

Alan Greenspan: Monetary policy and the 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, Washington, 17 April 2002.

* * *

I appreciate the opportunity to appear before the Joint Economic Committee to discuss the current state of the economy.

As we noted in our statement following the Federal Open Market Committee meeting in March, "The economy, bolstered by a marked swing in inventory investment, is expanding at a significant pace. Nonetheless, the degree of strengthening in final demand over coming quarters, an essential element in sustained economic expansion, is still uncertain." Little, if anything, has happened since the FOMC meeting to alter that assessment.

This morning I would like to elaborate on some of the forces that are likely to shape activity in the months ahead.

As I just noted, the behavior of inventories currently is the driving force in the near-term outlook. Stocks of goods in many industries were drawn down significantly last year, and preliminary data suggest that the pace of liquidation tapered off markedly in the first quarter. This development is important because the reduction in the rate of inventory liquidation has induced a rise in industrial production.

The pickup in the growth of activity, however, will be short-lived unless sustained increases in final demand kick in before the positive effects of inventory investment dissipate. We have seen encouraging signs in recent months that underlying trends in final demand are strengthening, but the dimensions of the pickup are still not clear.

A number of crosscurrents are likely to influence household spending this year. Through much of last year's slowdown, housing and consumption spending held up well and proved to be a major stabilizing force. But because there was little retrenchment during the cyclical downturn, the potential for a significant acceleration in activity in the household sector is likely to be more limited than in past business cycles.

One important source of support to household spending late last year--energy prices--will likely be less favorable in the months ahead. With the rise in world crude oil prices since the middle of January, higher energy costs are again sapping the purchasing power of households. To the extent that the increase in energy prices is limited in dimension--with prices not materially exceeding the trading range of recent weeks--the negative effects on spending in the aggregate should prove to be small. However, a price hike that drove oil prices well above existing levels for an appreciable period of time would likely have more far-reaching consequences.

In assessing the possible effects of higher oil prices, the inherent uncertainty about their future path is compounded by the limitations of the statistical models available to analyze such price shocks. When simulated over periods with observed oil prices spikes, these models do not show oil prices consistently having been a decisive factor in depressing economic activity. Yet, coincidence or not, all economic downturns in the United States since 1973, when oil became a prominent cost factor in business, have been preceded by sharp increases in the price of oil. This pattern leads one to suspect that the responsiveness of U.S. gross domestic product to energy prices is far more complex and may be quite different when households and businesses are confronted with abnormal price hikes. Macroeconometric models typically are specified as linear relationships, and they reflect average behavior over history. These models cannot distinguish between responses to outsized spikes and normal price fluctuations and thus may not capture the effect of sudden and sizable shifts in oil prices on the economy.

Another factor likely to damp the growth of consumer spending in the period ahead, at least to some extent, is the change in overall household financial positions over the past two years. Household wealth relative to income has dropped from a peak multiple of about 6.3 at the end of 1999 to around 5.3 currently. Econometric evidence suggests that wealth is an important determinant of spending, explaining about one-fifth of the total level of consumer outlays. Indeed, about nine-tenths of the

decline in the personal saving rate from 1995 to 1999 can be attributed to the rise in the ratio of wealth to income, and the subsequent decline in that ratio is doubtless restraining the growth of consumption.

Much of the movement in household net worth in recent years has been driven by changes on the asset side of the household balance sheet. But household liabilities have generally moved higher as well. Accordingly, the aggregate household debt service burden, defined as the ratio of households' required debt payments to their disposable personal income, rose considerably in recent years, returning last year to close to its previous cyclical peak of the mid-1980s, where it has remained.

Neither wealth nor the burden of debt is distributed evenly across households. Hence, the spending effects of changes in these influences also will not be evenly distributed. For example, increased debt burdens appear disproportionately attributable to higher-income households. Calculations by staff at the Federal Reserve suggest that the ratio of household liabilities to annual after-tax income for the top fifth of all households ranked by income rose from about 1.1 at the end of 1998 to 1.3 at the end of 2001. The increase for the lower four-fifths was not quite half as large.

