Modest U.S. Economic Growth Expected in 1995 and 1996

The U.S. Gross Domestic Product (GDP) is expected to grow between 2.8 and 3.2 percent in 1995, down from 1994's increase of 4.1 percent. GDP growth for 1996 will range from 2.0 to 2.6 percent over 1995, with manufacturing output rising 2.6 to 3.0 percent during the year. Industrial markets for agricultural materials should grow somewhat more slowly than overall manufacturing for the next 6 quarters.

The U.S. Gross Domestic Product (GDP) grew 4.1 percent from the fourth quarter of 1993 to the fourth quarter of 1994. The robust growth benefitted goods relative to services and durables relative to nondurables. Of nine major industries using agricultural materials (lumber and products, furniture and fixtures, industrial machinery and equipment, transportation equipment, textile-mill products, paper and products, chemicals and products, rubber and plastic products, and leather and products), six expanded output faster than GDP. Industrial machinery and equipment led the way with 13.2 percent growth. Rubber and plastic products had a 10.1-percent rise in output, as real (adjusted for inflation) sales in automobiles and auto parts and business equipment grew 6 and 18 percent, respectively. Real spending on housing and consumer durables increased more than 8 percent. As a result, manufacturing prospered, with lumber and textile mill production up sharply. Only leather product output declined in 1994, by 1.5 percent.

Strong growth in employment, real income, and industrial output worked together in 1994 to overcome the negative effects of increasing short- and long-term interest rates, declining government spending, and an increasing trade deficit. The economy expanded so rapidly that capacity utilization in December 1994 reached 85.5 percent, well above the rate historically associated with rising inflation. Yet, by any measure, inflation was below 3 percent.

Manufacturing Output Declines in the Second Quarter

To prevent higher inflation, the Federal Reserve Board (Fed) raised short-term interest rates six times from February 1994 to February 1995. The resulting slowdown in the U.S. economy in 1995 was most pronounced in the second quarter. In the first quarter of 1995, GDP grew 2.7 percent, likely buoyed by an almost 150 basis-point drop in long-term interest rates. In the second quarter, GDP rose only 1.1 percent and inventory accumulation declined sharply, which in turn hit the industrial sectors of the economy particularly hard. From automobiles to building materials, factory output was cut. Industries using agricultural materials saw their production decline more than the 3.4-percent fall in overall manufacturing output (table 1). Lumber-and-products and furniture-and-fixtures output dropped 13.4 and 10.3 percent, respectively, reflecting a sharp drop in the demand for housing and home furnishings. Transportation equipment output decreased 15.0 percent in the second quarter, reflecting a decline in car and light truck sales and lower inventories.

Table 1--Growth rates for GDP, industrial production, and selected industries using agricultural materials

Item	4th qtr 1994	1st qtr 1995	2nd qtr 1995
		Percent change	
Gross domestic product	5.1	2.7	1.1
Industrial production	5.9	5.2	-2.4
Manufacturing	7.7	5.1	-3.4
Lumber and products	5.0	-1.3	-13.4
Furniture and fixtures	0.8	3.2	-10.3
Industrial machinery and equipment 1/	12.5	9.9	4.2
Transportation equipment	9.5	9.4	-15.0
Textile-mill production	10.3	0.8	-12.6
Paper and products	7.5	-1.2	-2.2
Chemicals and products	5.4	12.4	-6.0
Rubber and plastic products	11.6	4.6	-6.5
Leather and products	-4.1	-9.2	-13.9

1/ Overall sector growth. Computers and office equipment grew 25.5, 27.3, and 31.0 percent, respectively. Growth in other industrial machinery and equipment categories was much lower.

Sources: Gross Domestic Product Release, Department of Commerce, Bureau of Economic Analysis, August 1995; and Industrial Production Report, Federal Reserve Bank, Washington, DC, September 1995.

The chance of higher inflation abated in the second quarter of 1995 due to the declines in employment and industrial production and the sharp decrease in capacity utilization to 83.3 percent in June 1995. As a result, the Fed lowered the Federal funds rate (the rate at which banks borrowed from each other to meet reserve requirements) by 0.25 percent in July 1995. The bank prime rate went from 9.0 percent to 8.75 percent.

Growth Should Rebound in the Rest of 1995 and 1996

Lower interest rates, slowing retail and manufacturing inventory accumulations, and good consumer and business balance sheets suggest 2.0- to 2.6-percent annualized growth in the last 2 quarters of 1995. In an environment of continued low interest rates, housing and plant spending will ordinarily pick up. Car sales will increase some, but much of the replacement demand was satisfied in 1994. The boom in business-equipment spending should continue, but at a slower pace than in the first 8 months of 1995.

August's preliminary industrial production estimate was up 1.1 percent on top of July's 0.3-percent increase, which was largely due to high electricity usage during the month's unusually hot weather. Manufacturing was flat during July. August showed a dramatic upturn with manufacturing up 1.0 percent. Except for paper and products, which was constrained by the highest capacity utilization rate in the economy, every major industrial user of agricultural materials took part in the growth. Because of sales incentives, automobile and light truck output, the largest component of transportation equipment, rose 6.0 percent in August. Other sectors showed less dramatic turnarounds. August's pace of industrial recovery, while not sustainable because of large inventories, is evidence of an overall pickup in manufacturing.

Nonetheless, the sectoral pattern and modest level of growth for the rest of 1995 yield a mixed outlook for industries using agricultural materials. Housing and housing-related durable spending should grow moderately, as excess housing and durable inventories decline. This in turn will stimulate output in lumber and products, furniture, and textile-mill products in the third and fourth quarters. The small growth expected in domestic car sales, aided by a weak dollar, should modestly boost output of transportation equipment. The continued drawing down of excess inventories will keep growth and inflation modest. GDP is expected to grow between 2.8 and 3.2 percent in 1995.

The annual growth rate for 1996 over 1995 is expected to be between 2.0 and 2.6 percent. Interest rates should fall slightly below current levels. A weak but appreciating dollar and stronger growth in Europe, Japan, and Mexico will lead to strong export gains in 1996. Moderate construction growth will be supported by low interest rates and a modest 3.5-percent inflation rate. Export and construction growth should increase manufacturing output 2.6 to 3.0 percent. Lumber and furniture output is expected to rise more than 3 percent in 1996.

Moderate Growth Seen in Crude Oil Pricing

Despite a runup in the price of crude oil starting in early 1995—the refiner's acquisition cost was close to $19 per barrel during May—oil prices are likely to move down in the second half of 1995. Slow growth rates in developed countries will keep crude oil prices down. The second quarter of 1995 saw an average crude oil price of $18.20 per barrel, which will fall to about $16.75 in the third quarter because of a very slow recovery in world industrial production. The U.S. Department of Energy's Energy Information Administration (EIA) expects oil prices to average about $17.60 per barrel for the last quarter of 1995 and all of 1996.

Gasoline prices are expected to average $1.21 per gallon in 1995, up from $1.17 in 1994. The price is expected to hit $1.25 per gallon in 1996. Because of weak industrial production, diesel prices in 1995 probably will go up only 2 cents above 1994's $1.11 per gallon. Reflecting a moderate improvement in industrial output, diesel prices are expected to be up 5 cents per gallon in 1996.

Some analysts, who expect some stronger U.S. and world growth, expect crude oil prices to average about $18.50 per barrel for the last quarter of 1995 and all of 1996. Gasoline and diesel prices would then be about 3 cents higher than those expected by EIA in 1996. In either case, real crude and product prices are expected to be quite low for the near term. [David Torgerson, (202) 501-8447]