PROSPECTS FOR THE U.S. ECONOMY IN 1988:
THE VIEW FROM THE CENTRAL BANK
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Good morning! It is a pleasure and an honor for me to initiate what promises to be a stimulating morning of presentations and discussion on the prospects for the national and local economies in the year ahead. This conference gives us a running start in a year which will undoubtedly provide more than its share of public policy debate as the presidential election draws the attention of candidates in both parties and the public generally to economic issues. This is fortunate because several of those issues warrant thoughtful consideration at this moment in our nation's history.

Last October the stock market dramatically signaled investors' uneasiness with the current or anticipated future state of affairs. While I do not share the view of those who see a recession on the horizon, I do believe that the market's warning must be heeded. In particular, we must seriously grapple with the issue of global competitiveness lest we sacrifice our own and our children's future standard of living. Because the manner in which we address this issue will have a profound effect on our long-term economic performance, I feel it is appropriate to give competitiveness a prominent place in this morning's proceedings. For that reason, I will begin by presenting a brief outlook for the nation, the Southeast, and Florida in particular. After that, I will discuss why our competitiveness is threatened and what we must do about it.

The National Outlook

In the year just ended, GNP grew about 3 percent, a rate of expansion that helped keep the unemployment rate at or below 6 percent throughout the second half. The final figure on inflation should come in at between 4 1/2 and 5 percent on average for the year. Looking to 1988, as I just mentioned I see no recession but rather a continuation of expansion at a slower pace of 2 percent or a little higher. With decelerating growth, unemployment should stay near the 6 percent mark or perhaps rise somewhat. Inflation is likely to be about the same as last year. My outlook for continued growth in GNP rests on three areas of strength: continued modest advances in consumption, further gains in capital spending on new equipment, and a fairly significant improvement in the foreign trade sector.

Consumer spending is likely to advance, albeit modestly, in 1988, in spite of the stock market crash last fall. Well before October 19 household consumption had slowed considerably from its pace earlier in the expansion. Perhaps consumers were reading the writing on the wall even before the gurus of Wall Street were. At any rate, the main source of momentum for growth will not be consumption but rather net exports, which in real, or inflation-adjusted terms, have been trending up since late 1986. The dollar's substantial drop in value against foreign currencies makes our goods more attractive to foreigners. This development has boosted production and employment in our manufacturing sector. In addition, West Germany and Japan have recently begun to stimulate their economies, which should further bolster our sales of U.S. manufactured goods abroad.

However, given the extent of the dollar's fall, we have yet to see import prices rise as much as anticipated, a factor which would curb imports and foster more domestic consumption of U.S.-made goods. Foreign producers have been able to cut profits in order to hold on to U.S. market share or to divert sourcing to countries whose currencies have not appreciated as much against the dollar. Overall, therefore, foreign goods continue to come into the country in large volume. Nonetheless, export growth should continue to boost ongoing gains in the manufacturing sector, in turn spurring investment, especially in equipment. Early surveys of capital spending plans suggest fairly good gains in this area.

Probably the weakest sector of the economy during the coming year will be commercial and residential construction. Substantial amounts of office, condominium, and apartment space remain to be absorbed. In addition, the stock market's decline could make it harder for businesses to raise capital for major new projects. Government spending will not exactly be a weak spot. Indeed, the federal budget deficit is likely to increase moderately in 1988. Last year's reductions were achieved in part through one-time occurrences such as asset sales. Nonetheless, the attention paid the deficit following the stock market crash means that fiscal stimulus will be less than in recent years. Together these factors suggest that GNP growth will continue in 1988, but not quite as rapidly as in 1987.

Turning to inflation, oil prices are likely to stay in their present range despite some discord in OPEC at year's end. However, last year's further decline in the dollar should push non-oil import prices up even more. As this happens, the dollar-related increase in domestic manufacturing could exert upward pressure on labor costs, especially since capacity utilization has been rising and unemployment is close to the "natural rate" at which further efforts to stimulate growth result in more wage pressures than job gains. Hence, I expect prices to advance at about the same rate this year as last i.e. 4 1/2-5 percent. In all, with slower but still moderate growth in GNP and no acceleration in price increases in the offing, we can look forward to another year of decent economic performance.

