

THE INTERNATIONAL ECONOMIC OUTLOOK
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Good evening! I am pleased and honored to have the opportunity of speaking again to the German American Chamber. The year since I last discussed my outlook for the international economy with you has been an exciting one. For Germany and, indeed, for the entire world 1989 marked a watershed in history. We watched as communist nations suddenly turned on the repressive regimes imposed on them over 40 years ago. There was no more dramatic symbol of that movement than the dismantling of the Berlin Wall. Both in concrete and symbolic terms, this image signified the end of the Cold War and, I hope, the beginning of an era in which our minds will cease to be dominated by the vocabulary of the Cold War. Instead, I believe we will increasingly turn to new ways of fostering global commerce and cooperation.

Still, some major obstacles remain to be resolved before that shift in thinking and actions can be achieved. I would, therefore, like to spend a few minutes this afternoon looking at the economic implications of developments in Eastern Europe and the rest of the communist—or perhaps I should say former communist—bloc. First, however, let me give you my outlook for the international economy, beginning with the United States.

Outlook for the United States

I believe that growth in this country will slow in 1990. Real gross national product should decelerate to 2 or 2 1/2 percent for the year. Even though we could see a quarter or two of very subdued business activity after a rebound from the Boeing strike, I see few signs that suggest the current expansion will end in the near term. Indeed, the rate I am projecting is close to our nation's average over the last four decades, that is, pretty close to our long-range potential. With slower growth than in 1989, though, the jobless rate

could edge up slightly to 5 1/2 percent. At the same time, slower growth should also ease price pressures, holding inflation to around 4 1/2 percent after a spurt early in the year.

Unlike recent years, when consumption or export-driven manufacturing has been a clear leader in propelling the expansion, I do not expect one particular sector to set the pace in 1990. Indeed, the kind of growth I anticipate should be largely the result of momentum from past expansion that is rather evenly distributed among personal consumption, capital spending by businesses, and real net exports. I also look for a good year in agriculture in most of the country, assuming the weather cooperates.

On the other hand, auto sales and residential construction are weaknesses I see in next year's economic picture. People have bought a lot of new cars and houses in the last few years, and pent-up demand may have been met for the time being. Government spending is slowing as well--though not quickly enough to suit me. Still, fiscal stimulus will probably diminish.

Aside from these soft spots, the chief dark cloud on an otherwise bright horizon is still inflation. In addition to temporary weather-induced pressures, we will continue to experience growing labor shortages due to demographic shifts. These fundamentals suggest that no letup in price pressures is likely in the early years of the 1990s unless we are willing to tolerate slow growth for a sustained period. Thus while the nation enjoys respectable growth 1990, we need to keep a watchful eye on inflation.

International Outlook

The general outlines of my projections for the U.S. economy apply as well to the world's major industrialized countries: somewhat slower growth, slightly less inflation, and unemployment approximately in the present range. Economic growth among these countries should back off about half a percentage point overall to the vicinity of 3

percent on average for the year. Prospects for inflation are mixed, but the margin of price increases could be a bit smaller on average. Unemployment will probably remain relatively high in Europe, though just below the double digit rates of the mid-1980s, and low in Japan—probably just over 2 percent.

Turning to the outlook for individual countries, Germany performed considerably better in 1989 than many predicted, probably growing nearly 4 percent. In 1990, expansion should slow to 3 or 3 1/2 percent while inflation accelerates to a little above 2 1/2 percent. As a result of the opening of East Europe, Germany will probably continue to receive an influx of new residents. This new wave of immigration is estimated to have added nearly one percent to Germany's population in 1989. The new arrivals should have a high propensity to consume and add to demand for goods and services. In addition, many of them are young, skilled technical workers who will provide a good complement to demographic trends in West Germany, where population growth has been quite slow and probably will decline further over the next two decades. Thus, Germany should be able to absorb immigrants readily without suffering higher unemployment.

I also look for another record trade surplus in West Germany this year. Through most of 1989 the deutsche mark remained relatively weak. The mark has strengthened somewhat over the past several months, but any effect of this exchange-rate shift on the direction of trade would not be felt for some time. Moreover, one reason for the mark's recent gains has been the expectation that Germany's export markets stand to improve from developments in East Europe. These potential new markets for German products—especially the capital goods needed by fledgling industries—could boost Germany's trade sector for many years to come.

