THE OUTLOOK FOR THE U.S. ECONOMY

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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 late last year and the ensuing turmoil in Latin American financial markets. Although I am not overly optimistic 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 as it pursues sound policies.

Although the main topic of my speech today is the economic outlook for the United States, after I discuss that, 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.

The U.S. Economy

First let me address the specifics of the U.S. economic outlook. 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 or possibly a bit higher 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 in 1995 would also be more appropriate.

With growth decelerating, it is unlikely that unemployment will decline much further, and it has already edged up a bit since the beginning of the year. 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 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 U.S. 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 rate. Healthy demand for automobiles and other durable consumer goods accounted for much of the acceleration in personal consumption last year. Sales of automobiles and other durables will be good again in 1995, but they will not provide as large a boost to the economy as they did in 1994. That deceleration is the result of increases in interest rates that have occurred. Also, pent-up demand has largely been met.

Consumption of nondurable goods like clothing will continue to grow, but not enough to offset the expected slowing in demand for consumer durables to a pace that is more sustainable.

The same theme holds true in the area of investment by businesses in productive capital, such as plant and equipment. Capital spending has been growing in the double-digit range for two years now. Although this investment will be decelerating, this retreat is from a very high pace. I would like to add that this aspect of growth is quite significant. That is because it expands the capacity of the economy, a matter which is quite vital at this time when we seem to be near or at our capacity--whether measured in terms of the unemployment rate or factory use. This rapid addition to productive capacity helps to temper price pressures from strong demand and is reflected in the inflation forecast.

Another type of investment spending, construction of single-family homes, has contributed strongly to economic growth in the United States over the past few years. This boom in building activity has now peaked. Although multifamily and commercial construction should be increasing in 1995, these anticipated increases will not offset the decline in single-family construction.

Government spending is likely to be flat after shrinking somewhat last year. Even in the face of the defeat of the balanced budget amendment, the ongoing pressure to reduce the federal budget deficit should help to keep government spending down. Of course, it is hard enough to make economic forecasts. I am certainly not going to attempt a U.S. political forecast, especially this year. 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. Let me emphasize also that, although government spending will not add to GDP, any progress toward reducing the deficit will be good for the long-term prospects for economic growth.

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. However, this is not to say the deficit will go away. The U.S. trade balance will continue to be in considerable deficit. The United States has been growing relatively faster than its traditional trading partners. In turn, the demand for imports in the United States has increased faster than the demand abroad for U.S. exports.

Fortunately, the signs point to a narrowing of this trade gap this year, as the U.S. expansion slows and the pace of economic growth picks up in Europe 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. Again, as I mentioned, the Mexican peso has depreciated dramatically in recent months. This development, along with the institution of more restrictive economic policies in that country and possibly others in Latin America, will probably restrain demand for U.S. exports from those areas.

So, to recap briefly, in the United States this year, GDP should grow by about 3 percent, with inflation rising to somewhat above 3 percent, and unemployment averaging between 5-1/4 percent and 5-1/2 percent. Although it is true that some areas of the U.S. economy may be slightly weaker than in the past year or two, overall the economy will be very healthy.

Policy Issues in the Global Economy

Let me turn now to the three international policy issues I raised at the beginning of my remarks. I think now that the European countries are out of their recessions and in expansion modes, most members of the European Union appear to be in a position to push on toward monetary union--even though recent currency realignments within the EU suggest a more distant starting point for this effort. The reality that European leaders must face 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 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 polices, will enable many of these countries to form a monetary union within the next five years. Now, I said "many," because studies we have done at the Atlanta Reserve Bank and studies done by others 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 and has adopted a rigorous economic stabilization plan. So, 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 their debt problem.

After nearly three months of uncertainty, 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 and some in Congress questioned whether the United States and other nations should have provided assistance to Mexico to help it overcome its present difficulties. I must say that my confidence in Mexico for the long term remains intact. We have made an agreement with our Mexican neighbors to open our economies to one another, and it would have been unacceptable to turn our backs during this time of trouble. It is in the United States' 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, namely, that despite recent events in Mexico and the uncertainty that this situation creates, it seems to me that 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, political, and social changes--and those changes have been for the better. Democracy and free-market economies are now the norm where dictatorships and centralized economies once were the model. We must remember that these have been dramatic and far-reaching changes. Therefore, I do not think it would be realistic to expect these nations to 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 at the end of last year, 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, which suggests that 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 a decided edge in that marketplace.

Conclusion

In conclusion, the U.S. economic outlook is healthy, although, as a central banker, I cannot completely discount concerns about inflationary pressures. The EU must overcome some immediate difficulties due to currency realignments but seems to be in a good position to move toward monetary union, and the Mexican financial situation does not appear so far 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.