Mr Greenspan's testimony on monetary policy and the economic outlook in the United States

Testimony of the Chairman of the Board of Governors of the US Federal Reserve System, Mr Alan Greenspan, before the Joint Economic Committee of the US Congress on 17 June 1999.

As emphasized by the important hearings this committee has held in the past few days, an impressive proliferation of new technologies is inducing major shifts in the underlying structure of the American economy. These fundamental changes appear to be far from complete. The way America does business, including the interaction among the various economic players in our economy, is in the midst of a significant transformation, though the pace of change is unclear.

As a consequence, many of the empirical regularities depicting the complex of economic relationships on which policymakers rely have been markedly altered. The Federal Reserve has thus been pressed to continuously update our understanding of how the newer forces are developing in order for us to address appropriately our underlying monetary policy objective: maximum sustainable economic growth.

The failure of economic models based on history to anticipate the acceleration in productivity contributed to the recent persistent underprediction of economic growth and overprediction of inflation. Guiding policy by those models doubtless would have unduly inhibited what has been a remarkable run of economic prosperity.

And yet, while we have been adjusting the implicit models of the underlying economic forces on which we base our decisions, certain verities remain.

Importantly, the evidence has become increasingly persuasive that relatively stable prices – neither persistently rising nor falling – are more predictable hence result in a lower risk premium for investment. Because the nation's level of investment, to a large extent, determines our prosperity over time, stability in the general level of prices for goods and services is clearly a necessary condition for maximum sustainable growth. However, product price stability does not guarantee either the maintenance of financial market stability or maximum sustainable growth.

As recent experience attests, a prolonged period of price stability does help to foster economic prosperity. But, as we have also observed over recent years, as have others in times past, such a benign economic environment can induce investors to take on more risk and drive asset prices to unsustainable levels. This can occur when investors implicitly project rising prosperity further into the future than can reasonably be supported. By 1997, for example, measures of risk had fallen to historic lows as businesspeople, having experienced years of continuous good times, assumed, not unreasonably, that the most likely forecast was more of the same.

The Asian crisis, and especially the Russian devaluation and debt moratorium of August 1998, brought the inevitable rude awakening. In the ensuing weeks, financial markets in the United States virtually seized-up, risk premiums soared, and for a period sellers of even investment grade bonds had difficulty finding buyers. The Federal Reserve responded with a three step reduction in the federal funds rate totaling 75 basis points.

Market strains receded – whether as a consequence of our actions or of other forces – and yield spreads have since fallen but not all the way back to their unduly thin levels of last summer.

The American economy has retained its momentum and emerging economies in Asia and Latin America are clearly on firmer footing, though in some cases their turnarounds appear fragile. The recovery of financial markets, viewed in isolation, would have suggested that at least part of the emergency injection of liquidity, and the associated 75 basis point decline in the funds rate, ceased to be necessary. But, with wage growth and price inflation declining by a number of measures earlier this year, and productivity evidently still accelerating – thereby keeping inflation in check – we chose to maintain the lower level of the funds rate.

While this stellar noninflationary economic expansion still appears remarkably stress free on the surface, there are developing imbalances that give us pause and raise the question: Do these imbalances place our economic expansion at risk?

For the period immediately ahead, inflationary pressures still seem well contained. To be sure, oil prices have nearly doubled and some other commodity prices have firmed, but large productivity gains have held unit cost increases to negligible levels. Pricing power is still generally reported to be virtually nonexistent. Moreover, the re-emergence of rising profit margins, after severe problems last fall, indicates cost pressures on prices remain small.

Nonetheless, the persistence of certain imbalances pose a risk to the longer-run outlook. Strong demand for labor has continued to reduce the pool of available workers. Data showing the percent of the relevant population who are not at work, but would like a job, are around the low for this series, which started in 1970.

Despite its extraordinary acceleration, labor productivity has not grown fast enough to accommodate the increased demand for labor induced by the exceptional strength in demand for goods and services.

Overall economic growth during the past three years has averaged four percent annually, of which roughly two percentage points reflected increased productivity and about one point the growth in our working age population. The remainder was drawn from the ever decreasing pool of available job seekers without work.

