1973-74: BOOM, CRUNCH, BUST?

by

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before the

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The economy is now in its third year of expansion following the last recession. Recently the expansion has reached boom proportions. Retail sales are 14 percent above a year ago. Auto sales are setting new records. Unfilled jobs are twice what they were a year ago. Many industries, notably autos, rubber, paper, petroleum, and nonferrous metals are operating near capacity. Inflationary fears are intensifying and some forecasters are saying that what goes up must come down -- the boom of '73 will turn into the bust of '74. They insert between the words "boom" and "bust" the word "crunch".

We have a boom. The prospects of a crunch and bust strike me as too pessimistic, but there are some arguments going for them. What I'd like to do tonight is look at these prospects and assess their probability of occurring.

The Cyclical Setting

A business expansion can last months or years, depending on the underlying forces at work in the economy. Is the current expansion about spent or does it still have some life in it?

Once in motion, an expansion is a cumulative set of forces -- each feeding into the other. Typically, an industry you're close to -- housing -- plays an early role. During a recession, funds usually flow into thrift institutions because market interest rates are low and there are ample funds around. Housing starts to accelerate. Also, usually, Government gives the economy a boost by running large deficits.

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Then the forces of expansion begin to spread out. Salesmen find new orders are not quite as hard to get. Factory shipments pick up and inventories begin to edge down. Production schedules are speeded up. New workers are hired. Consumer confidence improves and retail cash registers ring more frequently. Businessmen start thinking about expanding their plants and buying new equipment. And so on and on as the economy gains still more momentum. Meanwhile, as credit demands increase with the pace of economic activity, interest rates rise. Also, as demand picks up, inflationary pressures intensify.

Then what happens? Does the expansion roar on and burn itself out by its own momentum? Or, does the expansion settle down to a more sustainable pace and last awhile? As I look ahead, I think this expansion has a lot of life in it. Forces are at work that will slow the economy down, a slowing that is welcome if the excesses that ultimately lead to a recession are to be avoided.

Slowing, But No Recession '73-'74

Again, an industry you're close to — housing — will play a pivotal role. As interest rates rise, thrift institutions should become less attractive to savers. The flow of funds into savings and loan associations and mutual savings banks will tend to slow. In fact, some net drain could occur before this year is out. Thrift institutions, then, will begin to cut back on mortgage commitments and in time construction should slow. In effect, housing, which gave a shove to the economy when general business activity was slack, should be providing a drag on the economy.

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Some tempering in the torrid pace of retail sales also seems likely during the next year. Consumers tend to spend in spurts on things like automobiles and other hard goods. Then they try to catch their breaths and pay down some of their debts. They get worried about over-spending and concerned about inflation. We are already seeing some signs of consumer anxiety and we probably will see more as the year unfolds. But it's important to distinguish between a slowdown in the pace of spending and the level of consumer spending. What I'm talking about is a slowdown in pace, not the level.

Elsewhere in the economv, however, it's difficult to forecast much of a slowdown, at least this year. Business profits are heading for new records and the outlook for capital spending is bullish. Corporations are using their cash flow to finance expansion, acquire cost-saving equipment, and invest in plants that are less pollution-prone.

A particularly favorable aspect of the current cycle has been the tendency for businessmen to watch their inventories more closely. Businessmen often have overreacted to rising sales by overbuilding inventories. They then try to let sales run ahead of production to get inventories back into line. Production workers are laid off, spend less, sales go down and so on. This sequence of events has frequently been enough to trip the economy into a recession -- a so-called "inventory recession."

During the current expansion, however, inventory accumulation has not run ahead of sales. In fact, there has been some tendency for inventories not to keep up with sales. Managers, through better inventory

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control, seem to have gone a long way in taming the inventory cycle. The importance of this for the next year is that business probably will not have to cut back inventory spending because of past excesses, and this greatly reduces the risk of a recession.

As far as Government spending is concerned, the outlook is for increases at both the state and local and the Federal level. I'm inclined to think, however, that the President will succeed on the whole in holding down Federal spending so that the high-employment budget will move from a stimulating to a neutral or restraining position. This means that in total the Government sector should be a much less dominant factor in the outlook than it has been.

In summary, the shape of the economy looks like this for the months ahead: a slowing in housing, some moderation in the pace of consumer spending, but considerable strength in business spending. On balance, then, the booming economy of recent months should moderate to more sustainable growth rates in the coming months. And the unemployment rate, now around 5 percent, should drop into the 4.5 to 5.0 percent range during the next year. In short, I don't see the ingredients for a bust in '74.

