# Alan Greenspan: Monetary policy and economic outlook

Testimony of Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Joint Economic Committee, U.S. Congress, 17 October 2001.

*     *     *

I appreciate this opportunity to appear before the Committee to discuss recent developments in the United States economy. Despite the tragic events of September 11, the foundations of our free society remain sound, and I am confident that we will recover and prosper as we have in the past.

But before the recovery process gets under way, stability will need to be restored to the American economy and to others around the world. Arguably, that stability was only barely becoming evident in the United States in the period immediately preceding the act of terrorism.

Aggregate measures of production, employment, and business spending continued to be weak in August. Consumer spending, however, moved higher that month and appeared to be reasonably well maintained in the first part of September. Industry analysts suggest that motor vehicle sales were running close to August levels, and chain store sales were only modestly lower. New orders for nondefense capital goods stabilized in August. Moreover, the dramatic rate of decline in profits was slowing. To be sure, these signs were tentative but, on the whole, encouraging.

In the days following the attack, the level of activity declined significantly. The shock was most evident in consumer markets, as many potential purchasers stayed riveted to their televisions and away from shopping malls. Both motor vehicle sales and sales at major chain stores fell off noticeably. The airline and travel industries also suffered severe cutbacks.

The unprecedented shutdown of American air travel and tightened border restrictions induced dramatic curtailments of production at some establishments with tight just-in-time supply chain practices, most notably in the motor vehicle industry.

As the initial shock began to wear off, economic activity recovered somewhat from the depressed levels that immediately followed the attacks, though the recovery has been uneven. Markedly increased incentives induced a sharp rebound in motor vehicle sales by the end of the month that has carried apparently undiminished into the first half of October. However, many retailers of other consumer goods report that sales have only partially retraced the steep drops that occurred in mid-September. Fortunately, air freight is largely back to normal. Overall airline passenger traffic, while above its mid-September lows, was still off considerably in early October from pre-attack levels. Similarly, the hospitality and entertainment industries have overcome some of their earlier difficulties but continue to struggle.

The effect on financial markets of the devastating attack on the World Trade Center was pronounced, as telecommunications and trading capacities were severely impaired. But the markets are mostly functioning normally now, and as in the past, the infrastructure will be rapidly restored.

For a brief time, the terrorist attacks markedly disrupted payment transfers, leaving those counting on receiving payments caught short. Those needs ultimately were met by the Federal Reserve, both through record lending at the discount window and through an extraordinary infusion of funds through open-market operations. To facilitate the channeling of dollar liquidity to foreign financial institutions operating in the United States, thirty-day currency swap lines were arranged with major central banks, again in record volumes. It was essential in such an environment to meet all appropriate demands for dollar liquidity. As repair of the financial markets and payment infrastructure proceeded apace, loans were repaid, open-market operations could be scaled back, the unusual swap lines were allowed to expire, and the temporarily bloated balance sheet of the Federal Reserve largely returned to normal.

But even as market functioning and liquidity flows were restored, the potential for heightened uncertainty to damp household and business spending for a time persisted. To cushion these effects, we have eased the stance of monetary policy appreciably since September 11.

*     *     *

We in the United States have assumed ourselves to be fairly well-insulated from terrorism or, at most, subject to limited and sporadic episodes similar to those previously observed on a number of occasions in Europe.

We have been aware of the possibility for losses on a much greater scale. But I suspect that those possibilities were deemed so remote that they were never seriously incorporated into most conventional assessments of economic risk.

The shock of the tragedies at the World Trade Center and the Pentagon has reshaped those assessments of risk and required an abrupt realignment of prices in many markets to reflect the expected costs of operating in what we now recognize as a more hostile world. These circumstances pose a difficult challenge for business decisionmaking, not so much because the costs are inordinately large, but because the events, which have potentially substantial consequences, are so uncertain. Insurance deals with this problem by spreading the risk and converting potential large unknown costs into a steady stream of known insurance premiums that facilitates the forward planning so essential to an effective business operation.

Obviously, sharp increases in insurance premiums for all forms of businesses are to be expected. Some higher insurance costs, in effect, will be borne implicitly rather than explicitly, as firms choose to self-insure, at least in part, rather than lay off all of this risk in the marketplace.

These higher insurance costs, both explicit and implicit, endeavor to anticipate future losses. But in addition, they cover the physical capital and labor resources businesses will be required to devote to enhanced security, and to increased redundancies as protection against interruption of supplies or production. For example, the degree of comfort businesses have in allowing inventories to shrink to minimal levels in a just-in-time supply chain is lessened. In this regard, increased security threats, not pooled through insurance, have exactly the opposite effect on productivity than that which is gained by an improvement in information technology. In addition to the loss of human life and capital assets, these are important collateral costs associated with the new threats that we now face.

The pronounced rise in uncertainty also has damped consumer spending and capital investment; households and businesses, confronted with heightened uncertainty, have pulled back from the marketplace, though that withdrawal has been partial and presumably temporary. The very great economic uncertainties that have arisen in the current environment have also, at least temporarily, resulted in a widening of bond spreads on high-yield instruments.

Markets across our economy will adjust to the altered perceptions of risk that we now confront. Critical to that adjustment process is the behavior of consumers and business people. Behavior is difficult to predict in circumstances such as those we have experienced in the past five weeks. But judging from history, human beings have demonstrated a remarkable capacity to adapt to extraordinarily adverse circumstances. And, I expect the same adaptability to become evident in the present situation.

Although it is difficult to determine with any precision, it seems quite likely that a significant repricing of risk has already found its way into our markets, as many economic decisions are responding to shifting market signals. But these adjustments in prices and in the associated allocation of resources, when complete, represent one-time level adjustments, without necessary implications for our longer-term growth prospects.

Indeed, the exploitation of available networking and other information technologies was only partially completed when the cyclical retrenchment of the past year began. High-tech equipment investment at elevated rates of return will, most likely, resume once very high uncertainty premiums recede to more normal levels.

The level of productivity will presumably undergo a one-time downward adjustment as our economy responds to higher levels of perceived risk. But once the adjustment is completed, productivity growth should resume at rates in excess of those that prevailed in the quarter-century preceding 1995.

It is worth noting that increased production to enhance security will be counted in measured output without contributing to our standards of living, as was the case during our military buildup of the Cold War. Our productivity measures have always endeavored to capture increased productive efficiency, not increased well-being. We are, in effect, currently using part of our increase in efficiency to supply increased security. Of course, given the heightened risks we face, these investments in security are, doubtless, quite sound. In any event, such costs are likely to fall short of the costs we incurred for security during the height of the Cold War.

Nobody has the capacity to fathom fully how the effects of the tragedy of September 11 will play out in our economy. But in the weeks ahead, as the initial shock continues to wear off, we should be able to better gauge how the ongoing dynamics of these events are shaping the immediate economic outlook.

For the longer term, prospects for ongoing rapid technological advance and associated faster productivity growth are scarcely diminished. Those prospects, born of the ingenuity of our people and the strength of our system, fortify a promising future for our free nation.