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THE NATIONAL ECONOMIC OUTLOOK FOR 1989
Remarks by Robert P. Forrestal, President
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Good afternoon! I am pleased and honored at the opportunity to participate in Berry College's annual Business Outlook Conference. My task is to discuss the way I see the national economy evolving in 1989. Since most of you are actively involved in business or preparing yourselves for a business career, I am sure you are aware of how quickly and extensively the economies of the world are converging into a single global market. More and more, developments in places as far away as Taiwan and Brazil make their influence felt not only in money centers like New York, but also here in the northwest corner of our state. For that reason, I will sketch both the big picture of the U.S. economy and the bigger picture of the global economy for you. This year, of course, a new figure has entered the picture in the person of our new president. Thus, I would like to devote part of my time this afternoon to outlining the chief economic priorities that I feel President Bush needs to address.

The National Outlook

The past year was one that held surprises for just about all of us who venture economic outlooks. Most forecasts, like mine, undershot GNP both here and in the major economies abroad. When the effects of the drought are factored out, growth in the U.S. economy was quite strong in 1988--just over 4 percent. Because the nonfarm economy grew at such a substantial rate, unemployment fell to a relatively low 5.3 percent by year's end. The sharp drop in oil prices during 1988 helped to offset some inflationary pressures, and held price rises as measured by the Consumer Price Index to about four and a half percent from December of 1987 to December of last year.

What accounted for this strong showing? The dollar's decline boosted our manufacturing sector by providing an impetus from exports. 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, consumption remained fairly resilient and added to the stimulus provided by manufacturing despite the substantial loss of wealth that occurred as a result of the market break in October 1987. 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 a continuation of expansion in the U.S. economy, but at a somewhat slower pace. On a year-over-year basis, reported GNP growth will probably be just over 3 percent. Leaving drought effects aside, our growth should be a little over 2 1/2 percent. By either measure, the rate of expansion should decelerate, and as a result, 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 some people are becoming complacent with the present 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 inflation

pressures as a serious threat to the economy.

Sources of Economic Strength and Weakness

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 we have still experienced a drop of 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.

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. The low relative value of the dollar and the rebuilding of domestic stockpiles should buoy up exports of farm commodities and help agriculture to a relatively good year.

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.

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 new workers 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 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 regard 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, 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.

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, particularly of capital machinery, will remain a source of strength. 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. 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 about 3 percent in 1989. High capacity utilization is likely to 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 economy over the next few years. 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 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 of this into account, the year ahead looks to be a good one for the major

industrialized nations and many newly industrialized countries also. Some potential dangers emerge from the outlook, however. One consistent theme in looking toward the year ahead 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. A major result of an LBO is the substitution of securities like junk bonds, which 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. Producers with receivables from leveraged firms must also be counted among creditors. 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. 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, restricting this kind of lending would be difficult 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, corporations are taxed for profits, 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. 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.