

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## The Economic Outlook: Growth Weakens, Inflation Unchanged

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**T**here was some sense of drama in the air as the latest meeting of the Fourth District Economists' Roundtable, held January 26 at the Federal Reserve Bank of Cleveland, came to order. With the meeting set to begin at 9:30 a.m., many of the 27 participating economists anxiously perused the fourth-quarter 1989 figures released by the Commerce Department just an hour earlier. Would the numbers reflect the slowdown-without-recession so greatly anticipated as the economy headed into its eighth year of expansion?

The answer was, largely, yes. The participating economists' median forecast had called for a fourth-quarter real GNP growth rate of 0.7 percent; the government's advance estimate (subject, of course, to later revision) was 0.5 percent (see table 1). The government's GNP price index showed an increase of 3.8 percent for the quarter; Roundtable economists had posted precisely the same median figure.

Naturally, their range of predictions was wider. The high figure for fourth-quarter GNP growth was 2 percent; the low, a pessimistic -0.9 percent. The range was equally broad for the inflation figure, with predictions spread between a high of 5.5 percent and a low of 1.9 percent.

Yet all gathered seemed to agree, despite the inevitable difference in views on specifics among economists from manufacturing, services, and banking, that the economic expansion is still continuing, and several key factors seem to suggest a strengthening pace later in 1990 and beyond.

### ■ The Consensus Outlook

The median forecast of the economy shows a growth rate in real GNP of about 2.1 percent from the fourth quarter of 1989 to the fourth quarter of 1990, slightly less than the comparable period in 1989. The forecasters anticipate growth at about a 1.5 percent annual rate in the first half, to be followed by about a 2.5 percent growth rate in the second half, continuing into early 1991. Only one economist expects a decline in real GNP in the first half of 1990, with the decline to be followed by a 3.5 percent growth rate for the second half of the year.

Where will the expected growth in the economy come from in 1990? The forecasters agreed that fixed investment and exports will provide most of the strength, although growth rates in both of those sectors are expected to be less than in 1988 or 1989. A Midwest banking economist noted that business fixed investment and exports, which accounted for 53 percent of the economic growth between 1987 and 1989, were

The consensus forecast among economists attending the most recent Fourth District Economists' Roundtable calls for continuing slow growth well into 1990 followed by a more rapid growth in output by late this year. Little improvement is expected, however, in the overall inflation rate despite the current slow growth.

not expected to do as well in 1990. He pointed to capital spending surveys for 1990 that call for a reduced pace of spending from 1989; easing capacity utilization rates in manufacturing; and declines in cash flow brought about by eroding profits as suggesting slower growth in investment this year than last.

The merchandise trade deficit is unlikely to improve much in 1990 and will hold in a \$110 to \$120 billion range. That view is based on the rise in the dollar exchange rate during the first half of 1989 and an expected slowing in economic growth abroad in 1990.

Most of the forecasters anticipate that consumer spending will help to sustain overall growth of the economy, but will not add to the growth rate. An economist asserted that consumers have built their desired stock of durable goods, at least for the moment, and in the pro-

**TABLE 1 MEDIAN FORECAST OF CHANGE IN GNP AND RELATED ITEMS**

	Change in levels, billions of dollars, s.a.a.r. <sup>a</sup>					
	1989 <sup>b</sup>	1990 <sup>b</sup>	1990			
			IQ	IIQ	IIIQ	IVQ
GNP in constant (1982) dollars	98.7	86.7	11.2	17.9	22.7	29.0
Personal consumption expenditures	61.6	61.0	13.1	12.9	15.2	16.1
Nonresidential fixed investment	21.3	9.9	1.7	2.0	3.5	4.8
Residential construction	-12.1	7.8	1.0	2.0	1.8	1.8
Change in business inventories	14.3	-4.0	-8.3	0.9	1.3	2.3
Net exports	12.0	6.2	2.6	0.8	0.3	1.6
Government purchases	1.5	4.3	-1.0	0.7	1.7	1.7
	Percent change at annual rates					
GNP in current dollars	6.4	6.0	5.1	5.7	6.1	6.4
GNP implicit price deflator	3.8	3.9	3.8	4.1	3.7	3.7
GNP in constant (1982) dollars	2.4	2.2	1.1	1.7	2.2	2.8
FRB index of industrial production	1.7	2.3	0.3	2.0	2.6	3.1
	Absolute levels, percent					
Unemployment rate	5.3	5.6	5.5	5.6	5.7	5.7

a. Seasonally adjusted annual rate.

b. Calculated fourth quarter to fourth quarter.

SOURCES: Fourth District Economists' Roundtable, Federal Reserve Bank of Cleveland, January 26, 1990; and U.S. Department of Commerce, Bureau of Economic Analysis.

cess have acquired considerable debt relative to income. In 1990, he expects that consumers will rely more on income growth than on debt acquisition, and income growth will slow because job growth has been slowing.

