THE ECONOMIC OUTLOOK: CAUSE FOR OPTIMISM?

*Aubrey N. Snellings**

The economy is just entering the second year of recovery from the most severe recession this country has experienced since the 1930's. Over the course of the past year opinion as to the strength and durability of the recovery has undergone a number of changes. In the early months of the upswing widespread concern was expressed as to its durability; more recently, opinion generally has become rather bullish, with some forecasters talking of a possible economic boom. This brief article attempts to put our present economic situation in perspective and to assess the prospects for continued economic expansion.

We might begin by noting that the economy has shown considerable improvement over the last twelve months. Real GNP in the first quarter of 1976 was up some 7.1 percent since the first quarter of last year, and industrial production is 11½ percent higher than it was last April. The rise in output is reflected in increased utilization of plant and equipment and a great deal of improvement in labor markets. Employment has risen by 3.6 million since last spring, the average factory workweek has lengthened, and the unemployment rate is at 7.3 percent, down from 8.9 percent last May. At the same time, there has been considerable progress in the effort to get a grip on the problem of inflation.

In spite of these heartening developments, this would have to be rated as one of the slower recoveries in the period since World War II. The 7.1 percent rise in real GNP between first quarter 1975 and first quarter 1976 compares with an average gain of 8¼ percent in the comparable periods of the five other postwar revivals. (See chart, page 5.) The 4.5 percent growth in real final sales over the last year was the smallest of any postwar recovery. In addition, we still have some 7 million workers unemployed and about one-fourth of our manufacturing capacity idle, so the recovery process is still far from complete.

Not only is this economic upturn one of the slowest of the postwar period, it also differs in some other important respects from most of these other recoveries. Of course, such students of business cycles as Arthur Burns and Wesley Mitchell always emphasized that each cycle is unique, so we shouldn't expect developments in this period to be exactly like those in any other recovery we have known. Nevertheless, all of the other postwar expansions have shown a number of common characteristics. This one differs from these others in a number of respects.

The most important difference is in the timing of the beginning of recovery in the various major sectors of the economy. Over the past year the process of expansion has developed in something of a slow-motion fashion, with revival in some major sectors of the economy delayed much longer than in the typical postwar upturn. The result has been an attenuation of the recovery process, with some sectors still failing to contribute significantly to the upswing.

Typically, the consumer sector accounted for much of the growth in final sales in the early months of the revival. But even so, the increase in total consumer spending since last spring has been smaller than in the comparable periods of most postwar recoveries. Business fixed investment spending, on the other hand, showed virtually no increase (in real terms) from the trough of the recession to the first quarter of 1976. Business fixed investment is something of a lagging series, of course, but in the five earlier recoveries since World War II this type of outlay increased an average of 10 percent over the first year of economic rebound.

The swing in inventory policy last summer, when businesses stopped liquidating inventories, provided a big boost to production and employment. But unlike other recent recovery periods, businesses did not begin immediately to rebuild inventories when recovery began. As a matter of fact, real inventories declined slightly in each of the last two quarters of 1975, although businesses did begin to add to stocks at a rather substantial pace last quarter.

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* Vice President and Economist, Federal Reserve Bank of Richmond. This article is adapted from a speech before the Automotive Market Research Council, Hilton Head, South Carolina, April 21, 1976.

The situation in housing has been different this time, too. In recent years, the housing sector has tended to lead the overall economy, with outlays on residential construction beginning to fall long before the economy turned down and then leading the upturn by one or two quarters. In the most recent period, the housing sector did not lead the recovery at all, and as a result it provided less stimulus in the early stages of the upturn than it usually does. Outlays on residential construction did pick up in the second half of 1975, however, and the increase over the first four quarters of recovery was about in line with the average gain in the comparable periods of other postwar upturns. Nevertheless, because the recovery started from a very low level, a great deal of unused capacity exists in the housing industry.

Perhaps one should not make too much of the differences between this recovery and what might be called the typical postwar recovery. It seems possible, however, that the unusually attenuated process of recovery over the past year has set the stage for a much more prolonged expansion than has been typical in the postwar period. It also could turn out to be one of the strongest recoveries, if things go right.

