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Comments on the Current Economic Recovery

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In my remarks this evening I would like to discuss the current national economic situation and the longer-run prospects for the economy. Of course, having posed such a topic, the first question that many would ask is: when will this economy really recover? The short answer is that the economy already is in the early stages of a recovery. I feel as though we have been in those early stages for quite a long time. Some parts of the country are further along in the recovery process than others. But the pace of aggregate national growth is quite sluggish by historical cyclical standards, and questions remain about the sustainability of the current recovery.

Background — Recession and the Current Recovery

Before discussing the outlook in greater detail, however, let me first put this recession and recovery into perspective. As you recall, real gross domestic product—the broadest measure of the nation's output and income—fell sharply in the latter part of 1990 and early 1991 following the Iraqi invasion of Kuwait. But seen in a broader context, that two-quarter contraction of activity was only part of a longer period of sluggish economic performance, extending back three years. Even after excluding the brief downturn related to the Gulf War, the economy has only been growing at an annual rate of a little less than 1–1/2 percent since early 1989. Although this is a positive number, it is well below the pace needed to raise general standards of living.

Measured from the trough in real GDP, this has been the slowest recovery in half a century. The recovery seemed to be on track immediately after the end of the Gulf War, but it faltered in the second half of last year. Activity began to pick up early this year, and real GDP is now estimated by the Commerce

Department to have rebounded at a 2.4 percent annual rate in the first quarter—a healthy increase, but still rather modest for the early phase of an economic recovery.

The economic tea leaves so far in the second quarter seem to be consistent with continued—albeit moderate—growth of activity. Production around the turn of the year had been held down, in part, as businesses attempted to shed excess inventories. However, considerable progress was made in paring stocks early this year. With inventories in better shape, the stage is now set for further gains in aggregate demand to be reflected relatively quickly in higher production. In fact, industrial production rose half a percent in February and continued to advance at about that pace in March and April. With these gains, the cumulative rise in production between February and April retraced nearly all of the decline that occurred between last October and January.

The data on the labor market for the month of May published last week are mixed—good and bad news. In particular, as has been widely reported in the press, the unemployment rate jumped from 7.2 percent in April to 7.5 percent in May. This is its highest level in nearly eight years. A significant part of the increase reflected a rise in the number of young people (aged 16 to 24) entering the labor force to find work at the beginning of the summer. At the same time, however, the number of workers on nonfarm payrolls advanced another 68,000 in May, continuing the expansion of employment that resumed in February. In addition, work schedules lengthened and overtime hours increased in a number of industries. Thus, seen from the demand side of the labor market—that is, employment and hours—it appears that income and economic activity have continued to expand at a moderate pace.

Let me now turn from employment and production to indicators of aggregate demand, starting with housing. As you know, this is a bellwether sector of the business cycle. Encouraged by declines in mortgage interest rates, households boosted their purchases of homes around the turn of the year. Sales of new and existing homes picked up in the fourth quarter of last year and increased further in the first quarter. The data on sales and new construction in April were somewhat disappointing, but the fundamentals—such as mortgage rates and real incomes—point to further solid gains in activity in this sector. Moreover, favorable spillover from the strengthening of new construction that now is under way—if sustained—should affect a much broader circle of industries in coming months. We are already beginning to see improvement in housing related industries.

Recent data on consumer spending also have had their ups and downs from month to month. Personal consumption expenditures rose smartly in the first quarter and edged up further in April. The retail sales figures that were released this morning showed no improvement in May. However, sales of domestically produced autos and light trucks, which had been on a respectably high plateau advanced further last month. Looking ahead, real incomes and consumer confidence have been rising, which suggests the likelihood of a revival of the uptrend in household spending sometime soon.

Business spending for new equipment remains somewhat lackluster, perhaps reflecting an abundance of caution in the business sector. But a modest recovery in coming months may be in train. New orders for nondefense capital goods have traced an uneven, but generally upward, path since reaching their trough early last year. For computers, new orders have been rising, on balance, in recent months. With prices continuing to fall, demand is likely to expand further. For aircraft, by contrast, the outlook is relatively weak. In short, business investment is an area which bears watching in coming months to see whether recovery is sustained.

