ECONOMIC COMMENTARY
Federal Reserve Bank of Cleveland

The Outlook: No Boom, No Doom

by John J. Erceg and Lydia K. Leovic

The economy's mixed performance in recent months has led to a growing perception that a recovery has not yet begun, or that its sustainability is threatened. Recent declines in housing sales and new car sales, stalled industrial production, and minimal growth in employment have caused some observers to dismiss the reported third-quarter revival in economic growth. Pending layoffs by some manufacturers, financial institutions, and retailers are seen as additional warning flags of a faltering economy.

Is the economy indeed headed for a double-dip recession in the coming months? Not according to a panel of 25 experts who met at the Federal Reserve Bank of Cleveland in late October. The Fourth District Economists' Roundtable, which convenes three times a year to discuss current conditions and to present expectations for the economy, unanimously believes that the 1990–91 recession ended last spring and that growth is under way, albeit slowly.

Recession Is Over, but Recovery Is Weak

None of the Roundtable forecasters expects a decline in real GNP through at least year-end 1992 (see figure 1). Instead, their median real GNP forecast calls for a moderate growth rate of about 3 percent from the present quarter through 1992:IVQ.[1] They expect that industrial production, which rose at a 7 percent annual rate in 1991:IIIQ, will increase at about a 4 percent rate over the next four quarters. Consistent with this relatively slow-growth scenario, the Roundtable group looks for labor markets to revive gradually, with the unemployment rate holding at 6.8 percent again this quarter and then receding to 6.3 percent by 1992:IVQ.

Compared with the seven previous postwar recoveries, these predictions indicate an uncommonly weak upturn, which is consistent with the economy's recent mixed and jagged performance. One panelist acknowledged that some information suggests an apparent stalling in economic activity since late summer, and noted that continued slow growth will inevitably raise questions about the sustainability of recovery. A widespread mood of job insecurity is said to be an important cause of the recent waning in consumer confidence.

What's Holding Us Back?

A variety of constraints are claimed to be holding the growth rate of the 1991–92 business upturn below average, according to the Roundtable. Some point to the debt buildup of households and firms in the 1980s, which must be worked down before consumers and businesses can resume a higher pace of spending. Additional roadblocks are restructuring in the service sector, especially financial, trade, and real estate; declines in defense spending; a continued trend toward efficiency in inventories; plus fiscal and monetary policies that are unlikely to be as stimulative as in most previous upturns.

Still, as one panelist pointed out, export growth can be expected to continue to support the domestic economy, although the path will be bumpy, and residential construction, especially of one- to four-family units, should be reasonably strong as a result of the lowest mortgage interest rates since the mid-1970s.

Although economic growth apparently has lost momentum in recent months, there is reason for optimism. According to the Fourth District Economists' Roundtable, recovery is under way, and no double-dip recession is anticipated. Compared with previous episodes, however, the upturn is likely to remain weak in response to a number of structural adjustments. The inflation rate is expected to moderate.

Although none of the Roundtable members predicted recession, one economist acknowledged the possibility that real GNP growth could revert to zero in any one quarter, because the margin between growth and no growth is relatively small. Yet even if the economy expands at a 3 percent rate during its first year of recovery, as the panel expects, this would still approximate the pace of growth that prevailed during the second half of the 1980s, and would be similar to that of the two slowest recoveries, in 1970–71 and 1980–81, when real GNP rose about 3.3 percent. Such a sluggish recovery would fall far short of the seven upturns since the early 1950s, however, when real GNP growth averaged 5.7 percent.

