Prospects for the U.S. Economy
Remarks of Robert P. Forrestal, President
Federal Reserve Bank of Atlanta
To the South Metro Corporate Breakfast
Sponsored by First Georgia Bank
Atlanta, Georgia
December 5, 1985

Good morning! I am delighted to be here with you today to share my thoughts on the outlook for the United States economy. My comments will focus first on the nation's recent economic performance. Next I'll offer my view of where we seem to be headed over the next year or so. Finally, I'll be making some remarks about the imbalances that are currently generating pressures in several areas and which portend serious long-range problems unless measures are quickly undertaken to correct them. When I've finished, I'll be happy to entertain questions.

Review of Recent Economic Performance

After two years marked by dramatic recovery and expansion from a severe recession, U.S. economic performance became hardly more than lackluster in the first half of 1985. Many people, including myself, felt the pace of growth had to slow from the extremely high rates we had been experiencing early in 1984, lest bottlenecks develop and a rekindling of inflation ensue. However, I expected a transition or adjustment period of about a quarter followed by sustained growth of around 3 percent that has proven our long-term average in the post-war period. Thus, I admit that I have been a bit surprised that economic expansion slowed by as much and for as long a time as it did. GNP growth was virtually flat in the first quarter and a modest 1.9 percent in the second. Last December and January the nation's jobless rate actually edged up slightly and then held steady at 7.3 percent for six months. Fortunately, the third quarter brought a considerable upturn: GNP grew more than 4 percent in the July-September period. In August the unemployment rate finally dipped below the 7.3 percent mark and has remained there. In October the proportion of the labor force unable to find work was

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

7.1 percent. Other indicators of economic activity support the view that we are seeing a meaningful improvement in business activity, and, quite frankly, I sense more positive expectations in many business people with whom I have spoken lately.

Consumers propelled much of this long awaited revival in economic activity. Housing began to improve this summer, apparently in response to declines in interest rates. By October housing starts had rebounded to the highest level since last April. Auto sales also surged as consumers rushed to take advantage of manufacturers' low financing rates. Finally, one of the most positive features of our recent economic performance is the very low level of inflation we are having. The rate of price increases for consumer goods has actually fallen in recent months. Inflation was down to almost 3 percent for the 12-month period ending in October, a better performance than the rate of about 4 percent during the previous two years. A significant part of this improvement, however, is attributable to the strength of the dollar in the foreign exchange markets through early 1985.

Despite this moderate rebound, fourth quarter performance has been mixed. Industrial production was flat in the first month of the quarter, as were new orders for durable goods, excluding the volatile defense category. We used less, not more, of our industrial productive capacity. Much of the third-quarter surge in GNP was due to auto sales, which were not sustained once promotions ended in October. Moreover, consumers borrowed heavily to finance these purchases, and as a result, the personal savings rate dipped to a record low of 1.8 percent of disposable income in September. Savings rose to 3 percent of disposable income in October, but at the same time consumer spending also slowed. This drop has been especially noticeable in car sales.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Fortunately, I believe these latest monthly fluctuations in consumer spending habits may be merely a short-lived transition. Personal income and employment advanced in October, and if we factor car sales out of the figures for retail expenditure, we find that October's gain, although modest, surpassed that of September. Another significant area of weakness is the international sector, which has been occasioned by the strength of the dollar. Between July 1980 and February of this year the foreign exchange value of the dollar rose over 90 percent against the currencies of our major trading partners. Last year we had a record trade deficit of over $120 billion, and this year the figure is likely to be even higher, given the lags with which changes in exchange rates usually affect trade flows. Ongoing increases in the value of imports over exports have exerted a considerable drag on economic growth.

Why has the dollar become so strong in the 1980s after almost a decade of sustained weakness relative to other currencies? Certainly, an important cause of the dollar's strength is the very large budget deficits the United States government has been running up in the last few years. The sheer size of these deficits and the expectation that they would continue have put substantial upward pressure on interest rates especially in the context of a strong recovery in which both businesses and consumers have also been borrowing heavily. Our total demand for credit has outstripped the supply available from our pool of savings, and the gap has been made up by tapping foreign savings. Attracted by our relatively high interest rates, lenders from abroad provided a very large share of the funds we needed to finance our public and private spending spree. Of course, other factors no doubt contributed to the availability of foreign savings to fund American debt. There appears to have been a shift in the preference of foreigners for dollar-denominated assets compared with the 1970s, and this shift may have occurred for reasons that lie beyond the dynamics of our economy alone. Whether perceived political instability elsewhere in the world enhanced the view of the United

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

States as a "safe haven" for investments or other explanations account for this change in foreign preference for dollars, this shift, along with the deficit-generated pressures exerted on U.S. real interest rates, has attracted a vast amount of foreign financing.

