BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

July 11, 2005

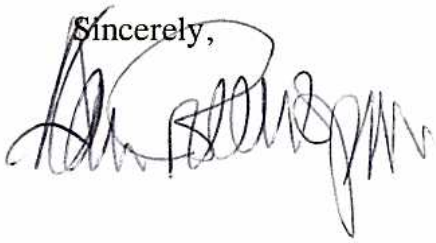
The Honorable Jim Saxton
Chairman
Joint Economic Committee
Washington, D.C. 20510

Dear Mr. Chairman:

I am enclosing for the record my responses to your additional questions following the Committee's hearing of June 9, 2005, on the Economic Outlook.

Please let me know if I can be of further assistance.

Sincerely,



Enclosure

Chairman Greenspan subsequently submitted the following in response to written questions received from Chairman Saxton in connection with the hearing before the Joint Economic Committee on June 9, 2005:

• **Economists have established a connection between movements in the yield spread (i.e., the difference between the long-term bond yield and the fed funds rate) and the thrust of monetary policy. As the yield spread widens, policy becomes easier and becomes tighter as the spread narrows or inverts. Such an empirical relation has been identified by a number of researchers, including several within the Federal Reserve System. Further, the Conference Board uses this spread as one of its most reliable components in its index of leading economic indicators.**

On the other hand, some policymakers and researchers seem to contend that the recent decline in the long-bond yield is an independent source of policy stimulus. An example of this is provided by the recent reduction in the long bond yield that stimulated the real estate sector. In this view, in situations when the yield spread narrows in part due to a decline in the long bond yield, the spread does not measure the same degree of monetary policy restrictiveness. Recently, for example, as the Fed narrowed the spread by increasing the fed funds rate and an accompanying fall in the long-bond yield took place, a given narrowing of the spread was not seen as restrictive as earlier was believed. According to this view, in these circumstances, it is possible that the monetary authorities could misinterpret heretofore important policy indicators.

At our recent JEC hearing, you indicated that the decline of the long-bond yield may be stimulative. In that context,

(1) Could you comment on the above interpretation?
(2) In our current circumstances, do you view a reduction in the long-bond yield as stimulative or restrictive?
(3) Could you expand on your previous discussions of this topic?

Although the slope of the yield curve can at times be a useful indicator, there are several points to bear in mind.

- First, the slope of the yield curve has flattened considerably over the past year, but currently it is about in its average range for the last twenty years.
- Second, a sharp flattening of the yield curve is not a foolproof indicator of economic weakness. Indeed, the yield curve narrowed sharply over the period 1992-1994 even as the economy was entering the longest sustained expansion of the postwar period.

- Third, researchers have developed a number of statistical models relating the slope of the yield curve to future GDP growth. Based on recent readings of the slope of the yield curve, such models typically project continued moderate expansion of GDP for the foreseeable future.

The decline in long-term nominal bond yields observed over the past year appears to have reflected, at least in part, in lower real interest rates. Lower real interest rates reduce the cost of borrowing for households and businesses and support the prices of many other assets. Thus, the decline in long-term yields, other things equal, is stimulative. However, interest rates both affect, and are affected by, a wide range of other variables. Consequently, movements in bond yields should not be assessed in isolation but need to be interpreted in the context of overall domestic and foreign economic and financial developments.

- **During the June 9 Joint Economic Committee hearing, I asked you about a *Wall Street Journal* article published that morning that included criticism of the Fed for its handling of the conditions arising from the 2000 bursting of the stock market and technology bubbles. The article contended that in addressing the macroeconomic fallout of the bubbles that popped in 2000, the Fed helped create a housing bubble that is still expanding. In response to my question, you effectively defended the Fed's actions. However, could you expand on the potential risks to the macroeconomic situation had the Fed not acted as it did in easing monetary policy?**

The Federal Reserve aggressively eased monetary policy over the course of 2001, beginning early that year, in response to factors that were tending to weaken the U.S. economy. Those factors initially included a considerable slump in capital spending in the wake of the shakeout in the technology sector, a substantial inventory correction, a slowing of economic growth abroad, and the effects on consumer spending of the sharp decline in equity prices. Later in the year, those influences were compounded by the adverse economic effects of the terrorist attacks on September 11.

In the event, the United States experienced a recession during 2001, albeit one that was neither especially severe nor prolonged in comparison with other downturns in the post-World-War-II period. Absent the monetary stimulus applied promptly by the Federal Reserve in 2001, that recession could have been considerably deeper and more costly for our nation. The sharp reduction in money market interest rates resulting from our monetary policy actions fostered a considerable easing of broader financial market conditions. Longer-term interest rates fell particularly notably, reaching their lowest levels in decades. The drop in yields provided substantial support to interest-sensitive spending--especially housing, but probably to expenditures on consumer durables and business investment as well. Without the more accommodative financial conditions, this pickup in interest-sensitive spending would presumably have been greatly damped--or may not have

occurred at all--and the result could have been a much more severe economic downturn. Moreover, it is worth recalling that, even as events turned out, inflation appeared to be in the process of falling to uncomfortably low levels--and possibly so low that the ability of monetary policy to help stabilize the economy could have been impaired.

