November 15, 1989

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

How Soft a Landing?

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If the economic expansion that has graced the U.S. economy since the conclusion of the recession of 1981-1982 were a party, the band is now on a break and refreshments are running a little low. No one is certain about what might happen after the break, but the band just may be saving its best material for the next set, and most feel that things will pick up rather nicely later in the evening —in the case of the economy, late in 1990, heading into 1991.

This scenario roughly conveys the combined perspective of a group of nearly 30 economists who gathered at the Federal Reserve Bank of Cleveland on October 20 for the fall 1989 version of the Bank's periodic Fourth District Economists' Roundtable.

The group was a diverse one, representing manufacturing, trade, and financial industries. Its outlook calls for a slowdown in growth heading into 1990, concentrated in the manufacturing sector; continued slow growth in real GNP; continued, though slightly moderating inflation in the range of 4 to 4½ percent, led by price increases in the services sector; and an apparent end to the capital spending boom.

Additionally, according to some of the participants, an end to the improvement in the trade deficit is in store, the value of the dollar in foreign exchange markets will likely move irregularly downward for the next few years, and pressure will grow on the Federal Reserve to gradually shift away from its stated goal of price stability toward sustaining the expansion.

■ The Pause That Refreshes

Nearly all assembled were in agreement that the economy, relative to the rapid pace of 1987 and 1988, is clearly in a cooling-off period. Generally, most of the Roundtable economists predicted slow growth in output for the remainder of 1989 and through the second quarter of 1990, with a pickup beginning late in 1990 and carrying into 1991 (see figure 1). Although fewer expected a recession to occur than at the Roundtable meeting held in June, the range of forecasts was wider, and the group believed that the margin for error had shifted toward the possibility of a weaker-than-expected expansion.

Representatives from the manufacturing industries—automotive, heavy equipment, and electronics—invariably reported softening in capital spending, high but easing capacity utilization rates, scattered layoffs, and cautious management of inventories. Manufacturing output has shown little or no growth at all since last spring, manufacturing employment has been declining, and construction is sluggish.

One auto economist noted that the auto industry is generally gearing up for a period of declining sales in the 1990s. The industry itself is paying very close attention to inventories, as are its supplying industries, particularly steel. He noted that auto sales incentives "...will be around forever," stating that the various incentive programs in place during 1989 were responsible for as many as 800,000 units of total industry sales, after contributing 500,000 units in both 1988 and 1987. The incentives are *not,* however, leading to a particularly noticeable net increase in floor traffic or sales closures; rather, they seem to have become expected by consumers, who merely wait for the incentives before making their purchase.

While nearly everyone in attendance at a recent Fourth District Economists' Roundtable agreed that the economy is in a cooling-off period that should last well into 1990, few predicted a recession. There was less agreement on the "livability" of the current rate of inflation, however.

One factor in the automotive market leading to a slightly optimistic long-run outlook is the relatively high age of the car fleet. Demand is expected to pick up when those who have finally achieved some equity after paying off most of the now-standard five-year loans begin to trade in for new cars.

The auto economist warned that the competition is going to remain fierce. There are now no less than 38 car manufacturers competing in the world

ISSN 0428-1276

market, capacity is incredibly high, and "...no manufacturer wants to be the first one to blink."

An exception to the flattening output trend are the service industries, which seem to be emerging from the slow-growth economy "relatively unscathed," according to one economist. Growth of output in the service industries so far this year has shown no slowing. However, prices in the service sector have continued at an annual rate of increase of about 5 percent, while prices in manufacturing have either flattened or declined in recent months. Thus, as one economist asserted, the economy is in a period of "stagflation," with the "stag" in the goods-producing sector of the economy and the "flation" in the services-producing sector.

In sum, the outlook is relatively optimistic in the sense that real GNP growth is expected to continue, albeit slowly, even though the period of rapid economic expansion may be over (see table 1). One economist characterized this as having been a "rolling expansion," shifting from a consumer-led economy to an export and capital-goods-led economy during the last two years. "Perhaps we can go back to the consumers," he commented wryly.

