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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

United States Congress

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Mr Chairman and members of the Committee, I am pleased to have the opportunity to appear before you again. As you know, the Federal Reserve's semiannual Monetary Policy Report and testimony, which were submitted to the Congress last month, provided an extensive review of recent and prospective economic developments and of monetary policy actions and intentions. Rather than take you through the details of that report this morning, I would like, first, to focus on a few of the most critical considerations affecting the outlook for the economy and the formulation of monetary policy and, then, to turn briefly to budgetary issues.

The Economic Outlook and Monetary Policy

The recently available readings on business activity indicate that the economic contraction that began during the latter part of 1990 continued through February. The economic data of the past few weeks also included further indications of reduced cost pressures on prices and provided scope for a further easing of monetary policy last Friday. The combination of lower interest rates, the reduction in oil prices, and the resolution of the situation in the Gulf continue, on balance, to suggest an upturn in real activity later this year, in line with the "central tendency" forecast of the FOMC members and other Reserve Bank presidents that we presented a month ago.

In discussing those projections, we stressed the extent to which uncertainties associated both with the situation in the Gulf and with a number of unresolved problems in the economy made the outlook unusually difficult to assess, to a somewhat lesser extent, that is still the case. Certainly, the successful end to the hostilities in the

Gulf has removed a troublesome uncertainty and should provide some lift to consumer and business confidence. But the other factors that we noted earlier--concerns about credit availability and problems in real estate markets--continue to restrain activity and to weigh importantly on business thinking.

The restraint on credit availability at depository institutions represents a continuing clear risk to the outlook and, therefore, is a critical challenge for policy. To date, our assessment is that reduced demand for credit stemming from the decline in real activity accounts for most of the recent weakness in bank lending. Nonetheless, developments on the supply side also have had a noticeable effect. The surveys of senior loan officers that are conducted by the Federal Reserve at three-month intervals have shown progressive tightening of business credit terms since last spring. Banks report that they have been applying more stringent credit standards and have made the price and nonprice terms of business credit less favorable to a wide range of customers.

Several factors underlie these changes in lending practices. Given the uncertain economic environment, banks are appropriately taking a closer look at prospective borrowers in some specific industries. But what is of most concern to us is restraint on lending by commercial bankers to otherwise creditworthy customers. For borrowers whose riskiness has been essentially unaffected by the recession or by developments in specific markets, the reluctance of banks to lend seems to arise from attempts to bolster capital positions. Banks are trying to raise capital-asset ratios, or at least hold down declines in those

ratios that might result from losses on outstanding loans. In some cases, loan losses and pressures on capital may be exacerbated by the degree to which examination standards are forcing loans to be written down inappropriately or by market reaction to aggregated data on problem credits on certain categories of loans.

Information from our surveys and estimates of funds supplied in financial markets indicate that the majority of those who have been turned away or who have been discouraged from borrowing at depository institutions have been able to find financing elsewhere. But one must assume that the alternatives, when they exist, are only available at a higher price. The problems of locating other sources of credit may be especially severe for some types of borrowers--small businesses and those in commercial real estate, for instance--who may not have ready access to securities markets. How much production has been lost as a result of sound projects cut back or unable to go forward because of a rise in financing costs or because of an actual or feared lack of financing is difficult to assess. But it is clear that the restraint on credit availability, along with the deterioration in profits, began to enter importantly in business decisionmaking even before the onset of the recession.

A number of steps have been taken by the Federal Reserve that should relieve constraints on credit supplies. These include lowering interest rates, reducing reserve requirements, and working with other depository supervisory agencies to identify and correct practices that may be unnecessarily discouraging the flow of funds to creditworthy borrowers. Taken together, these steps may well prove sufficient to

foster the growth of credit needed to finance economic expansion. But, we recognize the risk that problems in this area could persist and could warrant further actions

Another clear negative in the outlook remains the real estate sector, whose problems have exacerbated the difficulties of financial institutions. In the commercial sector, the overhang of vacant space is still substantial, implying that further declines in new construction will probably occur, even during a period of renewed economic growth. Beyond the impact on new construction, the existence of a sizable stock of underused properties whose asset values have declined has repercussions for financial institutions that are carrying them on their balance sheets.

