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Structural Shifts in the U.S. Economy in an International Setting

Remarks by

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In my remarks today, I would like to review with you certain aspects of the current U.S. economic situation and assess that situation in the context of recent international developments. Throughout this discussion, I believe that a number of longer-term structural changes that are affecting both the United States and some foreign countries will become evident as dominant influences on our respective economies.

In any economic analysis, we must remember that the United States is an open economy operating in a highly interdependent world. Moreover, we are not alone among industrial countries in having to cope with slower growth and weaker labor-market conditions. To varying extents our main trading partners also are facing similar problems. Several major foreign industrial countries -- notably the United Kingdom, some Scandinavian countries, and Canada -- have experienced persistent recessions and delayed recoveries. Even in Japan and Germany, growth has slowed markedly during 1992 Both of those countries had been reliable sources of strength. As a result of the widespread deceleration of economic activity, almost all the major industrial countries -- including the United States -- now find themselves below potential output. Many have historically high rates of unemployment Of course, in an open economy such as ours, slower growth by our trading partners translates into less foreign demand for U.S. products and makes a healthy U.S. recovery all the more difficult to attain -- and vice-versa. Accordingly, it is worth examining the contours of the current global slowdown, both to see what lessons it may hold for recent U.S. performance and to assess the prospects for return to more sustainable rates of growth in the industrial world.

Imbalances and Strains of the 1980s

During the past two years, growth of real economic output in the major foreign industrial countries has slipped from about 2-1/2 percent in 1990 to nearly half that rate this year This is more than 1-1/2 percentage points below the average real growth rate of nearly 3 percent recorded in the 1980s. To a considerable extent, slower growth abroad -- and also in the United States -- reflects a struggle to correct a number of critical imbalances and longer-term strains that had developed during the high-growth 1980s. Rapid expansion (and expectations of further growth in the 1990s), fueled by easy credit and -- in some instances by the transition to deregulated financial systems -- led to large-scale spending, especially on real property, and a build-up of private-sector debt. In some countries, substantial increases in real estate prices, equity values, and credit growth were mutually reinforcing as asset-price inflation provided collateral for additional lending. Some of our industrial trading partners -- Japan, the United Kingdom, and the Nordic countries, in particular -- experienced large increases in both household and corporate debt. In some instances, the private debt situation was compounded by expansionary government spending that engendered large public-sector deficits as well.

Once the bubble of asset-price inflation came to a halt or reversed, it became clear that such imbalances were unsustainable. In many cases a shift to tighter macroeconomic policy stances -- intended to counter asset-price inflation -- contributed to the downturn. Authorities in many countries introduced ambitious programs of tax reform and fiscal consolidation. In France, Japan, and the United Kingdom, levels of outstanding debt, expressed as a share of GDP, were reduced substantially, and the latter two countries even ran overall budget surpluses in some recent years. Other countries with large outstanding public debt, such as Canada, Sweden, and Italy, have made less progress but appear committed to debt reduction.

As part of the shift to more restrained policies, authorities also moved to tighten monetary conditions. Tighter macroeconomic policy, of course, contributed to slower activity, but it also has yielded some progress in reducing the debt overhang and inflation. In Japan, the United Kingdom, and the Nordic countries, for example, outstanding consumer credit has declined or grown sluggishly, while mortgage growth has tailed off. The reluctance of households to take on new credit probably has restrained the pace of recovery, however. Consumer confidence has been slow to revive, and the adjustment process has been more protracted than had been expected.

Private corporations in the major foreign industrial countries have exhibited diverse experiences with regard to debt reduction. In some countries, the debt and equity capital markets are not deep enough to accommodate direct financing or restructuring easily. In the United Kingdom, for example, firms have been able to raise capital through new equity issues, whereas in Japan equity financing has been limited because of the steep fall in Japanese stock prices. Moreover, the corporate bond market is not well developed in Japan.

