

**THE ECONOMIC OUTLOOK FOR THE U.S.
AND THE SOUTHEAST
AND COMMENTS ON ECONOMIC ISSUES
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To the First National Bank in Palm Beach
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Good afternoon! I am pleased and honored by your invitation to return to Palm Beach and meet with the officers and guests of the First National Bank. I would like to use this opportunity to talk about a fairly broad issue--namely, our excessively short-term focus as a nation and how that is now beginning to haunt us. In the process of discussing this issue, I will be reviewing several more specific areas of concern including banking 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 to a considerable extent 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. Even though we have little tangible evidence that the recession is abating, the conditions are in place for expansion in real gross national product (GNP) to resume by the second half of 1991. Thus, I believe the rate of change in GNP will be positive for the year, averaging 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 4 or 4 1/2 percent as an annual average.

Let me elaborate briefly on the sources of strengths and weaknesses underlying these projections. Given continuing pressures from the energy sector, I feel that the strongest components of the economy will be exports and the personal consumption of services. 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.

One sector lending momentum to the U.S. economy in the year ahead will be services, which represents half of all personal consumption expenditures. Net exports should also remain a source of strength. In spite of recessions in Canada and the United Kingdom, Japan and several of our West European trading partners are experiencing relatively strong

expansion. Also adding impetus to growth are the Federal Reserve's earlier easing moves, which should make themselves felt over time.

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 material 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 that has occurred as the Southeast's economic structure has matured and become more diversified. Equally important is the fact that 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 has become quite acute in Florida, but it is cropping up in Atlanta and certain other places around the region. For all of these reasons, there is little cause to believe that employment growth in the year ahead will outperform the nation as it has in seven of the past ten years.

Some areas will benefit more than others from such changes in economic patterns, however. As is usually the case, 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 strength to the state's outlook. However, Florida's growth rate is likely to continue slowing in concert with subdued business activity nationally and moderating in-migration. 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 somewhat more difficult for people to sell their homes in other parts of the country. Less stimulus from in-migration will probably be reflected in slower service-sector growth here in the year ahead. Construction, coming off an especially weak year in 1990, should also remain soft in 1991 because of slower population growth and the overbuilding of the 1980s.

Perspective from the First Year of the 1990s

While I believe that the U.S. 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. This afternoon, 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 begin with the issue of banking reform. We took a significant step toward evolving a coherent plan for the industry's future when the Treasury Department released its proposal for a major overhaul earlier this year. For too long, though, we have addressed the problems faced by the financial services industry with short-term palliatives and policy measures more oriented to symptoms than to underlying causes of strain. Thus, it is urgent to take a more systematic approach toward strengthening our banking system, and I think we should do this 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. Other measures should be adopted, as practical, to increase the role of market discipline. 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.

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.