THE ECONOMIC OUTLOOK FOR 1986
Remarks by Mr. Robert P. Forrestal, President
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Introduction

Good evening! I am honored by your invitation to speak to you tonight. This occasion, honoring outstanding students in business and management at West Georgia College, marks an important event in your lives. As such, it is a good time to consider some of the economic developments that you'll soon be facing as you embark upon your careers. My remarks concern the economic outlook for 1986. I'll be focusing primarily on prospects for the nation, but I'll have some comments about the Southeast as well. I'd also like to spend a few moments discussing some problem areas and issues that we all should be thinking about in the year ahead.

Last Year's Economic Performance

Let me state at the outset that I am optimistic about the economy as I look ahead. I think this statement is important in view of the uncertainty that developed last year when economic growth slowed more than many had expected. It is also important because some forecasters have chosen to emphasize the near-term negative impacts of the sharp decline in energy prices while underemphasizing the positive effects this development will have over time. The outlook for the national economy is better than it has been in some time, and the recent release of GNP data for the first quarter demonstrates this. The economy grew at a rate of a little over 3 percent, after adjusting for inflation—quite an acceleration over last year, when the economy expanded by only a little more than 2 percent on average. What's more, I think activity will pick up further toward year's end.

What has caused this expected revival? Basically, a combination of factors, some of which are fortuitous, give rise to this brightened outlook. First, the decline in the value of the dollar in foreign exchange markets, which began a little over a year ago, is finally starting to have an impact. Yes, it takes that long since many internationally traded commodities are covered by contracts that have to expire and be renegotiated before the effect of a lower dollar becomes apparent. As the year progresses, we are likely to see a turnaround in the trade situation. We will be importing a little less and starting to export a little more. (Due to various technical factors, however, data that are adjusted for inflation may not show this for some time.) Aside from the positive effects the dollar's decline will have on our trade balance, prospects for stronger growth in Europe suggest that demand for U.S. products will increase ever further. So there is some light at the end of the tunnel.

A second reason for my optimistic outlook arises from current financial conditions. The stock market rally increases consumer wealth and, with time, consumer spending. Rising equity prices make it less costly for business to raise the capital needed for growth. With a better outlook taking hold, I would expect to see some expansion in investment by businesses in the months ahead. However, the increase is likely to be modest since there has already been considerable investment in office buildings in the past few years, and many markets are now "overbuilt."

Another factor spurring activity is the decline in interest rates that has occurred. Fixed-rate mortgages have reached their lowest level since 1978. We have already seen their effect on the housing market, where starts are being sustained at the 1.9 to 2.0 million pace compared to around 1.7 million in 1985. Reductions in interest rates work much like the fall in the dollar--they affect the economy with a lag. Since much of the decline has occurred since last fall, especially in the past few months, we should see favorable impacts for some time to come.

Finally, we have the very large drop in the price of oil and energy generally. By raising consumer's discretionary income, this decline acts as a tax cut. Some technical studies have estimated that the drop in oil prices is equal to a tax cut of about $50 billion, arising as the net of a $75 billion boost in consumer and business income and a $25 billion cut in the production area. As the cost of gasoline and heating fuel falls, households have more to spend on other things, and they generally do spend most of this extra income rather than divert it to savings. Lower energy prices also reduce production costs for business and make the climate for expansion favorable.

Of course, oil price reductions also have adverse impacts, and often these negative effects are more noticeable initially as producers in this industry are quick to cut production and even shut down operations. Only later do consumers and businesses realize the benefits of lower energy prices and begin to spend more freely. Ultimately, though, the positive effects should prove long lasting and more powerful than the cutbacks that predominate in the short run.

Oil price cuts also help several of the major industrialized nations and non-oil exporting less developed countries (LDCs) in addition to benefiting us here, and, as I noted earlier, faster economic growth in the world benefits everybody. Again, however, we must keep in mind that it is a net positive effect: some oil-exporting LDCs face a more difficult climate. So we will continue to see imbalances among the different countries, just as we see them in various regions of the United States. I'll talk more about these imbalances in a few minutes.

Because energy prices are falling, the outlook for prices in 1986 appears comfortable. It is true that the fall in the dollar works to speed inflation as imported goods become more expensive and demand for domestic products expands. Yet, the drop in oil costs works the other way. Thus, we should see lower inflation numbers for much of the year, with a modest increase developing toward year's end. By then the impact of lower oil prices will probably start fading, while the upward price pressures exerted by a lower dollar will still be with us. On balance, the outlook for the U.S. economy is for a continuation of what is already a rather long expansion and at a faster pace--say 3 to 3 1/2 percent. This rate of growth should bring the unemployment rate down to around 6 1/2 percent and, due mainly to a fortuitous drop in oil prices, keep inflation modest.

