Alan Greenspan: Semiannual monetary policy report to the US Congress

Testimony of Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, on the occasion of the Federal Reserve Board's semiannual monetary policy report to Congress, before the Committee on Banking, Housing, and Urban Affairs, US Senate, 20 July 2004.

Mr Greenspan presented identical testimony before the Committee on Financial Services, US House of Representatives, on 21 July 2004.

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Mr Chairman and members of the Committee, I am pleased to be here today to present the Federal Reserve's Monetary Policy Report to the Congress.

Economic developments in the United States have generally been quite favorable in 2004, lending increasing support to the view that the expansion is self-sustaining. Not only has economic activity quickened, but the expansion has become more broad-based and has produced notable gains in employment. The evident strengthening in demand that underlies this improved performance doubtless has been a factor contributing to the rise in inflation this year. But inflation also seems to have been boosted by transitory factors such as the surge in energy prices. Those higher prices, by eroding households' disposable income, have accounted for at least some of the observed softness in consumer spending of late, a softness which should prove short-lived.

When I testified before this Committee in February, many of the signs of the step-up in economic activity were already evident. Capital spending had increased markedly in the second half of last year, no doubt spurred by significantly improving profits, a low cost of capital, and the investment tax incentives enacted in 2002 and enhanced in 2003. The renewed strength in capital spending carried over into the first half of 2004. Orders and shipments of nondefense capital goods have been on the rise, and backlogs of unfilled orders for new equipment continue to build.

A key element of the expansion that was still lacking in February, however, was evidence that businesses were willing to ramp up hiring to meet the stepped-up pace of sales and production. Businesses' ability to boost output without adding appreciably to their workforces likely resulted from a backlog of unexploited capabilities for enhancing productivity with minimal capital investment, which was an apparent outgrowth of the capital goods boom of the 1990s. Indeed, over much of the previous three years, managers had seemed to pursue every avenue to avoid new hiring despite rising business sales. Their hesitancy to assume risks and expand employment was accentuated and extended by the corporate accounting and governance scandals that surfaced in the aftermath of the decline in stock prices and also, of course, by the environment of heightened geopolitical tensions. Even now, following the pattern of recent quarters, corporate investment in fixed capital and inventories apparently continues to fall short of cash flow. The protracted nature of this shortfall is unprecedented over the past three decades. Moreover, the proportion of temporary hires relative to total employment continues to rise, underscoring that business caution remains a feature of the economic landscape.

That said, there have been much clearer indications over recent months that conditions in the labor market are improving. Most notably, gains in private nonfarm payroll employment have averaged about 200,000 per month over the past six months, up sharply from the pace of roughly 60,000 per month registered over the fourth quarter of 2003.

The improvement in labor market conditions will doubtless have important follow-on effects for household spending. Expanding employment should provide a lift to personal disposable income, adding to the support stemming from cuts in personal income taxes over the past year. In addition, the low interest rates of recent years have allowed many households to lower the burdens of their financial obligations. Although mortgage rates are up from recent lows, they remain quite attractive from a longer-run perspective and are providing solid support to home sales. Despite the softness of recent retail sales, the combination of higher current and anticipated future income, strengthened balance sheets, and still-low interest rates bodes well for consumer spending.

Consumer prices excluding food and energy - so-called core prices - have been rising more rapidly this year than in 2003. For example, the twelve-month change in the core personal consumption expenditures price index stood at 0.8 percent in December of last year and climbed to 1.6 percent by May of this year. Core inflation, of course, has been elevated by the indirect effects of higher energy prices on business costs and by increases in non-oil import prices that reflect past dollar depreciation and the surge in global prices for primary commodities. But the acceleration of core prices has been augmented by a marked rise in profit margins, even excluding domestic energy corporations.

This surge in profits reflects, at least in part, the recent recovery of demand after a couple of years during which weak demand led to relatively heavy price discounting by businesses. 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. Half of this rise in the profit share occurred between the first quarter of 2003 and the first quarter of 2004, a period during which business costs were unusually subdued. In fact, consolidated unit costs for the nonfinancial corporate business sector actually declined during this period. The increase in output per hour in the nonfinancial corporate business sector of more than 6 percent accounted for much of the net decline in unit costs. The remainder was due to the effects of rising output in reducing nonlabor fixed costs per unit of output. Hence, at least from an accounting perspective, between the first quarter of 2003 and the first quarter of 2004, all of the 1.1 percent increase in the prices of final goods and services produced in the nonfinancial corporate sector can be attributed to a rise in profit margins rather than rising cost pressures.

