For Release On Delivery
6:00 p.m. CDT (7:00 p.m. EDT)
October 15, 1992

# "Our Remarkably Resilient Economy"

by

Edward W. Kelley, Jr.

Member

Board of Governors of the Federal Reserve System

Before

Government Bond Club of Houston

Houston, Texas

October 15, 1992

All observers can quickly agree that the United States' economy is not as strong as we wish it were and is not behaving as we would like to see it. This has been going on for some time. The Gross Domestic Product has been in either a slow or negative growth mode since 1988, when we had 3.3% growth. Consumption expenditures are up only .8% in total from the peak second quarter of 1990 through the second quarter of 1992. Employment peaked in the second quarter of 1990 and has not regained that level. Depending on when one starts counting, there have been thousands of failures of financial institutions. By any standard, this has not been a good era and has not been what we want.

But wait a minute. How bad is it, really? Have we had our day and we are facing sunset in America? Some say we are in a state of irreversible decline and that we have become a flabby people who either cannot or will not work. Are we doomed to become the listless and uncompetitive wards of more productive states?

I think not. Given the events of the past five years or so, I believe that in many respects our economy had turned in a remarkable performance. It has demonstrated great resilience and an underlying vitality that is enormously impressive and holds out every possibility for an excellent future.

Let me hasten to say this is not a political statement. I am not here to either blame or praise this donkey or that elephant. A look at recent economic history offers an opportunity for some applause and abundant blame to be assigned to everybody. Certainly, many of the negative factors impacting the economy should not and need not have occurred; and, there is ample evidence of poor policy and overly partisan politics. But much that has happened occurred in other lands, beyond our control, and much of what holds us back today will have a positive impact in the future. These remarks are intended to focus on the economy itself and not on policy or politics.

Let's go through a quick review of what our economy has been through in the past half decade or so. Both internationally and domestically this has been an historically turbulent time.

Easily the most significant event has been the demise of the USSR. Without attempting to assess the full scope of this event, here is a quick list of the major economic impacts to date. First, the defense industry is a major part of our economy, and it has been undergoing a radical downsizing and a shift in composition that is a major economic drag. The end of the cold war opened the way for the major disruption in the Middle East and our brief war with Iraq. Overnight our economy was required to first buildup and then standdown a very significant war machine. Also, this episode caused a huge, if brief, oil shock that many economists feel was more economically significant than the war itself. Lastly, massive forces have been set in motion in Europe with the emergence of the former Iron Curtain countries which, while full of long term promise, have provided abundant short term problems. These disruptions, especially in Germany, have been major factors in the slowdown of the European economy which has adversely impacted our volume of exports, a major source of economic strength in recent years.

Domestically we have had an equally excruciating period. In my view the most important single development has been the deleveraging of America. Two years or so ago, our household and corporate sectors decided they had accumulated too much debt and reversed course. We stopped rapidly creating new debt, which had been stimulating economic growth through the 1980's, and began deleveraging by reducing our debt level, which has had the opposite effect of slowing economic activity. This process continues to have an enormous impact. Concurrently, and also of vital importance, we have been engaged in the process of corporate cost cutting and restructuring. The causes of this effort have been many and the long term effects will be very beneficial. However, in the short term there have been massive job loses, which has had a direct effect on employment and income and an equally important indirect effect on confidence.

Then there is the powerful real estate contraction. Construction is a large industry and a key cyclical swing factor. The current situation is the mother of all real estate downswings. Part of this contraction's impact has been it's effect on the value of homes, which are a crucial wealth component of the American family. Home values went up consistently for years and that process has now largely ceased, a fact which has become a major contributor to consumer reluctance to spend.

The collapse of the commercial real estate market was a major cause of the trauma in the banking system, which has undergone a terrific implosion as thousands of institutions and hundreds of billions of dollars of assets have been blown away. The many causes of this have been endlessly discussed and need not be repeated here. However, a healthy banking system is a key foundation block for any economy and (by historic standards) our's was crippled. This event, had it occurred in an earlier age, would have been sufficient by itself to cause a substantial economic crash.

One other. Government policies allowed our fiscal deficit and the national debt to explode through the boom years of the 1980's. The result has been that when a downturn came, deficit spending was not available to help out when needed. That policy option has been taken off the table, at least so far.

