DOCUMENT RESUME

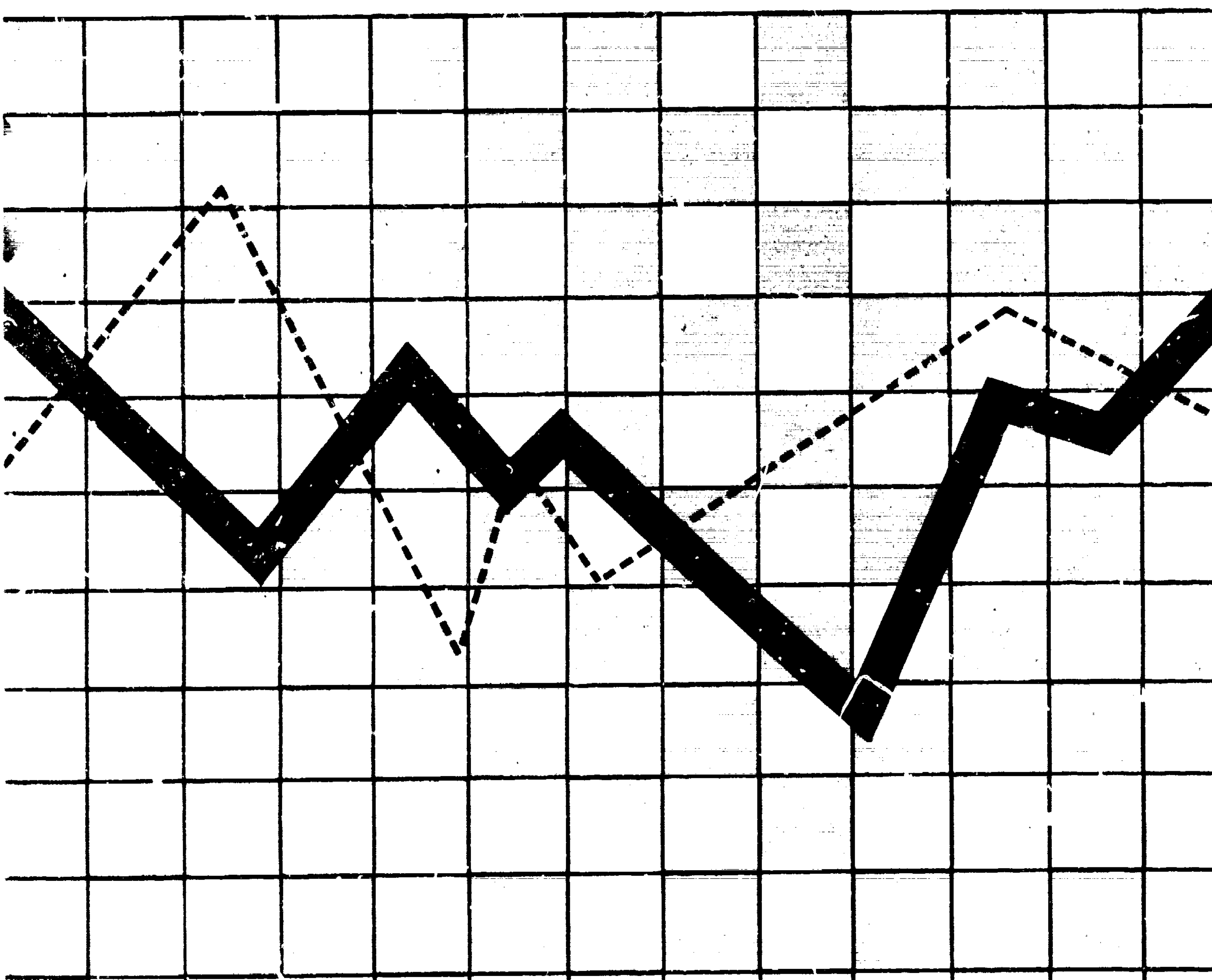
00265 - [A0590654]

Economic Outlook Report: The Current Pause in the Economy and Future Policy Options. December 3, 1976. 6 pp.

