TRENDLINE: draft H.P.M. April 5, 1976

The bottom of the 1973-75 recession ocurred just about one year ago. The halt of the "deep plunge" of 1974IV-1975I was abrupt, and with the decrease in inventory liquidation we witnessed a sharp rise in 1975III. The last two quarters 1975IV and 1976I can be characterized as a "normal" recovery: The fine year to year statistics reflect the depth of the decline rather than the sharpness of the recovery.

Even though employment is up and the unemployment rate is down to 7½% we must be acutely aware that we still have some seven million recorded as unemployed and seeking jobs. The unemployment figures are a bit misleading. At present at least 350,000 are employed in emergency employment through state and local governments: the 1976 equivalent of W.P.A. These programs are due to end on June 30th. If these workers were included in the unemployed, the unemployment rate would be almost 8%. (Incidently during the Great Depression those on W.P.A., CCC, and out of school N.Y.A. - the 1930's public service employees - were counted among the unemployed.)

If we combine the emergency public service employment and the hugh increase in unemployment insurance, food stamps, and other transfer payments into an analysis of what happened during this recession, it seems clear that the resilliance the economy has exhibited is <u>not due</u> to the workings of natural market forces as much as to the strong government action - some automatic and some through legislative programs. We are as a nation "hooked" on big government in order to sustain the economy. Instead of debating and attacking big government, as the politicians of almost all stripes are doing, the issue that needs to be debated is the "shape" of government programs, i.e."how can we make big government more responsive and more efficient?"

Because of the depth of the recession and because of special situations which were built up during the good times of the '60's and '70's, the recovery has been spotty. Multifamily housing, commercial construction, and commercial aircraft production remain at their lows: in fact commercial aircraft production still seems to be tracking downwards. Consumer non-durables and automobiles are doing well. Single family home construction has recovered nicely and machinery orders are showing signs of new activity. The picture is one of a drag upon the recovery from the overbuilding of speculative housing and commercial projects in the 1960's and 1970's.

The suspicion of government is evident in the slowdown of "state" and "local" government construction. In previous postwar recoveries state and local government often played a leading role. We just have to recall the spate of schools, hospitals, and municipal stadia that were built by local government units in the 60's and first half of the 1970's. Now we find no such new projects on the drawing board and given the sad history of

New York City and State, which rests in part on debt issues for special purpose construction, it is doubtful if many states can market anything less than full faith and credit bonds. The special gimmick financing by state and local governments is over for a while. These developments on the state and local government front if combined with the developments in commercial and multifamily (more than five units) construction indicate that the recession in construction is most likely to continue.

If we look a bit more deeply at the pattern of business investment - mainly manufacturing - that is developing we note that it is largely machinery and equipment expenditures that are recovering. Aside from energy related investment little in the way of new plants are on the drawing borad and authorizations for such expansions are lagging. In part this reflects a continued pressure on business to clean up their balance sheets: to get out from under the burden of debt.

Thus the recovery has been largely consumer based. The transfer payment explosion of 1974-75 meant that households savings increased rapidly. After a year or so of "accumulating" liquid assets and reducing debts consumers have begun to spend and to go into debt. Not unless there is such a burst of consumer spending as to lead to visible capacity shortages, can we expect to see any burst of capital spending in manufactures. The indications are that over the rest of 1976 the closer a business is to the final consumer, the better it will do and for those businesses that are closely related to construction, the recession will continue.

From a conventional perspective, much of the good news has been on the price front. Because food prices have been stable or going down a bit the overall index of prices has been relatively stable. The rate of increase of prices that we should experience in 1976 should be lower than the forecast rate of 6% - unless there is a significant wage push. Although the Teamsters settlement has been hailed as relatively modest, there is reason to believe that it will be significantly inflationary. This is so because the increase in productivity that we can expect in trucking is relatively modest.

There is a myth that any wage increase in the neighborhood of 3% per year is non-inflationary. This myth rests upon a belief that there is about a 3% annual increase in productivity over all the economy. However the impact of a wage increase upon a specific price depends upon the specific increase in productivity in the output for which the wage increase takes place. During the era in which the main interstate highways were being built, the increase in productivity ot truck transport was very large indeed. Each new highway completed and put into place meant a decrease in elapsed time. This combined with the larger and more reliabilte tractors meant a significant increase in productivity which enabled the hugh increase of teamster wages to be offset in part.

But we now have speed restrictions - albeit poorly enforced - and we have virtually completed the main lines of the interstate network. We can readily assert that the further road building will not have the impact on elapsed time between origin and destination that was experienced in the 1960 and 1970's as the interstate network was coming into use. Thus a larger proportion than hitherto of the wage increase to the teamsters will be reflected in rising prices. If we combine this efficiency effect with the full cost of living escalator in the contract, the outlook is for an inflationary push from wages - especially if the teamsters settlement becomes the pattern of future wage settlements i.e. 9%-10% per year plus full indexing is strongly inflationary in our present climate.

Given the supply and demand situation in financial markets, in the absence of inflationary wage pushes the forecast for interest rates over the next six months to a year would be a relatively stable pattern of short term rates and a declining trend in long term rates. The underlying economic situation calls for that pattern of interest rates. However the Federal Reserve's response to inflationary wage pressures, if they develop, might very well lead to a firming of short term rates from their present confortable range.

The Federal Reserve did move towards tighter money market conditions some six months ago and then backed off. Predicting Federal Reserve action is an exercise in politics and psychology as much as in economics. My view is that if there is a tightening of money market conditions in the next six months it will be transitory. There really is nothing in the fundamental position of the economy that will validate higher interest rates.

In a real and meaningful sense the period to October 1973 and even through to October 1974 was a period in which speculative activity - inventories, R.E.I.T.'s, facilities - pushed the economy into a strong demand pull inflation. There is nothing on the horizon and there are no ongoing financial market developments that point towards a resumption of such speculative activity. Thus a continued modest recovery, heavily dependent upon big government with some dangers of a cost-push type of inflation seems the best qualitative forecast for the remainder of the year.