Alan Greenspan: Semi-annual monetary policy report to the US Congress

Testimony of Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, on the occasion of the Federal Reserve Board's semiannual monetary policy report to the Congress, before the Committee on Financial Services, US House of Representatives, 17 July 2002.

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I appreciate this opportunity to present the Federal Reserve's Monetary Policy Report to the Congress.

Over the four and one-half months since I last testified before this Committee on monetary policy, the economy has continued to expand, largely along the broad contours we had anticipated at that time. Although the uncertainties of earlier this year are as yet not fully resolved, the U.S. economy appears to have withstood a set of blows--major declines in equity markets, a sharp retrenchment in investment spending, and the tragic terrorist attacks of last September--that in previous business cycles almost surely would have induced a severe contraction. The mildness and brevity of the downturn, as I indicated earlier this year, are a testament to the notable improvement in the resilience and flexibility of the U.S. economy.

But while the economy has held up remarkably well, not surprisingly the depressing effects of recent events linger. Spending will continue to adjust for some time to the declines that have occurred in equity prices. In recent weeks, those prices have fallen further on net, in part under the influence of growing concerns about corporate governance and business transparency problems that evidently accumulated during the earlier rapid runup in these markets. Considerable uncertainties--about the progress of the adjustment of capital spending and the rebound in profitability, about the potential for additional revelations of corporate malfeasance, and about possible risks from global political events and terrorism--still confront us.

Nevertheless, the fundamentals are in place for a return to sustained healthy growth: Imbalances in inventories and capital goods appear largely to have been worked off; inflation is quite low and is expected to remain so; and productivity growth has been remarkably strong, implying considerable underlying support to household and business spending as well as potential relief from cost and price pressures. In considering policy actions this year, the Federal Open Market Committee has recognized that the accommodative stance of policy adopted last year in response to the substantial forces restraining the economy likely will not prove compatible over time with maximum sustainable growth and price stability. But, with inflation currently contained and with few signs that upward pressures are likely to develop any time soon, we have chosen to maintain that stance pending evidence that the forces inhibiting economic growth are dissipating enough to allow the strong fundamentals to show through more fully.

As has often been the case in the past, the behavior of inventories provided substantial impetus for the initial strengthening of the economy. Manufacturers, wholesalers, and retailers took vigorous steps throughout 2001 to eliminate an unwanted buildup of stocks that emerged when final demand slowed late in 2000. By early this year, with inventory levels having apparently come into better alignment with expected sales, the pace of inventory reduction began to ebb, and efforts to limit further drawdowns provided a considerable boost to production. The available evidence suggests that, in some sectors, liquidation may be giving way to a rebuilding of inventories. However, as inventories start to grow more in line with sales in coming quarters, the contribution of inventory investment to real GDP growth should lessen. As a result, the strength of final demand will play its usual central role in determining the vigor of the expansion. While final demand has been increasing, the pace of forward momentum remains uncertain.

Household spending held up quite well during the downturn and through recent months, and thus served as an important stabilizing force for the overall economy. Real consumer outlays and spending on residential construction each rose about 3 percent over the course of 2001, even as the growth of real GDP fell off to only ½ percent. Household spending was boosted by ongoing increases in incomes, which in turn were spurred by strong advances in productivity as well as by legislated tax reductions and, in recent months, by extended unemployment insurance benefits.

Monetary policy also played a role by cutting short-term interest rates, which helped lower household borrowing costs. Particularly important in buoying spending were the very low levels of mortgage interest rates, which encouraged households to purchase homes, refinance debt and lower debt service burdens, and extract equity from homes to finance expenditures. Fixed mortgage rates remain at historically low levels and thus should continue to fuel reasonably strong housing demand and, through equity extraction, to support consumer spending as well. Indeed, recent sizable increases in home prices, which reflect the effects on demand of low mortgage rates, immigration, and shortages of buildable land in some areas, have significantly increased the equity in houses that homeowners can readily tap through home equity loans and mortgage refinancing.

