Diseases of Middle-Age

THE learned doctors who watch over the health of the business cycle are now looking rather quizzically at their ostensibly healthy middle-aged patient. One diagnosis is that the four-year-old expansion is showing signs of hypertension as a result of too many middle-aged excesses. A conflicting diagnosis is that the patient is slowing down with age. But a detailed examination may show that the patient—with the help of the modern economist's pharmacopoeia—is still bursting with good health.

The symptoms of hypertension, according to some diagnosticians, include the torrid pace of activity in industries such as autos and steel. Other symptoms include manpower pressures—for example, a continued decline in the unemployment rate (although it is still too high) and the lowest rate of insured unemployment in almost a decade. Then, again, there are price pressures—for example, an upward drift in the wholesale price index, amounting to about 1½ percent since last summer, and a rise in the brokers' loan rate from 4½ to 4¾ percent.

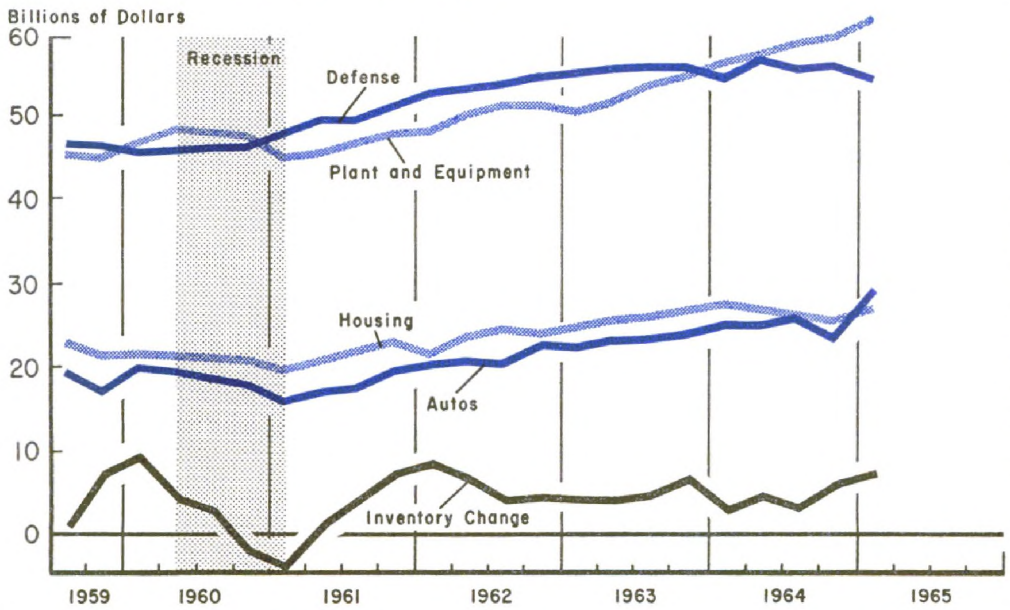
But some observers claim that the economy in future months will be plagued, not by hypertension, but rather by middle-aged sluggishness. They point, for instance, to the fact that new orders for durable goods leveled off during the first quarter of the year, and that sales during that period were somewhat artificially inflated—auto sales by makeup purchases and steel sales by strike-hedge buying. Developments of this type thus led the Council of Economic Advisers to warn against "assuming that continuing gains at the recent rate are assured."

Robust good health

The conflicting diagnoses were made against a backdrop of an extremely strong first-quarter performance. In that period, gross national product rose to $649 billion, at a seasonally adjusted annual rate. The quarterly rate of increase was $14½ billion — almost equal to the entire gain of the preceding two quarters and the strongest gain since early in the 1961-64 expansion.

Over the past half year or so, the strength of this middle-aged expansion has been concentrated in consumer durables buying and business fixed investment — both of which increased about 5 percent over the period — and in a sharp buildup in business inventories. During the same period, oth-

Hyperactive expansion stimulated by autos, inventories, capital goods



Source: Department of Commerce.

er consumer buying continued rising (as always), while residential construction rose about 2 percent from its 1964 low point. In the government sector, meanwhile, a drop of about 2 percent in Federal defense spending was offset by a comparable rise in state and local government expenditures.

The major questions about the continuing strength of this expansion center around those sectors that have recently shown the most ebullience. In the next several months, will the inventory buildup reach an unsustainable level, as auto dealers and steel manufacturers attempt to respond to their customers' exaggerated demands? In the next several quarters, will manufacturers' fixed investment continue rising in the event that their orderbooks lose some of their recent thickness?

