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# Current Outlook: Sustained Growth, Sustained Inflation

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Like the northern climes, the U.S. economy has weathered the cold of winter and seems to be entering a renewed phase of growth. Although the economic renewal is not without its impending storm clouds, there seem to be firm grounds for optimism about the balance of 1990 and perhaps beyond.

That optimism was expressed by the 28 economists making forecasts for the latest Fourth District Economists' Roundtable, held May 4 at the Federal Reserve Bank of Cleveland. The group, representing manufacturing, trade, and financial institutions, was cautiously optimistic about economic growth, predicting continued expansion in the economy through 1991, without a single forecast of recession.

Few of the participants, however, expect much relief from inflation, which is forecast to persist at a rate of about 4 percent through 1991. None called for a repeat of the surprising 8.5 percent boost in the Consumer Price Index (CPI) experienced during the first quarter of 1990, which was characterized as an aberration.

The group's median forecast for output calls for real GNP to grow at an annualized rate of nearly 2 percent for the first half of 1990, and to improve to a rate of between 2.2 and 2.6 percent through the end of 1991. Most expect strength to come from sustained increases in business fixed investment and from exports, with steady but moderate growth in consumer spending throughout the period. The outlook for manufacturing is positive as well, calling for revived growth following the slowdown that began in late 1989.

The majority of forecasters expect interest rates to remain at a plateau through 1990 and then to increase slightly in 1991, with a prime rate between 10.0 and 10.2 percent for the period. All perceive that ample credit is available, although credit standards have apparently tightened, especially for real estate loans and perhaps more noticeably in New England and the Southwest than in other regions.

As usual, there was spirited debate on the appropriate course for Federal Reserve policy, particularly among representatives of the manufacturing and service industries.

**Forecasters attending the most recent Fourth District Economists' Roundtable expect a stronger long-term growth path for the economy than experienced in past months, with brightened prospects for manufacturing following last year's slowdown. Despite some surprising CPI figures for 1990:IQ, the economists call for a sustained underlying rate of inflation of about 4 percent through 1991.**

## ■ The Outlook

In contrast to discussions at the January 1990 Roundtable, not a single economist predicted a decline in real GNP, at least through 1991. The largest source of optimism was an improving outlook for manufacturing. Estimates of industrial production called for a significant rebound from a mild decline experienced over the first quarter of the current year to an average growth rate of 3 percent through 1991, led by exports and business fixed investment.

"We're very bullish on manufacturing," stated one financial economist. His perspective was based on a rebound in auto production in the second quarter of the current year, on a warm-weather boost in construction, and on anticipated replacement of declining inventories. The core of optimism is an improving profit picture because of a "solid cost-cutting program by the U.S. manufacturing sector" that has left industry poised for a substantial earnings rebound.

Perhaps the industry with the most solid prospects for 1990 and beyond is

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aerospace. World orders for commercial aircraft rose 78 percent in 1989 from the previous record year in 1988. Between 1990 and 2005, nearly 10,000 commercial aircraft with an estimated value of $626 billion (in 1990 dollars) are scheduled to be delivered, for an average delivery of about $38 billion annually, compared with $14 billion annually between 1970 and 1989. The U.S. share of those deliveries is nearly 40 percent. U.S. deliveries are projected to increase to an average of about $14 billion annually between 1990 and 2000, or double the yearly average of the past decade.

The aerospace industry will be an important source of sustained growth for U.S. exports, especially in 1990 and 1991. According to one panelist, however, the impressive outlook is contingent on whether the industry can avoid potential problems associated with debt buildup and with financial speculation by lenders and borrowers anticipating aircraft price increases.

An auto representative was guardedly optimistic on the state of that industry, which experienced a painful slump in sales of new cars and trucks in 1989:IVQ, followed by steadily declining production rates for the first three months of 1990, with a low of 13.8 million units at an annual rate in March. This economist expects sales to rebound slightly to a 14.5-million-unit annual rate in the second half of the year. He characterized current inventories as being in better balance for the Big Three automakers than at year-end 1989.

The auto economist lamented an exchange rate that is currently providing Japanese manufacturers with a cost advantage of roughly $1,600 per vehicle, and expressed some additional concern about upcoming labor negotiations in the domestic auto industry that could increase cost/price pressures.

Some accompanying debate focused on the true cost of new-car purchases. Incentives have been increased, but prices of options have risen as well. The auto economist noted that incentives in general, such as rebates, were beginning to lose their effect.

A manufacturer of industrial components noted that the first-quarter cut in auto inventories hurt that industry somewhat, as did overbuilding of steel inventories by distributors in 1989, but offered a positive outlook based on, among other factors, an expected 1991 rebound in orders for heavy-duty trucks and a bullish perspective on long-term nonresidential investment.

