

**THE INTERNATIONAL ECONOMIC OUTLOOK FOR 1986**  
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**To the Florida International Bankers' Association**  
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Good evening! As all of you are well aware, the world is increasingly becoming a single marketplace. This shift toward greater economic integration poses certain challenges, but it also offers enormous opportunities for higher living standards for people in all countries. Thus, I am delighted to have a chance to discuss current international economic conditions and the outlook for the coming year. After briefly reviewing global performance in 1985, I'll outline the prospects for this year. The remainder of my remarks will focus on some important issues facing the world economy that I believe are of special significance to international bankers. When I've finished, I'll try to answer any questions you might have.

**Economic Performance in 1985**

As we all know, U.S. economic growth last year did not match the expectations of many people, including myself. GNP expanded slightly less than 2 1/2 percent in 1985. Progress toward reducing unemployment was slow especially during the first half, though the unemployment rate dipped below 7 percent by December and subsequently declined even more. On a more positive note, inflation proved to be milder than expected. Consumer prices increased at an annual average rate of 3.5 percent rather than the 4 1/2 to 5 percent that many had expected.

Some slowing from the unsustainably high rate of growth we had experienced in 1984--6.6 percent on average--was necessary if we were to avoid the bottlenecks and inflationary consequences that typically arise when economic activity is expanding so rapidly. Nonetheless, the pace of economic growth was somewhat less than most people

had hoped. Indeed, it was a little less than our probable long-run potential of around 3 percent. This limit is estimated by taking our resource and productivity gains into account. Far more troubling than the slowdown in economic performance last year were the imbalances in the U.S. economy that placed the brunt on a few sectors, especially those that are most exposed to international trade—farming and manufacturing.

The imbalance between the international and domestic sectors arose mainly from the demands of a large federal deficit, which made people believe that our interest rates would remain high by past standards. These expectations 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 had reached a point almost 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.

Economic performance elsewhere in the world followed a similar pattern of deceleration. In the advanced economies of Europe the pace of expansion slowed to around 2 1/2 percent even though producers there continued to make substantial inroads into the American market and their domestic markets were shielded from U.S. competition by the high price of American goods. Probably the main reason for such moderate growth is that, in contrast to the United States, domestic demand in Europe has been rather weak. Fiscal and monetary policies have not been stimulative, and unemployment rates are stubbornly high in many European countries. By year's end 1985, joblessness was still in the double-digit range in France, Britain, Holland, Belgium, and Italy, and West Germany's unemployment rate was nearly 9 1/2 percent. Canada's growth

rate of 4 percent was somewhat higher than that of the United States and Europe. Japan's growth last year--around 5 percent--was also substantially faster than that of other advanced economies. As in Europe, much of Japan's growth was export-driven, and domestic demand remained rather tepid by American standards. Japan was probably able to outpace Europe because of its faster productivity gains, its aggressive export orientation, and its hard-to-penetrate nontariff barriers.

Less developed countries, or LDCs as they are often called, also experienced moderate growth in 1985. Their diversity renders an average somewhat meaningless, but it is clear that their expansions slowed, especially in comparison to the robust pace of development many experienced during the 1970s. Several LDCs suffered a slowdown in export growth last year when economic growth in advanced economies decelerated. In addition, certain LDCs such as Argentina and Venezuela established austerity policies on the fiscal side as a means of reigning in inflation, and these measures had a dampening short-run effect on economic expansion.

### **Outlook for 1986**

United States. I expect the U.S. economy to experience somewhat stronger and more balanced growth in 1986. GNP will probably expand in excess of 3 percent. The unemployment rate has been dropping, reaching a level of 6.7 percent last month, and I think it can fall further. The outlook for prices is a little uncertain at this point, but on the whole I think inflation will remain subdued.

