THE INTERNATIONAL ECONOMIC OUTLOOK AND THE SOUTHEAST

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Good morning! I am delighted that the International Business Council has chosen to hold its meeting in Atlanta, and I am honored to be leading off your program. As all of you are well aware, the world is increasingly becoming a single marketplace. This shift toward greater international economic integration poses certain challenges, but it also offers enormous opportunities for higher living standards for people in all countries. Americans are developing a new awareness of the importance of the international sector as a lingering trade deficit saps strength from U.S. farms and factories. Most of my remarks today will focus on the prospects for economic growth, both in the United States and abroad. I'll also have a few words to say about the significance of likely international developments for the states in this region. When I've finished, I'll try to answer your questions.

Economic Performance in 1985

As we survey the world economy in 1986, it seems appropriate to begin with the United States because of our leading role as an "engine of growth." U.S. economic growth this year has been marked by imbalances. GNP expanded at a rapid 3.7 percent pace in the first quarter and then slowed to 0.6 percent in the second. Progress toward reducing unemployment remains frustratingly slow. The jobless rate still stands at the same level it did two years ago—7 percent. On a more positive note, inflation proved to be considerably milder than expected. Due largely to declines in oil prices, consumer prices actually fell for several months and, as of August, the CPI was up just 1.6 percent from its level a year ago.

While the uneven economic performance of GNP from quarter to quarter is troubling, the imbalances among sectors of the economy give me greater concern. Consumer spending is growing at a healthy pace, benefiting the service and housing sectors for example. On the other hand, the energy industry, along with those sectors most exposed to international trade—farming and manufacturing—have suffered adverse effects more serious than general macroeconomic indicators reveal.

The imbalance between the international and domestic sectors can be traced to the demands of a large federal deficit, which made people believe that U.S. 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 because their prices to foreigners were much higher. Although the dollar has been declining steadily and substantially over the last year and a half, our trade deficit remains at record levels despite the modest improvement indicated by recent merchandise trade figures. Some lag was expected before the trade balance improved, but the length is somewhat surprising.

One reason we haven't seen a turnaround in the U.S. net export position despite the dollar's more than one-third drop against the currencies of Japan and Europe is that economic performance elsewhere in the world has remained slower than in the United States. In fact, GNP fell in the first quarter in a number of advanced economies.

Fortunately, activity did pick up substantially in the April-to-June period in Germany as well as much of Europe. Japan's economy also advanced, though more modestly. Despite these more positive second quarter indicators, however, growth in the other advanced economies has been sluggish. Probably the main reason for this performance is that, in contrast to the United States, domestic demand in Japan and Europe has been weak. Fiscal policy has not been particularly stimulative even though inflation has been moderate and unemployment rates are stubbornly high. In Britain, Holland, and Belgium, 1986 is likely to be the fifth straight year of double-digit joblessness. Many other countries also report high unemployment though we have seen modest improvements in some, such as Germany.

Less developed countries, or LDCs as they are often called, have also experienced moderate growth thus far in 1986—around 3 percent, which is somewhat slower than in 1985. Although inflation remains a problem in some nations, the decline in interest rates has been a boon to many indebted Latin American countries. On the other hand, the drop in oil prices is having a devastating effect on some oil-exporting LDCs like Mexico, Nigeria, Ecuador, and Venezuela.

Outlook

At the same time, I think that there are several factors that warrant optimism about the future. For the United States, consumer spending is an ongoing source of strength. Recent figures have looked quite strong, and the prospects seem good for that trend to continue, though at a more modest pace. The drop in oil prices that has been so painful to the oil patch has bolstered household discretionary income across the country. As people now need to spend less on gas and oil, they increase purchases of other goods like housing, furniture, cars, and a variety of services.

Also, I am confident that our balance of trade will begin to improve, boosting income and lowering unemployment in its wake. Some delay in the economy's response to a lower dollar was expected since an upturn in net exports typically follows a currency depreciation or devaluation with a long lag. Because the dollar price of imported goods rises while that of exported commodities remains unchanged, 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. It is important to understand that 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. I am not suggesting anywhere near a return to a balanced position but rather pointing out the large impact that a slight improvement would have.

It is true that prospects for business investment are not bright. Tax revisions, low capacity utilization, and a glut of office space will probably discourage business investment in structures. At the same time, we should see some investment in productivity-enhancing equipment and the very low level of inventories relative to sales suggests an increase here as well. Government spending, too, probably won't be a stimulus though neither will it exert a significant drag, given the slim hopes for permanent deficit reduction of any size. Even with the probable flatness in these sectors, the balance of current strengths and weaknesses suggests that economic growth over the rest of 1986 will be respectable for an expansion of this length. In addition, the pace of growth should pick up in 1987.

