Alan Greenspan: The US economy

Remarks by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Independent Community Bankers of America, Honolulu, Hawaii (via satellite) 13 March 2002.

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I am pleased to appear once again before the Independent Community Bankers of America. There can be little doubt that the business environment in which you have operated over the past year has been challenging.

Today I would like to review some of the principal forces likely to operate on the economy in coming months. But I would also like to focus on the emerging longer-term challenges, particularly on the need to augment our domestic saving rate to facilitate the financing of the investment that will almost surely be required as the baby boomers retire. As bankers, you will play a central part in meeting that challenge by channeling today's saving into the capital that will be essential in providing for tomorrow's income.

As I have noted in recent testimony, in the past several months, we have seen increasing signs that some of the forces restraining the economy over the past year are starting to diminish and that activity is beginning to firm.

One key force in the economy is the movement 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. With production running well below sales, the lift to income and spending from the inevitable cessation of inventory liquidation could be significant.

But that impetus to the growth of activity will be short-lived unless sustained increases in final demand kick in before the positive effects of the swing from inventory liquidation dissipate. In recent days, encouraging signs of strengthening underlying trends in final demand have emerged, although the dimensions of the pickup remain uncertain.

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 as well as an abatement of inventory liquidation. Through much of last year's slowdown, however, spending by the household sector held up well and proved to be 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 likely to be more limited than in past cycles.

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. However, layoffs diminished noticeably in January, and employment turned up last month. Moreover, initial claims for unemployment insurance have decreased markedly, on balance, providing further evidence of an improvement in labor market conditions.

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 and a half was central to the sharp slowing we experienced in overall activity. On balance, the recovery in spending on business fixed investment is likely to be only gradual; in particular, its growth will doubtless be less frenetic than in 1999 and early 2000--a period during which outlays were boosted by the dislocations of Y2K and the extraordinarily low cost of equity capital available to many firms. Nonetheless, if the recent more-favorable economic developments gather momentum, uncertainties will diminish, risk premiums will fall, and the pace of capital investment embodying new technologies will increase.

Even a subdued recovery would constitute a truly remarkable performance for the American economy in the face of so severe a decline in equity asset values and an unprecedented blow from terrorists to the foundations of our market systems. For if the tentative indications that the contraction phase of this business cycle has drawn to a close are ultimately confirmed, we will have experienced a significantly milder downturn than the long history of business cycles would have led us to expect.

Although there are ample reasons to be cautious about the economic outlook, the recuperative powers of the U.S. economy in the recent past have been encouraging. One important ingredient in that resilience has been the performance of productivity. Even discounting somewhat the phenomenal strength of the growth of output per hour of late, one cannot help but be impressed with how well productivity has held up in the face of the abrupt slowing of the economy in late 2000 and in 2001.

That performance has been encouraging because the nation's fortunes, to a very great degree, will depend on the evolution of the growth of productivity. In particular, productivity will play a central role in determining the nature of the economy's response to the aging of the population soon upon us.

Most economic forecasts are subject to significant uncertainty. At least by comparison, one judgment looks to be a reasonably sure proposition: The ratio of retirees to those still working will rise precipitously starting at the end of this decade and will continue to climb through the first third of this century and remain high thereafter. In part, this projected development owes to the retirement of the baby boomers. But the phenomenon is broader than that and reflects the aging of our society. Importantly, according to the social security trustees, the demographic challenge will not go away with the passing of the baby-boom generation.

This ever-larger retired population will have to be fed, clothed, housed, and serviced by a workforce growing far less rapidly. The retirees may have accumulated a large stock of retirement savings, but the goods and services needed to redeem those savings must be produced by an active workforce assisted by a stock of plant and equipment sufficiently productive to meet the needs both of retirees and of a workforce expecting an ever-increasing standard of living.

Though from an individual household's point of view, saving reflects financial claims adequate to meet future needs, the focus for the economy as a whole, of necessity, must be on producing the real resources needed to redeem the financial assets.

The role of finance is to channel saving into investment in the physical capital assets that assist in the production of the gross domestic product, which, in turn, serves both retirees and active workers. Clearly, an efficient system of finance can more effectively deploy a given stock of capital and thus maximize its contribution to supporting the population.

Any analysis of the amount and type of saving required to finance the bulge in retirements that is just over the horizon clearly needs to project (1) the number of retirees, (2) the size of our workforce, and (3) the productivity of that workforce. Of the three, productivity is most directly affected by the level of investment, which, of course, is financed by saving.

The size of the future workforce, excluding immigrants, and the size of the future retired population are relatively simple to project from today's age distribution. The level of immigration, both legal and illegal, will be dominated by public policy decisions and by economic forces, both in the United States and in the countries from which our immigrants are drawn. This forecast is more problematic, and its level matters: Over the past decade, for example, immigration accounted for approximately one-third of the increase in our workforce. The larger our workforce in 2010 and beyond, the easier producing goods and services for both retirees and active workers will be. Immigration policy will, therefore, be a key component of baby-boom retirement policy.

The rate of saving--for retirement and other purposes--may not directly affect either the number of retirees or the size of the workforce. But it surely affects capital investment, which it finances, and the productivity that it engenders.

