Alan Greenspan: Outlook for the United States economy

Remarks by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, at the Securities Industry Association annual meeting, Boca Raton, Florida, 6 November 2003.

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I am pleased to join you today to discuss the outlook for the United States economy.[1]

About a year ago, the uncertainties surrounding a possible war in Iraq began to have a perceptible macroeconomic effect. Those uncertainties, coupled with the lingering concerns that had been created by corporate governance scandals, were among the key factors causing the performance of the U.S. economy late last year and early this year to be lackluster.

Risk spreads on corporate bonds peaked in the fall of 2002 at the highest levels observed in at least a decade. Business fixed investment then stalled in the first quarter of this year, and many firms, particularly outside the motor vehicle sector, were content to meet some of the increase in demand by drawing down inventories. Fortunately, a vibrant housing market lifted construction activity and, by facilitating home equity extraction, provided extra support to consumer spending.

When hostilities commenced in March, uncertainties related both to the potential for damage to Iraq's oil fields and to the possibility of broader turmoil in the Middle East rapidly dissipated. Risk spreads fell sharply as did the price of oil. Stock prices rose. Economic activity perked up in late spring and then accelerated further this summer as tax cuts provided a substantial boost to the disposable incomes of households.

For the third quarter as a whole, real GDP, our broadest measure of output, is reported to have increased 7-1/4 percent at an annual rate, the fastest quarterly rate of growth in nearly twenty years and obviously a pace not sustainable over the longer run. Even though consumer spending evidently slowed somewhat this fall, new orders received by manufacturers of nondefense capital goods, excluding aircraft, have been rising as have unfilled orders - developments that suggest some further increase in equipment spending is likely in train.

There have been some signs in recent weeks that the labor market may be stabilizing. However, viewed from the perspective of the past couple of years, the jobs picture has been weak. Indeed, since November 2001 - the estimated trough of this cycle - total payroll employment is currently reported to have declined by 1 million, and aggregate hours worked in the nonfarm business sector have come down 1-1/2 percent.

The combination of growing output and falling hours worked was made possible by a startlingly large rise in productivity. Indeed, since the fourth quarter of 2001, output per hour in the nonfarm business sector has increased 5 percent at an annual rate. And during the second and third quarters of this year, output per hour increased at the astonishing average annual pace of about 7-1/2 percent. This outcome has been associated with a dramatic increase in profits despite little evidence of corporate pricing power.

The explanations of the past two years' surge in productivity are wide-ranging.

One hypothesis is that some of the increase represents a temporary rise in the level of productivity reflecting a view that an unusual amount of caution is leading businesses to press workers and facilities to a greater degree than can be sustained over the longer haul. By this hypothesis, as that caution dissipates, employment growth will pick up and the level of output per hour will drop back.

Another hypothesis is that the level of productivity has undergone a one-time permanent upward shift. This hypothesis builds on the idea that the heavy emphasis on exploiting new and expanding markets from 1995 to 2000 likely diverted some corporate management from the hard work of controlling costs. The payoffs from cost control doubtless seemed small relative to those thought to attend big-picture expansion. But with tepid sales growth, uncertainty about the strength of future demand, and a fierce discipline exerted by financial markets, companies have been forced to search aggressively for ways

1 The views I will be expressing are my own and not necessarily those of the Federal Reserve Board.

to use resources more efficiently, to cut costs, and restore operating profit margins. The extent to which businesses have succeeded in boosting output with fewer labor hours and minimal capital investment over the past two years points up the possibility that a considerable stock of inefficiencies accumulated in the boom years and that this stock is still being worked off.

Finally, yet another hypothesis stresses a more-lasting increase in the *growth* of output per hour. This notion focuses on the considerable lag between the introduction of new technologies and their full integration into production processes and business practices. To reap the full benefits of technological innovation takes learning time, especially if there are large synergies through network effects.

Of course, given the exceptionally high rate of growth in output per hour over the past two years, some combination of short-term and longer-term productivity-enhancing forces seems likely to have been at work. In any event, one consequence of these improvements in efficiency has been a temporary ability of many businesses to meet increases in demand while paring existing workforces and continuing to exercise restraint on capital spending.

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If businesses are to spend and hire more vigorously, they will need to be convinced that economic growth can be sustained beyond the short run. One prominent concern is that, if the labor market remains weak, household confidence will suffer, with detrimental consequences for spending. Although layoffs seem to be diminishing, surveys indicate that households continue to be worried about the condition of labor markets.

While real after-tax personal income increased at more than a 7 percent annual rate in the third quarter, most of that gain reflected the influence of this year’s cut in taxes. Unless hiring picks up and layoffs ease, assuaging the latent job security fears of many of those currently employed, the share of income spent could decline, a development that would hamper the vigor of the expansion.