However, businesses are limited in the degree to which they can raise margins by raising prices. An increase in margins should affect mainly the level of prices associated with any given level of unit costs but, by itself, should not prompt a sustained pickup in the rate of inflation going forward. In a market economy, any tendency for profit margins to continue to rise is countered largely by the entry of new competitors willing to undercut prices and by increased labor costs as more firms attempt to exploit the opportunity for outsized profits by expanding employment and output. That increase in competitive pressure, as history has amply demonstrated, with time, returns markups to more normal levels.

Over the past three decades, the share of the profits of nonfinancial corporations in the total nominal income of that sector has fluctuated around a longer-run average of roughly 10-1/2 percent. The profit share in the first quarter of this year, at about 12 percent, was well above that level. The gap suggested that the growth of unit profits would eventually slow relative to increases in unit costs. This outlook had accorded with analysts' expectations for earnings growth over the next year, which are substantially below the realized growth of profits in recent quarters.

Indeed, some leveling or downward pressure on profit margins may already be in train, owing to a pickup in unit labor costs. Although advances in productivity are continuing at a rate above the long-term average, they have slowed from the extraordinary pace of last summer and are now running below increases in hourly compensation. The available information suggests that hourly compensation has been increasing at an annual rate of about 4-1/2 percent in the first half of the year. To be sure, the increases in average hourly earnings of nonsupervisory workers have been subdued in recent months and barely budged in June. But other compensation has accelerated this year, reflecting continued sizable increases in health insurance costs, a sharp increase in business contributions to pension funds, and an apparently more robust rate of growth of hourly earnings of supervisory workers. The larger wage gains for supervisory workers together with anecdotal reports of growing skill shortages are consistent with earlier evidence of rising wage premiums for skilled workers relative to less-skilled workers.

For the moment, the modest upward path of unit labor costs does not appear to threaten longer-term price stability, especially if current exceptionally high profit margins begin to come under more intense competitive pressures at home and from abroad. Although some signs of protectionist sentiment have emerged, there is little evidence that the price-containing forces of ever-widening global competition have ebbed. In addition, the economy is not yet operating at its productive capacity, which should help to contain cost pressures. But we cannot be certain that this benign environment will persist and that there are not more deep-seated forces emerging as a consequence of prolonged monetary accommodation. Accordingly, in assessing the appropriateness of the stance of policy, the Federal Reserve will pay close attention to incoming data, especially on costs and prices.

What does seem clear is that the concerns about the remote possibility of deflation that had been critical in the deliberations of the Federal Open Market Committee (FOMC) last year can now be safely set aside. Those deflationary pressures were largely a consequence of the stock market slump, the capital goods contraction that commenced in 2000, and, as I noted earlier, the extreme business caution that followed from these events as well as from terrorist attacks, corporate scandals, and the lead-up to the war in Iraq. Both equity prices and capital goods spending have turned up over the past year, and the probability that economic activity might stagnate has receded.

As always, considerable uncertainties remain about the pace of the expansion and the path of inflation. Some of those uncertainties, especially ones associated with potential terrorism both here and abroad, are difficult to quantify. Such possibilities have threatened the balance of world supply and demand in oil markets in recent months, especially as demand has risen with the pace of world economic growth. Yet aside from energy, markets exhibit little evidence of heightened perceptions of risk. Credit spreads remain low, and market-based indicators of inflation expectations, after rising earlier this year, have receded.

With the growth of aggregate demand looking more sustainable and with employment expanding broadly, the considerable monetary accommodation put in place starting in 2001 is becoming increasingly unnecessary. In May, the FOMC believed that policy accommodation needed to be removed and that removal could be accomplished at a pace that is likely to be measured. At our meeting last month, the FOMC raised the target federal funds rate from 1 percent to 1-1/4 percent, and the discount rate was raised commensurately. Policymakers reiterated that, based on our current outlook, the removal of accommodation would likely proceed at a measured pace. But in light of the considerable uncertainty surrounding the anticipated evolution of price pressures, the FOMC emphasized that it will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

If economic developments are such that monetary policy neutrality can be restored at a measured pace, a relatively smooth adjustment of businesses and households to a more typical level of interest rates seems likely. Even if economic developments dictate that the stance of policy must be adjusted in a less gradual manner to ensure price stability, our economy appears to have prepared itself for a more dynamic adjustment of interest rates. Of course, considerably more uncertainty and hence risk surrounds the behavior of the economy with a more rapid tightening of monetary policy than is the case when tightening is more measured. In either scenario, individual instances of financial strain cannot be ruled out.

