THE INTERNATIONAL ECONOMIC OUTLOOK FOR 1989
Remarks by Robert P. Forrestal, President
Federal Reserve Bank of Atlanta
To the German American Chamber of Commerce
January 19, 1989

Good afternoon! I am pleased and honored to appear before The German American Chamber to discuss the way I see the international economy shaping up in the year ahead. This year marks the seventy-fifth anniversary of the Federal Reserve System, and in that span of time, the Fed has taken ever increasing cognizance of the importance of international developments as we implement monetary and regulatory policies. Working within this biggest of all economic big pictures is to me one of the most stimulating aspects of my job as a central banker.

One international development that will affect the way all of us do business will occur in 1992. At that time, Europeans will take a giant step toward further economic integration when they relax a host of inter-country trade restrictions. Despite the magnitude of this transition, many on this side of the Atlantic are not yet fully aware of its potential impact. Therefore, I would like to spend part of my time this afternoon discussing some of the implications the events of 1992 might hold, particularly for the financial services industry. Before I do that, however, I shall begin with a summary of the national and international economic outlook for the year ahead.

The National Outlook

Economic performance in 1988 was considerably stronger than most people had anticipated, not only in the United States but in the other major industrialized nations as well. I believe underlying economic momentum in this country, that is, factoring out the effects of the drought, was quite strong in 1988--probably just over 4 percent in terms of real GNP growth. Because America's nonfarm economy grew at such a substantial rate, unemployment ended the year at 5.3 percent. The sharp drop in oil prices during 1988 helped offset some inflationary pressures, keeping the rise in the Consumer Price Index to around 4 1/2 percent on average.

In the year ahead, I see the U.S. economy decelerating to a growth rate of 2 1/2 to 3 percent, net of drought effects. As a result of slowing growth, unemployment will probably not fall much below its current rate. While slower growth is welcome, I am concerned that inflation will probably edge up toward 5 percent. The drought's delayed effects on food prices will not be entirely worked through until the next harvest. Also, the prospects now are for higher oil prices. In addition, there are problems of capacity constraints that I will discuss.

Manufacturing will again be among the chief factors adding momentum to the continuing expansion. Exports are likely to bring 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 in mid-1988. The lagged effects of this drop will continue to help make U.S. goods attractive to foreigners. 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. 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.

As I mentioned, inflationary pressures are the most worrisome aspect of the outlook. 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, labor costs 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 productivity enhancements 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.

International Outlook

In general, the outlook for the world's other industrialized nations is similar to that for the United States. They tended to have better-than-anticipated expansion in the year just ended, and they will likely continue to grow in 1989, but at a more moderate pace. Last year unemployment fell slightly among the major free-market economies and should hold at just over 8 percent overall and and just over 10 percent in Europe in the year ahead. Even though those rates seem quite high--especially in Europe--there appear to be a substantial number of Europeans who have become more or less permanent members of state welfare rolls. Thus, the drop in joblessness to current levels, in combination with shrinking amounts of unused capacity in many countries, may be sufficient to add to inflationary pressures. These pressures could be balanced to some extent by general increases in productivity and also by continued low energy prices. Since oil prices are denominated in dollars, many of our major trading partners receive a price break from the differential in exchange rates. Nonetheless, I expect inflation in those countries to accelerate slightly on average in the year ahead.

Turning to highlights in the outlooks for specific countries, I think 1989 will find West Germany dropping back to the vicinity of 2 percent GNP growth after a year of 3 to 3 1/2 percent expansion. A slowing of consumer demand due to higher indirect taxes will probably lead toward this lower growth rate. On the other hand, exports will remain a source of strength. Factories around the world are adding to capacity, and these investments will support markets for Germany's important capital equipment producers. Thus all signs point toward a further increase in that country's substantial trade surplus in the year ahead.

