Testimony of Chairman Alan Greenspan

Federal Reserve Board's semiannual Monetary Policy Report to the Congress
Before the Committee on Financial Services, U.S. House of Representatives
February 11, 2004

Chairman Greenspan presented identical testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on February 12, 2004

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.

When I testified before this committee in July, I reported that conditions had become a good deal more supportive of economic expansion over the previous few months. A notable reduction in geopolitical concerns, strengthening confidence in economic prospects, and an improvement in financial conditions boded well for spending and production over the second half of the year. Still, convincing signs of a sustained acceleration in activity were not yet in evidence. Since then, the picture has brightened. The gross domestic product expanded vigorously over the second half of 2003 while productivity surged, prices remained stable, and financial conditions improved further. Overall, the economy has made impressive gains in output and real incomes; however, progress in creating jobs has been limited.

Looking forward, the prospects are good for sustained expansion of the U.S. economy. The household sector's financial condition is stronger, and the business sector has made substantial strides in bolstering balance sheets. Narrowing credit risk spreads and a considerable rally in equity prices have reduced financing costs and increased household wealth, which should provide substantial support for spending by businesses and households. With short-term real interest rates close to zero, monetary policy remains highly accommodative. And it appears that the impetus from fiscal policy will stay expansionary, on net, through this year. These circumstances all should spur the expansion of aggregate demand in 2004. At the same time, increases in efficiency and a significant level of underutilized resources should help keep a lid on inflation.

In retrospect, last year appears to have marked a transition from an extended period of subpar economic performance to one of more vigorous expansion. Once again, household spending was the mainstay, with real personal consumption spending increasing nearly 4 percent and real outlays on residential structures rising about 10 percent. Last year's reductions in personal income tax rates and the advance of rebates to those households that were eligible for the expanded child tax credit boosted the growth of real disposable personal income. The very low level of interest rates also encouraged household spending through a variety of channels. Automakers took advantage of low interest rates to offer attractive incentive deals, buoying the purchase of new vehicles. The lowest home mortgage rates in decades were a major contributor to record sales of existing residences, engendering a large extraction of cash from home equity. A significant part of that cash supported personal consumption expenditures and home improvement. In addition, many households took out cash in the process of refinancing, often using the proceeds to substitute for higher-cost consumer debt. That refinancing also permitted some households to lower the monthly carrying costs for their homes and thus freed up funds for other expenditures. Not least, the low mortgage rates spurred sales and starts of new homes to very high levels.

These developments were reflected in household financing patterns. Home mortgage debt increased about 13 percent last year, while consumer credit expanded much more slowly. Even though the ratio of overall household debt to income continued to increase, as it has for more than a half-century, the rise in home and equity prices enabled the ratio of household net worth to disposable income to recover to a little above its long-term average. The low level of interest rates and large volume of mortgage refinancing activity helped reduce households' debt-service and financial-obligation ratios a bit. And many measures of consumer credit quality improved over the year, with delinquency rates on consumer loans and home mortgages declining.

A strengthening in capital spending over 2003 contributed importantly to the acceleration of real output. In the first quarter of the year, business fixed investment extended the downtrend that began in early 2001. Capital spending, however, ramped up considerably over the final three quarters of 2003, reflecting a pickup in expenditures for equipment and software. Outlays for high-tech equipment showed particular vigor last year. Even spending on communications equipment, which had been quite soft in the previous two years, accelerated. A growing confidence of business executives in the durability of the expansion, strong final sales, the desire to renew capital stocks after replacements had been postponed, and favorable financial conditions all contributed to the turnaround in equipment spending.

By contrast, expenditures on nonresidential structures continued to contract on balance, albeit less rapidly than in 2001 and 2002. High vacancy rates for office buildings and low rates of capacity utilization in manufacturing evidently limited the demand for new structures. Inventory investment likewise failed to pick up much momentum over the year, as managers remained cautious. Firms finished 2003 with lean inventories relative to sales, an encouraging sign for the expansion of production going forward.

