THE ECONOMIC OUTLOOK FOR THE UNITED STATES AND THE SOUTHEAST

Remarks by Robert P. Forrestal
President and Chief Executive Officer
Federal Reserve Bank of Atlanta
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It is a pleasure to be here today at this Women Business Owners luncheon meeting. As business owners, I am sure you are all vitally interested in the outlook for the national and local economy, which I will address in a few moments. However, I imagine you are equally interested in the state of business lending. About three months ago, I was on Capitol Hill along with the eleven other Federal Reserve Bank presidents to testify before the Senate Banking Committee about regional economic conditions. At that time, one of the senators questioned us about the credit crunch. I pointed out that two years ago, the credit crunch was largely a supply phenomenon in that banks were concentrating on working out bad loans and rebuilding capital and liquidity rather than on making new loans. Recently, it seems the situation has become much less of a supply problem and more of a demand problem. By that, I mean that many bankers tell me they are now in a better position to make loans, but that they are having to beat the bushes to find loans they can make.

Since most of you in this audience are on the demand side, perhaps you see things a bit differently. Clearly, the credit crunch affected small businesses the most. For quite a while now, large companies have been able to go straight to the commercial paper markets for their financing. More recently, acceptance corporations have also begun to provide a limited range of financing to all sizes of companies for specific purposes. Typical small business owners, on the other hand, must continue to depend on their commercial banker when they need general purpose credit. Therefore, while bankers concentrated on cleaning up their own balance sheets during the height of the credit crunch, many small business owners bore the brunt of the tightened credit situation. In addition, the tightness continues for customers of those banks that took hits to their balance sheets during the 1980s because of loose standards on loans. These banks have now tightened their standards in terms of who they will lend to and what kind of documentation they will require, and there is no reason to think that they will loosen these standards again.

Overall, however, I believe the credit crunch has abated thanks to the improving balance sheets within the banking industry. I am still concerned, though, about whether small businesses have ready access to financing that allows them to continue to grow. The U.S. economy depends on small business to fill market niches during good times and to take up the slack, so to speak, during down cycles. As people get laid off from jobs with big companies, they often start their own new businesses, helping to keep the economy resilient. Because of the importance of small businesses to the U.S. economy, I believe it is critical to maintain appropriate access to financing from their primary source of funds, commercial banks. In that vein, at the end of my talk I plan to touch on an idea whose time has come--the securitization of small business loans.

The U.S. Economy

Let me begin, though, by briefly outlining U.S. economic prospects to provide a context for discussing the outlook in the Southeast. For the near term, that is the remainder of 1993, I expect the overall economy to do better than it did last year when gross domestic product, or

GDP, expanded by only around 2 percent. Still, economic growth is likely to be moderate, but also not anemic. The recent GDP figure for the first quarter of less than 1 percent was, in my opinion, a retreat from an unsustainable pace late last year. Even without the effects of the March blizzards, growth would have slackened. The weak first quarter numbers are as unlikely to be repeated as were the extraordinarily strong third and fourth quarter numbers from 1992. Growth for 1993 as a whole should end up, on an annual average basis, at around 3 percent.

Inflation still remains under control, although it has begun to creep up and may go higher than the 3 percent level of last year to land somewhere between 3 percent and 3-1/2 percent. The unemployment rate has moved down from 7.1 percent in January to 6.9 percent. Nonetheless, I expect this number will average out at 7 percent.

The main sources of strength underlying the U.S. economy 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. As a result, households are in a better position to purchase goods that are typically financed with credit, and the cost of doing so is much lower than before. Moreover, there is pent-up demand in that durables simply wore out during the period of slow growth. These developments, along with employment being likely to remain on an upward trend, mean that consumer spending should remain fairly healthy--even at moderate rates of income growth.

At the same time, however, 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. 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. This population trend will also delay the turnaround in construction of multifamily housing--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 lowest point.

On the business side, capital spending will continue to be enhanced by the reduction in borrowing costs. Also, businesses are focusing on purchasing efficiency-promoting equipment like computers. Demand for industrial equipment has been hurt somewhat by a sluggish manufacturing sector but is beginning to pick up. In the commercial construction area, office construction is not likely to turn around this year because it still suffers from a glut of office space on the market. Retail store construction, however, is beginning to show a healthy increase based on construction contracts, which should carry into next year.

Areas of weakness in the economy include not only office construction but also government spending and, for the first time in many years, international trade. With the new Administration and Congress still working to agree on a deficit reduction package, it is somewhat risky to forecast government spending. Clearly, though, defense expenditures will decline. Therefore, on balance, I believe that in 1993, as in 1992, government spending will not add to growth. I find more worrisome the shift in international trade from the positive to the negative side of the growth ledger. The main reason for this change is the worsening economic outlook for most of our major trading partners. This worldwide weakness is not likely to be reversed in 1993. Fortunately, our largest trading partner, Canada, is recovering at a moderately healthy pace. Also, the outlook for Mexico, our third largest trading partner, continues to show strong demand for capital goods--an area where the United States has a strong advantage. Still, imports will continue to outpace exports as U.S. growth remains stronger than many of our trading partners until next year.

