I am pleased as always to appear before this distinguished committee. As you know, the Federal Reserve will be submitting its semiannual Humphrey-Hawkins report to the Congress in just a few weeks. At that time, I'll be in a position to address more meaningfully the tactics and strategy of monetary policy. Under the circumstances, I thought it might be most useful for me to focus my initial remarks this morning on the current state of the economy.

Concerns that our long economic expansion may be nearing an end may have been intensified last week by the release of initial estimates showing that real GNP rose only 1/2 percent at an annual rate in the fourth quarter of 1989. To be sure, activity in that period was affected by a number of special transitory influences—the California earthquake, Hurricane Hugo, extraordinarily cold weather, and the long strike at Boeing. But even allowing for those factors, business activity in recent months clearly has been less vigorous than it was earlier.

The locus of the recent softness is in what we can broadly characterize as "durable" goods. Most notably, weakness has emerged in the auto industry, and this has spread to related supplier industries, including metals, textiles, and machine tools. In addition, a number of categories of capital goods and consumer hard goods, as well as construction of both residential and nonresidential buildings have softened in recent months.

In evaluating trends in such long-lived physical assets, one must remember that household and business users' ownership of them does not appear anywhere in the gross national income and product accounts,
nevertheless, by providing flows of services, these balance sheet items are an important determinant of the level of production. A fundamental characteristic of such durable items is that demand for them is shaped in part by the size of outstanding stocks relative to current household and producer needs. Viewed in this light, the current economic slowdown represents, at least to an extent, a pause in the accumulation of physical assets, a form of "inventory correction," so that levels of ownership do not get too far ahead of the long-term desired levels.

Because of their importance in understanding the current economic situation, it is worth examining some of these stock adjustment relationships in detail. Let me start with motor vehicles, where manufacturers have made sizable production cutbacks recently. It appears that auto assemblies in January may fall short of a 4-1/2 million unit annual rate, well below the 7 million unit rate over 1989 as a whole. The proximate cause of the recent production cutback was soft demand and rising dealer inventories last fall. The soft demand reflects a payback from the elevated sales pace of the third quarter during which the use of price incentives was especially heavy on the 1989 model-year cars. Moreover, demand for 1990 model-year cars has been restrained by increases in sticker prices, which in many cases exceeded 5 percent. However, with the introduction of new incentive programs, sales picked up in late December and early January. This has reduced dealer inventories to more acceptable levels, and automakers reportedly plan to step-up production somewhat in the coming weeks.

Looking beneath these short-run variations in sales, production, and dealer inventories, however, current and prospective
developments in the auto market reflect in part longer-range demand factors. Among the underlying forces are the existing number of motor vehicles owned per household and the average age of the auto and truck stocks. In order to see the role of these factors more clearly, it is useful to go back to the beginning of the last decade. Between 1979 and 1983, the number of vehicles per household—which had been on a strong uptrend throughout the postwar period—fell nearly 3 percent. A decline of 3 percent may not sound very large until you consider that it represented a shortfall on the order of 10 million cars and trucks between the actual stock of motor vehicles and the underlying trend stock. This decline in the per household ownership of motor vehicles was likely a result of consumer reaction to the relative increase in gasoline prices and the downturn in economic activity that occurred during the period. Also, during the late 1970s and early 1980s, consumers slowed the pace at which they scrapped their existing cars and light trucks; the combination of lower scrappage and the lower sales of new vehicles pushed the average age of both the auto and truck stocks up by approximately one year to over 7 years.

The combination of an enormous pent-up demand—reflecting the gap between actual and presumptive desired levels of ownership—as well as increased replacement needs associated with an aging auto stock, provided the stimulus for the extraordinarily strong pace of auto sales posted from 1983 through much of the remainder of the decade. The number of vehicles per household has risen substantially, rising well above the earlier peak, and, as scrappage rates have returned to prior levels, the average ages of the auto and truck stocks have leveled out.
This rebuilding of the motor vehicle stock and stabilization in its average age suggest that the number of autos sitting in America's driveways is adequate to meet much of the desired demand for transportation equipment, and lowered sales are at this point likely to reflect primarily replacement needs and growth in the driving-age population.

In contrast to motor vehicles, the current slowdown in construction of new homes and commercial buildings seems to reflect a situation where earlier activity was so robust that the actual stocks of residential and nonresidential structures exceed desired levels—at least in some locales. Moreover, in the housing market longer-run demographic factors also are having an effect on the underlying stock demand—especially the rate of household formation. This rate has been slowing and will slow further as more and more of the low birth cohort of the 1960s and 1970s matures into adulthood. What this means, of course, is that we need to lower our sights about what constitutes "normal" levels of homebuilding activity during the 1990s compared with the 1980s.

How the broad decade averages of demand get distributed from year to year depends in large part on financial conditions. Interest rates on home mortgages have been around 10 percent since mid-1989, and so, from the homebuyer's perspective, financial considerations have not varied to a great extent. In recent months, however, segments of the construction industry have reported difficulty in obtaining credit in the wake of newly imposed restrictions on lending by thrift institutions. Some added caution in acquisition, development, and
construction lending was called for, given the riskiness of this activity, but the difficulties now being experienced by builders should diminish considerably over time as these businesses secure other financing sources for their creditworthy projects.