Imbalances and Strains of the 1980s

With this background on the recent recession and recovery, let me now turn from the numbers to a more fundamental question about our nation's economic condition. Why has this recovery been so sluggish, and, looking forward, why might the climb back continue to be slower than other recoveries? A key part of the answer, in my opinion, is that growth has been retarded in recent years because the economy has been struggling to correct a number of critical imbalances and work through some longer-term strains in particular sectors of the economy.

Perhaps the most visible of these imbalances are the vacant office buildings that dot the landscape of our metropolitan areas. The overbuilding of commercial structures in the 1980s has come to have strikingly negative effects on the economy. In many areas of the country, floor space for offices and other commercial activities was created at a pace far more rapid than could be justified by normal absorption rates or even by reasonable considerations of long-run profitability. The end result was a huge overhang of vacant space, a plunge in new construction, and steep markdowns in the values of existing properties.

With the fall in the value of commercial real estate, the loans that helped to fuel the construction boom also lost value. Many lenders saw profits plummet and their capital shrink, causing them to become more cautious in providing credit. This reluctance to lend has been especially evident among banks and life insurance companies and has contributed, in turn, to the sluggish pace of economic activity.

Just as commercial construction was the area of perhaps the greatest imbalance coming into the 1990s, it also is the area where a turnabout may take longest. In many locales, the construction work-in-process was begun some time ago, and with few new projects entering the pipeline, spending and employment in this sector probably will continue to fall in coming quarters. However, as activity nears a cyclical trough, the drag of this sector on overall growth of the economy should begin to diminish.

The recovery also is being restrained at the moment by fiscal imbalances at all levels of government. At the federal level, attempts to correct a major budgetary imbalance have dominated the political debate for a number of years, with mixed results. Some successes have been made in limiting spending and in shifting fiscal policy more toward underlying restraint. Nevertheless, the deficit remains very large; and it appears that the federal budgetary imbalance is going to be with us for some time to come. We will have to see what, if anything, comes of the current round of balanced-budget initiatives. Even if a constitutional amendment is passed, efforts to correct the fiscal imbalance are bound to have at least a mildly restraining effect on the economy. Nevertheless, if carefully administered, the long-term effect of moving forward with corrective actions can only be favorable.

The aggregate budgetary statistics for state and local governments tell a story similar in some ways to that of the federal government. Spending rose rapidly for a number of years as states were forced to take on many of the programs formerly funded at the federal level. State tax receipts did not keep pace. As a result, the combined state and local budget deficit, net of social insurance funds, shifted from a slight positive in 1986 to a sizable negative in 1990. Faced with rising deficits, a number of states and localities have raised taxes, but the more common reaction has been to restrain spending. Total real purchases of goods and services by state and local governments were essentially flat in 1991, after seven years of relatively strong increases. State and local officials have had to face many painful budgetary choices. Cutbacks in some budget categories have been necessary to make way for increased spending for high-priority categories or for federally mandated programs.

The rapid buildup of debt in the 1980s was not confined to the public sector. In the business sector, the 1980s brought merger mania and a wave of corporate buyouts that often entailed the substitution of debt for equity. The debt of nonfinancial corporations rose much faster than GDP in the 1980s, and corporate interest expenses increased sharply relative to cash flow. As firms became more heavily leveraged, their credit ratings deteriorated. By 1990, when the economy had weakened, the number of downgradings far exceeded the number of upgradings.

Turning to the household sector, purchases of motor vehicles and other durables were at high levels for an extended period in the last decade. To finance those purchases, households turned heavily toward borrowing. Growth of the financial liabilities of the household sector averaged about 12 percent per year from the end of 1982 through 1988. Because this rate considerably exceeded the growth of personal income, many households found it necessary to stretch out loan repayment schedules, thereby committing more of their future income to the repayment of debt. That strategy worked well as long as income growth was maintained. But when income growth slowed in 1989, the squeeze was on, and a period of belt-tightening has ensued. At the same time, changes in the tax code led to the phase-out of some interest rate deductions and further inhibited spending for big-ticket items. Households began to reduce their purchases of consumer durables in 1989, and they trimmed those outlays further in the next two years. Other types of spending have similarly been scaled back.

