THE ECONOMIC OUTLOOK FOR THE NATION AND THE SOUTHEAST IN 1987
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to the Southern Municipal Finance Association
March 5, 1987

Good afternoon! I am honored by the invitation to speak to this gathering of people who work to keep our cities solvent. Your vocations make you particularly sensitive to the pulse of the economy and the ways in which the economics of municipal finance is affected by the state, regional, and national contexts in which each locality functions. While I won't address the specific conditions in your various cities, I would like to draw for you in rather broad strokes the larger picture of the economy's past performance and its prospects for the year ahead. I'll look first at the U.S. economy overall and then narrow the focus to the Southeast to examine how national developments will influence our region.

Last Year's Performance

There are three basic measures of performance commonly used to gauge how the nation is doing, economically speaking—gross national product adjusted for prices (or real GNP), unemployment, and inflation. Last year real GNP grew 2 1/2 percent. 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 was difficult to nudge unemployment down from the 7 percent mark, where it remained lodged for most of the year, though it has fallen recently to 6.7 percent. We'll get new figures on this tomorrow, and I hope they will show that the recent drop was sustained.

The measure by which we did best in 1986 is inflation. The rise in the consumer price index was the lowest in two decades. Wholesale prices actually declined. The low level of price increases was a pleasant surprise, but it was 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, as measured by the consumer price index, may rise to 4 percent or more since we no longer have the benefit of sharp declines in energy prices. 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. Three factors--the international sector, consumer spending, and energy prices--will be of prime importance in this move toward better balance.

The chief source of support for the growth I envision is a turnaround in 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 first five years of this decade led to a weakening of 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 economic activity--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. However, international trade flows typically respond only with a lag to changes in foreign exchange rates. What's more, a number of special factors delayed the adjustment of trade patterns to this currency realignment. The sharp drop of oil prices spurred oil imports. The dollar did not depreciate against the currencies of some of our major trading partners like Canada and the Pacific rim nations. Many foreign manufacturers shaved profits to maintain market share.

The dollar's substantial decline has made this strategy increasingly untenable. The 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. Meanwhile, oil prices have stabilized. What's more, research conducted at the Atlanta Fed shows that the dollar's fall has finally broadened to include the currencies of Canada and the newly industrializing countries of the Pacific, though the margin of decline is still much less. Thus, there is reason to believe that the dollar doesn't need to drop any more. The decline we have had should, over time, provide U.S. manufacturers with stronger demand, from at home as well as abroad.

This statement is not predicated merely upon theory or wishful thinking but on empirical evidence. In the fourth quarter of 1986 real net exports showed an improvement of $12 billion over the third quarter. January's monthly data showed a seeming reversal of this trend, though these very preliminary estimates are for nominal as opposed to real trade flows. We will probably continue to see some month-to-month volatility in trade figures. Still, I expect the deficit to continue narrowing in 1987. As

that happens, demand for American farm and manufactured goods should increase, adding significant stimulus to GNP. Exports should increase moderately as prices of U.S. goods to foreigners have fallen considerably. 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 foreign goods and the less volatile price of oil in recent months. This would also give a boost to hard-pressed U.S. producers.

Aside from an improvement in our international trade position, another factor that should help maintain the pace of economic activity is consumer spending even though it is likely to grow at a more modest pace than in the last few years. The sustaining factors underlying the rate of growth in consumer spending will be reasonably healthy wage and salary growth and personal tax cuts that will increase disposable income of many households. Also the stock market rally had added to household wealth and is likely to boost spending moderately.

On the other hand, some consumer-financed consumption could be discouraged by the fact that consumers are highly leveraged and deductions for interest charges on most credit purchases will be phased out under the new tax law, although home equity financing programs could offset much of this effect. 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.

Even allowing for this deceleration in consumer spending, it is still likely to lend the economy some momentum because it's such a large component of overall demand and, even at a moderate growth rate, it has a substantial effect. It's also important to bear in mind that as the trade deficit narrows, more of the goods consumers purchase

should come from domestic producers. So the lower rate of growth in consumer spending does not mean a lower rate of growth in production. The satisfaction of more demand domestically, together with the third positive development—anticipated stabilization in energy prices—would help those areas of the country most dependent on mining and manufacturing. These developments would foster that balance among sectors and regions that I mentioned at the outset.

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 declining, partly because of low capacity utilization but mainly due to the overbuilding of offices and retail space. 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 until excess rental space is absorbed. Office construction, along with apartment and condominium building, is likely to be weak in the year ahead. While mortgage rates—now at their lowest level since the late 1970s—should continue to boost the single-family housing market, I don't expect to see much further increase in housing starts since they are already at a very healthy level. The chief determinants of new home sales will probably be demographics and overall economic growth.

Even taking my concerns into account, I am confident that increased exports and domestic sales together with the lower level of energy costs we now enjoy 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 are still well below their levels of a year ago. Without the boon of declining energy and commodity prices, though, measures of inflation are likly to return to their pre-1986 pattern. Moreover, prices of imported goods, excluding petroleum products, rose about 10 percent last year compared to the general inflation rate of less than 2 percent. I certainly don't foresee inflation returning to the unacceptably high levels we saw earlier in the decade. Still, we need to be watchful about even small increases.

