

THE 1995 INTERNATIONAL ECONOMIC OUTLOOK
Remarks by Robert P. Forrestal
President and Chief Executive Officer
Federal Reserve Bank of Atlanta
To the German American Chamber of Commerce and the World Trade Center Atlanta
Atlanta, Georgia
January 24, 1995

Nineteen ninety-four was a year of turnaround and resurgence in many areas of the world and one in which some clouds appeared on the horizon. While 1994 saw the ratification of the General Agreement on Tariffs and Trade (GATT) in the United States and the beginning of recoveries for our trading partners in Europe and Japan, it also saw the sharp depreciation of the Mexican peso in late December and the ensuing turmoil in Latin American financial markets. Although I am no Pollyanna on the topic of Latin America, I do believe that this emerging region is fundamentally sound and that it will persevere through the latest economic problems. After I discuss the international economic outlook, I would like to talk about longer-term prospects for global integration in the face of the negative developments we have encountered this past year. There are three issues in particular that I think are important: the reality of a European monetary union, the Mexican situation, and the need for the Western hemisphere to press on toward further opening of trade and deeper financial linkages.

An International Overview

Beginning with the Group of Seven industrialized nations, growth for the G-7 as a whole should continue to increase moderately to about 3 percent as an annual average in 1995. That would be up from the 2-1/2 percent pace of last year. [Let me interject here that the economic numbers for countries other than the United States that I am using this evening are based on forecasts done by the Organisation for Economic Cooperation and Development (OECD).] I am

even more encouraged about the pick-up in growth now that the recovery in Germany is fully under way. A week ago, accumulating signs were positive for Japan. The recent earthquake will alter that assessment, although it is too soon to know the extent of the damage. We do know that the rebuilding that follows such a catastrophe tends to stimulate economic activity, even though the event itself reduces wealth. Those countries leading the G-7 with the strongest growth will be Canada and Great Britain, followed by the United States and France. Notwithstanding this stronger growth in general, the average inflation in all of the G-7 countries should continue to stay within a reasonable range of between 2-1/2 percent and 3 percent in 1995, up a bit from just over 2-1/2 percent in 1994.

The U.S. Economic Outlook

Now let me discuss the outlooks for the individual G-7 countries, starting with the United States. Growth in output, or gross domestic product (GDP), of 4 percent last year was stronger than I had anticipated. This year also looks like another good year, but with somewhat more moderate growth of 3 percent on an annual average basis. I might add that, considering that the expansion has been going on for nearly four years, this rate of growth would also be more appropriate. With growth decelerating, it is unlikely that unemployment will decline much further, and it could even edge up a bit as the year progresses. My best guess is that it will average between 5-1/4 percent and 5-1/2 percent. Inflation may rise to somewhat above 3 percent, since price pressures tend to increase, albeit at a lag, as the economy operates at or near capacity. Moreover, energy prices are likely to rise. Demand is increasing in Europe and other industrialized countries whose recoveries are gaining momentum, as well as in China and other rapidly developing countries.

As has been true the past few years, the main areas of strengths and weaknesses in the economy will not change much in 1995. Certain components of gross domestic product that have been growing strongly through 1994, such as personal consumption, capital spending, and construction, will still be growing--but at a slower and more sustainable rate. Sales of automobiles and other durables will be good again in 1995, but they will not provide an added boost to the economy as they did in 1994. Capital spending on plant and equipment, which has been growing in the double-digit range for two years now, will be decelerating. The boom in building activity--particularly construction of single-family homes--has now peaked.

As for weaknesses, government spending is likely to remain essentially flat after shrinking somewhat last year. The ongoing pressure to reduce the federal deficit should help to keep government spending down. Of course, even with modern computer technology and advances in methodology, it is hard to make political forecasts. Still, any changes that the new Congress might enact are not likely to affect economic activity directly in 1995, although they could indirectly affect expectations as reflected in financial markets.