Outlook for the Southeast

The outlook for the Southeast will be determined largely by the performance of the nation, which, as I've just described, promises to be noticeably better than last year. Thus, 1986 should bring faster and more even growth to the Southeast. The pace of office, apartment, and condominium building is likely to slow, allowing excess supplies to be absorbed. On the other hand, manufacturers, many of whom have been under intense competitive pressure from foreign producers, will probably see some improvement in the coming months.

The performance of industries heavily concentrated in this region will also shape the economic course of the Southeast in the year ahead. Defense spending should be a plus for many areas, including Atlanta, Florida, and parts of Alabama, Mississippi, and Louisiana, since the nature of defense contracts and commitments is such that government spending in this area is likely to maintain substantial momentum through 1986. The region's increasing number of auto and truck plants, such as those in Tennessee and Georgia, and perhaps Alabama's important tire industry will probably benefit from developments such as the stock and bond market rallies and the drop in oil prices that are likely to spur consumer spending.

Another favorable factor is population growth. Many parts of the Southeast will continue to attract people from other sections of the United States. This influx of new residents will fuel demand for housing as well as ongoing expansion of the service sector. Indeed, such services as banking, restaurants, department stores, medical care, and airports are collectively likely to provide the most new jobs in the Southeast this year. Tourism, another regionally significant service industry, stands to gain from the dollar's depreciation and the drop in oil prices.

The dollar's decline should help some of the area's traditional economic activities such as chemicals, textiles, and apparel that have been hard hit by import competition. However, progress may be slow and halting even if the dollar depreciates further. For example, some countries in which the chief foreign competitors of U.S. apparel and lumber producers are located have not experienced the sort of currency appreciation relative to the dollar that has characterized the movement of advanced economies' exchange rates over the last year. Canada's currency at present is nearly the same relative to the dollar as it was a year ago, whereas the yen and the Deutschemark have risen by more than one-third. Moreover, even if the Canadian dollar were to appreciate substantially, the effect on the Southeast might not be great. In this region import competition from Canada has been heavily concentrated in the softwood lumber market, which is important in residential construction. Unfortunately, a moderate realignment of U.S. and Canadian currency might not dramatically reduce the large market share our northern neighbors have gained because other factors make basic costs of this resource lower in Canada. The same can be said of Asian competitors in the apparel industry, who have an enormous labor cost advantage over U.S. manufacturers, an advantage that cannot be eliminated by any realistic currency realignment.

For some regionally important economic sectors, especially those involved in natural resource extraction and processing, the outlook is rather bleak. I've already described the situation in the forest products industry. Southeastern farmers have no particular reason for faring better than their counterparts elsewhere in the country although generally their financial plight is not as distressed as that of farmers in the Midwest. The outlook for regional energy producers is probably the most dire. Lower oil prices can only spell bad news for the vast majority of the region's oil and natural gas industries, which are concentrated in Louisiana and southern Mississippi. What's more, the downward pressure on oil prices does not bode well for for Alabama's coal industry.

Reviewing the sources of strength for the southeastern economy--defense expenditures, consumer spending, population growth, and the dollar's decline--Florida and Georgia seem likely to enjoy the brightest prospects in 1986, while Louisiana will probably remain weak. Tennessee, Alabama, and perhaps Mississippi, should fall in the middle. Generally, cities such as Nashville, Atlanta, and the numerous urban areas of Florida should fare better than rural areas. Most of the population growth--and hence service sector expansion--is taking place in metropolitan areas, whereas small towns and rural areas not only depend more heavily on agriculture but also face the challenge of finding new sources of jobs for many permanently displaced manufacturing workers.

Problems and Issues

While this national and regional outlook is fairly bright, nonetheless, we still face certain problems that add an element of concern, especially regarding our prospects beyond 1986. By way of conclusion I'd like to turn to some of the major issues that confront us. First, a growth rate of 3 or 3 1/2 percent, while respectable in this the fourth year of expansion, is not really fast enough to enable us to simply "outgrow" certain serious problems. What's more, the fact that our longer term growth potential is around 3 percent means that we cannot employ standard macroeconomic tools to ameliorate unemployment and certain other problems without engendering adverse side-effects such as renewed inflation. With regard to unemployment, I realize the current U.S. jobless rate of 7.1 percent is well below the double-digit levels still prevailing in many Western European countries. Of course, a large percentage of the U.S. population is in the work force. With more men and women seeking jobs than has been usual in the post-World War II period, the unemployment rate would tend to be higher than in earlier decades. Still, it is a matter of concern that so many people still are out of work since at this point in the expansion a repeat of the sort of rapid GNP and employment growth we experienced in 1983 and 1984 is unlikely. Moreover, monetary and fiscal policy are not ideal tools for addressing this issue because aggressive macroeconomic action to reduce joblessness could rekindle inflationary pressures, given current labor market conditions.

