

**THE ECONOMIC OUTLOOK**  
**Remarks of Robert P. Forrestal, President**  
**Federal Reserve Bank of Atlanta**  
**To the Marietta Kiwanis Club**  
**Marietta, Georgia**  
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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 Georgia 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. We need to remember, of course, that high growth rates of 4 percent or more 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, and even temporarily more rapid growth would enable us to reduce unemployment before pressures on wages started to emerge. While I am pleased that the July unemployment rate moved a little below 7

percent, we have sufficient slack in labor markets and substantial excess capacity to support faster growth for a time, both in this country and abroad.

Another reason for my belief that growth could accelerate 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.

My generally positive assessment of the economy should not be mistaken for glibness about certain shortcomings and imbalances. As I mentioned earlier, 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 <sup>not</sup> 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. In May 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. Furthermore, early signs of third quarter activity such as the July unemployment rate, the index of leading indicators, and new factory orders (excluding the volatile defense category), are positive. While it's always risky to base an outlook on just a few recent statistics, I think the economic fundamentals lend confidence to this assessment.

Consumer spending has been quite strong, 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 certain regions 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 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.

### **Georgia's Economy**

Turning to Georgia's economy, recent performance is mixed. The statewide unemployment rate stood at 5.9 percent, on a seasonally adjusted basis, in June and Atlanta's rate was just 4.3 percent. However, much of the apparent statewide strength seems to be a result of Atlanta's vibrant economy. Elsewhere, particularly in rural areas more dependent on manufacturing and agriculture, conditions are generally less favorable. Manufacturing employment, which is more important in rural areas and some smaller cities, declined in May. Employment gains were concentrated in construction, services, and trade--sectors that are quite strong in Atlanta, where an expanding population requires additional housing, office space, shopping centers, entertainment facilities, and other services. Similarly, department store sales in the Atlanta metropolitan area continue to outperform the rest of the nation. Home appliances and furnishings have reportedly been moving especially well, a development we would expect given the strength of the local residential construction sector. New car sales have also been more robust than in the United States as a whole.

There are certain blemishes in Atlanta's recent economic performance, nonetheless. Prices have been rising more rapidly than nationally. As of April, for example, Atlanta's inflation rate was 3.2 percent compared to the national CPI increase of 2.0 percent. In addition, some construction bottlenecks are appearing as homebuilders expand into outlying areas and infrastructure like sewers and water is not yet in place. These factors caused a downturn in residential building in May, but this dip should prove temporary. Office vacancy rates are also high, although they are high nationally and builders remain active despite these rates and the possibility of unfavorable investment treatment under a new tax law.

Outside Atlanta one of the most important developments is the drought, which is more severe in Georgia than in most of the Southeast. Livestock inventories, especially hogs, are being reduced, and estimated crop revenue is down even though lower interest and energy costs have cut total expenses. Imports continue to have a widespread detrimental effect despite the dollar's sharp decline against the currencies of Japan and Europe. Apparel and textile manufacturers face stiff competition from countries like Korea and Taiwan, whose currencies have not changed much at all relative to the dollar. The same is true of producers of softwood lumber, who must compete against lower-priced Canadian imports. However, representatives of this industry report that they are at least earning moderate profits this year despite the large market share now commanded by the Canadians.

Fortunately, there are some bright spots in the Georgia economy outside Atlanta, Port activity in Brunswick and Savannah has been up sharply. Tourism, buoyed by lower gasoline prices, reduced air fares, and the dollar's depreciation, is also booming at most of the state's beaches and recreational facilities.

Over the next year or so, Georgia's economy should continue to fare well. The strengths that have given Atlanta such a rapid rate of growth and low unemployment rate in recent years are likely to continue, though perhaps the pace will slow somewhat. Commercial construction, for instance, seems destined for a pause in light of current vacancy rates. Elsewhere in the state the expected rebound in national economic growth should prove beneficial. Of particular importance is the lagged effect of a lower dollar, which should eventually bring relief to import-sensitive industries and make exports of Georgia's farms and factories more attractive to foreign buyers.

### **Longer Term National Challenges**

Notwithstanding the fairly optimistic outlook for both Georgia and the nation over the next year, we face certain longer-term 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 rebound will facilitate the kind of structural changes that seem necessary. 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.