



FEDERAL RESERVE BANK OF SAN FRANCISCO  
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# THE BUSINESS AND FINANCIAL OUTLOOK

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## The Business and Financial Outlook

A distinguished central banker once described the Federal Reserve's function as taking away the punchbowl just at the time when the party's getting started. I'm sure that same thought has occurred to you on certain occasions--in 1966, say, or 1969 or 1974--when you had a beautiful deal wrapped up and it fell apart at the last minute because of tight-money problems. Today some people would say that we at the Fed are taking away the punchbowl even before the invitations have been printed for the next party.

I won't comment on that particular allegation, but I believe I can throw some light on the current posture of monetary policy by discussing three basic questions. How strong will be the business recovery? How dangerous will be the threat of inflation? What impact will these factors have on financial markets?

### How Strong the Recovery?

You'll notice, to begin with, that I didn't raise the question of when the recession will end. That question seems to be settled; the lowpoint apparently was reached during the spring months, and the long trek up the recovery path then got underway. In particular, the broadest measure of business activity--real GNP--increased in the second quarter after the most prolonged and most severe decline of the past 40 years. Some significant problems remain, of course. Although the number of jobs has increased in recent months, almost 8½ percent of the labor force is unemployed, and more than one million of the 8 million jobless have been looking unsuccessfully for work since early in the year. Roughly one-third of the theoretical capacity of the nation's industrial plant remains unutilized, and this has

caused corporate planners to reverse gears and slash away at their budgets for new plant and equipment.

Nonetheless, the script for recovery has already been written, especially in the form of the spring upturn in consumer expenditures. In real terms, consumer spending rose at more than a 6-percent annual rate during that period, reflecting an unparalleled 22-percent rate of gain in real disposable income, which offset practically all of the prolonged income decline since late 1973.

Take-home pay was boosted about \$48 billion this spring by the provisions of the Tax Reduction Act, including actual tax cuts as well as increases in social-security and other transfer payments. That stimulus was reinforced by a slowing of the inflation rate, which also helped boost real income. Admittedly, little of this strength has shown up in the crucial auto and housing industries, but the upsurge in buying power creates the groundwork now for a strong rise in other household-budget categories, and later on for an upturn in those two depressed sectors as well.

A second major element in the recovery script is the prospective turnaround in business spending for inventories. This sector was the weakest link in the severe slump of last winter and spring, but because of its self-correcting nature, it should be one of the stronger elements of the outlook for the next year or so. Business inventories declined at a \$25-billion annual rate in the first half of this year, so that stock-room shelves have now been cleared of most of their excess supplies. Just ending the cutbacks, without any net increase in inventories, would thus mean a \$25-billion boost in GNP.

In contrast, business spending for new plant and equipment continues to look weak, with only a modest increase projected for 1975 in current-dollar terms--and an  $11\frac{1}{2}$ -percent decline expected in real terms. A rising proportion of businessmen report having unwanted facilities on their hands; for durable-goods manufacturers, the proportion with excess plant and equipment jumped from 6 percent last fall to 21 percent this spring. I'm sure that many of you have seen this sentiment reflected in your own operations.

Nonetheless, the overall script shows final demand still rising, thereby encouraging businessmen to order more inventory, cautiously at first and then more confidently. Also, as consumer buying continues to rise and as inventory restocking begins, businessmen will be forced to restart some of their idled production lines. Rising demands on capacity, plus the increased investment tax credit, should then lead corporations to resuscitate some of their now-dormant capital-spending plans. On the basis of this unfolding scenario, real GNP could increase as much as 8 percent by a year from now.

#### How Bad the Inflation?

This raises the question: Can we achieve a strong economic recovery without inflation? Judging from Wall Street's recent behavior, many people are betting that we can't. But let's not ignore what has been accomplished to date in the fight against inflation. Specifically, the annual rate of inflation declined during the second quarter to the 5-percent level, far below the  $14\frac{1}{2}$ -percent peak rate of late 1974. One hopeful sign during that spring period was an upturn in labor productivity, which helped reduce price pressures through a significant deceleration in unit labor costs.

