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Economic Outlook for 1983

by Paulette Maclin and Joanne Bronish

Twenty-nine economists met at the Federal Reserve Bank of Cleveland this March to discuss the economy. Known as the Fourth District Economists Round Table, this meeting produced a rather subdued economic outlook, indicating that 1983 would be a year of relatively slow recovery. The median of 29 forecasts anticipated real gross national product (GNP) growth of 4.1 percent over the year (fourth quarter to fourth quarter), compared with an average 6 percent increase in the first year of the six previous postwar recoveries. The expected growth, however, will not be distributed evenly among sectors; some industries that are important to the Fourth District economy, such as capital goods and primary metals, will recuperate more slowly. The Round Table economists also expressed concern about the viability of the recovery beyond 1983. Monetary policy, interest rates, and inflation psychology are variables that add a great deal of uncertainty to the economic outlook. This *Economic Commentary* reviews the major factors shaping the Round Table's 1983 forecast, touching on some of the uncertainties for 1984 and beyond.

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The views stated herein are those of the authors and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

Sources of Recovery

According to the Round Table's median forecast, a swing in business inventories from liquidation to accumulation is expected to be a prime source of renewed economic expansion in early 1983. The Round Table's current forecast of inventory accumulation is greater than the buildup predicted at the October 1982 Round Table, largely because of the unanticipated record inventory liquidation that took place in the fourth quarter of 1982. The buildup in stocks in 1983 is expected to amount to about $10.5 billion, compared with liquidation of twice that size last year (see table 1).

Housing is another major sector of the economy that is expected to provide impetus to economic activity in the first half of this year. Residential construction expenditures could increase approximately 7 percent in each of the first two quarters, with overall growth of 23 percent for the year. While this is a stronger expansion than the group's median forecast last October, it

Table 1 Median Forecasts of Changes in GNP and Related Indicators[a]

March 1983

Indicator	1982 actual	1983 forecast	1983 IQ	1983 IIQ	1983 IIIQ	1983 IVQ	1984 IQ	1984 IIQ
	Change in levels, billions of dollars, saar							
GNP, constant dollars	-26.6	34.6	15.5	10.6	16.4	18.6	15.4	17.6
Personal consumption expenditures	9.4	29.1	5.5	7.3	11.1	8.6	9.5	8.5
Nonresidential fixed investment	-6.5	-9.4	-3.6	-1.5	0.1	2.0	1.9	3.1
Residential construction	-4.7	9.3	3.1	3.2	2.1	2.1	2.2	1.9
Changes in business inventories	-17.8	10.5	14.7	5.0	2.5	1.5	1.6	1.5
Net exports	-11.1	-10.9	-2.3	-1.0	-0.1	0.3	0.7	0.8
Government purchases	4.1	5.6	-3.2	-1.5	2.5	1.0	1.4	0.9
	Percent changes, annual rates							
GNP, current dollars	4.1	6.8	8.8	7.4	9.5	10.4	9.7	10.5
GNP implicit price deflator	5.9	4.5	4.6	4.4	4.2	5.6	5.4	4.9
GNP, constant dollars	-1.8	2.3	4.3	2.9	4.5	5.0	4.1	4.6
Industrial production	-8.2	2.2	5.7	9.4	8.8	8.9	5.3	8.1
	Absolute levels							
Unemployment rate, level	9.7	10.2	10.5	10.3	10.1	10.0	9.8	9.6

a. Median forecasts are based on individual forecasts of the Fourth District Economists Round Table; they do not represent forecasts of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

SOURCE: Fourth District Economists Round Table, Federal Reserve Bank of Cleveland.

remains within the bounds of past experience. Although recent declines in mortgage interest rates to about 12.8 percent have contributed to the improved housing outlook, several elements are still seen as constraining a housing recovery. Some forecasters believe further reductions in mortgage rates are necessary if the rebound in housing is to continue. Sluggish income growth, for example, will constrain housing demand. The Round Table economists expect disposable personal income to increase about 3 percent in 1983; last October, the group anticipated disposable personal income growth in the 5 percent to 6 percent range, which is typical for the first year of a recovery. In addition, federal borrowing to finance record federal budget deficits could limit the flow, as well as the price, of credit market funds available for mortgages.

The expected growth in residential construction during the first half of 1983 reflects a rather typical V-shaped recovery in housing starts from the trough in the fourth quarter of 1981. By the end of 1982, starts increased 45 percent from their 1981 fourth-quarter low of 0.9 million units (annual rate). The Round Table economists expect starts to increase another 15 percent by the end of 1983. The recovery in housing, however, has been stronger than anticipated. In the first quarter of 1983, for example, new housing starts rose to nearly a 1.7 million unit annual rate.