Despite the reduced pace of housing construction, there continues to be an overhang of new single-family homes and condominiums for sale in a few regions of the country, and rental vacancy rates in the multifamily market remain high. But, it is important to note that much of the market overhang is concentrated in the northeast and shows few signs of leading to a national real estate market contraction. The reason is that the spread of local problems generally is limited by the geographical segmentation of real estate markets. Because neither residential property nor occupants are perfectly mobile, the market will not necessarily arbitrage away price differences observed in different local markets. Hence, softness in housing prices in some areas is unlikely to prove highly contagious in the short run. Indeed, in most areas, and on average nationally, real estate values have continued to increase.

In the case of nonresidential structures, there also is an indication of stock overhang, with vacancy rates for office space in metropolitan areas at near record levels. Moreover, lending institutions—stung by a long series of questionable investments—are more carefully scrutinizing loan applications than in the past so that highly risky projects are not getting funded as readily. Reflecting these developments, building permits have turned down and new
construction spending has been stagnant over the past year in all major sectors except industrial building.

Business demands for new equipment also reflect, to a large degree, stock-adjustment motives. Recently available data for the fourth quarter show that a sizable deceleration in business equipment spending is underway, reflecting the general slowdown in economic activity and expected sales. Real spending on producers' durable equipment fell more than 4 percent at an annual rate in the fourth quarter. Part of the decline resulted from the work stoppage at Boeing, but even allowing for that special factor, real equipment outlays still declined somewhat.

Looking forward, recent data are offering mixed signals about future capital spending. For example, orders for nondefense capital goods received in November and December show a bounceback from the decline that had occurred in the third quarter. Other indicators of capital spending, however, give the impression of softness ahead. For example, recent declines in real cash flow of nonfinancial corporations do not bode well for investment spending in the near term. In the 1980s, growth in cash flow—measured as the sum of undistributed after-tax profits and depreciation allowances—tended to move with growth in real gross business fixed investment. Thus the recent cash flow experience—which has signaled a deterioration in the availability of internal funds—has one factor likely to be a restraining influence on capital spending in 1990. Moreover, this signal is being reinforced by surveys of plant and equipment expenditures taken this past fall that indicate real capital spending will grow less this year than last, the
deceleration being most noticeable among nondurable manufacturing and non-manufacturing firms.

Until now, I have been sketching the negative side of the economic landscape. Let me now suggest where we can look for more favorable signs. First, demand for long-lived assets is still growing in some areas, creating opportunities for strong production growth. This is most clearly evident in the case of civilian aircraft for which the level of the orders backlog has doubled over the past two years. Second, in contrast to some past cycles, we have not seen the type of speculative buildups of materials and finished goods by businesses that can exacerbate the effects of any weakening in sales trends. I believe one reason for this is that thus far we have avoided a cyclical upswing in inflation, so that the buy-in-advance motive has been less of an influence. Third, foreign demand for many of our manufactured products is strong. Real export growth of manufactured goods, although down somewhat from the torrid pace of 1988, remains sizable. Strength runs across a wide variety of consumer and capital goods as well as industrial supplies.

Fourth, there is evidence from labor markets that the spillover effects from durable manufacturing have been limited. Although manufacturing employment has fallen nearly 195,000 jobs since last March, total private nonfarm payrolls have continued to rise, with the increase totaling about 1-1/2 million over that period. The contribution from the health services area to the overall increase has been especially noteworthy. Employment in medical care, which made up about 7 percent of total payroll employment early last year, has
increased nearly 400,000 since then. Other sizable employment contributions have come from business services and state and local governments.

Favorable signs about the economy's economic health are also revealed by comparing recent movements in an index of leading economic indicators with its pattern of movements just before and during previous recessions. Recently, statistical procedures have been developed that allow such a comparison to be translated into the likelihood of a recession. These procedures have been applied by Board staff to the Commerce Department's index of leading economic indicators, which comprise several real and financial market variables. The resulting measure suggests that the probability of a recession developing in the next six months increased last spring to almost 30 percent, but according to the most recent estimates has declined to about 20 percent.

A second probability-of-recession measure is based on a leading index recently compiled by economists at the National Bureau of Economic Research, which relies less heavily on data from the manufacturing sector than does the Commerce Department index and does not include stock prices. The probability of a recession in the next six months based on the NBER index also has declined since last spring and according to the December reading stands at about 10 percent. Both probabilities are much smaller than those occurring at the beginning of each of the four recessions since the late 1960s. For example, the probability exceeded 50 percent shortly before each of the previous recessions using the NBER index.
I wouldn't want to bet the ranch on such statistical measures. I think we must continue to monitor developments closely and stay alert to the possibility that, perhaps reinforced by some adverse shock not now visible, the weakness in the several sectors I've discussed might cumulate and lead to a more widespread downturn in activity. But such imbalances and dislocations as we see in the economy today probably do not suggest anything more than a temporary hesitation in the continuing expansion of the economy.