CHAPTER 2

Recent Developments and the Economic Outlook

THE U.S. ECONOMY ENTERED 1991 in the midst of the ninth recession since the end of World War II. The recession began in the second half of 1990, following the longest peacetime expansion in the Nation's history. A recovery appeared to begin in the spring of 1991 and continue into the summer, as production, employment, and spending all rose. Total output grew in the second and third quarters of 1991, recovering about one-half of the decline that occurred during the recession. In midsummer, however, the economy began to flatten out, and then production, employment, and spending faltered late in the year.

Even during the initial months of recovery, many key economic indicators did not improve much. Only about one-fifth of the jobs lost from July 1990 to April 1991 were regained by October 1991, and employment declined toward the end of the year. The unemployment rate hovered around the 6.9-percent level reached in June, before rising to 7.1 percent in December. By June personal income, adjusted for inflation and taxes, recovered about four-fifths of its 1.5-percent decline but then flattened out for most of the second half of the year. Although many indicators were sluggish or fell back at the end of the year, others continued to improve. For example, growth in exports contributed to a further reduction of the Nation's trade deficit and residential investment showed a strong gain.

The economy is expected to be sluggish in early 1992, but growth is expected to pick up in the middle part of the year. With adoption of the Administration's pro-growth policies, real, or inflation-adjusted, growth, as measured by the change in gross domestic product (GDP) in 1987 dollars, is forecast to be 2.2 percent in 1992, and to average 3 percent in the mid-1990s. The unemployment rate is expected to plateau, or perhaps rise slightly, in early 1992 but should begin to decline by midyear. As the economy picks up, inflation and interest rates are expected to rise slightly over the next year from their recent lows, and then stabilize, before gradually falling.

Although the economy is expected to improve in 1992, the magnitude of the improvement is still uncertain. In addition to uncertainties about the economy's short-term cyclical performance, there also are various structural imbalances in the economy that are being worked through. Beyond the short term, the economy faces the serious challenge of improving productivity; slow productivity growth has plagued the economy for two decades.

One of the major cyclical concerns is whether growth of money and credit—which has been quite sluggish—will be sufficient to promote near-term recovery. Also, consumer confidence, which has fallen significantly, likely will be restored only when prospects for employment and income improve and household balance sheets reflect stable or rising asset values. Higher levels of consumer confidence are essential for growth in consumer spending. Because consumer spending accounts for two-thirds of total spending, its growth is a key ingredient for a durable economic recovery. While exports are expected to continue to promote growth in the domestic economy, the export sector faces risks from the possibility that growth abroad will be slower than expected.

Underlying these cyclical issues are structural imbalances and adjustments that also pose potential difficulties. Although the economy is flexible and continuously restructuring, the number of major structural adjustments currently occurring is abnormally large. Changes in world capital markets in recent years have affected the cost of capital in the United States. In early 1990, for example, long-term interests rates were pushed up significantly by expectations of increased demand for capital—associated with German unification, a reemergent Latin America, and the opening up of Eastern Europe—and an abrupt decline in the supply of capital to the rest of the world from Germany and Japan. The availability of credit also has been restricted as financial institutions have moved to shore up their capital positions and as they have faced more stringent regulation. Sufficient credit is necessary to finance expansion. High levels of public and private debt, high vacancy rates in commercial and residential buildings, and failing financial institutions also could limit prospects for spending. Budget problems of State and local governments have resulted in higher taxes and spending constraints, adding a fiscal drag on the recovery. Impediments to free and fair trade must be removed or avoided to bolster international trade and growth of U.S. exports.

Nonetheless, fundamentals are in place to promote growth in the economy. Nominal interest rates are generally at their lowest levels in two decades, and recent declines should help boost interest-sensitive spending. Lower interest rates also are allowing many homeowners to refinance their mortgages, thereby reducing monthly payments and increasing income available for purchases of goods and services. Inflation is relatively low, and is expected to remain low in the near term. Low and stable inflation reduces the uncertainty confronting businesses and consumers about prices and the purchasing power of money and income, and thus provides a better environment for investment, production, and growth. Imbalances in international accounts have been substantially reduced, and the Nation's trade position should improve further over time as exports continue to grow and the Nation's international competitive position strengthens.

As has been stated in previous *Economic Reports* of this Administration, *the Nation faces serious challenges and cannot take economic growth for granted.* The Administration's policies are designed to support sustained increases in the Nation's standard of living by raising long-run productivity growth. Such policies include a pro-growth fiscal policy that enhances incentives for entrepreneurship, saving, and investment and reduces the multiyear structural budget deficit over time; a trade policy that promotes growth through opening markets worldwide; and a regulatory policy that avoids unnecessary burdens on business and consumers. The Administration also supports a monetary policy that promotes solid real growth while gradually reducing inflation pressures. The adoption of the Administration's pro-growth policies would not only boost the expected rate of growth in the near term and beyond but also would reduce uncertainty and the risk that the economy's performance will be worse than expected.

AN OVERVIEW OF THE ECONOMY IN 1991

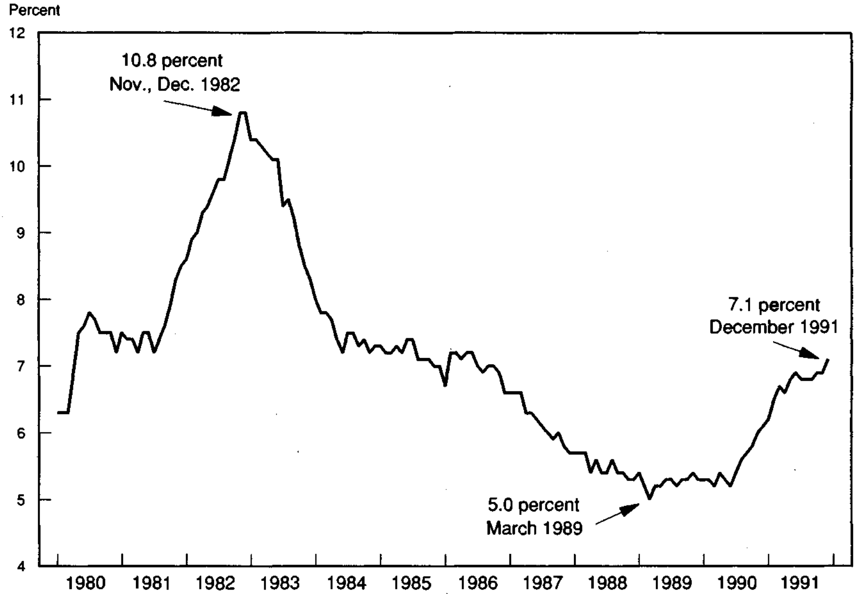
The major economic indicators reflected the effects of the recession in the second half of 1990 and the first half of 1991. Payroll employment, industrial production, real sales, and real personal income fell during this period. The unemployment rate rose to 6.9 percent in June 1991, up from 5.2 percent in June 1990—the approximate level for most of the previous 2 years (Chart 2-1). The unemployment rate then fell slightly and flattened out for several months before rising at the end of the year Real GDP—the value of all goods and services produced in the United States—rose 0.2 percent during 1991 (on a fourth-quarter-to-fourth-quarter basis), following a 0.1-percent decline in 1990 (Chart 2-2).

SIGNS OF A RECOVERY

In the spring of 1991 signs of a recovery began to emerge. The index of leading indicators reached its low in January and then rose sharply through July. Production, sales, and income all bottomed out between February and April and then rose into the summer. By July industrial production had recovered about 3 percentage points of the 5-percent decline that occurred from September 1990 to March 1991. Nonfarm payroll employment did not re-

Chart 2-1 **Civilian Unemployment Rate**

The unemployment rate fell to its lowest level in a decade and a half in 1989 but then rose during the 1990-91 recession to hover around 7 percent.



Source: Department of Labor.

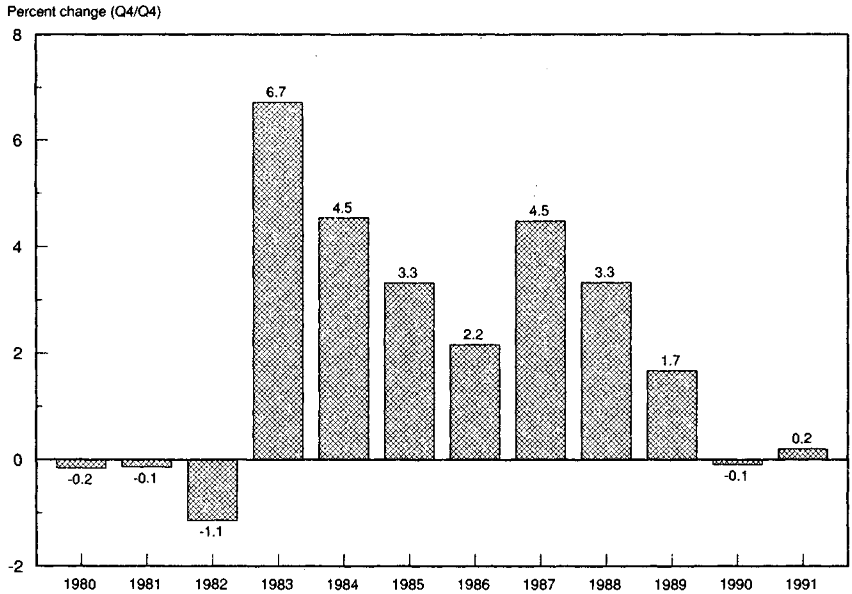
spond very much, however, and after increasing significantly in May, trended up only slightly through October. Total output and spending also rose; following the 1.6-percent decline registered over the fourth quarter of 1990 and the first quarter of 1991, real GDP increased in the second and third quarters, recovering about 0.8 percent, or about half, of the earlier loss.

Other key data also pointed to recovery. Total retail sales and sales of cars and light trucks hit lows in January 1991 and rose into the early summer. Housing starts, which bottomed out in January, rose 25 percent by August. New orders and shipments for manufacturers' durable goods reached lows in March and rose through July; the 11.7-percent increase in new orders in July was the largest monthly increase on record. Initial claims for unemployment insurance reached a peak in March and then fell for 4 consecutive months through July.

Various conditions had emerged in early 1991 that helped set the stage for the pickup in the economy. Oil prices, which had shot up after Iraq invaded Kuwait in August 1990, fell back to their pre-invasion levels within hours of the successful launch of the air-war phase of Operation Desert Storm in January. Prospects for growth in the international economy—and continued growth in U.S. ex-

Chart 2-2 **Real GDP Growth, 1980-1991**

Real gross domestic product grew strongly during the first 6 years of the expansion but slowed in 1989 and fell in 1990. Growth resumed in 1991, but at a very slight pace.



Source: Department of Commerce.

ports—improved as the threat to oil supplies was eliminated. With the successful end of the ground war, consumer and business confidence rebounded in March. Declining interest rates in late 1990 and early 1991—both short and long term—supported an upturn in residential construction and other interest-sensitive sectors. Furthermore, household net worth recovered somewhat in the first half of 1991; the value of owner-occupied housing and land stopped declining, the runup in the stock market boosted the value of financial assets, and the increase in household liabilities was quite modest.

THE ECONOMY FLATTENS OUT

By late summer the recovery lost momentum. A self-reinforcing process of growth—in which increases in spending, production, and employment tend to bolster one another—typically occurs in recoveries. In 1991, however, the spending and production gains and the positive feedback between them were not sufficient to sustain a solid recovery. The leading index flattened out in the late summer and early fall and even declined slightly at the end of the year. After rising through the summer from its trough in April, payroll employment fell significantly in November before rising slightly in

December. Industrial production rose slightly from July through September and then fell slightly in each of the final 3 months of the year. Real income was sluggish from August through October and fell in November, before rising in December.

Other indicators pointed to a lackluster economy at the end of the year. Retail sales were relatively flat from late summer into the fall but declined at the end of the year. Motor vehicle sales slipped in July and August and then remained weak in the fall and early winter. Initial claims for unemployment insurance were higher at the end of the year than at midyear. Manufacturers' shipments of durable and nondurable goods showed gains throughout most of the second half of the year, but fell significantly in December.

On the positive side, merchandise exports continued to rise, and housing starts continued on an upward trend through the end of the year. Stock prices rose strongly at year-end, with various market indexes hitting record highs. And, according to a government survey, businesses plan to increase spending for plant and equipment by 5.4 percent in 1992, following a 0.5-percent decrease in 1991. Thus, by the end of 1991, the economy was sluggish at best, but some forward-looking indicators were pointing to improvement in mid-1992.