One of the most important developments underlying this optimistic outlook is the recent decline in oil prices. Although some regions of the country and certain financial institutions may find this decline bad news, overall lower energy costs should have a strong positive effect on the U.S. economy. Since energy is such a widespread and

important input, lower costs for this economic "staple" should lower prices for many goods and services. The cost structure and profitability of many businesses should be favored by this development. Net farm income may rise as well since much fertilizer is derived from petroleum. Households will also have more money to spend on discretionary items. Consumer spending will probably be a source of moderate growth in 1986. Even though consumers have been borrowing heavily to finance their purchases, personal income growth showed a fairly healthy rise at year's end, and payroll employment grew by a larger margin in January than at any time since September 1983. Furthermore, the stock and bond markets rallies that began last year enhanced consumers' net worth.

We are also likely to see some improvement in the international sector. At present, the value of the U.S. dollar, weighted against the currencies of 10 other advanced economies, has fallen more than 25 percent from its peak in February of 1985. Since it usually takes six months to a year for such changes to be translated into adjustments in foreign trade patterns, I expect to see some pick-up in the international sector in 1986. Although the dollar's decline is eventually likely to raise the prices of imports, on which we have come to depend so heavily, I am hopeful that lower energy costs will have an offsetting effect, especially in 1986.

An additional strength is the decline of interest rates that occurred during 1985. Ample supplies of credit and lower interest rates should have a positive impact on consumer purchases of durable goods and housing. Houses have become far more affordable. The decline in interest rates should also reduce the cost structure of builders and other businesses. Many corporations, for example, have been calling in high-rate bonds issued in the early 1980s and refinancing at significantly lower rates.

Some sectors may not grow as fast in 1986. Recent surveys of business fixed investment plans for 1986 indicate a scaling back of capital expenditures owing to the current surfeit of offices and certain other structures, uncertainty about tax reforms that could reduce investment incentives, and the considerable amount of excess productive capacity on hand. The public sector is 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--as is its constitutionality, this legislation holds the promise of generating some progress toward reducing America's large federal budget deficits. Thus, 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, because of the nature of defense contracts and commitments, the momentum from defense spending will probably be sustained through the next 12 months or so. Finally, 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 could diminish, thereby creating a better climate for business while fostering 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.

When we add up the strengths I've mentioned--reduced energy costs, consumer spending, lower credit costs, the depreciation of the dollar, and the positive effect that lower federal budget deficits would have on interest rates--I believe that these will be sufficient to offset anticipated weaknesses in capital investment and fiscal stimulus. The net result should be faster and more balanced growth in the U.S. economy than we experienced last year.

Europe. Europe's growth in 1986 should be a little higher than last year. Germany will be a key source of this acceleration, whereas the United Kingdom's expansion may slacken somewhat from last year's comparatively strong advance of over 3 percent. France and Italy remain concerned with containing inflation and are therefore likely to continue their more moderate pace of growth.

One favorable factor for many European nations is the oil price declines already experienced and the possibility of further decreases. Since energy costs affect so many economic activities and Europeans lack the domestic energy resources that favor the United States, a reduction in oil prices is especially significant. In addition, a number of stimulative fiscal policy measures have been planned, including personal tax cuts and incentives to increase business investment. If fully implemented, these measures should spur growth even more. However, progress toward the implementation of these proposed fiscal changes thus far has been slow. Hence, fiscal stimulus will probably have only a modest impact. Another important development is the more flexible, market-oriented policies that many European governments have been adopting recently, together with popular attitudes that support less rigidity in labor markets. The shift in policy orientation may, over time, help to reduce the high unemployment level still prevailing in many European countries. While this anticipated growth rate shows little change in degree from last year, there is one important difference. Much of the expansion, especially in Germany, should be fueled by domestic demand rather than by exports. This change will be especially welcome news to U.S. manufacturers.

Canada and Japan. Turning to the world's other major advanced economies, Canada and Japan, deceleration is likely in 1986. It is true that the foreign exchange value of the Canadian dollar has actually fallen somewhat relative to the U.S. dollar. Hence, Canada's exports to this country, its major trading partner, should not be

adversely affected by the dollar's general depreciation. Moreover, as in Europe, domestic private demand has been strengthening. However, Canada is struggling with its own budget deficit problem. In the first half of 1985, its federal budget deficit rose to 7.8 percent of GNP. In 1986, Canada is expected to move toward fiscal restraint, which should moderate its growth.

