HOW SLOW THE SLOWDOWN?

Remarks

to

Atlanta Rotary Club
Atlanta, Georgia
February 5, 1979

by

Monroe Kimbrel, President
Federal Reserve Bank of Atlanta

HOW SLOW THE SLOWDOWN?

Recession--will there be one in 1979? Most professional private forecasters think a recession will come before the end of 1979. Others expect a slowdown but not a recession.

Economic growth is almost certain to slow down this year. The question is how much. If a recession is in the making, though, it is sending up only vague warnings.

Whatever the outcome, a downturn is not imminent. Production, employment, and spending were all still advancing at year-end. And in the fourth quarter real GNP grew more than in the third quarter. This is atypical of the onset of a recession, but it does not preclude one later this year.

A recession later this year, if it occurs, probably would be brought on from one of a small number of developments. A major trouble spot could be the economy's vulnerability to surprises. Rapid inflation, heavy borrowing, high interest rates, and uneasiness about the future have diminished the capacity of the economy to recover from an unexpected tumble. Last time around, we were caught off balance by the oil embargo, suddenly-multiplied energy prices, and poor world-wide harvests. This time--Iran, Middle East tensions, strikes--

who knows? Maybe, if we are lucky, nothing. But let's be aware of our vulnerability at this stage of economic activity.

Another potential source of difficulty is our enormous inflation. Last year's consumer price rise was about 9 percent. This year's rate will not be much lower; it may even go higher.

Several factors point in this unhappy direction. A few industries lack the physical capacity to meet their markets. Productivity growth is virtually zero. Skilled, experienced workers are scarce.

Labor costs are escalating everywhere, and there are reasons to believe this will continue. More collective bargaining contracts are being negotiated in 1979 than in 1978. Nonorganized laborers are eager to make up for the shrinking dollar as well. Add to the growing list of rapid cost increases the minimum wage and Social Security increases and OPEC's shocking 14 1/2-percent oil price hike by October 1 and you have an unwieldy bundle.

Slower increases in food prices depend on good weather. Even this must be weighed against the near certainty of considerably higher meat prices. I say "near certainty" advisedly because beef producers have been thinning their herds, and pork and poultry are not expected to take up the slack of lower beef production.

There are observers who think the voluntary wage-price standards will restrain wages and prices. On the other hand, some businessmen are saying: "We'd better get prices up now. There may be some freezing of prices, and we will get left out." All of this encourages price increases and hardens the demands of labor for higher wages. These factors suggest the logic of rapid inflation this year is compelling.

Inflation can lead to recession when consumer buying power is reduced to a point where consumers simply can't afford to buy as much. We keep looking for signs of this happening. When we adjust earnings for increases in prices and taxes, we find that the average weekly paycheck of nonsupervisory employees is down from a year ago. Nevertheless, total personal income, adjusted for inflation, is still going up because the number of people employed increased rapidly last year. It's the case of just plain population growth and an extra breadwinner in the family working to keep up with inflation. Still, sooner or later, inflation is certain to restrain spending.

Inflation these days influences people in far different ways than in other times. Consumers a few years ago would not go on a buying spree when they thought prices were headed up, except in wartime. Instead, they spent less and saved more. In 1973-74, for example, consumers were cautious despite double-digit inflation.

The 1978 story was different. People borrowed and bought heavily, anticipating higher prices and higher interest rates. They reduced their saving to abnormal rates. And they used credit at record-breaking rates. Getting deeper into debt was all part of the debtor philosophy--beat further price increases and repay the loan with inflated dollars.

This urge to buy has been particularly strong in residential housing. Homes have been in demand as an inflation hedge and tax shelter, and buyers have not been deterred by price and interest rates. Mortgage costs have broken the 10-percent mark nationwide; yet about the only question homebuyers have is the amount of the monthly payment, since they expect inflation to increase the value of their investment.

A reversal in this psychology causing consumers to become more cautious would mean a drop-off in sales and could leave builders with unsold homes and merchants with excessive stocks. In 1973-74, partly because builders thought the boom would never end and then housing took a dizzying drop, we had the worst recession since World War II.

Fortunately, there has been less overbuilding this time, and mortgage money is still available as banks and thrift institutions continue to attract deposits from the new high-yielding saving certificates. So, all indications point to a modest downturn in housing rather than a collapse.

A modest downturn, if realized, will also limit strains on the lumber, furniture, and appliance sectors, which are closely tied to homebuilding.

In addition to housing, other signs point to a gradual braking in the buying spree rather than a screeching stop. Christmas sales, for example, were good but not spectacular.

We should observe the consumer, in any event, as an economic leader. A classic demand-type recession would show up first in consumer actions. Reduced purchases by consumers would quickly result in a pileup of goods on store shelves, and in order cancellations, layoffs, and reductions in output. Recession would then loom as a more likely prospect.

At the moment, the two sectors to watch closely are soft goods and automobiles. Of all types of consumer purchases, soft goods are the easiest to postpone. A decline in soft goods spending is often an early sign of weakness.

Soft goods are not in the best position right now. Inventories of general merchandisers in late 1978 were higher in relation to sales than they have ever been. Sharp price markdowns that have been made should eventually clear up this inventory problem. But statements that inventories throughout the economy are slim and for this reason a recession is unlikely should be taken with a grain of salt.

