

finds no relationship for other consumer durable goods, such as furniture. In general, the effect of interest rates on consumer spending appears to have gradually declined.

Housing, however, is still sensitive to interest-rate changes. Single-family homes are especially sensitive to these changes, which perhaps is best illustrated by the decline in sales and housing starts that occurred in response to rising mortgage rates in 1987 and, of course, to the stock-market crash in October of that year. However, that sensitivity apparently has lessened in response to several financial market innovations and to regulatory changes affecting mortgage markets, according to another Roundtable panelist.

With respect to interest-rate effects on investment spending, the point was made that capital spending in 1989 would not be curtailed by interest rates because the rise in yields on long-term bonds has not been large enough to affect capital spending decisions. Moreover, interest rates have probably peaked, according to one economist, so that the direct effects of interest rates on capital spending this year would be negligible.

The runup in short-term interest rates since early 1988, however, is expected to curtail inventory investment. The higher cost of holding inventories will

cause businesses to reduce their stocks that, in turn, will contribute to a weakening in aggregate demand by midyear, according to one of the Roundtable members.

These comments do not imply that interest rates have no effect on spending. Rather, the effects vary among the different sectors of the economy, and sensitivity of those sectors appears to have lessened in recent years. It may be that interest rates, and especially real rates of interest, would have to rise to higher levels than they have been in order to restrain spending.

■ Conclusion

An important point discussed at the Roundtable meeting is that the slow-growth scenario of the consensus forecast, even if it were achieved, is expected to accomplish little in terms of bringing down the inflation rate from the recent 5 percent zone, let alone back to the 3.5% average annual rate that existed between 1983 and 1987 (see chart 3). Therefore, if the growth rate of the economy revives to, or above, the growth rate of potential output in the second half of 1990, as indicated in the consensus forecast, the 4.5 percent inflation rate that is now expected would become the base from which the inflation rate in the early 1990s will build.

Given that prospect, Roundtable participants discussed whether to expect that monetary policy would shift toward less restraint, or whether policymakers would risk a further reduction of the economy's growth rate in order to avoid further price increases. Many of the participants appeared to be willing to aim for a lower inflation rate than the 4.5 percent indicated in their median forecast.

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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.

■ Economic Prospects

A number of alternative views of economic growth, each with somewhat different implications for inflation, surfaced at the Roundtable meeting. The median forecast of the 27 participants indicates that they expect a "soft landing," that is, growth of the economy will slow to a rate below its potential output into mid-1990, and inflation will rise a little 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 weakening demand, especially for consumer durable goods and residential construction, and a curtailed pace for exports and investment spending, the two sectors that led the accelerated pace 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 output growth is slowing.

An alternative minority 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 his 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

Table 1 Median Forecasts of Fourth District Roundtable: GNP and Related Items

	1989		1989				1990			
	IQ ^a	IIQ	IIIQ	IVQ	IQ	IIQ	IIIQ	IVQ		
	Percent change at annual rates									
GNP in constant (1982) dollars	43.1	18.3	13.8	11.2	10.3	20.8	25.8	31.0		
Personal consumption expenditures	7.4	16.6	12.6	10.8	13.0	13.5	15.2	16.6		
Nonresidential fixed investment	9.1	5.8	4.2	2.1	0.1	3.9	3.0	4.2		
Residential construction	-2.7	-1.6	-1.2	-0.8	0.0	1.7	2.0	2.3		
Change in business inventories	8.9	-12.9	-5.5	-5.5	-4.0	-2.7	0.0	1.0		
Net exports	17.6	2.9	1.9	4.0	3.1	2.4	2.9	2.0		
Government purchases	2.8	3.9	1.9	2.4	1.5	2.0	2.0	3.0		
GNP in constant 1982 dollars	4.3	1.8	1.3	1.1	1.0	2.0	2.5	3.0		
GNP implicit price deflator	3.9	4.9	4.8	4.7	4.7	4.7	4.4	4.3		
Consumer Price Index	5.8	6.4	5.0	4.9	4.8	4.7	4.5	4.7		
FRB index of industrial production	3.2	2.3	1.7	1.4	1.4	2.5	2.8	3.2		

a. Actual data as of June 2, 1989 Roundtable meeting.

SOURCE: Fourth District Economists' Roundtable Meeting, Federal Reserve Bank of Cleveland, June 2, 1989.; and U.S. Department of Commerce.

(see chart 1). The recovery following such a recession is expected to show growth in output at about a 4 percent annual rate. The brief and mild nature of the expected recession will result in no large or lasting improvement in the overall rate of inflation, according to two of the recession forecasts.

■ 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 4.5 percent to 5.0 percent range from second quarter 1989 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 discouraging and common element of the soft-landing scenario is that the inflation rate appears to be relatively intractable, despite the expected slow growth in output.

A guest panelist at the Roundtable meeting made a number of points about inflation that raise some skepticism about the feasibility of a soft-landing scenario. Inflation, he noted, builds momentum over a long period and is difficult to bring down quickly. In his view, it is necessary to lower the nation's demand for goods and services to just below the supply, and to hold the growth rate of the economy to 1% or so just to keep the inflation rate from rising further.

The stubbornness of inflation that is anticipated in the Roundtable's median forecast may reflect the fact that disinflation has typically been associated with economic slack that is characteristic of recessions. Because most of the soft-landing scenarios are based on 1 percent to 2 percent growth rates in output, prospects for bringing down the inflation rate do not appear to be very promising.

Implications for Federal Reserve monetary policy in the present economic setting are very uncertain.

