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The Honorable Alan Greenspan
Chairman, Federal Reserve

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Questioners: Mr. Martin Davis, Chairman
Paramount Communications

Mr. Henry Kaufman, President
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Introduction

Former Chairman Richard A. Voell

...338th meeting in the 86th year of the Economic Club of New York. I'm Dick Voell, past chairman of the Club and tonight I'm pinch-hitting for Don Marron, your present chairman, who is out of the country. I'm delighted, but certainly not surprised, to see such a fine turnout given our speaker this evening and the importance of the subject matter at hand.

If our country today is at last united behind the idea that we must grapple seriously and decisively with the federal budget deficit, much of the credit for this new resolve has to be given to our guest speaker tonight, Federal Reserve Chairman, Alan Greenspan. While in Washington and around the country, the debate still rages about what to cut, how much to cut, and dare I say it, how much revenue enhancement is required, there is an unprecedented sense of national urgency about the deficit. There is also, I believe, an unprecedented degree of understanding about the interconnectedness among the deficit, interest rates, and inflation, and how all these things affect business and the everyday lives of the American people.

President Clinton and the candidates in the last election brought these issues to the forefront of the national consciousness. But the ground for their debates was well prepared by the quiet, steady, authoritative voice of Alan Greenspan. Chairman Greenspan has presided at the Fed during one of the most turbulent periods in American financial history. Throughout it, he has kept a firm hand at the tiller, helping to guide the economy past the market crash of 1987, bank solvency crises, and a tenacious recession. At the same time, he consistently, consistently reminded Washington and the public of the perils of the surging federal budget deficit and the risks of compounding that danger by resorting to politically attractive but economically unsound fixes.

Like another prominent figure in our national capital, Alan Greenspan got started on a totally different stage. He was a tenor saxophonist and a clarinetist with the Henry Jerome Band in the heyday of big bands in New York City. But fortunately for us, he pursued his interest in economics and he moved on to huge success at his own economic consulting firm before first entering the political arena as an advisor to candidate Richard Nixon in his '68 campaign. He served as Chief Economic Advisor to President Ford and then in 1982 was named Chairman of the Bipartisan Commission on Social Security. And it was there that he displayed consummate skill in building a consensus on a plan to save the system from collapse – a plan that incidentally was acceptable to both Congress and the White House.

His accomplishments on Wall Street and in Washington made him the natural choice of President Reagan to succeed Paul Volcker as Chairman of the Fed. Now in his second term, the Greenspan style has become widely known, not only inside the Beltway but in capital markets around the world. Ever sensitive to the power of words, spoken by the preeminent figure in global finance, Chairman Greenspan once remarked to Congress, "Since become a central banker, I have learned to mumble with great incoherence." (Laughter) Chairman Greenspan, however you choose to speak to us tonight, we're pleased and honored to have you with us. (Applause)

The Honorable Alan Greenspan

Chairman of the Federal Reserve

Thank you very much, Dick. I suspect many of you are going to learn about how great that incoherence can be this evening. It's certainly a pleasure being back amongst a number of old friends at the Economic Club where I've spent a number of very pleasant evenings. I'm sorry that my colleague and your trustee Gerry Corrigan couldn't be with us tonight, especially after he twisted my arm to come up here to talk. But we had to send him off, or he sent himself off to represent the Federal Reserve System in Basel, Switzerland. And I will communicate as succinctly as I can, it's more important that he is there than here.

As you all know, Gerry, after an extraordinarily distinguished career at the Federal Reserve has decided he wants to take a shot at the private sector. I would certainly describe Gerry Corrigan as being as indispensable as anyone I know of at the Federal Reserve System, and as a consequence his leaving is not only going to be a great loss to all of his colleagues who leaned on him for an awful lot of insights, but his joining the private sector may conversely be perhaps the best expansionary impetus that the private sector can get these days. And we all wish him well, and if he were here tonight, I would tell him, he might as well give my speech because he and I very rarely disagree about anything. And I want to see whether or not his going into the private sector is going to change any of that.

This evening, I plan to address a set of issues which are surely going to influence economic policy in this country for the years ahead. We seem to be well through a period of major readjustment, a readjustment whose roots lie more than a quarter century ago with the inflation induced by the Vietnam war. Budget deficits began to rise. Inflation took hold, and currency values became unhinged, and our economic policy apparatus was apparently unprepared to deal effectively with any of these developments.