Japan, too, will almost certainly post a record trade surplus in 1990. Recent talks between the United States and Japan could help ease this growing imbalance in world trade in the future. However, these discussions have also highlighted structural features

in both economies that encourage deficits here and surpluses there. Japan has a rigid distribution system with many redundant levels. That country also allows strategic alliances among corporations that would be viewed as collusive here. In addition, tax considerations along with public policies designed to preserve small family farms prevent transfer of farmland to other uses.

Our greatest structural problem is a federal budget deficit coupled with a low domestic savings rate. The United States' need to import capital to fund our financing and investment needs was really at the root of our large trade deficits in the 1980s. Both Japan and the United States have made a little progress toward altering these deeply ingrained patterns, but significant changes will not be noticeable for some time. Thus, we can expect our large trade deficit with Japan to linger for some time. Strength in exports will probably help Japan lead the industrialized countries in growth at a rate between 4 1/2 and 5 percent. Additional support should come from a continuation of last year's surge in consumer demand. Increased investment in capacity to help meet this demand should also contribute to a brisk pace of business activity.

In the United Kingdom and Canada, much of the year was spent fighting inflationary pressures, and neither can afford to let up much in the year ahead. Consumer prices in England rose about 8 percent in 1989 and will probably go up another 6 percent in 1990. The country's fiscal surpluses prompted the government to cut taxes, which had the effect of unleashing consumer spending and, in time, price pressures. This increased demand also added to Britain's persistent trade deficit, which is considerably larger than our own as a percentage of GNP. Meanwhile, the battle against inflation pushed interest rates up and helped keep the pound high on foreign exchange markets. The pound's relative strength added fuel to the trade deficit. In 1990, the dampening effect of the trade deficit on manufacturing will probably more than offset stimulus from strong domestic demand. This shift should lead to a year of moderate growth in

England--probably at about the rate I expect for the United States.

Canada's foreign trade sector, like the United Kingdom's, was hurt by a relatively strong currency in 1989. Canadian economic growth will likely slow this year in a similar fashion as well. Since commodities play a major role in Canadian exports, the country will continue to receive a little help from somewhat higher oil prices, which should carry over into 1990. Weakness in the U.S. auto industry, however, is likely to exert a negative spillover effect.

Like Japan, the newly industrializing countries of the Pacific Rim--Taiwan, Korea, Hong Kong, and Singapore--should also post strong export-driven growth. These countries seem to be moving to more sophisticated export products and transferring lower value-added production to places like Thailand, Indonesia, and Malaysia. Taiwan and Korea have experienced some labor unrest that could lead to higher costs. Nonetheless, their growth could well be bolstered by orders for products diverted from China as a result of that country's political uncertainties.

In sum, Japan and Germany should continue to grow at a fairly robust pace, while the United States, Canada, and England decelerate to a moderate rate. This should lead to growth on average among the industrialized economies in the 3 percent range in 1990. It appears, however, that trade imbalances will continue and that inflation, while abating somewhat, still carries troublesome implications in many countries.

Unfortunately, the prospects for the developing countries of Latin America and Africa are far more bleak. Many of their economies are moving backward, bringing physical suffering in the present and compromising their ability to build for future competitiveness in the global market. In addition, their economic weakness denies the rest of the world, and not the least the United States, potentially strong markets for exports. Nonetheless, I see grounds for some optimism because some very fundamental

changes have occurred over the last few years. After concentrating on shoring up the position of creditor banks in this country, we have achieved success to the extent that our financial system could take the shock of significant defaults without collapsing.

More recently, Treasury Secretary Brady's plan has moved us in the new direction of reducing debt in the LDCs, and I think this is a good and necessary step. Still, we must continue to make this issue a top priority if we are to achieve the benefits of a truly global market. For their part, the LDCs seem to have abjured the socialist economic approaches to development which have proved so disastrous elsewhere and are moving toward market solutions. As these seeds begin to sprout, I am hopeful that they will bear the fruit of greater prosperity and an end to the long period of austerity these countries have endured.

