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THE INTERNATIONAL ECONOMIC OUTLOOK FOR 1989
Remarks by Robert P. Forrestal, President
Federal Reserve Bank of Atlanta
To The Program in International Banking and Finance
Georgia State University
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Good afternoon! I am pleased and honored to have been asked to participate in the Program in International Banking and Finance once again. I think it is vital for students of any aspect of business today to be tuning into international developments, and you have certainly chosen an exciting way to go about it. Your field trips will take you to Europe's great financial centers and give you first-hand exposure to the ways in which the financial services industry is becoming global in scope. In particular, Europe is the setting for one of the most important transformations in the overall globalization of markets. The nations of the European Community (EC) are working toward greater economic integration among themselves and have targeted 1992 as the year in which many changes in business procedures will go into effect. I would like to talk about a few implications of 1992 for the American financial services industry this afternoon. Before I do that, however, I shall begin with a summary of the national and international economic outlook for the remainder of the year to provide some context for your study of international banking and finance today and as we move toward 1992.

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 decelerate. 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.

While I welcome this deceleration in overall business activities, 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, it is still about 30 percent below the peak of 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, especially 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 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 14 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

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 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 scan allow firms to combine in ways that would increase their strength and 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. Look ahead to 1992, one possible scenario is that banks in Europe will be allowed to branch across borders. The debate there has revolved 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 something less than full reciprocity. 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 our ability to reciprocate.

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 broker powers for banks and nationwide interstate banking for some time. The potential improvements in service and costs for our own customers are good enough reasons to take quick action on such banking reforms at the national level. If in addition our banks 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 than 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.