■ Capital Spending: Is the Boom Over?

Capital investment has been one of the major sources of growth that supported the accelerated pace of manufacturing output and real GNP growth in 1987 and 1988. In 1989, the growth rate of real business fixed investment has slowed from its near double-digit pace of the previous two years, and last quarter, growth was the slowest so far this year.

Representatives from both high-tech and traditional capital-goods producers agree that activity in orders and production peaked in 1988 or early 1989, and some industries are now at or near a trough, while some others may not experience a trough until 1990.

Growth rates in new orders for and production of communications equipment peaked in early 1988 and 1989, respectively, and not much improvement is expected in 1990.

Major markets for electronic components, especially semiconductors, have cut back their demand from peak rates in late 1988, with the result that order growth has softened. Continued declines for electronics equipment are expected into 1990.

Industrial machinery orders have been on a downward path because of declines in corporate cash flow and in commercial and industrial construction. Although orders from domestic buyers have fallen, export orders remain strong.

Heavy-duty truck orders and production have declined substantially from the near-record rates in late 1988 and early 1989, when anticipated price increases and extended deliveries contributed to a bulge in orders. The order decline is apparently near a trough. The level of orders in September was a little above its six-month average, and cancellations have receded.

Notwithstanding reports of a slowdown in those capital-goods industries, most of the Roundtable forecasters expect a small increase in real nonresidential fixed investment over the next four quarters — about 1.5 percent. Consequently, should that expectation be borne out, neither manufacturing nor overall economic growth will be supported by business fixed investment, as was the case in 1987 and 1988.

■ The Dollar and Deficits

The slow growth rate in output that is widely expected for 1990 is also associated with little further improvement in net exports. Many forecasters attribute the slowdown in net exports to dollar appreciation since early 1989 and to slower growth in economies abroad. Of course, U.S. imports of petroleum products continue to increase as domestic production and supply are constrained by limited availability and price.

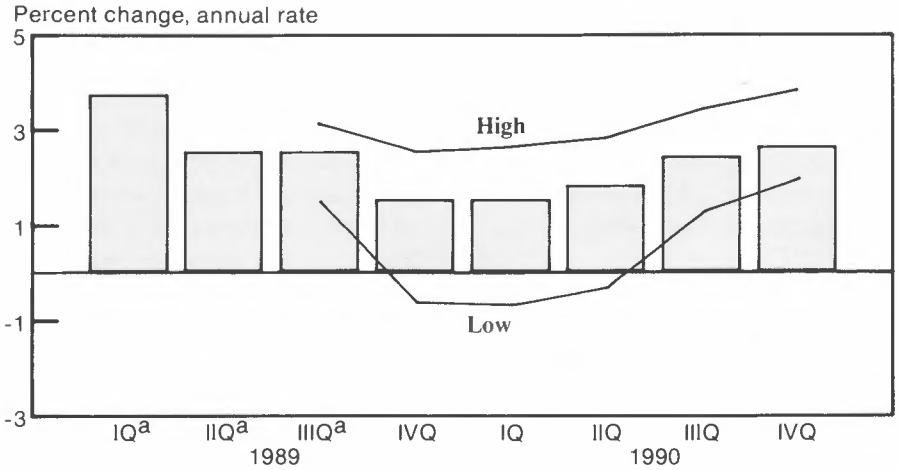
An international economist explained that the generally unexpected appreciation of the dollar in foreign exchange markets in 1989 was due to both political and economic considerations. Political unrest in West Germany and in Japan and uncertainty about the latest developments in Eastern Europe strengthened the dollar in exchange markets. Perceptions abroad about the strength of the U.S. economy and the avowed commitment to controlling inflation, supported by much slower growth in the money stock relative to its major trading partners, have made the U.S. attractive for foreign investment.

