Occasional Paper 18

11-1-1978

The Coming Slowdown in the U.S. Economy

Murray L. Weidenbaum
Washington University in St Louis

THE COMING SLOWDOWN IN THE U.S. ECONOMY

By Murray L. Weidenbaum

An Address to the Thirty-Second Annual Conference of Bank Correspondents of the First National Bank in St. Louis, St. Louis, Mo., November 16, 1978.

CSAB WASHINGTON UNIVERSITY BOX 1208 ST. LOUIS, MISSOURI 6313C

CENTER FOR THE STUDY
OF AMERICAN BUSINESS

THE COMING SLOWDOWN IN THE U.S. ECONOMY

By Murray L. Weidenbaum, Director
Center for the Study of American Business
Washington University, St. Louis

An Address to the Thirty-Second Annual Conference of Bank Correspondents of the First National Bank in St. Louis, St. Louis, Mo., November 16, 1978.

Judging by recent developments, the practitioners of economic forecasting should be eligible for hazardous duty pay -- or perhaps the working conditions should be subject to the rules governing safety in the work place. In any event, the uncertainty attached to making prognostications of the business outlook is far greater than it normally is during the forecasting season.

Nevertheless, several key trends seem to be evident. First and foremost is the great likelihood that the pace of economic activity in the United States is slowing down. We can debate whether or not we technically will be in a recession next year. But what does seem clear is that the economy is shifting to a lower gear. Surely we are going most of the way to recession, whether or not we technically experience two consecutive quarters of negative real growth. From the rapid rebound of 8.7 percent in the second quarter of this year, real GNP grew at 3.4 percent in the third quarter. Gains for the next three quarters are likely to be smaller, if any. Thus, the economy is becoming vulnerable to recession. Future changes in public policy and the subsequent public reaction can easily spell the difference between slow growth and actual recession.

Economic Strengths and Weaknesses

In making a forecast, it is useful first to briefly examine the strengths and weaknesses that now characterize the American economy. The plus factors should not be underestimated.

1. The continued expansion of personal income. To a significant extent, this reflects the positive side of big government. The massive infusion of transfer payments is likely to be accelerated by a slowdown in the private economy.
2. The substantial amount of capital spending that is in the pipeline. Capital outlay trends, we must realize, are very uneven. While business as a whole is planning a modest 10 percent increase in new plant and equipment next year, aerospace and fabricated metal producers anticipate increases in excess of 20 percent. In contrast, rubber, textile, and food processors are cutting back from the 1978 level. All in all, about 3 percent real growth in business investment is now anticipated for 1979.
3. The cuts in taxes recently voted by the Congress. A real plus was the elimination of virtually all of the misguided attempts at closing so-called loopholes and the welcome shift in emphasis to promoting investment.
4. The reduction in our foreign trade deficit. This is resulting from a variety of factors, such as the recovery of the Western European economies (more exports), the slowdown in our own (less imports), and the depreciation of the dollar which occurred earlier this year.

Offsetting these are important negative factors:

1. First of all is the expected slowdown in monetary growth and a further rise in interest rates. Such action, long overdue,

is necessary to contain the rising inflationary pressures. But, to the extent that restrictive monetary policy succeeds, it also tends to adversely affect the real level of output in the economy.

2. <u>The high level of consumer indebtedness, which may act as a brake on future purchases of consumer goods</u>. The data show that individual families are not increasing their debt burdens, but that more people are going into debt. Installment debt payments are equal to about 6 percent of disposable personal income -- which is not a new record for the American economy -- but surely a soft spot in the economy.
3. <u>The tendency of high interest rates to curb new housing construction</u>. A downturn in new starts is likely in 1979, to about 1.5 million from this year's expected total of approximately 2 million. High interest rates are discouraging savings and loan associations from issuing more certificates based on Treasury bill rates. They will be depending more heavily on federal housing agencies for their financing, which often is a tail-chasing activity. I say this because those off-budget agencies in turn get their funds by borrowing in the market in competition with the demand for housing and business credit.
4. <u>The slow growth in productivity</u>. This situation is being exacerbated by often needlessly costly government regulation. Here, frankly, the Administration seems to be trying to do as much as they can within the confines of existing statutes. What is needed, of course, is a new law passed by the Congress limiting new regulations to those instances where the benefits exceed the costs.

5. The prospect of more "jawboning" and other federal intervention in wages and prices. Controls are not inevitable. Yet, the administration seems to be walking down that road, albeit hesitantly and with sincere protestations about not going all the way. Meanwhile, the 7 percent pay guidelines of the administration can be described as based on a "lick and a promise." At least half of all workers may be exempt because of the exclusion of those earning less than $4 an hour and those covered by existing union contracts. Similar constraints do not appear on the price side. This means that, were the guidelines to be taken seriously, they would lead to a squeeze on profits. For a while, large and visible companies are likely to try to avoid public confrontations with the Administration.

