

THE ECONOMIC OUTLOOK FOR 1987 AND BEYOND
Remarks by Mr. Robert P. Forrestal, President
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Introduction

Good afternoon! This year marks the fourth time I've had the opportunity to discuss the state of the economy with you, and it has become a most important event to me. At the New Year one reviews both his achievements and shortcomings in the past twelve months and looks ahead to the coming year, and the Rotary Club forum impels me to a similar exercise with reference to economic trends in the nation and the region. As I prepare for this talk I am put into a reflective state of mind that has yielded some of my most valuable personal insights. I hope that I can communicate some of those feelings along with the economic facts.

In the past year, one in which I travelled to Japan and China and presided over several innovative international research projects at the bank, I was impressed even more deeply than before by the pace at which the many economies of the world are becoming one economy and how in this increasingly unified system an event in any given area evokes reactions in other, often widely separated places. In the postwar era, we in the United States have had the luxury of being able to attend primarily to our own business, pulling the rest of the free world in our wake. Today we feel the push and pull of global forces more directly. It is sometimes an uncomfortable feeling, but it is leading us to the unprecedented opportunities implicit in broader-based economic participation. Before exploring together some of the long-term trends shaping the future, let us look for a moment at the year past and the year to come.

Last Year's Performance Scorecard

As I reviewed the nation's performance during 1986, I often came across the adjectives "lackluster" and "sluggish," used regularly by the financial press in

commenting on new economic figures. Last year when I spoke here, I projected very nearly the same numbers that others later found uninspiring. I described the potential for an increase of 2 1/2 percent in GNP and a continuation of unemployment in the 7 percent range but also for more balanced growth than in the previous year. It seemed like an optimistic forecast, especially in comparison to some that were heard at the time, and in retrospect I think it proper to say that even if the hoped-for balance wasn't attained, the economy did turn in a performance on a par with its postwar average. Of the triad of indicators most often cited in analyzing the economy, the one I missed the mark on was inflation, which will probably come in at something under 2 percent rather than my 4 percent—better than almost anyone thought it would be.

The 2 1/2 percent year-over-year increase in gross national product that I projected last January was based largely on the prospects for consumer spending, which then seemed likely to remain a sustaining force in the economy. Indeed, it turned out that way. Through year's end, we witnessed continued strength in purchases of consumer durables associated with an increase in housing activity earlier in the year. Incentives from auto makers provided considerable stimulus in the latter portion of the year, and the strength of overall domestic demand was impressive.

Unemployment remained lodged within fractions of the 7 percent mark throughout the year. Given the modest level of growth in the economy, it has been difficult to nudge unemployment down to the more acceptable 6 to 6 1/2 percent range. The low level of inflation, on the other hand, was a pleasant surprise attributable primarily to the drop in oil prices. After falling briefly below \$10 per barrel, oil prices settled in at around \$14 to \$15 per barrel, bringing respite from the inflationary tendencies fueled by higher energy costs in the recent past.

Forecast for 1987

Turning to the outlook for 1987, I foresee the expansion continuing at about the same pace as last year, that is around 2 1/2 percent. That rate of growth is unlikely to bring about much reduction in unemployment, and so the jobless rate will probably remain near the 7 percent level as well. However, inflation could inch back up to around 3 to 3 1/2 percent, more like its behavior in 1985 when it averaged 3.8 percent. Although this sounds like more of the same, this continued growth should bring with it greater balance among the various sectors of the economy and regions of the country.

The chief sources of expected strength underlying this forecast are consumer spending, stabilization of energy prices, and, most importantly, the international sector. Though still a small part of our economy, the international sector is really the peg on which expectations of continued expansion are hung. The dollar's high value on foreign exchange markets during the early 1980s weakened U.S. exports of farm and manufactured goods and facilitated import penetration into domestic markets by foreign producers. This deterioration in our trade position has exerted a tremendous drag on overall GNP growth—shaving as much as a point or more off total GNP growth. It has also had a devastating effect on local areas whose economies are export-oriented or vulnerable to foreign competition.

Fortunately, during the last year and a half the dollar has declined substantially against the currencies of most of our major trading partners, though not against those of Canada and the newly industrializing countries of the Pacific. This decline in the dollar's foreign exchange value is raising the price of most foreign goods—with the important exception of oil—relative to domestically produced items. It should, over time, provide U.S. manufacturers with stronger demand, from at home as well as abroad. A number of factors, including the sharp drop of oil prices and a subsequent surge in the volume of oil imports, delayed the adjustment of trade patterns to this currency realignment, but

beginning last summer the trade deficit at last diminished for three successive months.

