THE ECONOMIC OUTLOOK FOR 1987 AND BEYOND

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Good afternoon! This is the first time I've had the opportunity to speak to a group of people so closely involved with the financial management of our public sector as represented by local, state, and federal government agencies. As a central banker, concerned with the safety and soundness of the nation's financial system, I feel we have much in common. Despite the common threads of our work—public policy and finance, I wouldn't be surprised if many of your were not a bit uncertain about some of the functions performed by the Fed. Thus, I was delighted by Mr. Lariscy's invitation to give a brief status report on the Federal Reserve as well as our view of the economy in the months ahead. At the beginning of the new year individuals review both their achievements and shortcomings in the past twelve months and look ahead to the coming year. Organizations do the same. The Federal Reserve wears three hats, so to speak, and accordingly has three areas to review—payments, bank regulation, and monetary policy.

Last Year's Performance

At the Atlanta Fed, we feel we have completed another successful year of providing services to the U.S. Treasury and financial institutions in our District, which encompasses Alabama, Florida, Georgia, and parts of Louisiana, Mississippi, and Tennessee. We have recovered our costs in the areas of check clearing, cash services, and electronic funds safekeeping and transfer, as we are required to do by Congressional mandate.

In the area of bank supervision and regulation, though the number of bank failures nationwide was up rather substantially again last year as it was in 1985, I think we've done a good job of minimizing the broader risks and providing a smooth transition for those institutions that have gone under in the Southeast. The addition of examiners and the tightening of procedures that was a major initiative last year gives me confidence that we have in place a much better mechanism for anticipating problems, at least those under our jurisdiction. Nationally and internationally, of course, more work remains to be done to help the financial system adapt to the economic and technological realities of today. Some of these changes involve additional deregulation to bring about greater fairness and more economic efficiency; others entail, if not reregulation, at least a new and better approach to regulation. Deposit insurance and off-balance sheet items are just two issues that come to mind when I think about an agenda for improving the regulatory framework.

The third function of the Fed, monetary policy, is the one that involves us most directly with the economy, which is the main focus of my remarks today. In this area too I think we have done reasonably well. Economic growth was pretty good for the fourth year of an expansion, and inflation came down again. The unemployment rate changed very little, however. These results might have been worse if the Fed had not pursued a fairly accommodative monetary policy.

GNP, adjusted for prices, grew about 2 1/2 percent last year. That was close to par for our nation's postwar performance, but with ample excess capacity in the nation the rise did not seem all that fast. The increase in GNP was sustained largely by consumer spending. A strong housing market, especially early in the year, and incentives from auto makers provided considerable stimulus to demand. Despite the vitality of consumer spending, other major components of GNP, particularly capital spending by businesses and net exports, were weak, dampening growth. Given this relatively moderate pace of expansion, it has been difficult to nudge unemployment down to the more acceptable 6 to 6 1/2 percent range from the 7 percent mark, where it remained lodged for most of the year. Fortunately, it did decline to 6.7 percent in the final month of 1986 though I'm reluctant to interpret one month as a trend. Despite this modest pace of economic activity, I think things could have been worse under a different policy approach. Lowering the discount rate on three occasions, along with open market operations which generally assured an ample supply of credit, certainly helped make possible the growth we had in construction and consumer durables.

The measure by which we have done best is inflation. The consumer price index will probably come in at something under 2 percent—better than almost anyone thought it would. Wholesale prices actually declined. Unfortunately I don't think the Fed can take as much direct credit for this as we did for the progress against inflation achieved earlier in the 1980s. The low level of price increases 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 economic 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 joblessness will probably not fall too much further, if at all. 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. Even though this sounds like more of the same, continued growth should bring with it greater balance among the various sectors of the economy and regions of the country.

The chief sources of support for 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 economic growth 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 two years 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 depreciation in the dollar's foreign exchange value has been 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.

I believe the reversal in November will prove temporary and the trade deficit will continue narrowing in 1987, thereby boosting demand for American farm and manufactured goods and adding 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 this tendency. Imports seem likely at least to stabilize this year in view of rising prices for most and the less volatile price of oil in recent months. This would also give a boost to hard-pressed U.S. producers.

Consumer spending should be sustained by reasonably healthy wage and salary growth and 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. It's also important to bear in mind that 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 energy prices would help those areas of the country affected most severely by the oil 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 all recognize the necessity of 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 revision 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 rental space is absorbed. Office construction, along with apartment and condominium building, is likely to be weak in the year ahead. Though mortgage rates--now at their lowest level since the late 1970s--

should boost the single-family housing market, demand, to a considerable extent, has been met for the time being, and the chief determinants of new home sales will probably be demographics and overall economic growth.

Even taking several of my concerns into account, 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. Prices of petroleum and other commodities and long-term interest rates are still well below their levels of a year ago, but without the boon of declining energy and commodity prices, measures of inflation should return to their pre-1986 pattern. Moreover, 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 these caveats I don't foresee an upsurge in inflation. In spite of 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 appropriate attitude when looking toward 1987 and beyond is one of patient optimism. 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 expansion of the past year.

Outlook for the Southeast

One of those areas is here in the Southeast, namely Louisiana, which has been hard hit by the contraction of the energy sector. The region also includes the robust economies of Florida and Atlanta, however. This diverse region reflected the national picture in 1986 and will again in 1987. In general the economy of our district should show improvement in 1987, perhaps exceeding the rate of gain foreseen for the national economy once again. 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, though because of technical efficiencies achieved during recent adjustments employment in some industries like apparel is unlikely to rise in proportion to its 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 several years to come. Heavy indebtedness incurred during periods of prosperity will continue to go unserviced, resulting in additional bankruptcies and foreclosures among borrowers and loan losses for lenders. Fortunately, the effects of the drought should largely be behind us. What's more, we have seen an inching up in the rig count. If oil prices remain in the $15-18 area, the weakened energy sector should stabilize or even improve a little. Overall, 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, thereby keeping the overall pace of growth in the region ahead of the nation.

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. Two lingering and related problems are the federal budget deficit and the trade deficit. 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, 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. Though both seem to be on a downward course, much faster progress is possible. International policy makers have done about as much as they safely can to engineer reductions in the dollar; further currency realignment and trade adjustment must come from substantial reductions in the federal budget deficit. Were such steps undertaken, we would see a significant rebound in GNP growth and, with that, some significant declines in unemployment.

Another continuing concern is the debt of the less developed countries, which fortunately last year was mitigated through the diligent efforts of the International Monetary Fund 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 more stable conditions there and in other debt-burdened LDCs that might follow Mexico's lead.

One of the most serious potential dangers I foresee in the months ahead is renewed protectionist sentiment, which 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 40 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 recently concluded with Canada on timber exports, and through GATT and other international organizations are the correct avenues 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 is the root of the problem. 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 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.

Conclusion

While seizing control of the foregoing problems will require vigilance and concerted effort for some time to come, I believe that the process can begin right now and I am optimistic about the eventual outcome. Thus, I feel I can end on a positive note after dealing with some rather dark topics. The year ahead should build upon the moderately expansive record of 1986 while moving toward better balance. The respite offered by our economy's current stability provides an opportunity to work on answers to the hard questions I have posed.