Report.

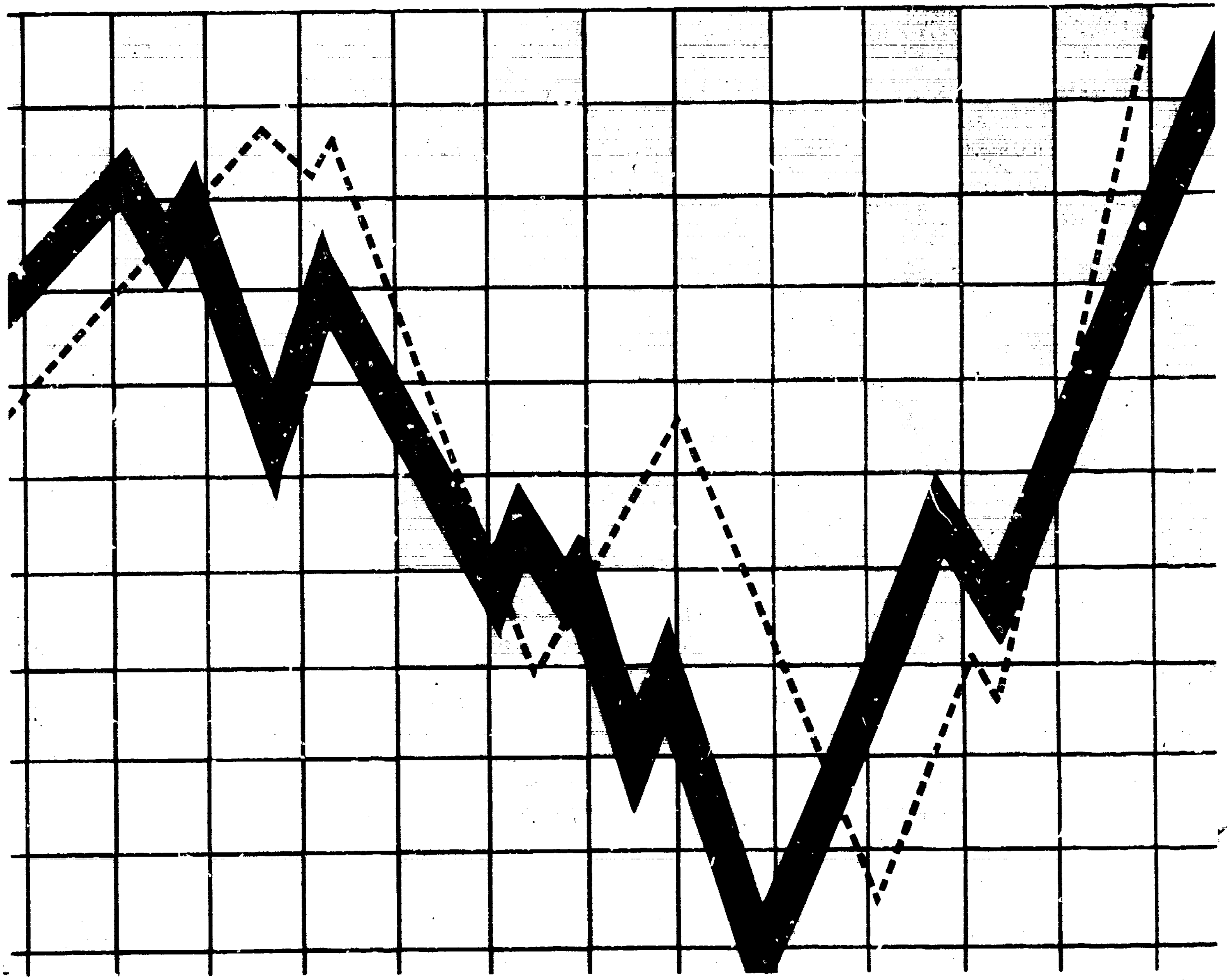
Issue Area: National Productivity (2900).
Contact: Program Analysis Div.
Budget Function: General Government (800).

