[Naples, FL]

THE ECONOMIC OUTLOOK: NATIONAL AND GLOBAL CHALLENGES

Remarks by Robert P. Forrestal, President
Federal Reserve Bank of Atlanta
To the National Retail Federation
June 27, 1991

Good morning! I am pleased and honored by your invitation to speak to the National Retail Federation. I have been asked to give my views on the outlook for the national and international economy and some implications for the retail industry. One theme that will run through my remarks is that the economic effects of demographic changes in the United States will probably dampen the growth in consumer demand. Retailing is one sector that has entered a slower growth period and, along with several other industries, the challenge you face may be to develop new markets for your services.

With the European Community starting to coalesce in 1992 and strong growth likely in the Pacific Rim, it seems to me that more of our firms should be finding ways to do business abroad. In the past, our domestic markets have been very strong, and American businesses have rarely looked for opportunities outside of the United States. Although many foreign firms have long invested in understanding the preferences of American consumers, their U.S. counterparts have tended to remain more insular. For these reasons, I would like to talk to you today about the opportunities and challenges posed by the evolving global market, as well as the need to support further reductions in trade barriers. Before discussing these issues, however, let me provide a context for my thoughts by sharing with you my economic outlook for the nation and the industrialized world, not only in the near term, but further into the decade as well.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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 recovery 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 a little 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 positive growth next year, albeit at a moderate pace. One reason for this turnaround is the easing moves the Federal Reserve has taken over the past year, which make themselves felt over time. Since employment lags behind GNP, I think the unemployment rate will take a little longer to fall, declining from around 7 percent now to around 6 1/2 percent at year's end. Joblessness should continue to fall in 1992. 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.

To elaborate briefly on the sources of strength and weakness underlying these projections: The sectors supporting the economy should be net exports, personal consumption of services, and inventory formation. Weaker areas for this year include construction, business plant investment, and other consumer purchases, especially of durable goods. By next year, however, most of these sectors should begin lending support to growth. U.S. businesses' aggressive shift to sophisticated inventory control methods and their anticipation of the recent recession led them to sharp and prompt cutbacks in inventories. These moves, in turn, helped to push the economy

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

into a downturn. Inventories are very low now, and this should bode well for a near-term recovery since growth in demand quickly feeds through to production. Government is likely to be a slightly negative factor overall this year and to become more of a drag in 1992. I believe we should be pleased with this, however, because lower federal government spending is needed to bring fiscal policy into better balance.

Except for a brief lull during the bottom of the recession, one sector lending consistent momentum to the U.S. economy is services, which now represents half of all personal consumption expenditures. Net exports should also remain a source of strength, with growth in the exports of goods and services outpacing that of imports. The deficit in our net exports that was more than $160 billion in the mid-1980s could turn marginally positive next year. The chief support for an improving trade balance here is the continued, moderate growth I foresee in the international economy. In the months ahead, relatively strong performance in Western Europe and the Pacific-Rim nations should balance more sluggish economies in the United States, Great Britain, and Canada. Equally important, the dollar is near its weakest level since 1985, and export demand responds to currency values with a substantial lag--as much as two years. With the U.S. inflation rate being held in check, our exports should remain attractive. Over the long run, because of reductions in trade barriers and the impetus to greater economic integration throughout the world, growth should be relatively strong as we move through the 1990s. Thus, the tradeable goods sector is critical, and if we are unable to become more effective participants in the international economy, it can only retard our growth.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Residential construction is undergoing a modest rebound, but the aging of the population and the lower rate of family formation means that there are not as many first-time home buyers as there were when we came out of the last recession in 1982. Thus, demographics are also exacerbating the recession's effect on consumption of durable goods, such as the carpeting and furniture that new homeowners usually purchase. Still, demand for autos and other consumer durables should begin to pick up slowly in the second half and continue into 1992, largely because it has been extremely weak of late.

In sum, I look for exports and consumption of services to provide support to economic growth over the coming year and a half. Investment--especially in the form of inventories at the start of the recovery--should help to push production higher after a brief lag. Still, the rebound is likely to be modest in comparison with those in the past. Although we may see a quarter of rapid growth from time to time, I expect annual average growth to be below the pace we experienced during much of the '80s.

