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Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

U S House of Representatives

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Mr Chairman, I am pleased to appear here today As you know, the Federal Reserve will submit its semiannual report on monetary policy to the Congress later this month That report will cover in detail the System's policy targets for 1992, as well as our expectations for growth and inflation Today, I would like to focus on some of the broad considerations bearing on our economic prospects

The recent performance of the economy clearly has been disappointing, and it is apparent that some strong forces have been working against a typical cyclical revival in economic activity Indeed, in many respects, these underlying forces, which were obscured for a time by the gyrations associated with the crisis in the Persian Gulf, have been impeding growth since well before the economy tilted into recession in the fall of 1990

During the 1980s, large stocks of physical assets were amassed in a number of sectors, largely financed by huge increases in indebtedness The buildup of debt was originally largely collateralized or matched by rising asset values, but owing to the weakening of property values, the debts have become more troubling The endeavor to redress these debt imbalances has led many businesses and households to divert cash flows to debt repayment rather than investment and consumption, thereby depressing aggregate economic demand

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 This process has also damaged the asset positions, creditworthiness, and possibly the willingness to borrow of many developers, entrepreneurs, and other businesses Another characteristic of the 1980s was the 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

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 normal 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

Most analysts, of course, were aware of the increasingly disturbing trends of rising household debt and elevated corporate leverage However, they did not think that these burdens had reached a magnitude that would restrain the American economy from a moderate cyclical recovery in 1991 Indeed, output began to move up last spring and, as inventory liquidation abated around midyear, 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

By late summer, however, with half the decline in output during the recession recovered, it became clear that the cumulative upward momentum that had 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

Consumer spending on motor vehicles and other items softened, and household and business sentiment, which had rebounded in a normal fashion as the cyclical recovery began last spring, fell back in the autumn as the recovery stalled Inventories backed up in the wholesale and retail trade sectors, particularly of goods ordered earlier from abroad in anticipation of climbing sales The inventory bulge, in turn, contributed to the drop in imports of late and to the persistent slackness in industrial production in the U S 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 growth of demand from abroad for our goods All told, U S industrial output changed little between July and December

Against a backdrop of sluggish activity, receding inflationary pressures, and weakness in the monetary aggregates, the Federal Reserve eased monetary policy over the last several months of 1991--at times aggressively As we indicated in our press release accompanying the cut in the discount rate to 3-1/2 percent in December, we expect that the amount of monetary ease in the pipeline is adequate to turn the economy onto the path of sustained recovery But, assessing the economic outlook at the present time is extraordinarily difficult We are, of course, continuing to evaluate whether some additional insurance in the way of further monetary ease would be appropriate

Not unexpectedly, lower interest rates are reducing debt service burdens and are encouraging companies and households to hasten the repair of stretched balance sheets. Offerings of new corporate equity shares in our capital markets have risen to record levels, and large bond issues are funding short-term liabilities and higher-cost

long-term debt Households are not only repaying debt but are initiating heavy mortgage refinancings that are reducing their debt service burdens as well

We thus have already made considerable progress in the balance-sheet adjustment process, and this unusual restraint on economic activity should begin to dissipate, hopefully in the reasonably near future But resumption of a sustainable, healthy recovery also depends, among other things, on a restoration of consumer and business confidence

On the surface, the extraordinary apprehension on the part of consumers and businesses does not seem to square with the broad macroeconomic circumstances To be sure, our recent economic performance is disappointing when measured against the norms of previous recoveries--or even against the forecasts made last summer And such gains as there have been since last spring have not reached all sectors of the economy or all regions of the nation .But, it does not appear that we are tumbling into another significant contraction in overall activity

This suggests that the highly aggregated macroeconomic data may not be capturing the full story For example, although consumers as a group are clearly benefitting from the recent developments in financial markets, some individuals--many them retirees--are suffering because their interest income has shrunk And on the employment front, the unexpectedly sharp slowing in labor force growth over the past few years suggests that individuals' assessments of job availability may be much more negative than is implied by many of the traditional labor market indicators In addition, the string of job cuts announced by many large corporations undoubtedly has heightened concern about job security--both now and in the future

More fundamentally, I suspect that what troubles consumers, and indeed everyone, is that the current pause in activity may be underscoring a sense of retardation in the growth of living standards over the long run. So long as the recovery remained convincingly on track, these latent concerns did not surface. But as the recovery failed to meet expectations, earlier worries about our long-run economic prospects and whether the current generation will live as well as previous ones reemerged

The record of the past decade provides ample reason for concern While we saw some improvement in productivity trends--at least relative to the experience of the late 1970s--our performance left much to be desired, a fact reflected in our loss of international competitiveness in a number of industries and in the disappointing real incomes of too many American families Especially disturbing was the failure of many young persons to acquire the education and skills needed to keep pace with the demands of our rapidly changing economy--and the prospect that they will fall even further behind in the 1990s

The attainment of rising living standards in the future will hinge crucially on our ability to elevate productivity growth To be sure, economists have not had great success in forecasting, or even explaining after the fact, the shifts in productivity in years past It is thus conceivable that the pay-off from the restructuring efforts of American business will turn out to be considerably larger than we now expect But we cannot count on such an outcome The surest way to ensure a better productivity trend is to take actions that will increase domestic investment: it is here that our major policy focus must rest

I, and others, have long argued before this Committee that bolstering the supply of saving available to support productive

private investment must be a priority for fiscal policy In that regard, reducing the call of the federal government on the nation's pool of saving is essential Above all, I urge you to adhere to a budgetary strategy for FY1993 and beyond that is geared to the longer-run needs of the U S economy At a minimum, maintaining a commitment to the elimination of the structural budget deficit over the coming years will help enormously to alleviate the concerns of the American people about our economic future.