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THE ECONOMIC OUTLOOK FOR 1989
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To the Atlanta Rotary Club
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Good afternoon! I am pleased and honored to appear before my fellow Rotarians once again to discuss the way I see the economy shaping up in the year ahead. This year marks the seventy-fifth anniversary of the opening of the Federal Reserve Bank of Atlanta, and for the last several decades of that span it has been the privilege of the Atlanta Fed's presidents to offer an economic outlook from this platform each year. I view this association with the Rotary Club as an important part of the Bank's history. For one thing, it has provided a valuable channel of communication to Atlanta's business and civic leaders. For another, this custom is one of the forces that prompt us to gather our thoughts about economic conditions at the beginning of each new year.

As you know, unlike many forecasters, I always review the results of my previous year's outlook for you. In light of this self-imposed accountability I will begin by telling you how I fared on the outlook I gave you last year at this time. Then I shall venture my thoughts on prospects for the year ahead in the nation and the Southeast. Finally, since we stand at the beginning of a new administration, I will conclude by indicating the chief economic priorities facing the new president. Among these, I would like to pay particular attention to the possible policy implications of the recent wave of leveraged buyouts.

Last Year's Performance Scorecard and the National Outlook

The past year was one that held surprises for just about all of us who venture economic outlooks. In January of last year I said that on average for the year I expected the expansion to continue but at a pace of around 2 percent or a bit higher. I thought

inflation would be in the 4 1/2 to 5 percent range, and unemployment would remain near 6 percent. Like most other forecasts made at the beginning of the year, mine undershot GNP. The economic growth picture is muddied a bit by the effects of the drought, and the numbers ultimately reported for GNP will have to be read with that in mind. I believe underlying economic momentum, that is, net of the drought, was quite strong in 1988--probably just over 4 percent. Because the nonfarm economy grew at such a substantial rate, unemployment was lower than my estimate--averaging 5.5 percent. The sharp drop in oil prices during 1988 pulled inflation lower than I anticipated, too. Prices rose around 4 1/2 percent on average in 1988 according to the Consumer Price Index.

What accounted for this strong showing? I was correct in anticipating that the dollar's decline would boost our manufacturing sector by providing an impetus from exports. Along with help from the dollar, though, we were further assisted by better-than-expected growth among our trading partners. As a result, exports rose to historical highs. This propelled industrial output and employment even more. Also, like most others, I thought consumption would slow in 1988 and provide less support for the economy than it had during much of this decade. Consumption had been growing faster than income, and consumer debt levels were high. We had had a severe stock market correction a few months earlier, and I believed the loss of wealth from the crash would lead consumers to cut back on their spending. Yet consumption remained fairly resilient and added to the stimulus provided by manufacturing. Thus the economy as a whole grew quite briskly in spite of a severe drought, and its strength pulled the jobless rate to a 14-year low.

In the year ahead, I see the the economy decelerating to a growth rate of 2 1/2 to 3 percent. Unemployment will probably not fall much below its current rate of 5.3 percent. Inflation could edge up toward 5 percent though I want to assure you at the

outset that the Fed is committed to keeping price pressures in check. We have to bear in mind that last year's drought will still be a factor in measures of economic performance in the year ahead for the simple reason that 1989 growth will be defined relative to 1988's base. All this means that drought effects will make 1989 look better on paper than it will actually be. On a year-over-year basis, reported GNP growth will probably be around 3 1/4 percent. I prefer to look at measures that remove drought effects and focus on the underlying growth rate. The figure I mentioned earlier is on that basis. By either measure, though, economic activity seems likely to slow in 1989, and, with that, the jobless rate will probably not fall by much. On the other hand, one thing that concerns me very much is that inflation promises to accelerate even though the pace of economic activity should slacken. That is largely because of the drought's delayed effects on food prices, which will not be entirely worked through until the next harvest, as well as prospects for higher oil prices. There are also problems of capacity constraints that I will discuss in a moment.

Sources of Economic Strength and Weakness

Underlying this outlook are several dynamics. Chief among the factors adding momentum will be manufacturing. Exports are likely to continue bringing the trade deficit lower this year, and manufacturers will turn out more goods to meet foreign demand. In recent months the dollar has fallen slightly below its year-end 1987 levels after rising earlier last year. The lagged effects of this drop will continue to help make U.S. goods attractive to foreigners. The Canadian free-trade agreement should also enhance our export picture by giving us better access to the market of our largest single trading partner. At the same time, 1988's dollar declines will no doubt translate into higher prices for imports. Thus, consumers here can be expected to shift more of their purchases to domestically produced items.

By adding jobs to factory payrolls, strength in manufacturing should help workers' purchasing power and keep consumption going at a respectable rate. It is likely that auto sales will slow from their relatively high levels of the past year, though, and this development may moderate the pace of consumption somewhat. Business investment in capital goods and plants should also post moderate gains as factories are expanded and equipment is upgraded to accommodate increased industrial production. Assuming the weather cooperates, agriculture, too, will probably prosper. Exports of farm commodities should be buoyed by the low relative value of the dollar and the rebuilding of domestic stockpiles.

