THE ECONOMIC OUTLOOK FOR THE NATION AND THE SOUTHEAST
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to the Chamber of Commerce, Jackson, Mississippi
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Good afternoon! I am pleased and honored to have this opportunity to meet with the Jackson Chamber. I have been asked to offer you my perspective on the economic situation in the nation and the southeast. We are living in interesting times, economically speaking--probably a bit too interesting for some. Since the stock market's crash on October 19, much has been written and said about the condition of our financial markets and what they are telling us about the potential direction of the economy. We have heard predictions of disaster from some quarters, while from others we are told that the event had meaning only for overheated exchanges. Fortunately, the aftershocks of "Black Monday" seem to be leveling out now, and so we should be at a point where we can bring some balance to the discussion of the outlook for our national and regional economies. Let me say at the outset, that the prospects for continued health in the financial community are excellent. The turbulence since mid-October has tested the depth and resiliency of the capital markets, and they have not been found wanting. Amid the gyrations of prices, we were again reminded of the Fed's steady commitment to ensure that the financial system has sufficient liquidity, an example of the sturdy structures that remain in place to undergird the soundness of our economic institutions.

The markets' turmoil also points up other themes on which I was asked to comment and which are integral parts of my outlook--the global economy and the budget and trade deficits. Internationalization of markets is, in my opinion, the most important dynamic affecting the economic picture today. We need look no further than the worldwide extent of mid-October's collapse in equity markets to realize that events in one country's finances generate virtually instantaneous responses of unprecedented proportions in all the world's financial capitals. I will begin, then, with a review of the national outlook and an assessment of our region's prospects, which are, of course, determined in large measure by what happens in the nation as a whole. Then I shall discuss the role of the Federal Reserve System—another of your requests—and leave a few minutes for any questions you may have.

The National Economic Outlook

As you know, there are three basic measures of performance commonly used to gauge how the nation is doing, economically speaking—gross national product, unemployment, and inflation. I look for real GNP to expand this year at a rate of about 3 percent, and to come in a bit under that in 1988. Unemployment has fallen from the 7 percent level, where it remained lodged most of last year, to 6 percent in October. I am hopeful that it will remain in that range, which is a seven-year low and close to what I consider the "natural rate" of joblessness. Inflation, as measured by the consumer price index, is clearly above last year's very low pace. Prices will probably end up about 5 percent higher for 1987 and rise by a little less than that in 1988.

Developments in the international sector are critical to this outlook. The higher prices in this forecast are due in large part to the lifting of oil prices from very low 1986 levels but also to the rise in prices of other imports, which as of the end of the third quarter were up 7 percent. As for GNP growth, improvement in the foreign trade situation will remain the engine behind our moderate but healthy rate of expansion. The trade deficit is already shifting in our favor in real terms, although the gap between imports and exports is taking longer to narrow in current dollars. Even in nominal terms, however, the October trade deficit figure of $14.1 billion was a welcome sign of some improvement. With this turnaround in net exports, and particularly in strong export growth, we have seen an improvement in the manufacturing sector. Industrial production is now 5 percent higher than it was last year at this time, and capacity utilization is the highest it has been in over three years.

Consumption, while slower than in past years, may be helped by international developments. The growth in salaries associated with manufacturing's rebound--factory wages tend to be higher than those for service-sector jobs--should help bolster consumer spending. Nonetheless, consumption, which accounts for about two-thirds of GNP, is not likely to be nearly as strong as in recent years--nor should we expect it to be. First, the stock market plunge has adversely affected consumers' wealth. More fundamentally, the low savings rate and high debt-to-income ratios that resulted from very high consumer spending growth over the past few years will dampen household expenditures as we go forward.

Another factor retarding growth in the consumer component of GNP reflects the beginning of a long-term trend we at the Atlanta Fed have been predicting for some time, namely, smaller annual increases in per-capita consumption. This is largely the inevitable "morning after" following the spending binge that we as a nation have been on--both publicly and privately--almost since the start of this decade. Now we must embark on what will be a rather long period of paying back to the rest of the world some of the debt that we amassed to finance that binge, and, of course, we have to pay back not just the huge principal but also the increasing burden of debt service. The only way we can accomplish this task is by consuming less of our own increases in production and exporting more.

International developments will also have a bearing on investment, a small but important part of GNP. First, recent stock market volatility around the globe has added an element of uncertainty that clouds the outlook for investment even though interest rates fell in the wake of the crash. Second, by treating some aspects of investment less favorably, changes in the tax code have exacerbated the effects of residential and office overbuilding that occurred over the past several years. In time this should lead to a more efficient allocation of capital as the revised tax code encourages investment dollars to be distributed more in accordance with the dynamics of supply and demand. In the near term, though, there is considerable excess space to absorb. Even in an environment of lower mortgage rates single-family housing is likely to remain weak at least until the latter part of next year. On the other hand, the fact that I look for exports to increase, means that investment in equipment, factories, and warehouses should be reasonably strong as domestic manufacturers boost output. Combining the two components, we come up with little change in investment. Thus, on balance it will neither retard nor push GNP growth. As for government purchases, budget deficits are, thankfully, on a downward slope. At this point, Congress and the Administration appear to be making some further headway in achieving a permanent reduction in the full-employment budget deficit relative to GNP, but we will need more of this since progress on this front is vital to our economic health as a nation.

