The Business And Financial Outlook for 1976

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BUSINESS CONDITIONS AND OUTLOOK

Economic statistics for the spring and summer of 1975 confirmed that the recession of 1974-75 was over and revealed the vigorous beginning of the recovery. The recession was both the longest and deepest in the United States since the 1930's. The overall rate of unemployment peaked at more than 9 per cent of the civilian labor force, and the rate of capacity utilization in manufacturing fell to 67 per cent. But in addition to the ills of recession, American society suffered simultaneously from some of the highest rates of inflation in its history. Indeed, the inflation was a major factor in the economic slump. It is important to keep these features of the immediate past in mind as one analyzes the outlook for economic recovery in 1976.

THE RECOVERY IN 1975

Real gross national product (GNP) grew only slightly in the second quarter of 1975—at less than a 2 per cent annual rate—but enough to mark that period as the initial quarter of the recovery. The turnaround probably occurred at some time during the quarter: industrial production reached its low point in April and the decline in total civilian employment ended in March (both on a seasonally adjusted basis). After allowing for price change, the rise in final purchases was composed of increases in personal consumption expenditures, net exports, and government purchases, large enough to more than offset a decline in business fixed investment. (The change in residential construction spending, while positive, was very small.) But the quarterly increase in real GNP was smaller than the rise in real final sales because the liquidation of business inventories went on at a more rapid pace in the second quarter than in the first, thus making the inventory sector a continuing drag on overall output growth.

The third quarter was a different story, however, with several of the economy's major sectors making significantly different contributions to the total. Real final purchases increased by nearly $10 billion, slightly more than in the second quarter. In the third quarter, moreover, even though business inventories continued to be liquidated, the inventory sector ceased to be a drag on total output growth as the pace of liquidation slowed considerably. Within the final demand group, the private domestic sectors provided the thrust to growth: consumer spending continued to grow strongly, business fixed investment ceased its decline, and residential construction spending grew substantially. Government purchases increased hardly at all, and net exports declined as import growth exceeded the growth of U. S. exports. This sectoral mix provided for real GNP growth in the third quarter at an annual rate of more than 13 per cent.

The recovery in total economic activity and output was reflected in improved labor market conditions and in increased productivity. Quarterly average unemployment rates for nearly all major labor force categories retreated in the third quarter from their second quarter cyclical peaks. For example, the overall rate of civilian unemployment fell from 8.9 per cent to 8.4 per cent and the rate for all household heads declined from 6.1 per cent to 5.7 per cent. Nonfarm payroll employment also rose substantially in the third quarter, and the average length of workweek edged upward. But the increase in output so far outstripped the increase in hours worked that output per hour in the nonfarm sector posted its largest quarterly gain since early 1961. This second consecutive quarterly increase in productivity, to be expected early in a recovery, followed several quarters of substantial decline. When these rates of productivity increase were coupled with the recent pattern of moderating rates of increase in compensation per hour, the result was a dramatic change from high rates of increase in unit labor costs to an actual decline. That, in turn, was reflected in a similarly dramatic decline in the rate of increase of the implicit price deflator for the private nonfarm economy, from 11.1 per cent in 1974 to an annual rate of slightly more than 4 per cent in the second and third quarters of 1975.

The total GNP deflator has also shown a sharp decline in its rate of increase during 1975 (though not as dramatic a shift as that for the private nonfarm economy). During the five quarters of falling real output (all of 1974 and the first quarter of 1975), the GNP deflator rose at an annual rate of 11.3 per cent; in the second and third quarters of 1975 the annual rate of increase averaged just under 5 per cent. (The GNP implicit price deflator is influenced by changes in the composition of output. A GNP fixed-weighted price index showed the following annual rates of increase in the first three quarters of 1975: 7.5 per cent, 5.5 per cent, and 6.8 per cent.) Price increases as measured by the Consumer Price Index (CPI) have also been smaller in 1975 than in 1974. However, after a sharp decline in the first quarter of 1975, the quarterly average rate of increase in the CPI was above that of the preceding quarter in both the second and third quarters of the year.