Given these real and potential pitfalls to economic growth, what keeps the economy from sliding into a recession? Among the mitigating factors offered by some of the economists was the responsiveness on the part of the Federal Reserve, which began to ease policy in the spring of 1989; a corresponding acceleration in M2 growth, beginning in June 1989; the absence of major excesses in the economy that would have to be corrected; and a relative stability in the services sector of the economy.

"Consumer spending on services is four times as large as spending on durables, and will be the single most important factor in 1990 for recession avoidance," concluded a banking economist.

#### ■ The View from Manufacturing

Concern for the short run was echoed in comments of economists representing various manufacturing industries. A representative of one of the Big Three automakers noted that combined car and truck sales for 1989 were down 6 percent from 1988 levels and were off 9 percent from the record year of 1986. Sales fell most significantly in the Northeast (10 percent), which has been hit by recession in several of its key industries and by declining real estate prices.

The auto economist noted that the Japanese share of the American market has continued to grow. Each of the Japanese retailers had higher sales in 1989 compared to the previous year. An interesting aspect of this statistic, however, was the fact that 7.9 percent of the current Japanese market share is in the form of transplants — Japanese autos manufactured in the U.S. — and that virtually all of Japan's market-share gain in 1989 came from this domestic source. "This is okay for the U.S. economy, but bad for the domestic auto industry," he noted.

The auto economist concluded his remarks by saying that the outlook for 1990 is not particularly bad, but that profits will be squeezed and that excess capacity will become a problem. He laid any hopes for a significant recovery on the expectation that interest rates will decline further by the end of this quarter. Very likely, the first quarter will be the low point in sales and production for the year.

A major manufacturer of appliances echoed much of the automaker's concerns as they related to his own industry. Lower interest rates might be helpful, he said, while acknowledging that lower interest rates over the past year had not stimulated housing.

Concern for manufacturers of consumer durables centers on the softness in the housing market. An aging population and a decline in new household formations are hurting the purchase of durables, such as major appliances, that are usually associated with a strong housing market.

The primary complaint emanating from manufacturing is the tremendous pressure on profit margins. "Inflation is not in commodities in the long run," noted the economist. "It is elsewhere. Prices are down in durable goods."

Another manufacturing economist concurred, noting that price increases in his market segment are "nil." This economist predicted that capital spending will rise in manufacturing because survival depends on it, regardless of bad profits. "Without spending to increase productivity, industries will die in the brutally competitive 1990s," he said.

Aging capital stock will help to support a strong capital spending year in 1990. Growth in producers' capital equipment may nearly match 1989 levels, and spending for industrial construction will remain strong into the mid-1990s. All in all, growth in real nonresidential fixed investment may turn out to match or exceed that of 1989, despite a mixture of developments within that sector of the economy. It was

pointed out, for example, that the communications and electronics industries will be weak in the first half of 1990 before reviving in the second half.

The manufacturing economist, reflecting a view among part of the group, credited the Federal Reserve for having made "preemptive" moves to ease money in 1989, thus avoiding a large decline in the economy.

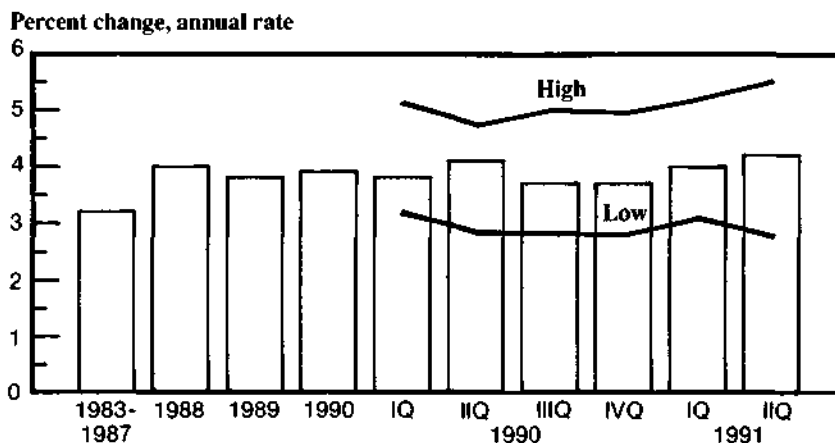
#### ■ Same Story, New Angle

The group's aggregate no-recession forecast was lent further credence by the latest research on business cycles, and particularly on coincident and leading economic indicators. Two research economists at the National Bureau of Economic Research (NBER), one of whom was a guest panelist at the Roundtable meeting, recently developed a pair of new indexes that forecast growth and turning points in economic activity. Their experimental indexes include coincident economic indicators (CEI), leading economic indicators (LEI), and a recession index (RI).

The LEI, which includes three output series, three series based on interest rates, and one on exchange rates, is used to predict the CEI six months ahead. Because the CEI is closely correlated with GNP, the LEI can be used to forecast the real GNP growth rate of the next two quarters. Of the seven leading indicators in the LEI, the researchers found that the most sensitive and best predictor of real GNP is the yield spread between the six-month commercial paper rate and the six-month Treasury bill rate, because that spread is affected by investors' expectation of risk of default on private debt, which in turn will affect GNP growth.

