

THE ECONOMIC OUTLOOK
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I am delighted to be here with you this morning. As this year draws to a close, it is natural to take stock of where we as individuals and as a nation have come and where we seem to be headed. My remarks today will focus on our country's economic performance. Most of my comments will concern the U.S. economy as a whole, but I'll cover the Southeast as well, including Georgia. When I've finished, I'll be happy to answer your questions.

Recent Economic Performance

As we assess 1986, or at least the first eleven months, it seems at first glance that we haven't done all that well. Unemployment is still around 7 percent, where it's been for two years. That's largely because we have some serious imbalances and a certain degree of structural unemployment, which I'll talk about presently. Another possible factor is that GNP growth has been more modest than expected. For the first three quarters our total output of goods and services grew by about two and a half percent, roughly the same rate we have experienced over the past 20 years. Fortunately, activity accelerated nicely in the third quarter from a virtual standstill in the second. The U.S. economy has also scored some important successes, and there are large areas of strength, particularly in housing and consumer spending. Price increases have also been modest this year. The most recent figures for September show somewhat of a jump from August, but much of this was due to a partial reversal of earlier oil prices declines. For 1986 overall, the consumer price index will probably rise only 2 percent compared to almost a 4 percent increase last year.

Unfortunately, these aggregate measures mask substantial imbalances among regions of the country and between major sectors of the economy. Services and construction have been doing quite well. Residential construction has proven responsive to the decline in mortgage interest rates that has occurred over the last year or so. Starts are being sustained at an annual rate of over 1.6 million. That pace is slower than earlier this year but definitely healthy. Single-family sales jumped over 10 percent in September. In contrast, the sharp drop in oil prices has virtually crippled producers in that industry and devastated employment and incomes in Texas, Oklahoma, Louisiana, and even parts of Mississippi. Currently, the latter two states are vying for the nation's top rank in joblessness, with more than 12 percent of their would-be workers unemployed.

At the same time, conditions in the international sector and soft prices generally have adversely affected many farmers and manufacturers across the nation despite the dollar's extended and substantial decline, at least against the currencies of some of our major trading partners. Although the trade situation will soon improve for reasons I'll describe in a moment, the slow response of our trade balance to this currency realignment means that industries sensitive to import competition as well as many export-oriented farms and factories continue to languish.

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 somewhat faster growth that would help us reduce the level of unemployment. I think that there are several reasons for optimism.

Consumer spending has been quite strong, and the prospects seem good for it to remain so, though the pace is likely to slacken noticeably for a while. Personal income has been rising, but unevenly from month to month. The drop in oil prices that has been so painful to certain regions of the country has boosted household discretionary income nationally. As people spend less on gas and oil, they can increase purchases of other goods like housing, furniture, cars, and a variety of services. However, consumers have been on something of a buying spree for autos this year, drawing down savings in the process. This could result in a deceleration of what has been the chief source of economic momentum in the past few years. The tax law's effects on consumer spending are hard to predict. Lower brackets could encourage consumption, and even the phase-out of interest deductibility for consumer durables may be at least partially offset by the use of home equity loans to the extent allowable.

Residential construction is also likely to retain considerable vigor, at least in the area of single-family homes. The substantial decline in interest rates we've had over the last two years has been translated into much lower mortgage rates, and home buyers have been responding.

Deficit spending by the federal government, another major source of growth in this expansion, is not likely to undergo the dramatic reduction that seemed likely a year ago when Gramm-Rudman was passed. Frankly, I think that development is unfortunate because of its long-term effects on our capital markets and on our foreign trade position. However, in the immediate future it means we will feel a smaller drag since the contraction in the government sector will be less than expected.

The area that is most likely to add to or at least help sustain the economy's

momentum is the international sector. I know this promise is beginning to sound hollow after being made for so long by economic forecasters. Still, I think we should continue to have faith that the trade balance will improve because of a number of factors that account for the slow progress we've had so far. First, the dollar has not declined against the currencies of Canada and certain Asian nations which have become large trading partners. At the Atlanta Fed we have developed a new dollar index to focus on currency changes in specific groups of countries like Canada or the newly industrializing Pacific rim nations of Korea, Singapore, Hong Kong, China, and Taiwan. What we have found is that the dollar has actually risen slightly against these currencies whereas it has fallen about 20 percent against those of our 18 largest trading partners overall. In view of these contrasting patterns, it shouldn't surprise us that we haven't seen more relief in industries like textiles, apparel, and lumber that compete with these countries. While this situation may not change soon, other obstacles to improvement should turn around.

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, with an initially unchanged volume of trade, the trade deficit 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. One factor that has extended these lags is that much of the dollar's decline was not initially translated into higher import prices. Instead foreign producers chose to hold the line on prices, absorbing the difference in reduced profits in order to maintain their share of the U.S. market. This tactic obviously can't be pursued indefinitely, and I think there's evidence that narrowing profit margins are beginning to reach their limits with the ongoing dollar depreciation we've had this year. Import prices, exclusive of fuels, have

risen by 10 percent over the past year, much higher than the domestic rate of price increases.