More generally, the termination of asset-price booms also resulted in many borrowers being unable to service existing debts, with a resulting increase in bankruptcies. This, in turn, led bank profits to fall sharply. Capital positions of at least some banks deteriorated, and bank credit growth slowed -- in some cases dramatically. Despite some problems, there does not appear to be a threat of significant financial system failure in any of the major industrial countries. Authorities have responded promptly and contained the risk posed by one or more troubled institutions. However, rescues to date of damaged financial institutions by governments abroad have been costly, and there may be additional future burdens for foreign taxpayers before financial sectors are restored to soundness. In Japan, for example, a program for assisting troubled banks is being developed under the auspices of the government that ultimately may be quite expensive.

The very special developments in the German economy also have played a key role in shaping recent macroeconomic developments in Europe. As German policymakers have confronted the challenge of reunification and transforming the former East

German economy to a market-based system, German policy has had a sharply different thrust from policy in its European partners. Expenditure related to unification on balance has been a positive element in German growth and, of course, will provide important longer-run benefits to Germany and the global economy. Nevertheless, the transformation has been slower than had been expected, and there have been spillover effects to other trading partners. Increased German expenditure related to unification has been largely debt financed. This, in turn, has raised persistent fears of rekindling inflation in Germany at a time when other countries generally are facing a deflationary environment. Increased official borrowing to finance German unification and the resulting deterioration of Germany's current account position have added upward pressure on long-term interest rates in international financial markets. Notwithstanding some easing of German interest rates in recent weeks, the combination of tight monetary policy and expansionary fiscal policy in Germany has posed problems for Germany's partner countries -- especially its partners that are linked through the EMS fixed exchange rate system.

In short, budget deficits, balance sheet problems associated with the debt build-up, and excess capacity -- as well as negative spillover effects for some European countries from tight monetary policy in Germany -- have been common factors in slowing economic activity in our industrial-country trading partners. Although adjustments now appear to be underway, they are not yet complete. Reductions in trade associated with disruptions in Eastern Europe and the breakup of the former Soviet Union also have contributed additional downside risk to the near-term outlook for some countries. Accordingly, growth prospects for the major foreign industrial countries have been lowered, and it still may be some time before output in our key trading partners revives to corresponding levels of potential growth.

Recent U.S. Performance and Outlook

With this background on some of our major trading partners, I would like to turn now to the U.S. situation. The current recovery basically seems to be a story of fits and starts around a slow growth trend. As you know, the Commerce Department estimates that the U.S. economy grew at a 2.7 percent annual rate in the third quarter. But this stronger performance follows considerably slower growth, on average, during the first five quarters of the recovery. Indeed, this has been the slowest economic recovery of the post-World War II era, with average growth of output well below the pace needed to generate substantial decreases in unemployment and acceptable gains in general standards of living.

Many of the factors that have contributed to slow growth abroad have been evident in recent U.S. economic performance. Much like the situation in the foreign industrial countries, growth here has been held back by the need to correct critical strains that developed during the 1980s. This has been reflected particularly in fiscal imbalances, a build-up of private debt, overbuilding of commercial real estate, and financial-sector stresses. However, there has been substantial recent progress on structural adjustment in several areas. The so-called "headwinds" associated with sectoral imbalances and financial stresses against which the U.S. recovery has been pressing appear to have slackened somewhat and are expected to diminish further over time.

A key element in the U.S. outlook is the steady decline in dollar interest rates that started somewhat earlier and has proceeded considerably further than in our industrial-country partners. During the past three years, U.S. short-term interest rates have fallen almost 7 percentage points to approximately 3 percent, while mortgage rates -- although up a bit in recent days -- have eased to around 8 percent, their lowest level in a number of years.

Balance-sheet adjustment has been occurring in the household sector. The buildup of household financial liabilities slowed sharply last year. Households also have been taking advantage of the present low interest rate environment to reduce personal debt by paying off high-rate consumer credit and refinancing mortgages. These financial adjustments gradually are putting households in a better position to spend and to contribute an important lift to the general economy.

