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THE U.S. ECONOMIC OUTLOOK IN WORLD PERSPECTIVE

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I'm delighted to be here this morning to talk with you briefly about the outlook for economic activity in the United States.

I'd like to begin by reviewing some of the things that have been happening in the U.S. economy during the course of 1977 by way of providing a backdrop for probable developments next year. We got off to a very fast start this year in terms of the growth rate of economic activity. During the first half, our real gross national product increased at an annual rate of 6¾ percent. That large increase reflected, in part, a rise in inventory investment from a very low level at the close of 1976 to approximately a normal level in relation to gross national product by the middle of this year. That source of stimulus is of necessity of a temporary character. Therefore, some slowdown in the pace of growth appeared to almost all forecasters inevitable.

The actual slowdown that has occurred, however, has exceeded our expectations in terms of both duration and magnitude. During the third quarter, the real gross national product increased at a rate of only 3.8 percent, a rate of growth approximately in line with our long-run potential. This slowdown in the rate of expansion was reflected in a number of other measures as well. For example, during the 3 months from June to September, industrial production in our country went up at an annual rate of approximately 3 percent. That compares with a rate of increase from December to June of approximately 7 percent. And the unemployment rate has been approximately flat at 7 percent since last April. Our economy has been growing fast enough to keep the unemployment rate from rising and absorb new entrants into the labor force, but not enough to make progress of the kind we want in getting the unemployment rate down.

What, besides the slowdown in inventory investment, explains why our economy has been behaving relatively sluggishly recently? I think there are several elements. First, the pace of consumer spending has been relatively sluggish since the first quarter. In real terms, personal consumption expenditures have gone up much less than disposable income. Or to put it another way, the rate of personal savings relative to disposable income has risen quite sharply.

This would be a worrisome development if it reflected a basic weakening of consumer spending propensities. Fortunately, however, this does not appear to be the case. For example, attitudinal surveys taken by the Michigan Survey Research Center or the Conference Board indicate that consumer attitudes have deteriorated a little during the course of the spring and the summer but indices of confidence are about as high this fall as they were last spring. And the expansion of consumer installment credit and the pace of housing and auto sales confirm that consumers are still buying durable goods relatively freely. They are still increasing their purchases of homes. They are still expanding their installment debts.

What then accounts for the rise in the personal savings rate and the associated slowdown in consumer spending? It is mainly the fact that during the first 2 years of the recovery the savings rate went down to unusually low levels. It was driven down even further by special factors during the first quarter of this year, such as the cold weather which generated large fuel bills. During that quarter, the rate of personal savings relative to disposable income was just barely over 4 percent, the lowest figure for any quarter since 1951. Some rebound in that savings rate was therefore inevitable. Consumer spending simply had to slow down.

A second factor in the sluggish pace of economic activity has been the response of businesses to the weakening pace of consumer spending. In the past, businesses typically have waited awhile to appraise new developing trends in consumer spending rather than reacting immediately. Consequently, a reduced pace of consumer spending has typically been reflected in a rise in the rate of inventory investment—which has tended to buffer rates of production and the level of employment from the effects of changes in the pace of consumer spending. That did not happen last year when consumer spending slowed. And it did not happen again this year. Businesses are pursuing extremely cautious inventory policies and they have begun to make their adjustments in production immediately upon perceiving some change in the pace of consumer spending. This has some good aspects and some bad aspects. The bad aspects are that changes in the pace of consumer spending are reflected strongly and quickly in production, and therefore, in employment, in consumer incomes, and in buying power. This tends to magnify the initial response of consumer spending.

The good aspect is that businesses this year, as last, have kept their inventory-to-sales ratios in good order. An undesired buildup of inventories has not occurred. Inventories are still relatively lean so that when a pickup in consumer spending begins again, one may anticipate that, as we saw in the late months of 1976, a prompt rise in production and employment in response to the improved pace of consumer sales.

A third factor in the relatively disappointing performance of our economy in the past couple of quarters has been the continuing drag exerted by our foreign trade position. In the third quarter of 1976, we enjoyed a surplus of net exports of goods and services of about $8 billion. By the third quarter of this year, our trade position had switched markedly. Net exports of goods and services, as we measure them in the gross national product accounts, were in deficit to the extent of about $12 billion. That switch from an $8 billion surplus to a $12 billion deficit is a drain of $20 billion of income that goes abroad. It acts, in effect, like an increase in taxes of $20 billion in terms of its effects on consumer purchasing power.

The reasons for this continued movement towards deficit of our international trade position are quite well known. A major factor is that oil imports are still very large. Another important factor, however, has been the very sluggish pace of our exports, reflecting the disappointing recovery abroad. In general, most industrialized countries have experienced even greater disappointment this year with the performance of their economies than we have. In particular, the pace of business investment has been sluggish worldwide and since we tend to be a heavy exporter of capital goods, that has taken its toll on our export position.

