More Moderate Economic Growth Expected In the Rest of 1996 and 1997

The strong growth in U.S. gross domestic product in the second quarter of 1996 is expected to give way to more moderate growth for the rest of 1996 and 1997. Reflecting moderating growth, manufacturing output is expected to rise at an average annual rate of 3.5 to 4.5 percent through the end of 1997. As mature industries in a mature economic recovery, most of the industrial sectors using agricultural inputs will grow more slowly than manufacturing overall.

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. gross domestic product (GDP) grew a robust 4.2 percent in the second quarter of 1996, reflecting strong manufacturing growth. Lumber-and-products output rose as new housing and home improvement projects, delayed by bad weather in the first quarter, began in the second. Also, housing demand was up because strong disposable-income growth from a real increase in total wages paid (employment increased sharply during the quarter) and the use of variable rate mortgages overcame the impact of long-term mortgage rates that were 1 percent higher than at the end of 1995. Transportation-equipment output increased because of car and van rebates, good personal-income growth, rising business spending on vehicles, and dealers rebuilding inventories depleted by the strike at General Motors (GM). Textile-mill production rose because of increased spending on furniture. Chemicals and products and rubber and plastics were hurt by higher energy prices and a strengthening of the dollar that slowed exports and increased imports.

Manufacturing output increased 2.4 percent in the first quarter of 1996, while GDP grew a moderate 2.0 percent (table 1). 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), only two experienced gains in the first quarter. Industrial machinery and equipment grew at an annualized rate of 19.5 percent and chemicals and products increased 1.7 percent. Production dropped in the other seven industries. Lumber-and-products output declined because of unusually bad weather that inhibited construction. The GM strike was responsible for a quarterly decline in transportation-equipment output. Rubber output was stagnant as export sales could not make up for a drop in domestic demand for tires and material on GM cars.

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

Item	3rd qtr 1995	4th qtr 1995	1st qtr 1996	2nd qtr 1996
	Percent change 1/			
Gross domestic product	3.6	0.3	2.0	4.2
Industrial production	3.2	0.6	3.0	6.0
Manufacturing	2.6	1.4	2.4	6.5
Lumber and products	6.7	4.7	-4.3	14.6
Furniture and fixtures	0.6	-4.8	-2.9	7.9
Industrial machinery and equipment 2/	10.7	18.8	19.5	13.1
Transportation equipment	-2.8	-13.7	-4.8	31.7
Textile-mill products	-9.6	-5.3	-10.4	11.4
Paper and products	-5.5	-4.7	-11.1	17.1
Chemicals and products	2.0	5.9	1.7	-1.9
Rubber and plastic products	-0.6	3.0	-0.1	-0.3
Leather and products	-10.6	-8.5	-8.8	-2.9

1/ Annualized on a quarterly basis. 2/ Overall sector growth. Computers and office equipment grew 23.9, 45.0, 48.4, and 41.4 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, August 1, 1996; and Industrial Production and Capacity Utilization Report, Federal Reserve Bank, Washington, DC, August 15, 1996.

Mature Industries in a Mature Recovery

The current recovery is at a mature stage, which means the robust growth seen in the second quarter will not be reflected in the nine industries. Only the industrial-machinery-and-equipment industry, because of computers and business equipment, and the rubber-and-plastic-products industry are running at capacity utilization rates similar to those of the 1988-89 peak of the last business cycle (table 2). These two industries have also averaged output growth comparable to that of the last two business recoveries that lasted more than 5 years (1961-69 and 1981-89).

Based on capacity utilization behavior and other characteristics, the nine industries generally could be described as mature industries. The chemicals-and-products and non-computer-based-machinery industries are cases in point. Employment growth in these industries is below average for the economy as a whole, and output has not generally

Table 2--Capacity utilization for selected industries using agricultural materials

Item	Peak 1988-89	April 1996	May 1996	June 1996
	Percent			
Total industry	84.9	82.9	83.1	83.2
Manufacturing	85.2	81.8	81.8	82.0
Lumber and products	93.3	89.2	88.3	88.8
Furniture and fixtures	86.8	79.9	81.5	80.8
Industrial machinery and equipment	84.0	89.6	89.6	89.9
Transportation equipment	84.4	74.0	73.9	74.4
Textile-mill products	83.3	81.6	81.2	80.8
Paper and products	94.8	87.7	87.6	86.7
Chemicals and products	85.9	79.5	79.4	79.6
Rubber and plastic products	90.5	87.7	89.6	89.5
Leather and products	83.8	78.0	77.7	78.6

Source: Industrial Production and Capacity Utilization Report, Federal Reserve Bank, Washington, DC, July 1996.

expanded as fast as overall manufacturing. Double-digit output-growth rates, such as those of the technology-driven computer industry, are very unlikely. Finally, the industries they provide with inputs, such as other manufacturers, are also mature, providing only modest growth in derived demand.