The most notable feature of the current downturn has been the marked erosion of business attitudes and consumer confidence that occurred after July. In the business sector, the clearest manifestation of the deterioration in attitudes was the rapidity with which producers moved to cut output and to pare inventories in response to actual or anticipated weakness in sales. Judging from readings of anticipated hiring, inventory accumulation, and capital spending, businesses remained in this cautious stance early this year, awaiting firm indications of the timing and strength of any recovery in demand.

Consumer confidence also registered an unprecedented plunge between July and October of last year, which probably was an element depressing business expectations for sales. Such a decline in sentiment also might have been expected to result in a rise in precautionary saving. But, income growth also was depressed, and when the sudden rise

in oil prices forced households to devote a significantly higher share of their disposable income to energy bills, both saving and spending, in real terms, were cut back sharply

It would be most unwise to ignore the possibility that all or some combination of these negative factors could cause the contraction in economic activity to last longer or be more serious than is currently anticipated

Nonetheless, a number of elements appear to be moving into place that should enhance prospects for recovery. On balance, when these positive forces are weighed against the negatives, the scales appear to tip slightly in favor of suggesting that the current downturn might well prove milder than most of the recessions in the past forty years

One important factor on the positive side of the outlook is the sharp drop in petroleum prices that accompanied the onset of the war in the Gulf. The price of gasoline is back to its late-July level; the cost of home heating oil should retreat further as well in coming months. While the secondary effects of the cutbacks in employment and income are still running their course, the relief from lower energy prices, along with the apparent boost to confidence from the end of the Gulf war, should be laying the groundwork for some firming in consumer spending in coming months

Indeed, in the days following the termination of hostilities, the anecdotal reports of increased traffic in real estate offices and auto showrooms raise the possibility that stronger consumer demand may be emerging. But, I would caution that such early signals can be quite

difficult to read, particularly at this time of the year. Typically, sales of houses and autos surge in March. For example, as the weather improves, sales of new and existing homes register their sharpest month-to-month gains between February and March--jumps of 35 and 25 percent respectively. The usual over-the-month pickup in domestic car sales also is sizable (almost 19 percent). What is difficult to judge from the very recent reports is how much more than the seasonal rise, if any, is occurring as psychology improves. Hard economic data for the period following the successful ground war will not be available for some weeks.

Another important influence that is expected to provide support for economic activity as the year progresses is the decline in interest rates, which began more than a year and a half ago, but was especially sharp in the past several months. Since late October, when the budget accord was reached and economic activity showed clear signs of weakening, the Federal Reserve has moved aggressively in a series of actions to ease money market conditions. Because a lessening of cost pressures has improved the outlook for prices, the easing of policy has been possible without raising new concerns in financial markets about inflation prospects. Such concerns could have had adverse consequences for the foreign exchange value of the dollar and for long-term interest rates.

But, in the prevailing circumstances, the substantial drop in short-term market rates was accompanied by a net decline in long-term rates as well. In particular, fixed-rate mortgage interest rates are close to their lowest levels since the late 1970s, and the resulting

improvement in the affordability of single-family housing eventually should show through in a pickup in sales and homebuilding. Other sectors also are expected to respond to lower financing costs as the year progresses. Although long-term interest rates have risen a bit in recent weeks, this should not materially interfere with an upturn in activity. The increase seems to reflect new optimism about the prospects for the U.S. economy as the Gulf war came to a successful conclusion. Indeed, yields on non-investment-grade bonds actually declined in response to that expectation.

Since the onset of the recession last year, the areas of greatest concern in the economy have been those related to domestic spending, because it has been in those sectors--consumption, homebuilding, nonresidential construction, and business inventory investment--that the dropoff in activity has been most pronounced. Nonetheless, it is also important to consider how domestic production has been affected by the trends in exports and imports in recent months and to assess prospects for sustained stimulus from net exports.

