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Private and public forecasts for foreign economies in 1987 suggest little change from 1986, with Japan’s growth in real GNP expected to be about the same as last year’s rate of 2.5 percent, and with West Germany’s growth rate being slightly less than in 1986. West Germany and Japan both have relatively large trade surpluses with the U.S., and both countries had relatively high unemployment rates and declining inflation during most of 1986.

U.S. public officials have for some time urged West German and Japanese authorities to take stimulative fiscal and monetary action to boost domestic demand. Both nations, however, have been reluctant to do so for fear of re-igniting inflation.

The problem underlying the trade deficit with Japan is linked to the imbalance between saving and domestic investment in the U.S. compared with Japan. The U.S. has inadequate savings relative to domestic investment because of unusually large federal budget deficits.

In summary, it appears that improvement in the U.S. trade account requires slower growth in domestic demand relative to domestic production, and that saving must increase to balance domestic investment. An increase in growth rates of domestic demand abroad would help the U.S. trade deficit, although prospects for this happening are not encouraging.

Conclusion

The Roundtable group uniformly agreed that overall growth of the economy will be sustained at least through the first half of 1986, which would make the current expansion the second longest in the post-World War II period.

Consumer spending, however, over whether the level of output and prices in 1987 first quarter represents the beginning of a higher inflationary growth path, or if it is simply a temporary “bubble.” Differences also surfaced over whether or not the Federal Reserve should place a higher priority on resisting inflation and rising expectations of inflation.

The economy is in the fifth year of an expansion that has been characterized by a relatively high real interest rate, by moderate growth in output, and by the continuation of large trade and federal deficits.

Some observers feel that the economy, like Shakespeare’s Hamlet, is trying to make up its mind and is currently wavering between tendencies toward accelerated growth in output and inflation, or toward another year of moderate growth in inflation and output.

Still, the tone of the May Roundtable meeting was even more upbeat than indicated in the group’s median forecast. One prediction was that the jump in mortgage interest rates to about 10.5 percent, if sustained at the May level, could weaken new housing starts, dropping them to a 1.0 to 1.5 million rate from last year’s 1.8 million level.

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U.S. public officials have for some time urged West German and Japanese authorities to take stimulative fiscal and monetary action to boost domestic demand. Both nations, however, have been reluctant to do so for fear of re-igniting inflation.
With the exception of autos, there is ample room for growth in durable and nondurable goods inventories, according to one report. Prospects for real nonresidential fixed investment (NRFI) also appear to be on a rising trend for 1987 following a decline in 1986. It was pointed out that NRFI last year was weakened by the effects of tax reform — especially by the loss of tax incentives and by increases in the after-tax cost of capital. With tax reform completed, the introduction of new information-processing equipment, plus a swing from a deficit to a small surplus in trade for capital goods, should help increase investment in producers' durable goods by 5 percent in 1987 and 8 percent in 1988.

Even larger increases are anticipated for information-processing equipment. Improvement is also expected in transportation equipment, aircraft, and industrial, agricultural, construction, and oil equipment.

Investment in structures, however, in 1987 will continue to be depressed because of the oil-price decline in early 1986, because of overbuilding of office and commercial buildings, and because of tax reform. Older industrial contracts have been rising erratically since the steep decline in late 1985 and early 1986, suggesting that business spending for structures will likely hit a low point this year before resuming a rising trend in 1988.

### Autos

The Roundtable discussion of the domestic economy included the automotive industry, where the steep decline in the foreign-exchange value of the dollar since early 1985 has boosted prices and reduced demand for foreign cars. An industry economist said that there has been a shift linked to the falling value of the dollar and that the Japanese cost advantage has shrunk considerably. Japanese automakers, he said, have used to have about a $2,500 cost advantage over U.S. automakers on certain models. This advantage has shrunk to about $400.

Japanese automakers have been forced to raise import prices of 1986 models by about 13.4 percent because of the drop in the dollar. Prices of 1987 models have been raised another 5.3 percent. Price increases for domestic cars have amounted to about 8.8 percent over the 1986 and 1987 model years. This change in relative price has brought down the Japanese market share to a more "natural" level, according to the auto analyst. Also, at one point, it was expected that total imports would capture about 40 percent of the market, so the dollar-induced decline has been beneficial for domestic manufacturers. Unit sales of Japanese imports, in particular, are leveling out at about 20 percent of the market, although market shares of some other foreign producers, especially Korea, are rising. This doesn't mean, however, that there will be smooth sailing for domestic manufacturers. The industry, said the analyst, faces a serious overcapacity problem. There are too many cars in the market and not enough customers. For example, production capacity of foreign car-makers in the U.S. amounts to an estimated 8,150,000 units for the present model year, and may be boosted to 1.9 million units by 1990.

Overcapacity is seen as a worldwide problem. Cars entering the U.S. market are being manufactured domestically plus being produced in Canada, Mexico, Japan, Korea, and Yugoslavia.

