THE INTERNATIONAL ECONOMIC OUTLOOK FOR 1994
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It is always a pleasure to visit the World Trade Club Atlanta to address the German American Chamber of Commerce and the other co-sponsoring groups on the topic of my international economic outlook for the new year. This year, I find myself in the enviable position of being able to report on many positive developments in international trade as well as some promising changes in the long-term outlook for the United States. At the same time, I must speak less happily about the state of the world economy in which many ordinarily resilient economies have been experiencing slowdowns and recessions.

Overall, there are some notable contradictions in the world situation today. Like the lyrics from a Broadway musical by Stephen Sondheim: "What's hard is simple, what's natural comes hard." For instance, what could be more natural than free and open trade with our good neighbors, Canada and Mexico? But as we saw in 1993, getting Congress to sign off on NAFTA (the North American Free Trade Agreement) was surprisingly difficult for the Administration. In the same vein, it was easy to be caught up in the euphoria that accompanied the end of the Cold War and to focus on the peace dividend and other positive long-term outcomes. In the near term, however, reformers in various countries face serious difficulties in changing the face of government. Here in the United States, we are learning to contend with the needed defense cutbacks and their effects on certain hard-hit regions of the country.

On the other side of the coin, some things that seemed hard to do were really much simpler than we imagined. Many people seemed to think that it would be nearly impossible to revive the U.S. economy after the recession since fiscal policy was not available as a tool for stimulating the economy. As a central banker involved in monetary policy, I am very pleased to point out that monetary policy, along with the responsiveness and flexibility of the U.S. economy, has managed to see the economy through. The current environment of low inflation and low interest rates has facilitated several important structural adjustments, such as reduced leverage and increased productivity. This achievement flies in the face of what had been common wisdom about the need for stimulative fiscal policy measures.

Some of the policy issues that I believe will continue to have significant consequences for the global economy include free trade, employment (or, I should say, *un*employment), and the apparent struggle for economic reform in Russia. At the end of my remarks this evening, I will go into more detail about these issues. First, however, let me provide a run-through of the economic outlook for 1994 throughout the world, starting with the Group-of-Seven industrialized nations.

International Overview

Looking at the G-7 economies as a whole, growth should pick up moderately, increasing to about 2 percent as an annual average in 1994. This rate would be up from the modest pace of just over 1 percent last year, projected on an annual average basis. Those G-7 countries with the strongest growth will be Canada at more than 3-1/2 percent annually, followed by the United States and Great Britain. Inflation in all of the G-7 countries still appears to be under control, with a projection of a bit more than 2 percent in 1994, down from a 1993 estimate of 2.4 percent. I should mention that these and other economic forecasts for countries other than the United States are based on OECD (Organization for Economic Cooperation and Development) numbers.

U.S. Economic Outlook

Now let me turn to the outlook for the individual G-7 nations and then other industrialized and developing nations. In the United States, I believe we will have another good year of moderate growth with GDP expanding by about 3 percent--slightly faster than in 1993. In fact, the momentum of business activity in the last three months could even push this figure higher. I expect inflation, as measured by the CPI, to increase at an annual average rate of between 2-1/2 percent and 3 percent. Earlier declines in oil prices and ongoing import competition are keeping prices well behaved. Of course, if growth does prove stronger than expected, we could see rising pressures on resources by the end of the year. Unemployment should continue to improve, perhaps dropping by as much as half a percentage point, even though certain methodological changes by the U.S. Department of Labor will raise the stated rate somewhat.

Areas of strength will change little from last year. Consumer spending will still be strong, especially on durable goods like autos and household appliances. Home furnishings should also remain healthy, owing to the fact that residential construction will again be a solid contributor to growth. The continuation of pent-up demand for consumer goods should support continued growth in manufacturing. Finally, capital spending by businesses, especially on computers and industrial equipment, should remain vigorous. The relatively low interest rates we have had in recent years is a factor in all of these areas. Recent employment gains should also provide support for further increases in personal income and consumer spending.

To be sure, there are also specific areas of weakness in the economy, which are essentially the same as last year: commercial construction, government spending, and international trade. Office construction still suffers from overbuilding in previous years, but I believe that we are slowly beginning to see a modest upturn. While state and local purchases will grow, government spending overall will be weak because purchases on the federal level are being affected by defense cutbacks and deficit reduction. Of course, I do not view this "weakness" negatively because deficit reduction is long overdue. Another negative factor is the outlook for net exports, which remains poor. Whatever growth in exports the United States does have will come from Mexico and other Latin American countries, as well as Canada--our largest trading partner--and Asia, excluding Japan. Computers, telecommunications, and other capital equipment should continue to be the leading exports. At the same time, imports will continue to outpace exports as growth in U.S. spending continues to outstrip that of many of our trading partners.

