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Remarks by

Susan M. Phillips

Member

Board of Governors of the Federal Reserve System

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University of Tennessee School of Business

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In my remarks today, I would like to discuss the current economic situation and the prospects for the economy. I have two inter-connected messages: First, some of the more fundamental imbalances (or, as some have labelled them, excesses) which developed in the decade of the 1980s are now beginning to abate. This should pave the way for a more vigorous and sustained expansion. And, second, there is emerging evidence, albeit not unambiguous evidence, that the pace of activity may soon begin to quicken.

Let me turn to the first of my two themes--the fundamental 1980s imbalances still affecting economic performance. The broadest measure of the nation's output and income--real GDP--fell sharply in the latter part of 1990 and early 1991 following the Iraqi invasion of Kuwait and the resulting Gulf War. Seen in a broader context, however, 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 about a 1-1/4 percent annual rate since early 1989. Although this is a positive number, it is roughly half our potential growth rate and 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--since the end of World War II. Based on our historical experience, the recovery seemed to be on track immediately after the ending of the Gulf War, but it faltered in the second half of last year. The Commerce Department won't be releasing information on first quarter real GDP until the end of April; but my reading of the available data points to a figure greater than 1 percent and similar to the pace observed during most of the past three years.

The sluggishness of the economic recovery has been mirrored in the labor market. The number of workers on nonfarm payrolls expanded slowly last spring and summer, but fell again during the fourth quarter. There was a continuing drumbeat of layoffs in the latter part of 1991. Many had hoped that the disappointing performance of the labor market would end with the new year as firms tried to get all of the bad news behind them. Unfortunately, the data suggest that the labor market picture may still get worse before it gets better as businesses continue the process of restructuring and cost cutting. Although sizable gains in employment and hours worked were reported in February, the unemployment rate continued to move up, and initial claims for unemployment insurance in the past few weeks have still shown no significant improvement in joblessness.

The problems of structural change and adaptation are perhaps most severe in defense-related industries. But firms in a wide variety of nondefense industries are also refocusing corporate activities and eliminating inefficient operations to be competitive in today's market. Some of America's most prominent companies, which had reputations for employment stability, now find that they too must make adjustments. As a result, even workers in professions once thought to be immune from economic hard times, such as accountants and middle management, find themselves facing the reality, or the potential, for job loss and perhaps "downward mobility".

In this environment, it is not surprising that consumer confidence is depressed--indeed, far lower than would seem warranted by the actual economic data in hand. For example, the Conference Board's index of consumer confidence in the past three months has been at its lowest level since late 1974. And, although the index of consumer sentiment that is prepared by the University of Michigan rose

in March, it was still below the level that prevailed even in the summer of 1991. The negative attitudes expressed in the consumer surveys reflect the sense of anxiety that many people seem to feel about both their personal and the country's economic prospects.

Why has this recovery been so sluggish, and, more generally, why has the economy been performing so poorly since early 1989? As I suggested at the beginning of my remarks, growth has been retarded in recent years as the economy struggles to correct a number of critical imbalances. I would now like to discuss those imbalances in more detail.

Perhaps the most visible examples of 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 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 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 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. Increases in spending for high-priority categories or for federally mandated programs have had to be offset by cutbacks elsewhere.

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

Turning to 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 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.

Fortunately, adjustments are underway that should correct many of these imbalances and set the stage for sustained growth as we move 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. The volume of consumer installment credit outstanding actually declined for the first time since 1958. Mortgage refinancing also is allowing many households to reduce personal debt. 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.

Parallel efforts have been under way 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. 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. With the decreases in interest rates and the diminished use of debt, the debt-servicing burden of nonfinancial corporations has begun to ease.

Restructuring is affecting not only the financial side of business activities, but also the operating side. While disruptive now, these actions will help to position the economy for a stronger performance later on. Manufacturers achieved strong gains in productivity over the course of the 1980s, and their international

competitiveness improved markedly. But in the service sector of the economy, productivity gains were less forthcoming. Recently, however, 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 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.

The pickup in inflationary pressures that began to emerge in the latter part of the 1980s has been reversed. 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 February, the overall consumer price index rose 2.8 percent, down from a 5-1/4 percent increase during the preceding twelve month period. Granted, much of the slowing reflects lower oil prices. But even excluding the volatile energy and food categories, price increases have slowed from 5-1/2 percent last year to 3-3/4 percent this year.

As an aside, I should mention that while the CPI excluding energy and food is one measure of the core rate of inflation, it certainly is not the only measure, nor is it necessarily a perfect target for monetary policy. As the inflation rate moves lower, we are likely to see an active debate in the press, on Wall Street, among academics, and in government concerning the appropriate statistical measure of prices for guiding economic policy.

Although the economy is getting poised for sustainable long-run growth, what about the near-term situation? The data are still mixed, but the positive signs have been getting stronger in recent days and seem to be outweighing the negatives by a widening margin.

Let me start with housing. As you know, this is a bellwether sector of the business cycle. Encouraged by declines in mortgage interest rates, households have been boosting their purchases of homes. Sales of new and existing homes picked up in the fourth quarter of last year and increased further this year. With demand strengthening, new construction also has picked up. Starts of single-family houses rose in each of the last three quarters of 1991, and posted additional increases in January and February. All the signs

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 been decidedly upbeat reflecting, in part, the improvement in household balance sheets. Sales at general merchandise, apparel, appliance, and furniture stores were exceptionally robust in the first two months of the year. Sales of domestically produced autos and light trucks also have strengthened recently. At a 10.1 million unit rate during the first 20 days of March, sales of motor vehicles were at their strongest pace since last September. If the recent burst of consumer demand is sustained in the next two or three months, it should ultimately be translated into increases in production, employment, and income.

Business spending for new equipment remains somewhat lackluster, but a modest recovery in coming months may be in train. New orders for nondefense capital goods other than aircraft and computers during January and February were 1.1 percent above their fourth-quarter level and have been trending up 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. Business investment is an area which bears watching in coming months to see if recovery is sustained.

Turning from spending to output, industrial production increased 0.6 percent in February, retracting about a third of the drop recorded over the preceding three months. Production around the

turn of the year had been held down, in part, as businesses attempted to shed excess inventories. However, businesses made considerable progress in paring stocks early this year. Thus, with inventories in better shape, the stage is set for further gains in aggregate demand to be reflected relatively quickly in higher production.

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, continued unemployment, the federal government budget deficit, and depressed consumer sentiment. Moreover, it may be some time before households and businesses are fully satisfied with their financial structures.

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 productivity, an upward trend in exports, 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.