To a considerable degree, the gathering strength of capital spending reflects a substantial improvement in the financial condition of businesses over the past few years. Firms' profits rose steeply during 2003 following smaller gains in the previous two years. The significantly stronger cash flow generated by profits and depreciation allowances was more than adequate to cover rising capital expenditures in the aggregate. As a result, businesses had little need to borrow during 2003. For the nonfinancial business sector as a whole, debt is estimated to have grown just 3-1/2 percent.

Firms encountered very receptive conditions in longer-term credit markets in 2003. Interest rate spreads on both investment-grade and speculative-grade bond issues narrowed substantially over the year, as investors apparently became more confident about the economic expansion and saw less risk of adverse shocks from accounting and other corporate scandals. Corporate treasurers took advantage of the attractive market conditions by issuing long-term debt to lengthen the maturities of corporate liabilities.

As a consequence, net short-term financing was extremely weak. The stock of business loans extended by banks and commercial paper issued by nonfinancial firms declined more than $100 billion over the year, apparently owing to slack demand for short-term credit rather than to a constriction in supply. Interest-rate spreads on commercial paper, like those on corporate bonds, were quite narrow. And although a Federal Reserve survey indicates that banks had continued to tighten lending conditions early in the year, by the second half, terms and standards were being eased noticeably. Moreover, responses to that survey pointed to a lack of demand for business loans until late in the year.

Partly as a result of the balance-sheet restructuring, business credit quality appears to have recuperated considerably over the past few years. Last year, the default rate on bonds fell sharply, recovery rates on defaulted issues rose, the number of rating downgrades moderated substantially, and delinquencies on business loans continued to decline. The improved balance sheets and strong profits of business firms, together with attractive terms for financing in open markets and from banks, suggest that financial conditions remain quite supportive of further gains in capital spending in coming quarters.

The profitability of the business sector was again propelled by stunning increases in productivity. The advance in output per hour in the nonfarm business sector picked up to 5-1/4 percent in 2003 after unusually brisk gains in the previous two years. The productivity performance of the past few years has been particularly striking in that these increases occurred in a period of relatively sluggish output growth. The vigorous advance in efficiency represents a notable extension of the pickup that started around the mid-1990s. Apparently, businesses are still reaping the benefits of the marked acceleration in technology.

The strong gains in productivity, however, have obviated robust increases in business payrolls. To date, the expansion of employment has significantly lagged increases in output. Gross separations from employment, two-fifths of which have been involuntary, are about what would be expected from past cyclical experience, given the current pace of output growth. New hires and recalls from layoffs, however, are far below what historical experience indicates. To a surprising degree, firms seem able to continue identifying and implementing new efficiencies in their production processes and thus have found it possible so far to meet increasing orders without stepping up hiring.

In all likelihood, employment will begin to grow more quickly before long as output continues to expand. Productivity over the past few years has probably received a boost from the efforts of businesses to work off the stock of inefficiencies that had accumulated in the boom years. As those opportunities to enhance efficiency become scarcer and as managers become more confident in the durability of the expansion, firms will surely once again add to their payrolls.

A consequence of the rapid gains in productivity and slack in our labor and product markets has been sustained downward pressure on inflation. As measured by the chain-weighted price index for personal consumption expenditures excluding food and energy, prices rose less than 1 percent in 2003. Given the biases in such indexes, this performance puts measured inflation in a range consistent with price stability--a statutory objective of the Federal Reserve and a key goal of all central banks because it is perceived as a prerequisite for maximum sustainable economic growth.

The recent performance of inflation has been especially notable in view of the substantial depreciation of the dollar in 2003. Against a broad basket of currencies of our trading partners, the foreign exchange value of the U.S. dollar has declined about 13 percent from its peak in early 2002. Ordinarily, currency depreciation is accompanied by a rise in dollar prices of imported goods and services, because foreign exporters endeavor to avoid experiencing price declines in their own currencies, which would otherwise result from the fall in the foreign exchange value of the dollar. Reflecting the swing from dollar appreciation to dollar depreciation, the dollar prices of goods and services imported into the United States have begun to rise after declining on balance for several years, but the turnaround to date has been mild. Apparently, foreign exporters have been willing to absorb some of the price decline measured in their own currencies and the consequent squeeze on profit margins it entails.

