THE OUTLOOK FOR THE UNITED STATES AND THE SOUTHEAST IN 1993

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This year marks the tenth time I have had the pleasure of addressing the Rotary Club of Atlanta. Thus, it is an especially meaningful occasion for me, and I would like to mark this occasion by being a bit retrospective before I turn to the recent past and the prospects for the immediate future. In particular, I would like to discuss two ongoing issues--inflation and the federal budget deficit.

Inflation and Deficits

Looking back over this period, one of my abiding concerns as a central banker has been price stability. On this score I am very pleased with the progress this country has made during the last ten years. In 1984, when I first spoke to the Atlanta Rotary, inflation averaged around 4 1/2 percent. After the double-digit CPI figures of the late 1970s and early 1980s, this rate of inflation was a vast improvement. Moreover, for a number of years the CPI did not accelerate despite robust economic growth. While price pressures began to mount late in the 1980s, the Fed succeeded in reining them in as well as in lowering inflation significantly--so that it is now close to 3 percent. I do not need to lecture to this group about the positive effects of low inflation. Nonetheless, I do want to emphasize this very important accomplishment because it is too often overlooked in the negative assessments of U.S. economic performance that have become commonplace.

At the same time another issue that permeated my thoughts as a policy maker during the last decade has received too little attention and experienced woefully inadequate improvement. That issue is the federal budget deficit. Like others in the Federal Reserve, I have been on a virtual soapbox since the early 1980s warning about the perils that the large buildup of government debt brings. Unfortunately, this problem has not yet been addressed by those with the power and the authority to do so.

The deficit has been one factor that has constrained our growth, ever since we started recovering from the 1990-91 recession. We did not have much, if any, latitude to use fiscal policy to counter the downturn and, instead, needed to rely solely on monetary policy. While the Fed stimulated the economy by lowering interest rates substantially over the past two years, our policies are simply unable to have much impact in certain areas. Fiscal policy can typically affect employment more directly, for example, through expanded public works or job re-training.

I do not want to leave the impression that I am among those who regard public policy as not particularly effective. Both monetary and fiscal policy have important roles to play in an advanced economy. Aside from the potential countercyclical role that fiscal policy can play, for example, I believe government spending in such areas as education can raise the nation's productivity and hence its long-run potential for growth. The problem with the deficit buildup of the 1980s was that much of the fiscal stimulus was not targeted toward such investment. Thus, the deficit not only extended the recent weakness, but, as we look ahead to 1993 and beyond, we see it has constrained prospects for growth, notwithstanding the beneficial effects of much greater price stability.

Having set forth two critical long-term trends that have marked our past decade and will form the context of economic performance for years to come, let me turn now to discuss current economic conditions in more detail as well as the outlook for 1993.

The U.S. Economy

Last year, you may recall, I forecast that gross domestic product, or GDP, would expand by around 2 percent. When the final numbers come in, this forecast should prove to have been on target. Likewise inflation, as measured by the consumer price index, should average 3 percent as I predicted. At the same time, productivity gains were better than I expected and they dampened job growth. As a result, unemployment did not remain unchanged from its late 1991 rate of 6.8 percent as I had forecast. Instead, the unemployment rate increased and averaged 7.4 percent during the year.

Turning to the outlook for 1993, I expect GDP to expand, on an annual average basis, by close to 3.0 percent. The unemployment rate should average around 7 percent and could end the year slightly below that level. The CPI should remain in the same range as in 1992, although, with the pick-up in business activity, we could see a final number a shade above 3 percent since prices tend to move with business activity.

The main sources of strength underlying the U.S. economy as it moves forward into an expansion phase will be consumer spending (particularly on durables), residential construction, and capital investments by businesses especially on computers and other equipment. Lower interest rates are a factor in all of these areas. First of all, they have enabled households and businesses to restructure their balance sheets. Consumer debt service as a percent of income, for example, has fallen to levels not seen since 1986. As a result, they are in a better position to purchase goods that are typically financed with credit and the cost of doing this is much lower than before.

Also on the consumer side, several positive factors are at work in addition to the lagged effects of lower short-term interest rates. Recent improvements in employment reports have raised hopes for sustained job and income growth. The reduced fear of job loss is likely to foster more consumer spending. Moreover, the gradual absorption of the large inventories of homes built in the 1980s, the fact that house buying activity had been so soft for a long period, as well as the decline in mortgage rates spurred better demand for housing. Greater activity in the housing sector boosts demand for construction materials and major appliances and furniture. Moreover, there is pent-up demand in that durables simply wore out during the period of slow growth. Since the decline in interest rates over the last few years has enabled many households to adjust their debt levels and with employment likely to remain on an upward trend, these purchases are now more affordable--even at moderate rates of income growth.

