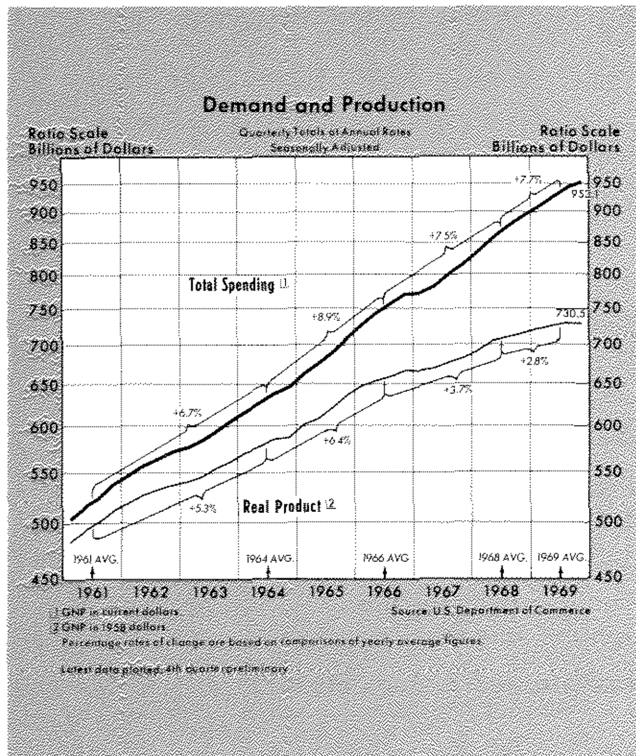
Real Economic Expansion Pauses

EVIDENCE of the last six months indicates that a pause has developed in the prolonged economic expansion that began in early 1961. In the first part of 1967, another pause developed which, like the present one, was preceded by a period of marked monetary restraint.

A few months ago the major question about economic policy was when were the effects of the progressively more restrictive monetary policy going to appear. Now that the effects of policy are definitely evident in trends of total spending and real output, the major questions are how far will the downturn go, and how long will it last.

Production has weakened considerably since mid-1969. Real output of goods and services, which rose at a 4 per cent annual rate from 1957 to 1969, increased at only a 2 per cent rate from the second to the third quarter last year and showed no increase in the fourth quarter. Industrial production declined at a 5 per cent rate from July to December. Payroll employment rose at only a 1 per cent rate from June to December, compared with a 3.7 per cent rise in the previous year.



Production has responded to a slower growth in demand. Growth of final sales of goods and services (total sales less those for inventory purposes) declined from an 8.3 per cent annual rate in the first half of 1969 to a 6.3 per cent rate in the third quarter and to a 5.8 per cent rate in the fourth quarter. Retail sales in the last part of 1969 were rising at about a 1 per cent annual rate, compared with a 4 per cent rate in late 1968 and early 1969. Sales growth has probably slowed further in January and early February.

The slower sales growth reflects more restrictive public policies. In mid-1968, taxes were raised and growth of Government spending was markedly curtailed. In early 1969 growth of the money supply slowed from the 7.3 per cent annual rate of the previous two years to a 4 per cent rate, and then slowed further to less than a 1 per cent rate from June to December.

The more restrictive fiscal and monetary actions were taken with a view to slowing the excessive spending and inflation and, indirectly and ultimately, to reducing the inordinately high interest rates. The general price level, which was nearly stable in the early Sixties, rose 1.7 per cent during 1965, 3.2 per cent from the fourth quarter of 1965 to the second quarter of 1967, 4 per cent in 1968, and 5.1 per cent in 1969.

According to our studies, inflationary pressures may continue strong as a result of the excesses of the 1965-68 period. During 1970, prices are likely to rise at relatively rapid rates. At the same time, as a result of the delayed effects of the restrictive actions and the consequent effect on total spending in 1969, total real output is not likely to rise in 1970 and may even decline slightly. The rate of unemployment will probably show a considerable increase in the last half of the year.

To put recent developments into perspective this article reviews briefly the changing character of the eight and one-half year economic expansion from 1961 to mid-1969, and then discusses the evidences of slowdown that are appearing in the economy.

