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 Senate, Washington, 21 April 2004.

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Mr. Chairman and members of the committee, I am pleased to be here today to offer my views on the outlook for the U.S. economy.

The economy appears to have emerged around the middle of last year from an extended stretch of subpar growth and entered a period of more vigorous expansion. After having risen at an annual rate of 2-1/2 percent in the first half of last year, real GDP increased at an annual pace of more than 6 percent in the second half. Aided by tax cuts, low interest rates, and rising wealth, household spending continued to post sizable gains last year. In addition, an upturn in business investment, which followed several years of lackluster performance, and a sharp rise in exports contributed importantly to the acceleration in real GDP over 2003.

Although real GDP is not likely to continue advancing at the same pace as in the second half of 2003, recent data indicate that growth of activity has remained robust thus far this year. Household spending has continued to move up, and residential home sales and construction remain at elevated levels. In addition, the improvement in business activity has become more widespread. In the industrial sector, nearly two-thirds of the industries that make up the index of industrial production have experienced an increase in output over the past three months. More broadly, indicators of business investment point to increases in spending for many types of capital equipment. And importantly, the latest employment figures suggest that businesses are becoming more willing to add to their workforces, with the result that the labor market now appears to be gradually improving after a protracted period of weakness.

Looking forward, the prospects for sustaining solid economic growth in the period ahead are good. Monetary policy remains quite accommodative, with short-term real interest rates still close to zero. In addition, fiscal policy will likely continue to provide considerable impetus to domestic spending through the end of this year.

Importantly, the caution among business executives that had previously led them to limit their capital expenditures appears to be giving way to a growing confidence in the durability of the expansion. That confidence has, no doubt, been bolstered by favorable borrowing conditions, ongoing improvements in efficiency, and rising profitability, which have put many firms on a more solid financial footing.

Nevertheless, some of the strains that accompanied the difficult business environment of the past several years apparently still linger. Although businesses are replacing obsolescent equipment at an accelerated pace, many managers continue to exhibit an unusual reluctance to anticipate and prepare for future orders by adding to their capital stock. Despite a dramatic increase in cash flow, business fixed and inventory investment, taken together, have risen only moderately. Indeed, internal corporate funds exceeded investment over the course of last year for the first time since 1975.

Similar cautious behavior has also been evident in the hiring decisions of U.S. firms, during the past several years. Rather than seeking profit opportunities in expanding markets, business managers hunkered down and focused on repairing severely depleted profitability predominately by cutting costs and restricting their hiring. Firms succeeded in that endeavor largely by taking advantage of the untapped potential for increased efficiencies that had built up during the rapid capital accumulation of the latter part of the 1990s. That process has not yet played out completely. Many firms seem to be continuing to find new ways to exploit the technological opportunities embodied in the substantial investments in high-tech equipment that they had made over the past decade.

When aggregate demand accelerated in the second half of 2003, the pace of job cuts slowed. But because of the newfound improvements in the efficiency of their operations, firms were able to meet increasing demand without adding many new workers.

As the opportunities to enhance efficiency from the capital investments of the late 1990s inevitably become scarcer, productivity growth will doubtless slow from its recent phenomenal pace. And, if demand continues to firm, companies will ultimately find that they have no choice but to increase their workforces if they are to address growing backlogs of orders. In such an environment, the pace of hiring should pick up on a more sustained basis, bringing with it larger persistent increases in net employment than those prevailing until recently.

Still, the anxiety that many in our workforce feel will not subside quickly. In March of this year, about 85,000 jobless individuals per week exhausted their unemployment insurance benefits - more than double the 35,000 per week in September 2000. Moreover, the average duration of unemployment increased from twelve weeks in September 2000 to twenty weeks in March of this year. These developments have led to a notable rise in insecurity among workers.

Most of the recent increases in productivity have been reflected in a sharp rise in the pretax profits of nonfinancial corporations from a very low 7 percent share of that sector's gross value added in the third quarter of 2001 to a high 12 percent share in the fourth quarter of last year. The increase in real hourly compensation was quite modest over that period. The consequence was a marked fall in the ratio of employee compensation to gross nonfinancial corporate income to a very low level by the standards of the past three decades.

If history is any guide, competitive pressures, at some point, will shift in favor of real hourly compensation at the expense of corporate profits. That shift, coupled with further gains in employment, should cause labor's share of income to begin to rise toward historical norms.

Such a process need not add to inflation pressures. Although labor costs, which compose nearly two thirds of consolidated costs, no longer seem to be falling at the pace that prevailed in the second half of last year, those costs have yet to post a decisive upturn. And even if they do, the current high level of profit margins suggests that firms may come under competitive pressure to absorb some acceleration of labor costs. Should such an acceleration of costs persist, however, higher price inflation would inevitably follow.

The pace of economic expansion here and abroad is evidently contributing to some price pressures at earlier stages of the production process and in energy markets, and the decline in the dollar's exchange rate has fostered a modest firming of core import prices. More broadly, however, although the recent data suggest that the worrisome trend of disinflation presumably has come to an end, still-significant productivity growth and a sizable margin of underutilized resources, to date, have checked any sustained acceleration of the general price level and should continue to do so for a time. Moreover, the initial effect of a slowing of productivity growth is more likely to be an easing of profit margins than an acceleration of prices.

As I have noted previously, the federal funds rate must rise at some point to prevent pressures on price inflation from eventually emerging. As yet, the protracted period of monetary accommodation has not fostered an environment in which broad-based inflation pressures appear to be building. But the Federal Reserve recognizes that sustained prosperity requires the maintenance of price stability and will act, as necessary, to ensure that outcome.