From early 1987 to mid-1989, the deficit in U.S. net exports improved by about $84 billion. The deficit, however, is now expected to flatten and even worsen, as it did in 1989:IIIQ, according to the Commerce Department's preliminary estimate. One economist pointed out that markets abroad have begun to slow, and foreign investors' favorable perception of the U.S. economy may be eroding. The exchange value of the dollar may decline by a few percent in 1990. Over the next few years, U.S. trade deficits can be expected to worsen instead of improve even though U.S. imports would likely decline in the event of a recession. That view, however, is somewhat more bearish than expected by most of the Roundtable forecasters, who still anticipate a slight improvement in the net export balance continuing at least through 1990.

■ Inflation: What's the Cost?

A Roundtable session on inflation was titled, "Can We Live With 4½ Percent?". The position of one financial economist was that any kind of inflation—whether unanticipated or anticipated or at any constant rate—imposes long-run costs on the economy. Anticipated inflation hinders economic growth by fostering debilitating shifts in resource allocation, and even a stable 4½ percent inflation rate is no better than the variable, high inflation rates of the late 1970s and early 1980s (see figure 2).

FIGURE 1 MEDIAN REAL GNP FORECAST



a. Actual data.

SOURCE: Fourth District Economists' Roundtable, Federal Reserve Bank of Cleveland, October 20, 1989.

TABLE 1 MEDIAN FORECASTS OF FOURTH DISTRICT ROUNDTABLE: GNP AND RELATED ITEMS

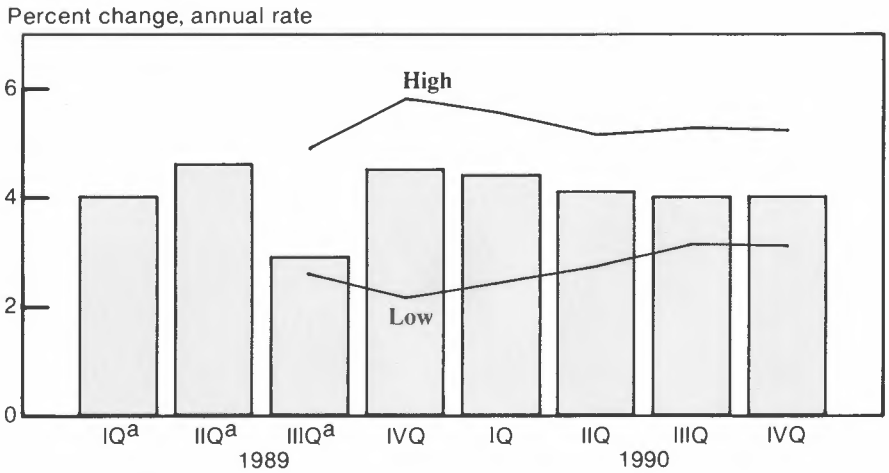
Change in levels, billions of dollars, s.a.a.r.[a]

	1989	1990			
	IVQ	IQ	IIQ	IIIQ	IVQ
GNP in constant (1982) dollars	15.0	15.3	18.7	25.0	27.2
Personal consumption expenditures	7.5	11.0	12.3	14.9	16.5
Nonresidential fixed investment	2.3	1.0	1.9	3.4	4.2
Residential construction	0.9	0.7	2.1	2.5	2.1
Change in business inventories	-1.1	-1.1	0.1	1.0	1.0
Net exports	0.6	2.0	1.4	1.0	2.0
Government purchases	2.6	0.0	1.0	1.9	2.7
	Percent change at annual rates				
GNP in current dollars	5.7	6.0	6.2	6.6	6.9
GNP implicit price deflator	4.5	4.4	4.1	4.0	4.0
GNP in constant (1982) dollars	1.5	1.5	1.8	2.4	2.6
FRB index of industrial production	0.8	0.8	2.0	2.5	2.8

a. Seasonally adjusted annual rate.

SOURCES: Fourth District Economists' Roundtable, Federal Reserve Bank of Cleveland, October 20, 1989; and U.S. Commerce Department, Bureau of Economic Analysis.