More and more countries are producing cars and all are competing for U.S. customers. This will result in an extremely competitive market. In demand, in the near future it is expected to show little growth, which will put a squeeze on profits for some manufacturers.

### Table 1 Median Forecasts of Change in GNP and Related Items

<table>
<thead>
<tr>
<th>Year</th>
<th>IVQ</th>
<th>IQ</th>
<th>IQ</th>
<th>IVQ</th>
<th>IQ</th>
<th>III</th>
<th>IQ</th>
<th>IVQ</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>90.7</td>
<td>9.7</td>
<td>35.8</td>
<td>10.4</td>
<td>27.0</td>
<td>30.0</td>
<td>30.9</td>
<td>28.0</td>
</tr>
<tr>
<td>1988</td>
<td>75.8</td>
<td>8.8</td>
<td>32.9</td>
<td>10.3</td>
<td>27.0</td>
<td>30.0</td>
<td>30.9</td>
<td>28.0</td>
</tr>
</tbody>
</table>

### Table 2 Automobile Outlook

<table>
<thead>
<tr>
<th>Year</th>
<th>IVQ</th>
<th>IQ</th>
<th>IQ</th>
<th>IVQ</th>
<th>IQ</th>
<th>III</th>
<th>IQ</th>
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<tr>
<td>1987</td>
<td>7,287</td>
<td>7,256</td>
<td>2,075</td>
<td>1,969</td>
<td>1,500</td>
<td>1,750</td>
<td>1,900</td>
<td>1,960</td>
</tr>
<tr>
<td>1988</td>
<td>6,725</td>
<td>6,725</td>
<td>2,000</td>
<td>1,800</td>
<td>1,600</td>
<td>1,750</td>
<td>1,900</td>
<td>1,960</td>
</tr>
</tbody>
</table>

### Monetary Policy Issues

The Roundtable discussion of monetary policy centered largely on Federal Reserve objectives and on how those objectives should be influenced by domestic and international considerations. The spurt in prices in recent months has contributed to expectations about inflation, and has led some financial market participants to call for greater emphasis on controlling inflation.

Several Roundtable economists expressed a view that the discount rate should be raised soon. They said this would be a signal to domestic and foreign-exchange markets that the Federal Reserve is willing and prepared to deal with the possibility of accelerating inflation.

Several key issues underlie the course of monetary policy. The first relates to the strength of the economy. Those who urge immediate further action assert that the growth of the economy shows signs of accelerating from the 2 4 percent growth that has existed since mid-1984. They are also convinced that probabilities about the economy have shifted in favor of faster- than-expected growth—which is something that was not predicted at the last few meetings of the Roundtable.

Concern was also expressed by some of the Roundtable economists over whether the first quarter 1987 spike in prices is indicative of accelerating inflation. Most Fourth District forecasters expect prices to increase in a 3.5 to 4 percent range through the balance of 1987, and in a 4 percent zone at least through the first half of 1988. A few expect inflation to accelerate to a 4 to 5 percent range, mainly in response to higher priced imports.

These economists urging immediate tightening action by the Federal Reserve pointed to similarities to economic conditions in May 1983, when a period of accelerated growth in both output and prices led to tightening action. The claim was made that willingness to raise interest rates at that time contributed to lower interest rates since then—which may not have occurred to the same degree if the policy action had not been taken.

Those Roundtable economists who see clear signs of accelerating growth in output and inflation believe that the priority in Federal Reserve policy should be to counter inflationary tendencies. Some support a more strict adherence to monetary targeting to achieve the desired disinflation objective.

Although not necessarily supporting targeting narrow money stock (M1) at present, some suggest that a growing of the broader money stock aggregates, particularly M2, within their targeted moneys could be achieved. Those that felt that restricted confidence in foreign-exchange markets would be a by-product of control over money stock growth, especially if growth of money at home were less than growth among key trading partners.

Some others, however, doubted that there is sufficient information to corroborate the view that the growth rate of output and of inflation is accelerating. According to them, the economy is still giving mixed signs. Likewise, they feel it is still uncertain whether the price increases that occurred last quarter represented an acceleration in the price level— which may not have occurred to the same degree if the policy action had not been taken.

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### International Prospects

Many Roundtable forecasters expect that a primary source of thrust in domestic output will be an improvement in the international trade sector, which has been a major drag on domestic output during most of the current expansion. Over the next four quarters, for example, the median forecast by the 25 Fourth District economists shows a sizable improvement in real net exports of nearly $20 billion, following the $29 billion increase that has taken place between the third quarter 1986 and first quarter 1987.

Even with such an improvement, however, a sizable trade deficit would remain and many analysts are skeptical that further dollar depreciation alone can contribute much more to reducing the overall trade deficit. They expect to see faster growth in exports for continued improvement in U.S. net exports.