The Round Table economists view consumer spending as a moderately positive factor in the 1983 outlook. Real personal consumption expenditures (PCE) rose sharply in the final quarter of 1982, to a large extent reflecting lower interest rates and price incentives in the automobile industry. Similarly, the below-market automobile installment loan rates offered by major automakers boosted domestic new-car sales to their highest annual rate since the third quarter of 1981. The improvement in housing sales also caused an increase in spending for household furniture and equipment, and consumers showed a greater willingness to spend for apparel and other "soft" goods and services. Expenditures for fuel oil, however, weakened over the period because of unusually mild weather.

Because of atypically slow growth in real disposable income, the Round Table economists do not expect the large fourth-quarter 1982 increase in consumer spending to continue throughout 1983. Growth in real disposable income, which slowed in the final period of 1982, is expected to be about 3 percent (fourth quarter to fourth quarter) in 1983. The projected increase is similar to that achieved in the year following the 1980 cyclical trough, but it is well below the average 5.6 percent gain posted in the first year of previous postwar recoveries.

The unusually slow growth expected in personal consumption expenditures and real disposable income in part reflects the persistently high rates of unemployment forecast by the Round Table economists. Although most participants projected slow, but appreciable, gains in employment, they expect the unemployment rate to remain around 10 percent during 1983 and therefore to constrain consumer confidence (see table 2). Several economists noted that lingering doubts about the recovery and about job security, combined with historically high real interest rates, could result in further increases in the personal saving rate and dampen the recovery in consumer durable-goods spending.

Table 2 Median Economic Forecasts: 1983–84
Percent changes, fourth quarter to fourth quarter

Indicator	1982 actual	Forecast 1983	Forecast 1984
GNP, constant dollars	−1.1	4.1	4.2
GNP implicit price deflator	4.4	4.7	5.1
Consumer price index	4.5	3.9	5.2
Industrial production	−7.6	8.2	6.8
Unemployment rate, level	10.7	10.0	9.0

SOURCE: Fourth District Economists Round Table, Federal Reserve Bank of Cleveland, March 11, 1983.

The median Fourth District forecast thus shows PCE growth at about a 3 percent rate in the first half of 1983, accelerating slightly to nearly 4 percent over the second half. The economists expect PCE to expand approximately 3.5 percent from the fourth quarter of 1982 to the fourth quarter of 1983, compared with 4.5 percent to 7.0 percent in the first year of past recoveries. Some Round Table participants, however, expect an almost typical recovery in PCE, basing their forecast on the large increase in liquidity built into the economy in the latter part of 1982 by the rapid expansion in the nation's money supply. In their view, this liquidity should offset interest-rate constraints through much of 1983.

Restraints on the Recovery

Since their October 1982 meeting, the Round Table economists have become increasingly bearish about the near-term outlook for nonresidential fixed investment. While recoveries in capital spending typically lag recoveries in overall economic activity by about one quarter, little improvement is expected in this sector until late 1983. In October 1982, the Round Table predicted some recovery in capital spending by the second quarter of 1983; the most recent forecast indicated a 1.9 percent decline in 1983, compared with the October 1982 estimate of a 1.1 percent increase (fourth quarter to fourth quarter). While high real interest rates are a major constraint to the overall recovery, idle capacity is the overriding factor delaying the upturn in business fixed investment. Manufacturers experienced a 13 percentage point drop in capacity utilization during the 1981–82 recession, to a new postwar low operating rate of approximately 67 percent. Moreover, industrial production is expected to increase about 8 percent in 1983, substantially below its average recovery growth of 15 percent to 18 percent. This slow recovery in industrial production implies a wide margin of idle capacity and, hence, less capital spending in the near term.

The Round Table economists also expect that net exports will continue to have a negative impact on domestic economic growth in 1983. The median forecast calls for a 13 percent decline in net exports this year. Since 1980, on an inflation-adjusted basis, net exports have demonstrated their largest decline in recent history, a major factor contributing to the recent slowdown in real U.S. economic activity. A speedier recovery in the United States than abroad and a persistently strong dollar in foreign-exchange markets are the major factors that will continue to provide strength to U.S. imports but weakness to U.S. exports. According to one Round Table participant, recent oil-price declines also could weaken U.S. exports of capital goods to oil-producing countries.