Reports on the consumer spending outlook were mixed. An economist representing a major retailer expressed concern about the current state of the retailing industry, which has been racked by major bankruptcies and by a recent surge of inflation in apparel costs, particularly for women's clothing. He also noted that the purchase of durable goods may be softened somewhat by the expected flatness in housing starts, and said that inventories in the retailing industry are still too high.

There was also some question about whether retail sales in recent months have been understated because of the restructuring occurring in the retail industry. Some department-store chains reportedly are no longer submitting their sales data to the Commerce Department, which would then cause the Commerce Department to compute its own sales figure for the nonreporters.

### ■ Is There a Credit Crunch?

A great deal of recent media attention has been directed toward what has been labeled the "credit crunch"—the lack of available funds at any interest rate. The Roundtable panel, which includes several economists representing large banks in and outside the Fourth Federal Reserve District, was essentially unanimous in its view that there is very little evidence of such a problem. However, lenders are more cautious of late, especially concerning real estate loans, partly as a result of higher loss experiences and increased scrutiny by regulators.

"There is no evidence, no hard data, to support the assertion that there is a credit crunch," said one banking economist. Credit is available and it is still growing, but at a slower rate than a year ago. Nonfederal debt is still growing faster than nominal GNP. Consumer credit continues to increase, and commercial paper is soaring. In fact, commercial paper and business loans combined grew at a 15 percent annual rate through April. The Federal Reserve is still supplying credit, as evidenced by the continued growth in the monetary base, indicating that, according to this panelist, "the Fed is not squeezing the economy."

Nevertheless, banks have tightened standards, with some no longer interested in participating in highly leveraged transactions or in taking on new loans for nonresidential construction, particularly in New England and the Southwest. But, "there's no lack of money to lend," according to the economist.

### ■ Inflation: Some Letup, but 4 Percent Persists

The surge in prices in 1990:IQ has raised concerns about whether those price increases were associated largely with transitory factors or whether they represent a worsening in the overall inflation rate. The CPI, for example, rose at an 8.5 percent annual rate, the worst since the early 1980s, and the GNP implicit price deflator (IPD), the broadest price measure, rose at a 5.7 percent rate, the highest since 1982. The spike in prices was only partly associated with temporary constraints in energy and food supplies. Excluding food and energy, the CPI rose at a 7.5 percent rate last quarter, and increased 4.9 percent between March 1989 and March 1990.

Still, forecasters at the Roundtable meeting continue to believe that upward price pressures will abate beginning in 1990:IIQ. The median forecast of the group shows an inflation rate, represented by the IPD, in a range of 3.6 to 4.3 percent between 1990:IIQ and 1991:IVQ. This is essentially the same rate the participants expected at the January meeting. In other words, they believe that the so-called core, or underlying, rate of inflation has remained steady, despite the flurry of cost and price increases in recent months.

Several explanations were offered for the anticipated abatement in prices. Oil prices have declined, and food prices rose much less in both February and March than in January. Some also expect that the double-digit boost in apparel prices in February and March will dissipate quickly as consumers express resistance to higher prices. Costs of consumer services, which account for about 51 percent of the CPI, also spurted last quarter, probably in response to a step-up in wages. Consumer prices for shelter also surged last quarter, but one of the economists was skeptical about that reported increase in view of the softening in housing activity.

An economist in the retail industry suggested that much of the recent boost in apparel costs may have been due to the collapse of the Campeau organization, which had been driving retail prices down in order to raise cash. "When they bankrupted, prices shot upwards," he stated. He expects price increases for apparel to taper off to about 3 percent next year.

The surge in retail apparel prices was attributed to a number of factors external to the industry. Adding to upward cost/price pressures in general merchandising are the Social Security tax hike, the increase in the minimum wage, pending air-quality legislation, state packaging rules that lack uniformity, and proposed global quotas on textiles that some fear would inflate textile prices. Some observers doubt that these costs can be passed through to consumers, because overcapacity in the retail industry is likely to result in strained profit margins rather than higher prices.

One economist pointed out that his forecast of a 3.5 percent annual rate of increase in the IPD over the next several quarters also assumes that growth of money stock will slow to within a 5 to 6 percent range this year, which should keep inflation from accelerating.

The 4 percent outlook for inflation may be overly optimistic, according to some of the group. Despite a large inventory, the price of crude oil may climb again, particularly if OPEC producers successfully implement plans to cut back production. Some price analysts are skeptical about how much easing will occur in industrial commodity prices, in view of steady upward pressures in both spot and futures prices for industrial commodities and an apparent strengthening in industrial activity.

