Alan Greenspan: Federal Reserve's report on monetary policy

Testimony of Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs of the US Senate on 20 July 2000.

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Mr Chairman and other members of the Committee, I appreciate this opportunity to present the Federal Reserve's *report on monetary policy*.

The Federal Reserve has been confronting a complex set of challenges in judging the stance of policy that will best contribute to sustaining the strong and long-running expansion of our economy. The challenges will be no less in coming months as we judge whether ongoing adjustments in supply and demand will be sufficient to prevent distortions that would undermine the economy's extraordinary performance.

For some time now, the growth of aggregate demand has exceeded the expansion of production potential. Technological innovations have boosted the growth rate of potential, but as I noted in my testimony last February, the effects of this process also have spurred aggregate demand. It has been clear to us that, with labor markets already quite tight, a continuing disparity between the growth of demand and potential supply would produce disruptive imbalances.

A key element in this disparity has been the very rapid growth of consumption resulting from the effects on spending of the remarkable rise in household wealth. However, the growth in household spending has slowed noticeably this spring from the unusually rapid pace observed late in 1999 and early this year. Some argue that this slowing is a pause following the surge in demand through the warmer-than-normal winter months and hence a reacceleration can be expected later this year. Certainly, we have seen slowdowns in spending during this near-decade-long expansion that have proven temporary, with aggregate demand growth subsequently rebounding to an unsustainable pace.

But other analysts point to a number of factors that may be exerting more persistent restraint on spending. One they cite is the flattening in equity prices, on net, this year. They attribute much of the slowing of consumer spending to this diminution of the wealth effect through the spring and early summer. This view looks to equity markets as a key influence on the trend in consumer spending over the rest of this year and next.

Another factor said by some to account for the spending slowdown is the rising debt burden of households. Interest and amortization as a percent of disposable income have risen materially during the past six years, as consumer and especially mortgage debt has climbed and, more recently, as interest rates have moved higher.

In addition, the past year's rise in the price of oil has amounted to an annual $75 billion levy by foreign producers on domestic consumers of imported oil, the equivalent of a tax of roughly 1 percent of disposable income. This burden is another likely source of the slowed growth in real consumption outlays in recent months, though one that may prove to be largely transitory.

Mentioned less prominently have been the effects of the faster increase in the stock of consumer durable assets - both household durable goods and houses - in the last several years, a rate of increase that history tells us is usually followed by a pause. Stocks of household durable goods, including motor vehicles, are estimated to have increased at nearly a 6 percent annual rate over the past three years, a marked acceleration from the growth rate of the previous ten years. The number of cars and light trucks owned or leased by households, for example, apparently has continued to rise in recent years despite having reached nearly 1¾ vehicles per household by the mid-1990s. Notwithstanding their recent slowing, sales of new homes continue at extraordinarily high levels relative to new household formations. While we will not know for sure until the 2000 census is tabulated, the surge in new home sales is strong evidence that the growth of owner-occupied homes has accelerated during the past five years.

Those who focus on the high and rising stocks of durable assets point out that even without the rise in interest rates, an eventual leveling out or some tapering off of purchases of durable goods and construction of single-family housing would be expected. Reflecting both higher interest rates and higher stocks of housing, starts of new housing units have fallen off of late. If that slowing were to persist, some reduction in the rapid pace of accumulation of household appliances across our more than hundred million households would not come as a surprise, nor would a slowdown in vehicle demand so often historically associated with declines in housing demand.

Inventories of durable assets in households are just as formidable a factor in new production as inventories at manufacturing and trade establishments. The notion that consumer spending and housing construction may be slowing because the stock of consumer durables and houses may be running into upside resistance is a credible addition to the possible explanations of current consumer trends. This effect on spending would be reinforced by the waning effects of gains in wealth.

Because the softness in outlay growth is so recent, all of the aforementioned hypotheses, of course, must be provisional. It is certainly premature to make a definitive assessment of either the recent trends in household spending or what they mean. But it is clear that, for the time being at least, the increase in spending on consumer goods and houses has come down several notches, albeit from very high levels.

In one sense, the more important question for the longer-term economic outlook is the extent of any productivity slowdown that might accompany a more subdued pace of production and consumer spending, should it persist. The behavior of productivity under such circumstances will be a revealing test of just how much of the rapid growth of productivity in recent years has represented structural change as distinct from cyclical aberrations and, hence, how truly different the developments of the past five years have been. At issue is how much of the current downshift in our overall economic growth rate can be accounted for by reduced growth in output per hour and how much by slowed increases in hours.