A fourth factor in the performance of the economy this year has been some weakening in the rise of business investment. For example, between the second and third quarters, production of business equipment rose at an annual rate of only about 7 percent. That's about half the rate of increase that occurred from the fourth quarter of 1976 to the second quarter of this year.

More worrisome even than the slowdown in the actual pace of business fixed investment has been some evidence that perhaps businesses are planning more cautiously for the future than they were earlier this year. Orders for nondefense capital goods have been behaving erratically in recent months but on balance they were a little lower in the third quarter of this year, in current dollar terms, than they were in the second quarter. In real terms—after adjusting for price changes—orders were down significantly. Moreover, private surveys of businesss spending plans for next year suggest that the rise in business fixed investment outlays during 1978 might be somewhat smaller than it was in 1977.

Reasons for this hesitancy in the prospective pace of business fixed investment are not fully evident. It may be that businesses are uncertain because of the delay of congressional passage of the energy program, particularly those businesses whose investments are critically related to the energy package. It maybe, also, that businesses have become more cautious because they fear the recovery could be faltering given the slowdown in the pace of consumer spending. If those two factors are important, one can make a reasonable case that the hesitancy in business fixed investment planning is more likely to reflect delays or postponement of spending programs than cancellations. That would suggest that we are likely to see some renewed strength building up over the course of 1978.

We, at the Council of Economic Advisers, are still reasonably confident that activity is going to pick up soon and that a better growth rate of economic activity will emerge in statistics of the fourth quarter, for a number of reasons.

First, the stimulus programs, introduced earlier this year by the administration and passed by the Congress, are gathering strength. They will be building up to peak force in the early part of 1978. They are gathering momentum now, will be adding to disposable income in the future, and will help to strengthen the growth of employment and consumer purchasing power.

Second, other governmental expenditures are also rising, particularly defense purchases. The advance indicators of defense purchases began to show strength around the middle of 1976. Actual purchases by the Federal Government began to rise in the second quarter; they showed another good growth in the third quarter, and we anticipate further expansion in the quarters ahead. The Federal pay raise is also adding sizably to disposable income this fall.

Third, the personal saving rate has risen a good deal from its low point at the first of this year. It's now back to a more normal level so that we can reasonably expect that as disposable income rises, personal consumption expenditures will begin to move up again. And with inventories relatively lean, we should see translation of rising consumer spending into increases in production and employment relatively soon.

We can't be sure when the pickup will occur, but recent monthly statistics are consistent with the view that an upturn is fairly close at hand. New orders for durable goods have been rising more strongly recently. The aggregate of hours worked began to move up in September and continued to rise in October. The most heartening sign is that recent figures on retail sales indicate a strengthening trend during the course of the summer months in consumer spending. October retail sales figures were released yesterday. They showed that in the month of October, we had an increase about 1¾ percent in total retail sales. From June to October, retail sales rose 12 percent at an annual rate. After allowance for the probable rise of prices, retail sales advanced 5 to 6 percent, a much stronger rate than we have seen since March.

Let me talk just a little bit about price developments thus far in 1977 and then turn to the outlook for 1978. We've had some rather wide variations in the rate of price increase overall this year, but they have been largely due to developments affecting food prices. I would be carrying coals to Newcastle if I tried to tell this group what's been happening to food prices and why, and so I won't try. But let me mention that the food price situation has been extremely important in terms of the overall behavior of the price indexes. For example, the total of consumer prices during the first half of this year rose at an annual rate of 9 percent, but during the third quarter, with food prices at retail rising much more moderately, the consumer price index overall rose at an annual rate of only 4 percent. Not all of that improvement was due to food prices, but a good part of it was. We did, fortunately, see some moderation in components of consumer prices other than food—nonfood commodities and, to some degree, services.

Abstracting from the volatile movements of food and energy prices, however, the underlying inflation rate this year is still hanging in the 6 to 6½ percent range. For example, in September consumer prices excluding food and fuel were 6.1 percent above the year earlier figure. And wholesale prices of industrial commodities, excluding energy items, were 5.9 percent higher in October than a year earlier.

Wage rate increases have also remained about where they were a year ago—at about 7 percent. Nonwage labor costs have been rising somewhat faster than wage rates, so that total compensation per hour worked is rising in the range of 8 to 8½ percent. That means with long-term growth of productivity around 2 percent, the underlying trend of industrial costs is in the 6 to 6½ percent range.

That, of course, is our underlying rate of inflation—6 to 6½ percent. And it has remained there for the past 2 years. There's been no material change in that rate since the middle of 1975. Inability to make progress in reducing the underlying rate of inflation has been a major disappointment. But, at least one can say that the rate is unlikely to change in the near future. In all probability, 1978 will witness a continuation of an underlying rate of inflation in the range of 6 to 6½ percent.

