Economic Pause— Some Perspective and Interpretation

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THE economy began a recovery in the second quarter of 1975 and made significant advances in its first year. In the last two quarters, however, the pace of economic activity has been less robust. The economy's performance in this most recent period has triggered a great deal of concern over the sustainability of the recovery. These fears have probably been intensified by a number of considerations, including the fact that the unemployment rate has risen recently — a development not generally observed at this point in a recovery. In addition, concern over the economy was no doubt heightened by the political campaigns conducted in this election year where the release of any economic news, whether good or bad, sparked considerable public discussion.

Analysts have offered a whole host of explanations for the current economic lull. Some seem more credible than others, but when recent developments are placed in perspective, a less pessimistic economic picture is painted.

MEASURING THE DIMENSIONS OF THE SLOWDOWN

The term "pause" has been employed by analysts to describe the current state of economic activity. Although popular, use of the term is a bit misleading since it implies some degree of stagnation or inactivity. While developments of the last two quarters have not been favorably regarded by some analysts, the economy has not been inactive or stagnant. Its upward momentum, however, has moderated since the spring of 1976 and it is this period of slower growth to which the term "pause" refers.

Measures of aggregate output are often cited as evidence of this slowing. For example, real GNP expanded by more than 7 percent during the first year of the recovery from the 1973-75 recession. In the past two quarters this measure of aggregate output has slowed to about a 4 percent rate of growth. Industrial production, another measure of the nation's output, posted a substantial gain of about 15 percent during the first 12 months of the recovery which began in early 1975. Since March, however, this measure of real output has slowed to about a 5 percent pace.

The unemployment rate, after peaking at 8.9 percent in May 1975, responded to the forces of recovery and began a descent which carried it to 7.3 percent in June 1976. Since then, however, this rate has tended to rise and stood at 8.1 percent in November.

Personal income, which registered an 11.1 percent advance in the first year of the recovery, has since exhibited a more modest 8.6 percent rate of growth. Along with this slowdown in income, consumption expenditures have also displayed some signs of sluggishness. For instance, from first quarter 1975 to first quarter 1976, personal consumption expenditures rose by almost 12 percent, somewhat more robust than the nearly 9 percent growth rate registered since the first quarter of this year. Growth of consumption expenditures adjusted for price changes fell from about 6 to 4 percent over the same time periods.

Retail sales have likewise mirrored the pattern of overall activity. During the first 12 months of the most recent recovery, retail sales grew by more than 16 percent. Since March of this year, retail sales have slowed to about a 6.4 percent rate of advance.

EXPLANATIONS FOR THE PAUSE

Monetary and Fiscal Policies

Both monetary and fiscal policies have been offered by various analysts as factors contributing to the pause.[1] Some monetary analysts have pointed to the relatively slow monetary growth in late 1975 and early 1976 as a causal factor. Money (M_1) grew at only a 2.5 percent rate in this period, after a rapid 7.4 percent rate in the previous two quarters. Studies have been conducted which show that marked and sustained fluctuations in money growth have important effects on variations in output growth, and it cannot be ruled out that some restrictive influence on the economy resulted from this period of slower money growth.

Another popular explanation for the current lull in economic activity is associated with fiscal policy — in particular, Federal Government spending. In the first three quarters of the year, the Government spent less than the amount budgeted. Estimates of the amount of this "shortfall" range from $4 billion to $17 billion. Proponents of this "underspending" viewpoint argue that the deviation of actual expenditures from planned or budgeted expenditures has acted to restrain activity and, in fact, is one of the key factors affecting the current economic slowdown.[2] This type of argument, however, is somewhat suspect. The consensus has usually been that economic activity is influenced by the "spent" government dollar. Now it appears as if economic activity is sensitive to the "unspent" government dollar as well.[3]

A less stimulative fiscal policy however, is evident from recent trends in *actual* Government expenditures. Over the past three quarters of this year, Federal expenditures have increased at a 5.4 percent rate, compared to a 12.8 percent rate in calendar 1975. To the extent that Government spending has an impact on economic activity independent of monetary actions, this measure of fiscal policy does imply a slowing in the pace of economic activity. But the extent of the implied slowing is less than that associated with the so-called "shortfall" argument above.

