Mr Greenspan presents the Federal Reserve's semi-annual report on the economy and monetary policy to the US House of Representatives

Testimony of Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Banking and Financial Services, US House of Representatives on 17 February 2000.

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I appreciate this opportunity to present the Federal Reserve's *semi-annual report on the economy and monetary policy*.

There is little evidence that the American economy, which grew more than 4% in 1999 and surged forward at an even faster pace in the second half of the year, is slowing appreciably. At the same time, inflation has remained largely contained. An increase in the overall rate of inflation in 1999 was mainly a result of higher energy prices. Importantly, unit labor costs actually declined in the second half of the year. Indeed, still-preliminary data indicate that total unit cost increases last year remained extraordinarily low, even as the business expansion approached a record nine years. Domestic operating profit margins, after sagging for eighteen months, apparently turned up again in the fourth quarter, and profit expectations for major corporations for the first quarter have been undergoing upward revisions since the beginning of the year - scarcely an indication of imminent economic weakness.

The economic forces at work

Underlying this performance, unprecedented in my half-century of observing the American economy, is a continuing acceleration in productivity. Non-farm business output per workhour increased 3¼% during the past year - likely more than 4% when measured by non-farm business income. Security analysts' projections of long-term earnings, an indicator of expectations of company productivity, continued to be revised upward in January, extending a string of upward revisions that began in early 1995. One result of this remarkable economic performance has been a pronounced increase in living standards for the majority of Americans. Another has been a labor market that has provided job opportunities for large numbers of people previously struggling to get on the first rung of a ladder leading to training, skills, and permanent employment.

Yet those profoundly beneficial forces driving the American economy to competitive excellence are also engendering a set of imbalances that, unless contained, threaten our continuing prosperity. Accelerating productivity entails a matching acceleration in the potential output of goods and services and a corresponding rise in real incomes available to purchase the new output. The problem is that the pickup in productivity tends to create even greater increases in aggregate demand than in potential aggregate supply. This occurs principally because a rise in structural productivity growth has its counterpart in higher expectations for long-term corporate earnings. This, in turn, not only spurs business investment but also increases stock prices and the market value of assets held by households, creating additional purchasing power for which no additional goods or services have yet been produced.

Historical evidence suggests that perhaps three to four cents out of every additional dollar of stock market wealth eventually is reflected in increased consumer purchases. The sharp rise in the amount of consumer outlays relative to disposable incomes in recent years, and the corresponding fall in the saving rate, has been consistent with this so-called wealth effect on household purchases. Moreover, higher stock prices, by lowering the cost of equity capital, have helped to support the boom in capital spending.

Outlays prompted by capital gains in excess of increases in income, as best we can judge, have added about 1 percentage point to annual growth of gross domestic purchases, on average, over the past five years. The additional growth in spending of recent years that has accompanied these wealth gains as well as other supporting influences on the economy appears to have been met in about equal measure from increased net imports and from goods and services produced by the net increase in newly hired workers over and above the normal growth of the work force, including a substantial net inflow of workers from abroad.

But these safety valves that have been supplying goods and services to meet the recent increments to purchasing power largely generated by capital gains cannot be expected to absorb an excess of demand over supply indefinitely. First, growing net imports and a widening current account deficit require ever larger portfolio and direct foreign investments in the United States, an outcome that cannot continue without limit.

Imbalances in the labor markets perhaps may have even more serious implications for inflation pressures. While the pool of officially unemployed and those otherwise willing to work may continue to shrink, as it has persistently over the past seven years, there is an effective limit to new hiring, unless immigration is uncapped. At some point in the continuous reduction in the number of available workers willing to take jobs, short of the repeal of the law of supply and demand, wage increases must rise above even impressive gains in productivity. This would intensify inflationary pressures or squeeze profit margins, with either outcome capable of bringing our growing prosperity to an end.