One might envision the following scenario: Consumer spending, which has provided much of the strength in final sales thus far, will continue to show moderately strong growth over the months ahead. Inventory accumulation, which until last quarter contributed almost nothing to the upturn, should continue to show a good deal of strength throughout the remainder of this year. This would provide substantial boosts to production, employment, and income over the remainder of this year; and the improvement in income would sustain and strengthen consumption. Residential construction, which is improving, could continue to add strength over the next year. Finally, by the end of the year, rising output, improved capacity utilization rates, and a healthy profit picture could set in motion a burst of capital spending that might sustain the expansion through 1977 and perhaps beyond.

Now, admittedly, the development of this scenario depends on the achievement of the best possible outcome in each of the major sectors of the economy. There are a lot of points where things could go wrong, but the scenario seems entirely attainable. The most important prerequisite to the realization of this projected chain of events is continued strength in consumer spending, and it seems that prospects in the consumer area are fairly good, although not as bright as they appeared a few months ago. In the early months of this year, the improved employment outlook, the reduced inflation rate, rising real personal income, and the tremendous improvement in stock prices all contributed to a major improvement in consumer confidence. The Conference Board survey of consumer attitudes showed a sharp rise in consumer confidence between last October and February, to the highest level since October 1973. Consumers' buying plans also improved sharply, with the percentage of respondents planning to purchase a car in the next six months setting a record high in the history of the series. The University of Michigan survey conducted at about the same time showed similar results. More recently, however, the Conference Board index of consumer confidence declined enough to more than offset the January-February gain, and other indexes of consumer sentiment evidenced some weakness. The reasons for this apparent weakening of consumer confidence are not entirely clear, but many respondents mentioned the fear of a new outburst of inflation. The recent hesitation in the stock market also may have been a factor.

Consumer activity since last fall tends to confirm the increased willingness to spend, although in recent weeks the growth in consumer outlays has tapered off. But total consumer expenditures in the GNP accounts rose at an annual rate of about 11 percent in the first quarter (7¾ percent in real terms), and retail sales, after pausing briefly last fall, rose at an annual rate of 14 percent between November and April. Moreover, price increases have been quite moderate over the past six months, so much of this increase represents a gain in real sales volume.

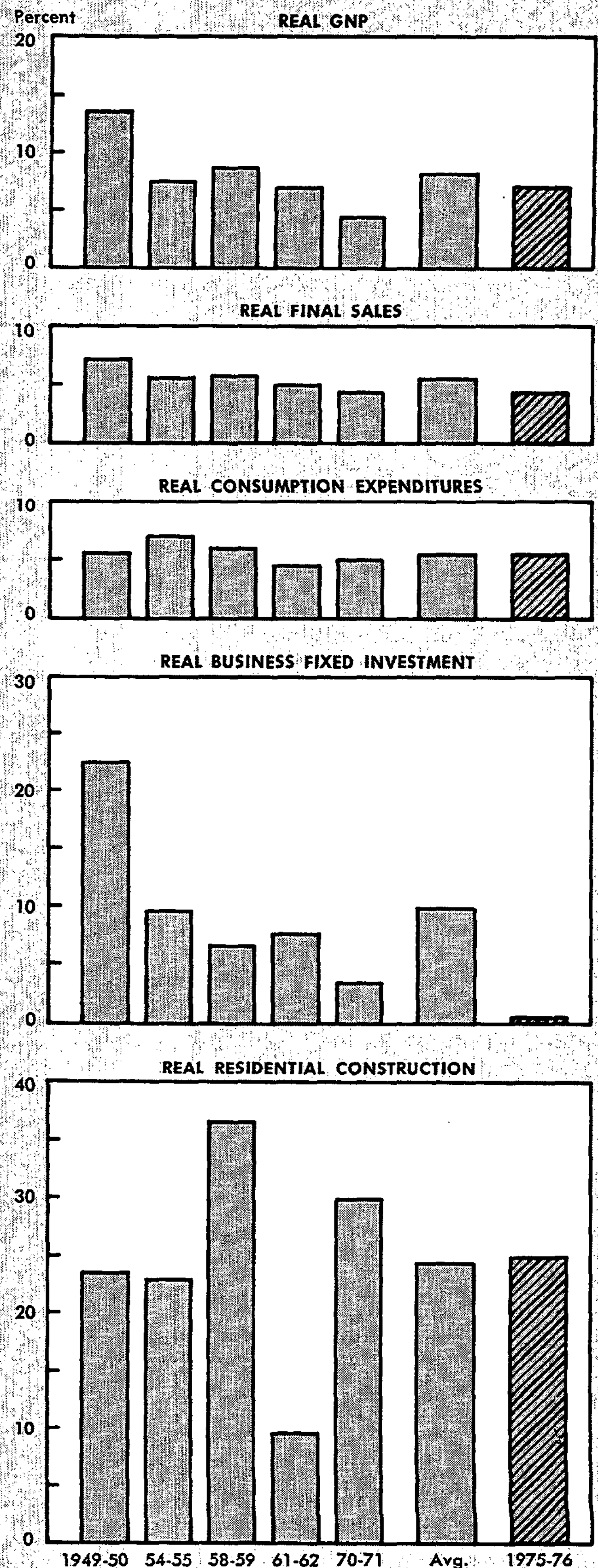
This strength of consumer demand has led businessmen to reassess their inventory positions. Inventory-sales ratios fell sharply in 1975, and at the retail level they are near the lowest point in a number of years. Businessmen learned some very tough lessons on inventory management in 1974 and 1975, and they would be expected to follow very cautious policies for some time to come. But there is some evidence that vendors have been losing sales because of an inability to meet demands from existing stocks, especially at the retail level, and delivery times are getting longer. As retail sales continue to rise, businessmen may increase orders and production at a pace faster than the increase in sales in order to rebuild in-

