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Testimony by

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of the

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and the

Committee on the Budget

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I am pleased to appear here today at this special joint session of the Banking and Budget Committees. I hope that I shall be able to contribute something to your effort to analyze the forces affecting the economy. This analytical process is critical to the formulation of sound public policy.

The upturn in economic activity that began earlier this year clearly has faltered. It is apparent that the economy is struggling and that there have been some strong forces working against cyclical revival. Now that we are well past the period of gyrations associated with the crisis in the Persian Gulf, we can better gauge the strength of the underlying disinflationary forces that were active well before the economy tilted into recession in the autumn of 1990.

During the 1980s, large stocks of physical assets were amassed in a number of sectors, largely financed by huge increases in indebtedness. In the business sector, the most obvious example is that of commercial real estate, with the accumulation of vast amounts of office and other commercial space--space beyond the plausible needs in most locales well into the future. Our financial intermediaries, not just depository institutions but other lenders as well, lavished credit upon developers, and they are paying the price today in the form of loan losses and impaired capital positions, with adverse effects on their willingness to extend credit. The 1980s were also characterized by a wave

of mergers and buyouts--purchases of corporate assets, often involving substitution of debt for equity and anticipating the sale of assets at higher prices. I needn't recount for you the subsequent disappointments, and the fallout for holders of many below investment grade bonds and related loans.

In the household sector, purchases of motor vehicles and other consumer durables ran for a number of years at remarkably high levels, and were often paid for with installment or other debt that carried longer maturities than had been the norm. In some parts of the country, the household spending boom reached to the purchase of homes, not simply for essential shelter, but as speculative investments--and often involving borrowing that constituted a heavy call on current and expected family incomes. The aftermath of all this is a considerable degree of financial stress in the household sector.

The bottom line of this brief account is that the national balance sheet has been severely stretched. The buildup of debt was originally largely collateralized or matched by rising asset values. But owing to the recent weakness of property values, the debts have become more troubling, depressing aggregate economic demand.

While most analysts, of course, were aware of the increasingly disturbing trends of rising household debt and elevated corporate leverage, it was not clear that these

burdens had as yet reached a magnitude that would restrain the American economy from a moderate cyclical recovery in 1991.

Indeed, as inventory liquidation abated at midyear, output moved up and closed the gap with the consumption of goods and services in much the same manner evident in the early stages of other recent business cycle recoveries. A range of leading indicators still was flashing positive signals on the economy's prospects.

By late summer, however, with half the decline in output during the recession recovered, it became clear that the cumulative upward momentum that characterized previous recoveries was spent. The continued strong propensity of households to pare debt and businesses to reduce leverage was a signal that the balance-sheet restraints, a concern of many for a long time, had indeed taken hold, working against the normal forces of economic growth.

Consumer spending, housing starts, industrial production, and employment all flattened out--and business and consumer sentiment began to erode. Inventories backed up somewhat in the retail sector by early fall. This appears to have been particularly related to goods ordered from abroad during the late spring in anticipation of climbing retail sales. However, it also suggests that domestic production had gotten a little ahead of domestic demand. Moreover, although export activity has remained a

bright spot for us, recessions and slower than expected economic growth in a number of major industrial countries over the second half of 1991 limited the demand from abroad for our goods, holding down the growth of exports. All told, the available data indicate that U.S. industrial output was flat to declining slightly at the end of last year. Fourth quarter Gross Domestic Product appears to have been little changed from third quarter levels.

Not unexpectedly, stretched balance sheets are creating pressures on companies and households to hasten their repair. Record issuance of corporate equity in our capital markets recently is contributing to deleveraging. And large bond issues are funding short-term debt and high interest rate long-term debt thereby removing some of the balance-sheet strain. In addition, lower interest rates are easing business debt service burdens. Households are not only repaying debt but are initiating heavy mortgage refinancings that are reducing their debt service burdens as well.

We have made a good deal of progress in the balance-sheet adjustment process in recent years, and the payoff in the form of an easing of unusual restraint should begin to become evident in the reasonably near future.

Monetary policy has had an important role in addressing balance-sheet stress, the core of the structural weakness currently confronting our economy.

For example, the Federal Reserve eased money market conditions in July 1990 to address the balance-sheet stress manifest in the emerging "credit crunch"; this continued the pattern of gradual ease initiated more than a year earlier when inflationary pressures exhibited signs of unwinding. Monetary easing was accelerated as the economy moved into recession in the autumn of 1990, but went on temporary hold last spring as money supply growth and the recovery began to show signs of building some momentum.

We at the Federal Reserve have chosen to adjust policy during the past 2-1/2 years mostly in small increments, deciding to accelerate or decelerate the pace of easing through the frequency rather than the magnitude of our adjustments. When evidence of an unexpected slowing in monetary growth began to appear during last summer, Federal Reserve easing resumed; and as the shortfall in money growth deepened and the strength of disinflationary pressure became more evident, the frequency of those moves picked up.

Most recently, as you know, the Federal Reserve lowered the discount rate by a full percentage point. We were able to act more forcefully because of the clear disinflationary trend established, and emerging evidence in long-term bond markets that inflation expectations, which had been stubbornly high for some time, were moderating as well. Moderation in these expectations is crucial for sustaining the highest possible economic growth over time.

Policies that did not take this into account would be less effective and ultimately potentially counterproductive.

The markets have obviously responded positively to the December 20 initiative, with both long-term yields falling markedly and stock prices rising sharply. The good response of long-term securities markets is essential in current circumstances. The recent rise in stock prices should encourage continued elevated equity offerings, while lower corporate bond rates should spur additional funding of liabilities--both factors directed at helping to repair stretched private balance sheets.

As we noted in the press release that accompanied our most recent discount rate decrease, we believe that action, combined with the effects of previous easing actions, should provide considerable impetus toward a sustained revival of economic expansion in 1992. However, we also recognize that the unusual factors retarding the economy may continue to operate in ways we, and the financial markets, can not now anticipate. We will continue to monitor the situation carefully, and stand ready to take steps necessary to foster sustainable economic expansion.

Budget policy can also contribute to a restoration of a more vigorous economy, primarily by focusing on longer-term issues related to saving and investment. I, and others, have long argued that the lack of saving and investment is the most fundamental shortcoming of our

economy. Bolstering the supply of saving available to support productive private investment must be a priority for fiscal policy, and in that regard, reducing the call of the federal government on the nation's pool of saving is essential. Federal expenditure restraint is, in turn, essential to this goal. At a minimum, care should be taken to ensure that any short-run budget initiatives do not imply a widening of the deficit over the longer run.

The increasing evidence that inflationary pressures and expectations have been contained augurs well for a restoration of long-term economic growth. So, too, does the evidence that American industry is striving to enhance efficiency and competitiveness, as does the ongoing rebuilding of balance sheets by lenders and borrowers. Together, these trends will make a significant contribution to promoting the return to solid economic expansion the American people rightfully expect.