The fundamental causes underlying the faltering recovery likely will be a source of continuing debate. Most forecasts—including the Administration forecast of a year ago—had foreseen a relatively modest rebound from a relatively shallow downturn. Until the last few months, this scenario seemed to be on track. It now appears that the structural imbalances in the economy were larger—and were taking longer to work off—than expected; it soon became evident that the oil shock and the war were not the economy's only problems. Credit remained tight and money growth was slow. Relatively high levels of household debt incurred earlier constrained consumer spending. The weaker outlook for the economy created greater uncertainty about employment and income prospects as businesses became more cautious in hiring and spending plans; several major corporations announced plans for further downsizing in efforts to reduce costs and become more competitive. These factors contributed to lower consumer confidence and restrained consumer spending. The State and local fiscal drag continued.

SUMMARY

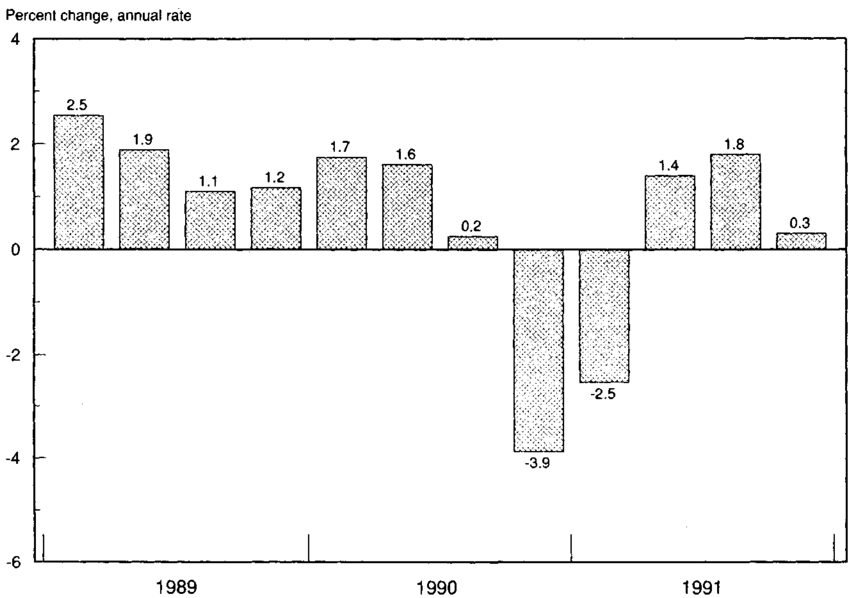
- The economy entered 1991 in a recession that began in the second half of 1990. In the spring, various indicators pointed to the beginning of a recovery.
- Late in the summer, however, the recovery lost momentum and the economy was sluggish in the second half of the year.

REASONS FOR THE SLUGGISH ECONOMY

The recession of 1990–91 followed the longest peacetime expansion in the Nation's history. During the expansion of 1982–90, real output increased by more than 30 percent, more than 21 million jobs were created, and 5 million businesses were incorporated. The unemployment rate fell from a peak of almost 11 percent in late 1982 to 5 percent in March 1989—a level not experienced since 1973. Employment as a percentage of working-age population reached a peacetime high of more than 63 percent in early 1990. Consumer price inflation remained relatively low and stable throughout the expansion, averaging about 4 percent a year. For a year and a half before the recession, however, real GDP grew at an annual rate of only about 1¼ percent (Chart 2–3). (All real figures are measured in constant 1987 dollars.)

Chart 2-3 **Quarterly Real GDP Growth, 1989-1991**

Real GDP had been growing slowly for a year and a half before the recession. Slow growth resumed in the final 3 quarters of 1991.



Source: Department of Commerce.

Economic expansions do not end on their own; they end as a result of external shocks to the economy, economic imbalances that must be worked off, or inappropriate economic policies. Hopes that the expansion would continue were dashed in August 1990, when the economy was hit with an external shock—the rise in oil prices resulting from the Iraqi invasion of Kuwait. Oil prices rose sharply, from less than $19 a barrel in July to more than $30 in late

August, and peaked at about $40 in early October. It is natural to point to the oil shock—coupled with the resulting declines in consumer and business confidence—as the event that pushed the economy into recession. However, a number of structural imbalances and the lagged effect of tight monetary policy in 1988 and 1989 also slowed the economy. While the oil shock significantly aggravated weakness in the economy, it is a matter of debate whether these other factors on their own eventually would have pushed the economy into recession, or, alternatively, whether the economy would have experienced a prolonged period of sluggish growth.

STRUCTURAL ADJUSTMENTS

By the end of the 1980s, economic growth was constrained by various imbalances that had accumulated over the past two decades. Although some of these imbalances were concentrated in specific sectors and regions of the country, their effects generally were felt nationwide. The economy also has had to deal with a reallocation from defense to other sectors and changing national demographic trends.

Demographic Trends

The baby-boom generation matured in the 1970s and early 1980s, boosting the rate of household formation. As household formation rises, so does the demand for houses and big-ticket durable items such as cars and appliances. The assumption of higher levels of mortgage and installment debt in the process of acquiring better housing and durable goods is a natural result of these demographic trends.

The more recent shift to lower growth in residential housing and in the demand for cars and other durable goods also in part reflects demographic trends. The average annual rate of household formation was 1.8 percent during the 1960s, 2.5 percent during the 1970s, and 1.7 percent from 1983 to 1989. The rate then fell to about 0.8 percent from 1989 to 1991. According to middle-path projections by the Department of Commerce, the rate of household formation is expected to be about 1.3 percent from 1990 to 2000, higher than in recent years but lower than the average rate of the past several decades. While household formation varies cyclically, the declines from the 1970s to 1980s and prospective declines in the rate of household formation reflect an underlying trend to an older population.

Buildup in Private Debt

Private debt relative to income rose significantly during the expansion. From 1982 to 1988 household borrowing increased at a 12-percent annual rate, while personal income measured in current dollars increased at the much lower rate of 7 percent. Similarly, corporate borrowing surged, rising at an annual rate of 11 percent.

Borrowing to finance real estate purchases grew substantially. From 1982 to 1989 home mortgage borrowing increased at a 12-percent annual rate and commercial mortgage borrowing at a 10-percent rate. During this period, national income increased about 67 percent, but nonfarm mortgage debt more than doubled. The borrowing financed a surge in construction, which began to outstrip demand. By the late 1980s, both commercial and residential real estate showed signs of overbuilding; the problem was particularly acute in commercial real estate. Vacancy rates in rental housing rose from just above 5 percent in 1982 to about 8 percent at the end of 1987. Commercial office vacancy rates in downtown areas increased from less than 8 percent in 1982 to more than 16 percent in 1988, according to the Coldwell Banker Office Vacancy Index. Favorable provisions in the 1981 tax laws had boosted building and contributed to the upswing in the early to mid-1980s, but the changes in 1986 reversed many of those provisions, hitting commercial real estate and building hard.

By the end of the expansion, many consumers had accumulated relatively high levels of debt. At the same time, the value of their largest asset—their homes—was flat or declining. Householders' expectations of continued increases in the equity in their homes were not being realized. After rising at an average annual rate of 7.5 percent—about twice the rate of inflation—from the end of 1984 through 1989, the value of owner-occupied housing and land fell 1.6 percent in 1990. In addition, the value of other household assets, such as durable goods, stocks, bonds, pensions, and other financial assets, grew only slowly in 1990. Total household net worth—the difference between the household sector's assets and liabilities as measured by the Federal Reserve's flow of funds accounts—fell 1 percent in 1990.

Financial Sector Imbalances

The real estate situation brought about a further erosion of confidence by exacerbating problems in the already troubled financial sector. Also, a shifting financial regulatory environment—from being too lax during the good times of the expansion to being too tight more recently—further aggravated financial sector difficulties and constrained lending activity and economic growth.

Those troubles had begun in the 1970s, when an increase in inflation and interest rates had produced large and widespread losses on mortgage portfolios—the predominant assets on the balance sheets of savings and loans (S&Ls). These assets consisted primarily of fixed-rate, 20- to 30-year mortgages, but deposit liabilities were primarily short term. When interest rates rose, S&Ls had to increase deposit interest rates to retain deposits—the source of their funds. Hence, the cost of funds to S&Ls increased, even though revenues from outstanding mortgages remained fixed. Moreover, because the market value of a fixed-rate asset falls as interest rates rise, the increase in interest rates in the 1970s slashed the market value of the outstanding mortgages held by S&Ls. By 1980 the thrift industry as a whole was already heavily insolvent.

In the 1980s, an extension of deposit insurance that did not account for the riskiness of the institution's investments and a loosening of lending restrictions—both of which came about mainly in response to the problems in the industry—allowed weak S&Ls to stay open and to pursue risky investment strategies without losing the confidence of their depositors. Government insurance meant that shaky S&Ls could continue to attract deposits because depositors knew they were protected. Many of the risky investments were real estate projects that eventually failed as a result of overbuilding and declining real estate prices. The risk ultimately was borne by the insurer—in the end, the Federal Government and the taxpayers. In fact, in 1984, a task force headed by then Vice President Bush proposed risk-based deposit insurance, which would have sharply curtailed the excessive risk-taking by requiring depository institutions to pay higher deposit insurance premiums if they pursued risky investment strategies.

Besides S&Ls, other financial institutions also experienced balance sheet difficulties as the value of commercial real estate assets declined, and many large banks continued to carry problem loans to Third World countries on their balance sheets. As a result of these factors, bankers grew more cautious about extending loans. Their caution also reflected hesitancy over the profitability of lending projects as a result of the slowing economy.

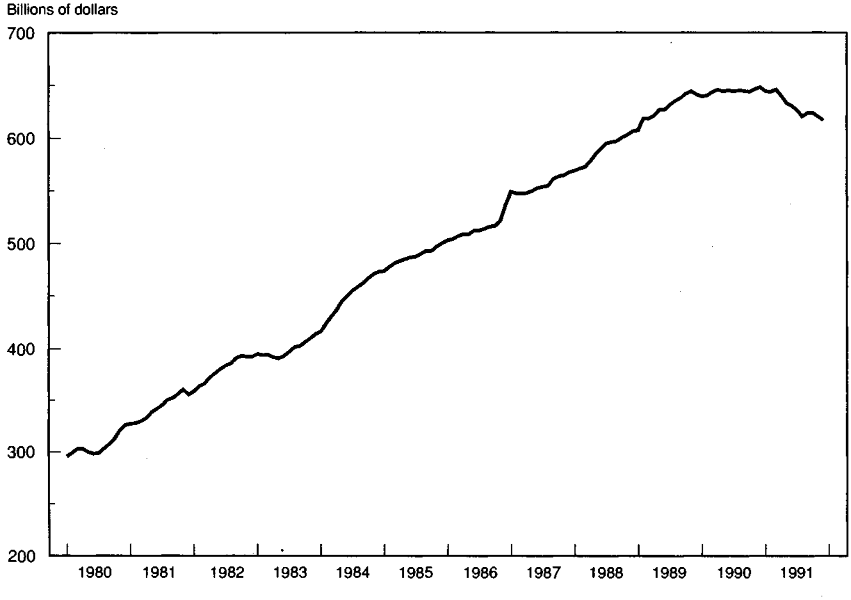
Tighter lending standards cannot be attributed entirely to caution resulting from a weak economy. Banks' balance sheets had deteriorated with the increase in loan losses taken during the 1980s, and banks moved to rebuild equity and shift their portfolios away from business loans and toward assets with lower default risk. Much of this shift in bank portfolios was a response to financial market demands for increased equity.

But bank regulatory policies played a significant role as well. Although tighter supervision clearly was warranted, it appears that examiners overcompensated and discouraged financial institutions from engaging in some viable lending opportunities. Moreover, the phase-in of capital standards established in the 1988 Basle Accords—an agreement among banking regulators in the major industrialized countries that set capital adequacy standards—also caused some banks to reduce business loans and move into assets deemed safer by the accords, such as Treasury notes and securities issued by U.S. Government agencies. All of these factors likely have contributed to overly restrictive credit supplies, or a "credit crunch" (Box 2-1).

Indeed, growth of commercial and industrial loans by banks slowed during 1990 and fell in 1991 (Chart 2-4); the 4.8-percent decline in commercial and industrial loans during 1991 was the first annual decline since the 3.8-percent fall in 1975. For many small and medium-sized businesses, bank loans represent their only source of external finance, and the fall in commercial and industrial lending likely has stifled activity for a large number of potentially prosperous businesses. Furthermore, borrowing on the high yield, below-investment-grade bond market—the junk bond market—contracted precipitously in 1990. This market had provided an alternative source of funds for many businesses that otherwise could not tap the commercial paper market.

