

FINAL

THE ECONOMIC OUTLOOK AND POLICY CHALLENGES FOR 1993

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I am honored to have the opportunity to address the Atlanta CFO Forum. I have been asked to discuss economic policy, certainly a very timely topic as we begin a new year and a new Administration and Congress are about to take office. By way of background for this discussion, I would like to begin with an overview of the economic outlook for 1993, a rather pleasurable task because prospects are a bit better than a year ago. I would also like to share with you very briefly my view on economic prospects for the Southeast. Then, from this context I will talk about several national policy issues that are of particular significance at this juncture.

The U.S. Economy

Turning first to the U.S. economy, last year gross domestic product, or GDP, expanded by around 2 percent. Inflation, as measured by the consumer price index, averaged just under 3 percent. At the same time, productivity gains were better than expected and they dampened job growth. As a result, the unemployment rate actually increased and averaged 7.4 percent during the year.

In 1993 I expect GDP to expand, on an annual average basis, by close to 3 percent. The unemployment rate should average around 7 percent and could end the year slightly below that level. Indeed, employment clearly began to grow in 1992 after shrinking the year before. 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, households 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. Construction of single-family houses has already been rising for more than a year in the wake of lower mortgage interest rates and the gradual absorption of the large inventories of homes built in the 1980s. 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, 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.

More troubling 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 have been 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 is not likely to be completely reversed in 1993, nor is slackened demand for U.S. products in the advanced economies likely to be offset by rising demand in Latin America and the Pacific Rim. Their rapid growth rates are not enough to make up for their relatively small share of U.S. exports. 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. The positive national prospects for single-family housing and increased consumer spending on durables bode well for several important southeastern industries, particularly textiles, lumber, home appliances, furniture, and auto-related

manufacturing. Demand for these products will be propelled not only by economic forces at work nationally but also by the regional rebuilding going on in south Florida and Louisiana as a result of Hurricane Andrew.

Since the region is not a major capital goods producer, the expected strength in capital spending by businesses on equipment will be less of an advantage. At the same time, the decline in defense spending and the deceleration in export growth will have a smaller adverse impact on the Southeast. For the most part, these industries are less important in this region than in others. Another area of potential weakness is the service sector. 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. Overall, however, the region should grow at a faster pace in 1993 than in 1992.

Policy Issues for 1993

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 the 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.

I do not want to leave the impression that I am among those who regard public policy as not particularly effective. In my view, 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. In this sense a very serious side-effect of the large deficits we have had is that they created a cynicism about policy on the part of Americans. Many people came to believe that fiscal 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 are seen as increasing the potential to grow.

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. I am very pleased with the progress this country has made during the last ten years. Inflation reached double-digit rates in the late 1970s and early 1980s. The Fed was able to bring this rate down to around 4 1/2 percent by 1984, 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.

Moving forward, we must not 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.

Conclusion

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.