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Statement of

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Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

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Mr. Chairman and members of the Committee, I am pleased to present the Federal Reserve's semiannual Monetary Policy Report to the Congress.

When in late April I last reviewed the economic outlook before the Congress, full-scale military operations in Iraq had concluded, and there were signs that some of the impediments to brisker growth in economic activity in the months leading up to the conflict were beginning to lift. Many, though by no means all, of the economic uncertainties stemming from the situation in Iraq had been resolved, and that reduction in uncertainty had left an imprint on a broad range of indicators.

Stock prices had risen, risk spreads on corporate bonds had narrowed, oil prices had dropped sharply, and measures of consumer sentiment appeared to be on the mend. But, as I noted in April, hard data indicating that these favorable developments were quickening the pace of spending and production were not yet in evidence, and it was likely that the extent of the underlying vigor of the economy would become apparent only gradually.

In the months since, some of the residual war-related uncertainties have abated further and financial conditions have turned decidedly more accommodative, supported, in part, by the Federal Reserve's commitment to foster sustainable growth and to guard against a substantial further disinflation. Yields across maturities and risk classes have posted marked declines, which together with improved profits boosted stock prices and household wealth. If the past is any guide, these domestic financial developments, apart from the heavy dose of fiscal stimulus now in train, should bolster economic activity over coming quarters.

To be sure, industrial production does appear to have stabilized in recent weeks after months of declines. Consumer spending has held up reasonably well, and activity in housing markets continues strong. But incoming data on employment and aggregate output remain

mixed. A pervasive sense of caution reflecting, in part, the aftermath of corporate governance scandals appears to have left businesses focused on strengthening their balance sheets and, to date, reluctant to ramp up significantly their hiring and spending. Continued global uncertainties and economic weakness abroad, particularly among some of our major trading partners, also have extended the ongoing softness in the demand for U.S. goods and services.

When the Federal Open Market Committee (FOMC) met last month, with the economy not yet showing convincing signs of a sustained pickup in growth, and against the backdrop of our concerns about the implications of a possible substantial decline in inflation, we elected to ease policy another quarter-point. The FOMC stands prepared to maintain a highly accommodative stance of policy for as long as needed to promote satisfactory economic performance. In the judgment of the Committee, policy accommodation aimed at raising the growth of output, boosting the utilization of resources, and warding off unwelcome disinflation can be maintained for a considerable period without ultimately stoking inflationary pressures.

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The prospects for a resumption of strong economic growth have been enhanced by steps taken in the private sector over the past couple of years to restructure and strengthen balance sheets. These changes, assisted by improved prices in asset markets, have left households and businesses better positioned than they were earlier to boost outlays as their wariness about the economic environment abates.

Nowhere has this process of balance sheet adjustment been more evident than in the household sector. On the asset side of the balance sheet, the decline in longer-term interest rates and diminished perceptions of credit risk in recent months have provided a substantial lift to the market value of nearly all major categories of household assets. Most notably, historically low

mortgage interest rates have helped to propel a solid advance in the value of the owner-occupied housing stock. And the lowered rate at which investors discount future business earnings has contributed to the substantial appreciation in broad equity price indexes this year, reversing a portion of their previous declines.

In addition, reflecting growing confidence, households have been shifting the composition of their portfolios in favor of riskier assets. In recent months, equity mutual funds attracted sizable inflows following the redemptions recorded over much of the last year. Moreover, strong inflows to corporate bond funds, particularly those specializing in speculative-grade securities, have provided further evidence of a renewed appetite for risk-taking among retail investors.

On the liability side of the balance sheet, despite the significant increase in debt encouraged by higher asset values, lower interest rates have facilitated a restructuring of existing debt. Households have taken advantage of new lows in mortgage interest rates to refinance debt on more favorable terms, to lengthen debt maturity, and, in many cases, to extract equity from their homes to pay down other higher-cost debt. Debt service burdens, accordingly, have declined.

Overall, during the first half of 2003, the net worth of households is estimated to have risen 4-1/2 percent--somewhat faster than the rise in nominal disposable personal income. Only 15 percent of that increase in wealth represented the accumulated personal saving of households. Additions to net worth have largely reflected capital gains both from financial investments and from home price appreciation. Net additions to home equity, despite very large extractions, remained positive in the first half.

Significant balance-sheet restructuring in an environment of low interest rates has gone far beyond that experienced in the past. In large measure, this reflects changes in technology and mortgage markets that have dramatically transformed accumulated home equity from a very illiquid asset into one that is now an integral part of households' ongoing balance-sheet management and spending decisions. This enhanced capacity doubtless added significant support to consumer markets during the past three years as numerous shocks--a stock price fall, 9/11, and the Iraq war--pummeled consumer sentiment.