THE OUTLOOK FOR *1976*

As the recovery proceeds, the roles of the various sectors of the economy may be expected to change further. The contribution of the inventory sector, for example, is likely to be of less relative importance to overall growth in the near future. Liquidation may well give way to renewed accumulation around the turn of the year as stocks are brought into line with sales. The extent to which inventory investment will enhance total real growth will, of course, depend on businessmen's expectations about the growth of sales and about the effects of the recovery on the rate of inflation and the possibility of shortages. Moderation in the rate of recovery would be expected to restrain the growth of inventories on all three counts.

Personal consumption expenditures (along with inventory change) may be given considerable credit for the bottoming-out of the economy and its early recovery. The improved performance of real disposable personal income, attributable partly to a moderating rate of inflation and to personal income tax reductions, provided consumers the wherewithal for increasing purchases of goods and services, especially durable goods. Without a return to rates of inflation like those of 1973-74, and assuming at least a continuation of the personal income tax reductions of 1975 (on a full-year basis), increases in manhours worked should occur, resulting in a solid growth in real disposable income. If so, personal consumption spending is likely to continue to grow enough to provide a firm underpinning for the economy's continued recovery.

Although the turnaround in residential construction was rather late in the cycle, private housing starts in September 1975 were about 40 per cent above their low at the close of 1974 and residential construction spending contributed significantly to the third quarter's growth in total output. It is not clear, however, that strong growth in homebuilding can be sustained through 1976. The series on building permits is recovering from its cyclical trough but is still at a historically rather low level, and questions must be raised about the underlying demand for housing at current high prices.

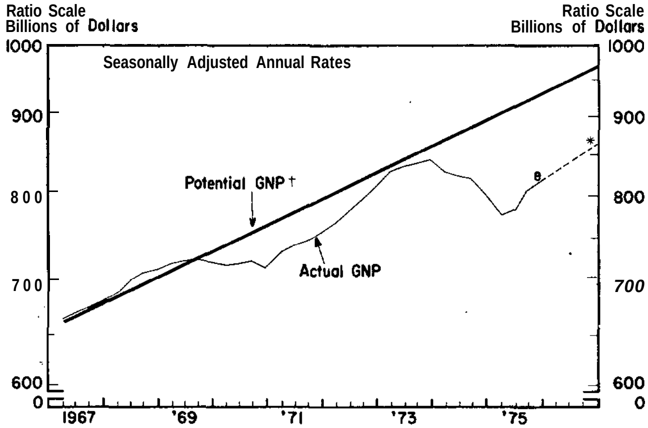
Finally, there is the question of sufficient financing for residential construction. Inflows of funds to thrift institutions (the major source of that financing) were very strong through most of the summer of 1975, permitting the advance in homebuilding that occurred. But the situation seems to have changed somewhat since late summer. Net new savings received by savings and loan institutions appear to have increased less than seasonally in August and September, but rebounded substantially in October. These movements apparently reflected an increase in market interest rates which was later reversed. Whether rates will again rise enough to hamper the inflow of deposits to these institutions will depend on the pace of the economic recovery and the course of monetary policy. Should homebuilding activity slow markedly (or, worse, cease to grow), the overall recovery would be weakened considerably.

Business spending for fixed investment suffered greatly from the recession, declining at an annual rate of nearly 10 per cent in real terms through 1974 and the first three quarters of 1975. The decline appears to have ended in the third quarter of 1975. Rising profits as the recovery progresses will be a positive influence on business capital spending in 1976. However, fairly strong growth in final demand for output will be required to justify very rapid expansion in fixed investment, given the low rate of utilization of existing plant. Advance indicators, such as new orders of nondefense capital goods industries, are not yet giving unambiguous signals of substantial increases in fixed investment spending. The McGraw-Hill fall survey of business spending plans for new plant and equipment in 1976 suggests a minimal real increase in business fixed investment.