Economic Expansion 1961-1968: Changing Characteristics

In many respects, the early years of the economic expansion were quite different from the more recent years. In the 1961 to 1964 period, most of the spending on goods and services was reflected in a rise of real output, while prices remained relatively stable.

During this period of surging real output and generally stable prices, corporate profits before taxes rose at a 10 per cent average annual rate, personal income rose at an average rate of 6 per cent, and wages of production workers in manufacturing industries increased at an average rate of 3.7 per cent. Since prices remained fairly stable, most of these gains in profits, income, and wages represented real gains for the recipients.

In the two-year period from 1964 to 1966, real output and employment expanded more rapidly than during the previous three years. However, one very noticeable feature of the 1964-66 period was the more rapid rise of prices, compared with the 1961-64 period. In the 1964-66 period the general price index rose at a 2.3 per cent annual rate, considerably above the 1.3 per cent rate of increase over the previous three years. The faster increases in prices offset some of the nominal gains of the recipients of increased profits, personal income and wages.

In the following two years, 1966-68, except for a 5-6 month period in early 1967, GNP continued to expand at a rapid rate. However, the economy was now placed under increasing strain to meet the continued rapid rise in the demand for real output.

Accelerating Prices

The most striking feature of the 1966-68 period was the accelerating price level, with the general level of prices rising at a 3.6 per cent annual rate, almost three times faster than during the 1961-64 period. In the later period approximately 50 per cent of the rise in total spending reflected rising prices.

Recipients of rising levels of wages and other personal income were affected by accelerating prices. For example, though the money wages of production workers rose at a 4.4 per cent average annual rate from 1966 to 1968, considerably faster than the 3.7 per cent rate from 1961-64, their real wages rose at only a 0.9 per cent annual rate from 1966 to 1968. This rate of real increase in wages was less than half as rapid as that during the 1964-66 period.

Rapid Rises in Interest Rates

Another noticeable distinction between the first part of the 1961-69 period and the last half was the behavior of market interest rates. The 1961-64 period was characterized by stable or slowly declining long-term interest rates and slowly rising short-term rates. The last half of the period was characterized by progressively more rapid increases in both long- and short-term interest rates. These rapid rises in the level of market interest rates reflected mainly the acceleration of prices, which resulted from an overly expansionary monetary policy. The "historically high levels of interest rates" reflect not a "tight monetary policy," but the eventual results of the very expansionary monetary policy pursued by the Federal Reserve until early 1969.

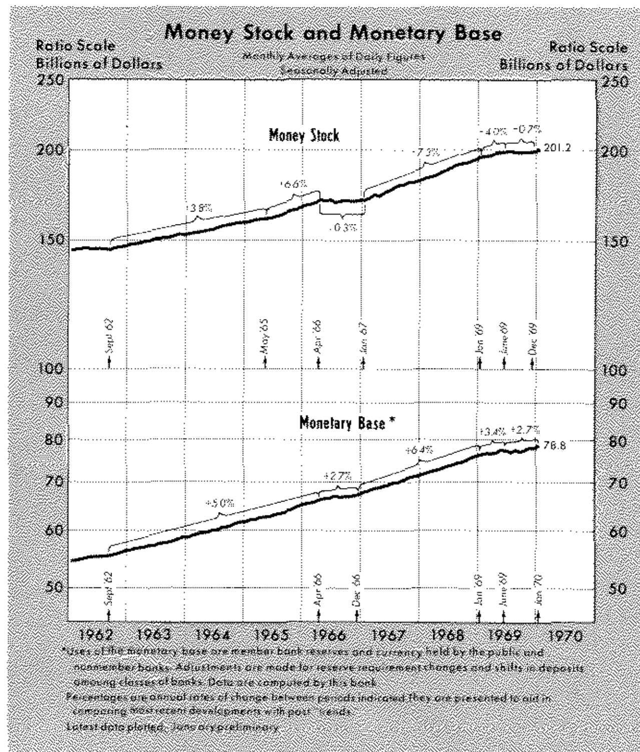
As the economy moved into 1969 the switch in the predominant characteristics of the economic expansion became even more evident. Over the first half of 1969, although GNP spending continued to expand at a 7.4 per cent rate, real output grew at only a 2.3 per cent rate. Approximately 70 per cent of the expansion in GNP was price inflation.