These negatives notwithstanding, I am optimistic because the economy expanded last year and because, at long last, the nation has begun to take major steps toward solving long-term problems. First, looking at inflation, we have had clear success in bringing it down to a much more acceptable level than at the beginning of this decade when the CPI rose 5-1/2 percent. Second, in the area of the budget deficit, where we have needed to change our ways, Congress passed a plan last year that begins to deal with it. Third, health care reform has finally moved to the top of the list of socioeconomic issues we must grapple with, and at least we are beginning to debate this difficult issue as a society.

Outlook for Other Industrialized Nations

As for the G-7 nations in Europe, it seems that the continental European recession is bottoming out, but recovery in many countries continues to be slow. In the case of Germany, economic activity appears to be restrained by rising unemployment and, in a larger sense, by the strains of reunification. Overall growth is expected to be less than 1 percent this year, with less than 1/2 percent in western Germany and about 6.5 percent in the much smaller east. France should begin to see a recovery in its economic growth this year, thanks in part to interest-rate cuts that should stimulate activity. Improved export markets should also help the French economy begin to grow slowly this year at slightly more than 1 percent, compared with a contraction in 1993. Unfortunately, unemployment reached a record 12 percent last year and could remain high. In Italy, where unemployment is also a major problem, increased exports generated mainly by the depreciating lira may help the economy to expand by more than 1 percent also.

In other European countries, the outlook is mixed. Belgium should shake off its recession this year, but its recovery will likely depend on what happens in Germany. Denmark looks like it might achieve moderate growth this year of around 2-1/2 percent. Switzerland should be coming out of its recession this year, particularly if inflation continues to fall. Finland, where one-fifth of the labor force was unemployed last year, is not likely to begin a recovery this year, despite strong growth in exports.

The pace of business activity is somewhat better in Great Britain, where the economy continues to recover. Expansion could reach a 2 percent rate this year, as unemployment declines slightly and consumers spur much of the growth. The moderate recovery in Canada should continue to strengthen this year, making Canada the strongest economy of the G-7 for three years running now. The weaker Canadian dollar is boosting manufacturing activity and exports, and consumer spending has been stronger than expected. Canada also benefits from stronger growth in its dominant trading partner, the United States. A third English-speaking country, Australia, also has been recovering from its recession, and its economy should become stronger this year with average GDP growth expected to be more than 3 percent.

Like other G-7 countries, Japan has been struggling with a much-weakened economy and rising unemployment. One promising sign for the future, though, was the recent agreement between Prime Minister Hosokawa and the LDP (Liberal Democratic Party) on a political reform package. Investors were certainly encouraged, sending the Nikkei average up considerably soon after the agreement was announced. With the beginning of reform in hand, perhaps leaders in Japan can now focus new attention on using the budget for stimulus. Such action may help Japan to ensure a turnaround in the second half of the year. Average annual growth for 1994, however, is still expected to come in once again under 1 percent, far below the rate that had become customary for Japan.

Outlook for Developing Nations

Turning now to the economic outlook for developing nations in the world, Latin America continues to be a bright spot in the global economy. In past years, I have gone into some detail on this topic, so I will not do so this year except to say that the economy of Chile is performing better than expected with growth of nearly 5 percent projected for this year and that the economy of Mexico should see stronger growth ahead now that NAFTA has been approved.

Most of Africa still has almost insurmountable problems, but I would like to focus on the promise of South Africa. This nation has made great strides in the past year toward seeking a new recognition of all of its citizens by ending apartheid. South Africa has the most advanced economy in Africa. If people in that country can at last work together, its economy could begin to form the nucleus of significant economic growth and development among a number of other southern African nations, and perhaps signal a turning point for the continent as a whole.

For the long term, it is the economies of China and East Asia that will present the most interesting challenges to the rest of the world because of their tremendous growth and their increasing importance in the global economy. Of the most important Pacific Rim economies, none has projected growth of less than 5 percent this year. Growth in China is expected to average more than 9 percent. As these nations take their places in the global economy, the United States and other countries should have many economic opportunities, if we can become active participants in their markets.

To sum up my outlook then, before I discuss some important policy issues, the strongest GDP growth in the world is coming from developing Asian economies, as the industrialized nations are either trying to recover from recessions or experiencing moderate expansions. Lower oil prices should help the industrialized economies at least in the near term, but growth in Europe and Japan appears likely to remain too slow to prevent rising levels of unemployment.

Policy Issues in the Global Economy

Last year, we reached promising milestones for the global economy with the successful conclusion of the Uruguay Round of GATT and the approval of NAFTA. When such meaningful events take place, it is almost a shame that we cannot celebrate them together as global citizens. Speaking personally, I am very pleased that we achieved the additional steps toward trade liberalization even though the successes were incomplete. Nonetheless, the debate over NAFTA and the difficulty of concluding a GATT agreement show how strong the forces of protectionism are. These episodes also point out the challenges that lie ahead.

However, there are two other issues, which I mentioned at the beginning of my remarks, that do not represent the sort of progress we have seen in the area of international trade. This evening, in taking a look at problems that could possibly affect the global economy, I would like to focus on unemployment and troubles with reform in the former Soviet Union.