Net exports, and government purchases of goods and services, are the remaining final demand sectors to be considered. Net exports supported the recovery in its early stages, but with the recoveries here and abroad proceeding out of phase with one another, a reduction in that support is expected in 1976. Federal purchases are likely to increase only modestly, as are those of state and local governments. Little stimulus to economic activity in 1976 may be counted on from increased government demand for output. Thus, private domestic final demand is likely to be the key to the outlook for real economic growth in 1976.

Chart 1

REAL GNP, ACTUAL AND POTENTIAL



e Estimated.
* Illustrative example.
†Trend line increase of 4 per cent per year
SOURCE: U. S. Department of Commerce.

Discussion of the outlook by sector suggests an overall pattern that might include a growth in real GNP of about 4 to 6 per cent from the end of 1975 to the end of 1976. Such a pace would be slower than in four-quarter periods in similar stages of most postwar recoveries, and considerably slower than that achieved in the last half of 1975. Growth at a 5 per cent rate, which is only slightly faster than the economy's long-run trend rate of growth, would continue to close the large gap between actual and potential real GNP that was opened by the recession (Chart 1). But because the gap is so large, the economy would remain a long way from full employment of its industrial and labor resources at the end of 1976. One measure of the degree of underutilization of resources, the overall unemployment rate, may be estimated from the size of the GNP gap by using a convenient rule of thumb.' In this illustration, the unemployment rate at the end of 1976 might be expected to fall near the midpoint of a range of 7.5 to 8.5 per cent. Thus, recovery through 1976 at a rate near 5 per cent would still leave a large disparity between what the U. S. economy would be capable of producing and what it would actually be producing.

The continued existence of a lot of slack in the economy by the end of 1976 (and the modest speed at which the gap is expected to be reduced) has important implications for the rate at which the general price level may be expected to rise. There is little reason to believe that the illustrated growth of aggregate demand would put enough pressure on the resource base, given the amount of idle capacity (including labor) existent at the end of 1975 and expected at the end of 1976, to bring undue upward pressure on the rate of inflation in 1976, or even in 1977. As earlier cost increases were passed through and some catch-up in wage rates occurred, inflation rates remained high in 1974 in the face of a large quantity of underused resources. Many of these lagged effects appear to be over, however, as are the more direct impacts of the runup of food and fuel prices in 1973-74. The year 1976 is likely to be a year of rising productivity and, at worst, stable to slightly rising unit labor costs—if labor compensation increases continue to be of reasonable size in spite of a heavy collective bargaining calendar. If so, these features should combine to produce a rate of increase in the general price level well below a double-digit level,

There is, of course, the possibility of further exogenous shocks to the economy and to the rate of inflation from large increases in the prices of food and fuel, especially oil. At this time, it appears that increases in food and oil prices will be much smaller than those of 1973-74. Food prices in the United States rose 14 per cent in both 1973 and 1974, and an estimated 9 per cent in 1975. The U. S. Department of Agriculture estimated in November that retail food prices will rise at a 5 per cent annual rate in the first half of 1976. Whether or not this particular estimate is on the mark, it is clear that the overall agricultural situation now differs from that in the earlier years, in terms of both domestic harvests and export demands, in such a way that price increases of that earlier magnitude are less likely to occur.

The increase of about 10 per cent in the price of crude oil, announced by the Organization of Petroleum Exporting Countries in the fall of 1975, was near the low end of the range of earlier expectations. While that increase will have an impact on world' energy prices, it will be both less than many observers had expected and much less than that of 1973-74. At the same time, however, failure to resolve the question of decontrol of domestic oil prices and the related question of the future of the $2 tax on imported oil, leaves considerable uncertainty about the future of energy costs in the United States. Decontrol accomplished over a period as long as 39 months (proposed earlier by the Administration) would spread the effect over a longer period than would abrupt decontrol. A conclusion of cautious optimism seems warranted about the impact of rising food and fuel prices in 1976, both on the rate of inflation and on the growth of consumers' real income.