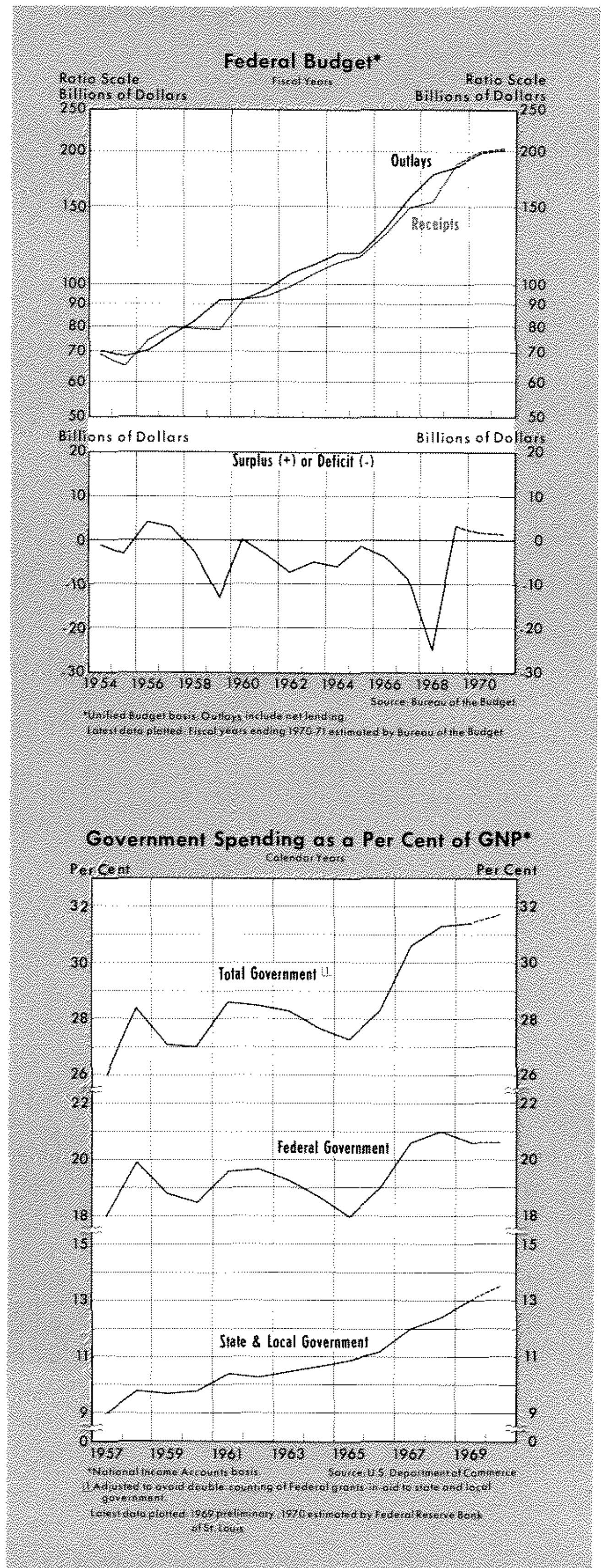
The accelerating prices and rapidly rising interest rates of the 1965-69 period followed from: (1) the economy having reached and gone beyond an efficient level of resource use; (2) accelerated growth of public expenditures resulting in government deficits and, most importantly, (3) an excessive rate of monetary expansion.

1969: Progressively Greater Monetary Restraint

In the first half of 1969, in contrast with the previous two years, policy actions by the Federal Reserve became less expansive. After mid-1969, policy actions exerted a very restrictive effect on the monetary aggregates. From January 1967 to January 1969 the money stock increased at a 7.3 per cent rate. During the first half of 1969 the growth rate of money was cut to a 4 per cent annual rate. From June to December there was almost no increase in money balances held by the public.

