THE ECONOMIC OUTLOOK FOR THE NATION AND THE SOUTHEAST

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Good afternoon! Once again, I am pleased and honored to appear before my fellow Rotarians and usher in a new year with an outlook for the economy in the United States and the Southeast. Of all the times I have spoken to you on this subject, the present is probably fraught with the most uncertainty. We already had some concerns about economic conditions in this country when Iraq's invasion of Kuwait suddenly destabilized the national and international order. We still await with great trepidation the outcome of events in the Middle East. Yet the international arena also brought our city and state news of a most welcome nature last year when it was announced that Atlanta would host the 1996 Olympics. This remarkable achievement is, I think, helping us sustain a vision of a prosperous decade here that transcends the immediate problems of Saddam Hussein and a weak U.S. economy. While I will discuss the near-term outlook, I want to spend most of my time on several long-term issues that I feel merit more attention than we have been giving them. These are: (1) financial industry restructuring; (2) the federal budget deficit; and (3) inflation. I would like to share my thoughts on these matters today, but before I do, let me give you my outlook for the U.S. and southeastern economy. I will begin with a recap of my outlook from this time last year, and compare it to the results I think we are actually likely to see.

Last Year's Performance Scorecard and the National Outlook

Of course, the Iraqi invasion of Kuwait had significant implications for the outcome of all economic forecasts made last January. Mine, being predicated on an annual average price of $18 per barrel for oil, was no exception. The reduction in capacity due to the oil-price shock and, perhaps even more importantly, the uncertainty that ensued have dampened even further an economy that I told you last year would slow as time went on. Thus, instead of the 2 percent expansion in real gross national product (GNP) I thought we would enjoy, we will probably grow in the vicinity of 1 percent on average for the year. My unemployment forecast for a yearly average of 5 1/2 percent hit the mark, though we ended the year with 6.1 percent of the civilian labor force idle. Finally, the precipitous rise in energy prices should leave us with an increase in the Consumer Price Index (CPI) of 5 1/2 percent, about a percentage point above the rate I anticipated.

Turning to the U.S. outlook for 1991, I look for GNP to average about 1/2 percent for the year. The contraction we are likely to have seen in the final quarter of 1990 will probably continue for a while and retard overall growth for the year in spite of a pickup later on. For example, expansion could be around 1 1/2 percent on a fourth-quarter 1991 over fourth-quarter 1990 basis. Since employment lags behind GNP, I think joblessness will be slightly above 6 1/2 percent at year's end, and the annual average rate will probably be close to that level as well. I look for inflation to abate, however, and drop back to between 4 1/2 and 5 percent as an annual average. Let me elaborate briefly on the sources of strengths and weaknesses that should bring about this sort of economic performance in the coming year.

Strengths and Weaknesses in the U.S. Economic Outlook

Again, let me emphasize that I am speaking in an atmosphere of great uncertainty. It is impossible to predict what the consequences of a shooting war in the Middle East would be, and I can only weigh the economic variables as I see them in the absence of such an unfortunate turn of events. Even barring further conflict, however, the invasion of Kuwait has already brought a significant adverse supply shock to the U.S. economy. This shock has reduced the economy's ability to produce a given level of output at a given price and should entail a decrease in economic performance in the months ahead. Ultimately, however, I think we should see a further drop in energy prices. The fundamentals, especially greatly increased output from oil producers other than Iraq and Kuwait, suggest that current supply shortages are being met for the most part. Still, oil prices are not likely to return to their pre-August 1990 levels for any extended period. For one thing, prices had already been trending up prior to the initiation of hostilities. Moreover, the politics of oil have changed to the extent that oil producers with low reserves seem inclined to support the price even if they disapprove of Hussein's tactics.