As I mentioned earlier, consumer spending has picked up recently and surveys of consumer attitudes show a pronounced improvement in confidence in recent months. Nonetheless, the levels of most confidence indexes are still low by historical standards. This apprehension about business conditions and about personal finances is another factor that has been, and likely will continue to be, a damping influence on the pace of economic recovery. I suspect that consumers have nagging worries about our nation's long-run economic prospects and whether the current and future generations will live as well as the previous ones. Even workers in professions once thought to be immune to economic hard times, such as accountants and middle management, find themselves facing the reality, or the potential, of job loss or what has become known as "downward mobility." The problems of structural change and adaptation are perhaps most severe in defense-related industries. But firms in a wide variety of nondefense industries, including banking, are also refocusing corporate activities and eliminating inefficient operations to be competitive in today's market. Adding to the uncertainty are a lack of confidence in the ability of governments to deal with their budget deficits, racial tensions and problems in urban areas, and the disintegration of nations around the world into warring ethnic factions. These anxieties may well continue to be manifested in lower consumption and borrowing levels, thereby damping the pace of economic recovery somewhat.

The financial sector also experienced significant strains in the decade of the 1980s. The "S&L crisis" is well known, and we are still working through its resolution. The banking sector also has been strained by having to work through or write off nonperforming loans in agriculture, energy, commercial real estate, and to less developed countries. Higher interest rates, narrow margins, and limitations on product line opportunities may also have put pressure on bank profit margins. Moreover, efforts to address problem loans and strengthened capital standards have made it difficult for many banks to maintain or expand their lending activities.

Corrections Underway in the 1990s

Fortunately, adjustments are underway that should correct many of the imbalances and drags on our economy, setting the stage for sustained growth as we move further into the 1990s. In particular, the balance sheet and operating restructurings taking place at all levels—households, businesses, and governments—should lead to reduced financial vulnerability and improved efficiency. In the household sector, for example, the buildup of financial liabilities slowed sharply last year to a 4 percent increase — half the rate just two years earlier and less than a third the pace in the mid-1980s. The volume of consumer installment credit outstanding actually declined in 1991 for the first time since 1958. Households also have been actively taking advantage of the low-interest rate environment to reduce personal debt by paying off high-rate consumer credit and refinancing mortgages. With the growth of household credit slowing and interest rates down, the share of personal income needed to service debt has begun to tilt back down, after many years of steady increase. These financial adjustments are gradually putting households in a better position to spend and eventually to contribute an important lift to the general economy. Continued expansion of payroll employment is key, of course, to continued consumer spending.

Parallel efforts have been underway to restructure corporate balance sheets. Aided by a strong stock market, issuance of equity by nonfinancial corporations outstripped equity retirements in 1991 for the first time since 1983, and the pace of gross equity issuance so far this year has been at a record level. The growth of business debt has almost come to a halt. The mix of debt also took a significant shift toward the long end of the maturity spectrum, as corporations took advantage of declines in long-term interest rates. Indeed, the ratio of short-term debt (bank loans, commercial paper, finance company loans, and so forth) to long-term debt now is about where it was in 1980. With the decreases in interest rates and the diminished use of debt, the debt-servicing burden of nonfinancial corporations has begun to ease.

The financial sector is also showing signs of improvement. Bank profits and capital levels are strengthening. The rate of bank failures has slowed and loan portfolios appear to have stabilized. The so-called "credit crunch" may be starting to ease, as lenders appear to be more willing to make at least some kinds of loans, a posture that can be supported by the banking system's better access to capital and funding markets. Although not yet a closed chapter, the discussions of the S&L resolution now seem to focus on finishing and winding down the process. With lower interest rates, a strong secondary stock market, and an improving banking industry, the financial sector now seems better positioned to finance a budding recovery.