On one hand, we have benefited from the availability of foreign funds to supplement our own inadequate pool of savings. For example, we have been able to sustain high federal budget deficits without the sharp increases in interest rates that normally would have brought construction and other interest-sensitive sectors to a virtual standstill. American consumers have been able to go deeply into debt to pay for purchase of new homes, cars, appliances, and numerous other items. Businesses have been borrowing heavily to finance mergers and acquisitions as well as investment in inventories, equipment, buildings, and other spending. At the same time and on an even larger scale, the public sector has been relying on debt to make up for the difference between spending and revenues. Rising government expenditures, especially for defense, have fostered strong gains in both output and employment in related industries. For several years, thanks largely to foreign creditors, Americans as individuals and as a nation have been on a spending binge that, at least until a year ago, propelled enormous macroeconomic growth. We have had both "guns and butter," as it were. However, this foreign source of credit has not been without its costs. The key problem has been the rise in the foreign exchange value of the dollar that has been associated with the increased demand for dollar-denominated assets.

The harmful effects of the sharp rise in the dollar are most apparent in the manufacturing and agricultural sectors. A heavy toll has been taken on those manufacturers and farmers who rely on exports as a major source of revenues. At the same time, and perhaps in a more noticeable fashion, industries most sensitive to import competition have suffered the strains of increased pressure from foreign producers whose

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

goods have become less expensive in terms of dollars. Some textile, apparel, and footwear plants have been forced to furlough workers, reduce hours, or even shut down permanently. Here in the Southeast, lumber producers have seen their market share, especially for softwoods that are so important to home-building, eroded by Canadian imports. Even some capital-intensive industries have not been immune to import pressures. Moreover, the efforts of many manufacturers to meet foreign competition by improving productivity often entail reduced need for labor inputs.

For farmers the effect has been less noticeable in terms of jobs than in financial affairs. The strong dollar combined with worldwide surpluses of many farm commodities have depressed agricultural commodity prices and, concomitantly, farm revenues. Thus, farmers have found it increasingly difficult to service, let alone retire, the heavy debt burden they built up during a period several years ago when expanding markets and the expectation of higher land values spurred them to borrow heavily. When you add to these factors the dollar's negative effects on foreign demand for U.S. crops, it is easy to see why some farmers as well as the financial institutions that service them are considered to be on the verge of crisis.

It is true that through late November the dollar declined over 20 percent from its February peak. However, the Canadian dollar has not risen by as much, and Canada is our major trading partner. Moreover, the beneficial effects of this decline in exchange rates against many currencies will take some time to be felt in trading patterns for industrial and agricultural goods. Many trading relationships are established by contract and remain in effect until the expiration date regardless of exchange rate fluctuations. Foreign sellers may be willing to allow margins to shrink in order to retain market share. Importers may actually rush purchases into the present because they anticipate prices will rise in the future. For these and other reasons, it seems unlikely that

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

improvements in the exchange value of the dollar will have an appreciable effect for six months to a year. Certain farmers and manufacturers feel that they cannot hold on that long and are actively seeking either protectionist legislation, public financial support, or both.

The current flare-up we are seeing in protectionist sentiment among our legislators is deeply troubling to me. I fully sympathize with the desire of some of the nation's elected officials to come to the aid of their constituents. However, the history of well-intentioned protectionist measures is marked by a consistent pattern of reprisals from abroad, reduced trade flows, and sometimes even recessions. If Congress enacts either some form of tariffs or the putatively more benign measure of subsidies, I feel certain that other countries will retaliate, and the network of anti-trade measures that is likely to ensue could well take years to undo.

Even in the short run such measures could have serious consequences. For example, some of the industries most likely to be aided by protectionism are the same industries on which our less developed trading partners most heavily rely to boost their own exports and thereby to service their debts to American financial institutions. Although the LDC debt situation is not as ominous as it once was, dislocations to some of these fragile foreign economies would probably have ripple effects, some would say tidal wave effects, on certain financial institutions and perhaps subsequently on the safety and soundness of our financial system in general. When you add to this potential problem others already troubling the financial services industry, such as the pressures on farm banks and even Government-sponsored farm credit agencies that I've already mentioned, I think you will agree that there is due cause for concern about problems in the international sector and how they impinge on the American economy.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Economic Outlook

Notwithstanding the array of problems I've just outlined, I do expect the U.S. economy to sustain a growth rate of around 3 percent in the future, and I believe that this kind of growth in the mature phase of expansion, such as the present, is quite respectable. Of course, given the sluggish pace of the first half, the moderate dimensions of acceleration thus far in the second half probably will limit growth for 1985 to modest proportions. Looking ahead, though, I believe we are likely to enjoy a better record of expansion during 1986.