As would be expected, imbalances between demand and potential supply in markets for goods and services are being mirrored in the financial markets by an excess in the demand for funds. As a consequence, market interest rates are already moving in the direction of containing the excess of demand in financial markets and therefore in product markets as well. For example, BBB corporate bond rates adjusted for inflation expectations have risen by more than 1 percentage point during the past two years. However, to date, rising business earnings expectations and declining compensation for risk have more than offset the effects of this increase, propelling equity prices and the wealth effect higher. Should this process continue, however, with the assistance of a monetary policy vigilant against emerging macroeconomic imbalances, real long-term rates will at some point be high enough to finally balance demand with supply at the economy's potential in both the financial and product markets. Other things equal, this condition will involve equity discount factors high enough to bring the rise in asset values into line with that of household incomes, thereby stemming the impetus to consumption relative to income that has come from rising wealth. This does not necessarily imply a decline in asset values - although that, of course, can happen at any time for any number of reasons - but rather that these values will increase no faster than household incomes.

Because there are limits to the amount of goods and services that can be supplied from increasing net imports and by drawing on a limited pool of persons willing to work, it necessarily follows that consumption cannot keep rising faster than income. Moreover, outsized increases in wealth cannot persist indefinitely either. For so long as the levels of consumption and investment are sensitive to asset values, equity values increasing at a pace faster than income, other things equal, will induce a rise in overall demand in excess of potential supply. But that situation cannot persist without limit because the supply safety valves are themselves limited.

With foreign economies strengthening and labor markets already tight, how the current wealth effect is finally contained will determine whether the extraordinary expansion that it has helped foster can slow to a sustainable pace, without destabilizing the economy in the process.

Technological change continues apace

On a broader front, there are few signs to date of slowing in the pace of innovation and the spread of our newer technologies that, as I have indicated in previous testimonies, have been at the root of our extraordinary productivity improvement. Indeed, some analysts conjecture that we still may be in the earlier stages of the rapid adoption of new technologies and not yet in sight of the stage when this wave of innovation will crest. With so few examples in our history, there is very little basis for determining the particular stage of development through which we are currently passing.

Without doubt, the synergies of the microprocessor, laser, fiber-optic glass, and satellite technologies have brought quantum advances in information availability. These advances, in turn, have dramatically decreased business operational uncertainties and risk premiums and, thereby, have engendered major cost reductions and productivity advances. There seems little question that further major advances lie ahead. What is uncertain is the future pace of the application of these innovations, because it is this pace that governs the rate of change in productivity and economic potential.

Monetary policy, of course, did not produce the intellectual insights behind the technological advances that have been responsible for the recent phenomenal reshaping of our economic landscape. It has, however, been instrumental, we trust, in establishing a stable financial and economic environment with low inflation that is conducive to the investments that have exploited these innovative technologies.

Federal budget policy has also played a pivotal role. The emergence of surpluses in the unified budget and of the associated increase in government saving over the past few years has been exceptionally important to the balance of the expansion, because the surpluses have been absorbing a portion of the potential excess of demand over sustainable supply associated partly with the wealth effect. Moreover, because the surpluses are augmenting the pool of domestic saving, they have held interest rates below the levels that otherwise would have been needed to achieve financial and economic balance during this period of exceptional economic growth. They have, in effect, helped to finance and sustain the productive private investment that has been key to capturing the benefits of the newer technologies that, in turn, have boosted the long-term growth potential of the US economy.

The recent good news on the budget suggests that our longer-run prospects for continuing this beneficial process of recycling savings from the public to the private sectors have improved greatly in recent years. Nonetheless, budget outlays are expected to come under mounting pressure as the baby boom generation moves into retirement, a process that gets under way a decade from now. Maintaining the surpluses and using them to repay debt over coming years will continue to be an important way the federal government can encourage productivity-enhancing investment and rising standards of living. Thus, we cannot afford to be lulled into letting down our guard on budgetary matters, an issue to which I shall return later in this testimony.

