THE INTERNATIONAL ECONOMIC OUTLOOK FOR 1994
Remarks by Robert P. Forrestal
President and Chief Executive Officer
Federal Reserve Bank of Atlanta
Alabama Foreign Trade Relations Commission
Mobile, Alabama
June 29, 1994

It is a pleasure to be here today to address your group, particularly since it gives me the opportunity to discuss some issues in the international arena. Although the news may be filled with many disturbing items about the world--North Korea, Bosnia, and Haiti, just to name a few--there are also many positive developments in the international economy to report on, as well as some promising changes in the long-term outlook for the United States.

Overall, there are some notable contradictions in the world situation today. One that comes to the top of the mind is why the U.S. dollar weakened last week even as the U.S. economy has been exhibiting steady growth. There are no simple answers to this question. Another puzzle on the topic of free trade hearkens back to last year. The North American Free Trade Agreement was necessary to ensure free and open trade with our good neighbors, Canada and Mexico. Nonetheless, as we saw in 1993, getting Congress to sign off on NAFTA was surprisingly difficult for the Administration. I realize that I feel like Daniel walking into the lion's den since I am speaking here in Alabama where many apparel manufacturers are being adversely affected by foreign competition. Most of you probably know, though, that this competition pre-dated NAFTA. From the larger point of view, I think we all agree that free trade is a necessary underpinning of good foreign relations and good economics.

Continuing in the vein of notable contradictions, would anyone in this room have imagined that, in 1994, we would witness the Japanese economy being affected by a government in disarray, while some Latin American economies benefit from concerted government efforts to hold down inflation? One final example from our own nation: 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, managed to see the economy through. The current environment of low inflation and relatively low interest rates, even though they have risen since the beginning of the year, has facilitated several important structural adjustments, such as reduced leverage and increased productivity. This achievement flies in the face of so-called common wisdom about the need for stimulative fiscal policy measures.

Three policy issues that I believe will continue to have significant consequences for the global economy are free trade, employment (or, I should say *un*employment), and the need to keep central banks independent from politics. At the end of my remarks this afternoon, 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 2-1/2 percent as an annual average in 1994. This rate would be up from the modest pace of just over 1 percent last year. I am even more encouraged about the pick-up in growth because of the signs of an incipient upturn in both Germany and Japan. Those countries leading the G-7 with the strongest growth will be the United States and Canada, followed by Great Britain. Inflation in all of the G-7 countries still appears to be under control, with a projection of between 2 percent and 2-1/2 percent in 1994, perhaps down slightly from 2-1/2 percent in 1993. I should mention that these economic forecasts for countries other than the United States are based on numbers from the Organization for Economic Cooperation and Development (OECD).

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 the economy could grow between 3 and 3-1/2 percent for the year as measured by gross domestic product (GDP). Inflation, as measured by the consumer price index (CPI), should increase by around 3 percent this year. Earlier declines in oil prices, productivity gains, and ongoing import competition are keeping prices well behaved in the near term. Unemployment should move down to about 6 percent toward the end of the year.

The main strength supporting this outlook lies in consumer spending, especially on durable goods like autos and household appliances, but there are other strengths. Residential construction will also make a solid contribution to growth, leading to continuing strength in related areas, such as home furnishings. The purchases of consumer goods should support continued growth in manufacturing. Finally, capital spending by businesses, especially on computers and industrial equipment, should remain vigorous. The lagged impacts of the relatively low interest rates of the last few years--even though rates have moved up recently--are a factor in all of these areas. Recent employment gains should also provide support for further increases in personal income and consumer spending. On another promising note, imbalances have been worked down substantially on corporate balance sheets, due largely to the earlier declines in interest rates, the lengthening of debt maturities, and equity issuance. Banks and real estate firms are also stronger.

To be sure, there are also specific areas of weakness in the economy: commercial construction, government spending, and international trade. Office construction still suffers from overbuilding in previous years, but I believe that we are beginning to see a modest upturn. While state and local purchases will grow, government spending overall will be weak because expenditures at 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.

The third negative factor is the outlook for net exports, which remains poor due mainly to the weak economic conditions of many of our largest trading partners. This situation abroad, however, has begun to show signs of reversing. I expect the western European economies to round the corner later this year. Whatever growth in exports the United States does have will come from Latin American countries, Canada--our largest trading partner--and Asia, excluding Japan. Computers, telecommunications, and other capital equipment, as well as services, should remain the leading exports. In fact, our leadership in technology bodes well for the future. At the same time, imports will continue to grow faster than exports as the increase in U.S. spending still outstrips that of many of our trading partners.

These weaknesses notwithstanding, the risk in this outlook is not whether the U.S. economy can expand. Rather, it is the possibility that too rapid and thus unsustainable growth will ultimately contribute to rising inflation--an outcome the Federal Reserve most assuredly wants to avoid. Therefore, the Fed began in February to shift away from the accommodative monetary policy stance we had had for some time.

