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National Economic Trends

THE FEDERAL RESERVE BANK of ST. LOUIS

Another Soft Inventory Landing?

Historically, most postwar recessions have coincided with inventory corrections. Inventory fluctuations can amplify what may otherwise have been a small downturn in demand. When firms overestimate growth in demand, inventory stocks increase faster than desired. If firms cut back sharply on orders and production to adjust stocks, demand can be depressed further, exacerbating the downturns. In the past two decades, changes in business practices have resulted in improved management of the supply chain. Data from this time period suggest that these changes may help to dampen business cycle fluctuations.

The chart shows the year-over-year percent change in real manufacturing and trade inventories from the first quarter of 1960 to the second quarter of 1999 and changes in real Gross Domestic Product (GDP) over the same period. The cycles of GDP and inventory investment are coincident for the most part. In the mid-eighties and again in the mid-nineties, firms reduced the pace of inventory investment without a recession occurring. In both cases, inventory growth never became negative, as the preceding inventory overhang was not too severe.

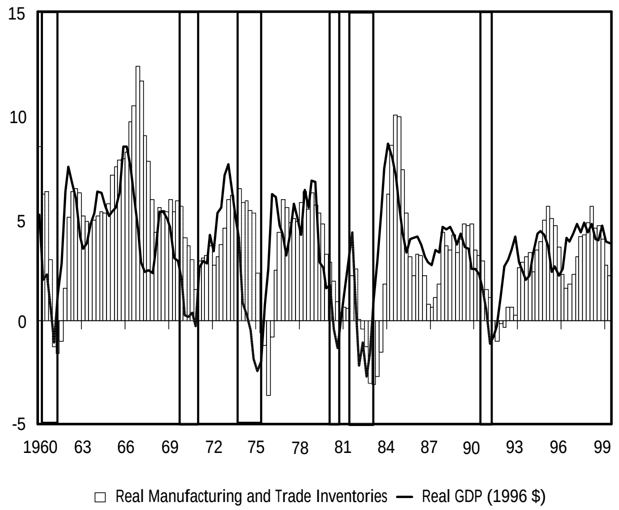
In the third quarter of 1984, annual inventory investment growth peaked at about 10 percent. The subsequent correction reduced annual inventory growth to a trough of 0.7 percent in the first quarter of 1987. The next inventory build-up reached a peak of 4.7 percent from one year before in the second and fourth quarters of 1989. Before this inventory correction hit its trough of –0.3 percent annual growth in the first quarter of 1992, the economy had already gone through a comparatively mild recession. By the first quarter of 1995, annual growth in manufacturing and trade inventories peaked at 5.6 percent. The subsequent correction slowed the annual growth in inventories by the second quarter of 1996 to 1.6 percent. As in 1984-87, the economy avoided recession even though inventory growth went from a peak to a trough.

Current indications are that we might again have a relatively benign inventory correction. In the first quarter of 1998, annual inventory investment growth peaked at 5.6 percent. The ensuing correction reduced inventory investment to a 2.2 percent annual growth rate by the second quarter of 1999. In the meantime, domestic demand has remained strong, and manufacturing orders and shipments now appear to be on the rise again due to recovery in international markets. Preliminary data suggest that growth in inventory investment increased in the third quarter of 1999. Better control of the supply chain is attenuating excessive accumulations of inventory and subsequent decumulations, thereby contributing to the record-breaking longevity of the current economic expansion.

—Donald S. Allen

GDP Growth and Inventory Changes

(Quarterly Data, Year-Over-Year Percent Change)



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