ECONOMIC COMMENTARY
Federal Reserve Bank of Cleveland

Roundtable's R_X for the Economy: First, Do No Harm

by John J. Erceg and John B. Martin

Participants in the latest meeting of the Fourth District Economists' Roundtable believe that growth will once again be under way by spring, though at a subdued rate compared to other postwar recoveries. The group attributes this slower pace to longer-term structural adjustments taking place in many U.S. industries — a realignment that most panelists believe is beyond the Federal Reserve's ability to control. Thus, in attempting to remedy the economy's woes, policymakers are advised to tread cautiously, following the physicians' oath to "first, do no harm."

In this political season, there are as many prescriptions being written for the economy as there are would-be healers. Though the diagnosticians agree that the patient will certainly recover, they are divided on just how aggressively treatment should proceed.

Participants in the latest meeting of the Fourth District Economists' Roundtable, held January 24 at the Federal Reserve Bank of Cleveland, did not give the economy a clean bill of health, but their prognosis for the next year and a half is encouraging. Consequently, support for more expansive fiscal or monetary policy actions was tempered.

All 24 panelists agree that the recovery is likely to be more subdued than other postwar upturns because of longer-run adjustments taking place in many of the nation's industries, particularly banking, retailing, computer equipment, and autos. As a result, policymakers are advised to tread cautiously in attempting to restore the nation's economic health, lest their efforts interfere with this necessary longer-term realignment.

■ The Economic Overview

A spate of less-than-encouraging economic indicators in recent months has reinforced the view of those who think that the economy has not yet begun to rise from its sickbed. Roundtable members acknowledged the recent slippage by scaling down their growth rates of real gross domestic product (GDP) to near zero this quarter after a meager 0.3 percent rise in 1991:IVQ (see figure 1).

The group's forecast for the rest of 1992 is brighter. A step-up in growth of real GDP is predicted for the second quarter, followed by output and price increases averaging an annualized 3 percent through mid-1993 (see figure 2). Nevertheless, the group expects the *pace* of renewed growth to be slow judged against the average of past business recoveries. Though some sectors and regions of the country may expand rapidly, others will likely be constrained by longer-term structural adjustments. The Roundtable focused on a few of the industries in which this realignment is expected to persist even after the economy regains its strength.

■ Where's My Friendly Banker?

Banking underwent major changes in the 1980s and apparently faces tougher challenges in the years ahead, according to one panelist and industry expert. The domestic industry has been losing market share to nonbank financial institutions, as well as to global competition. Between 1975 and 1990, banks' share of commercial and industrial loans shrank substantially, from about 71 percent of all short-term credit issued to less than 50 percent. Their share of consumer loans also fell, as Americans continued to turn to a variety of nonbank financial sources.

The industry has become increasingly vulnerable to changes in the economy. The same panelist reported that a succession of problem loans that began in agriculture and then moved into energy and real estate has sparked significant increases in the number of nonperforming loans and loan charge-offs. As a result, the number of banks that have had to merge or to fold has been on the rise since the mid-1980s.

ISSN 0428-1276

Despite this downsizing, there are still too many banks and too many bank employees, according to the economist. Acquisitions and mergers, many of which occurred at the bank holding company level, have neither produced the expected cost reductions nor eliminated a significant number of banks. Consequently, efforts to increase efficiency and to improve revenues are likely to result in further reductions in the number of banks and bank employees.

■ Too Many Retailers?

A retail industry representative claimed that retailers, like bankers, will continue to feel the pinch of a contracting marketplace over the coming decade. At the heart of the industry's difficulties is a downtrend in consumer spending.

Between 1970 and 1986, consumer outlays for goods rose at an average annual rate of 3 percent. Since then, spending has been trending down. In 1991:IVQ, skittish buyers bought fewer goods than in any quarter since 1988:IQ. As part of this retrenchment, the retailer noted, Americans have also been cutting back on the number of credit cards they hold.

He attributed the current declining trend in consumer spending to demographic shifts, tax changes, and an apparent growing desire by households to save more. Thus, a rebound in income growth seems likely to translate into a higher rate of personal saving than in past recoveries.

While consumers were guarding their wallets more closely, construction of retail space exploded, jumping about one-third between the first half and the second half of the 1980s. As a result, retail space productivity, or sales per square foot, fell sharply, and the industry began to downsize.

Over the remainder of the current decade, the panelist expects that new construction of retail space is unlikely to grow much and that shrinkage in the number of retail establishments and workers will continue. The industry has already shed half a million employees since mid-1990, when its payrolls peaked at 19.7 million.

■ Computers: More Like Other Durable Goods?

The computer and office equipment industry is also going through a restructuring process that is restraining economic growth. One Roundtable participant reported that both cyclical and longer-term developments are behind the industry's drive to increase efficiency and to adjust to changing market needs.