The decline in the growth of output in the economy has been reflected in measures of labor force utilization since the early summer of 1976. In August, the labor force participation peaked and since then the number of persons in the labor force actually declined. Inflation has continued to ease. With the exception of residential housing, the major sectors of the economy are sluggish. The Government sector continues to spend at about its previous levels. Professor Lawrence Klein of the Wharton Econometric Forecasting Services has suggested the following policy options: (1) a capitation grant of $50 per person; (2) a 5.85 percent reduction in income tax withholding; (3) a monthly geometrically declining adjustment to income tax withholding; and (4) expediture programs consisting of either increasing military procurement and/or increasing grants-in-aid to State and local governments. It is generally assumed that the President-elect will support such economic stimulus policies. (BRS)



pad economic review

economic analysis staff



ECONOMIC OUTLOOK REPORT:
THE CURRENT PAUSE IN THE ECONOMY AND FUTURE POLICY OPTIONS

December 3, 1976

THE "PAUSE"

The Gross National Product (GNP), measured in constant dollars, grew only 3.8 percent in the third quarter after increasing 4.5 percent in the second quarter. These rates of economic expansion are a marked decline from the 9.2 percent growth rate during the first quarter. At this time, it appears that this "pause" in economic activity will continue through this quarter, raising the concern that the pause may be unduly prolonged or lead to a recession. Although a pause need not turn into a recession, underemployment of labor and underinvestment in plant and equipment would leave the economy progressively weaker as time passed. This continued weakness, particularly on the heels of the severe 1974-75 recession, would drive the prevailing high levels of unemployment even higher.

CHARACTERISTICS OF THE PAUSE

The decline in the growth of output has been reflected in measures of labor force utilization since early this summer. In May, the unemployment rate reached its low point of 7.3 percent, and in both June and July the overall rate rose. Since July, the unemployment rate has remained just below 8 percent. The early summer increases in the unemployment rate reflected both an increase in the number of people wanting to work and a deterioration of the economic situation for those already working.

In August, the labor force participation rate peaked. Since then the number of persons in the labor force (working or looking for work) has actually declined while the unemployment rate has remained relatively constant. It appears that persons who might otherwise seek jobs are "discouraged" from entering the labor market by current economic conditions. Thus, the recent increases in unemployment reflect people losing jobs, not additional people looking for jobs.

Inflation continues to ease. The implicit price deflator for GNP which rose at an annual rate of 5.2 percent in the second quarter dropped to 4.2 percent for the third quarter. The wholesale price index for all commodities shows a similar pattern of decline, dropping from an average annual rate of 6.1 percent in the second quarter to 4.8 percent in the third. However, the wholesale price index for industrial goods rose by 5.7 percent in the second quarter and by 7.0 percent in the third. The differences in inflationary trends represent adjustments in the prices of industrial goods relative to other commodities, and may reflect some price positioning in anticipation of the OPEC meetings and the change in the Administration. The increasing share of U.S. energy supplied by imported petroleum and the anticipated OPEC increase in the price of oil will continue to push prices up.

PERFORMANCE OF THE MAJOR SECTORS OF THE ECONOMY

With the exception of residential housing, the major sectors of the economy are sluggish. Consumer demand, which initially led the economy out of the recession, has slowed down and has just kept pace with the growth in GNP. The weakness in consumption is largely explained by the fact that disposable income per capita fell by .1 percent between the second and third quarters.

Business investment expenditures have risen only slowly throughout 1976. In spite of record profits in many sectors, investment expenditures this year, adjusted for price change, are still below the 1974 level. This reflects the existence of idle capacity and uncertainty over future economic and political events. Investment anticipation surveys taken several months ago presented a bright picture for investment expenditures in the third and fourth quarter which did not materialize. Businesses are still extremely cautious on inventory accumulation with inventory-sales ratios being held down. Petroleum is probably the only major product group in which any anticipatory inventory build-up will occur this quarter.

All indicators for the residential housing sector remain expansionary. Housing starts, for single and multiple family units, are at the highest rates they have achieved since early 1973. Savings and loan institutions which finance this investment market are very liquid, and growth in the demand for housing appears to be strong despite the fact that interest rates are still well above those of the 1960s. Consumers may now have become accustomed to those rates.