Finally, prices in the service industry continue to rise rapidly, especially for medical care prices, which jumped nearly 9 percent between March 1989 and March 1990.

### ■ Health Care Costs: Relative or Overall Prices?

Except for the past year, services prices have risen at a faster rate than the overall CPI throughout this 7½-year-old expansion. Medical care costs have typically risen one and one-half to two times as fast as the overall CPI, especially for professional services (doctors and dentists), hospital costs, and prescription drugs, all of which have been rising at about 7 to 9 percent annually for the past several years. Two guest panelists, specialists in health care, pointed out some of the problems associated with the interpretation of rising costs and prices, ranging from the nature of demand for medical care to productivity-measurement problems in the field.

Health care expenditures currently account for about 11 percent of GNP, a share that has been relatively steady for the last few years, but which averaged a little more than 8 percent in the 1970s. Real growth of medical care expenditures during the 1980s fluctuated within a 5 to 7 percent range annually—more than twice the rate of growth in real GNP. Some of this growth is associated with steady increases in demand for medical care. In constant 1982 dollars, health care spending per capita has risen from an estimated $1,275 in 1980 to $1,750 in 1987.

Per capita growth in real expenditures has been rapid despite steady increases in health care costs. Cost containment programs temporarily interrupt the rising trend of health care costs, but costs soon revert to a rising trend, apparently because of increasing demand for medical care services, rapid growth in technology, and difficulties in improving productivity.

A panelist pointed out that it is difficult to substitute capital for labor in some services, so wage rates must increase to attract workers, and hence relative expenditures increase. Still, society can be better off even if marginal productivity is falling, and in health care, marginal productivity may fall more than in other industries. Falling marginal productivity in health care is not necessarily bad, because it could still result in increased life expectancy. Productivity can be improved in several ways, although that may come at the expense of quality medical care.

Despite the rising costs and prices of health care, however, one health care panelist asserted that price changes in this sector should be regarded as relative. When these prices increase, other prices should decline, and the overall price level should be unchanged. Spending for health care reduces spending for other goods and services and should exert downward pressure on those prices.

### ■ Monetary Policy

Apparently, most of the Roundtable economists are comfortable with the present posture of policy, represented by a federal funds rate of 8¼ percent and a growth in money stock (M2) at the upper end of the 1990 target range of 3 to 7 percent. Some emphasized the need to slow growth in M2 from the 7 percent annual rate of increase that has prevailed since mid-1989. About a third of the group prefers a growth rate in the 3 to 5 percent range, which has characterized the past three years.

A few others, especially financial economists, recommended a prompt increase in the federal funds rate of at least one-quarter percentage point, to 8½ percent. A shift toward restraint would represent a change in sentiment from the January meeting of the Roundtable. At that time, a common view was that policy should ease as a means of fostering the strengthened pace of output that was expected for the second half of 1990.

The recommended change in the policy path is in response to the large and unexpected run-up in prices that occurred in recent months. Some Roundtable members voiced concern that Federal Reserve credibility was damaged by the easing in interest rates late last year and urged a firmer policy in response. Those in favor of a tightening in policy indicated that market prices have moved in a direction that supports policy tightening.

A panelist discussed monetary policy in a framework of market price indicators rather than monetary aggregates. These market price indicators include commodity prices, the yield spread, and the dollar's position in exchange markets. In this view, commodity prices and the dollar are regarded as proxies for the value of money. A rise in commodity prices and a decline in the value of the dollar would represent a decline in the value of the currency. Both of these series are more volatile than the yield spread, so that greater weight is given to the yield spread, especially when the commodity prices and exchange rates give conflicting signals. What this market price approach to policy is signaling at present, according to one of the Roundtable economists, is a need for tightening in policy.

The market price approach is an alternative to monetary aggregates as a policy guide. According to some of the Roundtable economists, both approaches supported tightening late last year, and both currently support tightening.

## ■ Conclusion

Late in 1989 and early this year, the U.S. experienced its second-slowest growth phase since the beginning of the current expansion. The economy now seems to be on a path of stronger growth, as expected by most forecasters. And, important to a region heavily dependent on consumer and producer durable goods, prospects for manufacturing appear to be brightening from the recent slowdown. There is even room for optimism, because the economy seems to be getting over the recent bulge in the inflation rate.

The central issue in the outlook, however, is how satisfied we should be with a persisting 4 percent inflation rate. Some of the Roundtable group believe a nudge toward tightening monetary policy could go a long way toward altering expectations about inflation, with little adverse effects on the overall economy or on manufacturing. Some argue that risks are greater for inflation to accelerate than for a recession to occur, which is the opposite of a view expressed by most of the Roundtable participants last January.

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