The expected Japanese growth rate of 3 to 3 1/2 percent is due largely to a sharp slowdown in Japanese exports and the relative weakness in domestic demand in that country. Japanese exports soared 18 percent in 1984 and 8 percent in 1985, as the lagged effects of the appreciating U.S. dollar and strong domestic demand here bolstered the market for Japanese exports. Now that the dollar has depreciated, this source of growth should atrophy. Japanese interest rates have fallen considerably since mid-November, and in late January the Bank of Japan lowered its discount rate from 5 percent to 4 1/2 percent. Still, the yen has appreciated even further, reaching a range of 180 to 185 relative to the dollar. Although a trade surplus is likely even at current exchange-rate levels for the yen, Japan's growth prospects in 1986 will thus depend more heavily on domestic demand. Fiscal easing moves undertaken in October should stimulate such demand through the first half of the year. Yet, Japan's latest budget actually tightens fiscal policy somewhat, and so the government sector's growth-inducing influence on the Japanese economy is likely to end by the second half. Even the fillip expected from fiscal policy in the first half will not be substantial because, as in Europe, fiscal stimulus has not been fully implemented. Of course, Japan could grow faster than many people now anticipate. Lower oil prices should be especially beneficial for the same reasons as in Europe, and the projected growth rate for this year is certainly below Japan's long-run potential and recent performance.

Developing Countries. Assuming that the industrial nations of the world grow at a respectable pace, the overall outlook for 1986 is for some improvement. LDCs depend heavily on advanced economies to absorb their exports. Hence, a temporary lull in U.S. or Japanese growth could substantially retard the expected pace of LDC expansion. The possibility that certain developing nations, particularly Brazil, will have to implement austerity measures similar to those undertaken by Argentina and Venezuela last year to deal with the problem of inflation suggests further limits on expected growth in the third world. One factor that could brighten prospects for Brazil and many other LDCs is the decline in energy prices. However, oil-exporting developing countries such as Mexico and Venezuela are likely to have problems, and these troubles could result in serious consequences for their lending institutions in the United States and elsewhere.

### **Issues and Problems**

The mixed effects of an energy price decline both for developing countries and the international financial system demonstrates that despite the generally positive outlook for the world economy in 1986, certain important problems remain unresolved. These issues warrant careful monitoring and consideration. One such problem is the burden of LDC debt that continues to burden many countries as well as U.S. financial institutions. The substantial decline in interest rates that we have already experienced makes it easier for indebted countries and their lending institutions to restructure and service this debt. However, the decline in the value of the U.S. dollar will make exports of some developing countries whose currencies are not pegged to the dollar 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, especially in the area of domestic demand, give reason to expect that the economic fundamentals

will be in place for such a transition. However, Europe and Japan must also exhibit the political willingness to absorb 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.

The LDC debt situation is a matter of concern for several reasons. First, servicing this debt is exerting considerable drag on the economic growth of developing countries. Debt service is consuming about one-fifth of the value of products that these countries are exporting. Consequently, LDCs are able to import less equipment and other products that they need to carry out their development plans. In addition, the austerity measures that were imposed by these countries in exchange for International Monetary Fund (IMF) loans during the past several years have lasted longer than leaders and citizens of these countries expected, and they are feeling increasingly frustrated with the stalled progress in resolving the debt problems and raising living standards through economic development. This economic frustration, of course, increases the chances for political unrest and instability. It also tends to build support for more extreme measures, such as a repudiation of the debt by a coalition of borrowing nations.

Aside from the hardships imposed on citizens of LDCs, this debt poses serious threats to the continuing stability of the international financial system. LDC debt is concentrated among a relatively small number of borrowers and lenders, primarily from Latin America and the Caribbean. This concentration might lead one to believe that problems could be easily contained. In fact, the implications of such concentration are quite ominous. On the borrowers' side, troubles in a single country could spark severe instability even if overall international economic conditions are sound. During the 1982 debt crisis, problems in one or two countries led to a drying up of new credit in

neighboring nations and subsequent crises there as well. With respect to lenders, the amount of debt owed by developing countries just to U.S. banks is substantial. The volume of loans to Latin American and Caribbean countries equals over two-thirds of the capital of the 200 largest banks in the United States. Moreover, of all the Latin American and Caribbean debt held by these 200 banks, just nine institutions account for five-eighths of the total. What's more, the volume of loans to four countries--Argentina, Brazil, Mexico, and Venezuela--exceeds the joint capital of these nine banks.