ventories to a level they consider consistent with the improved level of consumer spending. Gross National Product data show that inventories were accumulated at a substantial rate in the first quarter, and further needed accumulation may provide significant strength to the recovery throughout this year.

Prospects for residential construction appear to have improved, although the housing industry is still faced with a number of large problems. Housing starts are up substantially from last year's low, but the industry is by no means out of the woods. Important barriers to rapid improvement are the extensive overbuilding that occurred in the 1972-73 boom, the extraordinary rise in home prices in recent years, and the conditions that have prevailed in mortgage markets. In February, for example, the average price for a new single-family house was $42,300, about 11½ percent higher than a year earlier. When the high cost of mortgage money is added to the price of the average house today, the result is a very large monthly mortgage payment, and it is easy to see why it is said that many families in this country have been priced out of the housing market.

Still, things are looking better in the housing sector, especially in the market for single-family homes. Sales of houses improved in the second half of 1975, and the backlog of unsold units declined. Rental vacancy rates have declined. Wage increases in the construction industry have been comparatively small this year, and there have been reports that construction workers in some parts of the country have agreed to wage reductions, developments that suggest some slowing in the rise of home prices.

Housing starts declined slightly in March and April, but this followed a very large jump in February. Seasonal adjustment problems for this particular series are especially difficult for the winter months, of course, and there is general agreement that the February figure overstated the improvement in housing. Still, an average of the February-April figures indicates a substantial improvement in the housing picture, and building permits issued in the first four months of 1976 were some 55 percent higher than in the comparable period of 1975. All in all, there seems a fairly good chance that the housing industry will provide additional stimulus to the economy throughout 1976. The determining factor may be the continued availability of mortgage money. Savings have been flowing into thrift



Source: U. S. Department of Commerce, Survey of Current Business.

institutions in large amounts and, until recently, there was some easing in mortgage rates. Continued availability of mortgage financing may depend on what happens to the inflation rate, the strength of loan demand, and the rate of growth of the money supply.

Business outlays on plant and equipment have picked up much more slowly in this expansion than in other postwar recoveries. As noted earlier, in real terms plant and equipment expenditures were about the same last quarter as in the first quarter of 1975, although there was a nice increase from the fourth quarter 1975 to first quarter 1976. But it seems that a number of conditions favorable to a resumption of capital formation have developed. Capital appropriations of large manufacturers rose substantially in the fourth quarter of 1975, and the output of business equipment has risen in recent months. Capacity utilization rates are rising, corporate profits have been moving up strongly, and cash flows are immensely improved. Finally, like consumers, businessmen have regained their confidence, while financial markets are substantially better than they were a year ago. For example, a number of non-blue chip corporations that were excluded from bond markets last year are now able to float security issues, and the rate spread between issues of varying quality is reduced. Evidence of these changes is provided in the recently completed McGraw-Hill survey of business spending intentions. In this survey, estimates of expected outlays on plant and equipment in 1976 were revised upward to 13 percent from last fall's 9 percent figure, with a sharp surge of expenditures indicated for the second half of this year.