Chart 2-4 **Commercial and Industrial Loans**

Commercial and industrial loans by commercial banks fell in 1991, the largest decline in a decade and a half.



Source: Board of Governors of the Federal Reserve System.

Financial sector problems have had a significant effect on the current economic situation because of the integral role the financial sector plays in ensuring a growing, healthy, and flexible economy. When functioning properly, financial institutions help allocate capital efficiently and thus promote economic growth. Structural problems—like the recent constraints on credit—that impair the

Box 2-1.—Credit Crunches

A credit crunch occurs when the supply of credit is restricted below the range usually identified with prevailing market interest rates and the profitability of investment projects. Credit crunches often involve a reduction in the funds that depository institutions, such as commercial banks and savings and loans, channel from savers to investors. Credit crunches affect economic activity because most small and medium-sized businesses depend on banks when financing investment projects or current operations. Thus, unusual circumstances that force depositories to reduce business loans can restrict the activity of these firms regardless of market interest rates. Households, however, have been relatively unaffected by the recent credit crunch because innovations such as home equity lines of credit and the secondary market in repackaged home mortgages have supported lending to households.

Credit crunches used to occur from time to time because regulations fixed an upper limit on the interest rates that could be paid on deposits. When market rates rose above those limits, depositors withdrew funds from banks and thrifts and put them in assets paying higher rates of return. Depository institutions had difficulty attracting deposits and had to cut back on loans. Eliminating the interest rate caps on deposit accounts removed this source of credit crunches.

As discussed in this chapter, restructuring of depositories' balance sheets—in part market driven and in part to meet new international capital standards—as well as the overreaction of examiners to the earlier excesses of banks and savings and loans have contributed to a credit crunch over the past 2 years. This experience reminds us that a tension exists between the short- and long-run consequences of policies overseeing financial markets. When the economy is sluggish, it is important that depository institutions do not deny credit to worthy borrowers. Undue restrictions on credit would depress spending even more and hamper the recovery. In the long run, however, a well-capitalized banking system is less vulnerable to risky excesses in lending.

ability of financial institutions to function efficiently also reduce growth.

Defense

At the end of the 1980s and into the 1990s, public-sector budgets came under increasing pressure and tax increases put a drag on the economy. Also, Federal spending priorities shifted. The defense buildup in the mid-1980s gave way to a period of moderate cutbacks in the late 1980s and then to planned significant cuts from the early to mid-1990s. This shifted the defense sector from being a stimulus to the economy to being a contractionary force.

While increases in defense spending contributed to growth in the economy for much of the 1980s, by the end of the decade, international developments, fiscal constraints, and shifting spending priorities led to cuts in defense spending, and the effects of these cuts were felt throughout the economy. Real defense purchases of goods and services in the national income and product accounts (NIPAs) rose nearly 60 percent from 1979 to 1987 but fell 4 percent from 1987 to 1990. As a share of Federal spending, national defense rose from 23 percent in fiscal 1979 to 28 percent in fiscal 1987 but then fell back to about 21 percent in fiscal 1991. The defense downsizing is projected to continue and has already begun to affect both direct Defense Department employment (military and civilian) and employment in defense industries as firms adjust to expected changes. The economy has adjusted to defense downsizing in the past and is flexible enough to do so now. Such adjustment is neither instantaneous nor without costs, however; significant disruptions can occur in local economies where defense industries are a primary source of employment.

MONETARY POLICY AND INTEREST RATE DEVELOPMENTS

The Federal Reserve has stated a policy goal of achieving, over time, "price stability." Price stability need not literally mean a zero change in the price level, but a change that is low enough so that inflation no longer is an important factor in the economic decisions of consumers and businesses. Over the past few years, the Federal Reserve generally has maintained a relatively tight monetary policy in an attempt to achieve this goal. These efforts have prevented inflation from being higher than it otherwise would have been, but they also have been one of the important factors contributing to slower growth over the past 3 years.

The Nation's long-term growth prospects were enhanced by the reduction of inflation from the double-digit rates experienced in the 1970s. High inflation causes households and businesses to divert effort from productive activities toward preventing the value of their assets from eroding with inflation. High and variable inflation often is associated with increased uncertainty about the future course of the economy; such uncertainty can add a risk premium to interest rates and reduce investment. Variable inflation makes it difficult to judge the change in the prices of items relative to one another; in market economies, relative prices signal suppliers to devote more resources to products that consumers value more.

Thus, low and stable inflation is an important ingredient in achieving maximum sustainable long-term growth. But just as high and variable inflation can be costly, lowering inflation sometimes has costly consequences in the short run for economic growth and employment, which also must be considered when implementing monetary policy.

Monetary Policy, Nominal GDP, and Inflation

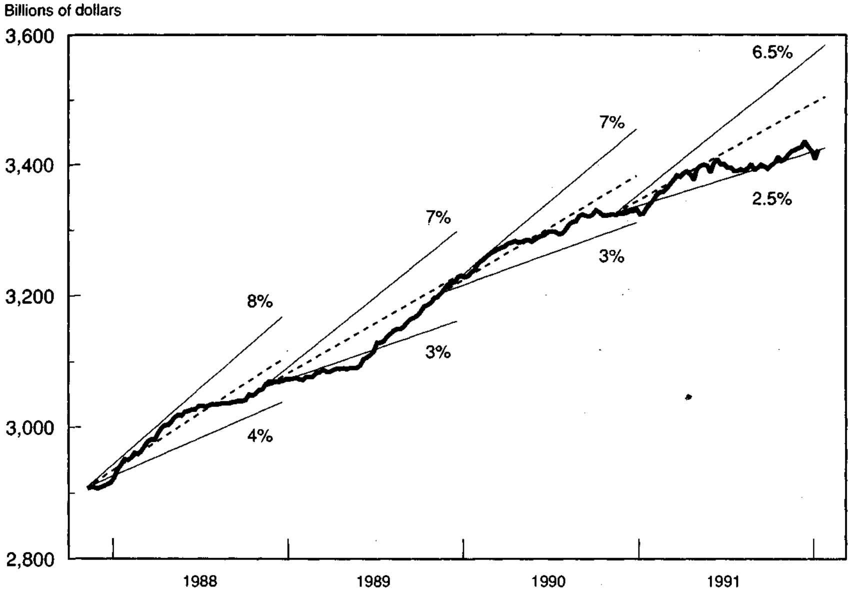
The growth in nominal GDP is composed of growth in real GDP and changes in prices—or inflation. Over the long run, there has been a fairly stable relationship between the growth in money as measured by the M2 aggregate—the primary definition of money monitored by the Fed (Chapter 7)—and the rate of growth of nominal GDP. Over the past several years, the Federal Reserve has aimed to lower the growth of money gradually in order to lower inflation without a recession. When money growth slows for an extended period of time, it is likely that nominal GDP growth will fall. However, there are lags—which cannot be predicted with certainty—between the time money growth slows and the effect on nominal GDP. And determining how much of the slower nominal GDP growth will be reflected in lower inflation and how much in lower real GDP growth is difficult.

Each February, the Fed sets a target range for growth of the money supply over the coming year. (The target ranges for the growth in money define the cones, pictured in Chart 2-5, within which the Fed attempts to keep the quantity of money. The new targets are set from where the money supply ends the year, not the midpoint of the previous target range.) The midpoint of the target range for M2 was lowered from 7 percent in 1987 to 4.5 percent in 1991. In addition, actual M2 growth has tended to be in the lower part of the target range. It has taken some time, however, for inflation to begin to moderate, and much of the monetary restraint apparently has shown up in terms of lower output in the last 3 years. Indeed, the growth in real GDP was lower than the Federal Reserve, the Administration, and most private analysts had expected.

While the long-run relationships between money and nominal GDP are relatively stable, the short-run relationships are not. Furthermore, particularly in the short and medium terms, the Fed is able only to influence, not control, the quantity of money. The Federal Reserve is, however, able to directly affect the Federal funds rate, the interest rate on overnight borrowing among banks. Consequently, in its short-run implementation of monetary policy the Fed focuses mainly on managing the Federal funds rate. The Fed generally increases the Federal funds rate when inflation pressures appear to be rising and lowers the rate when inflation appears to be waning and the economy is sluggish. Changes in the Federal funds rate, however, do not necessarily signal a fundamental shift

Chart 2-5 **M2 Money Stock and Federal Reserve Target Ranges**

In recent years, the Federal Reserve has gradually lowered the target range for M2 growth. M2 generally has been below the middle of the target cones.



Note: Weekly data. Percentage growth lines mark out growth ranges set by the Federal Reserve for that year.
Source: Board of Governors of the Federal Reserve System.

in policy toward loosening or tightening because of the natural tendency for market interest rates to decline when the demand for credit falls during a period of sluggishness or to rise when demand for credit increases in a strong economy.

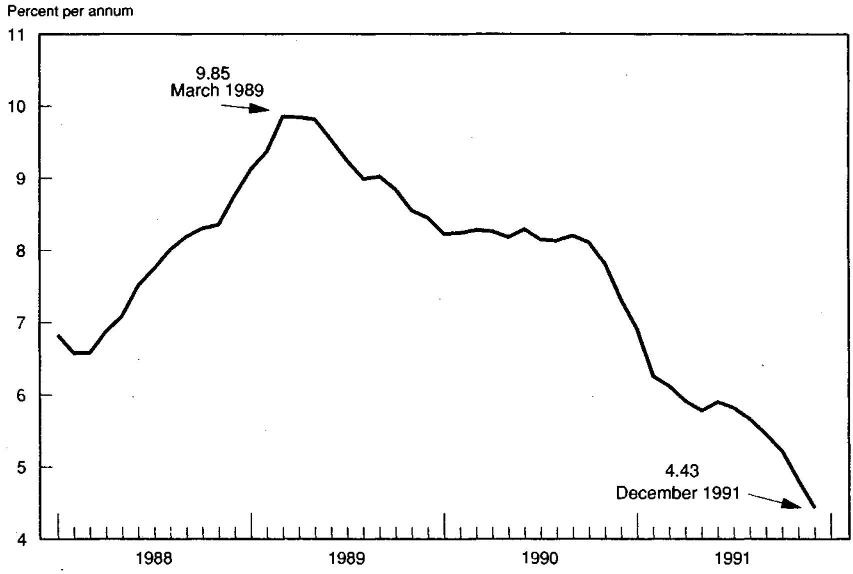
The Attempt to Engineer a Soft Landing in 1988 and 1989

Solid economic growth in 1987 and 1988 pushed capacity utilization up, and unemployment rates fell to their lowest levels in a decade and a half. These developments spurred concerns that the economy might be outstripping its productive capacity, increasing the possibility of rising inflation. Monetary policy moved toward engineering a "soft landing"—slower growth with low inflation but no recession. Beginning in early 1988, the Federal Reserve gradually increased the Federal funds rate (Chart 2-6) and in 1988 and in 1989 it lowered the midpoint of the target range for the growth of M2 a full percentage point from the previous year.

This tight monetary policy removed some of the incipient inflationary pressure from the economy. However, tighter monetary policy also put substantial downward pressure on output and employment growth.

Chart 2-6 **Federal Funds Rate**

The federal funds rate rose in 1988 and early 1989 and then fell as the economy weakened.



Source: Board of Governors of the Federal Reserve System.

Monetary Policy and Credit Conditions in Late 1989 and 1990

As growth slowed in 1989 and inflation pressures waned, market interest rates began to fall. The Federal Reserve began to reduce the Federal funds rate in the middle of 1989; over the remainder of the year the rate fell from roughly 9¾ percent to about 8¼ percent.

Despite declining short-term rates, by early 1990 long-term interest rates were rising. Yields on long-term Treasury bonds rose from below 8 percent at the end of 1989 to more than 9 percent in September 1990, and high-grade corporate bond yields rose to more than 9.5 percent. The rise partly reflected the increase in long-term interest rates throughout the world, discussed earlier. Because interest rates in the United States are influenced by developments in world markets, these events put upward pressure on U.S. long-term rates. Furthermore, tighter credit conditions—the credit crunch described in the previous section—held lending by banks and S&Ls to levels below those normally associated with the prevailing market interest rates and the profitability of investment projects. Higher world interest rates and the credit crunch resulted in tighter credit conditions than otherwise would have been associated with the level of the Federal funds rate.

Monetary Policy and Interest Rates From Late 1990

Market interest rates fell in late 1990 and much of 1991, reflecting lower demand for borrowed funds in the weakened economy, and, after early 1991, declining inflation rates. Furthermore, the prospect of reducing the long-term Federal structural budget deficit led many people to expect that improved coordination between monetary and fiscal policy could result in lower interest rates.