FINANCIAL DEVELOPMENTS AND IMPLICATIONS

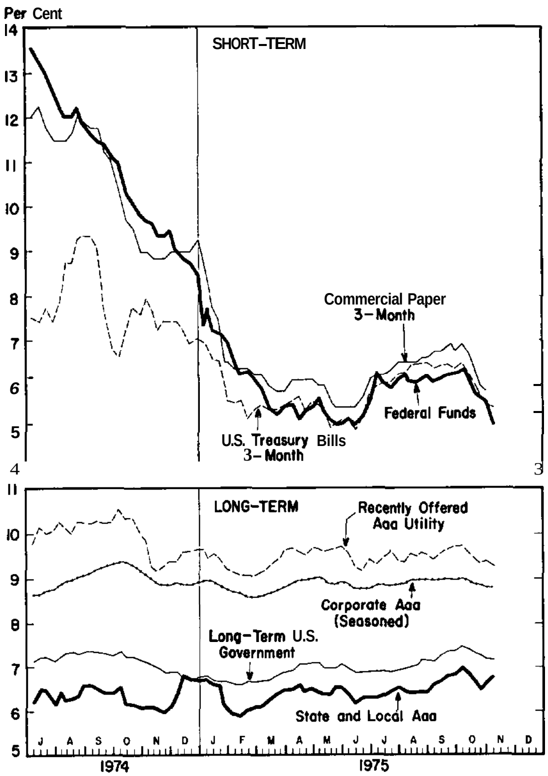
In 1976, the course of inflation and the economy will affect and be affected by financial developments. This section discusses the ways that financial and economic variables may interact as the year unfolds. A brief review of 1975 sets the stage for the treatment of prospective events.

FINANCIAL DEVELOPMENTS IN 1975

Interaction between financial and economic variables was quite evident in 1975. The first quarter decline in production and the rate of inflation was accompanied by a sharp drop in the demand for money and credit. Falling monetary demands contributed to the decline in interest rates that occurred in the first quarter. At the same time,

1/The relationship known as "Okun's Law" suggests that a 1 percentage point reduction in the unemployment rate is associated with a 3.2 percentage point reduction in the GNP gap expressed as a per cent of actual GNP.

Chart 2
SELECTED INTEREST RATES



declining production and sluggish monetary growth encouraged an increasingly accommodative monetary policy. Monetary accommodation helped reverse the sluggish growth in the money supply and contributed to the drop in interest rates. The decline in rates was quite pronounced, especially in short-term markets. The Federal funds rate, for example, fell from around 8.5 per cent in late 1974 to around 5.5 per cent at the end of March. Long-term rates declined also but'to a lesser extent. (See Chart 2.)

Rebounding economic activity in the second and third quarters helped reverse the downward movement in short-term interest rates. Consequently, short-term rates increased in the latter part of the second quarter and moved up somewhat further in the third quarter. Rapid monetary growth, however, counteracted some of the upward pressure on interest rates emanating from the rebounding economy. Monetary growth was especially rapid in the second quarter as the public temporarily deposited income tax rebates. After midyear, the public drew heavily on rebate-inflated deposits so that monetary growth slowed sharply in the July-September period. Nevertheless, for the second and third quarters combined the narrowly defined money supply increased at a seasonally adjusted annual rate of around 8 per cent. While the 8 per cent rate is somewhat less than the spring-summer growth rate in the overall economy, monetary expansion was sufficient to counteract most of the demand-induced upward pressure on interest rates. At the end of September, the Federal funds rate was 6.25 per cent--only moderately higher than in late March.