Another problem related to the growth prospects for 1986 is our mediocre record on productivity. For this cycle as a whole, performance has been below the postwar average. Until 1973, for instance, productivity increased at an annual average rate of more than 2 percent, measuring between the peaks of successive business cycles. During several periods we achieved a gain of 2.9 percent. In contrast, productivity advanced only 1.6 percent in 1984, and last year it actually slipped. This experience is especially troubling in view of the fact that GNP growth was extremely robust in 1985, fiscal measures were in effect to increase investment and thereby boost productivity, and many of the developments that were deemed to have slowed productivity sharply in the 1970s have abated in importance. These factors include energy cost increases, the imposition of new and widespread regulations that may have diverted investment away from productivity and toward such areas as pollution control and product safety, and a decline in worker quality. This last factor is associated with an influx of young, inexperienced, and hence less productive workers into the labor force as the baby-boom generation came of age and more women began to work. So far in the 1980s energy costs have not only stopped accelerating but recently began declining, no new broad regulatory measures have been initiated, older ones are being enforced with greater flexibility, and baby-boomers have largely been absorbed into the work force. Consequently, many people expected productivity to resume the growth pattern of the 1950s and 1960s. Yet little evidence exists that such a reversal has begun. Even the tax incentives that were designed to increase investment and thereby boost productivity do not seem to have had much of an impact.

One of the flaws in the particular fiscal measures adopted was that they were more favorable to investment in structures--offices, hotels, apartments, and condominiums--than to investment in productivity-enhancing equipment. Moreover, when the economy slows substantially as it did last year, it is to be expected that productivity gains will also wane. Workers are typically kept on after orders begin to slacken while employers determine whether or not the deceleration is temporary. In such periods, output per man-hour usually drops. Our performance should become better this year as the economy picks up.

Nonetheless, we must be concerned with our nation's recent record of productivity gains. When our performance falls behind that of foreign competitors year after year, the result is likely to be ongoing erosion in our share of world markets. Moreover, productivity growth largely determines per-capita living standards. Unless each of us on average produces goods and services of greater value, our claims to higher incomes will tend to have inflationary results. Finally, productivity gains are closely tied to our ability to make progress in reducing the very large federal budget deficits and the serious problems related to these deficits. Some of these associated problems such as upward pressure on interest rates and the dollar's high value on foreign exchange markets are already taking their toll. These deficits will also place a heavy future burden on the generation of young people being honored here tonight because it is you who will have to pay off this huge debt.

Productivity is related to solving the deficit problem. Faster gains in output per worker hour would lift the constraints on our nation's long-run growth potential without posing the danger of renewing inflation. The faster our economy can grow over time, the easier it will be to cut the federal budget deficit as a proportion of GNP. In recent years limited productivity gains, technological advances, and resources have restricted our trend growth rate to around 3 percent. We can see how important productivity gains are to transcending the bounds of recent economic growth if we think of aggregate economic output as the total hours of labor employed times the output per worker-hour of labor. The latter is, of course, a simple definition of productivity. Viewed in these terms, it is clear that output can be expanded by increasing either employment or productivity. Since employment gains tend to be limited by labor force participation, which in turn is determined largely by long-term demographic trends and by social customs, this approach seems less open to policy influence. Consequently, productivity tends to receive most of the attention.

If we can't rely on such factors as deregulation, declining energy prices, a more experienced work force, and investment incentives in our tax laws to raise trend productivity, then we are faced with two alternatives. Either we must be content with a moderate long-run growth rate of around 3 percent and the attendant political and economic painfulness such a ceiling implies for deficit reductions, or we must find another solution to the challenge of productivity and the other issues I've discussed.

These problems--unemployment, flagging productivity, and large federal budget deficits--will not lend themselves to quick fixes or short-term remedies. Policy measures must be fashioned to achieve long-term improvements. Unfortunately, as I've mentioned in the case of the current unemployment rate, monetary and fiscal policy do not seem to be the most effective tools to deal with some of these problems. Both were accommodative last year, yet progress toward reducing joblessness, for example, has been slow, and productivity fell. As fiscal policy becomes more restrained in the spirit of Gramm-Rudman, the elimination of the stimulus generated by large deficits may initially exacerbate the unemployment situation. By increasing incentives to save and by channeling investment into more productive projects, prudently formulated tax incentives could ease some of these problems. Federal policymakers cannot shoulder the entire burden, though. State and local governments will need to take greater responsibility for addressing some of these problems. Federal deficit reduction in the context of our current growth potential requires such a shift. What's more, the solutions needed are measures historically in the bailiwick of state and local governments. The types of policies I'm talking about include human capital investment, especially in the area of general education and vocational training to prepare workers for the demands of tomorrow's global economy. A better educated work force will ultimately help reduce unemployment and raise productivity, thereby expanding our long-run growth potential.

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 faster and more balanced in 1986 than in 1985. Some potential problems exist, but I am hopeful that any disruption they occasion will be minimal. I have no doubt that Americans can successfully deal with the complexities and problems that I've reviewed. We've met such formidable challenges admirably in the past and I'm sure we can muster the collective will to adopt public policies in the months and years ahead to launch the U.S. economy on a path of enduring and healthy growth.