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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 appear here today. Two weeks ago, the Federal Reserve submitted its semiannual report on monetary policy to the Congress That report covered very specifically the System's expectations for money and credit growth in 1992, as well as our forecast for economic growth and inflation. Today, I would like to focus on some of the broad considerations bearing on the outlook

The performance of the economy clearly has been disappointing The recovery in business activity since last spring has been anemic, job losses have continued to mount, and confidence has sunk to depressed levels As we look ahead, there are a few hopeful signs--but, at this stage, they are quite tentative Anecdotal reports and the early data on activity since the turn of the year suggest that spending is starting to firm in some sectors And, in the financial markets, the cumulative effects of the Federal Reserve's easing actions appear to be manifesting themselves in some strengthening of late in the money supply These are the types of indications one looks for when business activity is picking up But, as I have indicated previously, there are some extraordinary forces at work in the economy that add an exceptional measure of uncertainty to the current picture

I refer in particular to the sizable adjustments to business and household balance sheets now under way These adjustments, which are without parallel in the postwar period, are a consequence of the enormous accumulation during the 1980s of certain kinds of real assets and even faster growth of debt and leverage.

Rapid rates of debt-financed asset accumulation were widespread during the 1980s In the business sector, a primary example is that of commercial real estate, where overbuilding was propelled by a combination of relatively low vacancy rates early in the decade and generous depreciation provisions Meanwhile, a dramatic increase in leverage among corporations was associated with a wave of mergers and buyouts The debt burdens of households also rose markedly over the course of the decade, as purchases of motor vehicles and other durables ran at high levels for an extended period and home buying in some parts of the country soared

To a degree, the increase in leverage was a natural and economically efficient outcome of deregulation and financial innovation It also may have reflected a lingering inflation psychology from the 1970s--that is, people may have expected rapid increases in prices, especially those of specific real assets, that would make debt-financed purchases profitable Many analysts were well aware at the time of the increasingly disturbing trends in debt and leverage But in retrospect, as the values of real property and other assets stagnated or declined, the mismatch between debt, on the one hand, and the likely prospects for incomes and asset values, on the other, turned out to be even greater than many had perceived

In part, our current economic adjustments can be seen as arising out of a process in which debt is being realigned with a more realistic outlook for incomes and asset values Faced with mounting financial problems and uncertainty about the future, one's natural reaction is to withdraw from commitments where possible and to conserve and even build savings and capital. Not surprisingly, many households and businesses have taken measures over the past few years to reduce drains on their cash flow and to lower their exposures to further surprises Part of the process has involved unusually conservative spending patterns, and part has involved the early stages of a restructuring of financial positions

The monetary policy actions of recent quarters have helped to reduce the debt service burdens of households and businesses and are encouraging them to shore up their financial positions. Moreover, the recently announced cut in reserve requirements on transactions deposits should free up some funds for lending and should help--at least to some extent--to break the grip of the so-called "credit crunch," which has imposed an undue financial constraint on the activities of many firms

Businesses have been taking steps to reduce leverage, enhance liquidity, and cut down on interest obligations in order to lower their exposures to risk. In addition, they have been adjusting production promptly in an attempt to keep inventories in line, and have cut back staffing levels and closed inefficient plants Meanwhile, households have restrained their expenditures and have paid down debt to reduce interest expenses Also, as long-term interest rates have declined, both businesses and households have refinanced mortgages and other loans

Unfortunately, history provides little guidance in assessing how much additional adjustment to balance sheets is in store--and how fast it is likely to proceed Our best guess is that this unusual restraint on economic activity should begin to dissipate in the reasonably near future But the uncertainties in this regard are enormous and add significantly to the typical risks in the economic outlook