Government demand seems very likely to generate ongoing strength in defense-related manufacturing. Many of these items entail long-term commitments that are unlikely to be affected in any near term deficit-reduction measures that may be enacted. Another factor I see underlying this improved picture is the small stock of inventories on hand. Inventory-to-sales ratios have been running at very low levels for some time. Recently they have been reduced even further, largely as the result of strong consumer spending on items such as cars. Even though car sales may not rebound fully from their sluggish fall performance to the summer's unusually brisk pace, car makers and dealers will have to rebuild their stocks somewhat because supplies were drawn down so heavily by the combination of booming sales and several strikes. Inventory rebuilding should not be limited to autos and related industries because consumer spending in the third quarter was strong on a broad front. Therefore, I expect some stimulus to manufacturing to come from inventory investment.

Business capital investment is harder to predict. The likelihood that investment in buildings and other structures will provide much momentum is low. Office and hotel vacancy rates are quite high nationally, and capacity utilization has dipped in recent months. On the other hand, lower credit costs make such expenditures less expensive,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

and as the economy resumes growth, many businesses are upgrading their capital spending plans for 1986. Another positive omen for investment in machinery, equipment and even new plants is the decline in the value of the dollar that has taken place since February. Even allowing for normal lags, the effects of our more favorable foreign exchange rate should begin to benefit many factories and farms. Once manufacturers and farmers increase sales abroad, capital spending plans are likely to pick up further.

Growth in money and credit has been exceptionally rapid for some time now. While I am not a monetarist, I do take note of the fact that in most cases the economy has accelerated following such a pickup in monetary growth. There are exceptions. However, in many instances these exceptions are explained by institutional changes, such as the introduction of new financial instruments in 1983 that generated an apparent rise in M1 at the time. No such institutional changes are taking place now. Thus, I expect recent monetary growth to have a positive impact on the economy in the months ahead.

In any case, I doubt that this anticipated economic improvement will be translated into dramatic progress toward reducing unemployment even though we could see the proportion of those unable to find work drop below the 7 percent mark. Yet, I am not too troubled about a jobless rate that lingers in the 7 percent range. This remark does not reflect callousness on my part. Rather, it is due to the fact that the United States already has such a large percentage of our population working. As high as 7 percent sounds to many Americans, it is probably not much above a reasonable "full employment" level, given the high labor force participation rate currently prevailing. In my view, the jobless rate will fall on its own over the longer term as a result of demographic changes. Now that our baby-boom generation has virtually been absorbed into the labor force, there will be fewer new entrants seeking their first jobs each year. Thus, as long

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

as economic growth continues at a reasonable pace, there seem to be grounds for expecting a gradual decline in the unemployment rate.

On the inflation front, though, this anticipated improvement in overall economic performance has some negative implications since some of the growth I foresee is predicated on declines in the value of the dollar. As the dollar's exchange rate falls, the prices of U.S. goods abroad are likely to drop. While this development should help American producers regain reduced market shares and promote job growth, the resulting stimulus to the economy could create price pressures, particularly if we are already near the full-employment level. In addition, American consumers will have to pay higher prices for goods from abroad. What's more, there is always the danger that American producers will be somewhat less price conscious once they are relieved of some of the pressure of foreign competition. The net result could be a rise in prices from the current level.

Summing up the near-term outlook, I believe we could experience a better year in 1986 than in 1985, with full-year growth in the 3 percent range. The unemployment rate is unlikely to dip dramatically at this point in the expansion, but continuing sound gains in the number of people employed appear quite probable. Finally, it seems possible that inflation will accelerate somewhat as prices of imports, on which we have come to depend so heavily, rise in concert with declines in the foreign exchange value of the dollar. Nevertheless, there is little reason to expect price increases to accelerate sharply in the near term. I would caution you, however, that we should not hope for too much of a decline in the dollar. If a sharp drop develops, it could contain very negative implications for inflation.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Imbalances and the Longer Term Outlook

Beyond the next year or so, I am concerned that the imbalances that have been troubling the economy will adversely affect longer term developments, and, I fear, they might do so in far more negative ways unless their underlying cause is corrected. The negative effects of the federal budget deficits mount over time. We have already begun to feel the drag of an "overvalued" dollar on employment and output in the nation's manufacturing and agricultural sectors, as I described a few minutes ago. Although we should recoup many of our losses as the dollar declines, some manufacturing concerns that closed down may never reopen and the decline in market share that certain industries have been experiencing as international comparative advantage shifts may have taken place faster than it otherwise would have done.

Other potential economic problems also loom over the United States. The continuing high level of interest rates makes it more difficult for thrift institutions to correct portfolio imbalances between assets and liabilities. A large portion of loan portfolios at savings and loans institutions still consists of low interest rate mortgages, whereas thrifts must offer higher interest rates on their deposits to compete with money market funds and Money Market Deposit Accounts. Until the decline in the dollar's value has time to affect trade flows and contracts, American farmers will have difficulty selling abroad and retiring or reducing their debt burden. Consequently, I am afraid that many farm banks as well as other depositories will remain in a tenuous condition until we can make a convincing expression of our determination to reduce the federal budget deficit.