To recap, the outlook for the nation for the rest of 1993 is one of moderate growth with some promise for increased consumer spending and business investment thanks in the main to lower interest rates. The proposals to reduce the deficit made by the Administration 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 this year.

Southeastern Outlook

Turning to the Southeast, I am pleased to say that the outlook for 1993 is brighter than it has been in several years. In the area of employment growth, the Southeast has been ahead of the nation and should remain so. During 1992 the region added nearly 300,000 new jobs. This figure represents more than a 2 percent growth rate, which is at least twice the national gain. On an average annual basis, the Southeast could add more than 400,000 jobs this year to the economy, which is certainly not bad. As good as that number sounds, it also shows, though, how moderate this rebound is. During the recovery in the early 1980s, by contrast, the Southeast added around 700,000 jobs--and it did so from a smaller base.

Why will the Southeast do better than the nation? The main reason is that this region produces the goods that people have been buying once the recession ended and the recovery began. For instance, with lower interest rates, more people have been able to purchase homes. Fortuitously, the Southeast is a major nationwide supplier of lumber used in residential construction. In addition to lumber, the large textile industry in the Southeast 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. Demand for home appliances that are produced in several southeastern states is also receiving a temporary boost from the rebuilding going on in south Florida and Louisiana as a result of Hurricane Andrew. However, the stimulus from Hurricane Andrew will diminish in the second half of the year as the rebuilding effort peaks.

Aside from construction-related spending, the expected nationwide increase in demand for consumer durables is good news for the numerous auto and auto-related manufacturers in the Southeast. Textiles mills should also gain from this development since many textile products are destined for automobiles. On balance, regional manufacturing should lend strength to the economy of the Southeast.

Another sector contributing strength to the regional expansion 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. New home sales remain strong. In fact, payroll employment figures show that the southeastern construction industry created more jobs in the first quarter than were recorded nationwide on a net basis. A good part of this activity is due to the many young home-buying people who live in or who have moved to this region of the country. While apartment and condominium building will remain weak, the long slide in multifamily and nonresidential construction appears to be over.

The good news extends even to banking and financial services employment, which is slowly edging higher. This turnaround may be attributed to the increased refinancing activity from both households and business. As I mentioned at the outset, the level of business loans also is improving slowly and should gain momentum through the year.

There are, to be sure, certain areas of weakness. Industries that specialize in nondurable goods, most prominently apparel, will contribute less than they did during the initial recovery period, and this will have an effect on the regional economy. 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. Moreover, there are other areas of potential weaknesses. The region is not a major capital goods producer. Thus, the expected strength in capital spending by businesses on equipment will be less of an advantage. It also remains to be seen whether the trend toward consolidation and layoffs in communication, transportation, and other professional and business services has hit bottom. This dynamic has been a blow to several large southeastern cities, just as it has been nationally.

The decline in defense spending nationally will also certainly have an adverse impact on the Southeast. For the most part, though, defense-related manufacturing is less important in this region than in areas like the Northeast and the Far West. While the region depends less on defense contracting than other parts of the nation, the Southeast does have a greater proportion of military personnel. Therefore, the proposed military base closures will affect this region through job losses.

Access to Financing for Small Businesses

With the outlook for 1993 looking relatively good for the Southeast as a whole, let me address the topic of business lending. We at the Fed are looking for ways to lighten the load on banks from unnecessary regulations that stem the flow of business lending. The underlying problem is that new regulatory requirements on banks meant to increase safety and soundness also sometimes carry unwanted baggage. Specifically, the increased burden of regulation on banks raises the cost of financial intermediation, which, in turn, raises the cost of bank credit.

In an effort to find new ways to assure access to capital for small businesses, the Fed supports securitizing business loans just as mortgages and credit card loans have been securitized. A secondary market for business loans could substantially increase access to capital for small businesses. Of course, one of the reasons such loans have not been securitized before now is that small business loans are quite diverse. In comparison, mortgages, for example, are fairly standardized. I am confident, though, that the markets will be able to meet this challenge just as they have in the past with other seemingly diverse items. Even so, character loans that depend on the judgment of the lender will probably remain too individualized to be packaged and sold. Therefore, banks and bankers will still be the lender of first and last resort for many small business owners. With that in mind, the Fed, the Department of the Treasury, and other regulatory agencies will continue to search for ways to mitigate the regulatory burden. One such measure, which is now being debated, involves increasing the percentage of loans with minimal documentation that sound banks can make. Also, because small businesses often rely on real estate as collateral, regulators are looking to see if the efforts to stem real estate lending problems in the wake of the savings and loan crisis might be having an unintended adverse effect. A current proposal would raise the threshold above which appraisals are required. Efforts such as these should help to encourage banks to make more loans to worthy small businesses.

Conclusion

In conclusion, the national economy is embarking on an expansion, and the Southeast will do better than the United States during 1993 in terms of growth. As a nation, we have begun to grapple with the budget deficits, which I believe have created a significant drag on economic growth in the past few years. If we are able to succeed with solid deficit reductions, the implications for long-term growth in the economy are encouraging. Still, some problems remain in the area of financing for small businesses. I am more hopeful than ever that we can meet this challenge and that the business owners in this room will continue to contribute to the strength and vitality of the strongest economy in the world.