Recovery 1971: Uptick or Upsurge?

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We may well be in the midst of the most talked about economic recovery since World War II. Businessmen, bankers, economists and the press have publicly examined and re-examined the economic evidence from every point of view. And with each new shred of information from Washington, the reshredding begins all over again. If the amount of talking, the amount of re-examination and the amount of concern were directly related to the rate of recovery, we would be surging ahead. But it isn't. And we aren't.

Almost everyone is agreed that we are in the recovery stage of the business cycle--the first cycle since 1960-61 and the fifth cycle in the postwar period. But almost everyone has a different angle as to the most likely or most desirable speed of recovery in real output--or decline in the rate of inflation--ahead of us. The majority of forecasts are for moderate expansion in 1971. The so-called consensus forecast rounds off at $1,050 billion GNP. But there are vocal dissenters. I'm sure there is no one here who hasn't heard of the $1,065 billion forecast for 1971.

This is an optimistic forecast. It may well be too optimistic--particularly if its achievement is forced through increased budget spending and overly easy credit availability--inflationary steps we will surely regret later on. And yet we cannot say that the administration's optimistic target is outside the range of our experience with past postwar recoveries. It isn't. In fact, what is striking is that even that optimistic goal implies a relatively sluggish performance of our economy as compared with past recoveries. But what a review of past cycles highlights most clearly is that this is a different business cycle. We're in a different ball game. We started the game with players in different positions and the effectiveness of our plays is different. We may even need some new plays.

It has been a long time since we have had an identifiable recession--not since 1960-61. As a result, some of us may have forgotten that economic downturns can differ significantly in their essential characteristics. It would be helpful, it seems to me, to take a look at the earlier contractions in the postwar period and compare them with the 1969-70 decline and the likely 1971 pattern of recovery. Differences as well as similarities can be useful in evaluating prospects and economic policies.

All of the postwar business cycles, including this one, are similar in the sense that they have been characterized by a "peak" in one year and a "trough" in the following year. Furthermore, each of the cycles peaking in 1948, 1953, 1957, 1960--and most recently in 1969--had the usually defined characteristics of a contraction in total economic activity so as to be considered a business cycle. They were characterized by breadth of effect (a significant number of sectors were affected), duration (they extended over a sufficiently long period) and severity (there was a significant percentage decline in activity). But beyond this the cycles have differed considerably in the sharpness of decline and the speed of recovery.

As you are aware, comparisons of business cycles may be made in various ways. So at the outset I had better indicate what ways and how I am making the comparisons. First, I use as my basic measure the rate of total spending on goods and services adjusted for price changes--"real GNP." Second, I have selected my peaks and troughs in real GNP on a quarterly basis. Using quarters rather than months reduces the number of double peaks and troughs that may be troublesome in this kind of analysis. But even using quarterly data, adjacent quarters are very close in some cases. One such case is the first and second quarters of 1960. As now tabulated, the second quarter real GNP for 1960 was one-tenth of 1 percent below the total for the first quarter. However, rebuilding of steel inventories following the very long 1959 steel strike tended to inflate activity in the first quarter of 1960. Mainly for this reason, but also because of the performance of other data, we may date the peak of the 1960 cycle in the second quarter. For other cycles, except the current one, we will use the peak and trough in real GNP figures, as now estimated.

For the current cycle we have a similar problem on strike effects. For purposes of comparison I will assume the low for real GNP in this cycle as the first quarter of 1970. Real GNP was actually lower in the fourth quarter of 1970 than in the first quarter--by about one-half of 1 percent. But the fourth quarter reflected most of the auto strike that lasted more than two months. Without this strike real GNP in the fourth quarter of 1970 may have shown a slight rise, as did the second and third quarters. The 1970 auto strike was by far the most important of the strikes since World War II in its effect on consumer purchases and hence on total spending on finished goods and services.

One further point should be made on the mechanics of the comparison. Duration and depth of decline can both be measured from peak to trough. The rapidity of recovery can be measured by the number of quarters until the former peak has been reached, or--because the economy is growing--the number of quarters elapsing before reaching the former peak, plus some growth factor--say 2 to 4 percent.

