An international economist pointed out, however, that growth rates of foreign economies have been sluggish and that prospects for accelerated growth, that might benefit U.S. exports, are not encouraging, especially in the absence of fiscal stimulus on the part of foreign governments.

Since mid-1985, industrial production abroad, especially in Western Europe and Japan, has been relatively flat. Also, until 1986, growth of domestic demand among major trading partners was generally weaker than real foreign GDP, with the difference being made up largely—especially by the U.S.

Private and public forecasts for foreign economies in 1987 suggest little change from 1986, with Japan’s growth in real GDP expected to be about the same as last year’s 2.5 percent, and with West Germany’s growth rate being slightly less than in 1986. West Germany and Japan both have relatively large trade surpluses with the U.S., and both countries had relatively high unemployment rates and declining inflation during most of 1986. U.S. public officials have for some time urged West German and Japanese officials to take stimulative fiscal and monetary action to boost domestic demand. Both nations, however, have been reluctant to do so for fear of retarding inflation.

The economy is in the fifth year of an expansion that has been characterized by a relative moderation in inflation rate, by moderate growth in output, and by the continuation of large trade and federal deficits.

Some observers feel that the economy, like Shakespeare’s character Hamlet, is trying to make up its mind and is currently wavering between tendencies toward accelerated growth in output and inflation, or toward another year of moderate growth in inflation and output. Predicting which path will be taken was one of the topics discussed at the May 8 meeting of the Fourth District Economic Roundtable. The meeting, held at the Federal Reserve Bank of Cleveland, was attended by about 25 economists from a mixture of financial, industrial, and retail firms headquartered within and outside the Fourth Federal Reserve District, which includes Ohio and parts of Pennsylvania, West Virginia, and Kentucky.

Roundtable meetings are scheduled three times a year to give economists an opportunity to exchange views about national and industry conditions. In spite of turbulence that marked financial markets since the group’s first meeting of the year in February, and despite the widely unanticipated upsurge in output and prices last quarter, Roundtable forecasts as of May 8 were essentially unchanged from those made in February. The group was more cautious about the same growth path for output, except that second quarter expectations were cut back in view of higher-than-expected output gain reported for the first quarter of the year. The economists’ inflation forecasts were virtually unchanged from those made in February, despite a surge in consumer and producer prices earlier this year.

This Economic Commentary summarizes the Roundtable forecasts and the discussion that centered on whether the unanticipated first-quarter surge in both output and prices was transitory, or if it was the beginning of a stronger growth path that would indicate that a higher policy priority should be given to controlling inflation and inflation expectations.

Economic Prospects

As indicated in table 1, the median forecast of the Roundtable economists anticipates much slower growth in real gross national product (GNP) in the second quarter of this year than in the first quarter (3.1 percent annual rate vs. 4.4 percent, respectively). A $14 billion reduction in inventory investment in the second quarter contributed to output growth in the first quarter of the year. The econometric models used by the Roundtable economists anticipate moderate growth in output and inflation, or toward another year of moderate growth in inflation and output. The first quarter of 1987 was a weaker quarter due to higher-than-expected output and prices, while the second quarter of 1987 is forecast to have stronger-than-median performance for the various sectors, especially automobiles, and in real GNP, accord-ingly.

The median forecast for real GNP growth could amount to nearly 4 percent over the second quarter 1987 and second quarter 1988, and prices could accelerate close to a 4.5 percent annual rate by the first half of 1988.
With the exception of autos, there is ample room for growth in durable and nondurable goods inventories, according to one report. Prospects for real nonresidential fixed investment (NRFI) also appear to be on a rising trend for 1987 following a decline in 1986. It was pointed out that NRFI last year was weakened by the effects of tax reform — especially by the loss of tax incentives and by increases in the after-tax cost of capital. With tax reform completed, the introduction of new information-processing products, plus a swing from a deficit to a small surplus in trade for capital goods, should help increase investment in producers' durable goods by 5 percent in 1987 and 8 percent in 1988.