Viewed at the manufacturing level, the sources of changes in production can be examined by combining monthly data on factory output, inventories, and sales with data on international trade flows. A comparison of the six-month period prior to the downturn in industrial activity last October and the four months of contraction through January offers some interesting results.

In the six months prior to the downturn, manufacturing production was rising at about a 2-1/2 percent annual rate, boosted considerably by a recovery in motor vehicle assemblies from the very low

levels earlier in the year. Domestic demand for business equipment and for industrial materials also was relatively robust, although rising imports drained some of that strength away from domestic producers. At the same time, export demand was providing little impetus to manufacturing production. The slowdown in exports of industrial goods marked a sharp departure from the trend over the preceding four years, when the share of exports in our factory output rose 5 percentage points to 13-3/4 percent.

However, since the peak in industrial production last September, the situation has reversed. Between last September and this January, there has been a resumption of growth in foreign demand for U S -manufactured goods and a reduction in domestic demand for imported manufactured products and materials, including oil. For example, imports as a proportion of our overall domestic demand for manufactured goods stabilized late last year. When combined with rising exports, net imports of industrial goods as a proportion of manufacturing production declined from about 4-1/4 percent late last summer to less than 4 percent at the turn of the year. These developments have cushioned the steep declines that have occurred as production has responded unusually promptly to the weakness in the domestic economy. Cutbacks in domestic purchases and inventory holdings of a wide range of domestically manufactured consumer goods, business equipment, construction supplies, and industrial materials have more than accounted for the drop of almost 4 percent (not annualized) in manufacturing industrial production between September and January.

The brisk expansion in nonagricultural merchandise exports late last year occurred in a variety of industrial supplies and materials, as well as in consumer goods and many types of capital equipment. The sharpest gains were in shipments destined for countries in Western Europe. This increase in export growth came despite a weakening of activity in several of our key markets abroad, and it undoubtedly reflected the gains in U.S. international price competitiveness that had been building for some time.

As a result of the decline in the foreign exchange value of the dollar and only moderate increases in U.S. export prices, the average price of U.S. exports measured in terms of foreign currencies has fallen nearly 15 percent since mid-1989, at the same time, the prices of goods produced abroad have been rising. In the past, such gains in U.S. price competitiveness have led to significant growth in our exports, and if the recent improvement is sustained, continued expansion of U.S. exports would seem to be on track. Even if growth abroad were to slow somewhat, an increasing share of foreign markets would provide considerable support for our exports.

Of course, the prospects for sustained strong growth in our exports of goods and services depend importantly on the outlook for economic activity among our trading partners as well. Among the major foreign industrial countries, significant divergences in economic performance emerged last year and are likely to continue this year. Canada and the United Kingdom both moved into recession in 1990, and signs of a turnaround are not yet evident in either case.

In contrast to the weakness in those two countries, activity remains vigorous in Germany, where the stimulus of reunification between East and West Germany has produced rapid real growth and has sustained very high rates of utilization in industry in the western region. Indeed, the continued strength of aggregate demand in Germany has been a major cause of recent upward movements in German interest rates. In Japan, despite some indications of a moderation in economic growth, prospects for a continued expansion are still favorable. On balance, it is quite possible that growth among our major industrial trading partners will strengthen somewhat later this year, particularly if those countries experiencing recession start to recover.

Among developing countries, recent economic performance has been uneven as well. Mexico continues to achieve success in maintaining growth while pursuing economic reforms. However, in other Western Hemisphere countries, slowdown or even recession has accompanied current programs aimed at macroeconomic stabilization. The crisis in the Persian Gulf has disrupted output for some Middle East countries, but has permitted other developing country exporters of oil to expand. In the period ahead, the reconstruction in the Middle East is likely to provide a significant boost to the exports of the United States and of a number of other industrial countries.