Because of all these considerations, there may well be a significant rebound in business investment in the second half of this year or in early 1977. Indeed, first quarter figures indicate it may already be under way. But the timing and strength of this development will depend primarily on the strength of consumer demand and the inventory policies of businesses. If the rebound in plant and equipment spending does begin to gather strength toward year's end, it would go a long way toward extending the recovery through 1977 and perhaps beyond.

The scenario outlined above paints a rather optimistic picture of the economic outlook over the next eighteen months, but it is one that can be achieved. The future is never certain, however, and there are several developments that could jeopardize the achievement of this scenario. One is a strong resurgence of inflation, another a sharp rise in interest rates. These two things are not unrelated, of course. But a renewed burst of inflation would erode the gains in real income that have been realized in recent months and destroy the improvement in consumer confidence that is vital to continued growth in retail activity. Business confidence also would be impaired, and in the face of weakening consumer outlays, both inventory accumulation and plant and equipment expenditures would be adversely affected. Finally, an acceleration of price increases would damage the much-improved but highly sensitive financial markets and contribute to a run-up in interest rates.

The inflation picture has improved greatly over the last year or so, of course, in spite of the recent uptick in both wholesale and consumer prices. But much of the improvement in 1975 came from a working out of the extraordinary price increases associated with worldwide crop failures, OPEC, the lifting of price controls, and other special factors in 1973 and 1974. In more recent months, temporary declines in food and fuel prices have moderated the rate of inflation, but these already have been reversed. Gasoline prices are moving up again, and farm prices jumped sharply in April. In addition, price increases for a number of metals have been announced recently.

Given the large cushion of unemployed resources, demand-pull inflation is not likely to be a factor this year, although a strong surge in economic activity might run up against capacity limits in some industries. But the most important single factor influencing prices in the months ahead will be the rise in labor costs. A number of important wage contracts come up for renewal this year, and the outcome of these negotiations will affect not only the rate of inflation but the rate of economic recovery as well. There have already been some rather sizable settlements agreed to this year, of course, and the rubber industry is still involved in a lengthy strike. But the average increase in labor costs for the economy will be considerably smaller than the first-year increases provided for in these new contracts. A number of contracts not expiring this year were front-loaded, so the increase this year won't be so large. In addition, nonunion wage increases may be smaller this year because of the lower inflation rate. Finally, we should keep in

mind that a strong recovery in economic activity would produce substantial productivity gains that would reduce the impact of higher wages on unit labor costs.

A sharp rise in interest rates also might be bad news for the continuation of the recovery. The most immediate impact, of course, would be on the housing sector. A run-up in rates would dry up the flow of savings into thrift institutions, and mortgage money would become very scarce and very costly. Other financial markets would be adversely affected and the recent improvement in consumer confidence endangered. Finally, the expected resurgence in business investment could be aborted.

Interest rates have performed rather well thus far in the recovery. After moving up fairly sharply last summer, they drifted downward for about six months and, until recently, most of them were at about the level they were a year earlier. In late April, however, rates began to move back up. As the economy continues to expand, further upward pressure on interest rates should be expected. Government is borrowing huge amounts of the funds flowing into the capital markets and, if private demands increase with the recovery, total demand in the market may exceed the supply at current rate levels. Some well-informed observers fear the "crowding out" of private borrowers that was so much talked about last year. The prospect of "crowding out" appears somewhat more plausible this year than last simply because the position of businessmen has been reversed. Throughout 1975 businesses were reducing demands for funds by cutting back on inventories and scaling back capital outlays; in the year ahead they may be doing just the opposite. Continued economic recovery, however, would reduce Government demands for funds.

If things should develop this way, with interest rates rising rapidly and private borrowers being crowded out of financial markets, it could create some thorny problems for the Federal Reserve System. A sharp rise in rates would not be welcome because of the adverse effects on continued expansion at a time of relatively high unemployment. But an attempt to prevent a rise in interest rates, under these conditions, could bring a very rapid growth in the money supply that would almost surely bring on renewed inflation. It may be possible, of course, to strike some happy medium between these extremes and to achieve a moderate growth in money without a sharp run-up in interest rates. Such a development would bode well for the continuation of the recovery.