As one Roundtable participant asked, "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 and the cost of bringing it down in the future will be greater than it is now. They are willing to accept the risk of a recession, and cautioned against the kind of ease in monetary policy that others in the group expect will lead to a strengthening in output and to accelerating inflation after mid-1990. Still, a few Roundtable participants believe that the inflation rate may be peaking, and although they believe no easing in monetary policy is appropriate, they would not opt for any further tightening that could result in a recession.

■ Wage-Cost Pressures?

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 accord by some major steel producers as

CHART 1 MEDIAN FORECAST OF REAL GNP

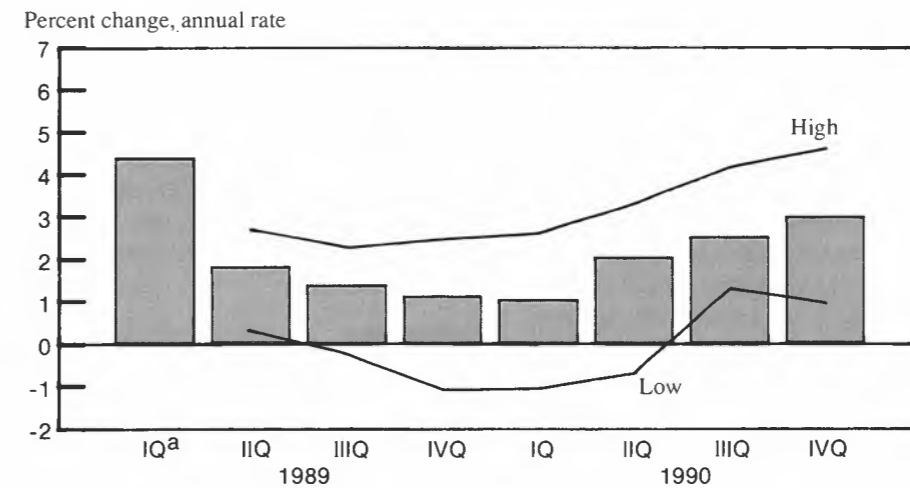


CHART 2 MEDIAN FORECAST OF GNP IMPLICIT PRICE DEFLATOR

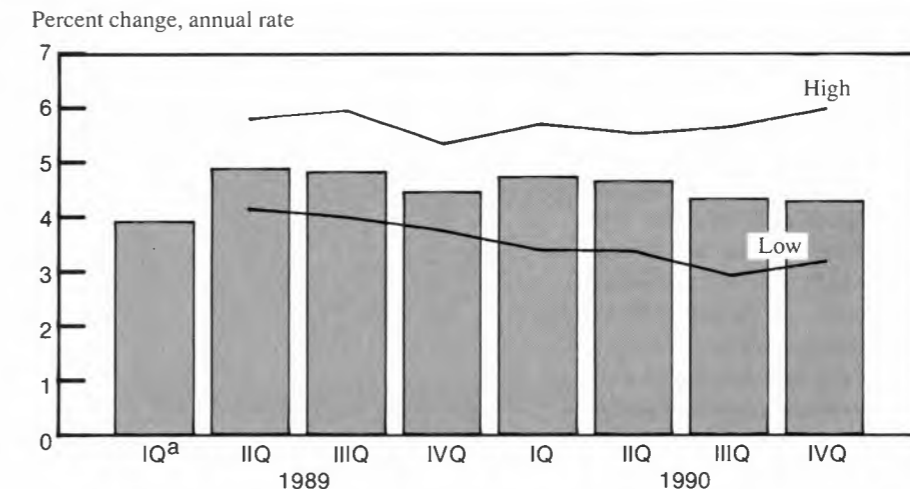
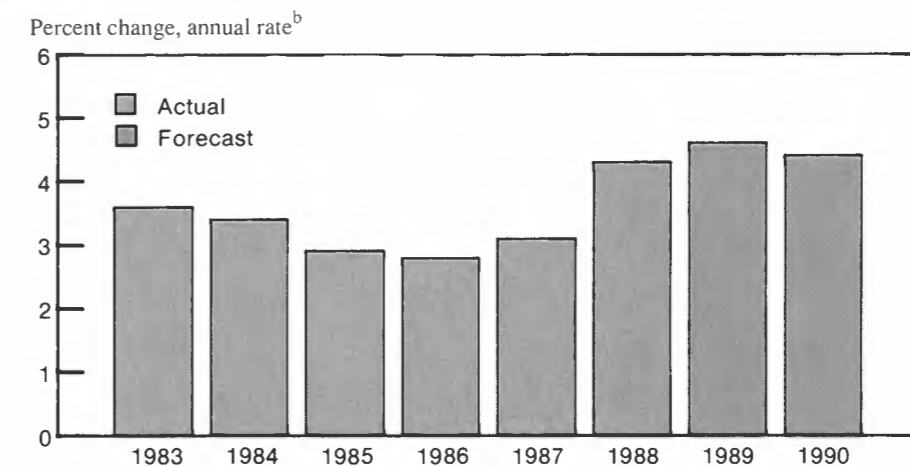


CHART 3 GNP IMPLICIT PRICE DEFLATOR



a. Actual data as of June 2, 1989 Roundtable meeting.

b. Based on fourth quarter to fourth quarter.

NOTE: Lines represent averages of the three highest and the three lowest forecasts.

SOURCE: Fourth District Economists' Roundtable Meeting, Federal Reserve Bank of Cleveland, June 2, 1989.; and U.S. Department of Commerce.

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 20 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.

Roundtable discussants pointed out that the major effect of higher interest rates seems to be found largely in single-family housing, although effects on business investment are mixed.

Interest rates have had little effect on consumer spending either currently or earlier in this expansion, according to a study by one of the panelists. His work shows a weak relationship between interest rates and consumer spending in recent years, unlike in the 1970s. He finds little relationship between interest rates and car sales, especially since auto finance companies offer below-market interest rates to buyers, and