The progressive slowing in the growth rate of money has reflected a marked reduction in the growth of the monetary base and bank reserves. The base grew at a 3.4 per cent annual rate from January to June 1969, compared with a 6.4 per cent rate from December 1966 to January 1969. From June to January 1970, base money increased at only a 2.7 per cent rate, less than one-half as rapidly as during



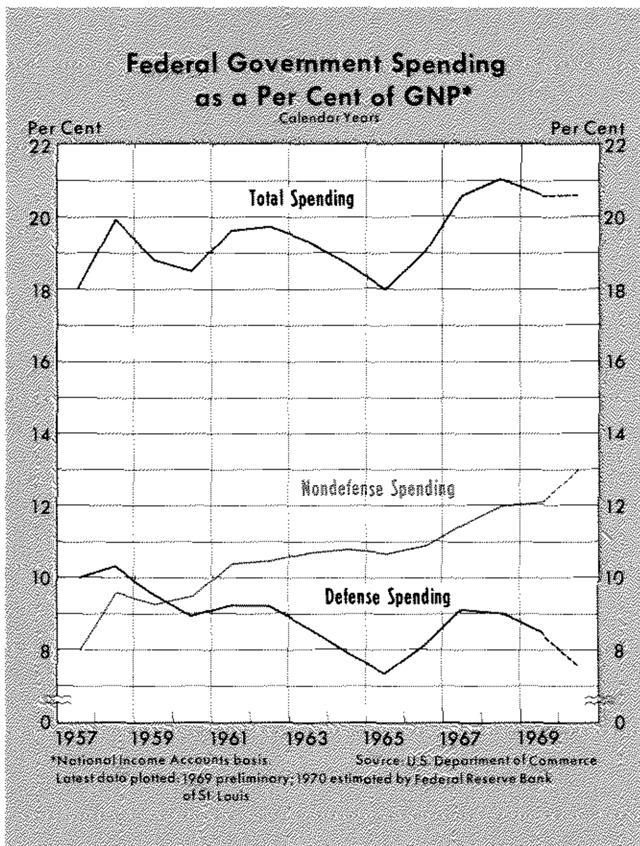


1968. Member bank reserves declined at a 2.5 per cent rate from January to December 1969, compared with a 9 per cent rate of increase over the previous two years.

The money stock rose sharply in the last half of December. However, this rapid increase in money only reflected temporary technical factors. From the peak in late December, money has declined to an average at the end of January that is the same as the average level from June through November 1969.

The Stance of Fiscal Policy

The expansionary monetary actions during the 1967-68 period stemmed from accommodation of large Federal budget deficits and, after fiscal policy became restrictive in mid-1968, a desire to cushion an expected moderation in total spending growth in late 1968. The Federal budget has shown a slight surplus since 1968, and Government borrowing needs have been greatly below those of the 1966-68 period. Consequently, the monetary authorities have been spared



the responsibility of financing large Government borrowing and have been free to pursue a restrictive policy.

As currently estimated by the Bureau of the Budget, the Government plans to maintain a small budget surplus through mid-1971. Expenditures are projected to increase 1.5 per cent rate from fiscal 1970 to fiscal 1971. The budget surplus is not expected to increase, as revenue growth is expected to be slowed by moderate advances of income and profits this year; in addition, the surcharge expires in June. The recent Congressional changes in tax structure will also serve to reduce the growth of revenue. If current budget plans are realized, and they are still subject to Congressional approval, the stance of fiscal policy would allow the monetary authorities considerable discretion in formulating monetary policy.

Interest Rates

From 1965 to 1969 the sharp rise of interest rates resulted mainly from the increasing demand for loan funds, which, in turn derived increasingly from rising anticipations of inflation. In 1969 the short-run impact effects of the reduced rate of expansion of the monetary base reinforced the upward pressures of price expectations on market interest rates. Consequently, market interest rates rose very rapidly in 1969. A sharp short-run impetus to market interest rates was to be expected to follow from a much reduced rate of expansion of base money. However, as the effects of the reduced growth rate of money continue to result in reduced demand for real output and consequently a reduction in the demand for credit and less upward pressure on commodity prices, there should be easing in credit market interest rates.

