manufacturers require that steel prices be fixed at least for the duration of the contract, thus preventing increased production costs from being passed on to auto manufacturers. The combination of poor domestic markets, import competition, and fixed-price contracts resulted in transaction prices declining by as much as 20 percent between 1981 and 1983, according to one economist. In fact, the inability to adjust prices contributed to the steel industry's expectations that profits will not be reported until the second quarter of 1984, although many product lines were operating at full capacity in March.

Capital goods. Economists affiliated with capital-goods producers reported that the unusually rapid investment recovery last year probably will be followed by another atypically strong recovery in 1984. Although starting from capacity utilization rates as low as 75 percent in some product lines, overall utilization rates for capital-goods industries rebounded faster in this recovery than in past recoveries. As of March 1984, some capital-goods producers were operating at capacity, although producers of farm, construction, mining, and materials-handling equipment have slowly increased operations. One producer of equipment that manufactures semiconductors not only has been operating at capacity but plans to expand this year. Imports of some high-technology products were increasing rapidly, but imports of some traditional capital goods, such as machine tools, have also accounted for a rapidly growing share of the market. Despite scattered evidence of price increases, prices of traditional capital goods have been held down by excess capacity and by imports.

Inflation and Monetary Policy

Recognition of increased competitive pressures on prices since the previous meeting in October accounted for a downward adjustment in the median forecast of inflation in 1984 from 5 percent to 4.5 percent. The Round Table economists, however, still expect spreading shortages, rising unit labor costs, and the decline of the dollar in foreign exchange markets to contribute to inflation by late 1984. Inflation (as measured by the GNP implicit price deflator) was expected to accelerate from 4.9 percent in the first quarter of 1984 to 6 percent by the second quarter of 1985. Several economists expressed concern that inflation in late 1984 and 1985 could exceed this forecast. One bank economist projected a 7 percent (ar) increase in the deflator in the fourth quarter of 1984. He also expected that this recovery's rapid drop in the unemployment rate and relatively slow increase in productivity would drive up wages. This economist anticipated that faster money stock growth (compared with West Germany and Japan) would further devalue the dollar and add 1 to 2 percentage points to the domestic inflation rate by early 1985.

The group questioned the appropriate monetary policy response to these developments. Several economists at the meeting expressed concern that the rapid growth of M-1 from mid-1982 through mid-1984 would accelerate inflationary pressures in 1985. Over the first two months of 1984, M-1 growth averaged 8.6 percent, which caused much concern among the group. The Round Table economists suggested that M-1 growth should slow to about 6 percent—the midpoint of the 1984 target range—from 10 percent growth in 1983. Nearly two-thirds of the group preferred that money stock growth stay within a 6 percent to 8 percent range; the rest of the group preferred even slower growth. Generally, the Round Table economists agreed that monetary policymakers should consider a moderate tightening now to avoid the risk of more severe tightening later in the recovery.

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The Economy in 1984: Industry Perspectives

by Robert H. Schnorbus

The U.S. economy steamed into its second year of recovery, with little perceptible reacceleration in inflation. In the first quarter of 1984, gains in employment and production accelerated at near-record rates; new-auto sales rose to their highest levels since 1979; and housing starts reached their highest rates since 1978. Indirect evidence of the recovery's strength was equally impressive. Supply shortages cropped up, which is unusual for so early in a recovery. Even some of the troubled smokestack industries reported, or expect to report, profits in 1984.

The reaction to these trends was not one of universal rejoicing; in fact, money, capital, and equity markets slumped in the first quarter. The strength of the recovery aroused concern in the business community that a too-rapid expansion would reaccelerate inflation. The response of financial markets to the threat of inflation would probably result in further credit-market tightening, or higher interest rates. Stock market participants were, and still are, concerned that economic expansion will halt just as industries are experiencing stronger profits. This explains the apparent contradiction between the surging strength of the economy and the shrinking confidence of financial markets.

At the March meeting of the Fourth District Economists Round Table, economists from 26 financial and nonfinancial firms discussed the direction of the economy into 1985, focusing on major industries in the Fourth Federal Reserve District.[1] This *Economic Commentary* summarizes forecasts made by economists at the Round Table and deals with an important question that emerged during the meeting. Will the slowdown that typically occurs in the second year of a recovery be sufficient to prevent a reacceleration of inflation during a sustained period of expansion in this business cycle?