Let me just turn briefly to the outlook for 1978. The last official forecast put out by the administration was released in July. We will not release another official forecast until the one that accompanies the fiscal 1979 budget in January. But our tentative thinking at the Council of Economic Advisers is that we should be able to achieve a real growth rate of somewhere in the range of 4½ to 5 percent for 1978, measured year over year. Such a growth rate, we believe, could be achieved with no new fiscal stimulants other than what the administration has announced up to this time. That would still mean a sizable increase in Federal spending between fiscal year 1977 and fiscal 1978.

The current projection of Federal outlays for fiscal 1978 implies a rise in total outlays of between 13 and 14 percent. A large part of that increase reflects the stimulus programs introduced earlier in 1977, and they will be reaching their maximum potential for stimulating the economy during the first half of calendar 1978. Thereafter, the thrust from those programs will be leveling out.

Our expectations of a 4½ to 5 percent growth rate also assume a relatively accommodative monetary policy. We recognize that short-term interest rates may rise somewhat further, but we anticipate a relatively moderate rise. And if that moderate rise occurs, long-term interest rates will probably remain relatively stable as long as the rate of inflation stays well behaved.

Let me talk just briefly about some of the major sectors of the economy and what we might expect from them during the course of 1978—beginning first with those from which we cannot realistically expect much stimulus.

Consumer spending is, of course, the largest element of our gross national product. Consumers led the recovery for the first 2 years. We can't expect that to continue. The savings rate, though higher than it was at the beginning of this year, is still below what one might consider to be a normal rate. It's at about 5½ percent. A normal rate would be in the range of 6 percent or so. We anticipate, therefore, the possibility of some further rise in the saving rate, so that personal consumption expenditures probably will grow a little less rapidly than disposable income. A rise in real consumer spending in the range of 4 to 4½ percent seems reasonable.

The housing industry has also been a major source of stimulus during the past couple of years. We can't expect that to continue. Single family starts have surpassed earlier peaks, backlogs of demand have been filled, prices of houses are rising very rapidly, interest rates have also moved up somewhat. We probably will see a moderate further rise in residential construction in the next several quarters, but the thrust from that sector will diminish as 1978 goes on.

For net exports, fortunately, we do not expect the drag to continue. We do not expect our net export balance to worsen, but we expect it to remain at somewhere around the 1977 level. We'll probably not see much rise in our oil imports next year. We don't have to rebuild stocks as we did this year following a cold winter. We do have some Alaskan oil production coming in. But, unfortunately, the outlook for our nonagricultural exports is still not very favorable. A number of industrial countries abroad have announced stimulative actions that are likely to result in an improvement in activity during 1978 (relative to 1977), but it will be some time yet before a capital goods boom develops around the industrial world that would give real life to our exports.

The sectors from which we can expect stimulus next year are two in number. First, governmental spending and second, business fixed investment. For governmental spending, as I indicated, the stimulus programs will be building up. Also, State and local government finances are in better shape now than they were a year or two ago. We would anticipate a rise of governmental spending next year somewhere between 5 and 6 percent in real terms.

If we're going to get the kind of growth we want, however, we've got to have a very strong rise in business fixed investment. Business capital outlays will need to rise somewhere in the range of 7 to 9 percent in real terms in 1978 to achieve the increase of 4½ to 5 percent in real gross national product that we're looking for.

Until the signs of hesitancy that I mentioned earlier became evident, a growth rate of 7 to 9 percent in real business fixed investment looked quite feasible. After all, profits had been rising through the recovery, the financial condition of businesses was and still is quite strong, and rates of capacity utilization have now risen to a point where in the past that had signaled to businesses the need to begin expanding their investment planning. A growth rate of 7 to 9 percent still seems realizable if some of the uncertainties we've seen recently begin to disappear, as we think they will. One helpful factor, I believe, will be the fact that the President will announce at some time fairly soon, after the energy program and Social Security programs have gone through Congress, a tax package that will help to strengthen business fixed investment. Whether or not there will be any direct investment incentives in such a package, such as an increase in the investment tax credit or some accelerated depreciation, is not clear. What is clear is that there will be measures that will be helpful in terms of business fixed investment.

Our view of the outlook for 1978 at the Council of Economic Advisers is a fairly positive one. We see no major imbalances in the recovery process to date. We believe that financial markets, though they are somewhat tighter than they were last spring, remain basically conducive to recovery. With inflation not likely to accelerate, some of the fears of a renewed inflationary outbreak have been allayed. We see no bottlenecks or shortage problems likely to develop to inhibit recovery. And so we think recovery should continue at a reasonably good pace next year.

We recognize, however, that others are somewhat less optimistic than we are. In particular, some forecasters are concerned about the possibility that the pace of economic expansion may slow as 1978 unfolds to an unacceptably low rate by the end of the year.

The administration is cognizant of this potential problem. Over the next few months, the outlook for 1978 will be reassessed. If it appears that we are not moving up during the fourth quarter with the vigor we anticipate, or that the outlook for capital spending is weaker than we think it will be, additional fiscal actions may be needed to reach our growth objectives for next year. Those actions could be most readily incorporated into the President's budget for fiscal year 1979.