

THE U.S. ECONOMY IN 1985 AND BEYOND

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I am delighted to have an opportunity to take part in this symposium. My interest in the role of international trade is long-standing, and I believe that our nation's competitiveness in the global marketplace is a paramount concern for the 1980s. The aspect of that issue that this conference will highlight—management and industrial relations—is an important one, deserving of greater attention. I would like to talk tonight about the economic outlook for 1985 and, in a broader context, the longer term prospects for the U.S. economy, including factors that are likely to influence our productivity and global competitiveness.

National Scene

The outlook for 1985 cannot be adequately assessed without reviewing the economy's performance in 1984 and evaluating what the underlying conditions at year's end portend for the next 12 months. At the beginning of last year many economists had serious doubts about the recovery's strength and durability, and 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 GNP while overestimating both the inflation and unemployment that we actually experienced in 1984. As you all know, 1984 brought heady economic growth. GNP expanded at a rate far in excess of what had been anticipated, and the full-year growth rate was nearly 7 percent, the highest in over 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.

Despite a sharp slowdown in the third quarter that rekindled doubts about the longevity of the expansion, we finished the year on a strong note. The annual growth rate of GNP revived to 4.9 percent from the third quarter's sluggish pace of 1.6 percent. Consumers regained confidence and increased their spending almost 4 percent in the fourth quarter after essentially standing pat from the second to the third quarter. An important factor underlying this revival of consumer spending was the continued growth of employment and personal income. Business investment, especially in plants, office

buildings, and other structures rather than machinery and equipment, also contributed to growth in the fourth quarter. Largely because of the advances in consumer spending and capital investment by businesses, final sales rose over 8 percent in the last three months of 1984 after declining 1 percent in the third quarter. Meanwhile, inventory growth was only half that of the third quarter. This combination of higher sales and lower inventory accumulation enabled producers and retailers to adjust their stocks to more desired levels, thereby setting the stage for renewed growth in factory orders, industrial output, and employment. Indeed, these developments have already begun, and, as a result, the proportion of our nation's productive capacity being utilized continued to edge up in January for the third consecutive month.

At the same time the economy was regaining its momentum, consumer prices continued to moderate, rising at a 2.3 percent yearly rate in December, compared to increases of around 3 1/2 percent in earlier months. Competition from imports and oil price reductions accounted for much of this year-end deceleration in inflation. Yet even service prices, which had been rising more rapidly than the overall price index, abated in December. Although January's unemployment rate rose slightly to 7.4 percent, this change was due largely to a faster increase in the labor force than in employment. While we all would have preferred a fall in the jobless rate, the reasons for the latest increase betoken renewed confidence in the economy. The return to economic growth probably brightened people's attitudes about the prospects for finding employment and caused them to enter the labor force in search of work.

Thus, concerns voiced only a month or two ago that our expansion might not last much longer have been quelled, and expectations are now widespread that growth will continue at a moderate but respectable pace throughout 1985. It now seems clear

that the weakness manifested in the third quarter was part of a transition from the very rapid, potentially inflationary, and unsustainable growth in early 1984 to a more sustainable pace in 1985. Few imbalances or weaknesses currently exist in the economy. Healthy monetary growth and lower interest rates together with the nearly complete inventory correction have laid the groundwork for economic growth in the coming months. 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 1/2 to 4 percent.

Consumer spending is likely to remain healthy since personal income and employment continue to advance. The only current cause for concern is the rapidly rising level of consumer debt, which now stands at over 17 percent of disposable personal income. This level is the highest since April 1980. Moreover, its implications are somewhat more troubling since the lower level of inflation that we are enjoying today will not reduce the burden of this debt as it did in the period of the previous peak. This high level of debt could eventually place a constraint on consumption.

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 or modified. Currently lower interest rates and slowly rising capacity

utilization should provide sufficient impetus for ongoing growth in business investment this year. In addition, business investment in inventories will likely rebound somewhat, following the sharp deceleration in the fourth quarter of 1984 and the improvement in final sales.

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 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 stimulus is the interest rate decline late in 1984. Monetary growth rebounded smartly in recent months after a previous weakening, particularly in the growth of M1. This growth and the concomitant decline in interest rates should encourage economic growth in 1985. Even though residential construction tends to lag behind other changes, some of this effect has already been observed in the housing sector. By making it relatively cheaper for builders to undertake new projects, reduced credit costs should spark at least a temporary revival in home building. Housing starts did jump almost 15 percent in January, although apartments and other multifamily building accounted for this growth. 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.

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. Perhaps the foremost area of continuing weakness 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. In contrast to recent business cycles in which the adverse effect of high real rates has been felt as "crowding out" of construction and capital investment, the foreign trade sector has suffered the most in this business cycle. While capital spending and residential building proceeded apace despite high real interest rates, the merchandise trade deficit for 1984 totaled over \$123 billion, far higher than the previous record shortfall of \$69 billion in 1983. The outlook for a decline in the value of the dollar is uncertain. Despite narrowing interest rate differentials and large trade deficits, the trade-weighted index of the dollar has risen considerably just since the beginning of 1985. Even if the dollar were to decline, it would take time to have a substantial effect on trade patterns.

A second potentially dampening factor is fiscal policy. Significant alterations, particularly in the tax system, could adversely affect financial markets. Many businesses are concerned that efforts to reduce the deficit will lead to higher corporate taxes, which would tend to limit long-term investment. Uncertainty about potential tax changes may cause businesses to defer planned investment, particularly in the near term, until the nature of tax changes likely to be enacted becomes more evident.