That last development represents an unsustainable trend that has been produced by an inclination of households and firms to increase their spending on goods and services beyond the gains in their income from production. That propensity to spend, in turn, has been spurred by the rise in equity and home prices, which our analysis suggests can account for at least one percentage point of GDP growth over the past three years.

Even if this period of rapid expansion of capital gains comes to an end shortly, there remains a substantial amount in the pipeline to support outsized increases in consumption for many months into the future. Of course, a dramatic contraction in equity market prices would greatly reduce this backlog of extra spending.

To be sure, labor market tightness has not, as yet, put the current expansion at risk. Despite the ever shrinking pool of available labor, recent readings on year-over-year increases in labor compensation have held steady or, by some measures, even eased. This seems to have resulted

in part from falling inflation, which has implied that relatively modest nominal wage gains have provided healthy increases in purchasing power. Also, a residual fear of job skill obsolescence, which has induced a preference for job security over wage gains, probably is still holding down wage levels.

But should labor markets continue to tighten, significant increases in wages, in excess of productivity growth, will inevitably emerge, absent the unlikely repeal of the law of supply and demand. Because monetary policy operates with a significant lag, we have to make judgments, not only about the current degree of balance in the economy, but about how the economy is likely to fare a year or more in the future under the current policy stance.

The return of financial markets to greater stability and our growing concerns about emerging imbalances led the Federal Open Market Committee to adopt a policy position at our May meeting that contemplated a possible need for an upward adjustment of the federal funds rate in the months ahead. The issue is what policy setting has the capacity to sustain our remarkable economic expansion, now in its ninth year. This is the question the FOMC will be addressing at its meeting at the end of the month.

One of the important issues for the FOMC as it has made such judgments in recent years has been the weight to place on asset prices. As I have already noted, history suggests that owing to the growing optimism that may develop with extended periods of economic expansion, asset price values can climb to unsustainable levels even if product prices are relatively stable.

The 1990s have witnessed one of the great bull stock markets in American history. Whether that means an unstable bubble has developed in its wake is difficult to assess. A large number of analysts have judged the level of equity prices to be excessive, even taking into account the rise in “fair value” resulting from the acceleration of productivity and the associated long-term corporate earnings outlook.

But bubbles generally are perceptible only after the fact. To spot a bubble in advance requires a judgment that hundreds of thousands of informed investors have it all wrong. Betting against markets is usually precarious at best.

While bubbles that burst are scarcely benign, the consequences need not be catastrophic for the economy.

The bursting of the Japanese bubble a decade ago did not lead immediately to sharp contractions in output or a significant rise in unemployment. Arguably, it was the subsequent failure to address the damage to the financial system in a timely manner that caused Japan’s current economic problems. Likewise, while the stock market crash of 1929 was destabilizing, most analysts attribute the Great Depression to ensuing failures of policy. And certainly the crash of October 1987 left little lasting imprint on the American economy.

This all leads to the conclusion that monetary policy is best primarily focused on stability of the general level of prices of goods and services as the most credible means to achieve sustainable economic growth. Should volatile asset prices cause problems, policy is probably best positioned to address the consequences when the economy is working from a base of stable product prices.

For monetary policy to foster maximum sustainable economic growth, it is useful to pre-empt forces of imbalance before they threaten economic stability. But this may not always be possible – the future at times can be too opaque to penetrate. When we can be pre-emptive we should be, because modest pre-emptive actions can obviate the need of more drastic actions at a later date that could destabilize the economy.

The economic expansion has generated many benefits. It has been a major factor in rebalancing our federal budget. But more important, a broad majority of our people have moved to a higher standard of living, and we have managed to bring into the productive workforce those who have too long been at its periphery. This has enabled large segments of our society to gain skills on the job and the self-esteem associated with work. Our responsibility, at the Federal Reserve and in Congress, is to create the conditions most likely to preserve and extend the expansion.

Should the economic expansion continue into February of next year, it will have become the longest in America's economic annals. Someday, of course, the expansion will end; human nature has exhibited a tendency to excess through the generations with the inevitable economic hangover. There is nothing in our economic data series to suggest that this propensity has changed. It is the job of economic policymakers to mitigate the fallout when it occurs, and, hopefully, ease the transition to the next expansion.