The Economic Outlook
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I am honored by your invitation to speak to you today. Let me begin by reviewing how the U.S. economy has fared in 1986. I will then discuss the outlook for the nation and, briefly, the prospects for Louisiana before returning to some issues that affect all citizens. When I've finished, I'll be happy to answer questions you may have.

Recent Economic Performance

Turning to the national economy, real GNP, that is, output adjusted for inflation, expanded at a strong annual rate of 3.8 percent in the first quarter, although growth apparently slowed to just over 1 percent in the subsequent three months. On balance, the pace of expansion in the first half of this year was almost the same as the 2.7 percent we averaged in 1985 and not very different from growth over the past twenty years. In fact, GNP increases of 2 1/2 to 3 percent seem to be very close to the economy's long-term potential to grow, taking account of demographic factors.

At the same time, I believe we could stand a period of somewhat faster expansion. The unemployment rate has hovered just above 7 percent for the past two years. Even temporary stronger growth would enable us to reduce unemployment before pressures on wages started to emerge. We should remember, of course, that growth rates of 4 percent, for example, are not sustainable for more than six months to a year without running the risk of rekindling inflation. Still, a drop in the employment rate of one-half to one percentage point would move us to a more acceptable level.

Another reason for my belief that growth could reaccelerate pertains to inflation. Price increases have been modest this year, despite the recent jump in the consumer price index to an annual rate of 5.7 percent, which I see as a temporary aberration. Indeed, price behavior throughout this expansion has for the most part been very gratifying. We have slowed from terribly high inflation rates of close to 12 percent four years ago to around 2 1/2 to 3 percent. This is a faster deceleration than I expected. Some special factors have helped moderate prices significantly. The strong rise in the value of the dollar until early 1985 constrained both domestic and import prices, although this factor now lies behind us. The recent sharp—actually precipitous—drop in oil prices is certainly responsible for the low inflation we have seen this year. When you look behind the price numbers, though, some important areas of the economy are showing faster increases. In the expanding service sector, which includes such activities as health care, professional counsel, and entertainment, inflation has been around 5 to 6 percent for some time.

Overall, these three broad barometers—GNP, inflation, and unemployment—suggest that economic performance has been pretty good. This evaluation appears more valid when you consider that the expansion has lasted nearly four years, longer than any we have seen since the 1960s. At the same time, the economic environment is subject to far more pressures than it was during the Sixties. Some of the pressures such as the greater mobility of capital, both nationally and internationally, and the development of more specialized capital markets generally have positive impacts. On the other hand, pressures like increasing global competition are creating severe dislocations and forcing profound structural changes. You are very much aware of these changes here in Louisiana, I'm sure.

My generally positive assessment of the economy should not be mistaken for glibness about certain shortcomings and imbalances. For one, the national unemployment rate looks somewhat too high. The pace of expansion in the last two years would be more acceptable if the level of joblessness were lower, especially given the progress we've achieved in reducing inflation. Moreover, there are imbalances among economic sectors that these three aggregate measures do not reveal. While services and the housing industry are quite healthy, serious problems beset farmers, energy producers, and manufacturers.

GNP growth has been sustained by fairly healthy consumer spending. Residential construction, for example, has proven quite responsive to recent drops in mortgage interest rates. Starts are being sustained at an annual rate in excess of 1.8 million. That pace is slower than earlier this year but definitely ahead of 1985. Another indication of the strength in consumer spending is that retail sales have been trending up modestly if you separate the auto sales component, which is quite volatile.

Other sectors have not been faring as well, however. The sharp drop in oil prices has virtually crippled producers in this industry. Oil prices have apparently not yet bottomed out as it seemed they would several months ago. As a result, the downturn in the energy sector has been steeper and its impact, more widespread and severe. This development has contributed to the lackluster levels of capital spending by businesses. However, investment is weak for other reasons as well. Office space around the country is overbuilt, and a correction has seemed inevitable for some time. Tax reform proposals are creating an atmosphere of uncertainty in which businesses are reluctant to undertake major new capital projects. Slipping utilization of the nation's productive capacity makes business even more hesitant to invest in new plants and equipment.

Finally, and perhaps most important, the international sector continues to exert a drag on growth. This is happening despite the dollar's extended and substantial decline, at least against the currencies of our major trading partners. Since February 1985 the dollar has depreciated by about a third against the yen and the Deutschemark, for example. The results of these dislocations in the international sector are most apparent in farming and manufacturing. Farmers have been undergoing several years of hardship as a result of excess supplies worldwide, falling commodity prices, and a heavy burden of debt taken on in far different economic circumstances. The dollar's high value on foreign exchange markets has exacerbated these conditions by eroding U.S. farmers' exports. For the first time in twenty years the United States imported more farm products than it exported. What's more, the surfeit of farm products globally is so big that even the significant currency realignment we have had has not been sufficient to bring relief to U.S. agriculture. American manufacturing did not start out in such bad straits, but the dollar's high value has, nonetheless, taken a heavy toll on export-oriented industries as well as those sensitive to import competition.

