

**THE ECONOMIC OUTLOOK FOR THE FINANCIAL SERVICES INDUSTRY IN THE 1990s**  
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**To the Southern Business Administration Association**  
**November 8, 1989**

Good morning! I am pleased and honored to be a part of this thirty-seventh annual meeting of the Southern Business Administration Association. I have been asked to share my views on economic trends that might affect the financial services industry in the 1990s. Of course, anyone projecting an economic outlook ten years into the future must do so with some trepidation. It is difficult enough to foresee what might happen in the last two months of this year, let alone in the next decade.

In the absence of any unexpected shocks, however, I believe several major dynamics are likely to shape our economy in the 1990s. Three forces stand out: the globalization of world markets for goods and services, U.S. federal budget deficit pressures, and major demographic shifts. I would like to sketch the broad outlines of these themes for you this morning. I shall then summarize how they might in concert influence U.S. economic performance and conclude with a few remarks on ways in which the financial services industry in particular might be affected.

### **The Globalizing Marketplace**

Very simply, globalization entails the increased linkage of individual national markets into a more intertwined worldwide network. Such a network permits freer exchanges of capital and labor resources as well as goods and services. Globalization is occurring largely because of the success of post-World War II policies to encourage freer trade, but it is also being hastened by broader applications of technology. Computers and satellite linkages make it possible to compare prices for products or locate sources of funds anywhere in the world and then to consummate a deal by phone or fax. This

shrinking of physical distances has made national boundaries less and less important as far as business is concerned. Moreover, as Federal Reserve Chairman Alan Greenspan has pointed out, technology has also made many products, like radios and computing devices, much smaller. The use of high-tech components and new materials reduces the physical dimensions and weight of many manufactured goods. This makes shipping easier and further contributes to the growth of international trade.

As we look ahead, globalization is taking giant steps forward in Europe. Members of the European Community will lower many barriers to international trade in 1992. This will create a new, unified market boasting a greater number of consumers than the United States. Communist countries may also show greater interest in engaging in trade with the rest of the world. The Soviet Union, its satellites, and--despite its recent setback--China, appear to be drawing closer toward market structures at home and abroad. Their increased international participation promises to expand sources for labor and outlets for goods. These economic prospects should also serve to moderate the military threats that for several decades have dominated our thinking in foreign relations.

I feel that by making a broader range of products available at competitive prices, globalization promises to raise living standards around the world. There are, unfortunately, several obstacles in the path of globalization. Protectionism is still a threat to greater merging of markets, particularly as trade imbalances persist in this country. We need to understand that attempting to assist uncompetitive industries through artificial trade restrictions gives them no incentive to improve. Protecting such industries also lowers our living standards by depriving consumers of lower priced imports or the full range of products available abroad. It also pushes our trading partners toward retaliating with protectionist barriers of their own--something that happened in the

1930s and helped push the world toward war.

The correct approach is not to protect our industries but to bolster their competitiveness. American businesses, particularly small- and medium-sized firms, are somewhat behind their foreign counterparts in their ability to market abroad. In addition, the global marketplace will require of us a better trained, more flexible workforce that can adapt to changing market conditions. Information-based businesses are replacing hands-on manufacturing here, and many of the low-wage, low-skill jobs Americans used to do are being exported. We will need to commit the resources necessary to provide rising generations of workers and those already on the job the skills relevant to the new world economy.

There is also the nagging problem of less developed countries (LDCs) that are being excluded from the global market due in large measure to their heavy debt burdens. These countries have the farthest to go in providing better lives for their people, and the gains the rest of us make from broader world trade will be hollow ones as long as they are left out. The efforts to relieve LDC debt currently being conducted by this country and others are moving us slowly in the right direction, but we must continue to make this issue a top priority if we are to achieve a truly global market.

### **Deficit Considerations**

The second long-term economic trend I would like to consider is the impact of our continuing federal budget deficit. Since 1982 we have run federal budget deficits twice to four times as large in dollar terms as those incurred at the height of the second World War. Of course, such deficits are a smaller percentage of GNP now than in 1944, but they are, even in relative terms, much bigger than in any of the 35 years between 1946 and 1981. Today's budget deficits are also troubling for several other reasons. For one

thing, the funds they represent have largely gone to consumption rather than investment that would increase the nation's future productive capacity and enhance our global competitiveness. What's more, the daunting size of our current obligations will inhibit our ability to undertake new investments in public programs for some time to come. Finally, unlike most of our recent experience with public debt, we owe a large portion of today's debt to foreigners.

