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Remarks by

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I am pleased to have the opportunity this morning to participate in your national convention In a few days, I shall be submitting the Federal Reserve's semiannual report to the Congress That report will spell out the System's policy targets for 1992, as well as our expectations for economic growth and inflation. This morning I would like to share with you, however, some of the broad considerations that I consider important in assessing economic prospects I intend to focus, in large part, on issues that I believe will be crucial to achieving sustained economic growth and rising standards of living.

Viewed either in the context of longer-run growth trends or in a cyclical context, the recent performance of the economy clearly has been disappointing After two quarters of moderate growth, real gross domestic product posted only a marginal increase last quarter, and it has retraced just half of the declines that occurred in late 1990 and early 1991 Rehiring has been particularly slow, and recent employment trends have been weak

Last year, as the economy began to turn upward, we recognized that some unresolved problems would be working against a robust cyclical revival Indeed, those underlying counterforces--particularly the strains from excessive levels of private and public debt--were already active well before the economy was tilted into recession by the crisis in the Persian Gulf With the gyrations brought on by that crisis behind us, we have been able to reassess the importance of eliminating these impediments to growth

As you well know, over the course of the 1980s, large stocks of physical assets were amassed in a number of sectors and were

financed principally by huge increases in indebtedness In those years, the buildup of debt was largely matched by rising asset values The collateral behind loans looked ample But owing to the weakening of property values in recent years, the debts became more troubling The endeavor to redress these debt imbalances has led many businesses and households to divert cash flows to debt repayment rather than to investment and consumption, thereby depressing aggregate economic demand

In the business sector, the most obvious example of the excesses of the 1980s is that of commercial real estate We accumulated vast amounts of office and other commercial space--space beyond the plausible needs in most locales well into the future I needn't tell you that many lenders who lavished credit upon developers are paying the price today in the form of loan losses and impaired capital positions The natural result has been a reduced 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

The 1980s also were characterized by a wave of mergers and buyouts--purchases of corporate assets that often involved substitution of debt for equity and that were undertaken in anticipation that the sale of assets at higher prices could be relied upon to repay the debt The subsequent disappointments have been numerous, and the fallout for holders of many below investment grade bonds and related loans, painful

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 income

As I noted earlier, even prior to the recession, most analysts were well aware of these increasingly disturbing trends of elevated corporate leverage and rising household debt Thus, the signs that emerged last year that businesses and households were taking action to restore healthier balances between their debt and income were no surprise--indeed, they were viewed as positive developments for the long run The ratio of domestic nonfinancial sector debt to nominal gross domestic product, which had been on a steep uptrend in the 1980s, began to flatten out last year Equity issuance by nonfinancial corporations picked up and once again exceeded share retirements Repayments of consumer credit outpaced new extensions

Nonetheless, last spring and early last summer, household spending and business equipment outlays were growing moderately But, restrained by the strong desire to restructure balance sheets and the retrenchment in commercial real estate, the recovery in final sales was moving at a rate well below that typically recorded in most business cycle expansions Then, by late last summer, what upward momentum there was in the system was largely spent The continued strong propensity of households to pare debt and of businesses to reduce leverage had indeed taken hold

Last autumn, consumer spending on motor vehicles and other items softened, the expansion in new homebuilding faltered, and business spending failed to pick up any steam 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 In the event, inventories backed up a bit in the wholesale and retail trade sectors, particularly of imported goods ordered earlier from abroad in anticipation of a sustained rise in sales. Efforts by businesses to eliminate the inventory bulge, in turn, included both the slowdown in industrial production in the U S and a sharp drop in imports late last year

Against the backdrop of the slowdown in economic activity and in monetary growth, as well as receding inflationary pressures, 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 believe that the amount of monetary ease now in the pipeline is adequate to turn the economy onto the path of sustained recovery But with all of the uncertainties attending the current circumstances, we must--and will--continue to monitor day-to-day developments closely for validation of that judgment, and, if necessary, move toward an increased degree of monetary ease

I believe that a good deal of progress has been accomplished by businesses and households to date in the balance-sheet adjustment process I expect that the payoff in the form of an easing of unusual restraint will begin to become evident, hopefully in the reasonably near future 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 not only are repaying debt, but are initiating heavy

mortgage refinancings that are reducing their debt-service burdens as well.