The Federal Reserve proceeded cautiously with a small reduction in the Federal funds rate following passage of the Omnibus Budget Reconciliation Act in late October 1990. In late 1990 and early 1991, as weakness in the economy became more evident and short-term market rates continued to move downward, the Federal funds rate was lowered by 2 percentage points to 5¾ percent by late April 1991 (Chart 2–6). In the late spring and early summer, when the economy appeared to be entering a recovery, there was little movement in the Federal funds rate.

M2 growth was somewhat erratic during much of this period (Chart 2–5). Through most of the first half of 1991, M2 stayed near the middle of its target cone. M2 then fell for several weeks, reaching the lower bound of the cone in early September. Broader measures of credit also were weak, particularly bank loans to businesses. The implications of these developments were not clear; as mentioned above, in the short run the relationship between M2 and nominal GDP can be quite unpredictable, and money supply data can be quite difficult to interpret (Box 2–2). Nonetheless, the weak money growth raised concerns that the growth in credit would be insufficient to support a healthy expansion.

In the late summer and the fall, employment, sales, and other indicators flattened or fell. As the recovery wavered and money growth remained weak, a series of cuts brought the Federal funds rate to 4.5 percent by early December. In mid-December, the Fed responded to growing concerns about the faltering recovery by lowering the Federal funds rate one-half percentage point to around 4 percent and cutting the discount rate—the rate the Federal Reserve charges on its loans to banks—a full percentage point to 3.5 percent, the lowest nominal discount rate since 1964. This aggressive move by the Fed contributed to a downward movement in market interest rates around the end of the year.

In retrospect, it appears that monetary policy should have been geared to lowering interest rates faster and earlier. It is likely that sluggish demand for credit in a weaker-than-expected economy and continued fallout from the problems in the banking industry prevented the quantity of credit from expanding as the Fed thought it would when it lowered interest rates. Indeed, M2 growth did not react as the Fed expected when it lowered the Federal funds rate in the second half of 1991.

Box 2-2.—Interpreting the Money Statistics in the Second Half of 1991

Interpreting the money statistics during the second half of 1991 was not a straightforward matter. Although M2 growth was weak, M1—a narrower measure of money composed solely of components used in transactions—grew at nearly a 9-percent annual rate in the second half of 1991, compared to an average annual rate of 7.6 percent from the end of 1982 to the end of 1989, when the economy was expanding rapidly.

The weakness in M2 and credit growth likely reflected a variety of demand and supply factors. On the demand side, weak credit growth in part was caused by sluggish loan demand; businesses saw fewer profitable borrowing opportunities than during a period of rapid expansion. Households also appear to have moved out of M2 assets such as money market accounts to seek higher returns in longer maturity bond and equity mutual funds. Declining yields on M2 assets relative to consumer debt also may have caused consumers to move away from financing purchases with debt or to use M2 assets to pay down existing debt. Such shuffling of assets by households likely had little effect on the overall availability of credit in the economy.

On the supply side, banks apparently were not actively seeking deposits; they likely felt that they could satisfy loan demand with their current deposit base. Furthermore, loan supply may have been restricted by a continuation of some of the factors underlying the credit crunch.

At the end of 1991 and into early 1992, interest rates generally were at their lowest levels in 2 decades or more. Three-month Treasury bill rates fell from 7.2 percent in October 1990 to about 3.8 percent in early 1992, the lowest level of nominal Treasury bill rates since 1972. Near troughs of recessions, however, short-term real interest rates—that is, interest rates adjusted for expected inflation—often are quite low, sometimes negative. Currently, real short-term rates are higher than they have been during many comparable periods in the past.

By mid-January 1992, nominal long-term interest rates also were relatively low. Yields on 10-year Treasury notes were about 6.8 percent, the lowest level of nominal interest rates since 1977. Rates on 30-year fixed mortgages fell from a little more than 10 percent in late 1990 to about 8¼ percent in mid-January 1992. The decline in mortgage rates has substantially enhanced the affordability of housing. In addition, interest rates on adjustable rate mortgages have come down, many homeowners have refinanced mortgages at lower rates, and interest rates on consumer installment credit also have fallen. These factors have freed up income for other purposes, allowing households to reduce their debt burdens and to enhance their purchasing power. Of course, these effects are offset somewhat by the lower income earned by holders of interest-bearing assets.

Yields on publicly traded short-term commercial paper and longer term corporate bonds also fell between late 1990 and early 1992. Although some rates lagged a bit late, the overall decline in yields on corporate debt was roughly in line with the fall in interest rates on Treasury issues of comparable maturity. As with households, the decline in borrowing costs has improved the cash-flow positions of businesses, enhancing profitability and freeing funds for productive purposes.

In contrast, the prime rate—the rate banks charge their best business borrowers—generally did not fall as quickly or as much as other short-term interest rates. This rising spread reflected an attempt by banks to increase profitability and rebuild their balance sheets as well as some reluctance to lend to small and medium-size businesses because of the unfavorable effects such loans might have on their capital positions. In December, however, following the 1-percentage-point cut in the Federal Reserve's discount rate, the prime rate fell 1 percentage point to 6.5 percent, its lowest level since 1977.

SUMMARY

- A number of structural imbalances that had evolved over a number of years—including high public and private debt, overbuilding in commercial real estate, and financial sector difficulties—constrained growth in the economy in the late 1980s and early 1990s. Constraints on State and local budgets along with defense downsizing also put a drag on the economy. The large Federal fiscal stimulus usually present during a recession did not occur.
- In the late 1980s, the Federal Reserve tightened monetary policy in an effort to restrain incipient inflation pressures. However, the tighter monetary policy also was one of the factors contributing to the sluggish performance of output and employment over the past 3 years.

RECENT ECONOMIC PERFORMANCE IN HISTORICAL CONTEXT

CYCLICAL COMPARISONS

Table 2-1 compares the 1990-91 recession with previous recessions since World War II. GDP data consistent with the December 1991 revisions are not yet available for the years before 1959 (Box 2-3). Comparisons between a given recession and the *average* of the experiences over a number of cycles are informative, but one should keep in mind that there is no such thing as a *typical* or *average* recession. Because of differences in the events causing recessions, the state of the economy when those events occur, and the responses of markets, individuals, and the government to the downturn in activity, the range of cyclical experiences is quite broad.

TABLE 2-1.—*Cyclical Comparisons*

Recession	Duration[1]	Real GDP	Payroll employment	Unemployment rate	
				Change	High
	Months	Percent Change	Percent change	Percentage points	Percent
1948-49	11	(2)	−5.2	4.2	7.9
1953-54	10	(2)	−3.5	3.6	6.1
1957-58	8	(2)	−4.3	3.8	7.5
1960-61	10	−0.6	−2.2	2.3	7.1
1969-70	11	−1.0	−1.5	2.6	6.1
1973-75	16	−4.1	−2.9	4.4	9.0
1980	6	−2.6	−1.4	1.9	7.8
1981-82	16	−2.8	−3.1	3.6	10.8
Recession Average	11	−2.2	−3.0	3.3	7.8
1990-91	(3)	[4]−1.6	[4]−1.5	[4]1.9	[4]7.1

[1] Duration based on National Bureau of Economic Research dating of business cycle peaks and troughs.
[2] Data for GDP in 1987 dollars is not yet available prior to 1959.
[3] The trough of the recession has not yet been determined, although a majority of the Blue Chip forecasters surveyed in January 1992 placed it in the second quarter of 1991.
[4] The values for the recession that began in 1990 may differ depending on the course of the economy and data revisions.
Note.—Changes determined from series-specific peaks and troughs in neighborhood of recession.
Source: Department of Commerce, Department of Labor, and National Bureau of Economic Research.

Gross Domestic Product

In terms of the direct effect on output—assuming that output does not fall significantly in 1992 (the Administration forecasts an increase)—the 1990-91 recession was somewhat milder than the average for recessions since 1959. As the Administration predicted last year, real GDP fell for two consecutive quarters—the fourth quarter of 1990 and the first quarter of 1991—and then rose in the second and third quarters. However, real GDP was essentially flat in the fourth quarter. The decline in real GDP from the third quarter of 1990 through the first quarter of 1991 was 1.6 percent, compared with the 2.2-percent average for recessions since 1959.

Box 2-3.—Emphasizing GDP and the NIPA Benchmark Revision

In 1991 the national income and product accounts (NIPAs) began emphasizing GDP, or gross domestic product, instead of gross national product (GNP). GDP measures the value of items produced *within the borders* of the United States, while GNP measures the output of the *residents* of the United States (Chapter 7). GDP corresponds more closely than GNP to many other indicators—such as employment and industrial production—that are used to analyze near-term developments in the economy. GDP also is more useful for making international comparisons.

The shift to GDP was one element of the comprehensive, or "benchmark," revision to the NIPAs that took place in December 1991. Benchmark revisions are the final phase of the NIPA estimating cycle; the last benchmark was in December 1985. In the first month of each quarter, the Bureau of Economic Analysis (BEA) publishes the initial, or "advance," NIPA estimate for the preceding quarter. In the subsequent 2 months, as more data become available, revised "preliminary" and "final" estimates are published. Many sources of data are useful for constructing the NIPAs, but are not available even for the final estimate. Some of these can be incorporated in annual revisions each July. Other information is available even less regularly; some examples are the quinquennial censuses of businesses and government, data from taxpayer compliance programs, and a number of special studies. The benchmark revisions incorporate such newly available data as well as institute changes in definitions and statistical methodology.

Between 1977 and 1990, real GDP now is estimated to have increased at a 2.5-percent annual rate, 0.2 percentage point less than before the benchmark revisions. Real GDP measures output using prices in a fixed "base period" to isolate changes in quantities from inflation. Not all prices change at the same rate, however, and the price of one item relative to another is likely to vary over time. The benchmark changed the base period from 1982 to 1987 so real GDP would reflect more recent relative values of goods and services (Chapter 7). The revisions to real GDP growth largely were accounted for by the change in the base period; other revisions to GDP growth generally were smaller, and largely offset one another.

Employment and Unemployment

Based on data available through the end of 1991, the effect of the 1990-91 recession on labor markets also was less severe than average. The 1.5-percent decline in nonfarm payroll employment from June 1990 to April 1991 was about half the average for all postwar recessions, and the 1.9-percentage point increase in the unemployment rate from June 1990 to December 1991 was about 40 percent less than the postwar average. Similarly, through the fourth quarter, the number of discouraged workers—those who are no longer actively seeking work because they think they cannot find a job—increased about 270,000, less than half the 680,000 increase that resulted from the more severe recession of 1981-82. Although the unemployment rate is expected to improve in the middle of 1992, both it and the number of discouraged workers could rise in early 1992, depending on the course of the economy. Other labor market indicators suggest greater severity of the recession. During recessions, for example, businesses often lay off workers temporarily, planning to rehire them when demand picks back up. Over the past several years, however, there has been a trend toward laying off workers permanently. During the second half of 1991, more than 40 percent of the unemployed did not expect to be recalled to their old jobs.

Duration

The National Bureau of Economic Research, the private organization that officially dates the beginning and end of recessions, has not yet decided on the trough of the most recent recession. There is uncertainty about whether the trough of the recession occurred in the spring of 1991 or whether the recession continued, with a trough at a later date. Thus, at this time, the length of the recession cannot be compared with those of other recessions since World War II, which varied between the 6-month recession in 1980 and the 16-month downturns in 1973-75 and 1981-82.

PERFORMANCE OF GDP COMPONENTS IN 1991

The decline in real economic activity during the recession from the third quarter of 1990 through the first quarter of 1991 was spread across the various sectors of the economy, but much of the decline occurred in investment, with a less severe fall in consumption. In fact, the decline in investment exceeded the total decline in GDP but was offset by an improved net export position and by government spending, which rose slightly. In the second and third quarters of 1991, the performance of GDP components was largely consistent with what would be expected in the early stages of recovery. However, in the fourth quarter the economy flattened out, with declines in consumption and government spending being offset by a small increase in investment and a significant improvement in net exports.

Consumption and Saving

Consumer spending in real terms fell by about 1¼ percent during the recession, compared with a slight increase, on average, in previous recessions. During 1991, real consumer spending rose 0.3 percent. Real disposable personal income, a key determinant of consumer spending, rose 0.4 percent during 1991. In terms of current dollars, consumer spending and other outlays rose less than disposable income so that personal saving rose to 5.3 percent in 1991 from 5.1 percent in 1990.