Auto sales are also a herald of things to come. Last year, consumers took the higher prices on automobiles in their stride. In fact, car sales were one of the highest ever recorded. Increasingly liberal repayment terms on automobile loans facilitated this buying. And automobile credit increased some 24 percent.

It was part of the "buy now, tomorrow may cost more" philosophy. Some automakers seem untroubled by this phenomenon. General Motors is forecasting a record sales year for the industry in 1979. This optimism may be related partly to favorable price differentials between American and foreign cars--the result of earlier declines in the dollar against the mark and yen. Yet, I wonder whether phenomenal sales last year will take away from new car demand this year.

Also, I wonder whether people can keep up the current credit binge indefinitely. The typical consumer now sets aside 20 percent of his take-home pay to service existing debt, including mortgage payments. In the past, people reduced their buying when debt repayment rates were lower than they are now. To be sure, there are more breadwinners in the family nowadays, making the debt more bearable. But there are limits to how deeply people can continue to go into debt. And I think we are approaching these limits.

The most recent Commerce Department survey of capital spending plans shows business outlays increasing only a scant 3 percent this year, after adjustment for inflation. If sales turn out less than businessmen anticipate, some cancellations or postponements of projects may be expected.

Businessmen might pull back on capital outlays because of an underlying fear of mandatory wage-price controls, despite Administration denials of any desire to propose them to Congress. Compulsory controls were ineffective the last time they were tried: inflation halted temporarily, but prices exploded after the wage-price controls were lifted. As long as controls were in effect, manufacturers limited the output of products they could not produce profitably. And because they were not allowed to raise prices to meet the increased demand, the building of new facilities was discouraged.

The current voluntary pay-price standards may not be stringent enough to have this damaging restriction on supply, but the current concern with controls and their unhappy history cast gloom on the whole outlook for capital spending.

Were it not for these factors, I might be a little more optimistic about business investment. After all, even those who fully expect recession think it will be short and mild. Many businessmen look beyond the valleys of economic activity when it comes to fixed investment outlays. Many will probably go ahead with their plans regardless of recession symptoms.

Capital spending has been fairly sluggish in recent years. The average manufacturer today operates only two points away from the 1973-74 boom operating rate. With productivity as low as it is, incentives for more efficient facilities and equipment are growing. Therefore, those who feel we are not too far from an upsurge in plant and equipment spending could be right, although I do not see it happening this year.

On the positive side, office and commercial construction should continue at above normal rates in 1979 and exports should climb briskly.

Also, count me with the optimists in the debate over a possible financial crisis of the sort experienced in 1974. Credit remains available at a price. Even residential mortgage money will continue to be available, I think, because mortgage lenders and borrowers now have greater access to funds.

High interest rates basically reflect an inflation premium rather than a shortage of funds. Businessmen are cautious. The federal deficit is diminishing, though more slowly than we would like. Lenders are gradually tightening their terms and commitments. Nevertheless, we do not see a credit crunch.

In recent weeks, several economists have advanced the thought that a mild recession would not be all bad, and, in fact, if the economy does not falter on its own, the Federal Reserve ought to help it along. These economists reason that a mild recession would contribute to a reduction in the inflation rate. Between 1974 and 1976, for example, the inflation rate fell from something over 10 percent to under 5 percent, a better than 50-percent reduction.

A related benefit advanced is that businessmen tighten up in slack periods. They strengthen balance sheets, fire deadwood, cut corners, and strive for all sorts of improved efficiency. Goods become easier to get, are delivered faster, and are of higher quality. With more people out of work, those who have jobs work harder and are satisfied with smaller pay raises. As a result, costs during recessions stop rising or rise more slowly.

The argument continues: Once inflation moderates, interest rates should come down, resulting in increased bond prices. When this happens, the stock market usually is not far behind.

Another point made is that less inflation would result in greater confidence in the dollar. Any increase of the dollar against other currencies would reduce the cost of imported products and lower domestic prices. Slower domestic activity would reduce our need for imports and lower our trade deficit.

Following this reasoning, a recession possibly would produce benefits except for the obvious increase in unemployment. If that were the only negative development, the case for recession would be stronger. When unemployment starts climbing, pressures become enormous to stimulate the economy by increasing spending, cutting taxes, and enlarging the deficit. Experience shows that when government policies are directed primarily to creating jobs, as they are in recession, groundwork is laid for even more severe inflation. This damaging impact from fiscal easing worries me deeply.

Less inflation is a benefit much to be desired, but this benefit might not last. If we get into a period of economic stagnation, I hope it will be short and mild. If it is deep, we will almost surely end up with programs that lead to more rapid inflation.

Our judgment is that 1979 will be characterized by less vigorous activity and some rise in unemployment. Consumer durable goods and housing are vulnerable to declines. Undoubtedly, some households will experience financial problems. Young, first-time home buyers, dependent on combined husband-wife incomes and burdened with high mortgage and instalment debt, will find the going rough if one income is lost, even temporarily.

There is always the possibility that the entire credit structure is weaker than the figures indicate. But there is little at the moment which suggests anything more than a period of adjustment which should not be severe.

Prudence is not an outdated quality in financial management. Recognize that cold winds could chill some sectors of the economy and be prepared. We would approach the year with caution but not with a sense of panic or doom.