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THE 1970 ECONOMIC OUTLOOK

THE ADMINISTRATION'S FORECAST

A 1970 economic forecast is put forward in the recent Economic Report as follows:

- current price GNP, $985 billion, up 5.7 percent from 1969;

- real GNP apparently up about 1.3 percent; little or no growth in the first half of the year, but expansion resumed in the second half and the path of "potential GNP" regained in 1972, at the latest; in any case, "no recession" in 1970;

- unemployment rising in the first half of 1970, presumably to a rate between 4.0 and 4.5 percent, but dropping in 1971 to the 3.8 percent implicit in potential GNP;

- a price level increase (GNP deflator) of 4.2 percent apparently implied for 1970, as compared with 4.7 in 1969, but the inflation rate "substantially lower" at the end of 1970 than at the end of 1969.

In many respects, the most interesting feature of this forecast is the belief that the inflation rate can be lowered substantially without an actual decline in output and thus without recession. In turn, this is based on the belief that a gap between actual and potential GNP -- which appeared in the fourth quarter of 1969 and is destined to become larger in the first half of 1970 and to continue into 1971 -- will supply the necessary deflationary effect. As the Economic Report puts it, "the exact timing and degree of expansion that would be consistent with a significant reduction in inflation in 1970 are uncertain," but "the growth of GNP has already been slowed to a rate ... which is lower than needs to be sustained for long in order to achieve significant disinflation." (pages 58-59). As we now know, GNP revisions completed subsequent to the publication of the Economic Report yield a small drop in 1969's fourth quarter.

<u>WILL A GAP BETWEEN ACTUAL GNP THAT IS FLAT OR SLOWLY RISING AND STEADILY AND STRONGLY RISING POTENTIAL GNP LOWER THE INFLATION RATE SUFFICIENTLY FOR STABILIZATION PURPOSES?</u>

There are two principal bases for skepticism regarding this prognosis, of which the first has to do with the possibility of overcoming inflation, not as a result of a significant decline in output, but because a gap develops between actual production and hypothetical potential output. These doubts may be summarized as follows:

(1) A comparison extending back to the early fifties of GNP gaps with price level changes shows that the larger the gap the lower the rate of price inflation, but that large changes in the gap have been associated at times with relatively small changes in the inflation rate, even with a one-year lag in the latter. In short, there is a deflationary impact arising from a gap but it typically takes considerable time to work itself out.

(2) Furthermore, the GNP gap projected for 1970 in the official forecast is

small relative to the one which, in the fifties, was associated with a significant drop in price inflation. The GNP deflator was reduced from 3.9 percent in 1957 to 1.3 percent in 1961 in a context in which the GNP gap averaged 8 percent for four years, 1958 through 1961 inclusive. The projected 1970 gap, on the other hand, is only 4 percent, and narrows after one year.

(3) The gap in the second half of the fifties was accompanied by a lower rate of increase of the money supply than is likely in the present case. Thus, from December 1956 through 1969 the money supply (narrowly defined) increased only 0.8 percent a year on the average. Although the CEA is wisely noncommittal about what money supply figure would yield the needed deflation in 1970, it is doubtful that a rate as low as 0.8 percent is contemplated.

(4) Although the increase of federal expenditures projected for fiscal 1971 (1.5 percent) is more limiting than those that characterized the late fifties (7 percent a year, on the average, in fiscal years 1957 through 1960), the fiscal 1971 figure is more likely to be above than below the budget proposal.

(5) There was much discussion in the late fifties of the inevitability of price increases, but the inflation psychology is more deeply rooted now than it was then, and to eliminate it would seem to require less difference between gaps then and gaps now than the official GNP forecast suggests there will be.

(6) In order to achieve the price level objectives of the Administration's strategy it will be necessary to reduce annual labor cost increases by about 2 percentage points. Although this cannot be rejected as a possibility (e.g., the increase of average hourly earnings dropped from 5 percent in 1957 to under 3.5 percent in 1958-60), it will not be easily achieved because of the level and momentum of current increases and the relatively small increase in unemployment that appears to be contemplated.

QUESTION: RECESSION - YES OR NO?

The second basis for skepticism regarding a 1970 "no recession" forecast has to do with the possibility of holding the present trend to a pause and preventing it from becoming a downturn. Without ruling out the possibility of avoiding recession -- and I do not rule it out -- it must be conceded that pauses, i.e., periods of zero or negligible change in real output, are rare events in GNP history. Typically, the dynamics of the economy transform a pause rather quickly either into an actual decline or, if circumstances are right and the policy response is appropriate, into a resumed advance.

Whether the present episode will qualify as a pause will depend in part on how the fourth quarter of 1969 is interpreted, but if it is taken as substantially flat except for the effect of the GE strike, and if we accept as a virtual certainty, as I do, that aggregate physical output will be down in the first quarter of 1970, then the question becomes what will happen in the second quarter of this year. It is this point which, in my judgment, is still an open question.

It must be acknowledged that there is a distinct possibility that the second quarter of 1970 as well as the first will be down, at least moderately, and that by the usual tests this will constitute a mild recession. For this view there is the following evidence:

(1) The leading indicators have been trending down, slowly but without interruption, since September and their diffusion indexes (at or close to 50) suggest further declines.