Japan, too, will have another year of huge trade surpluses. Despite increases in imports, exports may grow even more. Part of Japan's export expansion will also come from capital goods exports, much of which will be tied to Japanese direct investment in other countries. Internally, the country is in the midst of a vigorous wave of nonresidential investment, which provides economic stimulus now and paves the way for future competitive strength. The main soft spot in Japan's outlook is consumer spending. Personal consumption should moderate in 1989, in part because of tax reforms to be put in place in the spring. Thus Japan should continue its robust growth, but at a pace closer to 4 percent as opposed to the past year's 5 1/2 percent or more. Rapid growth should be the norm throughout the Pacific Basin, in fact, as the export-oriented newly industrializing countries--Taiwan, South Korea, Singapore, and Hong Kong--gain between 6 and 7 percent in real GNP.

As trade surpluses were growing in Germany and the Pacific, Great Britain spent last year at the other end of the spectrum with a record deficit. Imports were up 14 percent over the previous year due largely to rising values for the pound sterling. Economic growth was quite brisk over the period, however. Boosted by consumer spending, GNP growth was in the 4 to 4 1/2 percent range. At the same time, inflation heated up to around 5 percent last year and could surpass 6 percent in 1989. In an effort to cool off the overheated economy, the Bank of England raised interest rates several times, bringing the base rate to 13 percent. Thus growth in England will probably back off to around 3 percent this year.

In this hemisphere, Canada should grow around 3 percent in 1989. High capacity utilization should mean that business investment will provide a major push to the Canadian economy, and I expect direct tax cuts and more rapid growth in wage income to support private consumption as well. The U.S.-Canadian free trade agreement is likely to boost both imports and exports and provide an additional benefit to the economy over the next few years. Unfortunately, similar good news cannot be reported for Latin America. Most countries to the south are showing signs of stress. Though a firming of oil prices has helped a bit, chronic debt and inflation problems reduce the prospects of improvement. Mexico, which is our biggest trading partner in Latin America, is still adjusting to the opportunities created by its reduction of trade barriers. Over time, though, this shift to a more market-oriented trade policy should boost both exports and imports in that country.

Taking all this into account, the year ahead looks to be a good one for the major industrialized nations and many newly industrialized countries also. There are some potential dangers that emerge from the outlook, however. One consistent theme in looking toward the year ahead is the possibility of growing inflation throughout the industrialized world. Policy makers here and abroad need to keep a wary eye on prices so that the positive benefits of worldwide expansion are not eroded by price increases. A second theme is the persistence of large external imbalances--the continuing surpluses in Germany and Japan as against the deficits of Great Britain and the United States. It does not appear that we will see dramatic progress in reducing these imbalances in the near term, and the potential adverse effects on capital flows is always of concern when trade balances are as misaligned as they are now. Imbalances can also inspire the advocates of protectionism to agitate against free trade. Indeed, I feel protectionist sentiment is very much a danger at present in spite of advances like the U.S.-Canadian free trade agreement. We could see several rounds of escalation in the agricultural dispute between America and Europe, for example. As I have said on many occasions in the past, protectionism can only undo the benefits of higher quality and more competitive prices that all of us stand to gain from the greater integration of the world market.

1992 in Europe

Greater market integration is under way in a very real sense in Europe, and I would like to round out my remarks this afternoon by discussing some of the implications I see arising out of developments there that will coalesce in 1992. After several visits to Europe last year and numerous discussions with financial leaders there, I am convinced that the long-standing dream of a truly common market will be realized in the next decade. An economically united Europe would create a formidable new force in the world's economy. The 12 members of the European Community (EC) together have a population one-third larger than the United States and a combined GNP about equal to ours.

The move toward unifying that large market is underway as the nearly 300 separate trade barriers maintained by individual nations are being dismantled. Simply reducing the additional costs imposed by such barriers will raise the EC's economic growth, cut consumer prices, and create millions of new jobs. Beyond that, easing restrictions on business can allow firms to combine in ways that would increase their strength and efficiency. Already, European companies are moving to achieve world-class size in anticipation of 1992. Pechiney, a French company, became the world's largest packaging company when it acquired Triangle Industries recently. By purchasing Pillsbury, Britain's Grand Metropolitan stands to become one of the world's biggest food and drink businesses. Such giant European companies will become increasingly powerful rivals for American producers in the post-1992 environment.