Outlook for the Retail Industry

You have asked me to make a few comments on the retail 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. Department stores have posted consistent growth in sales over the past two decades, though this trend has moderated. Real growth in sales averaged nearly 4.5 percent per year from 1970 through the mid-1980s and then moved closer to 2 percent since 1987. In the short run, the signs point to a continuation of growth at the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

lower end of this range. I do not look for consumption of the durable and nondurable goods that are your stock in trade to provide more than a modest push to the overall economy in 1992 after two negative years. Beyond that, the longer-term demographic trends I alluded to when discussing the difficulties of the U.S. housing and auto industries could exert a persistent moderating influence on domestic sales of many of your products. While an aging population will have a continuing need to replace housewares, clothing, appliances, and the like, we probably will not experience again the kind of concentrated stimulus the economy received when the baby boom generation was making numerous first-time household purchases and raising its children. 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 retail market will probably experience slower growth than it has been accustomed to. For this reason, it becomes important to pursue new market strategies that will keep you ahead of the demographic curve.

One option that has been relatively unexploited by U.S. retailers is international expansion. Obviously, you are active participants in the international marketplace as the "Made-in-Hong Kong, Korea, and Thailand" labels of a good many of your products show. However, few U.S. retailers have opened stores in foreign countries. In the past, there have probably been good reasons for this focus on the home market. It has been sufficiently large and robust to keep retailers busy, and, earlier in the 1980s, the high value of the dollar kept many U.S. companies from venturing farther afield. The demographic picture I have drawn for you, though, suggests that key underlying economic conditions are changing. Already we have seen considerable

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

consolidation in the industry, in part as a reflection of this shrinkage in the home market. Meanwhile, economies abroad are tending to show stronger growth than our own. Looking ahead, the restructuring that is taking place in the international markets may provide some of you with a more familiar environment for doing business. I refer in particular to the potential free-trade agreement with Mexico and the oncoming unification of European markets, as well as the expansion of trade and growth in markets that should result from a reduction in trade barriers. Numerous obstacles, however, need to be overcome before U.S. industry can reap all the potential benefits from these developments, and I would like to conclude this morning with a look at both the opportunities and challenges in the evolving global economy.

Challenges in the Global Marketplace

As I see it, two impediments, in particular, stand in the way of businesses' greater entry into the global marketplace. First, too many trade barriers still exist. If this nation's businesses intend to look to global markets for growth, it is vitally important that we continue our efforts to reduce trade barriers. Second, there are many cultures to contend with that are different from ours and about which we simply know very little.

It is critical that we continue to press for reductions in tariff and non-tariff barriers through the General Agreement on Tariffs and Trade (GATT). Our ultimate objective must always be worldwide free trade, and this can be achieved only through multilateral forums like the GATT. Still, it is difficult and time-consuming to bring 95 different points of view on trade relations into harmony, which is what the GATT attempts to do. Although it was disappointing not to reach

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

an agreement following the Uruguay Round of GATT, it is encouraging that more talks have been scheduled. I am also gratified that Congress has legislated the so-called fast-track authority so that these agreements can be reached more expeditiously. The complexity of reaching a consensus in the GATT has led to bilateral and regional discussions that I hope can play an intermediate role in bringing down international trade barriers. These talks are only useful, however, insofar as they are conducted in the spirit of the GATT and aim toward the same objectives. One such regional initiative that fulfills that requirement is being pursued by the United States and Mexico.

If these two countries can succeed in negotiating a free-trade agreement, a large new market could become available to U.S. businesses. Together with the existing U.S.-Canada Free-Trade Agreement, an accord with Mexico would create a North American trade zone that would surpass the European Community (EC) as a marketplace. Although Mexico's economy is smaller than ours or Canada's, people there are already predisposed to purchase U.S. goods. Some 70 percent of their imports originate in this country. Moreover, Mexico has achieved a dramatic reduction of the government intervention in trade and domestic business activities that has crippled its economy in the past. These moves should help increase per capita income over time as they contribute to general economic growth. Thus, somewhat further down the road, U.S. retailers may find fertile ground for new outlets in an expanded North American economy.