Business Confidence

Lack of business confidence is also said to have played some part in the current hesitation in economic growth, although this explanation is difficult to demonstrate.[4] Uncertainty about future economic policies always exists, but it is especially great in election years. Expectations of future government actions, such as tax policies regarding business, can greatly influence investment decisions made in the current period. One such consideration is the investment tax credit. Since current discussion suggests the possibility of increasing the amount of the credit, businessmen may be taking a wait-and-see attitude with regard to capital expansion programs, thus contributing to the more modest rate of economic expansion.

Inventories

The behavior of business inventories over the current recovery offers another explanation for the recent pause.[5] Movements in inventories in the current recession/recovery period have been very large by historical standards. Real inventory swings were quite severe in early 1975 with a $21 billion annual rate of decumulation in the second quarter. From the fourth quarter of last year to the first quarter of this year, inventories exhibited a large swing, from a run-off at a $5.5 billion annual rate to a $10.4 billion annual rate of accumulation. This sharp rebuilding of inventories boosted GNP growth in the first quarter to an unsustainable 9.2 percent rate. In the subsequent two quarters, inventories were accumulated at about the same rate as in the first quarter, thus providing no further impetus to GNP growth rates.[6]

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[1]"A Longer Pause Than Expected," *Business Week*, 18 October 1976, p. 36. Also, "Sagging 76 — Slowdown Surprises Most Analysts; Some Expect It To Persist," *Wall Street Journal*, 6 October 1976.

[2]See *The Federal Budget: Its Impact on the Economy*, The Conference Board, October 27, 1976.

[3]To the extent that economic forecasts are based on planned expenditures, the shortfall in expenditures can serve as an explanation of why forecasts of economic activity differ from actual performance. But this is quite a different argument from the one advanced above.

[4]Statement by Arthur F. Burns, Chairman, Board of Governors of the Federal Reserve System, before the U.S. Senate, Committee on Banking, Housing and Urban Affairs, November 11, 1976.

[5]Burton G. Malkiel, Council of Economic Advisers, "U.S. Economic Outlook" (Speech delivered before the 1977 U.S. Outlook Conference, November 15-18, 1976).

[6]The arithmetic of how inventories affect the *level* of GNP in a given period and the *change* in GNP between periods is

Table I

The Pattern of Economic Growth in Recoveries

Recession Trough	REAL GNP Compounded Annual Rates of Change: First Year of Expansion	Second Year of Expansion	CHANGE IN REAL INVENTORY INVESTMENT Billions of Dollars: First Year of Expansion	Second Year of Expansion	REAL FINAL SALES Compounded Annual Rates of Change: First Year of Expansion	Second Year of Expansion	MONEY SUPPLY Compounded Annual Rates of Change: First Year of Expansion	Second Year of Expansion
II/1954	7.5%	2.6%	+$12.1	−$ 2.5	5.4%	3.0%	3.8%	1.2%
II/1958	8.7	1.7	+$19.2	−$ 8.1	5.8	2.9	4.5	−0.7
I/1961	7.0	3.2	+$14.4	−$ 3.0	5.0	3.7	3.0	1.7
IV/1970	4.6	7.3	+$ 0.4	+$ 7.1	4.6	6.7	6.7	8.4
Average	7.0	3.7			5.2	4.1	4.5	2.7
I/1975	7.3	4.1*	+$30.9	−$ 0.2*	4.6	4.2*	5.0	6.4*

*Measured from I/1976 to III/1976.

INVENTORIES AND THE PATTERN OF RECOVERY

All of the factors mentioned in the explanations above may have had some influence on the current period of slowing. Upon further investigation, however, the inventory pattern appears to have been the most influential factor.