Outlook for the Southeast

In its diversity the southeastern economy reflects the strengths and weaknesses of the nation as a whole. The likelihood of continued or even faster growth in manufacturing bodes well--at least for those regional factories that have been modernized. Although last year the dollar finally began to depreciate against the currencies of developing countries in the Pacific basin and Canada--the chief competitors of many regional industries like apparel, the amount of currency realignment is quite small compared to the dollar's fall against the yen, deutsche mark, and currencies of other advanced economies. Moreover, cost structures in many of these developing countries are far more favorable to the kind of low-wage, labor-intensive production that became the staple in much of the South as the labor force shifted out of farming. Thus, for many of the region's industries the likelihood of substantial improvement is not high. Fortunately, the outlook for agriculture, while not rosy, is brighter than it has been in some time, as worldwide supply and demand move closer to some sort of balance. The situation for natural resources like oil is similar.

In terms of specific states, Louisiana and Mississippi will do better than last year, which appears to have been the trough. The rise in cotton prices is helping Mississippi's large farming sector. However, the upturn in manufacturing that the rest of the country has been experiencing may largely bypass Mississippi since so much of its factory output is in the low-wage sector, where developing countries have a decided advantage. Louisiana's situation is in some ways worse because its economy is so lacking in balance. Even its small manufacturing sector is tied largely to energy. However, if oil prices remain fairly stable, the modest recovery in drilling activity should continue and expand in 1988.

Alabama should continue to occupy the middle ground economically as well as geographically. Manufacturing gains should help this state further the advances begun last year, since its economy remains heavily oriented toward industrial production despite growing health and educational services, especially in Birmingham. In addition, with somewhat brighter prospects for farming and energy, Alabama's still important natural resources sector should experience some improvement. Indeed, coal production had already begun increasing last fall.

The states in the eastern portion of the region--Georgia, Florida, and Tennessee--can expect to see more of the good performance they have experienced of late. These states enjoy diversified economies, in which more technologically advanced manufacturing and a growing service sector help offset weaknesses, whether in industries like apparel which have been battered by imports or the production of phosphates and other commodities whose prices remain depressed in world markets. Of course, rapid population growth is also a boon, especially to Florida and Georgia.

Looking specifically at Florida, it is likely that the feverish pace of tourism and in-migration witnessed in 1987 will abate somewhat in 1988. Even if these two engines of growth slow, however, they should be sufficient to keep the state's economy moving ahead at a rate above the national average. I look for population growth to be near 3 percent and add some 350,000 new residents who will help employment in the trade and service sectors to expand at a moderately fast pace, though not as rapidly as in 1987. New Floridians should also keep homebuilders at work and help fill up shopping malls and office buildings. Nonetheless, I don't foresee housing starts reaching last year's levels, and commercial real estate remains overbuilt, retarding the construction industry in general. Sagging construction will probably cause the state's goods-producing sector, which also includes mining and manufacturing, to show weaker growth than the goods sector nationally. In manufacturing, chemicals, paper, and several durable goods industries such as metals and machinery should turn in good performances this year. However, there are relatively few Florida producers in these industries that can be expected to reap significant competitive benefits in domestic and foreign markets from the cheaper dollar. Still, Florida's vibrant economy, fueled by the flow of temporary visitors and permanent residents into the state, should lead to an expansion in employment of about 3.5 percent in 1988. This continued growth in Florida will also be one of the primary factors leading the Southeast to outperform the nation as a whole again in 1988.

Competitiveness—The Only Answer to Our Twin Deficits

At first glance this outlook would seem to suggest it is "business as usual." After all, the United States has had more than five years of continuous growth, and the economic indicators point to more expansion in the near term. Yet a number of signs indicate that all is not well--the stock market crash, our slow progress in narrowing the trade deficit, and, perhaps most important, the growing level of debt. In the same period that we have enjoyed our longest postwar economic expansion, we have gone from being the world's largest creditor nation to becoming its greatest debtor. In 1981, the world outside owed us about $140 billion, more than at any time in the past. At the end of 1987, we owed nearly $400 billion to foreigners, also a record amount. More significantly, this debt was not used to finance an expansion of our productive capacity but rather to pay for current spending, especially by the government.

This remarkable turnaround from creditor to debtor helps explain the feeling of uneasiness that exists in the midst of our apparent prosperity. We have rightly begun to question how we are going to make the "monthly payments" on all the purchases we have put on the national "credit card." When the bull market came to an abrupt halt on Black Monday, the stock market was saying that the future was just too uncertain. Investors no longer believe we can pay up without either changing the way we do business or becoming content with reduced living standards for ourselves and our children.

