[Callaway Gardens, GA]

**THE ECONOMIC OUTLOOK FOR 1991**
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**To the Financial Management Forum**
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Good morning! I am pleased and honored by your invitation to speak to the Financial Management Forum of Coca-Cola bottlers. I have been asked to give my views on current economic conditions and the outlook for the United States and its major trading partners. As I discuss the prospects for growth and inflation, especially here in the United States, one of my themes will be the effects of changing demographics associated with the aging of the "baby boom" generation. This development also has significant implications for the soft-drink bottling industry, which I will explore briefly. Before discussing these specific issues, however, I would like to provide a context for my thoughts by sharing with you my economic outlook for the nation and the industrialized world in the coming 18 months.

## The U.S. Outlook

Let me begin by saying that the recession in the U.S. economy appears to be in its final stages. Most of the conditions that should lead us to a rebound are in place, and I am confident that we are poised to reach a turning point if we have not done so already. While it has taken us longer to reach a trough than I earlier expected, expansion in real gross national product (GNP) now seems quite likely to resume by the second half of 1991. The first quarter's contraction will pull down GNP growth in 1991, making it slightly negative on an annual average basis. However, I look for modest but positive growth next year. Since employment lags behind GNP, I think the unemployment rate will drop back from a midyear 1991 rate of nearly 7 percent to closer to 6 1/2 percent at year's end. Joblessness should continue to fall

toward 6 percent in 1992. I think inflation has abated from last year's nearly 5 1/2 percent rate, and could drop back to perhaps 4 1/2 percent as an annual average in 1991 and nearer 4 percent in 1992.

Let me elaborate briefly on the sources of strengths and weaknesses underlying these projections. The strongest sectors of the economy will be exports and personal consumption of services. Weaker areas for this year include construction, business investment, and other consumers' purchases, especially of durable goods. By next year, however, most of these sectors should begin lending support to growth. Government could be a slightly negative factor on balance this year and become more of a drag in 1992, although this sector of the economy is harder to predict.

Except for a brief lull during the bottom of the recession, one sector lending consistent momentum to the U.S. economy is services, which represents half of all personal consumption expenditures. Net exports should also remain a source of strength. The deficit in net exports could drop to under $5 billion on average for 1991 and turn marginally positive next year. I will have more to say about factors in the international economy that lead to this outlook in a moment. Also adding impetus to growth are the easing moves the Federal Reserve has taken, which make themselves felt over time.

I am sure that you are all familiar with the weaknesses in our economy. The construction industry suffers from lingering excess supplies due to past overbuilding as well as hesitancy

among many lenders to finance new projects. Residential construction is undergoing a modest rebound, but the aging of the population means that there are not as many first-time home buyers as there were when we came out of the last recession in 1982. In addition, office building and other commercial construction will probably continue to decline for a year or more, though the rate of decline should diminish markedly later in 1991. Overall, construction will be less of a drag on growth for the remainder of this year, but it will not lend momentum to the economy until sometime in 1992.

Demographics are also exacerbating the recession's effect on consumption of durable goods. However, demand for autos and other consumer durables should begin to pick up in 1992. In addition to this slump in consumer demand, many in the business sector are encountering tighter lending standards at their banks. Thus, it does not look as if businesses' expenditures on new plants, offices, or equipment will be strong enough to lend support to the economy in the near term. However, I expect a rebound in business investment as 1992 proceeds, and capital spending should become one of the economy's mainstays.

With the abrupt end to the Gulf war, we have seen military base closings and cut-backs in personnel as part of the effort to trim defense spending. Nondefense federal spending seems likely to be constrained this year, along with state and local government activity, by the soft economy and weak revenue growth. Already some state and local governments have initiated hiring freezes and project cancellations as a result, and this could continue to bring negative effects over the next 18 months.

In sum, I look for exports and consumption of services to lead economic growth over the coming year and a half. Construction, consumption of durable goods, investment, and government sectors will remain weak this year but could begin to strengthen toward the latter part of the forecast horizon.

**International Outlook**

Since net exports is one of the strong points in my U.S. outlook, I would like to dwell for a moment on the elements of the international economy that support my opinion. I believe that, on average, growth worldwide will be slow to moderate in 1991, but I see considerable improvement on the horizon for 1992. Japan and Western Europe should still turn in decent performances this year. However, with the U.S. economy weak and Great Britain and Canada in recessions that have carried over from 1990, economic growth is not likely to increase much more than 1 percent in the industrialized economies overall. Unemployment will probably remain relatively high in Europe, though below the double digit rates of the mid-1980s, and low in Japan--probably just over 2 percent. Price pressures are likely to be uncharacteristically high in Germany this year, but inflation will probably remain near 1990 levels in other West European countries and Japan.

