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LAYING THE GROUNDWORK FOR THE LONG RUN

Remarks by

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I'm very pleased to have the opportunity to speak to you today. I will confess that this is one of my first public speeches since joining the Federal Reserve Board. It seems appropriate that one of my first public forays would be before fund managers since much of my prior life was spent in the financial markets--as a regulator and as a chief financial officer.

Today, I would like to share with you my views on the state of the general economy. In particular, I will focus on what I believe to be the broad forces shaping the course of recent economic activity and on those that are likely to be of critical importance for the decade of the 1990s.

The basic theme of my talk is quite straightforward: The economy has been passing through an extended period of sluggish growth, which in fact now stretches back almost three years. To a considerable degree, that extended period of sluggishness appears to be the outgrowth of what some have characterized as the "excesses" of the 1980s. Whether or not you agree with the term excess, I think most would agree that certain imbalances did develop in many sectors of the economy during the long expansion of the 1980s. The ongoing correction of those imbalances has been a principal factor behind the weak recovery from the recession.

In some sectors--commercial construction especially--the corrective processes probably still have a way to go, and activity in those sectors may very well contract further. But in other sectors the outlook is brightening, aided considerably by the monetary policy actions of recent months. All told, I think that while growth may remain sluggish in the near term, the groundwork is being laid for what should prove to be a sustained period of very healthy economic performance as we move further into the 1990s.

With that basic outline in mind, let me turn back to the current situation. As you are well aware, the economy still is struggling. Although the growth of output has been positive in each of the last three quarters, the rate of expansion has fallen far short of the pace seen in previous postwar recoveries. In the labor market, the level of payroll employment in January was only slightly above its recession low, and the unemployment rate has continued to drift up in recent months. A wide array of other economic indicators have been lackluster as well.

Moreover, these statistics, by themselves, do not capture fully the sense of anxiety that many people seem to feel. In some instances, technical change and corporate restructurings are disrupting career paths that were thought to be fixed. A good many workers who had thought themselves

safe from the sting of recession now see their jobs as being potentially at risk and their futures insecure. More generally, attitudes probably have been affected by the long duration of the period of sluggish economic performance. To drive this point home, let me cite a couple pieces of data. The growth of real GDP since the first quarter of 1989 has averaged less than 1/2 percent annually, and real disposable income per capita has actually declined slightly, on net, over that period.

I suspect that as the economy regains its footing and as real income starts to grow, the present sense of gloom will begin to lift. At the moment, however, attitudes are quite negative, and this lack of confidence is an important intangible in the outlook.

In my opening remarks I attributed the recent poor performance of the economy to imbalances that developed during the economic expansion of the 1980s. I would now like to discuss those imbalances in more detail.

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 bottom, the drag of this sector on overall growth of the economy should 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. But, nevertheless, the deficit

remains very large, and in the face of a weak economy, there is the obvious temptation to postpone corrective actions. Whatever fiscal actions are taken this year--and I'll be coming back to that topic later on in my talk--the plain fact is that the federal budgetary imbalance is going to be with us for some time to come. Moreover, efforts to correct that imbalance are bound to have at least a mildly restraining effect on the economy. However, the long-term impact of moving forward with those 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 took on many of the programs formerly administered at the federal level. 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, as increases in

spending for high-priority categories or for federally mandated programs have had to be offset by cutbacks elsewhere.

The silver lining in all of this is that state and local finances are gradually being put back on a sounder footing. Indeed, the combined state and local budget deficit fell in each of the first three quarters of 1991 and probably was down still further in the fourth quarter.

The rapid buildup of debt in the 1980s was not confined to the public sector alone. Household 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 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 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.

Recently, however, there have been adjustments in household finances that are favorable for the long run. The buildup of household financial liabilities slowed sharply last year. The volume of consumer installment credit outstanding actually declined for the first time since 1958. In addition, 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 to contribute important lift to the general economy.

