U.S. Economic Growth Is Expected To Moderate in the Rest of 1997 and 1998

The strong growth in the U.S. Gross Domestic Product (GDP) in the first half of 1997 will give way to more moderate growth for the rest of 1997 and 1998. Even as GDP growth moderates, the economy will support manufacturing-output growth of 4.0 percent for 1997. Forces driving the manufacturing sector will spur modest growth in industries that use agricultural inputs.

U.S. industries that use agricultural inputs tend to be mature industries and, as such, find their economic prospects closely tied to changes in the general U.S. economy. This section provides an overview of the U.S. economy and manufacturing sector, focusing on nine major industries that use agricultural materials.

The U.S. economy continues its seventh year of economic expansion. In the first quarter of 1997, the U.S. Gross Domestic Product (GDP) grew at an extraordinary annualized rate of 5.9 percent, which supported a 5.3-percent increase in manufacturing (table 2). Ordinarily, the strong manufacturing growth that has occurred in the previous year and the maturity of the economic recovery would bring a moderation in manufacturing output. However, that has not happened. The only major component of GDP that fell in the first quarter of 1997 was net exports, as the real trade deficit widened by almost $18 billion. Exports rose at an 11-percent annual rate, $18 billion, while imports rose by 23 percent, $36 billion. The growth of manufactured goods exports in the first quarter was concentrated in auto parts, computers, and airplanes. This export growth, along with a strong inventory buildup and a sharp increase in consumer demand for trucks, led to the strong manufacturing output seen in early 1997. Manufacturing growth remained strong in the second quarter, while GDP growth moderated.

Table 2--Growth rates for GDP, industrial production, and selected industries using agricultural materials

Item	3rd qtr 1996	4th qtr 1996	1st qtr 1997	2nd qtr 1997
	Percent change 1/			
Gross domestic product	2.1	3.8	5.9	2.5 2/
Industrial production	3.3	4.5	4.4	4.3
Manufacturing	5.0	4.3	5.3	4.4
Lumber and products	-1.9	-1.3	4.2	9.2
Furniture and fixtures	-2.7	7.1	-0.5	10.3
Industrial machinery and equipment 3/	11.6	6.8	12.3	12.5
Transportation equipment	7.6	-2.2	14.2	-3.4
Textile mill products	5.4	-1.8	-0.9	6.1
Paper and products	4.2	2.8	5.2	4.9
Chemicals and products	6.9	12.3	1.8	1.0
Rubber and plastic products	7.8	0.3	2.7	0.3
Leather and products	-6.2	-5.1	-2.3	-5.1

1/ Annualized on a quarterly basis. 2/ ERS estimate. 3/ Overall sector growth. Computers and office equipment grew 43.0, 22.1, 25.9, and 28.4 percent, respectively, during the four quarters. Growth in other industrial-machinery-and-equipment categories was much lower.
Sources: Gross Domestic Product Release, Department of Commerce, Bureau of Economic Analysis, June 1997; and Industrial Production and Capacity Utilization Report, Federal Reserve Bank, Washington, DC, July 1997.

Among the nine industries using agricultural materials, the increase in output during the first half of 1997 was even more remarkable for those not subject to strong foreign price competition. Lumber and products output rose 4.2 percent in the first quarter of 1997 due to a weather-induced increase in commercial and residential construction and a rise in building-supply-store inventories. Without a strong economy, lumber output and/or prices would have fallen despite the warm winter. With housing demand high because of strong labor income growth (from higher real wages and strong employment gains) and record high levels of consumer confidence, lumber product output rose 9.2 percent in the second quarter. Stable mortgage rates, strong corporate profits, and abundant credit further supported commercial construction.

Similarly, transportation equipment output rose 14.2 percent in the first quarter due to an unusually strong 22.4-percent annualized growth in car and truck production. The strong vehicle output reflected a rebuilding of inventories and strong growth in light truck sales. Consumer vehicle spending was supported by good personal income growth and record consumer confidence levels. Because of warm weather, light truck sales occurred in January and February instead of the more usual April or May. Reflecting this early buying, transportation equipment output dropped 3.4 percent in the second quarter. Although furniture and household equipment sales were strong in the first quarter, the growth was from higher appliance sales and furniture inventory liquidation and not furniture output, which stagnated during the quarter. During the second quarter, furniture output expanded at an annualized rate of 10.3 percent because of strong disposable income growth and the previous quarter's inventory liquidation.