Looking at that part of our economic growth that is affected by foreign trade, I can say that the gap between exports and imports should begin to shrink this year after several years of growing larger. The U.S. trade balance, however, will continue to be in considerable deficit. The United States has been growing relatively faster than its traditional trading partners. In turn, the demand here for imports has increased faster than the demand abroad for U.S. exports. Fortunately, the signs point to a narrowing of the trade gap this year, as the U.S. expansion

slows and the pace of economic growth picks up in some of our important trading partners, such as Germany and Japan. Additionally, the ratification of the General Agreement on Tariffs and Trade (GATT) will set a more positive climate for U.S. trade, although I do not expect a substantial impact in 1995. At the same time, the Mexican peso has depreciated dramatically in recent weeks. This development, along with the institution of more restrictive economic policies in that country and possibly others in Latin America, may restrain demand for U.S. exports.

The Outlook for Other Industrialized Nations

Let me now turn to the prospects for other industrialized nations. The European recession has ended, and recoveries are under way in most countries. The strength of the economic recovery in Germany was welcome news, given the difficult forces of unemployment and the pressures of reunification that Germany has had to confront. One method of alleviating the strains of reunification on the German budget is the so-called unity tax. The government will try this tax again in 1995 at a rate of 7-1/2 percent. For the nation as a whole, growth could reach nearly 3 percent this year, up from roughly 2-3/4 percent in 1994. Strong investment spending in North American and booming East Asia is boosting exports by the traditionally strong capital goods industry in Germany. This activity has helped to promote the German economic expansion in the face of sluggish consumer demand at home.

France has also begun to recover from its recession, and improved export markets should help the French economy to grow at around 3 percent this year, compared with a little more than 2 percent in 1994. Exports and capital spending by businesses should provide the impetus for the

better performance. Wage and salary restraint should contribute to keeping the inflation rate low. It should rise only moderately from less than 2 percent last year. France, however, is still struggling with unemployment of more than 12 percent, which is not expected to decline in view of the accelerating GDP growth. Italy continues to have a similar problem with unemployment, but increased exports may help the economy to expand by more than 2-1/2 percent. The depreciation of the lira by some 30 percent against the mark since 1992 accounts for this important windfall to the Italian economy.

With the economy continuing to recover in Great Britain, growth should remain near the 3-1/2 percent level of 1994, which is quite a healthy growth rate for this nation. As many of you know, the British economy has been so strong that the Bank of England has raised interest rates to try to ensure that inflation remains under control. The housing market has been hit by the increasing rates, and the resulting slowdown in housing should serve to subdue overall consumer spending growth in 1995. However, a continuing decline in unemployment should work in the opposite direction. Also, as in the case of Italy, exports have benefited from a depreciation of the currency.

Other European countries seem to be benefiting from the German turnaround and are also continuing their recoveries. Both the Netherlands and Spain are expected to reach growth of nearly 3 percent this year. The economic recovery in Switzerland should strengthen in 1995, but the growth rate, which is expected to be a little more than 2 percent this year, may be slowed by tight monetary policy and efforts to cut budget deficits. Finally, in Sweden, high interest rates

will probably continue to depress domestic demand, leading to a growth rate of less than 2-1/2 percent.

For two years now, Japan has been dealing with a weak economy and rising unemployment and has only recently begun to stage a recovery. The fairly substantial increase in value of the yen has also been a factor in keeping growth sluggish. More recently, the effects of the tragic earthquake in Kobe will not be clear for a while. An ironic fact, though, is that when so much destruction occurs, the rebuilding afterwards often temporarily spurs economic growth. We saw this kind of spurt after Hurricane Andrew devastated south Florida in 1992. Before the Japanese earthquake, the average annual growth for Japan in 1995 was expected to be more than 2 percent after two years of growth of less than 1 percent.

Looking farther south, Australia is experiencing rapid growth that is projected to remain at above the 4 percent level, as it was in 1994.

