



## The Federal Reserve Board

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### **Testimony of Chairman Alan Greenspan**

*The economic outlook*

**Before the Joint Economic Committee, U.S. Congress**

**June 9, 2005**

Chairman Saxton, Vice Chairman Bennett, and members of the Committee, I am pleased to appear once again before the Joint Economic Committee. Over the past year, the pace of economic activity in the United States has alternately paused and quickened. The most recent data support the view that the soft readings on the economy observed in the early spring were not presaging a more-serious slowdown in the pace of activity. Consumer spending firmed again, and indicators of business investment became somewhat more upbeat. Nonetheless, policymakers confront many of the same imbalances and uncertainties that were apparent a year ago.

Our household saving rate remains negligible. Moreover, modest, if any, progress is evident in addressing the challenges associated with the pending shift of the baby-boom generation into retirement that will begin in a very few years. And although prices of imports have accelerated, we are, at best, in only the earliest stages of a stabilization of our current account deficit--a deficit that now exceeds 6 percent of U.S. gross domestic product (GDP).

A major economic development over the past year has been the surge in the price of oil. Sharply higher prices of oil imports have diminished U.S. purchasing power. The value of petroleum imports rose from 1.4 percent of nominal GDP in the first quarter of 2004 to 1.8 percent in the first quarter of this year. The alternating bouts of rising and falling oil prices have doubtless been a significant contributor to the periods of deceleration and acceleration of U.S. economic activity over the past year.

Despite the uneven character of the expansion over the past year, the U.S. economy has done well, on net, by most measures. Real GDP has grown by 3.7 percent over that period, the unemployment rate has fallen to 5.1 percent, and core personal consumption expenditure prices have risen a historically modest 1.6 percent. But the growth of productivity, though respectable at 2-1/2 percent over the year ending in the first quarter, is far less than the extraordinary pace of 5-1/2 percent during 2003. Excluding a large but apparently transitory surge in bonuses and the proceeds of stock option exercises late last year, overall hourly labor compensation has exhibited few signs of acceleration. Thus, the rise in underlying unit labor costs has been mainly the result of the slower growth of output per hour. At the same time, evidence of increased pricing power can be gleaned from the profit margins of nonfinancial businesses, which have continued to press higher even outside the energy sector. Whether that rise in unit costs will feed into the core price level or will be absorbed by a fall in profit margins remains an open question.

Among the biggest surprises of the past year has been the pronounced decline in long-term interest rates on U.S. Treasury securities despite a 2-percentage-point increase in the federal funds rate. This is clearly without recent precedent. The yield on ten-year Treasury notes, currently at about 4 percent, is 80 basis points less than its level of a year ago. Moreover, even after the recent backup in credit risk spreads, yields for both investment-grade and less-than-investment-grade corporate bonds have declined even more than Treasuries over the same period.

The unusual behavior of long-term interest rates first became apparent almost a year ago. In May and June of last year, market participants were behaving as expected. With a firming of monetary policy by the Federal Reserve widely expected, they built large short positions in long-term debt instruments in anticipation of the increase in bond yields that has been historically associated with a rising federal funds rate. But by summer, pressures emerged in the marketplace that drove long-term rates back down. In March of this year, market participants once again bid up long-term rates, but as occurred last year, forces came into play to make those increases short lived. There remains considerable conjecture among analysts as to the nature of those market forces.

That said, there can be little doubt that exceptionally low interest rates on ten-year Treasury notes, and hence on home mortgages, have been a major factor in the recent surge of homebuilding and home turnover, and especially in the steep climb in home prices. Although a "bubble" in home prices for the nation as a whole does not appear likely, there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels.

The housing market in the United States is quite heterogeneous, and it does not have the capacity to move excesses easily from one area to another. Instead, we have a collection of only loosely connected local markets. Thus, while investors can arbitrage the price of a commodity such as aluminum between Portland, Maine, and Portland, Oregon, they cannot do that with home prices because they cannot move the houses. As a consequence, unlike the behavior of commodity prices, which varies little from place to place, the behavior of home prices varies widely across the nation.

Speculation in homes is largely local, especially for owner-occupied residences. For homeowners to realize accumulated capital gains on a residence--a precondition of a speculative market--they must move. Another formidable barrier to the emergence of speculative activity in housing markets is that home sales involve significant commissions and closing costs, which average in the neighborhood of 10 percent of the sales price. Where homeowner sales predominate, speculative turnover of homes is difficult.

But in recent years, the pace of turnover of existing homes has quickened. It appears that a substantial part of the acceleration in turnover reflects the purchase of second homes--either for investment or vacation purposes. Transactions in second homes, of course, are not restrained by the same forces that restrict the purchases or sales of primary residences--an individual can sell without having to move. This suggests that speculative activity may have had a greater role in generating the recent price increases than it has customarily had in the

past.

The apparent froth in housing markets may have spilled over into mortgage markets. The dramatic increase in the prevalence of interest-only loans, as well as the introduction of other relatively exotic forms of adjustable-rate mortgages, are developments of particular concern. To be sure, these financing vehicles have their appropriate uses. But to the extent that some households may be employing these instruments to purchase a home that would otherwise be unaffordable, their use is beginning to add to the pressures in the marketplace.

The U.S. economy has weathered such episodes before without experiencing significant declines in the national average level of home prices. In part, this is explained by an underlying uptrend in home prices. Because of the degree of customization of homes, it is difficult to achieve significant productivity gains in residential building despite the ongoing technological advances in other areas of our economy. As a result, productivity gains in residential construction have lagged behind the average productivity increases in the United States for many decades. This shortfall has been one of the reasons that house prices have consistently outpaced the general price level for many decades.

Although we certainly cannot rule out home price declines, especially in some local markets, these declines, were they to occur, likely would not have substantial macroeconomic implications. Nationwide banking and widespread securitization of mortgages make it less likely that financial intermediation would be impaired than was the case in prior episodes of regional house price corrections. Moreover, a substantial rise in bankruptcies would require a quite-significant overall reduction in the national housing price level because the vast majority of homeowners have built up substantial equity in their homes despite large home equity withdrawals in recent years financed by the mortgage market.

In conclusion, Mr. Chairman, despite some of the risks that I have highlighted, the U.S. economy seems to be on a reasonably firm footing, and underlying inflation remains contained. Accordingly, the Federal Open Market Committee in its May meeting reaffirmed that it "... believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

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