Mr Greenspan testifies on the state of the US economy

Testimony of the Chairman of the Board of Governors of the US Federal Reserve System, Mr Alan Greenspan, before the Committee on Ways and Means of the US House of Representatives on 20/1/99.

The American economy through year-end continued to perform in an outstanding manner. Economic growth remained solid, and financial markets, after freezing up temporarily following the Russian default, are again channeling an ample flow of capital to businesses and households. Labor markets have remained quite tight, but, to date, this has failed to ignite the inflationary pressures that many had feared.

To be sure, there is decided softness in a number of manufacturing industries as weakness in many foreign economies has reduced demand for US exports and intensified competition from imports. Moreover, underutilized production capacity and pressure on domestic profit margins, especially among manufacturers, are likely to rein in the rapid growth of new capital investment. With corporations already relying increasingly on borrowing to finance capital investment, any evidence of a marked slowing in corporate cash flow is likely to induce a relatively prompt review of capital budgets.

The situation in Brazil and its potential for spilling over to reduce demand in other emerging market economies also constitute a possible source of downside risk for demand in the United States. So far, markets seem to have reacted reasonably well to the decisions by the Brazilian authorities to float their currency and redouble efforts at fiscal discipline. But follow through in reducing budget imbalances and in containing the effects on inflation of the drop in value of the currency will be needed to bolster confidence and to limit the potential for contagion to the financial markets and economies of Brazil’s important trading partners, including the United States.

While there are risks going forward, to date domestic demand, and hence employment and output in the United States, certainly has remained vigorous. Though the pace of economic expansion is widely expected to moderate as 1999 unfolds, signs of an appreciable slowdown as yet remain scant.

But to assess the economic outlook properly, we need to reach beyond the mere description of America’s sparkling economic performance of eight years of record peacetime expansion to seek a deeper understanding of the forces that have produced it. I want to take a few moments this morning to discuss one key element behind our current prosperity: the rise in the value markets place on the capital assets of US businesses. Lower inflation, greater competitiveness, and the flexibility and adaptability of our businesses have enabled them to take advantage of a rapid pace of technological change to make our capital stock more productive and profitable. I will argue that the process of recognizing this greater value has produced capital gains in equity markets that have lowered the cost of investment in new plant and equipment and spurred consumption. But, while asset values are very important to the economy and so must be carefully monitored and assessed by the Federal Reserve, they are not themselves a target of monetary policy. We need to react to changes in financial markets, as we did this fall, but our objective is the maximum sustainable growth of the US economy, not particular levels of asset prices.

As I have testified before the Congress many times, I believe, at root, the remarkable generation of capital gains of recent years has resulted from the dramatic fall in inflation expectations and

associated risk premiums, and broad advances in a wide variety of technologies that produced critical synergies in the 1990s.

Capital investment, especially in high-tech equipment, has accelerated dramatically since 1993, presumably reflecting a perception on the part of businesses that the application of these emerging technological synergies would engender a significant increase in rates of return on new investment.

Indeed, some calculations support that perception. They suggest that the rate of return on capital facilities put in place during recent years has, in fact, moved up markedly. In part this may result from improved capital productivity – that is, the efficiency of the capital stock. In addition, we may be witnessing some payoffs from improved organizational and managerial efficiencies of US businesses and from the greater education – in school and on the job – that US workers have acquired to keep pace with the new technology. All these factors have been reflected in an acceleration of labor productivity growth.

Parenthetically, improved productivity probably explains why the American economy has done so well despite our oft-cited subnormal national saving rate. The profitability of investment here has attracted saving from abroad, an attraction that has enabled us to finance a current account deficit while maintaining a strong dollar. Clearly, we use both domestic saving and imported financial capital in a highly efficient manner, apparently more efficiently than many, if not most, other major industrial countries.

While discussions of consumer spending often continue to emphasize current income from labor and capital as the prime sources of funds, during the 1990s, capital gains, which reflect the valuation of expected future incomes, have taken on a more prominent role in driving our economy.

The steep uptrend in asset values of recent years has had important effects on virtually all areas of our economy, but perhaps most significantly on household behavior. It can be seen most clearly in the measured personal saving rate, which has declined from almost 6% in 1992 to effectively zero today.

Arguably, the average household does not perceive that its saving has fallen off since 1992. In fact, the net worth of the average household has increased by nearly 50% since the end of 1992, well in excess of the gains of the previous six years. Households have been accumulating resources for retirement or for a rainy day, despite very low measured saving rates.

The resolution of this seeming dilemma illustrates the growing role of rising asset values in supporting personal consumption expenditures in recent years. It also illustrates the importance when interpreting our official statistics of taking account of how they deal with changes in asset values.

With regard first to the statistical issues, capital gains themselves are not counted as income, but some transactions resulting from capital gains reduce disposable household income as we measure it, while having no effect on consumption. As a consequence, as capital gains and these associated transactions mount, published saving rates are decreased. For example, reported personal income is reduced when corporations cut back payments into defined-benefit pension plans owing to higher equity prices; however, such reductions do not diminish anticipated retirement income and thus should not lower consumption. And reported disposable income is decreased when households pay taxes on capital gains realizations that would not have been so

large in less ebullient markets. However, capital gains tax payments also are highly unlikely to be associated with lower spending because the cash realized from the sale of the asset exceeds the tax, and in most cases the typical household presumably does not perceive this transaction as reducing available income or financial resources. Together these two effects probably account for an appreciable portion of the reduction in the reported saving rate.