Households have been able to extract home equity by drawing on home equity loan lines, by realizing capital gains through the sale of existing homes, and by extracting cash as part of the refinancing of existing mortgages, so-called cash-outs. Although all three of these vehicles have been employed extensively by homeowners in recent years, home turnover has accounted for most equity extraction.

Since originations to purchase existing homes tend to be roughly twice as large as repayments of the remaining balances on outstanding mortgages of home sellers, the very high levels of existing home turnover have resulted in substantial equity extraction, largely realized capital gains. Indeed, of the estimated net increase of $1.1 trillion in home mortgage debt during the past year and a half, approximately half resulted from existing home turnover.

The huge wave of refinancings this year and last has been impressive. Owing chiefly to the decline in mortgage rates to their lowest levels in more than three decades, estimated mortgage refinancings net of cash-outs last year rose to a record high of more than $1.6 trillion. With mortgage rates declining further in recent months, the pace of refinancing surged even higher over the first half of this year. Cash-outs also increased, but at a slowed pace. Net of duplicate refinancings, approximately half of the dollar value of outstanding regular mortgages

has been refinanced during the past year and a half. Moreover, applications to refinance existing mortgages jumped to record levels last month. Given that refinance applications lead originations by about five weeks and that current mortgage rates remain significantly below those on existing mortgages, refinance originations likely will remain at an elevated level well into the current quarter.

We expect both equity extraction and lower debt service to continue to provide support for household spending in the period ahead, though the strength of this support is likely to diminish over time. In recent quarters, low mortgage rates have carried new home sales and construction to elevated levels. Sales of new single-family homes through the first five months of this year are well ahead of last year's record pace. And declines in financing rates on new auto loans to the lowest levels in many years have spurred purchases of new motor vehicles.

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In addition to balance sheet improvements, the recently passed tax legislation will provide a considerable lift to disposable incomes of households in the second half of the year, even after accounting for some state and local offsets. At this point, most firms have likely implemented the lower withholding schedules that have been released by the Treasury, and advance rebates of child tax credits are being mailed beginning later this month. The Joint Committee on Taxation estimates that these and other tax changes should increase households' cash flow in the third quarter by $35 billion. Most mainstream economic models predict that such tax-induced increases in disposable income should produce a prompt and appreciable pickup in consumer spending. Moreover, most models would also project positive follow-on effects on capital spending. The evolution of spending over the next few months may provide an

important test of the extent to which this traditional view of expansionary fiscal policy holds in the current environment.

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Much like households, businesses have taken advantage of low interest rates to shore up their balance sheets. Most notably, firms have issued long-term debt and employed the proceeds to pay down commercial paper, bank loans, and other short-term debt. Although rates on commercial paper and bank loans are well below yields on new long-term bonds, firms have evidently judged that now is an opportune time to lock in long-term funding and avoid the liquidity risks that can be associated with heavy reliance on short-term funding. At the same time, the average coupon on outstanding corporate bonds remains considerably above rates on new debt issues, suggesting that firms are well positioned to cut their debt service burdens still further as outstanding bonds mature or are called. The net effect of these trends to date has been a decline in the ratio of business interest payments to net cash flow, a significant increase in the average maturity of liabilities, and a rise in the ratio of current assets to current liabilities.

With business balance sheets having been strengthened and with investors notably more receptive to risk, the overall climate in credit markets has become more hospitable in recent months. Specifically, improvements in forward-looking measures of default risk, a decline in actual defaults, and a moderation in the pace of debt-rating downgrades have prompted a marked narrowing of credit spreads and credit default swap premiums. That change in sentiment has extended even to the speculative-grade bond market, where issuance has revived considerably, even by lower-tier issuers that would have been hard-pressed to tap the capital markets over much of the last few years. Banks, for their part, remain well-capitalized and willing lenders.

In the past, such reductions in private yields and in the cost of capital faced by firms have been associated with rising capital spending. But as yet there is little evidence that the more accommodative financial environment has materially improved the willingness of top executives to increase capital investment. Corporate executives and boards of directors are seemingly unclear, in the wake of the recent intense focus on corporate behavior, about how an increase in risk-taking on their part would be viewed by shareholders and regulators.

As a result, business leaders have been quite circumspect about embarking on major new investment projects. Moreover, still-ample capacity in some sectors and lingering uncertainty about the strength of prospective final sales have added to the reluctance to expand capital outlays. But should firms begin to perceive that the pickup in demand is durable, they doubtless would be more inclined to increase hiring and production, replenish depleted inventories, and bring new capital on line. These actions in turn would tend to further boost incomes and output.

Tentative signs suggest that this favorable dynamic may be beginning to take hold. Industrial production, as I indicated earlier, seems to have stabilized, and various regional and national business surveys point to a recent firming in new orders. Indeed, the backlog of unfilled orders for nondefense capital goods, excluding aircraft, increased, on net, over the first five months of this year. Investment in structures, however, continues to weaken.

