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ECONOMIC COMMENTARY

Reappraising the 1987-88 Outlook

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The economy is in the fifth year of an expansion that has been characterized by a relatively moderate 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 Economists' 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 surge in output and prices last quarter, Roundtable forecasts as of May 8 were essentially unchanged from those made in February. The group still expects 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 (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:IIIQ to 1988:IIQ, however, growth in real GNP is still expected to accelerate to about a 3 percent average annual rate, which 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 about 10.5 percent, if sustained at the May level, could weaken new housing starts, dropping them to a 1.6 to 1.65 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 output and employment for U.S. manufacturers.

If these four forces materialize, real GNP growth could amount to nearly 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.

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Table 1 Median Forecasts of Change in GNP and Related Items

	Change in Levels, Billions of Dollars, s.a.a.r.*							
	1987	1986	1987				1988	
	Year	IVQ	IQ	IIQ	IIIQ	IVQ	IQ	IIQ
GNP in constant (1982) dollars	90.7	9.7	39.8	10.4	27.0	30.0	30.9	28.0
Personal consumption expenditures	52.1	-2.2	-6.9	19.9	16.6	16.0	16.0	16.1
Nonresidential fixed investment	-7.3	3.4	-8.5	5.8	3.0	4.3	4.0	4.0
Residential construction	2.4	2.5	-2.2	1.3	0.2	0.0	0.0	-0.5
Change in business inventories	9.3	-28.2	63.6	-19.4	1.5	0.5	3.0	2.0
Net exports	20.7	15.3	10.8	5.1	4.0	4.3	6.0	4.0
Government purchases	16.2	18.9	-14.0	3.6	3.5	4.7	2.0	2.6
	Percent Changes (Annual Rates)							
GNP in current dollars	5.4	1.7	8.7	4.8	6.6	7.3	7.4	7.0
GNP implicit price deflator	2.8	0.7	4.1	3.5	3.8	4.1	3.7	4.1
GNP in constant (1982) dollars	2.5	1.1	4.4	1.1	2.9	3.2	3.3	2.9
	Interest Rates (Percents)							
Prime Rate	8.3	7.8	7.5	7.5	7.8	7.9	8.0	8.0
Moody AAA Corporate Bond Price	9.0	8.9	8.7	8.4	8.8	8.9	9.0	9.1

* Seasonally adjusted annual rate.
Source: Fourth District Economists' Roundtable, May 8, 1987.

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, and for industrial, agricultural, construction, and oil equipment.

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. Commercial and 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.

Autos

The Roundtable discussion of the domestic economy included the automotive industry, where the steep decline in the foreign-exchange value of the dollar since early 1985 has boosted prices and reduced demand for foreign cars.

An industry economist said that there has been a shift linked to the falling value of the dollar and that the Japanese cost advantage has shrunk considerably. Japanese automakers, he said, used to have about a $2,500 cost advantage over U.S. carmakers on certain models. This advantage has shrunk to about $400.

Japanese automakers have been forced to raise import prices of 1986 models by about 13.4 percent because of the drop in the dollar. Prices of 1987 models have been raised another 5.3 percent. Price increases for domestic cars have amounted to about 8.8 percent over the 1986 and 1987 model years.

This change in relative price has brought down the Japanese market share to a more "natural" level, according to the auto analyst. Also, at one point, he added, it was expected that total imports would capture about 40 percent of the market, so the dollar-induced decline has been beneficial for domestic manufacturers. Unit sales of Japanese imports, in particular, are leveling out at about 20 percent of the market, although market shares of some other foreign producers, especially Korea, are rising.

This doesn't mean, however, that there will be smooth sailing for domestic manufacturers. The industry, said the analyst, faces a serious overcapacity problem. There are too many cars and not enough customers. For example, production capacity of foreign carmakers in the U.S. amounts to an estimated 815,000 units for the present model year, and may be boosted to 1.9 million units by 1990.

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.