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FIGURE 1 REAL GNP OUTLOOK

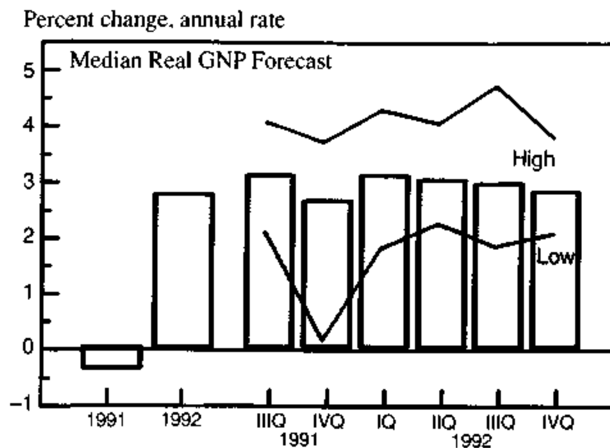
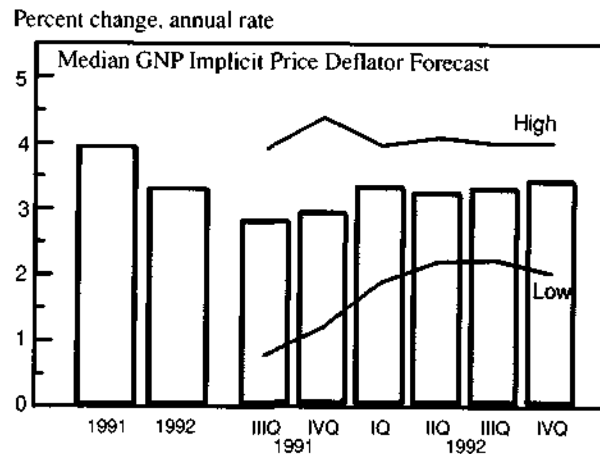


FIGURE 2 INFLATION OUTLOOK



NOTE: High and low are the average of the three highest and lowest forecasts, respectively.
SOURCE: Fourth District Economists' Roundtable, October 25, 1991.

Manufacturing: A Respectable Comeback

Recoveries in manufacturing production have typically coincided with overall economic expansions, and the rise in output has averaged about twice the gain in real GNP in the past seven recoveries. In the latest manufacturing upturn, which began in April 1991, production rose at about a 6 percent annual rate through October, slightly more than the initially reported rate of increase in real GNP for 1991:IIIQ.

The turnaround in manufacturing has been broad-based, led especially by a revival in consumer durable goods. Automobile production rose from an annual rate of about 5.1 million units in 1991:IQ to about 6 million units in October. For 1992, an auto economist expects domestic car output at about 9 million units and light truck output at about 4.7 million units—below levels that are indicative of a "good" year. In his view, a lower-than-usual level of car inventories for this season, strengthening in used car prices, and relatively low inflation and interest rates are all positive factors in the auto outlook. Slow growth in employment and income, and personal tax increases in many states, are said to be negative influences.

Capital goods industries have also been contributing to the revival in manufacturing output, but the comeback has been mixed and sluggish. Year-over-year comparisons can conceal changes in direction, but a three-month moving average shows a slow and uneven upturn in the electronics industry since 1991:IQ, according to a capital goods economist. He expects further improvement because inventories are below their longer-term trend. Semiconductor orders have been increasing at about a 10 percent annual rate in recent months, supported by higher demand from several markets, especially automotive and computer and office machinery. Further growth is expected in 1992, but at about half the pace of previous recoveries. The decline in orders for communications equipment has not yet ended, but is expected to do so within the next few months.

The steel industry has mounted a slow comeback from recession. Steel shipments have been picking up gradually since early this year, but are expected to fall a few percent short of the 85-million-ton average of the past three years. Some producers are reported to be operating their flat-rolled steel facilities at close to capacity. For 1992, rebuilding of steel stocks and higher steel consumption are expected to boost both shipments and production a few percent from 1991 levels, according to the median of steel forecasts. An economist noted that better management of steel stocks, from raw materials to finished steel, has resulted in a lower ratio of steel inventories to total manufacturing stocks in recent years compared with 10 years ago.