The economic outlook

Although the outlook is clouded by a number of uncertainties, the central tendencies of the projections of the Board members and Reserve Bank presidents imply continued good economic performance in the United States. Most of them expect economic growth to slow somewhat this year, easing into the 3½-3¾% area. The unemployment rate would remain in the neighborhood of 4-4¼%. The rate of inflation for total personal consumption expenditures is expected to be 1¾-2%, at or a bit below the rate in 1999, which was elevated by rising energy prices.

In preparing these forecasts, the Federal Open Market Committee members had to consider several of the crucial demand- and supply-side forces I referred to earlier. Continued favorable developments in labor productivity are anticipated both to raise the economy’s capacity to produce and, through its supporting effects on real incomes and asset values, to boost private domestic demand. When productivity-driven wealth increases were spurring demand a few years ago, the effects on resource utilization and inflation pressures were offset in part by the effects of weakening foreign economies and a rising foreign exchange value of the dollar, which depressed exports and encouraged imports. Last year, with the welcome recovery of foreign economies and with the leveling out of the dollar, these factors holding down demand and prices in the United States started to unwind. Strong growth in foreign economic activity is expected to continue this year, and, other things equal, the effect of the previous appreciation of the dollar should wane, augmenting demand on US resources and lessening one source of downward pressure on our prices.

As a consequence, the necessary alignment of the growth of aggregate demand with the growth of potential aggregate supply may well depend on restraint on domestic demand, which continues to be buoyed by the lagged effects of increases in stock market valuations. Accordingly, the appreciable increases in both nominal and real intermediate- and long-term interest rates over the last two years should act as a needed restraining influence in the period ahead. However, to date, interest-sensitive spending has remained robust, and the FOMC will have to stay alert for signs that real interest rates have not yet risen enough to bring the growth of demand into line with that of potential supply, even should the acceleration of productivity continue.

Achieving that alignment seems more pressing today than it did earlier, before the effects of imbalances began to cumulate, lessening the depth of our various buffers against inflationary pressures. Labor markets, for example, have tightened in recent years as demand has persistently outstripped even accelerating potential supply. As I have previously noted, we cannot be sure in an environment with so little historical precedent what degree of labor market tautness could begin to push unit costs and prices up more rapidly. We know, however, that there is a limit, and we can be sure that the smaller the pool of people without jobs willing to take them, the closer we are to that limit. As the FOMC indicated after its last meeting, the risks still seem to be weighted on the side of building inflation pressures.

A central bank can best contribute to economic growth and rising standards of living by fostering a financial environment that promotes overall balance in the economy and price stability. Maintaining an environment of effective price stability is essential, because the experience in the United States and abroad has underscored that low and stable inflation is a prerequisite for healthy, balanced, economic expansion. Sustained expansion and price stability provide a backdrop against which workers and businesses can respond to signals from the marketplace in ways that make most efficient use of the evolving technologies.

Federal budget policy issues

Before closing, I should like to revisit some issues of federal budget policy that I have addressed in previous congressional testimony. Some modest erosion in fiscal discipline resulted last year through the use of the "emergency" spending initiatives and some "creative accounting". Although somewhat disappointing, that erosion was small relative to the influence of the wise choice of the Administration and the Congress to allow the bulk of the unified budget surpluses projected for the next several years to build and retire debt to the public. The idea that we should stop borrowing from the social security trust fund to finance other outlays has gained surprising - and welcome - traction, and it establishes, in effect, a new budgetary framework that is centered on the on-budget surplus and how it should be used.

This new framework is useful because it offers a clear objective that should strengthen budgetary discipline. It moves the budget process closer to accrual accounting, the private-sector norm, and - I would hope - the ultimate objective of federal budget accounting.

