

**The Outlook for the Economy and Small Businesses**  
**Remarks of Robert P. Forrestal**  
**to**  
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I. Introduction

- A. I'd like to make a few remarks about the economy and our outlook in the next 12 months.
- B. In that context, I'll have a few words to say about what the outlook holds for small businesses

II. The current economic situation is mixed but I am confident that the outlook is basically for faster growth toward year end.

A. Strengths

- 1. GNP growth was up from an essentially flat Q1 to 2.0 percent in Q2
- 2. Money supply growth has been rapid -- perhaps overly so -- and interest rates have declined significantly and are like to spur growth in
  - a. Single-family housing
    - (1) Latest data for sales of existing homes showed strong increase
    - (2) new single-family home sales rose 1.4 percent in July
  - b. Auto sales in early August were strong, probably in part in response to lower auto loan rates
  - c. Business investment--I believe that the latest GNP numbers portend some investment in inventories in order to replenish stocks
- 3. Inflation remains modest, i.e. less than 4 percent
  - a. In fact, latest figures indicated prices rose at an annual rate of 3.5 percent through the first 7 months of the year.
  - b. Price increases are likely to remain moderate due to
    - (1) Unused capacity and labor
    - (2) International competition and lagged effects of dollar appreciation,

which keep prices of imported goods low long after exchange rate of the dollar has begun to fall

(3) Possible continuing declines in oil prices

4. Employment gains continue to be respectable.

a. It is true that manufacturing employment dropped sharply for several months: earlier this year monthly job losses in manufacturing were in excess of 40,000.

b. However, recent data indicate a leveling off of job losses in the industrial sector: in July the decline was only 7,000.

B. Weaknesses

1. International sector remains a source of weakness

a. The strong dollar has been a key factor underlying the weakness in our manufacturing sector, and this weakness shows few signs of abating

(1) Factory order fell 1.3 percent in July after slight increases in the previous two months

(2) Even factoring out the more volatile orders for military goods, orders for non-defense capital goods decreased 5.4 percent in July.

b. Despite fairly steady and significant declines in dollar since February peak, it will take considerable time for these to affect the domestic economy.

2. The farm sector is adversely affected by strong dollar, expected bountiful harvests worldwide, and resulting low commodity prices

3. Multifamily and nonresidential construction is another area of concern

a. Housing starts fell 2.4 percent in July

(1) This reflected weakness in multifamily sector

(2) Single-family starts rose somewhat--1.1 percent

b. Vacancy rates in offices, apartments, and condominiums are high,

suggesting future problems

4. Consumer spending is less dynamic than earlier in the expansion and seems unlikely to fuel as much growth in the future as in the past
  - a. Debt burden is high
  - b. Savings rate quite low -- less than 4 percent of disposable income in June and July
  - c. Personal income gains have been lackluster, with latest advances occurring primarily in social security payments rather than the more stimulative wages and salaries component
  - d. Auto sales have slackened
  - e. July's rise in retail sales reversed a decline in June, but only modestly

### III. Summary of Outlook for Rest of 1985

- A. Year-over-year GNP in the second half of this year should be around 3 percent and perhaps even as high as 4 percent
- B. Jobless rate not likely to decline much this year
- C. Inflation likely to remain about where it is for the time being

### IV. How Will This Outlook Affect Small Businesses?

- A. Current economic conditions are generally favorable for the vast number of small businesses which provide services, from the traditional family-owned retail establishment to the more innovative services just surfacing in our economy.
  1. The service sector has been the main source of employment growth during the last year or so of the current expansion
  2. Services will be much less adversely affected than older and larger businesses in "smokestack" industries by proposed tax reforms that would eliminate special tax treatment for capital investments
- B. Many construction companies are also small businesses, and these should benefit from declines in interest rates over the past months and possible growth in

residential construction

- C. Another important factor influencing small businesses in recent years has been deregulation that has occurred in transportation, financial services, and communications
  - 1. This has generally been a boon
    - a. It has aided the formation of new businesses
    - b. Credit is more readily available than in an earlier era when interest rate ceilings meant credit sources simply dried up when rates become too high
  - 2. On the other hand, because deregulation has also entailed a heightened level of competition and generally more widespread and varied consumer products, the role for small companies that cater exclusively to certain minority groups previously ignored by larger firms has diminished
    - a. Such minority businesses may face difficulty in the future unless they revamp their marketing strategies
    - b. Moreover, such businesses may have to make internal management and other adjustments to cope with the keener competition of deregulated markets
- V. How Can the Picture for Small Businesses, Including Those That Are Minority-Owned, Be Improved?
  - A. Critical Step is to reduce the deficit, which stands at \$156 billion for the first nine months of this fiscal year compared to \$142 billion for the same period last year and which is projected to exceed \$200 billion for the full year.
    - 1. Private savings by consumers and businesses plus government revenues falls short of investment needs plus government spending
    - 2. We have been able to finance our current spending binge because of the availability of foreign savings

3. If the deficit is not reduced, eventually foreign investors will begin to lose faith in dollar and reduce their financial support of our consumption habits
  - a. In this 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
  - b. This development would be especially onerous for small businesses because they are typically more leveraged and already have higher credit costs
- B. Reducing the federal deficit would ease the upward pressure it is putting on interest rates and on dollar
  1. Progress on this front would help many small businesses that are import-sensitive and aid the vast number of family farmers who rely on exports
  2. It would also help ease pressure on states and local governments, which will find themselves in an increasing bind to maintain existing services without raising taxes
    - a. Small businesses should be concerned about the revenue health of state and local governments because these firms are generally not in as good a position to educate and train workers as many large corporations; therefore, they must rely on the public sector to develop a well-educated work force
    - b. They must also rely on public sector investment in such infrastructure as mass transportation to get workers to jobs that are increasingly distant from the neighborhoods where those most in need of work live; without such transportation, labor costs will inevitably rise, further squeezing the profits of small business
    - c. Another, perhaps longer-term solution, is to seek measures that would increase Americans' savings habits

VI. Conclusion--Despite areas of continuing weakness and additional future problems associated with the large federal budget deficit, I foresee respectable economic growth in the year ahead and a generally bright outlook for small businesses