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Remarks of

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I'm very pleased to have the opportunity to speak at this year's Economic Education Winter Institute. I'd especially like to commend the organizers of this session for their efforts to bring economics closer to students and the community. The study of economics is something that many people avoid, perhaps due to its reputation as the "dismal science." However, like it or not, economics is a part of our daily lives. Individuals, households, businesses, and governments all make economic choices every day, within the constraints of available resources. Initiatives to improve economic education such as this Institute help ensure that our economic choices will be informed--more rational and intelligent than they otherwise would be.

My task today, as I perceive it, is to provide a broad overview of recent developments in the U.S. economy. I hope this analysis will provide a basis to assess U.S. economic prospects for the remainder of this decade and on into the next century. I hope also to identify some areas where improvement is needed to ensure sustainable economic growth and improved standards of living.

As most of you probably know, performance of the economy has improved considerably in the past couple of years. Output has been growing rapidly. Job opportunities are increasing. Unemployment is at a low level. Factories are humming. Surveys indicate that consumers feel confident about the outlook. Businesses apparently also feel confident, judging from their increases in capital spending recently.

Not so long ago, prospects seemed less hopeful. The economy came into the decade of the 1990s with a number of serious imbalances that had built up during the 1980s. A recession developed in the summer of 1990 and was made worse by repercussions from oil price increases after the Iraqi invasion of Kuwait. Although the recession officially came to an end early in 1991, the economy then had trouble generating a normal recovery.

The transition from the sluggish conditions of the early 1990s to the current strong economy is to some extent a working out of fairly normal business cycle forces. But no two business cycles are alike. The extended period of slow growth that we experienced earlier in the decade was, in part, a reflection of developments that either were unique to the most recent business cycle, or, in some ways, were more severe than similar forces had been in the past. I'd like to spend a few minutes reviewing those developments, in order to give you a flavor of how the business cycle has been unfolding over the past few years.

Recent Cyclical Developments in the Economy

One of the factors that kept the economy sluggish earlier in the decade was an unusually severe contraction in certain parts of the construction business. A boom in nonresidential construction activity in the middle part of the 1980s, encouraged by tax incentives, led to overbuilding of various types of structures, including multifamily housing, office buildings, and other commercial structures.

By the end of the last decade, vacancy rates had moved up. Market conditions for commercial properties were deteriorating. New construction was plummeting. Multifamily housing fell to the lowest levels on record by late 1992 and early 1993. Construction of office space plunged by two-thirds from the mid-1980s to 1993. Industrial construction and other commercial construction also contracted.

More recently, conditions have been improving in these markets. Multifamily housing bottomed out in early 1993 at a very low level, but since has turned up sharply. Construction of new industrial space also is rising. Even the construction of new office space has picked up, in response to declining vacancy rates and firming market conditions.

Another special factor that slowed the economy earlier in the 1990s was the unusual restraint that developed in the credit markets. This so-called "credit crunch" occurred even as the Federal Reserve was shifting toward ease in an effort to shore up the economy. Reacting in part to what was happening in construction and commercial real estate markets, lenders became much more conservative in the late 1980s and early 1990s. Loans for some purposes became extremely difficult to obtain. Growth of the credit supplied by depository institutions turned down for a time, and growth of total nonfinancial debt became quite sluggish.

But in the past two years, conditions in the credit markets have taken an expansionary turn. Lenders have once again become more aggressive in searching out loan opportunities, and the terms of lending have become more liberal. Outside financing has become more readily available even for those activities--such as site development--where lender restrictions on the supply of credit previously had appeared to be the most stringent. Depository institutions have become more willing lenders of late: Bank lending actually increased fairly sharply in 1994. Indeed, so marked has the turnabout been from the situation of a few years ago that it seems as though yesterday's "headwinds" in the credit markets now have become "tailwinds," helping to propel the economy forward.

A third factor that began to come into play in 1991 and 1992 was a sharp contraction of the defense industry.

In real terms, federal outlays for defense started to plummet after the end of the Gulf War, and they have remained on a sharp downward trend ever since. Many communities that depended on defense-related industries have gone through hard times since these cutbacks began. Many workers in defense-related industries have had to seek employment elsewhere. Indications are, however, that defense downsizing may be about at its end, and the drag on the economy from this source should be diminishing in the not-too-distant future.