Of the nine industries, those that have more direct foreign competition did less well during the first half of 1997. Textile mill production was flat in the first quarter, despite booming clothing and vehicle sales. Because of the strong dollar, imported textiles supplied the increased demand. In contrast, textile production rose 6.1 percent in the second quarter. Rubber production and chemicals and products output were hurt by the strong dollar during the first half of 1997, which slowed exports, increased imports, and resulted in subpar growth.

Industrial machinery is a very competitive sector internationally. The roughly 10-percent growth in machinery output from the second quarter of 1996 to the first quarter of 1997 has been driven by computer and office equipment production, which expanded over 28 percent during the year. The spectacular growth in domestic equipment investment was supported by very strong computer export growth over the same period. The rest of the machinery sector, which is the part that uses agricultural materials, has been growing much less rapidly. The United States has a comparative advantage in the production of office equipment and a comparative disadvantage in making many other types of machinery. Similarly, leather goods production, which is quite labor intensive, continues to decline irrespective of the rate of economic growth.

The Outlook Is for More Modest Growth

A potential risk to continued economic growth evaporated in early 1997, as crude oil prices, which peaked at over $23 per barrel in December 1996, fell below $19 per barrel by May 1997. A rise in fuel prices is not expected this summer despite the usual summer increase in fuel demand because of plentiful world supplies. Crude oil prices should average below $19 per barrel for the next seven quarters; various forecasts range from $16 to $19 per barrel. Low energy prices will help support manufacturing by slowing input price inflation throughout 1997 and 1998.

Preliminary data show strong industrial production and employment growth and declines in retail sales during the second quarter, which suggest strong inventory accumulation that may exceed the first quarter's $31.5 billion. In the second quarter, GDP is estimated to have grown at an annualized rate of between 2.4 and 2.6 percent as manufacturing output increased 4.4 percent. Some of the first quarter's extraordinary growth spilled over into manufacturing in the second quarter. The slowdown via the corrections in inventories, business investment, and consumer durable spending should be evident by the third quarter of 1997.

The cyclical adjustments that will slow spending growth on consumer durables and producer equipment and generate a lower rate of inventory buildup may be facilitated by a modest tightening of interest rates by the Federal Reserve (Fed) this fall. This will mean more modest growth in GDP and manufacturing in the second half of 1997 and 1998. For those six quarters, GDP is expected to grow at an average annualized rate of about 2.2 percent. Record high consumer confidence will fall as employment growth moderates, although wage gains will keep confidence from falling sharply. Tight labor markets will result in real wage gains in both 1997 and 1998. The expected continued growth in real wages, as employment gains moderate, is key to strong disposable income growth for the rest of 1997 and 1998. Growing after-tax personal income will mean continued growth in consumer spending.

The growth of consumer spending on durable goods, which has supported manufacturing growth, will be modest. Consumer debt is at very high levels, so lenders will be more careful about making new loans. The Fed's likely hike in short-term interest rates, done to keep inflation from accelerating in 1998, will be reflected in somewhat higher long-term rates. Higher commercial interest rates and tighter standards for consumer credit will constrain growth in spending on durable goods, such as cars, furniture, and household appliances. Moreover, the pent-up demand for durable goods has mostly been filled. From 1994 through the first quarter of 1997, consumer spending on cars, furniture, and appliances was very high, largely reflecting postponement of purchases due to slow personal income growth, high interest rates, or lack of credit availability from 1990 to 1993. Near-term growth in durable goods demand will be based largely on demographics, such as new household formation. Consumer spending on services and nondurables will be the major components of consumer spending growth through the end of 1998.

Higher wages will slow employment growth as employers shed excess workers to offset lower profit growth. Tighter credit standards and flat business profits will slow growth in business equipment sales, especially in 1998. Higher interest rates will keep the dollar strong in 1997 and 1998. A strong dollar and modest growth in the economies of our major trading partners, except for Canada, will slow export growth to single-digit levels and keep import growth somewhat higher. On average, the trade deficit should rise modestly for the second half of 1997. The slowdown in investment and export growth will further curtail future manufacturing growth. Government spending will increase very modestly as lower Federal purchases are offset by local governments spending the higher income- and excise-tax revenues resulting from higher wages.