Total Spending and Components

If economic expansion is evaluated solely by the rate of increase of GNP spending, the restrictive effect of policy actions has become apparent only in recent months. The expansion of GNP slowed to a 6.2 per cent rate in the second half of 1969, somewhat slower than over the first half of the year. From the second quarter of 1969 to the third quarter of 1969, GNP rose at an 8 per cent annual rate, then slowed to a 4.4 per cent rate from the third to fourth quarter.

Table I

GROSS NATIONAL PRODUCT
PRODUCTION AND PRICES — 1969

(Billions of dollars)

Quarter	Nominal GNP	Real Product
I	$ 16.2	$ 4.6
II	16.1	3.6
III	18.0	3.9
IV[1]	10.3	—0.1

(Annual rates of change from the preceding quarter)

Quarter	Nominal GNP	Real Product	Prices
I	7.5%	2.6%	4.9%
II	7.3	2.0	5.2
III	8.0	2.2	5.4
IV[1]	4.4	—0.1	4.7

[1]Preliminary

Table II

CHANGES IN COMPONENTS OF TOTAL SPENDING, 1969[1]

(Annual rates of change in parentheses)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter[2]
Consumption	11.3 (8.5)	10.8 (7.9)	7.0 (5.0)	9.4 (6.6)
Fixed Investment	5.2 (18.0)	1.9 (6.0)	2.0 (6.3)	2.0 (6.2)
Changes in Business Inventories	—3.9	0.3	3.8	—2.9
Government Spending	3.3 (6.5)	2.9 (5.6)	4.1 (7.9)	1.9 (3.5)
Net Exports	0.3	0.1	1.1	—0.1
Total Spending[3]	16.2 (7.5)	16.1 (7.3)	18.0 (8.0)	10.3 (4.4)

[1]In billions of dollars
[2]Preliminary
[3]Components may not sum to totals because of rounding.

Using criteria other than the broad yardstick of total spending, there is considerable evidence that the "economic expansion" came to a halt in late 1969. Since mid-1969 the index of industrial production has declined, while real output and payroll employment have both grown at barely a one per cent rate. Although the dollar value of final sales rose at a 6 per cent rate in the last half of 1969, the real volume of final sales showed almost no increase, compared to a 4.2 per cent annual rate of growth in real volume during 1966-68.

Personal income rose at about a 5 per cent annual rate in late 1969, down from a 9 per cent rate in the preceding year. Taking the rapid rise in prices into account, increases in personal income during the last four months of 1969 represented no gain in real command over goods and services. The slowing in personal income growth has been reflected in a decline in the growth of consumption expenditures, which rose at a 5.8 per cent rate over the last half of 1969 compared to an 8.2 per cent rate over the first half of the year.

Gross private domestic investment increased at a 7.4 per cent annual rate during the last half of 1969, compared to a 5.3 per cent rate over the first six months of 1969. This is the only one of the three major components of GNP that showed a sharp acceleration during the last half of 1969. However, this sharp increase in investment during the second half reflected a large increase in the third quarter. From the third quarter to the fourth quarter, investment spending declined at a 2.5 per cent annual rate.

One area of investment spending that has attracted considerable concern is business expenditure on new plant and equipment. New capital equipment spending by business in 1969 is estimated to have increased 11 per cent, compared to about a 4 per cent increase in 1968. The most recent survey by the Department of Commerce and Securities Exchange Commission indicates that the business sector plans to increase its spending on new plant and equipment by an additional 9.7 per cent in 1970.

When the rise in prices of machinery and equipment are taken into account, using the wholesale price index for machinery and equipment, the 11 per cent increase in 1969 represents about a 7.8 per cent rise in real terms. This increase in real terms, although quite large, is well below the average rate of increase in real terms of 14 per cent over the two years from 1964 to 1966. Assuming no acceleration in prices of machinery and equipment for 1970, the 9.7 per cent projected rise in spending would represent only a 6.4 per cent real increase.