Encouraged by declines in mortgage interest rates, households already are boosting their purchases of homes. Sales of both new and existing homes picked up in the fourth quarter of last year after a temporary lull in the summer. In addition, new construction has picked up. Starts of single-family houses rose in each of the last three quarters of 1991, and all the signs point to further solid gains in activity in this sector. Housing, of course, is a bellwether sector of the business cycle. Thus, 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.

The business sector closed out the 1980s with a mixed legacy. Manufacturers achieved strong gains in productivity over the course of the decade, and their international competitiveness improved markedly. But in the service sector of the economy, productivity gains were less forthcoming, and increases in output were achieved largely by hiring additional workers. On the financial side, 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 gross domestic product 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.

Some of these trends are changing, however. I sense that we currently are seeing in the business sector, as in other sectors, some fundamental shifts. While disruptive now, these shifts will help to position the economy for a stronger performance later on. In particular, the emphasis on achieving greater efficiency seems to have spread to areas well beyond the production line 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. Although those efforts to improve productivity 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.

Parallel efforts have been under way to restructure corporate balance sheets. Issuance of equity by nonfinancial corporations outstripped equity retirements in 1991 for the first time since 1983, and the growth of business debt came almost to a halt. The mix of debt took a significant shift toward the long end of the maturity spectrum, as corporations took advantage of declines in long-term interest rates. With the decreases in interest rates and the diminished use of debt, the debt-servicing burden of nonfinancial corporations has begun to ease.

The efficiency gains and related cost reductions that manufacturers achieved over the last decade have been manifested in sustained increases in exports. For a number of years now, serious questions have been raised about our ability to compete internationally. But the facts simply don't support the contention that the United States 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. Gains in exports this past year were especially encouraging, since income growth in the rest of the world was relatively slow, on average. Prospects for further increases in coming years would seem to be quite favorable.

Mind you, I do not mean to suggest that complacency is warranted on the part of U.S. firms or workers. To sit still is a prescription for falling behind, given the rapid pace of change in the world economy. But the facts seem to me to be much more encouraging than some of the recent rhetoric would seem to imply.

A list of the factors that are moving in a favorable direction would not be complete without some reference to inflation. With nominal wage increases gradually easing and the prices of imported goods exhibiting no serious upward pressure, I think the odds of seeing a further gradual reduction in the core rate of inflation are quite favorable. Indeed, a move of core inflation to near the low end of the range of the past generation does not seem to be far out of reach.

Conditions in the credit markets also should swing in a direction more conducive to growth as the year progresses. I know that caution still prevails at this point. Because of uncertainty about the economy, many borrowers are hesitant to take on new debt, and lenders are reluctant to provide it. But as economic activity picks up, both borrowers and lenders will start to focus more on opportunity, and the caution that has been evident in the credit markets over the past year should begin to ease.

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, and it may be some time before households and businesses are satisfied with the structure of their finances. No one can forecast with confidence exactly when the positives in the outlook will start to 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 the longer-run prospects. Low inflation, strong exports, and a commitment to fiscal restraint are not a bad baseline from which to begin, if the economy is to be put on sound footing for the long run.

But that brings me once again to the topic of fiscal policy. It now seems quite likely that some fiscal action will be taken. Like many of you perhaps, I have mixed feelings about that. Given the uncertainties that still exist in regard to the economic outlook, it is difficult to argue with full confidence that no fiscal action is needed. In fact, I personally would welcome some actions, such as a cut in capital gains taxes or other inducements that might be supportive of investment and growth over the longer run.

But at the same time, I find it difficult to believe that major fiscal initiatives are appropriate if they significantly increase the federal deficit. The economy, while sluggish, is not in collapse. And, as I have pointed out in some detail, many adjustments that now are under way will likely be slowly tilting the balance toward stronger, sustainable growth in the future. The monetary policy actions that have been taken to date should be a potent force helping to reinforce those tendencies toward stronger growth. But costly fiscal programs could disrupt these tendencies if adverse reactions were to develop in the bond and foreign exchange markets. I would hope, above all, that these potential repercussions and the longer-run implications of possible policy actions be kept in mind as the debate proceeds in coming months.

I have enjoyed being with you today. Thank you for  
inviting me.