As inflation accelerated through the 1970s, it appeared to be embarking on an inexorable upward path which monetary policy was able to block in the early 1980s but only at a significant cost in economic growth and jobs. The severe inflation and correspondingly high interest rates of the late 1970s and early 1980s, brought to or pushed over the edge of bankruptcy a large number of financial institutions that had lent long-term and borrowed short. The inevitable pressures to deregulate the financial system as a solution to the maturity mismatch coupled with the growing availability of new financial technology raised the apparent optimal debt-equity ratio of both business and consumers in the 1980s.

From 1984 through 1990, roughly $600 billion of corporate equity was replaced by debt. During the same years, mortgage debt on existing homes increased approximately $700 billion as householders endeavoring to leverage the equity in their homes, the prices of which seemed to be on a permanent uptrend.

A burgeoning service sector also created a large increase in the need for office space. Reinforced by favorable tax legislation, the demand for space led to a rapid rise in commercial property asset prices and commercial construction financed largely by debt. The decline in inflation and interest rates through most of the 1980s renewed a willingness to invest longer term, and rising equity prices as well as those for physical assets underscored the expansion.

The trouble encountered by some leverage buyouts and later the unexpected slump in real estate values exposed debt buildups that in retrospect had clearly been excessive. The effort to repair burdened balance sheets in the 1990s has put a damper on spending by many businesses and households suppressing economic growth. Financial institutions afflicted with heavy loan losses as asset prices fell tightened their lending standards exacerbating the economic slowdown. Accordingly, the modest economic advance of the past couple of years has been financed unprecedentedly from sources other than financial intermediaries.

We seem now to have come virtually full circle since the destabilizing deficit financing of the Vietnam War. The inflationary pressures that so dominated the economic events of most of the last quarter century appear largely, though not as yet wholly, subdued. Short-term interest rates are back to the levels of the early 1960s. Long-term rates, although at their lowest levels in two decades do not; at least as yet, reflect the benign view of long-term inflation that prevailed prior to the Vietnam War. I shall return to this issue later in this talk.

While much of the strain experienced during the inflationary episodes of the 1970s and the recent bout with excessive debt leverage have been painful, the legacy is not without important benefits. We did, of course, experience the longest peacetime expansion in history during the 1980s. Moreover, much has been learned about economic policy, about what government can and cannot effectively accomplish. Despite disturbing evidence of re-regulation in a number of sectors of our economy in recent years we are still enjoying the demonstrable benefits of a general movement toward freer, more competitive markets that occurred during the 1980s. Indeed, on a much broader scale, the failures of central planning have led to a virtual worldwide acceptance of the competitive market system as the best economic structure for fostering societal well-being.

With tax and regulatory reforms heightening incentives in the 1980s, innovation advanced measurably especially in computer and telecommunications technologies. In recent years, sophisticated software applications have interacted with rapidly improving hardware technologies to alter profoundly the way we organize the production of goods and services in this country. The distressing side of this transition has been significant permanent job losses as the extensive restructuring of American industry rendered large layers of operations redundant.

The benevolent side of the process may be a dramatic increase in trend productivity which to many appears to be on the horizon. It is too early to determine whether the recent surge in output per work hour is a cyclical phenomenon or an early indication that the long-term trend of productivity has already tilted upward.

Increased productivity, of course, is the only way to achieve sustained increases in real incomes and standards of living. At the core of the changing business landscape is the downsizing of economic output which continues apace. As microprocessors become more powerful, telecommunications more advanced, and physical products slim down, the gross domestic product is becoming progressively more conceptual and less physical. Ideas are replacing physical inputs in the production of goods and services. This is an irreversible process and bodes well for accelerating growth in the real values that make up our standard of living.

Indeed, low inflation feeds lower interest rates and costs of capital and thereby spurs innovation and productivity over the long run. But there is mounting evidence that low inflation is also associated with an acceleration in productivity growth in the short run as well. The history of the post-World War II period indicates a significant correlation between low inflation and high productivity growth. Apparently, as inflation falls, businesses seeking to increase their profit margins perceive that they can do so only by enhancing efficiency. When inflation is high, the alternative of expanding margins by raising prices is more tempting, although the gains usually prove to be only transitory as wages eventually catch up with the inflation rate.

My sense is that in the recent period, the lack of pricing leverage has once again concentrated the minds of business people on the need to increase productivity. This is one reason to suspect that the current productivity upswing may indeed be more than cyclical. This is another sense in which the post-Vietnam economic experience appears to be running full circle, back to the early 1960s, a period of low inflation and strong productivity growth. But while such a long-term outlook is increasingly possible and definitely appealing, it rests to a large extent on the expectation of continued subdued inflation. It is an open question whether we have learned enough to skirt the dangers of budgetary and monetary excess that have triggered past episodes of debilitating inflation.

