The 1997 Economic Outlook for North America

Remarks by Jack Guynn
President and Chief Executive Officer
Federal Reserve Bank of Atlanta
German American Chamber of Commerce
and World Trade Center Atlanta
Atlanta, Georgia
January 23, 1997

It's a pleasure to be here tonight. Is it just me or do these past two weeks seem to have been full of receptions? I know I saw many of you at that terrific reception for David Wright last Friday evening. As they say in the movies, "We've got to stop meeting this way."

At any rate, tonight I would like to keep my comments short and to the point so that we can get back to talking informally among ourselves. First, I'm going to discuss in general terms some of what I see going on in 1997 for North America, with a more detailed outlook for the country I know best, the United States. Then, I'll turn my attention to why I think the Southeast's future continues to look very good economically.

Before I begin, let me tip my hat to you in this room right now. You have created many of the business opportunities that have contributed to the Southeast's long-running economic health.

The North American Economic Outlook

When you take a step back and look at North America since the dawn of NAFTA (the North American Free Trade Agreement) in 1994, you get a picture of how well free trade can work to improve the economic situations in countries united by geography. The North American story is about one big economy and two smaller economies working toward the same goals. Let me throw out some numbers to explain this perspective. The U.S. gross domestic product of $7-1/4 trillion might well dwarf just about any nation's. In this case, Canada's GDP of $565 billion is about 8 percent of U.S. GDP, while Mexico's is about 4 percent.

Despite the differences in the size of our economies, all three of our countries have been working toward the same broad goals--(1) low, steady inflation and (2) getting our fiscal houses in order. However--same goals or not--as nations, we're not always equally affected by the same external events, and we may have different reactions to external events. What that means is that while we all share many common interests and linkages, we're not necessarily synchronized in terms of our business cycles. Why? Because of the vast differences in the sizes of our economies, because of the different composition of our output, and because of the different stages of development we're each in. These differences, though, do not change the fact that the close ties among our economies in Canada, Mexico, and the United States have been a boon for all three of us.

At the same time, those close ties have created some interesting situations that we've had to deal with. I'm thinking in particular of two recent events: first, the GM auto strike in Ontario late last year and, second, the early repayment by Mexico of its special loan from the United States last week. I think these two events show how trading partners get to be like family members: you look out for one another, you're deeply affected by one another's feelings and actions, and--when push comes to shove--you borrow from one another.

Now, usually, whatever is going on here in the United States tends to have some kind of an impact on our neighbors. For instance, our rising interest rates certainly contributed to Mexico's financial crisis in late 1994. But sometimes things can go the other way. Take, for example, the GM auto strike. As most of you know from having lived here in the Southeast for a while, we're just crazy about our pick-up trucks in this country. And when the CAW (Canadian Auto Workers) shut down a plant that makes the necessary parts for one of GM's most popular pick-up trucks, the strike suddenly became more than just a problem GM was having in Canada. In fact, we did notice some impact on U.S. durables production in the fourth quarter of 1996 due to this GM strike in Canada that affected U.S. plants. Plus, we couldn't get all the pick-ups we wanted--and, down here, that's a big deal.

Then, there's the good-news story we witnessed last week, when Mexico repaid three years early the rest of the money it had borrowed from the United States following the devaluation of the peso in late 1994. Let me remind you that the United States did something unprecedented back then when we offered Mexico $20 billion from the Treasury's Exchange Stabilization Fund without the direct consent of Congress. Mexico ended up borrowing about $12-1/2 billion from the fund. Its final payment last week of $3-1/2 billion cleared the books.

Now, I'm pleased to note a number of things about this story. First, the United States did the right thing by living up to the old saying, "A friend in need is a friend indeed." Second, we actually made money on the loan to the tune of $500 million in interest payments. That was a modest but reasonable return for our taxpayers. And, third, thanks to this crisis, new international mechanisms are being developed to handle the next crisis that might hit any country, so that the United States is more assured of having help from other nations.

I'll be the first to admit, though, that family members often tend to take one another for granted, too. For instance, in our nation, international trade news and headlines seem to be dominated by developments in China, Japan, and Europe. We find it easy to forget that two of our three largest trading partners are right here in our own backyard. In fact, Canada and the United States have the largest bilateral trade flow in the world. Canada, which is the largest single U.S. trading partner, and Mexico, which is third-largest, account for nearly 30 percent of all U.S. trade. This percentage compares with roughly 18 percent for Japan and China combined, and with 20 percent for the European Union.