At this point we might do well to take a look at the interrelationship between the nation's fiscal deficit and our trade imbalance. The two provide a good example of the impact international events have on the domestic economy as well as the problems associated with overly large deficits. To understand how our trade deficits are linked to fiscal deficits, it is necessary to look back to the tax cut of 1980 and the increase in defense spending. As federal revenues diminished relative to spending, the U.S. government had to borrow increasingly to make up the difference. It became clear that our domestic pool of savings was insufficient to provide the necessary funds to support both private investment and government financing needs. The shortfall drove up interest rates on investments here, attracting the attention of foreigners with excess capital to invest. In Japan, for instance, people save at a rate of some 18 percent compared to our 5 percent or less. Countries like Japan, Germany, and the OPEC nations also had hefty trade surpluses. With their edge in excess funds these countries became major players in the market for government debt instruments. In the process they bid the dollar to great heights as they purchased U.S. currency to buy bonds. The high dollar made our products expensive overseas and so reduced sales of U.S. goods abroad while making foreign goods cheaper here.

Now, however, I pin much of my positive forecast on an improvement in net exports. I expect this improvement for two reasons. The first is the decline in the value of the dollar in foreign exchange markets. According to a dollar index developed at the Atlanta Fed, our currency has fallen 30 percent against those of most of our major trading partners since its peak in February of 1985. It has not fallen nearly as much against the currencies of Canada, our major trading partner, and the newly industrializing countries of the Pacific rim, however. From February of 1985 to the end of late November, for example, the dollar was off only about 6 percent vis-a-vis the Canadian dollar and 8 percent against the currencies of countries like Taiwan, Korea, Hong Kong, and Singapore. In this current, highly volatile environment I would not want to speculate on what will happen to exchange rates in the future. I can say, though, that the currency realignment we've already had is starting to have a positive effect on our economy. In fact, exports began picking up in real terms in the last three months of 1986 while imports flattened. Real net exports had improved for three consecutive quarters for the first time since 1980 before reversing course slightly in the third quarter of this year. Despite the third quarter decline, which was largely due to an increase in oil imports, exports from this country continued to show significant gains. This seems to be passing through to our manufacturing sector, which had been so adversely affected by the dollar's earlier appreciation.

The second reason to expect a turnaround in the trade sector is related to something that we are all concerned about, namely, that we cannot keep increasing our borrowing from abroad indefinitely. For some time now we have been spending more on consumption, investment, and government than we actually produce domestically. The substantial expansion of the federal budget deficit contributed to this situation. To meet our financing needs, we have been borrowing from abroad. Of course, common sense tells us this cannot go on forever. Our creditors may become less willing to lend, and, just as any borrower eventually learns, debt service inevitably rises along with the debt and becomes a burden. So the time has come to start repaying. While GNP or national output will grow at about the same rate in 1987 as it did last year, more of that increase in output will be exported and less of it will be available for domestic use. While the current market situation renders any forecast less certain, we can at least hope that the stock market's message has been received in time for those in power to resolve their differences and embark our federal government on a lasting course of deficit reduction.

Outlook for the Southeast

What does this outlook imply for the Southeast, which includes not only prosperous and fast-growing cities 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. Continued stability in the energy sector is especially relevant to Louisiana and the parts of Mississippi that were adversely affected by the sharp fall in oil prices last year. Lower unemployment rates in both states are evidence of some improvement. I feel confident that they have reached bottom and are in position to begin to turn around. Agriculture, too, remains depressed but at least exhibits encouraging signs. The cotton crop is excellent this year, and prices are up. Except for feed grains and rice, total crop output is better than last year, and a combination of reduced acreage, higher yields, and stable or higher prices is expected to improve net farm revenues substantially. A few years of similar results could bring the industry back to health.

On a more immediately positive note, improvements in the trade balance should ultimately 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 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 hurt by the influx of 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 the first ten months of 1987 the dollar fell more sharply vis-a-vis Taiwan's currency, for example, than against the currencies of our other trading partners. I expect such realignments to help. Still, foreign competition has led certain traditional southeastern industries to restructure through increased automation. This means that whatever turnaround the textile and chemical 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, which is a significant and growing economic activity in Georgia, Tennessee, and Alabama, may not perform as strongly as last year 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 somewhat weaker.