Have these not been tremendous shocks to our economy? What should one expect to be the result? Can you imagine these things having occurred without creating any serious slowdown? There was no chance of that. This has not been your typical garden variety cyclical recession. Far more than that has been going on. So where, in fact, is the economy today?

Shortly, we will have the data on third quarter Real Gross Domestic Product which almost certainly crossed over into new high ground in the period. If so, we are no longer in "recovery" but now must technically call this an "expansion". Employment is down only 1.5% from its peak in the second quarter of 1990. On a purchasing power parity basis our per capita Gross Domestic Product is the highest in the world. And our banking system, while battered, is in place serving our society and earning record profits. All of this is certainly not great economic performance, and a great deal of pain has been inflicted upon many people, but it is far from doomsday.

Nevertheless, you may argue that the situation is largely unnecessary, totally unsatisfactory, and intolerable. Granted. I agree. My point is that these things happened. They are historical fact and in the face of them our economy, in my view, is displaying an amazing resiliency, flexibility and underlying strength. I doubt that there has been another society in history, or is existent in today's world, that could have been through what we have been through and be performing as well as our economy is today.

How has monetary policy fit into this episode? Policy is formulated from a mix of many factors, but two concepts are at its heart. The first is our long term national economic goal, which is to create maximum sustainable economic growth over time. As an element of the national policy machinery, the Federal Reserve strives to support this goal. Second is the concept of what monetary policy can and cannot do. Most economists, probably not all, agree that monetary policy can affect real activity in the short run but cannot directly do so in the long run. In the long run, monetary policy affects the price level which does, of course, have a very important indirect effect on real economic activity.

These are the key components of policy development. Price level stability is a necessary precondition to sustainable long-term growth and the Fed is in a unique position, and has a unique responsibility, to foster stable prices. This is the main contribution it can make to the national economic goal and the members of the FOMC are determined to meet that responsibility. If the Fed fails in this, there is no other institutional way to hold inflation in check and thereby meet this precondition for long-term sustainable economic growth.

But policymakers also cannot be indifferent to the short-run consequences of their actions. Since June 1989, when it became apparent to the FOMC that the economy was weakening, the Fed has eased well over twenty times. Fed funds have fallen from just under 10% to around 3%, a drop of 70%. This has been in response to a weakening economy and an effort to keep policy supportive of economic activity.

Given, first, the set of economic conditions just described; second, the Fed's important but limited capabilities; and, third, the Fed's assigned mission in our structure of government, should a different monetary policy path have been followed? Those who have been focused on short-term employment growth say "yes" -- easing has been too little and too late. The financial markets, by creating an historically steep yield curve, suggest we have gone too far, too fast. It is impossible to reach a definitive resolution of what constitutes perfect policy and I would not claim that it has necessarily been perfect. I will say, however, that I am comfortable that the Fed has performed well and responsibly.

Consider a few quick points. Long-term interest rates are critically important and are set by the market, not by the Fed. They have been very sticky, in large part due to bond market skepticism as to the Fed's determination to hold the line on inflation. It could be counterproductive to ease short rates if that were to trigger market nervousness which forced long rates to rise. Second, monetary policy change impacts the economy with a lag, and then over a rather extended period of time. The frequent small easings have kept an important stimulus consistently in the economic pipeline, somewhat like an "IV" does for a patient following surgery. Third, many have remarked that the monetary aggregates M2 and M3 have grown very slowly. It is clear that the function of money in our economy has been changing, that this phenomenon is not fully understood, and its longer-term effect is an open question. However, it is also clear from other measures of money that there is plenty of liquidity available to support the economy now and, indeed, this degree of liquidity has been itself a source of concern for some. Last but not least, inflation is now falling steadily but its reemergence two or three years down the road must be prevented.

What does all this imply for the future? Certainly we have pressing national problems that must be addressed. The deficit. A decaying infrastructure. Health care. The education system. Job creation. However, consider the emerging strengths. Capitalism has triumphed over Communism and the cold war is over. Incalculable positive results will flow from this momentous event. Domestically our economy is adding muscle materially day-by-day. Our balance sheets are strengthening, our productivity and competitiveness are improving, our financial system is regaining it's health and, inflation is coming under control.

Are all things exactly as we would like them to be? No. Are we in a long-term decline? No, and it is not necessary that we fall into one. Are we in depression? No, far from it. Are we displaying some basic strengths? Yes, remarkable strengths. Is there good reason to feel positive about the future? You bet!