Europe's growth during the remainder of the year may also be a little higher, though on average this year might fall below last. However, 1987 should bring a further resurgence, especially for Germany. One favorable factor for many European nations is the oil price declines. Since energy costs affect so many economic activities and Europeans lack the domestic energy resources that we in the United States have, the reduction in oil prices is especially significant. Since oil is a dollar commodity and the dollar has weakened significantly, their oil bill has fallen by much more than ours. The key factor determining whether or not Europe gains momentum is fiscal policy. Measures to cut personal taxes and to increase business investment would fuel domestic demand and thus offset the effect of slower export growth. This, in turn, would also help to correct the U.S. trade imbalance.

Japan's economy may not rebound as much, however. It has relatively little unused capacity. Unemployment, for instance, is only 2.9 percent. As in Europe, changes in fiscal policies in Japan have not gone beyond the talking stage. Moreover, there are fundamental factors that constrain consumption in that island nation.

Non-oil exporting LDCs should gain strength especially in 1987 as the industrial nations of the world do better. LDCs depend heavily on advanced economies to absorb their exports. Lower interest rates, the drop in oil prices, and progress toward reducing inflation and restructuring their economies toward a greater role for markets are additional favorable factors that underlie this outlook. However, oil-exporting developing countries such as Mexico and Venezuela are likely to continue to have problems. Now that oil prices seem to have stabilized, the outlook for them may be a little better. Furthermore, the progress toward averting an economic crisis that has been achieved thus far is encouraging. Mexico has joined the General Agreement on Tariffs and Trade, agreed to liberalize import restrictions, reduced or eliminated many subsidies, eased foreign investment procedures, and started plans to sell or close many state-owned enterprises. The loan package that was just completed is a very positive step in the right direction for all parties concerned, and thus is a very encouraging development despite the seriousness of the underlying problems. I hope Mexico's response to this extremely difficult situation will prove an example to other developing nations, and I think it will if we in the industrialized world do our share in resolving some important issues.

Issues and Problems

One such problem is the debt that continues to burden many developing 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. While 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, faster growth elsewhere in the world may offset part of this.

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 accounts for about one-fifth of the value of products that these countries are exporting. Consequently, LDCs are able to import less equipment and other products needed 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.

Aside from the hardships imposed on citizens of LDCs, this debt could affect individuals and institutions in the advanced economies. The size of the financial institutions involved and the concentration of their foreign loan exposure to a small number of countries suggest that serious problems in one or two countries or institutions could send shock waves through the entire international financial system. Although substantial progress has been made since 1982 toward resolving the debt crisis and the problem at present is well contained, the recent sharp drop in oil prices adds a new element of concern. The reduction in export earnings due to the fall of oil prices is exacerbating the problems faced by Mexico and other oil-exporting LDCs and their creditors.

A second major international issue confronting us 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. 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 a little over a year ago 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 differentials 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 several years. The ultimate inflationary effects could be troublesome here, and, if unaccompanied by offsetting policy changes, could lead to much slower growth among the world's other advanced economies. A further slowdown abroad would no doubt have repercussions among the export dependent LDCs, and the effects of that would ultimately be felt among America's financial institutions. 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 and reduced federal deficits in this country.

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. The U.S. record on this score is by no means perfect. We place quotas on foreign-made cars, textiles, and sugar, for example. Beyond these and other existing barriers, recent legislative proposals could greatly increase protectionist barriers in this country if enacted. That would indeed be cause for concern. 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, the outlook for economic growth here and around the world would be seriously compromised.

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 promise at least short-term improvements. This could 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" to prevent gross misalignments. At the same time, 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 have to undertake other fundamental changes, such as boosting productivity and increasing our pool of funds available for domestic investment and financing needs by reducing the credit demands of the public sector and increasing personal savings.

To resolve the final issue of trade barriers we must adopt measures that will ease the strains of adjustment for people employed in industries that have lost their comparative advantage. I wish I knew of an easy solution along these lines. Unfortunately, I don't know of any panaceas. A more neutral tax system would be a good starting place. However, as I mentioned, the tax reform package we seem likely to get looks like it will discourage some types of investment. I want to point out, though, that much of the investment we've had in the 1980s has been in offices, hotels, and similar structures. Their supply far exceeds current demand, and so tax reform to remove this distortion in investment funds is really for the best. I hope that we will see more investment in equipment.