The weak sectors in the economy will probably be construction and government. I expect modest growth in commercial building led by warehouses and other industrial structures. However, residential building shows few signs of strengthening. Government spending will have to remain on a downward slope if we are to meet Gramm-Rudman-Hollings requirements without raising taxes.

Inflationary pressures are the most worrisome aspect of the outlook as I see it. The U.S. economy's capacity to grow is realistically about 2 1/2 percent per year. Actual growth has been above that level for well over a year. Meanwhile, now that the baby boom generation has been absorbed into the work force and the number of entrants to the labor force is diminishing, labor markets have begun to show signs of tightening. If growth continues at last year's pace while the number of new workers declines, wages will tend to rise in the absence of stronger advances in productivity. Capacity utilization is also quite high, above 90 percent in certain industries. This combination of developments suggests that bottlenecks and shortages of materials may occur that could lead to general price increases.

One other cloud on the horizon is the possibility that foreign investors will lose patience with the pace of federal deficit reduction here and slow their support of government debt issues. If this were to happen, interest rates would probably rise to draw out more savings. Higher rates would in turn deter investment in higher productivity and in projects aimed at expanding capacity. In sum, the economy appears to be in good balance, yet the risks of inflation and foreign disenchantment over financing our borrowing must be taken very seriously as we look toward the year ahead.

Regional Outlook

As for our region, growth in the Southeast slowed appreciably last year, and I do not foresee a quick return to the robust pace earlier in the expansion when the margin of growth between the region and nation was pronounced. On balance, I expect that the southeastern economy will maintain the lower growth rate attained during 1988. Farmers in this part of the country did not fare as badly as their midwestern counterparts during last year's drought. Thus, agricultural producers here would stand to benefit from the good year in farm markets I anticipate. As in the rest of the nation, the Southeast should also enjoy continued growth in manufacturing as a result of improving exports and diminished import competition.

Interestingly, though, the rebound here so far has not been as strong as in the industrial heartland. The winding down of defense contracts has been a negative factor for aircraft and electronics plants in the region, and next year should offer no reversal. Still, many primary and intermediate producers--paper and chemicals, for example--are running at full tilt and will likely remain at high levels. If apparel sales maintain their momentum from the end of 1988, factory output in this important regional industry should reverse the losses incurred last year. An increase in apparel would boost overall manufacturing employment rather than exerting a drag as it did in 1988. Another major

southeastern industry, textiles, should perform well largely because of the degree of automation that has been added. However, automation also means that textiles will not contribute significantly to employment growth. Moreover, carpet demand could taper off as construction continues to ebb. Weakness in construction nationally will also inhibit growth in the region's important softwood lumber industry.

Construction will be weak here, as it will in other parts of the country. Except for industrial plants, commercial properties tend to be overbuilt just about everywhere. Moreover, the Southeast experienced a break in the pattern of steady population growth that had been an engine of expansion for many years--especially in Florida, Georgia, and parts of Tennessee. This slowdown in new arrivals made 1988 a weak year for residential construction as well. Underlying conditions suggest that this situation will persist in 1989, though some uptick in in-migration and, hence, building may well occur once repercussions of several major layoffs last year are behind us.

One reason for the diminished numbers of new residents has been the resurgence of manufacturing in areas of the country that had lost jobs earlier in the current expansion. Even Florida has felt the pinch as more older workers in other states, finding themselves in greater demand, elect to defer retirement. Fortunately, the lower value of the dollar against foreign currencies will encourage foreigners to visit Florida and other vacation spots in the region and prompt more domestic travel by U.S. residents by making trips abroad costlier. Thus tourism will boost economic growth.

Still, with fewer people coming to the Southeast than earlier in the decade, expansion in the service and trade sectors will probably remain slower than in recent years. Like construction, these businesses are quite population-sensitive. Nonetheless, these two sectors, by virtue of their size, will again be the major sources of new jobs.

Government, too, will probably employ more people. Past population growth has created a need to improve education and expand infrastructure, and these activities are falling largely on the shoulders of the state and local governments.

In summary, the region's growth rate, which had been better than the national average for much of this decade, will probably remain closer to that average in the year ahead. Florida will again lead the region in economic growth. Georgia and Tennessee will have respectable years but not up to the pace established through 1987. What would help Louisiana most in the short term would be an increase in oil prices. (In the long run, of course, the state must diversify.) Higher oil prices may be in the offing with OPEC's recent accord. These agreements seem to be far shakier in the 1980s than in the 1970s, though, and it is difficult to pin strong hopes on the success of this one. Nevertheless, even a modest upturn in energy prices would help Mississippi, too, and would benefit Alabama's producers of steel pipeline. Along with good foreign and domestic demand for steel and paper, better apparel sales could boost industries that are important to these two states, and help to offset expected weakness in their important lumber industries.