A fourth development that helped to slow the economy earlier in the 1990s was the restructuring of the corporate sector. Many large corporations underwent major reorganizations, and frequently, the reorganizations entailed sizable layoffs of both workers and supervisors. However, the frequency of these restructurings seems to have diminished a bit as the economy has improved. Moreover, in contrast to fears that were voiced a few years ago, the restructurings do not seem to have left us with an army of unemployable workers. New jobs have become available, although, to be sure, they may not be as good in many cases as the jobs that were lost.

Even households and businesses that were not directly affected by the downturn in construction, the defense cutbacks, or the corporate restructurings became more cautious in the early part of the 1990s. Households had borrowed heavily in the 1980s, and many felt overextended toward the end of that decade, especially as employment prospects became less certain. Households thus retrenched for a time, holding down their purchases of homes and consumer durables. They slowed sharply the buildup of their financial liabilities, making adjustments to their consumer debt positions and refinancing their home mortgages.

Once this restructuring of balance sheets had run its course, spending was ready to rebound. Undoubtedly, there was considerable pent-up demand from delayed purchases. Over the past two or three years, households have been investing heavily in motor vehicles, and their purchases of other household durables have been climbing. From all accounts, investments by households in computers and new communications technologies have been soaring, with no end in sight. Attractiveness of these investments has been enhanced by declining prices and rapid improvements in product quality.

Like households, businesses went through a period in the early 1990s in which they turned cautious about spending and focused instead on shoring up their finances. Investment expenditures and debt growth were cut back for a time, until economic footing seemed more secure. More recently, businesses have been operating from a position of strength. Profits have been high, and cash flow has been more than adequate. Strong investment spending has been achieved largely through internal funds. Total debt growth has picked up a bit in the business sector this past year, but the rate of growth has not been very large compared to past standards.

The Federal Reserve, in its efforts to achieve sustainable economic growth in an environment of stable prices, has had to take into account both the normal effects of the business cycle and the special "headwinds" created by the legacy of the 1980's imbalances. The Fed began to shift toward ease in 1989, when it became clear that a slowdown of the economy was under way. More moves toward accommodation followed in the next three years, as the economy struggled to move back into meaningful recovery. Only in early 1994, when it seemed that the economy finally had gained momentum did the Fed start to move back from a very accommodative position toward a more neutral stance. Further tightenings have since been undertaken to head off a potential buildup of inflationary pressures as the economy moved to high levels of resource utilization. So far, growth has remained strong, and inflationary pressures have remained in check.

The Forces of Structural Change: Reshaping the Economy

In addition to cyclical economic influences, there have been other recent developments that appear to transcend the business cycle. These developments are bringing about very fundamental changes in the fabric of our economy. To some extent these structural changes may be disruptive to the economy in the short run. But in the long run, they probably are taking us in the direction of a more efficient economy, in which faster growth of real living standards will be possible.

One of these ongoing structural changes is, of course, the computer revolution, which is affecting almost everyone in the economy. Businesses are striving to keep pace with rapid technical advances on a number of fronts, and more and more households have started to buy into new computer technologies as well.

At many companies, the workplace has been drastically altered as the computer revolution has gained momentum. Jobs that once were essential have been disappearing, and, at the same time, new types of jobs have opened up. A great deal of churning thus is taking place in labor markets. The ability of workers to retool--midway through their careers--is becoming more and more essential. To stand still with yesterday's skills is a strategy that is sure to lose ground.

Business operations are changing for reasons that are not solely related to the computer. I mentioned a moment ago that major restructurings have taken place in the corporate sector in the 1990s. At many companies, systems of management and control have been redesigned in recent years. Layers of supervisors have been thinned out, and the lines of communication from the top to the bottom have been shortened. Organizational structures are being redrawn in all sorts of ways in an effort to find combinations in which individuals can work together most efficiently. In the short run, these changes have been tough on many workers. But, in the long run, a stronger economy will be the result.

Another big change in the workplace in recent years is the increased use of temporary and contract workers. Influenced in part by the high cost of benefits for new employees, many firms have opted instead to look to temporary-help firms. Employers have sought not just traditional clerical workers, but also factory floor employees. Hiring workers on a temporary basis probably looked like an attractive alternative when labor markets were relatively slack earlier in the 1990s. But even with the pickup of the economy, hiring of the so-called "temps" has been proceeding at a hefty pace. Evidently, in a world marked by rapid change, many firms have continued to be attracted by the greater flexibility that comes with the hiring of workers on a temporary basis.

In these circumstances, workers who come to the market looking for lifetime job security may well be disappointed. On the other hand, workers with the skills to adapt quickly to changing market conditions probably are going to thrive. A workforce that already was more adaptable than in some other industrial countries probably is becoming still more flexible and adaptable.

