THE NATIONAL AND INTERNATIONAL ECONOMIC OUTLOOK

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I am pleased to be here today to speak with you about the national economic outlook and to give you my views on the outlook for trade with some of our major trading regions. Although this audience is not strictly made up of bankers, I have no doubt that each of you has a special relationship with a banker. So, at the end of my remarks, I will also address what sort of effects the changing economy may have on the banking industry.

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, early last year 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 recent slowing, while perhaps more than I expected, is not entirely unwelcome. Even with the recent deceleration, I expect GDP to grow by about 2 1/2 percent to 3 percent on an annual average basis or around 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. With this adjustment nearing completion, 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. The unemployment rate will probably will be between 5 1/2 and 6 percent on an annual average basis. Earlier this year many people, including me, had been concerned that the possibility of a recession had increased. This scenario is to be expected during a slowdown, since the process of decelerating can, in fact, snowball. Nonetheless, this was not the most likely outcome and now it seems quite remote. In my view, the underlying state of the economy is quite healthy, and, in fact, recent data suggest a well-balanced expansion at a moderate rate. The cut in the fed funds rate in July 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 have not changed much in 1995 nor should they in early 1996. Certain components of gross domestic product that grew strongly through 1994 will still be growing--but at a slower rate. I reference especially personal consumption but also construction. 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 services 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.

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. I expect a bottoming out of residential investment this year and very modest growth next year, concentrated in the multifamily category.

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 and the pace remains robust. 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.

Government spending is likely to continue shrinking somewhat. 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's recent rebound is not so dramatic as to make U.S. goods uncompetitive in world markets. Indeed, the dollar is still below its level 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 a few others in Latin America, as well as disappointing recent performance of the Japanese and German economies, will probably continue to 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 to 3 percent on an annual average basis, with inflation rising to around 3 percent, and unemployment averaging 5 1/2 to 6 percent. Overall, then, the national economy should be healthy, even though certain sectors will not be growing as quickly as before.

The International Outlook

Now many of you in this audience are no doubt interested in the trading outlook for the United States particularly if you are involved in exporting and importing yourselves. Let me then talk about the international economic outlook in terms of three major trading areas for the United States: Western Europe, the Asia/Pacific region, and the Americas.

Looking across the Atlantic Ocean, I am pleased to see that Western Europe has cast off the last remnants of its early 1990s recession. These economies should see growth between 2 1/2 and 3 percent this year as well as in 1996. U.S. trade with the European nations--which accounts for one-fifth of all U.S. trade--should pick up in the coming years. It does not seem likely that the move to incorporate more European nations into the European Union and further steps toward monetary union will have an adverse impact on U.S. trade with Europe.

The second key area I would like to discuss is the Asia/Pacific region. The economy of our second-largest trading partner, Japan--which accounts for 15 percent of all U.S. trade--may remain weak through 1995, but could do better next year if domestic demand picks up as expected. However, the benefits of financial deregulation, lower taxes, low interest rates, and increased government spending may be offset by problems in the country's banking industry. The economy in Japan is expected to grow 1/2 percent this year and a bit above 1 percent in 1996. Slow growth combined with problems in the banking industry of Japan do not bode well for an increase in U.S. trade with Japan in the near future.

However, many of the fastest-growing U.S. export markets are in Asia. Excluding Japan, trade with the Asian nations accounts for 20 percent of total U.S. trade. These economies are expected to grow between 7 1/2 and 8 percent in 1995 and 1996, down a bit from the 8 1/2 percent pace of last year. The potential for increased U.S. trade with this region is bright because of this growth forecast and continued efforts toward freer trade taken by Asian nations.

Back in our region of the world, U.S. trade with the developing countries of our own hemisphere has skyrocketed over the last five years. From 1990 to 1994, total trade with Mexico has nearly doubled to more than $100 billion. Trade with the other developing countries in Latin America grew from nearly $60 billion in 1990 to just over $80 billion in 1994--an increase of 35 percent. I just mentioned that many of our fastest-growing export markets this decade are located in Asia. Many others are in Latin America, and the region accounts for 15 percent of all U.S. trade.

However, this has been a trying year for many economies in our hemisphere, particularly that of Mexico, and, as I mentioned earlier, growth in trade with Latin America will decelerate this year. Nonetheless, I would like to point out that, faced with a difficult financial situation, Mexican leaders did not retreat into protectionism or nationalization as they did in the early

1980s. The fact that Mexico has enacted long-term policies designed to fix the current problem, and to prevent futures ones like it, encourages me to be optimistic about the future of Mexico.

Also within the Americas region is Canada. As our single largest trading partner, it accounts for nearly 21 percent of total U.S. trade. Economic growth in Canada is decelerating from the 4-1/2 percent rate of last year. Canadian real gross domestic product (GDP) should average about 2 1/2 percent in 1995 and 1996.

The Effect of the Economy on Banking Industry

Now, to shift the focus back to the domestic economy, let me speak briefly about the possible effects the changing economy may have on the banking industry. Nationally bank profitability declined slightly in 1994 from 1993's historically high levels of return on assets. Florida banks substantially improved their profitability in 1994, after several poor years. Overall, return on assets seems to have been about flat in the first quarter of 1995. A slowing economy suggests that this high profitability rate will not be repeated in 1995 and 1996 . First, loan losses and provisions are likely to increase. Second, the yield curve has flattened a great deal, cutting margins from borrowing short and lending long. This is not a prediction of apocalypse; it is simply a warning that bankers will need to work a little harder for their livings over the next year or two. Even with that note of caution I would like to point out that the industry is in a much stronger position now than it was in the early 1990s when we experienced a mild recession. Moreover, 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. Thus, the outlook for the industry, as for the economy, remains positive.

Conclusion

In conclusion, the U.S. economy is slowing but also reaching the goal of a sustainable rate of growth. 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. In the longer term, international trade promises to be a significant source of growth. Overall, 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.