Part of exporters' losses, however, have apparently been offset by short forward positions against the dollar in foreign exchange markets. A marked increase in foreign exchange derivative trading, especially in dollar-euro, is consistent with significant hedging of exports to the United States and to other markets that use currencies tied to the U.S. dollar. However, most contracts are short-term because long-term hedging is expensive. Thus, although hedging may delay the adjustment, it cannot eliminate the consequences of exchange rate change. Accordingly, the currency depreciation that we have experienced of late should eventually help to contain our current account deficit as foreign producers export less to the United States. On the other side of the ledger, the current account should improve as U.S. firms find the export market more receptive.

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Although the prospects for the U.S. economy look quite favorable, we need to remind ourselves that all forecasts are projections into an uncertain future. The fact that most professional forecasters perceive much the same benign short-term outlook that is our most likely expectation provides scant comfort. When the future surprises, history tells us, it often surprises us all. We must, as a consequence, remain alert to risks that could threaten the sustainability of the expansion.

Besides the chronic concern about a sharp spike in oil or natural gas prices, a number of risks can be identified. Of particular importance to monetary policy makers is the possibility that our stance could become improperly calibrated to evolving economic developments. To be sure, the Federal Open Market Committee's current judgment is that its accommodative posture is appropriate to foster sustainable expansion of economic activity. But the evidence indicates clearly that such a policy stance will not be compatible indefinitely with price stability and sustainable growth; the real federal funds rate will eventually need to rise toward a more neutral level. However, with inflation very low and substantial slack in the economy, the Federal Reserve can be patient in removing its current policy accommodation.

In the process of assessing risk, we monitor a broad range of economic and financial indicators. Included in this group are a number of measures of liquidity and credit creation in the economy. By most standard measures, aggregate liquidity does not appear excessive. The monetary aggregate M2 expanded only 5-1/4 percent during 2003, somewhat less than nominal GDP, and actually contracted during the fourth quarter. The growth of nonfederal debt, at 7-3/4 percent, was relatively brisk in 2003. However, a significant portion of that growth was associated with the record turnover of existing homes and the high level of cash-out refinancing, which are not expected to continue at their recent pace. A narrower measure, that of credit held by banks, also grew only moderately in 2003. All told, our accommodative monetary policy stance to date does not seem to have generated excessive volumes of liquidity or credit.

That said, as we evaluate the risks to the economy, we also assess developments in financial markets. Broad measures of equity prices rose 25 percent in 2003, and technology stocks increased twice as quickly. The rally has extended into this year. And as I noted previously, credit spreads on corporate bonds have narrowed considerably, particularly for speculative-grade issues. This performance of financial markets importantly reflects investors' response to robust earnings growth and the repair of business balance sheets over the past few years. However, history shows that pricing financial assets appropriately in real time can be extremely difficult and that, even in a seemingly benign economic environment, risks remain.

The outlook for the federal budget deficit is another critical issue for policymakers in assessing our intermediate- and long-run growth prospects and the risks to those prospects. As you are well aware, after a brief period of unified budget surpluses around the beginning of this decade, the federal budget has reverted to deficits. The unified deficit swelled to $375 billion in fiscal 2003 and appears to be widening considerably further in the current fiscal year. In part, these deficits are a result of the economic downturn and the period of slower growth that we recently experienced, as well as the earlier decline in equity prices. The deficits also reflect fiscal actions specifically intended to provide stimulus to the economy, a significant step-up in spending for national security, and a tendency toward diminished restraint on discretionary spending. Of course, as economic activity continues to expand, tax revenues should strengthen and the deficit will tend to narrow, all else being equal. But even budget projections that attempt to take such business-cycle influences into account, such as those from the Congressional Budget Office and the Office of Management and Budget, indicate that very sizable deficits are in prospect in the years to come.