Certainly, we recognize that the globalization of the U.S. economy helps to dampen domestic price pressures. However, the economy has been growing at a rate in excess of its long-run potential, thereby running the risk of constraints on capacity. This situation often leads to inflation. Early in a recovery period, this is not a problem, but, as the gap between actual and potential output narrows, central banks begin to become concerned that the momentum will push an economy through its capacity constraints. Although there have not yet been any signs of accelerating inflation at the retail or output level in the United States, the pressures that can lead to it are there. With the current course of monetary policy, the Fed wants to make sure that inflation will no longer be a problem in the United States. In that light, it is critical for us to fend off inflation before it starts recurring.

Before moving on to my outlook for the international economy, I would like to say a few more words about inflation. It may seem to many people that the Fed spends too much time worrying about inflation, particularly since the economy is healthy now, and inflation seems to be quiescent. However, an important point to remember is that the costs of inflation are significant. One reason for having an independent central bank is that it allows us to take a longer view of the economy. This long-term vision is especially important when dealing with inflation because price increases accelerate with a long lag. At the same time, I am not so single-minded as to believe that we must achieve zero inflation immediately or that we necessarily have to reduce inflation at every stage of the business cycle. As I see it, there are always trade-offs to be made when trying to bring inflation down. Businesses, labor, and consumers must be given time to adjust their financial behavior in light of changing economic policy. Too quick an adjustment can cause too much pain, and I personally believe policymakers must be attuned to these social costs.

Outlook for Other Industrialized Nations

Now let met turn the 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 picking up after a period in which it had been tempered by rising unemployment and, in a larger sense, by the strains of reunification. Overall growth is expected to be between 1-1/2 and 2 percent this year, with around 1 percent in western Germany and around 7 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 around 1-1/2 percent, compared with a contraction in 1993. Unfortunately, unemployment remains over 12 percent and could remain high for some time. In Italy, where unemployment is also a 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 percent. Switzerland should be coming out of its recession this year, and Finland, where one-fifth of the labor force is unemployed, is not likely to begin a recovery until next 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 2-1/2 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 to around 3-1/2 percent. 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.

Like other G-7 countries, Japan has been struggling with a much-weakened economy and rising unemployment. Political turmoil has made it difficult to confront economic weakness in the country. This situation was not helped by the resignation of Prime Minister Hata this last weekend after a short term in office. The hope was that with the beginning of political reform in hand as well as a budget, leaders in Japan could begin to focus new attention on the economy. It is not clear what affect this continuing political turmoil will have on the economy. As it stands now, however, average annual growth for 1994 is expected to come in once again under 1 percent, far below the rate that had become customary for Japan. Even as the economy in Japan begins to turn around, the thorny issue of its trade relations with other nations remains.

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. The economy of Chile continues to boom with growth of nearly 5 percent projected for this year. Growth in Brazil, Argentina, and most other Latin American economies is slowing a bit from 1993, but that appears to be the result of tough anti-inflation factors adopted by these countries. Growth for the region should still exceed 3 percent this year and will probably pick up again in 1995. Despite negative press reports and some market perceptions, I am still positive about prospects for Mexico. I believe that the leaders of the country have established a sound and solid base from which to recover from the tragic violence earlier this year. NAFTA should also help. As a result, growth should pick up this year and next as inflation continues to fall.

Most of Africa still has almost insurmountable problems, but I would like to focus on the promise of a free South Africa. 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. In contrast, the Middle East continues to struggle to achieve sustainable economic growth. Some negative factors include the painfully slow progress of the Arab-Israeli negotiations; the violent challenges to governments in Egypt and Algeria by Islamic fundamentalists; and the low price of oil.

Another area of concern is the former U.S.S.R. 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 allowed inflation to run rampant.

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. India, too, is also a country that offers substantial new opportunities as a result of its government having loosened certain regulations. Of the most important developing Pacific Rim economies, only the Philippines 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 experience moderate expansions. Lower oil prices have helped the industrialized economies in the last two years, but growth in Europe appears likely to remain too slow to cause a significant downward trend in unemployment.

Policy Issues in the Global Economy

Three policy issues I would like to discuss that have an effect on the global economy are free trade, unemployment, and the need to keep central banks independent. 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, particularly with getting GATT through our own Congress in the next few weeks.

However, another issue that can have an equally large effect on the global economy is unemployment. In Europe, 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 on which people in a society have come to depend. However, without some recognition that employment cannot be stimulated through regulation, it will be very difficult to ensure healthy economic expansions.

Before I conclude my comments this afternoon, I would like to discuss one other 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 other measures that would politicize the Fed. On this point, I would like to say that the deliberative approach we take to monetary policy would be seriously undermined by politicizing the central bank.

In addition to Congress, the executive branch 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. It appears that this proposal has not gained the necessary support. That is a good thing because, 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, however, 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 learned better 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 excited 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.