There certainly appears to be pronounced interest and political support throughout our nation for reining in outsized budget deficits. The president and the Congress are actively engaged in this process as we speak. While the debate is quintessentially political in the best sense of the word, there are nonetheless some economic principles that will affect the outcome. As I have emphasized in recent weeks before the Congress, according to both the Office of Management and Budget and the Congressional Budget Office, budget outlays under existing law are scheduled to rise at a pace in excess of taxable incomes after 1996.

As a consequence, a strategy based on these projections and designed to narrow or even to contain the deficits as a percent of nominal GDP wholly from the revenue side would require progressively higher rates of taxation and/or a continuous broadening of the tax base. At some point under such a regime, any economy would stagnate and tax revenues would fall.

Accordingly, if long-term deficit reduction is the goal, irrespective of what is enacted on the revenue side, there is no alternative to curbing the growth in spending to below the rate of growth of taxable incomes, what for the most part amounts to the same thing, nominal GDP.

To be sure, should recent improved productivity growth turn out to be longer lasting, tax receipts would obviously be higher than is currently being projected by either OMB or CBO. But short of a surge in productivity well beyond what one can credibly anticipate at this point, receipts growth still would fall short of the projected growth in outlays under current law. Moreover, projections of such outlays fail to account for future spending add-ons owing to ongoing congressional deliberations, administrative rulings, and judicial decisions.

It is not possible to know in advance which spending programs will be expanded, but we do know that some will. In recent years, current services outlay estimates have consistently been adjusted upward in response to such technical re-estimations of program costs. Indeed, technical re-estimates explain a significant part of the failure of the deficit to fall as contemplated at the time of enactment of the Omnibus Budget Reconciliation Act of 1990.

Statistically speaking, the currently projected unsustainable excess rate of growth in mandated federal outlays is concentrated in Medicare and Medicaid. And there is no question that their rates of growth must be slowed if eventual budget balance is to be achieved. But if such a complex process as reform of our medical care system turns out to be especially difficult and drawn out, paring back the growth in other areas of mandated outlays will clearly have to be considered. While shrinking the long-term budget deficit is doubtless a necessary condition for low inflation, it would not be sufficient. Monetary policy also must avoid the excesses of the past.

The interactions of monetary policy with inflation and inflation expectations have become increasingly apparent as a major economic force over the past quarter century. Through the first two decades of the post-World War II period, these interactions were patently less direct. Savers and investors, firms and households made economic and financial decisions based on an implicit assumption that inflation over the long run would remain low enough to be inconsequential. There was a sense that our institutional structure and culture, unlike those of many other nations of the world, were inhospitable to inflation.

As a consequence, inflation premiums embodied in long-term interest rates were low and effectively capped. Inflation expectations were reasonably impervious to unexpected shifts in the aggregate demand or supply of goods and services. In those circumstances, monetary policy had far more room to maneuver. Monetary policy, for example, could ease aggressively without igniting inflation expectations. Even during the rise in inflation of the late 1960s and 1970s, there was a clear reluctance on the part of investors and others to believe that the inflation being experienced was other than transitory. It was presumed that inflation would eventually retreat to 1 or 2% annual rate that prevailed during the 1950s and the first half of the 1960s.

Consequently, long-term interest rates remained contained. But the dam eventually broke and the huge losses suffered by bondholders during the 1970s and early 1980s sensitized them to the slightest sign, real or imagined of rising inflation. At the first indication of an inflationary policy, monetary or fiscal, investors now dumped bonds driving up long-term interest rates. To guard against unexpected losses, investors still demand a considerable premium in bond yields – a premium that affects the environment of monetary policy today.

This heightened sensitivity of investors has affected the way monetary policy has interacted with the economy. To be sure, a stimulative monetary policy can prompt a short-term acceleration of economic activity. But the experience of the 1970s, both here and abroad, provide convincing evidence that there is no lasting tradeoff between inflation and unemployment. In the long run, easier money buys higher inflation, but no increase in employment. An overly expansionary monetary policy or even its anticipation becomes embedded fairly soon in higher inflation expectations and nominal bond yield. Producers quickly incorporate expected cost increases into their own prices and eventually any increase in output dissipates as inflation rises and any initial decline in long-term nominal interest rates is more than retraced.

The goal of low to moderate long-term interest rates is particularly relevant in the current circumstances in which balance sheet constraints have been a major, if not the major, drag on the expansion. The halting but substantial declines in intermediate and long-term interest rates that have occurred over the past few years have been the single most important factor encouraging balance sheet restructuring by households and firms. They also engendered significant reductions in debt service burdens. Monetary policy has played a crucial role in facilitating balance sheet adjustments and thus enhancing the sustainability of the expansion. We have eased in measured steps helping to reassure investors that inflation is likely to remain subdued, thereby fostering the decline in longer term interest rates.

