

THE U.S. ECONOMIC OUTLOOK
Remarks by Robert P. Forrestal, President
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to the Eastern Secondary Mortgage Market Conference
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Good morning! I am pleased and honored by your invitation to speak to the Eastern Secondary Mortgage Market conference. I have been asked to give my views on the overall economic outlook for the United States and to outline some of the issues and implications for your industry.

Overall Economic Forecast

Let me first say that we seem to have begun a measured recovery from the recession that has been plaguing the U.S. economy. While the recession was milder than earlier ones, it took longer for the economy to start turning upward than I had expected. I am confident now that we have reached the turning point, even though the latest figures indicate that real gross national product shrunk slightly in the second quarter. I believe that GNP will expand through the end of this year, even though growth for the year as a whole will be slightly negative. Next year, I look for positive growth--albeit modest for a recovery--of about 2.5 percent on average. One reason for this turnaround is the easing moves the Federal Reserve has taken over the past year or so. Although the economic responses to these moves do not manifest themselves immediately, they do eventually.

Since employment lags behind GNP, I think the unemployment rate will take a little longer to fall, holding at near 7 percent through the end of this year, but declining to the 6 percent area by the end of 1992. The consumer price index (CPI) has abated from last year's nearly 5 1/2 percent rate, and price pressures look more moderate than they have in some time. The CPI could drop back to somewhat less than 4 1/2 percent as an annual average in 1991 and turn out between 3 1/2 and 4 percent in 1992.

Now, while these numbers are technically encouraging and while most economists say that the recovery began in April, many business people like yourselves ask, "If this is a recovery, why doesn't it feel better?" Let me digress for a moment to answer that question. First of all, this recovery has all the markings of a very modest rebound. In fact, it should be one-half to two-thirds the pace of recoveries after the recessions of 1974-75 and 1981-82. Second, business people and economists use different numbers by which to gauge current performance. Economists can generate numbers that are aggregated over the entire economy and seasonally adjusted. As a result, they can see--almost immediately--the impact of any positive change in the numbers. So, in their view, as soon as business activity begins to move up from the bottom, things are getting better. Therefore, they tend to become enthusiastic sooner than do business people, who rely largely on statistics generated by their own firms. In contrast, businesses often make comparisons with year-earlier levels. Since it takes some time into a recovery to regain these levels, the financial picture looks disappointing until activity becomes higher than it was a year ago. Thus, I think that currently negative perceptions of the economy's health are not cause for concern, although they could be in the long run if they persist.

Strengths and Weaknesses

To elaborate briefly on the sources of strength and weakness underlying my outlook, let me discuss some of the major sectors of the economy. The forces supporting growth should be inventory rebuilding, personal consumption of services, and net exports. Weaker areas for this year include construction and consumer purchases of durable goods. By next year, however, most of these sectors should begin lending support to growth. Orders to U.S. factories grew by more than 6 percent in July, which was the largest increase in nearly 21 years. This is a direct result of businesses' having cut back sharply on their inventories in anticipation of the recession, as well as their aggressive shift to sophisticated inventory control methods. Now they are replenishing their inventories, which in turn is leading to a strong increase in industrial production.

Net exports should also remain a source of support as our external position as a nation continues to improve. The deficit in our net exports that was more than \$160 billion in the mid-1980s could turn marginally positive next year.

Personal consumption of services, such as health care, continues to be strong. The service sector itself, however, appears weak compared with its performance in the past decade. The rapid employment growth in the last several decades has left a number of service companies with fat to be trimmed. Many are now going through a period of consolidation, resulting in furloughs and other cost-cutting measures. Nowhere is this trend more apparent than in banking, though airlines, retailing, and other services are also feeling the effects.

I am sure that you are all familiar with the weaknesses in our economy. The construction industry suffers from lingering excess supplies due to past overbuilding as well as hesitancy among many lenders to finance new projects. Demographics are also contributing to the sluggish housing market. The aging of the population means that there are not as many first-time home buyers as there were when we came out of the last recession in 1982. Residential construction, especially of single-family dwellings, is undergoing a modest rebound, but new home sales have been off. As you know, apartments and condominiums are overbuilt. All in all, there is no reason to expect that a housing rebound will help to lead the economy out of the recession, as typically has occurred in the past. In addition, office building and other commercial construction will probably continue to decline for a year or more, though the rate of decline should diminish markedly later this year. Overall, construction will be less of a drag on growth for the remainder of this year, but it will not lend momentum to the economy until sometime in 1992.

In addition to construction's lingering weakness, consumer demand for durable goods remains soft. There are several reasons for this. Personal income growth has been slow and actually fell for the first time in six months in July. Demographics are a factor as well. Fewer new households than a decade ago translate into fewer purchases of new cars, for example. Weakness in construction is exacerbating this pattern, since expenditures for furniture, household appliances, and other consumer durables tend to rise with growth in family formation and home sales.

