7-1-1976

Into the Second Year of Expansion

Hyman P. Minsky Ph.D.

INTO THE 2nd YEAR OF EXPANSION

The leading sectors in the recovery, which is now into its second year, have been government spending -- especially the explosion of transfer payments in 1975 -- and consumer spending -- especially the strong demand for automobiles in 1976. This recovery now seems to be at a "pause" stage: a pause that can be likened to that which occurs when gears are shifted in an accelerating car. The economy has accelerated as much as it can with the present lending sectors. A further strong expansion requires that sectors that have been holding back take the lead.

Two sectors that have been lagging are business investment and construction, other than single family residences. Given the lead time in large scale construction projects and the continued slack in many industries it is doubtful that there will be a significant pickup in these dimension of the economy in the second half of 1976. We expect the economy to "hover" in approximately its current state throughout the rest of this year. A capsule characterization of the rest of this year would run as follows: Unemployment in the neighborhood of 7.5%, Gross National Product, after allowing for price changes, to increase at a 4% - 5% annual rate, the prime rate moving in the narrow range of 7% - 7½%, some downside pressures on long rates, and business profits improving, but more slowly than in the past year.

This overall picture -- of an economy pausing in a recovery -- represents a not unusual situation, especially if the recession had been deep and had been associated with financial trauma. The financial trauma in

1973/75 were more serious than any financial difficulties in the era since World War II. One reason for the sluggishness in construction is that an entire specialized financial industry that catered to large scale commercial and housing construction -- the REIT's -- has been eliminated as a channel for funds for new developments. The re~~vomal~~moval of a liberal and accomodating source of financing from the construction industry means that projects in this slack economic environment have to meet tighter financial and economic feasibility standards than was true in the boom days. Until financing standards are relaxed or until the 'excess supply' in the previous boom areas are liquidated, the construction industry is expected to remain slack.

There is some evidence that the "housing shortage" that guided government policy and personal choices over the past 40 years may be a thing of the past. In part this reflects fundamental demographic changes -- smaller families, fewer children, later marriages -- in part it reflects the fact that housing has been built at a very rapid rate throughout the past 25 years. Furthermore, new housing has become expensive relative to family income: the average new house now costs in excess of $40,000 while the average annual income of a worker in manufacturing is about $10,000 a year. Given that mortgage interest rates are in excess of 8%, the market for new housing is restricted to a small proportion of the population. The housing industry is trying to sell an expensive project in a market with an ample supply.

Another factor in the changing picture in housing demand is "ideological". Ever since 1936, when President Roosevelt proclaimed that one-third of the nation was ill-housed, housing demand has been subsidized by government because of a sociological perception that unsatisfactory social conditions were the result of poor housing. The argument, naive as it may seem today, that has guided policy for forty years is that by improving the physical surroundings we can achieve an improvement in social conditions. We now know that bricks and stones do not by themselves make a good society. Thus public housing and government programs of extreme subsidization of ownership of single family homes are in disfavor. A government blank check for home ownership at the bottom of the income scale is a technique for broadening the market and sustaining the price of older homes. If this prop is removed from housing demand, some of the demand for new or newer housing is eliminated.

One surprising characteristic of the past year is that in spite of the fairly strong recovery from the bottom of the recession over a year ago, business loan demand at the largest banks and at the New York banks has tracked downward. In part this reflects slack demand for business investment. An investment project requires an assemblance of parts -- some on the site of the project, others off the site. This assemblance has to be financed while the pieces are being put together and before the finished project goes on stream and is paid for by longer term funds. Investment requires a great deal of short term financing as it is in "process". But investment has not recovered and there are serious signs that investment will not recover in the very near future. Thus slack demand for loans at the largest banks can be expected to continue.

One aspect in investment demand that apparently needs to be taken into account in assessing the course of the recovery is that electric utilities are now factoring a significantly slower rate of growth of demand for power than hitherto into the determination of their capacity requirements. A slow down in the rate of growth of final demand for electric power means that the current demand for capacity can be stretched out. For example if electric power demand is expected to grow at 7% a year then capacity needs to doubled in 10 years, if demand is expected to grow at 5% a year then capacity needs to be doubled in 14 years. If growth expectations by utilities change from a 7% to a 5% annual rate then only 63% of the capacity increase required by a 7% growth rate over ten years would have to be put in place. Furthermore if electric utilities had been ordering plants on the basis of a higher growth rate and the growth rate of demand drops, then surplus capacity will develop as plants in process come on stream. This will lead to an even greater decline in demand for new capacity.

With major utility starts sluggish, with the change in forecasted growth, and with financial difficulties of 1973/75 quite fresh in memory, it is not at all surprising that the demand for loans at the large banks and in New York City is sluggish. However, the sluggish demand for construction and investment does not mean that the recovery will turn into another slump before the economy improves over its present situation. One repercussion of the pause is that the government deficit will be larger than it would have been with a quicker and a more complete recovery. This means business profits will be sustained and portfolios will be improved as they absorb government debt. The total picture therefore is for a "pause" and a "lag" until business investment and construction take the lead, not for a decline from present levels.

For business -- both small and large -- the prospect for the second half of 1976 and into 1977 is well enough but not outstandingly good. As is always true of such a "pause", we now have a situation in which true enterprize is most rewarded, where creative innovation by business is most required. The history of our complex and diverse American Economy has been that the new thrusts from such an "hovering" economy have always been forthcoming -- and usually from directions that have not been predicted. It may be that we are now in a "pause" out of which new leading sectors for the growth of the economy will emerge. An imaginative and enterprising business man will be inquiring in what ways will the future differ from the past instead of whether more of the same will be profitable.