As I have noted before, the debate over budget priorities appears to be between those advocating additional tax cuts and those advocating increased spending. Although some stirrings in recent weeks in the Congress and elsewhere have been directed at actions that would lower forthcoming deficits, to date no effective constituency has offered programs to balance the budget. One critical element--present in the 1990s but now absent--is a framework of procedural rules to help fiscal policy makers make the difficult decisions that are required to forge a better fiscal balance.

The imbalance in the federal budgetary situation, unless addressed soon, will pose serious longer-term fiscal difficulties. Our demographics--especially the retirement of the baby-boom generation beginning in just a few years--mean that the ratio of workers to retirees will fall substantially. Without corrective action, this development will put substantial pressure on our ability in coming years to provide even minimal government services while maintaining entitlement benefits at their current level, without debilitating increases in tax rates. The longer we wait before addressing these imbalances, the more wrenching the fiscal adjustment ultimately will be.

The fiscal issues that we face pose long-term challenges, but federal budget deficits could cause difficulties even in the relatively near term. Long-term interest rates reflect not only the balance between the current demand for, and current supply of, credit, they also incorporate markets' expectations of those balances in the future. As a consequence, should investors become significantly more doubtful that the Congress will take the necessary fiscal measures, an appreciable backup in long-term interest rates is possible as prospects for outsized federal demands on national saving become more apparent. Such a development could constrain investment and other interest-sensitive spending and thus undermine the private capital formation that is a key element in our economy's growth prospects.

Addressing the federal budget deficit is even more important in view of the widening U.S. current account deficit. In 2003, the current account deficit reached $550 billion--about 5 percent of nominal GDP. The current account deficit and the federal budget deficit are related because the large federal dissaving represented by the budget deficit, together with relatively low rates of U.S. private saving, implies a need to attract saving from abroad to finance domestic private investment spending.

To date, the U.S. current account deficit has been financed with little difficulty. Although the foreign exchange value of the dollar has fallen over the past year, the decline generally has been gradual, and no material adverse side effects have been visible in U.S. capital markets. While demands for dollar-denominated assets by foreign private investors are off their record pace of mid-2003, such investors evidently continue to perceive the United States as an excellent place to invest, no doubt owing, in large part, to our vibrant market system and our economy's very strong productivity performance. Moreover, some governments have accumulated large amounts of dollar-denominated debt as a byproduct of resisting upward exchange rate adjustment.

Nonetheless, given the already-substantial accumulation of dollar-denominated debt, foreign investors, both private and official, may become less willing to absorb ever-growing claims on U.S. residents. Taking steps to increase our national saving through fiscal action to lower federal budget deficits would help diminish the risks that a further reduction in the rate of purchase of dollar assets by foreign investors could severely crimp the business investment that is crucial for our long-term growth.

The large current account deficits and the associated substantial trade deficits pose another imperative--the need to maintain the degree of flexibility that has been so prominent a force for U.S. economic stability in recent years. The greatest current threat to that flexibility is protectionism, a danger that has become increasingly visible on today's landscape. Over the years, protected interests have often endeavored to stop in its tracks the process of unsettling economic change. Pitted against the powerful forces of market competition, virtually all such efforts have failed. The costs of any new protectionist initiatives, in the context of wide current account imbalances, could significantly erode the flexibility of the global economy. Consequently, creeping protectionism must be thwarted and reversed.

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In summary, in recent years the U.S. economy has demonstrated considerable resilience to adversity. It has overcome significant shocks that, in the past, could have hobbled growth for a much longer period than they have in the current cycle. As I have noted previously, the U.S. economy has become far more flexible over the past two decades, and associated improvements have played a key role in lessening the effects of the recent adverse developments on our economy. Looking forward, the odds of sustained robust growth are good, although, as always, risks remain. The Congress can help foster sustainable expansion by taking steps to reduce federal budget deficits and thus contribute to national saving and by continuing to pursue opportunities to open markets and promote trade. For our part, the Federal Reserve intends to use its monetary tools to promote our goals of economic growth and maximum employment of our resources in an environment of effective price stability.

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