In sum, I feel that the appropriate attitude when looking toward 1987 and beyond is one of patient optimism. The stock market persists in its bullish ways, raising household wealth at the same time it indicates investors' confidence in our economic prospects. As the lagged effects of the dollar's decline lead to the expansion of foreign markets reopen, and the return of U.S. consumers 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

What does this outlook imply for the Southeast? Though the region on average has tended to outstrip the nation in its rate of expansion, the more balanced growth that I just mentioned would be especially welcome news to certain parts of this section of the country. The Southeast includes not only prosperous and fast-growing localities like Atlanta, Nashville, and most of Florida but also weak or even depressed places such as Louisiana, which is part of what we call the oil patch. The economies of Alabama and Tennessee as well as much of rural Georgia are more oriented to manufacturing and as such have been facing many of the same foreign-trade-related difficulties as the nation. In contrast, the service-based economies of Florida and certain metropolitan areas in

other states have been doing quite well and seem likely to continue on that path.

The main factors that will determine U.S. economic performance this year will also have a primary bearing on how this part of the country does. Stabilization of the energy sector will be especially important to Louisiana and parts of Mississippi, both of which have been adversely affected by the sharp fall in oil prices last year. There is reason to hope that things will not get any worse even if they don't get much better any time soon. The rig count has been inching up. While recent oil prices have not been flat, the trend does seem to be toward far more stability than last year. As in the case of the trade numbers, we need to beware of overreacting to a single month of data. If oil prices remain near or a little below recent levels, at least the losses should be stemmed even though little growth is on the horizon.

Along with the energy sector, agriculture will be the lingering area 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 that devastated much of the Southeast last summer should be largely behind us. Moreover, farming in the Southeast as a whole is less dependent on grain crops and hence on export markets, which are glutted. Thus, the Southeast stands to gain less from expected international developments than, say, the Midwest, but the basic picture is also less bleak to begin with.

Improvements in the trade balance would spell good news for many southeastern manufacturers who were subject to either intensified import competition or greater difficulty in marketing abroad after the dollar appreciated in the early 1980s. The example of the textile industry, one of those hardest hit by foreign competition, is

instructive. Having found ways to maximize productivity and minimize costs, textile producers seem to be experiencing greater profits. Profitability has come, however, through substituting capital for labor as much as possible. This means that whatever turnaround the textile industry and others in similar situations undergo is not likely to have a dramatic impact on employment. Any rise in output will generate some new jobs, but employment gains will not be proportionate to advances in output.

Other locally important industries are likely to face mixed prospects this year. Auto and related manufacturing, for instance, which is a significant and growing economic activity in Georgia, Tennessee, and Alabama, may not have as strong a year as last if consumer spending for durables tapers off at the national level. Defense contracts are the bread and butter of many of the region's electronics producers as well as makers of transportation equipment like aircraft. With spending by the federal government expected to slow, activities in these industries may be hampered. Much of Florida's industrial sector produces electronic and transportation equipment tied to the defense and space programs, and the resumption of serious work on the space shuttle will have positive effects for numerous private industries here. Unfortunately, the benefits of new shuttle efforts probably won't be felt until after mid-year. However, the lower dollar's effect on prices of electronic parts and products abroad should bolster high tech manufacturing in Florida and elsewhere to some extent.

Aside from the effect of macroeconomic factors like deficit spending trends, the trade balance, and consumer spending deceleration, this region's growth is heavily influenced by some unique regional factors. Probably the most important of these is population growth, or more specifically in-migration. Continuing inflows of people and corresponding gains in employment and personal income are major reasons for the more rapid growth of Florida and Georgia. Florida's population has expanded at a rate three

times as fast as the national average in the 1980s. The influx of new residents stimulates demand for new houses, apartments, offices, and retail space, in turn making for a bustling construction industry. Recent arrivals also generate greater demand for a variety of services ranging from schools and hospitals to recreation and the whole gamut of retail establishments.

Expectations of continued growth nationally suggest that movement to the Southeast will persist, since most people who want to relocate will be able to sell their homes elsewhere. In addition, the dollar's decline should have a positive impact on another kind of in-migrant--a temporary one, namely the tourist. Florida attracts more foreign visitors than any other state. A lower dollar translates into more visitors from abroad as well as more domestic travel by Americans. Tourism tends to stimulate demand for services and trade in much the same way as permanent population growth. Therefore, workers will continue to find jobs in the expanding service and trade areas so that the region's total employment should increase by about half a million new jobs in 1987.

Construction—the other population-driven economic sector—will not, however, do as well as one might expect, given the anticipated amount of population expansion. Single-family housing may continue to expand, but multifamily building along with construction of offices and retail space is likely to be weak. The reasons for this apparent anomaly are the tax law change and the fact that many local markets were substantially overbuilt in recent years and need time for all the new space to be absorbed.

Despite probable weaknesses in construction and energy, together with mixed performance in manufacturing, the Southeast overall seems likely to benefit from the

chief forces that will shape U.S. economic performance in 1987—particularly an improvement in the trade balance and more stable energy prices. In addition, the region should retain and even increase its attractiveness to new residents and businesses, both from elsewhere in the nation and from abroad. The states that are likely to do best are, once again, Florida and Georgia due to their disproportionate population growth and the diversity of their economies. Oil-dependent Louisiana and Mississippi, whose economy is based primarily on farming, forest products, and energy, will probably end up at the other end of the spectrum. Alabama and Tennessee will probably turn out to be somewhere in the middle. Whatever happens to manufacturing nationally should be reflected closely in these two states. Though growth in this region may decelerate somewhat from last year, it is still likely be fast enough on average to stay ahead of the nation.

Conclusion

In conclusion, I feel I can end on a positive note. The year ahead for the economy of the United States should build upon the moderately expansive record of 1986 while moving toward better balance. As the energy sector stabilizes and manufacturing feels the positive effects of an improved trade balance, those areas of the Southeast that have had hard times over the past twelve months should benefit. Meanwhile, the region's lure to new businesses and individuals should continue, helping this region maintain the vigorous pattern of growth that has characterized it in recent years.