Even larger increases are anticipated for information-processing equipment. Improvement is also expected in transportation equipment, again for industrial, agricultural, construction, and oil export.

Investment in structures, however, in 1987 will continue to be depressed because of the oil-price decline in early 1986, because of overbuilding of office and commercial buildings, and because of tax reform. Overcapacity in the industrial contracts have been rising irregularly since the steep decline in late 1985 and early 1986, suggesting that business spending for structures will likely hit a low point this year before resuming a rising trend in 1988.

### Table 1: Median Forecasts of Change in GNP and Related Items

<table>
<thead>
<tr>
<th>Year</th>
<th>1987</th>
<th>1986</th>
<th>1987</th>
<th>1988</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP in constant (1982) dollars</td>
<td>90.7</td>
<td>9.7</td>
<td>39.8</td>
<td>10.4</td>
</tr>
<tr>
<td>Personal consumption expenditures</td>
<td>52.1</td>
<td>2.5</td>
<td>6.9</td>
<td>19.9</td>
</tr>
<tr>
<td>Nonresidential fixed investment</td>
<td>17.3</td>
<td>3.4</td>
<td>8.5</td>
<td>5.8</td>
</tr>
<tr>
<td>Residential construction</td>
<td>2.5</td>
<td>2.5</td>
<td>2.2</td>
<td>1.3</td>
</tr>
<tr>
<td>Change in business inventories</td>
<td>8.3</td>
<td>-82.2</td>
<td>65.6</td>
<td>-19.4</td>
</tr>
<tr>
<td>Net exports</td>
<td>20.7</td>
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<td>30.5</td>
<td>4.0</td>
</tr>
<tr>
<td>Government purchases</td>
<td>16.2</td>
<td>18.9</td>
<td>-14.0</td>
<td>3.5</td>
</tr>
</tbody>
</table>

#### Change in Levels, Billions of Dollars, s.a.e.*

<table>
<thead>
<tr>
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#### Percent Changes (Annual Rates)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
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<tbody>
<tr>
<td>GNP in current dollars</td>
<td>5.4</td>
<td>1.7</td>
<td>8.7</td>
<td>4.8</td>
</tr>
<tr>
<td>GNP implicit price deflator</td>
<td>2.8</td>
<td>0.7</td>
<td>3.5</td>
<td>3.8</td>
</tr>
<tr>
<td>GNP in constant (1982) dollars</td>
<td>2.5</td>
<td>1.1</td>
<td>4.4</td>
<td>2.9</td>
</tr>
</tbody>
</table>

### Table 2: Automobile Outlook

#### Median Forecasts of Output, Sales and Inventories

<table>
<thead>
<tr>
<th>Year</th>
<th>1986</th>
<th>1987</th>
<th>1987</th>
<th>1988</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total new car sales</td>
<td>11,453</td>
<td>10,200</td>
<td>2,324</td>
<td>2,835</td>
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<tr>
<td>Change in dealer stocks</td>
<td>-129</td>
<td>+109</td>
<td>+439</td>
<td>-75</td>
</tr>
</tbody>
</table>

### Monetary Policy Issues

The Roundtable discussion of the monetary policy centered heavily on Federal Reserve policies and on how those objectives should be influenced by domestic and international considerations. The spurt in prices in recent months has contributed to a growing expectation about inflation, and has led some financial market participants to call for greater emphasis on controlling inflation.

Several Roundtable economists expressed a view that the discount rate should probably come up more in 1988 as a signal to domestic and foreign-exchange markets that the Federal Reserve is willing and prepared to deal with the possibility of accelerating inflation.

Several key issues underlie the course of monetary policy. The first relates to the strength of the economy. Those who urge immediate further action assert that the growth of the economy shows signs of accelerating from the 2.4 percent annual rate of change that has existed since mid-1984. They are also convinced that probabilities about the economy have shifted in favor of faster-than-expected growth—which is something that was not predicted at the last few meetings of the Roundtable.