Foreign trade has been decidedly less expansionary this year than last. Slow recovery among our leading trading partners, improved agricultural production around the world and our growing reliance on imported basic raw materials caused a downward shift of $13.5 billion in the U.S. balance of trade. This trend is not likely to be reversed rapidly because of continued slow growth in many of the developed countries and because of the further world-wide redistribution of income to the OPEC nations after the December 15 meeting. Any OPEC price increase will take a slice out of all oil-importing countries' discretionary income and, thus, reduce the demand for U.S. products.

The Government sector (Federal, State, and local) continues to spend at about its previous level. The well publicized shortfall in Federal expenditures over the past three quarters was small compared to the budget totals and in part reflected lower than anticipated price increases. Given the labor-intensive nature of many public services, the slackening in State and local government growth since the 1974-75 recession is an important element of the slow recovery in total employment.

PROFESSOR LAWRENCE KLEIN'S ECONOMIC POLICY OPTIONS

At the recent meeting of the Wharton Econometric Forecasting Services, Professor Lawrence Klein of the University of Pennsylvania's Wharton School, spoke on the policy options which had been suggested to the President-elect. Klein feels that there is no sector of the U.S. economy currently capable of supplying the momentum needed to increase the rate of growth. Klein is quite concerned not only over the domestic ramifications of continued low capacity utilization, but also over the international implications of low growth rates. He predicted that early in the Carter Presidency, a new international gathering of the heads of state of the major developed nations would be called. The purpose of this meeting will be to reverse the "go slow on growth to combat inflation" consensus of the Ford meeting in Puerto Rico. The United Kingdom, France, Italy, Japan, and the United States, all experiencing less than desirable rates of growth, will, according to Klein, call for expansionary economic policies.

Klein said that Carter's task force on economic policy originally discounted trying to influence the fiscal year 1977 budget. However, as the pause continued, the task force came to the conclusion that a Third Concurrent Resolution on the Budget, aimed at stimulating the economy, would be necessary. Klein estimates that a $10 billion fiscal stimulus would be enough. His preferred mechanism is a rebate scheme similar to the one used in the Spring of 1975, because the amount and distribution are easy to control and the effect on Federal revenues is temporary.

Klein discussed the following policy options: (1) a capitation grant of $50 per person; (2) a 5.85 percent reduction in income tax withholding; (3) a monthly geometrically declining adjustment to income tax withholding starting with 5.85 percent the first month; and (4) expenditure programs consisting of either increasing military procurement and/or increasing grants-in-aid to State and local governments.

According to Klein, the capitation grant of $50 would equal $10 billion and would be quick and easy to administer. The 5.85 percent withholding proposals would offset some of the social security tax burden. However, if extended over a full year, proposal No. 2 would exceed the desired amount of the cut; the final version is designed to limit the cut to $10 billion. Both the second and third proposals have the potentially controversial feature of appearing to integrate the social security tax with the general revenue systems. On the expenditure side, both suggestions would place additional funds in areas with a backlog of approved but unfunded projects and any appropriated funds would enter the income stream quickly.

Finally, Klein mentioned the long-run goals of the Carter Administration which include fundamental tax reform, government reorganization, achieving broad goals in the delivery of social services and balancing the budget by 1980. Professor Klein did not discuss the specifics of these goals.

MONETARY POLICY AND THE "PAUSE"

Although the President-elect has not yet committed himself to additional economic stimulus for 1977, it is generally assumed that he will support such measures. If the economic picture remains bleak, such stimulus may be necessary to avoid another recession and get the economy back on the path to recovery.

In the event of a more expansionary fiscal policy, monetary policy could try either to accommodate the fiscal policy or to neutralize it. Recent statements indicate that Federal Reserve Board Chairman Burns does not favor more fiscal expansion. This would be consistent with recent evidence that a restrictive monetary policy was pursued during the 1974-75 recession.

