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U.S. ECONOMIC OUTLOOK

(By Burton G. Malkiel, Member Council of Economic Advisers)

The economic expansion during the past 18 months can, I think, correctly be described as a typical business cycle recovery. It is typical first because it has been relatively sharp as one would have expected given the severity of the 1974–75 recession. Real growth during the last six quarters has proceeded at a rate of 6.3 percent. Since the trough of the recession 3.7 million people have found new jobs and record numbers of Americans, close to 88 million, are currently employed.

The recovery has also been much like other cyclical recoveries in that the pattern of growth has not been smooth. We had an initial sharp advance in the summer and fall of 1975 as the massive inventory liquidation of early 1975 all but came to a halt. During the fourth quarter of 1975 there was a brief shift back to fast decumulation. As a result the growth rate of real GNP diminished to 3.3 percent. You will recall at that time that press reports frequently expressed doubts as to the strength of the economy in 1976. Our own projection last year of a 6.2 percent growth rate for 1976 was widely doubted. Then in the first quater of 1976 the growth rate shot up to 9.2 percent as modest inventory rebuilding replaced inventory liquidation. At that time fears were raised that the boom might have gotten out of hand and that capacity shortages would be realized in the near future. But then inventory behavior stabilized again and the rate of growth in the second and third quarters of this year fell to 4¼ percent. The growth in final sales over the whole period has been much steadier. Final sales grew at a 4.3 percent annual rate in the past two quarters, not much below the 4.6 percent rate of the proceeding four quarters.

Despite the fact that it is typical for the pattern of recoveries to be jagged, there has again been considerable consternation—that the recovery may be in danger. Much publicity has been given to the fact that the slower growth phase in economic activity has now continued for half a year. The third quarter growth rate in real GNP was only 4.0 percent—somewhat below our mid-year projections and significantly below the growth in earlier quarters. The unemployment rate has risen from 7.3 percent in May to 7.9 percent in August and remained at that level in October. Moreover industrial production has declined in the last two months and the index of leading indicators declined in each of the past 2 months. These recent reports have led many to question whether the economic recovery is in trouble and if sustained expansion is possible over the remainder of this year and into the next.

I would like to spend most of my time today discussing these recent doubts. In the process, I will describe the economic outlook as we see it for next year.

We believe that the recent slowdown is neither unusual nor permanent. While we are disappointed by the continuation of sluggishness in the economy, we are convinced that a reacceleration of economic growth will soon be underway.

Our optimism is based on an expectation of an acceleration in consumption expenditures, a very sharp pick-up in business fixed investment and strong increases in residential construction. Let me discuss each of these elements in turn.

Monthly data on consumption indicate a leveling in real terms since late spring that surprised nearly all forecasters. Auto purchases stagnated in part because of shortages of preferred models, the strike at Ford Motor and consumer resistance to price increases. Moreover, sales of nondurables—particularly apparel and shoes appear to have been very sensitive to price increases. At the same time the rise in real disposable income shrank to less than a 1½ percent annual rate, largely because of declining farm net income. With auto shortages disappearing coupled with price decreases or rebates likely to boost auto sales and with real disposable income growth expected to pick up, the recent slowdown in consumer spending is not likely to persist. We believe that consumption will soon resume its growth and help sustain the economic expansion in coming quarters.

Business fixed investment has grown at a relatively modest 7.9 percent rate so far this year but appears to be set for substantially larger increases in the months ahead. Indeed investment in plant and equipment will provide a major source of strength for the expansion in 1977 and should make up for more modest increases expected in inventory investment. For some time now the fundamental factors supporting business investment have been highly favorable. Final sales have been rising. Business profitability and cash flow have improved substantially. Profits will be up about 30 percent this year and we project a further 15 percent increase next year. Equity and bond markets are more favorable for financing and business balance sheets have been materially strengthened. More recently, the leading indicators of business investment spending have shown significant increases. New orders for nondefense capital goods rose 7.7 percent during the second quarter. The monthly figures have been quite volatile in July and August—rising sharply in July but falling about the same amount in August. This August drop helped push the leading indicators down. Still the average for July and August is 11½ percent above the average during the first half of the year. Moreover, the September figures showed a strong gain over August. This is indicative of a strong rise of investment in the next four quarters. Our optimism is confirmed by the Conference Board data on new capital appropriations by manufacturers in the second quarter, which rose 13.2 percent, and by the value of plant and equipment projects started by manufacturers last quarter, which rose 13 percent by the second quarter from their low in the third quarter of last year. Moreover, the McGraw-Hill survey projects a 13 percent increase in business plans for capital spending next year. This survey usually undertakes investment spending in years of expansion. Thus, a healthy increase in business fixed investment over the coming quarters seems assured.

Housing is another area from which we expect substantial strength. The recovery in the housing sector now looks particularly strong and this in turn will have favorable influences on other sectors of the economy. During the third quarter the housing recovery accelerated sharply as the 11 percent increase in total starts in August was followed by an even healthier 18 percent increase in September to a level of 1.81 million units. The average level of starts during the third quarter was 1.58 million units, a 10 percent increase over the second quarter as compared with an average 2 percent increase in the first two quarters of the year.