The outlook for business profits is, of course, a key factor that will help determine whether the stirrings we currently observe in new orders presage a sustained pickup in production and new capital spending. Investors' outlook for near-term earnings has seemed a little brighter of late.

The favorable productivity trend of recent years, if continued, would certainly bode well for future profitability. Output per hour in the nonfarm business sector increased 2-1/2 percent over the year ending in the first quarter. It has been unusual that firms have been able to achieve consistently strong gains in productivity when the overall performance of the economy has been so lackluster. To some extent, companies under pressure to cut costs in an environment of still-tepid sales growth and an uncertain economic outlook might be expected to search aggressively for ways to employ resources more efficiently. That they have succeeded, in general, over a number of quarters suggests that a prior accumulation of inefficiencies was available to be eliminated. One potential source is that from 1995 to 2000 heavy emphasis on new and expanding markets likely diverted corporate management from tight cost controls whose payoffs doubtless seemed small relative to big-picture expansion.

However, one consequence of these improvements in efficiency has been an ability of many businesses to pare existing workforces and still meet increases in demand. Indeed, with the growth of real output below that of labor productivity for much of the period since 2000, aggregate hours and employment have fallen, and the unemployment rate rose last month to 6.4 percent of the civilian labor force.

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Although forward-looking indicators are mostly positive, downside risks to the business outlook are also apparent, including the partial rebound in energy costs and some recent signs that aggregate demand may be flagging among some of our important trading partners. Oil prices, after dropping sharply in March on news that the Iraqi oil fields had been secured, have climbed back above $30 per barrel as market expectations for a quick return of Iraqi production appear to have been overly optimistic given the current security situation.

Also worrisome is the rise in natural gas prices. Natural gas accounts for a substantial portion of total unit energy costs of production among nonfinancial, non-energy-producing firms. And as I noted in testimony last week, futures markets anticipate that the current shortage in natural gas will persist well into the future. Although they project a near-term modest decline from highly elevated levels, contracts written for delivery in 2009 in excess of $4.50 per million Btu are still at double the levels that had been contemplated when much of our existing gas-using capital stock was put in place.

The timing and extent of the pickup in economic activity in the United States will also depend on global developments. Lethargic growth among many of our important global trading partners is posing some downside risk to the U.S. economic outlook. As has been true for some time, Japan's economy remains in difficult straits, burdened by a weak banking sector and an ongoing deflation, although recent data have seemed somewhat less negative. Economic activity in many European countries--especially Germany--has been soft of late and has been accompanied by a decline in inflation to quite low levels. While Japan and Europe should benefit from global economic recovery, the near-term weakness remains a concern.

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Inflation developments have been important in shaping the economic outlook and the stance of policy over the first half of the year. With the economy operating below its potential for much of the past two years and productivity growth proceeding apace, measures of core consumer prices have decelerated noticeably. Allowing for known measurement biases, these inflation indexes have been in a neighborhood that corresponds to effective price stability--a long-held goal assigned to the Federal Reserve by the Congress. But we can pause at this

achievement only for a moment, mindful that we face new challenges in maintaining price stability, specifically to prevent inflation from falling too low.

This is one reason the FOMC has adopted a quite accommodative stance of policy. A very low inflation rate increases the risk that an adverse shock to the economy would be more difficult to counter effectively. Indeed, there is an especially pernicious, albeit remote, scenario in which inflation turns negative against a backdrop of weak aggregate demand, engendering a corrosive deflationary spiral.

Until recently, this topic was often regarded as an academic curiosity. Indeed, a decade ago, most economists would have dismissed the possibility that a government issuing a fiat currency would ever produce too little inflation. However, the recent record in Japan has reopened serious discussion of this issue. To be sure, there are credible arguments that the Japanese experience is idiosyncratic. But there are important lessons to be learned, and it is incumbent on a central bank to anticipate any contingency, however remote, if significant economic costs could be associated with that contingency.

The Federal Reserve has been studying how to provide policy stimulus should our primary tool of adjusting the target federal funds rate no longer be available. Indeed, the FOMC devoted considerable attention to this subject at its June meeting, examining potentially feasible policy alternatives. However, given the now highly stimulative stance of monetary and fiscal policy and well-anchored inflation expectations, the Committee concluded that economic fundamentals are such that situations requiring special policy actions are most unlikely to arise. Furthermore, with the target funds rate at 1 percent, substantial further conventional easings could be implemented if the FOMC judged such policy actions warranted. Doubtless, some financial firms would experience difficulties in such an environment, but these intermediaries

have exhibited considerable flexibility in the past to changing circumstances. More broadly, as I indicated earlier, the FOMC stands ready to maintain a highly accommodative stance of policy for as long as it takes to achieve a return to satisfactory economic performance.