In the context of continuing pressures from the energy sector, I feel that the strongest sectors of the economy will be services consumption and exports. Weaker sectors include construction, business fixed investment, and other consumers' purchases, especially of durable goods. Government will likely be a neutral factor in the next twelve months. Among the strong points for the U.S. economy in the year ahead, the service sector, which represents half of all personal consumption expenditures, will probably be stronger than manufacturing and construction. Net exports should also remain a source of strength as Japan and several West

European trading partners experience relatively strong expansion. The trade sector should thus contribute to growth in spite of recessions in Canada and the United Kingdom. In addition, business inventories are relatively lean, and adjustments to inventories will therefore not aggravate any downturn by nearly as much as at similar points in past cycles. Businesses have apparently been anticipating a downturn for six months or so and trimming their purchases. Over the longer term, they have also been shifting increasingly to "just-in-time" inventory methods, which keep their stocks lower than in the past. Underlying this anticipated growth are the Fed's earlier and recent easing moves. These affect the economy with a lag and should make themselves felt over time and provide impetus to growth.

The weak points in the outlook are conditioned to some extent by cyclical forces and by longer term trends. The construction industry suffers from the lingering overhang from past overbuilding and hesitancy among many lenders to finance new projects. Again in 1991, as in 1990, the population shift associated with the aging of the baby boom should dampen the demand for first-time home purchases. Thus the construction industry is not likely to provide support to growth in the year ahead. I feel, however, that the downturn in construction is probably near the bottom and that the industry is not as likely to exert as much of a drag in 1991, either. Consumption of durable and nondurable goods should likewise remain in a cyclical downturn this year. In addition to this slump in demand, many in the business sector are also encountering tighter lending standards at many banks. Thus, it does not look as if business fixed investment will lend support to the economy in 1991.

The role of fiscal policy in next year's economy appears relatively neutral. Last fall's budget deficit accord carries the promise of greater constraint in government purchases of goods and services. Spending on Operation Desert Shield may temporarily add to purchases, though, and transfer payments tend to go up during times of economic downturn as well. In sum, I look for services and exports to lead economic growth in 1991 while construction, consumption of durable goods, and investment remain soft.

Southeast Outlook

Turning to the Southeast, I feel the region's economy will probably track the nation's performance rather closely. Both are subject to the same general conditions coming into the year. Slowing consumer spending, sluggish construction, decelerating business investment, and weaker government spending at all levels will keep the region's economy from outpacing the nation as it typically has in the past decade. In part, this reflects the resemblance between the national and regional economies that has become more pronounced as the Southeast's economic structure has aged and become more diversified. Equally important, at least one of the region's major structural advantages--the number of new residents likely to move here--has diminished during the past decade. Consequently, there is little reason to believe that in the year ahead employment growth here will outperform the nation as it has in seven of the past ten years.

Let me touch on the slowing of in-migration first since the flow of people into the Southeast has long been the primary engine of regional growth, especially in Georgia and Florida. Some of the region's new residents have been retirees who sought our climate and recreational facilities. Others were attracted by jobs in firms that opened plants in the Southeast to capitalize on the region's relatively low business costs. Still others came to work in construction, trade, and services--industries that are fueled by population growth. While I expect retirees to continue coming to Florida in 1991, their numbers should be diminished somewhat. The weakening national economy seems likely to make it more difficult for them to sell their homes in other parts of the country. Meanwhile, slower job growth and rising unemployment in the region have reduced its appeal to job-seekers from outside. Compounding this situation are demographic trends that have moved a larger proportion of the nation's workforce into age groups that tend to be less willing to move. Thus, we cannot count on in-migration for the degree of economic stimulus in 1991 to which we had become accustomed in the 1970s and 1980s; nor should we expect in-migration to return to the pace of past decades any time soon.

Other long-term changes also reduce the region's ability to encourage business growth as well as in-migration. Public infrastructure has become more strained in many urban areas, and environmental amenities have been at least partially depleted in fast growing areas. Moreover, the Southeast long relied on low resource costs and low-wage, unskilled labor to induce companies to relocate their operations. These former advantages no longer offer the edge they once did. The gap between income levels and wages in the Southeast and the rest of the nation has been narrowing, and an unskilled laborforce is a distinct liability in the global market of the 1990s.