Outlook

In view of the current mixed state of the economy, we must ask ourselves whether the weaknesses are so serious that they threaten to terminate the expansion or at least snuff out the potential for a period of faster growth that would be so good for us. This consideration brings me to a discussion of the outlook. I think that there are several reasons for being optimistic that the economy will gain momentum. Recently released data for the second quarter shows very slow growth in part because of substantial inventory cutbacks. While that news was bad for the past quarter, its future implications are positive. Factory managers and retailers have drawn inventories down to extremely low levels. Thus any increase in demand is likely to be passed through to production quickly, and I think that such demand will come.

Consumer spending looked quite strong according to the latest figures, and the prospects seem good for it to remain so. Even though GNP rose at only 1.1 percent, personal consumption expenditures were up by nearly 6 percent, indicating that domestic demand remains quite vital. The drop in oil prices that has been so painful to this part of the country has bolstered household discretionary income nationally. As people spend less on gas and oil, they increase purchases of other goods like housing, furniture, cars, and a variety of services. I look for sustained growth in consumer spending, though perhaps a a slower pace than we have seen recently.

The reason that we didn't see strong growth in domestic demand paralleled in overall output is that the trade deficit worsened temporarily. With the decline in energy prices, oil imports have soared, making our trade balance worse despite the dollar's depreciation. It will take time for the drop in the dollar to bring relief to U.S. manufacturers and farmers. Some delay in the economy's response to a lower dollar is to be expected since an upturn in net exports typically follows a currency depreciation or devaluation only with a lag. Because the price of imported goods rises while that of exported commodities falls, the trade deficit initially worsens, especially for trade flows covered by contracts. Later the volume of imports slows in response to price increases, and the amount of exports rises as American goods become cheaper abroad. Still, we don't have to wait until exports begin surpassing imports again to see a rebound in GNP. Even if the trade deficit merely flattened, its drag on overall GNP growth would be reduced and the pace of expansion would accelerate. For instance, if the trade deficit had not worsened from 1984 to 1985 but merely stayed the same, albeit quite large, GNP growth would have been 1 1/2 percentage points higher last year.

When we add up these current strengths and weaknesses, the balance suggests that economic growth in 1986 will be respectable. In addition, the pace of expansion should pick up in 1987. What gives me special confidence in the face of repeated postponements is the fact that over the past few years several major developments deemed necessary by economic theory have in fact occurred. They did not come to pass as quickly as we might have liked, but ultimately the events called for by basic economic principles did take place. The dollar's decline is one example. I can remember a few years ago the repeated predictions that a currency realignment was bound to occur. The dollar had to come down, it was argued, because the fundamentals of the U.S. economy did not warrant the level then prevailing. Yet no evidence of such an adjustment was forthcoming on foreign exchange markets. Finally, last year such a downward trend did become established. Similarly, we appear to be making progress toward reducing our large federal budget deficits, a move that I called for so repeatedly that I began to tire of hearing myself. I wish that Congress had acted sooner because doing so would have reduced the base level of debt and total interest payments. That, in turn, would have eased the burden that we now face. Still, I have to acknowledge that significant progress does appear to be on the horizon.

Having learned the virtue of patient optimism, I truly expect the U.S. economy to begin picking up, especially as the international trade deficit begins to diminish. As that happens, the unemployment rate should resume its fall. The only dark spot in the offing is in the area of inflation. Turning around the trade deficit will probably involve some price increases. Moreover, once oil prices do bottom out, we won't have the benefit of declines in energy costs to retard inflation. Notwithstanding these likely developments, I am hopeful that inflation will remain moderate in the coming months. In specific terms, the economy should grow faster in 1987 perhaps as much as 3.5 percent, bringing unemployment below the 7 percent mark. Next year prices levels might be somewhat higher than in 1986, however, perhaps rising by 3 percent or more.

Louisiana's Economy

Turning to Louisiana's economy, I'm afraid the outlook is not as favorable. As you all well know, conditions in the state are bleak. The unemployment rate stood at 13.1 percent, on a seasonally adjusted basis, in May. While housing is virtually booming across the nation, single-family housing starts through the first five months of 1986 in Louisiana were some 15 percent below the same period last year. Multifamily permits this year are less than a third of last year's volume. Retail sales through the first four months of 1986 were more than 1 percent below 1985's level, and that figure is not adjusted for inflation's effects.

All of these measures of economic activity reflect the downturn in oil prices and Louisiana's heavy dependence on the energy sector. Oil production in the state during the past three months has averaged around 1.24 million barrels compared with 1.33 million in the same three months of 1985. As of the end of June, rig counts in the Louisiana area had tumbled to less than half the number active a year earlier. Until oil prices stabilize, prospects for improvement remain dim. Of course, once prices do reach a trough, it is possible that demand will pick up, given the much lower price of oil likely to prevail. However, it is difficult to predict when prices may stabilize.