At the same time, as I have mentioned in previous talks, the aging evident in most of our population, despite the recent uptick in births, will constrain any jump in demand for either housing or consumer durables. Fortunately, or unfortunately, as the case may be, the impacts of demographics are fairly predictable. The numbers of people reaching certain age groups, aside from infancy, can be readily predicted. Thus, it seems certain that demand for cars, household appliances, and the like will not rebound as sharply as it did during other post-recession expansions in the past two decades. These demographics will also delay the turnaround in construction of multifamily housing in most cases, a sector that remains overbuilt. While there are still too many apartments and condominiums on the market, the good news is that this component of the construction industry may be approaching its trough.

On the business side, capital spending will be enhanced by the reduction in borrowing costs, and businesses are likely to focus on efficiency-promoting equipment like computers. As the pace of growth accelerates, expenditures for industrial machinery will pick up this year. Still, commercial construction is not likely to turn around for the foreseeable future because excess office and retail space remains substantial. Nevertheless, nonresidential building should be less of a drag on growth than in the past few years.

Areas of weaknesses include not only commercial construction but also government spending and, for the first time in many years, international trade. With the new Administration just taking office, it is somewhat risky to forecast government spending. Clearly, though, there are well-defined plans in place and in progress to reduce defense expenditures. Thus, on balance, I believe that in 1993, as in 1992, government spending will not add to growth.

A more significant development is the shift in exports from the positive to the negative side of the growth ledger. The dollar's modest appreciation in the wake of last fall's European currency crisis is not really the culprit. U.S. goods can still compete on price. The main factor is that growth in most other major industrial nations has been slowing, and some countries are verging on recession. Germany's high interest rates are constraining demand, not only in that country but in Europe generally. Japan is going through a protracted adjustment to the drop in its very high asset values and the aging of its economy. This weakness should diminish in 1993, but slackened growth in demand for U.S. products in the advanced economies is not likely to be offset by rising demand elsewhere. Rapid growth rates in Latin America, for example, are not enough to make up for the relatively small share of U.S. exports that these countries represent. At the same time, a pick-up in GDP growth in the United States usually leads to a rise in imports. As a result, the merchandise trade gap should widen after narrowing steadily since the late 1980s.

Southeastern Outlook

In the Southeast the outlook for 1993 is brighter than it has been in several years and the region should also outpace the nation. It is true that industries that specialize in nondurable goods, most prominently apparel, will contribute less than they did during the recovery period. Apparel plants began to reduce employment rolls last year, and longer term apparel producers face increasing competition from countries where unskilled and semi-skilled workers are willing to work for less because they are poor. However, the positive national prospects for single-family housing and increased consumer spending bode well for several other important southeastern industries.

The Southeast is a major nationwide supplier of lumber used in residential construction. Recent environmental issues in the Pacific Northwest have worked to the benefit of southeastern lumber producers. The region's large textile industry tends to fare well when the residential building industry is doing well since many textile products are turned into carpets, draperies, and other home furnishings. Several southeastern states are important producers of home appliances, which are also in greater demand when home buying and building is on the upswing. Not only will national demand for these products expand in 1993, but regional demand will receive a temporary boost as well in the wake of rebuilding going on in south Florida and Louisiana as a result of Hurricane Andrew.

More generally, the expected increase in demand for consumer durables is good news for the region's many car, furniture, and appliance factories. Textiles mills too should gain since many textile products are destined for automobiles. However, the region is not a major capital goods producer, and so the expected strength in capital spending by businesses on equipment will be less of an advantage. Still, the region's relatively small dependence on exports means that the weakness in foreign demand will be less significant. Likewise, the decline in defense spending nationally will have a smaller impact on the Southeast because, for the most part, defense-related industries are less important in this region than in areas like the Northeast and the Far West. On balance, regional manufacturing should gain strength.

Another industry lending strength to the expansion regionally is construction, which is likely to continue the growth begun in 1991. Most building activity will be concentrated in single-family housing, as in the nation, but at least the long slide in multifamily and nonresidential construction appears to be nearly over. There are areas of potential weaknesses. It remains to be seen, for example, whether the trend toward consolidation and layoffs in banking, communication, transportation, and other professional and business services has bottomed out. This dynamic has been a blow to several large southeastern cities, just as it has been nationally. Overall, however, the region should grow at a faster pace in 1993 than in 1992.

Looking at the Southeast state by state, the factors that will propel the region as a whole should help Georgia resume its traditional role as one of the faster growing southeastern states now that it has made significant progress on its commercial real estate imbalances. While prospects of shrinking airline payrolls could retard growth, the worst is probably behind the state. In 1993 housing- and auto-related manufacturing, single-family home building, improved retail activity (especially for durables), and a pick-up in convention travel should propel faster growth.

