Western Europe as islands of prosperity in a sea of recession stretching from Japan, through the Pacific Basin, Russia and South America. In other words, a large part of the Third World would be in recession. A situation in which most of the world's wealthy countries (excluding Japan) are prosperous while most of the world's poor countries are in recession is not desirable. This would lead to widespread resentment against the West, and possibly lead to a backlash against free market policies in other parts of the world.

WHY THE UNITED STATES SHOULD AVOID RECESSION

There are a series of underlying strengths that should keep the United States out of recession. The most important is steady growth in employment and incomes. Payrolls increased by over $2 million in 1998. As a result, consumer demand should remain buoyant in 1999.

A second factor was the Federal Reserve's astute response to the global shocks. As the dimensions of the crisis became evident in August, the Fed lowered short-term interest rates by 75 basis points in three stages. These demonstrated Chairman Greenspan's commitment to containing the crisis. The rate cuts are important for another reason. The world economy needs more dollar liquidity. As monetary growth in the United States speeds up, the trade deficit injects more of this liquidity overseas.

A third factor has to do with a higher rate of productivity growth. In the early 1990s, there was some debate as to the rate of productivity growth that could be sustained. Pessimists argued that this was only in the range of 1.1 percent per year. In 1996, we forecast that the rate of productivity growth could be sustained at 1.6 to 1.8 percent per year. This was based primarily on a speed-up in the rate of technological advance. One item of evidence supporting this was that national income was growing faster than national product, indicating hidden productivity growth.

Since then, revisions to the national income accounts have largely validated the more optimistic forecast. In mid-1998, the Commerce Department published benchmark revisions to GDP, which demonstrated additional output growth and lower inflation in 1995–97. Simultaneously, the Bureau of Labor Statistics revised the 1996 productivity number up to more than 2 percent. Moreover, the speed-up in productivity has been sustained. Over the last four quarters, the average rate of productivity growth in nonfarm business has been 1.7 percent. Productivity of course does not operate only on the supply side. The path of wages—or more specifically the corridor within which wage increases do not raise inflation—depends on the rate of productivity growth.

ELEMENTS OF THE FORECAST

Here, we discuss selected elements of the forecast. For 1999, we project GDP growth at 2.3 percent for the year. This represents a substantial slowdown from the 3.6 percent pace that we probably achieved in 1998. However, even this rather guarded scenario is contingent on at least one more cut in interest rates by the Federal Reserve, and on a successful resolution of the situation in Latin America.

The strongest part of the economy is consumer spending, reflecting increase in incomes from higher employment and wages. Lower interest rates lead to an improvement in household balance sheets, due mainly to lower mortgage costs. The savings rate essentially remains at zero, or slightly below. Consumers spend all the income they take in, and continue to draw down financial assets.

Business investment hands in a mixed performance. Despite lower interest rates, residential construction declines, due to excess capacity. Nonresidential structures rebounds slightly, but this is largely a reflex response to the decline in 1998. The level of investment in nonresidential structures in 1999 remains lower than it was in 1997. Business equipment also slows down. This reflects excess worldwide capacity and a narrowing of profit margins.

The trade deficit continues to deteriorate, although the rate of deterioration is not as bad as in 1998. The exchange rate falls, but the improvement in competitiveness is swamped by the continuing shortfall in demand overseas. The effect on balance is to reduce GDP growth by slightly less than a percentage point.

The inflation rate remains low. High productivity growth and the arbitrage of world prices into domestic prices keeps the GDP deflator at only 1.5 percent.

Corporate earnings remain under pressure, primarily from the lack of pricing power. Prices in some sectors are actually declining, while in other sectors they are not rising as rapidly as labor costs. With the economy essentially at full employment (unemployment roughly at its natural rate), corporate margins are being squeezed. As a result, corporate profits decline slightly in 1998, and then achieve only a minor increase in 1999.

If a collapse in Latin America were to occur, the situation would be less favorable. We ran econometric simulations in which we assumed that Brazil falls into a deep recession and drags the rest of Latin America down with it. Even if the Federal Reserve loosens interest rates further at this juncture, it is too little, too late. As the experience of Asia has demonstrated, it is difficult to bring countries out of recession after they have already undergone financial collapses.

In this case, the growth rate initially slows to 2 percent in the first half of 1999, and to 1.6 percent in the second half as the trade deficit climbs. The United States would not actually go into recession, but instead would lapse into a period of near-stagnation.

A final risk is the Y2K problem, which of course is outside the range of the forecast. This is analogous to a natural disaster. If the problem is pervasive, it would lead to supply disruptions, forcing firms to divert resources into repairing computer systems. The most likely outcome is that this will be another in a series of shocks that have slowed the world economy since mid-1997.

Policy Implications

The downside risks have two major policy implications. The United States has to maintain a loose monetary policy in order to provide adequate liquidity to the world. Further reductions in interest rates are needed.

Congress, however, should provide additional stimulus by enacting a tax cut. Specifically, we recommend a 10 percent reduction in individual and corporate tax rates to raise consumer demand and keep spending strong over the next two to three years. Even in the event of a severe recession overseas, or disruptions from the Y2K problem, the United States will be able to maintain stable growth and full employment. At the same time, faster growth will enable the United States to act as a locomotive for the rest of the world economy, and for the Western hemisphere in particular. This will speed up recovery overseas.

To gauge the impact of this tax cut on the economy, we ran econometric simulations in which the rate reductions were assumed enacted in the second half of 1999. In the year 2000, the growth rate of GDP increases by 0.9 percent, and in 2001, it increases by 1.2 percent. The level of GDP increases by $130 billion (or 1.7 percent) in 2001, and shows a final gain of $166 billion, or 2.1 percent in 2002. The static cost of this tax cut is roughly $80 billion a year in 2000–01, but because of higher growth, the dynamic revenue cost is smaller. We estimate the dynamic revenue cost at $55 billion a year.

There are other reasons to cut taxes at the current time. The burden of taxation is now at a post World War II high. The ratio of total taxes collected to GDP is currently 32 percent, compared to 25 percent in the late 1950s. We also estimated the increase in the burden of taxation on workers, relative to their incomes. From 1959 to 1997 the average tax burden increased from 24 percent in 1959 to 36 percent in 1997. Clearly, this situation calls for tax relief.

In recommending a cut in income tax rates, we do not of course rule out cuts in other types of taxes. For instance, we argue that converting the Social Security system to a new system based on individual retirement accounts would also yield substantial economic benefits. The FICA tax has lowered the level of GDP, primarily by slowing growth in the labor force. Our econometric analyses indicate that if the FICA tax had not been raised, the level of GDP would be significantly higher today. For instance, if the FICA tax rate had not been increased during the period from 1984 onward, real GDP would have been higher by over $80 billion in 1997, while employment would be higher by 1 million. By implication, if Social Security were privatized, the economy would emerge with a higher level of GDP and employment in the early twenty-first century.

CONCLUSIONS

The economy is slowing down, following three years of strong growth in 1996–98. At the same time, there is a risk that the recession overseas will spread to Latin America in 1999. Our policy recommendations are twofold. First, monetary policy should be loosened through additional cuts in interest rates. Second, taxes should be reduced through a 10 percent rate cut. For the time being, the most important priority is to enact tax relief to maintain economic growth, and take out some insurance against the threat of a slowdown. Over the long run, Congress should draft legislation converting Social Security to a system of individual retirement accounts.