To analyze monetary policy, a measure of the money stock is needed. The most appropriate measure is the one which defines the commodity that the public treats most like money. In the past, economists have used M1, defined as the sum of currency in the hands of the public and private demand deposits in commercial banks. However, recent changes in institutions and regulations seem to indicate that a broader measure of the money supply, M2, is more useful. (M2 is defined as M1 plus time and savings accounts in banks, excluding large denomination certificates of deposit.) Rates of growth of M2 over the last three years are presented in the accompanying table.

Although M2 (unadjusted for price increases) grew quite rapidly during the last three years, real M2 (adjusted for price increases) actually fell from the second quarter of 1974 through the Spring of this year. That is, prices rose more rapidly than the money supply during this period. By definition, in any accounting period, M2 times velocity will equal GNP. Given a declining real M2, either the number of times

GROWTH OF THE MONEY SUPPLY 1/

Year and Quarter	Percent Change (From Same Quarter Previous Year)		Percent Change over the Cycle (Average Annual Rates of Growth from Same Quarter 1973)	
	Money Supply	Money Supply Adjusted for the Change in Prices 2/	Money Supply	Money Supply Adjusted for the Change in Prices 2/
1974.1	9.0	.6	9.0	.6
1974.2	8.6	-.7	8.6	-.7
1974.3	8.3	-2.1	8.3	-2.1
1974.4	7.7	-3.4	7.7	-3.4
1975.1	6.5	-4.6	7.7	-2.0
1975.2	7.4	-2.3	8.0	-1.5
1975.3	8.3	-.2	8.3	-1.2
1975.4	8.5	1.2	8.1	-1.1
1976.1	9.8	4.1	8.4	-.0
1976.2	10.0	4.2	8.6	.3
1976.3	9.7	4.5	8.7	.7

1/ Money supply measured as M2.

2/ Quantity of money supply, M2, deflated by the implicit price deflator for GNP, 1972 = 100.

a dollar is spent (the velocity of money) must increase or the total volume of transactions (GNP) must fall. The velocity of M2 varied very little during the past three years; it was 2.37 in 1974, dropped to 2.34 at the trough of the recession in 1975 and has since risen to 2.40 for the third quarter of 1976 (an increase of .6 percent at annual rates since 1973). Thus, the decline in M2 was reflected by the decline in GNP.

To achieve a fully-employed U.S. economy (producing at potential output levels), with the same price and M2 growth rate, would have required velocity to increase at a 2.5 percent rate. If velocity is assumed to remain constant, the Federal Reserve would have had to increase M2 at substantially faster rates to reach potential GNP. To the extent that higher growth in the stock of money would have cushioned externally generated price shocks (such as OPEC price increases) and encouraged interest rates to fall earlier in the recession, monetary policy bears a portion of the responsibility for the 1974-75 recession.

If ending the current pause requires further fiscal stimulus, monetary policy will have to be supportive in order to avoid a repetition of the 1974-75 experience. The policy options discussed above, providing a stimulus in the neighborhood of $10 billion, probably will not rekindle inflation given present slack in the economy. The current inflation and a substantial portion of the 1974-75 inflationary situation came from sources "outside" the U.S. economy--oil price increases, world food prices, and costs of basic raw materials.

SUMMARY OF POLICY OPTIONS

The short-run fiscal policy issue hinges on the length of the current pause. In the absence of a resurgence of consumer demand or a spurt in business investment, fiscal stimulus will be required to restore higher growth rates. If the decision is made to pursue this course, the actions which are taken should be selected for quick impact such as stimulating consumer demand by increasing disposable income. The success of such policies would depend on the public's confidence in the economic outlook as well as the Federal Reserve's willingness to pursue a monetary policy which will accommodate such short-term fiscal stimulus.

In the longer run, fiscal policy issues become more complex. Reducing unemployment, increasing investment and inducing technological improvements, without generating internal inflation, will require a careful selection of appropriate policies. A combination of selective employment programs, such as CETA and public works, with appropriate fiscal policies, including tax law changes such as the revised treatment of depreciation, may be necessary to return the economy to a sustainable growth path.