Recognizing emerging tendencies for the economy to slow, the Federal Reserve began to ease policy in the spring of 1989. In response to the downturn that began in August 1990, we accelerated the decline in short-term interest rates. Last year we extended our earlier reductions in rates by easing the federal funds rate cumulatively by another percentage point. In addition to lowering interest rates, the Federal Reserve cut Reserve requirements last spring for the second time in 16 months to help pare depository institutions' costs and encourage lending.

Although the easing actions over the past few years with few exceptions have been purposefully gradual, cumulatively they have been quite large. Short-term interest rates have been reduced since their 1989 peak by seven percentage points. Looked at differently, short rates have fallen by two-thirds. Nonetheless, some have argued that monetary policy has been too cautious, that short-term rates should have been lowered more sharply or in larger increments.

In my view, these arguments miss the crucial features of our current experience, the sensitivity of inflation expectations, and the necessity to work through structural imbalances in order to establish a basis for sustained growth. In these circumstances, monetary policy clearly has a role to play in helping the economy to grow. The process, by which monetary policy could contribute, however, has been different in some significant respects from past business cycles.

Lower inflation and intermediate and long-term interest rates are essential to the needed structural adjustments in our economy and monetary policy thus has given considerable weight to encouraging the downward trend of such rates. Some have suggested that the decline in inflation permitted more aggressive moves, and had the downward trajectory of short-term interest rates been somewhat steeper, that aggregate demand would have been appreciably stronger.

I suspect, however, that the disinflation very likely would not have occurred in the context of an appreciably more stimulative policy and that such a policy could have led to higher inflation in the next few years. Moreover, such a policy would not have dealt fundamentally with the very real imbalances in our economy that needed to be resolved before sustainable growth could resume. And it would have run the risk of aborting the process of balance sheet adjustment before it was completed. The credibility of non-inflationary policies would have been strained and longer term interest rates likely would be higher inhibiting the restructuring of the balance sheets and reducing the odds on sustainable growth.

Containing, and over time eliminating inflation is a key element in any strategy to foster maximum sustainable long-term growth of the economy. Over the past decade or so, our nation has made very substantial progress toward the achievement of price stability, reversing a dangerous upward trend of inflation and inflationary expectations. Last year's increase in the consumer price index, excluding volatile food and energy prices, was the lowest in 20 years and far lower than the debilitating double-digit rates at the close of the 1970s. Price stability does not require that measured inflation literally be zero, but it does require that inflation be low enough that anticipated changes in the general price level are insignificant for economic and financial planning. At current inflation rates, we are quite close to attaining this goal.

Regrettably, the inflation excesses of the 1970s still condition the inflationary expectations of today. Despite little apparent fear of an imminent upsurge in inflation, the very steepness of the Treasury yield curve reflects deep-seated investor concerns that inflation will significantly quicken in the latter part of this decade and beyond. I assume that the problem of our structural budget deficits for the years ahead is a key factor explaining the failure of long-term interest rates fully to follow short-term rates back to their levels of a quarter century ago.

The reasonably flat Treasury yields, out a year or more, are consistent with an economic environment that does not seem conducive to a near-term re-emergence of inflationary pressures.

The recent firming in some materials prices probably has more to do with improving demand and the restoration of more normal levels of profit margins than to early signals of sustained inflationary pressures. This hypothesis, of course, suggests that when margins are restored, the rate of material price increases should slow down.

Moreover, labor markets remain slack. The recent firming of wages reported in the March payroll data may reflect nothing more than excess overtime costs of cleanup following the late winter storms. And certainly the evident rise in productivity has to date persuasively contained increases in unit labor costs.

Finally, it is difficult to envision inflationary pressures intensifying in the context of a still partially infirmed financial system and exceptionally subdued credit expansion that tinder of past inflationary episodes. But because the old economic and financial verities have not served us particularly well in understanding the American economy in recent years, we need to be especially vigilant not to be mesmerized by the current tranquility of the inflationary environment.

I cannot indicate to you tonight where Federal Reserve policy will head in the weeks or years ahead. I do know that it would be irresponsible for us to dismiss the experience of the post-Vietnam War years and once again allow the destabilizing forces of inflation to undercut economic growth and employment. Suppressing inflation over the past decade and more has obviously not been without cost. To fritter away this substantial accomplishment by failing to contain inflationary forces that may emerge in the future would be folly.