Although high-income households should not experience much strain in meeting their debt-service obligations, others might. Indeed, repayment difficulties have already increased, particularly in the subprime markets for consumer loans and mortgages. Delinquency rates may well worsen as a delayed result of the strains on household finances over the past two years. Large erosions, however, do not seem likely, and the overall levels of debt and repayment delinquencies do not, as of now, appear to pose a major impediment to a moderate expansion of consumption spending going forward.

Although the macroeconomic effects of debt burdens may be limited, we have already observed significant spending restraint among the top fifth of income earners--who accounted for around 44 percent of total after-tax household income last year--presumably owing to the drop in equity prices, on net, over the past two years. The effect of the stock market on other households' spending has been less evident. Moderate-income households have a much larger proportion of their assets in homes, and the continuing rise in the value of houses has provided greater support for their net worth. Reflecting these differences in portfolio composition, the net worth of the top fifth of income earners has dropped far more than it did for the remaining four-fifths over the two-year period.

As a consequence, excluding capital gains and losses from the calculation, as is the convention in our national income accounts, personal saving for the upper fifth, which had been negative during 1999 and 2000, turned positive in 2001. By contrast, the average saving rate for the lower four-fifths of households, by income, was generally positive during the second half of the 1990s and has fluctuated in a narrow range in the past few years. Accordingly, most of the change in consumption expenditures that resulted from the bull stock market and its demise reflected shifts in spending by upper-income households. As I noted earlier, the restraining effects from the net decline in wealth during the past two years presumably have not, as yet, fully played out and could exert some further damping effect on the overall growth of household spending relative to that of income.

Perhaps most central to the outlook for consumer spending will be developments in the labor market, which has improved some in recent months. The pace of layoffs quickened last fall, especially after September 11, and the unemployment rate rose sharply. But layoffs have diminished noticeably in 2002, and payrolls grew again in March. In typical cyclical fashion, the unemployment rate has lagged the pickup in demand somewhat, but it has remained between 5-1/2 and 5-3/4 percent of late, after rising rapidly in 2001.

Over the longer haul, incomes and spending are driven most importantly by the behavior of labor productivity. And here the most recent readings have been very encouraging. Typically, labor productivity declines when output is cut back and businesses are reluctant to proportionately reduce their workforces. However, output per hour continued to grow last year. Indeed, it rose at an annual rate of 5-1/2 percent in the fourth quarter of last year and appears to have posted another sharp advance in the first quarter. No doubt, some of the recent acceleration reflects normal statistical noise. More fundamentally, some of this pickup probably occurred because businesses have remained cautious about boosting labor input in response to the surprising strength of demand in recent months. But the magnitude of the gains in productivity over the past year provides further evidence of improvement in the underlying pace of structural labor productivity. This development augurs well for firms' ability to grant wage increases to their employees without putting upward pressure on prices.

In housing markets, low mortgage interest rates and favorable weather have provided considerable support to homebuilding in recent months. Moreover, attractive mortgage rates have bolstered the sales of existing homes and the extraction of capital gains embedded in home equity that those sales

engender. Low rates have also encouraged households to take on larger mortgages when refinancing their homes. Drawing on home equity in this manner is a significant source of funding for consumption and home modernization. The pace of such extractions likely dropped along with the decline in refinancing activity that followed the backup in mortgage rates that began in early November. Mortgage rates have gone back down again in recent weeks and are at low levels. This should continue to underpin activity in housing, but with perhaps less spillover to consumption more generally.

The ongoing strength in the housing market has raised concerns about the possible emergence of a bubble in home prices. However, the analogy often made to the building and bursting of a stock price bubble is imperfect. First, unlike in the stock market, sales in the real estate market incur substantial transactions costs and, when most homes are sold, the seller must physically move out. Doing so often entails significant financial and emotional costs and is an obvious impediment to stimulating a bubble through speculative trading in homes. Thus, while stock market turnover is more than 100 percent annually, the turnover of home ownership is less than 10 percent annually--scarcely tinder for speculative conflagration. Second, arbitrage opportunities are much more limited in housing markets than in securities markets. A home in Portland, Oregon is not a close substitute for a home in Portland, Maine, and the "national" housing market is better understood as a collection of small, local housing markets. Even if a bubble were to develop in a local market, it would not necessarily have implications for the nation as a whole.

