

Final

The Economic Outlook for 1986
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Introduction

Good evening! I am delighted to be here with you tonight. My remarks will focus on the economic outlook for 1986, first for the nation and then, briefly, for the Southeast. I'll also spend a few moments discussing some problem areas and issues that we should be thinking about as we enter the new year. When I've finished, I'll be happy to entertain any questions you might have about the course the economy is likely to take in the coming twelve months and beyond.

Last Year's Forecast and Economic Performance

As you all know, economic growth last year did not match the expectations of many people, including myself. I was looking for GNP to expand in the range of 3 to 3 1/2 percent in 1985 instead of the 2 1/2 percent or so that we actually attained. Although I'm quite pleased that unemployment did dip below the 7 percent mark by December as I had anticipated, progress toward reducing unemployment during the year was slow and, in fact, intermittent. The nation's jobless rate actually rose slightly early in the year and held at 7.3 percent for 6 months. On a more positive note, inflation proved to be milder than expected. As of November prices were increasing at an annual average rate of less than 4 percent rather than the 4 1/2 to 5 percent that many had feared.

Despite the fact that economic growth was somewhat less than most people had hoped, on the whole I think we can look back on 1985 as a fairly good year. The economy adjusted from an unsustainably high, potentially inflationary growth rate in the first half

of 1984 to a pace that is closer to our long-run potential of around three percent. We should not be disappointed with such performance since it is closer to the range of expansion that we can expect, given contemporary limits on our resource and productivity gains. Rather than be unduly concerned with the slowdown in economic performance last year, we should be thinking more about the imbalances in the U.S. economy, about what caused them, and what can be done to correct them this year and in the future.

These imbalances were most apparent in the disparity between the domestic and the international sectors although the underlying causes of these imbalances lay elsewhere, namely with the very large federal budget deficits that we've been incurring and which I'll discuss in a few minutes. Because of deficit-induced strains between the domestic and foreign sectors of the economy, much of the growth in consumer purchases, as well as that of business investment in equipment, was met by foreign suppliers. As a result, domestic production languished, and employment in manufacturing actually declined for six consecutive months in the first half of the year. Despite sizeable expansion in the service sector, weakness in many industries contributed to the sustained increase in the jobless rate that I mentioned a moment ago. Sluggishness in manufacturing employment also slowed growth in personal income. One positive impact of the international trade situation, though, was that prices rose less rapidly than in 1984 and less than I expected.

U.S. Outlook for 1986

Although some sectors of the economy are not as robust as I thought they would be at this point, I expect more balanced growth in 1986. In my estimation, GNP will probably expand in the area of 2 1/2 percent or possibly somewhat higher. Unemployment may decline slightly, but I don't expect dramatic progress on that front.

If we sustain a decline below 7 percent, I'll be quite pleased. This year, however, I do think there is reason to expect a slight acceleration in inflation, bringing us back up to around 4 percent, and certain developments could make this figure higher.

One area that may help pull the economy along, especially in the early part of the year, is a continuation of the inventory rebuilding that began last year after stocks dropped to a very low level in the third quarter of 1985. We are also likely to see some improvement in the international sector. By the fourth quarter of last year, the exchange rate of the U.S. dollar had fallen over 20 percent from its peak in February of 1985. It usually takes six months to a year for changes in exchange rates to be translated into adjustments in foreign trade patterns. Therefore, I expect to see some improvement taking place in the international sector in 1986. This development would be especially welcome to the nation's manufacturers and farmers whose export markets have atrophied as the dollar rose in the foreign exchange market.

The rapid growth in money and credit during 1985 may have a positive impact on several sectors of the economy, particularly consumer purchases of durable goods and housing. The lower credit costs associated with this monetary expansion have made it less expensive for builders to undertake new projects. Although much of the demand for houses and durable goods has already been met, I feel optimistic that there is plenty of room for new sales of such items. With the sharp rise in new home sales during November, we may have started to see the beginning of a consumer response to the substantial decline in mortgage interest rates that occurred last year. If the economy continues to strengthen, I think many consumers will want to "trade up," so to speak, in their purchases of durable goods as well. The lower interest rates we have been experiencing should encourage this development.

This decline in rates should also reduce the cost structure of business in general, not only now but in the future as well. Many corporations, for example, have been calling in high rate bonds issued in the early 1980s and refinancing at significantly lower rates. Smaller businesses can more easily meet their borrowing needs with longer maturities than before. Additionally, stable short-term credit costs and the recent decline in the dollar should help ease some of the strains on our financial institutions, in particular, those that have heavy concentrations of loans to developing countries. Less developed countries are better able to service their heavy debt burden, and institutions whose loan portfolios are heavily weighted by LDC debt should see their financial situation improve as well.