After many years of rapid growth that was relatively insensitive to business fluctuations, the computer industry has experienced only minimal expansion since 1989. At the root of this slowdown are the increasing substitution of used computers for new ones, and the continued shift away from large mainframe units to small personal computers (PCs). The move to PCs, which began in the early 1980s, has fostered the rise of a group of small and efficient producers both in this country and abroad.

Furthermore, the domestic industry has been increasingly exposed to foreign competition. Between October 1990 and November 1991, imports of office and computer equipment rose at a 17 percent annual rate, while domestic purchases were up only 1 percent. Nonetheless, one Roundtable participant reported that "computer technology in the United States is still one to two years ahead of the foreign competition, especially for complex equipment."

■ Automotive Realignment: More to Come

U.S. automotive restructuring intensified in the early 1980s, when Americans increasingly opted for foreign cars (especially Japanese models), leading domestic producers to close plants and cut employment. Protectionist pressures in the United States and a desire to locate plants close to markets led the Japanese to begin transplanting their production facilities into this country in 1982. Their success both here and at home appears to be based largely on a revolutionary production system and on the widespread use of new technology, according to a guest panelist and industry authority.

The Japanese production method differs in several fundamental ways from traditional mass production techniques and forms the basis for the restructuring going on in the U.S. auto industry. Essentially, the "lean" system, as it has been termed, requires doing more with less. Lean producers use fewer suppliers and carry lower inventories than mass producers. They also employ a smaller, but more flexible and presumably more efficient, work force.

In the same expert's view, domestic automakers' biggest adjustment will be made in their supply chains. By the turn of the century, the number of independent U.S. motor vehicle suppliers is expected to have shrunk by as much as 40 percent.

He also noted that motor vehicle imports from Japan may be peaking. Coupled with recent developments in trade policy between our government, Canada, and Mexico, this could mean that more of the cars and trucks sold in North America will be made here. U.S. producers are likely to specialize in large, high-cost vehicles, he added, while the rapidly developing Mexican auto industry appears to be better suited for the production of smaller, economy models.

These changes should ultimately result in a more efficient and stable industry as we approach the mid-1990s, with vehicle assembly and parts production increasingly concentrated in the Midwest, particularly in Ohio. "Perhaps the most difficult question facing the motor vehicle industry today," the panelist speculated, "is how much production capacity will go to the U.S. domestic producers and how much will be garnered by the Japanese transplants." In large part, the answer lies with the U.S. producers themselves and how well they meet the twin challenges of lean production and consumer preferences over the next few years.

■ Fiscal Policy: Is Stimulus Appropriate?

The economy's lethargic performance has triggered interest in using fiscal actions (lower taxes, increased spending, or both) to stimulate economic growth. Yet,

FIGURE 1 REAL GDP

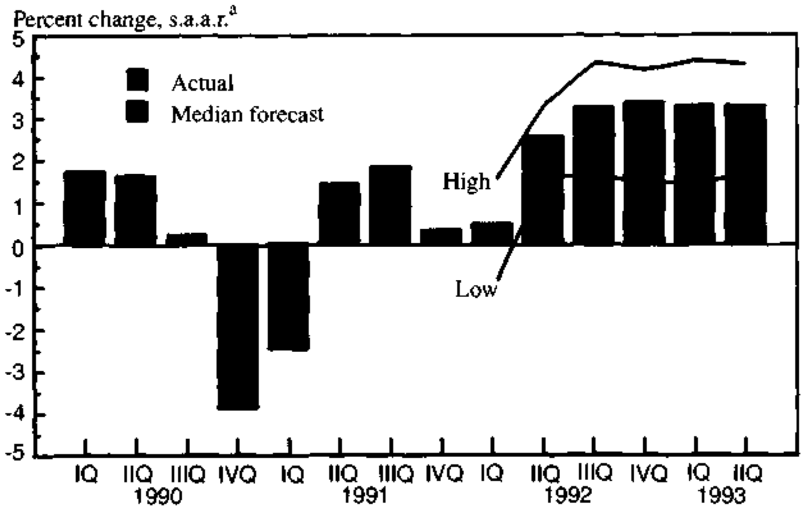
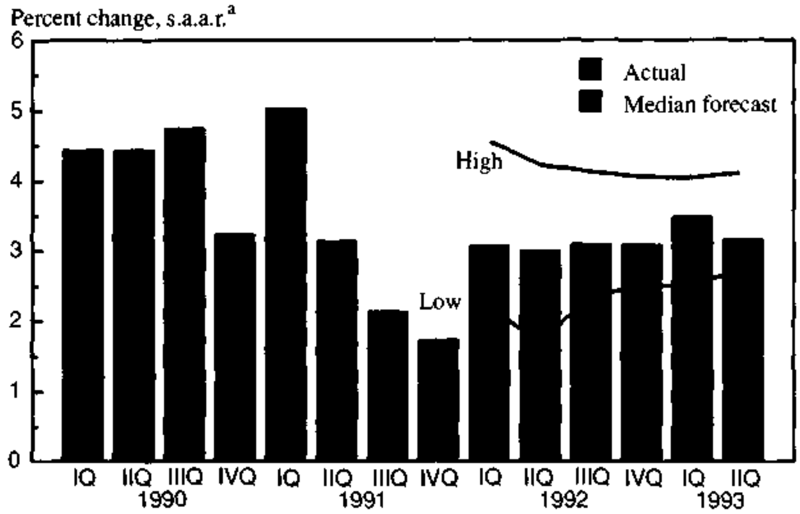