Economic Policy Impacts

Where does all this lead us? I believe that the odds are now increasing for recession sometime in 1979. Although that is no occasion for jumping with joy, it does have an obvious positive side: a sustained slowdown in the pace of economic activity will help to control the inflation that has become the most serious problem facing the nation. Frankly, I do not see much help from the administration's new wage and price program. The only truly successful example of jawbone action was reported in the Old Testament. Samson, according to the Bible, used the jawbone of an ass. Any amelioration of the inflation rate is likely to be temporary or accidental.

Personally, I prefer the more conventional approach of monetary and fiscal policy. Frankly, it is perplexing to see the administration boasting of getting the federal budget deficit down to "only" $40 billion.

When we add at least $10 billion for the so-called off-budget agencies, we are talking about a total of Treasury deficit financing in the neighborhood of $50 billion a year. That is not exactly my idea of fiscal stringency. Surely, the announced program of budget restraint is commendable and should be supported. But we must acknowledge that the bulk of the reduction in the estimated deficit for the current fiscal year is the almost accidental result of two independent factors: (1) a smaller tax cut than was originally proposed and the postponement of its effective date to January 1 and (2) the inability of the federal agencies to spend money as fast as Congress appropriates it (part of that is due to the natural tendency to avoid exceeding the Congressionally-mandated expenditure targets).

Trends in the Federal Budget

(In billions of dollars)

Category	Fiscal 1977 (Actual)	Fiscal 1978 (Estimate)	Fiscal 1979 Projected	
			Administration's Initial Proposal	Second Congressional Resolution
Receipts	357	400	440	449
Outlays	402	450	500	488
Deficit	45	50	60	39

Moreover, until the international fall of the dollar forced their action, the Federal Reserve System was not precisely following a policy of tight money. From the third quarter of 1977 to the third quarter of 1978, M1 rose by 8 percent. Over the past year, the monetary base has grown even faster -- by 9½ percent. It will take some time before that inflationary potential works its way through the economy.

When we consider all the inflationary legislation and regulation enacted and promulgated by the Congress and the administration during the past year, it is hard to take them seriously when they turn around and ask the private sector to exercise restraint. Current economic policy seems to be a classic case of the trite but appropriate statement, "Don't do as I do, do as I say."

We should not underestimate the strength of the many inflationary forces that are present in the economy:

1. On January 1, 1979, the statutory minimum wage is scheduled to rise by 25¢ an hour. Also effective with the beginning of the year, employer payments for social security will rise at a $5 billion annual rate.
2. Another oil price increase by the OPEC nations appears to be in the offing.
3. Wages and fringe benefits are rising at an average annual rate of about 8½ percent. With productivity up a sluggish 1½ percent, the underlying inflationary pressures (in terms of unit labor costs) are in the neighborhood of 7 percent -- a very rough neighborhood. Moreover, 1979 will be a year when major labor union agreements expire, notably the bellwether Teamster's over-the-road contract in March.
4. Inflationary expectations remain high. Unless altered by recent policy actions, they will be a self-fulfilling prophecy.

What is clearly needed for the economic health of the nation is to trim back the size of the public sector. Big government truly needs to administer to itself a carefully prescribed dose of self-restraint.

Otherwise, aroused taxpayers will force on it a crash starvation diet which it would surely deserve. The year 1979 may turn out to be the period in which a fundamental change is made. The new trend may occur in response to the rising voter resistance to the rising costs of government. If the change does occur, the effect will not be felt immediately, but the entire public policy process may well shift to a lower gear. That is, we will begin to experience slower long-term growth rates in government spending and in taxes.

A shift is occurring in the way that voters are evaluating the performance of their elected representatives. No longer is the electoral prize going to the candidate who can promise the biggest new spending programs. Rather, voters' hearts are being captivated by promises of tight budgeting and tax reduction. In a real sense, it is a new way of thinking about the public sector that is gaining acceptance among the electorate: the notion that, because society's resources are limited, government cannot attempt to meet every demand of every group in the nation.

The newer approach (some might say it really is a return to a way of thinking which was more conventional in an earlier age) is not likely to alter substantially the prognosis for high rates of inflation in 1979. But it does contribute to a more positive assessment of the longer-term economic outlook.

Conclusion

Let me leave you with my fearless forecast for 1979. Year to year, real GNP (output after deducting inflation) will be higher next year than this year. But the difference is likely to be so small (approximately 2 percent) that we can have one or two quarters of the year when the economy does not grow at all or even experiences a downturn. The legacy of strong inflationary pressures will produce an average inflation rate for 1979 in excess of 7 percent. The slow rate of growth also means that not enough new jobs will be created to absorb the growing labor force. Thus, the unemployment rate will turn up and will head towards 7 percent once again. On the other hand, I anticipate that interest rates -- which may continue rising through the spring -- are likely to be lower a year from now than they are today.

In my foggy crystal ball, we are likely to be looking down into the recessionary abyss during much of 1979. It is not written in the stars that we will fall in, but the odds now seem to favor it. Nevertheless, that is not really bad news for the long term. I say that because the seeds are being sown for a brighter outlook in the form of a smaller public sector in the 1980s and a new upsurge in private capital investment that should mean a resumption of greater economic growth on a healthier basis -- smaller budget deficits, higher productivity, lower interest rates, and less inflation. This optimistic scenario is not inevitable either, but the odds here, too, are higher than they were a year ago.