Second Year of Recovery—Median Forecast

Round Table economists generally anticipated moderate growth in 1984—slower than in 1983, yet stronger than usual for a second year of recovery. After real GNP grew 6.2 percent in 1983, the median forecast of the group dropped to 4.3 percent in 1984. Real GNP growth typically slows from 6.7 percent in the first year of recovery to 3.8 percent in the second year.[2] Although none of the Round Table economists expected a recession during the next five quarters, five forecasters anticipated that growth in real GNP in the first half of 1985 would average 2 percent or less.

The quarterly pattern of forecast real GNP growth showed a steady drop from 5.5 percent (annual rate) in the first quarter of 1984 to 3.1 percent in the second quarter of 1985 (see table 1). However, real GNP in the first quarter of 1984 actually

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The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

1. The Fourth District Economists Round Table meets three times a year at the Federal Reserve Bank of Cleveland. Participants represent financial and nonfinancial firms in the Fourth Federal Reserve District. The Fourth District includes the state of Ohio, western Pennsylvania, northern and eastern Kentucky, and the northern panhandle of West Virginia.

2. Measures of typical GNP growth in a recovery are based on the average quarterly pattern of five recoveries since 1954, excluding 1980-81.

Table 1 Median Round Table Forecasts[a]
March 1984; percent changes at annual rates

GNP and components	1983 actual	1984 forecast	1984 IQ	1984 IIQ	1984 IIIQ	1984 IVQ	1985 IQ	1985 IIQ
GNP, constant dollars	6.2	4.3	5.5	4.1	4.6	3.2	3.7	3.1
Personal consumption expenditures	5.4	4.0	5.4	2.4	3.9	4.2	3.4	2.4
Nonresidential fixed investment	12.6	6.2	5.2	7.6	6.6	5.6	6.8	5.6
Residential construction	37.4	4.6	2.8	8.6	4.1	2.7	-6.6	-7.0
Government purchases	-2.5	4.4	2.5	6.7	4.3	4.0	2.8	4.0

a. These median forecasts are based on individual forecasts of the Fourth District Economists Round Table held in March; they do not represent forecasts of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

grew at an impressive 8.3 percent, largely because of a massive inventory accumulation. Barring revisions in the official first-quarter data, the group may already have underestimated the strength of the second year of recovery.

The Round Table economists had expected a real inventory swing of $4.8 billion, well below the actual $17.9 billion. If the group had been right in this one component, and if actual GNP growth were appropriately adjusted downward to reflect the lower inventory investment, real GNP would have grown only 4.8 percent—much closer to the Round Table's forecast of 5.5 percent, but still reflecting a somewhat different expectation of what the sources of that growth would be.

In general, the consumer durable goods, residential construction, and nonresidential fixed investment components of real GNP performed much better than the group expected in the first quarter of 1984. Residential construction rose almost $14 billion (ar), compared with the group's expectations of a slim $0.4-billion contribution to GNP growth. New housing starts rose at a hefty 2.2 million units (ar) in February, while the median forecast showed a 1.7-million unit average over the quarter. Fixed investment rose $5.2 billion (ar), or over twice the forecast gain. Personal consumption expenditures (PCE) were actually about $1 billion more than the forecast $13.5-billion gain; PCE was driven largely by domestic new-car sales, which at the time of the meeting were reported as nearly 20 percent above the fourth-quarter 1983 pace. However, the group overstated the strength in net exports and government purchases. Net exports fell nearly three times the forecast $3.3-billion decline; government purchases, which were expected to rise $1.8 billion, actually declined $0.6 billion.

Consumer spending typically fuels the first year of recovery and slackens in the second year. Several economists asserted that this trend had already begun. One economist anticipated that between January and April 1984, consumer spending growth would moderate to less than one-half of the October 1983 to January 1984 rate. Only furniture and appliances, in response to the strong recovery in housing starts, were still selling well as of March 1984; sales of most other department-store goods apparently had already slowed. Another economist forecast that new-car sales for 1984 peaked in January. This led the group to expect that durable-goods sales would rise at less than a double-digit rate for the remainder of 1984.[3]

Based on the diminishing role of the consumer in driving the recovery, the group expected a decline in real GNP expansion to a 4.1 percent annual rate in the second quarter of 1984. Business investment is normally the prime mover of the economy in the second year of recovery, and an unusually vigorous business-investment expansion prevented forecasting a more substantial slowdown in the second half of 1984. Spending for traditional capital goods, including construction, farm, and materials-handling equipment, was expected to gain momentum. Such momentum would add to spending in high-growth sectors of the industry, such as computers, electronics, and refrigeration equipment, which were already operating at full capacity as of the March meeting. Most economists at the meeting expected that cash flow would be adequate to support domestic investment in 1984 and should not be crowded out by financing of federal deficits. Furthermore, foreign sources of capital were expected to be available during most of 1984. However, as the gap between capital investment and retained earnings widens in 1985, the federal deficit may well dampen private investment.

