The Federal Reserve Board

Testimony of Chairman Alan Greenspan

Federal Reserve Board's semiannual Monetary Policy Report to the Congress
Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate
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Chairman Greenspan presented identical testimony before the Committee on Financial Services, U.S. House of Representatives, on February 17, 2005

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. In the seven months since I last testified before this Committee, the U.S. economic expansion has firmed, overall inflation has subsided, and core inflation has remained low.

Over the first half of 2004, the available information increasingly suggested that the economic expansion was becoming less fragile and that the risk of an undesirable decline in inflation had greatly diminished. Toward midyear, the Federal Reserve came to the judgment that the extraordinary degree of policy accommodation that had been in place since the middle of 2003 was no longer warranted and, in the announcement released at the conclusion of our May meeting, signaled that a firming of policy was likely. The Federal Open Market Committee began to raise the federal funds rate at its June meeting, and the announcement following that meeting indicated the need for further, albeit gradual, withdrawal of monetary policy stimulus.

Around the same time, incoming data suggested a lull in activity as the economy absorbed the impact of higher energy prices. Much as had been expected, this soft patch proved to be short-lived. Accordingly, the Federal Reserve has followed the June policy move with similar actions at each meeting since then, including our most recent meeting earlier this month. The cumulative removal of policy accommodation to date has significantly raised measures of the real federal funds rate, but by most measures, it remains fairly low.

The evidence broadly supports the view that economic fundamentals have steadied. Consumer spending has been well maintained over recent months, buoyed by continued growth in disposable personal income, gains in net worth, and accommodative conditions in credit markets. Households have recorded a modest improvement in their financial position over this period, to the betterment of many indicators of credit quality. Low interest rates and rising incomes have contributed to a decline in the aggregate household financial obligation ratio, and delinquency and charge-off rates on various categories of consumer loans have stayed at low levels.

The sizable gains in consumer spending of recent years have been accompanied by a drop in the personal saving rate to an average of only 1 percent over 2004--a very low figure relative to the nearly 7 percent rate averaged over the previous three decades. Among the factors contributing to the strength of spending and the decline in saving have been developments in housing markets and home finance that have spurred rising household wealth and allowed greater access to that wealth. The rapid rise in home prices over the past several years has provided households with considerable capital gains. Moreover, a significant increase in the rate of single-family home turnover has meant that many consumers have been able to realize gains from the sale of their homes. To be sure, such capital gains, largely realized through an increase in mortgage debt on the home, do not increase the pool of national savings available to finance new capital investment. But from the perspective of an individual household, cash realized from capital gains has the same spending power as cash from any other source.

More broadly, rising home prices along with higher equity prices have outpaced the rise in household, largely mortgage, debt and have pushed up household net worth to about 5-1/2 times disposable income by the end of last year. Although the ratio of net worth to income is well below the peak attained in 1999, it remains above the long-term historical average. These gains in net worth help to explain why households in the aggregate do not appear uncomfortable with their financial position even though their reported personal saving rate is negligible.

Of course, household net worth may not continue to rise relative to income, and some reversal in that ratio is not out of the question. If that were to occur, households would probably perceive the need to save more out of current income; the personal saving rate would accordingly rise, and consumer spending would slow.

But while household spending may well play a smaller role in the expansion going forward, business executives apparently have become somewhat more optimistic in recent months. Capital spending and corporate borrowing have firmed noticeably, but some of the latter may have been directed to finance the recent backup in inventories. Mergers and acquisitions, though, have clearly perked up.

Even in the current much-improved environment, however, some caution among business executives remains. Although capital investment has been advancing at a reasonably good pace, it has nonetheless lagged the exceptional rise in profits and internal cash flow. This is most unusual; it took a deep recession to produce the last such configuration in 1975. The lingering caution evident in capital spending decisions has also been manifest in less-aggressive hiring by businesses. In contrast to the typical pattern early in previous business-cycle recoveries, firms have appeared reluctant to take on new workers and have remained focused on cost containment.

As opposed to the lingering hesitancy among business executives, participants in financial markets seem very confident about the future and, judging by the exceptionally low level of risk spreads in credit markets, quite willing to bear risk. This apparent disparity in sentiment between business people and market participants could reflect the heightened additional concerns of business executives about potential legal liabilities rather than a fundamentally different assessment of macroeconomic risks.

Turning to the outlook for costs and prices, productivity developments will likely play a key role. The growth of output per hour slowed over the past half year, giving a boost to unit labor costs after two years of declines. Going forward, the implications for inflation will be influenced by the extent and persistence of any slowdown in productivity. A lower rate of productivity growth in the context of relatively stable increases in average hourly compensation has led to slightly more rapid growth in unit labor costs. Whether inflation actually rises in the wake of slowing productivity growth, however, will depend on the rate of growth of labor compensation and the ability and willingness of firms to pass on higher costs to their customers. That, in turn, will depend on the degree of utilization of resources and how monetary policymakers respond. To date, with profit margins already high, competitive pressures have tended to limit the extent to which cost pressures have been reflected in higher prices.