The economic outlooks for all three countries in NAFTA are pretty good. Both the Canadian and Mexican economies are expected to post moderate yet healthy growth rates in 1997. And as I will discuss in more detail in just a moment, the U.S. economy is also heading for another year of moderate growth. In Canada, we're expecting growth of about 3 percent in GDP, with recent data showing a more broad-based economic expansion rather than one led by exports to the United States. The lack of job creation may continue to be a problem, though. In Mexico, recent growth has been fueled by exports and investment, while consumer demand has remained weak. This year's growth, looks like it will be about 3-3/4 percent, should broaden through a more substantial contribution from consumer purchases. All of
Numbers tell only one side of the story, though. Our relationships with Canada and Mexico go far beyond trade. For instance, the United States and Canada share the world's longest undefended borders and have stood side by side in times of international upheaval. We've all heard complaints that the United States overshadows its two neighbors. But who influences whom? All I can say is that we're the ones playing ice hockey—Canada's national game—in Florida and Arizona, two places that don't exactly fit the description of the Frozen North.

What else do our neighbors send us? We don't just buy Canadian or Mexican beer. Some of the things we import include autos, capital equipment, natural gas, and even electricity. The point is that the relationship is not simply economic. It's much more balanced than many people might believe, and the recent auto strike I mentioned is a perfect illustration of that fact.

Admittedly, in the past, the relationship between the United States and Mexico was not so smooth. We have, gladly, put those days behind us and built bridges between the two countries that are as sturdy as those with our northern neighbor. Expanding the U.S.-Canadian Free-Trade Agreement to include Mexico, which created NAFTA, was one such bridge. Another was the international loan package arranged by the United States for Mexico that I also mentioned earlier.

There's another interesting point about this early repayment, and Mexico's ability to refinance its loan at a lower cost. Since the devaluation of the peso two years ago, it's become much easier to assess the Mexican economy. Why this increased transparency? Because international markets demanded it. For instance, the Mexican central bank now provides information on reserves and other data. This change in behavior toward more openness of its financial records certainly helped Mexico to refinance its loan at more favorable rates, because Mexico could assure the market that the numbers were accurate. I see this situation as positive and one that is spilling over into other Latin American countries that have learned from Mexico's problems.

When I think about Mexico, I also can't also help but think of the rest of Latin America. Latin America is particularly important to us at the Atlanta Fed because our Bank oversees banks from this part of the world that are operating in the United States. Latin America is such a complex area, and I don't want to paint with too broad a brush, but it looks like overall economic growth could be about 4 percent in 1997 for the region as a whole, up from about 3 percent last year. Of course, even as the macroeconomic and political reforms in various countries in Latin America have been taking hold, there's still a long way to go in making the kind of progress that contributes to the economic well-being of all members of society.

The U.S. Economic Outlook
What I'd like to do in the next few minutes is to reflect very briefly on how the U.S. economy performed over the past year and then share my outlook for 1997, including some thoughts about what could go wrong.

I have the sense that most of us are going into the new year with great expectations—and I think for good reason. We're coming off a year here in the United States in which the economy performed quite well.

All of the official figures for 1996 aren't in yet, but it looks like the economy grew at an annual average of around 2-1/4 percent, with unemployment at about 5-1/2 percent on an annual average basis (which is as low as it's been since 1989) and with inflation holding at around 3 percent as measured by the CPI. And we're now into the seventh year of this economic expansion—only the third time in the last 50 years that we've had such a long period of sustained growth. I think most of us would agree that this kind of economic performance is really quite good.

So, now that I can say I'm pleased with the way things turned out in 1996, how do I see things shaping up for this year? Well, I believe we're most likely going to see more of the same in 1997. It looks like another year of moderate growth somewhere between 2 percent and 2-1/2 percent (perhaps a tad slower than last year), unemployment continuing near the low level of 5-1/2 percent we've seen over the last two years, and inflation, as measured by the CPI, continuing at about its current 3 percent level.

Barring any unexpected events, or "external shocks" as economists call them, once again, I expect that consumers will be leading the way in the U.S. economy—though not quite as vigorously as last year. Part of the reason for this ongoing strength is that prospects for job and income growth still remain relatively positive.

Housing will probably slow somewhat, mainly because most of the pent-up demand has been met but also because of demographic constraints. Now that we're feeling the effects of the baby-bust generation, there simply aren't as many new families out there looking for apartments and houses as there were in the 1970s and early 1980s.

I think business spending will be a source of strength in our economy again this year, albeit one that has been slowing down from its high point in 1994 of nearly 10 percent year-over-year growth. Everything I see and hear suggests that businesses will continue to spend—particularly on equipment—as it is now clear that re-engineering and investment in productivity-enhancing equipment was not just a short-term phenomenon.

Government spending should remain flat overall as moderate declines at the federal level—prompted by additional and, in my mind, much-needed efforts to rein in our large budget deficits—should be offset by moderate growth at the state and local levels.

Demand from abroad is not likely to change dramatically, given that the prospect for economic growth of our major trading partners still remains only moderate.

What Could Go Wrong?
Now, you might ask, What could possibly go wrong? There's always a list of things that could happen to change the outlook. Since we have such a well-balanced economy now, the good news is that there's simply less to worry about than is usually the case. Here are a couple of the things I'm keeping my eye on.