Less stimulus from in-migration is likely to be reflected in slower service-sector growth here in the year ahead. However, as in the national economic outlook, employment in services is less likely to be affected by the current cyclical downturn than other sectors. In addition, tourism, which I expect to be buoyed by international visitors and the convention business, will add strength to the economies of places like Florida, Atlanta, and New Orleans. Agriculture, too, should be a plus to the southeastern economy, assuming reasonable cooperation from the weather and energy costs that do not rise precipitously. The cost of feed for the region's poultry and other livestock is down as a result of low grain prices. Meanwhile prices for cotton, peanuts, tobacco and sugar remain high. Manufacturing for exports should help to some extent. The region produces auto parts, chemicals, and machinery, as well as farm and paper products for overseas markets. Still, compared with other regions we have no particular advantage in exporting, and I see no new products in the pipeline that might make exports a greater source of strength.

In fact, much of the region's manufacturing tends to be concentrated in industries that have experienced difficulties for several years. We have a large share of the nation's textile and apparel production, and both are likely to remain in the doldrums in 1991. Even those that had been doing quite well in recent years, such as chemicals, pulp and paper, and food products, will probably be flat as will non-export oriented durables manufacturing. Thus, southeastern manufacturing employment on balance should remain about even with 1990 levels. Finally, construction will probably weaken further in 1991, but not as dramatically as in the year just ended. Employment and population growth can be expected to prompt only slow absorption of the existing property overhang in both residential and commercial markets.

Some areas will benefit more than others from the economic patterns I have described. As usual, Florida promises to outperform the region and the nation on average in terms of employment growth. Port activity, tourism, and bright prospects for agriculture lend additional strength to the state's outlook. However, the state's growth rate is likely to continue slowing in concert with subdued business activity nationally and moderating in-migration. Moreover, Florida's infrastructure is being taxed by its booming population, and this problem may be a moderating influence on growth for some time to come. In Louisiana, where tourism should also be relatively brisk, the rise in oil prices promises to improve the states economy to a greater extent than in any year since the energy sector collapsed in 1985. Strength in shipbuilding and port activity should also contribute to bringing Louisiana's performance above the national average this year.

Georgia, Tennessee, and Alabama will probably perform about on a par with the nation's economy. I look for this year to bring a moderate rebound to the economy of Georgia and also to Atlanta. Services will probably provide the most support to employment growth, though not to the extent that it did in much of the past decade. A considerable inventory of unoccupied offices and dwellings still remains to be worked down before the construction industry can pick up in the state. Textiles could revive somewhat later in the year as the U.S. economy recovers, though job growth is likely to remain small in that capital-intensive industry. The low dollar could help increase foreign demand for paper products in the year ahead as well. And even though the Olympics are still 5 years away, I think the psychological boost the Atlanta games are giving the state will be a positive factor even before much of the building and other preparations shift into high gear. Tennessee's diversified manufacturing of consumer durables like appliances and furniture may expand in response to the expected strengthening of the national economy in the latter months of 1991. Growing export demand for autos and auto parts should also help. Construction, however, is unlikely to improve over its weak showing in 1990. Alabama, too, should advance modestly in 1991, as overall growth in the state's important manufacturing sector offsets weaknesses elsewhere. In particular, production of petroleum-related machinery as well as metals and aerospace equipment should provide additional jobs. Textile jobs are not likely to expand, and apparel will likely continue to suffer from import competition. Industrial construction, coming off a very good year, will probably increase, but not as strongly as in 1990.

Mississippi's economy is likely to lag behind the national and regional pace in 1991. The state has some oil and gas activity, which should accelerate, but not enough to offset declines that could continue and even worsen in construction, apparel, lumber, and furniture manufacturing. Nonetheless, strength in energy, continuing growth in nonmanufacturing sectors, a step-up in shipbuilding activity, and construction of a new rocket motor plant will probably keep Mississippi's slowdown from developing into a significant downturn.

To sum up, the region will perform about on par with the nation in the year ahead, largely as a result of the growing similarity between southeastern and national economic structures. Both Florida and Louisiana have unique factors working in their favor, and they will probably have rates of improvement above other states here. Georgia, Tennessee, and Alabama should conform to average standards of performance, and Mississippi may be below par.

