Alan Greenspan: Semiannual 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 Congress, before the Committee on Financial Services, US House of Representatives, 20 July 2005.

Mr Greenspan presented identical testimony before the Committee on Banking, Housing, and Urban Affairs, US Senate on 21 July 2005.

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Mr Chairman and members of the Committee, I am pleased to be here today to present the Federal Reserve's Monetary Policy Report to the Congress.

In mid-February, when I presented our last report to the Congress, the economy, supported by strong underlying fundamentals, appeared to be on a solid growth path, and those circumstances prevailed through March. Accordingly, the Federal Open Market Committee (FOMC) continued the process of a measured removal of monetary accommodation, which it had begun in June 2004, by raising the federal funds rate 1/4 percentage point at both the February and the March meetings.

The upbeat picture became cloudier this spring, when data on economic activity proved to be weaker than most market participants had anticipated and inflation moved up in response to the jump in world oil prices. By the time of the May FOMC meeting, some evidence suggested that the economy might have been entering a soft patch reminiscent of the middle of last year, perhaps as a result of higher energy costs worldwide. In particular, employment gains had slowed from the strong pace of the end of 2004, consumer sentiment had weakened, and the momentum in household and business spending appeared to have dissipated somewhat.

At the May meeting, the Committee had to weigh the extent to which this weakness was likely to be temporary--perhaps simply the product of the normal ebb and flow of a business expansion--and the extent to which it reflected some influence that might prove more persistent, such as the further run-up in crude oil prices. While the incoming data highlighted some downside risks to the outlook for economic growth, the FOMC judged the balance of information as suggesting that the economy had not weakened fundamentally.

Moreover, core inflation had moved higher again through the first quarter. The rising prices of energy and other commodities continued to place upward pressures on costs, and reports of greater pricing power of firms indicated that they might be more able to pass those higher costs on to their customers. Given these considerations, the Committee continued the process of gradually removing monetary accommodation in May.

The data released over the past two months or so accord with the view that the earlier soft readings on the economy were not presaging a more serious slowdown in the pace of activity. Employment has remained on an upward trend, retail spending has posted appreciable gains, inventory levels are modest, and business investment appears to have firmed. At the same time, low long-term interest rates have continued to provide a lift to housing activity. Although both overall and core consumer price inflation have eased of late, the prices of oil and natural gas have moved up again on balance since May and are likely to place some upward pressure on consumer prices, at least over the near term. Slack in labor and product markets has continued to decline. In light of these developments, the FOMC raised the federal funds rate at its June meeting to further reduce monetary policy accommodation. That action brought the cumulative increase in the funds rate over the past year to 2¼ percentage points.

Should the prices of crude oil and natural gas flatten out after their recent run-up--the forecast currently embedded in futures markets--the prospects for aggregate demand appear favorable. Household spending--buoyed by past gains in wealth, ongoing increases in employment and income, and relatively low interest rates--is likely to continue to expand. Business investment in equipment and software seems to be on a solid upward trajectory in response to supportive conditions in financial markets and the ongoing need to replace or upgrade aging high-tech and other equipment. Moreover, some recovery in nonresidential construction appears in the offing, spurred partly by lower vacancy rates and rising prices for commercial properties. However, given the comparatively less buoyant growth of many foreign economies and the recent increase in the foreign exchange value of the dollar, our external sector does not yet seem poised to contribute steadily to U.S. growth.

A flattening out of the prices of crude oil and natural gas, were it to materialize, would also lessen upward pressures on inflation. Overall inflation would probably drop back noticeably from the rates experienced in 2004 and early 2005, and core inflation could hold steady or edge lower. Prices of crude materials and intermediate goods have softened of late, and the slower rise in import prices that should result from the recent strength in the foreign exchange value of the dollar could also relieve some pressure on inflation.

Thus, our baseline outlook for the U.S. economy is one of sustained economic growth and contained inflation pressures. In our view, realizing this outcome will require the Federal Reserve to continue to remove monetary accommodation. This generally favorable outlook, however, is attended by some significant uncertainties that warrant careful scrutiny.

With regard to the outlook for inflation, future price performance will be influenced importantly by the trend in unit labor costs, or its equivalent, the ratio of hourly labor compensation to output per hour. Over most of the past several years, the behavior of unit labor costs has been quite subdued. But those costs have turned up of late, and whether the favorable trends of the past few years will be maintained is unclear. Hourly labor compensation as measured from the national income and product accounts increased sharply near the end of 2004. However, that measure appears to have been boosted significantly by temporary factors. Other broad measures suggest that hourly labor compensation continues to rise at a moderate rate.