FIGURE 2 MEDIAN GNP IMPLICIT PRICE DEFLATOR



a. Actual data.

SOURCE: Fourth District Economists' Roundtable, Federal Reserve Bank of Cleveland, October 20, 1989.

The consensus was that, while we can certainly live more easily with 4½ percent inflation than we were able to live with the double-digit rates of the recent past, the expectation that 4 to 5 percent is accceptable is "destructive," as one economist put it. "Remember: at these rates, the price level *doubles* in 16 years."

Beyond that, consensus breaks down. While most participants agreed that inflation would not slow down very much between now and the end of 1990, the debate centering on the "livability" of a 4½ percent rate compared with the potential costs of restoring price stability was lively and, ultimately, unsettled.

Viewpoints were split on the desirability of having the Federal Reserve reduce inflation regardless of other factors affecting the economy. Many questioned the Federal Reserve's stated policy priority of price stability. While all viewed zero inflation as an admirable goal, there were substantial differences of opinion regarding the adjustment costs of achieving that goal, and the manner in which these costs would fall on different sectors of the economy.

Several economists associated with manufacturing industries asserted that those industries would bear the brunt of any slowdown in overall economic activity, and that reducing the inflation rate has different effects on different sectors of the economy.

"Autos and appliances are the whipping boys in controlling inflation," asserted one economist, observing that manufacturing prices have risen less rapidly than service prices in this expansion, and that manufacturing profits are generally more sensitive to the business cycle. Some participants were concerned that the loss in output usually associated with reducing inflation would impact cash flow in highly cyclical industries. Moreover, the cost of capital could be raised because of a risk premium associated with cyclically sensitive industries.

Several participants went further to suggest that there really exists no broad-based, societal consensus for achieving price stability. Rather, there may be a consensus for inflation rate "predictability."

As to whether there *are* differential effects on separate sectors of the economy resulting from anti-inflation policies, one participant noted that there are always changes in relative prices in the economy. Even a constant 4½ percent inflation rate implies that prices in some sectors of the economy will rise faster, and prices in other sectors slower, than the overall inflation rate. Moreover, manufacturing industries perform well in the low-inflation economies of West Germany and Japan.

Many participants felt that the most important goal for the Federal Reserve was to gain credibility by committing itself to policies that will gradually result in reduced inflation accompanied by steady growth. Some called for legislation that specifies a zero target for inflation. Others believe credibility is achieved when the Federal Reserve takes actions that are perceived as being anti-inflationary.

Several also noted the need for the federal government to commit to price stability. "Other parts of the government have a vested interest in higher inflation," pointed out one economist, who noted that it is easier to pay off debt in cheaper dollars. Other types of pressure on prices result from government actions as well: prices are pushed up in health and agriculture, for example, by government policies.

■ Conclusion

Is the economy on a soft landing path? Only partially. Obviously, economic output has slowed and is expected to slow even further, though avoiding a recession, at least until mid-1990.

Consistent with a soft landing, inflation moderated last quarter, indeed more than widely expected, although a one-quarter improvement is scant evidence that the underlying inflation rate has improved.

According to the Roundtable group, the nation will not have to face the problem of accelerating inflation again until 1991, when economic growth will have strengthened.

In the interim, outright output declines in some sectors are still possible. Representatives of goods-producing firms painfully recall the 1984-1986 period, when their industries experienced intense foreign competition and limited ability to increase prices. They clearly do not relish reliving that experience, despite the fact that, overall, GNP grew at a healthy pace.

The Fourth District Economists' Roundtable showed little current agreement on the desirability of legislated solutions to the problem of inflation, nor on the characteristics of a transition period that would lead to zero inflation. There was, however, strong support for the general concept of price stability and its ultimately beneficial effects on the economy.

Paul J. Nickels is an editor and John J. Erceg is an assistant vice president and economist at the Federal Reserve Bank of Cleveland. *The authors would like to thank Gerald H. Anderson, Michael F. Bryan, John M. Davis, and Mark S. Sniderman for helpful comments.*

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