

**THE NATIONAL AND REGIONAL ECONOMIC OUTLOOK FOR 1989**  
**Remarks by Robert P. Forrestal, President**  
**Federal Reserve Bank of Atlanta**  
**To the First National in Palm Beach**  
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Good afternoon! I am pleased and honored at your invitation to return to West Palm Beach and follow up on the economic outlook I gave you last year. Tom Walker tells me that many of you took notes on my comments the last time around. That being the case, it behooves me to review briefly the way the economy actually performed in 1988. After that, I will discuss the outlook for the nation's economy during the rest of this year and say a few words about the prospects for growth in the Southeast. Since we have just begun a new administration, I think it is appropriate to conclude by 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 just under 4 1/2 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, in turn propelling industrial output and employment even more. Also,

despite the substantial loss of wealth that occurred as a result of the market break in October 1987, 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 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 about 2 1/2 percent. By either measure, the rate of expansion is likely to decelerate this year. Although I will point out several good reasons to expect such a deceleration, there may be also be an element of wisful thinking in this part of my outlook because I believe that it needs to happen. I think a 2 1/2 percent growth rate is appropriate at this point in the current expansion and would serve the best interests of the economy as a whole. As a result of somewhat slower growth, unemployment will probably decline less dramatically than in the last two years. Inflation, however, may accelerate to over 5 percent. Three months of this year have already passed, and oil prices have trended upward for some time. Thus there is no viable course of action that the Fed could take in the remaining months of 1989 to bring the inflation rate below 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 last few years, measures of inflation have given the appearance of being quite moderate, but this can be explained to a large extent by

weakness in energy prices. Meanwhile, underlying inflationary tendencies have actually been somewhat higher. 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 our nation's economic well-being.

### **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 against the currencies of our major trading partners, the Atlanta Fed dollar index shows we are still over 30 percent below 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 dampen 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 are likely to buoy 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. Except for the farm sector, 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 were to continue at last year's pace while the number of new workers declines, labor costs would 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.

### **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 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. In 1988 the winding down of defense contracts was a negative factor for aircraft and electronics plants in the region, and this 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 probably 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 now that the 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 is encouraging foreigners to visit Florida and other vacation spots in the region. The dollar's value is also prompting more domestic travel by U.S. residents by making trips abroad costlier. Thus tourism promises to 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.

Turning to Florida's economy, agriculture and port activity in particular are likely to be sources of strength in 1989. An anticipated 9 to 10 percent increase in the citrus crop and higher prices for cattle and calves should bolster farming income. Rapid growth in export trade through Florida's ports will also stimulate business activity. Both Miami and Tampa experienced unusually strong export growth during the past year, in part because of an improvement in trade with Latin America. Although, as I mentioned a moment ago, population growth slowed here in 1988, Florida remains the leading growth state within the Southeast. That continuing albeit slower influx of migrants should begin to revive residential construction soon. Thus the outlook for Florida is quite promising.

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 latest 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 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.

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 in the nation and the Southeast. 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. By working to resolve these

**problems, we can help raise living standards for this and future generations.**