Alan Greenspan: The economic outlook

Testimony by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Joint Economic Committee, US Congress, Washington, 21 May 2003.

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Mr. Chairman, I appreciate the opportunity to testify before the Joint Economic Committee. As you will recall, when I appeared here last November, I emphasized the extraordinary resilience manifested by the United States economy in recent years - the cumulative result of increased flexibility over the past quarter century. Since the middle of 2000, our economy has withstood serious blows: a significant decline in equity prices, a substantial fall in capital spending, the terrorist attacks of September 11, confidence-debilitating revelations of corporate malfeasance, and wars in Afghanistan and Iraq. Any combination of these shocks would arguably have induced a severe economic contraction two or three decades ago. Yet remarkably, over the past three years, activity has expanded, on balance - an outcome offering clear evidence of a flexible, more resilient, economic system.

Once again this year, our economy has struggled to surmount new obstacles. As the tensions with Iraq increased early in 2003, uncertainties surrounding a possible war contributed to a softening in economic activity. Oil prices moved up close to $40 a barrel in February, stock prices tested their lows of last fall, and consumer and business confidence ebbed. Although in January there were some signs of a post-holiday pickup in retail sales other than motor vehicles, spending was little changed, on balance, over the following three months as a gasoline price surge drained consumer purchasing power and severe winter weather kept many shoppers at home.

Businesses, too, were reluctant to initiate new projects in such a highly uncertain environment. Hiring slumped, capital spending plans were put on hold, and inventories were held to very lean levels. Collectively, households and businesses hesitated to make decisions, pending news about the timing, success, and cost of military action - factors that could significantly alter the outcomes of those decisions.

The start of the war and its early successes, especially the safeguarding of the Iraqi oilfields, were greeted positively by financial and commodities markets. Stock prices rallied, risk spreads narrowed, oil prices dropped sharply, and the dour mood that had gripped consumers started to lift, precursors that historically have led to improved economic activity. The quick conclusion of the conflict subsequently added to financial gains.

We do not yet have sufficient information on economic activity following the end of hostilities to make a firm judgment about the current underlying strength of the real economy. Incoming data on labor markets and production have been disappointing. Payrolls fell further in April, and industrial production declined as well. Because of the normal lags in scheduling production and in making employment decisions, these movements likely reflect business decisions that, for the most part, were made prior to the start of the war, and many more weeks of data will be needed to confidently discern the underlying trends in these areas.

One reassuring development that has been sustained through this extended period of economic weakness has been the performance of productivity. To the surprise of most analysts, labor productivity has continued to post solid gains. Businesses are apparently continuing to discover unexploited areas of cost reduction that had accumulated during the boom years of 1995 to 2000 when the projected huge returns from market expansion dulled incentives for seemingly mundane cost savings. The ability of business managers to reduce costs, especially labor costs, through investment or restructuring is, of course, one reason that labor markets have been so weak.

Looking ahead, the consensus expectation for a pickup in economic activity is not unreasonable, though the timing and extent of that improvement continue to be uncertain. The stance of monetary policy remains accommodative, and conditions in financial markets appear supportive of an increased pace of activity. Interest rates remain low, and funds seem to be readily available to creditworthy borrowers. These factors, along with the ability of households to tap equity accrued in residential properties, should continue to bolster consumer spending and the purchase of new homes.

The recent declines in energy prices are another positive factor in the economic outlook. The price of West Texas intermediate crude oil dropped back to below $26 per barrel by the end of April, but as indications of a delay in the restoration of Iraqi oil exports became evident and geopolitical risks crept back in, prices have risen to near $30 a barrel - a worrisome trend if continued. Nonetheless, the price of crude oil is still about $10 per barrel below its peak in February. This decline has already shown through to the price of gasoline in May. Some modest further declines in gas prices are likely in coming weeks, as marketers' profit margins continue to back off from their elevated levels of March and April to more normal levels.

In contrast, prices for natural gas have increased sharply in response to very tight supplies. Working gas in storage is presently at extremely low levels, and the normal seasonal rebuilding of these inventories seems to be behind the typical schedule. The colder-than-average winter played a role in producing today's tight supply situation as did the inability of heightened gas well drilling to significantly augment net marketed production. Canada, our major source of gas imports, has little room to expand shipments to the United States. Our limited capacity to import liquified natural gas effectively restricts our access to the world's abundant supplies of natural gas. The current tight domestic natural gas market reflects the increases in demand over the past two decades. That demand has been spurred by myriad new uses for natural gas in industry and by the increased use of natural gas as a clean-burning source of electric power.

On balance, recent movements in energy prices seem likely to be a favorable influence on the overall economy. In the short run, lower energy bills should give a boost to the real incomes of households and to business profits. To be sure, world energy markets obviously remain susceptible to politically driven supply disruptions, as has been evident recently from the events in Venezuela and Nigeria. But, even taking account of these risks, futures markets project crude oil prices to fall over the longer run, consistent with the notion that current prices are above the long-term supply price of oil.

As has been the case for some time, the central question about the outlook remains whether business firms will quicken the pace of investment now that some, but by no means all, of the geopolitical uncertainties have been resolved. A modestly encouraging sign is the backlog of orders for nondefense capital goods excluding aircraft, which has been moving up in recent months. Moreover, recent earnings reports suggest that the profitability of many businesses is on the mend. That said, firms still appear hesitant to spend and hire, and we need to remain mindful of the possibility that lingering business caution could be an impediment to improved economic performance.

One new uncertainty in the global economic outlook has been the outbreak of severe acute respiratory syndrome (SARS) in Southeast Asia and elsewhere. This epidemic has hit the economies of Hong Kong and China particularly hard, as tourism and business travel have been severely curtailed and as measures to contain the spread of the virus have held down retail sales.

To date, the effects of SARS on the U.S. economy have been minimal. Airlines have obviously suffered another serious blow, and some U.S. multinational corporations are reporting reduced foreign sales. But the effects on other industries have been small. Initially, there had been some concern that SARS would disrupt the just-in-time inventory systems of U.S. manufacturers. Many of those systems rely on components from Asia, and any disruption in the flow of these goods has the potential to affect production in the United States. So far, however, U.S. manufacturing output has not been noticeably affected.

In recent months, inflation has dropped to very low levels. As I noted earlier, energy prices already are reacting to the decline in crude oil prices, and core consumer price inflation has been minimal. Inflation is now sufficiently low that it no longer appears to be much of a factor in the economic calculations of households and businesses. Indeed, we have reached a point at which, in the judgment of the Federal Open Market Committee, the probability of an unwelcome substantial fall in inflation over the next few quarters, though minor, exceeds that of a pickup in inflation.

Mr. Chairman, the economic information received in recent weeks has not, in my judgment, materially altered the outlook. Nonetheless, the economy continues to be buffeted by strong cross currents. Recent readings on production and employment have been on the weak side, but the economic fundamentals - including the improved conditions in financial markets and the continued growth in productivity - augur well for the future.