I am particularly interested in the impact 1992 could have on the American financial services industry. These could take place in at least two major ways. One is that the current size advantage foreign banks enjoy could be amplified, hobbling U.S. banks' efforts to win the business of larger firms. The second is the potential effects European banking practices could have on the U.S. regulatory framework. In terms of asset size, 22 of the world's 50 largest banking institutions at the end of 1987 were housed in EC countries. Only 4 of the top 50 were American-based; 20 were Japanese, by the way. The further deregulation built into plans for 1992 in Europe could lead to the formation of more large banks there, and such a development could have important implications for the competitiveness of American banks.

Commercial entities of the magnitude of Pechiney and Grand Met look for banks that can offer one-stop convenience in meeting their requirements. As international trade grows, this demand requires financial industries to maintain a presence in all the important economic centers and the capacity to handle sizable transactions. Only large banks can meet these demands. U.S. banks are presently underrepresented among the world's top banking institutions in part because of interstate banking restrictions and limitations on the types of businesses in which banks can engage. Specifically, banks cannot expand across state lines in the United States unless they are permitted to purchase an organization in a state that allows such acquisitions. Here in the Southeast, for example, several states have allowed each others' banks to set up regional institutions in this way, but do not allow banks from, say, New York or California to enter their markets. In addition, the Glass-Steagall Act makes it illegal for banks to hold equity positions in commercial firms, something that many European banks are permitted to do. Thus, it is quite possible that American banking regulations will have to be restructured in order to allow U.S. institutions to be competitive in the post-1992 environment.

The manner in which Europeans treat American banks seeking to do business in their market after 1992 may provide a second reason for reevaluating the way we regulate banks here. Many statements regarding the future shape of business in the EC are couched in terms of "reciprocity." That is, American firms' entry into Europe will be conditioned by the treatment European firms receive in America. It is not yet clear how reciprocity might be applied to banking. Were total reciprocity demanded today, though, we would be a long way from matching European standards. Looking ahead to 1992, one possible scenario is that banks in Europe will be allowed to branch across borders. The debate there has centered around whether the home-country rules of the branching bank or those of the host country will govern its actions when it sets up shop in another country. Recently home-country rule has gained in favor. If this arrangement triumphs, it will mean that, in fairly short, order bank regulations within the EC would tend to be standardized around the most liberal framework. Bankers facing competition from banks headquartered in a country with less stringent regulations would naturally pressure their legislators to give them equal powers.

It is possible that negotiations will lead to a less than 100 percent reciprocal arrangement. Europeans might accept a core set of powers as parameters for their activities in this country. Nevertheless, Congress may still have to decide whether our system should be revamped in a way that permits unrestricted nationwide banking and even interstate branching. In addition, if action to alter Glass-Steagall restrictions has not yet been taken, the continued separation of banking and commerce will obviously pose another obstacle to reciprocity.

In my opinion, Europeans would probably do better not to go the route of reciprocity. They could decide instead to do business with any country that provides equal regulatory treatment--whatever those regulations might be--to domestic and foreign institutions alike. In that way, the EC could accept American banks and extend the benefits of greater competition to its own residents even if we persist in clinging to regulations that are largely outmoded. Indeed, I have called for progress on obtaining broader powers for banks and nationwide interstate banking for some time. The potential improvements in service and costs for our own consumers are good enough reasons to take quick action on such banking reforms at the national level. If in addition our banks might be might be kept out of Europe after 1992 because we are unable to stand the test of reciprocity, it is even more difficult to justify delaying our decisions. Now is the time to modernize our banking laws and set the stage for a more competitive international banking market in the 1990s, one in which American banks can be leading players.

Conclusion

In conclusion, we have seen that the year ahead promises continued growth both here and in most important economies abroad. Indeed, the fundamentals look positive for the longer term as we move toward one of the signal events of the twentieth century, the melding of European markets in 1992. The economic unification of the European

Community has the potential to bring greater competition to the global marketplace and to hasten the arrival of a truly international economic order. At this watershed, it is more important than ever that in Europe, the United States, and throughout the world all of us accept the challenge of competition and leave our markets free to do the work of serving consumers with the best products at the most efficient prices.