The reversal in November was probably due to temporary factors, and I expect the trade deficit to continue narrowing in 1987 and so boost demand for American farm and manufactured goods and add significant stimulus to GNP. Exports should increase moderately as prices of U.S. goods to foreigners become cheaper. However, the weakness of certain other major advanced economies will probably temper the price effect. Imports seem likely at least to stabilize this year in view of the rising prices of most imports and the less volatile price of oil in recent months, thus giving a boost to hard-pressed U.S. producers

Consumer spending should be sustained by reasonably healthy wage and salary growth, along with the low interest rates we have had and the personal tax cuts that will increase disposable income of many households. Still, I don't think we can count on the consumer as much as we have in the last few years to be the economy's chief expansionary force. Some consumer-financed consumption could be discouraged by the phase-out of deductions for interest charges on most credit purchases under the new tax law, although home equity financing programs could offset much of this effect. In addition, consumers are highly leveraged. Finally, this year is unlikely to bring another income windfall comparable to the sharp drop in petroleum prices that all of us, as consumers, enjoyed last year.

These factors suggest a deceleration of consumer spending, though this largest component of GNP should continue to grow. However, as the trade deficit narrows, even if consumer spending grows at a slower pace this year than last, more of the goods consumers purchase should come from domestic producers. Moreover, the anticipated stabilization in oil prices would help those areas of the country affected most severely by the price declines.

Of course, some factors are likely to constrain growth in 1987. The chief areas of weakness are capital spending by businesses and construction. In addition, federal budget deficits are on a downward slope. While I'm sure we're all happy to see this, it means that government spending will not provide as much stimulus as it has in recent years.

Business investment has been sluggish already because of low capacity utilization and overbuilding of offices and retail space as well as other structures. Changes in the tax code will exacerbate this situation by treating some aspects of investment less favorably. In time this should lead to a more efficient allocation of capital as the revised tax code encourages investment dollars to be distributed more according to the dynamics of supply and demand. In the near term, though, we may see some uncomfortable adjustments develop as excess supplies of rental space are absorbed. Office construction, along with apartment and condominium building, is likely to slow in the year ahead. Housing activity had already slackened at year's end 1986. Though mortgage rates—now at their lowest level since 1978—should boost the single-family housing market, demand, to a considerable extent, has been met for the time being, and new home sales will probably be tied to the rate of household formation, which tends to moderate in tandem with the pace of economic growth.

Even taking several of my concerns into account, though, I am confident that increased exports and domestic sales together with decreased energy costs should be sufficient to sustain the present level of growth for another year. The same forces, steady oil prices and shifts in international trade, will also dominate the inflation picture, but in ways that oppose one another. Prices of petroleum and other commodities and long-term interest rates are still well below their levels of a year ago, suggesting an upsurge of inflation is not imminent. A 7 percent unemployment rate implies that upward wage pressure in labor markets is also unlikely. On the other hand, prices of

imported goods, excluding petroleum products, which until recently have been an anti-inflationary force, rose about 10 percent last year compared to the general inflation rate of less than 2 percent. Initially, foreign manufacturers shaved profit to maintain market share, a strategy that has become increasingly untenable as the dollar continued its decline. Despite all the attention it receives, international activity is still a small proportion of total GNP, and for that reason I think that the rise in prices of imported products will not push the inflation rate over the 3 1/2 percent range during 1987.

In sum, I feel that the optimism with which I came to you last year was vindicated, and I return to the theme of patient optimism in looking toward 1987 and beyond. The stock and bond markets persist in their bullish ways, indicating investors' confidence in our economic prospects. As the dollar drops, foreign markets reopen, and domestic consumers return to American-made products, manufacturers will be able to expand production and contribute to that balanced growth which I hope will spread to those areas of the nation that did not share the growth of the past year.

Outlook for the Southeast

The Southeast, which encompasses Louisiana—one of the areas hardest hit by the oil-related depression—as well as the robust economies of Florida and the Atlanta region reflected the national picture in 1986 and will again in 1987. In general the economy of our district should show improvement in 1987, once more exceeding the rate of gain foreseen for the national economy. Continuing inflows of people and corresponding gains in employment and personal income are major reasons for the Southeast's more rapid growth. Single-family residential construction should be a leader in the expected increases, while commercial and multifamily construction will probably remain slow until overcapacity has been absorbed. Manufacturing activities could supply a larger share of domestic as well as foreign markets, although because of technical efficiencies achieved during recent adjustments, employment in some industries like apparel is unlikely to rise

in proportion to manufacturing output. Workers will continue to find jobs in the expanding service and trade areas, however, so that the region's total employment should increase by about half a million new jobs in 1987.