First, I think it's pretty clear that continued tightness in labor markets is a real concern for those who are concerned about business and trade like you and for policymakers like me. Job growth has continued to run well ahead of labor force growth. At our Bank, we've been finding for a while now that there's again a premium on people with automation skills. Other pockets of tightness in the Southeast have included construction and retailing as well as certain manufacturing skills like welding.

Net, labor markets are at least a question mark in my mind as I look ahead into 1997 and beyond.

A second area I'm watching—and a lot of other people are as well—is consumer spending. It's always a critical factor to watch since it makes up two-thirds of our
Southeast Economic Outlook

Now let me turn to a brief discussion of how I see things shaping up for this southeastern region of the United States. It's been a long run of good economic and payroll growth for this region. Overall, I believe we will continue to grow moderately and to do slightly better than the nation as a whole in 1997, even as the Southeast's rate of growth slows to something closer to the national trend.

Given that the Southeast has outpaced the United States since the beginning of the recovery more than six years ago, this slowdown to growth just under the national average isn't really surprising. Also, we have to remember that the Southeast's economic health is closely tied to the housing industry because of our strengths in business like lumbering, appliance manufacturing, and carpeting. What that means is that when the rest of the nation is building houses, the Southeast is doing well. But since our economy is so closely tied to the housing cycle, we're also sometimes doing worse than other parts of the nation.

There's no doubt that long-term factors that have propelled the South's relatively rapid economic development are still present in abundance. But short-term decreases in the rate of people moving into the region from the rest of the country—as well as some weaknesses in certain sectors and geographic areas—are temporarily slowing our pace of growth.

Let me wind up my comments this evening by taking a look at those long-term factors that have served—and will continue to serve—the Southeast well. First, let's think about regional economies in the United States. Generally speaking, different regions offer a combination of high services and high taxes or low services and low taxes. Companies make their decision about where to locate based on what elements are most important to them. So, along with its attractive weather, the Southeast's low-service, low-tax environment has helped it to flourish and to attract a good base of businesses. The high-service, high-tax region up near Minnesota is doing well for the same reason, although I wouldn't exactly recommend the weather. By this measure, the Northeast corridor where taxes are high but services are deteriorating has not been doing so well in attracting and keeping businesses. But it's also clear that governors there are trying aggressively to do something about the situation.

Another important factor that the Southeast has going for it is the economies of agglomeration. Put into plain language, that simply means that where there are many businesses of the same kind, more businesses will come. Perhaps the classic example of such agglomeration in the United States is Hollywood, where you started with movie studios that attracted all kinds of businesses related to film-making, from food caterers to accountants. The Southeast has benefited from a similar story in many areas: housing, medical, telecommunications, and automotive.

So, this region has been able to capitalize on both factor No. 1 (low taxes, low services) and factor No. 2 (the economies of agglomeration). In fact, these two reasons probably account for why many of you in this room are here in Atlanta and why you're encouraging business people from your nations to branch out here. Which, of course, can only add to the prospects of further growth. In addition, there's no physical limitation to growth as there is in, say, an area like Los Angeles. That area did well following World War II for about 40 years but has since run up against physical barriers to further growth, such as limits on the water supply. Atlanta and the Southeast, except for a few isolated areas, simply don't have such physical barriers to growth, and therefore they can continue to attract businesses and grow as a region for quite a long time.

And there's a further reason why you're here in Atlanta, rather than Birmingham or Nashville. Atlanta jumped ahead of the rest of the Southeast by putting in place the kind of infrastructure, such as highways and an international airport, that can accommodate the needs of business. Thanks in large measure to the Olympics this past summer. Atlanta is now the proud owner of another kind of important infrastructure: fiber optics for telecommunications. Since Atlanta began its existence as a railroad terminus and because of Hartsfield Airport, most people think of the city as a transportation hub. But it's also become a magnet for companies involved in telecommunications, and because the Olympics needed a network of fiber optics, that has conveniently reinforced the city's new standing as a telecommunications center. Now, while it's true that the Olympics didn't bring us all the good press we'd thought it would, the Olympics didn't exactly harm the area's reputation for business.

All of these factors speak of a long-term future that will allow Atlanta and the rest of the southeastern region to keep expanding. I've been speaking about how the Southeast doesn't have any physical limitations—but I've got a time limitation tonight, so I won't go on anymore. I'll save for another time my thoughts about how our low service in regard to education is starting to be a constraint to growth in the Southeast.

Conclusion

That's it. When it comes to outlooks for both North America and this Southeast region, I'm cautiously yet optimistically saying that if you liked 1996, I think you'll like 1997, too. I look forward to taking your questions, since I know this crowd can always come up with some really interesting ones.

CONTACTS

Jean Tate
404-498-8035