Volatile once again

Consider, first, the short-term situation in inventories. This sector obviously will be much in the limelight in coming months. Until recently, this normally volatile component of the national economy has shown more moderate fluctuations and less perverse timing than in any other postwar expansion. More recently, however, there have been signs of the most rapid inventory buildup since the period following the 1959 steel strike.

In comparison with January-September 1964, when business inventories increased at a $3 billion annual rate, the buildup in the two succeeding quarters was at a $6 billion rate—and currently it may be even higher. The buildup has been based mostly upon three factors: strike-hedge buying by steel consumers, restocking of auto dealers in the aftermath of the late-1964 auto strike, and catch-up buying by other retailers in the aftermath of the post-taxcut consumer-spending boom.

The present inventory situation has led business analysts to look again at the record of earlier postwar expansions. In those periods, unlike 1961-64, inventories began to outmatch final sales fairly early in the cycle's expansion phase. In each case, after about the sixth quarter of expansion, inventories increased even after the sales trend warranted little further growth. Mounting imbalances between inventories and sales then brought about higher costs and risks of inventory holding, and thus set the stage for a sharp liquidation when final sales eventually turned down.

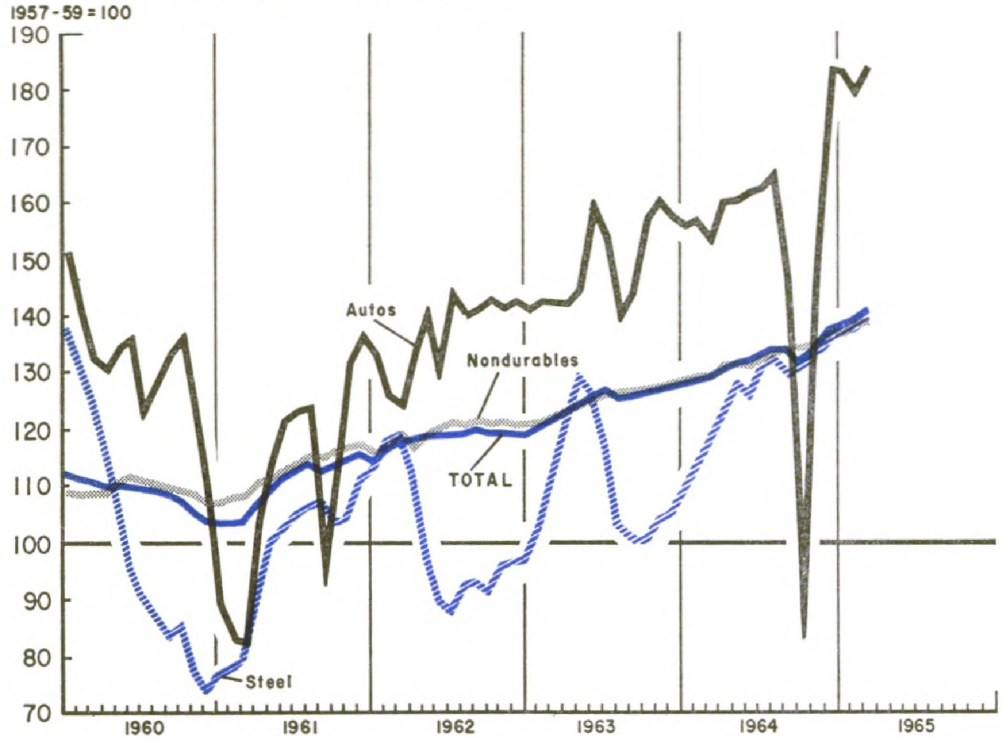
By way of contrast, the generally stable inventory situation of the 1961-64 period was based not only upon a steady rise in final sales but upon several other important factors as well. Improvements in inventory control—for example, the use of computers—became widespread enough to dampen the usual volatility of inventories. Moreover, expansion beyond current needs seemed unwarranted: speculative buying was unnecessary because of price stability, and reasonably prompt delivery was assured because of ample manufacturing capacity. Are those conditions still present? The next several months should tell.

Hard-driving sectors

The inventory picture will depend primarily upon developments in autos, steel, and other hard-driving sectors. In autos, the testing time may be near at hand, as dealers begin to confront their basic market instead of simply catching up with last fall's hungry market. In steel, the testing time may be postponed several months, in view of the extension of the steel labor contract from May 1 to September 1.

The recent strength of auto sales has confounded even the normally optimistic sales managers of Detroit. In the early months of 1965, domestically produced cars were selling at a 9½-million annual rate, although February seemed to mark a temporary peak. This performance eventually persuaded the industry's leaders to up their 1965 sales forecast to about 9 million cars—or perhaps even

Autos, steel boost production index with 20-percent gains within year



Source: Federal Reserve Board.

more if the excise tax on passenger cars should be reduced at midyear. So, while sales managers cheer, production lines hum along at a very busy pace as manufacturers attempt to keep abreast of dealers' inventory needs as well as consumers' clamoring demands.