Despite these positive signs, assessing the economic outlook at the present time is extraordinarily difficult The differences between current business conditions and between the structure of today's economy and the economic environment that generally has prevailed since the end of World War II are profound Moreover, one important imponderable factor in the current situation is the state of consumer and business confidence According to a number of surveys of American households, confidence about economic prospects has sunk to the depressed levels that we experienced in late 1990 and early 1991 during the crisis in the Persian Gulf

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 what gains in activity have occurred since last spring have not reached all sectors of the economy or all regions of the nation The Department of Labor reports, for example, that fewer than half of the major industries posted increases in payroll employment over the six months ending in January Moreover, looking ahead, some industries and regions are facing structural adjustments that will not be easy, I have in mind not only the contraction in industries dependent on commercial real estate development, but also the budgeted cutbacks facing defense industries and the restructuring under way in the service sector

All this suggests that the highly aggregated macroeconomic data may not be capturing the full story For example, although

consumers as a group are clearly benefiting from the recent developments in financial markets some individuals--many of them retirees--are suffering because their interest income has shrunk And, on the employment front, the unexpectedly sharp slowing in the growth of the labor force 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 employment cuts and restructurings announced by many large companies undoubtedly has heightened concern more generally about job security--both now and for the future

More fundamentally, I suspect that what troubles consumers, and indeed everyone, is that the current pause in activity may be underscoring their sense of a 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, nagging worries reemerged about our long-run economic prospects and whether the current generation will live as well as previous ones

The record of the past decade provides ample reason for concern While we saw some improvement in productivity trends--at least relative to the dismal experience of the late 1970s--our performance left much to be desired And that fact was reflected not only in a persistent struggle by American businesses to gain a competitive edge in world markets but also in the disappointing growth in the real income of too many American families

Those individuals with less formal education and skill realized significantly lesser gains in real income compared with those who were better educated and more highly skilled In fact, a significant part of our workforce has experienced a decline in real

incomes and a retardation of living standards even as underlying average real income levels for the nation as a whole were rising Presumably a considerable part of consumer discouragement of late reflects the concerns of this part of our workforce These developments, while disturbing, should not be surprising when one considers the profound impact that changes in the competitive environment and technological advances have had on labor markets over the past several decades

More specifically, we have experienced a pronounced rise in that part of the value of economic output that is conceptual, as distinct from physical Economic value added is becoming increasingly the result of ideas rather than the exploitation and fabrication of physical resources as in the past Output of comparable utility now generally has less bulk and weighs less The vacuum tube has been displaced by tiny transistors Huge tonnages of copper wire have been replaced with lesser volumes of fiber optics As a result, the official measure of gross domestic product adjusted for prices changes has been growing substantially faster in recent decades than the same product measured in tons These trends have changed the type of physical output we produce--for instance, offices built with lighter-weight steel and outfitted with high speed information-processing technology And they have affected how we produce that output--the use, for example of computer-assisted design systems, machine tools, and inventory control systems Moreover, developments such as breakthroughs in medical research that have revolutionized health care are illustrative of a long list of examples underscoring the rise in the ratio of concepts to physical effort and bulk as the source of economic value creation That growing intellectual contribution to output largely has been reflected in the

explosive growth in information gathering and processing techniques, which have greatly extended our analytical capabilities and have had enormous consequences for virtually all facets of our economic lives.

These changes in the structure of economic activity have understandably contributed to marked shifts in the patterns of employment across industries and regions, as well as to changes in the mix of occupations and in the nature of jobs In the statistics on income and employment experience, we see them reflected in the more rapid rise during the 1980s in the monetary returns to those individuals with the knowledge and skills to meet the growing demands for workers who can efficiently absorb information and perform analytical tasks

The growth of technology has both coincided with, and facilitated, the increased linkage of international markets and intensified foreign competition The ease and speed of technology transfer, across national boundaries as well as among domestic industries, has been a key factor Producers in other industrialized countries, by maintaining rapid rates of capital formation and having the flexibility to innovate quickly, have been able to capitalize on knowledge developed by themselves and others As a result, they now compete successfully with U S firms in high-technology products And among the developing countries, advances in automation have allowed producers to equip their low-wage work forces with modern machinery and to become highly competitive in many areas, including consumer electronics, steel, and textiles