A society's central bank is rarely popular. Its role in fostering maximum sustainable long-term economic growth requires it at times to take difficult steps to preserve the value of the currency both domestically and abroad. Such preservation of necessity implies inhibitions to inflationary financing whether the initiatives emerge from the private or the public sector. If our financial system is to continue to fund long-term projects, the hallmark of economies offering high living standards, a stable currency and domestic price level are preconditions. Thank you very much. (Applause)

QUESTION AND ANSWER PERIOD

CHAIRMAN RICHARD A. VOELL: Thank you, Alan, for those very illuminating and helpful insights. We now move into the question and answer session of our program. Our questioners this evening are Mr. Martin Davis, Chairman of Paramount Communications, seated to my far right, and Mr. Henry Kaufman, President of Henry Kaufman & Company seated to my far left. And Mr. Kaufman will ask the first question.

HENRY KAUFMAN: Thank you Mr. Chairman. Mr. Chairman, I'd like to ask you the first question concerning the American economy. What are your concerns about the durability of the current moderate economic recovery? Where do you think are the key risks on the upside as well as on the downside?

THE HONORABLE ALAN GREENSPAN: I think it's fairly apparent that if our financial system were whole, so to speak, and not partly infirmed as I earlier indicated, in this context of low inflation and increasing seeming stability, I would suspect that we would see a fairly solid, perhaps not exuberant, but a measurable continued expansion which even though productivity would be rising at a substantial extent in that environment, employment would also be growing and the economy would put on one of its better historical performances. But we do indeed still have an infirmed financial sector, not only commercial banking but obviously in a number of other areas of our economy. And until that fully disappears, it's hard to argue that this economy can continue to build momentum through the expansion. As I've indicated elsewhere, one of the major problems that exists in our financial system is not so much the problem of low commercial real estate values but the fact that there is virtually no market out there. It's an illiquid property market which to a large extent means that even though non-performing loans are calculated on the books of commercial banks, the true value of the collateral is not all that obvious because unless collateral can be sold expeditiously and at reasonably projected prices, one does not really know how good one's reserves are against loans and therefore, one does not know fully what one's capital, or in the extreme case, one's franchise position is. The result of this in my judgment has been a major retardation in lending capacity on the part, or I should say lending willingness, on the part of the commercial banks which obviously has had a fairly substantial and disproportionate effect on small and medium-sized businesses whose major credit financing comes from the commercial banks. And since, I think as all of you are aware, most of the momentum for innovation, risk taking, and employment growth come from our smaller business establishments, in order to maintain a viable expanding economic sector, it is important that that sector be properly financed. So at the moment I would say in the short term, Henry, that's the major element which I think is constraining what the potential outlook could be. In the longer run, I would say the major problem is clearly the difficult, budget deficit difficulties which you are all aware of and to which I alluded to at length in my prepared remarks.

MARTIN DAVIS: Mr. Chairman, as you pointed out healthcare continues to absorb a larger and larger percentage of our GNP. It also continues to be an ever-escalating corporate expense. As the Hillary Clinton Task Force concludes its deliberations, have you or the Fed been consulted on the impact of the reform proposals on the economy and its long-term impact on deficit reduction?

THE HONORABLE ALAN GREENSPAN: Well, I mean since I've had a number of discussions with the administration on a wide variety of subjects, clearly this inevitably came up on different occasions because it's a crucial element within the budget process and indeed as you point out it is not an insignificant element in the issue of permanent employment and the problems that are associated with the particularly high healthcare costs which has induced, at least amongst other things, a significant push towards more part-time and temporary employment rather than the permanent employment which generally characterizes a recovery of the nature that we hope we're in the process of seeing. The problem obviously with healthcare is that unlike what I recall in the early years of, the earlier years of the 20th century when the family doctor used to come, used to pound you on the chest, give you a couple of aspirins, say call me in the morning, that was high-tech medicine. And it obviously didn't cost very much and it's therefore not surprising that through the 20s and the 30s, instead of 14% of the gross domestic product, health costs averaged, as I recall, at something like 3.5%. But when you have the ability of a technology or a set of technologies to enhance human life, which remember did not exist in those days, the pressures to fund such technologies, whether it be equipment or pharmaceuticals, doesn't really matter. The pressures are extraordinarily high and what we get is, and have gotten, is a major diversion of economic resources to the medical area. There has been a set of balancing forces – it's fairly clear that only has technology significantly increased medical costs as well as obviously creating a magnificent medical care system, but technology has also very evidently decreased costs in a lot of areas. And there is a considerable amount of hope, I'm not sure it's terribly much more than that, that the cost element, cost reduction element, of the technology can be a major factor in the years ahead. In any event, it's clearly much too soon to become even modestly optimistic about the issue, but it is the case that the inflation rate for medical care services have been coming down fairly appreciably in the last year or so. And if this is a trend, it might be somewhat helpful in this whole regard. But having said that, it is the medical cost problem, as the president and Mrs. Clinton have said on enumerable occasions, it is a very major policy initiative of this administration for very important reasons. And it is a very large economic policy issue to implement and I'm very hopeful they will come up with viable solutions that can be implemented successfully in the years ahead.