The large federal budget deficit also creates imbalances with respect to monetary policy. Money and credit have expanded at a rapid pace for about a year now. This trend has certainly contributed to the decline in interest rates in 1985 and the associated

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

revival in interest-sensitive industries such as housing and autos. It may also have helped foster the fall in the value of the dollar this year. While monetary policy has thus helped ease the pressures of increased demand for money and credit by increasing supply, our elected representatives have done virtually nothing either to reduce the demand for borrowed funds by cutting spending or to increase the supply of funds to support the current level of federal spending by raising taxes. Thus, fiscal and monetary policy, while both in one sense stimulative, are "out of sync" given the present situation and its particular problems.

In the longer term other effects will come to have equally or even more serious consequences. It's not just that we're borrowing heavily as a nation. Americans have done that before and not usually suffered problems other than perhaps some redistribution of income in favor of those in upper income brackets and thus generally in the best position to provide the savings needed to finance such borrowing. The troubling feature of our current level of borrowing is that a major portion of these funds has come from abroad. We appear to have become a debtor nation after half a century of net creditor status. Borrowing from abroad to finance growth is appropriate for a developing country such as the United States was during the nineteenth century. However, it is unseemly for the world's largest economy to become dependent on other, smaller countries to finance its growth. This situation is bound to constrain the development potential for many less developed, third-world countries. Moreover, it transfers an enormous responsibility to future generations to repay the debt and the ever-mounting interest we are accumulating. Their standard of living will be lower than otherwise. Eventually foreigners will become less willing to finance our spending urge. Since this willingness has been motivated not only by the expectation of continuing high interest rates but also by certain external dynamics pertaining to the preference for dollars-- dynamics that we neither understand fully nor control, it could shift again, perhaps

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

suddenly. Ultimately, we shall have to find ways not only to reduce spending but also to save more just to pay off the debt we have already built up. Is it fair to force our children and grandchildren to save in order to pay for the high level of consumption that we have been enjoying?

Policy Implications

What should public policy-makers in the United States be doing? First and foremost, federal spending must be brought back into line with federal revenues. The resulting cut in of the deficit should be of sufficient magnitude to assure financial markets that we are serious about coming to grips with this problem. Once this medicine has been prescribed, pressure on interest rates should ease and, with that cutback in future federal demand for goods and services, the foreign exchange value of the dollar should continue to decline without igniting inflationary pressures. This measure in turn should speed up the scenario I have already predicted whereby manufacturers and farmers find it easier to export and less difficult to compete against imports. Employment advances could accelerate along with orders, production, and sales. In addition, this change in policy and its effects should mitigate the difficult situation in which many financial institutions now find themselves. Of course, there will be adjustments of a less sanguine nature, such as price pressures in some areas, but in the long run I feel gains will far outweigh any transitional problems.

It is essential that U.S. policy-makers implement these measures as soon as possible so that the burden we Americans transfer to future generations and the negative effects on longer term growth are kept as small as possible. As I've mentioned, the interest alone on the debt we've already accumulated is appreciable and will have to be paid back to our foreign lenders eventually, either by us or by future generations.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Another policy prescription that we should begin to think about concerns the low savings rate of the United States compared to other countries. Insofar as public policies discourage savings, we should be considering alternatives that would foster the expansion of our domestic pool of savings. We must do so in order to fund the ongoing capital investment that will be increasingly necessary to compete in a global marketplace. In addition, it is in our own interest to return as quickly as possible to the status of a creditor nation so that we can help other economies develop to the point at which they can become expanding markets for American products. However, whatever reforms we adopt to increase our propensity as a nation to save should, in my view, come to the top of our policy agenda only after we have addressed the pressing issue of the budget deficit. Otherwise, we might find well-meaning reforms designed to alter Americans' long-established savings habits are being introduced so abruptly that we inadvertently send the economy into a temporary tailspin.

Conclusion

In conclusion, I see the U.S. economic outlook as basically sound. We are closer to the maximum non-inflationary expansion rate we can expect to sustain over time. From my perspective, the intermittent performance of the economy we experienced earlier this year is attributable primarily to the large federal budget deficit and the imbalances it has introduced into the economy. We can overcome these imbalances and launch the economy onto a sustained trajectory of growth, but to do so will require reducing the deficit as quickly as possible and then devising policy measures designed to alter the savings customs of Americans. We have faced equally difficult problems in the past and resolved them. I am optimistic that we have the will as a people to take the necessary steps to rise to today's economic challenges.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis