

Mr. Greenspan highlights some key aspects of the current economic situation in the United States Testimony of the Chairman of the Board of the US Federal Reserve System, Mr. Alan Greenspan, before the Joint Economic Committee of the United States Congress on 20/3/97.

Mr. Chairman and members of the Committee, I am pleased to appear here today. Last month, the Federal Reserve Board submitted its semiannual report on monetary policy to the Congress. That report and my accompanying testimony covered in detail our assessment of the outlook for the U.S. economy. This morning, I would like to highlight some of the key aspects of the current economic situation.

As I told the Congress last month, the performance of the U.S. economy remains quite favorable. Real GDP growth picked up to more than 3 percent over the four quarters of 1996. Moreover, recently released data suggest that activity has retained a great deal of vigor in early 1997. In addition, nominal hourly wages and salaries have risen faster than prices over the past several quarters, meaning that workers have reaped some of the benefits of rising productivity and thus gained ground in real terms. Outside the food and energy sectors, increases in consumer prices have actually continued to edge lower, with core CPI inflation of only 2½ percent over the past twelve months.

The low inflation of the past year is both a symptom and a cause of the good economy. It is symptomatic of the balance and solidity of the expansion and the evident absence of major strains on resources. At the same time, continued low levels of inflation and inflation expectations have been a key support for healthy economic performance. They have helped to create a financial and economic environment conducive to strong capital spending and longer-range planning generally, and so to sustained economic expansion. These types of results are why we stressed in our monetary policy testimony the importance of acting promptly -- ideally pre-emptively -- to keep inflation low over the intermediate term and to promote price stability over time.

For some, the benign inflation outcome of the past year might be considered surprising, as resource utilization rates -- particularly of labor -- have been in the neighborhood of those that historically have been associated with building inflation pressures. To be sure, nominal hourly labor compensation, especially its wage component, accelerated in 1996. But the rate of pay increase still was markedly less than historical relationships with labor market conditions would have predicted.

Atypical restraint on compensation increases has been evident for a few years now. Almost certainly, it reflects a number of factors, including the sharp deceleration in health care costs and the heightened pressure on firms and workers in industries that compete internationally. Domestic deregulation has also intensified the competitive forces in some industries. But, as I outlined in some detail in testimony last month, I believe that job insecurity has played the dominant role. For example, in 1991, at the bottom of the recession, a survey of workers at large firms by International Survey Research Corporation indicated that 25 percent feared being laid off. In 1996, despite the sharply lower unemployment rate and the tighter labor market, the same survey organization found that 46 percent were fearful of a job layoff.

Whatever the reasons for its persistence, job insecurity cannot suppress wage growth indefinitely. Clearly, there is a limit to how long workers will remain willing to accept smaller increases in living standards in exchange for additional job security. Even if real wages were to remain permanently on a lower upward track than otherwise as a result of the greater

sense of insecurity, the rate of change of wages would revert at some point to a normal relationship with price inflation. The unknown is when a more normal pattern will resume.

Indeed, the labor markets bear especially careful watching for signs that such a process is under way. So far this year, the demand for labor has stayed strong. Payroll employment grew briskly in January and February, and the unemployment rate remained around 5¼ percent -- roughly matching the low of the last cyclical upswing, in the late 1980s. Also, initial claims for unemployment insurance remained low into March. In addition, the percentage of households telling the Conference Board that jobs are plentiful has risen sharply of late, which suggests that workers may be growing more confident about the job situation. Finally, wages rose faster in 1996 than in 1995 by most measures -- in fact, the acceleration was quite sizable by some measures. This, too, raises questions about whether the transitional period of unusually slow wage gains may be drawing to a close. In any event, further increases in labor utilization rates would heighten the risk of additional upward pressure on wage costs, and ultimately prices.

To be sure, the pickup in wage gains to date has not shown through to underlying price inflation. Increases in the core CPI, as well as in several other broad measures of prices, have stayed subdued or even edged off further of late. As best I can judge, faster productivity growth last year offset the pressure from rising compensation gains on labor costs per unit of output. And non-labor costs, which are roughly a quarter of total consolidated costs of the nonfinancial corporate sector, were little changed in 1996.

Owing in part to this subdued behavior of unit costs, profits and rates of return on capital have risen to high levels. As a consequence, a substantial number of businesses apparently believe that, were they to raise prices to boost profits further, competitors with already ample profit margins would not follow suit; instead, they would use the occasion to capture a greater market share. This interplay is doubtless a significant factor in the evident loss of pricing power in American business. Intensifying global competition may also be limiting the ability of domestic firms to hike prices as well as wages.

Competitive pressures here and abroad should continue to act as a restraint on inflation in the months ahead. In addition, crude oil prices have largely retraced last year's run-up, and, with the worldwide supply of oil having moved up relative to demand, futures markets project stable prices over the near term. Food prices should also rise less rapidly than they did in 1996 as some of last year's supply limitations ease. Nonetheless, the trends in the core CPI and in broader price measures are likely to come under pressure from a continued tight labor market, whose influence on costs will be augmented by the scheduled increase in the minimum wage later in the year. And, with considerable health-care savings already having been realized, larger increases in fringe benefits could put upward pressure on overall compensation. Moreover, although non-oil import prices should remain subdued in 1997 as the sharp rise in the dollar over the past year-and-a-half continues to feed through to domestic prices, their damping effects on U.S. inflation probably will not be as great as in 1996.