A 4 percent factor seems plausible on its face. Since World War II, growth in real GNP has averaged 4 percent per year. But it is not possible to compare postwar cycles applying the 4 percent growth rate to the cycle peaks, however. Only in the 1948-49 and 1960-61 cycles does growth catch up to this trend before another cycle develops. The recovery phase of the first of these cycles was boosted by the Korean War. The second was helped by the fact that the 1960 peak was far short of "full employment." We were starting from a base with substantial underutilization of resources,which permitted us to reach the 4 percent growth path by the first quarter of 1964--before the Viet Nam escalation. A 2 percent growth rate can, however, be applied to give some recognition to the need for growth in activity in an economy where the labor force and output per man-hour (productivity) rise through time.

By all measures, the 1969-70 recession was the mildest of the postwar recessions. The decline in real output from its peak in the third quarter of 1969 to its 1970 low was only a fraction of the magnitude of the earlier contractions. The duration of decline--a low in the second quarter after the peak--was comparable to that for the 1948-49 and 1957-58 recessions, but the decline in percentage terms was half of that for 1948-49 and a quarter of the 1957-58 decline.

But the 1969-70 recession is also the most stubborn. If we assume that this quarter is showing a fairly hefty increase in output as auto production resumes and steel strike hedge buying increases, we may have recovered by this quarter to the third quarter 1969 peak. This is a six quarter span to reach the former peak. All of the postwar recessions except that for 1953-54 have shown quicker recovery to the former peak. If we add in the 2 percent growth path and assume the standard forecast for 1971, it would take us at least until the first quarter of 1972 to recover from this contraction. So a ten quarter recovery may be the best we can hope for if real activity rises only 2 1/2 to 3 percent from 1970 to 1971, as suggested by the standard forecast. Even realization of the optimistic administration forecast for 1971 would make the current cycle the most stubborn of the postwar period, with 1953-54 (after the Korean War) as a runner-up.

There is little question that the deterioration of psychology in 1970 following the euphoria of the long inflationary boom of the late sixties must be given heavy weight in explaining the present low profile of recovery. The balloon of endless expansion inflated in the 1965-68 period burst. The drop in the stock market, the Penn Central failure, defense spending cutback repercussions and problems in the brokerage industry didn't add to confidence. Concern about income prospects even by individuals who previously had thought themselves immune to economic downturns, concern about inflation, anti-consumerism and disenchantment with the ultimate goals and structure of the society have all weakened consumer demands on a broad front.

Buffeted by both economic and non-economic forces, uncertain consumers and investors have altered their patterns of spending and investment decisions. To a large extent the changed psychology and attitudes are not adequately incorporated in either our econometric or our judgmental models. As a result our projections may be faulty, or at least more uncertain than usual. Both approaches to forecasting rely on a comparability of experience, a similarity of response that permits us to judge the effect of the underlying forces. But when our experience is new, when there are no real good measures for so many factors, projections of the future course become more varied and uncertain. Recall, for example, how long you have been hearing that the consumer is the key. He is. He has the income, the savings, the liquid assets and readily available consumer credit. The potential to spend is large. But everyone is having great difficulty in projecting when he will loosen up.

But what is even more unusual about the current recovery is the behavior of prices and labor costs. There are striking differences here that give this cycle its peculiar character. The GNP price deflator has not always had the upward bias of recent years during recessions. It declined 2.8 percent from a high in the third quarter of 1948 to a low in the first quarter of 1950 before starting upward sharply in the Korean War. Average prices did not decline in the 1953-54 recession, but the deflator was stable from the fourth quarter of 1952 to the fourth quarter of 1953. The price deflator rose through the 1957-58 recession, a development that caused much concern at the time. Price inflation continued in the 1960-61 recession, but at a reduced rate. The acceleration of price inflation in the 1969-70 downturn was, therefore, a unique development--or at best, a distinct worsening of the trend of a stubborn upward price bias.

Labor cost per unit of output in manufacturing declined significantly in 1950-51, 1954-55, 1958-59 and in 1961 after activity started to recover. The acceleration in labor cost increases in 1970 was unprecedented. Productivity gains were small or nonexistent in 1969-70. A large increase is expected in 1971. But even an increase of 4 to 5 percent (with a long-term average of about 3.5 percent) would fall far short of average increases in worker compensation that now range from 6 to 15 percent per year.

Where does this examination leave us? Clearly we are talking about a different kind of a business cycle. In broad terms we are viewing a cycle composed of a mild decline in output with an inordinately slow recovery constrained by adverse price and labor cost developments. Obviously this pattern has and will continue to influence our economic policies. We cannot react as though we were faced with a cycle of the 1960-61 variety.