The evolution of unit labor costs will also reflect the growth of output per hour. Over the past decade, the U.S. economy has benefited from a remarkable acceleration of productivity: Strong gains in efficiency have buoyed real incomes and restrained inflation. But experience suggests that such rapid advances are unlikely to be maintained in an economy that has reached the cutting edge of technology. Over the past two years, growth in output per hour seems to have moved off the peak that it reached in 2003. However, the cause, extent, and duration of that slowdown are not yet clear. The traditional measure of the growth in output per hour, which is based on output as measured from the product side of the national accounts, has slowed sharply in recent quarters. But a conceptually equivalent measure that uses output measured from the income side has slowed far less. Given the divergence between these two readings, a reasonably accurate determination of the extent of the recent slowing in productivity growth and its parsing into cyclical and secular influences will require the accumulation of more evidence.

Energy prices represent a second major uncertainty in the economic outlook. A further rise could cut materially into private spending and thus damp the rate of economic expansion. In recent weeks, spot prices for crude oil and natural gas have been both high and volatile.

Prices for far-future delivery of oil and gas have risen even more markedly than spot prices over the past year. Apparently, market participants now see little prospect of appreciable relief from elevated energy prices for years to come. Global demand for energy apparently is expected to remain strong, and market participants are evidencing increased concerns about the potential for supply disruptions in various oil-producing regions.

To be sure, the capacity to tap and utilize the world's supply of oil continues to expand. Major advances in recovery rates from existing reservoirs have enhanced proved reserves despite ever fewer discoveries of major oil fields. But, going forward, because of the geographic location of proved reserves, the great majority of the investment required to convert reserves into new crude oil productive capacity will need to be made in countries where foreign investment is currently prohibited or restricted or faces considerable political risk. Moreover, the preponderance of oil and gas revenues of the dominant national oil companies is perceived as necessary to meet the domestic needs of growing populations. These factors have the potential to constrain the ability of producers to expand capacity to keep up with the projected growth of world demand, which has been propelled to an unexpected extent by burgeoning demand in emerging Asia.

More favorably, the current and prospective expansion of U.S. capability to import liquefied natural gas will help ease longer-term natural gas stringencies and perhaps bring natural gas prices in the United States down to world levels.

The third major uncertainty in the economic outlook relates to the behavior of long-term interest rates. The yield on ten-year Treasury notes, currently near 4-1/4 percent, is about 50 basis points below its level of late spring 2004. Moreover, even after the recent widening of credit risk spreads, yields for both investment-grade and less-than-investment-grade corporate bonds have declined even more than those on Treasury notes over the same period.

This decline in long-term rates has occurred against the backdrop of generally firm U.S. economic growth, a continued boost to inflation from higher energy prices, and fiscal pressures associated with the fast approaching retirement of the baby-boom generation.[1] The drop in long-term rates is especially surprising given the increase in the federal funds rate over the same period. Such a pattern is clearly without precedent in our recent experience.

The unusual behavior of long-term interest rates first became apparent last year. In May and June of 2004, with a tightening of monetary policy by the Federal Reserve widely expected, market participants built large short positions in long-term debt instruments in anticipation of the increase in bond yields that has been historically associated with an initial rise in the federal funds rate. Accordingly, yields on ten-year Treasury notes rose during the spring of last year about 1 percentage point. But by summer, pressures emerged in the marketplace that drove long-term rates back down. In March of this year, long-term rates once again began to rise, but like last year, market forces came into play to make those increases short lived.

Considerable debate remains among analysts as to the nature of those market forces. Whatever those forces are, they are surely global, because the decline in long-term interest rates in the past year is even more pronounced in major foreign financial markets than in the United States.

Two distinct but overlapping developments appear to be at work: a longer-term trend decline in bond yields and an acceleration of that trend of late. Both developments are particularly evident in the interest rate applying to the one-year period ending ten years from today that can be inferred from the U.S. Treasury yield curve. In 1994, that so-called forward rate exceeded 8 percent. By mid-2004, it had declined to about 6-1/2 percent--an easing of about 15 basis points per year on average.[2] Over the past year, that drop steepened, and the forward rate fell 130 basis points to less than 5 percent.

Some, but not all, of the decade-long trend decline in that forward yield can be ascribed to expectations of lower inflation, a reduced risk premium resulting from less inflation volatility, and a smaller real term premium that seems due to a moderation of the business cycle over the past few decades.[3] This decline in inflation expectations and risk premiums is a signal development. As I noted in my testimony before this Committee in February, the effective productive capacity of the global economy has substantially increased, in part because of the breakup of the Soviet Union and the integration of China and India into the global marketplace. And this increase in capacity, in turn, has doubtless contributed to expectations of lower inflation and lower inflation-risk premiums.

