Alan Greenspan: The condition of the financial markets

Testimony of Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, 20 September 2001.

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I would like to begin my remarks this morning by noting how deeply saddened I and my Federal Reserve colleagues are that so many talented and productive people from so many walks of life were lost or irreparably harmed last week. Although we are here today to discuss some of the immediate economic and financial implications of that tragedy, we are all too aware that the topic we discuss will be a mere footnote.

The terrorism of September 11 will, doubtless, have significant effects on the U.S. economy over the short term. An enormous effort will be required on the part of many to cope with the human and physical destruction. But as we struggle to make sense of our profound loss and its immediate consequences for the economy, we must not lose sight of our longer-run prospects, which have not been significantly diminished by these terrible events.

Over the past couple of decades, the American economy has become increasingly resilient to shocks. Deregulated financial markets, far more flexible labor markets, and, more recently, the major advances in information technology have enhanced our ability to absorb disruptions and recover.

In the past, our economy has quickly regained its previous levels following the devastation of hurricanes, earthquakes, floods, and myriad other natural disasters that periodically batter various regions of our country. Although the trauma of September 11 shares some characteristics with such disruptions, the differences are important. In contrast to natural disasters, last week's events are of far greater concern because they strike at the roots of our free society, one aspect of which is our market-driven economy. All modern economies require the confidence that free-market institutions are firmly in place and that commitments made today by market participants will be honored not only tomorrow, but for years into the future. The greater the degree of confidence in the state of future markets, the greater the level of long-term investment. The shock of September 11, by markedly raising the degree of uncertainty about the future, has the potential to result, for a time, in a pronounced disengagement from future commitments. And that, in the short run, would imply a lessened current level of activity. Indeed, much economic activity ground to a halt last week.

But the foundations of our free society remain sound, and I am confident that we will recover and prosper as we have in the past. As a consequence of the spontaneous and almost universal support that we received from around the world, an agreement on a new round of multilateral trade negotiations now seems more feasible. Such an outcome would lead to a stronger global market system. A successful round would not only significantly enhance world economic growth but also answer terrorism with a firm reaffirmation of our commitment to open and free societies.

But before the recovery process gets under way, stability will need to be restored to the American economy and to others around the world. Arguably, that stability was only barely becoming evident in the United States in the period immediately preceding the acts of terrorism. Aggregate measures of production, employment, and business spending continued to be weak.

That said, consumer spending moved higher in August and appeared to be reasonably well maintained in the first part of September. Industry analysts suggest that motor vehicle sales were running close to August levels, and chain store sales were only modestly lower. Purchasing managers had noted an improvement in the orders picture in August. Moreover, the dramatic rate of decline in profits was slowing. To be sure, these signs were tentative but, on the whole, encouraging.

During the past week, of course, the level of activity has declined. The shock is most evident in consumer markets where many potential purchasers stayed riveted to their televisions and away from shopping malls. Both motor vehicle sales and sales at major chain stores, some of our most current information on consumer spending, appear to have fallen off noticeably. And, the airline and travel industries have suffered severe cutbacks.

The unprecedented shutdown of American air travel and tightened border restrictions have induced dramatic curtailments of production at some establishments with tight just-in-time supply chain practices. Automakers, for example, are reported to have pared production and even closed some plants in the past week, largely owing to supply shortages, though, doubtless, short-term demand uncertainties have also played a part.

The effect on financial markets of the devastating attack on the World Trade Center was pronounced, as telecommunications and trading capacities were severely impaired. But the markets are mostly functioning now, albeit in some cases using contingency arrangements, and, as in the past, the infrastructure will be rapidly restored.

For a brief time, the terrorist attack markedly disrupted payment transfers that are usually measured in terms of trillions of dollars each day. Many obligators temporarily lost their technical ability to pay on time, leaving those counting on receiving payments caught short. The pressures ultimately ended up concentrated in banks. Those needs were met by the Federal Reserve, both through record lending at the discount window and through an extraordinary infusion of funds through open market operations. To facilitate the channeling of dollar liquidity to foreign financial institutions operating in the United States, thirty-day currency swap lines were arranged with major central banks, again in record volumes. It was essential in such an environment to meet all appropriate demands for dollar liquidity. As the financial markets and payment infrastructure return to normal, loans are being repaid, and the temporarily bloated balance sheet of the Federal Reserve is now shrinking back to normal.

Nobody has the capacity to fathom fully how the tragedy of September 11 will play out. But in the weeks ahead, as the shock wears off, we should be able to better gauge how the ongoing dynamics of these events are shaping the immediate economic outlook.

For the longer term, prospects for continued rapid technological advance and associated faster productivity growth are scarcely diminished. Those prospects, born of the ingenuity of our people and the strength of our system, fortify a promising future for our free nation.