These regional developments, particularly increases in energy and farm prices and the lower dollar, are generally good news for the Mississippi economy, which is expected to grow at a faster pace in 1988 than in 1987. However, the probable winding down of the national defense build-up may partially offset this positive trend, at least in the Gulf Coast area. Another more broadly negative factor on Mississippi's horizon is the likelihood of continued out-migration from the state's rural areas.

Several longer term factors must also be considered when we look at Mississippi's economic prospects. First, the state remains largely rural and the service sector, of which we hear so much, tends to be more of an urban phenomenon. Second, Mississippi's industry mix is still heavily oriented toward production of apparel and other nondurable goods. These industries will continue to face competititve pressures from much lower-wage foreign producers. Thus, Mississippi's economic growth rate is unlikely to catch up to the national pace in the foreseeable future. Nonetheless, in 1988 Mississippi's growth should be faster than in the past six years.

Role of Federal Reserve Policy in the Economic Outlook

Having briefly examined the outlook for the nation and the Southeast, I will turn to the challenges the current situation holds for the Fed in its formulation of monetary policy. It will come as no surprise that the internationalization of markets and the twin deficits of budget and trade pose the primary restraints on our options and effectiveness. Internationally, we have found that we cannot act alone. Perhaps we never could, but we have become much more cognizant of that fact recently. In the past two years, for instance, we have been pressuring the Germans and Japanese to pursue more stimulative domestic policies to help reduce imbalances in world trade flows, especially our huge trade deficit. While Japan and, of late, Germany have begun to implement such changes, their slow response is one reason our trade balance has not narrowed much even though the dollar has declined on a bilateral basis against the Deutschemark and the yen almost to levels where it stood before our trade accounts began to go into the red.

At the same time that we have come to appreciate the need for international policy coordination, our domestic situation has heightened awareness of the importance of the monetary and fiscal policy mix. As I mentioned earlier, our massive federal budget deficit caused interest rates to rise in the early 1980s, and foreigners increased their purchases of dollars to take advantage of those higher interest rates. Concurrently, the dollar began an appreciation that reached a peak in early 1985. Relatively expensive dollars led to unprecedented trade imbalances. As this situation continued, the Fed's generally accommodative policy designed to address the domestic economic situation had the positive side-effect of lowering the dollar. While the dollar declined and U.S. exports began to improve as a result, in the absence of lasting progress toward reducing the deficit, monetary policy eventually reached the limits of its ability to deal with the trade situation. On one hand, despite its beneficial effects on trade, currency depreciation can eventually lead to substantial price pressures, as imported goods cost more and more. This is particularly true if the economy is operating close to capacity. At the same time, in an environment where the United States is dependent on capital inflows from abroad to finance its borrowing needs, an interest rate differential in favor of U.S. issues is essential to maintaining the attractiveness of dollar-denominated assets to foreigners. Thus the Fed is essentially backed into a corner in terms of how much easing it can do as long as federal budget deficits continue and foreign central banks are unwilling to maintain the interest rate differential by loosening their reins on money and credit in concert with the United States.

It might seem that we are in a new ball game in the wake of the stock market's Black Monday, with the dollar dropping to all time lows and the Fed providing ample liquidity. But this situation is our response to increased demands for liquidity, and not providing it would have been deflationary. Interest rates also declined, reflecting a pronounced shift in preferences in favor of fixed-income assets. The Fed has been readily able to carry out its responsibilities as a central bank. More recent data suggests that the health of the financial system and markets is improving. Precious metal prices have remained stable, and interest rate spreads between private and Treasury securities have narrowed in recent weeks. Still, the fundamental problem of the federal budget deficit remains. What the Fed can do to "help" the economy will depend very much on how much progress Congress and the Administration can make in reducing the full-employment budget deficit. If they are not successful, the U.S. economy will be saddled with an imposing debt burden that will fall largely on the next generation's shoulders to repay. Real interest rates will stay higher than they would otherwise be. As a result, investment and future growth will suffer.

Conclusion

I do not want to leave you with the impression that I am pessimistic about the future of our economy, however. On the contrary, my attitude remains one of cautious optimism regarding the prospects for business activity. While I respect the difficulties we face, I am not daunted by them. After all, our recent economic performance and the outlook through this time next year reflect good health--GNP growth is moderately strong, unemployment and inflation are low, and the dollar has reached low enough levels that I expect our net exports to continue improving. In addition, I am hopeful that the signals we have been given by the financial markets will be heeded by those in a position to act. As that happens, we will begin to sense the imbalances that have plagued us for several years start to disappear on their own. Finally, while monetary policy is not, as I have pointed out today, autonomous, it never really was independent of domestic fiscal policy or of international developments. It is just that modern technology lets us see their reactions and responses much more quickly. Notwithstanding these constraints, monetary policy has certain special advantages--it is flexible and subtle. For this reason, I remain confident that the Fed will be able to continue to meet its mandates to ensure the safety and soundness of one financial system and foster the greatest possible non-inflationary economic growth.