

## Alan Greenspan: Economic outlook

Testimonial by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Joint Economic Committee, US Congress, Washington DC, 3 November 2005.

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Mr Chairman, when I last appeared before the Joint Economic Committee in early June, economic activity appeared to be reaccelerating after a slowdown in the spring. The economy had weathered a further run-up in energy prices over the winter, and aggregate demand was again strengthening. Real gross domestic product (GDP) growth averaged 3 1/2 percent at an annual rate over the first half of the year, and subsequent readings on activity over the summer were positive. By early August, the economy appeared to have considerable momentum, despite a further ratcheting up of crude oil prices; pressures on inflation remained elevated.

As you know, the economy suffered significant shocks in late summer and early autumn. Crude oil prices moved sharply higher in August, bid up by growth in world demand that continued to outpace the growth of supply. Then Hurricane Katrina hit the Gulf Coast at the end of August, causing widespread disruptions to oil and natural gas production and driving the price of West Texas Intermediate crude oil above \$70 per barrel. Because of a lack of ready access to foreign supplies, natural gas prices rose even more sharply. At the end of September, with the recovery from the first storm barely under way, Hurricane Rita hit, causing additional damage and destruction--especially to the energy production and distribution systems in the Gulf. Most recently, Hurricane Wilma caused widespread power outages and property damage across the state of Florida. These events are likely to exert a drag on employment and production in the near term and to add to the upward pressures on the general price level. But the economic fundamentals remain firm, and the U.S. economy appears to retain important forward momentum.

Of course, the higher energy prices caused by the hurricanes are being felt well beyond the Gulf Coast region. Those higher prices resulted from the substantial damage that occurred to our nation's energy production and distribution systems. Of the more than 3,000 oil and gas production platforms in the paths of Katrina and Rita, more than 100 were destroyed, and an additional 50 suffered extensive damage. Of the 134 manned drilling rigs operating in the Gulf, 8 were lost, and an additional 38 were either set adrift by the storms or were badly damaged. At present, both oil and natural gas production in the Gulf are operating at less than 50 percent of pre-Katrina levels. Since the first evacuations of oil and gas facilities were ordered before Katrina, cumulative shortfalls represented almost 4 percent of the nation's annual production of crude oil and 2 percent of our output of natural gas.

The combination of flooding, wind damage, and a lack of electric power also forced many crude oil refineries and natural gas processing plants to shut down. The restoration of production at the affected natural gas processing facilities has proceeded particularly slowly, in part because of the lack of natural gas feedstocks and infrastructure problems. Most refineries, however, will be back on line within the next month or so, though a few may take longer.

In the interim, a greater output of refined petroleum products in other areas of the country and much higher imports, especially of gasoline, are making up for the production shortfalls in Gulf refining. The temporary lifting of some environmental regulations and the suspension of the Jones Act facilitated those adjustments. In addition, refiners have shifted the mix of production toward more gasoline and less heating oil and jet fuel. That shift has had benefits in the short run, though the longer it continues, the greater the possibility of upward pressure on distillate fuel oil prices during the winter heating season.

Releases from the nation's Strategic Petroleum Reserve relieved much of the upward pressure on crude oil prices, and imports of refined products responded rapidly to ease the price pressures stemming from the loss of refinery production in the Gulf. As a consequence, the nationwide retail price of gasoline for all grades has declined 60 cents per gallon from its peak of \$3.12 per gallon in the week of September 5. Motorists appear to have economized on their driving, and gasoline demand appears to be off a bit. However, it will take time and an appreciable increase in the fuel economy of our stock of motor vehicles to fundamentally change the amount of motor fuel used on our nation's highways.

The far more severe reaction of natural gas prices to the production setbacks that have occurred in the Gulf highlights again the need to expand our nation's ability to import natural gas. In contrast to the fall in crude oil prices and the sharp narrowing of refinery margins during the past two months, natural gas prices have remained high. Moreover, judging from elevated distant futures prices, traders expect natural gas prices to edge lower but to stay high for the foreseeable future. This expectation largely reflects a natural gas industry in North America that is already operating at close to capacity and our inability to import large quantities of far cheaper, liquefied natural gas (LNG) from other parts of the world. At present, natural gas supplies appear to be sufficient to meet the near-term demands--even with some ongoing shortfall in Gulf production. However, a colder-than-average winter would stress this market, and prices will likely remain vulnerable to spikes until the spring.

U.S. imports of LNG have been constrained by inadequate global capacity for liquefaction, as well as by environmental and safety concerns that have restricted the construction of new LNG import terminals in the United States. In 2002, such imports accounted for only 1 percent of US gas consumption. Despite the major effort to expand imports, the Department of Energy forecasts LNG imports this year at only 3 percent of gas consumption. Canada, which has recently supplied one-sixth of our consumption, cannot expand its pipeline exports significantly in the near term, in part because of the role that Canadian natural gas plays in supporting increasing oil production from tar sands.

The disruptions to energy production have noticeably affected economic activity. We estimate that the storms held down the increase in industrial production 0.4 percentage point in August and an additional 1.7 percentage point in September.

Except for the hurricane effects, readings on the economy indicate a continued solid expansion of aggregate demand and production. If allowance is taken for the effects of Katrina and Rita and for the now-settled machinist strike at Boeing, industrial production rose at an annual rate of 5-1/4 percent in the third quarter. That's up from an annual pace of 1-1/4 percent in the second quarter, when a marked slowing of inventory accumulation was a restraining influence on growth.

