Inflation and Soft Landing Prospects

by John J. Erceg

The U.S. economy has been growing steadily since late 1982 in what has become the longest peacetime expansion on record. The consensus forecast of a group of economists who met recently at the Federal Reserve Bank of Cleveland is that the expansion will continue at least through 1990, but at a pace slow enough to prevent a further growth of inflation.

The economists met on June 2 at the spring meeting of the Fourth Federal Reserve District Economists' Roundtable. This Economic Commentary discusses their forecasts for the economy and for inflation.

We should note before beginning our discussion that even if the consensus forecast of slower growth were achieved, the inflation rate expected by the economists by the end of 1990 will still be greater than the average annual rate that prevailed between 1983 and 1987.

A few of the forecasters expect a recession, that is, growth of the economy will slow to a rate below its potential output, and inflation will rise to a level less rapidly than its nearly 5% annual rate since early 1988. According to this view, real GNP will increase at an average annual rate of 1.5 percent between 1989 second quarter and 1990 second quarter, and then will increase at about a 2.8 percent annual rate in the second half of 1990 (see table 1). Underlying this projected slower growth rate is weaker consumer demand, especially for consumer durable goods and residential construction, and a curtailed pace for exports and investment spending, the two sectors that led the acceleration of growth in the economy in 1987 and 1988. The consensus forecast points to visible slowdowns in new car sales, employment growth, and housing as indications that growth is slowing.

One alternative view among Roundtable participants is that the growth of the economy has slowed because output has been constrained by capacity limits in some parts of the economy. According to this view, there is sufficient strength of demand in most sectors of the economy, except for consumer spending and residential construction, to sustain growth of real GNP that will grow at about a 2.5 percent average annual rate at least through the end of 1990. At the time of the June 2 meeting, neither the rise in interest rates nor the increases in the foreign exchange value of the dollar was thought to be strong enough to slow the growth of demand. Consequently, Roundtable participants with this view expect that upward pressures on wages and prices will continue.

A consensus forecast by 27 economists who met recently at the Federal Reserve Bank of Cleveland calls for continued slow growth in output and a "soft landing" for the economy through 1990. However, their projected inflation rate is relatively intractable and prospects for lower inflation in the near future do not appear promising.

One Roundtable economist felt that a 2.5 percent growth rate for 1989-90 is consistent with moderate inflation. According to this view, interest rates and inflation have peaked. Primary sources of sustained growth over the next seven quarters will be capital spending and exports. Capital spending is expected to increase 5 percent to 6 percent from 1988 because yields on long-term bonds have not moved up enough to cause a cutback in capital spending. He also believes that the U.S. trade balance will continue to improve until early 1990 when effects of dollar appreciation will slow or end the improvement. For the first time in this expansion, capital stock should increase faster than nonfarm output and thus relieve some of the upward pressures on resource utilization and prices.

A few of the forecasters expect a recession that will be mild and that will last two to three quarters, much like the mild recessions in 1960-61 and 1969-70.
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A guest panelist at the Roundtable meeting made a number of points about inflation. He noted, "Which is worse, 6 percent inflation or a 6 percent unemployment rate?" If a policy error were to be made, in which direction should that error be made?

Some of the group expressed a view that policy risks must be taken to bring down the inflation rate now; otherwise, inflation will build up in the future. Some Roundtable economists are concerned over prospects for accelerating inflation because of a recent increase in labor compensation and unit labor costs. They view the recent labor cost increases as the major effect of higher interest rates and consumer spending either currently or expected slowing in the growth rate of output.

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Examples of how cost pressures can aggravate the inflation rate despite a widely expected slowing in the growth rate of output.

An alternative view expressed at the meeting, however, is that the steel accord does not suggest a wage-cost push for inflation. First, the settlement's impact on the cost of steel production is likely to be much smaller than the publicized 25 percent increase in compensation over a 50-month period. Labor costs have been reduced substantially in recent years to about 20 percent to 25 percent of total steel costs and are still declining because of continuing productivity increases.

After taking into account some productivity improvement, the labor cost in the agreement may add about 1 percent annually to the total cost of steel production and its effects on steel prices will be further constrained by contracts with the large steel users and by competition from imported steel products. Hence, the cost-price pressures and the effect on overall inflation may well be minimal, according to a steel industry economist.

Interest Rates and the Economy

Interest-rate-sensitive sectors of the economy—especially consumer durable goods, housing, and business investment—are often monitored for indications that aggregate demand is being affected by monetary policy.

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To the extent that inflation expectations are indeed formed from past inflation rates, any increases in expected inflation would be equally likely to reverse as to persist. In other words, the recent rise in inflation expectations is not likely to have any significant long-term impact on the inflation rate. However, if inflation expectations were to increase significantly, then the potential for a higher inflation rate would need to be taken into account.

Inflation Outlook

A soft landing implies that the inflation rate of 5 percent or so will be constrained in response to a below-potential growth rate in the economy. Most of the Roundtable forecasters expect little relief in the inflation rate. The median of their forecasts shows an increase in the GNP implicit price deflator at an annual rate in a 5 percent to 5.5 percent range from second quarter 1990 through third quarter 1990, after which the inflation rate is expected to ease insignificantly (see chart 2).

There is, however, considerable variance around that median. The higher growth path for output of 2.5% or more is linked to further acceleration in prices largely because of wage-cost pressures. The zero to 1% growth path is linked to a slightly lower inflation rate than anticipated in the median forecast.

The high inflation rate in 1989 is not expected to persist in 1990. The median forecast for inflation is 4.5 percent for 1990, which is slightly above the 4% inflation rate expected by the Federal Reserve.

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