Whatever other measures we adopt to help distressed industries and their workers must be designed to promote necessary changes while bringing immediate relief to those in need. We must avoid the situation that we have in many agricultural programs, where policies to aid troubled farmers don't provide income sustenance directly to those most in need but instead work through price mechanisms, often bringing added revenues to already prosperous and efficient producers and in so doing foster excess production, lower market prices, and more problems in the long run. Aside from specific transition measures, somewhat faster economic growth would be a boon because it would provide more opportunities and greater rewards for workers who have realized the need to make career changes and have begun to work toward this end.

In addition, these transitional measures ought to be supplemented by international negotiations to redirect 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 own commercial policies. The last is especially important in view of the fact that some of these countries are generating large trade surpluses and yet their currencies have not appreciated relative to the dollar as the yen, Deutschemark, and other advanced economies' currencies have done in the last year.

Implications for the Southeast

These international issues are extremely serious, requiring attention at the highest levels of policy making. As such, they often seem remote from the daily lives of individuals who are not a part of such seemingly lofty circles. However, they are important to each of us, regardless of our degree of influence over their outcome. What happens in the international economic arena has a great bearing on all of us here in the Southeast. This region's economy is especially sensitive to competition by foreign imports. The textile and apparel industries, which are the leading employers in many southeastern states, have been especially hard hit by import penetration. Thus, the dollar's value on foreign exchange markets is quite important to a large number of workers. However, the fact that much of the competition in these industries comes from countries like Hong Kong and Korea, whose currencies have changed relatively little against the dollar, tends to make some people in this region favor short-term and ill-founded policy responses like protectionism.

The same is true of the lumber industry. Much of the area's vast woodlands consist of softwood, particularly pine trees, used in residential construction. This part of the forest products industry has had considerable difficulty competing against Canadian softwood lumber producers, who face a different cost structure. While hardwoods used in making furniture and flooring have remained fairly strong in the face of growing international competition and often are successful exporters, the softwood industry has suffered substantial market losses to the Canadians. Some of these issues will be solved only through international negotiations, but their importance to the local economy makes such resolution all the more urgent to people in this region.

On the export side global markets are somewhat less important than in many other regions of the United States. Whereas nationally more than 11 percent of manufacturing jobs can be traced to exports, only 7 to 10 percent of southeastern states' manufacturing is export-oriented. Nonetheless, certain locally important industries such as chemicals do rely heavily on foreign markets. In addition, the region's soybean and tobacco farmers are dependent on consumers abroad for a substantial portion of their sales, and even some of the service sector is affected by international developments. This includes not only the major ports and airports of the Southeast but also Florida's tourism attractions, which draw more foreign visitors than those of any other state in the nation. Issues like Latin American external debt and the dollar's value are no mere abstractions to such businesses.

Another dimension of international trade in the Southeast is the large amount of foreign direct investment. Georgia and Tennessee have gained much notice as the home of numerous Japanese-owned factories. However, many states in this region are now home to manufacturing plants and distribution offices of foreign companies. Dutch and French companies have invested significantly in insurance and real estate in Florida and elsewhere. German and Swiss investors are prominent investors in Louisiana's petrochemical facilities. Foreign companies are also well represented in the region's metal producing plants. This foreign investment not only boosts employment and income growth but also helps diversify the southeastern economy away from agriculture and farming. Along with these international activities—both exports and foreign investment—have come a number of international banking offices—Edge Act banks, international banking facilities as well as international departments of local banks.

Developments in each of these areas can affect employment, income, and the economy of the Southeast in important ways. Given the growing significance of international economics to this region, it is not surprising that interest in the kind of issues I've outlined this morning is rising. I have been impressed by the number of local groups that have featured speakers on the international economy in the past few years. In addition, political and business leaders in this region have played a key role in acquainting foreign investors with this region and its market potential. Local newspapers are also providing more and higher quality coverage to international events, including business and economic developments. This growing public awareness of the importance of international economic issues is very encouraging, in my opinion, because it will raise the level of public debate over such misguided proposals as protectionism. In this marketplace of ideas I am certain more informed public policies will emerge, policies that will address and resolve the serious international economic problems we face.

Conclusion

Summing up the international outlook, I believe that the United States economy should rebound in the year ahead and that we will see gains in some of our troubled sectors. Global economic performance should follow suit, especially in 1987. 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.