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Rotary Club

THE U.S. ECONOMY IN 1985 AND BEYOND

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I would like to talk today about the outlook for 1985, both for the nation and for our region. In a broader context, I would also like to discuss prospects for the economy in the longer term.

National Scene

A year ago at this time many economists had serious doubts about the recovery's strength and durability. As a result, most were predicting rather modest GNP growth. In addition, expectations were widespread that inflation would be higher than in 1983. On the brighter side, many economists forecast a decline in the exchange rate of the dollar and, hence, some improvement in our nation's international trade situation.

My views were generally similar to this consensus outlook. At that time, I projected that the economy was likely to slow to a growth rate of around 5 percent and that unemployment would probably hover at the 8 percent level, perhaps dropping to 7 1/2 percent by the end of 1984. In addition, I expected inflation to pick up to about 5 percent.

Although these projections were not far off the mark, it was my happy experience to have erred on the side of underestimating the enormous growth in G.N.P. while overestimating both the inflation and unemployment that we actually experienced in

1984. As you all know, 1984 brought heady economic growth in the first half. GNP expanded at a rate far in excess of what had been anticipated. We will probably have a full-year growth rate of nearly 7 percent, the highest in almost 30 years. This expansion was led by consumers, whose purchases of homes, cars, appliances, and a myriad of durable and nondurable items spurred businesses to increase production, expand their work forces, and build their inventories in anticipation of continued strong sales. Businesses also served as a dynamo of growth by sharply increasing their spending on capital goods. Business investment, particularly in machinery and other equipment and, to a lesser extent, in new plants, contributed significantly to the expansion we witnessed in manufacturing as well as construction.

A sharp slowdown did take place in the third quarter, reducing GNP growth in that quarter to less than two percent and raising concerns in some quarters that our expansion might not last much longer. Consumer spending, including auto sales, cooled substantially. Construction of single-family homes had slowed earlier in the year in response to upward movements in interest rates. The third-quarter moderation in consumer spending caught many producers and retailers off guard. When coupled with the previous weakening in construction, the reduced pace of consumer spending left many manufacturers and merchants with large inventories accumulated earlier in the year in anticipation of continuing strong sales. In order to stem this unintended buildup of stocks, businesses cut back their orders for new goods, and repercussions were felt throughout the economy. In addition, the widely predicted decline in the value of the dollar did not occur; instead, the opposite developed as the dollar gained record strength. Consequently, exports lagged, braking the speed of expansion even more.

Some of the softness, particularly in auto sales, was blamed on the General Motors strike and its effects on both consumer spending and on the many manufacturing industries tied to auto production. However, the bad news continued for a while, and some analysts began to argue that a new recession was on the horizon. Nonetheless, signs of improvement began to appear as early as October and November, and fundamental strengths persisted through the slowdown in the summer and fall. These factors lead me to believe that the weakness manifested in the third quarter was part of a transition from the very rapid and unsustainable growth in early 1984 to a more sustainable pace in 1985.

Indeed, the rapid growth that we experienced in the first half of last year had troublesome inflationary implications. For example, capacity utilization rose to over 80 percent, a level many economists believe cannot be sustained without creating bottlenecks that tend to drive up prices. Consequently, some slowing seemed necessary, although, like most people, I was surprised by its extent. Fortunately, even during the weak third quarter, most of the important underlying economic conditions remained positive. Personal income, for instance, still grew at an annual rate of about 4 percent, and personal savings rose as Americans spent less of their household budgets and their increased incomes on consumer goods. Inflation remained around 4 percent throughout the year, a low level given the robust expansion in 1984 and the nation's frightening inflationary experience in the late 1970s and early 1980s. Business investment slowed in the third and fourth quarters but remained essentially strong. Finally, interest rates began to fall late in 1984. By year-end, a number of indicators were already displaying renewed strength.