On the export side, several developments have constrained improvement. First, economic growth in our major export markets--Europe, Japan, and Latin America--has been quite slow. Germany has, however, picked up smartly, and some of the other European countries are doing a little better now. As they improve, we should see an increase in demand for U.S. goods. Earlier weak demand for U.S. farm products--we actually had a deficit in farm trade in May and June for the first time in two decades--appears to have been temporary. It probably stemmed from deferred purchases by foreign buyers who were waiting until new farm programs which lowered prices took effect. Agricultural exports seem to be picking up already.

All these extenuating circumstances may sound like so many excuses, but the latest available data, the merchandise trade deficit, narrowed in September again after declining somewhat in August. That is evidence that we may be finally beginning the turnaround I'm anticipating. As that happens, we can expect our manufacturing sector to perk up. This development, in turn, should have a positive effect on labor markets and personal income and thus help sustain consumer spending.

As we look at the monthly trade numbers, it's also important to bear in mind that exports don't have to surpass imports again for a rebound in GNP to occur. 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 one and a half percentage points higher last year or over 4 percent.

There are, I admit, definite areas of weakness. One problem involves farming, and here I'm afraid progress will be slow despite the fact that farm exports should strengthen somewhat with the implementation of lower price supports and the dollar depreciation that has already occurred. The core problem is the worldwide surfeit of many basic farm commodities. These surpluses are a result of favorable weather in much of the world, heavy subsidies to farmers in many countries, and both technological and policy changes that have boosted production in former importing nations such as India and China. The resulting plethora of farm products is depressing prices worldwide. Market prices of grains recently averaged 10 to 30 percent below year-ago levels, which were already depressed compared to the more favorable prices at the beginning of the 1980s. The outlook for agriculture will depend on how quickly farm supplies can be brought more closely into line with worldwide demand. Other issues, like credit burdens and farm foreclosures, will shrink in intensity as this main problem is addressed.

Another probable area of weakness is investment. Except for some rebuilding of inventories and the likelihood of continued strength in single-family home building, capital spending is not going to pull the economy along in 1987. Slipping utilization of the nation's productive capacity makes business hesitant to invest in new plants and equipment. With a national metropolitan vacancy rate in September of 21.5 percent, it is clear that the existing supply of office space around the country far exceeds current demand, and with the economy sluggish absorption could take some time, that is, several years. Furthermore, the new tax law is unfavorable to investment in many ways. In addition to a slowdown in commercial real estate building, we could also see a drop-off in multifamily housing since apartments and condominiums are also overbuilt in many localities.

Southeastern Economy

Here in the Southeast we've been enjoying pretty solid growth throughout this business cycle, notwithstanding problems in certain sectors like farming. This year employment has been increasing at about the same rate as nationally. The average would have been higher but was pulled down by weaknesses in Louisiana and Mississippi. Those states have been severely affected by the downturn in the energy industry.

Bank failures are but one symptom of the spillover of the oil and gas industries' problems. While smooth transitions have mitigated the consequences of those institutional breakdowns, sagging oil prices have had a more damaging effect on state and local governments whose budget revenues are tied closely to severance taxes. Layoffs and budget cuts have been common, further inhibiting public efforts to undertake the kinds of investment that are necessary to diversify the economic base away from excessive reliance on energy products. To make matters worse, ongoing erosion of agricultural export markets has slowed trade flowing through the area's shipping and port facilities. Cargo volume moving along the Southeast's extensive waterways has been far below earlier expectations.

In contrast to the western portion of the Southeast, the in-migration of people and businesses continued to fuel growth in both residential and commercial building as well as a broad range of services. Attracted by a favorable climate, job opportunities, and amenities that contribute to the quality of life, people continue to migrate to our region, settling primarily in the eastern metropolitan regions. Population increases have averaged nearly two percent a year since 1980 as compared to just over one percent in the United States as a whole.

The Southeast also attracts numerous temporary migrants in the form of snowbirds or shorter term vacationers and conventioners. Tourism has long been big business in Florida, where almost one-tenth of the workforce is employed in the hospitality trade. More recently, cities like Atlanta and Nashville have joined the competition for the lucrative convention market. In addition to creating jobs directly, visitors swell the sales tax coffers of the states they visit, expanding the services local and state governments can provide without raising the tax burden on residents. The dollar's decline, which discourages domestic travel abroad as well as attracting foreigners to the United States, has helped cities that cater to international travelers. This year occupancy has firmed somewhat in a number of "over-hoteled" cities including New Orleans, Nashville, and Miami Beach though it remains on the decline in Atlanta, Memphis, and Orlando.

Looking ahead to 1987, the picture promises to be similar to this year or perhaps a little brighter. The energy sector seems to be stabilizing, and this will stem the large losses in the industries and areas that have been so badly affected. Population growth seems likely to continue, and so the service sector should maintain its healthy expansion. The beneficial effect of a lower dollar is likely to continue boost travel to the Southeast in 1987 though it will take some time to fill all the hotel rooms in some cities just as the surfeit of offices in the region will require several years to be absorbed.