Many of the changes that have been undertaken at U.S. companies and in U.S. labor markets in recent years are, to a considerable degree, a response to the increased internationalization of the economy. Our linkages to other economies have been strengthening. This is not a new trend, of course, but it is one that has persisted. Internationalization may even be gaining momentum in view of such things as NAFTA and the ever declining costs of global telecommunications. For many firms, the real competition no longer is the factory in the next county or the next state. Instead, it's the producer in a foreign country. Making a better product more efficiently than a foreign firm will be the key to staying in business for many U.S. concerns in coming years. My own view is that we are reasonably well-positioned to thrive and compete successfully in this rapidly changing international environment.

But, we should not underestimate the degree of the challenge. Ongoing retooling of the economy to take advantage of emerging technologies is an immense task. The nation's stock of physical capital, which has been built up over many decades, is substantially larger than annual gross investment. It may therefore take a relatively long time before efficiencies that are embodied in recent innovations become fully rolled into the entire stock of capital.

Similar arguments apply to human capital. The skills of the work force at any particular moment in time depend on investments in education and training that were undertaken in the past--sometimes the distant past. With the speed of innovation in new technologies in recent years, I think it probably is accurate to say that many workers, if not most, still are trying to catch up to yesterday's innovations, let alone today's.

It is quite possible that much of the progress from the computer revolution and the other efforts to retool the economy still may be in the pipeline. There is considerable potential for increases in productivity and rising living standards as we move ahead. However, high rates of investment are going to be needed to make that potential a reality. Technology does not make its way through the economy like pollen on the breeze. Rather, it becomes reality through particular types of investments in physical and human capital. It is only through such investments that we can be sure of not falling behind the curve in a highly competitive and rapidly changing world economy.

That raises an additional challenge. Investment of the magnitude that we need will require a good deal of saving. On that score, this country has not had a very good record in recent years. Our national saving rate has been low, both in comparison to historical experience and in comparison to the rates of saving in many other industrial countries. In addition, the uses of U.S. domestic saving are far from optimal. A sizable portion of the pool of private saving has been drained off in recent years to finance large and persistent Federal budget deficits. The amount of domestic saving that is left for private investment in plant and equipment is thereby diminished.

In these circumstances, we've been depending for a number of years on large inflows of capital from abroad to make up for our own saving shortfall. In a very real sense, we consume more as a nation than we produce. Like any household, a nation can live beyond its means for a time if it starts out with sufficient assets or income to service its debt comfortably. But, there also clearly are limits as to how far this process can, or should, go.

Over the years, many representatives of the Federal Reserve have taken the view that steps to lower the federal deficit and foster a higher national saving rate would be desirable. I certainly share these views.

Inflation

I have not, to this point, talked much about inflation. It's a topic, in fact, that has not been on the minds of most people nearly as much as it once was. Many of you probably recall the late 1970s and early 1980s when underlying rates of inflation in the U.S. economy were 10 percent or more. Inflation in those days came to be like sand in the gears of our economy. Households and businesses alike began to devote enormous amounts of time to trying to figure out how best to survive a situation in which inflation was rapidly eroding the purchasing power of the dollar. Uncertainties mounted. Long-run planning became extremely difficult.

Out of that experience a strong national commitment developed to bring inflation down to the point where it would no longer be a serious factor in the decisions of households and businesses. Making good on that commitment took a long time because inflation is difficult to wring out of the economy once it is entrenched. But, eventually, considerable progress was made. Over the past four years, we've seen the longest stretch of relatively low price inflation in a full generation. We have gotten much of the sand out of the gears, but it's not yet all gone.

The task ahead is to make sure that we make further progress in achieving price stability, as the economy goes forward at sustainable levels of growth.

Summary

I've covered a lot of ground in a hurry. Let me briefly summarize my main points. The economy went through a period of unusually sluggish growth earlier in the 1990s, but most of the forces that had helped to retard growth have since dissipated. Growth of activity has been quite brisk over the past three years, and resource utilization rates have risen to quite high levels by recent historical standards.

The country also is making progress in pulling together a formula for the longer run. Among the main ingredients in that formula are improved productivity through innovation, high levels of saving and investment, and price stability. Not all of these ingredients are accomplished at this point, but significant gains have been made. I believe that we will begin seeing more clearly the results of those gains in measures of macroeconomic performance as we move on through the remainder of this decade and into the 21st century. Thank you.