But those sources of strength probably will be tempered by other influences. As we noted in February, because consumer and residential expenditures did not decline during the overall downturn, there is little pent-up demand to be satisfied. Consequently, a surge in household spending early in this recovery is unlikely. Moreover, the declines in household wealth that have occurred over the past couple of years should continue to restrain spending in the period ahead. Still, despite concerns about economic prospects, equity valuations, terrorism, and geopolitical conflicts, consumers do not appear to have retrenched in retail markets. Indeed, consumers responded strongly to the new interest rate incentives of motor vehicle manufacturers this month. Early reports indicate a significant improvement in sales over June.

By contrast, business spending has been depressed. The recent economic downturn was driven, in large measure, by the sharp falloff in the demand for capital goods that occurred when firms suddenly realized that stocks of such goods--both those already in place as well as those in inventory--were excessive. The resulting declines in the production of capital goods were particularly sizable in the high-tech sector. Monthly shipments of computers and peripherals, for example, fell by about 40 percent from their peak in 1999 through their trough in 2001. Sales by communications equipment producers slumped just as sharply. Outside the high-tech sector, production also declined. Assemblies of commercial aircraft slowed abruptly. In addition, the construction of office and industrial buildings fell off noticeably. The collapse of many Internet firms and the difficulties of the high-tech sector more generally led to a significant drop in the demand for office space that was exacerbated as the economic slowdown widened beyond the tech sector. Overall, the level of real business fixed investment plunged about 11 percent between its quarterly peak in the final months of 2000 and the first quarter of this year.

With the adjustment of the capital stock to desired levels now evidently well advanced, business fixed investment may be set to improve. A recovery in this category of spending is likely to be gradual by historical standards and uneven across sectors. For example, an upturn in production of semiconductors and computers has been under way now for nearly a year, but with significant overcapacity still prevailing in some segments of the telecom industry, investment in communications equipment is likely to remain subdued for some time to come. Overall capital expenditures should strengthen with time. In particular, firms should respond increasingly to the expected improvement in the outlook for sales and profits, low debt financing costs, the heightened incentives resulting from the partial expensing tax provisions legislated earlier this year, and especially the productivity enhancements offered by continuing advances in technology.

Indeed, despite the recent depressed level of investment expenditures, the productivity of the U.S. economy has continued to rise at a remarkably strong pace. In the nonfarm business sector, output per hour is currently estimated to have soared at an average annual rate of about 7 percent over the fourth quarter of 2001 and first quarter of 2002, and the available evidence points to continued gains last quarter--though not at the frenetic pace of the preceding half year. In part, these increases in productivity reflect the very cautious attitudes of managers toward hiring. But the magnitude of the recent gains would not have been possible without ongoing benefits from the rapid pace of technological advance and from the heavy investment over the latter half of the 1990s in capital equipment incorporating such advances.

Despite these encouraging developments regarding the longer-term prospects for the economy, financial markets have been notably skittish of late, and business managers remain decidedly cautious. In part, these attitudes reflect the lingering effects of the shocks that our economy endured in 2000 and 2001. Particularly given the dimensions of those shocks, some persistent uncertainty and concern are not surprising.

Also contributing to the dispirited attitudes among many corporate executives is the intensely competitive business environment facing their firms. Increased competition, while producing manifold benefits for consumers and for the economy as a whole, clearly makes individual firms' operations more difficult. Past deregulation and, more recently, the enhanced speed and efficiency of information flows resulting from technological advances are strengthening competition domestically. In addition, globalization is intensifying competition in a broad range of markets and damping pricing power across developed and developing nations alike.

Those businesses where heightened competition has engendered a loss of pricing power have sought ways to raise profit margins by employing technology to lower costs and improve efficiency. In the United States, as a consequence of the interaction of monetary policy, globalization, and cost-reducing productivity advances, price inflation has fallen in recent years to its lowest level in four decades, as has the recent growth rate of nominal GDP and consolidated corporate revenues.