Our need to service this debt guarantees that in the next decade, we will continue to experience budget shortfalls--especially when the Social Security surplus, which is added to the budget through some "creative accounting," is discounted. Deficit spending has led us to borrow at such a rate that net interest grew from 9 to 14 percent of outlays between 1980 and 1988. If we could deduct interest payments from the budget, we would be roughly in balance at present. Obviously we cannot do this. What's more, much of our spending requirements are locked into place. Entitlement programs account for about half of the budget, and discretionary programs have already been pared to minimal levels. Spending for education, for example, was only a small fraction higher in 1988 than in 1980.

In spite of these constraints, however, we are sure to experience greater demands for social investments to enhance our quality of life in years to come--environmental and medical concerns come immediately to mind. Public opinion polls show that the environment ranks at or near the top of voter concern in this country. In addition, it seems certain that our medical costs will grow. The aging of the population is just one force straining our medical system and pushing up costs. Price pressures in health care continue to outstrip other components of the consumer price index even though consumers are now bearing more of the direct costs in higher insurance policy deductibles, copayments, and the like.

In addition, we have had to go increasingly to foreign sources for funds. During the past decade, the United States has had an historically low savings rate, and on our own we have been unable to meet our investment and financing needs, including those of the federal government. Thus we have had to rely on foreigners with higher savings rates to finance our spending. In order to repay this foreign portion of our debt, we will have to export more of our products, and this means that living standards may not increase as rapidly here as in the past. For this reason, we owe it to our children and grandchildren to take steps to bring the deficit under control.

### **Demographic Changes**

A third continuing development, demographic changes, will have a considerable impact on our efforts to deal with the budget deficit and other aspects of our economy in the next decade. There are three major demographic strata to consider: the growing ranks of senior citizens; the maturing baby-boom generation; and the "baby bust" generation that follows. Among these three groups, the numbers of senior citizens are expanding most rapidly. The continued growth of this segment of society has several implications. For one thing, it guarantees that entitlements will continue to contribute to fiscal budget deficits. Military and government pensions will have to be paid out to increasing numbers of recipients for longer periods. The Social Security fund is capable of handling these greater demands at present, but over the longer run may experience difficulties. Social Security is now in surplus because of the contributions of the large baby boom generation. The fund is likely to be drawn down as baby boomers retire in the second decade of the next century, though. As demand increases and techniques become more sophisticated, health care costs, particularly those related to long-term nursing home care, will probably continue to be affected.

The baby boomers, the large cohort born between the mid-1940s and the early

1960s, are passing from their years of household formation into their peak productive years. They will probably begin saving more for their retirement. I look for their added savings to lead to an increase in the saving rate. This in turn will improve Americans' ability to finance our own investment and government financing needs. It should also allow greater investment in productivity-enhancing projects, which in combination with the cohort's maturing job skills should improve U.S. competitiveness.

Following the baby boom, however, is the smaller cohort called by some the baby bust. Over the longer term, there could be economic shortfalls associated with their life cycles. Already businesses are feeling the pinch in attempting to find workers for the entry-level positions this age group traditionally filled, especially in the service sector. This change could create wage pressures throughout American industry. In addition, further down the road, it will be more difficult for a smaller number of active workers to support the larger baby-boom generation through its retirement. We may well need to liberalize our immigration policies over the next ten years to open new sources of labor for American industries.

#### **Potential Economic Performance in the 1990s**

Having described these three major dynamics--globalization, fiscal deficits, and demographic changes--let me summarize how they might together affect economic performance in the 1990s. I feel all the signs point to respectable growth in the U.S. economy but also to the continuing threat of inflation in the coming decade.