Productivity is notoriously difficult to predict. Neither the large surge in output per hour from the first quarter of 2003 to the second quarter of 2004, nor the more recent moderation was easy to anticipate. It seems likely that these swings reflected delayed efficiency gains from the capital goods boom of the 1990s. Throughout the first half of last year, businesses were able to meet increasing orders with management efficiencies rather than new hires. But conceivably the backlog of untapped total efficiencies has run low, requiring new hires. Indeed, new hires as a percent of employment rose in the fourth quarter of last year to the highest level since the second quarter of 2001.

There is little question that the potential remains for large advances in productivity from further applications of existing knowledge, and insights into applications not even now contemplated doubtless will emerge in the years ahead. However, we have scant ability to infer the pace at which such gains will play out and, therefore, their implications for the growth of productivity over the longer run. It is, of course, the rate of change of productivity over time, and not its level, that influences the persistent changes in unit labor costs and hence the rate of inflation.

The inflation outlook will also be shaped by developments affecting the exchange value of the dollar and oil prices. Although the dollar has been declining since early 2002, exporters to the United States apparently have held dollar prices relatively steady to preserve their market share, effectively choosing to absorb the decline in the dollar by accepting a reduction in their profit margins. However, the recent somewhat quickened pace of increases in U.S. import prices suggests that profit margins of exporters to the United States have contracted to the point where the foreign shippers may exhibit only limited tolerance for additional reductions in margins should the dollar decline further.

The sharp rise in oil prices over the past year has no doubt boosted firms' costs and may have weighed on production, particularly given the sizable permanent component of oil price increases suggested by distant-horizon oil futures contracts. However, the share of total business expenses attributable to energy costs has declined appreciably over the past thirty years, which has helped to buffer profits and the economy more generally from the adverse effect of high oil and natural gas prices. Still, although the aggregate effect may be modest, we must recognize that some sectors of the economy and regions of the country have been hit hard by the increase in energy costs, especially over the past year.

Despite the combination of somewhat slower growth of productivity in recent quarters, higher energy prices, and a decline in the exchange rate for the dollar, core measures of consumer prices have registered only modest increases. The core PCE and CPI measures, for example, climbed about 1-1/4 and 2 percent, respectively, at an annual rate over the second half of last year.

All told, the economy seems to have entered 2005 expanding at a reasonably good pace, with inflation and inflation expectations well anchored. On the whole, financial markets appear to share this view. In particular, a broad array of financial indicators convey a pervasive sense of confidence among investors and an associated greater willingness to bear risk than is yet evident among business managers.

Both realized and option-implied measures of uncertainty in equity and fixed-income markets have declined markedly over recent months to quite low levels. Credit spreads, read from corporate bond yields and credit default swap premiums, have continued to narrow amid widespread signs of an improvement in corporate credit quality, including notable drops in corporate bond defaults and debt ratings downgrades. Moreover, recent surveys suggest that bank lending officers have further eased standards and terms on business loans, and anecdotal reports suggest that securities dealers and other market-makers appear quite willing to commit capital in providing market liquidity.

In this environment, long-term interest rates have trended lower in recent months even as the Federal Reserve has raised the level of the target federal funds rate by 150 basis points. This development contrasts with most experience, which suggests that, other things being equal, increasing short-term interest rates are normally accompanied by a rise in longer-term yields. The simple mathematics of the yield curve governs the relationship between short- and long-term interest rates. Ten-year yields, for example, can be thought of as an average of ten consecutive one-year forward rates. A rise in the first-year forward rate, which correlates closely with the federal funds rate, would increase the yield on ten-year U.S. Treasury notes even if the more-distant forward rates remain unchanged. Historically, though, even these distant forward rates have tended to rise in association with monetary policy tightening.

In the current episode, however, the more-distant forward rates declined at the same time that short-term rates were rising. Indeed, the tenth-year tranche, which yielded 6-1/2 percent last June, is now at about 5-1/4 percent. During the same period, comparable real forward rates derived from quotes on Treasury inflation-indexed debt fell significantly as well, suggesting that only a portion of the decline in nominal forward rates in distant tranches is attributable to a drop in long-term inflation expectations.

Some analysts have worried that the dip in forward real interest rates since last June may indicate that market participants have marked down their view of economic growth going forward, perhaps because of the rise in oil prices. But this interpretation does not mesh seamlessly with the rise in stock prices and the narrowing of credit spreads observed over the same interval. Others have emphasized the subdued overall business demand for credit in the United States and the apparent eagerness of lenders, including foreign investors, to provide financing. In particular, heavy purchases of longer-term Treasury securities by foreign central banks have often been cited as a factor boosting bond prices and pulling down longer-term yields. Thirty-year fixed-rate mortgage rates have dropped to a level only a little higher than the record lows touched in 2003 and, as a consequence, the estimated average duration of outstanding mortgage-backed securities has shortened appreciably over recent months. Attempts by mortgage investors to offset this decline in duration by purchasing longer-term securities may be yet another contributor to the recent downward pressure on longer-term yields.