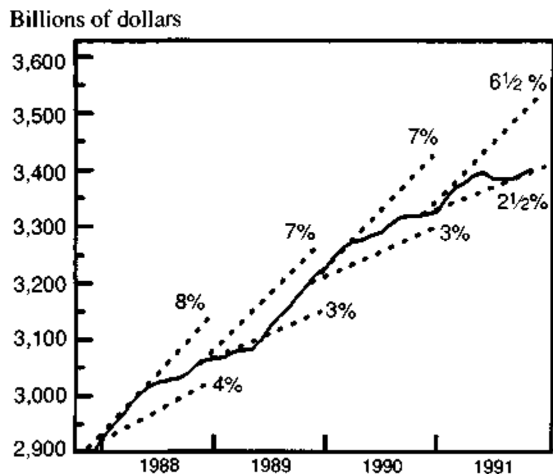
Inflation: Some Good News

For the past several years, the underlying inflation rate has been close to its long-term trend of 4 percent annually. The persistence of that rate has been disappointing to some economists, who expected to see signs of improvement in response to moderated growth in the money stock (M2), which has averaged about 4.5 percent annually since 1987. As recently as last June, the Fourth District panel expected the inflation rate (as measured by the GNP implicit price deflator) for 1991 to hold at about 3.7 percent at least through the second half of 1992.

At the October 25 Roundtable meeting, however, the economists nudged downward their expectations of inflation. Their median forecast calls for a 3.1 percent rate of price increase between 1991:IIQ and 1992:IIQ, and for only a slight step-up to about 3.3 percent in the second half of 1992 (see figure 2). These expectations are a bit lower than most other public forecasts.

This slight improvement in inflation expectations since June does not yet appear to be reflected in long-term bond yields. The 30-year Treasury bond yield has hovered narrowly around 8 percent in

FIGURE 3 THE M2 AGGREGATE



SOURCE: Board of Governors of the Federal Reserve System.

recent months, which some economists view as including a premium for the risk that the Federal Reserve will subordinate its long-term goal of price stability to that of sustaining the economic recovery. Financial-market participants apparently want more evidence that inflation measures are indeed improving.

■ Inventories: Sharp Correction but Mild Buildup

Inventory liquidation has typically accounted for the bulk of the declines in real GNP during each of the past seven recessions, and inventory buildup has typically been a major contributor to the revival in output by the second to third quarter after a recession trough. In addition to their swings in response to cyclical changes in economic activity, inventories have been shrinking relative to sales in the past decade, as firms have increasingly used better inventory-control techniques ("just-in-time" systems) and up-to-date information on sales and stocks.

Forecasters had generally expected that the business inventory liquidation in the 1990–91 recession would be mild relative to past episodes of cutbacks, mostly because the buildup of stocks prior to the recession was judged to be moderate. As it turned out, the liquidation phase was larger than average and began promptly with the beginning of the recession, continuing into the third quarter of 1991.

Roundtable economists predict a relatively small inventory accumulation during the first year of this recovery, and expect it to occur later than has traditionally been the case. If this proves correct, the buildup would rank among the mildest of the postwar recoveries and hence could add much less to output growth than in the past.

A guest panelist, who is the purchasing director for a major automotive and electronic parts producer, elaborated on how inventory practices have been upgraded. He emphasized that it is not only improved technology and information systems that have helped to bring about better control over inventories, but also changes in management attitudes (inventories are now perceived as a waste instead of an asset), improvement in customer-supplier relationships, and a streamlined manufacturing process.

■ Some Short-Run Monetary Policy Issues: What's Appropriate?

Persistent weakness in M2 growth since last spring has raised several issues about monetary policy objectives and appropriate responses. The reason for the concern is that M2 is the primary policy target of the Federal Reserve System, and year-to-date growth of the aggregate is at the bottom of the Fed's 2.5 to 6.5 percent target range for 1991. Moreover, M2 growth so far this year is well below its 4½ percent trend rate since 1987. The Roundtable group raised several issues concerning monetary policy:

- Which is the "correct" or most appropriate measure of money and monetary thrust? M2 showed virtually no growth between April and October, and since 1990:IVQ, growth has amounted to only about a 2.5 percent annual rate (see figure 3). The M2 shortfall is commonly explained in terms of a long-term shift out of small time deposits at thrift institutions and banks into other higher-yielding financial assets, especially bond funds, that are not included in M2.