Short-term interest rates declined early in the fourth quarter. By early December, for example, the Federal funds rate was around 5.25 per cent. The recent drop in interest rates was due partly to a more accommodative monetary policy. Greater accommodation reflected policymakers' concern about continued sluggish monetary growth. The accommodation developed at a time when financial markets were faced with increasing uncertainty associated with the financial problems of New York City.

Developments in 1975 show that changing economic and monetary conditions sometimes have little immediate impact in changing long-term interest rates. Despite sharp movements in production and variations in the pace of monetary growth, long-term interest rates fluctuated within a narrow range in 1975. For example, during most of the year, yields on Aaa utility bonds ranged between 9 and 9.6 per cent. Relative stability in long-term interest rates reflected a balancing of several conflicting factors. In the first part of the year, downward pressures from economic weakness, declining inflation, and falling short-term rates were countered by efforts of businesses to lengthen the maturity structure of liabilities. Efforts to restructure liabilities led businesses to borrow heavily in capital markets.

After midyear, businesses reduced their long-term borrowing. At about the same time, however, the U. S. Treasury began borrowing heavily in both money and capital markets. Increased Treasury borrowing along with the economic turnaround tended to counter the downward pressures on long-term rates produced by reduced private borrowing. In addition, sharp midyear jumps in wholesale and retail prices reinforced inflationary expectations and lessened downward pressures on long-term rates emanating from earlier declines in the rate of inflation.

FINANCIAL DEVELOPMENTS IN 1976

As in 1975, financial markets in 1976 will be importantly affected by the ongoing recovery in business activity. As production expands, demands for money and credit will be increasing. These rising monetary demands will be placing upward pressures on interest rates. Continued economic recovery in 1976, however, may not necessarily be accompanied by rising interest rates. While experience shows that interest rates rise at some point in the expansion phases of business cycles, rates do not always increase in the first several quarters of economic upturns. For example, interest rates declined for several quarters after the 1969 recession ended and rose only moderately following the end of the 1960-61 recession.

Factors in addition to the business recovery will be affecting financial markets in 1976. Continued price inflation, for example, will be adding to the amount of money and credit the public needs to transact business. The resulting increases in monetary demands will be augmenting the upward pressures that rising production will be placing on interest rates. The added pressure could be quite pronounced if the rate of price inflation accelerates significantly. Barring a large step-up in the rate of inflation, however, financial market pressures emanating from inflationary developments may remain moderate.

Interest rates in 1976 also will be affected by the availability of money and credit. Rising monetary availability will tend to counteract the upward pressures on interest rates emanating from increasing production and prices. The resulting behavior of interest rates will depend on the extent that rising production and prices stimulate monetary demands, compared with the extent of the increase in the supply of money and credit.

Monetary availability will be largely determined by the conduct of monetary policy. The Federal Reserve intends to conduct policy so that the monetary aggregates expand in line with targeted growth rates that have been publicly announced. For example, the narrowly defined money supply, M1, has been targeted to expand at an annual rate between 5 and 7.5 per cent.

As the money supply expands within the targeted range, money is likely to expand less rapidly in 1976 than the overall economy. In other words, money will probably grow less rapidly than nominal gross national product (GNP), which will be reflecting the increase in both production and prices. A less rapid growth in money than in the overall economy, or in nominal GNP, means that the turnover or velocity of money will be increasing.[2]

Rising velocity is frequently associated with rising interest rates because the demand for money tends to increase in line with the overall economy. When velocity is increasing — that is, when money is growing less rapidly than the overall economy— monetary availability tends to grow less rapidly than monetary demand. The shortfall in availability places upward pressure on interest rates. Rising interest rates encourage the public to economize on money holdings, thereby creating a balance between the demand for and supply of money.

