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THE 1978 ECONOMY: OUTLOOK AND POLICY

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This is the time of year that the innocent bystander is likely to get caught in the crossfire of conflicting forecasts. However, the disagreement among economists may not be as wide as it usually has been--not that there is any unanimity of opinion. By and large, most economists now anticipate that the expansion in the American economy will continue through 1978. The average rate of growth, however, is expected to slow a bit, from 5 percent in 1977 to about 4½ percent in 1978. The rate of inflation is generally anticipated to remain in the 6 percent zone, although edging up slightly. (See Table 1).

Table 1

Capsule Economic Outlook

	1977	1978
Real Growth	+ 5 %	+ 4 1/2%
Inflation	+ 5 3/4%	+ 6 1/4%
Total	+10 3/4%	+10 3/4%
Gross National Product (in billions)	$1,885	$2,090

The key disagreement relates to whether the year ahead will end on a downbeat (and thus set the stage for proposals for more economic stimulus) or whether 1978 will wind up on an upbeat. Personally, I am intrigued by the likelihood that we may be witnessing a new seasonal phenomenon--that 1976, 1977, and 1978 will all show a strong first half and a weaker second half. That surely may be mere coincidence. However, it is plausible that the recurring summer doldrums in business decision making and the widespread plant closings for vacations may be responsible for a relatively quiet second half of the year. In contrast, good Christmas sales may set in motion inventory restocking in the new year and another round of expansion. If this new seasonal pattern is the case, then a slowdown in growth during the second half of the year should not automatically be the occasion for pressing the panic button.

The Major Sectors of the Economy

Let us examine briefly the trends in each of the major sectors of the economy before drawing any conclusions about appropriate economic policy for 1978 (see Table 2).

Table 2

Projections of Major Economic Sectors

(In billions of dollars)

	1977	1978
Consumer Purchases	$1,208	$1,328
Business Investment	282	317
Government Purchases	395	445
Gross National Product	$1,885	$2,090

Consumer Spending

That major sector, consumer purchases of goods and services, which accounts for about two-thirds of the GNP, is shifting from a leading to a supporting role in the continued advance of the American economy. Real consumer spending is growing at about 5 percent this year and is likely to average a rise of not much above 4 percent in 1978. The major reason for the change of pace is in automobile buying, which has been expanding at a 10 percent rate this year and should be just about at the average for all consumer spending next year. The continued growth of personal income, before and after taxes, is the mainstay for the modest optimism for this sector. During the past month, the major retail chains have reported double-digit gains in sales over comparable periods in 1977. Surely, consumer spending remains on an upward course.

New Housing Construction

Homebuilding continues to be one of the growth sectors of the economy. New starts are running at a 1.9 million rate this year and could reach the 2 million level in 1978 (consisting of 1½ million single homes and 500,000 multifamily units). Demographic factors are strong, with a record number of young adults reaching the age at which they buy their first house. Constraints on new housing construction may come on the supply side during 1978, with problems in the availability of selected building materials such as insulation and of skilled employees in a few regions. As a result in part of greater local regulation, the supply of fully developed lots is rather modest in some housing markets.

With moderately rising interest rates (a subject to which we will return), we should anticipate a reduced inflow of savings into the thrift institutions during the coming twelve months. On the favorable side, my crystal ball shows neither a credit crunch nor disintermediation, although the latter situation may need careful watching. Many consumers are viewing the purchase of a larger (or at least more expensive) home as not only a good inflation hedge, but as one of the few opportunities available to most individuals to realize capital gains.

Business Investment

Capital spending is likely to continue to be a major growth area, but at 5 percent (in real terms) to disappoint those that expect a more rapid expansion. There are many reasons for this relatively modest pace. Most industries have adequate capacity, at least to meet short term needs. Uncertainty about federal energy and tax policy tends to delay new capital spending decisions. But perhaps more fundamentally, the typical business firm seems to be viewing long term investment as being riskier than in the past. To an increasing degree, there is a new dimension of risk facing American business. It is a special type of political risk, although not the danger of outright nationalization which occurs in some foreign countries. Rather, the political risk that is developing in the United States relates to the likelihood that the regulatory process will either impede the construction of major new facilities or interfere with their operation if or when they are completed.

Technically, this means that business firms are incorporating higher risk premiums in their investment calculations, thus discounting future earnings more substantially. In this view, outlays for equipment with relatively short pay-out periods are preferred to investments in more durable assets. The data on business investment in new construction tend to confirm this. The construction of new plants in real terms is running at an annual rate of about \$38 billion, which is substantially below the \$43 billion range reported back in 1972. With a few zigs and zags, the trend in real construction of new factories in this 5-year period has been distinctly downward. As an aside, extending the investment tax credit to cover construction as well as equipment might be an appropriate policy response to this situation.

Most business firms have been cautious in their inventory policies, remembering the excesses of 1973-74, and thus avoiding any hedge buying. In fact, I expect some moderate expansion in inventories during the coming year, especially in nondurable industries, in line with sales prospects.

Foreign Trade

The unusually large deficit in international trade that the United States is experiencing this year (approximately $30 billion) is likely to be repeated next year. One of the reasons is the GNP growth rate in the United States is greater than in most of the foreign countries that are our major customers. As a result, our imports (which depend on our GNP growth) are rising faster than our exports (which are influenced by their economic condition). Western European countries, for example, are reporting average real growth rates of only 2 - 3 percent.

