Chairman Greenspan subsequently submitted the following in response to written questions received from Chairman Shelby in connection with the July 20, 2004, hearing before the Committee on Banking, Housing, and Urban Affairs:

Q.1: The Housing Sector

The semi-annual written report refers to activity in the housing sector remaining "torrid" in the first half of 2004. There have been some concerns expressed about a potential bubble in housing prices. Your report indicates that house price increases have outstripped gains in incomes as well as rents in recent years. In a recent speech, one member of the Board of Governors, Governor Kohn, indicated that "the odds have risen that these prices could be out of line with fundamentals." Governor Kohn also indicated that "we still cannot be very confident about whether a significant misalignment exists, however."

- **What is your assessment of the continued rise in housing prices? Are there any particular geographic sectors that you are more concerned about than others?**

A.1: As you note, the most recent *Monetary Policy Report to the Congress* indicated that house price increases have outstripped gains in income as well as rents in recent years. This observation raises the possibility that real estate prices, at least in some markets, could be out of alignment with the fundamentals. But as Governor Kohn notes, that conclusion cannot be reached with any confidence. For example, the rise in house prices relative to rents and incomes has, no doubt, been influenced by the low level of mortgage interest rates in recent years in ways that cannot be gauged precisely. Moreover, the available data are not fully adequate for a complete analysis of the issue; house prices are difficult to measure given the enormous heterogeneity of the U.S. housing stock--both within and across geographic regions--and available measures of residential rents do not match precisely with the units for which we have prices. Although taking a firm stand on the appropriateness of real estate prices is not possible, policymakers do need to take account of their influence on economic activity. As is the case with other asset prices, we monitor real estate prices closely in developing our economic outlook.

The data limitations that prevent a complete analysis of housing price developments at the national level are even more binding at the local level, making it especially difficult to detect asset price misalignments for specific markets.

Q.2: Improvements in the World Economy

The semi-annual report comments on solid gains in U.S. exports since mid-2003 due to the strong economic performance of many of the major trading partners. What is your view as to the continued economic strength of our trading partners? In particular, do you believe the improvements in Japan will continue?

A.2: Over the past year, the global economic recovery has become both stronger and more sustainable. Growth has strengthened in every major region compared with the sluggish performance during the first half of 2003, and recent indicators suggest that the foreign economies continue to put in a favorable performance. To be sure, average growth in emerging Asia appears to have braked sharply in recent months, as policy measures muffled the boom in the Chinese economy. However, continued strong export growth and recent signs of an acceleration in consumer spending suggest that Chinese GDP growth will rebound in the second half of this year. Recovery in Canada and in Latin America also appears to be on track, and economic expansion in the United Kingdom continues unabated. The pace of recovery in the euro area has been sluggish, however, with particularly weak activity in Germany.

In Japan, the rebound that began last year has continued to broaden. Japanese exports have grown rapidly over the past couple of years, as exports to China and other emerging Asian economies have surged. The expansion in exports has contributed to a snapback in corporate profits in the export-related manufacturing sector, and the revival in profits appears to be spreading to the more domestic-oriented non-manufacturing sector. Rising profitability along with improving conditions in the corporate sector more generally have allowed investment to rebound from its recent trough. Labor markets have also revived, with employment rising and the unemployment rate declining from a peak of 5-1/2 percent early last year to 4.6 percent at present. Against this backdrop of strengthening activity, consumer price deflation has eased markedly since early 2002.

These positive developments suggest that Japan may finally be on its way to a self-sustaining recovery. However, there are several risks to the outlook. In particular, the recent run-up in oil prices, if sustained, may exert a significant drag on Japanese economic activity. Moreover, Japanese consumption has risen sharply over recent quarters, while employee compensation has fallen. The result has been a marked decline in the household saving rate. Most analysts expect the saving rate to move up as economic conditions improve. If this happens abruptly, consumption might lag the recovery even if compensation begins to rise. Third, the possibility of a hard landing in China carries significant risks for Japan as well as for other Asian economies. Finally, bank lending in Japan continues to contract, and more aggressive financial sector restructuring remains important for Japan's long-term growth prospects.

Q.3: The President's Working Group & Hedge Funds

In 1999, the President's Working Group concluded that "requiring hedge fund managers to register as investment advisers would not seem to be an appropriate method to monitor hedge fund activity."

- **a) In the intervening five years, have market conditions changed in order to justify a different conclusion?**

A.3a: No. The Working Group's report made two arguments in support of this conclusion. First, it argued that the provision of the Investment Advisers Act that exempts hedge fund managers from registration (Section 203(b)(3)) evidences a Congressional determination that clients of an advisor that has relatively few clients do not need the substantive protections of the Investment Advisers Act. Congress has not repealed Section 203(b)(3). Second, it argued that the sophisticated investors that typically invest in hedge funds are in a position to protect their own interests. There is no evidence that investors in hedge funds today are less sophisticated than they were in 1999. Indeed, institutional investors have accounted for a growing share of hedge fund investments, and they can and should protect their own interests rather than rely on the limited regulatory protections that would be provided as a result of a registration requirement.

- **b) What, if any, mechanism would be the appropriate method for monitoring hedge fund activity in light of their growth in recent years and the increased investor involvement while at the same time being mindful of liquidity concerns?**

A.3b: The case for monitoring hedge fund activity has not been made. Some have argued that monitoring of hedge funds is necessary to detect and deter market manipulation. But the data collected from registered advisers is limited to total assets under management, which would provide no insight into any manipulative activities. Concerns about market manipulation, whether by hedge funds or others, can best be addressed by enhanced market surveillance. If there were a public policy reason to monitor hedge fund activity, the best method of doing so without raising liquidity concerns would be indirectly through oversight of those broker-dealers (so-called prime brokers) that clear, settle, and finance trades for hedge funds. Although the use of multiple prime brokers by the largest funds would complicate the monitoring of individual funds by this method, such monitoring could provide much useful information on the hedge fund sector as a whole.