These factors certainly do not mean that bubbles cannot develop in house markets and that home prices cannot decline: Indeed, home prices fell significantly in several parts of the country in the early 1990s. But because the turnover of homes is so much smaller than that of stocks and because the underlying demand for living space tends to be revised very gradually, the speed and magnitude of price rises and declines often observed in markets for securities are more difficult to create in markets for homes.

The technological advances contributing to the gains in productivity that we have achieved over the past year should provide support not only to the household sector but also to the business sector through a recovery in corporate profits and capital investment.

The retrenchment in capital spending over the past year and a half was central to the sharp slowing in overall activity. These cutbacks in capital spending interacted with, and were reinforced by, falling profits and equity prices. Indeed, a striking feature of the current cyclical episode relative to many earlier ones has been the virtual absence of pricing power across much of American business, as increasing globalization and deregulation have enhanced competition. Business managers, with little opportunity to raise prices, have moved aggressively to stabilize cash flows by trimming workforces. These efforts have limited any rise in unit costs, attenuated the pressure on profit margins, and ultimately helped to preserve the vast majority of private-sector jobs. To the extent that businesses are successful in boosting profits and cash flow, capital spending should begin to recover more noticeably.

Part of the reduction in pricing power observed in this cycle should be reversed as firming demand enables businesses to take back large price discounts. Though such an adjustment would tend to elevate price levels, underlying inflationary cost pressures should remain contained. A lack of pressures in labor markets and increases in productivity are holding labor costs in check, resulting in rising profit margins even with inflation remaining low. Although energy-using companies will experience some profit pressures as recent increases in spot oil prices become imbedded in contracts, these effects should be limited unless oil prices increase appreciably further.

To be sure, over time, the current accommodative stance of monetary policy is not likely to be consistent with maintaining price stability. But prospects for low inflation and inflation expectations in the period ahead mean that the Federal Reserve should have ample opportunity to adjust policy to keep inflation pressures contained once sustained, solid, economic expansion is in view.

Improved profit margins over time and more assured prospects for rising final demand would likely be accompanied by a decline in risk premiums from their current elevated levels toward a more normal range. With real rates of return on high-tech equipment still attractive, the lowering of risk premiums should be an additional spur to new investment. Reports from businesses around the country suggest that the exploitation of available networking and other information technologies was only partially completed when the cyclical retrenchment of the past year began. Many business managers still hold the view, according to a recent survey of purchasing managers, that less than half of currently available new and, presumably profitable, supply-chain technologies have been put into use.

Recent evidence suggests that a recovery in at least some forms of high-tech investment is under way. Production of semiconductors, which in the past has been a leading indicator of computer production, turned up last fall. Expenditures on computers rose at a double-digit annual rate in real terms in the fourth quarter. But investment expenditures in the communications sector, where overcapacity was substantial, as yet show few signs of increasing, and business investment in some other sectors, such as aircraft, hit by the drop in air travel, will presumably remain weak in 2002. On balance, the recovery this year in overall spending on business fixed investment is likely to be gradual.

The U.S. economy has displayed a remarkable resilience over the past six months in the face of some very significant adverse shocks. But the strength of the economic expansion that is under way remains to be clarified. Some of the forces that have weighed heavily on the economy over the past year or so have begun to dissipate, but other factors, such as the sharp increase in world oil prices, have arisen that pose new challenges. As a result, the course of final demand will need to be monitored closely.

Still, there can be little doubt that prospects have brightened. Spending in the household sector has held up well, and some signs of improvement are evident in business profits and investment. Fiscal policy continues to provide stimulus to aggregate demand, and monetary policy is currently accommodative. With the growth of productivity well maintained and inflation pressures largely absent, the foundation for economic expansion has been laid.