So far there is little evidence to undermine the notion that most of the productivity increase of recent years has been structural and that structural productivity may still be accelerating. New orders for capital equipment continue quite strong - so strong that the rise in unfilled orders has actually steepened in recent months. Capital-deepening investment in a broad range of equipment embodying the newer productivity-enhancing technologies remains brisk.

To be sure, if current personal consumption outlays slow significantly further than the pattern now in train suggests, profit and sales expectations might be scaled back, possibly inducing some hesitancy in moving forward even with capital projects that appear quite profitable over the longer run. In addition, the direct negative effects of the sharp recent runup in energy prices on profits as well as on sales expectations may temporarily damp capital spending. Despite the marked decline over the past decades in the energy requirements per dollar of GDP, energy inputs are still a significant element in the cost structure of many American businesses.

For the moment, the dropoff in overall economic growth to date appears about matched by reduced growth in hours, suggesting continued strength in growth in output per hour. The increase of production worker hours from March through June, for example, was at an annual rate of ½ percent compared with 3¼ percent the previous three months. Of course, we do not have comprehensive measures of output on a monthly basis, but available data suggest a roughly comparable deceleration.

A lower overall rate of economic growth that did not carry with it a significant deterioration in productivity growth obviously would be a desirable outcome. It could conceivably slow or even bring to a halt the deterioration in the balance of overall demand and potential supply in our economy.

As I testified before this committee in February, domestic demand growth, influenced importantly by the wealth effect on consumer spending, has been running 1½ to 2 percentage points at an annual rate in excess of even the higher, productivity-driven, growth in potential supply since late 1997. That gap has been filled both by a marked rise in imports as a percent of GDP and by a marked increase in domestic production resulting both from significant immigration and from the employment of previously unutilized labor resources.

I also pointed out in February that there are limits to how far net imports - or the broader measure, our current account deficit - can rise, or our pool of unemployed labor resources can fall. As a consequence, the excess of the growth of domestic demand over potential supply must be closed before the resulting strains and imbalances undermine the economic expansion that now has reached 112 months, a record for peace or war.

The current account deficit is a proxy for the increase in net claims against US residents held by foreigners, mainly as debt, but increasingly as equities. So long as foreigners continue to seek to hold ever-increasing quantities of dollar investments in their portfolios, as they obviously have been, the exchange rate for the dollar will remain firm. Indeed, the same sharp rise in potential rates of return on new American investments that has been driving capital accumulation and accelerating productivity in the United States has also been inducing foreigners to expand their portfolios of American securities and direct investment. The latest data published by the Department of Commerce indicate that the annual pace of direct plus portfolio investment by foreigners in the US economy during the first quarter was more than two and one-half times its rate in 1995.

There has to be a limit as to how much of the world's savings our residents can borrow at close to prevailing interest and exchange rates. And a narrowing of disparities among global growth rates could induce a narrowing of rates of return here relative to those abroad that could adversely affect the propensity of foreigners to invest in the United States. But obviously, so long as our rates of return appear to be unusually high, if not rising, balance of payments trends are less likely to pose a threat to our prosperity. In addition, our burgeoning budget surpluses have clearly contributed to a fending off, if only temporarily, of some of the pressures on our balance of payments. The stresses on the global savings pool resulting from the excess of domestic private investment demands over domestic private saving have been mitigated by the large federal budget surpluses that have developed of late.

In addition, by substantially augmenting national saving, these budget surpluses have kept real interest rates at levels lower than they would have been otherwise. This development has helped foster the investment boom that in recent years has contributed greatly to the strengthening of US productivity and economic growth. The Congress and the Administration have wisely avoided steps that would materially reduce these budget surpluses. Continued fiscal discipline will contribute to maintaining robust expansion of the American economy in the future.