In any event, the restructuring of financial positions is not the only restraint on economic activity in the near term The activities of state and local governments have been atypically constrained by budget pressures More important, we are concurrently coping with a sizable adjustment in the area of national defense The cutbacks in military spending have been under way since the mid-1980s, when real budget authority turned down and orders for defense capital goods flattened out All told, real budget authority for defense has fallen more than 20 percent from its 1985 peak Similar trends have been evident in the data on industrial production, where the index of defense and space output has fallen roughly 15 percent since 1987 As you know, the 1990 budget agreement established caps on defense funding that imply sizable further reductions over the next several years, and the end of the Cold War raises the prospect that even larger cuts could be made without undue risk to our national security

From a longer-run perspective, the defense cutbacks carry substantial benefits for the U S economy By freeing up resources that could then be devoted to improving the nation's stock of productive physical and human capital, they should ultimately lead to better productivity performance over time. In the short run, of course, lower defense spending is a depressant on economic activity, and on jobs and incomes. For industries and regions that depend heavily on military spending, the dislocations could well be sizable

One sector that has been a bright spot as the recovery has struggled to take hold has been exports, which have benefited from both the cumulated gains in U S price competitiveness and income growth in our trading partners. The economies of Mexico, several of the other Latin American countries, and the newly industrialized nations in Asia have been notable areas of strength

In contrast, the economic performances of the major foreign industrial countries in the second half of last year generally were disappointing Real output in Germany and Japan, which had been growing extraordinarily rapidly earlier in the year, slowed sharply Meanwhile, in Canada and Great Britain, recovery from recession is proving elusive. Several of these countries have been struggling with problems of debt burdens and excess leveraging similar to those in the United States

Current economic indicators are lackluster in almost all the major industrial countries Consumer spending is weak and confidence is low, while firms are continuing to run down inventories and appear to be hesitant to spend on new plant and equipment Nonetheless, the odds are good that activity will strengthen over the course of the year In Canada, the United Kingdom, and Japan, the central banks have eased monetary conditions These actions should not only facilitate the portfolio adjustments under way in many countries, but also should contribute to rebounds in interest-sensitive spending

In Germany, monetary conditions remain tight as wage pressures threaten to add to inflation and money growth continues at rates above the Bundesbank's current targets. However, the ending in the middle of this year of an income tax surcharge should help to boost consumption. And in the five new states (former East Germany), construction and investment spending are vigorous and may well spark the turnaround in production in that region that has been anticipated since the Wall came down

If, in fact, developments in the industrialized countries materialize along these lines--and if growth in our other trading partners remains robust--exports should continue to bolster production here at home Such an outcome would elevate the likelihood of a moderate upturn in U S business activity in coming quarters

The recent news on U.S. inflation has been quite favorable Prices for a wide range of goods and services have decelerated notably over the past few quarters, and a further slowing in underlying price pressures is expected Moreover, with appropriate economic policies, the improvement in the inflation trend should extend into 1993--even, I would hope, with stronger growth in real activity than now appears in prospect for the current year

In formulating its objectives for monetary policy last month, the FOMC obviously had to grapple with the anomalous monetary behavior of the past two years and the sizable uncertainties in the outlook for 1992. In particular, the ongoing process of balance sheet restructuring may affect spending, as well as the relationship of various measures of money and credit to spending, in ways we are not anticipating Judging from the historical evidence, the adopted growth ranges for the monetary aggregates should support our projections for economic activity--and could accommodate an even stronger recovery Nonetheless, we will remain sensitive to signs that the anticipated pickup in business activity is not emerging and will be prepared to adjust money growth, as well as our stance in reserve markets, should the need arise

Our focus, quite naturally and appropriately, has been on the immediate situation--the causes of the recent slowdown and the prospects of returning to solid growth this year. However, as we move forward, we cannot lose sight of our longer-run objectives Much of the current difficulty and dissatisfaction with the U S economy comes from a sense that it is not delivering the kind of long-term improvement in living standards we have come to expect The Federal Reserve can help to address this deficiency by providing a stable financial background that fosters saving and investment and encourages sound balance sheet structures. The Congress can help by adopting a budget that is geared to the longer-run needs of the economy, at a minimum, that entails maintaining a commitment to the elimination of the structural budget deficit over the coming years. Together, we can achieve the strong economic performance that our fellow citizens rightly expect