The new budget projections from the Congressional Budget Office and the Administration generally look reasonable. But, as many analysts have stressed, these estimates represent a midrange of possible outcomes for the economy and the budget, and actual budgetary results could deviate quite significantly from current expectations. Some of the uncertainty centers on the likelihood that the recent spectacular growth of labor productivity will persist over the years ahead. Like many private forecasters, the CBO and the Office of Management and Budget assume that productivity growth will drop back somewhat from the recent stepped-up pace. But a distinct possibility, as I pointed out earlier, is that the development and diffusion of new technologies in the current wave of innovation may still be at a relatively early stage and that the scope for further acceleration of productivity is thus greater than is embodied in these budget projections. If so, the outlook for budget surpluses would be even brighter than is now anticipated.

But there are significant downside risks to the budget outlook as well. One is our limited knowledge of the forces driving the surge in tax revenues in recent years. Of course, a good part of that surge is due to the extraordinary rise in the market value of assets which, as I noted earlier, cannot be sustained at the pace of recent years. But that is not the entire story. These relationships are complex, and until we have detailed tabulations compiled from actual tax returns, we shall not really know why individual tax revenues, relative to income, have been even higher than would have been predicted from rising asset values and bracket creep. Thus, we cannot rule out the possibility that this so-called “tax surprise”, which has figured so prominently in the improved budget picture of recent years, will dissipate or reverse. If this were to happen, the projected surpluses, even with current economic assumptions, would shrink appreciably and perhaps disappear. Such an outcome would be especially likely if adverse developments occurred in other parts of the budget as well - for example, if the recent slowdown in health care spending were to be followed by a sharper pickup than is assumed in current budget projections.

Another consideration that argues for letting the unified surpluses build is that the budget is still significantly short of balance when measured on an accrual basis. If social security, for example, were measured on such a basis, counting benefits when they are earned by workers rather than when they are paid out, that program would have shown a substantial deficit last year. The deficit would have been large enough to push the total federal budget into the red, and an accrual-based budget measure could conceivably record noticeable deficits over the next few years, rather than the surpluses now indicated by the official projections for either the total unified budget or the on-budget accounts. Such accruals take account of still growing contingent liabilities that, under most reasonable sets of actuarial assumptions, currently amount to many trillions of dollars for social security benefits alone.

Even if accrual accounting is set aside, it might still be prudent to eschew new longer-term, potentially irreversible commitments until we are assured that the on-budget surplus projections are less conjectural than they are, of necessity, today.

Allowing surpluses to reduce the debt to the public, rather than for all practical purposes irrevocably committing to their disposition in advance, can be viewed as a holding action pending the clarification of the true underlying budget outcomes of the next few years. Debt repaid can very readily be reborrowed to fund delayed initiatives.

More fundamentally, the growth potential of our economy under current circumstances is best served, in my judgment, by allowing the unified budget surpluses presently in train to materialize and thereby reduce Treasury debt held by the public.

Yet I recognize that growing budget surpluses may be politically infeasible to defend. If this proves to be the case, as I have also testified previously, the likelihood of maintaining a still satisfactory overall budget position over the longer run is greater, I believe, if surpluses are used to lower tax rates rather than to embark on new spending programs. History illustrates the difficulties of keeping spending in check, especially in programs that are open-ended commitments, which too often have led to larger outlays than initially envisioned. Decisions to reduce taxes, however, are more likely to be contained by the need to maintain an adequate revenue base to finance necessary government services. Moreover, especially if designed to lower marginal rates, tax reductions can offer favorable incentives for economic performance.

Conclusion

As the US economy enters a new century as well as a new year, the time is opportune to reflect on the basic characteristics of our economic system that have brought about our success in recent years. Competitive and open markets, the rule of law, fiscal discipline, and a culture of enterprise and entrepreneurship should continue to undergird rapid innovation and enhanced productivity that in turn should foster a sustained further rise in living standards. It would be imprudent, however, to presume that the business cycle has been purged from market economies so long as human expectations are subject to bouts of euphoria and disillusionment. We can only anticipate that we will readily take such diversions in stride and trust that beneficent fundamentals will provide the framework for continued economic progress well into the new millennium.