

THE INTERNATIONAL ECONOMIC OUTLOOK FOR 1989
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Good evening! I am pleased and honored to appear before Miami's Latin Chamber of Commerce to discuss the way I see the international economy evolving in 1989. This year marks the seventy-fifth anniversary of the Federal Reserve System. In that span of time, the Federal Reserve has continually increased the emphasis given international developments as we formulate and 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. This year, of course, a new figure has entered the world's economic picture in the person of our new president. Thus, I would like to devote part of my time this evening to outlining the chief economic priorities that I feel President Bush needs to address. 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. When the effects of the drought are factored out, this country's growth was quite strong in 1988--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 a relatively low 5.3 percent. Fortunately, the sharp drop in oil prices during 1988 helped to offset some inflationary pressures associated with this brisk pace of economic activity. In December, prices were about 4 and a half percent above their level of a year earlier as measured by the Consumer Price Index.

In the year ahead, I see a continuation of expansion in the U.S. economy, but at the somewhat slower pace of a little over 2 1/2 percent. As a result of slowing growth, unemployment will probably decline less dramatically than in the last two years. Inflation, however, may accelerate to over 5 percent. I want to emphasize that I am not at all comfortable with this level of inflation, and I am becoming increasingly concerned that many people are becoming complacent with the current inflation rate. I would remind those who feel we can live with, say, 5 percent inflation that at this rate, prices would double in 13 years. What's more, it is a mistake to believe that inflation can somehow be stabilized in this range. We have never in the past been successful in capping inflation at 5 percent; instead, it has always accelerated beyond that level. In the past few years, measures of inflation have given the appearance of stability, but this can be explained to a large extent by weakness in energy prices. Meanwhile, underlying inflationary tendencies are somewhat higher. For example, in the near term, we are likely to feel pressures from the drought's delayed effects on food prices and perhaps from higher oil prices. In addition, we are running up against problems of capacity constraints that I will discuss in a moment. Therefore, we must treat current inflationary pressures as a serious threat to the economy.

The continuing expansion in 1989 will again be fueled by manufacturing. Exports are likely to bring the trade deficit lower again this year, and manufacturers will turn out more goods to meet foreign demand. Although in recent weeks the dollar has risen above its levels of mid-1988, the Atlanta Fed dollar index shows it has still dropped over 30 percent against the currencies of our major trading partners since the dollar's peak in early 1985. The lagged effects of this drop will continue to help make U.S. goods attractive to foreigners. At the same time, past 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, perhaps leading 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 U.S. economy appears headed for a good performance in 1989, although this year's growth should decelerate somewhat from last year's. I think it is important to remember that there is a considerable difference between a slowing economy and a slow economy. We need to become comfortable with a pace of 2 1/2 percent as a goal and not view it as weak. Instead, it is a rate of growth more in line with an economy that is at or very near full capacity. Thus, the anticipated slowdown should be viewed as a necessary and welcome adjustment. On the other hand, inflation and foreign disenchantment over

financing our borrowing present very real risks to the continued health of the economy.

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 in the year ahead. In Europe the percentage of jobless workers could hover near 10 percent. Even though those rates seem quite high--especially in Europe, a substantial number of Europeans appear to 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 relatively 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 sustain demand 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 probably 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 will pave 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. 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 Canadian economy over the next few years.

Latin American Economic Difficulties

Unfortunately, similar good news cannot be reported for Latin America. Most countries to the south are showing major signs of stress. Though a firming of oil prices has helped some countries a bit, chronic debt and inflation problems reduce the prospects of sustained growth. Of the 17 most highly indebted countries, 11 are located in Latin America. The four biggest debtors--Argentina, Brazil, Mexico, and Venezuela--together owe \$300 billion and are experiencing severe problems. Their total debt service payments as a proportion of export earnings ranges from 28 to over 50 percent. This means that they are fighting an uphill battle to earn enough foreign exchange to repay their creditors while also paying for vital imports.

From the point of view of American banks, the debt picture is brighter now--certainly in comparison to the situation in 1982. The overall exposure of American banks has been reduced by over \$60 billion--roughly 20 percent--since that time. Those with the greatest exposure are stronger in terms of capital and earnings. For their part, a number of debtor nations have proposed positive adjustment programs and continued to service their debts. Brazil, the nation with the largest debt, has instituted the "Summer Plan" aimed at decreasing inflation through a limited price freeze, tightening of monetary policy, and a reduction in government staff, among other austerity moves. That country's recent payment of \$530 million in overdue interest is certainly a hopeful sign. Mexico, too, has put a new economic pact in place to check wage increases and engineer a controlled devaluation of the peso through the first half of 1989. Mexico is our biggest trading partner in Latin America. After many years of pursuing heavily protectionist policies, it has entered the General Agreement on Tariffs and Trade, which

is accepted by most advanced economies. Mexico is still adjusting to the opportunities created by its sharp reduction of trade barriers. This shift to a more market-oriented trade policy should boost both exports and imports in that country.

Still, as with other restructuring measures, benefits will be realized only over the longer run. In the near term, countries taking such steps face the possibility of economic disruptions that could have important political implications. Organized labor in both Brazil and Mexico opposes further austerity, and farmers, shopkeepers, and other lower and middle class people have taken a beating from six years of inflation and economic stagnation. These hard-pressed voters might elect governments less willing to negotiate with creditors. Such a turn of events could undermine the search for the new capital necessary to return these countries to sustained growth.

At the same time that this debt burden undermines the living standards of Latin Americans, producers in the United States continue to suffer the loss of some of their best markets. With so much foreign exchange being soaked up by debt service, there has been little left for Latin Americans to spend on foreign goods. The costs to our own country have been high both in terms of lost jobs and lost opportunities to decrease our trade deficit. A number of solutions to this situation that has many losers and few apparent winners have been proposed. However, the lack of action reveals the very limited margin for give and take among the parties involved. Thus, even though it is in the best interest of debtors and creditors alike to resolve Latin America's debt crisis quickly, I am afraid the region's debt-driven difficulties are likely to remain with us for some time. Despite the complexities of the problem, though, the economic health of our friends in Latin America is vital for the long-term stability of this hemisphere. Therefore, we must spare no effort in working toward an equitable solution.

Taking all of 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 1989 is the possibility of growing inflation throughout the industrialized world. Policymakers 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 greater integration of world markets.

The Chief Economic Issues Facing the New Administration

With my outlook for continued growth in the United States and the other industrialized nations as a backdrop, I would like to spend a few minutes talking about what I feel are the 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. The president's first budget proposal reassures me that he recognizes the pressing need to attack fiscal imbalances. Yet it remains to be seen whether Congress

will have the discipline to follow his guidelines. I certainly hope they will.

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. The new administration moved quickly to display its concern over this issue, and I applaud the plan that has been advanced. In another area, 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 overall economy, is the question of leveraged buyouts, or LBOs. The wave of LBO activity and the general growth in corporate debt the LBOs have brought with them may make banks and other lenders more vulnerable to economic fluctuations. Although as my outlook indicated, I do not see a 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.

The present tax structure encourages LBO activity by exempting interest payments from taxes while in effect taxing dividends twice. As you know, corporations are taxed for profits and individuals receiving dividends are also taxed. I would like to see Congress eliminate this double tax on equity income. By removing the large role that tax considerations have come to play in investment decisions, Congress could help "rationalize" those decisions. 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 promises continued growth both here and in most of the advanced economies abroad. 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. Equally important, by working to resolve our own problems we can promote better balance in the evolving global economy. If we do so, we shall help raise living standards for this and future generations throughout the world.