The protracted period of low interest rates has facilitated a restructuring of household and business balance sheets. Businesses have been able to fund longer-term debt at highly favorable interest rates and, by extending the maturity of their liabilities, have rendered net earnings and capital values less exposed to destabilizing interest rate spikes. Households have made similar adjustments. Between mid-2002 and mid-2003, homeowners were able to refinance at lower interest rates almost half of total outstanding home mortgage debt and thereby to substantially reduce monthly debt service payments. Households also substituted mortgage debt for more-expensive consumer credit. Moreover, those households and businesses that held long-term investment-grade bonds in that year accumulated realized and unrealized capital gains as long-term rates declined.

The FOMC judged this extended period of exceptionally low interest rates to have been helpful in assisting the economy in recovering from a string of adverse shocks. But in the process of returning the stance of policy to a more neutral setting, at least some of the capital gains on debt instruments registered in recent years will inevitably be reversed.

Prices in financial markets have already adjusted in anticipation of a significant amount of policy tightening, engendering additional alteration of balance sheets in recent months. An unwinding of carry trades - that is, market positions premised on low short-term financing costs - seems to be under way, at least judging from a pronounced shift in the trading portfolios of primary dealers. In addition, investors classified as non-commercial have established net short positions in ten-year Treasury note futures in recent months. Indeed, the swing toward a net short position on ten-year Treasury note futures has been the largest since the inception of the contract in the 1980s, likely offsetting a significant portion of the interest rate exposure of previously established carry trade positions.

Moreover, the recent increase in market interest rates has slowed the pace of mortgage refinancing and reportedly has precipitated some winding down of leveraged positions among major mortgage market participants. These circumstances are quite different from the situation prevailing at this time last summer. Then, record levels of refinancing in the second half of 2002 and the first half of 2003 had pushed the duration of mortgage-backed securities (a measure of the price sensitivity of fixed-income instruments to changes in interest rates) 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 mortgage-backed securities endeavoring to hedge the resulting shifts in interest rate gaps moved rapidly to shed Treasuries and receive-fixed interest-rate swaps, and these actions magnified last summer's upturn in long-term interest rates. In the current environment, by contrast, it appears that the scope for such mortgage hedging effects to greatly amplify an increase in long-term rates is much diminished given the decline in the pace of refinancing and the associated increase in mortgage durations that have already occurred.

Lastly, very large fractions of the total outstanding obligations of businesses and households are long-term, fixed-rate debt. As a result, rising market interest rates will not have much immediate direct effect on business and household debt service burdens. Indeed, from early 1999 through early 2000, a period when interest rates on new home mortgage originations rose more than 150 basis points, the average interest rate on the total of home mortgage debt outstanding barely moved. Nonetheless, despite the lock-in of low interest rate costs on a substantial share of household and business liabilities, recent higher market interest rates will, in time, show through into increased charges against household and business income. To be sure, financial intermediaries and other creditors that extended loans or purchased securities in recent years at relatively low long-term interest rates will sustain capital losses as rates rise. In general, however, financial intermediaries are profitable and well-capitalized and appear to be well positioned to manage in a rising rate environment.

In short, financial markets along with households and businesses seem to be reasonably well prepared to cope with a transition to a more neutral stance of monetary policy. Some risks necessarily attend this transition, but they are outweighed in our judgment by those that would be associated with maintaining the existing degree of monetary policy accommodation in the current environment. Although many factors may affect inflation in the short-run, inflation in the long-run, it is important to remind ourselves, is a monetary phenomenon.

As we attempt to assess and manage these risks, we need, as always, to be prepared for the unexpected and to respond promptly and flexibly as situations warrant. But although our actions need to be flexible, our objectives are not. For twenty-five years, the Federal Reserve has worked to reestablish price stability on a sustained basis. An environment of price stability allows households and businesses to make decisions that best promote the longer-term growth of our economy and with it our nation's continuing prosperity.