Overcapacity is seen as a worldwide problem. Cars entering the U.S. market are being manufactured domestically, plus being produced in Canada, Mexico, Japan, Korea, and Yugoslavia.

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Some support a more strict approach to monetary targeting, while others suggest that further dollar depreciation alone is inadequate for accelerating inflation. The concern of another economist, however, is that the core inflation rate may reach as high as 4 percent. When the economy's output growth was about 2.5 percent in 1985 and 1986, he said, prices rose in the 3.5 to 4.5 percent range — even with the benefit of lower interest rates. Prices today are rising about 2.4 percent, and overall inflation rate is already moving above the core rate.

### International Prospects

Many Roundtable forecasters expect that a primary source of thrust in domestic output will be an improvement in the international trade sector, which has been a major drag on domestic output during most of the current expansion. Over the next four quarters, for example, the median forecast by the 25 Roundtable economists shows a sizable improvement in real net exports of nearly $20 billion, following the $29 billion increase that has taken place between third and fourth quarters of 1987. Even with such an improvement, however, a sizable trade deficit would remain.

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<td>8.6</td>
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<table>
<thead>
<tr>
<th>Year</th>
<th>Domestic Production</th>
<th>Change in dealers stocks</th>
<th>Import sales</th>
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<tbody>
<tr>
<td>1986</td>
<td>7,287</td>
<td>-129</td>
<td>3,238</td>
<td>11,453</td>
</tr>
<tr>
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<td>+439</td>
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Several Roundtable economists expressed a view that the discount rate should be raised further in the near future, as a signal to domestic and foreign-exchange markets that the Federal Reserve is willing and prepared to deal with a situation in which the economy growth is regaining confidence in foreign-exchange markets would be a by-product of a further rate increase.

Some others, however, doubted that targeting narrow money stock (M1) at present would be sufficient, given the growth of the broader money stock aggregates, particularly M2, within the first quarter of 1987.

Concern was also expressed by some of the Roundtable economists over whether the first quarter 1987 spike in prices is indicative of accelerating inflation. Most Fourth District forecasters expect prices to increase by 3.5 to 4 percent range through the first half of 1988. A few expect inflation to accelerate to a 4 to 5 percent range, mostly in response to higher petrol imports.

The concern of another economist, however, is that the core inflation rate may reach as high as 4 percent. When the economy's output was about 2.5 percent in 1985 and 1986, he said, prices rose in a 3.5 to 4 percent range — even with the benefit of lower oil prices. Now, however, the effects of dollar depreciation are probably adding one percentage point to the core inflation rate, pushing overall inflation rate already moving above the core rate.

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Even with such an improvement, however, a sizable trade deficit would remain and many analysts are skeptical that further dollar depreciation alone can contribute much more to reducing the trade deficit. Among other things, they expect to see faster growth in exports for continued improvement in U.S. net exports.
An international economist pointed out, however, that growth rates of foreign economies have been sluggish and that prospects for accelerated growth, that might benefit U.S. exports, are not encouraging, especially in the absence of fiscal stimulus on the part of foreign governments.

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U.S. public officials have for some time urged West German and Japanese officials to take stimulative fiscal and monetary action to boost domestic demand. Both nations, however, have been reluctant to do so for fear of reigniting inflation.

A report on the international outlook also pointed out that the U.S. may have difficulty improving its trade deficit with the newly industrialized nations (NICs) of the Pacific Basin, which includes South Korea, Taiwan, Hong Kong, and Singapore. In fact, growth with these Asian countries equals our entire deficit with Western Europe. The bulk of this trade deficit, however, is with Taiwan. The primary problem is that the U.S. dollar has not depreciated very much against the Taiwan dollar until the past six to 12 months. If the U.S. dollar were to depreciate further against other currencies, then an improvement in the U.S. trade deficit would depend importantly on the cause of the depreciation. According to simulations produced by an International Monetary Fund (IMF) computer model of U.S. and foreign economies, the most positive exchange-rate effect on the U.S. trade deficit would come from foreign fiscal stimulus. The IMF model predicted that a reasonable amount of foreign fiscal stimulus would improve the U.S. trade deficit by an estimated $14 billion in its first year. Monetary expansion, on the other hand, was estimated to have an initial perverse effect, which would result in a three-year lag before the trade deficit shows a net improvement.