Thus, the fundamentals seem to be in place for healthy growth in 1985, although at a slower pace than in 1984. Consumer purchases, investment by businesses, and expenditures by the government all should contribute to making 1985 a good year, with real GNP growth probably in the range of 3 to 3 1/2 percent. Consumer spending is likely to rebound since growth in personal income and employment persisted even during the lull. Business spending on capital goods should continue to fuel expansion in 1985, even though the growth rate in business investment, like that of consumer spending, probably will be slower than in 1984. Last year's legislative modifications of the tax treatment of business investment did not substantially alter the favorable climate for spending on capital goods established by Congress and the administration a few years ago. Recent Treasury Department tax reform proposals, which would eliminate many special provisions designed to spur investment, could, ironically, catalyze investment in equipment this year. Businesses may try to take advantage of such provisions before they are rescinded. On the other hand, uncertainty about potential tax changes may cause business to defer planned investment.

A third source of short-term strength is fiscal policy, which is highly stimulative. Defense expenditures in particular should help maintain substantial momentum in the the nation's factories, even if cuts are applied to defense as well as other federal programs. Military projects approved in the past few years should maintain strong activity through at least 1985 and possibly into 1986. Another source of stimulus is the interest rate decline late in 1984. Reduced credit costs should spark at least a temporary revival in residential housing by attracting buyers back into the market and making it relatively cheaper for builders to undertake new projects. Finally, while monetary growth did weaken for several months, particularly in the case of M1, recent numbers show a substantial rebound. In fact, M2 and M3 have been expanding at very rapid rates in the past few months.

Of course, some potential problems and weaknesses loom in the months ahead, and certain sectors of the economy are less likely to be sources of expansion this year. The construction industry will probably show mixed patterns in 1985. Much of the pent-up demand for housing has been filled. Consequently, a return to the booming single-family construction that we saw in the recovery stage is unlikely. The remaining housing demand will probably be rather sensitive to mortgage rates. Multifamily building may have grown faster than demand in 1984. Apartment vacancy rates are high in many areas, and the stock of unsold condominium units is also substantial. Nonresidential construction should continue its momentum, but I am concerned about commercial building. Office vacancy rates in many cities are worrisome.

Another area of continuing weakness, and perhaps one of the most important, is the international sector. The high exchange value of the dollar and the slower recovery abroad have sapped considerable strength from American manufacturing. Producers of textiles, apparel, lumber, and other goods that are sensitive to foreign competition experienced weak growth in 1984, and their condition probably will not improve in 1985. In addition, industries with a heavy dependence on exports, such as agriculture and machine tools, cannot hope for much stimulus from foreign demand. Even if the dollar were to decline, it would take time to have a substantial effect on trade patterns.

Because of these weaknesses and the likelihood of slower growth in consumer spending and business investment, unemployment will probably decline much less this year than it did in 1984. Still, I am quite hopeful that it will fall below the 7 percent mark. Also, at this mature stage of a business expansion, the anticipated resurgence of growth could possibly produce a somewhat higher rate of inflation, probably in the neighborhood of 4 1/2 to 5 percent. Overall, though, I look for respectable economic growth consonant with this stage of the business cycle.

Outlook for the Southeast

Businesses and workers here in the Southeast are likely to share the fruits of this anticipated economic expansion. However, because of the nature of many state economies, which tend to be concentrated along lines of local comparative advantage, particular strengths and weaknesses that affect the national economy may have a more pronounced impact in certain areas. Agriculture, a sector of substantial importance to many parts of the Southeast, faces a somewhat clouded year. Continued weakness expected for farm exports is one factor underlying this prognosis. In addition, many farmers in the Southeast have been financially troubled. Weak foreign sales, low prices for many crops and livestock, and high real interest rates make it difficult for such farmers to improve their credit situation, and no substantial change appears in the offing. This rather bleak farm outlook will affect many areas of the Southeast, but the combination of factors will probably have the most severe effects on Mississippi and Georgia since the agricultural sector plays a more important role in these states, and their financial plight is the most serious in the region.