(2) Rates of change for all series, including the coincident indicators, have dropped from strong plus to zero and in December were on the brink of turning negative. Unless this trend is quickly reversed, which is unlikely, a rash of negative numbers will appear in February and March, supplementing those already registered in December and January.

(3) Anticipations data are uniformly negative, in some cases strongly so, and project rather sharp drops in new orders, sales, <u>etc</u>., in the first half of 1970.

(4) With the leading indicators sending up recession signals, it is a simple matter, jointly with other clues, to put together a GNP model that involves declines in the second as well as in the first quarter of 1970. The following assumptions (which can be judged independently for their reasonableness or unreasonableness) are consistent with such a result: a) federal purchases of goods and services as projected in the Economic Report; b) state and local government purchases that rise $10 billion in 1970, as compared with $12 billion in 1969; c) a 5 percent rise in plant and equipment expenditures for 1970 as a whole, with a flat trend in the second half but no downturn; d) housing starts of 1,340,000 for the year, with an upturn in the second half, following a low point reached in the second quarter; d) inventory accumulation that drops to $3 billion in IIQ70, from $7.8 billion in IVQ69, but which does not turn negative as in 1960-61; f) personal consumption expenditures up 5 percent, with increases of 8.2 percent for services and 4.8 percent for nondurables but with a drop of 2.6 percent for durables; and g) total GNP, in current prices, of about $970 billion, possibly a bit less.

A current price GNP estimate of $970 billion for 1970 would almost certainly imply recession, and clearly so if the rate of increase of prices were to slow by only one full percentage point, that is, to 3.7 percent from 4.7 percent in 1969. But a first half downturn of recession-like proportions would also seem involved even if the rate of increase of the GNP deflator is assumed to drop to an annual rate of 2.5 percent by the end of the year.

There is a possibility, however, that the 1970 GNP figure may turn out much closer to the $985 projected by the Council, in which case the chances of averting recession are fairly good. Supporting this possibility we have the following two points:

(1) A close comparison of the behavior of the indicators in 1969 with their behavior in the months preceding downturns in 1957 and 1960 suggests that it is a mild cyclical pattern that is emerging, specifically that it may be more like 1960-61 than 1957-58, and less severe even than the former. If this is the case, a bottoming-out would occur in the late spring or early summer of 1970, and a second quarter downturn in output could be avoided. On the other hand, if the 1957-58 pattern obtains, the low point of the cycle would not come until fall 1970 and, being later as well as deeper at the trough, would be clearly inconsistent with the avoidance of recession. To date, however, the indications are that the 1960-61 pattern, or something less than that, will prevail.

(2) It seems to me still possible, however, to avert a second quarter downturn, in any case to hold output flat, by an early easing of monetary policy. Although the monetarists were saying last fall that it was too late to avoid recession, there is still a fair chance of doing so. It must be conceded, however, that time is running out and the inflation situation precludes a vigorous move toward ease, in any case.

TWO POSSIBILITIES: MILD RECESSION OR RECESSION BARELY AVOIDED; IMPLICATIONS FOR INFLATION, INTEREST RATES AND STOCK PRICES

What this comes to is that it is still an open question whether the outcome will be (i) mild recession or (ii) a recession barely avoided. To this observer, the odds have seemed about 50-50, and that is still the case. What remains is to consider certain implications of these two possible GNP paths.

FIRST, in either case, there is sure to be an increasingly adverse effect on corporate pretax profits. An estimate of profits of $85 billion for 1970 is consistent with a $970 GNP but in some analyses the number is put lower, approaching $82.5 billion. In any case, a corporate pretax profit projection of $89 billion, as in the fiscal 1971 budget, seems definitely on the high side.

SECOND, some reduction of borrowing costs seems likely in either event and would be greater, of course, in the recession pattern than if recession is avoided. However, there are grounds for believing that the decline in longterm bond yields would not be more than two full percentage points.

THIRD, it will not be easy for the stock market to digest the sag in corporate profits already alluded to, or the generally adverse economic news certain to be forthcoming in the period ahead, but if the economy is to reach a cyclical trough before mid-1970, or is to demonstrate in advance that recession is being avoided, and if a shift to a less restrictive credit policy becomes evident well before midyear, then it follows that stock prices are very likely now at or close to their bottom. It would be my judgment that they are close to a low point, if not already there, but the present and prospective condition of the economy -- in particular the continuance of some degree of inflation -- precludes an early return to a buoyant stock market.

FOURTH and finally, whether the economy passes through recession in 1970 or avoids it can have a crucial and possibly long-lasting effect on growth. It is quite possible, as argued above, that a shift toward less restrictive monetary and credit policies would avoid recession, at least for the time being, but it would also mean less progress in overcoming inflation than would be possible if money policy were continued for an additional period at its present tightness. Accordingly, relaxation now would mean less assurance of gaining the posture of price stability essential to vigorous growth. On the other hand, although a continuation of restraints as they are would lower growth in the nearterm and raise the risk of recession, the greater and more secure reduction of the inflation rate which it would almost certainly produce would significantly improve the economy's chances of achieving vigorous, inflation-free growth over the longer term. Basically, what it comes down to is not a choice between inflation and growth, because premature relaxation of monetary restraints could prolong inflation without any lasting improvement in growth prospects, but a choice between reduced growth in the nearterm and a chance -- in an inflation-free atmosphere -- to enjoy vigorous growth over the longer term.