Little substance in Greenspan’s reassurances

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Anxious not to set off a wave of selling in what he described as “skittish” financial markets, US Federal Reserve Board chairman Alan Greenspan offered some reassurances on the state of the American economy when he delivered his semi-annual report on monetary policy to the Senate on Tuesday.

The “mildness and brevity” of the downturn, he said, were an indication of an “improvement in the resilience and flexibility” of the US economy which had held up “remarkably well.” The “fundamentals” were in place for a “return to healthy growth.”

These remarks formed the basis of media reports to the effect that the Fed chief was “upbeat” on the economy. But the market failed to respond and declined by a further 160 points and in the body of Greenspan’s speech there was nothing to back up the claim. Indeed, some of the facts he cited point to a worsening economic outlook, both for the US and world economy.

He warned, for example, that spending would “continue to adjust for some time to the declines that have occurred in equity prices” and that there were still “considerable uncertainties” about adjustments in capital spending, the rebound in profitability, corporate malfeasance and global political events.

As far as the macro economy is concerned, the two most important “fundamentals” are the levels of consumer and investment spending. Here Greenspan’s statement offered no prospects for an upturn. Consumer spending had held up during the downturn and therefore could not be expected to undergo a “surge” in the coming period. In fact, the “declines in household wealth that have occurred over the past couple of years should continue to restrain spending in the period ahead.”

While consumer spending had not been cut back, business spending had been “depressed” with the downturn largely driven by a “sharp falloff” in the demand for capital goods. “Overall, the level of real business fixed investment plunged about 11 percent between its quarterly peak in the final months of 2000 and the first quarter of this year,” he noted.

Significantly there is nothing in the current economic climate which would point to a revival in business investment in the near future. Business managers “remain decidedly cautious” with the “intensely competitive business environment facing their firms” contributing to the “dispirited attitudes among many corporate executives.”

While the Fed has forecast a growth rate of between 3.5 and 3.75 percent, above what it predicted in February, business managers “remain sceptical of the evidence of an emerging upturn.”

And, one might add, for good reason. As Greenspan noted: “Profit margins do appear to be coming off their lows registered last year, but, unsurprisingly, the recovery in economic activity from the shallow decline appears less vigorous than in the past. The lowest sustained rates of inflation in 40 years imply that nominal growth in sales and profits looks particularly anemic. ... Reflecting concerns about the strength of the recovery, managers still continue to limit spending to only the most pressing needs.”

The low rate of inflation, verging on deflation, which prevents firms from fixing prices according to their needs, is one of the surest indicators of the pressure of profits, not only in the US but throughout the global economy.

Given the revelations of the past few weeks about the real state of business affairs in the US, Greenspan had to devote a significant section of his speech to the question of “corporate governance”.

He warned that the danger that breakdowns in governance could erode business efficiency remained “worrisome” and that “falsification and fraud are highly destructive to free-market capitalism and, more broadly, to the underpinnings of our society.”

Shareholders and investors, he continued, would have been protected from widespread misinformation if any one of the “many bulwarks safeguarding appropriate corporate evaluation” had held. But in many cases none did.

“Why did corporate governance checks and balances that served us reasonably well in the past break down? At root was the rapid enlargement of stock market capitalization in the latter part of the 1990s that arguably engendered an outsized increase in opportunities for avarice. An infectious greed seemed to grip much of our business community. Our historical guardians of financial information were overwhelmed. ... It is not that humans have become any more greedy than in generations past. It is that the avenues to express greed had grown so enormously.”

While Greenspan knows that the mere assertion that the problems reside with “evil-doers” in the upper echelons of corporate America will not wash, his attempted explanation only raises other questions.

In the first place it was not that the “guardians of financial

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information were overwhelmed." There was a wholesale winding back of any controls and regulations as the stock market bubble grew in size in the name of enhancing "flexibility". Moreover, there were those, Greenspan being among the most prominent, who maintained that the escalation in share prices was the outcome of the "new economy."