In addition to these factors, the trend reduction worldwide in long-term yields surely reflects an excess of intended saving over intended investment. This configuration is equivalent to an excess of the supply of funds relative to the demand for investment. What is unclear is whether the excess is due to a glut of saving or a shortfall of investment. Because intended capital investment is to some extent driven by forces independent of those governing intended saving, the gap between intended saving and investment can be quite wide and variable. It is real interest rates that bring actual capital investment worldwide and its means of financing, global saving, into equality. We can directly observe only the actual flows, not the saving and investment tendencies. Nonetheless, as best we can judge, *both* high levels of intended saving and low levels of intended investment have combined to lower real long-term interest rates over the past decade.

Since the mid-1990s, a significant increase in the share of world gross domestic product (GDP) produced by economies with persistently above-average saving--prominently the emerging economies of Asia--has put upward pressure on world saving. These pressures have been supplemented by shifts in income toward the oil-exporting countries, which more recently have built surpluses because of steep increases in oil prices. The changes in shares of world GDP, however, have had little effect

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1 Under current law, those longer-run pressures on the federal budget threaten to place the economy on an unsustainable path. Large deficits could result in rising interest rates and ever-growing interest payments on the accumulating stock of debt, which in turn would further augment deficits in future years. That process could result in deficits as a percentage of gross domestic product rising without limit. Unless such a development were headed off, these deficits could cause the economy to stagnate or worse at some point over the next couple of decades.

2 Dollar interest rate swaps five years forward and maturing in ten years declined 19 basis points per year on average over the same period. Comparable euro (pre-1999, Deutschemark) swaps declined 27 basis points, sterling swaps 35 basis points, and yen swaps 23 basis points.

3 Term premiums measure the extent to which current prices of bonds discount future uncertainties.

on actual world capital investment as a percentage of GDP. The fact that investment as a percentage of GDP apparently changed little when real interest rates were falling, even adjusting for the shift in the shares of world GDP, suggests that, on average, countries' investment propensities had been declining.[4]

Softness in intended investment is also evident in corporate behavior. Although corporate capital investment in the major industrial countries rose in recent years, it apparently failed to match increases in corporate cash flow.[5] In the United States, for example, capital expenditures were below the very substantial level of corporate cash flow in 2003, the first shortfall since the severe recession of 1975. That development was likely a result of the business caution that was apparent in the wake of the stock market decline and the corporate scandals early this decade. (Capital investment in the United States has only recently shown signs of shedding at least some of that caution.) Japanese investment exhibited prolonged restraint following the bursting of their speculative bubble in the early 1990s. And investment in emerging Asia excluding China fell appreciably after the Asian financial crisis in the late 1990s. Moreover, only a modest part of the large revenue surpluses of oil-producing nations has been reinvested in physical assets. In fact, capital investment in the Middle East in 2004, at 25 percent of the region's GDP, was the same as in 1998. National saving, however, rose from 21 percent to 32 percent of GDP. The unused saving of this region was invested in world markets.

Whether the excess of global intended saving over intended investment has been caused by weak investment or excessive saving--that is, by weak consumption--or, more likely, a combination of both does not much affect the intermediate-term outlook for world GDP or, for that matter, U.S. monetary policy. What have mattered in recent years are the sign and the size of the gap of intentions and the implications for interest rates, not whether the gap results from a saving glut or an investment shortfall. That said, saving and investment propensities do matter over the longer run. Higher levels of investment relative to consumption build up the capital stock and thus add to the productive potential of an economy.

The economic forces driving the global saving-investment balance have been unfolding over the course of the past decade, so the steepness of the recent decline in long-term dollar yields and the associated distant forward rates suggests that something more may have been at work over the past year.[6] Inflation premiums in forward rates ten years ahead have apparently continued to decline, but real yields have also fallen markedly over the past year. It is possible that the factors that have tended to depress real yields over the past decade have accelerated recently, though that notion seems implausible.

According to estimates prepared by the Federal Reserve Board staff, a significant portion of the sharp decline in the ten-year forward one-year rate over the past year appears to have resulted from a fall in term premiums. Such estimates are subject to considerable uncertainty. Nevertheless, they suggest that risk takers have been encouraged by a perceived increase in economic stability to reach out to more distant time horizons. These actions have been accompanied by significant declines in measures of expected volatility in equity and credit markets inferred from prices of stock and bond options and narrow credit risk premiums. History cautions that long periods of relative stability often engender unrealistic expectations of its permanence and, at times, may lead to financial excess and economic stress.