Despite these favorable factors, as I mentioned, I don't really foresee GNP growth exceeding 3 percent. There are reasons to expect consumer spending, which accounts for around two-thirds of GNP, to slow, at least temporarily. Consumption has been growing at a faster pace than personal income, and consumers have been borrowing heavily to finance their purchases. Thus, consumer spending is likely to be a sustaining force in 1986 but not the "engine of growth" that it has been.

Of even greater consequence is the clouded outlook for capital spending by business. Recent surveys of business investment plans for 1986 indicate a scaling back of capital expenditures. The very favorable tax treatment adopted in 1981 has resulted in substantial overbuilding of certain types of structures, particularly office buildings. High vacancy rates and rental discounts seem likely to dampen enthusiasm for initiating new projects, despite today's much lower interest rates. Uncertainty about likely tax treatment of investment in the future, as well as the vague possibility of retroactive treatment, may also be dampening investment. In addition, capacity utilization levels are well below maximum and lower than earlier in the expansion. In view of this excess

capacity on hand, many businesses are unwilling to expand their investment in plants and equipment.

I mentioned earlier that some pick-up in inflation is quite possible in 1986. The exchange rate of the dollar has fallen significantly and so the price of imports, on which we have come to depend so heavily, is likely to rise somewhat. However, I don't think this transition is cause for undue concern. We're not likely to see much in the way of price increases until later in the year, and, even then, these could be moderate as foreign producers struggle to maintain their share of the U.S. market. The real danger, which I'll discuss in a moment, lies in the possibility that the dollar might fall precipitously.

The public sector is difficult to classify as either a source of strength or weakness in 1986. Government spending, particularly for defense, should contribute to some strength in manufacturing. Much of the increase in defense spending was just implemented in 1985. Because of the nature of defense contracts and commitments, the momentum from defense spending is likely to be sustained through 1986. However, federal expenditures are likely to be reduced in the aggregate. Although the effects of the Gramm-Rudman budget amendment are rather uncertain at this point, this legislation holds the promise of generating some progress toward reducing our very large federal budget deficits. Since this reduction will probably take the form of lower federal spending, some of the stimulus that has helped propel economic growth during the past few years will be decreased. Small reductions are likely in the 1986 fiscal year, though the legislation, if implemented, indicates greater deficit reductions through the rest of the decade.

On the other hand, part of the adverse effect of reduced fiscal stimulus will be offset by diminished federal borrowing in financial markets. With less "crowding out" by

the public sector, the pressure on interest rates and financial markets may not materialize. This would create a better climate for business and also foster more consumer spending on durables and housing. In addition, the expectation that U.S. rates may not be under upward pressure could bring about a further decline in the foreign exchange value of the dollar. Our large deficit has been an important factor contributing to the escalation in the dollar over the last five years. Such rates have attracted foreigners to dollar-denominated assets, thereby boosting the dollar in foreign exchange markets.

When we add up these strengths and weaknesses, I believe that the former will be sufficient to generate more balanced growth in the economy than we experienced last year. I know that some forecasters are currently much more pessimistic. While I don't want to be a Pollyanna about the amount of expansion that is in store, I believe that the optimists, with whom I would classify myself on this issue, will prove more on target as the year unfolds. One factor that gives me special confidence, despite some recent reversals, is the rallies that have been taking place in both the stock and the bond markets. They suggest that a broad array of American businesses and investors share my sanguine expectations for 1986. The reasons for their bright outlook, I feel, are related to some of the strengths I have cited. The low level of inflation on the horizon makes investment returns more certain; the drop in the value of the dollar bodes well for businesses attuned to international markets; the decline in interest rates improves the prospects for many interest-sensitive businesses; and the likelihood of progress toward reducing the federal budget deficits should help keep interest rates lower through the remainder of the decade. Since all these factors work with a lag, it is possible that the markets have anticipated greater strength in the fundamentals of the economy than is apparent in the data released thus far.

Outlook for the Southeast

The outlook for the Southeast will be determined largely by the performance of the nation. In addition, the southeastern economy will reflect the strengths and weaknesses of the national economy--but perhaps to a greater degree on each side. Thus, defense spending as well as the space program should be a plus for many areas, including Georgia, Florida, and parts of Alabama, Mississippi, and Louisiana. Inventory rebuilding, particularly in the auto and truck industry, should be a boon to the region's increasing number of vehicle assembly plants, such as those in Tennessee and Georgia, and perhaps Alabama's important tire industry. Another favorable factor is population growth. Many parts of the Southeast are likely to continue to attract people from other sections of the United States, and this influx of new residents will fuel demand for housing as well as ongoing expansion of services, ranging from movie theaters, restaurants, and new department stores to doctors', dentists', and lawyers' offices.