Eastern Europe and the LDCs

I would like to round out my remarks this evening with some comments on a somewhat similar shift to market economies and the promise it holds for the Soviet Union and the countries of Eastern Europe. These countries want and, I believe, will move toward the political and economic self-determination their neighbors in Western Europe enjoy. As this shift occurs, they could provide fertile markets for outside goods and services as well as sources for labor, materials, and technical innovations. I alluded a moment ago to the excellent fit between West Germany's employment needs and skilled immigrants from East Europe. This observation applies as well in the broader context of the global market. The advanced economies have capital to develop new sources of production, and many of the nonmarket countries offer disciplined laborers seeking such work opportunities. Developing these matches could decrease unit costs of numerous products and help to hold prices down for consumers everywhere. In addition, bringing new sources of income to nonmarket economies could create large new markets for the goods of the United States and other industrialized countries.

In order to achieve greater integration with the global economy, though, the countries of East Europe will have to find ways to make an unprecedented transition. They must shift from the system of central planning that has failed to bring them material well-being in the past and introduce more market mechanisms into their economies. In spite of the enthusiasm for change that has emerged over the past several months, considerable practical and theoretical problems remain to be overcome. At the most basic level, the people in these countries have little or no experience with the realities of competitive markets. Managers of many enterprises do not understand the subtleties of projecting consumer demand or pricing products, for example. Before such techniques can be used with much success, a good deal of costly trial and error may be necessary, particularly in many of the large Soviet enterprises.

They also lack certain very basic elements of economic infrastructure. For example, they need central banks to maintain adequate supplies of money and credit while restraining inflationary tendencies. Then, mechanisms to carry out this monetary policy will have to be put in place, whether through the development of commercial banks or money and capital markets. Banks and capital markets are also necessary to allocate credit to its most productive uses rather than to those projects favored by Party bureaucrats. Finally, these countries need effective methods of tax collection to keep fiscal policies on target. When the state is the economy, as it has been for so many years, taxes take care of themselves, so to speak. But once enterprises are stripped away from the government, getting real resources to fund government activities will become more problematic. Aside from the basic human aversion to paying taxes, enterprises in partially decontrolled communist economies could experience extra pressure to avoid taxes. This is especially likely to be the case when they do not feel they can get the inputs they need without the extra money that would otherwise go to taxes.

reforms will bring their own frictions. Because they must rebuild their economic infrastructure from the bottom up, inflation could run out of control at times even while economic growth may be stagnating. Hardships stemming from such problems might lead some people in these countries to grow frustrated with the process of change and become more than nostalgic for the relative security of state planning. Should setbacks occur, some in this country will probably call upon the U.S. government to respond with sanctions, as we have seen in the aftermath of Tian'anmen.

Still, I feel we should base our policy toward the nonmarket economies on the belief that the move toward market and political liberalization is inexorable. There is no way for them to eliminate the weaknesses from their systems of production without making fundamental changes. Thus even if problems arise, I think they will for the most part represent temporary backsliding and not a return to earlier antagonisms. In this light, we should avoid sanctions that could force them to revert to the kind of economic isolation they have experienced until now. Instead, we should make every effort to feed the development of these emerging competitive markets by continuing to exchange goods and ideas with them.

What I am calling for is essentially a new way of thinking about these nations with which we have shared hostility since the end of World War II. We need to adopt a new vocabulary that replaces words like "iron curtain" and "cold war" with the terms of economic and political cooperation. We must drop outmoded distinctions between allies and enemies in favor of the comparative advantages of trading partners. Such a conceptual shift is not unlike the transition in thinking we have already made with reference to LDC debt. The Brady plan signals our recognition that the old answers are insufficient for the new world order, and it is also time to bring our thinking about the Soviet Union and Eastern Europe into line with present realities.

Conclusion

In conclusion, the year ahead promises to be a good one for the United States and the world's industrialized countries. We can expect reasonable growth with diminishing price pressures, though we cannot afford to be complacent about inflation. In addition, we could see further progress in extending the reach of the global market toward countries that have not enjoyed the full benefits of international trade for some time. The countries of Eastern Europe and the Soviet Union are poised to begin the arduous task of restructuring their economies. Should they encounter difficulties as they pursue this course, we in the industrialized economies must reaffirm our belief in free markets by rejecting economic sanctions and protectionism. Let us instead adopt a vision of an interactive world economy in which these and other weapons of international policy have been abandoned in favor of peaceful competition in the marketplace.