Real purchases of durable goods fell 2.8 percent during 1991, falling in the first and second quarters, before picking up in the third quarter and then falling again in the fourth quarter. Expenditures for nondurable goods fell 1.1 percent during 1991, declining slightly in the first quarter, rising slightly in the second quarter before being unchanged in the third quarter. In the fourth quarter, however, expenditures on nondurable goods fell significantly. Spending on services rose in each quarter of 1991, increasing 1.9 percent from the end of 1990 through the end of 1991.

The fundamentals underlying consumer spending were volatile but generally weak for much of the year. Real disposable personal income was essentially flat. Consumer confidence was on a roller coaster, falling in the second half after a strong post-Operation Desert Storm rebound (Chart 2–7). In fact, consumer confidence by year-end was very low, which suggests that consumer spending in early 1992 will be sluggish.

Residential Investment

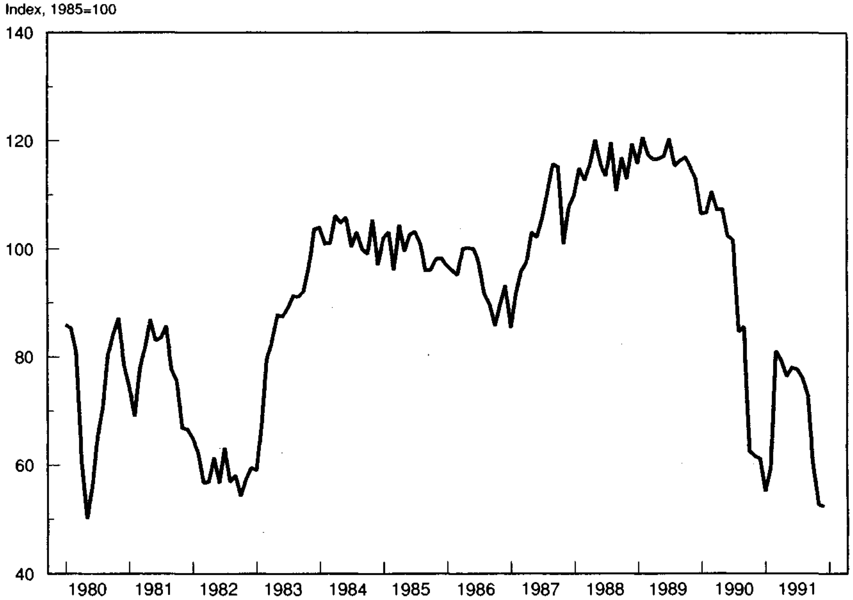
Real residential investment fell by about 10½ percent during the recession, just over half of the average decline in previous recessions since 1959. Residential investment fell 1.3 percent during 1991. However, residential investment climbed steadily in the last three quarters of the year, after falling significantly in the first quarter. Economic fundamentals—the most important being low mortgage rates (Chart 2–8)—supported the pickup in residential investment. By the end of 1991 mortgage rates were at their lowest levels in nearly two decades.

Business Fixed Investment

The decline in nonresidential fixed investment during the recession was on a par with the average for previous recessions—just above 6 percent. The 9-percent decline in investment in structures, however, was three times as large as the recession average of about 3 percent. That disproportionately large decline reflects the imbalances described earlier, particularly the high vacancy rates for commercial office space. Investment in durable equipment fell

Chart 2-7 **Consumer Confidence**

Consumer confidence plummeted during the Persian Gulf crisis, rebounded in early 1991, but then fell back at the end of the year.



Source: The Conference Board.

about 5 percent during the recession, about two-thirds the decline in the average recession.

During 1991, nonresidential fixed investment fell 6.9 percent, with investment in structures falling 15 percent and expenditures for durable equipment falling by more than 3 percent.

Inventories

As the economy entered the recession, many analysts cited the lean inventory position of businesses as one reason the recession would be relatively mild. However, early in the recession, businesses began cutting inventories almost as soon as demand began to fall. Inventories fell at an annual rate of $31 billion (1987 dollars) in the fourth quarter of 1990, and businesses continued to liquidate inventories through the second quarter of 1991. The shift in inventory investment of about $47 billion (1987 dollars)—from an accumulation of about $14 billion in the third quarter of 1990 to a liquidation of about $32 billion in the first quarter of 1991—represented nearly 1 percent of real GDP. Hence, a significant part of the fall in real output during the recession can be attributed directly to the inventory cutback, which occurred earlier than has typically been the case in previous recessions. By the end of 1991, inventory liqui-

Chart 2-8 **Mortgage Rates**

At the end of 1991, mortgage rates were at their lowest level in nearly a decade and a half and were much lower than their peak in 1981.

Note: Contract interest rates on commitments for fixed-rate first mortgages.
Source: Federal Home Loan Mortgage Corporation.

dation had ceased, and some accumulation of inventories began in the fourth quarter.

Government Spending

Real government purchases of goods and services fell 1.7 percent during 1991. On average, Federal defense purchases fell by about $13 billion, or 4.6 percent. Federal nondefense purchases rose only slightly during 1991. On average, Federal purchases increased by about 1 percent in previous recessions and by about 1¼ percent during the first year of expansions.

State and local government purchases were somewhat more constrained than the average for other recessions, falling about 0.6 percent during 1991. The fall in 1991 followed a 3.8-percent rise during 1990. The decline in 1991 reflected the tight State and local government budget situation. In earlier recessions, State and local government purchases were countercyclical, increasing 2 percent on average during recessions. During the first year of recoveries since 1959, State and local government spending increased 2.7 percent on average.

Exports and Imports

The improvement in the Nation's international trade position helped keep the recession from being more severe. Real exports continued to grow in 1991 and by the end of the year reached 11.6 percent of real GDP. In fact, over the past 4 years, real exports have gone up by nearly 1 percentage point of GDP each year. Over the same period, real imports as a percent of GDP remained relatively stable, usually between 11 and 12 percent.

The rising share of exports coupled with the stable share of imports has resulted in significant reductions in the Nation's trade deficit. Real net exports as measured in the national income and product accounts rose from −$155 billion (1987 dollars) in 1986 to −$27 billion in 1991. During the recession, real net exports were one bright spot, increasing by $47 billion, or nearly 1 percent of GDP—from the third quarter of 1990 through the first quarter of 1991. The importance of the improving trade position becomes more obvious when compared with the recession of 1981–82, when real net exports fell by nearly $40 billion, or approximately 1 percent of GDP. During 1991 real net exports improved from −$31 billion at the end of 1990 to -$8 billion at the end of 1991. The recent improvement in the trade balance and its contribution to economic growth help to reinforce the importance of maintaining open international markets in which free and fair trade can flourish.

The above discussion focuses on real imports and exports in the national income and product accounts and their contribution to real GDP growth. Other measures of U.S. international transactions in current-dollar terms also showed marked improvement in 1991. Through November, with exports reaching a record high, the merchandise trade deficit in 1991 was running at an annual rate of $65 billion, down from $102 billion in 1990. The current account balance—which includes trade of goods and services, flows of income payments, and unilateral transfers—showed a surplus of about $4 billion at an annual rate through the third quarter, a significant change from the $92 billion deficit of 1990. A major part of the improvement, however, resulted from the cash contributions of coalition partners in Operation Desert Storm.

INDUSTRIAL PRODUCTION AND CAPACITY UTILIZATION

Industrial production—the output of the Nation's factories, mines, and utilities—peaked in September 1990. From its trough after the 1981–82 recession in December 1982, industrial production increased by nearly 40 percent during the expansion—representing an average growth of about 4.4 percent a year. From September 1990 through March 1991, industrial production fell 5 percent, giving up the equivalent of slightly more than a year's worth of growth during the expansion. The average decline in industrial production during previous recessions in the postwar era was about 9 percent, nearly twice as large as the decline from September 1990 to March 1991.

Capacity utilization—the percentage of available equipment and structures used in production—also fell as industrial production declined. Capacity utilization peaked at 83.8 percent in June and July 1990. By March 1991 it had fallen to 78.4 percent.

The initial pickup in economic activity that occurred in the spring boosted industrial production and capacity utilization. Industrial production rose about 3 percent from March to July, and capacity utilization rose to 80 percent in July. Industrial production then flattened out in the second half of the year and even declined at the end of the year. Capacity utilization fell from 80 percent in July to 79 percent in December.

SECTORAL AND REGIONAL DIVERSITY DURING THE RECESSION

Developments in demand and technology vary significantly among industries; as a result, not all sectors of the economy expand or contract at the same rate. The efficient allocation of economic resources requires industries experiencing increases in demand or rapid technological advances to grow faster than industries not experiencing those advantages. Differences in relative demands and technological change mean that during a recession some industries still experience growth while others contract; conversely, an industry with outdated technology or falling demand may still decline during an expansion. Because of differences in natural resources, composition of the labor force, and historical development, a wide variety of industrial concentrations exists across the country. Regions experience fluctuations in growth commensurate with activity in their industrial concentration.

Industrial and regional diversity enhances the cyclical resiliency of the economy as a whole. The flow of labor and capital among regions and sectors permits more rapid adjustment to shocks, a more efficient allocation of scarce resources, and a larger national product. Indeed, subsidizing declining industries inhibits the efficient flow of resources from those industries to the expanding sectors of the economy. In contrast, policies aimed at aiding the flow of workers and capital among sectors can improve efficiency and enhance growth.

Sectoral Diversity in Employment

Table 2-2 presents the proportion of the decline in total nonfarm payroll employment attributable to each of the major industrial groupings during postwar recessions. These declines are compared to behavior of employment between its peak in June 1990 and its 1991 low in April.

TABLE 2-2.—*Accounting for the Decline in Payroll Employment*

[Decline in sector divided by total decline, percent]

Recession	Manufacturing	Construction	Service Producing	Mining
1948–49	72.4	0.9	8.8	17.9
1953–54	102.5	−.6	−6.8	4.9
1957–58	76.4	11.5	8.2	3.9
1960–61	81.6	11.4	2.2	4.7
1969–70	131.3	5.6	−36.7	−.2
1973–75	81.4	19.1	.3	−.8
1980	81.2	15.8	3.7	−.8
1981–82	82.2	12.5	−.4	5.7
Recession Average	88.6	9.5	−2.6	4.4
June 1990 to April 1991	[1] 46.9	[1] 29.1	[1] 23.5	[1] .5

[1] The values for the recession that began in 1990 may differ depending on subsequent changes in payroll employment and data revisions.

Note.—Changes determined from the peaks and troughs in total payroll employment in the neighborhood of the recession. Mining includes oil and gas extraction. A minus sign indicates an increase in employment in the sector.

Source: Department of Labor and National Bureau of Economic Research.

The manufacturing sector accounted for about 47 percent of the decline in total employment between June 1990 and April 1991, roughly half the average of previous postwar recessions. (Manufacturing employment, however, had fallen somewhat during 1989 and early 1990.) Before 1990–91, manufacturing had never accounted for less than 72 percent of the jobs lost during a recession. The smaller negative effect of manufacturing on the economy as a whole is not simply a result of its lower share of total employment; in percentage terms, the decline in manufacturing employment also was about half its cyclical average.

In the late 1970s and early 1980s, the cost-competitiveness of U.S. manufacturing declined relative to that of the Nation's major trading partners, in large part because of the rising exchange value of the dollar. The decline in competitiveness forced manufacturing to scale back operations. The restructuring caused painful dislocations—particularly in Midwestern States with a high dependence on traditional heavy manufacturing industries such as steel and autos—that lasted longer than the recessions in the national economy. But by the end of the 1980s, the competitive footing of U.S. manufacturing was much improved, a result both of cost-cutting steps and the decline in the exchange value of the dollar between 1985 and 1987. Indeed, over the past year and a half, the manufacturing sector has received a welcome boost from export demand. As a result of these factors, manufacturing did not display the same degree of cyclical sensitivity in 1990 and 1991 that it had during earlier recessions.

In contrast, construction accounted for 29 percent of the jobs lost between June 1990 and April 1991, about three times its cyclical average. The surge in building activity during the 1980s resulted in an excess supply of office space, commercial property, and apartments. Many of these buildings are vacant. And over the past 3 years, there has been a notable rise in vacancies in the Northeast—where the number of vacant residential rental units rose from 4.9 percent of the rental stock in the fourth quarter of 1988 to 6.3 percent in the fourth quarter of 1991. Because it could take some time for renewed demand to work off existing vacancies, construction is not likely to be robust even after the recovery gains momentum.

The service sector accounted for almost one-quarter of the overall decline in employment between June 1990 and April 1991, by far its largest share during any postwar recession. This sector covers a large number of diverse industries, such as wholesale trade, retailing, real estate, banking, insurance, health care, business services, and government. Many of these industries are undergoing longer term structural changes that have caused their cyclical behavior to differ noticeably from earlier experiences. Furthermore, there has been a trend toward manufacturers contracting out activities to workers that are counted in the services category, thereby increasing the cyclical sensitivity of the service-producing sector.