In the first place, a moderation in the pace of economic activity is not an unusual development at this stage of the business cycle, as three out of the last four recoveries have displayed such a slowing. In general, the pattern of real GNP growth is one of acceleration in the early stages of recovery, followed by a period of deceleration and more moderate growth.

This pattern is depicted in Table I where the growth in real GNP during the first year of each of the last five expansions is contrasted with that in the second year of expansion. Except for the recovery which commenced in the fourth quarter of 1970, economic growth in the second year has been noticeably less rapid than in the first. On average, real GNP in the last four recoveries has increased at a 7.0 percent rate in the first year, followed by a 3.7 percent rate in the second year; this is very similar to the respective 7.3 and 4.1 percent rates of advance recorded in the recovery to date. The tendency for recoveries to exhibit some slowing at this stage suggests the possibility of a common set of factors which influence the pattern of economic recovery.

The acceleration of real output growth in the early stages of recoveries is influenced to a great extent by the pattern of inventory investment. As shown in Table I, changes in real inventory investment in the first year of most recoveries have provided a substantial boost to GNP growth in that year; by the second year, inventory stimulus to aggregate demand growth has generally disappeared. Table I suggests, however, that the influence of inventories on recent real GNP growth has been even greater than in other recoveries. The $31 billion swing in inventory investment in the first year of the current recovery is by far the largest of the postwar period. The magnitude of this swing largely reflects the sharp inventory decumulation which occurred in 1974. The stage was set for this decumulation in 1972 and 1973 when shortages, price controls, and accelerating inflation resulted in a speculative buildup of inventories. Therefore, at least a portion of current movements in inventory investment is a response to these excesses and is independent of more fundamental determinants, such as the stance of aggregate demand policies.

Additional evidence of the impact of inventories in the current period can be gleaned from an examination of real final sales, which is real GNP minus changes in real inventories. In the recoveries which began in 1954, 1958, and 1961, growth of real final sales decelerated in the second year of economic expansion, as did real GNP. This indicates that the eco-

sometimes confusing. This confusion stems from the fact that the *change* in the stock of inventories in a period adds to the level of GNP in that period. Perhaps more confusing is that the difference of the change in inventory levels from one period to another affects the change in GNP from one period to another. Thus a change in inventories levels of $10 billion in each of two quarters implies no change in GNP between the two quarters, given everything else equal.

nomic slowing extended beyond inventories and that more fundamental factors were impacting on the economy. Probably the most important factor operating during these periods was monetary growth. Table I shows that the slowing in real final sales in the second year of these expansions was accompanied by a lessening of the stimulus provided by monetary expansion. Only a very slight slowing in real final sales, however, is detectable in the current recovery. This suggests that aggregate demand policies have not played a dominant role in the current period of slower economic growth.

To sum up, the inventory pattern seems to have masked the underlying growth pattern of the recovery, as revealed by a fairly stable growth of final sales. In retrospect, the strength of real GNP growth experienced in the first year of recovery was based largely on the strong inventory rebuilding. The "pause" in the past two quarters, on the other hand, largely reflects the lack of *further* stimulus to GNP growth from inventory investment rather than lack of stimulus provided by stabilization policies.