The huge size of these financial institutions, the concentration of their foreign loan exposure to a small number of countries, and their precarious balance sheet situation suggest that serious problems in one or two countries or institutions could send shock waves through the entire international financial system. Of course, such a scenario will probably never unfold because the Federal Reserve, the central banks of other industrialized nations, and international organizations such as the IMF would take prompt countermeasures. Notwithstanding this safety net, the present situation is engendering strains on the world economy. The uncertainty surrounding the debt situation is probably keeping interest rates higher and foreign lending lower than otherwise would be the case. It is thus acting as a deterrent to faster economic growth around the world.

Although substantial progress has been made since 1982 toward resolving the debt crisis and the problem at present does seem well contained, the recent sharp drop in oil prices adds a new element of concern. The probable reduction in export earnings due to the fall of oil prices can only exacerbate the problems faced by Mexico and other oil-exporting LDCs and their creditors. This situation needs to be monitored closely because of its potentially disruptive ramifications.

A second major international issue confronting us in the year ahead is the currency system and the present alignment of the world's major currencies. From a system of fixed exchange rates that endured for almost thirty years, we have shifted the financial basis of international trade and investment to a far more flexible system based on floating exchange rates. The system has worked fairly well since its inception in 1973, but in the past five years certain problems such as volatility and trade imbalances have become more severe. As the dollar appreciated dramatically from 1980 to 1985, the U.S. trade and current account deficits widened, reaching historical peaks in 1984 and 1985. While this shift has been a windfall to many countries, whose expansions have been driven largely by the increasing price attractiveness of their exports to American consumers, the misalignment of currencies eventually began to take its toll on the U.S. economy. Some people have begun to suggest that we should abandon the system of floating exchange rates adopted in 1973 or at least introduce restraints on this system that would prevent currencies from deviating so sharply.

Recognizing that the misalignment of currencies and associated imbalances in the U.S. economy could have serious repercussions on economic growth elsewhere, the world's five leading open economies--France, Germany, Great Britain, Japan, and the United States--promulgated the G-5 accord last September to extend the dollar depreciation that had already occurred in 1985. Through a combination of intervention in foreign-exchange markets and changes in domestic policies designed to narrow the interest-rate differential between the United States and the other four signatories, substantial progress was made in lowering the dollar even further. It's not clear to me that seeking further dramatic declines in the value of the dollar would be the best way to narrow the huge trade and current account deficits that the United States has been incurring in the last two years. The ultimate inflationary effects could be troublesome. Moreover, focusing on certain currencies such as the yen, against which the dollar has

fallen dramatically, can lead to an unrealistic concern with bilateral trade flows, and there may be limits to the amount of bilateral adjustment that could—and should—be made.

Japanese-American relations illustrate this point. Consumers in Japan tend to save a much larger proportion of their incomes, and government deficits have been proportionately smaller in recent years than those in the United States. The relatively large pool of savings that is consequently available forces Japanese portfolio managers to look abroad for investment opportunities, thereby creating a chronic capital outflow. The United States, in contrast, with its low savings rate and huge financing needs, especially on the part of the public sector, is a natural outlet for Japan's surplus capital. The capital flowing into the United States pressures the dollar-yen exchange rate to a level that may be higher than is consistent with our actual trade competitiveness vis-a-vis Japan. Similarly, bilateral trade flows sometimes tend to be permanently in deficit or surplus. Japan's reliance on external sources for most of its basic commodities, including energy, keeps its trade balances with many developing countries which supply these goods in a sustained state of deficit. To balance its international accounts overall, Japan tends to export manufactured goods to advanced economies, particularly the United States. Thus, there may be reasonable limits on the degree to which Americans can reduce our bilateral trade deficit with the Japanese. In my opinion, the best long-run approach to easing world trade imbalances would be based on greater fiscal stimulus in other advanced economies to spur their domestic demand, reduced federal deficits in this country, and a heightened orientation by U.S. business and financial institutions to the growth potential of foreign markets.

