

THE U.S. ECONOMY IN 1985 AND BEYOND

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to the Southeastern Lumber Manufacturers Association
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I am delighted to have an opportunity to speak to you today because my message, while not without certain concerns and caveats, is essentially hopeful. I would like to talk about the economic outlook for 1985, both for the nation and the Southeast. In a broader context, I would also like to discuss several factors that will fundamentally shape the longer term prospects for our economy. Before I do, perhaps I should first explain very briefly the role of the Federal Reserve System in our economy and how the Fed's actions can influence the economic outlook.

Federal Reserve Functions

The Federal Reserve System has three main functions: the formulation and implementation of monetary policy; the supervision and regulation of banks to maintain a sound financial system; and the provision of financial and central banking services. Conducting monetary policy is the function that bears most directly on the performance of the economy, although the Fed's contribution to a sound and stable banking system indirectly enhances the economy's capacity to expand in a steady fashion.

The system's organization is complex, but this structure makes us less sensitive to short-term political pressure. The Federal Reserve Bank of Atlanta, like other District Banks, shares responsibility for monetary policy with the Board of Governors

the Federal Open Market Committee, or FOMC. This committee consists of seven governors from the Board and five District Bank presidents. The seven governors are appointed to staggered terms by the President with Congressional approval. Bank presidents are chosen by directors of their respective Reserve Banks, subject to Board approval. With the exception of the New York Fed, District Bank presidents serve as voting members of the FOMC on a rotating basis, but they always have an opportunity for input at policy discussions. I shall have my first opportunity to vote in next week's FOMC, but I have been a participant for a year and a half. The New York Fed plays a key role in carrying out monetary policy through its trading desk, which buys and sells government securities as a means of expanding or contracting the nation's money supply. Consequently, the President of the New York Fed is a permanent voting member of the FOMC.

Policies set by the FOMC influence economic activity primarily through the effect that our actions have on bank reserves and on monetary growth and interest rates. Actions to raise monetary growth will result in lower short-term interest rates and, in turn, more stimulus to the economy. The FOMC's ability to affect the rate of monetary and credit expansion also enables it to mitigate inflation. The Fed can justifiably claim the lion's share of credit for the much abated rate of inflation we have experienced over the last few years. Thus, the Federal Reserve Bank of Atlanta plays an important role maintaining sound payments and banking systems and formulating monetary policies that have a profound influence on the regional, national, and international economic outlook. I am happy to be able to report to you today that, in my opinion, the outlook for the coming year and perhaps well beyond is quite promising.

National Scene

The outlook for 1985 cannot be 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 many, including myself, had anticipated, while inflation remained more moderate than generally expected. 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. Business investment, particularly in machinery

and other equipment and, to a lesser extent, in new plants, also 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 with healthy growth and abating inflation. 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. This slower pace is a welcome change from last year's very rapid growth rate which, especially early in the year, threatened to rekindle inflation. Few imbalances or weaknesses currently exist in the economy. Healthy monetary growth, perhaps overly so, and an adjustment of inventories 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. However, growth in consumer spending should not be as sharp as in 1984 because last year's sharp gains in consumer purchases were in large measure the result of demand that accumulated during two, almost back-to-back recessions. Most of this deferred demand has already been met. 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 expansion in capital spending by businesses this year. In addition, business

investment in inventories will likely rebound somewhat, following a sharp deceleration in the fourth quarter of 1984 and an 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 economic expansion in 1985. By making it relatively cheaper for builders to undertake new projects, reduced credit costs should spark 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 farming and manufacturing. Producers of textiles, apparel, and other goods that are sensitive to foreign competition experienced weak growth in 1984, and their condition probably will not improve much 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, foreign trade 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 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, investment could increase as businesses rush to take advantage of current tax incentives before they are rescinded.

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.

Lumber Industry

The outlook for the lumber industry will be influenced largely by two factors, interest rates and exchange rates. Mortgage rates have fallen for the last seven months. In February, conventional fixed-rate mortgages averaged less than 13 percent. As a result, construction should revive somewhat. Residential construction, particularly apartments and condominiums, did, in fact, rise sharply in January. With that upturn, demand for lumber products should strengthen. However, much of this expected

resurgence in demand could be met by foreign suppliers. The Canadian dollar has declined against the dollar by about 13 percent since 1980 and nearly 8 percent in the last year. Current exchange rates give Canadian imports a considerable edge over U.S. products. Thus, it is no surprise that Canadian lumber producers have gained a substantial share of the total U.S. market, almost one-third, according to U.S. Commerce Department estimates. At the same time, the strong dollar and weak recoveries abroad have contributed to a decline in American lumber exports, particularly of softwood like southern pine. Without a dramatic reversal in the value of the dollar, the outlook for significant change in this situation appears dim. Consequently, prospects for lumber producers in the Southeast and elsewhere in the nation are less promising than for some other industries.

Intermediate Range Problems

The way to dispel the clouds on the horizon of the lumber industry is not the short-term fix of protectionism, about which I shall have more to say in a moment. Rather, relief from this situation is to be found by addressing the most significant of several intermediate range problems that need to be resolved over the next few years. These problems include inflation, unemployment, the deficit, real interest rates, and international trade. Of these, I believe the deficit is the most serious.

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 jobless rate 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. Moreover, unemployment remains much higher than the national average in many industries and areas. Certainly, we must strive to lessen the human suffering and unrealized economic potential implied by these statistics.

The most significant problem, and the source of several others including weakness in the lumber industry, 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. In such an environment, consumer demand for houses, autos, appliances, and home furnishings is also dampened, and as a result, the lumber industry has less hope of prospering.

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. A continuation of the current international situation could result in a resurgence of protectionism. Only a few years ago certain

representatives of the U.S. forestry industry petitioned for countermeasures to stem the tide of Canadian lumber imports.

It is understandable that some firms would welcome protectionist measures to help them ride out what many 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 incentives for innovation, improvement, and necessary reform, protectionism ultimately weakens the very businesses and workers it is intended to protect. When shifting patterns of international trade are due to long-term changes in comparative advantage, the wisest public policy is often to do nothing except facilitate the transition to other economic activities that promise more lasting growth. When such shifts are attributable to unfair foreign practices such as subsidies and non-tariff barriers, then the answer lies in enforcing or extending international agreements like the GATT. This solution is not to be found in the sort of beggar-thy-neighbor policies that proved so disastrous earlier this century.

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 to Americans as well as citizens of those nations. 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, and productivity advances have been inconsistent. Productivity grew about two percent last year, the postwar average rate for the second year of an expansion. The longer term challenge will be to find ways to foster greater 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 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. 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.

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. 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. 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 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. 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 create an environment for stable 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, 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.