

Alan Greenspan: Follow-up to the semiannual monetary policy report to the Congress

Testimony of Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Financial Services, US House of Representatives, 30 April 2003.

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Mr. Chairman and members of the committee, I am pleased to have this opportunity to update you on developments in the US economy since mid-February, when I presented the Federal Reserve's semiannual monetary policy report.

At that time, I noted that the economic expansion over the preceding year had been modest. Spending by households had contributed importantly to the gains in economic activity. The nation's strong underlying productivity performance was providing ongoing support for household income. That rise in income, combined with low interest rates, reduced taxes, and the availability of substantial home equity, had spurred solid gains in consumer spending and a robust advance in residential construction.

In contrast, although the contraction in capital spending appeared to have slowed, we had yet to see any convincing signs that a sustained pickup in business spending was emerging. Moreover, heightened geopolitical tensions were adding to the already considerable uncertainties that had clouded the business outlook over the preceding three years. The general climate of caution in the business sector was manifest in a number of ways, including restrained hiring, a reluctance to invest in new capacity, and aggressive actions to maintain low levels of inventories.

In late February and early March, the risks and uncertainties surrounding the economic outlook intensified as the range of possibilities for the timing, duration, and economic consequences of the pending war in Iraq appeared to widen. In financial markets, a greater sense of caution among investors seemed to bolster the demand for Treasury and other fixed-income securities at the expense of equities; the price of crude oil moved up, as did the prices of gasoline and home heating oil; and consumer confidence sagged further. After picking up in January, payroll employment and manufacturing production turned down again in February and March.

When the onset of the war became imminent, financial markets rallied, and the price of crude oil dropped back. Market participants seemed buoyed simply by the elimination of uncertainty about the timing of the start, and hence the end of hostilities, although a still-significant amount of unease inevitably remained about the way the war might progress and how severely it might disrupt oil production and economic activity.

In such an environment, we had little ability to distinguish temporary changes from more persistent shifts in underlying economic trends. For that reason, the Federal Open Market Committee, at its March 18 meeting, refrained from making a determination about the balance of risks with respect to its long-run goals of price stability and sustainable economic growth. At the same time, we stepped up our surveillance of economic developments.

As part of that surveillance, we receive virtually continuous information from commodity and financial markets. The price of crude oil is now well below its peak of early March, as the potential for serious supply disruptions in world oil markets has diminished. Broad equity indexes remain well above their lows of mid-March and have been boosted most recently by incoming information on first-quarter earnings that market participants appear to view as generally positive.

In contrast, six weeks after the beginning of the war, we have only limited readings on broader economic conditions, and that information has been mixed. Households appear to have become somewhat less apprehensive about the economic outlook in recent weeks, though reports from businesses have not exhibited a similar improvement in tone. Consistent with this, the persistent high level of new claims for unemployment insurance suggests that firms may still be finding it possible to meet their customers' tepid increases in demand with a leaner workforce.

Going forward, some further unwinding of the economic tensions that have been associated with the situation in Iraq seems likely. As that occurs, the fundamental trends shaping the economic outlook should emerge more clearly. As I indicated when I met with you earlier this year, I continue to believe the economy is positioned to expand at a noticeably better pace than it has during the past year,

though the timing and the extent of that improvement remains uncertain. Fundamentally, the long-run growth potential of the economy remains solid. And the enhanced flexibility inherent in that trend imparts resilience against shocks of the kinds that we have experienced in the past few years.

Unfortunately, the future path of the economy is likely to come into sharper focus only gradually. In the interim, we need to remain mindful of the possibility that lingering business caution could be an impediment to improved economic performance.

As you may know, the consensus of economic forecasters is that a material rebound in economic activity will develop in the second half of this year, and certainly a number of elements should be working in that direction. The recent improvements in financial markets that I noted earlier, if maintained, would seem to suggest a turnaround in capital spending. In this regard, the ongoing decline in risk spreads in corporate bond markets so far this year is an encouraging development. To be sure, spreads remain high by historical standards, but the constraint imposed by last fall's huge run-up in risk premiums now appears to have been put largely behind us.

In addition, businesses should see some relief from the pressure on profit margins that had developed in recent months as energy prices rose sharply, and improvement on this front could be a positive development for capital spending. A modestly encouraging sign is provided by the backlog of orders for nondefense capital goods excluding aircraft, which has been moving up in recent months. Households, too, are likely to welcome lower energy bills and a continuation of favorable conditions in mortgage and credit markets.

As you know, core prices by many measures have increased very slowly over the last six months. With price inflation already at a low level, substantial further disinflation would be an unwelcome development, especially to the extent it put pressure on profit margins and impeded the revival of business spending.

The balance of influences on inflation and economic activity will be among the subjects of discussion by the Federal Open Market Committee when it meets in six days.