To give a few specifics for the major industrialized countries, in western Germany growth estimates have been revised down several times and now stand at 2 to 3 percent on average for 1991, though probably somewhat higher for next year. The costs of unification between the

eastern and western parts of the country, which now appear greater than initially estimated, are the primary reason Germany's growth prospects are lower. Concerns over the inflationary effects of additional government borrowing to pay for reunification have led to a relatively tight monetary policy that is also retarding growth. Tax increases slated for July are liable to dampen consumer spending, and the global economic slowdown is also taking its toll on German exports.

Growth in Italy and France this year could hover at or slightly above 1 1/2 percent and rise by 1 percent in 1992. Inflation in Italy is likely to be more than double France's rate of 3 percent, while unemployment in both countries could remain above EC averages. The downturns in both Britain and Canada may stretch late into the year. I expect both countries to bounce back to moderate expansion in 1992, however. Whereas a slowing economy should substantially reduce the U.K. inflation rate, inflation in Canada is likely to rise on average. However, this acceleration of price pressures in our northern neighbor is mainly the result of the "goods and services tax" that went into effect in January.

After averaging over 5 percent in 1990, Japan's growth rate should drop back closer to 3 or 3 1/2 percent this year--still enviable by international standards. Relatively slower overseas growth will probably cut into the country's export business, though buoyant domestic demand should compensate to some extent for this loss. Some potential clouds loom on the horizon for Japan, however. Last year's plunge in equity markets has hurt the prospects for business investment there. In addition, Japanese banks, which have experienced losses in capital as a

result of the crash, may now face declining real estate values as well. Despite these adjustments and shocks, Japan is expected to be able to sustain growth in the 3 1/2-4 percent range over the next several years.

In sum, the international outlook is for continued, albeit more moderate, growth as relatively strong performance in Western Europe and the Pacific-Rim nations balance more sluggish economies in the United States, Great Britain, and Canada. I look for the latter countries to emerge from their doldrums later in the year, however.

**Outlook for the Soft-Drink Industry**

You have asked me to make a few comments on the soft-drink industry's prospects, and I will be glad to draw some inferences from my overall outlook--with the caveat that everyone in this room knows more about this subject than I. Bottling is, of course, mostly a local industry, as it is not economical to ship liquids over long distances. Exports of your products are therefore relatively insignificant, as is competition from imports. Indeed, U.S. brands--bottled by foreign licensees--dominate the international markets, accounting for as much as 60 percent of all carbonated beverage sales.

Of more importance, it seems to me, are forces that are reshaping the domestic market, especially the demographic trends I alluded to when discussing the difficulties of the U.S. housing and auto industries. In inflation-adjusted terms, the value of shipments in the bottled and canned soft drink industry has grown between 3 1/2 and 4 percent per year in recent years.

However, the increase in soft-drink consumption is expected to slow in 1991 and subsequent years. As a result, the value of shipments is likely to drop back a bit as well. This decline in the rate of growth in consumption appears to be part of a trend reflecting the preferences of an aging population. Older people tend to drink fewer carbonated beverages. Moreover, the population cohorts following the baby boom generation are relatively smaller and, therefore, cannot be expected to take up as much of the slack. Thus, as with other sectors of the economy that are being affected by population changes, the domestic soft-drink market will probably experience slower growth than it has been accustomed to. It might be that you are already pursuing diversification strategies that will keep you ahead of the demographic curve.

**Concerns About Inflation**

Demographics will have a significant impact on a subject with which I am much more familiar, namely, inflation. I noted earlier that inflation appears to be abating over the short term, but it remains at an uncomfortably high level. It is worth remembering that, when inflation reached 4 percent in 1974, President Nixon was sufficiently alarmed that he instituted wage and price controls. Thus, we need to take inflation at current levels quite seriously. At the same time, we now confront some relatively unique factors that complicate our efforts to control inflation, and I will elaborate on a few of them for you.

For one thing, today's price pressures stem largely from the fact that fewer people are entering the workforce than in the past two decades. This change is part of the long-term demographic trend that I have mentioned several times. It is a development that could 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 cushion 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 structural nature of price pressures 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. Moreover, 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. The growth of two-income families, for example, 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 as a de facto solution, 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. As we come out of this recession during the second half of 1991 and rejoin the economies of our major trading partners on a path of moderate economic growth, we will have to reset our focus on this complex and challenging issue.