

THE ECONOMIC OUTLOOK FOR 1993
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It is a great pleasure for me to be here in Montgomery to address the Kiwanis Club. Before I get into my talk today about the economic outlook for the nation and the Southeast, let me first say that these are interesting times to be a citizen of the United States. At long last, both the people and our political leaders seem to be coming around to a point of view that the Federal Reserve has been voicing for some time--that is, that something must be done about the huge federal deficits that significantly hamper our long-term capacity to grow. As anyone who has ever overused a credit card or taken on excessive debt knows, paying down such debt involves some pain. The similar circumstance of our nation means that it will be painful to cut the deficits and eventually begin to pay down the national debt. But I am heartened by what seems to be a new attitude about changing our ways and returning to sound fiscal habits as a nation.

The U.S. Economy

Before I comment on this, let me turn to the outlook for 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 the economy to do better. GDP will 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.

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 inventory 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 weakness include not only commercial construction but also government spending and, for the first time in many years, international trade. With the new Administration having been in office for only a month, it is somewhat risky to forecast government spending, even knowing what spending cuts and increases President Clinton has proposed. Clearly, though, there are well-defined plans in place 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 has begun to widen--it grew by nearly 30 percent in 1992, widening to \$84 billion--and will continue to widen after narrowing steadily since the late 1980s.

The proposals to reduce the deficit made by the President last week have not caused me

to make any major changes in my overall economic outlook for the nation. However, they do make some areas of the outlook less certain. For instance, spending may shift among the consumer, government, and investment categories. Generally speaking, though, while the new fiscal policy should have an impact on the economy, significant effects probably will not be felt in 1993.

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. This is certainly evident here in Alabama where industries that produce nondurable goods like military apparel helped the state to survive the recession relatively unscathed. However, these producers began to experience weaker demand by the end of last year. In the 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.

Now for some specifics on the economic outlook for Alabama, whose economy performed rather well during the national recession and in the early stages of the recovery. Unfortunately, this relatively good performance does not presage a long period of above-average growth. Although the state has developed a more efficient and resilient industrial sector, much of the recent growth came from a surge in government employment over the past two years. This growth in the public sector cannot be sustained. Thus, an overall deceleration in growth seems to be on the horizon.

The Re-emergence of Fiscal Policy

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 I mentioned at the outset, I believe that the new leadership in this country is doing its part in this regard. In particular, I would like to give credit to the Administration for seeking to reestablish fiscal policy as a useful instrument. During the past recession, monetary policy bore virtually all the responsibility for reviving economic growth. The reason was that huge deficits made it nearly impossible to use fiscal policy as a countercyclical tool. From my perspective as a central banker, until a sound deficit reduction plan is implemented, monetary policy will continue to be the only countercyclical policy available. Now, however, the President has put on the table a far-reaching proposal for discussion and debate. While I do not have comments on particular aspects of the proposal, the action as a whole must be commended, in my view.

I am heartened that the initial reaction from the stock and bond markets has been favorable. Likewise, I believe the reaction from people across the nation has been promising. With these two sectors showing support for the plan, I believe it is all the more important for Congress to heed the call. If we are to make the changes that are necessary to ensure sustainable growth in the United States, Congress must show bipartisan support. Otherwise, the country could fall back into cynicism in regard to the need to address this issue, and we will have missed a unique opportunity.

Conclusion

In conclusion, the economy is embarking on a solid expansion, with many imbalances of recent years having been corrected. Thus conditions are as positive as they can be to address the most important economic problem--the federal budget deficit. I believe the nation is more ready

and able than it ever has been to tackle the tough problems that we have been avoiding for so long. If we can do so, then 1993 will be remembered as the year when the United States began to develop a policy framework to prepare us for the challenges of the twenty-first century.