In my view, the United States is generally well positioned to benefit from the movement toward greater integration in world markets. Two great and undiminished strengths that we still bring to the international market are the creativity that drives our research and development and our marketing expertise. In spite of the concern many

feel in regard to our trade deficit, I don't think we have lost the creativity that led to inventions like the personal computer and the VCR, for example. Nor do I think that foreign managers are outstripping our own in methods for getting production out. What's more, we have a good deal of experience in selling to a large, integrated market--our own. Thus as Europeans unify their markets in the 1990s, U.S. businesses should have an edge in marketing products and selling marketing skills as well.

In addition, a significant number of U.S. businesses have been undergoing structural changes that may leave them more competitive over time. I refer to the wave of leveraged buyouts (LBOs) that has transformed some of our large publicly held corporations into private firms. While some LBOs, especially those driven primarily by tax considerations, raise legitimate concerns over the extent of corporate America's debt burden, the better constructed deals have already led to the streamlining of organizations that had accumulated unnecessary layers of fat. Such buyouts also have the effect of bringing ownership and management together. In this way, LBOs are making U.S. corporations more like their competitors in foreign countries like Japan, where ownership tends to be shared by company management and financial institutions. In our case, the LBO replaces equity with debt that must be serviced in a disciplined way. This forces management to weigh each decision carefully and gives them the right incentives to be efficient and maximize the value of the firm. Thus I feel that market forces in the 1980s have been pushing U.S. industry toward adopting forms that could prove more effective in the global market of the future.

My optimism does not blind me to weaknesses that could ultimately undermine economic growth in the years ahead, however. For one thing, we must address our clear shortfall in the basics of education. How can we expect to compete successfully in a global marketplace when students in our schools cannot find our major foreign

competitors on a globe, let alone demonstrate necessary skills in math and communication? We are also lagging badly in making needed investments in our roads, bridges, and harbors--the infrastructure that moves our goods to market.

Our chief weakness, however, is the federal budget deficits that prevent us from taking progressive action on education, infrastructure, and other programs we will need to pursue in the 1990s. As long as we continue to run our federal government on excessive red ink, we can be assured that meeting accumulating interest payments will take precedence over investments in the nation's productivity. Moreover, these deficits ultimately weaken our external trade position. A soaring dollar in the middle years of this decade, reflecting expectations that U.S. interest rates would need to remain relatively high, helped cause our ballooning merchandise trade deficits. These trade woes brought on the demise of numerous U.S. businesses. Although manufacturing and exports have revived with the dollar's decline since 1985, this experience has left us with nagging concerns about our longer-run competitiveness. It is unlikely that we would see ourselves in such a negative light, however, were it not for the economic drag of those twin deficits.

Fiscal imbalances are also one reason that I believe inflationary pressures will continue through much of the 1990s. Even though deficits are on a gradual downward slope--largely due to the temporary surplus in Social Security funds--shortfalls appear certain to persist into the foreseeable future. In the absence of higher savings or continued strong foreign investment, we will find our investment and financing needs difficult to meet, and this would tend to constrain growth in productive capacity. Such capacity constraints, in combination with labor shortages expected with the baby bust can impart an inflationary bias to the economy. Action to resist such pressures, let alone reduce inflation from current levels, may end up keeping economic growth slower than

we would like for an extended period.

### **Implications for the Financial Services Industry**

This outlook and the three themes that underlie it--globalization, federal budget deficits, and demographics--hold numerous implications for the U.S. financial services industry. I would like to draw my presentation to a close by discussing a few of the more prominent of these possibilities.

The budget deficit's potential effects on financial services is a hard one to call. Fiscal deficits have been responsible for some of the sharp fluctuations in foreign exchange markets, and thus international markets for goods and services, in the past decade. In addition, uncertainty about inflation and future interest rates, inspired to some extent by expectations of ongoing shortfalls in government revenues relative to expenditures, will continue to complicate lending and investment decisions until the deficit is brought under control. Of course, this may create a demand for additional financial services to analyze and hedge risks generated by this uncertainty. Perhaps more importantly, though, public monies for services like housing are likely to be further squeezed by budgetary considerations, even though demand for these services may well be greater in coming years. Through vehicles like the Community Reinvestment Act, which has already brought greater scrutiny of the lending commitments of banks and S&Ls, pressures on these institutions to step into the gap with programs to assist lower income consumers could increase. Thus, the federal budget deficit threatens to remain an encumbrance for the financial services industry along with the rest of our economy.

