Greenspan predicts US "recovery" but sounds some warnings

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While US Federal Reserve Board chairman Alan Greenspan's semi-annual testimony to Congress on Wednesday was broadly in line with "market expectations"—forecasting a mild recovery for the US economy—there were some notes of caution, and even words of warning.

Greenspan began by saying that the "typical dynamics of the business cycle" had re-emerged and were prompting a "firming in economic activity." However, he was quick to add that an "array of influences unique to this business cycle" seemed likely to "moderate the speed of the anticipated recovery."

The "typical dynamics" relate to the rundown in inventory. As firms liquidate their stocks in the first phase of a recession, there eventually comes a point when inventories are so low that they must issue new orders. This stimulates an increase in industrial production, leading in turn to a rise in household income and spending.

But after pointing to this process, Greenspan cautioned that the "impetus to the growth of activity" would be "short-lived unless sustained increases in final demand kick in before the positive effects from inventory liquidation dissipate."

The central question is where is the increase in final demand going to come from? Here some of the problems confronting the American economy start to emerge.

As Greenspan noted, most recoveries in the postwar period have received a boost from a "rebound in consumer durables and housing from recession-depressed levels in addition to an abatement of inventory liquidation." But on this occasion, spending on both housing and consumer durables has remained relatively high during the downturn of the past 12 months and has proved to be a "major stabilising force."

This means that "the potential for a significant acceleration in activity in this sector is likely to be more limited than in past cycles." In fact, given that unemployment was likely to continue to rise, even if the economy were on the road to recovery "a soft labour market could put something of a damper on consumer spending." According to Federal Reserve estimates the unemployment rate is "anticipated to rise somewhat further" over 2002 to the region of 6-6.25 percent.

The key question for the state of the economy is what will happen to investment spending? This is because the current downturn—unlike others in the postwar period—was not induced by a fall in consumption spending which then flowed on to investment. Rather, it began because of a sharp fall in business investment that has continued even as consumption spending has remained relatively high.

In Greenspan's words, the "broad contours of the present cycle have been, and will continue to be, driven by the evolution of corporate profits and capital investment."

"The retrenchment in capital spending over the past year and a half was central to the sharp slowing we experienced in overall activity. The steep rise in high-tech spending that occurred in the early post Y-2K months was clearly not sustainable. The demand for many of the newer technologies was growing rapidly, but capacity was expanding even faster and that imbalance exerted significant downward pressure on the prices and profits of producers of high-tech goods and services."

As a result, for much of last year "the resulting decline in investment outlays was fierce and unrelenting" and even though the weakness was most pronounced in the technology area, "reductions in capitalist outlays were broad-based."

These cutbacks interacted with falling profits and equity prices with the resultant problems compounded by the fact that due to increased global competition there was a "virtual absence of pricing power across much of American business." In other words, in a generally low inflation environment, firms were unable to maintain profits by passing on cost increases to consumers.

While there was some evidence that a recovery in some forms of high-tech investment had begun—Greenspan noted the upturn in the production of semiconductors last autumn—the "contraction of investment in the communications sector, where the amount of overcapacity was substantial, as yet shows few signs of abating, and business investment in some other sectors, such as aircraft, hit by the drop in air travel, will presumably remain weak this year."

As in many previous speeches, Greenspan pointed to the positive effects of information technology. Improved access to real-time information and the deregulation of finance and product markets, leading to the spreading of risks, meant that imbalances would more likely be contained. Consequently "cyclical episodes should be less severe than would be the case otherwise." This "implied reduction in volatility", other things being equal, should bring lower risk.

However, he went on to warn that "other things ... may not be wholly equal." There was a danger that "the very technologies that appear to be the main cause of our apparent increased flexibility and resiliency may also be imparting different forms of vulnerability that could intensify or be intensified by the business cycle."

The new dangers of instability arise from the implications of the Enron collapse where a firm valued at hundreds of billions of dollars and ranked in the top ten of US corporations has disappeared virtually overnight.

"As the recent events surrounding Enron have highlighted, a firm is inherently fragile if its value added emanates more from conceptual as distinct from physical assets. A physical asset, whether an office building or an automotive assembly plant, has the capability of producing goods even if the reputation of the managers of such facilities falls under a cloud. The rapidity of Enron's decline is an effective illustration of the vulnerability of a firm whose market value largely rests on capitalised reputation. The physical assets of such a firm comprise a small portion of its asset base. Trust and reputation can vanish overnight. A factory cannot."

While Greenspan maintained a measured tone—the Fed chairman is all too well aware of the impact of his comments on jittery financial markets—the implications of his remarks are all too clear: significant dangers to the US and world economy arise from the fact that much accumulated corporate wealth is little more than a financial house of cards.

Even while carefully choosing his words, Greenspan did point to the potential flow-on effects of Enron-type collapses noting that "macroeconomic risks can emerge" if the problems at one particular firm tend to make investors uncertain about other firms they see as similarly situated.

"The difficulty of valuing such firms that deal primarily with concepts and the growing size and importance of these firms," he continued, "may make our economy more susceptible to this type of contagion."

Even though it has forecast a "recovery" for 2002, the Fed's growth estimates make clear that it will be very limited. The increase of real gross domestic product for the year is expected to be between 2.5 percent and 3 percent. In the view of some economists, any growth rate below 3 percent cannot be properly classed as a "recovery" because unemployment continues to rise, while profits and capacity utilisation continue to fall.

Even Greenspan, who generally tries to put the best gloss on the economic outlook, conceded that the Fed's forecasts were "somewhat below the rates of growth typically seen early in previous expansions."

"Certain factors, such as the lack of pent-up demand in the consumer sector, significant levels of excess capacity in a number of industries, weakness and financial fragility in some key international trading partners, and persistent caution in financial markets at home, seem likely to restrain the near-term performance of the economy," he said.

In other words, the present apparent upturn could be the prelude to another decline—the so-called "W" or double-dip recession forecast by some observers—or the start of a long period of sub-normal economic growth.