THE ECONOMIC OUTLOOK FOR THE U.S. AND THE SOUTHEAST AND COMMENTS ON ECONOMIC ISSUES

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Good evening! I am delighted to welcome the Harvard Business School Club of Atlanta to the Atlanta Fed. The Bank has a rather close relationship with the Harvard Business School since many of our senior managers are graduates of your executive MBA program. Thus we are happy to be able to host this meeting and meet some of you personally. I am also honored that you have asked me to speak to you, and I would like to use this opportunity to talk about a fairly broad issue. That is the ways in which our excessively short-term focus as a nation are now beginning to haunt us. I will be reviewing several more specific issues as examples. In particular, I will be talking about banking

Where we have been
Where we are
Where we are going

reform, the federal budget deficit, and inflation. Before I do so, however, let me provide a context for my views on these issues by sharing with you my economic outlook for the nation and the Southeast in the year ahead.

The U.S. Outlook

Even though the Gulf war has come to a remarkably gratifying conclusion, some of the uncertainty it brought to economic forecasting will last a while longer. Specifically, my outlook depends on the price of oil. The conflict in the Middle East caused a significant adverse supply shock which has affected both prices and production. This fact has been evident in the weaker economic performance of recent months and has led to forecasts for slower growth in the year ahead. Lately we have seen relatively low oil prices for several reasons. 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. In the long run, however, there is a limit to the decline in prices because non-OPEC production is falling off, and growth in demand has been only temporarily slowed by the price shock and the economic slowdown. Thus, the residual effects of the conflict in the Middle East continue to increase the uncertainty in the economic outlook.

With that caution in mind, allow me to give you just a few numbers. I look for growth in real gross national product (GNP) to improve in the second half of 1991 and bring annual average growth to about 1/2 percent. Since employment lags behind GNP, I think the unemployment rate will be slightly above 6 1/2 percent at year's end. I look for inflation to abate, however, and drop back to about 4 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. In the context of continuing pressures from the energy sector, I feel that the strongest components of the economy will be the personal consumption of services along with exports. Weaker sectors include construction, business investment, and other consumers' purchases, especially of durable goods. Government will likely be a positive factor on balance, although the scale of its contribution remains to be determined.

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 certainly be respectable. Net exports should also remain a source of strength as Japan and several of our West European trading partners experience relatively strong expansion. So, international trade should contribute to growth in spite of recessions in Canada and the United Kingdom. Underlying this anticipated growth are the Federal Reserve's earlier and recent easing moves which should make themselves felt over time and provide impetus to growth.

I am sure that you are all familiar with the weaknesses in the economy. The construction industry suffers from lingering excess supplies due to past overbuilding as well as hesitancy among many lenders to finance new projects. Again in 1991, as in 1990, the aging of the population 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 believe, 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 this year. Consumption of durable and nondurable goods should likewise remain weak this year. In addition to this slump in consumer demand, many in the business sector are encountering tighter lending standards at many banks. Thus, it does not look as if capital spending by businesses on new plant, offices, or equipment will lend support to the economy.

The Gulf war's impact will probably make fiscal policy a positive factor in this year's economy. However, the degree of stimulus provided by government spending will depend upon how long we maintain a presence in the Persian Gulf and what decisions are made on replacing the inventory of weapons and other materials consumed in the fighting.

Neither of these outcomes can be predicted at this point. In sum, I look for services and exports to lead economic growth in 1991 while construction, consumption of durable goods, and investment to remain weak.

Southeast Outlook

As for 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 increased resemblance between the national and regional economies as the Southeast's economic structure has matured 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. Moreover, in many places the region's infrastructure is being taxed by its booming population. This problem may be a moderating influence on growth for some time to come, particularly in places like Georgia and Florida. 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.