As a result of massive federal budget deficits, we have been exporting IOUs in the form of Treasury securities for the past five years or so. In order to service and ultimately retire our huge external debt, we must be able to run substantial export surpluses--and soon. The longer we wait to start paying these bills, the harder it will be. For one thing, the debt service burden will be that much larger. Moreover, our living standard will be adversely affected because future generations will have to earmark a higher portion of their incomes to interest payments abroad and less to personal consumption. Thus, our trade deficit is, indeed, a problem. It is imperative that we start shipping overseas more of our future increases in output. However, our fitful and slow progress on narrowing the trade deficit implies that this is going to be more difficult than we thought. The reason, in my opinion, is that we remain focused on the wrong strategy for improving our competitiveness. We are fighting the last war, so to speak.

Competitiveness is basically the relationship between the price and quality of one's own goods compared to the similar goods produced by someone else. These factors in turn are influenced by productivity--how much we get out of our resources and, in global markets, by exchange rates. One way of regaining our competitiveness is to focus on reducing the price of U.S. goods. Those who advocate protectionism are really taking this stance. Even though their rhetoric stresses other nations' unfair trade practices as the culprit, their solution--an attack on those practices through protectionist measures of our own--would lower the price of U.S. goods relative to products from abroad by erecting tariff barriers, import quotas, and the like. Those who focus on the dollar also support this price-reduction tactic. They maintain that we can let the dollar do all the work for us by falling so low that our products become a bargain to foreigners while their goods become increasingly more expensive to Americans.

As for protectionism, I have been on record for some time as opposing anything less than optimally open markets. Particularly in the wake of the most serious disruption in the stock market since 1929, it is a cruel deceit to promote protectionist legislation as a panacea for competitive ills. It was precisely such illogic that led to passage of the Smoot-Hawley tariff after the 1929 crash and propelled the world into the Great Depression. Protectionism in the past as now means only that everyone consumes less in the long run because trade barriers merely stifle competition and so raise prices and limit consumer choices. In other words, in the end it lowers living standards, the very result toward which we fear our present course is propelling us. I grant that there are inequities in the present playing field, but these can be resolved at the bargaining table in the manner of the past year's successful negotiations with Canada. Taking a confrontational position at this point will not hasten our progress in similar negotiations with other trading partners.

With regard to the dollar, I feel we are reaching the point of diminishing returns from the currency realignment that has been occurring for nearly three years now. The dollar fell to postwar lows against the yen and deutsche mark last November and December. Should the dollar continue to drop so precipitously, the likelihood of increased inflation would become much greater. So would the probability of economic downturns in those foreign economies to whom we hope to export more. Alternatively, defensive maneuvers on the part of our trading partners could lead to a series of competitive devaluations and trade wars. As in the worst-case protectionism scenario, such jockeying for position might lead to global depression. In any of these eventualities, the ultimate consequence of raising competitiveness through dollar depreciation would be a lower living standard here.

The problem with both protectionism and real, as opposed to nominal, dollar depreciation as strategies for solving the competitiveness problem is that they are cost minimization strategies. As such, they keep our thinking lodged in the past when this approach was a legitimate way of selling more U.S. products. America's comparative advantage once did rest on being the low-cost producer for the mass market. We left to Europe the specialized markets for high quality goods. This time is long past and a cost-minimization approach will not work for the United States in a truly global economy. In the 1980s American workers have restrained their wage gains appreciably.

Yet, countries like Taiwan, Korea, Mexico, Brazil, and China can still undercut our labor costs substantially. Do we really want American workers to cut back their incomes and living standards to the level that would allow us to offset the labor advantage of China?

The fallacy of thinking we can simply return to the status quo ante as the world's low-cost producer should be apparent, particularly to those of us in the South, since we have experienced first-hand the long-term disadvantages of depending on cheap labor as a competitive ploy. After World War II, the South attracted textile, apparel, and other labor-intensive industries from the North with the promise of low wages and low taxes. This recruitment policy seemed to work until other countries came on line with effective production and even lower labor costs. At that point, industries which were once drawn to the South moved "offshore" where even lower costs were readily available. The South, however, lost more than just industries from this shift in production. The tax breaks that had been used as an enticement to lure businesses left southern states with poor educational systems and an inadequate infrastructure--areas of public investment that had been sacrificed to keep taxes low. This legacy made it harder for workers to adjust to the structural changes of the '80s and less attractive for new, more technologically advanced industries to relocate here. It is difficult to imagine that we would be so out of touch with the structural challenges still being faced in many parts of the Southeast that we would favor a return to this no-win mode of operation.

If cost minimization, whether through protectionism or the falling dollar, cannot be counted on to enhance our competitiveness, where does that leave us? We must look at the other basic determinants of competitiveness--productivity and quality. To increase productivity we need to invest more in both our physical and human capital. We cannot expect to squeeze much more out of labor costs. I do not deny that we have made considerable productivity gains in manufacturing during the 1980s, largely in response to heightened foreign competition. The textile industry's comeback in the past several years is a good example of how this can work. Beset by competition from abroad, textile mill owners retooled and returned to profitability. Yet not all U.S. industries can boast of such progress. Unfortunately, much of our recent investment has not been directed to resource-saving equipment or new factories but rather has been sunk into hotels, offices, and the like--perhaps so we can spend more time meeting to discuss productivity!