In sum, I look for industrial production and exports to lead economic growth over the coming year and a half. Commercial real estate construction will remain weak this year, as will capital spending by businesses and personal consumption of durable goods. Housing should show growth in coming quarters, but it will be below average for recent recoveries. Starts will rise only modestly, due mainly to the effect of the much slower population growth.

Issues and Implications

What does this outlook mean for the secondary mortgage market industry? In my view, the moderate growth we are likely to see as the economy emerges into recovery and expansion should be sufficient to offset the soft or negative growth in volume that you have experienced during the recession. I also recognize that there are some regulatory changes banks are dealing with that may affect your business more immediately. In particular, there seems to be some confusion among both large and small banks about the capital that is being required for mortgages sold with recourse. As the regulators review the various cases to determine which banks were merely confused and which were taking improper advantage of the rule, many banks will be discouraged from making loans that they would normally have sold through private markets.

This situation, combined with the modest recovery I foresee, could make business conditions "feel" rather anemic. In essence, a slow turnaround does not seem different from a slow decline to those of you who have been waiting impatiently for a rebound. Builders, developers and mortgage lenders are all equally unhappy with the prospects for economic growth.

This 1 percent to 2 percent rate of growth does not compare with the boom that typically occurs after a recession. However, this growth rate is congruent with our low productivity growth and our low savings rate, compared with our major competitors' in today's global marketplace.

But no matter how anemic the recovery may feel to many business people, there is little monetary policy can do about the underlying causes. Unduly accommodative monetary policy could merely reverse whatever gains we have made in restraining inflation over the last few years. All of us can, however, support policies, like sustained deficit reduction, that will contribute to higher savings and productivity over time. This approach is something that business people everywhere, as well as central bankers such as myself, should be encouraging their legislators to take. It is, of course, a longer term solution, but, as a central banker, I try to keep my sights on the long term. Viewing your industry from this perspective leads me to raise three strategic issues.

First, the demographics of the so-called "baby bust" generation run counter to the secondary mortgage market's growth needs. As fewer people form families and take out mortgages to buy homes, there simply will be fewer mortgages to package and resell. That means that not only will this recovery be modest--even after we exhaust the excess housing supply--but that growth through the rest of the century will also be modest by the standards of the past 15 to 20 years.

Second, refinancing will probably not figure into most homeowners' plans, as it did in the mid- to late '80s. That is because it will probably prove difficult to bring down long-term interest rates on a par with their decline between 1980 and 1985. This difficulty is due to the huge federal budget deficits we continue to amass and also to the contingent liabilities the federal government now carries off-budget. You are, of course, most familiar with Fannie Mae and Ginnie Mae, two agencies that issue debt backed by government guarantees. The problem is there are numerous contingent liabilities to which the federal government has committed. While no one expects all of them to be called in at once, the potential costs are sufficiently large to impose some kind of inflation premium on long-term investment. Until we can decisively bring direct and potential federal spending in line with our willingness to pay for these commitments, it will be unlikely that long-term interest rates will drop substantially. Thus, we probably will not see a spurt in refinancing in this decade.

The third issue is this: Should such a huge and thriving industry as yours essentially be guaranteed by the government? Since the great percentage of mortgages you resell are backed by the government, your industry has in fact benefitted from a sort of government subsidy. Indeed, perhaps one of the reasons the secondary mortgage market has grown so large is the relative safety of the products with which you deal. This excess capacity is especially troubling, because a small capital base is supporting massive contingent liabilities. I can think of an immediate parallel to this situation in the banking industry where deposit insurance has served as an implicit government subsidy, allowing the industry to become overpopulated. This overcapacity, in turn, has reduced profits to such unsustainably low levels that deposit insurance

has become a focus in the financial industry reform legislation now being debated in Congress. I cannot forecast what will happen to your industry in the following years, because I am not in your business, but as a policymaker, I can tell you that we are trying to find ways to rein in the subsidies that have supported the banking industry. Over time, I believe policymakers will seek to return more market discipline to the whole spectrum of industries that have grown artificially from government subsidies. This approach may eventually affect your industry.

Conclusion

In conclusion, I feel that the U.S. economy has begun its recovery from the recession. I do not, however, expect improvement to be dramatic, in part as a result of long-term demographic trends that are moderating the nation's consumption patterns. Instead, we should return to modest growth that, while not as robust as that to which we had become accustomed to in the 1980s, should nonetheless prove sustainable. This expansion ought to give us the much-needed breathing space to make the kind of adjustments that will help to make our economy work better in the long run.