FIGURE 2 GDP IMPLICIT PRICE DEFLATOR



a. Seasonally adjusted annual rate.

NOTE: High and low are the average of the three highest and lowest forecasts, respectively.

SOURCES: Fourth District Economists' Roundtable, Federal Reserve Bank of Cleveland, January 24, 1992; and U.S. Department of Commerce, Bureau of Economic Analysis.

sentiment for a fiscal stimulus package is divided, at least among economists. Slightly more than half the Roundtable participants favor such legislation, while the rest believe either that no stimulus is needed, or that such measures, because of the lags involved, would provide no thrust until after the expansion is well under way.

One guest panelist and tax authority noted that it is not recession but the *lack of economic growth* that should form the basis for any tax relief. Virtually any kind of a tax cut will mean pushing the federal budget even deeper into deficit unless policymakers abandon the 1990 budget agreement and tap future defense spending cuts to finance the reductions. He also pointed out that it is unclear whether the proposed tax cuts are aimed at consumption or saving, or if they are intended to stimulate growth in the short term or over a longer horizon.

The same expert questioned whether even a $50 billion tax cut, which is about 1 percent of nominal GDP, would help to lower the unemployment rate. Because it takes time for tax changes to filter through the system, any stimulative effect would not be noticed this year. Moreover, some economists believe that the fiscal proposals currently on the table might have no stimulative effect at all. In their view, short-run tax changes could do more damage than good in an economy that needs incentives for saving and investment in order to improve productivity growth. Given these circumstances, one participant remarked that "doing nothing at all for a while might be the most appropriate policy."

■ **Monetary Policy: Easy or Not?**
At the core of the debate over whether monetary policy is tight or easy is the disagreement about which set of money stock measures is the best indicator of policy: M1, which expanded rapidly last year, or M2, which grew 3.1 percent, slightly above the lower bound of its 2.5 to 6.5 percent target range. The Federal Reserve uses M2, the broader measure, as its policy target.

Some economists believe that M2 is no longer the most appropriate indicator of monetary policy because of a portfolio shift by depositors out of low-yielding instruments into higher-yielding financial assets not included in M2, especially bond funds. Others are concerned that last year's rapid growth in M1 (as well as in bank reserves and the monetary base) was too expansive and thus inconsistent with longer-term price stability. However, one participant asserted that the accelerated pace of M1 growth is not necessarily inflationary, since the aggregate typically expands at a brisk rate when short-term interest rates fall.

Another financial economist argued that M2 is still the most reliable signal of policy because its velocity is more stable than that of other reserve and monetary measures, and because it has been a good predictor of nominal GDP. He concluded that the link between M2 and inflation suggests the Federal Reserve is on a 1 to 2 percent inflation path over the next few quarters, but remarked, "I don't think the market expects sustained 2 percent inflation." He also argued that the Fed has not moved away from its price stability path recently, as evidenced by that fact that yields on both Treasury bills and Treasury bonds remain above nominal GDP growth, unlike the case in most past business recoveries.

In essence, this panelist's view is that the Federal Reserve has provided sufficient liquidity to encourage economic growth, and that any further easing would be inappropriate because of supply constraints in the economy that are beyond the power of the central bank to control.

■ Concluding Comment

A mood of cautious optimism emerged from the Roundtable proceedings. Participants acknowledge a virtually flat economy, but one that is unlikely to relapse into recession. Most expect a step-up in growth to be under way by spring.

All those gathered predict that the renewed growth will be moderate relative to past recoveries. This subdued pace was attributed to ongoing adjustments in many U.S. industries.

Panelists warned against policies that could prove costly to the economy's future health. Serious reservations were expressed about the appropriateness, timing, and effects of the so-called fiscal stimulus packages currently before Congress. Monetary policy was described by some as still tight, though on a path toward price stability.

The forecasts of output and prices portend better economic times ahead. The group predicts that GDP will grow at an average annual rate of approximately 6 percent over the next five quarters, about evenly divided between output and prices. Yet, in the last two quarters, prices rose at a better-than-expected annualized rate of about 2 percent. If the Federal Reserve continues to hold the line on M2 growth, that split could well be 4 percent output and 2 percent inflation. That's not a bad prognosis.

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