The kind of investment we need goes beyond the narrow classifications made in constructing the GNP components. In addition to spending more on new equipment, research, and so on, we must also invest more in our public infrastructure--roads, mass transit, and the like. We must pay particular attention to building up human capital even though in an accounting sense such government expenditures are considered consumption. Unless U.S. workers are better educated, they will be unable to use new technologies. Moreover, they will lack the flexibility to make the necessary adjustments, not only to technologically advanced production processes or ways of providing services but also to another fundamental change we must make--toward higher quality.

In the past, Americans have tended to make standard, mass-produced goods especially for our large home market. We made the Ford family sedans and the Kodak Instamatics and let others turn out specialized, high-quality products--Mercedes and Leicas--for a variety of markets. Again, the arrival of much lower cost producers has meant that we can no longer hope to survive by concentrating on low-end goods. As we rethink our production objectives and move into the better quality niches, U.S. business leaders and workers alike will be called on to change old habits and ways of thinking, and this shift requires a better educated work force at all levels. We need managers who can think analytically and creatively, who have the vision to see market opportunities in the far corners of the world. Yet our schools seem to have difficulty teaching students to read and write, to compute, and to master even the basics of science, history, and geography.

Policy Directions and Personal Responsibilities

Clearly, we need to invest more to achieve the productivity and quality needed to maintain our living standard to be competitive in world markets and so retire our external debt. Our problem is like that of many less developed countries: being so indebted, they have great difficulty eliciting new capital infusions. Whichever way we turn, the alternatives end up looking very much like the austerity programs upon which LDCs embark periodically.

On one hand, we must learn to consume less and save more; in particular, to save at a level consistent with the position we hope to maintain in the world economy. We have also been looking to the government to cut its deficit spending and thereby free up more funds for private investment. It is easy to blame the federal budget deficit as setting the tone for borrowing in order to consume--a bit too easy, perhaps. The deficit is not a new problem. Again, it is something about which I have voiced my opinions for several years. To be sure, we need to keep pressure on policy makers to continue reducing the gap between revenues and outlays. At the same time, there may be limits to how far we can go in reducing government spending. Many budgetary outlays--estimates range from 40 to 80 percent--have become locked into place. Entitlements, with their inflation indexing, place a particularly unrelenting demand on spending priorities. Cutting them requires more resolve than politicians--and we who vote for them--seem able to muster. Other large portions of the budget that cannot really be touched are interest on the money borrowed in the past and the funds it takes to maintain an acceptable level of defense. What is left to cut? Shall we make even less investment in public infrastructure than the insufficient amount we have been making? Shall we further minimize our commitment to education? In my view, such a strategy would be extremely short-sighted because it could hinder our attempts to enhance our productivity and quality, and thereby pay off our debt to foreigners by exporting more.

Thus, despite the mounting frustration we may feel at the lack of progress on this front, we must stop blaming the government. Instead, it is time for all of us to say we have met the government, and it is us. Through our votes, the American people have the final voice in policy matters, and we overwhelmingly reaffirmed the policies that led to our deficit by our votes in the past.

What can and should we do? A starting point might be further progress toward a truly neutral tax system. The one we now have still encourages consumption relative to saving. It also extends more favorable tax treatment to debt relative to equity financing by taxing corporate dividends twice. We cannot pass the buck entirely to Washington, though. Rather, we must curb our personal proclivity for consumption and rein in our huge household debt. We should also give more support to local and state policy makers who are attempting to upgrade our nation's schools. That means viewing these efforts as investments for which we should willingly pay through property, sales, and other taxes. While these measures mean that a smaller portion of income growth will be available for consumption, we must remember that in the long run they are the only way we can work to preserve the living standard that has come to be the envy of the world.

Conclusion

Before I began to address the related problems of competitiveness and debt, I started out by saying that we could look forward to another reasonably good year in the national and regional economies. If I have rained on the parade a bit, it is because I wanted to impart my own sense of urgency that we address these latent problems from a position of relative strength. For all my rhetoric, our huge debt has not placed us in the position of an LDC. We still have time to correct our course and minimize the damage, but first we have to muster the resolve--personally and publicly--to do so. I am hopeful that in the year ahead we will give careful thought to these issues and meet this challenge boldly.