The major reason, however, for our large trade deficit is our continued heavy dependence on imported oil. Restraints on the domestic price of energy, although they may have political appeal, continue to dampen the incentive for increasing domestic energy supplies. They simultaneously encourage a high level of consumption beyond the current capacity of our domestic energy industry, and thus increase this country's dependence on expensive imported oil. It is ironic that our reluctance to see American oil companies earn attractive levels of profits means, in practice, that much higher levels of profits are being obtained by foreign oil producers. Deregulation of domestic energy prices, in addition to achieving important domestic objectives, would also help to improve the foreign trade position of the United States.

Government Purchases

Purchases of goods and services by all levels of government are expected to rise (in real terms) from a 4 percent rate in 1977 to 6 percent in 1978. The expansion is likely to be generalized, including federal, state, and local procurements, and both military and civilian programs.

The Overall Outlook

What does all this add up to? Nothing very dramatic, is the most accurate answer. I anticipate that real economic growth will average 5 percent in 1977 and about 4½ percent in 1978. The rate of inflation, which should turn out to be a little less than 6 percent this year, may be a bit above 6 percent next year. The unemployment rate will continue to decline moderately. Although this trend may disappoint some, it is the kind of sustainable situation which is most conducive to achieving long term prosperity. Maintaining this trend should avoid a boom-and-bust cycle and permit sustained expansion of productive job opportunities.

Public Policy Questions

Important questions relating to monetary and fiscal policy will arise during the course of the next twelve months. In the money and credit area, I anticipate that the Federal Reserve will moderate the rapid growth in the money supply that has characterized much of this year. Personally, I do not foresee a credit crunch because I expect (or at least hope) that the Fed will not swing to an extreme position, but merely ensure a more slowly growing supply of money than has been our recent experience. On that basis, I would forecast a further rise of about one percentage point in short-term interest rates during the year ahead, and perhaps approximately 3/4 of one percent in long-term rates. The end of 1978, however, may see interest rates a little below the peaks that they will reach earlier in the year.

Fiscal policy is likely to remain expansive. On the basis of current policy, I would expect that the federal budget deficit will rise from \$45 billion in the fiscal year that ended on September 30, 1977 to \$55 billion in fiscal 1978. The odds now seem to favor a tax cut next year to provide additional stimulation to the economy of about \$15 - \$20 billion. (See Table 3). It would be helpful if a substantial portion of the tax reduction were focused on business. A reduction in the corporate income tax rate or an increase in the amount and coverage of the investment tax credit would provide significant benefits in terms of added capital investment and thus a more rapid rate of economic growth. More detailed tax "reform" appears to have been postponed indefinitely. After examining the recent trial balloons by the Carter Administration (such as eliminating capital gains, etc), I am beginning to believe that the optimum amount of tax reform is zero.

Table 3

PROJECTIONS OF THE FEDERAL BUDGET

(Fiscal Years. In billions of dollars)

	1977 estimate	1978 estimate	1979 projection
Current Policy			
Outlays	402	452	499
Revenues	357	397	467
Surplus (+) or Deficit (-)	-45	-55	-32
Assuming Tax Cut			
Outlays	402	452	498
Revenues	357	397	448
Surplus (+) or Deficit (-)	-45	-55	-50

"Incomes" policy, thankfully, seems to have become a dead letter. Any of the various forms of direct government intervention in wage and price decision making (be they "voluntary" guidelines or flat-out controls), would be counterproductive. However, I share the concern with many that monetary and fiscal policy do not seem to be adequate to deal with the simultaneous presence of high inflation and high unemployment. I would like to see those "macroeconomic" policy mechanisms supplemented with what I call the Free Market approach to economic policy.

But my prescription for change is hardly in terms of a further shift of power from the private sector to the public. To me, that would be in the nature of the traditional hangover remedy known as "having a bit of the hair of the dog that bit you." Rather, I urge greater reliance on the competitive forces of the business system to keep down inflationary pressures while providing higher levels of production, income, and employment. Specifically, we need to reduce that massive array of government laws, rules, and regulations that give an inflationary bias to the economy and often also reduce job opportunities in the process.

The consumer pays in many ways for excessive government intervention in the economy: higher taxes to support a veritable army of regulators, higher prices to pay for the more expensive production methods required by government agencies oblivious to the costs they impose, and delay in the introduction of new and better products, as government reviews, postpones and reviews again.

We all have read about the cases where Interstate Commerce Commission rules require trucks to remain empty on long return trips, even when suitable loads are available. Those inefficiencies are not isolated examples. Professional studies show that the annual cost to the consumer of excessive federal government regulation comes to over $60 billion a year.

I do not mean to pick on the ICC. It is no isolated example. Large costs and inefficiencies result from the anticompetitive rulings of many of the other regulatory agencies. The Civil Aeronautics Board restricts airline entry. The International Trade Commission restricts imports. The Federal Communications Commission restricts ownership of radio and television stations. The Federal Power Commission controls the price and thus restricts the supply of natural gas. The Federal Maritime Commission subsidizes inefficiency and thus reduces the competitiveness of the American merchant marine.

What's the answer? Congress should take a new and hard look at that massive array of government regulation that has accumulated over the last century. It should eliminate those, such as in the transportation field, that interfere with the effective functioning of competitive market forces. The others, such as in the health and safety areas, should be required to meet the rigorous standards of a benefit-cost test.

This approach is not a guarantee for less government intervention in the economy, but it will help to ensure less costly and less disruptive regulation where government action is necessary. Thus, progress will be made to reduce inflation and unemployment without expanding further the role of government.

Conclusion

Despite the relatively low level of business confidence in the economy (much of which I would attribute to the extended period of on-the-job training on the part of the Carter Administration), I expect that the coming year will be a period of some prosperity for the United

States. Although it will not be one for the record books, 1978 as a whole likely will see rising overall levels of production, employment, sales, and profits. We could do worse--and we may, if some of the enthusiasts for greater government intervention have their way.