The dollar's decline should help some of the region's traditional economic activities such as agriculture, textiles, apparel, and lumber, which have been hard hit by import competition. However, in the case of certain distressed sectors, such as lumber and farming, we must keep in mind that the current plight of these industries developed over several years and is unlikely to be reversed completely in the near term. For the textile industry we must remember that employment has been declining for well over a decade; that is, even during the 1970s when the U.S. dollar was widely regarded as "undervalued" on foreign currency markets. For some time, the textile industry has been growing more capital intensive and technological in order to compete in today's international markets. Thus, we shouldn't expect textile mills to resume their role as major employers even though their corporate balance sheets should begin to look healthier. In fact, we should recognize the aggregate productivity gains that result from

the movement of large portions of our labor force out of low-wage industries. As our work force shifts into higher wage jobs in areas less vulnerable to foreign competition, and, in many cases, in a good position to export, the income level of the Southeast should move closer to the national average.

For the regionally important oil and natural gas industries, which are concentrated in Louisiana and southern Mississippi, the overall prospects are more clouded. Worldwide demand has been slack relative to supplies, and prices are soft. However, current oil inventories look rather low. Also, the decline in oil prices in terms of foreign currencies has been very substantial and could well generate significant growth in demand. Thus, it is possible that some improvement is on the horizon for this portion of the energy sector.

Another regionally important industry that seems destined to undergo some retrenchment is nonresidential construction. Despite the large number of people and companies that have been moving to the Southeast, we have more office space than current demand warrants. There is a glut of hotels in many southeastern cities as well. These phenomena are reflected in high vacancy rates and the proliferation of special rental discounts. The number of new department stores and shopping centers planned for certain southeastern cities may also be outstripping their potential for growth in consumer spending over the next few years. Therefore, I feel that some slowdown is inevitable, even desirable, to allow existing supplies to be absorbed.

Reviewing these sources of strength for the southeastern economy--defense spending, inventory rebuilding, population growth, and the dollar's decline--it seems likely that Florida and Georgia, and more specifically Atlanta, will enjoy the brightest prospects in 1986, while Mississippi and Louisiana will probably remain weak. Generally, cities, where services are concentrated, are also likely to fare better than rural areas,

which are not only more heavily dependent on agriculture but also face the challenge of finding new sources of jobs for many permanently displaced textile, apparel, and other manufacturing workers.

Looking just at Florida, I think we can expect economic performance to be better than in most other southeastern states and somewhat stronger than in the nation, as a whole. I've already mentioned that the outlook for continued strong defense spending bodes well for Florida's electronics industry. Another favorable factor is the depreciation of the dollar that occurred last year. This substantial drop should boost Florida's important lumber and wood industry, which has been adversely affected by the strong dollar. In addition, the state's vital tourism industry should enjoy some upturn in both foreign and domestic visitors as the result of the change in foreign exchange rates. Another strength is the expected continuation of population growth. If the U.S. economy performs as well as I expect, migration from other areas of the country to Florida should remain strong. Moreover, most of the people moving here will probably come with substantial income or net wealth and, thereby, foster ongoing expansion of Florida's large trade and service sectors.

On the negative side, the most salient area is construction. With the possible exception of single-family residences, every major component of the building industry--apartments and condominiums as well as offices, hotels, and other commercial structures--is overbuilt. Consequently, this important Florida industry is unlikely to add to the state's economic growth in 1986. On the whole, however, 1986 promises to be another good year for the Florida economy.

Major Problems and Issues

While this national and regional outlook is generally rather moderate, I want to re-emphasize that the level of economic expansion I envision for 1986 is more balanced than 1985 and is close to our sustainable, long-run growth potential of around 3 percent. Nonetheless, we will still face certain issues that add an element of uncertainty to this outlook. By way of conclusion I'd like to turn to some of the major issues that confront us this year.

A potential problem is the possibility of a rapid fall in the dollar. One result of such a drop could be a sharp rise in inflation. In an environment of increasing prices for imports and rising foreign and domestic demand for American-made products, the adjustment process could be severely strained. It is true that the economy has substantial excess productive capacity. We've been running near 80 percent for some time, and this rate is down from earlier in the expansion. However, we are close to the full employment level. A much higher proportion of Americans is in the labor force than a decade ago. If the economy rebounds strongly, we would probably encounter substantial bottlenecks as well as upward pressure on wages and prices. The net result--perhaps late in 1986--could be an acceleration of prices beyond the moderate 4 percent level that I mentioned earlier.

