

## FINANCIAL FAQs

### JUNE 6, 2005--GREENSPAN-SPEAK CALMS FINANCIAL MARKETS

Today's speech before the Joint Congressional Finance Committee calmed the markets. Federal Reserve Chairman Greenspan gave them what they were asking for—"contained" inflationary pressure, "reasonably firm" economic growth, a Federal Open Market Committee that can continue to raise their rates at a "measured pace"; even an explanation for the "frothy" housing prices in some regions of the country,

Mostly he reassured the markets that "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 imbalance and uncertainties that were apparent a year ago."

Inflation has been contained for several reasons. Labor compensation has "shown few signs of acceleration." Some higher unit labor costs are mainly due to increased output and falling productivity, which is to be expected at this stage of the expansion cycle. And the tremendous influx of cheaper imports from lower wage-paying countries has kept consumer prices down. Indeed, it looks like the whole world is experiencing lower pricing pressures in this decade because of the globalization of our supply lines.

Somewhat surprising was his explanation for the elevated housing prices. Because so much of housing is custom-built, housing productivity has lagged behind other sectors of the economy "for decades". This has resulted in supply bottlenecks that have unbalanced the supply and demand curve. Although we are back to constructing approximately 1.8 million new single-family housing units per year, it is still below the 2 million plus volume of the 1970s. This is while the number of households seeking shelter has almost doubled!

He did not seem to put much of the blame on the availability of easy credit. Rather, it is those buying second and vacation homes that seem to be driving the frothiness. They tend to treat the home they do not live in as a commodity that can be more easily sold, whereas sales costs can be as much as 10 percent of the price for a homeowner who has to move family and change jobs.

What are some "imbalances and uncertainties" that still confront us? A low household savings rate, and 6 percent of GDP current account (i.e., imports less exports and exchange payments) deficit has caused the dollar to continue to depreciate. This has contributed to "sharply higher" oil prices. And, "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," he said.

Chairman Greenspan continues to be surprised by the "pronounced" decline in long-term interest rates, which is a worldwide, rather than U.S. phenomenon. "This is clearly without recent precedent," he said. "There remains considerable conjecture among analysts as to the nature of those market forces." Yields on 10-year Treasury notes are 80 basis points (0.8 percent) below year-ago levels.

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