In part because nominal corporate revenues, although no longer declining, are growing only tepidly, managers seem to remain skeptical of the evidence of an emerging upturn. Profit margins do appear to be coming off their lows registered late last year, but, unsurprisingly, the recovery in economic activity from a shallow decline appears less vigorous than in the past. The lowest sustained rates of inflation in forty years imply that nominal growth in sales and profits looks particularly anemic. In contrast, in the 1950s and early 1960s, the last period of stable prices, populations and employment were growing considerably faster than the recent pace so that growth in nominal GDP, consolidated corporate sales, and profits was seen as still quite respectable. Reflecting concerns about the strength of the recovery, managers continue to limit capital spending to only the most pressing needs.

Given the key role of perceptions of subdued profitability in the current period, it is ironic that the practice of not expensing stock-option grants, which contributed to the surge in earnings reported to shareholders from 1997 to 2000, has imparted a deceptive weakness to the growth of earnings reported to shareholders in recent quarters. As stock market gains turned to losses a couple of years ago, the willingness of employees to accept stock options in lieu of cash or other forms of compensation apparently diminished. According to estimates by Federal Reserve staff, the value of stock option grants for the S&P 500 corporations fell about 15 percent from 2000 to 2001, and grant values have likely declined still further this year. Moreover, options grants are presumably being replaced over time by cash or other forms of compensation, which are expensed, contributing further to less robust growth in earnings reported to shareholders from its trough last year.

In contrast, the measure of profits calculated by the Department of Commerce for the National Income and Product Accounts is designed to gauge the economic profitability of current operations. It excludes a number of one-time charges that appear in shareholder reports, and, importantly, records options as an expense, albeit at the time of exercise. Although this treatment of the cost of options is not ideal, it is arguably superior to their treatment in shareholder reports, where options are generally not expensed at all. NIPA profits closely approximate those obtained from reports submitted for tax purposes, and, for obvious reasons, corporations tend not to inflate taxable earnings. Consequently, NIPA profits have been far less subject to the spin evident in reports to shareholders in recent years. NIPA profits have increased sharply since the third quarter of last year, partly reflecting the dramatic jump in productivity and decline in unit labor costs.

The difficulties of judging earnings trends have been intensified by revelations of misleading accounting practices at some prominent businesses. The resulting investor skepticism about earnings reports has not only depressed the valuation of equity shares, but it also has been reportedly a factor in the rising risk spreads on corporate debt issued by the lower rung of investment-grade and below-investment grade firms, further elevating the cost of capital for these borrowers. Businesses concerned about the impact of possible adverse publicity regarding their accounting practices on their access to finance could revert to a much heavier emphasis on cash generation and accumulation. Such an emphasis could slow new capital investment initiatives.

The recent impressive advances in productivity suggest that to date any impairment of efficiency of U. S. corporations overall has been small. Efficiency is of course a key measure of corporate governance. Nonetheless, the danger that breakdowns in governance could at some point significantly erode business efficiency remains worrisome. Well-functioning markets require accurate information to allocate capital and other resources, and market participants must have confidence that our predominately voluntary system of exchange is transparent and fair. Although business transactions are governed by laws and contracts, if even a modest fraction of those transactions had to be adjudicated, our courts would be swamped into immobility. Thus, our market system depends critically on trust--trust in the word of our colleagues and trust in the word of those with whom we do business. Falsification and fraud are highly destructive to free-market capitalism and, more broadly, to the underpinnings of our society.

In recent years, shareholders and potential investors would have been protected from widespread misinformation if any one of the many bulwarks safeguarding appropriate corporate evaluation had held. In too many cases, none did. Lawyers, internal and external auditors, corporate boards, Wall Street security analysts, rating agencies, and large institutional holders of stock all failed for one reason or another to detect and blow the whistle on those who breached the level of trust essential to well-functioning markets.