Such perceptions, many observers believe, are contributing to the boom in home prices and creating some associated risks. And, certainly, the exceptionally low interest rates on ten-year Treasury notes, and hence on home mortgages, have been a major factor in the recent surge of homebuilding, home turnover, and particularly in the steep climb in home prices. Whether home prices on average for the

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4 Nominal GDP figures by country are estimated in dollars by the International Monetary Fund using purchasing power parities (PPP) of currencies. These GDP figures are used to calculate weights applied to national saving and investment rates to form global measures. When the GDP figures are instead measured at market exchange rates, the results are similar. The PPP estimates emphasize the economic factors generating investment and the use of saving. Exchange rates emphasize the financial forces governing the financing of investment across borders. Both approaches are useful.

5 A significant part of the surge in cash flow of U.S. corporations was accrued by those financial intermediaries that invest only a small part in capital assets. It appears that the value added of intermediation has increased materially over the past decade because of major advances in financial product innovation.

6 The decline of euro, sterling, and yen forward swap rates also steepened.

nation as a whole are overvalued relative to underlying determinants is difficult to ascertain, but there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels. Among other indicators, the significant rise in purchases of homes for investment since 2001 seems to have charged some regional markets with speculative fervor.

The apparent froth in housing markets appears to have interacted with evolving practices in mortgage markets. The increase in the prevalence of interest-only loans and the introduction of more-exotic forms of adjustable-rate mortgages are developments of particular concern. To be sure, these financing vehicles have their appropriate uses. But some households may be employing these instruments to purchase homes that would otherwise be unaffordable, and consequently their use could be adding to pressures in the housing market. Moreover, these contracts may leave some mortgagors vulnerable to adverse events. It is important that lenders fully appreciate the risk that some households may have trouble meeting monthly payments as interest rates and the macroeconomic climate change.

The U.S. economy has weathered such episodes before without experiencing significant declines in the national average level of home prices. Nevertheless, we certainly cannot rule out declines in home prices, especially in some local markets. If declines were to occur, they likely would be accompanied by some economic stress, though the macroeconomic implications need not be substantial. Nationwide banking and widespread securitization of mortgages make financial intermediation less likely to be impaired than it was in some previous episodes of regional house-price correction. Moreover, a decline in the national housing price level would need to be substantial to trigger a significant rise in foreclosures, because the vast majority of homeowners have built up substantial equity in their homes despite large mortgage-market-financed withdrawals of home equity in recent years.

Historically, it has been rising real long-term interest rates that have restrained the pace of residential building and have suppressed existing home sales, high levels of which have been the major contributor to the home equity extraction that arguably has financed a noticeable share of personal consumption expenditures and home modernization outlays.

The trend of mortgage rates, or long-term interest rates more generally, is likely to be influenced importantly by the worldwide evolution of intended saving and intended investment. We at the Federal Reserve will be closely monitoring the path of this global development few, if any, have previously experienced. As I indicated earlier, the capital investment climate in the United States appears to be improving following significant headwinds since late 2000, as is that in Japan. Capital investment in Europe, however, remains tepid. A broad worldwide expansion of capital investment not offset by a rising worldwide propensity to save would presumably move real long-term interest rates higher. Moreover, with term premiums at historical lows, further downward pressure on long-term rates from this source is unlikely.

We collectively confront many risks beyond those that I have just mentioned. As was tragically evidenced again by the bombings in London earlier this month, terrorism and geopolitical risk have become enduring features of the global landscape. Another prominent concern is the growing evidence of anti-globalization sentiment and protectionist initiatives, which, if implemented, would significantly threaten the flexibility and resilience of many economies. This situation is especially troubling for the United States, where openness and flexibility have allowed us to absorb a succession of large shocks in recent years with only minimal economic disruption. That flexibility is, in large measure, a testament to the industry and resourcefulness of our workers and businesses. But our success in this dimension has also been aided importantly by more than two and a half decades of bipartisan effort aimed at reducing unnecessary regulation and promoting the openness of our market economy. Going forward, policymakers will need to be vigilant to preserve this flexibility, which has contributed so constructively to our economic performance in recent years.

In conclusion, Mr. Chairman, despite the challenges that I have highlighted and the many I have not, the U.S. economy has remained on a firm footing, and inflation continues to be well contained. Moreover, the prospects are favorable for a continuation of those trends. Accordingly, the Federal Open Market Committee in its June meeting reaffirmed that it

"... believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."