Another concern pertains to the stability of our financial system. LDC debt continues to burden many financial institutions. As I noted, the substantial decline in interest rates that we have already experienced makes it easier for the countries involved and their lending institutions to restructure and service this debt. However, the decline in the value of the U.S. dollar will make LDC exports to the United States more expensive to Americans and thus could reduce LDC earnings and growth. I am hopeful that America's colleagues among the industrial nations can help take up the slack that

may develop in LDCs export markets. Recent signs of stronger growth in Europe give reason to expect that the economic fundamentals will be in place for such a transition. However, European countries must also exhibit the political willingness to assume a larger share of LDC exports. If, instead, other advanced economies seek to protect their own favorite industries, the likelihood of continued progress on the part of LDCs would be diminished.

This scenario would exacerbate the already fragile situation of our financial system. In addition to the problems posed by loans to LDCs, many institutions are troubled by farm and energy loans. Moreover, all the major segments of the U.S. economy--consumers, governments, and businesses--are highly leveraged. I've already described the problems associated with individual and public sector debt. Leverage in the corporate sector has been greatly increased by the surge of takeovers and mergers in recent years. Many of these have been financed by issuing debt in the form of low-grade investment, or junk, bonds, and prominent among the investors in such instruments has been the already troubled thrift industry. A sudden economic disruption could have extremely troubling results and thereby threaten the continued stability of our financial system. Thus, I believe we must be extremely watchful of developments in LDCs, in the farm sector, and with respect to the continuing use of leveraged buy-outs.

The last problem I want to discuss this evening, and in some ways the most troublesome, is protectionism. It is true that the President wisely, in my opinion, has vetoed a major protectionist bill. In addition, the substantial depreciation of the dollar last year should ease some strains on affected industries. Significant progress in reducing the deficit would also help by allowing for a decline in the dollar that would not lead to strains on domestic capacity and add to inflation. Nonetheless, I am still concerned about continuing political pressures to enact protectionist policies. This

threat to the goal of free trade disturbs me deeply. I don't have to explain to this audience the many economic arguments against protectionism. Whether in the form of quotas and tariffs or the seemingly more benign form of subsidies, these efforts bring advantages to a small group of employees and employers at the expense of the vast majority of consumers who must pay more for the goods they purchase. Usually any advantages are short-lived and merely postpone inevitable adjustments in affected firms and industries. Finally, protectionist measures by one country are almost always followed by retaliatory actions by many other nations, and the net result is a decline in world trade and economic activity. In effect, protectionism chokes off foreign markets that have the potential to become major consumers of those U.S. goods in which we have a comparative advantage.

I would like to add to these well known economic arguments against protectionism a social or moral observation about the sentiments that underlie the support for such measures. This apparent political groundswell indicates a short-sighted approach to public policy and can erode the social values that are the foundation of our laws and policies. Efforts to protect domestic industry against foreign competition transfer the burden of making necessary adjustments to our children. Instead of getting our economic health "into shape" so that we leave a legacy of a more productive economy -- one in which more workers are earning higher real incomes, one based on a mix of higher value-added economic activities suited to the world's leading economy -- the adoption of protectionist policies would allow us to remain slack for a while longer, deferring to the next generation the inevitable process of transition.

The best way to resolve the social and economic ills underlying recent calls for protectionism, in addition to seeking higher productivity and efficiency in all our economic activities, is to work toward lowering the federal budget deficit through the

remainder of the decade. The Gramm-Rudman bill is an important step in the right direction, but it is only the beginning. We must make our legislators in Washington aware that there is widespread popular support for deficit reduction so that significant progress toward this goal is made.

Conclusion

As serious as I believe these problems and issues are, I do not want to leave you on a pessimistic note. I believe we will see definite gains in some of our troubled sectors and economic growth will be more balanced in 1986 than in 1985. There are some potential problems, but I am hopeful that these problems will not manifest themselves or at least that any disruption that they occasion will be minimal. I have no doubt that Americans can successfully deal with the complexities of global economic integration and other problems that I've reviewed. We've met such formidable challenges admirably in the past. I think that the support of enlightened business leaders such as you can be especially helpful in surmounting the present problems. If we all do what we can in our personal and professional lives to promote more far-sighted economic thinking and corresponding public policies, I am certain we can help launch the U.S. economy on a path of enduring and healthy growth.