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Some Implications of Current Economic Developments

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Some Implications of Current Economic Developments

Current statistical reports on the business situation are restoring confidence that the economic upturn which began in March 1961 still has a way to go. With the advent of spring, output, incomes, employment, sales--virtually all relevant economic series--again have shown more than seasonal improvement. These encouraging developments tend to suggest that the signs of slackness which developed late last winter represented only a temporary aberration, resulting mostly from the weather, from the impossibility of making precise seasonal adjustments or from random events. Especially encouraging have been the recent pickup in retail trade, particularly sales of new cars, and the sharp spurt in housing starts, which had lagged badly during the winter months.

Prospects for further gains in aggregate economic activity also appear broadly favorable. Under the impetus of rising incomes, the upward movement of consumer spending can be expected to continue, and currently may even be in the process of accelerating. Government expenditures, both local and national, also are expanding, in reflection of the needs and desires of a growing population as well as the requirements of the international situation. And business expenditures for new plant and equipment appear to be rising significantly, reflecting the expanded cash flows available for such purposes and in response to pressures to mechanize, modernize and generally upgrade the capital facilities with which to compete. Recent surveys of business plans for capital investment indicate an expansion this year of around one-tenth, with much of this gain yet to come.

There are, of course, a number of important uncertainties in the business picture. One relates to inventory investment, which has dropped abruptly with the ending of any threat of a steel strike. The consequent adjustment in steel and steel product stocks should not prove cumulative in nature and may be relatively brief. But a broader question remains regarding the strength of incentives to accumulate and hold inventories in an environment where supplies are abundantly available and upward price pressures are conspicuous mostly by their absence. A second uncertainty relates to the underlying strength of housing demand. Despite wide month-to-month fluctuations in housing starts, most recently on the upward side, the general configuration of residential building in this expansion has been notably less vigorous than in earlier economic upturns. Still another uncertainty exists in the international economic sphere, with regard to the sustainability of our $5 billion trade surplus on non-military goods and services with the rest of the world, and the pressures which the continuing deficit in the balance of payments might bring to bear.

Despite these uncertainties, I am sure that the general view is that the economic trend is upward, and I share this view. But the matter can hardly be left there. We have to allow for the possibility that fragments of evidence in this recovery point to a basic deficiency in our economic structure. Moreover, we should not view a succession of new record highs in economic performance as confirmation that all is well. Output gains must meet different standards. The real questions are whether the uptrend is sufficiently strong for sustainability of the movement and for satisfactory utilization of our resources. If new production highs fall persistently short of our large and constantly growing economic potential the performance is stultifying for anticipations, for investment incentives, for consumption, for the workers and communities and industries involved.

Measured in terms of potential, rather than previous performance, the economic gains of the past year leave something to be desired. More than a year after the business recovery commenced, unemployment still amounts to 5-1/2 per cent of the civilian labor force--even though that labor force has failed to grow as demographic factors indicated it should, probably because of lack of job opportunities. Capital facilities also are still operating below a generally satisfactory rate. According to a recent McGraw-Hill survey of manufacturers, the average rate of capacity utilization at the end of 1961 was only 83 per cent, as against a preferred operating rate of 90 per cent. For producers of major industrial materials, such as steel, nonferrous metals, cement, pulp and paper, textiles, petroleum and industrial chemicals, output in the first quarter of this year averaged 82 per cent of capacity. These resource utilization rates may improve with further expansion of business activity, but it should be remembered that results must be measured against an ever-growing potential stock of labor and other resources.

Despite the ample availability of workers, materials and unused industrial capacity, the expansion in economic activity since the recovery commenced is not especially large for this stage of the cycle. The real GNP, for example, has risen 8 per cent in the first year of recovery, as against 10 per cent from the second quarter of 1958 to the record quarter of 1959. Industrial production has advanced 14-1/2 per cent in the 14 months since the February 1961 low, but this compares with a 26 per cent increase in the same interval after the 1958 low. Similarly, the 14-month rise in nonfarm wage and salary employment amounts to 3 per cent as against 5.7 per cent in the last recovery. These lesser gains are largely attributable to the two hesitations which have occurred in this recovery--in September-October and again in

January-February--but the fact of these falterings may tell us something about the underlying strength of demands.

The significant points are that the business recovery has not been sufficiently vigorous to date, and that substantial further gains will be necessary if the economy is to reach a much higher level of resource utilization. From month to month, hopefully, we look for these gains to materialize, for consumer demands to show unusual strength and business capital expenditures to rise markedly. But the character of the business expansion, except for some strong April statistics, continues rather moderate, and the standard pattern of forecasts by competent observers is cautious optimism.

The relative lack of vigor in economic performance and prospect is reflected in the behavior of financial markets thus far this year. As is well known, bond prices have risen substantially, rather than tending downward as had been widely anticipated last fall, and stock prices have fallen dramatically. No one knows how far these movements may extend, but it is apparent that they are associated phenomena and connected with the decline in inflation psychology.

In the bond markets, relatively moderate demands for credit have combined with large supplies of funds from current saving to produce an expected effect on yields; they have declined. It is sometimes asserted that the decline in yields is attributable to Federal Reserve policy, but this is putting the cart before the horse. It is true that the System has continued to supply additional reserves to the banks at a moderate rate, but it is the lack of vigor in credit demands which in large measure has been responsible for downward pressure on rates. The combination of Treasury debt management operations, which have increased the supply of short-term securities, and efforts to hold short-term rates roughly competitive with those available in foreign money centers, after allowance for forward exchange cover, may in fact have served to hold yields in this section of the market higher than they might otherwise have been.

The change in Regulation Q, which permitted banks to increase rates paid on time and savings deposits, does appear to have had a pronounced impact on yields. The subsequent sharp increase in savings funds, along with the increase in costs, induced many bank managements to enlarge their investment in higher yielding assets, particularly tax-exempt bonds and mortgages. But in large part these savings funds appear to represent a shift in asset form, from idle demand deposit balances, other savings institutions, or market securities, rather than an abrupt increase in aggregate new saving. To the extent that this is so, the effect has been more to redirect than to enlarge the supply of investment funds, so that the impact has been largely on the structure rather than the level of market interest rates.

The basic forces leading to the decline in yields appear mainly to lie in the normal working of supply and demand. On the supply side, the flow of funds has remained unusually large, reflecting expansion in consumer incomes and corporate earnings and possibly also some tendency to spend less relative to earnings than in the comparable stage of previous cycles. On the demand side, credit needs have been substantial but not vigorous in relation to the expanding size of the economy. Both mortgage and consumer credit have increased relatively less than in 1959 or 1955. Corporate needs for external funds also have been modest in view of relatively moderate capital spending and working capital requirements and the expanding flow of funds generated internally through depreciation charges and retained earnings.

The result has been a significant drop in yields in all sections of the credit market except for the shortest maturities. As compared with the highs reached last year, after the business upturn was well under way, yields have dropped back by nearly 50 basis points for high-grade municipal obligations and also for new issues of top-rated corporate bonds. Yields on long-term Treasury bonds have dropped 25 basis points since February of this year, while yields on intermediate maturity Treasuries have declined about 40 basis points in about the same period. Only in the very short-term maturities have rates remained about where they were, with yields on 3-month Treasury bills fluctuating narrowly this year between 2.60-2.80 per cent. Maintenance of short-term rates in the face of declines elsewhere reflects largely increases in the amounts issued by the Treasury and a tendency towards diminution in demand, as investors have shifted more into time deposits and into longer maturity, higher yielding, assets.

Disappointment with business developments and prospects also has been an important influence on the dramatic decline in the stock market, where prices on average had dropped 14 per cent between mid-December and last week's low. Many people regard major stock market setbacks as a forerunner of general business deterioration some months hence. And it is true that stock prices have started to drop prior to each of the postwar recessions. Often overlooked, however, is the fact that the stock market has sometimes declined significantly when the underlying business trend did not change materially. Thus, the composite price averages dropped 9 per cent in the summer of 1959, 11 per cent in the fall of 1956 and 15 per cent in the summer of 1950. In each instance the market had more than regained its losses before recession-related declines commenced.

Thus the stock market may not be signaling a business recession, but simply a more restrained evaluation of current and prospective developments. This possibility is reinforced by the very general character of the price decline. On May 14, nearly 500 of the stocks traded on the New York Stock Exchange reached new lows for the year. Cyclical stocks have dropped substantially, but so have stocks in virtually all other industry groups. And the percentage declines have been strikingly uniform, with the exception of a few groups where the difference seems readily explainable. Since December, stock price declines in three-quarters of the individual industry groupings have been within 5 per cent of the composite decline. In contrast, during the 1957 decline, which was cyclical, only two-fifths of the industry groups were within 5 per cent of the average decline, while more than two-fifths deviated from the average by 20 per cent or more.

My feeling is that a general revaluation of stocks as investments has been in progress. And, although investor concern regarding Government-business relations may have played a part in this decline, other influences clearly have been more important. Continued stability in commodity and product prices, and the evident intent of the Administration to resist significant increases in the future, may finally have dealt the market's inflationary psychosis a serious blow. And the moderate character of the business expansion to date, and still apparently in prospect, may have forced a reassessment of highly optimistic stock price valuations.

Business profits, more than any other economic variable, would benefit from a high rate of utilization of the nation's resources. As the residual dollar in the business profit and loss account, earnings rise much more than proportionally with expansion in sales volume and fuller utilization of facilities, but suffer when operations are below optimum levels and competition is keen. If doubts have multiplied as to whether the economy will reach this optimum level in the near-term, investors may simply have decided that the high multiples of earnings at which stocks were generally selling were not justified.

If this analysis is accurate, it is evident that the continued shortfall of the economy relative to its potential has had broad ramifications for workers, businesses and investors alike. What underlies the apparent sluggishness of the economy, which is so unlike the experience of most other developed countries in recent years? The truth is that we don't know. It may lie in demographic factors--the changes in population distribution accompanying the postwar baby boom. Or it may be that the large buildup of stocks of capital equipment, housing and consumers' durable goods have dulled appetites for more of the same, and that the economy has had difficulty in making the transition to a different pattern of demands. Or it could be that the structure of costs and prices which has developed is incompatible with full resource utilization, or that the distribution of incomes is not conducive to sustained high-level consumption.

If the economy continues to fall well short of its potentials, however, increasingly serious consideration will have to be given to possible remedies. Perhaps economic growth could be encouraged by a reorganization of our tax structure, which plays such an important part in business, investor and consumer planning. Perhaps additional investment incentives are needed, either directly or through stimulation of consumer demand. Perhaps the level of Federal tax revenue vis-a-vis expenditure is really not appropriate for the early 1960's, given the consumer's capacity for financial saving and the existing state of investment motivations. I say perhaps, today, but in the coming months policy makers may have to choose among these alternatives because the recovery while setting new records loses ground against its potential.

Given our economic traditions and environment, it seems clear that the aggregative needs and desires of the nation's people will remain large. It seems equally clear that continued and avoidable under-utilization of the economy's resources would represent a distressing wastage of its real wealth. The task of policy makers, therefore, subject only to the broad limitations imposed by international considerations and the requirements of longer run stabilization objectives, is to be prepared with structural proposals to deal with a new postwar problem.