ECONOMIC OUTLOOK FOR THE UNITED STATES AND THE SOUTHEAST

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to the
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I am delighted to have an opportunity to speak to you today. As you may know, I am a member of the Atlanta Rotary Club. Your growth as a separate organization here in Buckhead testifies to the economic boom that has been going on in our metropolitan area. I would like to talk about the economic outlook for 1985 and how Atlanta and the Southeast are likely to fare. I would also like to discuss several factors that, I believe, will fundamentally shape the longer term prospects for our economy.

National Scene

The outlook for the rest of 1985 cannot be assessed without reviewing the economy's recent performance and evaluating what the underlying conditions portend for the months ahead. 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. Despite a sharp slowdown in the third quarter, we finished the year on a strong note. Many factors at that time suggested that the stage was set for a continuation of this healthy expansion well into 1985. These included the ongoing growth of employment and personal income, renewed consumer confidence and spending, an inventory adjustment, moderate inflation, and the acceleration of monetary growth after several months of only modest increases.

Despite these favorable fundamentals, the pace of economic activity thus far in 1985 has proven sluggish. GNP barely advanced in the first quarter, and our manufacturing and agricultural sectors are showing considerable weakness as a strong currency leads to import substitution and declining demand for our exports. Although personal income, consumption, employment, and construction have risen, in the first quarter, GNP grew at a mere 0.7 percent annual rate, according to the latest estimate. This figure, contrary to widespread expectations, was even lower than the initial estimates of growth. Weaknesses were concentrated in net exports. The merchandise trade deficit - the excess of imported goods over exports - was $33 billion, even higher than in the first quarter of last year. The United States has become much more integrated with the world economy in the last decade. As a result, current problems in the international sector are having a widespread effect, causing weaknesses especially in manufacturing and agriculture.

The imbalances in the current expansion are leading to patterns that are different from those experienced in the past. In contrast to recent business cycles, in which the adverse effect of high real interest rates has shown up in a "crowding out" of some construction and capital investment, foreign trade has suffered the most in this business cycle. While capital spending and residential building proceeded apace, the merchandise trade deficit for 1984 totaled over $123 billion, far higher than the previous record shortfall of $69 billion in 1983. Weakness in the international sector has spilled over into industrial production. Industrial output has been virtually flat since last July, falling 0.2 percent in April after rising a mere 0.3 percent in March. A major reason for this languor is import competition: foreign producers are satisfying much of the current demand for goods and equipment. New factory orders for durable goods rose only 1 percent in April following declines in the previous two months. Current international conditions may be discouraging some U.S. industrialists from investing in machinery and equipment, given the stalled growth in capacity utilization in recent months. This spillover into business investment is causing a further drag on economic growth.

Fortunately, other sectors of the economy are showing strength. Bouyed by declining mortgage rates, single-family housing has been trending upward this year. In April, housing starts rose to an annual rate of 1.9 million units, and sales have also been robust for some time now. Nonresidential construction has been expanding at a brisk, possibly even an excessive, pace. Auto sales have been especially strong in recent months, and consumer spending generally seems to be pretty healthy. Although further gains in the struggle against inflation may be difficult to obtain, the rate of price increases has accelerated only slightly thus far in 1985. The CPI rose at a 4.6 percent annual growth rate in April after a 5.8 percent increase in March. This rise did not reflect price increases across the board, but rather, was due largely to a surge in energy prices, which is likely to prove temporary.

There has also been ample growth in money and credit to support expansion. Credit demand among consumers has been quite strong, though current high debt-to-income ratios may be due in part to earlier problems with IRS refunds. M1 has decelerated from unusually rapid growth earlier, and M2 and M3 were flat in April—also following very rapid growth. Recent declines in interest rates have been substantial and, with a lag, are likely to result in faster economic growth. The dollar has also eased somewhat in foreign exchange markets, though it is still above year-ago levels.

What does the recent intermittent growth pattern mean? Is our economy on a healthy course guided by fundamental strengths, or are we beset by imbalances that are destined to become more troubling with each successive quarter? I believe the significance of the recent volatility in U.S. economic growth can best be understood by looking at the past year or so from a longer term perspective. Viewed in this manner, our recent performance can be explained as part of the continuing transition from an inflationary economy with declining productivity to a healthier one with more moderate but sustainable growth. We simply cannot expect to grow by seven percent every year, or even during every year of an expansion. Our performance in 1984 may have raised expectations unrealistically in two respects. First, when the economy grows as rapidly as it did last year, especially in the first half, inflation usually accelerates because producers cannot respond fast enough to increases in demand. In their rush to do so, supply bottlenecks inevitably occur and with them, higher prices. We were able to have the best of both worlds last year because there was sizable excess capacity and our currency strengthened. Second, last year's economic performance relied heavily on foreign savings to fuel such growth. An inflow of foreign funds financed the equivalent of about one-fourth of America's savings needs in 1984. It is unrealistic to expect such an abundance of foreign funds year after year. Americans will need to save more, borrow less, or both in the future in order to sustain a reasonable growth rate.

The unusual circumstances underlying last year's phenomenal growth have not only given rise to unrealistic assumptions about the sustainability of that growth but also have masked problems and imbalances that currently exist. The usual imbalances that often arise in the third year of an expansion, such as involuntary inventory accumulation, flagging demand in housing and nonresidential construction, and rising prices, are not evident. However, imbalances of another kind are beginning to appear.

The most important of these is the federal deficit. Growth in the deficit stimulates some sectors of the economy because the government pays out more than it takes in. Meanwhile, by causing investors and others to expect upward pressures on interest rates down the road, the deficit sustains the dollar's strength while stifling growth in the international sector. This development, in turn, has rekindled widespread protectionist sentiments.

Weighing the strengths and weaknesses of our economy from the vantage of this longer-term perspective, I believe that economic growth should still be reasonably good this year. I see little evidence of any serious unintended inventory accumulation, a traditional harbinger of an economic slowdown. Consequently, further weakening in the second and third quarters seems unlikely. On the contrary, the economy should do better in the months ahead. Recent interest rate declines are likely to foster economic growth as the year progresses. Another 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. As a result of these underlying sources of growth, 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 neighborhood of 3 percent. Consumer spending is likely to remain healthy since personal income and employment continue to advance. Housing will probably show further gains in view of the lower interest rates we are experiencing. Because of the sustained growth in final domestic demand, business investment, should continue to support expansion in 1985. The recent decline in capital spending by businesses was largely the result of a rush to import certain equipment before an expected decline of the dollar or the possible imposition of import restraints. However, the growth rate of business investment in such physical structures as office buildings probably will slow further because of rising vacancy rates. Finally, government spending should rebound, while import growth is likely to abate as a lagged response to the recent depreciation of the dollar.

Expected slower growth in consumer spending and business investment make it unlikely that unemployment will decline as much this year as it did in 1984. The unemployment rate has been holding steady at 7.3 percent for several months even though employment has been expanding. Still, I am quite hopeful that the jobless rate will fall further. Import competition, lower oil prices, and bountiful harvests should hold price increases close to recent trends. Overall, I look for reasonable growth consonant with this stage of an expansion.

The Southeast

How does the Southeast fit into this picture? How is our economy performing and what is the economic outlook for our region? As you well know, Atlanta has been enjoying prosperity of almost unparalleled proportions, and economic growth has also been strong in Georgia generally as well as in Florida. The tide of new residents flocking to these and other states in the Southeast has been fueling the demand for houses, apartments, office buildings as well as for services like medical care and entertainment. Since in-migration tends to be greatest in Georgia and Florida, these states have developed a large service-based economy. A considerable portion of the manufacturing base of these states is oriented to the defense and space industries, both of which have benefited from the federal fiscal stimulus I mentioned earlier. As a result of this type of economic foundation, Georgia's and Florida's jobless rates have remained lower than the national average.

However, other states have not been faring as well. In fact, unemployment rates in Alabama, Mississippi, and Tennessee are still in the double-digit range! A major explanation for this pattern of inconsistent expansion is to be found in the same international factors that have caused problems for our national economy. The high exchange value of the dollar is taking its toll on import-sensitive and export-dependent industries in the Southeast. An inflow of refined petroleum products from abroad has cut into Louisiana's share of the petrochemical industry. Moreover, this market has already deteriorated somewhat as a result of the weak position of U.S. agriculture: burdened by low revenues as a result of weak foreign demand, farmers have not increased their orders for fertilizer, the major end use of petrochemicals. Even the carpet industry, which had been doing well as a result of the spate of new office buildings going up all over the country and the resurgence of home building, slowed somewhat this spring, partially in response to increasing imports. Although farming no longer plays the dominant role it once did in the southeastern economy, agriculture still is an important activity in many parts of our region. Farmers too have been hurt by international trade conditions. Pork producers, for instance, are facing increasing competition from Canadian imports. Grains have been sagging because of the dollar's high value abroad.

What does the future hold? Since migration to this section of the country is likely to continue for the foreseeable future, our outlook is bright. This forecast is especially true for those sectors of the economy that turn most closely on in-migration—construction and services. Atlanta, as much if not more than any city in the Southeast, will enjoy the fruits of this influx of people. This is not to say there are no problems on our local horizon. One cause for concern is the surfeit of office space in the metro area. However, in Atlanta and elsewhere in the Southeast, defense spending should help sustain the momentum of many manufacturing firms. Even if the federal budget deficit is cut by the $50 billion that the Senate recently endorsed, the effects on defense could be slight and the overall impact would not be felt for some time. Although the outlook for some industries and localities remains clouded by uncertainties regarding the dollar and its effects on U.S. exports and imports, on average the Southeast should experience even greater economic growth over the next year or so than the nation.

Intermediate Range Problems

I am basically optimistic about the economic future of our nation and our region, 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 near 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 that 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.

Probably the most important problem is the very large federal budget deficit. Congressional action to reduce the deficit has 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 American exports and sharply increasing imports.

Additionally, a continuation of the current international situation could result in a resurgence of protectionism. 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, improvements, and necessary reforms, protectionism ultimately weakens the very businesses and workers it is intended to protect. Third, 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 constant surveillance and careful consideration as we fashion or modify policies intended to correct domestic economic problems and promote growth in the United States.

On the other hand, if we can bring the deficit down substantially, we will require a smaller pool of savings, thereby reducing the demand for money and credit and easing the upward pressure on interest rates. Improvement on the deficit and lower interest rates would tend to diminish the value of the dollar on foreign exchange markets and, thus, make it easier for American farmers and manufacturers to export their products while mitigating the pressure of foreign imports on U.S. manufacturers.

However, a decline in the dollar is not a panacea. First of all, we would not feel an immediate impact on domestic demand and production. Lags could take as long as a year. In fact, our balance of trade might initially deteriorate even further because of the weight of prior contracts. Imports governed by such contracts would cost more in dollars at the same time that previously contracted exports are raising fewer dollars. Furthermore, we could well experience an anticipatory surge in imports if businesses and consumers believe the dollar is embarking on a downward trend. Similarly, foreigners might wait to see how far the dollar is likely to fall before placing their orders. A decline in the value of the dollar could also raise prices to some extent, just as it has helped us maintain a low rate of inflation during the past two years of rapid growth.

To deal with these intermediate range problems two approaches are required. First, we must deal with the deficit now. It is imperative that some progress be made this year toward reducing the deficit before current imbalances become harder to modify. Second, we must expand our efforts to improve productivity on a broad front, ranging from capital investments in technologically advanced equipment and processes to a variety of management strategies that will raise the level of performance of white collar and service employees as well as blue collar workers. I am optimistic that this latter objective can be attained because of several fundamental factors that I believe are gaining increasing importance and that will shape our destiny for years to come.

Longer Term Outlook—A New Industrial Revolution

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 that will shape our destiny for years to come. These are technology, demographic changes, and the evolution of a global economy.

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 almost 3 percent last year, higher than the postwar average rate for the second year of an expansion. Yet, gains have not been consistent. In the first 3 months of this year, for instance, productivity fell 2.5 percent. The longer term challenge will be to find ways to foster sustained 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. Achieving this goal will require not only investing in new technologies but also finding better management techniques to foster peak performance from all workers.

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 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 and Conclusion

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. I am an optimist, though, 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.