For various reasons, however, rising velocity is not always associated with rising interest rates. During the first several quarters of economic upturns, for example, velocity invariably increases, but interest rates sometimes fail to rise. As economic recovery begins, several factors may temper increases in monetary demand and allow velocity to increase without putting upward pressure on interest rates. The business sector is frequently in a fa-

2/Velocity is the ratio of nominal GNP to the money supply. Therefore, if the money supply increases less rapidly than nominal GNP, velocity increases. Velocity declines if the money supply increases more rapidly than nominal GNP.

vorable position with regard to liquidity. In addition, businesses are typically anticipating that rising profits will be augmenting their cash flows. These factors may induce firms to maintain relatively low money balances, so that monetary demands may tend to expand less rapidly than the overall economy.

Interest rate behavior during the first part of recoveries depends partly on the magnitude of the rise in velocity. Relatively small increases in velocity tend to be accompanied by moderate increases or even declines in interest rates. Similarly, relatively large increases in velocity tend to be accompanied by relatively sharp increases in interest rates. Thus, in the first year following the 1969 recession, velocity rose arelatively moderate 2.5 per cent and interest rates declined. In the first year after the 1960-61 recession, velocity rose more—5.6 per cent—and interest rates increased moderately. Both velocity and interest rates jumped sharply in the first several quarters following the 1953-54 and 1957-58 recessions.

If economic activity advances at a moderate pace during the current recovery's initial phase, the rise in velocity may be moderate. In this case, the first part of the recovery—encompassing perhaps the period from mid-1975 through 1976—may be accompanied by stable or only moderately rising interest rates. A moderate increase in economic activity at an annual rate of around 6 per cent from mid-1975 through 1976 may be associated with a rise in velocity between 4.5 and 7 per cent. Velocity increases within this range assume an inflation rate around 6 per cent and a money growth rate within the targeted 5 to 7.5 per cent range. Experience suggests that velocity increases toward the lower end of the 4.5 to 7 per cent range' are compatible with stable or moderately rising interest rates. Given the 6 per cent economic growth rate and the 6 per cent inflation rate, velocity increases toward the low end of the 4.5 to 7 per cent range imply a money growth rate toward the upper end of the 5 to *7.5* per cent range.[3]

It should be noted that a 6 per cent economic growth rate over the mid-1975 through 1976 period implies a lower growth rate in 1976 because the rate exceeded 6 per cent in the last half of 1975. Thus, the assumption of a 6 per cent growth rate in the economy over the first six quarters of the recovery implies about a 5 per cent growth rate for 1976 as a whole. As noted in the section on the business outlook, a 5 per cent economic growth rate would be consistent with the pattern of business activity projected to emerge in 1976.

A continuation into 1976 of the rapid economic growth rate experienced in the last half of 1975 would likely be accompanied by sharply rising velocity and interest rates. In addition, with production expanding sharply, inflation likely would accelerate. Vigorous economic growth into 1976 would significantly reduce unemployment levels. A moderate pace may be more desirable in the long run, though, as a vigorous recovery may be short-lived.

The rise in interest rates and accelerated inflation likely to accompany a rapid recovery would create severe financial distortions and strains. These difficulties would adversely affect the economy and possibly terminate the recovery. In the face of rapid economic growth and accelerating inflation, the Federal Reserve could temporarily hold down interest rates by boosting the money growth rate. Rapid monetary growth, however, would add to long-run inflationary pressures and thereby endanger a sustainable business expansion.

3/Since velocity equals the ratio of nominal GNP to the money supply, the growth rate of velocity approximately equals the growth rate of nominal GNP minus the growth rate of the money supply. The growth rate of nominal GNP is approximately equal to the inflation rate plus the economic growth rate. Thus, the growth rate of velocity approximately equals the inflation rate plus the economic growth rate minus the money growth rate. For example, if the inflation rate is *6* per cent, theeconomic growth rate is 6 per cent, and the money growth rate is 7.5 per cent, the growth rate of velocity is approximately 6+6 −7.5, or 4.5 per cent.