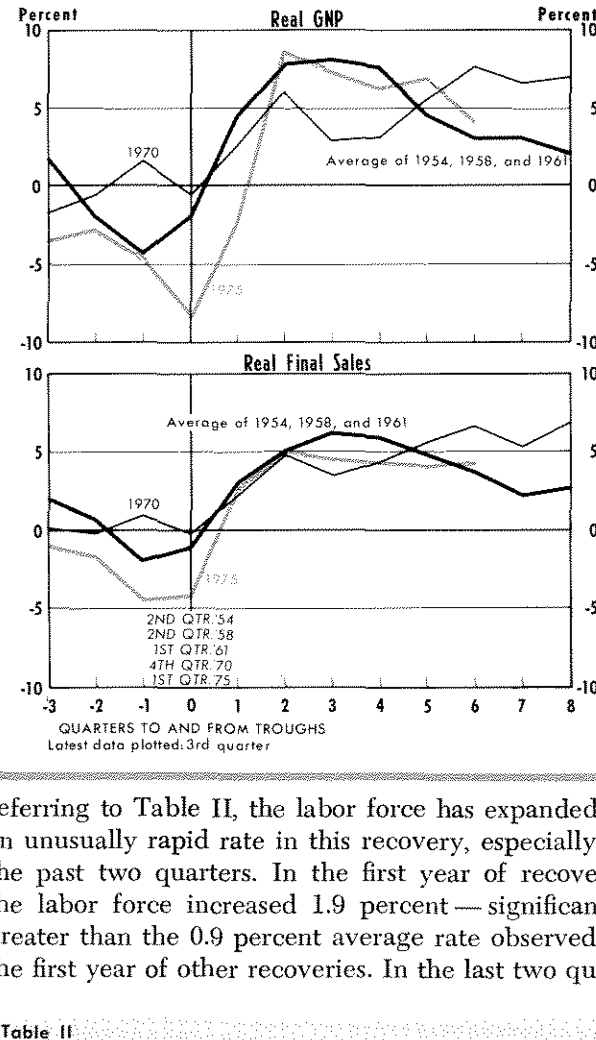
UNEMPLOYMENT RATE PATTERN — A DISTINCT FEATURE OF THE CURRENT RECOVERY

The high and recently rising unemployment rate is a feature of the current recovery which has been most disconcerting. The unemployment rate fell from a high of 8.7 percent in the second quarter of 1975 to 7.6 percent in the first quarter of 1976. With the period of slower real GNP growth this year, the unemployment rate has reversed its downward course, averaging 7.8 percent in the third quarter.

This recent upward movement in the unemployment rate is especially curious on two counts — it is contrary to historical patterns and it occurred despite relatively strong employment gains. The unemployment rate historically has registered its largest declines during the first year of recovery. In the second year this measure of labor market conditions has tended to stabilize or fall somewhat further. In addition, total employment has risen rapidly in the past two quarters when compared to the average growth in the second year of several other recoveries (see Table II). This suggests that the demand for labor has not been the primary factor affecting the rise in the unemployment rate.

The recent rise in the unemployment rate appears to reflect atypical labor supply developments. Again,

The Pattern of Economic Growth in Recent Recoveries
(Two-Quarter Annual Rates of Change)
Seasonally Adjusted



referring to Table II, the labor force has expanded at an unusually rapid rate in this recovery, especially in the past two quarters. In the first year of recovery, the labor force increased 1.9 percent — significantly greater than the 0.9 percent average rate observed in the first year of other recoveries. In the last two quar-

Table II

Labor Market Developments in Recoveries

	CIVILIAN EMPLOYMENT GROWTH		CIVILIAN LABOR FORCE GROWTH	
	Compounded Annual Rates of Change		Compounded Annual Rates of Change	
Recession Trough	First Year of Expansion	Second Year of Expansion	First Year of Expansion	Second Year of Expansion
II/1954	2.8%	3.4%	1.3%	3.2%
II/1958	3.2	2.0	0.8	2.1
I/1961	1.0	1.2	−0.3	1.3
IV/1970	1.7	3.2	1.7	2.7
Average	2.2	2.5	0.9	2.3
I/1975	2.5	3.5*	1.9	3.9*

*Measured from I/1976 to III/1976.

ters, labor force growth accelerated to a 3.9 percent rate — noticeably higher than the 2.3 percent average in the second year of previous recoveries. This unusual growth of the labor force reflects both demographic factors which have worked to increase the number of teenagers of working age and the increased participation of those of working age, particularly among teenagers and women.

The impact on the unemployment rate from the increased supply of labor is magnified by the composition of this supply. Women and teenagers who are entering the labor force in greater numbers tend to have had a higher degree of unemployment among their ranks. Chronic unemployment for these groups is, in part, the result of a number of structural barriers including minimum wage laws, discrimination, and the lack of suitable work skills. As a result, demand-oriented policies, unless accompanied by appropriate structural reforms, are not likely to reduce unemployment to levels attained in other expansions without accelerating inflation.