In steel, an inventory buildup may well continue for several months longer, since many steel users had smaller stocks than desired when the strike deadline was set back four months. The contract extension, incidentally, involves placing 11½ cents an hour in an informal escrow fund for each hour worked by the steel union's 425,000 members. The agreement amounts to a labor-cost increase of roughly 2.7 percent per year—as compared with the 3.2-percent figure recommended in the Administration's guidelines, the 3.5-percent figure achieved recently in the steel union's contract with can manufacturers, and the even greater increase achieved last fall by the auto workers' union.

At the time of the contract extension, steel output was running about 50 percent above the 1957-59 average and about 20 percent above the year-ago level. Much of the strength, however, was simply due to the ebullience of final consumer demand, and so inventory building has been not much more significant than in the similar contract-negotiation periods of 1962 and 1963. Even so, steel consumers have added about 4 million tons to their stocks of steel within the past half-year. Thus, if an early settlement is reached in contract negotiations and if output should slow in autos and other overheated fields, the next half-year may witness substantial cutbacks in steel inventories.

Bricks, mortar, machinery

Consider, also, the longer-term situation in business plant-equipment spending. This sector now appears quite strong, on the basis of the 12-percent year-to-year increase projected in the Commerce-S.E.C. survey, and the even stronger gain shown in the more recent McGraw-Hill survey. According to the Commerce-S.E.C. survey, this sector will show an increase for the fifth straight year and (unlike earlier years) the gain will outpace the rise in GNP for the second consecutive year.

The survey highlights several factors favorable to the continuation of the boom. For one thing, expenditures on new plant are scheduled to rise faster than expenditures on equipment; in other words, the emphasis will be

on the expansion of capacity rather than simply the modernization and replacement of facilities. Moreover, manufacturers' carry-over of uncompleted investment projects was about 40 percent higher at the beginning of this year than a year before, while new orders for machinery and equipment have been somewhat stronger than in the big investment boom of the mid-1950s.

The anticipated expansion of plant-equipment spending comes on top of an almost 50-percent increase over the earlier course of the four-year long expansion. Investment spending has responded to a gradual rise in operating rates; capacity utilization has increased from about 82 percent to 87 percent during this expansion. Spending has also risen in response to the growth in demand for final products; total sales in manufacturing and trade have risen from $61 billion to $73 billion over the last several years. Again, spending has responded to improved rates of profits and cash flow, augmented by the new depreciation guidelines, the investment tax credit, and the reduction of tax rates; internally generated funds have risen from $30 billion to $41 billion between 1961 and 1964. In addition, this sector has expanded in response to the continued availability of credit at relatively stable rates of interest; last year, corporate issues for new capital approached the 1957 peak, while the corporate bond yield has held stable at about 4.3-4.4 percent for several years now.

Watch the laggards

In the present testing period, diagnosticians searching for clues as to the future health of this business cycle may find some answers by examining inventory behavior and fixed-investment spending plans, and perhaps by examining other "lagging" cyclical indicators as well. In the terminology of the National Bureau of Economic Research, manufacturers' inventories and plant and equipment spending—along with such indicators as unit labor costs, bank rates on business loans, and consumer instalment debt—tend to lag somewhat behind the movements in the broad aggregates of economic activity, and to lag even further behind the "leading" cyclical indicators. Nonetheless, these indicators are valuable for cyclical analysis in that they warn of excesses that frequently develop in a mature cyclical expansion.

Several of the lagging indicators measure costs—that is, the cost of money or the labor cost per unit of output. Others measure costs along with business risks—that is, inventories and consumer debt. And, since excessive costs generally tend to bring an expansion to an end, the pre-condition for a business decline is a significant rise in lagging indicators.

In the typical case, rising costs and slower increases in volume lead to shaved profit margins, and the financing of burdensome inventories creates additional problems. Expectations diminish, commercial failures rise, and stock prices and new incorporations fall. Attempts to reduce inventories are soon reflected in declines in new orders and in sensitive commodity prices. In addition, hiring slows down, layoffs rise, and the average workweek declines as overtime is eliminated and short-time is instituted. Moreover, if confidence becomes sufficiently impaired, major business decisions to invest may be postponed.

Until recently, this dire sequence of events was only a dim possibility, since the striking feature of this business expansion to date has been the slow response of lagging indicators. The excesses which were common during the advanced stages of previous expansions simply were not visible. But the laggards will be watched closely in coming months, however, as the doctors now hovering over the incredibly long-lived business expansion continue to probe for signs of excesses which could bring on a decline.

—William Burke