In this environment, our prospects for economic growth will depend strongly on our ability to develop and to apply technology Admittedly, our ability to retain control over new ideas and products has become more difficult because of the rapid international diffusion

of technology But we must not fall behind in converting scientific and technological breakthroughs into viable products

The attainment of rising living standards in the future for all our people depends critically on our ability to get productivity growth up, and that will require greater amounts of investment--in human capital and in research and development, as well as in the more tangible plant and equipment

On the human capital front, workers who are better educated and are equipped with the skills to deal with more complex problems or processes generally have the ability to adapt more readily to the changing demands of the economy They can switch jobs more easily, and they tend to spend less time unemployed In coming years, we should see some increment to the growth rate of productivity simply from the aging of the workforce--a shift to a mix of workers with more years of experience

We also need to accelerate the pace at which our stock of knowledge is growing By this I mean increasing the flow of inventive activities--usually measured by research and development expenditures--that results in changes in technology that in turn increase the amount of output that can be realized with a given amount of labor and capital Most indicators suggest that during the 1980s the expansion of inventive activity was not keeping pace with the rate at which the structure of our economy was becoming dependent on ever-changing technology We can see this in the data on spending for research and development, employment of scientists and engineers conducting R&D, and the number of patents granted Indeed, compared with other industrialized countries, U S R&D spending had historically been the highest as a percentage of gross domestic product Japan and Germany have, however, been increasing their ratio

of R&D to gross domestic product steadily, and during the 1980s pulled even with the U S

We also must be willing to maintain a high level of business investment, in order to outfit our production facilities with the most up-to-date technology and machinery But here, too, recent trends have not been favorable Investment net of depreciation--that is, the portion of investment spending that actually adds to the nation's capital stock--declined noticeably as a share of net national product during the 1980s The effect this decline had on our productive capacity was offset, to some extent, by increased productivity of certain types of short-lived equipment such as computers Nonetheless, the quantity and quality of investment has apparently been inadequate to speed the growth of productivity

Prospects for investment in coming years will depend on a number of factors, but undoubtedly will be improved by the adoption of sound macroeconomic and structural government policies I have long argued that bolstering the supply of domestic 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 I have recently urged a budgetary strategy for the fiscal year 1993 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

An improvement in private saving would also be desirable, although, to date, we have had little success in designing policies to boost private saving Nonetheless, our history suggests that in the

past we have saved and invested at higher rates and hence can presumably do so again

In closing, let me briefly offer an assessment of where we stand on several economic developments critically related to the longer-run outlook As I outlined at the outset, I see the recent shifts in business and household management of their balance sheets as a promising sign that consumer and business demand will be firming, I hope, in the near term But, just as important, I suspect that we will not see a return to the excessive debt reliance of the 1980s In essence, I trust we have learned an important lesson--albeit a painful one--from that experience

The increasing evidence that inflationary pressures and expectations have been contained also augurs well for the outlook I believe that we are on a course consistent with further meaningful progress in reducing inflation over the next several years Lower rates of inflation and reduced uncertainty about inflation should create an environment conducive to higher levels of saving and investment Specifically, low inflation expectations reduce incentives to engage in destructive leveraging of balance sheets

As I indicated earlier, our ability to raise investment will determine our success in achieving a higher sustainable trend in economic growth But no single policy or program, by itself, is likely to ensure that result Rather, improving productivity will require action on many fronts, in both the public and private sectors

Many of the challenges that we face today evolved from the rapid changes in the economy that we witnessed in the 1980s--intensified international competition, spreading deregulation, technological advances, financial innovations All such changes in the structure of the economy naturally create frictions, at least

temporarily As those frictions dissipate, I suspect that the economy will emerge healthier And, if we are able to boost our investment in people, ideas, processes, and machines so that the economy can operate more effectively as it adapts to change, an even greater payoff should come in a broadly based rise in living standards over the longer run