Wholesale and retail trade accounted for nearly one-third of the decline in total payroll employment between June and April; this share was about three times its cyclical average. Retail trade in particular has undergone significant structural changes over the past several years. The 1980s witnessed a large expansion in retailing. According to estimates by the Department of Energy, in 1983 there were 44 square feet of floorspace at mercantile and service establishments for every person in the Nation; by 1986, this figure had risen to 53 square feet per person. Such increases apparently reflected building beyond the demand for retail services. More recently, many traditional department store chains have scaled back operations as they face intense competition, much of it coming from expanding discount outlets.

Employment in the finance, insurance, and real estate industries typically has grown during recessions. In 1990–91, however, the number of jobs in these industries fell, accounting for about 1½ percent of the total decline in payroll employment. The problems with the financial industries noted earlier—as well as changes in the way that financial services are provided to households and businesses—have resulted in a restructuring that likely will leave the Nation with fewer banks and savings and loans. Job opportunities in real estate were adversely affected by the slump in the construction industry.

One industry that did not contract during this recession was health care services. This industry continued to expand during the recession despite the weakness in the aggregate economy. All told, the services subgrouping, which includes health and business services as well as a miscellany of other service industries, added more than 300,000 jobs between June 1990 and April 1991.

Regional Disparity

Before this latest cycle, some people argued that the East and West coasts were "recession proof." This claim seems to have been based on the experience of the early 1980s. Chart 2-9 plots the average unemployment rate in each State during the 12 months ending at the cyclical trough in November 1982. The figure highlights that unemployment rates generally were much lower on the East Coast than in the Midwestern industrial States and some portions of the South, which were hard hit by the problems in manufacturing. Despite the claims, unemployment on the West Coast was higher than in the country as a whole. Chart 2-10, which plots average unemployment rates from December 1990 to November 1991, indicates that many of the coastal States—namely, Maine, New Hampshire, Massachusetts, Rhode Island, Florida, and California—fared worse than the Nation as a whole during the latest recession. The unemployment rate through much of the industrial parts of the Midwest has been closer to the national average. Both charts highlight, however, that there has been significant diversity in the economic performance of different regions of the country. (Data for State-level unemployment rates in December 1991 were not available at the time this *Report* was published; for the Nation as a whole, the unemployment rate rose 0.2 percentage point in December.)

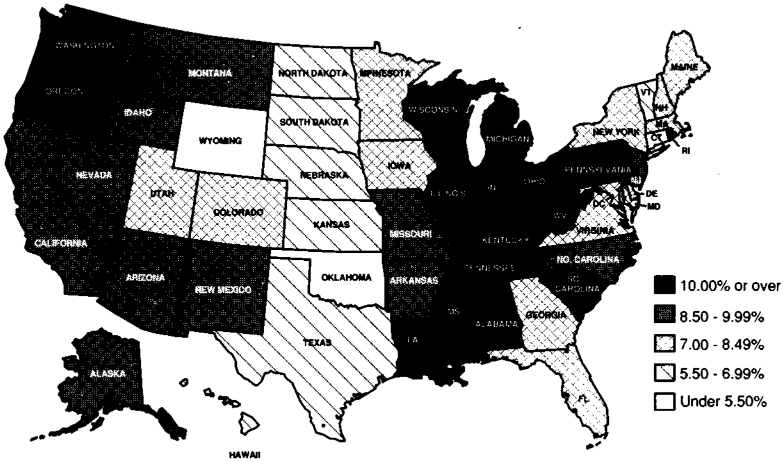
One exception in the Midwest has been Michigan, where the weakness in the automobile industry has caused high unemployment. Indeed, in 1991 the "big three" domestic automakers sold roughly 8½ million cars and trucks in the United States, only about 14 percent above sales in 1982 during that severe recession. In addition to cyclical developments, motor vehicle sales have been adversely affected by the decline in the rate of household formation, which is one of the key determinants of longer run trends in demand for big-ticket durable items such as automobiles.

Was This a White-Collar Recession?

Because of the job losses in banking, insurance, real estate, and other industries with a high proportion of white-collar workers, some have argued that the 1990–91 recession was a "white-collar

Chart 2-9 **Unemployment Rates by State, Year Ending November 1982**

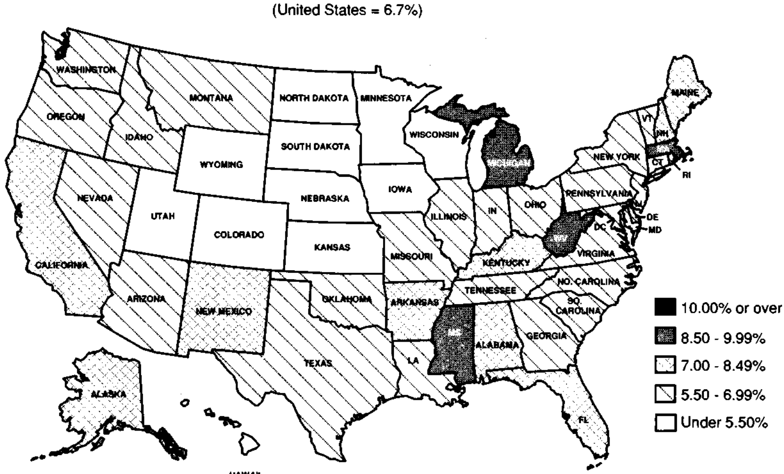
Twelve months ending November 1982
(United States = 9.5%)



Note: Average of the rates for the twelve months ending November 1982.
Source: Department of Labor.

Chart 2-10 **Unemployment Rates by State, Year Ending November 1991**

Twelve months ending November 1991
(United States = 6.7%)

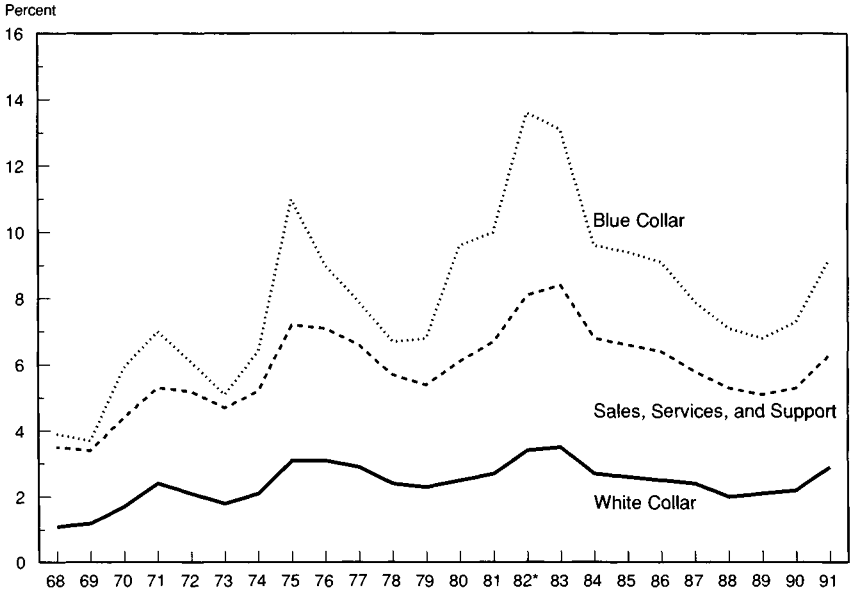


Note: Average of the rates for the twelve months ending November 1991.
Source: Department of Labor.

recession." Chart 2-11 illustrates that the unemployment rate for white-collar workers is lower than in other occupations, and also is below its recent peak in 1983. Because of the trend toward more employment in the typically white-collar jobs, however, these workers now account for a larger proportion of total unemployment than they have in previous recessions. Nonetheless, they still account for a smaller proportion of total unemployment than the blue-collar or sales, services, and support categories.

Chart 2-11 **Unemployment Rates by Occupation**

White-collar unemployment rates are below those of other broad occupational categories.



WHITE COLLAR: Managerial, Professional, Technical, and Administrative.
SALES, SERVICES, AND SUPPORT: Sales, Clerical and Kindred, and Services.
BLUE COLLAR: Precision Production, Operators, Fabricators, Laborers, Farming, Forestry, and Fishing.
* The occupational classifications used to construct these series are not strictly comparable before and after 1982.
Source: Department of Labor.

Blue-collar unemployment rates on average run higher, and recently have risen more, than the rates for white-collar and service workers. However, the less severe cycle in manufacturing has meant that the blue-collar unemployment rate is substantially below the peaks experienced in the mid-1970s and early 1980s.

SUMMARY

- While a majority of the private Blue Chip forecasters surveyed in January 1992 placed the end of the recession in the second quarter of 1991, as noted above the trough of the recession has not yet been officially determined. Thus, the statements in this section are consistent with the majority Blue Chip view, but it should be borne in mind that the future course of the economy may affect the values for the recession that began in the third quarter of 1990.

- The decline in output from the third quarter of 1990 through the first quarter of 1991 and the number of jobs lost between June 1990 and April 1991 was somewhat less severe than the average for post-World War II recessions. Much of the decline in output occurred in investment, particularly in inventories. There was a smaller decline in consumption, and an improvement in net exports helped to keep the recession from being more severe.
- Sectoral comparisons show that, relative to previous recessions, manufacturing accounted for a smaller proportion of jobs lost; the construction and service-producing sectors accounted for a much larger proportion.
- The rise in white-collar unemployment represented a larger proportion of total unemployment compared to previous recessions. However, blue-collar unemployment still accounted for a larger share of total unemployment than white-collar unemployment did.

THE INFLATION RECORD

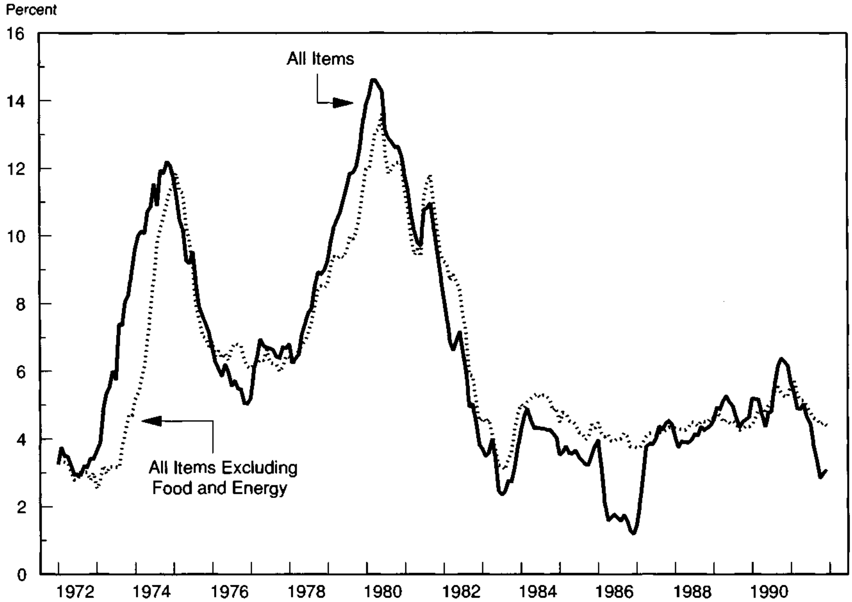
Falling energy prices and the weak economy held inflation in 1991 at relatively low levels in comparison to the past two decades. Price inflation, measured by the annual rate of change in the consumer price index (CPI), averaged 9.3 percent from the end of 1973 through 1981, peaked at over 13 percent in 1979 (December-to-December), but fell to 3.9 percent from the end of 1982 through 1991 (Chart 2–12). Core or underlying inflation—as measured by the CPI excluding food and energy—peaked in 1980 at more than 12 percent and averaged 9 percent from the end of 1973 through 1981 but declined to 4.5 percent from the end of 1982 through 1991. During 1991 consumer price inflation was only 3.1 percent, down from 6.1 percent in 1990 and the second lowest rate since 1967. Core inflation was 4.4 percent, down from 5.2 percent in 1990.

Commodity prices declined significantly over the past year and a half, signaling continued low inflation. Crude oil prices were down nearly 50 percent from their peak in the fall of 1990, and nonenergy commodity prices also fell. Producer prices for sensitive crude and intermediate materials (which do not include energy commodities) declined about 4 percent during 1991, and the Commodity Research Bureau's index of spot market prices for raw industrial materials was down more than 10 percent. Many view gold as a hedge against inflation; its price fell by about 12 percent from the beginning of 1990 to the end of 1991.