The lagged effects of the increase in the exchange value of the dollar will also likely restrain real U.S. net exports this year. In addition, declines in real federal government purchases should exert a modest degree of restraint on overall demand, and residential construction will probably not repeat the gains of 1996. On the other hand, financial conditions overall remain supportive to the real economy, and creditworthy borrowers are finding funding to be readily available from intermediaries and in the securities markets. Moreover, we do not

see evidence of widespread imbalances either in business inventories or in stocks of capital equipment and consumer durables that would lead to a substantial cutback in spending.

The trends in consumer spending on items other than durables also look solid. Retail sales posted robust gains in January and February, and, according to various surveys, sentiment is decidedly upbeat. Moreover, consumers have enjoyed healthy increases in their real incomes over the past couple of years, along with the extraordinary stock-market driven rise in their financial wealth.

Should the higher wealth be sustained, it could provide important support to consumption in 1997. But, looking at the data through 1996, the surging stock market does not seem to have imparted as big a boost to spending as past relationships would have predicted. The lack of a more substantial wealth effect is especially surprising because we have also seen a noticeable widening in the ownership of stocks over the past several years. Indeed, the Federal Reserve's recently released Survey of Consumer Finances suggests that of the total value of all families' holdings of publicly traded stocks and mutual funds, the share held by those with incomes below \$100,000 (in 1995 dollars) rose from 32 percent in 1989 to 46 percent in 1995.

It is possible, however, that the wealth effect is being offset by other factors. In particular, families may be reluctant to spend their added wealth because they see a greater need to keep it to support spending in retirement. Many have expressed heightened concern about their financial security in old age, in part because of growing skepticism about the viability of the Social Security system. This concern has reportedly led to stepped-up saving for retirement.

The sharp increase in debt burdens in recent years may also be constraining spending by some families. Indeed, although our consumer survey showed that debt usage rose between 1992 and 1995 for almost all income groups, changes in financial conditions were not uniform across families. Notably, the median ratio of debt payments to income for families with debt -- a useful measure of the typical debt burden -- held steady or declined for families with incomes of at least \$50,000, but it rose for those with incomes below \$50,000. We don't know whether these latter families took on the additional debt because they perceived brighter future income prospects, or simply to accelerate purchases they would have made later. Nonetheless, these families are probably the most vulnerable to disruptions in income, and the rise in their debt burdens is likely to make both borrowers and lenders a bit more cautious as we move forward.

Both household and business balance sheets have expanded at a pace considerably faster than income and product flows over the past decade. Accordingly, any percentage change in assets or liabilities has a greater effect on economic growth than it used to. However, identifying such influences in the aggregate data is not always easy. At present, the difficulty is compounded by concern that the currently published national statistics may not provide an accurate reading of the trends in recent years, especially for productivity.

In any event, other data suggest that wealth and debt effects may be exerting a measurable influence on the consumption and saving decisions of different segments of the population. According to the Consumer Expenditure Survey conducted by the Bureau of Labor Statistics, saving out of current income by families in the upper-income quintile evidently has declined in recent years. At the same time, Federal Reserve estimates suggest that the use of credit for purchases has leveled off after a sharp run-up from 1993 to 1996, perhaps because some families are becoming debt constrained and, as a result, are curtailing their spending.

The Federal Reserve, of course, will be weighing these and other influences as it makes future policy decisions. Demand has been growing quite strongly in recent months, and the FOMC, at its meeting next week, will have to judge whether that pace of expansion will be maintained, and, if so, whether it will continue to be met by solid productivity growth, as it apparently has been -- official figures to the contrary notwithstanding. Alternatively, if strong demand is expected to persist, and does not seem likely to be matched by productivity improvement, the FOMC will have to decide whether increased pressures on supply will eventually produce the types of inflationary imbalances that, if not addressed early, will undermine the long expansion.

Should we choose to alter monetary policy, we know from past experience that, although the financial markets may respond immediately, the main effects on inflationary pressures may not be felt until late this year and in 1998. Because forecasts that far out are highly uncertain, we rarely think in terms of a single outlook. Rather, we endeavor to assess the likely consequences of our decisions in terms of a reasonable range of possible outcomes. Part of our evaluation is to judge not only the benefits that are likely to result from appropriate policy, but also the costs should we be wrong. In any action -- including leaving policy unchanged -- we seek to assure ourselves that the expected benefits are large enough to risk the cost of a mistake.

In closing, I would like to note that the current economic expansion is now entering its seventh year. That makes it already a long upswing by historical standards. And yet, looking ahead, the prospects for sustaining the expansion are quite favorable. The flexibility of our market system and the vibrancy of our private sector remain examples for the whole world to emulate. We will endeavor to do our part by continuing to foster a monetary framework under which our citizens can prosper to the fullest possible extent.