The odds, however, do increasingly favor a revival in job creation. The surge in final demand in recent months has been met in part by drawing down inventories. In many industries, available data suggest that inventories have become low relative to sales, and purchasing managers’ perceptions of their customers’ inventories corroborate that view. Any swing from inventory liquidation to accumulation would add significantly to the level of GDP. Efforts to rebuild inventories and a dwindling pool of possible efficiencies seem a combination that could generate a notable pickup in hiring should growth in final sales remain firm.

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A critical factor distinguishing the current economic environment from much of the previous experience of the past half century is the inflation backdrop. In previous recessions since the 1960s, the underlying rate of inflation at economic troughs remained clearly above any level that could be associated with effective price stability. As a consequence, with some risk to economic activity, monetary policy typically had to move aggressively in the uncertain early stages of past economic recoveries to ensure that inflation would be contained.

By contrast, in the current episode, core consumer price inflation as measured in the national income and product accounts has been running only a little more than 1 percent over the last year, and firms exhibit scant evidence that they are gaining appreciable pricing power despite the pickup in the pace of economic growth. Indeed, the Federal Open Market Committee has judged that the probability, though minor, of an unwelcome fall in inflation exceeds that of a rise in inflation from its already low level. In these circumstances, monetary policy is able to be more patient. That said, no central bank can ever afford to be less than vigilant about the prospects for inflation.

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The foregoing relatively optimistic short-term outlook for the U.S. economy is playing out against a backdrop of growing longer-term concern in financial markets about our federal budget.

As you know, the Congressional Budget Office is projecting that, if current policies remain in place, the unified budget will post deficits throughout the remainder of this decade - a sharp turnaround from the large and growing surpluses projected just a few years ago.

Given the events of the past three years - the economic downturn, the retrenchment in equity markets, the increased need for spending on homeland security, and the wars in Afghanistan and Iraq - some deterioration in the federal budget balance was probably unavoidable, particularly in the short term. One source of deterioration - the buildup of a larger military force structure - will not persist indefinitely.

Merely maintaining a given force structure rather than increasing it will remove an important factor driving the deficit higher.

Of course, the deterioration in the fiscal balance has already increased the level of debt relative to GDP, and thus has elevated the starting point from which policymakers will soon have to address the budget implications of the impending retirement of the baby-boom generation.

Recent budget deliberations are not encouraging. The current debate appears to be about how much to cut taxes or how much to *increase* spending. No significant constituency seems to support taking the actions that will be necessary to move toward, and one hopes achieve, budget balance. In retrospect, the emergence of budget surpluses in the late 1990s eroded the discipline that emerged as a consequence of the earlier fear of ever rising and, hence, potentially destructive deficits.

Indeed, many of the rules that helped to discipline budgetary decisionmaking in the 1990s - in particular, the statutory limits on discretionary spending and the so-called PAYGO rules - were allowed to expire. Many analysts properly continue to be concerned that, without these enforcement mechanisms and the fundamental political will they signal, the built-in bias in favor of red ink will once again become entrenched. Policymakers have become all too aware that government spending programs and tax preferences can be easy to initiate but extraordinarily difficult to shut down once constituencies develop that have a stake in maintaining the status quo.

The now-expired major provisions of the Budget Enforcement Act of 1990, and the act's later modifications and extensions, provided a set of rules that helped translate a general commitment to fiscal discipline into the actions necessary to achieve it.

Remember that in just five years the first cohort of the baby-boom generation will reach 62, the earliest age at which social security retirement benefits may be claimed and the age at which about half of the prospective beneficiaries choose to retire. In about 2008, the proportion of the working-age population that will retire is projected to begin escalating. Almost surely, the social security and Medicare benefits that are promised under current law to future retirees cannot be financed with existing tax rates. Budget simulations by a broad range of analysts (including those at the Office of Management and Budget and the Congressional Budget Office) suggest that the rapid increase in the unified budget deficits that would occur under current law as the baby-boom generation retires could set in motion an unsustainable dynamic in which large deficits result in growing interest payments that augment deficits in future years. Such a development could have notable, destabilizing effects on the economy.

Increased productivity growth, while helpful, does not alter that conclusion, because when productivity growth increases, so do social security obligations and, indirectly, Medicare benefits as well. Productivity would have to grow at a rate far in excess of the historical average to fully resolve the long-term financing problems of social security and Medicare.

Tax rate increases of sufficient dimension to deal with our looming fiscal problems arguably pose significant risks to economic growth and the revenue base. The exact magnitude of such risks are very difficult to estimate, but they are of enough concern, in my judgment, to warrant aiming to close the fiscal gap primarily, if not wholly, from outlay restraint. At the same time, the dimension of the challenge, especially in later years, cannot be underestimated. The one certainty is that the resolution of this situation will require difficult choices, and the future performance of the economy will depend on those choices.

History has shown that, when faced with large challenges, elected officials have risen to the occasion. In particular, looking back over the past twenty years or so, it has been evident that the prospect of large deficits generally has led to actions to narrow them. I trust that the recent deterioration in the budget outlook and the fast-approaching retirement of the baby-boom generation will be met with similar determination and effectiveness.