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December 1975 Trendline

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Anderson

file: policy study group

TRENDLINE

DECEMBER 6, 1975

By H.P.M.

The standard or consensus forecast for 1976 is that it will be a year of relative tranquility characterized by twin-sixes (shades of Packard); that is the usual forecast is that there will be six percent increase in real Gross National Product and a six percent rise in the comprehensive price level. In the light of the failure of standard forecasting techniques over the past several years, and the turmoil and instability exhibited by the economy in recent years, it is best if we take this forecase with a proverbial grain of salt. We had better take a look at what happened in 1975 and the way in which the events of 1975 set the stage for 1976 before we accept this scenario of moderate expansion and moderating inflation.

A vigorous expansion occurred in the last three quarters of 1972 and the first quarter of 1973, during which Gross National Product rose at an eight percent annual rate. This was followed by three quarters of unsatisfactory growth in late 1973, a moderate decline in the first three quarters of 1974, and a sharp decline in the last quarter of 1974 and the first quarter of 1975. The trends in these two quarters just a year ago were such that if such a decline had persisted for another two quarters we really would have had a "hair curling" depression. However the decline was braked sharply in the second quarter of 1975 and the third quarter of 1975 saw a rapid rise in real Gross National Product. Thus the first three quarters of 1975 were characterized by (1) an 11.4% annual rate drop in Gross National Product in the first quarter, (2) a 1.9% annual rate rise in the second quarter, and (3) a whopping 18.6% annual rate rise in the third quarter. These rapid changes in direction are hardly a history that foreshadows tranquility in 1976.

Data on the Flow of Funds in the American Economy through the third quarter of 1975 became available in mid-November. These financial data give us some deeper inkling

of what happened than the raw Gross National Product data. It is clear from Table I that the years 1970-73 saw an explosion in the funds that households and corporate business raised in financial markets. The funds raised by households rose from $23.4 billions in 1970 to $72.8 billions in 1973, before falling to $44.0 billions in 1974. The funds raised by corporate business rose from $39.5 billions in 1970 to $77.1 billions in 1974. The growth rate of new debt by primary private sectors far exceeded the growth rate of the income of these sectors.

TABLE I

Funds Raised by U.S. Government and
Private Domestic Non-Financial Sectors
in
Billions of Dollars

	U.S. Government	State & Local Government	Households	Corporate Non-Financial Sector
		ANNUAL FLOWS		
1970	12.8	11.3	23.4	39.5
1971	25.5	17.8	39.8	46.3
1972	17.3	14.2	63.1	55.3
1973	9.7	12.3	72.8	67.2
1974	12.0	16.6	44.0	77.1
1975I-III	59.6	10.8	28.7	21.3
		QUARTERLY UNADJUSTED FLOWS		
1973I	8.853	2.570	11.900	16.241
II	-5.994	2.468	20.572	20.627
III	-0.457	3.934	19.463	15.311
IV	7.312	3.284	20.880	14.972
1974I	3.389	3.784	3.694	16.479
II	-6.186	4.526	15.534	25.937
III	4.485	4.223	11.918	17.192
IV	10.310	4.023	12.845	17.504
1975I	19.244	3.275	3.262	4.428
II	16.615	4.198	13.296	10.303
III	23.741	3.362	12.172	6.600

The modest decline in income in 1974 was associated with a fall of some $28 billions in the funds raised by households. Some $12 billions of this was a fall in home mortgages, and $13.3 billions was a fall in consumer credit. The weakness of housing and automobile demand is reflected in the financial data. After the initial fall in home mortgages in early 1974 from the levels of 1973, the flow of home mortgages has been quite stable, which reflects the fact that single family home sales and prices have held up well in the last two years. On the other hand the sharp decline in automobile and consumer durable sales in 1975 is reflected in a further drop in consumer credit in 1975. A recovery of consumer credit in 1975III is associated with a sharp recovery in spending on consumer durables.