Besides the total amount of saving and investment, changes in the allocation of those funds among different types of capital also appear to influence the growth of labor productivity. A dollar of new saving flows through financial markets to firms that allocate it among different types of capital investment. Clearly, firms' choices about the types of investments to make matter crucially for how much labor productivity ultimately is boosted.

In the late 1990s, for example, businesses allocated much more of their investment dollars toward high-tech, higher-return capital than they did in earlier years. Businesses made this shift and are continuing to move further in that direction in response to the extremely rapid decline in the prices of high-tech assets and the new opportunities that these assets have afforded. According to one set of calculations, of the roughly 2-1/2 percent annual rate of increase in output per hour, or labor productivity, between 1995 and 2001, perhaps a quarter of that growth could be attributed to on-going shifts in the composition, as distinct from the dollar level, of capital.

Improvements in the quantity and quality of our workforce's education enhance workers' skills and contribute importantly to the growth of labor productivity. But far more important over the past six years have been the gains in output attributable to technological innovation, especially information technology and improved managerial organization, and, as I noted in testimony last week, the greater flexibility and resilience of our economy stemming from deregulation, primarily in finance.

Notwithstanding these more-intangible contributions, the level of saving remains a key ingredient of economic growth. But we need also to know whether the source of that saving is sustainable and, beyond that, whether the type of financial assets in which our saving overall is accumulated affects our productivity.

During the past six years, about 40 percent of the total increase in our capital stock in effect has been financed, on net, by saving from abroad. This situation is reflected in our ongoing current account deficit, which, by definition, is a measure of our net investment in domestic plant and equipment financed with foreign funds, both debt and equity. But this deficit is also a measure of the increase in the level of net claims, primarily debt claims, that foreigners have on our assets. As the stock of such claims grows, an ever-larger flow of interest payments must be provided to the foreign suppliers of this capital. Countries that have gone down this path invariably have run into trouble, and so would we. Eventually, the current account deficit will have to be restrained. The nation's economic potential will be brighter if that comes about through an increase in domestic saving rather than a reduction in domestic investment.

A more contentious issue is whether the mix of domestic private and government saving affects the rate of productivity growth. Another is whether the form of private saving--for example in stocks or debt instruments including bank deposits--affects productivity growth.

Ultimately, the composition of real investment in our economy will reflect, among other influences, the attitudes toward risk of those who own the financial claims against the capital stock. The nation's savers, daily in the marketplace, exhibit an obvious sensitivity to the association between expected return and risk. Few, if any, individuals would be willing to accept greater risk without the potential for greater reward. Similarly, a nation as a whole would not be willing to invest in riskier assets without a commensurately greater overall economic growth potential. That same tradeoff is reflected in the willingness of many investors to forgo the higher rates of return on equity for the greater tranquility of the lesser stress and risk associated with most debt instruments. Reflecting that differential in risk, returns on common stocks over rolling twenty-year periods have almost always outpaced the returns on less-risky securities.

Should relative preferences of savers in the aggregate shift toward debt instruments and away from equity, interest rates will be driven lower and equity-price ratios higher. These shifts in asset valuation will induce business enterprises to alter their choice of capital projects. Specifically, firms will find that only projects with lower average rates of return will meet the requirement of providing the more certain, more stable income stream desired by savers. The physical counterpart to this choice by businesses of projects with lower expected financial returns is a slower growth of productivity, on average, across the economy.

Conversely, if savers become more risk-tolerant, financial risk premiums will decline. In response to these reduced penalties on risk, firms will be induced to adjust the mix of their endeavors toward more-speculative projects--but, importantly, presumably ones that also offer higher prospective rates of return on average, which more often than not, translate into higher long-term average economic growth.

Thus, the answer to whether government or private saving does more to foster productivity growth arguably comes down to the propensity of U.S. savers to take risks.

Government saving is reflected largely in a retirement of debt. Having chosen to hold at least a portion of their savings in riskless securities, holders of government debt when confronted with debt retirement presumably would chose less-risky private debt securities over common stocks to rebalance their portfolios. Thus an increased share of saving from the government is a markedly more conservative financial strategy than if the saving were undertaken in the private sector.

Obviously, the federal government could invest in higher-risk assets, such as equities. But for reasons that I have expressed many times, I do not believe that, other than in defined-contribution plans, such investment can be accomplished free of political pressures that would distort the efficient use of capital.

Presumably, most of those who maintain that greater risk-taking would likely produce faster long-term growth would acknowledge that increased competition and economic growth would also bring greater volatility and social stress. Because of the near certainty of a major rise in the retiree-to-worker ratio in the next few decades, we now face the pressing need to set policies for the enhanced productivity growth that will be necessary if we are to successfully meet the pending demographic challenge.

How much personal stress--and, some argue, increased inequality, which may be a byproduct of a highly competitive, high-octane economy--have we as a nation chosen? Is the amount compatible with the level of domestic saving and possibly the risk-taking that is consonant with the elevated level of productivity growth necessary to meet the needs of an aging population? A national consensus on these questions is clearly missing. This is doubtless an area for useful debate.

Regardless of the outcome of that debate, there can be little disagreement that an efficient banking system and sound financial markets will be critical in directing our scarce national saving into the productive investments that will provide the wherewithal to meet our future needs. Each of you can contribute to a process that will lift the standards of living enjoyed by our fellow citizens