Alan Greenspan: The state of the U.S. economy

Testimony by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on the Budget, U.S. Senate, Washington, 24 January 2002.

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Mr. Chairman and members of the committee, in just a few weeks, the Federal Reserve Board will submit its semiannual report on monetary policy to the Congress. That report, and my accompanying testimony, will give our detailed assessment of the outlook for the U.S. economy and the implications of that outlook for monetary policy. This morning, I would like to offer some general comments about the state of the economy before turning to the federal budget. I want to emphasize that I speak for myself and not necessarily for the Federal Reserve.

It is clear that the U.S. economy went through a significant cyclical adjustment in 2001 that was exacerbated by the effects of the terrorist attacks on September 11. That adjustment was characterized by sharp reductions in business investment and pronounced liquidations in business inventories and was compounded by the simultaneous economic difficulties of some of our major trading partners. But there have been signs recently that some of the forces that have been restraining the economy over the past year are starting to diminish and that activity is beginning to firm.

One key consideration in that assessment is the behaviour of inventories. Stocks in many industries have been drawn down to levels at which firms will soon need to taper off their rate of liquidation, if they have not already done so. Any slowing in the rate of inventory liquidation will induce a rise in industrial production if demand for those products is stable or is falling only moderately. That rise in production will, other things being equal, increase household income and spending. The runoff of inventories, even apart from the large reduction in motor vehicle stocks, remained sizable in the fourth quarter. Hence, with production running well below sales, the potential positive effect on income and spending of the inevitable cessation of inventory liquidation could be significant.

But that impetus to activity will be short-lived unless sustained growth of final demand kicks in before the positive effects of the swing from inventory liquidation to accumulation dissipate. Most recoveries in the post-World War II period received a boost from a rebound in demand for consumer durables and housing from recession-depressed levels in addition to some abatement of the liquidation of inventories. Through most of last year's slowdown, in contrast to the usual pattern, the household sector was a major stabilizing force. As a consequence, although household spending should continue to trend up, the potential for significant acceleration in activity in this sector is more limited.

In fact, there are a number of pluses and minuses in the outlook for household spending. Low mortgage interest rates and favorable weather have provided considerable support to homebuilding in recent months. Moreover, attractive mortgage rates have bolstered both the sales of existing homes and the realized capital gains that those sales engender. They have also spurred refinancing of existing homes and the associated liquification of increases in house values. These gains have been important to the ongoing extraction of home equity for consumption and home modernization. The pace of such extractions likely dropped in response to the decline in refinancing activity that followed the backup in mortgage rates that began in early November. But mortgage rates remain at low levels and should continue to provide support to activity in this sector.

Consumer spending received a considerable lift from the sales of new motor vehicles, which were remarkably strong in October and November owing to major financing incentives. Sales have receded some as incentives were scaled back, but they have remained surprisingly resilient. Other consumer spending appears to have advanced at a moderate pace in recent months.

The substantial declines in the prices of natural gas, fuel oil, and gasoline have clearly provided some support to real disposable income and spending. To have a more persistent effect on the ongoing growth of total personal consumption expenditures, energy prices would need to continue declining. Futures prices do not suggest that such a decline is in the immediate offing, but the forecast record of these markets is less than sterling.

Although the quantitative magnitude and the precise timing of the wealth effect remain uncertain, the steep decline in stock prices since March 2000 has, no doubt, curbed the growth of household spending. Although stock prices recently have retraced a portion of their earlier losses, the restraining effects from the net decline in equity values presumably have not, as yet, fully played out. Future wealth effects will depend importantly on whether corporate earnings improve to the extent currently embedded in share prices.

Perhaps most central to the outlook for consumer spending will be developments in the labor market. The pace of layoffs quickened last fall, especially after September 11, and the unemployment rate rose sharply. Over the past month or so, however, initial claims for unemployment insurance have decreased markedly, on balance, suggesting some abatement in the rate of job loss.

Although this development would be welcome, the unemployment rate may continue to rise for a time, and job losses could put something of a damper on consumer spending. However, the extent of such restraint will depend on how much of any rise in unemployment is the result of weakened demand and how much reflects strengthened productivity. In the latter case, average real incomes could rise, at least partially offsetting losses of purchasing power that stem from diminished levels of employment. Indeed, fragmentary data suggest that productivity has held up quite well of late.

The dynamics of inventory investment and the balance of factors influencing consumer demand will have important consequences for the economic outlook in coming months. But the broad contours of the present cycle have been, and will continue to be, driven by the evolution of corporate profits and capital investment.