The very high September figure does not appear to be a one-shot aberration. Permits plus starts outside permit issuing places reached a level of 1.82 million units in September, slightly greater than total starts in that month, and thus an indication that high levels of starts are likely to be sustained in the months ahead. Moreover, Federal assistance programs will continue to support multifamily starts in the year ahead. Financial developments have also been encouraging for the housing recovery as both short-term and long-term interest rates have been declining. The yield on new home mortgages in the secondary market (FHA) fell for the third consecutive month in October to 8.82 percent. Moreover, funds for mortgages are readily available and this should encourage further building.

Thus, there is no reason to doubt the underlying durability of the recovery. Consumption should show substantial gains, and residential construction should continue its sharp recovery from the low levels of 1974. Even without any additional fiscal stimulus, the quarterly pattern of real growth should expand to a 5 percent rate in 1977.

I think it is important to note that there is no indication of any of the imbalances which normally portend a future weakening in the economy. While there has been a bit of unwanted inventory accumulation in some nondurable goods sectors, inventories overall are not high—they are low in relation to production and sales. Moderate further growth in inventory accumulation can occur without an increase in inventory to sales ratios. Consumers have not been on a spending binge, their balance sheets have been substantially repaired, and gains in consumer confidence have recently been registered according to the University of Michigan survey. Retrenchment by consumers and businessmen under these conditions is not likely. Indeed, the very caution of businessmen and consumers is a healthy sign for the durability of the recovery. By keeping the economy from overheating, their actions help contain inflation which has been proceeding this year at only a 5 percent rate, allow time for capital spending projects to expand capacity and retard the emergence of new imbalances. Thus, I believe the current pause is not the precursor of a period of economic stagnation but should soon be followed by a reacceleration of economic activity.

Let me turn finally to the question of government spending which has received much attention in the press and to the issue of policies for next year. Federal government expenditures in the last two quarters were below budgeted levels, and this "shortfall" has been viewed as the culprit responsible for the slowdown in real growth. It is important first to state that the magnitude of the shortfall has been greatly exaggerated in the press. In the first place, part of the discrepancy which appeared in the second quarter was added during the mid-year budget review to spending estimates for the third quarter and thus were in effect counted twice. This double-counting inflated the estimate shortfall by about $4 million over the past two quarters. Secondly, the figures quoted in the press relate to the Unified budget, whose numbers are affected by purely financial transactions which do not affect the current level of real activity. For example, sales of offshore oil-land leases in the third quarter were $800 million higher than expected and HUD sold an unanticipated $900 million of mortgages from its portfolio. Both transactions show up as a lower level of outlays on a unified basis, but neither has any direct affect on GNP because they are simply financial transactions representing transfers of assets.

Briefly, the facts on the shortfall are these. In the National Income Accounts budget—the budget which shows the impact of the Government sector on the economy—Federal spending in the second quarter was $3.2 billion below the January estimate (quarterly rate); for fiscal 1976 as a whole, actual expenditures were about $3.8 billion below target. In the third quarter, spending was actually $.4 billion above the original estimate made in January.

While a proper accounting shows that the underestimate of Federal spending was relatively modest and is well within the normal statistical margin of error, it *was* concentrated in the second quarter.

Moreover, the NIA budget may understate the full impact of the budget on the economy since defense expenditures are included in NIA totals only when the final payment is made. During 1976 there have been substantial shortfalls in defense obligations which have a more immediate impact on the economy. When this is combined with the unusually sluggish growth in State and local spending earlier this year, there was an unplanned net reduction on the stimulative impact of the Government sector on the economy—particularly in the second quarter—and this may well have contributed to the slowdown of the expansion.

The question now is what should be the appropriate policy response—if anything—to insure that the expansion returns to a path of faster growth. Federal spending already appears to have returned to its targeted level in the third quarter. We also expect spending by State and local governments to pick up noticeably in the future, in view of the improvement in their financial situation. Thus all signs indicate that the Government sector will be exerting a more expansive impact on the economy over the next two or three quarters.

Nevertheless, it is clear that fiscal policies must be designed to provide sufficient stimulus to the economy so that real growth can proceed at a fast enough rate to reduce the margin of excess capacity in the economy and to lower the unemployment rate to acceptable levels. Thus, a tax cut such as the additional $10 billion tax reduction originally proposed by President Ford in last year's budget must certainly be considered.

In designing fiscal policies for the period ahead, however, two factors should be kept clearly in mind. First, excessive fiscal stimulus must be avoided. Overly expansive fiscal policies which threaten to intensify inflationary expectations and fears of new instability could prove counterproductive by causing both consumers and businessmen to cut back on spending plans. Secondly, the type of fiscal measures chosen must be consistent with the need to stimulate investment as well as consumption. A major reason for the sluggishness of the economy is that major long-term investments by corporations in plant and equipment have been disappointingly slow. Over the longer run, substantial increases in business fixed investment are essential if we are to have enough factories and tools to employ all those who seek work and if we are to encourage the kind of productivity increases necessary to increase real living standards and to provide adequate supplies of goods and services over the longer term. The encouragement of investment is thus an essential step in the control of inflation and in returning our economy to a path of stable growth.