• **Oil prices have increased significantly to levels above $50/b. In assessing the economic effects of these oil price increases, the earlier experience of the U.S. still influences many. Historically, the U.S. has experienced a number of supply-restrictive episodes; prices increased largely because of restrictive supply. The oil price supply shocks of the 1970s, for example, caused prices to increase sharply and adversely impacted the real sectors of most economies.**

Currently, we are again experiencing significant increases in oil prices. Today, however, there are a number of reasons to believe that those oil price hikes may not impact the real economy as severely as earlier episodes of the 1970s did. Consider, for example, the following:

- ✓**The economy is more energy-efficient today.**
- ✓**The real price of oil has not increased to the degree that it did in the 1970s.**
- ✓**Recent price hikes have (for the most part) been the result of increases in demand, and therefore, the product of healthy economies rather than supply-side shortages.**

In view of these considerations, what is the Fed's latest thinking on the following:
(1) The economic affects of our current oil price increases?
(2) The future of the price of oil?

The spot price of West Texas Intermediate crude oil currently is trading around $60 per barrel. The high price reflects the significant global demand for crude oil as well as the limited ability of oil-producing nations to expand their production in the short run. Far-dated futures prices, which reflect the market's expectations of prices six years hence, are around $55 per barrel. The small expected decline from current prices reflects the market's view that the supply-demand balance for oil will not change appreciably over the medium term.

These high oil prices are having an effect on the U.S. economy. Consumer price inflation has moved up along with the higher crude oil prices. This has reduced households' purchasing power and adversely affected spending. Businesses too seem to have reassessed the profitability of some investment projects in the light of significantly higher energy costs. Based on econometric estimates done by the Board staff, the increase in oil prices since the end of 2003 probably has shaved roughly 1/2 percentage point off of real GDP growth last year, and they look to restrain growth this year by approximately

3/4 percentage point. Aside from these "headwinds," the U.S. economy seems to be coping pretty well with the run-up in crude oil prices.

- **A consensus view among monetary policy makers is that monetary policy should not be used to respond to, manage, or attempt to "burst" an asset price "bubble." Rather, monetary policy should be used to provide for overall macroeconomic price stability, not asset price stability in one particular sector. Should a "bubble burst" and adversely affect the macroeconomy, then the monitoring authority can and should respond.**

  - ✓**Given this view, is there any regulatory policy tool that can be used to moderate lending in "frothy" sectors that fuel asset price inflation?**

  - ✓**Is there a "regulatory substitute" that can help minimize asset bubbles?**

  - ✓**Is the recent Interagency Credit Risk Management Guidance for Home Equity Lending such an attempt?**

  - ✓**Is this Guidance an example of some "regulatory suasion" to help with this problem?**

  - ✓**What regulatory options does the Federal Reserve have to better manage or influence asset bubbles?**

  - ✓**What are the most risky lending practices currently contributing to the froth in the housing sector?**

Bank regulatory policies are neither designed nor used to influence asset prices in particular sectors of the economy. Rather, their purpose is to ensure adequate bank risk management and thereby strengthen the safety and soundness of individual banking firms, foster a resilient banking system, and protect FDIC-insured deposits. To be sure, bank regulatory policies can be influenced by macroeconomic and broad market developments. Macroeconomic and market trends and risks may induce action to modify regulations, particularly if banks do not appear to be taking appropriate account of such developments in the measurement and management of their own risks.

With respect to regulatory options or "regulatory substitutes" to address asset price bubbles, some observers have suggested increasing margin requirements to counter perceived speculation in equities markets. Even if one presumes that a bubble in this market can be identified before it bursts, however, such an approach is unlikely to succeed. Only a small fraction of equity is purchased using credit. Moreover, money is fungible, so that if an attempt were made to limit the amount of credit that could be used for a

particular purpose, say, the purchase of securities, it is highly likely that some investors who would be constrained by such a regulation would find ways to channel credit from other sources to effect the desired purchases--for example, by funding more of the security purchase with funds ostensibly borrowed for other purposes, such as mortgage or consumer loans.

The recent Interagency Credit Risk Management Guidance for Home Equity Lending was not a regulatory effort to combat a housing price bubble, nor was it an example of regulatory suasion aimed at asset prices. Rather, it was a response to indications that some banks were not appropriately managing risks in the home equity area. The regulatory system is not designed to influence or control asset bubbles, but rather to ensure that bubbles, should they develop, do not lead to unsafe lending practices. Although the guidance was not aimed at affecting asset prices directly, it may nevertheless affect market conditions through changes in the availability of credit for some riskier households.

As I indicated in my testimony, there does not appear to be a "bubble" in home prices for the nation as a whole, but there are signs of "froth" in some local markets where home prices seem to have risen to unsustainable levels. It is not clear whether lending practices have contributed to these local conditions. After all, the mortgage market is national in scope, while rapid price increases have been in particular areas. The Interagency Credit Risk Management Guidance for Home Equity Lending listed a number of product, risk management, and underwriting risk factors and trends that suggested that some financial institutions may not fully recognize the risk embedded in home equity loan portfolios. These factors include interest-only features on some loans, loans with limited or no documentation of borrowers' financial condition, high loan-to-value and debt-to-income ratios, greater use of automated valuation models, and increased use of loan brokers or other third parties to generate transactions. These factors have not necessarily had a material effect on housing prices. The possibility that home prices may be unsustainably high does, however, contribute to the risks associated with such lending, since it may suggest that the value of some loans' collateral may be vulnerable to declines. Indeed, the guidance indicated that financial institutions should perform stress tests of their key portfolio segments, including evaluations of the effects of declines in home values.