The agricultural and energy-producing sectors will be the lingering areas of weakness, not only during 1987 but perhaps for many years to come, though the effects of the drought should largely be behind us. Still, heavy indebtedness incurred during periods of prosperity will continue to go unserved, resulting in additional bankruptcies and foreclosures among borrowers and loan losses for lenders. Overall, though, the Southeast seems likely to retain and even increase its attractiveness to new residents and businesses both from elsewhere in the nation and from abroad.

Problems and Issues

At each point in my remarks, the generally optimistic tone of my outlook for the Southeast and the nation is tempered by awareness of problems that could develop even out of present strengths. This is always the situation in a complex and dynamic system, and economic internationalization has created new difficulties as well as opportunities. Last year I noted three potential dangers facing the economy, all of international scope. Two of them seem to have been managed effectively for the present. The year passed without a rapid "free-fall" of the dollar; instead, the dollar maintained a gradual, steady depreciation against enough currencies to initiate the desired reversal in the trade deficit. That does not mean we are out of the woods on either front—should foreign investors suddenly lose interest in dollar-denominated assets, particularly government securities, and stop absorbing such a large share of new issues and refinancing, the disruption would be enormous. I do not see the makings for such a scenario at present, even though reservations about the twin deficits and the Iran imbroglio no doubt give pause to some foreign investors.

The second of last year's dangers, the debt of the less developed countries, was also mitigated through the diligent efforts of the IMF and American banking leaders. The situation need no longer be called a crisis, but it remains a grave danger to our own economic stability as well as that of our neighbors. Default on outstanding loans would be an economic nightmare sending shock waves through world financial centers. The concept evolved in negotiations with Mexico—additional loans which will allow continuity of service on pre-existing debt—offers the most reasonable near-term solution and holds the most promise for progress toward an ultimate return to more stable conditions there and in other debt-burdened LDCs that might follow Mexico's lead.

I believe we still confront the third of the potential dangers in last year's outlook, however. Protectionist sentiment appears to loom even more ominously following November's mid-term elections. Politicians fearful of making the difficult decisions that would address the federal budget deficit, the real cause of our foreign trade imbalance, exploit public sympathies for displaced farm and textile workers as if tariffs or quotas would somehow ease their suffering. The irony is, of course, that those two industries in particular have been protected for years, and protection was not only unable to save them but may have accelerated their weakening. The only thing that protectionism accomplishes is more protectionism in the sort of one-upsmanship that helped push the world toward the Great Depression of the 1930s.

Since the end of World War II, it has been our country's strategy to encourage free-market economies as alternatives to the types of government-controlled economies that led to hostility in the past. We rebuilt former enemies into trading partners in the belief that participation in competitive markets would help prevent a return to naked aggression or tyrannical domination. That farsighted strategy has borne fruit in forty years of relative peace and a world-wide standard of living that is much higher than anyone would have predicted at the end of the war. Our role as the engine of global

growth has meant some sacrifices on our part, and it will continue to carry the responsibility of championing freer rather than more restricted markets. Negotiations with individual countries, like those which just resulted in the compromise with the Canadian government on timber exports, and through GATT and other international organizations are the correct venues for adjusting trade inequities, not the political stump.

If Congress is truly serious about helping American industry confront foreign competition, it can attack the budget deficit which raised the value of the dollar in the early years of this decade and gave those competitors a leg up. When taxes were cut in 1980 without parallel cuts in spending, our government had to borrow increasingly to make up the difference. With a rapid expansion in government debt instruments, interest rates rose, and foreign investors became increasingly active in the bond market, simultaneously bidding the dollar to great heights as they scrambled for greenbacks with which to purchase government securities. The damage done by expensive dollars was felt in the outright loss of markets for several of our industries. Unless concrete steps are taken soon, future generations of Americans will pay dearly for our profligacy. We can't go on borrowing forever. To avoid placing such a burden on our children, policy makers have two reasonable alternatives: they must cut spending or raise taxes. Both alternatives require more courage than we have seen Washington demonstrate in recent years, but doing nothing—the policy of default—keeps increasing the long-term burden created by the need to service foreign debt. It threatens the future standard of living.