The retrenchment in capital spending over the past year was central to the sharp slowing we experienced in overall activity. The steep rise in high-tech spending that occurred in the early post-Y2K months was clearly not sustainable. The demand for many of the newer technologies was growing rapidly, but capacity was expanding even faster, exerting severe pressure on prices and profits. New orders for equipment and software hesitated in the middle of 2000 and then fell sharply as firms re-evaluated their capital investment programs. Uncertainty about economic prospects boosted risk premiums significantly, and this rise, in turn, propelled required, or hurdle, rates of return to markedly elevated levels. In most cases, businesses required that new investments pay off much more rapidly than they had previously. For much of last year, the resulting decline in investment outlays was fierce and unrelenting. Although the weakness was most pronounced in the technology area, the reductions in capital outlays were broad-based.

These cutbacks in capital spending interacted with, and were reinforced by, falling profits and equity prices. Indeed, a striking feature of the current cyclical episode relative to many earlier ones has been the virtual absence of pricing power across much of American business, as increasing globalization and deregulation have enhanced competition. In this low-inflation environment, firms have perceived very little ability to pass cost increases on to customers. Growth in hourly labor compensation has slowed in response to deteriorating economic conditions, but even those smaller increases have continued to outstrip gains in output per hour for the corporate sector on a consolidated basis. The result has been that profit margins are still under pressure.

Business managers, with little opportunity to raise prices, have moved aggressively to stabilize cash flows by trimming workforces. These efforts have limited the rise in unit costs, attenuated the pressure on profit margins, and ultimately helped to preserve the vast majority of private-sector jobs. To the extent that businesses are successful in stabilizing and eventually boosting profits and cash flow, capital spending should begin to recover more noticeably.

Such success would likely be accompanied by a decline in elevated risk premiums back to more normal levels and, with real rates of return on high-tech equipment still attractive, should provide an additional spur to new investment. When capital spending fully recovers, its growth is likely to be less frenetic than that which characterized 1999 and early 2000--a period during which outlays were boosted by the dislocations of Y2K and the extraordinarily low cost of capital faced by many firms.

Still, the evidence strongly suggests that new technologies will present ample opportunities to earn enhanced rates of return. Indeed, reports from businesses around the country suggest that the exploitation of available networking and other information technologies was only partially completed when the cyclical retrenchment of the past year began. Many business managers are still of the view, according to a recent survey of purchasing managers, that less than half of currently available new, and presumably profitable, supply chain technologies have been put into use.

If the recent more-favorable economic developments continue and gather momentum, uncertainties will diminish, risk premiums will fall, and the pace of capital investment embodying these technologies will increase. As we have witnessed so clearly in recent years, the resulting enhanced growth of productivity will lift our standard of living.

The economic and financial developments I have described, of course, have important implications for the federal budget and can help explain a significant portion of the shift in the budget situation over the past year. A year ago, the Congressional Budget Office expected the unified surplus to continue to mount if no new policy actions were taken and to cumulate to $5.6 trillion for fiscal years 2002 to 2011.

As you know, if today's policies remain in place, CBO is currently forecasting a cumulative surplus over the same ten years that is $4 trillion below what had been anticipated in its baseline a year ago. CBO calculates that the now less favorable economic assumptions--especially in the near term--contribute nearly $1 trillion--after taking account of the associated cost of debt service--to the downward revision in its ten-year surplus projections. In addition, more than $600 billion of the downward revision reflects CBO's view that the ten-year estimates it made a year ago of receipts relative to taxable incomes were too high; the revision was based in part on the recent disappointing tax collections and lowered estimates of realized capital gains in the wake of stock market declines.

If CBO had been able to employ what has been learned about recent developments and the long-term outlook in the past year--that is, if it had used its current economic and technical assumptions when it put together its budget projections last January--a still formidable surplus would have emerged. Instead of projecting a $5.6 trillion current-policy surplus, it would have estimated $4 trillion.[1] Of course, legislated tax and spending actions over the past year, as estimated by CBO, have reduced the ten-year surplus by $2.4 trillion. This leaves a current-policy ten-year surplus expectation of $1.6 trillion through fiscal 2011.

Despite the erosion in the budget picture over the past year, our underlying fiscal situation today remains considerably stronger than that of a decade ago, when policymakers were struggling to rein in chronic deficits. The shift from a deficit equal to nearly 5 percent of GDP in fiscal 1992 to a surplus equal to 2-1/2 percent of GDP in fiscal 2000 was truly remarkable. Restraint on outlays accounted for about 40 percent of the fiscal reversal over this period, and revenue growth in excess of GDP growth accounted for about 45 percent; the associated declines in debt service accounted for the remainder. The fall in the non-interest outlay share of GDP largely reflected lower defense spending as the Cold War came to an end, but other spending also was fairly well restrained. At least until the past few years, the statutory caps helped to hold nondefense discretionary expenditures in check, and the pay-as-you-go rules forced careful consideration of deficit-expanding initiatives.[2]

The extraordinary rise in receipts over the past decade resulted from the exceptional performance of the U.S. economy and the associated rise in the market value of assets, which helped lift receipts from 17-1/2 percent of GDP in fiscal year 1992 to a postwar high of nearly 21 percent of GDP in fiscal 2000. The increase in receipts in the second half of the 1990s was particularly impressive--especially for individual income taxes, which grew about 11 percent per year, on average, between 1995 and 2000. The surge in individual taxes was attributable in part to the strong growth in incomes from production and to the tendency of rising levels of income to shift a greater share of taxable income into higher tax brackets.