Inflation - A Major Threat

I haven't talked about inflation yet, not because it isn't a problem, but because I wanted to get the good news out first. The outlook for inflation is discomforting. Food prices, of course, have risen in giant leaps. Agricultural experts predict some relief during the second half of the year, and any relief would be welcome. But more fundamentally, we're

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heading into the part of the business cycle which is inflation-prone. For one thing, productivity gains will tend to taper off. For another, wage rates will tend to go up as skilled labor becomes harder to get. And businesses always find it easier to mark up prices when sales are strong and productive capacity is running full steam. Add to these "normal" reasons for price pressures the fact that most people have come to regard inflation as a way of life -- something inevitable. Phase III is supposed to counter these inflationary expectations, and it may still succeed in doing this. But at least for the moment the public still has to be convinced that Phase III will be successful. The danger is that they will build their inflationary expectations into wage contracts, lending contracts, real estate contracts, and so on across the economic spectrum.

So, the threat of inflation is a dark cloud on the horizon. Both demand-pull pressures of economic expansion and cost-push forces stemming from inflationary expectations will be with us during the coming months.

Interest Rates, Credit Crunch, and Monetary Policy

With inflation becoming the major threat to the domestic economy, the Federal Reserve has adjusted its policies. Typically, the Fed is more generous with funds during the early phases of a business expansion and less generous with funds when the economy is growing rapidly and nearing capacity. So, in recent months the Fed has tried to slow the growth in the money supply from the fairly rapid growth rate of last year. In addition to the Fed's "snugging up", businesses and consumers have increased their demands for funds and the result has been rising interest rates, particularly short-term rates.

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Rising interest rates are a normal outgrowth of a business expansion. If the Federal Reserve pumped enough credit into the economy to keep interest rates from rising, the result could be an inflationary explosion in 1974 and 1975. At the same time, however, the Fed has to be careful not to be overly restrictive in supplying funds to the economy. Being too stingy, too fast, could precipitate a credit crunch.

One of the major ingredients of past crunches has been a fairly abrupt and extreme tightening of monetary policy. A more gradual and less drastic tightening of monetary policy considerably reduces the risks of a crunch. But a gradual tightening requires more foresight. My reading of monetary policy is that the tightening was started early enough to avoid very severe restriction later on.

This pattern of policy reflects lessons learned in the 1960's. That period demonstrated that the Fed cannot counteract all the inflationary pressures that may be at work. If it tries to do so, it has to pull back on the money reins so sharply that a crunch and recession may result. In my judgment, this is unlikely to happen in 1973.

There could still be tightness in the mortgage market, however. As market interest rates rise, funds are diverted away from thrift institutions to higher yields elsewhere. How much disintermediation occurs depends partly on the level of interest rate ceilings on deposits. It is ironical that although interest ceilings have often been designed to help housing, if they make it more difficult for thrift institutions to attract funds, they end up by depressing housing.

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A recent Staff Study by the Federal Reserve System has succinctly summed up the issue:

> These ceiling rates have adverse effects on economic efficiency and they result in an inequitable treatment of small savers who do not have the financial sophistication, or the amounts of funds necessary, to invest directly in market securities. These ceilings have outlived their usefulness. Steps should be taken to permit free competition in the markets for consumer savings.[1]

A similar argument can also be made for the ceiling on mortgages in Pennsylvania. If mortgage lenders can't attract funds because they can't afford to pay savers the going rate, there won't be many mortgages. A citizen might well ask: What good is a low mortgage rate on a loan I can't get?

The outlook for housing, therefore, will depend, once more, partly on what is done with interest ceilings on savings. If these are held at restrictive levels we may again see a phenomenon of recent years -- efforts of the Federally sponsored credit agencies to support the flow of mortgage money. For example, according to the Federal Reserve Staff Study "... the Federal Credit agencies were supplying directly or indirectly through FHLB advances, more than 40 percent of the net funds borrowed to finance housing in 1969 and 35 percent in 1970."[2] Here is another factor that can modify an impending squeeze in the mortgage market.

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[1] Federal Reserve Staff Study: Ways to Moderate Fluctuation in Housing Construction, p. 36.

[2] Ibid, p. 13.

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Conclusion

To sum up, I see a continuation of the business expansion into '74, but at a slower and healthier pace. Chances of a recession seem to me to be on the small side. But continued prosperity brings with it its own set of problems -- rising interest rates and rising prices. It also raises the spectre of credit crunches. This time around, however, I think we have a leg up on avoiding a credit crunch generally, and in mitigating to some extent the effects of a restrictive monetary policy on housing in particular.

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