Georgia and Florida probably will continue to enjoy the greatest growth among states in the Sixth Federal Reserve District. Both these states escaped relatively unscathed from the last recession, and their performance in the expansion has remained remarkably strong, given their already vibrant activity. A continuing population influx helps both states by sustaining the need for new homes, apartments, and office buildings. A growing population also boosts demand for business and personal services, which are important components of the Florida and Georgia economies. Another source of national strength—defense spending—will be of particular importance to Florida and Georgia, since defense-related manufacturing of electronics and transportation equipment is important in both states. Finally, the healthy effect of lower interest rates on auto sales augurs well for local car production and assembly plants.

Mississippi, Alabama, and Louisiana are likely to remain the weakest states, economically-speaking, in the Southeast. Worldwide energy supplies that far exceed demand have depressed prices and conditions generally for Louisiana's petroleum products and Alabama's coal. The unusually high exchange rate of the dollar is aggravating problems of the Southeast's energy sector by making its products more expensive in world markets, and improvement appears unlikely in the near term. The dollar's high value is also intensifying the foreign competition faced by Alabama's important steel industry. Moreover, two of these three states also have a large concentration of textile and apparel industries that have been hard hit by imports, whose prices are discounted by the current value of the dollar. The textile and apparel industries are likely to remain weak in 1985, thus compounding the problems foreseen for Alabama and Mississippi and muting the growth expected in Georgia and Tennessee, where these industries are also important.

Tennessee's prospects for 1985 lie somewhere between the extremes of Florida and Georgia on the one hand and Alabama, Mississippi, and Louisiana on the other, but it seems likely that Tennessee's performance will lean toward greater strength than weakness. Expected growth in consumer buying and capital spending by businesses should boost Tennessee's important durable manufacturing sector. However, nondurables like textiles, apparel, and chemicals will probably continue to languish as a result of intense price competition by foreign producers. Notwithstanding probable weaknesses in some aspects of the southeastern economy, on the whole, most residents of this region should enjoy a year of economic prosperity as good, if not better, than that experienced by the rest of the nation.

Problems

I am basically optimistic that the future looks positive, but some areas remain weak and in need of change in the next few years. These problems include inflation, unemployment, real interest rates, the deficit, and international trade. The rate of price increases did decelerate dramatically in the early 1980s and has remained a moderate 4 percent despite the rapid economic growth we experienced last year. Nonetheless, little more than a decade ago 4 percent was deemed sufficiently high to warrant the imposition of wage and price controls. Clearly, we have room for more improvement on this front.

Similarly, the progress we have made toward reducing the unemployment rate from double-digit levels is cause for enormous satisfaction with our economy's capacity to rebound. Still, the current 7.2 percent jobless rate is far from the full-employment level of 4 or 5 percent that we as a nation have been committed to since the end of World War II. Moreover, unemployment remains much higher than 7 percent in many industries and areas, including parts of our own region. Certainly, we must strive to lessen the human suffering and unrealized economic potential implied by these statistics.

A third problem is the high level of real interest rates we are experiencing. High real interest rates increase business costs generally and discourage investment. Consumer demand for houses, autos, appliances, and home furnishings is also dampened in such an environment. Thus, credit costs are a cause for concern since the large federal deficit seems likely to remain a source of upward pressure on real interest rates. The federal budget deficit, even adjusted to the level that could be expected if we had full employment, is now over 3 percent of GNP compared to about 1 to 2 percent in most of the 1970s. It's actually closer to five percent since we haven't had full employment. The burden of this deficit will carry over to future generations. We are obligating our children and grandchildren to save more and to pay higher taxes in order to service the interest on and retire the huge debt burden that we as a nation are accumulating.

Deficit problems affect not only domestic financial markets but also the international sector, as high real U.S. rates make dollar-denominated investments more attractive to foreigners. The higher return from holding dollars raises our currency's exchange rate and thereby worsens our trade deficit by raising prices of exported goods to foreigners and lowering prices of imports to Americans. I have already mentioned that the dollar's strength is seriously hurting American exports and sharply increasing imports, exacting a considerable toll on American manufacturers in a wide variety of industries ranging from labor-intensive apparel mills to capital-intensive steel mills.