Why did corporate governance checks and balances that served us reasonably well in the past break down? At root was the rapid enlargement of stock market capitalizations in the latter part of the 1990s that arguably engendered an outsized increase in opportunities for avarice. An infectious greed seemed to grip much of our business community. Our historical guardians of financial information were overwhelmed. Too many corporate executives sought ways to "harvest" some of those stock market gains. As a result, the highly desirable spread of shareholding and options among business managers perversely created incentives to artificially inflate reported earnings in order to keep stock prices high and rising. This outcome suggests that the options were poorly structured, and, consequently, they failed to properly align the long-term interests of shareholders and managers, the paradigm so essential for effective corporate governance. The incentives they created overcame the good judgment of too many corporate managers. It is not that humans have become any more greedy than in generations past. It is that the avenues to express greed had grown so enormously.

Perhaps the recent breakdown of protective barriers resulted from a once-in-a-generation frenzy of speculation that is now over. With profitable opportunities for malfeasance markedly diminished, far fewer questionable practices are likely to be initiated in the immediate future. To be sure, previously undiscovered misdeeds will no doubt continue to surface in the weeks ahead as chastened CEOs restate earnings. But even if the worst is over, history cautions us that memories fade. Thus, it is incumbent upon us to apply the lessons of this recent period to inhibit any recurrence in the future.

A major focus of reform of corporate governance, of course, should be an improved functioning of our economy. A related, but separate, issue is that shareholders must perceive that corporate governance is properly structured so that financial gains are fairly negotiated between existing shareholders and corporate officeholders. Shareholding is now predominately for investment, not corporate control. Our vast and highly liquid financial markets enable large institutional shareholders to sell their shares when they perceive inadequacies of corporate governance, rather than fix them. This has placed de facto control in the hands of the chief executive officer. Shareholders routinely authorize slates of directors recommended by the CEO. Generally, problems need to become quite large before CEOs are dislodged by dissenting shareholders or hostile takeovers.

Manifestations of lax corporate governance, in my judgment, are largely a symptom of a failed CEO. Having independent directors, whose votes are not controlled by the CEO, is essential, of course, for any effective board of directors. However, we need to be careful that in the process, we do not create a competing set of directors and conflicting sources of power that are likely to impair a corporation's effectiveness. The functioning of any business requires a central point of authority.

In the end, a CEO must be afforded full authority to implement corporate strategies, but also must bear the responsibility to accurately report the resulting condition of the corporation to shareholders and potential investors. Unless such responsibilities are enforced with very stiff penalties for non-compliance, as many now recommend, our accounting systems and other elements of corporate governance will function in a less than optimum manner.

Already existing statutes, of course, prohibit corporate fraud and misrepresentation. But even a small increase in the likelihood of large, possibly criminal penalties for egregious behavior of CEOs can have profoundly important effects on all aspects of corporate governance because the fulcrum of governance is the chief executive officer. If a CEO countenances managing reported earnings, that attitude will drive the entire accounting regime of the firm. If he or she instead insists on an objective representation of a company's business dealings, that standard will govern recordkeeping and due diligence. It has been my experience on numerous corporate boards that CEOs who insist that their auditors render objective accounts get them. And CEOs who discourage corner-cutting by subordinates are rarely exposed to it.

I recognize that I am saying that the state of corporate governance to a very large extent reflects the character of the CEO, and that this is a very difficult issue to address. Although we may not be able to change the character of corporate officers, we can change behavior through incentives and penalties. That, in my judgment, could dramatically improve the state of corporate governance.

Our most recent experiences clearly indicate, however, that adjustments to the existing structure of regulation of corporate governance and accounting beyond addressing the role of the CEO are needed. In designing changes to our regulatory framework, we should keep in mind that regulation and supervision of our financial markets need to be flexible enough to adapt to an ever-changing and evolving financial structure. Regulation cannot be static or it will soon distort the efficient flow of capital from savers to those who invest in plant and equipment. There will be certain areas where Congress will choose to provide a specific statutory direction that will be as applicable thirty years from now as today. In other cases, agency rule-making flexibility under new or existing statutes is more appropriate. Finally, there are some areas where private supervision would be most effective, such as that of the New York Stock Exchange, which requires certain standards of governance for listing.