HENRY KAUFMAN: Mr. Chairman, as you know in the past year or so, the behavior of the monetary aggregates has been very difficult to interpret and has served as a rather limited role in probably monetary policy implementation. How do you feel about using monetary aggregates under these circumstances? What other targets or approaches perhaps would you want to put forth here that ought to be part of the monetary approach in setting interest rates and setting targets and so on?

THE HONORABLE ALAN GREENSPAN: Well, Henry, as you know, we have all developed over the years a set of monetary targets which in the guise of M2 a specific set of relationships – I'm not sure it's specific – adding up of certain types of deposits, currency, and a number of other associated elements have basically given us a proxy for the way the total financial system is functioning and therefore its impact on real economic activity and employment. And over the years it has been a very useful indicator largely because it is available almost immediately and tends to lead a number of areas of the economy, the financial sector and ultimately the real sector. So having those monetary aggregates, especially M2, as a viable monetary target clearly made monetary policy a lot easier than it has been in the last year or two when it's fairly apparent that something fundamental, maybe not permanent but pretty important, has happened to the relationship between M2, the monetary aggregates, its relationship to the financial system, and indeed the relationship of the financial system to the economy overall. So rather than being able to focus fairly heavily on the monetary aggregates in gauging the effectiveness of monetary policy, we've had to reach beyond the proxy which in a sense has summarized all the other elements in the economy which one tends to look at. And what that has meant is rather than look at a few things which we knew were summarizing a number of other aspects of the economy, we have had to look at virtually everything and as a consequence we are looking at the whole process on a continuous basis. And that, as I think you would be more aware than most anybody I know, is not an effective set of targets to employ if one wants to feel comfortable with monetary policy implementation. I don't know yet whether what we are looking at in the breakdown, in the relationship between money, short-term borrowing, and economic activity, is something of an irreversible nature. My gut feeling says probably not. But it is a sufficiently long period of transition that in my judgment if we were to follow the M2 targets in a fairly rigid way in a manner which in the past we tended to do, I suspect we would end up with a policy which in retrospect would not have been a sound one. So it's hard to know at this stage what various aggregates one should be looking at or targets, but I'm inclined, as I believe you are, to be looking more at the credit side when conditions such as this arise. And we are clearly very closely watching the whole structure of the commercial banking system, and not only the liability side where a goodly part of the M2 is engendered, but also on the asset side where one gets an inclination of both the propensity to borrow and propensity to lend, and hence, the way in which the commercial banks, not to mention the other financial intermediaries are basically financing economic activity. But as I indicated earlier, because of the shortfall in the basic structure of financial intermediation which is not only the commercial banks but to some extent obviously what's remaining, the savings and loan industry, the life insurance companies, and others, we do have a fairly significant set of problems to keep an eye on. I hope that we may find that we can get through this period without relying on the specific targets that we have so importantly used over the past and hope that they will come back in their useful form. If not, I hope we will be able to unearth from this very unusual state a new set of relationships which will make our job easier. But if not, we will just have to continue what we are doing now and that is watch all aspects of the system in great detail and try to infer how the financial sector is interfacing with the economy and very specifically how Federal Reserve monetary policy is affecting the system as a whole.

MARTIN DAVIS: Mr. Chairman, the Gramm-Rudman-Hollings Act was hailed as the first meaningful step towards deficit reduction yet it failed and the structural deficit is higher now than ever. Do you think Congress can ever discipline itself when it comes to serious spending cuts? And if not, are we just fooling ourselves when it comes to meaningful deficit reduction?

THE HONORABLE ALAN GREENSPAN: Well, I wouldn't argue whether they are or they are not. I would just say there is no alternative because if we fail in reining in the rate of growth in expenditures, unless the laws of arithmetic are repealed, we are in for some very serious financial difficulties over the longer term. So in my judgment, it's not a question of whether, but of necessity, when, and obviously sooner is substantially better than later. (Applause)

HENRY KAUFMAN: Mr. Chairman, you spoke before about the progress that has been made by the commercial banking system in increasing capital, profitability, and so forth. But bankers do complain that they're faced with exceptional burdens as compared with their non-bank financial competitors. As the key central banker, what would you recommend to perhaps make the playing field somewhat more competitive and ease the commercial banking burden?