A continuation of the current international situation could result in a resurgence of protectionism. Many firms have been holding on by a thread, hoping the exchange rate of the dollar will decline. It is understandable that firms in such straits would welcome protectionist measures to help them ride out what most economists view as an abnormal situation. However, protectionism tends to adhere to Newton's Third Law in the sense that action by one country is usually followed by countermeasures in other countries. It may take years of negotiations to return to the degree of free trade that prevailed at the outset, even when protectionist policies are conceived as mere interim measures. Moreover, by postponing necessary reforms, protectionism ultimately weakens the very businesses and workers it is intended to protect. Another adverse consequence of protectionism today could be to snuff out the weak economic recovery in many developing countries by reducing their access to American markets, eliminating a major source of the limited growth they have achieved.

The situation in developing nations is important for another reason. Many less developed countries are heavily indebted, and while default by a third-world nation is highly unlikely, the problem of LDC debt is a serious and long-lasting one. It requires continuing surveillance and careful consideration as we fashion or modify policies intended to correct domestic economic problems and promote growth in the United States.

Longer Term Outlook

Let me turn now to the outlook for the future in a broader context and over a longer term period, say to the end of the century. Looking beyond 1985, it is, of course, much harder to project accurately how the economy will fare. Nonetheless, it is possible to identify the fundamental forces of strength and weakness as well as changes that seem to be occurring in the structure of the economy. In my judgment, there are at least three critical environmental factors at work in our economy and our society generally that will shape our destiny for years to come. These are technology, demographic changes, and the evolution of a global economy. I will discuss each of these in turn as well as their implications for public policy.

When historians and other observers look back in another 50 years to the era of the 1980s, they will no doubt compare our technological revolution to the industrial revolution of the 1800s. Even though, in typical human fashion we are becoming used to our new technology and even taking it for granted, the fact remains that we are witnessing and living through a miraculous time in human history in terms of technological breakthrough—going into space, computerization, miniaturization, to say nothing of the advances in medical science and associated surgical procedures such as the mechanical heart. These are truly wonderful advances that will enrich the lives of people everywhere.

In economic terms, the application of new technology generally results in higher productivity and greater economic growth in the aggregate. American businesses learned in the last recession the importance of investing in technologically advanced equipment and methods in order to compete in the global marketplace. As I've already observed, business investment grew so rapidly in 1984 that it was a leading catalyst of the economy's expansion. Some workers will certainly be displaced as the result of technological innovations, but the flexibility of our labor force due to its greater education and mobility will help in this regard. The challenge will be to find ways to apply technology to the services. This sector will provide a vast portion of the new jobs in the future, and it is important to make them more productive so that wages can rise without inflationary consequences. Finally, we must remember that technological change is nothing new but rather a fundamental force in our economy. Viewed from the broader perspective of history, it has been the source of our leadership among nations. Experiences of the last two decades have made us forget that terms like ingenuity and innovation are virtually synonymous with America!

A second environmental factor that will affect us and our policies is the demographic changes that are occurring in our society. First, we have the "graying" of the population and, second, the maturing of the postwar baby-boom generation. The aging of our population has profound implications for the way in which we structure our work force, retirement, Social Security, and our health care and health delivery systems. With respect to the "baby-boomers," absorption of these men and women into the labor force is virtually complete. Consequently, finding entry-level jobs should be less difficult than over the last decade and a half. Productivity should also increase as a larger proportion of the nation's work force consists of experienced workers, who tend to be more productive. As the postwar generation passes through its peak spending period, demand for all sorts of consumer goods should be strong. Since the number of students now entering school is generally less than when the baby boomers were moving through the educational system, the need to invest in bricks and mortar to accommodate larger student populations should abate. That will leave a larger share of public funds for improving the quality of education, a trend that should add to gains in productivity expected from other factors.

A third environmental factor is the evolution of a truly global market economy. We have come to realize, I believe, that the United States is no longer able to buy and sell only within its own borders. With the possible exception of the Soviet bloc the world is truly one marketplace. The obvious implication of this development is that U.S. industry and business must learn to compete more effectively with foreign competitors. I do not for a moment believe that we need to berate ourselves, as we often do, about our performance relative to foreign economies. In the first place, our manufacturing sector is not nearly as bad off as some would have us believe, and the potential for significant advances in productivity is at hand. With all due respect to our Japanese friends, I am a little tired of hearing constantly about superior Japanese management. I firmly believe that American management is as good as, if not better than, management anywhere in the world. Nevertheless, improvement can be made, and we do need to improve our productivity and the quality of our products so as to compete more effectively in world markets.