More and more countries are producing cars and all are competing for U.S. customers. This will result in an extremely competitive market. In addition, demand in the near future is expected to show little growth, which will put a squeeze on profits for some manufacturers.

As indicated in table 2, the Fourth District panel expects a 7 percent decline in auto output this year compared to last year, primarily in response to lower sales of both domestic and imported cars.

Table 2 Automobile Outlook
Median Forecasts of Output, Sales and Inventories*

(Number of cars - 000 units)

	1986	1987	1987 IQ	1987 IIQ	1987 IIIQ	1987 IVQ	1988 IQ	1988 IIQ
Domestic production	7,827	7,295	2,075	1,969	1,500	1,760	1,900	1,960
Domestic sales	8,215	7,275	1,668	2,057	1,800	1,782	1,770	2,000
Change in dealer stocks	-129	+109	+439	-75	-300	+30	+100	-10
Import sales	3,238	3,040	656	790	800	782	750	850
Total new car sales	11,453	10,200	2,324	2,835	2,600	2,550	2,620	2,840

*Nonseasonally adjusted.
Source: Fourth District Economists' Roundtable, May 8, 1987.

Monetary Policy Issues

The Roundtable discussion of monetary policy centered largely on Federal Reserve objectives and on how those objectives should be influenced by domestic and international considerations. The spurt in prices in recent months has contributed to rising expectations 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 be increased in the near future 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.

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 in a 3.5 to 4 percent range through the balance of 1987, and in a 4 percent zone at least through the first half of 1988. A few expect inflation to accelerate to a 4 to 5 percent range, mostly in response to higher prices of imports.

Those economists urging immediate tightening action by the Federal Reserve pointed to similarities to economic conditions in May 1983, when a period of accelerated growth in both output and prices led to tightening action. The claim was made that willingness to raise interest rates at that time contributed to lower interest rates since then — which may not have occurred to the same degree if the policy action had not been taken.

Those Roundtable economists who see clear signs of accelerating growth in output and inflation believe that the priority in Federal Reserve policy should be to counter inflationary tendencies. Some support a more strict adherence to monetary targeting to achieve their desired inflation objective.

Although not necessarily supporting targeting narrow money stock (M1) at present, one member suggested keeping growth of the broader money stock aggregates, particularly M2, within their target ranges for 1987. He felt that regained confidence in foreign-exchange markets would be a by-product of control over money stock growth, especially if growth of money at home were less than growth among key trading partners.

Some others, however, doubted that there is sufficient information to corroborate the view that the growth rate of output and of inflation is accelerating. According to them, the economy is still giving mixed signs. Likewise, they feel it is still uncertain whether the price increases that occurred last quarter represent the early stage of accelerating inflation or if they are simply a return to the "core" rate of inflation—the 3 to 4 percent rate that existed before the energy price declines in early 1986.

Uncertainty over whether or not inflation will accelerate beyond the 3 to 4 percent core rate that apparently has been accepted by markets and policymakers suggests that it may be premature to tighten monetary policy. The best course, one participant suggested, may be to adopt a wait-and-see approach, and to avoid taking downside risks to the economy in response to what may be a temporary run-up in market expectations about 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 a 3.5 to 4 percent range — even with the benefit of lower import prices. Now, however, the effects of dollar depreciation are probably adding one percentage point to the domestic inflation rate, so that the 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 Fourth District economists shows a sizable improvement in real net exports of nearly $20 billion, following the $29 billion increase that has taken place between third quarter 1986 and first quarter 1987.

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 it. Among other things, they look to 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.

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 foreign real GNP, with the difference being made up by exports—especially to the U.S.

Private and public forecasts for foreign economies in 1987 suggest little change from 1986, with Japan's growth in real GNP expected to be about the same as last year's rate of 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 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. Our deficit 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 1988, which would make the current expansion the second longest in the post-World War II period.

Considerable differences surfaced, however, over whether the level of output and prices in 1987 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.

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