Thus, another economic sector closely tied to population growth—construction—will probably decelerate. Surveying the cities around the Southeast, I find many with vacancy rates even higher than the 21.5 percent national average. In Ft. Lauderdale and Orlando, for instance, almost 30 percent of the available space has yet to be leased, and in Nashville and New Orleans the proportion is one-fourth. We are actually somewhat

below the national norm here in Atlanta with a vacancy rate of 19.6 percent, and Miami is also close to the U.S. level. Nonetheless, there are areas of Atlanta like the perimeter with much higher rates. More generally across the South, even the expected in-migration is not going to be sufficient to absorb all of this space quickly. Thus, as a result of current excess supplies and recent tax law changes that are far less favorable to multifamily and commercial construction than the previous code, construction will probably continue the slowdown that has already begun. Apartment and condominium permits have declined slightly from a lower 1985 level, in all a sharp drop from the heady growth of recent years.

In manufacturing the best-performing industries have been car and plane production, food processing, and paper products. Another forest product industry, lumber manufacturing, has not done as well, however, because of foreign competition. Our main competitor in softwood lumber, for example, is Canada, and the Canadian dollar has hardly budged relative to the U.S. dollar, as I mentioned earlier. An import levy of around 15 percent could boost demand for U.S. made wood, given the probability that continuing demand for single-family homes will keep lumber use high in 1987. However, the longer-term implications of such a tariff for this industry and for the U.S. economy as a whole are troubling.

Other regionally important, import-sensitive industries, particularly textiles and apparel, are in straits similar to the lumber industry. The chief competitors are in countries whose currencies haven't changed significantly since the dollar began its decline 18 months ago. Moreover, they have been undergoing declining employment for over a decade as competition from lower cost developing countries has gained steady momentum, forcing some southeastern plants to close and owners of others to look for

ways to cut expenses in order to survive. Given the labor-intensive nature of these industries, cost-cutting usually entails reducing the work force. Fortunately, the situation in textiles seems to have stabilized somewhat. Many companies are reporting firmer profits, and employment actually increased slightly this year at the region's textile mills. Still, many jobs in these industries are probably permanently lost. This kind of structural unemployment is probably one of the reasons the nation's jobless rate has fallen even though GNP growth has been close to our post-war norm. Finding new careers for the many thousands of workers who are probably permanently displaced remains a challenge. The solutions will no be easy or painless. They'll involve retraining and, in many cases, relocating.

The chemical industry, another large southeastern employer undergoing what may be a long-term employment shrinkage, also continued to cut jobs in 1986, a trend apparent at least since 1979. Foreign competition has exacerbated the supply side of this industry, while sharply reduced farm demand for chemicals used in fertilizers, insecticides, and herbicides hurt the demand side. Man-made fiber manufactureres have also reduced use of chemical raw materials as their former shares of domestic textile markets dwindled. Clearly, a turnaround in chemical manufacturing will depend on improvements in textiles, farming, and other related areas.

I've already discussed the prospects for agriculture nationally. Here in the Southeast circumstances are similar, but farmers have had the extra problem of drought to contend with. Production fell by a third in some areas as a result of this summer's unusually dry, hot weather. In Georgia, where the drought was most intense, average yields of soybean crops were cut by nearly 40 percent. Forage feed for livestock was all but eradicated in some zones. The rains of August and September came too late to

reverse most of the damage. As a result, farmers here face the multiple problems of low market prices, reduced production, and worsening finances. For those already in debt the situation cannot become but worse. Happily, almost half the farmers in the region have little or no debt. Moreover, low grain prices are good news for livestock and poultry producers, and they can look forward to a much better year in 1987.

Georgia Economy

While the overall outlook for the southeastern economy is bright but mixed, the prospects for Georgia are somewhat better. You hear a lot about Atlanta's prosperity, but statewide the unemployment rate in September was only 6 percent. Overall employment has been growing about a percentage point faster than in the nation, and even manufacturing employment has held its own compared to declines nationally. Retail sales have advanced at the same rate as in the nation, and merchants expect moderate growth for the important holiday season coming up. A few weaknesses do cloud the picture slightly. As in the rest of the Southeast, commercial construction has already begun to slow, and prices have also been rising more rapidly than in the nation in Atlanta. On the whole, however, this year was much better for Georgians than for many elsewhere in the Southeast or the nation, and next year promises to be at least as good if not better.

Conclusion

In closing, I want to reiterate my concern about the lack of progress in reducing unemployment. However, when we weigh the current strengths and weaknesses of the economy, I believe there is reason to expect this expansion to continue, and it's quite possible that growth will speed up somewhat, especially as the trade deficit begins to narrow. As that happens, we could see some modest renewal of inflation, but I don't

think we have too much to fear there. The signs just aren't out there to indicate a rekindling of inflation of the sort we had in the late 1970s. With faster growth, we should find it easier to deal with the such problems as displaced workers and the federal budget deficit, which is really at the root of our current trade malaise and no doubt exacerbating structural unemployment. As these are tackled, I am confident that this nation can embark upon a long period of robust but noninflationary economic growth that will bring greater prosperity to citizens from every social stratum and all regions.