3. Durable-goods sales rose 17.2 percent (ar) in the first quarter of 1984, according to the Commerce Department's preliminary report.

Production Constraints among Industries

The extent to which the economy and key industries are constrained by capacity ceilings will determine whether the expected economic slowdown will be sufficient to avoid reacceleration of inflation. Most capital-goods industries are well below capacity and are only beginning to increase their utilization rates. However, other key industries in the Fourth District, such as autos, steel, and tires, are already at or rapidly approaching capacity. According to the Federal Reserve Board's production index, these latter industries generally exceeded 90 percent capacity as of the March meeting. In most cases, their utilization rates were greater than the most efficient operating rates. Although capacity constraints were generally sparse as of the March meeting, shortages and rising costs may become rather widespread as output increases.

Autos. In March, the auto industry was operating at full capacity for most mid-sized and standard-sized cars, and there was a shortage of V-8 engines and automatic transmissions. However, a large number of General Motors' production facilities for mid-sized autos were scheduled to shut down from March through mid-year 1984 for early model changeovers. One auto industry economist estimated that this temporary shutdown would reduce real GNP by an annual rate of $3 billion to $4 billion in the second quarter of 1984. This economist also expected that domestic auto production, which rose about 1 million units (ar) in the first quarter of 1984, would fall to about 7.5 million units (ar) in the second quarter. The median industry forecast, made by eight economists, predicted that auto production would fall from 8.5 million units (ar) in the first quarter to 8.3 million units in the second quarter of 1984 (see table 2). Domestic auto sales were expected to average only 7.2 million units in the second half of 1984, although total sales were expected to exceed 10 million units.

Table 2 Median Auto Forecasts[a]
March 1984; in thousands; annual rates

Indicator	1983 actual	1984 forecast	1984 IQ	1984 IIQ	1984 IIIQ	1984 IVQ	1985 IQ	1985 IIQ
Domestic production, U.S. manufacturers	6,779	7,800	8,540	8,320	6,752	7,792	8,172	8,640
Domestic sales, U.S. cars	6,795	7,950	7,820	8,520	7,464	7,904	7,960	8,616
Imports	2,375	2,520	2,452	2,700	2,540	2,312	2,712	2,880
Total new car sales	9,170	10,400	10,320	11,252	10,060	10,248	10,600	11,552
Change in dealers' stocks	-275	150	294	-3	-108	10	95	60

a. These median forecasts are based on individual forecasts of the Fourth District Economists Round Table held in March; they do not represent forecasts of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

Despite strong demand for autos (and a protective quota on imports), industry economists expressed concern about the long-run effects of raising prices in response to short-run supply problems. To some extent, the industry may be responding to lessons learned from past experience, when rising prices opened the domestic market to imports. An appropriate long-term pricing strategy would most likely recognize a necessity to narrow the price gap between domestic and imported vehicles.

Tires. The tire industry was operating at or above the 92-percent peak rate reached during the 1977-79 boom. Since 1979, the industry has closed plants and cut back operations. Although some producers were operating full-time, seven days a week, there were no plans to expand capacity. Although tire prices were 8 percent below year-earlier levels, manufacturers may attempt to compensate for this decline by gradually raising prices in 1984.

Steel. The steel industry's operating rate expanded to about 80 percent of capacity, but capacity shrank from 160 million ingot-tons in 1979 to roughly 126 ingot-tons in March 1984. Flat-rolled steel, especially important to the automotive and appliance industries, was at capacity as of March, but pipe and plate steel trailed the general recovery. Three Round Table economists anticipated that domestic steel consumption would expand by about 8 percent to 12 percent in 1984, with gains evenly distributed over four quarters. Little change was anticipated in either inventories or imports.

The steel industry has experienced competitive pressures from foreign suppliers similar to those in the auto industry. The steel industry was not expected to raise prices, a strategy that could risk losing customers or encouraging imports during the next recession. In addition to pressures from imports, steel producers are also finding customers to be more price-sensitive. New contracts with auto