



ECOMENTARY™

MAS 012402B

Greenspan at the Senate Budget Hearings: when good news is bad news

Activist monetary policy has been used during this recession as never before—but we have never had a Fed Chairman like the present one. Halo or not, this Chairman learned all the lessons from the past wars. If this war is like the last ones, the economy is out of the soup.

Most recoveries in the post-World War II period received a boost from a rebound in demand for consumer durables and housing from recession-depressed levels in addition to some abatement of the liquidation of inventories. Through most of last year's slowdown, in contrast to the usual pattern, the household sector was a major stabilizing force. As a consequence, although household spending should continue to trend up, the potential for significant acceleration in activity in this sector is more limited.

The consumer could be the weak link in the recovery path. Low interest rates have prompted a splurge of consumer durables spending, particularly autos and housing. Ultimately, a reduction in stocks creates a requirement to rebuild inventories, but sustained recoveries, and an acceleration of growth, requires business to spend for new capital equipment. This has been a capital boom collapse---a 19th century type of economic disturbance. It was fought with activist monetary policy and complementary fiscal policy...up to a point. The pre-Keynesian tradition claimed that a Bust had to end in a Liquidation Crisis---which then 'reset' the springs for a recovery by wiping out some of the accumulated excesses. That provided the acceleration. This Fed has interrupted the classic liquidation cycle with unparalleled monetary ease. Has the spring been compressed sufficiently to power an aggressive recovery?

The Goldilocks era blended rising productivity, access to cheaper intermediate goods following the Asian shock, lower energy prices (until early 1999) and falling unemployment into a gigantic equity boom. Underneath, there was accommodating monetary policy---particularly used to offset the Asian, Russian and LTCM shocks. As capital investment soared, a great deal of wealth was produced, and not all of it was paper, despite the massive write-downs from the Internet/Telcom Bust.

In this speech, Greenspan pointed to all the factors that he hopes will help sustain real incomes of consumers...and then sustain their spending until business investment kicks in again. We've been here before: lower interest rates; commodity prices that are falling (in particular energy prices), good weather helping the housing market; and, zero cost financing for autos and tax cuts. (See the graphs below that illustrate the continued surge in home sales).

In addition to concerns about the rebound, the CBO's forecast from last year of a burgeoning budget surplus has been sharply reduced by some 4 trillion dollars over the decade. While this poses no short run problem, there will be increased financing needs by the Government to cover this year's and next year's deficits. That represents a demand for funds in the capital market coming at a time when the huge explosion in monetary aggregates used to fight this Bust will be slowed. Interest rates are likely to rise along the curve. The only issue is when and by how much? And what will that do to spending for housing, autos and ultimately the estimates of profitability of future investment? Where's the beef?



ECOMENTARY™

“Still the evidence strongly suggests that new technologies will present ample opportunities to earn enhanced rates of return.” Greenspan has used *technology* as a *deus ex machina* many times before during the Long Boom. Economic growth in 2002 is tethered to this prophecy. New Home sales data are shown below for November. Existing Home Sales are for December. Data in the next two or three months will be very revealing.