But individual taxes also received a boost from the enormous rise in the value of financial assets during that period--directly through taxes on higher capital gains realizations and indirectly through the taxes collected from the exercise of stock options, from stock-price-related bonuses to workers in the financial industry, and from withdrawals from capital-gains-augmented IRAs and 401(k) plans.

Estimates based in part on data from the Statistics of Income and other sources suggest that such market-related receipts accounted for only about 15 percent of total individual receipts in fiscal 1995;

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1 That projection would have indicated a need for significant accumulation of private assets in federal government accounts by 2009. In the actual CBO estimates of January 2001, that date was two years earlier. In the absence of cuts in taxes or increases in outlays that are programmed and phased in well in advance, the avoidance of sizable private asset accumulation might require taking actions that would essentially eliminate the surplus as the federal debt approached its irreducible minimum. As I argued a year ago, such actions could result in a fiscal policy wholly inconsistent with the state of the economy at that time. For reasons I discussed last January, I believe that cutting taxes is a far preferable way to reduce the surplus over time than to institute new expenditure programs. CBO's projections of a year ago, which implied a substantial shortfall of reducible debt as early as 2007, suggested to me some urgency in phasing down the surplus. If CBO had access to the economic and technical developments of all of 2001 last January, it would have projected a somewhat later date for that shortfall. In the event, of course, a considerable part of the current-policy surplus was used to reduce taxes and to increase spending so that the most recent current-policy projections of the CBO do not anticipate a need for significant nonfederal asset accumulation until well into the next decade.

2 Relatively favorable demographic trends helped to restrain spending on social security and health programs; and although health spending rose very rapidly in the first half of the 1990s, these outlays decelerated markedly in the second half as a result of both legislative actions and the cost-containment efforts in the medical sector.

but because they grew about 25 percent per year, on average, between 1995 and 2000, they accounted for more than one-third of the increase in total individual receipts over that period. Receipts that are more directly related to production in the broader economy--that is, those associated with wages and salaries, business and professional incomes, dividends, and interest income--rose 8-1/2 percent per year, on average, between 1995 and 2000, one-third the pace of receipts on stock-market-related taxable incomes.

Had equity asset values risen only as fast as nominal GDP between 1995 and 2000--that is, about 6 percent per year--taxes related to stock-price levels would have been approximately $130 billion less in fiscal 2000, even without taking account of the reduced receipts that would have resulted from a presumably less buoyant economy.

Recent developments, of course, have reversed part of this fiscal bonanza. Tax cuts, the weakening in economic activity, and the sharp decline in stock prices have reduced individual tax receipts. In addition, taxes on capital gains realizations have become an increasingly important component of corporate receipts in recent years--perhaps as much as one-fourth. Consequently, declines in stock prices have exerted additional downward pressure on corporate receipts, which had already taken a large hit from declining profit margins.

Increased funding for defense and homeland security and the higher expenditures on unemployment benefits and other cyclically sensitive programs are also pressing on our current-policy fiscal balances. Such calculations, of course, do not include the additional expenditures that doubtless will be authorized as the year progresses.

The current-policy budget outlook prepared by the Congressional Budget Office for the coming decade, though less favorable than a year ago, is still quite positive. CBO remains reasonably sanguine about the economy's growth prospects for the next ten years, and this is reflected in the re-emergence in its current-policy projections of moderate unified budget surpluses by the middle of the decade. If realized, such surpluses, by lowering the publicly held federal debt and freeing up private saving to be channeled into capital investment, would help us prepare for the considerable demographic changes that we face over the longer run. This will clearly be no simple task. As Dr. Crippen emphasized yesterday, the fiscal pressures that will almost surely arise after 2010 will be formidable.

Achieving a satisfactory budget posture will depend on ensuring that new initiatives are consistent with our longer-run budgetary objectives. Indeed, as you craft a budget strategy for coming years, you might again want to consider provisions that, in some way, would limit tax and spending initiatives if specified targets for the budget surplus and federal debt were not satisfied.

The significant improvement in the budget in the 1990s reflected not only decidedly positive economic forces but also much hard work and many difficult decisions on the part of this committee and others. Similar efforts will be required in the years ahead.