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 seven percent mark. Import competition, lower oil prices, and bountiful harvests should hold

price increases to 3 1/2 to 4 percent, close to recent trends. Overall, 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. One source of national strength—defense spending—will be of particular importance to many southeastern states where defense-related manufacturing of electronics and transportation equipment is important. The healthy effect of lower interest rates on auto sales augurs well for car assembly plants in this region. Finally, a continuing population influx should help many southeastern states outperform national averages by sustaining the need for new homes, apartments, and office buildings. A growing population also boosts demand for business and personal services.

Agriculture, a sector of substantial importance to many parts of the Southeast, faces a somewhat clouded year. Weak foreign sales, low prices for many crops and livestock, and high real interest rates make it difficult for farmers to improve their credit situation, and no substantial change in these conditions appears in the offing. 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 steel producers in the region. Moreover, many southeastern

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. 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 as, if not better than, that experienced by the rest of the nation.

Problems

I am basically optimistic about the future, but some areas remain weak and in need of change in the next few years. These problems include inflation, unemployment, the deficit, real interest rates, and international trade. The rate of price increases did decelerate dramatically in the early 1980s and has remained a moderate four percent despite the rapid economic growth we experienced last year. Nonetheless, little more than a decade ago four 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 7.4 percent jobless rate is far from the full-employment level of 4 or 5 percent to which we as a nation have been committed since the end of World War II. Moreover, unemployment remains much higher than seven percent in many industries and areas. Certainly, we must strive to lessen the human suffering and unrealized economic potential implied by these statistics.

A third problem is the very large federal budget deficit. As macroeconomic growth moderates and the deficit increases in absolute terms, the federal budget deficit, even adjusted to the level that could be expected if we had full employment, is likely to remain around 3 1/2 to 4 percent of GNP throughout 1985 compared to an average of about 1 percent since the mid-sixties. This deficit is extremely troubling for several reasons. Large federal budget deficits tend to exert upward pressure on real interest rates. High real rates increase business costs generally and discourage investment. Consumer demand for houses, autos, appliances, and home furnishings is also dampened in such an environment.

Deficit problems affect the international sector as well because 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 foreigners must pay for exported U.S. goods and lowering prices Americans pay for imports. 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 plants 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 history in terms of technological breakthroughs—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 developments 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. The United States has historically been a technological leader. Experiences of the last two decades have made us forget that terms like ingenuity and innovation are virtually synonymous with America and that technological leadership is fundamentally related to our political and economic leadership among nations. In the last recession, American businesses learned, or rather relearned, the importance of investing in technologically advanced equipment and methods in order to compete in the global marketplace. Nonetheless, we have not yet felt the full effect of that investment. Productivity grew about two percent last year, the postwar average rate for the second year of an expansion. However, productivity gains have not been consistent. In the third quarter, productivity fell 1.1 percent, and the fourth quarter gain was only 1.7 percent. Although the considerable investment that has taken place could render performance this year better than in the typical mature phase of the business cycle when productivity gains usually slow, the longer term challenge will be to find ways to supplement technology-related productivity gains, especially in the service sector. This part of the economy is likely to provide a

vast portion of the new jobs in the future, and services historically have been less amenable than manufacturing to technology-induced productivity advances.

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. As the postwar generation passes through its peak spending period, demand for all sorts of consumer goods should be strong. Productivity should also increase as a larger proportion of the nation's work force consists of experienced workers, who tend to be more productive. 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 producers. I do not for a moment believe that we need to berate ourselves, as we often do, about

our performance relative to other 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. 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 raise our productivity and the quality of our products so as to compete more effectively in world markets.

One way to achieve these goals is to seek better relations between labor and management, whether by giving workers an equity stake in their organization through employee stock ownership plans, by adopting and adapting some of the collaborative techniques that have worked well in Japanese and European companies, or by other innovative, uniquely American measures. Researchers at the Federal Reserve Bank of Atlanta have found that companies with outstanding financial performance tend to give employee job satisfaction a high priority among corporate goals. Other research conducted by Bank staff has discovered that gain-sharing measures like employee stock ownership can be effective, often highly remunerative, benefits and significantly reduce turnover, thereby making companies' investment in their employees more worthwhile. If ways can be found to improve our human capital through relations on the job, the productivity advances that should occur from demographic and technological changes will be greatly augmented.

As pointed out in a recent report of the Committee for Economic Development, another way to improve our productivity and product quality and thereby enhance our global competitiveness 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 products and work places safer and our environment freer of pollution. Meanwhile, workers were seeking to increase their share of our national income distribution. 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 most of 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. Furthermore, workers have come to recognize the inflationary consequences of wage gains that exceed productivity improvements. Recent contracts and wage settlements reflect this awareness and a new flexibility on both sides of the bargaining table. I am grateful that we are moving away from our period of malaise and that Americans are more upbeat about themselves and more adaptable to the economic realities of the 1980s, particularly the implications of global competition.

Still, we must nourish this renewed faith in our nation's institutions. We should 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. As managers, whether in the public or the private sector, we must constantly strive for greater cooperation with those we supervise so we can all enjoy a higher level of productivity and economic growth.

Policy Implications

In assessing and evaluating these forces in our economy, I would offer the following prescriptions to ensure 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 and the working environment; (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. 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. 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.