Restructuring is affecting not only the financial side of business activities, but also the operating side. Manufacturers achieved strong gains in productivity over the course of the 1980s, and their international competitiveness improved markedly. Recently the emphasis on achieving greater efficiency seems to have spread to areas well beyond the production line to the service sector and to businesses outside manufacturing. Many corporations are reassessing the manner in which they have their businesses organized and are undertaking fundamental restructurings aimed at boosting productivity and enhancing their ability to react promptly to demand shifts. Although these efforts may keep near-term employment gains small, they also will tend to lower production costs, enhance competitiveness, and raise our real standard of living over the long haul.

The efficiency gains and related cost reductions that manufacturers achieved over the last decade have resulted in sustained increases in exports. For a number of years now, serious questions have been raised about the ability of the United States to compete internationally. But the facts simply don't support the contention that the U.S. is not competing in the global economy. In the six-year period from 1985 to 1991, our real exports of goods and services rose about 75 percent, and we made substantial progress toward closing the trade deficit. Prospects for further increases in coming years depend, in part, on the economic situation of our major trading partners. Growth in many of the industrial economies has been sluggish over the past year, but is likely to recover in the period ahead. At the same time, activity in Latin America and the newly industrializing economies of Asia remains relatively strong. On balance, the export situation does seem to be much more encouraging than some of the recent rhetoric would imply.

A list of factors affecting the longer-run sustainability of economic growth would not be complete without reference to inflation. [**Note**—CPI data to be released 6/12/92.] The pickup in inflationary pressures that began to emerge in the latter part of the 1980s has been reversed. I know that some commentators view this morning's reported jump in the producer price index as a sign that inflation in beginning to re-accelerate. However, with nominal wage increases gradually easing, I think the odds of seeing a further gradual reduction in the core rate of inflation are quite favorable. Let me cite a few numbers. Over the twelve months ending in April, the overall consumer price index rose 3–1/4 percent, down from a 5 percent increase during the preceding twelve-month period.

Granted, some of the slowing reflects lower oil prices . But even excluding the volatile energy and food categories, price increases have slowed from 5 percent last year to slightly less than 4 percent this year.

As an aside, although attention always seems to focus on the CPI, and the CPI excluding energy and food certainly is a key measure of the core rate of inflation, it may not necessarily be the only rate we should be following to assess underlying price pressures. Even changes in the "core" CPI reflect more than "pure" price changes. For example, many economists feel that quality improvements in the basket of goods and services purchased by consumers are not adequately captured in the CPI. Indeed, some have argued that the inadequacies of the quality adjustments could account for as much as 2 percentage points in the annual rate of CPI inflation. Looking at a variety of indicators may help to get a better feel for the deceleration of inflationary pressures—for example, GDP price indexes, producer prices at all stages of processing, or labor cost measures. However one measures it, as we move closer to a stable price environment, we are likely to see an active debate concerning the appropriate statistical measure of prices for guiding economic policy.

Back to the subject at hand—at this juncture, having given a fair bit of attention to the favorable trends I see emerging, I should perhaps inject a cautionary note. Certainly, I do not want to sound more optimistic than a full assessment of the facts would warrant. There still are significant areas of weakness in the economy—commercial real estate, the defense industry, continued unemployment, and government budget deficits. Long-term interest rates have remained high relative to shorter rates, which is probably inhibiting investment somewhat. Moreover, it may be some time before households and businesses are fully satisfied with their financial structures. This balance sheet restructuring or deleveraging may go on for a while, serving to damp the pace of recovery.

Conclusion

In summary, no one can forecast with confidence exactly when the positives in the outlook will completely outweigh the remaining negatives. The risk of a temporary setback can never be fully discounted. But, that said, there are clearly reasons to be encouraged about both the longer-run and near-term prospects for the economy. Stronger balance sheets, improved industrial production and productivity, a stronger trend in exports, a strengthening financial sector, and lower inflation all auger well for the longer-run performance. And, despite the remaining uncertainties, I expect the economic data increasingly to shift in a more favorable direction as the year progresses.

Thank you for your kind attention.