Fourth District Industries

Steel, machine tools, and automobiles are three industries whose well-being is particularly important to the Fourth District economy. Each of these industries experienced severe declines in business during the latest recession; and each should experience an atypically slow recovery, according to the Round Table economists. Steel shipments in 1982 were at their lowest levels since 1958, with only an 18 percent to 20 percent increase in shipments expected for 1983 because of minimal growth in domestic steel consumption. The relatively mild increase in shipments, coupled with weak steel prices (currently well below published prices), could result in another unprofitable year in 1983, according to some Round Table participants.

Three developments, however, could affect the cost/price relationship in the steel industry. First, the recent contract settlement with the United Steelworkers of America will aid producers in efforts to hold down production costs. Three major concessions approved by the union were (1) a cut in wages of $1.25 per hour, (2) a freeze in cost-of-living payments until July 1984, and (3) reduced vacation time. Second, various other cost-containment programs also have been instituted. Administrative workers have taken a pay cut, and early retirement programs have allowed businesses to reduce the number of employees, causing a drop in total labor costs. Finally, many producers have closed inefficient facilities in an effort to reduce average operating costs. While some of the facilities will be called back into production when the recovery gains momentum, many of the closings are part of a long-term adjustment to declining demand for domestic steel. For the near term, producers probably will have to rely on cost-reduction efforts until financial positions (i.e., profits) improve.

The machine-tool industry has been severely hampered by the recent contraction in capital spending. Orders declined by 87 percent from early 1979 to the trough in the third quarter of 1982, compared with a 73 percent peak-to-trough reduction in the 1974–75 recession. Because of the unusual length and depth of the latest contraction, order backlogs declined from their usual one-year level to five months, as shipments outpaced orders. Although orders are expected to show a mild improvement this year, shipments could decline another 30 percent to 40 percent from their 1982 levels.

The automobile industry is expected to fare somewhat better than the steel and machine-tool industries in 1983, as manufacturers' incentives and weakening oil prices boost new-car sales. The Round Table's median forecast shows a pickup in domestic new-car sales to about 6.5 million units in 1983 from 5.8 million units last year. The 1983 sales level, however, would be about 3.5 million units below 1978 sales. Even the most optimistic forecast does not show a return to 1978 levels until 1984 at the earliest. One economist noted, however, that incentives offered during the 1981–82 recession prevented automobile sales from declining as much as they could have, given the income and employment mix. He suggested that the shallower drop in automobile sales could have been bought at the expense of a steeper gain during the recovery period.

Monetary Policy and Inflation

Monetary policy will play a key role in shaping the 1983 outlook and in determining whether the expansion will continue into 1984 and beyond, according to the Fourth District economists. The liquidity built into the economy during the latter half of 1982 and early 1983 is expected to support at least moderate economic growth over the year ahead. Moreover, it is anticipated that this expansion will be achieved with little or no acceleration in inflation in 1983. Price increases probably will occur in some key industries as firms attempt to restore profit margins, but other factors will moderate upward price pressures. Weakening oil prices, for example, have led several economists to scale downward their 1983 inflation forecasts, even though they expect increases in natural-gas prices to offset partially the drop in oil prices. Moreover, a sharp rise in productivity usually slows the pace of price increases in the early stages of recovery. Despite the significant gains posted in 1982, a further increase in productivity, similar to that experienced in past recoveries, should occur. Firms also will continue to emphasize cost containment until remaining doubts about the durability of the current expansion are dispelled. On the other hand, Fourth District economists expect no further improvement in inflation in 1984;

indeed, they anticipate the appearance of cyclical increases in prices, ranging from 4 percent to 5 percent. Significant price effects from recent rapid money-supply growth could emerge in late 1984, or more likely in 1985, according to some Round Table economists.

The possibility of sustained economic growth through 1984 seemed doubtful at the Round Table, especially if interest rates do not decline from current levels. Lower interest rates would be necessary to maintain momentum in residential construction and consumer durable-goods spending. They also believe that, as idle capacity diminishes, high real interest rates could become an important factor holding back a revival of business fixed investment. The Round Table's median forecast, however, anticipates little further decline in interest rates. The prime rate is expected to drift down to an average of 10.1 percent in the second quarter of 1983 and to remain at that level before beginning to edge back up in the fourth quarter. Moody's rate on Aaa-rated corporate bonds is expected to hover around 11 percent throughout 1983 and the first half of 1984.

Given this background, participants were hopeful that monetary policymakers would tread a narrow path in 1983 to prevent a stalling of the recovery. Several of the group's members were concerned that monetary policymakers might interpret the business sector's efforts to restore profit margins as a resurgence of inflation, triggering a rise in interest rates. Near-term tightening in money-market conditions, according to these economists, could lead to a peaking of economic activity as early as the fourth quarter of 1983. However, other economists argued that, unless growth of money stock slows soon, double-digit inflation could return by 1985.

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