OUTLOOK

Although some degree of moderation has set in, the expansion has not run its course. Some recent indicators of economic activity suggest that GNP growth in the fourth quarter of 1976 may be somewhat less than the growth recorded in the third quarter. But fundamental forces affecting demand and supply suggest that such growth should be interpreted as chiefly a random fluctuation and not indicative of the likely future direction of economic activity.

Demand Forces

Monetary developments are a particularly important determinant of fluctuations in economic activity, as was discussed above. Table I showed that the three recoveries which slowed in the second year were accompanied by slower monetary growth. In the recovery beginning in early 1971, economic growth accelerated in the second year, apparently reflecting the acceleration in money growth.

The current stance of monetary policy appears to be moderately expansive. In the past nine months, M1 has increased at a 6 percent annual rate, above the 4.9 percent growth observed in the first year of economic expansion. While this growth of money, if sustained over the long-term, is too rapid to make progress in reducing inflation, such growth increases the likelihood of some acceleration in the pace of economic advances in 1977 from currently prevailing rates.

Supply Conditions

While growth of aggregate demand is likely to accelerate in 1977, a fundamental consideration is the ability of the economy to translate these demands into real goods and services. Measures of the utilization of manufacturing capacity give some indication of this capability.

A recent major revision of the Federal Reserve Boards' capacity utilization rate in manufacturing has reduced substantially the amount of excess capacity which was previously thought to exist. According to the revised figures, manufacturing capacity utilization is estimated to be at about 81 percent in the third quarter, not significantly different from the utilization rate achieved after six quarters in the previous three recoveries.

The comparability of utilization rates in both the current and previous expansion periods is noteworthy, since at the depths of the 1973-75 recession, manufacturing capacity utilization was less than in any previous postwar recession. The recent 10 percentage point gain in this utilization rate, however, was the result of a slower-than-average increase in manufacturing capacity, rather than a greater-than-average increase in output. This slower growth in capacity is quite disconcerting since it has an effect on the ability of the economy to quickly absorb all of the unemployed labor resources at prevailing prices and wages and to sustain the increases in real income achieved over the past 30 years.

Utilization rates in recent peacetime expansions have peaked at rates which have ranged from the middle to the upper 80's. Thus the excess capacity implied from the current operating rate of 81 percent should allow the economy in 1977 to generate increases in output at rates greater than the long-run trend rate. But the extent of this excess capacity may be less than is implied by a comparison of the currently reported operating rate with previous peak rates. In particular, analysts have noted that events of the last few years, such as the quadrupling of oil prices, have reduced the economy's potential output. Given the uncertainty of whether or not such events have been fully captured by the recently revised capacity data, the economy may be closer to an effective capacity constraint than is indicated by reported data.[7]

CONCLUSION

Fluctuations in inventory investment have been an important influence on the recovery pattern to date. Upon reflection the "pause" seems to be little more than the economy's reaction to the lack of further inventory stimulus in the past two quarters, not a reflection of insufficient stimulus to aggregate demand. Existing demand and supply conditions now seem set for further economic expansion next year.

The relatively high unemployment rate continues bothersome. This high rate, however, largely reflects labor supply factors and is not necessarily indicative of weak aggregate demand. Part of the unemployment is of a chronic nature which can only be solved by structural reforms in the labor markets. As such, adopting demand policies designed to reduce the unemployment rate to levels achieved in other recoveries is likely to be frustrated by accelerating inflation. Instead, policies designed to promote a favorable environment for much needed capital investment seem in order.

[7]For further articulation of this view, see Denis S. Karnosky, "The Link Between Money and Prices — 1971-76," this *Review* (June 1976), pp. 17-23. Whether the recent capacity revision reflects this type of analysis is unclear. The revision does not *directly* incorporate any adjustment factor for the effects of the oil price change on economic capacity, but it may *indirectly* reflect such events through the incorporation of a recent McGraw-Hill survey of capacity utilization rates.