I look for the economy in Atlanta and Georgia generally to mirror the nation's in the year ahead. Services could grow enough to offset declines in other sectors, but only by a moderate amount. Meanwhile, construction should remain soft in 1991 because of slower population growth and the overbuilding of the 1980s. Weakness in durables production may also affect the state for a while longer. Our export and tradeable goods sectors are still relatively small compared with other states. Thus we will probably receive less benefit from the strength I expect the nation to exhibit in net exports. Moreover, we have several unique problems that are likely to exert a continuing drag in the near term. The demise of Eastern Airlines was a setback for the Atlanta area especially. Even when a replacement for Eastern is found, it will probably take several months for that carrier to become fully operational. Moreover, while other parts of the country gained from participating in the war effort, the economy here was dampened to some extent. We produce very little military materiel. On the other hand, only one other state--Louisiana--supplied more men and women to the Gulf war effort than did Georgia. In their absence, the loss of

spending on consumer goods and of other forms of economic stimulus affects our state more adversely than others. In sum, even though we are beginning to see signs that the state's downturn may be near it's bottom, our rebound is not likely to be quick or dramatic.

Perspective from the First Year of the 1990s

While I believe that the economy will rebound by year's end, 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. Tonight, 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

The next decade is here

deficit, and inflation.

Let me begin with the issue of banking reform, which, I am glad to say, is beginning to receive the attention it warrants with the Treasury Department's recent proposal for a major overhaul. In my view, we need to strengthen our banking system in four fundamental ways. First, deposit insurance protection must be well defined and strictly limited in scope, thereby eliminating incentives for excessive risk-taking. Deposit insurance has allowed us to take the safety of our personal transaction balances for granted, and this has served well to prevent bank runs on solvent institutions. However, the present system has frequently protected far more than just individual accounts and thus has inadvertently created incentives for excessive risk-taking. These incentives must be eliminated. Second, capital levels need to be raised

to increase incentives for prudent management. Third, we need a structural change in regulatory oversight capable of forcing institutions to take immediate steps, including liquidation when necessary, if their capital ratios fall below established thresholds. Policies must be designed so that prompt corrective action and sufficient capital cushions minimize the costs of the collapse and liquidation of the largest banks. This expectation should be enforced in ways that prevent the possibility of a contagious loss of confidence in the financial system. Fourth, after reducing the deposit insurance subsidy and bolstering banks' capital, we should allow a general expansion of bank powers. If policymakers can address these four concerns, I believe U.S. banks will be better suited to handle future cyclical swings in our own economy as well as the competition posed by foreign institutions in the expanding global market.

As for our fiscal deficit, in the 1980s our approach to financing the federal government's substantial consumption expenditures could well be described as "buy now-pay later." 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 as rapidly as in the past 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.

The date decade is here

Another, though more subtle, assault on our standard of living is coming from inflation. Recent events in the Middle East have reminded many of us of the inflationary spiral that was a front-page story in the 1970s and early 1980s. Actually, however, today's price pressures stem largely from the fact that fewer people are entering the workforce than in the past two decades. This is part of a long-term demographic trend that will exert consistent upward pressure on labor costs for the foreseeable future. Despite the ample warning we have had regarding this population shift, we have not done enough to prepare for its effects. Most importantly, as a nation we have not adjusted the balance between our saving and consumption in a way that could finance investment in education to boost the productivity of our human capital. Now we find that many new workers are unprepared for the demands of contemporary factories and

offices, not to mention international competition. Thus, we have deferred essential changes that could have helped cushioned the economy against the inflationary implications of labor shortages.

As a policymaker, I have mixed feelings on the subject of inflation. Current price pressures suggest we need to take decisive action. On the other hand, traditional monetary policy tools like open market operations are not well suited to address the fundamental cause of the type of price pressure we are facing in the labor force. Moreover, other factors make today's inflation especially difficult to address.

For example, services have come to dominate our picture of inflation, accounting for over 50 percent of the total

consumer price index, as opposed to about 38 percent 10 years ago. Services have not lent themselves as readily as manufacturing to productivity enhancements. At the same time, our changing life style in this country necessitates the purchase of more services. For example, the growth of two-income families has contributed to increased demand for support services like child care. Another complicating factor is the difficulty we have in measuring inflation in services. When a visit to a physician costs more than it did twenty years ago, all of the increase has been registered as inflation. Yet none of us would choose a doctor who used only the same methods available in 1971. Nor are we likely to forego available technologies that can save or enhance human life, regardless of their cost.

Because of these considerations, 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. Historically it has always been tempting for nations in debt to look to inflation, especially those that have difficulty agreeing on more direct forms of taxation. 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. 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 will avoid a sustained economic downturn in the year ahead, and return to better growth in the U.S. and the Southeast during the latter half 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.