Prospects for Industrial Materials Moderate

As a result of slowing growth in construction, spending on consumer durables and business equipment, and exports, no major manufacturing sector will do as well in the last half of 1997 or 1998 as they did from the second quarter of 1996 to the first quarter of 1997. Nevertheless, the strength of the U.S. economy, even as growth moderates, will increase manufacturing output 4.0 percent for all of 1997. Forces driving the manufacturing sector will spur modest growth in the nine industries using agricultural inputs. However, in

1998, noncomputer manufacturing will grow only 1 percent, making prospects for further growth in the nine industries modest to poor.

Lumber and products output will grow about 2 percent in 1997 and 1 percent in 1998. Construction growth will slow during the rest of this year and next. Lumber prices should fall modestly because of a decline in capacity utilization. Furniture and fixtures output is expected to grow 3 percent in 1997, reflecting many people's desire to fill their relatively new houses with new furniture. The furniture sector is expected to grow 2 percent in 1998, reflecting market maturity. Sluggish demand will bring small price cuts in 1998.

Transportation equipment will grow 5 percent in 1997, reflecting further growth in light truck and bus sales. Prices are expected to rise about 2 percent. The prospects for 1998 are for a mere 1-percent growth in output, triggered by modest price cuts. The generally austere Federal budget will curtail large purchases of fleet buses and subway cars by local transit authorities in 1998.

Output of textile mill products has bounced back from the flat first quarter and should finish 1997 with 3-percent growth because of a rise in spending on household furnishings driven by good personal income growth. The strong dollar will keep price increases at 1 percent in 1997. In 1998, output should rise 5 percent, again due to household furnishings demand. Wholesale textile prices should be up 3 percent in 1998, reflecting strong demand.

Paper and products output should rise 4 percent in 1997 and 3 percent in 1998, reflecting good personal income growth. Prices should increase 4 to 6 percent by the end of 1998, as supplies continue to be tight. Chemical and products output should be up 4 percent in 1997. Most of the rise will be driven by increased sales of drugs and agricultural chemicals. A modest expansion in chemical exports in 1998, due to a rise in foreign economic growth, will boost output 1.5 percent.

Rubber and plastic production will increase 3.6 percent in 1997 because of strong consumer demand and higher production of transportation equipment. In 1998, output growth will slow to about 1.5 percent, reflecting modest gains in consumer demand. Prices should rise about 4 percent by the end of 1998.

The Midterm Prospects for U.S. Manufacturing

The potential for continued growth in U.S. manufacturing is good. The next decade is expected to have moderate GDP growth, slowly rising real oil prices, only a modest increase in inflation from current levels, a dollar not greatly overvalued compared with the relative purchasing power of our trading partners' currencies, and a balanced budget by 2002. However, the manufacturing sector has three interrelated challenges. The sector is highly cyclical, dependent on appropriate adoption of new technology, and exposed to international competition.

Manufacturing demand is driven by consumer demand for durables, business investment in plant and equipment, and exports, all very cyclical parts of GDP. Manufacturing has become increasingly dependent on export markets and is subject to quality and price competition from foreign firms. For example, the very high value of the dollar from 1982 to 1986 severely curtailed manufacturing growth and led to a consolidation within the sector, personnel downsizing, and the bankruptcy of many smaller firms. The manufacturers that survived did so by adopting appropriate technology and using new capital investment. In this process, many jobs were lost and labor productivity rose sharply. The U.S. auto industry went from a declining sector to one that reinvented itself and adopted the inventory practices and niche-market-seeking philosophy of its Japanese competitors. Costs went down and American cars became cost competitive.

The major risks to moderately good manufacturing growth over the next decade are:

- Prolonged or very deep recessions;
- A substantial real oil price shock as large as 1973-74 and lasting for several years, which would increase interest rates and likely slow investment spending;
- A greatly overvalued dollar for several years, as occurred during the mid-1980's; or
- A trade war.

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