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 transportation 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. Nearly two-thirds of the group preferred that money stock growth stay within a 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.

The reaction to these trends was not as optimistic as the forecasts. 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 strong profits. They explained 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 3.6 percent in the second. 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 grew 7.5 percent.

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.
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 the year.

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 this expansion. However, other key industries, such as the tire industry, were expected to raise prices in order to increase their utilization rates. Furthermore, foreign sources of raw materials are already operating at full capacity. The steel industry was not expected to raise prices, a strategy that could risk losing customers or encouraging imports.

Despite strong demand for autos (and a positive quota on imports), industry economists expressed concern about the long-run effects of raising prices in response to supply constraints. An appropriate long-term pricing strategy would most likely recognize a need to narrow the price gap between domestic and foreign autos, steel, and tires, which are expected to remain sensitive. New contracts with auto 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 shrinkage from 160 million ingots in 1979 to roughly 125 million ingots 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. In addition to pressures from imports, steel producers are also finding customers to be more price-sensitive. New contracts with auto manufacturers may try to compensate for this decline by gradually raising prices in 1984.

3. Durable-goods sales rose 172 percent (ar) in the first quarter of 1984, according to the Commerce Department's preliminary report.