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June 1976 Trendline

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One year ago - in the second quarter of 1975 - the massive government deficit brought the sharp decline of the economy to a halt. It is quite evident that the first and second quarters of 1976 have seen a stronger than anticipated recovery. This stronger than anticipated recovery has been largely consumer based.

During 1975 the Federal Government ran a massive deficit. This deficit was offset by higher consumer savings and a decrease in the business sector deficits. The higher consumer savings took two forms: an accumulation of liquid assets and a decrease in household debt. The decrease in household debt was in good part the other side of the coin to the miserable automobile sales.

Postwar experience has shown a consistent pattern of household behavior in which consumer spending leads in an expansion. The floor to the economy provided by the now large government not only limits the rise in unemployment but also, as we saw last year, turns the economy around. During the time unemployment is increasing and business is deteriorating household savings ratios rise as employed workers save for the rainy day that seems upon them. Once it is recognized that the sharp rise in unemployment is halted and the drop in business has ceased the household savings ratio decreases and households begin to use their accumulated liquid assets for purchasing.

Initially we can expect the purchases not to involve large bodies of consumer debt. The strong vacation travel during last winter may have been a first sign of recovery in consumer spending.

But as consumer confidence recovers, consumer debt financed spending recovers. We see this in the current strong sales of automobiles.

Thus 1976 is turning out to be a good year for those whose business is close to consumer sales. However the recovery to date has not been strong in plant and equipment spending. One sign of the continued lag in business spending is the behavior of business borrowing from banks: Commercial and industrial loans at the large weekly reporting banks stood at approximately $111 billions in mid May 1976 and at approximately $123 billions one year earlier. In spite of the recovery over the past year, business borrowing is down by 10% - and still trending down.

Another sign of the lackluster demand for business financing is seen in the decline of the outstanding negotiable certificates of deposits. At year end 1975 these certificates stood at $83 billions, at mid May they stood at $67 billions - a decline of some 20% in less than five months. Large denomination certificates of deposits are a key element in liability management banking and the outstandings reflect the need for funds by the borrowing banks. It is clear that banks are not aggressively selling their debt in order to acquire funds to finance business.

In the light of the slack loan demand and the absence of pressures upon bank resources the rise of money market interest rates during May seems to be an anomaly. During May interest rates on Federal Funds and three month Treasury debt rose a bit more than 50 basis points, so that at the end of May they stood at around 5.5%. Longer term rates also went up: Long term government securities and corporate AAA bonds both went up by 25 basis points.

Even though it became clear as May proceeded that the recovery was stronger than anticipated it nevertheless is <u>not</u> a boom; unemployment rates are still very high, and excess capacity is still widespread. Furthermore the demand for business financing is still declining and banks are not hard pressed for funds. The basic supply and demand situation does not call for a rise in interest rates. Furthermore the stock market has been in a doldrums; bank resources are not being absorbed by any burst of stock market credit.

One interpretation of the rise in interest rates is that the money market is reacting not to current conditions but to anticipated actions by the Federal Reserve System. As a result of pressures from Congress and economists who follow the Monetarist persuassion the Federal Reserve has announced targets for money stock growth. Even though the growth of the money stock over the past year - and even since the middle of December - is well within the target rate set by the Federal Reserve the money stock has grown faster than the target rate since the first of the year and particularily over the past two months.

Even though the objective economic situation still calls for an even keel monetary policy by the Federal Reserve, the recent growth in the money supply means that the Federal Reserve will need to slow down the rate of growth of the money supply if the announced targets are not to be exceeded. The way in which the Federal Reserve tries to slow monetary growth is by raising the Federal Funds rate which it operates to achieve. Thus the rise in short term interest rates reflects a constraint imposed upon the economy not by the objective existing situation but by the theory which sets arbitrary limits on the short run growth in the money supply-because of a theory of how money supply in the long run affects income employment and prices.

On the whole the economy to date in 1976 has been behaving as we indicated it would in our TRENDLINES. The prospect for the rest of 1976 is for continued expansion. In spite of the recovery the government budget remains in substantial deficit and is expected to remain in deficit at least through 1977. Given that consumer's savings ratios have decreased and they can be expected to remain at the lower levels through the next year, the prospect is for continued increases in business profits.

The continued rise in business profits along with the modest increments to business plant and equipment spending means that business liquidity will continue to improve. This internal improvement of business liquidity along with the large volume of bond and new equity financing means that the financial stage is being set for a new business investment boom beginning in 1977. At that time a replay of tighter financial markets and accelerating inflation is likely to occur.

This prospect of a solid expansion through the remainder of 1976 and a more rapid, inflationary boom in 1977 can be aborted if a markedly unfavorable turn occurs in our balance of payments. Recent information on the rapid rise in gasoline consumption over 1976 indicates that pressures which can abort the recovery may arise from the trade balance. However this cloud is still quite small - and given the deteriorating political climate in much of Europe, even a large oil deficit by the United States might not cause much trouble. The oil exporting countries may have nothing much to do with their funds but invest in the United States.