The Gulf war has been overshadowing developments elsewhere, particularly in Europe, and in the sphere of international trade negotiations; these factors have potentially important implications for both the U.S. economy and the economies of our major trading partners. As the Western European economies move closer to the 1992 single

internal market, they will benefit from structural adjustment and increased competition. A stronger, more vibrant European economy in the long run will be a more vigorous trading partner for the U.S. economy. In addition, progress in the historic transformation of the economies of Eastern Europe can be expected to lead to new opportunities for U.S. producers of consumer and capital goods. As these economies become more fully integrated into the world trading order, they will broaden opportunities for two-way trade with mutual benefits to all.

The focus on our export prospects highlights the importance of a successful conclusion to the Uruguay Round of trade negotiations. Indeed, the costs of a failure of that effort could be serious. We all would lose opportunities to strengthen trade flows and realize efficiencies that could enhance standards of living worldwide. It certainly would be unfortunate if, instead, moves toward protectionism elicited retaliation, which would have particularly adverse consequences for U.S. producers just when their competitive position is so strong.

Taken together, the favorable factors at work abroad and the stimulative forces in train in the domestic economy suggest the likelihood of a pickup in aggregate demand over coming months. And, with inventories relatively lean at most businesses, a recovery in demand should show through fairly promptly in a higher level of production.

Our monetary policy objective for 1991 is to promote economic recovery and to sustain growth at a rate that is consistent with progress over time toward price stability. Whether further adjustments to policy will be required to foster an upturn in output and employment

is not yet clear. Any decision in that regard will depend on how trends in real activity, inflation, and the monetary aggregates unfold.

Fiscal Policy Considerations

Until clear signs of a recovery in economic activity emerge, fiscal policymakers are likely to remain under persistent pressure to take actions to offset other contractionary forces. Concerns about the appropriateness of maintaining a policy of fiscal restraint during a period of weak economic performance are understandable. However, they must be balanced against the benefits that will flow from adhering to a budget strategy that is geared to the longer-run needs of the economy. Those needs can best be met by keeping the underlying or "structural" deficit firmly on a downward path, even as the actual deficit is being swollen temporarily by the effects of a weak economy.

In light of these considerations, voting to suspend the enforcement provisions of the budget reconciliation act would be a mistake. Together with the Administration, you worked long and hard last year to reach an acceptable package of tax and spending changes and budget process reforms. The budget agreement gave financial markets some assurance of stability and of a future easing of federal credit demands. Undercutting this commitment now risks adverse effects on long-term interest rates and thus well might be self-defeating.

The new budget procedures make it easier than under the previous Gramm-Rudman-Hollings procedures for fiscal policy to have a stabilizing effect on the economy. Among other things, because the focus over the next several years is on the reduction in the deficit brought about by legislative action, rather than the level of the

deficit per se, the need for policy adjustments to offset the effects of changes in economic conditions has been eliminated. As a consequence, the automatic stabilizers that are in place can function as intended.

Moreover, the historical evidence on the implementation of discretionary countercyclical fiscal policy is not encouraging. In the past, programs designed to stimulate the economy during a contraction frequently did not come on stream until well after the recovery was under way. If assessments of prospects for a turnaround in the economy this year are on target, the adoption of new programs now may only end up repeating that pattern.

The military operations in the Gulf will cause some unplanned addition to spending in the current fiscal year. Defense purchases already have been raised somewhat by the war, and, as weapons are replaced, the new production will boost GNP. Current estimates suggest that a substantial part of the incremental expense ultimately will be paid by other nations, cushioning the effect on the budget deficit. Moreover, it is important to bear in mind that the successful conclusion of the Gulf war now ensures that these expenditures will be limited, with only minimal consequences for the longer-term thrust of fiscal policy.

On the whole, the budget accord provides a useful framework for conducting fiscal policy. It provides sufficient flexibility for specific tax and spending policies to be altered, if deemed desirable, to improve economic incentives or to reset priorities. Such specific changes in fiscal policy tools are possible while still moving along a steady path toward fiscal balance. That path promises to improve

prospects for increased capital accumulation and higher productivity
It will complement monetary policy in the attainment of the nation's
overall economic objectives for the longer run