One way to achieve these goals, as pointed out in a recent report of the Committee for Economic Development, is to remove government barriers and regulations to the greatest possible extent and to allow free market forces to work in our economy. This is a polite way of saying, let's get the government off our backs. If we need any evidence that this is the right way to go, we need only compare our nation's economic performance during the recovery to that of many developed and developing countries. Too frequently, their economic growth has been constrained and stifled by a large public sector's unintended effects on the economy and its ability to adapt to change. Cradle-to-grave welfare systems are limiting economic recovery in Europe and perpetuating high unemployment rates. In LDCs measures such as price regulations on certain basic goods are distorting their economies, bloating their underground sectors and generally retarding their development. If our government will retreat from the private sector, if the public sector is diminished, market forces will hone our competitive edge and, thereby, enhance our position in world markets.

Finally, let me add one other environmental factor. I believe that we are now emerging from a period of deep negativism in our country to a far healthier attitude of hope and positive thinking. During the 1970s our nation underwent enormous changes such as the shock of oil price increases following the formation of OPEC and the implementation of a new series of regulations designed to make our work places safer and our environment freer of pollution. In addition, the momentum of far-reaching social change begun in the 1960s continued into the 1970s. Once barriers to racial and sexual equality began to be removed, as a society we began to address more subtle and harder-to-remove vestiges of inequality. It is not surprising that in this environment of profound social, political, and economic change that Americans began questioning and criticizing some of the fundamental aspects of our culture.

The changes that occurred exacted a considerable toll on our economy although future generations will probably look back and thank us for making the decisions that we did. Fortunately, the pains of this transition are essentially behind us, and along with that, I believe people are becoming more positive about our nation's performance, economically and in other spheres. Still, we must nourish this renewed faith in our nation's institutions and not become misled by the bad news we often hear and read in the media. As an open and free society, we are often our own severest critic; so it is natural that bad news rather than good fills most of our headlines. At the same time, we must keep our focus on the substance of news reports and on the underlying forces at work in our economy and our nation lest we lose the competitive edge that comes with well-founded self-confidence.

I am not one of those jingoistic, chauvinistic people who believes that all truth, beauty, goodness, and wisdom reposes in the U.S.A. On the other hand, I do believe that we are a rich society in the best sense of the word, and we have proven to be the appropriate leader of the free world. Therefore, I am grateful that we are moving away from our period of malaise and that the American people are more upbeat about themselves. This country has always been a strong, proud, progress-oriented nation with a deep-seated belief that today is better than yesterday and tomorrow will be better than today. Ben Wattenburg, an economist, has recently written a book entitled, The Good News is the Bad News is Wrong. He is right.

Policy Implications

In assessing and evaluating these forces in our economy, I would offer the following prescriptions to insure that we have sustainable, noninflationary growth through the end of the century: (1) take advantage of new technology and improve productivity; (2) invest in human capital by well-chosen policies designed to improve the quality of education; (3) provide a good mix of fiscal and monetary policies; and (4) reduce the federal budget deficit over the next five years.

Let me conclude where I began. Nineteen Hundred Eighty-Five will be a year of good economic growth, with relatively low inflation and unemployment. There are and always will be dangers, problems, and uncertainties. When you add to the economic concerns I have already mentioned, other problems such as the Middle East, Central America, arms control, terrorism—and the list goes on and on—it is obvious we live in a dangerous and difficult world. But I am an optimist, and I think we optimists have proven over time to be the realists. I really believe the future holds promise. We are at the threshold of a new world, but we are also at a crossroads. If we can solve our problems, we have the chance to create an economy and a society that will provide unparalleled prosperity for us, our children, and our grandchildren in the years ahead. We can succeed if we have the wisdom and the will to do it. I believe we can.