During the Roundtable discussion, it was pointed out that neither fiscal nor monetary policies alone can explain the dollar's recent decline. The fall in the dollar was seen to be due to a complicated combination of factors.

The problem underlying the trade deficit with Japan is linked to the imbalance between saving and domestic investment in the U.S. compared with Japan. The U.S. has inadequate savings relative to domestic investment because of unusually large federal budget deficits.

In summary, it appears that improvement in the U.S. trade account requires slower growth in domestic demand relative to domestic production, and that saving must increase to balance domestic investment. An increase in growth rates of domestic demand abroad would help the U.S. trade deficit, although prospects for this happening are not encouraging.

Conclusion

The Roundtable group uniformly agreed that overall growth of the economy will be sustained at least through the first half of 1986, which would make the current expansion the second longest in the post-World War II period. Consensus also was present, however, over whether the level of output and prices in 1986 first quarter represents the beginning of a higher inflationary growth path, or if it is simply a temporary “bubble.” Differences also surfaced over whether or not the Federal Reserve should place a higher priority on resisting inflation and rising expectations of inflation.

The economy is in the fifth year of an expansion that has been characterized by a relatively high inflation rate, by moderate growth in output, and by the continuation of large trade and federal deficits.

Some observers feel that the economy, like Shakespeare's character Hamlet, is trying to make up its mind and is currently wavering between tendencies toward accelerated growth in output and inflation, or toward another year of moderate growth in inflation and output.

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As indicated in table 1, the median forecast of the Roundtable economists anticipates much slower growth in real gross national product (GNP) in the second quarter of this year than in the first quarter (1.1 percent annual rate vs. 4.4 percent, respectively). A $19 billion reduction in inventory investment in the second quarter and a smaller improvement in net exports are expected to account for the slower second quarter growth in real GNP. From 1987:1Q to 1988:1Q, however, growth in real GNP is still expected to accelerate to about a 3 percent average annual rate. This is about the same as the Roundtable forecasters expected in February.

A few of the participants were more cautious about the median forecast, especially in light of the run-up in interest rates since last March. Concern was expressed that higher interest rates would dampen interest-rate sensitive sectors, especially autos and housing. Sustained higher interest rates might warrant a cutback in consumer spending for durable goods, especially automobiles, and in real GNP, according to one economist. Another Roundtable member expects that the jump in mortgage interest rates to 10.5 percent, if sustained at the May level, could weaken new housing starts, dropping them to a 1.0 to 1.5 million rate from last year's 1.8 million level.

Still, the tone of the May Roundtable meeting was even more upbeat than indicated in the group's median forecast. One prediction was that a stronger-than-median performance for both output and inflation would result because four forces are pointing in the same direction: 1) Fiscal policy, especially government spending, will show less restraint than widely expected; 2) lagged effects of declines in real interest rates will be positive to interest-rate sensitive sectors; 3) lagged effects of rapid money stock expansion in 1986, along with higher oil and import prices, will produce higher-than-expected rates of inflation; and 4) the effects of dollar depreciation will increase foreign demand for U.S. manufactured goods.

If these four forces materialize, real GNP growth could average 4 percent between second quarter 1987 and second quarter 1988, and prices could accelerate close to a 4.5 percent annual rate by the first half of 1988.

Reappraising the 1987-88 Outlook

by John J. Ercog and William C. Murmann

John J. Ercog is an assistant vice president and economist at the Federal Reserve Bank of Cleve-
land. William C. Murmann is editor of the Eco-

nomic Review and Economic Commentary for the Federal Reserve Bank of Cleveland. The views stated herein are those of the authors and not necessarily those of the Federal Reserve Bank of Cleveland or the board of governors of the Federal Reserve System.

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