The September employment report showed a loss of 35,000 jobs. However, an upward revision to payroll gains over the summer indicated a stronger underlying pace of hiring before the storms than had been previously estimated. The Bureau of Labor Statistics estimates that employment growth in areas not affected by the storms was in line with the average pace over the twelve months ending in August.

Retail spending eased off in September, likely reflecting the effects of the hurricanes and higher gasoline prices. Major chain stores report a gradual recovery over October in the pace of spending, though light motor vehicle sales declined sharply last month, when some major incentives to purchase expired.

The longer-term prospects for the U.S. economy remain favorable. Structural productivity continues to grow at a firm pace, and rebuilding activity following the hurricanes should boost real GDP growth for a while. More uncertainty, however, surrounds the outlook for inflation.

The past decade of low inflation and solid economic growth in the United States and in many other countries around the world has been without precedent in recent decades. Much of that favorable performance is attributable to the remarkable confluence of innovations that spawned new computer, telecommunication, and networking technologies, which, especially in the United States, have elevated the growth of productivity, suppressed unit labor costs, and helped to contain inflationary pressures. The result has been a virtuous cycle of low prices and solid growth.

Contributing to the disinflationary pressures that have been evident in the global economy over the past decade or more has been the integration of in excess of 100 million educated workers from the former Soviet bloc into the world's open trading system. More recently, and of even greater significance, has been the freeing from central planning of large segments of China's 750 million workforce. The gradual addition of these workers plus workers from India--a country which is also currently undergoing a notable increase in its participation in the world trading system--would approximately double the overall supply of labor once all these workers become fully engaged in competitive world markets. Of course, at current rates of productivity, the half of the world's labor force that has been newly added to the world competitive marketplace is producing no more than one quarter of world output. With increased education and increased absorption of significant cutting-edge technologies, that share will surely rise.

Over the past decade or more, the gradual assimilation of these new entrants into the world's free-market trading system has restrained the rise of unit labor costs in much of the world and hence has helped to contain inflation.

As this process has unfolded, inflation expectations have decreased, and accordingly, the inflation premiums embodied in long-term interest rates around the world have come down. The effective augmentation of world supply and the accompanying disinflationary pressures have made it easier for the Federal Reserve and other central banks to achieve price stability in an environment of generally solid economic growth.

But this seminal shift in the world's workforce is producing, in effect, a level adjustment in unit labor costs. To be sure, economic systems evolve from centrally planned to market-based only gradually and, at times, in fits and starts. Thus, this level adjustment is being spread over an extended period. Nevertheless, the suppression of cost growth and world inflation, at some point, will begin to abate and, with the completion of this level adjustment, gradually end.

These global forces pressing inflation and interest rates lower may well persist for some time. Nonetheless, it is the rate at which countries are integrated into the global economic system, not the extent of their integration, that governs the degree to which the rise in world unit labor costs will continue to be subdued. Where the global economy is currently in this dynamic process remains open to question. But going forward, these trends will need to be monitored carefully by the world's central banks.

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I want to conclude with a few remarks about the federal budget situation, which--at least until Hurricanes Katrina and Rita struck the Gulf Coast--was showing signs of modest improvement. Indeed, tax receipts have exhibited considerable strength of late, posting an increase of nearly 15 percent in fiscal 2005 as a result of sizable gains in individual and, even more, corporate income taxes. Thus, although spending continued to rise rapidly last year, the deficit in the unified budget dropped to \$319 billion, nearly \$100 billion less than the figure for fiscal year 2004 and a much smaller figure than many had anticipated earlier in the year. Lowering the deficit further in the near term, however, will be difficult in light of the need to pay for post-hurricane reconstruction and relief.

But even apart from the hurricanes, our budget position is unlikely to improve substantially further until we restore constraints similar to the Budget Enforcement Act of 1990, which were allowed to lapse in 2002. Even so, the restoration of paygo and discretionary caps will not address the far more difficult choices that confront the Congress as the baby-boom generation edges toward retirement. As I have testified on numerous occasions, current entitlement law may have already promised to this next generation of retirees more in real resources than our economy, with its predictably slowing rate of labor force growth, will be able to supply.

So long as health-care costs continue to grow faster than the economy as a whole, as seems likely, federal spending on health and retirement programs would rise at a rate that risks placing the budget on an unsustainable trajectory. Specifically, large deficits will result in rising interest rates and an ever-growing ratio of debt service to GDP. Unless the situation is reversed, at some point these budget trends will cause serious economic disruptions.

We owe it to those who will retire over the next couple of decades to promise only what the government can deliver. The present policy path makes current promises, at least in real terms, highly conjectural. If fewer resources will be available per retiree than promised under current law, those in their later working years need sufficient time to adjust their work and retirement decisions.

Crafting a budget strategy that meets the nation's longer-run needs will become ever more difficult and costly the more we delay. The one certainty is that the resolution of the nation's demographic challenge will require hard choices and that the future performance of the economy will depend on those choices. No changes will be easy, as they all will involve setting priorities and making tradeoffs among valued alternatives. The Congress must determine how best to address the competing claims on our limited resources. In doing so, you will need to consider not only the distributional effects of policy changes but also the broader economic effects on labor supply, retirement behavior, and private saving. The benefits of taking sound, timely action could extend many decades into the future.