

**THE ECONOMIC OUTLOOK FOR THE NATION AND THE SOUTHEAST IN 1987**  
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**to the Canadian-American Society**  
**March 27, 1987**

Good afternoon! I am pleased to have an opportunity to meet with this group dedicated to furthering the many ties between Canada and the United States. As someone whose responsibilities include keeping my fingers on the pulse of the economy, Canada is naturally of particular interest. The economies of our two countries are interwoven by the largest bilateral trade relationship in the world. After experiencing some difficulties in recent months, our trade negotiators now appear to be making progress. The spirit of these talks could serve as a model for similar discussions with other nations. That's particularly important to the United States because international commerce looms quite large in the prospects for continued economic growth in the year ahead. Before discussing the nation's prospects for 1987, I'll make a few remarks about the performance of the economy during the past year. I'll then focus briefly on the Southeast and conclude with some comments on foreign direct investment, one of the channels for integrating foreign and American business activities that is having a significant impact on this region of the country.

**Last Year's Performance**

As you know, 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. Civilian unemployment fell to 6.7 percent in December, though, and managed to hold steady at that level through February.

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**

In 1987, I foresee the expansion continuing at about the same pace as last year, that is around 2 1/2 percent. A growth rate of 2 1/2 percent is unlikely to bring about much further reduction in unemployment since the number of new jobs will just keep pace with the number of people who want them. So joblessness may fall only a little bit, if at all. However, inflation, as measured by the consumer price index, may rise to 4 or even 4 1/2 percent 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. Many foreign manufacturers shaved profits to maintain market share. 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.

However, the dollar's substantial decline has made the strategy of cutting profit margins to retain market share 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 trade 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 import-sensitive 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 has 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 earlier.

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. There is also a surfeit of apartments and condominiums. Changes in the tax code will exacerbate this situation by treating some aspects of investment less favorably. 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 pretty healthy level.

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. Although the mix of

higher import prices and more stable energy and commodity prices suggests that inflation is likely to return to its pre-1986 pattern, I certainly don't foresee inflation returning to the unacceptably high levels we saw earlier in the decade. Still, we need to be watchful of even small increases. In sum, I feel that the appropriate attitude when looking toward 1987 and beyond is one of patient optimism. As the lagged effects of the dollar's decline lead to the expansion of foreign markets 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.

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. The trend does seem to be toward far more stability in oil prices 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 in the Southeast, not only during 1987 but perhaps for several years to come due to continuing imbalances between supply and demand. At least the effects of the drought that devastated much of the Southeast last summer should be largely behind us.

On a more positive note, 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. One particular problem that affected many industries here is something I mentioned earlier in passing—the failure of the dollar to depreciate against major foreign competitors such as Canada and the newly industrializing countries of the Pacific rim. Consequently, the Southeast's important forestry industry continued to be battered by Canadian softwood; the same has been true of apparel makers who compete with clothing manufacturers in Taiwan, Korea, and Hong Kong. Fortunately, this situation has finally begun to show some progress. In recent months the new dollar index, developed by economists at the Atlanta Fed in part to measure the differential impacts of currency changes on particular regions and industries, has indicated that the dollar is on a downward trend relative to these currencies. I expect these realignments to help. Still, foreign competition has led to quite a restructuring of certain traditional southeastern industries. 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. The resumption of serious work on the space shuttle will have positive effects for numerous Florida companies that produce electronic and transportation equipment. 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, the Southeast'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 overseas visitors than any other state and, as you know, Canadians are even more

numerous visitors to Florida. 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. Tourism will thus help boost job creation, especially in the service and trade areas, thereby contributing to an expected increase in the region's total employment of 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 multi-family 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 in the Southeast were substantially overbuilt in recent years and need time for all the new space to be absorbed. Summing up, though growth in the Southeast on the whole may decelerate somewhat from last year, it is still likely be fast enough on average to stay ahead of the nation, and in many areas the prospects are for pretty robust expansion.

### **Foreign Direct Investment**

Another factor that will propel growth in the Southeast in the future is foreign direct investment. Total assets of foreign-owned companies in the United States as a whole stood at nearly \$600 billion in 1984, a six-fold increase over the levels of 1977. The number of Americans employed by those companies more than doubled, from 1.5 percent of all non-agricultural employment in 1977 to 2.9 percent in 1984. Counting the Carolinas along with the six states in our Federal Reserve District, the Southeast's share of employment in foreign-owned businesses grew from 15 to 25 percent during the same period.

Foreign enterprises choose to locate in our region for the same reasons as domestic employers do—it costs less to do business here than in other areas of the country. Low labor costs generally lead the list of factors that influence the decision to open an affiliate in the Southeast. Reductions in energy costs due to climate, along with proximity to our large markets, also figure into the equation. The one consideration that is different for foreign firms is the desire to neutralize the protectionist sentiment they perceive as a potential threat to their access to U.S. markets. Locating their operations within our boundaries removes their products from customs assessments and at the same time creates a measure of goodwill that might help blunt protectionist sentiments.

Foreign businesses do much to enhance the economy of the region in which they choose to invest. Aside from putting local residents to work in new jobs, their factories and distribution facilities add to the economy's productive capacity. The taxes paid on land and sales of products add to local, state, and federal revenues, providing funds that can be recycled into the economy in the form of government jobs and purchases. The substitution of domestic production for imports could also help narrow our merchandise trade deficit.

The chief criticism of this type of business activity is that the economic growth it engenders tends to be confined to the immediate jobs a new facility creates. Foreign firms may rely on supplies and business services from the home country instead of catalyzing the growth of a cluster of businesses offering accounting, engineering, data processing, and similar services. Of course, the same can be true of U.S. branch plants; what's more, new jobs and the associated increase in income still stimulate many activities, especially consumer services. A more general concern is that profits are typically remitted to the country of origin, and profits can be a substantial share of a facility, especially in it is a low-wage operation. Overall, though, the benefits of foreign

direct investment seem to outweigh the potential problems.

The outlook for continued growth of foreign investment are quite good. Large surpluses of foreign exchange and price advantages due to cheap dollars have made the Japanese leading players in setting up affiliates here, and it seems we read headlines announcing still another Japanese plant on a weekly basis. Interestingly, though auto plants tend to make the biggest splashes, over 40 percent of Japanese investment was in wholesale trade through the end of 1984, and primary metal production was second. Transportation equipment, including autos, at that time—the closest year for which statistics are final—accounted for less than one percent of Japanese investment. This pattern of diversity extends across the board. Among types of foreign investment in general, chemicals and allied products were the leading category in 1984, and machinery manufacturing constituted a second large category. The variety of foreign investment bodes well for the future of this source of economic growth, suggesting that we can expect a further broadening of the investment base even as the success of firms already here deepens their commitment to supplying the American market on American soil.

### **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 individuals and businesses, both foreign and domestic, should continue, helping this region maintain the vigorous pattern of growth that has characterized it in recent years.