THE HONORABLE ALAN GREENSPAN: Well, it's obvious that we spend a considerable amount of time on precisely this issue because the burdens are there and while one can argue that a substantial proportion of the decline in commercial bank, in the franchise of the commercial bank which is basically credit knowledge and therefore credit lending, is a function of the extraordinary improvements in technology which have taken the knowledge of individual credit risks which make up the commercial bankers' trade, so to speak, with the high technology and information that has accrued in recent years, his quasi-monopoly insight into credit status has been continuously eroded and that has been obviously a major factor in the decline in the commercial bank status within the financial system. But superimposed on that is an extraordinary amount of regulatory cost which has made the job of competing with other institutions not directly affected by these costs, has made the competitive capability of banks to compete less than we would like. Now one could argue access to the discount window at the Federal Reserve and the existence of a significant amount of deposit insurance has created some advantages, competitive advantages, for commercial banks which the non-commercial banks clearly do not have. And there's a great dispute in and amongst statisticians in trying to evaluate this tradeoff where it all comes out. My impression is, however, that the commercial banks are unduly burdened especially in light of the significant amount of micro-management that is engendering significant costs as a consequence of the Federal Deposit Insurance Improvement Act of last year. This is the reason that not only we at the Federal Reserve but the administration as well is trying to find ways to, as you would put it, level the playing field, but I think it's much too early at this point to make any judgments as to how this particular activity at the end of the day will turn out.

MARTIN DAVIS: Mr. Chairman, Paul Volcker endorsed legislation to make the term of the Fed Chairman coterminous with the president's. Is it a good idea to allow a new president to appoint his own chairman and would you endorse similar legislation?

THE HONORABLE ALAN GREENSPAN: I think that what Paul Volcker was supporting was not coterminous but with a one-year lag so that the president would be in for a year to get his footings and then to make changes. I'm frankly an agnostic on that issue. (Laughter) I've employed my increasing capabilities of being obscure to that end in congressional testimony and I have no endeavor at this point to become unduly clear. (Laughter and Applause)

HENRY KAUFMAN: Mr. Chairman, I'd like to focus your attention a little bit on the international side. Looking back on the convulsions that afflicted the exchange rate mechanism in the fall of last year, what lessons do you think that holds for central bankers? Does it make you more of a floater or more of a fixer?

THE HONORABLE ALAN GREENSPAN: You know, you're asking me what lessons, Henry, and my answer was going to be many. But because I've been eschewing discussing the exchange rates at this stage, I mean in fact I haven't discussed exchange rate policy publicly for so long, I've forgotten what it sounds like in a large audience. And equivalent to the answer to the last question, I'm going to try to beg off and try not to answer that, and I suspect I may be able to be successful. (Laughter)

HENRY KAUFMAN: We'll try it another way. (Laughter) The Japanese government is planning a $110 billion stimulus package to revive an economy half our size while we're having difficulties enacting a $16 billion program. Is the administration's proposal too limited to have an impact on our economy? And if it fails to get off the ground, will the Fed be looking at alternative measures?

THE HONORABLE ALAN GREENSPAN: I was doing fairly well before. I was able to answer almost all of the questions that came up. It's going downhill very rapidly. (Laughter) I will merely repeat what I've said in congressional testimony that the stimulus package of its size in a $6 trillion economy clearly cannot have a substantial effect one way or the other, and I will leave it at that.

MARTIN DAVIS: Let me approach the international side from a little different angle. Now that the LDC debt crisis has substantially diminished and waned, what have we really learned from that that might be applicable, let's say to the problems of Russia, the Eastern European countries that need a substantial amount of credit in order to rehabilitate and to become more viable economic democracies?