The labor cost situation in 1991 also was quite favorable for reducing inflation pressures. Unit labor costs, which influence inflation by affecting the cost of producing goods and services, are de-

Chart 2-12 **Inflation and Core Inflation**

Overall consumer price inflation fell significantly in 1991. Core inflation, a measure that excludes food and energy prices, also fell.



Note: Percent change in CPI from 12 months earlier.
Source: Department of Labor.

termined by dividing hourly compensation by output per hour. Effects of increases in wages and salaries and other labor compensation are thus offset by any increases in the productivity of workers. Although real compensation tends to follow productivity gains (Chapter 3), nominal compensation typically increases at a higher rate than productivity, raising unit labor costs and contributing to inflation. Unit labor costs continued to rise in 1991, but at a much slower rate than in recent years. Through the first three quarters of 1991, unit labor costs increased at an annual rate of only 2.3 percent, as labor compensation rose at a 3.4-percent rate and productivity increased at about a 1-percent rate. This compares favorably to the 6-percent rise in unit labor costs in 1990, and the 4½ percent average annual increase during the 1980s.

Price changes during 1991 were affected primarily by the declines in energy prices from their peak in the fall of 1990; the slowdown in labor markets, money growth, and the economy in general also helped keep inflation pressures low. Still, some longer run trends continued in 1991 as prices for consumer services rose faster than those for consumer goods. During 1991 services prices rose 4.6 percent, compared with a 1.2-percent rise for consumer goods. In particular, the cost of medical care services continued to soar, rising 7.9 percent.

SUMMARY

- Inflation in 1991 was relatively low, partly as a result of lower oil prices, but also as a result of several years of slow money growth, slack labor markets, and excess capacity in many industries.
- Inflation is expected to remain relatively low in the coming years.

FISCAL POLICY

Fiscal policy comprises the spending, tax, borrowing, and credit activities of the Federal Government. The Administration supports a responsible growth-oriented fiscal policy. The Omnibus Budget Reconciliation Act of 1990 established spending constraints that will help reduce the medium-term structural budget deficit—that is, the deficit excluding the cyclical component of expenditures and revenues. (Chapter 7 discusses budget concepts.)

In fiscal 1991 total Federal outlays were $1.323 trillion and Federal receipts were $1.054 trillion, yielding a Federal budget deficit of $269 billion. As a percent of GDP, receipts were 18.7 percent, outlays were 23.5 percent, and the deficit was 4.8 percent. In comparison, in fiscal 1990 the deficit was $220 billion, or 4 percent of GDP.

The rise in the deficit reflects a number of factors. As an economy dips into recession, income tax receipts fall and outlays for some programs rise, even without any legislated changes in the programs. Such automatic stabilizers are an important element of systematic fiscal policy since they cushion the fall in the economy, preventing further contraction. On balance, for example, the automatic stabilizers offset other factors in fiscal 1991, leaving the overall stance of Federal fiscal policy slightly stimulative. Usually late in a recession or early in a recovery, tax cuts or an increase in discretionary fiscal spending increases the structural budget deficit, providing notably more stimulus than the automatic stabilizers alone. In contrast, between fiscal 1990 and fiscal 1991, the structural budget deficit, excluding outlays for deposit insurance, changed little.

It is important to note that the deficit has been boosted by a temporary bulge in deposit insurance outlays, which exceeded 1 percent of GDP in fiscal 1991. It is widely accepted that the actual timing of outlays and borrowing to protect insured depositors has little impact on credit markets, interest rates, and the economy. So the component of the deficit due to deposit insurance—about $66 billion, or roughly one-quarter of the deficit in fiscal 1991—does not represent fiscal stimulus.

For fiscal 1992, outlays are projected to be $1.475 trillion, receipts $1.076 trillion, and the deficit $399 billion, or 6.8 percent of GDP. Excluding deposit insurance outlays, projected to be about $80 billion, the projected deficit would be 5.5 percent of GDP. The projected increase in the deficit from fiscal 1991 reflects both the effect of automatic stabilizers and discretionary stimulus from an increase in the short-term structural deficit.

Growth Agenda

The President has presented a comprehensive and coordinated growth agenda for the Nation. The agenda includes fiscal and other measures that will stimulate the economy in the short run, address the structural imbalances, and promote the Nation's long-term growth.

The agenda focuses directly on increasing economic growth. The short-term agenda includes executive actions and proposed legislation that will stimulate economic growth immediately. Executive actions with immediate impact include the reduction in excessive personal income tax withholding and acceleration of previously appropriated Federal spending. Reinvigorated action to reduce the burden of unnecessary regulation and prudent measures to reduce the credit crunch will improve the environment for growth now.

Proposed legislation for a 15-percent tax allowance and simplified and liberalized treatment of depreciation under the alternative minimum tax will spur job-creating investment. Penalty-free withdrawal from individual retirement accounts and a $5,000 tax credit for first-time homebuyers along with other incentives will boost real estate. The President has repeatedly proposed reducing the tax rate on capital gains; the first effect of such a reduction would be to raise asset values, bolstering confidence and spending.

There also are proposals to assist families. These include an increase in the tax exemption for each child, a new flexible individual retirement account, and student loan interest deductions. The incentives for first-time homebuyers mentioned above will encourage homeownership—one of the most important ingredients to family financial and social well-being. Comprehensive health reform will increase the affordability and security of health insurance.

Bolstering the short-term agenda are proposals for the long term that invest in the Nation's future by increasing the productivity of people and business. Record Federal investment in research and development and infrastructure, and the extension of the research and experimentation tax credit will help generate new technologies that enhance productivity and employment growth. The Administration also has advocated making the research and experimentation tax credit a permanent part of the tax code. Record Federal investment in Head Start will prepare all eligible disadvantaged 4-year-olds for effective learning when they start school. Record Federal investment in programs for children and education will improve the opportunities for today's youth when they enter the labor market in the future. Record Federal investment in programs designed to deal directly with the crime and drug problems will, in combination with other programs, move many of those from this subculture into socially productive activity. The comprehensive job-training program will help millions of Americans to acquire the skills necessary to succeed in the changing labor market.

A number of Administration proposals aimed at improving economic performance await congressional action. Education reform through America 2000 will revolutionize education, strengthen accountability, and improve performance. Financial sector reform will strengthen the financial system, improve its ability to contribute to business growth, and sustain international competitiveness. Civil justice reform will curb wasteful litigation and enhance productive activity. The National Energy Strategy will increase energy security and conservation. The long-term growth agenda also includes continued efforts to expand international markets through multilateral, regional, and bilateral negotiations.

The proposed cut in the capital gains tax rate is an important element of the long-term growth agenda. The capital gains tax rate cut would encourage entrepreneurial activity, create new products, new methods of production, and new businesses. These, in turn, would generate new jobs. A capital gains differential would reduce the tax bias against equity financing and the overall cost of capital, thereby increasing investment and growth. The Administration also has supported a zero capital gains tax rate for areas designated as Enterprise Zones to spur investment and encourage entrepreneurial activity in inner cities and rural areas.

Fiscal discipline has been a centerpiece of all of this Administration's budgets. The Administration's proposals are designed to foster long-term growth by encouraging saving, investment, and entrepreneurship. Controlling the growth of government spending and deficits frees resources for private investment. This is but one part of a more comprehensive fiscal program that, within proposed spending categories, also shifts spending from current consumption to investment (such as expenditures for research and development and investments in public infrastructure that pass cost-benefit tests).

SUMMARY

- Federal fiscal policy typically provides a significant stimulus to the economy during recessions and early recovery periods.

From 1990 to 1991, automatic stabilizers offset other factors, leaving fiscal policy slightly stimulative. Federal fiscal stimulus is projected to be stronger in fiscal 1992, but still within the constraints of the Omnibus Budget Reconciliation Act.

- The prompt enactment of the Administration's pro-growth policy proposals will boost the economy in the short run and will enhance productivity, investment, and economic growth in the long run.

DEVELOPMENTS OUTSIDE THE UNITED STATES

The increase in U.S. exports, noted above, was one of the important factors that kept the recession from being more severe. Exports have been aided by the exchange value of the dollar, which has fluctuated within a fairly narrow range since the significant depreciation between 1985 and 1987. During 1990 and 1991, however, several of our major trading partners were in recession—among them Canada and the United Kingdom—or, more recently, periods of slower growth—such as Germany and Japan. These developments have reduced growth in demand for U.S. exports.

BUSINESS CYCLE DEVELOPMENTS ABROAD

In Canada, the United States' largest trading partner, GDP began to fall in the second quarter of 1990, two quarters before the decline in output in the United States. The recession in Canada was more severe than in the United States, with GDP falling 2.8 percent from the first quarter of 1990 through the first quarter of 1991. Growth rebounded to a 5.7-percent annual rate in the second quarter of 1991, but activity has fallen back to a more sluggish pace in recent months. The United Kingdom also fell into recession before the United States and experienced a more severe downturn. Real GDP in the United Kingdom fell 1.2 percent in 1990 and remained on a downward course during the first half of 1991. Activity picked up around midyear, but the economy still was sluggish. French GDP fell a bit late in 1990, and recovery was subdued during 1991.

The cyclical experiences of Japan and Germany were quite different. While most of the industrial world experienced slow growth in 1989 and early 1990, Japan and Germany registered rather robust growth, which continued into early 1991. More recently, however, activity has begun to slow in Germany. The costs of unification, the pent-up demand for consumer goods by citizens who live in the former East Germany, and the one-for-one conversion of the East German mark all contributed to inflationary pressures. In response, the Bundesbank tightened monetary policy and growth slowed; this tightening has had repercussions for the other economies in Western Europe. Japan's gross national product grew solidly in 1990 and the first quarter of 1991 but has slowed since. The reduced pace of activity in Japan largely reflects the lagged effects of a tightening of monetary policy in 1989 and 1990.

About one-quarter of U.S. merchandise exports go to Latin America and the newly industrialized countries of Asia. The economic reform programs in Mexico and in a number of other Latin American countries have started to result in solid growth for them as well as expanded exports for the United States. The newly industrialized countries of Asia continue to register strong growth, and the share of U.S. exports going to these countries increased from less than 8 percent in 1985 to more than 10 percent in 1990.

INFLATION, MONETARY POLICY, AND INTEREST RATES ABROAD

Like the United States, other major industrial countries have sought to reduce inflation in recent years by following tight monetary policies. These policies have had substantial effects on output and employment. During 1991, the combination of slack demand for funds, lower expectations regarding inflation, and an easing of monetary policy led to declines in interest rates in a number of countries, including Japan, Canada, and the United Kingdom.

The experience of Germany has been different. The strains of unification have led to budget deficits, higher consumer price inflation, and increased wage pressures. After substantial upward movement in 1989–90, interest rates in Germany remained on a high plateau through most of 1991, with long-term government bonds yielding above 8 percent and short-term securities more than 9 percent. Continued wage and price pressures induced the Bundesbank to raise key official short-term rates again in December 1991, and the Lombard rate—the interest rate the Bundesbank charges banks for short-term borrowing—hit a historical peak. The operation of the exchange-rate mechanism—an agreement among European countries aimed at keeping exchange rates among European currencies relatively stable—combined with the high degree of capital mobility within the European Monetary System required central banks in some other European countries to limit monetary easing (particularly in the United Kingdom, and also in France). In other countries, central banks raised their rates in line with Germany (most notably the Netherlands and Belgium). This linkage of monetary policies has been a major reason why many countries in Europe are in recession or growing slowly.

The dollar appreciated about 15 percent (on a trade-weighted basis) in the first half of 1991 but returned back to beginning-of-year levels over the last half of the year. During 1991 as a whole, the dollar appreciated moderately against most European currencies, while it depreciated about 7½ percent against the Japanese yen. The dollar was appreciating against European currencies at the beginning of 1992.

Developments in the major foreign stock markets mirrored those in the United States early in 1991; stock indexes surged from mid-January to April with the resolution of the Middle East crisis. After April, most foreign stock markets experienced little movement, on balance. The major exception was Japan, where the Nikkei index fell about 15 percent between March and December after falling even more sharply in 1990.

EXTERNAL ACCOUNTS

While economic activity in both Japan and Germany was slowing, their external accounts were behaving quite differently. Following declines in 1989 and 1990, Japan's external surplus rose in 1991; these movements largely reflected developments in the exchange value of the yen and changes in the prices of exports relative to imports.

