

THE ECONOMIC OUTLOOK FOR THE UNITED STATES AND THE SOUTHEAST

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Julian Hester has asked me to give you a mid-year update on the outlook for the national and regional economy. I believe now is an interesting time to speak about the outlook since much has changed in the economy since the beginning of the year. At the end of my remarks, I would also like to talk with you a bit about how the Federal Reserve may be close to engineering a "soft landing" for the U.S. economy and how we think this may or may not occur.

The U.S. Economy

Let me turn first to the U.S. economy. Growth in output last year was 4 percent, and the last quarter of the year was very strong. In fact, the Federal Reserve took certain measures to restrain this rate of growth because it was very robust relative to our overall resource utilization and the potential of capacity to expand. So the current slowing, while perhaps more than I expected, is not entirely unwelcome. Of course, that will be true only to the extent that we do not slow too much. I expect GDP to grow by about 2 1/2 percent on an annual average basis or somewhat under 2 percent using the Q1V to Q1V basis that many refer to. The deceleration in output growth, which was quite sharp in the second quarter, was due to business efforts to reduce inventories in the wake of a pause in consumer spending. As this adjustment is completed, I expect that the pace of expansion will likely rebound.

Considering that the expansion has been going on for four years, the moderate growth rate we anticipate this year is absolutely appropriate and necessary. In fact, we welcome this development since we hope that the cyclical price pressures that we have seen will indeed be a temporary phenomenon. Right now it seems that inflation this year will average around 3 percent compared with 2.6 percent last year. With growth decelerating, of course, it is unlikely that the unemployment rate will decline much further. My best guess is that it will be close to 6 percent on an annual average basis. Many people, including me, have been concerned that the possibility of a recession has increased. This scenario is to be expected as the duration of the expansion lengthens. However, in my view, the underlying state of the economy is quite healthy, and, in fact, recent data indicate that the possibility of a downturn has diminished. The cut in the fed funds rate two weeks ago further supports a more optimistic outlook.

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 will still be growing--but at a slower rate. I reference especially personal consumption but also investment spending for equipment and construction to a lesser degree. 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 is slower than last year. That deceleration is the result of earlier increases in interest rates and the fact that pent-up demand has largely been met. Consumption of nondurable goods like clothing remains healthy, but the margin of growth is not large enough to offset the slowing in demand for consumer durables. However, I emphasize that the overall pace of consumer spending should remain quite respectable compared with last year.

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, it is a moderate retreat from a very rapid 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 a time when we have been very near our capacity limits--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.

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 peaked last year. Although multifamily and commercial construction have been increasing in 1995, these anticipated increases will not offset the decline in single-family construction. Again, I would stress the projected weakness in housing is quite mild compared with previous business cycles.

Government spending is likely to be flat after shrinking somewhat last year. Ongoing pressure to reduce the federal budget deficit should help to keep government spending down. 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.

In the area of foreign trade, a number of issues should affect U.S. exports and imports. With U.S. economic growth decelerating, demand from domestic sectors for all goods--imported

goods as well as those produced in the United States--should slow. Many European economies are on a moderate growth path now, while the dollar is lower than it was last year at this time. These circumstances should help our net export position. On the negative side, the Mexican peso depreciated considerably in the early part of 1995. The currencies of some other Latin American countries have also been under pressure at times. This development, along with more restrictive economic policies in that country and possibly others in Latin America, will probably restrain demand for U.S. exports from those areas. Fortunately, the worst is over even though the rebound may not be smooth sailing. While this situation will have a negative effect on trade, over time U.S. trade will benefit from the structural reforms being implemented by a number of our Latin American trading partners.

Overall, the real story in exports is that there has been a long-term expansion in the volume of international trade going on for more than 20 years now. This trend has completely dominated the trade picture and any cyclical pattern. What that development means is that it is not so much the business cycle that we must worry about but rather U.S. trade policies. Over time, we have progressively moved to more open trade, which has been very good, on balance, for our economy. Consequently, even though the trade balance will improve only slowly over the next two years, the volume of exports--and imports as well--is likely to continue growing. In more immediate terms, I can also say that the gap between exports and imports should not get much bigger during this year and may actually begin to narrow toward the end of the year.

Summing up the outlook for the United States this year, GDP, despite some quarter-to-quarter fluctuations, should grow by about 2-1/2 percent on an annual average basis, with inflation rising to around 3 percent, and unemployment averaging about just under 6 percent. Overall, then, the national economy should be healthy, even though certain sectors will not be growing as quickly as before.

Regional Economic Outlook

Now let me move on to the regional economy and go into a bit more detail for the Southeast. Its recent economic performance during and after the recession has been nothing short of spectacular. After three years of leading the nation in job growth, the region has seen a leveling off of employment creation in 1995. However, this development is nothing to be alarmed about because the Southeast should still enjoy healthy job growth this year. Gains in southeastern employment have slowed from a peak of 3-1/2 percent in 1993 to around 3 percent annually last year. Payroll expansion may continue to decelerate modestly to a rate of about 2-1/2 percent to 3 percent during this year. Although the nation had been lagging behind the Southeast, it now may catch up.

Since the recession, the Southeast has shown strength because it is home to a concentration of industries that usually grow quickly when the national economy emerges from recession. One of these areas is durable goods purchased by consumers. Building-related industries, such as wood products, furniture, and appliances as well as textiles used for carpets, draperies, and the like, have benefited from the growth in residential construction, both in the Southeast and across the nation.

