The Economic Outlook for 1986
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Good morning! I am delighted to be here with you today. My remarks will focus on the economic outlook for 1986. I'll also spend a few moments discussing some associated issues facing financial institutions. When I've finished, I'll be happy to try to answer any questions you might have.

Last Year's Economic Performance

As you all know, economic growth last year did not match the expectations of many people, including myself. GNP expanded less than 2 1/2 percent in 1985. Although I'm quite pleased that unemployment dipped below the 7 percent mark by December, as I had anticipated, progress toward reducing unemployment during the year was slow and 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. Prices increased 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 3 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.

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. The government's huge financing needs and the expectation that these would continue indefinitely have been keeping U.S. interest rates high by historical standards. High rates in turn attracted foreign investors to dollar-denominated assets. This strong international demand for dollars drove up the value of U.S. currency on foreign exchange markets. By February of last year the dollar was some 90 percent above its 1980 trough, on a trade-weighted basis.

Because of the dollar's high value, much of the growth in consumer purchases, as well as that of business investment in equipment, was met by foreign suppliers. At the same time, American farmers and manufacturers found it increasingly difficult to sell their products abroad. As a result, domestic production languished, and employment in manufacturing actually declined for six consecutive months in the first half of the year. Despite a 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.

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 somewhat stronger and more balanced growth in 1986. In my estimation, GNP will probably expand in the neighborhood of 3 percent. Unemployment may decline slightly, but I don't expect dramatic progress on that front. If we sustain the 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 25 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 decline of interest rates during 1985 should have a positive impact on several sectors of the economy, particularly consumer purchases of durable goods and housing. Lower credit costs 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 late last year, we may have started to see the beginning of a consumer response to the substantial decline in mortgage interest rates that occurred during 1985. Mortgage rates are at their lowest level since 1979. 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 the strains on some of our financial institutions. In an environment of lower interest rates, less developed countries, or LDCs, are better able to service their heavy debt burden; institutions whose loan portfolios are heavily weighted by LDC debt should see their financial situation improve as well. Of course, recent oil price declines could offset this effect for developing countries that rely on petroleum exports and their U.S. lenders. On the whole, however, the decline in rates should have a broad, positive impact. When ample supplies of money and credit become available, as happened last year, often a general increase in economic activity follows.

Despite these favorable factors, I don't really foresee GNP growth exceeding 3 percent. Recent surveys of business investment plans for 1986 indicate a scaling back of capital expenditures. The very favorable tax treatment adopted in 1981 has contributed to 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.

Some people expect consumer spending, which accounts for around two-thirds of GNP, to slow, at least temporarily. It is true that consumers have been borrowing heavily to finance their purchases. However, the Commerce Department's revised National Income accounts indicate that the savings rate was not as low as earlier figures had indicated. In addition, the latest data on personal income growth showed a fairly healthy rise. Furthermore, the stock and bond markets rallies late last year enhanced consumers' net worth despite recent setbacks. The fact that retail sales ended the year on a rather strong note suggests consumers may not follow the forecast of the skeptics who emphasize the high burden of debt. All in all, it is hard to say whether or not consumer spending will be a source of growth in 1986, but these recent favorable developments, combined with the fact that consumer spending makes up such a large share of GNP, make me hopeful that the skeptics are wrong.

The public sector is also difficult to classify as either a source of strength or weakness in 1986. 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. However, only small reductions are likely in the 1986 fiscal year. Moreover, defense spending 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. Nonetheless, the Gramm-Rudman legislation, if implemented, indicates greater deficit reductions through the rest of the decade. Thus, federal expenditures could start to be reduced in the aggregate beginning this fall, when the 1987 fiscal year begins.

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.

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 increases could be moderate as foreign producers struggle to maintain their share of the U.S. market.

The real danger lies in the possibility that the dollar might fall precipitously. 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. 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. We shouldn't dismiss this possibility since we don't fully understand the dynamics that attracted foreigners to the dollar for so long after our current account deficits became very large; therefore, we are not on solid ground in predicting future trends in foreign investment.

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. The drop in the value of the dollar bodes well for businesses attuned to international markets. Prospects for many credit-sensitive businesses are improved by the decline in interest rates that has occurred. The likelihood of progress toward reducing the federal budget deficits should help keep interest rates lower through the remainder of the decade. Finally, investment returns are more certain in the context of moderate inflation that is probably on the horizon. Since all these factors work with a lag, we should not be surprised that the effects of these factors are not always apparent in the data released thus far.

Implications for Financial Institutions

The prospects for expansion at a rate close to our long-run growth potential of around 3 percent should be good news for most financial institutions. Nonetheless, our financial system faces certain issues that warrant careful monitoring. 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. LDC earnings and growth could decline as a result. 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 fail to sustain a reasonable level of domestic growth or seek to protect their own favorite industries, the likelihood of continued progress on the part of LDCs would be diminished.

This scenario would exacerbate certain existing issues faced by our financial system. In addition to the problems posed by loans to LDCs, many institutions are troubled by farm and energy loans. The recent sharp fall in oil prices augurs good news for consumers and many businesses, but the picture is quite different for companies that produce, refine, and service the oil industry. Similarly, financial institutions that have lent heavily to oil companies or to oil-exporting countries such as Mexico will find this development much less sanguine. 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 bonds, and the already troubled thrift industry has been prominent among the investors in such "junk bonds." 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 Federal Reserve System is doing what it can to maintain and enhance financial stability. Last year, for example, our supervision and regulation efforts were thoroughly reviewed, and new efforts were launched to deal with the most serious potential problems. Although numerous policy and procedural changes were set in place last year, the new program consists essentially of five reforms: (1) strengthening existing standards, (2) identifying problems earlier, (3) correcting existing weaknesses,

(4) communicating examination findings more clearly, and (5) increasing cooperation with state supervisory agencies.

Notwithstanding the significance of these regulatory reforms, I believe the best way to resolve the issues facing our economic and financial systems is to work toward lowering the federal budget deficit through the remainder of the decade. The lower interest rates that would eventually result from reduced deficits would have widespread beneficial effects. Consumers would find it easier to make purchases. Businesses would be more likely to invest in new plants and equipment. Financial institutions should see their balance sheets improve as some of their troubled borrowers, ranging from farmers and firms in the oil industry to developing nations, find it easier to service and retire their debt. The Gramm-Rudman act is an important step in the right direction, but it is only the beginning. As individual citizens as well as representatives of business and financial organizations, we must make our legislators in Washington aware that there is widespread popular support for deficit reduction to assure that they make significant progress toward this important goal.

Conclusion

Summing up the prospects for the year ahead, 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 that could affect the financial system, but I am hopeful that these will not manifest themselves or at least that any disruption that they occasion will be minimal. If we all do what we can in our personal and professional lives to promote more far-sighted economic thinking and corresponding public policies, especially in regard to the deficit, I am certain we can help launch the U.S. economy on a path of enduring and healthy growth.