A final problem is that of trade barriers. It seems as though we've reached a plateau in the progress we've made since World War II toward freer trade. Japan has

done fairly little to open up its financial services to outsiders despite official affirmation of such a policy. European countries have numerous trade restrictions and nontariff barriers that seem designed to keep out such growth industries as insurance, data processing, and other services in which the United States has an edge. Quotas on foreign autos, textiles, and sugar exemplify U.S. trade restrictions. It would be tragic if current shortsightedness led the United States and other countries to repeat the beggar-thy-neighbor policies that helped thrust the world into depression during the 1930s.

### **Policy Implications**

Although the three issues that I've raised—LDC debt, currency alignments, and trade barriers—do not lend themselves to easy solutions, several recent policy proposals, along with the generally positive prospects for the international economy in 1986, promise at least short-term mitigations which would allow some breathing space to formulate and implement long-term structural solutions. With regard to LDC debt, the recent proposal, supported by both the Fed and the U.S. Treasury, that American banks increase lending to the most heavily indebted LDCs is an important step in the right direction. By fostering faster growth, increased lending would obviate the need for developing countries to reduce imports unduly, impose severe fiscal restraints, and undertake other extreme belt-tightening measures. In addition, this initiative's call for developing nations to make structural economic changes that would place more reliance on the private sector should address the inflation problems besetting many developing countries, whose excessive dependence on the public sector has tended to worsen inflationary pressures. Another inflation-fighting aspect of this proposal is its call for LDCs to discourage protection of domestic industries, a move that would open up internal prices to more competition.

On the subject of currency alignments, I would strongly object to a return to fixed exchange rates. Experience, as well as economic theory, has taught us that even relatively free markets adjust better to shocks than do bureaucracies. Nonetheless, I find some merit in proposals to intervene when necessary to keep exchange rates within fairly wide "target zones" so that they do not become grossly misaligned. However, adhering to such zones will require greater coordination of fiscal and monetary policies on the part of the world's advanced economies. Moreover, the United States will also have to undertake other fundamental changes, such as increasing our pool of funds available for domestic investment and financing needs by reducing the demands of the public sector and increasing personal savings. Finally, the United States will have to adopt measures designed to improve productivity and ease the strains of adjustment from industries in which advanced economies are losing their comparative advantage to lower-cost developing nations.

Such gains will be especially important if American businesses are to succeed in the efforts I've advocated to expand their exports. Measures to ease the pains of transition should also help mollify the ills that have given renewed support to protectionism in the United States and trade barriers in many advanced economies. In view of this anticipated respite, international negotiations should have a better chance of redirecting the course of international trade toward greater economic integration and cooperation. A key measure I would like to see adopted is the incorporation of services into GATT--the General Agreement on Tariffs and Trade--since this sector is one in which the United States often has a strong comparative advantage. The plethora of nontariff barriers in advanced economies needs to be rolled back. Finally, the rapidly industrializing developing nations need to do more to apply the rules of GATT to their commercial policies. The last is especially important in view of the fact that many of

these countries have not shared in the exchange rate appreciation relative to the dollar that the yen, Deutschemark, and other advanced economies' currencies have been undergoing in the last year.

### **Conclusion**

Summing up the international outlook, I believe that the United States could rebound somewhat in 1986 and that we will see definite gains in some of our troubled sectors. Global economic performance should equal or slightly exceed 1985's growth rate. The significance and complexity of the longer-term and more fundamental issues that I've outlined should not be underestimated. Nonetheless, I am heartened by some of the recent policy initiatives to address these problems and by the growing public awareness of the importance of international trade and finance. The support of representatives of the financial community and the heightened understanding that can be achieved through meetings such as this one tonight can be especially helpful in meeting the present challenges and launching the world's economies on a path of healthy and enduring growth.