Even as household debt financing was decreasing in 1974 and early 1975, personal income and more clearly disposable personal income kept growing during the recession, because of the continued growth in transfer payments and the tax rebates of 1975. As a result of this combination the savings rate rose to the extremely high 10.6% rate in 1975II. This savings rate indicated that consumers spending would soon increase, as it did the next quarter.

There was a sharp drop in funds raised in 1975I through III by the corporate, non-financial sector. In good measure this drop in funds raised reflects the liquidation of inventories. However it also reflects a decline in corporate investment spending relative to corporate cash flows which is more important than the inventory liquidation, and the resultant fall in the need for short term funds, for the future of the economy was the closing of the gap between fixed investment and external funds over 1975. This occurred because of a stabilization in dollar terms of fixed investment and a sharp rise in corporate internal funds.

One of the historical patterns is that a rise of the ratio of corporate external funds to gross internal funds takes place in good times - especially in periods of

extended good times - and a decline of this ratio even unto negative values, occurs in recessions and periods of sluggish performance. The corporate business sector increases its leverage in good times and builds a financial basis for renewing capital expansion in recessions. However experience has been that when the ratio of fixed investment to internal funds falls to or below 1, it does not immediately return to ~~the~~ ratios such as were exhibited in 1973 and 1974 (see Table II). But historically it is the excess of corporate spending on fixed investment over corporate retained earnings that has powered strong booms. Thus the 1973-75 evidence on corporate financial behavior indicates that it will take some time - certainly a matter of several quarters and perhaps several years before the internal motivations of corporations will lead to a serious expansion of investment. In both the liquidation of inventories and the 1975I-III pattern of corporate finance we see evidence of a new corporate financial conservatism - imposed by a combination of the burden of inherited debts, the skin of our teeth experience of many organizations in 1974 and 1975, and the greater caution of bankers and financial market participants.

TABLE II

Non-Financial Corporate Business Financing
Requirements for Fixed Investment

Quarterly 1973I-1975III

	Gross Internal Funds	Fixed Investment	Required External Finance	Ratio of Required External Finance to Internal Funds
1973I	19.919	22.571	2.652	13.3%
II	21.448	29.107	7.659	35.7
III	21.580	28.291	6.711	31.1
IV	21.649	28.659	7.010	32.4
1974I	20.355	24.161	3.806	18.7
II	20.679	32.168	11.483	55.5
III	19.535	29.739	10.194	52.2
IV	20.914	28.899	7.985	38.2
1975I	21.272	22.746	1.474	6.9
II	24.818	29.480	4.662	18.8
III	28.282	29.503	0.221	0.8

One aspect that is worth noting in Table II is the sharp rise in corporate gross internal funds over the period of the recession. This indicates that corporate profit margins have increased substantially; corporate gross internal funds in 1975III were approximately 40% greater than in 1974III in spite of the smaller real Gross National Product and a modest 6% rise in nominal Gross National Product. This growth rate, of corporate internal funds relative to the growth of Gross National Product cannot be sustained for too many quarters, however to the extent that it is sustained the ability of corporations to service and thus to issue debt is improved. The path of corporate internal funds should be watched carefully as an early signal for the establishment of a situation conducive to a resumption of net debt financing of corporate investment.

The screeching halt to the decline in 1975II and the sharp recovery in 1975III can be imputed to the hugh government deficit that was piled up in the year 1974IV-1975III. It must be clear to all that a government deficit of $70 billions over a four quarter period will have an enourmous expansionary effect - because of both the direct effect of the incomes thrown at households and the orders flung at business by such deficit financing and the indirect effect of the forcing of secure financial assets in the form of government debt into the economy. The $69.9 billions of funds raised by the U.S. Government between 1974IV and 1975III have to show up directly or indirectly as assets in private portfolios. If they are bought by households or business they show up directly, if they are bought by banks or other financial institutions they show up in the asset composition behind the liabilities of these banks or financial institutions. Thus the government deficit over the past four quarters has both directly halted the fall in income and it is providing secure safe assets for absorption in portfolios; assets which cushion the effect of weakened private assets in financial institutions. The more secure portfolios will, in time, provide the foundation for a renewal of business expansion by means of deficit financing through these financial institutions.