Perspective from the First Year of the 1990s

As I said, I do not want to spend too much time focusing on the short run. While I believe that the economy will quickly rebound, there is little likelihood in the near term that we will return to the kind of performance we enjoyed in the mid-1980s. A primary reason is that we achieved that growth by borrowing against future expansion and put off action on several longer term issues in the bargain. Today, I would like to talk about the consequences of that failure to adopt a longer term perspective in three vital areas. These are financial services industry restructuring, the federal budget deficit, and inflation. Let me deal with each of these themes, but in unequal detail since I have already made my views well known on the first two subjects.

First, I shall touch on financial services industry restructuring. Last year brought home to many Americans how expensive the cleanup of the thrift industry would be. In particular, the public learned that deposit insurance, which has allowed us to take the safety of our personal transaction balances for granted in the short run can ultimately carry significant costs to us as taxpayers. We need to get on with the task of reducing the incentives to excessive risk-taking that our deposit insurance system brings to our financial services industry. At present, we seem to be fascinated with punishing the abuses--some of them quite spectacular--that led to the demise of numerous thrifts. While we should not treat these lightly, it is still more important to reform our deposit insurance system, whose structural weaknesses can exacerbate losses even in cases where criminal intent is not a factor. At the same time, U.S. banking must be enabled to deal with the competitive pressures of an increasingly global economic environment. In balancing these two goals we must be especially careful to avoid the lure of quick fixes aimed at treating symptoms rather than causes. Such an approach characterized reforms of the thrift industry a decade ago. In 1991, we must begin developing more systematic and long-lasting solutions.

As for our fiscal deficit, in the 1980s our approach to financing consumption as a nation could well be described as "buy now-pay later." This was the watchword for households, businesses, and, most of all, the federal government throughout the last decade. Last fall's lengthy budget-reduction debate carried with it the message that the "later date" to which payment had been deferred is now at hand. Not only will greater tax revenues be required, but as a nation we must devote a growing portion of any expansion we might experience to servicing our debt, which is now held to a greater extent than in the past by foreign creditors. Thus, many Americans are confronting the painful reality that our standard of living is not increasing even though we are working just as hard, if not harder, than ever and producing more than before. This is the case because too little of our borrowing was used for productivity-enhancing investment.

Another, though more subtle, assault on our standard of living is coming from inflation, the theme I would like to discuss in greatest detail. Recent events in the global market--specifically, the oil-price shock that followed the turn of events in the Middle East--have called to mind the inflationary spiral that was a front-page story in the early 1980s. Actually, the current round of oil price hikes, which has added over fifty percent to the refiners' acquisition cost for oil, is not as severe as we experienced previously. In the episodes of the mid- and late 1970s, that cost nearly tripled. Moreover, much of the energy-saving investment made from the early 1970s until the mid-1980s is still in place, and overall U.S. energy consumption is up by only about 7 percent over 1973.

Nonetheless, even without the jump in gas prices, we have an underlying rate of inflation that is quite troublesome, and today's price pressures are different in at least two important ways from those of the 1980s. One source of inflationary pressures is a long-term change coming from demographics. We are undergoing a shrinkage of new entrants into the workforce, and this trend will exert consistent upward pressure on labor costs. This is a long-term phenomenon in some sense akin to the kind of supply shock that accompanies a sudden but sustained cutback in energy. We have had ample warning to prepare for the effects of this demographic shift. In many manufacturing firms, we have done a pretty good job of raising productivity through investments in labor-saving equipment. However, as a nation we have not adjusted the balance between our saving and consumption in a way that could finance other needed investments.

Our approach to education, or, as economists call it, investment in human capital, typifies this country's short-term orientation. We seem to have difficulty coming to grips with situations like education that have long payback periods. Thus, we have deferred essential changes to such an extent that many workers are insufficiently prepared for the demands of contemporary factories and offices, not to mention international competition. The Southeast in particular needs to keep improvement of our labor force at the top of its agenda for the 1990s if we are to keep pace. Unfortunately, our unwillingness as a society to devote adequate resources to this end has left all levels of government confronting severe budget pressures. As a result, we are faced with an inflationary dynamic that is impossible for the standard macroeconomic policy tools to address directly.