NIPA REVISIONS

The foregoing discussion of previous recoveries is based on the U.S. Department of Commerce's series of national income and product accounts (NIPA), which incorporate 1982 prices. According to a senior official of the Bureau of Economic Analysis, the Commerce Department will release revised data in December incorporating several changes, the most significant of which is a revision in the price base, which will affect both output and inflation data. The Department has already released preliminary estimates of real GNP since 1982 rebased in 1987 prices. The revisions show a slightly deeper recession in 1990–91 than reported in 1982 dollars, but only a two-quarter drop in real GNP instead of the three-quarter decline that was reported in 1982 dollars.

Also included will be improvements in data and changes in definitions and classifications. The Commerce Department plans to issue an alternative measure of real GNP based on changing weights, a procedure similar to that used for some other measures of economic activity, such as the industrial production index. The panelist reported that in future releases of NIPA, emphasis will be shifted from gross national product to gross domestic product, which excludes net foreign income.

The overall result of these changes is that the U.S. national income and product accounts will be more compatible with those of other nations than has previously been the case.

Other monetary and reserve aggregates have displayed strength, however. The monetary base, M1, and M2 excluding time deposits have all risen at annual rates between 6 and 7 percent since 1990:IVQ. The Roundtable group was not in agreement as to which measure of the money stock is most appropriate, and what the risks are if the Federal Reserve ignores the M2 weakness or continues to attempt to push M2 growth above the bottom of its target range.

- What should be the short-run policy objective of the Federal Reserve? In the view of one panelist, it should be to "...provide sufficient liquidity to facilitate a modest recovery consistent with low inflation." Restoring M2 growth to its recent trend rate of 4.5 percent would require a sharp step-up in the money supply that he contends would be inconsistent with a noninflationary economic recovery.

- How should monetary policy respond to present credit-market conditions, especially to the perceived credit crunch? A suggested way of dealing with a supply-constrained credit market is through regulatory changes, such as by easing capital requirements, rather than through a more rapid expansion of money. One economist posited that the problem may be the result of a reduction in demand, not in supply. If the supply of credit were constrained, he observed, interest rates would have risen rather than declined, as they have done since early 1989.

- What should be the appropriate monetary policy response to fiscal policy changes? According to a panelist, monetary and fiscal policies are not substitutes. Monetary policy has long-run effects on inflation and should be used to pursue the long-term objective of price stability. Fiscal policy has its own set of objectives, and its effects are unclear.

While no clear-cut answers to these issues emerged, some members cautioned the Federal Reserve to be mindful of the recent weakness in M2, while others warned the central bank about repeating errors of the past that have caused the inflation rate to accelerate.

What's the Prognosis?

The recession ended last spring, but so far the recovery is off to a slow start relative to the average of postwar business upturns, according to the Roundtable panel. Consequently, not all regions and industries may yet be experiencing a comeback from the 1990–91 recession.

Moreover, the Roundtable group acknowledges that growth of the economy apparently stalled in recent months, but uniformly rules out prospects for a double-dip recession. Several structural adjustments, such as the overbuilding in commercial real estate and more conservative inventory practices, coupled with less stimulative fiscal and monetary policies, are among the constraints on the recovery.

Expectations about inflation, however, are becoming more favorable. Indeed, prices so far in this business upturn have been rising even less than in 1970–71 and 1980–81, the two previous slow-recovery episodes. The problem now is how to stay on that disinflationary path.

Footnote

1. An informal telephone survey of most Roundtable members taken in late November suggests a downward revision of real GNP growth to about a 1 percent annual rate in 1991:IVQ and to about a 2 percent annual rate in 1992:IQ from the forecasts prepared in October. For the second half of 1992, however, several economists raised their real GNP forecast, and most forecasts were in a 3 percent to 4 percent range.

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