THE HONORABLE ALAN GREENSPAN: I think that what we have learned and I think you may have well pointed this out yourself on other occasions, is that what was lent as debt ended up as equity. And it may well be that this whole process that we are, I might say equity inadvertently, this whole very difficult process I think very clearly indicates that the ultimate solution, if one wants to put it that way, is not credits, although credits can clearly act as a bridge to a more important solution, ultimately what you need in the whole area of Eastern Europe that has come out of an extraordinary period under central planning, is a very substantial part, a very heavy dose of equity financing. Indeed, I would suspect that were that done in lieu of the LDC financing a decade or so ago that many of the problems which emerged in the financial system as a consequence clearly would not have happened. But having said that, let me emphasize that equity financing presupposes a basic law of contracts, law of property rights, a legal statute which very broadly defines what constitutes bankruptcy. Because unless you can get a legal system into a previously centrally planned economic system, you cannot really viably have significant privatization on the one hand or equity investment on the other because both presuppose the concept of property values. And what is lacking, has been lacking in Eastern Europe, obviously to an increasingly lesser extent in Poland, the Czech Republic, Slovakia, and Hungary, but still very substantially with difficulties in other areas of Eastern Europe, what is missing is the basic infrastructure for private investment. And one of the reasons why we're all having difficulty in moving equity funds is this basic problem. The Russians fully understand this. I mean they will give you a better lecture on why one needs this than any American can because they are living with it. But I would say parenthetically that one of the things that we take for granted in this country and in the West is a number of institutions like auditing, accounting, the law of contracts, marketing, all the various business professions which we just assume are peripheral to our system. They are crucial to the system and the system couldn't function without it. And we are learning this largely as a consequence of watching how the other countries of Eastern Europe are struggling to emerge as forceful entities in the world free market economy. And one of the lessons that we have learned in all of this is that there are certain priorities of what comes first. And I would say that what you need is the conceptual infrastructure first. You've got to have a culture which supports private property, supports the issue of contractual relationships, and what happens when one abrogates one. Because unless you have that, then the system basically cannot function. So well before we put more debt out as a major force in economic expansion, we have to recognize there's got to be a major layer of equity finance in the system. I fully support, I might say, the initiative that is currently being undertaken by the G-7 in trying to build up a lot of the extremely weak parts of Russia and clearly it is a necessary investment to sustain the bridging process to a better environment. But I think we have to look at this as a very long project and the major issue is how to get investment in these various previously centrally planned economies and that investment has to be principally, if not wholly in some cases, equity investment. I'm not sure we have learned the lesson, as you put it, yet, but I think we are in the process of getting there.

CHAIRMAN RICHARD A. VOELL: We have time for one more question.

HENRY KAUFMAN: Mr. Chairman, I believe you have indicated that given your choice you would prefer deep spending cuts to hefty tax increases as a way of bringing down the deficit. Yet Congress seems to have in your words a propensity to avoid hard choices when it comes to expenditure reductions. It has been suggested that Congress must reinvent itself in order to get meaningful reductions. What about a line item veto or a balanced budget amendment?

THE HONORABLE ALAN GREENSPAN: I have nothing against a line item veto. I think it is a useful tool. It's a limited tool. I wouldn't want to make it appear as though it's going to solve a lot of problems. And while I'm not against a balanced budget amendment in principle, I am against an amendment which, unless we find a means of implementing it, would create a very serious question of legal conflict in our system. I have a technical problem which I communicated to the Senate Finance Committee a couple of weeks ago, and of course it's repeating notions I've had on this question to various committees of the Congress over the years, that one of the difficulties with having a mandated balanced budget amendment is that it starts too late in the spending process. That is, basically a balanced budget amendment stipulates that you cannot expend more than a certain amount of money during a certain particular period. But basically because it's not easy, especially with all of the entitlements we have in our system, to know in advance what the expenditure would be, you can't really do that. And as a consequence, you're confronted with an enforcement problem of what is it you do? And you get very idiosyncratic consequences which we don't need. I think we get the same thing if, for example, we were to have a constitutional amendment which stipulated that you needed a super-majority vote, say 60% of the Congress, to enact an authorization and an appropriation as well as expenditures. In other words, catch the spending process before it gets going so that if you hold the authorizations down and the collateral appropriations, you can subdue spending and get the same result and not be caught as you would in a balanced budget amendment with having to enforce an event which is at that point already in tow. And I also argued before the Senate Finance Committee that I would join that type of either constitutional amendment or legislative vehicle with sunset legislation which essentially would mean that every law has to be re-voted upon every five years, seven years, or what have you. And if the constitutional amendment exists, it would be the super-majority. All of the legislation which is working, is good, has strong support amongst the American people, would have no difficulty whatever being voted through. But you would find inevitably that a minority of the various different forms of programs which we have in this budget would fail the test, which is another way of saying they really don't have the support any longer of the American people. And one way to create discipline in a level of outlays is to be willing to discard the ones which don't work all that well rather than build up as we are prone to do program on program on program. I mean I hate to tell you how many programs we have under various different titles in this government because I've sat through and been involved with programs which were guaranteed to do X 20 years ago. It didn't so we had another program, you know, five or maybe ten years ago to do X. It still doesn't work. And you end up with not obliterating X-1 or X-2 or anything like that. They just are still there. And the way to clean this out is sunset legislation and I must say to you I forcefully advocated that and the silence was deafening. Thank you very much ladies and gentlemen. (Applause)

CHAIRMAN RICHARD A. VOELL: Chairman Greenspan, we're profoundly grateful to you for your years of public service and most particularly for taking your time to share your ideas and your time with us this evening. Thank you very much. The meeting is adjourned.