Economic data for the third quarter are still coming in, and the effects of the recent hurricanes will make interpretation of the numbers unusually difficult. However, we can make a few observations. In the housing sector, falling mortgage interest rates have provided a mild boost recently to activity, although not as much of a boost as in recent recoveries. Likewise, the recovery in consumer spending has fallen short of previous cyclical norms, despite strong gains earlier this summer. Households still appear to be in the process of shoring up balance sheets, which may be affecting both housing and spending on consumer durables.

In the business sector, efforts also have been underway to restructure corporate balance sheets in the United States Aided by a reasonably 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. At the same time, growth of business debt has slowed. The mix of debt also has shifted significantly toward the long end of the maturity spectrum, as corporations have taken advantage of declines in long-term interest rates. Mature U.S. markets provide opportunities for direct corporate access to debt and equity capital to accommodate new issues, refinancing, or restructuring,

Restructuring is affecting not only the financial side of business activities, but also the operating side. U.S. manufacturers achieved strong gains in productivity over the course of the 1980s, and their international competitiveness improved markedly. The overhang of excess investment in commercial property is still with us and probably will be a negative factor in the U.S. outlook for some time. But lower interest rates and the restructuring process have stimulated business equipment spending. Strengthening of private investment demand during the first three quarters of the year primarily reflected continued increases in outlays for computing equipment. In general, corporate profits and business cash flow have continued to rise, and the business sector appears to be in position for future expansion.

The financial sector is showing signs of improvement as well. 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. Although not yet a closed chapter, the discussions of the S&L resolution now seem to be focused on finishing and winding down the process. With lower interest rates, a relatively strong secondary stock market, and an improving banking industry, the financial sector now seems better positioned to finance a budding recovery.

In the public sector, progress on reducing fiscal imbalances has been mixed at best. While there has been some success in limiting spending and shifting the thrust of fiscal policy at the federal level, the deficit remains very large. It appears that the federal budget imbalance will be with us for some time to come. Aggregate budgetary statistics for state and local governments tell a similar story. As spending rose in the

1980s, state tax receipts did not keep pace; budget positions have been undermined further by the effects of the recent economic slowdown. Some states and localities have raised taxes, but spending also has had to be restrained. It appears that budget restructuring at the state and local level likely will continue over the near term.

The structural adjustment process -- both in this country and abroad -- has produced significant progress on inflation. The pickup in inflationary pressures that began to emerge in the latter part of the 1980s has been reversed. In this country, over the twelve months ending in September the overall consumer price index rose only 3 percent. Similar declines in inflation have been recorded in the foreign industrial countries.

The United States in the World Economy

The adjustment process in the United States still is not yet complete in some areas, and the uneven sluggish performance of U.S. activity and employment is worrisome. In addition, lagging recovery abroad has made some people question the prospects for U.S. external trade. I believe that such worries are not well-founded. Recent strong U.S. productivity gains and continued low U.S. inflation should ensure that U.S. products are competitive, and thus net exports are not a drag on growth. In fact, recovery of U.S. domestic demand may assist our foreign industrial partners in achieving healthier performances, which is good for the United States in the long run.

The prospect of somewhat different timing of recoveries in this country and abroad raises issues related to cooperation among the major industrial countries. The economies of United States and other industrial countries have become increasingly linked to one another. Closer integration means that economic disturbances that arise outside the United States are transmitted rapidly to the U.S. economy through open financial markets and extensive trading relations. Moreover, there may be differences in emphasis and priorities among countries in reacting to new developments. A good illustration of difficulties that can arise when closely linked economies and economic policies are regarded as "out of sync" is the recent turmoil in European foreign exchange markets. Market participants seemed to perceive the need to make individual countries' policies conform more closely in pursuit of European unification.

Clearly, successful implementation of policies among the major industrial countries that are broadly consistent and compatible has become more challenging and more critical. Foreign economic shocks (including policy responses) have to be taken into account carefully in determining our own policy settings. In addition, U.S. policy cannot be conducted without regard to its effects on our partners, especially since the United States remains the dominant international economic power. Fortunately, the major industrial countries have subscribed to a similar broad objective of achieving sustainable, non-inflationary growth. In fact, this goal is a key element of the so-called consensus "medium-term strategy" that has become a building block of cooperation among the major industrial countries in recent years.