The Chief Economic Issues Facing the New Administration

With my outlook for continued growth in the nation and the region as a backdrop, I would like to spend a few minutes talking about what I feel are key economic issues facing the new administration. Let me begin by reemphasizing the position I have taken for the past several years: coming to terms with the federal budget deficit is the nation's number-one priority. The deficit is simply too large, and no discussion of business or economic prospects can take place without reference to it. One concern that has become more pressing of late is that our foreign creditors may grow impatient with our lack of progress. As I mentioned earlier, if this should happen, their demands could push interest rates to levels that would slow our economic growth. President Bush must

set to work immediately to demonstrate good faith in regard to deficit reduction.

A second priority involves addressing problems in the financial system, the keystone of any economy. Among these problems, the need to put an end to the uncontrolled growth of FSLIC liabilities stands out as one demanding decisive action. In addition, Congress adjourned last year without moving on the question of expanding banks' powers. There is a pressing need to rationalize and modernize the ground rules for the financial services industry. This entails in part establishing parameters that keep pace with developments outside the industry and around the world. I feel we are under certain time constraints to get moving on this question. Europeans will open their internal borders in 1992 and make their product regulations much less restrictive than our present rules. If we do not permit American banks to broaden their scope, they will be at a competitive disadvantage in the post-1992 international markets. Elsewhere in the international arena, LDC debt remains an unresolved situation with profound implications for financial institutions. Indeed, the economy as a whole and even international relations may suffer if we are unable to find a solution for the LDC debt that works for all parties involved.

A third issue, one that also carries implications for the deficit, banking, and the stability of the economy as a whole, is the question of leveraged buyouts, or LBOs. A major result of an LBO is the substitution of securities like junk bonds that are classed as debt for securities that are called equity. Since interest on debt securities is an expense deducted from taxable income and dividends on equity are not deductible, an important result of the LBO movement is a loss in federal tax revenues. One estimate puts the annual loss from the RJR Nabisco deal at around $400 million, for example.

Aside from loss of revenues that could be applied to balancing the federal budget,

the wave of LBO activity and the general growth in leverage the LBOs have brought with them may pose certain dangers to economic stability. One of these dangers is greater vulnerability to economic fluctuations on the part of lenders. Banks are major participants in LBOs initially. What is more, thrifts hold about 10 percent of outstanding junk bonds, and producers with receivables from leveraged firms must also be counted among creditors. Although as my outlook indicated, I see no recession in the offing for the next 12 months, that does not mean that the economy is immune from a downturn during the lifetime of the debt accumulated in LBO financing. My concern is that even a slowdown could cause some highly leveraged companies to default, causing significant losses to the financial system and other businesses to which they owe money. Should those companies be driven to bankruptcy, their employees and the communities in which they are located would suffer as well.

Because the competition to buy out RJR Nabisco attracted so much attention to LBOs, there may be pressure from Congress to regulate this type of maneuver in the coming year. Some might call for restrictions to banks' participation in buyouts, since a large proportion of the financing originates from banks. However, it would be difficult to restrict this kind of lending without also hampering other types of financing. How would we effectively distinguish between a bridge loan for an LBO and a loan for expanding plant capacity, for example? Restrictions on U.S. banks could also have the effect of driving capital markets offshore, undermining our competitive position in financial services.

If some sort of reform is desirable, I think the tax laws are the place to start. The present tax structure encourages LBO activity by exempting interest payments from taxes while in effect taxing dividends twice. As you know, profits are taxed to the corporation and individuals receiving dividends are also taxed. Since debt financing has

become virtually interchangeable with equity in the LBO strategy, one approach to lessening the incentive for leveraged buyouts would be to remove the exemption for interest paid on debt instruments. As I see it, however, it would be better to eliminate the double tax on equity income. This is something I have suggested on more than one occasion in the past, and it makes even more sense in light of recent developments. Beyond helping reduce whatever unsettling effects might be posed by LBOs, this kind of tax reform would have a beneficial effect for the economy in general. Essentially, it would "rationalize" investment decisions by removing the large role that tax considerations have come to play and instead fostering flows of savings to their most productive use in an economic sense. More generally, tax revisions to encourage savings and discourage borrowing would also be helpful in regard to several other issues I mentioned earlier--reducing our nation's budget deficit and our reliance on foreigners to finance it.

Conclusion

In conclusion, I think the year ahead will be one in which growth will continue but at a slower, more sustainable pace than in the year just ended and in which unemployment will remain low nationally. In the Southeast, our growth will continue at about the same rate or perhaps a bit better than in 1988. Although it may end up comparing favorably with the national average, it may not be by as wide a margin as in recent years. While I doubt that the U.S. or the Southeast economy will overheat, I want to emphasize my commitment to policies that will resist any tendency for the inflation rate to rise.

Working from the sound economic base I foresee, the new administration has an excellent opportunity to lay the groundwork for a realistic approach to reducing our overly large budget deficit. It would also be a good time to bring the banking industry's regulatory framework up to date and to revise our tax laws in a way that treats equity

and debt neutrally. All these steps hold promise for expanding our nation's productive capacity and competitiveness, thereby raising living standards for us and future generations.