Although construction and manufacturing of consumer durables helped the Southeast to outpace the country early in the recovery, it is still wise to remember the cyclical nature of these major industries. Fortunately, the Southeast can depend on a strong underlying, or long-term, growth trend thanks to some regional factors that result in the continued in-migration of people and businesses from other regions of the country, as well as a diversified economy and dynamic industries, including the service sector. Health care, business services (such as temporary agencies), and tourism account for the bulk of these new service jobs. Employment in these services stopped accelerating in 1994 but has maintained a strong growth rate of about 6 percent. These service jobs continue to grow at a faster rate than manufacturing.

The two states in the Southeast that have the brightest outlook this year are Florida and Georgia. In Georgia, the upcoming Centennial Olympic Games are spurring a great deal of construction, ranging from housing for athletes to the Olympic stadium--not to mention the ancillary construction for retail, vendors, and tourism that will expand because of the Games. Although this construction is an obvious sign of economic growth, it will account directly for only a small portion of the overall growth in the state. I think it is also telling that, of all 50 states, Georgia created the third largest number of jobs since the recession. (The other two are Texas and Florida.)

In Florida, although tourism took a hit in 1994, following several years of economic weakness abroad, it has begun to recover this year. Construction will also remain healthy, with strong commercial activity. In addition, continued in-migration of people from other states is propelling residential development, which will contribute to overall growth in construction.

The other states in our region should continue to expand moderately although not at the pace that Florida and Georgia will. Tennessee, which has become the center of the new southern auto industry, should find that auto parts and components-related production will continue to push the state forward. However, Tennessee is experiencing labor shortages, partially because it has traditionally not attracted the kind of in-migration Florida does and because out-migration from other states has slowed as the rest of the nation recovers. The economy in Mississippi is slowing from a spurt of growth that is attributable to gambling-related industries, although overall levels of income and employment remain high. In Louisiana payroll employment growth remains strong at nearly 2 percent for the first quarter. However, the state's fiscal condition is clouded by the likelihood that it will lose about \$750 million in Medicaid funds. Alabama is the weakest of the southeastern states in terms of growth. The apparel industry continues to downsize, and federal budget constraints are affecting NASA and, in turn, Huntsville. Fortunately, construction related to the Mercedes plant is beginning to spur stronger job growth and higher property values elsewhere in the northern portion of the state.

Reasons Why the Fed Can Manage a Soft Landing This Time

Now, let me finish my remarks with a few comments about the slowing of the U.S. economy. There is a lot of concern about a possible downturn. As I mentioned before, we came through 1994 with a high rate of growth that prompted the Federal Reserve to raise short-term rates further in an effort to slow the rate of growth and subdue inflation pressures. I should point out that it was not our desire to kill growth, but rather to reach sustainable growth. Now, while the threat of recession has increased, I believe that outcome is not inevitable nor ever the most

likely outcome. The Fed's recent move to lower the fed funds rate is a very positive development for the economy.

Let me give some reasons why I think we can weather a slowdown without a recession this time around, compared with the near-miss soft landing of 1990-91. (We will never know if we could have had a soft landing at that time since the oil shock and the Persian Gulf War intervened.) In both cases, we had rapid growth, and so the Federal Reserve imposed restraints. But the distinctions between then and now are sustainability and balance. I think that now, because of the balance within the U.S. economy, we are more capable of reaching sustainable growth.

First, much progress has been made in eliminating the imbalances in both corporate and consumer balance sheets since the late 1980s when both corporations and homeowners were carrying a great deal of debt. Not only have they paid down the debt levels, but declines in interest rates allowed many corporations and homeowners to refinance their debt. Second, there had been considerable overbuilding by the construction industry and excesses in retailing. Although it was painful, these excesses in the construction and retailing industries have been reduced. Third, the current data on orders and income have been good. These areas may have weakened slightly, but from a high level; moreover, most recently they have rebounded. Fourth, the banking system is very healthy. We do not know of any reason to believe there is a credit crunch. Also, the stock and bond markets have behaved pretty well. So, it seems far more possible to slow the economy without precipitating a recession.

Without being too immodest, I would like to point out that the Federal Reserve and its policies deserve much of the credit for bringing about these results in the economy. One final point that is distinctly different from the situation in 1990-91 is that the value of the dollar is more favorable for stimulating exports.

All of these circumstances argue that the most likely outcome this time around is a soft landing. As a policymaker, my concerns are always the risks to an economic outlook. Therefore, I do tend to focus on the risks, but I will say that I am not at all surprised at the kind of economic information we have been getting lately. One quarter of weak economic data from a well-balanced economy, of course, is a concern at the Fed; however, we are always looking at the long term. In my view, when we take a cold, hard look at the long term, we can see a softer economy, yes, but one that achieves sustainable growth.

Conclusion

In conclusion, the U.S. economy is slowing but also reaching the goal of a sustainable rate of growth. The Southeast has done particularly well following the recession and has a good future thanks to its diversified economy and the continuing in-migration of people and businesses. Although some of the short-term economic news may be negative and although we may have a quarter or two of very low numbers, I think 1996 will be a comeback year. I believe that in the long run, the data will prove that the Federal Reserve has taken the correct steps to put the national economy on the path toward moderate and yet sustainable growth.