In other words, powerful forces were at work in creating and then maintaining the stock market bubble. The real question is why the US economy became so dependent on the stock market boom, which led in turn to the establishment of the "creative accounting" methods now being denounced as fraudulent.

As one commentator noted recently in a perceptive remark, the problem was not so much "dodgy accounting" as a "dodgy economy." That is, the stock market bubble, and everything that went with it, played an indispensable role in maintaining the profits of US corporations and sustaining the US economy.

Greenspan himself is well aware of this process. As the recently released minutes of the Federal Reserve Board have revealed, back in May 1996 he was pointing to the role of the stock market boom and its associated "wealth effect" in boosting the US economy.

Just months before, members of the board had been wondering "what elements in GDP [gross domestic product] were going to strengthen and sustain the recovery. We could not find it in residential construction. We could not find it in capital investment. The consumer was dead. The government had gone out of business. And clearly the export side was not doing anything." What had changed was that stock market indexes were "going straight up in the charts."

Rather than undertake action to deflate the bubble, its emergence was welcomed because it brought a close to the worst growth in any five-year period (1990-95) for the major capitalist economies since 1950.

The stock market bubble began to play a pivotal role in the functioning of the US economy in the latter part of the 1990s, fuelling investment in high-tech capital equipment, boosting profits and encouraging the capital inflow from the rest of the world needed to finance the ever-growing US balance of payments deficit.

The extent of the latter process is well illustrated by figures published by Morgan Stanley last week. Up to 1981, the US was the world's largest creditor nation. Then, in the mid to late eighties, depending on which valuation method is used, it became a debtor.

In the period 1990-96, the net external debt averaged about $268 billion. But thereafter it exploded to a total of $2.3 trillion at the end of 2001, equivalent to about 23 percent of GDP.

Now there are fears that these processes will go into reverse with a fall in the market leading to an outflow of US dollars, a fall in the value of the US currency on international markets, sparking a further market decline and withdrawal of foreign investment capital.

There are signs that this process may have begun. This week the euro reached parity with the US dollar, after being as low as 86 cents last March. The *Washington Post* said it was a "fresh sign of the deepening pessimism in US financial markets and the growing disillusionment among investors worldwide over the scandals besetting US companies."

Evidence of a withdrawal of investors from all US financial markets, not just equities, was cited in an article in the *Australian Financial Review* of July 17. According to John Vail, the US investment strategist for Mizuho Securities: "The frightening thing about the market today is that even though the stock market is weak, the bond market didn't strengthen—it weakened too."

Normally a fall in the stock market is accompanied by a rise in the bond market as money moves there. According to Vail, the reason for anomaly is that neither market is proving attractive and that "bond yields are just too low for foreigners and their selling is overwhelming domestic buying."

Another factor complicating the financial situation is the re-emergence of the US budget deficit—a development to which Greenspan made reference in his speech.

The lowering of budget deficits from the late 1980s, he said, had put downward pressure on interest rates and "enhanced the incentives of businesses to invest in productive plant and equipment." But recently some these gains had been "given up." While the return to deficits was in part due to the downturn there was "signs that the underlying disciplinary mechanisms that formed the framework for federal budget decisions over the most of the past 15 years have eroded," he said.

The Bush administration has announced that it expects the deficit to grow to $165 billion this fiscal year—the largest in seven years and more than 50 percent above what it predicted a few months ago. The sagging markets, and the associated decline in tax revenues, have been blamed for the reversal.

It seems that, like the corporate world, US government finances in the late 1990s were increasingly dependent on the rise in equity markets. According to a statement by the Office of Management and Budget: "The stock market and the capital gains receipts it generates have become more important than ever to the federal budget outlook."

In the latter part of the 1990s, rising stock markets formed the key component of what appeared to be a virtuous circle of rising profits, increased growth, large capital inflows, federal budget surpluses and lower interest rates. Now the reversal of all these processes has set up the conditions for the financial equivalent of the "perfect storm."

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