But from recent indications, it will be quite difficult keeping the inflation rate as low as 5 percent. For the last two months, wholesale and consumer prices have been behaving as badly as they did a year ago. Food prices have risen sharply, and they could continue to do so in the wake of heavy export sales to the Russians and other overseas buyers. Fuel prices could jump again in the event of another price increase by the OPEC oil cartel, or in the wake of sudden decontrol of the domestic market, necessary as that move appears to be for the sake of a rational energy policy. Industrial prices also are stirring again, with steel posting a 3.8-percent average increase, autos a 4.4-percent increase, trucks 7.3 percent, and so on down the list.

However, it's not the increases in individual sectors of the economy that we have to worry about; these happen every day in response to specific market forces. The danger is an upsurge generated by the same basic forces that have been behind the powerful groundswell of prices throughout the past decade; that is, unparalleled Federal budget deficits and a necessarily accommodative monetary policy. The portents are not entirely favorable.

Fiscal 1975 just ended with a near-record \$44-billion deficit, compared with the \$9-billion deficit the Treasury forecast in its initial estimates for the year. The increase in Federal spending last year (\$57 billion) was as large as the total budget in Korean War days. Now along comes fiscal 1976, which will have the unenviable distinction of breaking the World War II record with a deficit currently estimated at \$59 billion. The budget figures are now reflecting the full force of the tax cut, the recession-caused decline in revenues, and the substantial rise in new expenditures. Moreover, the Administration calculates that the deficit could

actually go as high as \$88 billion if Congress extends the tax-cut legislation, ignores Administration spending-cut requests, and passes new spending bills that have already been reported out of committee.

How Much Financial Impact?

More Federal spending would aggravate the pressures already evident in financial markets, with unparalleled Federal demands piled on top of gradually reviving private credit demands. This is the well-publicized and all-too-real problem of "crowding out." It's true that financial conditions normally ease substantially during a recession and remain easy even in the initial recovery period. But if the Federal deficit substantially exceeds the Administration's proposed figure, total credit demands could rapidly outrun the available supply of funds, forcing interest rates higher and crowding many non-Federal borrowers out of the market.

Look at what's already happened. The anti-recession program, with its outpouring of Treasury funds into private deposits, helped bring about a  $14\frac{1}{2}$ -percent annual rate of growth in the money supply during May and June. Since this rate of expansion was far outside of the Federal Reserve's 5-to- $7\frac{1}{2}$  percent target range, the Fed moved to offset the money-supply bulge in the course of its regular open-market activities. But in the wake of this action to avert future inflationary pressures, short-term interest rates suddenly rose by a full percentage point or more, and fears of renewed credit stringency began to surface again. Certainly it's very unusual at this early stage of recovery to see Treasury bill rates at 7 percent or the prime business-loan rate at  $7\frac{3}{4}$  percent.

Many analysts believe that the "crowding out" argument is overdone, and that we are more likely to encounter a "crowding in" effect as the economy continues along the recovery path. According to this view, as long as deficit spending succeeds in its goal of stimulating business activity, the growth in profits will lead to more capital investment without any significant increase in pressure on financial markets. Admittedly, the profits picture has improved; even after subtracting inflation-swollen inventory profits, corporate accountants posted a 6-percent profits increase during the April-June quarter, and a return to early 1974's peak figure can be expected later this year as business sales improve. But we have some distance to go to achieve the average return on capital considered normal a decade ago, and meanwhile the nation's investment needs grow apace--for energy development, for pollution control, and for job creation in general. It's only logical to expect a substantial growth in private credit demands in these circumstances, which means wholesale crowding out if Treasury deficits continue to rise.

Some observers argue that the Federal Reserve's task is to ensure that all borrowing demands--both Federal and private--are accommodated at stable or declining rates. Such an approach, by flooding the markets with liquidity, could prevent current credit-market strains but at the expense of fueling inflation anew as the recovery builds up steam. But, the question goes, with so many idle resources in the economy, how could inflationary pressures arise from easy money at this stage?

The answer, at least in part, involves the lags in the effects of monetary policy, which seem to be much shorter for production, employment and profits than for prices. Our knowledge about the length of those lags