Keynes once differentiated between the state of confidence and the state of credit: the state of confidence referring to the views of businessmen as to the likely success of ventures and the state of credit referring to the willingness of bankers to finance an expansion. Keynes argued that on the whole after a blow - such as the economy suffered over 1974 and 1975 - entrepreneurial confidence is quite quick to recover but the state of credit, which reflects the views of lenders and financiers, recovers more slowly. As is well known the problems of the big banks are not over, even if the slide of the economy has halted. The likelihood persists that even after the bail out of New York City by the Ford Administration some of the other financial excesses of the giant banks will come home to haunt them: be it the airlines, oil tankers, another W.T. Grant, or the collapse of the credit of some third world country. Thus we can expect that the big banks with their exposure to large losses and their already paper thin equity positions will not quickly finance a strong expansion.

The recovery is very vulnerable to a disturbance from financial markets - a disturbance that can take the form of either more obvious difficulties for a giant bank or the form of bankruptcy of one of the "walking" bankrupts in a highly visible industry such as the airlines or even a major REIT. We should factor into our explanation of the rapid decline in income in 1974IV and 1975I the formal liquidation of Franklin National in 1974IV. A similar spectacular event sometime in the next six months will upset the tranquil and modest progress scenario that has been sketched for 1976. It is no accident that when the chips were down Ford backed down from his hard line on New York City. One "shock: that it is likely to be forthcoming is foreshadowed by the action of Marine-Midland banks in cutting its dividend rate. How will financial markets and banks react to a dividend cut by other perhaps more prominent giant banks?

I would expect that if the recovery is to be at all strong and sustained the private driving force will first come from below: from smaller firms which do not use

elaborate plant, which can experiment with capital saving-labor using technologies, and which can be financed by the relatively stronger and more secure portion of our financial structure - the middle sized to smaller banks. However we do not expect such structural changes to come quickly.

Because of the importance of the big banks in our economy and because of their expected financial conservatism over 1976 - a conservatism which will reflect both their loss experiences and pressure from the Federal Reserve - we can expect a two-tier effect in financing terms to exist. The interest rates on risk free assets and the prime interest rates will go down, reflecting the big banks quest for security and the greater reliance on internal funds by the corporate sector. At the same time as interest rates are declining we can expect to see that the filter which bankers and financial markets use for any quality class to become finer. Thus even as money market rates go down we can expect 1976 to see increased differentials among interest rates - differentials which reflect not so much the current and future prospects of the enterprise concerned as the loss experiences of 1974-75.

Even though the rise in corporate internal funds through 1975 indicate that a quick resumption of expansion is in order, increased financial conservatism will put a damper on the recovery. In the light of the expected lack of exuberance in private externally financed investment in 1976, the path of the recovery will largely be determined by the pace of government deficit spending. The horendous social costs of the thrust of existing policies calls for restructuring and reform of the interaction between government and the private economy, even as economic stabilization and recovery call for a continuation of the trends in government spending. It was government spending and taxing policies largely due to transfer payments that led to the remarkable phenomena in 1974-75 that quarterly disposable personal income never fell in spite of the sharp fall in employment.

We have to begin to recognize that our present way of maintaining Gross National Product and even our present structure of Gross National Product are inefficient. We truely need a new age of reform - but what we are getting are slogans and more of the old programs.

Meanwhile the six-six forecast looks good unless the apple cart is upset by either further exposure of financial weaknesses or an attempt by the government to bring expenses quickly in line with revenues. If we didn't have the hugh deficit in 1975 the trends in Gross National Product of 1974IV and 1975I would have persisted, and if we pull the prop of govermment deficits and debts out too quickly we might soon resume that decline. Unfortunately we are addicted to government deficits and to an inefficient structure of government spending.