Alan Greenspan: Central Bank panel discussion - economic developments

Remarks by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, at the International Monetary Conference, London (via satellite), 8 June 2004.

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One of the defining characteristics of the recent business expansion in the United States has been the evident reluctance of corporate managers to expand spending and hiring aggressively in response to and in anticipation of continued cyclical growth. A substantial rebound in business spending had been a hallmark of most past economic expansions. Judging by the pickup in capital spending in recent quarters, businesses are becoming more confident in the strength and durability of the cyclical upturn. Still, over the four quarters ending in March, corporate investment in capital and inventories likely fell short of rapidly rising cash flow for the first time, over a comparable period, since the mid-1970s. Corporate debt expansion has accordingly been tepid. Indeed, corporate net bond issuance was negative in May.

The exceptional reluctance to expand payrolls also appears to have waned this year, and businesses are once again hiring with some vigor. But for nearly three years prior, managers sought every avenue to forestall new hiring despite rising business sales. Their ability to boost output without adding appreciably to their workforces, appears to have reflected a backlog of unexploited capabilities to enhance productivity with minimal capital investment, a delayed effect of the capital goods boom of the 1990s. Even now, the proportion of increases in temporary workers relative to total employment gains has been unusually large, suggesting that business caution remains a feature of the economic landscape.

This hesitancy on the part of businesses to expand risk-taking, as I have noted in the past, is an apparent consequence of scandals surrounding corporate accounting and governance, an aftermath of the stock market surge. Although there is no compelling evidence that corporate governance risk has fully subsided, with time, it should. An increased willingness to borrow, and ample liquid assets, should provide a further lift to capital investment and, with it, economic activity.

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With concerns of deflation now presumably safely behind us, developments ahead are likely to be dominated by the paths of productivity growth and profit margins - assuming, of course, the always latent danger of terrorism in the United States remains in check. Profits of nonfinancial corporations as a share of sector output, after falling to 7 percent in the third quarter of 2001, rebounded to 12 percent in the first quarter of 2004, a pace of advance not experienced since 1983. This sharp recovery in profits reflects, at least in part, the dramatic swing over the past couple of years from relatively heavy business price discounting to the restoration of a significant degree of pricing power.

The most visible manifestation of the return to pricing power can be seen in the recent acceleration of core consumer prices. The twelve-month percent change in the core PCE price index, which stood at just above 0.8 percent in December of last year, was at 1.4 percent in May.

To better understand recent developments, it is helpful to view prices from the perspective of consolidated costs and profit margins. From the first quarter of 2003 to the first quarter of 2004, consolidated unit costs for the nonfinancial corporate business sector declined. Hence, at least from an accounting perspective, all of the 1.1 percent increase in the prices of final goods and services produced in that sector during that period was the consequence of a rise in profit margins. The 6.4 percent increase in nonfinancial corporate business productivity over those four quarters accounts for much of the decline in unit costs. The remainder of the decline is accounted for by the effects of accelerating output in reducing nonlabor fixed costs per unit of output.

Productivity in the nonfinancial corporate sector evidently decelerated somewhat this year. Moreover, as best we can judge, the growth of compensation per hour has stepped up in recent months. With gains in hourly compensation now apparently outstripping advances in productivity, unit labor costs have moved up. Moreover, the increase in overall operating expenses over the last couple of months has also reflected higher energy costs and rising prices of imported non-oil inputs. It seems unlikely, however, that a further rise in profit margins will contribute to significantly higher prices of final goods and services. In an endeavor to exploit current high margins, businesses are being driven to expand their use of capital and labor resources. If history is any guide, this will tend to increase both real wages and interest rates. Fears of losing market share should dissuade businesses from passing these high costs fully through to prices. Accordingly, the forces of competition should cap the rise in profit margins and ultimately return them to more normal levels.

To date, the aforementioned cost pressures have been relatively subdued. Nonetheless, the persistence of the rise in energy prices is a worrisome element in the cost picture.

Fears for the long-term security of oil production in the Middle East, along with increased concerns about prospects in other oil-producing countries, are doubtless key factors behind the nearly $9 per barrel rise in distant crude oil futures since 2000. This run-up presumably reflects a broadening of demand for claims on oil inventories beyond traditional commercial buyers and sellers of crude oil and petroleum products. The marked rise in the net long positions of non-commercial investors in oil futures and options since May 2003 has increased net claims on an already diminished global level of commercial crude and product inventories. Oil prices accordingly have surged.

At some point, however, investors will have achieved the level of claims on oil that they seek. When that occurs, their demand will presumably stop rising, thus removing some of the current upward pressure on prices. Nonetheless, the increased value of oil imports has been a net drain on purchasing power, spending, and production in the United States. Moreover, higher oil prices, if they persist, are likely to boost core consumer prices, as well as the total price level, in this country. The recent modest declines in oil and natural gas prices may or may not signal a trend but are nonetheless welcome.

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The end of deflationary fears and the onset of modest upward pressure on costs, coupled with a strengthening economic outlook in the United States, have driven long-term interest rates higher, which has spurred a marked shift in credit flows and has prompted many firms to focus on the possibility of further interest rate increases in developing their hedging strategies. The rise in rates, for example, has induced a dramatic fall in mortgage refinancing and, hence, has produced a pronounced rise in the duration of mortgage-backed securities (MBS). Owing to the volume of the earlier wave of mortgage refinancing, there is now a paucity of existing mortgages at rates appreciably above current levels, implying that the extent of further duration hedging is likely to be quite modest.

As a consequence of record levels of refinancing in the second half of 2002 and the first half of 2003 - which, by our estimates, encompassed roughly 45 percent of the total value of home mortgages outstanding - MBS duration fell to exceptionally low levels. As mortgage and other long-term rates rebounded last summer, a consequence of rapidly improving economic conditions and the fading of deflationary concerns, refinancing fell sharply, removing most downward pressure on duration. Holders of MBS endeavoring to hedge developing interest rate gaps rapidly shed receive-fixed swaps and Treasuries, and these actions markedly aggravated last summer’s long-term interest rate upturn.

In recent months, mortgage rates have risen further, suppressing much of what is left of incentives to refinance, thereby increasing mortgage duration to its current elevated level. This suggests that the vast secondary market for home mortgages has largely adjusted to the recent increases in mortgage rates.

Moreover, the expectation of Federal Reserve tightening has apparently already induced other significant balance sheet adjustments as well. An unwinding of carry trades is notably under way at least judging from the shift in the trading portfolios of primary dealers. In addition, a swing toward a net short position on ten-year Treasury note futures among investors has been the largest since the inception of the contract in the 1980s.

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Economic developments going forward will determine the level and term structure of interest rates. Federal funds futures prices already reflect expectations of a substantial firming of policy by the Federal Open Market Committee (FOMC). Unlike 1994, there has been an appreciable increase of market rates in anticipation of policy tightening, though history cautions that investors’ anticipations of the cumulative magnitude of policy actions and their timing under such circumstances are far from perfect.

Lastly, let me emphasize that recent financial indicators, including rapid growth of the money supply, underscore that the FOMC has provided ample liquidity to the financial system that will become increasingly unnecessary over time. The Committee is of the view, as you know, that monetary policy accommodation can be removed at a pace that is likely to be measured. That conclusion is based on our current best judgment of how economic and financial forces will evolve in the months and quarters ahead. Should that judgment prove misplaced, however, the FOMC is prepared to do what is required to fulfill our obligations to achieve the maintenance of price stability so as to ensure maximum sustainable economic growth.