In addition, I hardly need remind you that the European Community is progressing toward the economic integration that will begin to create a market with more consumers than in this

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

country. This development will have a major impact on the future course of business in Europe and among the EC's trading partners, including the United States. Most immediately, the dismantling of barriers to shipping and selling goods should make this European market more amenable to the kind of retailing in which we are experienced. The European Community after 1992 will tend toward a market structure that is more similar to ours. But though it will be large, it will not necessarily be homogenous. That is, as the differences among countries caused by artificial barriers decline after 1992, it is not clear how quickly or to what extent the national preferences that reflect varying cultures, characters and histories might consolidate. The challenge for U.S. retailers will be to familiarize yourselves with the customers in these international markets and to begin to understand better what products and services they want.

Another wrinkle that remains to be ironed out in the process of EC market unification is the question of non-tariff barriers. A variety of non-tariff barriers arose after most overt tariffs and quotas were eliminated in the late 1950s. These include, for example, differences in product standards across countries, local content and domestic origin rules, and controls and taxes imposed at national borders. Agreements adopted in 1985 deal with these non-tariff barriers through the principle of "mutual recognition." Under this principle, by the end of 1992 each nation must freely admit products meeting the legal standards of other member states, even if its own standards are different. There have been estimates of a considerable boost in the European Community's gross domestic product when such provisions take effect, and, indeed, substantial savings in cost should occur over time. But it will take some thoughtful research on the part of American businesses to take advantage of this new, more integrated market. Moreover, Europe's

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

rich cultural diversity suggests that strongly segmented markets for foods and other products will persist. Thus, while some food companies that concentrate on a few products, such as McDonald's and Coca-Cola, have been able to sell their home-market products overseas--in part, because they are very American--it may be that retailers who market thousands of product lines may not be able to follow suit immediately.

These difficulties notwithstanding, I feel that the continuing negotiations among the nations of the European Community, the U.S.-Canadian accord, and our efforts to establish greater links with Mexico should be viewed as model programs that offer opportunities to try out free trade concepts in smaller, less complex situations. The success that I believe they will enjoy will then strengthen the arguments for dropping barriers among a broader range of countries such as the GATT signatories. And, as I noted, we will benefit greatly from this as a nation.

Implications for U.S. Industry

The restructuring of trade arrangements that is taking place in the global marketplace has numerous important implications for your industry and U.S. business in general, but I would like to underscore two that are of primary importance. One is the need to focus policymakers' attention on reworking our own trade policies and cooperating through the GATT and other agreements to reduce and eventually to eliminate the remaining obstacles to international commerce. There are powerful voices that oppose progress in this direction, and the proponents of free trade must be equally--or, I hope, more--persuasive. I know that the retail industry has consistently supported efforts to bring down trade barriers, and I trust that you will continue

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

expressing your convictions to your representatives in Congress.

No matter how far we are able to proceed toward easing trade restrictions, however, U.S. industry is likely to find its success in foreign markets limited until we shed our insularity. We need to develop a cadre of internationalists in management and marketing who can provide cultural insights, whether within companies or as consultants. Our companies must do a better job of discovering the foreign markets that are receptive to their products. They also must acquire a sense of how to appeal to consumers and businesses in other countries and begin to speak their languages. Obviously, it will take some time to attain such expertise, and we should act quickly to avoid falling further behind our European and Asian competitors in this regard.

Conclusion

In conclusion, I feel that the U.S. economy is poised for recovery. I do not, however, expect improvement to be dramatic, in part as a result of long-term demographic trends that are moderating the nation's consumption patterns. Instead, we should return to moderate growth that, while not as robust as that to which we had become accustomed in the 1980s, should nonetheless prove sustainable. The international economy--especially in Western Europe and the Pacific--should perform somewhat better than our own and provide some stimulus here in the form of relatively strong export markets for our goods. I expect the retail industry to reflect the somewhat diminished prospects of the domestic economy as a whole, and perhaps over time to look for new opportunities in the global market. Such opportunities are growing as the international market is restructured in favor of freer trade. However, we must not flag in our

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

efforts as a nation to push for the remaining adjustments that can ensure freer flows of goods and services. We must also break out of the insularity that has been our posture through much of our past and begin thinking of ourselves in the global terms that will define our future.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis