The Shape of the Recovery

with Charles J. Haulk

With the worst of the recession apparently behind us, business analysts are turning their attention to the recovery. In this interview (conducted in August), Business Economist Charles J. Haulk comments on the prevailing government forecast for the upcoming year and explains why he thinks the recovery could be sluggish after a strong start.

Q **Do Congress and the Administration agree on what to expect from the economy in 1980-81?**

A Basically, they both see the recession ending before the end of 1980 and a return to fairly even growth through 1981. The Administration's midyear outlook calls for real GNP, which was expected to fall at a 3-percent rate in the last half of 1980, to grow at 2.6 percent from fourth quarter 1980 to fourth quarter 1981. Unemployment is expected to rise to 8.5 percent by the fourth quarter of 1980 and stay there for the next year. Inflation, as measured by the GNP deflator, is expected to remain in the 9-percent range. The Congressional Budget Office in its July forecast sees the economy much the same as does the Administration, although it puts wider ranges on values of the forecast variables. The CBO sees unemployment rising to as high as 9.4 percent in 1981, for example.

Q **Do you see any factors which could make the recovery differ from the consensus view?**

A Yes. To begin with, it appears that the recession has been confined primarily to autos and housing and related industries. Seventy-five percent of the GNP drop in the second quarter was attributable to residential construction and consumer durable outlays, a very large portion of which was in auto sales. Car sales, domestic and imported, plunged after the credit tightening and credit restraint program in March. Changes in inventories

were small in real terms in the second quarter, contrary to most expectations. The export sector and government spending showed small growth.

The government's mid-year forecast (Chart 1) shows a substantial real GNP drop in the third quarter and a small decline in real GNP in the fourth quarter, with the recession ending before the quarter is over and then a return to fairly even growth throughout 1981.

My alternative scenario, depicted by the green bars, calls for a rebound of fairly strong dimensions in the fourth quarter, maybe 4 percent or higher. After the fourth quarter, the strength of the recovery weakens as monetary restraint drives interest rates higher very quickly due to fears of rekindled inflation and tightening credit markets. Unemployment rates in the 8-percent range will likely not subdue growth in compensation or unit labor costs quickly enough to change expectations of inflation substantially.

Nineteen eighty-one's second half could be a period of very slow but positive growth, with unemployment not improving appreciably (Chart 2) and inflation showing very slight improvement by year-end (Chart 3). This scenario, or any other for that matter, depends on how soon the Federal Reserve is forced to rein in money growth, which depends, in turn, on whether there has been a shift in the demand for money and a recovery from that shift. If money growth is well above Federal Reserve targets in the third quarter, that probably means the economy is rebounding strongly and moving toward further growth in the fourth quarter. If money growth is tamer, I think interest rates could remain steady at or slightly below current levels, which appear to be low enough to continue encouraging recovery, so either way the next few months look good for real activity. The only exception would be if money growth is so fast that a run-up in short rates of 300-400 basis points occurred, putting the housing and durable goods sectors on the skids again, in which case the recovery would be forestalled before it proceeds very far. The same might hold if the Fed lowered its money growth targets in fear of too fast a recovery and a rekindling of inflation fears.

Chart 1
REAL GNP GROWTH

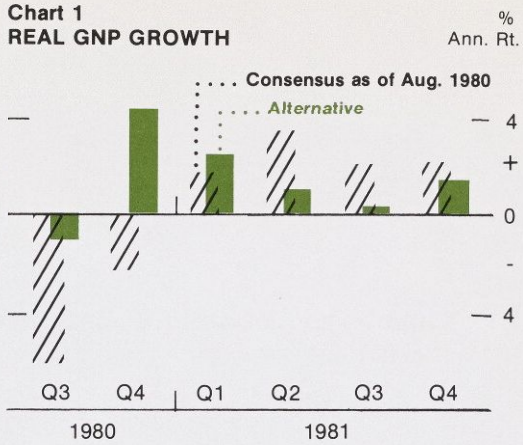


Chart 2
UNEMPLOYMENT RATE

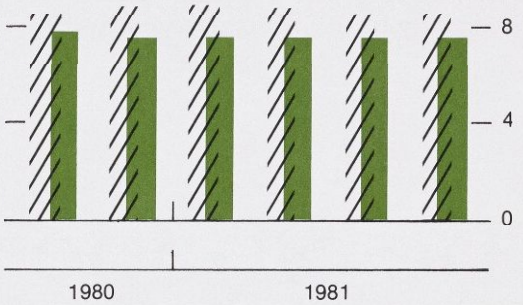
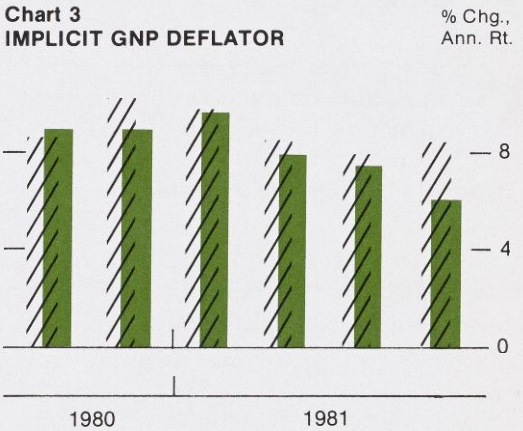


Chart 3
IMPLICIT GNP DEFLATOR



Q What is the rationale for your alternative scenario?

A My belief that there will be a sharp turnaround by the fourth quarter is predicated on two things. First, the history of recessions since the second World War is that, by and large, the downturn and the recovery tend approximately to be mirror images. The drop in real GNP in the second quarter was the largest absolute one-quarter decline and the second largest percentage drop in the history of modern GNP accounting, 34 billion 1972 dollars and 9.1 percent, respectively. A fast upturn is almost surely coming. Secondly, there are crucial changes in the structure and institutions of the economy which some econometric models have either discounted or ignored altogether and which have led to forecasting errors in recent years.

Q What effects do these structural changes have on the economy?

A Structural changes have created an economy which resists downturns and has great rebound capacity, but with a strong inflationary bias. First, there has been a decline in the share of manufacturing, particularly durables, in the nation's output and employment together with growth in the share of interest rate-*in*sensitive sectors, such as services and government. Second, because government participation in the economy leans toward protecting or creating jobs and maintaining spending power (unemployment compensation, trade adjustment compensation, new jobs programs, etc.), behavior of the private sector has been altered in a way which leads to expectations of monetary and fiscal stimulus at the first indication of unemployment rate increases.

These expectations of prompt stimulus have steadily pushed upward the unemployment rate at which inflation begins to slow and also have pushed higher the unemployment rate required to prompt reduced wage demands. This has led to an increase in the fraction of the labor force persistently out of work or underemployed. Third, the growth of the underground economy, which is predominantly service-oriented and, therefore, not interest rate-sensitive, creates additional recession resistance and recovery potential. These plus the cost of governmental regulations and other rigidities create a situation where inflation is harder and harder to contain.

The situation we face now and for the foreseeable future is an economy with sectoral hardship in a few areas but one with a lot of inherent overall strength. The problem is that, with each recovery, inflation gets worse.

Q **Do you see any particular developments which will definitely play a role in the recovery?**

A The hefty 14.7-percent increase in Social Security benefits boosted personal income in July. The savings rate, which had risen for one quarter, will likely not rise further. That means relatively strong consumption spending will return, especially in view of the elimination of credit controls.

New factory orders for durable goods, other than transportation, actually rose in June, and nondurable orders were about unchanged from May, indicating some turn-around in manufacturing may be coming by early fall. July durable goods orders rose by over $6 billion. Total labor force grew by 780,000 from April to July, a sign that people are still relatively optimistic about finding work.

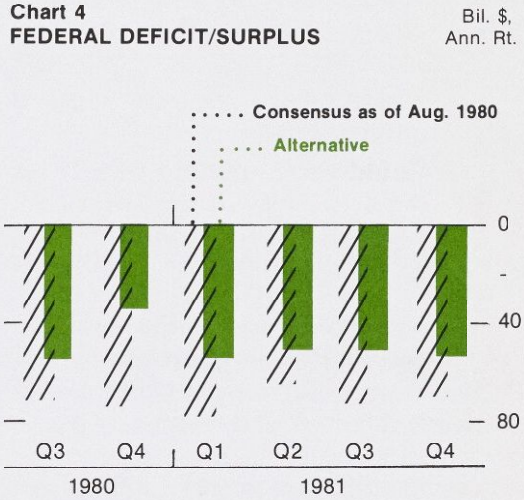
The pent-up demand for cars, combined with the new, small lines of domestic autos, should provide a much needed lift to the auto makers and their workers.

Q **This is an election year. How will fiscal policy affect the recovery?**

A The federal budget has moved steeply into deficit and should be acting to contain the recession. With a tax cut likely early next year, the Federal Government would remain stimulative unless substantial spending cuts were also forthcoming (Chart 4). With an election coming up in November, it is probably safe to say that there could be some surprises on the fiscal front, either before or after the election or both. It also seems safe to say that fiscal policy will remain stimulative for a while longer, although not as much as some would wish.

In any event, unless there are expectational effects following the November election that are strong enough to have an immediate impact on inflationary tendencies, 1981 does not appear to be a very robust year. We could go through another roller coaster year, with swings less turbulent than in 1980.

Chart 4
FEDERAL DEFICIT/SURPLUS



Q **Some people speak of a "full employment budget" being in surplus, thus making fiscal policy not stimulative at all. Apparently, you are unconvinced by this view.**

A There is a concept in the economics literature called the "full employment surplus or deficit" which calculates the federal deficit by estimating revenues that would be forthcoming if the economy were at full employment, currently defined at 5.1-percent unemployment. Those who accept the concept argue that we are currently restrictive with fiscal policy. My own opinion is that the concept of full employment is too arbitrarily defined and does not adequately take into account the reality that inflation now worsens long before a 5-percent unemployment rate is reached.

Q **In previous *Review* articles, you predicted the Southeast would fare better than the nation. What is the current outlook?**

A Most of the District has outperformed the nation during the recession, although high unemployment in Alabama and Tennessee brought overall unemployment in the District to 7.8 percent in July, equalling the national rate. The more favorable industry mix in the Southeast, the lack of overbuilding prior to the onset of recession, and special factors in Florida and Louisiana have kept the District as a whole in good shape. Barring a complete collapse of the national recovery, the Southeast should continue to outperform the nation throughout the remainder of 1980 and 1981.

Q **Could you comment further on the prospects for the longer term, especially with regard to inflation?**

A As I mentioned earlier, our economy has undergone several important changes which create a bias toward inflation and resistance to downturn. These developments create a particularly difficult situation for monetary policy. In order to decelerate inflation, the economy has to be slowed sufficiently to alter expectations and curb wage demands in the heavily unionized sectors, particularly durable goods manufacturing and construction. Unless progress can be made in reducing wage demands, then, overall demands must be restrained further to slow inflation.

With an economy inherently strong due to structural changes that have occurred, it becomes necessary to inflict ever more crushing burdens on durable goods, particularly autos and housing, to accomplish demand restraint sufficient to reduce inflation.

The longer term outlook for inflation will likely not improve substantially until the government's pro-employment, job and income protecting policies, and the government's influence on wage setting, are changed. ER