Demographic shifts, too, probably hold opportunities as well as drawbacks for the financial services industry. As baby boomers divert more of their incomes from consumption to savings for their retirement years, they expand the pool of funds

available for investment and financing and thus make the work of bankers and other financial intermediaries a little easier. In terms of financial products, oncoming generations are ever more computer-literate and less inclined to distrust electronic banking techniques than their elders. Through their influence, we may achieve the long-sought objective of diminishing our dependence on paper payment mechanisms and all the attendant costs in the next decade. Some of the traditional mainstays on the asset side of the ledger are likely to be negatively affected, however. With fewer family formations expected among the baby-bust group than among the baby boomers, the residential housing market would not appear to have the potential for further vigorous growth of the kind that it enjoyed through much of the postwar period, for example. And as with other services, financial institutions may experience shortages among entry-level workers which could raise costs.

The likely role of globalization in the future of the financial services industry is somewhat clearer from our present vantage since the industry has already been a major force driving the greater integration of international markets. I expect this involvement to intensify in coming years with developments like Europe 1992. I see the ability to innovate in response to changing market conditions as a source of strength for U.S. providers of financial services--as it is for U.S. industry in general--in the global market. The proliferation in recent years of sophisticated new products like swaps, caps, and collars are examples of the kind of innovation to which I refer. Such instruments are designed to exploit term and interest-rate differentials not only for speculative purposes but also to help businesses hedge risk. It also seems reasonable to assume that the trend toward more of the kinds of securitization pioneered in the U.S. market will continue. In an environment in which the speed, size, and number of financial transactions seem destined to multiply significantly, the opportunities for evolving new investment and risk-management instruments of this nature are almost certain to increase. Thus we are

entering the 1990s with a lead in the development and execution of financial market innovation, and I see no reason why our expertise should not remain in great demand.

At the same time, we can also expect increased competition from foreign providers in the 1990s. I am sure everyone here is aware of the size disparities between U.S. and foreign banks--especially Japanese institutions. At the end of 1987, only one of the top 25 banks in the world in terms of assets was located in the United States. Of course, shifts in exchange rates have a good deal to do with measures of relative size, and our standing among the biggest banks has fallen along with the relative value of the dollar since 1985. Nevertheless, U.S. banks, which labor under numerous outmoded product and geographic restrictions, are prevented from growing in some of the ways in which their overseas competitors can. Globalization also implies the continued growth of large multinational firms, and these corporations probably have a tendency to seek banks big enough to provide "one-stop shopping" services for their full range of international needs. Thus if size is important in the global market of the future, the regulatory structure here will remain a stumbling block to growth if changes are not made.

It is true that one regulatory change is already in place that should work in favor of the U.S. financial services industry, however. I am referring to the adoption of risk-based capital standards that will be completed in 1992. Our institutions tend to be closer to meeting those standards at present than many of their competitors abroad. Nonetheless, we still need to work toward a more level playing field for our institutions, and I hope that Congress will move toward nationwide interstate banking and repeal of the Glass-Steagall Act as early in the next decade as possible.

### **Conclusion**

In conclusion, it is my opinion that the globalization of markets, continuing fiscal

deficits, and demographic shifts will combine to influence the economic environment in which the financial services industry will operate in the 1990s. I believe U.S. industry can succeed in that environment as long as we keep our sights on our long-run comparative advantages. We still have the resilience and creativity that brought a dazzling array of products to consumers around the world. And financial innovations like leveraged buyouts--another American invention--are perhaps helping U.S. industry evolve an ownership structure that should serve us well in the global market. Thus it seems bankers and other providers of financial services should look toward the 1990s, as I do, with cautious optimism. Moreover, as a nation we still have the option of minimizing the constraints on our future economic prospects by acting on some very clear priorities. We must bring the fiscal process into balance, and we must complete the work of deregulating the financial services industry. A third imperative for the 1990s is to resist the temptation to protect uncompetitive industries from outside competition. Let us instead reaffirm our commitment to defending free markets--the most essential condition for economic growth in the 1990s and beyond.