But beyond these statistical issues, there is little doubt that capital gains have increased consumption relative to income from current production over recent years. Economists have long recognized a "wealth effect" – a tendency for consumption to rise by a fraction of the capital gains on existing assets owned by households – though the magnitude of this effect remains difficult to estimate accurately. We have some evidence from recent years that all or most of the decline in the saving rate is accounted for by the upper income quintile where the capital gains have disproportionately accrued, which suggests that the wealth effect has been real and significant. Thus, all else equal, a flattening of stock prices would likely slow the growth of spending, and a decline in equity values, especially a severe one, could lead to a considerable weakening of consumer demand.

Some moderation in economic growth, however, might be required to sustain the expansion. Through the end of 1998, the economy continued to grow more rapidly than can be currently accommodated on an ongoing basis, even with higher, technology-driven productivity growth. Growth has continued to shrink the pool of workers willing to work but without jobs. While higher productivity has helped to keep labor cost increases in check, it cannot be expected to do so indefinitely in ever tighter labor markets.

Despite brisk demand and improved productivity growth, corporate profits have sagged over recent quarters. This is attributable in part to some acceleration in labor compensation, but other factors have also been pressing, especially intensified competition and lower prices facing our exporters and those industries competing with imports. In these circumstances, businesses will feel under considerable pressure to preserve profit margins should labor costs accelerate further, or should the falling prices of commodity inputs, like oil, turn around. But, to date, businesses' evident pricing power has been scant. Either that would change and inflation could begin to mount or, if costs could not be recouped, capital outlays might well be cut back.

The recent behavior of profits also underlines the unusual nature of the rebound in equity prices and the possibility that the recent performance of the equity markets will have difficulty in being sustained. The level of equity prices would appear to envision substantially greater growth of profits than has been experienced of late.

Moreover, the impressive capital gains of recent years would seem also to rest on a perception of relatively low risk in corporate ownership. Risk aversion and uncertainty rose sharply over the late summer and fall of 1998 following the Russian default in mid-August, as evidenced by widening spreads among yields on debt of differing credit qualities and liquidity. The rise in uncertainty increased the discounting of claims on future incomes, and that reduced stock market prices even as the long-term earnings growth expectations of security analysts continued to rise. As risk aversion subsided after mid-October, stock prices returned to record levels.

Markets have doubtless stabilized significantly after the turbulence of last fall but they remain fragile, as the repercussions of the recent Brazilian devaluation attest. Moreover, our chronic current account deficit has widened significantly, in part reflecting the strength of domestic demand that has accompanied the further accumulation of capital gains. The continued increase in our net external debt and its growing servicing costs clearly are not sustainable indefinitely.

In light of the importance of financial markets in the economy, and of the volatility and vulnerability in financial asset prices more generally, policymakers must continue to pay particular attention to these markets. The Federal Reserve's easing last fall responded to an abrupt stringency in financial markets and the effects that the consequent increased risk aversion was likely to have on economic activity going forward. We were particularly concerned about higher costs and disrupted financing in debt markets, where much of consumption and investment is funded. We were not attempting to prop up equity prices, nor did we plan to continue to ease rates until equity prices recovered, as some have erroneously inferred.

This has not been, and is not now, our policy or intent. As I have discussed earlier, movements in equity prices can play an important role in the economy, which the central bank must take into account. And we may question from time to time whether asset prices may not embody a more optimistic outlook than seems reasonable, or what the consequences might be of a further rise in those prices followed by a steep decline. But many other forces also drive our economy, and it is the performance of the entire economy that forms our objectives and shapes our actions.

Nonetheless, in the current state of financial markets, policymakers are going to have to be particularly wary of actions that unnecessarily sow uncertainties, undermine confidence, and interfere with the efficient allocation of capital on which our economic prosperity and asset values rest. It is important not to undermine the highly sensitive ongoing process of reallocation of capital from less to more productive uses. For productivity and standards of living to grow, not only must capital raised in markets be allocated efficiently, but internal cash flow, including the depreciation charges from the existing capital stock, must be continuously directed to their most profitable uses. It is this continuous churning, this so-called creative destruction, that has become so essential to the effective deployment of advanced technologies by this country over recent decades. In this regard, drift toward protectionist trade policies, which are always so difficult to reverse, is a much greater threat than is generally understood.

It is well known that erecting barriers to the free flow of goods and services across national borders undermines the division of labor and standards of living by impeding the adjustment of the capital stock to its most productive uses. Not so well understood, in my judgment, is the impact that fear of growing protectionism would have on profit expectations, and hence on the current values of capital assets. Protectionism was a threat to standards of living when capital asset values were low relative to income. It becomes particularly pernicious in an environment, such as today's, when that is no longer the case.

In sum, it has been the ability of our flexible and innovative businesses and workforce that has enabled the United States to take full advantage of emerging technologies to produce greater growth and higher asset values. Policy has facilitated this process by containing inflation and by promoting competitiveness through deregulation and an open global trading system. Our task going forward – at the Federal Reserve as well as in the Congress and Administration – is to sustain and strengthen these policies, which in turn have sustained and strengthened our now record peacetime economic expansion.

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