I have no basis for disagreeing at this juncture with the view that the expansion will be moderate. Developments in, for example, the consumer and business areas may prove me wrong if confidence is rejuvenated much more rapidly than now seems likely. I would be happy to be shown wrong on these grounds but most unhappy to be proved wrong because we moved to short-sighted highly stimulative economic policies.

As you are well aware there are a number of critics of Federal Reserve policy who argue for a much more stimulative monetary policy. I disagree. This is the kind of cycle in which more expansive monetary actions now will buy us little in the way of increased real output in the near term but will buy us much in the way of inflation troubles in the longer run.

The financial foundations have already been laid for a sustained recovery. The easier monetary policies that have been pursued during the past year have not yet accomplished their purpose. The fact that there are lags between monetary policy actions and their effects is well known. The lags apparently are even longer this time. To my knowledge, there is no such thing as "instant" monetary policy. But disappointment with the results of monetary policy thus far must not lead to incautious excesses that may be harmful rather than beneficial to economic recovery. The available funds are there today.

Federal Reserve credit has increased over the past 12 months at a substantial pace. The rate of change in the narrowly defined money stock (currency and demand deposits) frequently used as a symbol of the overall thrust of monetary policy expanded in the past year by about 6 percent--a rate of expansion well above the average of about 3 to 3 1/2 percent over the last 20 years. This rate of growth has been exceeded very few times and then in years of intense inflation. However, with unusual liquidity needs and the sluggishness of the economy such a rapid rate of monetary expansion is not inappropriate.

Broader measures of the money supply which include commercial bank time accounts indicate the rather expansive course of monetary policy even more clearly. The total money stock plus time deposits has grown about 15 percent over the last 12 months. In part, of course, this reflects the elimination of Regulation Q constraints on the issuance of large CDs. Nevertheless, this is a significant expansion clearly above that for earlier recovery periods.

Deposits at savings and loan associations and mutual savings banks rose sharply in 1970 and on into 1971. Inflows have been described as "ridiculously" large. On a seasonally adjusted basis, January net inflows were more than double for those in December. Much of the increase in deposits have been reflected in larger holdings of mortgage loans. Commitments, both new and outstanding this January were 80 percent higher than in January 1970. But with the continued rapid rate of inflow, the supply of mortgage money has been outrunning the demand by a wide margin.

For commercial banks the increase in available bank funds has been well above the growth of demand for loans. As a result banks have been adding to their holdings of municipals and governments.

And the securities markets have been absorbing an enormous volume of new issues. As you all know, offerings in 1970 were at record levels. So far in 1971 offerings of both corporate and municipal securities have substantially exceeded the levels of early 1970. The large volume of corporate securities sold has helped to improve the balance sheet liquidity ratios of many firms. The long-term decline in the ratio of corporate liquid assets to short-term liabilities was probably halted and reversed last year.

The changing financial climate would argue that the stage has been set for a sustained recovery of production and employment. Some of the indicators suggest that we are on the way. Investors are beginning to look forward expectantly to renewed expansion in earnings and business activity. Interest in common stocks has revived and share prices have staged a spirited recovery. Housing starts have risen briskly and state and local construction is on its way.

But the situation is certainly not yet strong enough to suggest that the expansionary posture should give way to a neutral policy, much less a more restrictive one. The recovery must not be nipped in the bud. As long as there is substantial unused capacity in the form of manpower and facilities, Federal Reserve policy actions must continue to encourage the growth of bank deposits, other liquid assets and the availability of credit. Acceptance of this view, however, does not imply that monetary ease can be pushed to any length without serious consequences.

We must move ahead slowly and cautiously in this "new" business cycle. The economy will be operating below potential for some time. Consequently, the reduction in demand pressures will be tending toward lower prices. But the refrain is still the same--we were building price pressures over a long time and it will take a long time to slow them. Few argue any more that we should retard the advance in aggregate demand even more to make faster inroads on prices. The costs in terms of jobs and output lost are too great, especially in light of the fact that further restrictions on aggregate demand may have limited impacts on prices because of our institutional arrangements.

There is little question that the dimensions and forms of the problems confronting us in this business cycle are different. But with appropriate monetary and fiscal policies and responsible union and management policies in industry, there is every reason to be confident that we can again get back on the road to sound economic growth.