Above all, we must bear in mind that the critical issue should be how to strengthen the legal base of free market capitalism: the property rights of shareholders and other owners of capital. Fraud and deception are thefts of property. In my judgment, more generally, unless the laws governing how markets and corporations function are perceived as fair, our economic system cannot achieve its full potential.

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A considerable volume of market commentary in recent weeks has suggested that concerns about earnings prospects and the proliferating revelations of serious governance and accounting issues have contributed not only to lower equity prices but also to a decline in the foreign exchange value of the dollar. And some of that commentary has extrapolated the trend of dollar weakness. As you know, the Secretary of the Treasury speaks for our government on exchange rate policy. But, given the recent intense interest in the future course of the dollar, I would like to raise a technical issue and a flag of caution regarding those forecasts--or, for that matter, any forecast of exchange rates. There may be more forecasting of exchange rates, with less success, than almost any other economic variable.

The reason that it is so difficult is that an exchange rate is a very complex price that balances, on the one hand, the demand for, for example, dollars stemming from the demand for dollar investments and for U.S. exports against, on the other hand, the demand for foreign currencies by U.S. investors desiring to acquire foreign assets and by U.S. importers of foreign goods and services. Hence, exchange-rate movements depend on shifting perceptions of the relative returns from investing in different countries and on the myriad influences on relative tendencies to import and export. The net effect of these factors over any future time period is extraordinarily difficult to assess in advance. Although measures such as real interest rate differentials, differential rates of productivity gains, and chronic external deficits are often employed to explain exchange rate behavior, none has been found to be consistently useful in forecasting exchange rates even over substantial periods of one or two years.

Our ability to attract foreign capital in coming years will help facilitate the increases in investment that will promote continued gains in productivity and standards of living. But policymakers should also recognize the important role that prudent fiscal policy can play in promoting national saving and maintaining conditions conducive to investment and continued strong growth of productivity. Beginning in the late 1980s, impressive progress was made in reining in federal expenditures and restoring a better balance between spending and revenues. The lower federal deficits and, for a time, the realization of surpluses contributed significantly to improved national saving and thereby put downward pressure on real interest rates. This, in turn, enhanced the incentives of businesses to invest in productive plant and equipment.

Recently, however, some of those gains have been given up. To a degree, the return to budget deficits has been a result of temporary factors, especially the falloff in revenues and the increase in outlays associated with the economic downturn. Those influences should tend to reverse over the next year or two, other things equal, although the decline in revenues reflecting the drop in capital gains realizations, including those on options, is unlikely to be fully reversed. And the necessary rise in expenditures related to the war on terrorism and enhanced homeland security has also played a role, as have the tax reductions legislated last year. Unfortunately, there are also signs that the underlying disciplinary mechanisms that formed the framework for federal budget decisions over most of the past fifteen years have eroded. The Administration and the Congress can make a valuable contribution to the prospects for the growth of the economy by taking measures to restore this discipline and return the federal budget over time to a posture that is supportive of long-term economic growth.

To sum up, the U.S. economy has confronted very significant challenges over the past year or so. Those problems, however, led to only a relatively brief and mild downturn in economic activity, reflecting the underlying strength and increased resiliency that the economy has achieved in recent years. The effects of the recent difficulties will linger for a bit longer but, as they wear off, and absent significant further adverse shocks, the U.S. economy is poised to resume a pattern of sustainable growth. Indeed, the central tendency of Federal Reserve policymakers' forecasts is for expansion of real GDP over the four quarters of 2002 of 3-1/2 to 3-3/4 percent, somewhat above the rates anticipated in our February report. Economic growth is projected to be solid again next year, with real output rising 3-1/2 to 4 percent. Monetary policymakers anticipate that these gains should be sufficient to bring the unemployment rate down to 5-1/4 to 5-1/2 percent by the end of next year. Inflation is expected to be subdued throughout, with prices for personal consumption expenditures increasing at only a 1-1/2 to 1-3/4 percent rate. Our prospects for extending this performance over time can be enhanced through implementation of sound monetary, financial, fiscal, and trade policies.