The RI is an estimate of the probability of a recession six months ahead. According to this index, the probability that the economy will dip into recession by May 1990 is only 9 percent. That probability is only 6 percent for the month of June 1990, as reported by the NBER several days after the Roundtable meeting.

FIGURE 1 MEDIAN GNP IMPLICIT PRICE DEFLATOR



a. Actual data.

SOURCES: Fourth District Economists' Roundtable, Federal Reserve Bank of Cleveland, January 26, 1990; and U.S. Department of Commerce, Bureau of Economic Analysis.

Looking backward, the RI successfully predicted each of the four recessions that occurred since the early 1960s, but also predicted a recession in 1967 that did not occur.

#### ■ Inflation: Any Progress?

About the most positive development of the past year regarding inflation was that the overall inflation rate, measured by the GNP implicit price deflator (IPD), did not worsen any further. Between 1988:IVQ and 1989:IVQ, the IDP rose an estimated 3.9 percent, virtually the same as in the comparable period for 1988. In the first five years of the current expansion, which began in November 1982, the rate of increase was about 3.1 percent annually.

The Roundtable economists expect that little progress will be made in 1990 toward reducing the overall rate of inflation (see figure 1). They expect that the IDP will increase again by about 3.9 percent for the year, measured fourth quarter to fourth quarter. They expect transitory improvement in the second half of 1990, but see the inflation rate accelerating to the 4 to 4½ percent range in early 1991. If that median forecast comes to pass, 1990 will mark the third successive year of inflation near the 4 percent range, even though economic growth has slowed considerably since 1988.

There were some encouraging developments in prices during 1989 that reflect changes in relative prices in the economy rather than changes in the aggregate price level. Producer prices for intermediate goods, excluding food and energy, eased throughout 1989, and crude materials prices, less energy, have also been declining, although price moderation at these early stages of production has yet to be reflected at the finished goods level. Spot prices for raw industrial materials have fallen about 10 percent since last spring.

Why do most of the forecasters expect a persistence of 4 percent inflation in 1990 despite the several quarters of softness in economic activity that they project? Apparently, some believe that a growth recession does not create enough slack in the economy to allow moderation in costs and prices. Moreover, some apparently believe that 4 percent inflation is generally acceptable to the public and to policymakers, because of the perceived high costs of transition to lower inflation.

Alternatively, however, some in the group believe that the anti-inflation battle is being won, and that the overall inflation rate will recede to the 3.5 percent range over the next several quarters. They point to the weakening in industrial prices, and to the fact that wage increases for both manufacturing

and services workers peaked more than a year ago.

Yet another inflation scenario calls for a sustained inflation rate of about 4 percent this year and next, but a substantial reduction in the rate by 1992. This scenario is based on the assumption that the Federal Reserve is targeting a 2.5 percent growth rate for real GNP, despite a potential output growth rate that is estimated at about 3.5 percent annually.

What adds to the problem of inflation is expectations about inflation, because people act on their expectations. In a study of three surveys of inflation expectations, a guest panelist pointed out that even though all the surveys overestimated the inflation rate for the past several years, the different groups in those surveys have different views about inflation, and each group acts on its own inflation expectations. Households, for example, attempt to obtain an inflation premium in their compensation, while financial officers attempt to include an inflation premium in their interest rates. Inflation expectations are relatively sticky and cannot be altered downward easily except by policy actions, according to the panelist.

The latest information shows some reduction in inflation expectations during 1989, although a combination of

higher petroleum prices and rising interest rates abroad contributed to an increase in inflation expectations late last year and early this year.

#### ■ Monetary Policy: To Ease or Not to Ease

Many of the Roundtable economists apparently assume a close relationship between money stock and output, and expressed a belief that monetary policy should loosen further to foster the higher growth in output they anticipate after mid-1990. They expect the prime rate to fall to about 9.5 percent by mid-year, followed by a small increase early in 1991. Most of the economists assume a growth rate in money stock (M2) in 1990 within a range of 5 to 7 percent, although only half would prefer growth that high. Expected growth in that high range may also explain the expected persistence of inflation in the 4 percent zone over the next several quarters.

Many others at the Roundtable, however, prefer money stock growth in a 3 to 5 percent range, which is similar to the actual growth rates of the past three years. In the view of a financial economist, this year is the appropriate time to lower the monetary targets, despite the high probability of a mild recession he expects for this half. He considers a lowering of the M2 target range for 1990 from 1989, combined with a state-

ment of support for achieving a gradual reduction in inflation, as signals to markets of serious anti-inflation resolve that would reduce inflation and expectations about inflation.

#### ■ Conclusion

Sluggish performance of the economy that is widely expected between last quarter and mid-1990 should be followed by a more rapid growth in output by late this year, according to Roundtable economists. They also expect little improvement in the overall inflation rate despite the three quarters of slow economic growth that is anticipated. It is apparent that neither inflation nor expectations about inflation have been significantly dampened as yet by the present slow-growth episode. In suggesting further policy easing, some of the group apparently are willing to risk the costs of higher inflation in the future.

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