But we should be careful in endeavoring to account for the decline in long-term interest rates by adverting to technical factors in the United States alone because yields and risk spreads have narrowed globally. The German ten-year Bund rate, for example, has declined from 4-1/4 percent last June to current levels of 3-1/2 percent. And spreads of yields on bonds issued by emerging-market nations over U.S. Treasury yields have declined to very low levels.

There is little doubt that, with the breakup of the Soviet Union and the integration of China and India into the global trading market, more of the world's productive capacity is being tapped to satisfy global demands for goods and services. Concurrently, greater integration of financial markets has meant that a larger share of the world's pool of savings is being deployed in cross-border financing of investment. The favorable inflation performance across a broad range of countries resulting from enlarged global goods, services and financial capacity has doubtless contributed to expectations of lower inflation in the years ahead and lower inflation risk premiums. But none of this is new and hence it is difficult to attribute the long-term interest rate declines of the last nine months to glacially increasing globalization. For the moment, the broadly unanticipated behavior of world bond markets remains a conundrum. Bond price movements may be a short-term aberration, but it will be some time before we are able to better judge the forces underlying recent experience.

This is but one of many uncertainties that will confront world policymakers. Over the past two decades, the industrial world has fended off two severe stock market corrections, a major financial crisis in developing nations, corporate scandals, and, of course, the tragedy of September 11, 2001. Yet overall economic activity experienced only modest difficulties. In the United States, only five quarters in the past twenty years exhibited declines in GDP, and those declines were small. Thus, it is not altogether unexpected or irrational that participants in the world marketplace would project more of the same going forward.

Yet history cautions that people experiencing long periods of relative stability are prone to excess. We must thus remain vigilant against complacency, especially since several important economic challenges confront policymakers in the years ahead.

Prominent among these challenges in the United States is the pressing need to maintain the flexibility of our economic and financial system. This will be essential if we are to address our current account deficit without significant disruption. Besides market pressures, which appear poised to stabilize and over the longer run possibly to decrease the U.S. current account deficit and its attendant financing requirements, some forces in the domestic U.S. economy seem about to head in the same direction. Central to that adjustment must be an increase in net national saving. This serves to underscore the imperative to restore fiscal discipline.

Beyond the near term, benefits promised to a burgeoning retirement-age population under mandatory entitlement programs, most notably Social Security and Medicare, threaten to strain the resources of the working-age population in the years ahead. Real progress on these issues will unavoidably entail many difficult choices. But the demographics are inexorable, and call for action before the leading edge of baby boomer retirement becomes evident in 2008. This is especially the case because longer-term problems, if not addressed, could begin to affect longer-dated debt issues, the value of which is based partly on expectations of developments many years in the future.

Another critical long-run economic challenge facing the United States is the need to ensure that our workforce is equipped with the requisite skills to compete effectively in an environment of rapid technological progress and global competition. Technological advance is continually altering the shape, nature, and complexity of our economic processes. But technology and, more recently, competition from abroad have grown to a point at which demand for the least-skilled workers in the United States and other developed countries is diminishing, placing downward pressure on their wages. These workers will need to acquire the skills required to compete effectively for the new jobs that our economy will create.

At the risk of some oversimplification, if the skill composition of our workforce meshed fully with the needs of our increasingly complex capital stock, wage-skill differentials would be stable, and percentage changes in wage rates would be the same for all job grades. But for the past twenty years, the supply of skilled, particularly highly skilled, workers has failed to keep up with a persistent rise in the demand for such skills. Conversely, the demand for lesser-skilled workers has declined, especially in response to growing international competition. The failure of our society to enhance the skills of a significant segment of our workforce has left a disproportionate share with lesser skills. The effect, of course, is to widen the wage gap between the skilled and the lesser skilled.

In a democratic society, such a stark bifurcation of wealth and income trends among large segments of the population can fuel resentment and political polarization. These social developments can lead to political clashes and misguided economic policies that work to the detriment of the economy and society as a whole. As I have noted on previous occasions, strengthening elementary and secondary schooling in the United States--especially in the core disciplines of math, science, and written and verbal communications--is one crucial element in avoiding such outcomes. We need to reduce the relative excess of lesser-skilled workers and enhance the number of skilled workers by expediting the acquisition of skills by all students, both through formal education and on-the-job training.

Although the long-run challenges confronting the U.S. economy are significant, I fully anticipate that they will ultimately be met and resolved. In recent decades our nation has demonstrated remarkable resilience and flexibility when tested by events, and we have every reason to be confident that it will weather future challenges as well. For our part, the Federal Reserve will pursue its statutory objectives of price stability and maximum sustainable employment--the latter of which we have learned can best be achieved in the long run by maintaining price stability. This is the surest contribution that the Federal Reserve can make in fostering the economic prosperity and well-being of our nation and its people.

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