Despite occasional problems, such as the recent disruptions in European foreign currency markets, the process of coordination has worked reasonably well. Although there are uncertainties at present about the pace and nature of European unification, the basic direction of a Europe moving toward reducing economic barriers and promoting growth seems firm. The prospects of a single European market sparked vigorous investment and growth during the 1980s and still holds promise of increased opportunities for all firms operating in Europe, including U.S. firms. A stronger, more dynamic European economy, of course, is likely to be a longer-run source of strong demand for U.S. exports.

The international economic environment contains several other bright spots for the longer run. Developing countries -- including especially fast-growing markets in East Asia and Latin America -- have been a particular source of strength during our recession and recovery and have kept U.S. economic activity from falling to even more disappointing levels. The Mexican economy in particular has been growing vigorously. As a result, U.S. exports to Mexico have grown at double-digit rates in each of the past two years. Mexico is now our third largest export market, only slightly behind Japan. While expansion of our exports may not sustain their recent rapid pace, the Mexican market is likely to continue to expand and be an increasingly important destination for U.S. products. Our exports to Venezuela, Argentina, and Brazil have grown strongly over the past year, as well. Recovery of export markets in these countries reflects successful and dramatic macroeconomic policy adjustments and structural reforms -- especially in Mexico. We are hopeful that these advances will prove lasting and over time will encompass other countries in the western hemisphere as well.

In another important development affecting economic relationships with our neighbors, U.S. officials recently have completed negotiations on a North American Free Trade Agreement with U.S. counterparts from Mexico and Canada. If the treaty is approved, it should create new opportunities for U.S. firms and should promote further trade among the North American economies In the future, other U.S. trading partners in this hemisphere may also choose to join similar mutual arrangements to lower trade barriers. A successful conclusion to the Uruguay Round of global trade negotiations also would be of great benefit. Simply put, for the long run, the U.S. economy and other countries all benefit from expanding trade and more efficient use of economic resources.

On another front, events in Eastern Europe and in the countries of the former Soviet Union have set in motion even greater economic and political changes in that part of the world. There are great uncertainties and considerable difficulties associated with the effort to transform these countries into market-based economies, and there are no guarantees of success. These countries have great undeveloped natural resources and potential for human resource development. But much remains to be done for these countries to develop into industrial economies and for the people to be reoriented to a radically different incentive structure. They are likely to require substantial financing and technical assistance from the industrial countries during the process of change. However, the potential rewards of success are great Prosperous market economies in this part of the world are a potentially important additional source of demand for U.S. goods, services, and expertise. Moreover, improved standards of living will help to stabilize the democratic political processes now struggling to get established. Such an outcome would permit us to continue to redirect resources formerly used for defense to investment in new industries that will strengthen economic growth here and improve our competitiveness in world markets.

Conclusion

In summary, no one can forecast with confidence exactly when the positive factors in the outlook will completely outweigh the remaining negatives. Moreover, for different countries, this changeover may take place at different times and rates. For the United States, undeniably there still are areas of weakness in the economy -- commercial real estate, a shrinking defense industry, public-sector deficits, and continued unemployment. In addition, long-term interest rates have remained high relative to short-term rates and probably are inhibiting investment somewhat. Despite considerable progress on balance-sheet restructuring, it is uncertain how much further such restructuring has to proceed. Nevertheless, there are reasons to be encouraged about the long-run prospects for the U.S. economy. We have come through a difficult period and have made substantial progress on adjustment in some key areas In fact, the U.S. economy appears to be recovering somewhat more rapidly at present than many of its main trading partners in the industrial world that have experienced similar problems Healthier private-sector balance sheets, improved productivity, stronger corporate profits and cash flows, a strengthened financial sector, well developed capital markets, lower inflation, and a dynamic world economy all point to a positive longer-run outlook for the United States. Despite the remaining uncertainties, I expect the economic data increasingly to shift in a more favorable direction for our country as we move further into the decade of the 1990s.