THE U.S. ECONOMY IN 1985 AND BEYOND

Remarks of Mr. Robert P. Forrestal
President
Federal Reserve Bank of Atlanta
Birmingham, Alabama
March 18, 1985

I am delighted to have an opportunity to take part in this conference on successful strategic planning for Alabama communities. I would like to talk today about the economic outlook for 1985. In a broader context, I would also like to discuss certain trends that will profoundly shape prospects for the U.S. economy in the longer term and influence what policymakers at the community level can and should do to promote local economic development.

National Scene

As you all know, 1984 brought heady economic growth. GNP expanded at a rate far in excess of what many, including myself, had anticipated. Despite a sharp slowdown in the third quarter, the full-year growth rate was nearly 7 percent, the highest in over 30 years, while inflation remained around 4 percent. 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. Business investment, particularly in machinery and other equipment, also contributed significantly to the expansion we witnessed in manufacturing as well as construction.

Growth should continue at a moderate but respectable and sustainable pace throughout 1985. The slower increase is a welcome change from last year's growth rate, which was so rapid, especially in the first half, that it threatened to rekindle inflation. Few imbalances or weaknesses currently exist in the economy. Healthy monetary growth, perhaps overly so, and an inventory adjustment in the latter part of 1984 have laid the groundwork for expansion 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. However, the growth rate of consumer buying will probably be lower this year than last. Sharp gains in consumer purchases earlier in this business cycle, to a great extent, reflect demand that accumulated during two, almost back-to-back recessions. Much of this deferred demand has already been satisfied.

Business spending on capital goods should continue to support expansion in 1985, even though the growth rate in business investment, like that of consumer spending, probably will be slower than in 1984. The sustained growth of final demand should provide sufficient impetus for ongoing advances 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 major source of short-term strength is fiscal policy, which is highly stimulative. Defense expenditures, in particular, should work to maintain substantial momentum in the nation's factories, even if some cuts are applied in this area. Another stimulus is monetary growth, which rebounded smartly in recent months after a previous weakening, particularly in the growth of M1. This growth and the associated declines in interest rates should encourage further economic expansion in 1985. By making it relatively cheaper for builders to undertake new projects, reduced credit costs should spark at least an improvement in home building, as new data suggest, even though a return to the booming single-family construction that we saw in the recovery stage is unlikely since much of the pent-up demand for housing has been filled.

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 and farming. 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, foreign trade has suffered the most in the current 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 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 tax policy. Uncertainty about possible 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. On the other hand, capital spending could accelerate this year as businesses rush to take advantage of current tax incentives before they are rescinded or modified.

Because of 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 an expansion.

Intermediate Range 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 around 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 jobless rate of more than 7 percent indicates we are short of the full-employment level to which we as a nation have been committed since the end of World War II. More importantly, unemployment remains much higher than seven percent in many industries and areas. In Alabama, it is still in the double-digit range. 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. Congressional action to reduce the deficit has thus far been disappointing. 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 farmers and a wide variety of industries ranging from labor-intensive apparel plants to capital-intensive steel mills.

Unfortunately, a continuation of the current international situation could result in a resurgence of protectionism. It is understandable that many firms would welcome protectionist measures to help them ride out what most economists view as an abnormal exchange rate 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 curtailing the incentive for necessary improvements, innovations, and 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. 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.

Do these changes imply that our economy is being transformed into a "high-tech" system? Do they suggest that policymakers intent on fostering development, whether at the national or the community level, should focus on electronics, ordnance, and advanced pharmaceuticals while relegating our traditional industries such as textiles, apparel, and steel to the dustbin of history or to third-world producers? I believe that we are becoming a high-tech economy, but not in the sense that computer factories will replace apparel plants as a vital source of employment in our region's small towns and cities. Nor do I expect research and development labs to supplant our nation's large steel mills as a key part of our economic base. However, I believe that advanced technologies will play, indeed already are playing, a much greater role in all sectors of the economy, including traditional industries.

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. I say relearned because the United States has historically been a technological leader. Experiences of the last two decades 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. The effect of the recent resurgence in capital investment should be a reacceleration in U.S. productivity growth. We have not yet felt the full effect of that capital spending. Productivity advanced about two percent last year, or close to the postwar average rate for the second year of an expansion. However, productivity gains were not consistent, and the longer term challenge will be to find ways to apply technological innovations more broadly, especially to sagging traditional industries and to the service sector.

A second environmental factor that will affect us and our policies is the demographic changes 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. Marketing new products and services to the expanding generation of retirees offers challenges but also enormous growth potential. 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 bigger 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 hope, that the United States no longer buys and sells 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. 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. 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.

As pointed out in a recent report of the Committee for Economic Development, one 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. Measures such as price regulations on certain basic goods are distorting LDC 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.

This doesn't imply that there's no role for communities to encourage local development. It does suggest that government and public interest groups, especially at the national level, may be most successful if they create an environment where business in general can flourish rather than a protected "hothouse" where only a few favored industries can thrive. At the state and local level, governments can, and often must, take steps to lay the groundwork for economic growth. The most obvious cases are projects that have what economists call externalities, or side effects that make private sector initiative unlikely because of the difficulty in capturing all the returns to such investment. Schools, highways, harbors, and airports are traditional examples of investments that often must be made by the public sector if private businesses are to have sufficient infrastructure to operate. Today, policymakers are relearning the economic importance of public investment in human capital through better schools. They are also coming to recognize new dimensions of community involvement such as maintaining a favorable business climate as a means of fostering desirable levels of local economic growth.

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. 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, although future generations will probably look back and thank us for making most of the decisions 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. 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.

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; and, most importantly, (3) reduce the federal budget deficit over the next five years so that the mix of fiscal and monetary policies works more effectively to foster an environment conducive to widespread innovation, entrepreneurship, and economic growth. We cannot afford to have future generations pay the price for our failure to keep our fiscal house in order.

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 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.