Finally, returning to North America, strong growth in Canada should continue this year at around 4 percent, similar to growth in 1994. Although the Canadian dollar depreciated by roughly 6 percent against the U.S. dollar last year, recent interest rate increases in Canada should provide some support for the currency. Growth may be adversely affected by these higher rates. Still, exports should continue to grow strongly and may offset some weakness in consumer demand. Political uncertainty in the nation is the bigger issue that could have an effect on

growth, though, as are the large budget deficits in some provincial governments and the national government.

The Outlook for Developing Nations

Let me now move on to the developing nations in the world. The current situation in Mexico has clouded the short-term economic outlook for that country and for some others in Latin America. Nevertheless, the longer-term outlook remains positive for the region as a whole. Growth in Mexico, while not as high as was predicted before the recent economic problems, could remain positive in 1995. However, inflation could also rise considerably, particularly in the short term, as a consequence of the depreciation of the peso. The longer-run fate of inflation depends on the success of the reform plan formulated by the government.

Conditions in Argentina and Brazil are fundamentally sound, with Brazil having made a remarkable policy turnaround over the past year or so that has helped to bring inflation down. Chile, Colombia, and Peru are likely to outpace the other countries, with GDP gains of between 5 percent and 7 percent. Meanwhile, Venezuela, which had been so promising, has taken a large step backward following the bankruptcy of its second-largest bank and the subsequent de facto nationalization of its banking system. Inflation for Latin American countries should decline in 1995 to between 20 and 30 percent. That range may seem high to us, but it is quite an accomplishment considering that, in 1993, the inflation rate for the region was more than 1,000 percent. I will return to this topic to speak in more detail about Mexico and Latin America a bit later in my remarks.

Most of Africa has not made much headway with its difficult economic problems, but I still hold out hope that South Africa, which has the most advanced economy in sub-Saharan Africa, will become a magnet for more cooperation among other southern African nations. In contrast, the Middle East continues to struggle to achieve sustainable economic growth. Clearly, the low price of oil is taking its toll on most of the economies in that region. Some other negative factors are political and social in nature, such as the violent challenges to governments in Egypt and Algeria by religious groups and the continuing unrest between Israelis and Palestinians. However, if the parties involved can resolve some of their political conflicts, there is the potential for stronger growth in the future. Another area of concern is the former U.S.S.R. Economically speaking, the future of the new nations depends so heavily on politics that it is difficult to give a standard economic outlook. In 1994, GDP declined 15 percent, and prices ended the year 200 percent higher than at the end of 1993. Moreover, the conflict in Chechnya does not bode well for the region. Pausing to remember the abhorrent loss of life in Chechnya, as well as in Bosnia, we must also consider the long-term crippling effects on economic progress in these areas.

Saving the strongest for last, I now come to the economies of China and the Pacific Rim. Despite a slight deceleration in growth from 8 percent in 1994, economic growth in these developing economies of the Asia-Pacific region should continue to be the fastest in the world. Growth in 1995 should be between 7 percent and 7-1/2 percent. As the Chinese government makes efforts to stem high inflation near 20 percent, the economy should slow from its 1994 growth rate of 11 percent. Trade should remain the fastest-expanding element of the economy.

Investment in infrastructure, such as ports, airports, and telecommunications, should be another dynamic factor in the continued rapid growth of the region generally.

To sum up my outlook then, the strongest rate of output growth in the world continues to come from developing Asian economies. The industrialized nations have, in the main, left recessions behind them and are experiencing moderate growth during their recoveries. Latin American fundamentals remain strong, and growth should progress despite some uncertainty at present. The economies of Europe should continue to expand this year, placing the European Union (EU) members back on the path toward full monetary union by the end of the century. It is this issue to which I will turn next in more detail.

Policy Issues in the Global Economy

After recovering from recession, the members of the European Union appear to be ready again to push on toward full monetary union. The reality that European leaders must face, though, is that most EU members do not currently meet the stringent criteria set forth in the Maastricht Treaty to join the monetary union. But as most of us here in the United States understand, when a country is going through a recession, it is difficult to concentrate on anything other than getting a recovery started. Nevertheless, I am confident that stronger economic growth, coupled with sound fiscal and monetary policies, will enable many of these countries to form a monetary union within the next five years. I say "many," because studies done by economists at the Atlanta Fed and elsewhere suggest that not all EU members may be ready to enter a full monetary union by the end of 1999. How policymakers in Europe handle this possible problem will prove to be one of the more challenging developments over the next few years.