A second difference between present and past inflationary patterns is that during the 1980s we saw a shift in emphasis toward higher prices in services relative to those affecting manufactured items. U.S. manufacturers had to keep prices low and productivity high as a result of intense worldwide competition when the dollar soared on foreign exchange markets in the early- to mid-1980s. Afterward, many foreign producers had attained sufficient market share to keep the pressure on, and competition further intensified with the subsequent opening of new labor sources like China, India, Malaysia, and Thailand. Such global market forces have held price hikes for manufactured goods behind the growth of the overall consumer price index since 1979. By contrast, the CPI's services component has consistently increased more rapidly than the overall index during the same period. Thus, services have come to dominate our picture of inflation, accounting for over 50 percent of the total CPI, as opposed to about 38 percent 10 years ago.

For a variety of reasons it is difficult to control price-pressures in services. First, services do not lend themselves as readily to productivity enhancements. Instead, most are intrinsically labor-intensive and tend to grow in terms of employment even as costly labor is being replaced by high-tech machinery in other industries. In law and accounting, to name two such services, individualized attention is required in most aspects of client service. Second, whereas goods are subject to international competition, services tend to be locally purchased and lack significant competition from other parts of our own country, let alone foreign providers. For instance, restaurants have to be located at least within a reasonable drive of their customers as do banks, grocery stores, and hospitals.

In addition, our changing life style in this country necessitates the purchase of more services. The growth of two-income families has contributed to the expansion of services in general by adding to the demand for support services like child care and dry cleaning. Moreover, in the area of medicine, one of the fastest growing segments of the CPI, incentives for comparison shopping that would in other types of industries help restrain prices are diminished by the specialized expertise required as well as by the fact that insurance picks up much of the tab. We also have access to expensive new medical procedures, and it is ethically difficult for us to forgo available technologies that can save lives or enhance them. Thus, there seem to be certain inescapable limits on health-cost containment in an affluent society.

The medical profession offers another example of the problems surrounding service-sector inflation, and that is the difficulty that we have in measuring it. When a visit to a physician costs more than it did twenty years ago, all of the increase has been registered as inflation. Yet you would not go to a doctor who charged the same price as in 1971 if he or she made use of only the same methods available at that time. For all these reasons, our policy tools can have only a marginal effect in addressing service-sector price pressures, just as we can do little to counter an oil shock like the one we are now experiencing.

As a policymaker, I have mixed feelings on the subject of inflation. I recognize all the special circumstances I just enumerated. On the other hand, I know that historically it has always been tempting for nations in debt to look to inflation, especially for those that have difficulty agreeing on more direct forms of taxation. At such times, inflation offers a seemingly easy, short-run approach to reducing outstanding liabilities. It is not that anyone today is seriously advocating monetization of our debts as a general macroeconomic policy strategy. Instead, concern over the need to service and repay creditors works more insidiously by making each of us less concerned about inflation than we would otherwise be. This tendency would seem to call for some braking action, particularly to someone like myself, who, as you know, has strong views on inflation. Yet because inflation itself is difficult to measure, we may need to tolerate slower progress against inflation than we had earlier hoped for. At the same time, we must balance our approach to this matter carefully. Given our tendency to want growth in the near term as well as the seductive lure that inflation holds for a debtor nation, we must prevent ourselves from succumbing to yet another temptation to sacrifice the long run for the short run. It is important to do a better job of educating people that growth obtained at the expense of inflation is illusory and brings no real improvement in our standard of living.

Conclusion

In conclusion, we have before us a full agenda of thorny issues. All of these have arisen to some extent from our penchant for deferring difficult choices. We have waited too long to resolve the deposit insurance question, bring down the federal budget deficit, and make the investments in education and productivity that would help us combat inflationary pressures and foster true prosperity. I believe we can avoid a sustained economic downturn in the year ahead, and return to better growth in the U.S. and the Southeast by the latter part of the year. Still, we can no longer afford to delay bringing more balance to our economic priorities. It is time--indeed, it is past time--to replace the short-term fascination of the 1980s with a long-term perspective more in keeping with the realities of the 1990s.