In the meantime, the state's heavy dependence on energy is wreaking havoc with other sectors and, in the process, making it difficult for policy makers and business and community leaders to implement strategies to escape this dependency. For example, Louisiana's reliance on oil-generated revenues to fund its public sector means less money is available to upgrade physical infrastructure like highways and airports. Similarly, efforts to improve education and thereby enhance growth opportunities over the long run will prove difficult as the revenue source of much of the educational budget shrinks. This contraction of state revenues comes at a particularly difficult time because less federal aid will be available. As Congress enacts much needed measures to reduce the federal budget deficit, localities and states will have to draw more on their own resources for such investments. Clearly, the citizens of Louisiana face serious challenges in restructuring their economy, but these can and must be met.

Fortunately, the state does have certain comparative advantages on which it can build. New Orleans has almost unsurpassed tourist appeal, and with careful marketing and management that city can begin to fill up its new array of first-class hotels with convention delegates and vacationing families, not just during Mardi Gras but year round. In the agricultural sector, a shift toward more specialty crops that are less vulnerable to the vagaries of international commodity prices may be the appropriate strategy. In addition, the state's port facilities are an enormous asset. With the development of more international infrastructure—expanded airports and more foreign banking facilities, for example—Louisiana could attract additional foreign investment and become the scene of increased international trade and finance. Regardless of the specific directions adopted, considerable effort will be required at the local level—by bankers, city planners, state legislators, and business leaders like yourselves—to escape the boom-and-bust cycle and launch the state on a path of steadier growth.

Longer Term National Challenges

Although Louisiana's problems are extreme by national standards, the state is not alone in facing some major economic challenges. The nation as a whole must come to grips with the fact that we are now dealing in a global market place. Accordingly, competition will remain intense even after the dollar's depreciation begins to take effect. That fact in turn suggests that we must begin to work toward changes that will enhance our competitiveness worldwide. Productivity performance must be improved, for a start. If we continue to lag behind countries like Japan year after year, our international trade share will inevitably erode. At the same time, we must continue to make progress in solving the problem of debt among less developed countries, or LDCs. Most of those nations grew at a rapid pace during the 1960s and early 1970s and provided a growing outlet for U.S. exports. Until their credit problems can be resolved, it is unlikely that these markets will again present such opportunities to U.S. businesses.

America's stake in putting the world's developing nations back on a faster growth track stands out when we consider certain obstacles to expanding our shipments to Europe and Japan. As we have seen, the European countries have proven averse to stimulating domestic demand. To the extent that the reluctance of these policy makers is deeply rooted in political and cultural values, Europe is not likely to absorb more exports, from either the United States or less developed countries. I'm not sure to what extent Europeans' historical memory of the ravages of inflation deters their leaders from taking actions that might trigger price increases. I remain hopeful, though, that policy makers across the Atlantic can be convinced that steps to stimulate their own economies are not only important but also unlikely to rekindle inflation, especially in the current environment of high unemployment and excess capacity.

In the case of the Japanese, however, the sort of economic restructuring that would enable them to import a significantly larger share of U.S. goods may take some time. This is because many factors not easily or quickly changed discourage consumption in that country. Social security does not provide for retirement in the way that it does here, and, hence, individuals must save proportionately more and consume less. Consumption is also constrained by geography. The crowding of people into Tokyo and other large cities in the island nation's narrow coastal plain makes it difficult to imagine housing and consumer durables attaining a level of importance comparable to that in the United States. Moreover, Japan's lack of basic resources such as oil and other raw materials virtually dictates that it maintain a strong export position in order to generate foreign exchange to pay for these essential imports. Since these raw materials typically come from developing countries, Japan is likely to continue exporting its manufactured goods to advanced economies. Hence, the United States will probably go on running a deficit with Japan, perhaps smaller than in recent years, but a deficit nonetheless.

If we are to bring our total trade flows more into balance, we must look for other foreign outlets for our products, and the most promising place is among the underdeveloped countries. Here the Japanese could help by playing a larger role as creditor to the world's developing nations. As the U.S. government's financing needs shrink with the gradual reduction of federal budget deficits, it should prove easier for Japanese portfolio managers to look to outlets other than the United States for excess Japanese savings, perhaps among LDCs. At the same time the United States must bring its investment and financing needs into balance with domestic savings. We must also compete more effectively against new competitors like those of East Asia, and doing so will involve improving our record of productivity gains.

Conclusion

Fortunately, productivity should improve somewhat as the economy does. If U.S. economic growth begins to accelerate soon, as I expect, the upturn in international trade underlying this resurgence should be especially beneficial to Louisiana's port and other existing international activities. In addition, this rebound will facilitate the kind of structural changes that seem necessary, both in Louisiana and the rest of the United States. I am hopeful that such relief will provide you and business, labor, and political leaders throughout the nation the opportunity to begin these important undertakings.