Another negative legacy that we may be passing to succeeding generations affects more of our society than just the economy, although Wall Street's insider trading scandal was its most notable symptom in 1986. The crisis in ethics, illustrated by the Boesky affair, threatens the root of our system's strength—the cooperative environment that allows the remarkable degree of freedom our markets enjoy. Society can regulate that

environment only to the boundaries of the law; in the gray areas beyond, the individual must take the responsibility to act according to the spirit of the law. That spirit derives from pride in the system as a whole and respect for the others who participate in it. In the insider trading schemes we see arrogance crowding out pride in the system and self-aggrandizement replacing respect. It is not that there are more evil people now than at other times in our history, but there is, I feel, a destructive amount of cynicism at all levels of society that makes ethical considerations subservient to the acquisition of money. This cynicism is supported by the perception that even if one is caught in an illegality, money can buy release. Perhaps the availability of instant credit in a society that more and more demands immediate gratification for its desires helps to explain this phenomenon. It is easy now to have the trappings of success—the expensive auto, home, and clothing expected of the upwardly mobile—before any concrete measures of performance confirm that success. Traditional values that counseled saving up resources until one could afford such purchases are scorned by those who fear they can't afford not to drive a designer car or live in the right suburb.

It is up to the business leaders in the community to counter the perception that advancement can be achieved by appearances rather than accomplishments. We need to examine our corporate cultures and our personal motivations to insure that we are rewarding quality work, that we are not ourselves blinded by glittering accessories. At the management level we could demonstrate our resolve to live within our means by reducing the scale of luxurious perks that create the illusion of a privileged class. The current crisis calls for a commitment from the top to show by positive example that ethical standards persist and are applied in major business dealings and in the day-to-day matters of hiring, promotions, and the other rewards and punishments that promote service and productivity.

While seizing control of the foregoing problems will require vigilance and concerted

effort for some time to come, there is one area in which I see a positive resolution emerging from the struggles of the recent past. Over the course of several decades we have witnessed one of the great revolutions in American society, the simultaneous integration into the mainstream work force of women and minorities. The enormity of the transition often escapes us because we are so bound up in it, but the proper perspective to take is that in effecting this change, the United States once again achieved something without parallel in world history—and something that will ultimately enhance our output, productivity, and competitiveness. The social consciousness raised by the civil rights and equal rights movements was manifested in legislation that affected our industrial sector, and the impetus to correct society's problems carried over into regulation of workplace and consumer product safety as well as environmental protection. These measures improved the standard of living of our citizens.

Whenever legislation is used to promote change, however needed, it also brings some costs. With respect to business this transition was attended by some experimentation and resultant inefficiency; it has brought in its wake alterations in management style and production techniques that are frequently criticized by those who see only the present costs rather than the possibilities arising from change. To them we might answer that the impact of the two-income family and the expansion of ethnic markets that arose from these changes are already positively affecting the present. The rapid development of the service sector is due in no small measure to the need to purchase services that were formerly taken for granted as wifely duties. The increase in consumption allowed by a broader base of income earners has been one of the ingredients spurring the growth we have enjoyed.

Even more important, however, is the vitality that these newly incorporated elements bring for the future of our economy. As their absorption into the workforce becomes more thorough, we can expect contributions of the type that our pluralistic

society has always received in return for its tolerance of diversity. In a tradition that continues to this day, generations of immigrants have brought with them ideas rejected by older, more hidebound societies. It was this creative energy applied within an economic system that rewards ideas, as does no other, that made the United States the leading manufacturer of ideas in the world. Having now assumed a leadership role in making the sociological adjustments required by the forward momentum of industrialized society, we will reap the benefits toward the end of the century. I foresee a renewed competitive advantage springing from the creativity generated by the amalgamation currently under way.

Conclusion

I am pleased to be able to end on a positive note after dealing with some rather dark topics. The year ahead should build upon the record of 1986 in a stable, balanced, and moderately expansive way. The long-term view is one in which the adaptive powers of the American people will continue to create new opportunities out of old problems. In recent years, our society and economy have together been buffeted by a unique set of social transitions and unprecedented external competition. The troubling side-effects of those forces have caused some to lose hope just when hope is most appropriate. We must keep in mind the strengths our system has revealed in the past, strengths that warrant an attitude of patient optimism for our prospects. The respite offered by our economy's current stability provides an opportunity to work on answers to the hard questions I have posed. Let us be confident in our heritage, which promises that solutions will come from the resolution to find them.