Tennessee is also likely to outpace the nation. This industrially oriented state is bucking the national trend and increasing capacity in auto manufacturing. The expected rise in the demand for consumer durables in the nation should be a boon to Tennessee, a state that is a significant producer of a variety of household appliances, furniture, and the like.

Florida's construction imbalances were more pronounced than Georgia's, and it is taking this state longer to emerge from the doldrums of slow growth. Unlike other southeastern states, defense-related industries are significant locally, and the decline in defense spending augurs poorly for Florida. In addition, while the reduction in interest rates has stimulated demand elsewhere, it has lowered interest income for retirees, a community that is relatively large in Florida. Nonetheless, improved tourism and the likelihood of healthy export growth to Latin-America should help the largest state in the Southeast do better than in 1992. Hurricane-related rebuilding and retail purchases should add a temporary stimulus.

Mississippi, which barely noticed the recession of 1990-91 because of a temporary surge in shipbuilding and repair should begin to slip in 1993 as expenditures in this high-wage defense industry decline. Increasing activity in the state's other major industries--apparel, food processing, lumber, and furniture is not likely to offset these losses. Also, low energy prices are a negative for Mississippi, as they are for Louisiana and Alabama.

In Alabama, industries that produce nondurable goods like military apparel helped the state survive the recession relatively unscathed. However, these producers had already begun to experience weaker demand by the end of last year. While other manufacturers should do better in 1993, the rapid expansion in public sector jobs that has favored Alabama over the last several years cannot be sustained. Thus, a deceleration in growth is on the horizon for both Alabama and Mississippi.

Louisiana, which is far more energy dependent than Alabama or Mississippi, is running very much against the national economic current. Its economy faces the prospect of a possible slump in 1993 in the wake of substantial layoffs in the energy industries, which include not only drilling activity but also manufacturing.

Conclusion

Summing up the outlook for 1993, economic growth promises to be somewhat better, both nationally and regionally, than in 1992. Nonetheless, I recognize that certain sectors will decelerate and others still have excess inventories to be worked off. Moreover, moving from 2 to 3 percent GDP growth is not the typically robust acceleration we usually see in the early phases of an expansion. It is clearly not fast enough to push unemployment down quickly. In addition, there are other pressing economic problems like health care, education, and more generally, families at risk that affect all of American society in some way. While the Federal Reserve has been grappling with the problems of the economy in recent years, it is appropriate and necessary for us to develop broader approaches to economic policy.

As we address near-term concerns, however, it is important to keep our eyes on long-term considerations. We have already placed a substantial burden on future generations, and we must begin to reduce that burden. Our failure to develop a rational fiscal policy during the expansion phase of the 1980s virtually mandated the long period of substandard growth that we have been experiencing. By the time we needed fiscal policy to mitigate the economic downturn, it was simply not available as a tool. In fact, the size of the deficit kept real long-term interest rates relatively high and crowded out private investment as well. Perhaps even worse, the situation created a cynicism about policy on the part of Americans. Many people came to believe that public policy could do little to help us become a productive nation--quite the opposite of the situation in other countries, where public investment in infrastructure and human capital is seen as increasing the potential to grow. As I mentioned at the outset, I firmly believe that public policy can be effective when directed toward such areas.

As we consider the composition of government spending, we must also remember that we should remain vigilant in regard to inflation and not be lulled into complacency by current low rates. We cannot forget that our high degree of indebtedness as a nation can predispose us to a more inflationary posture. We all know that inflation reduces the pain of debt repayment by making the amount of that repayment less in real terms. While the recent recession prompted households and businesses to reduce their debt levels, there was no such reduction in the burden of accumulated federal debt. Given our inability as a society to agree on a way to distribute the burden of deficit reduction, inflation remains a tempting de facto tax.

While fiscal and monetary issues are the immediate responsibility of the government and the Fed, we must remember that our public policy institutions ultimately reflect and respond to the society that created them. Thus, as concerned citizens each of us bears responsibility for the kinds of pressures and expectations we put on our government and the central bank.

Having expressed these caveats about policy directions in the year ahead, let me close by expressing my fervent hope for this significant year. We have not only a new president but also a new Congress. If they set out to work together in developing a fresh and far-sighted approach to some of the major problems that beset the U.S. economy, like the deficit, health care, and our long-term productive capacity, I am certain that the old saw, "Well begun is half done," will apply. Businesses, bankers, financial market participants, consumers, workers, all of us must be ready and willing to support public policies that hold the promise of improving the performance of the U.S. economy over time. Unless we do this, we will find ourselves unable to compete in the global marketplace that is already with us and unable to improve living standards significantly in the future. I look forward with excitement to 1993 and to the development of a policy framework that prepares us for the twenty-first century.