

**The Outlook for the Economy and Small Businesses**  
**Remarks of Mr. Robert P. Forrestal, President**  
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**to**  
**The Small Business Administration Regional Executive Committee**  
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Good morning! I am delighted to have this opportunity to talk with you this morning about the economy. My comments will focus on the outlook for the next 12 months. In that context I'll have a few words to say about what the outlook holds for small businesses.

### **Current Economic Situation**

Strengths. The current economic situation is somewhat mixed, but I am confident that the pace of economic activity will improve as the year progresses. GNP growth in the second quarter did rise to two percent from its essentially flat performance in the first three months of this year, according to the latest estimate. Moreover, final sales continued to grow at a strong pace of nearly five percent. Although this growth rate is not as high as the three percent originally estimated, there is an auspicious element underlying the downward revision. Much of it was attributable to a drop in inventories. While this decline in inventories detracted from second quarter growth, it is an encouraging sign for the next few months because it probably means that businesses will have to increase orders and production to replenish stocks.

Despite the modest growth we experienced in the first half, several areas of strength are apparent in the economy. Factory orders edged up slightly in the last two months, and, as I've pointed out, further inventory building is quite possible. Money supply growth has been rapid, perhaps overly so, and interest rates have declined significantly. This ample supply and lower cost of credit should spur growth in single-family housing and also renewed strength in business investment. Capital spending for equipment seems especially promising as businesses seek ways to improve their efficiency and competitiveness. Signs already exist that investment in producers' durable equipment is rebounding significantly from the first quarter when business fixed investment fell at a 1.5 percent annual rate. Surveys of businesses also indicate that capital spending plans augur continued growth even though the margin of this growth appears less robust than expected earlier.

Another positive feature of our current economic state is the modest rate of inflation we have been experiencing. As I see it, this performance and the likelihood that it will continue for the foreseeable future is due primarily to three factors. First, unused capacity and labor are helping to keep in check increases in prices and wages. Second, oil prices have been declining and show few signs of reversing this trend. Third, and perhaps most important, international competition and the high value of the U.S. dollar

are providing Americans with cheaper foreign goods and pressuring American producers to meet this intense competition. The dollar has declined substantially and rather consistently, with one notable exception, since February. However, changes in the exchange of the dollar affect other sectors of the economy only with a considerable lag. These lags will keep the prices of imported goods low long after the exchange rate of the dollar began to fall. For these reasons, I expect inflation to remain in its current moderate range of 3.5 to 4 percent.

A final area of current strength concerns employment. Employment gains have been respectable even though the unemployment rate has held at the 7.3 percent mark for months. It is true, of course, that job growth in manufacturing dropped for several months earlier this year, but recent data indicate a leveling off.

Weaknesses. The reason that these strengths have not given rise to a faster rate of expansion is, of course, related to several weaknesses that have been troubling our economy. The international sector is a key example of such weaknesses, and this is true despite the decline in the dollar that I mentioned. The reason, of course, is that it will take considerable time for this drop in the value of the dollar to have an effect on the domestic economy. We all are keenly aware how much this situation has been hurting a number of industries in the manufacturing sector. It is also a contributor to the present

woes of the nation's farmers. However, agriculture problems are also the result of expected bountiful harvests worldwide and associated low commodity prices.

Another area of weakness is in construction, in particular, multifamily and nonresidential building. Currently vacancy rates on apartments, condominiums, and office buildings are high, and this pattern suggests little growth and possibly some problems in this portion of the construction industry.

A final area that has become a matter of increasing concern is the status of the consumer. Debt burdens are quite high, and the savings rate, quite low. In June and July consumers saved less than four percent of their disposable incomes! Fortunately, advance in the stock market and other factors have helped buoy consumers' asset position, sustaining their debt-to-wealth ratios at a healthier level. However, recent personal income gains have not been substantial. The latest advances occurred primarily in the area of social security payments, rather than in the wages and salaries component. It is the latter which is generally more stimulative of consumer spending. These factors make me doubt that consumer spending will fuel as much growth as earlier in the expansion. We have already seen the pace of auto sales slacken from a few months ago. July's rise in retail sales did reverse the decline that occurred in June, but the margin of increase was quite small.

Weighing these signs of strength and weakness, on balance I personally expect GNP growth to perk up in the second half to a pace of around 3 percent and perhaps as high as 4 percent. I don't foresee much progress toward lowering the jobless rate this year. On the brighter side, though, inflation appears likely to remain near its current moderate pace.

### **Impact on Small Businesses**

What does this economic outlook bode for our nation's vast number of small businesses? As you know, many companies in this category are in the service sector. I'm thinking not only of the the traditional family-owned retail establishment but also of the more innovative services that have been surfacing in recent years. In my opinion, current economic conditions are essentially favorable for most such businesses. The service sector has been doing well throughout this latest recovery and expansion period, and in the last year or so of the current expansion the service sector has been the main source of employment growth. Another factor that portends well for small service businesses is the tax reform proposals, particularly those pertaining to investment. If proposed tax reforms to eliminate or sharply reduce special tax treatment for capital investment are enacted, adverse effects will be felt much less severely by service

businesses than by older and larger businesses in so-called "smokestack" industries.

Many small businesses are also in the construction industry. While some such businesses may feel the impact in changes of depreciation schedules for investment in structures, should proposed tax legislation pass, in the near term the many small businesses involved in residential building should benefit from the decline in interest rates we have experienced. This decline not only reduces an important part of their costs but is likely to stimulate some growth in home sales.

Another important factor influencing small businesses in recent years has been deregulation. Much of this has been concentrated in transportation, financial services, and communications. In general, I believe that deregulation has been a boon to small businesses. Credit is now more readily available than in an earlier era when the existence of interest-rate ceilings meant that credit sources simply dried up when rates became too high. This availability of credit helps the formation of new businesses and enhances the ability of existing small businesses to adapt and change as opportunities arise. Deregulation has also entailed a heightened level of competition. Such competition brings with it more widespread, varied, and often less expensive consumer products. This trend is also positive for most small businesses, enabling them to compete more effectively with their larger counterparts.

However, the effects of competition may not have been salubrious for all small companies. A number of small businesses exist which established a profitable niche by catering exclusively to certain minority groups that historically had been virtually ignored by larger firms. Deregulation and increased competition, for example, in the financial services industry, has meant that such groups are far less likely to be overlooked or excluded from the mainstream of the market. As their once-profitable niche diminishes, small businesses that followed this course will face difficulty in the future unless they can revamp their marketing strategies. Moreover, they may have to make internal management changes and other adjustments in order to cope with the keener competition of deregulated markets.

### **Policy Implications**

While the implications of the economic outlook for small businesses are generally positive, there are certain policy steps that could brighten this picture considerably. Paramount among these is reducing the deficit. The sum of private savings by consumers and businesses plus government revenues falls short of investment needs and government spending. We have been able to finance a spending binge during this recovery and expansion because of the availability of foreign savings. However, if the deficit is not

reduced, eventually foreign investors will begin to lose faith in the dollar. When this happens, they will reduce their financial support of our consumption habits. In such an environment interest rates at one point would have to rise because the pool of savings from domestic sources is simply too small to sustain continuing growth. This sort of development would be especially onerous for small businesses because they are typically more leveraged than larger firms and their credit costs are usually higher to begin with.

While part of the longer term solution no doubt involves finding ways to change the savings habits of Americans, we need remedies that can be implemented over the next few years. Reducing the deficit would ease the upward pressure it is putting on interest rates and, concomitantly, on the dollar. Progress on this front would help many small businesses that are import-sensitive. It would also aid the numerous family farmers who rely heavily on exports.

Another important benefit, and one easily overlooked, pertains to states and local governments. By easing credit costs, the health of state and local budgets would be improved. Without such a development, this important part of the public sector will surely have an increasingly difficult time maintaining existing services without raising taxes. Why should small businesses be concerned about the fiscal well-being of state and local governments? The reason is that smaller companies are generally not in as good a

position to educate and train workers as many large corporations are. Therefore, small businesses must rely on the public sector to develop a well-educated work force. Small businesses also rely on public sector investment in such infrastructure as mass transportation to enable workers to commute to their place of employment. Both people and businesses are moving into suburban neighborhoods farther and farther away from the center of the city. Those inner city residents most in need of work and most likely to be seeking the lower-wage jobs that many small businesses provide will be unable to take advantage of employment opportunities on the fringes of urban areas unless state and local governments have the financial wherewithal to develop the transportation networks appropriate to increasingly dispersed residential and working patterns. If they do not, labor costs will inevitably rise, and the profits of small businesses would be further squeezed.

### **Conclusion**

Summing up, despite areas of weakness in the economy that show few signs of abating and the potential for serious problems in the future associated with the very large federal budget deficit, I anticipate respectable economic growth in the remainder of 1985. What's more, I believe that the outlook for small business is generally a bright

one.