The situation in Mexico, on the other hand, is a challenging development this year. Throughout the recent difficulties, I have been encouraged by the difference between the way Mexico handled its debt crisis of the early 1980s and how it is responding to this current problem in the era of the North American Free Trade Agreement (NAFTA). During the debt crisis a decade ago, Mexico nationalized banks, reneged on liabilities denominated in dollars by converting them to pesos on the spot, and imposed tighter controls on foreign investors. The reaction by the Mexican government to current developments is quite different. Provisions for foreign ownership, investment, and trade remain intact. Trade barriers have not been reinstated, and privatization continues to be a priority for the Mexican government. In addition, the government has pledged fiscal discipline. In my estimation, the free trade agreement with Mexico has significantly raised the costs to Mexico of returning to the old, inflation-prone methods of coping with debt.

After more than a month of uncertainty, the situation appears to be stabilizing. It is my hope that the focus will return to the positive fundamentals of the Mexican economy and the enormous potential it holds. Some analysts have questioned whether the United States and other nations should provide assistance to Mexico to help it overcome its present difficulties. To them I must say that my confidence in Mexico remains intact. Having made an agreement with our Mexican neighbors to open our economies to one another, it would be unacceptable to turn our backs during this time of trouble. It is in our own interest to take reasonable steps to help ensure that a temporary financial crisis does not turn into a long-term economic and political problem that would have serious consequences for the people of both Mexico and the United States.

This brings me to my final discussion point this evening, namely, that despite recent events in Mexico and the uncertainty that situation creates, we must forge ahead toward fuller integration and cooperation with the developing economies of Latin America. Over the past decade, Latin American nations have undergone profound economic and political change--and those changes have been for the better. Democracy and free-market economies are now the norm where dictatorships and centralized economies once were. We must remember, though, that these have been dramatic and far-reaching changes. It would not be realistic to think that these nations could make this transition without occasional setbacks.

To my mind, we must persist in our efforts to forge closer economic ties if we want to ensure that our Latin American neighbors remain on the path they have chosen. Expanding NAFTA to include other Latin American economies that have embarked on market-oriented policy reforms is a logical next step to achieve this goal. The Free Trade Area of the Americas (FTAA), launched in Miami last month, should remain a top priority for the United States. Other aspects of promoting closer economic ties with Latin American countries include implementing GATT and doing our best to maintain stable and noninflationary growth in the G-7 countries.

The beauty of such actions, of course, is that they benefit all parties. According to some economic research, proximity is one of three characteristics of enduring trading partners. The current experience of the United States bears this out, since Canada is our No. 1 export market, and Mexico virtually shares second place with Japan, whose economy is much larger. In addition, the economies in this part of the world are growing faster than our traditional trading partners are, which means Latin Americans will have more money to spend on products and

services from the United States than in the past. It seems very likely to me that U.S. export shares will continue to increase to the growing regions of the world, such as Latin America and East Asia, and that our proximity to Latin America gives us an edge in that marketplace.

Conclusion

In conclusion, the international economic outlook is the most positive it has been in many years. Output in the industrialized countries and most developing regions is growing. The European monetary union appears to be basically on track, and the Mexican financial situation does not appear to have crippled that country the way the debt crisis in the early 1980s did. Finally, the move toward economic integration in the western hemisphere offers benefits to all the countries involved, including the United States, where foreign trade has come to account for a rising share of output.

Moreover, I believe we have begun to reach a point in the history of the world when more leaders and their people understand the importance of being connected with one another through free trade and open economies. Perhaps it is the strong pull of technological changes that has brought on the realization that, whether or not countries are ready for integration, they already are integrated at some level. I applaud this recognition because I firmly believe that increased global integration will serve to enhance the economic welfare of every nation in the world.