In contrast, Germany's external balance moved sharply into deficit. Most of the movements in the German accounts can be traced to unification, which resulted in a shift in resources from exports to internal reconstruction and a spillover of higher domestic demands onto imports. Indeed, the shift in the external balance from surplus to deficit in Germany was on the same order of magnitude as the large and rapid shift that occurred in the United States in the early to mid-1980s. Such a change in the external balance of one of the world's traditional surplus nations provided stimulus for Germany's trading partners and was a factor elevating world long-term interest rates higher than they otherwise would have been.

SUMMARY

- Many of the Nation's trading partners recently experienced slower growth or recessions.
- Tighter monetary policies in many major industrialized countries have helped to reduce inflation pressures, but also have contributed to lower real growth.

THE ECONOMIC OUTLOOK

The Administration projects that the economy is likely to remain sluggish in the early part of 1992 but that a renewed pickup is likely to begin by the middle of the year. With the adoption of the President's policy proposals, the economy is then expected to return to solid real GDP growth of about 3 percent a year through the mid-1990s, and the unemployment rate is expected to decline from around 7 percent to less than 5½ percent.

The sluggish performance of the economy and the declines in consumer and business confidence at the end of 1991 all point to a continued slow economy in the early part of 1992. Various recent developments, however, indicate a resumption of stronger growth in the middle of the year. The cuts in interest rates in the second half of 1991 are expected to support gains in consumer and business spending by the middle of 1992. Relatively low interest rates also should help households and businesses reduce debt-servicing costs and improve their financial positions. The improvement in personal finances would help boost consumer confidence and encourage growth in consumer spending. Declines in long-term interest rates should continue to have positive effects on investment spending; low mortgage rates, in particular, should help to boost residential investment. Business inventories remain relatively lean. As a result, production likely will respond quickly to meet increases in demand, and a sustained increase in demand would encourage businesses to rebuild inventories. The relatively low exchange value of the dollar and growth in the world economy should help to promote continued export growth.

Economic forecasting is an imprecise science, however. Unexpected events and policy changes can cause actual events to be substantially different from the forecast. Forecasts are based largely on predictions about human behavior, usually taking previous patterns of behavior as a guide. But human behavior is complex, difficult to predict, and subject to change. People do not always respond the same way, or with the same speed, in what appear to be similar circumstances. Hence, uncertainty remains about the outlook for the economy.

If the problems the economy has been facing are resolved relatively quickly and confidence is restored, growth could rise faster than is expected. The relatively low rate of inflation combined with the large degree of slack in the economy is particularly noteworthy, for it could allow the Federal Reserve to keep interest rates low—or cut them further, if necessary—to help boost growth with little immediate concern about reintroducing inflation pressures. A quick shift to a significant rebuilding of inventories alone could add as much as a percentage point to the rate of growth over the next year. Alternatively, if the problems are resolved slowly, the economy could perform worse than expected. Tight credit and slow money growth, along with the continuing structural adjustments described earlier could continue to hinder the economy. Under those conditions confidence could remain low, and the rate of growth likely would be lower than expected.

THE PRESIDENT'S POLICIES OR BUSINESS AS USUAL

With the adoption of the President's pro-growth proposals as outlined in the State of the Union address and presented in detail in the budget, the prospects for renewed solid growth improve markedly. The policy forecast in Table 2–3 shows the expected course of the economy given the adoption of the pro-growth policies. The President's proposals will inspire confidence and provide a stimulus to the economy in the short run, boosting output, income, and employment. The productivity-enhancing nature of the proposals will also improve the economic outlook in future years. If the President's policy proposals are not adopted relatively promptly, however, and a "business-as-usual" situation persists in determining Federal spending and tax policies, the economy is expected to perform worse than projected, as indicated by the business-as-usual forecast.

TABLE 2–3.—*Administration Forecasts*

Item	1991	1992	1993	1994	1995	1996	1997
	Percent change, fourth quarter to fourth quarter						
POLICY FORECAST							
Real GDP	0.2	2.2	3.0	3.0	3.0	2.9	2.8
GDP deflator, 1987=100	3.2	3.2	3.4	3.3	3.3	3.2	3.2
Consumer price index	2.9	3.1	3.3	3.2	3.2	3.2	3.1
	Calendar year average, percent						
Unemployment rate	6.7	6.9	6.5	6.1	5.8	5.4	5.3
Interest rate, 91-day Treasury bills	5.4	4.1	4.9	5.3	5.3	5.2	5.1
Interest rate, 10-year Treasury notes	7.9	7.0	6.9	6.7	6.6	6.6	6.6
Civilian employment	116.8	117.4	119.6	121.7	123.7	125.8	127.8
	Percent change, fourth quarter to fourth quarter						
BUSINESS AS USUAL FORECAST							
Real GDP	0.2	1.6	2.4	2.5	2.6	2.5	2.4
	Calendar year average, percent						
Unemployment rate	6.7	7.1	6.9	6.7	6.3	5.8	5.6
Interest rate, 91-day Treasury bills	5.4	4.2	5.1	5.5	5.5	5.4	5.3
Interest rate, 10-year Treasury notes	7.9	7.2	7.3	7.1	7.0	7.0	6.9

Sources: Council of Economic Advisers, Department of Commerce, Department of Labor, Department of the Treasury, and Office of Management and Budget.

With the President's pro-growth policies, the Administration expects real GDP to increase 2.2 percent from the fourth quarter of 1991 to the fourth quarter of 1992. This represents a significant improvement from the 0.2-percent growth during 1991 and the 0.1-percent decline during 1990. Inflation in 1992 should be only slightly higher than in 1991. The relatively low inflation pressures in 1991 partly were a result of the fall in oil prices from their peak in late 1990. But several years of slow money growth and a slow economy, which eased tightness in labor markets and created excess capacity in many industries, also kept inflation pressures down. In 1993 real growth is expected to be even stronger than in 1992—at about a 3-percent rate—as the economy continues to rebound from the recession and the sluggish growth over the 1989–91 period.

The President's policies will also improve the outlook in labor markets, and the unemployment rate is expected to fall from about 6.9 percent in 1992 to 6.1 percent in 1994. Interest rates are expected to fall in 1992 from 1991, reflecting the sluggish economy and the low level of interest rates at the end of 1991. As the expansion becomes more robust, however, short-term interest rates are expected to rise somewhat through 1995 before declining slightly in 1996 and 1997. Long-term interest rates are expected to fall gradually through 1995 and then flatten out, reflecting continued, relatively low inflation and lower uncertainty about fiscal policy and the economic outlook.

Under the business-as-usual projection, real growth in 1992 would likely be around 1.6 percent, well below the rate that would be achieved with the adoption of the President's policy proposals. The period of slow growth that has existed since early 1989 would likely continue in 1992. By 1993 business-as-usual growth picks up some, but remains more than a half percentage point below policy growth. The differences in real growth in the policy and business-as-usual forecasts persist beyond the short-term outlook because of the productivity-enhancing nature of the President's proposals. In the policy forecast, real growth in the 3-percent range continues through the mid-1990s. With business-as-usual, growth averages only in the 2.5-percent range.

ACCOUNTING FOR GROWTH IN THE LONGER TERM

In the longer term the main determinants of average growth are the factors that influence the overall supply of goods and services generated in the economy. One way to focus on supply factors is to decompose real GDP growth into four components: (1) labor force growth, that is, the growth in the number of people available for work each year; (2) the change in the share of the labor force that is employed, or the employment rate; (3) the growth in the number of hours an employed person works each year, represented as the growth in average weekly hours; and (4) labor productivity growth, or the growth in the amount of goods and services that can be produced with an hour of labor.

Table 2–4 shows the contribution of these various factors in average real GDP growth for various periods. The first three columns provide historical comparisons for periods from business-cycle peak to business-cycle peak. The final column shows the contributions for the period incorporating the historical performance since the recent business cycle peak (in the third quarter of 1990) along with the policy forecast period. Economic growth is projected to average 2.2 percent a year from the business cycle peak in 1990 through the end of the forecast in 1997.

TABLE 2-4.—*Accounting for Growth in Real GDP, 1960–97*

[Average annual percent change]

Item	1960 II to 1981 III	1973 IV to 1981 III	1981 III to 1990 III	1990 III to 1997 IV
GROWTH IN:				
1) Civilian noninstitutional population aged 16 and over	1.8	1.8	1.1	0.9
2) PLUS: Civilian labor force participation rate	.3	.5	.4	.2
3) EQUALS: Civilian labor force	2.1	2.4	1.6	1.1
4) PLUS: Civilian employment rate	–.1	–.4	.2	.0
5) EQUALS: Civilian employment	2.0	2.0	1.8	1.2
6) PLUS: Nonfarm business employment as a share of civilian employment[1]	.1	.1	.3	–.0
7) EQUALS: Nonfarm business employment	2.1	2.1	2.1	1.2
8) PLUS: Average weekly hours (nonfarm business sector)	–.6	–.7	.0	.0
9) EQUALS: Hours of all persons (nonfarm business)	1.5	1.3	2.1	1.2
10) PLUS: Output per hour (productivity, nonfarm business)	1.7	.6	.8	1.4
11) EQUALS: Nonfarm business output	3.3	1.9	2.9	2.6
12) LESS: Nonfarm business output as a share of real GDP[2]	.1	–.2	.2	.4
13) EQUALS: Real GDP	3.2	2.1	2.7	2.2

[1] Line six translates the civilian employment growth rate into the nonfarm business employment growth rate.
[2] Line 12 translates nonfarm business output back into output for all sectors, or GDP, which includes the output of farms and general government.

Note.—Data may not add due to rounding.
Time periods are from business cycle peak to business cycle peak to avoid cyclical effects.

Sources: Council of Economic Advisers, Department of Commerce, Department of Labor, Department of the Treasury, and Office of Management and Budget.

This projection assumes an average rise of 1.1 percent a year in the labor force over the 1990–97 period, a lower growth rate than during the 1980s. Slower labor force growth results from smaller increases in projected labor force participation rates and from slower growth in the working-age population. Although the labor force is assumed to grow 1.3 percent a year in the forecast, the low growth of the labor force that occurred in late 1990 and in 1991 pulls down the average for the entire period.

Decreases in the unemployment rate from the third quarter of 1990 through the end of the forecast are expected to contribute only slightly, on average, each year to real GDP growth. The largest contribution from a falling unemployment rate occurs in the 1992–94 period. As the economy nears full employment, increases in employment make smaller contributions.

A key assumption underlying the average 2.2-percent growth rate is that labor productivity growth will average 1.4 percent a year. After 1992, assuming the Administration's pro-growth initiatives are adopted, underlying economic growth is expected to approach 3 percent and labor productivity growth is projected to be about 1.6 percent. That is very close to the average rate of productivity growth since 1959. It is below the 2.4-percent rate from 1959 to 1969, but above the average rate for the 1980s. This rise in labor productivity will be facilitated by the higher level of capital accumulation that results from lower real interest rates, lower Federal borrowing as a percent of GDP, and the productivity-enhancing components of the President's proposals.

SUMMARY

- The economy is expected to remain sluggish in early 1992, but a renewed pickup should occur by midyear. The prompt enactment of the President's proposals would boost the economy in the short run and promote higher growth in the long run.
- However, if the President's proposals are not adopted promptly and a "business-as-usual" environment prevails, growth in the economy will be lower in both the short and long run.
- In the long run, the President's proposals will promote higher private capital accumulation and faster productivity growth. The economy's underlying medium-term growth potential is expected to be about 3 percent a year. Inflation and nominal interest rates are projected to rise slightly in the short run, but then fall gradually thereafter.

CONCLUSION

Following a year and a half of slow growth, the Nation's economy entered a recession in the second half of 1990. In the late spring of 1991, the economy began to recover. However, the recovery lost momentum in mid-summer, and by the end of the year the economy was sluggish at best.

It is natural to point to the oil shock and the resulting decline in confidence as the reason the economy fell into recession. However, growth in the economy already had been slowed by a number of structural imbalances and the lagged effects of tight monetary policy in earlier years. The flat economy at the end of 1991 was evidence that the structural imbalances in the economy were larger and taking longer to work off than had been expected.

Growth is expected to remain sluggish in the early part of 1992. By midyear, however, the economy is expected to improve. The prompt enactment of the President's pro-growth proposals announced in the State of the Union address will spur economic recovery and promote long-term investment and growth, as well as improve the Nation's competitive position in global markets.

Over the longer term, the Omnibus Budget Reconciliation Act establishes discipline to lower the multiyear structural Federal deficit and therefore, Federal borrowing requirements. Combined with a monetary policy aimed at maintaining solid economic growth while gradually reducing the underlying inflation rate, both nominal and real interest rates are likely to remain relatively low. Credible monetary policy and growth-oriented fiscal policy will facilitate higher levels of capital accumulation, raise labor productivity and thereby real wages, and enhance the economy's growth potential.