Just as there is a limit to our reliance on foreign saving, so is there a limit to the continuing drain on our unused labor resources. Despite the ever-tightening labor market, as yet, gains in compensation per hour are not significantly outstripping gains in productivity. But as I have argued previously, should labor markets continue to tighten, short of a repeal of the law of supply and demand, labor costs eventually would have to accelerate to levels threatening price stability and our continuing economic expansion. The more modest pace of increase in domestic final spending in recent months suggests that aggregate demand may be moving closer into line with the rate of advance in the economy's potential, given our continued impressive productivity growth. Should these trends toward supply and demand balance persist, the ongoing need for ever-rising imports and for a further draining of our limited labor resources should ease or perhaps even end. Should this favorable outcome prevail, the immediate threat to our prosperity from growing imbalances in our economy would abate.

But as I indicated earlier, it is much too soon to conclude that these concerns are behind us. We cannot yet be sure that the slower expansion of domestic final demand, at a pace more in line with potential supply, will persist. Even if the growth rates of demand and potential supply move into better balance, there is still uncertainty about whether the current level of labor resource utilization can be maintained without generating increased cost and price pressures.

As I have already noted, to date costs have been held in check by productivity gains. But at the same time, inflation has picked up - even the core measures that do not include energy prices directly. Higher rates of core inflation may mostly reflect the indirect effects of energy prices, but the Federal Reserve will need to be alert to the risks that high levels of resource utilization may put upward pressure on inflation.

Moreover, energy prices may pose a challenge to containing inflation. Energy price changes represent a one-time shift in a set of important prices, but by themselves generally cannot drive an ongoing inflation process. The key to whether such a process could get under way is inflation expectations. To date, survey evidence, as well as readings from the Treasury's inflation-indexed securities, suggests that households and investors do not view the current energy price surge as affecting longer-term inflation. But any deterioration in such expectations would pose a risk to the economic outlook.

As the financing requirements for our ever-rising capital investment needs mounted in recent years - beyond forthcoming domestic saving - real long-term interest rates rose to address this gap. We at the Federal Reserve, responding to the same economic forces, have moved the overnight federal funds rate up 1¾ percentage points over the past year. To have held to the federal funds rate of June 1999 would have required a massive increase in liquidity that would presumably have underwritten an acceleration of prices and, hence, an eventual curbing of economic growth.

By our meeting this June, the appraisal of all the foregoing issues led the Federal Open Market Committee to conclude that, while some signs of slower growth were evident and justified standing pat at least for the time being, they were not sufficiently compelling to alter our view that the risks remained more on the side of higher inflation.

As indicated in their forecasts, FOMC members and nonvoting presidents expect that the long period of continuous economic expansion will be extended over the next year and one-half, but with growth at a somewhat slower pace than over the past several years. For the current year, the central tendency of Board members' and Reserve Bank presidents' forecasts is for real GDP to increase 4 to 4½ percent, suggesting a noticeable deceleration over the second half of 2000 from its likely pace over the first half. The unemployment rate is projected to remain close to 4 percent. This outlook is a little stronger than anticipated last February, no doubt owing primarily to the unexpectedly strong jump in output in the first quarter. Mainly reflecting higher prices of energy products than had been foreseen, the central tendency for inflation this year in prices for personal consumption expenditures also has been revised up somewhat, to the vicinity of 2½ to 2¾ percent.

Given the firmer financial conditions that have developed over the past eighteen months, the Committee expects economic growth to moderate somewhat next year. Real output is anticipated to expand 3¼ to 3¾ percent, somewhat less rapidly than in recent years. The unemployment rate is likely to remain close to its recent very low levels. Energy prices could ease somewhat, helping to trim PCE inflation next year to around 2 to 2½ percent, somewhat above the average of recent years.

Conclusion

The last decade has been a remarkable period of expansion for our economy. Federal Reserve policy through this period has been required to react to a constantly evolving set of economic forces, often at variance with historical relationships, changing federal funds rates when events appeared to threaten our prosperity, and refraining from action when that appeared warranted. Early in the expansion, for example, we kept rates unusually low for an extended period, when financial sector fragility held back the economy. Most recently we have needed to raise rates to relatively high levels in real terms in response to the side effects of accelerating growth and related demand-supply imbalances. Variations in the stance of policy - or keeping it the same - in response to evolving forces are made in the framework of an unchanging objective - to foster as best we can those financial conditions most likely to promote sustained economic expansion at the highest rate possible. Maximum sustainable growth, as history so amply demonstrates, requires price stability. Irrespective of the complexities of economic change, our primary goal is to find those policies that best contribute to a noninflationary environment and hence to growth. The Federal Reserve, I trust, will always remain vigilant in pursuit of that goal.