THE INTERNATIONAL ECONOMIC OUTLOOK FOR 1989
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To The American-European Small Business Trade Congress
June 7, 1989

Good afternoon! I am pleased and honored to participate in this symposium focusing attention on international trade opportunities for small businesses. No one is more convinced than I am of the important role small- and medium-sized U.S. businesses have to play in correcting our nation's trade imbalance and maintaining our competitive edge in world trade. I am sure you will have heard numerous times before the end of this gathering that we are part of a globalizing economy. This entails unprecedented challenges, but the growth of a unified worldwide market also offers entrepreneurs like yourselves opportunities until now enjoyed mostly by large multinational corporations.

Too often occurrences in the international arena take us by surprise. Having had little time to prepare, we have no choice but to react as best we can. The economic integration of the European Community (EC) scheduled for 1992, though, is a case where we have ample advance notice of impending change. Businesses in this country would do well to take advantage of this lead time to formulate their strategies. For that reason, I would like to spend part of my time this afternoon discussing some of the implications the events of 1992 might hold for smaller U.S. firms. Before I do that, however, I shall begin with a summary of the national and international economic outlook for the year ahead since understanding the current business environment is critical in planning for tomorrow.

The National Outlook

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. Factoring out last year's drought effects, our growth should be a little over 2 1/2 percent. By either measure, the rate of expansion seems likely to slow. As a result, unemployment will probably decline less dramatically than in the last two years. Inflation, however, may accelerate to over 5 percent on average for 1989, especially in light of the price pressures we've already experienced.

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 14 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 appeared moderate, but this can be explained to a large extent by weakness in energy prices. Meanwhile, underlying inflationary tendencies have actually been 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 our nation's economic well-being.

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, t~~he Atlanta Fed dollar index shows~~ it is still ~~we still are~~ about 30 percent below the ~~dollar's~~ peak of ~~in~~ early 1985 vis-a-vis the currencies of our major trading partners. U.S. goods should remain attractive to foreigners in terms of their prices, expecially since currency realignments affect trade flows with a considerable lag. At the same time, past dollar declines will no doubt translate into higher prices for imports. Thus, consumers here can be expected to continue shifting 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 reasonable rate. Business investment in capital goods and plants should also post respectable gains as factories are expanded and equipment is upgraded to accommodate increased industrial production.

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. The housing cycle remains in a downturn and is not necessarily at its lowest point. Demographic trends, especially the passage of the baby-boom generation from its period of peak household formation, also contribute to a soft housing market. Government spending, too, 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.

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 presents 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 current levels of joblessness, 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 1/2 percent GNP growth after a year of nearly 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 due to recent tax reforms. Thus Japan should continue its robust growth, but at a pace closer to 4 percent as opposed to the past year's 5.7 percent. Rapid growth should be the norm throughout the Pacific Basin, in fact, as the export-oriented newly industrialized 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 high domestic demand in the face of capacity constraints and rising values for the pound sterling. Economic growth was quite brisk over the period, however. Boosted by consumer spending, GNP growth was close to 4 1/2 percent. At the same time, inflation heated up to around 6 percent, and it could surpass this level 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 in contrast to 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 here in spite of advances like the U.S.-Canadian free trade agreement. As the Omnibus Trade Act that became law last year begins to be implemented, there will undoubtedly be attempts by particular industires to use its provisions in a protectionist manner. The effect of this would be to close off our markets to foreign competition instead of opening foreign markets to our exports.

1992 in Europe

Although I believe a positive environment for U.S. investment and business is emerging in the EC as 1992 nears, protectionism is a threat in Europe as it is here. I would like to round out my remarks this afternoon by discussing some of the opportunities and obstacles implied by the "1992" movement there. After numerous discussions with European financial and political leaders, 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 EC together have a population one-third larger than the United States and a combined GNP about equal to ours.

Already important steps have been taken in Europe as some of the nearly 300 trade barriers maintained by individual nations are being dismantled. A private sector response is under way in the form of increased merger and acquisition activity among European firms in anticipation of new market conditions. The clearest advantage for U.S. businesses in all this is the possibility of one large market for goods and services in place of today's 12 smaller markets, each with its own peculiarities.

Given our marketing expertise, the unification of Europe's fragmented national markets should work to the advantage of U.S. firms. After all, we have more experience than anyone else in selling to a large, unified market--our own. Our industries are geared toward long manufacturing runs that supply products to national retail chains. These companies lend their reputations to the products they buy and also handle national distribution and advertising. This is one factor that has eased foreign firms' penetration of our market in recent years. Here they have to make just one sale of any product--to the purchasers at a major chain--and their volume is assured.

By creating a large-scale distribution network similar to ours, the upsizing of the EC market could relieve one of the problems we have had in selling to Europe. Traditionally, we have not done as well in products for specialized markets as for mass-marketed items. Thus, European firms have built their comparative advantage in speciality items like Leicas and Rolexes while we have sold the world Kodaks and Timexes. There should be room for both types of products in the future EC just as there are in this country, and that would work to our economic advantage.

To realize these potential advantages our industries, particularly our small- to medium-sized firms, will have to direct some of their resources toward preparing for 1992 in Europe. For much of the post-World War II period, we have had the luxury of being able to live quite well by servicing the consumers in our domestic market. If U.S. companies hope to keep pace in the next decade, however, they should be gearing up to exploit the marketing advantages they hold when the EC opens its markets. Even though our smaller firms have had experience in dealing with an integrated market that few of their foreign competitors possess, they have a long way to go in catching up to the strong export orientation of their counterparts abroad. One thing we can learn from foreign firms is the importance of adopting long-term strategies--something our focus on today's bottom line seems to have diminished in this country. Thinking long-term may require making the investment of sending some of your own sales personnel, who know your products better than foreign distributors do, to represent you in Europe, for example. It certainly means acquiring enough linguistic expertise and cultural knowledge to allow you to spot changes in consumer preference that could affect your performance overseas.

The chief obstacle I see in the changes surrounding 1992 is protectionist pressures that will continue to arise, as in the past, from vested interests in EC countries. The impetus for pulling Europe together came partially from a perception that Europe was being left behind in the growth of economic expansion by the United States and Japan. European leaders reasoned that lowering trade barriers within Europe would eliminate a major drag on growth. They also anticipated economies of scale and scope that could come from a consolidation of small, national industries. Their vision is a good theoretical rebuttal to the shortcomings of protectionist policies among nations, and I hope they will extend it to their non-European trading partners as well.

However, many observers outside Europe fear that Europeans could try to legislate competitors like ourselves and the Japanese out of some of their internal markets to shore up industries they deem vital. The lobbyists for certain traditionally important enterprises may influence their parliaments to press for individual exemptions of their industries when barriers are lowered. Thus, there are numerous pressures within Europe that could lead toward the expression of a "Fortress Europe" mentality.

It would be far better if Europe and the rest of us continued to subscribe to the gradual, but successful, reduction of barriers that has been brought about by multilateral negotiations through GATT since the end of World War II. After all, the last world war was brought on in no small measure by the escalation of protectionism in the 1930s. Part of the reason for the formation of the European Economic Community was the hope that future competition could be confined to the marketplace and kept off the battlefield. It would, therefore, be a bitter irony if this idealistic notion were to reverse itself just when the union of Europe reached fruition, and the EC became a force for world divisiveness rather than cooperation.

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.