The rising level of unemployment, reaching into the double digits, is a plague on the economic houses of many European nations. (Even Japan, which has the lowest unemployment levels of the G-7 nations, is being affected by increasing unemployment among its labor force--a novel situation.) In Europe, though, as much as the rising levels of unemployment are a problem, the nature of the unemployment is more troubling: rather than people being out of work for short periods of time, unemployment is proving to be long term. Young people in their 20s and 30s are among those most affected. This kind of unemployment has been created in part by regulations that limit flexibility in labor markets; regulations that make it very expensive for companies to hire or fire people; regulations that require, for instance, six weeks or more of vacation. Such regulations dampen the ability of companies to initiate new projects, because they are afraid of being saddled with surplus employees if the project does not work out. Politically, it is always difficult to change rules that people in a society have come to depend on. However, without some recognition that employment cannot be stimulated through regulation, it will be very difficult to ensure healthy economic expansions.

Another area of concern is the situation in Russia where reform-minded politicians seem to have been shunted aside and Russian nationalists have been voted into power. I am troubled by this situation. What many of us may not realize is that the break-up of the former Soviet Union disrupted trade not only among its former satellite countries but also within the huge nation itself--between Russia and Ukraine, for example. This situation has contributed to problems with output. Concurrently, monetary problems developed as former republics have tried to set up their own monetary systems separate from Russia's, and, more fundamentally, as the central bank has allowed inflation to run rampant.

Although more than $25 billion in aid was promised last year by G-7 nations, apparently nowhere near that amount has been delivered. The fragility of the economic and political systems makes it difficult to provide such aid without conditions. At the same time, there is enormous potential in these nations even though their citizens have much to learn about market economies. We can only hope that the countless and sincere efforts of individual firms, educational institutions, and specialized groups will create domestic support for the groundings of a market economy--in contract law, property rights, and the rudiments of fiscal and monetary policy, for example.

Independence of the Central Bank

Before I conclude my comments tonight, I would like to discuss another subject that is close to my heart as the President of the Federal Reserve Bank of Atlanta. I find it quite ironic that in a period of great changes in the world, when more and more countries are making their central banks *more* independent, here in the United States, we seem to be trying to make ours *less* independent. Although Congress has occasionally questioned the need for various aspects of the Fed's independence, lately it seems to me that it has been more-than-usually interested in reining in the independence of the Fed. For instance, the chairman of the House Banking Committee is sponsoring legislation to videotape monetary policy deliberations along with a variety of other measures that would politicize the Fed. On this point, I would like to say that the deliberative and thoughtful approach we take to monetary policy would be seriously undermined by politicizing the central bank.

In addition to Congress, the executive branch has recently added its voice to the chorus by putting forth a proposal to remove the Fed from its bank regulatory and supervisory function in order to create a simplified regulatory system. Since my time this evening is limited, I will refrain from entering into a spirited defense of the Fed. I will add, however, without going into any detail, that since the central bank is the organization charged with maintaining the health and stability of our complex banking system, a wholesale change of the regulatory system such as the Administration has proposed could needlessly imperil the financial system. In my view, removing the Fed from hands-on responsibilities for supervising at least a part of the banking industry reduces our ability to deal with systemic risk.

Perhaps the Fed has not been articulate enough or persuasive enough in explaining its vital role in the smooth functioning of the U.S. economy. The plain truth is that the healthiest economies in the world are served by the most independent central banks. Those countries that have the strongest separation between the fiscal and monetary authorities are also most likely to have low rates of inflation and growth that is sustainable. I do not like to think of what might have happened in the United States had the Fed not taken anti-inflationary actions over a long period of time to create the current sustainable growth that benefits the entire nation. To achieve this goal, we have not pursued a single-minded effort to reduce inflation without regard to transition costs and social preferences. In fact, the accommodative policy stance we pursued in recent years helped to soften the recession and foster the ensuing recovery and expansion.

Despite this success, the importance of central bank independence is a lesson that some foreign countries seemed to have better learned than we Americans. I am hopeful that those countries now moving toward greater independence for their central banks will offer up an object lesson that might, by virtue of its distance, provide some perspective to those in the United States who question the need for an independent central bank. While the Fed will always have its critics--and, in a democratic society, that is as it should be--their criticisms should not make us lose sight of the value of the checks and balances that strengthen this nation.

Conclusion

In conclusion, I am, as ever, energized by the challenges and opportunities presented in our world today. Yes, we have many problems yet to deal with, but I believe we must also take pride in the substantial headway we have made in terms of international trade issues. Many developing nations have begun to exhibit the kind of growth rates that the industrialized nations were accustomed to in the past. Many industrialized nations are struggling with constrained circumstances, but should be emerging from their travails if not this year, then next. Unemployment and economic reforms present serious challenges for the future. The changes many countries are going through are definitely not easy. Nevertheless, I believe that we all have a future that is much more hopeful for an integrated global economy than it ever has been in the past.