Prospects for the Rest of 1996 and 1997

In the second quarter of 1996, the nine major industries using agricultural materials enjoyed a good economic environment. The next year and a half probably will be less favorable as economic conditions will be more like an average of the previous four quarters. While growth in the third quarter of 1996 may be above trend because of the positive impact of the previous two quarters' gains, the fundamentals point to moderate growth for the rest of 1996 and 1997. GDP growth is expected to average 2 to 2.6 percent during the period, with manufacturing output expected to rise 3.5 to 4.5 percent.

Consumers, while stimulated by higher incomes, are not likely to continue accumulating debt as they have for the last year and a half. Credit card and other loan delinquencies are up, so lenders are likely to increase their scrutiny of potential borrowers. Cash-strapped State and local governments, faced with increasing school enrollments and declining Federal assistance, will raise fees and property, income, and sales taxes, further cutting into consumers' spendable income. The 100-basis-point rise in long-term interest rates since late 1995 will further slow consumer durable spending and contribute to lower investment growth.

Investment spending is apparently slowing as manufacturers and resellers of computers, which have led the investment boom of the last 3 years, have recently reported sluggish sales growth. The record increases in profits are moderating, making some slowdown in equipment spending inevitable. The recent strengthening of the dollar versus the German mark and the Japanese yen makes it unlikely that a declining real trade deficit will provide an impetus for growth. Lower Federal spending, only partially offset by higher local spending, will be an additional drag on GDP growth.

Crude oil prices are likely to fall as North Sea and Iranian production expand. Prices are expected to average $18 to $19 per barrel during the next six quarters. If prices do rise, because of unexpected supply disruptions or pressure from higher than expected U.S. and world growth, they are not likely to increase above $25 per barrel due to the large excess capacity held by increasingly independent oil producers.

If the strong growth of the second quarter continues into the summer, the Federal Reserve (Fed) may raise short-term interest rates. Although housing and consumer durable growth will decline soon after any rate hike, a significant slowing of the economy would not be seen for four to six quarters. The banking-credit system, however, is in good shape and, with available funds, lending should not be severely restrained.

Although the economy has been quite strong, capacity utilization is not close to a level presaging inflationary bottlenecks. Productivity has grown faster than wages so far in this expansion, also insulating the economy from a runup in inflation. Greater industrial competitiveness, which makes it hard to pass on wage increases, is another impediment to sharply higher inflation. Thus, there is little chance of higher wages or production bottlenecks starting an inflationary spiral that the Fed will have to choke off with large hikes in short-term interest rates.

Prospects for the Nine Industries Mixed But Modestly Good

None of the nine major industries using agricultural materials should be in recession in 1996 or 1997 due to general economic conditions, but growth will be below that of the first two quarters of 1996. Lumber and products and furniture and fixtures, due to less expected construction activity and slow growth in durable spending by consumers, will likely grow modestly at best, compared with the second quarter. Higher short-term interest rates, if they occur, would further slow construction and durable spending growth.

The prospects for transportation-equipment growth are modest at best, because the domestic light-vehicle market is saturated and local governments are likely too strapped for cash to buy vehicles. However, the U.S. competitive position for airplane exports is good, possibly bringing growth in transportation equipment in one or two of the next six quarters, despite weak fundamentals for the rest of the industry. Production of paper and products and rubber and plastic products is close to full capacity, making growth prospects limited. Rubber is also constrained by the meager prospects for transportation-equipment-output growth.

The major risk to the industries' moderate prospects is stronger GDP growth than the 2- to 2.6-percent average expected for the rest of 1996 and 1997. If growth stays strong, the Fed will raise short-term rates more than currently anticipated. This would likely boost long-term rates as well. Lumber and products and furniture and fixtures would do well for a quarter or two, then likely be faced with several quarters of declining output. Industrial machinery and equipment and transportation equipment would likely face sharp declines in late 1996 and 1997 with higher interest rates. Chemicals and products and rubber and plastic products would likely do somewhat better in 1996 at the cost of a much weaker 1997. Slow auto industry growth and the likely rise in the dollar from higher U.S. interest rates, which would lower exports, would reduce output and prices in 1997 for most companies in these two industries. [David Torgerson, ERS, (202) 501-8447, dtorg@econ.ag.gov]