The projected rise in spending on new plant and equipment is not evenly spread over all industries. The projected rise in manufacturing industries is only 6.4 per cent, or about 3.2 per cent after an adjustment for a continued rise in prices. Of the twenty-one major industry categories in the Department of Commerce – SEC Survey, respondents in nine of the twenty-one industry categories project no change or a decrease in capital spending. For example, the motor vehicles and parts industry projects no increase in capital spending, and therefore a decline in real terms.

Corporate profits are already beginning to show noticeable signs of the deceleration of the growth in total spending. After rising through the first half of 1969, profits declined after midyear. As the slowing in real personal income continues, as the rate of increase of payroll employment continues to slow, and if a sharp increase in government demand for goods and services does not arise to offset the slowing in real private demand, business will likely revise downward its expectations of future demand for real output. Consequently, a significant part of the anticipated spending by the business sector on new plant and equipment may not materialize as 1970 progresses.

A Real Interest Rate Guideline

Although market interest rates on long-term capital borrowing rose very rapidly in 1969, they apparently had little effect in dampening the business sectors' demand for credit. If, instead of focusing attention on market interest rates, real interest rates are considered, then this anomaly of rising market interest rates and rising demands for long-term credit largely disappears. The real costs of long-term borrowing declined slightly over the first three quarters of 1969. Only in the last part of 1969 did the real cost of borrowing show a significant upward movement.

Ceilings and Channels of Credit Flows

As credit market interest rates rose to high levels in 1969, the policies of the Federal Reserve, Federal Home Loan Bank Board, and Federal Deposit Insurance Corporation, which impose ceiling rates on the interest rates commercial banks, mutual savings banks, and savings and loan institutions can pay to attract deposits, favored borrowing by large corporations. Large business borrowers with direct access to the money and capital markets, by issuing bonds and commercial

paper, were able to competitively bid funds away from savings institutions. In 1969 the outstanding volume of commercial paper averaged $27.3 billion, up from $19.4 billion in 1968, and double the average outstanding volume in 1966. In 1967 and 1968 the household sector reduced its holdings of municipal and corporate securities. However, in the first half of 1969, the household sector increased its holdings of these securities by approximately $9.7 billion.

As funds flowed through channels other than the savings institutions, the ability of these institutions to extend credit to specific sectors of the economy, especially housing, was reduced. Although such a process of fund diversion probably did not affect total credit considerably, it had a significant effect on the locus and form of real investment.

In mid-January, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board raised the maximum rates intermediaries are permitted to pay for funds. Under the amended Regulation Q effective January 21, member banks are permitted to pay 4.5 per cent on passbook savings deposits, up from the 4 per cent ceiling in effect since November 1964. Small certificates maturing in one year are permitted to yield 5.50 per cent, and small certificates maturing in two years are permitted to yield 5.75 per cent (See the table on page 29 for all Regulation Q ceilings). Previously, since September 1966, the ceiling on all single maturity deposits less than $100,000 had been 5 per cent.

However, these new ceiling rates are still below the market yields available to many savers on competitive financial assets. For example, in mid-January the yield on commercial paper and Treasury bills, which are directly competitive with large CD's, were 8.75 per cent and 7.80 per cent respectively. Seasoned corporate bonds, which are partial competitors for savings deposits, were yielding about 7.90 per cent, compared to the new ceiling rates that savings institutions could offer of 5 to 5.75 per cent.

Prices

If one looks at prices, evidence of the effect of restriction imposed by policy since midyear is not clearly evident. In the second half of 1969 the general price index rose at the same 5.1 per cent annual rate as during the first half of the year. In the fourth quarter of 1969 the general price index showed a slower 4.7 per cent rate of increase. However, monthly data on consumer and wholesale prices cast some doubt on the degree of reduction of price increases in the last quarter of 1969. From September to December consumer prices rose at a 6.3 per cent annual rate, slightly faster than over the first nine months of 1969. The rate of increase of wholesale prices also rose in the last three months of 1969, increasing from an annual rate of 4.6 per cent over the first nine months to a rate of 5.4 per cent from September to December. The rate of increase of wholesale prices of industrial commodities accelerated to a 5 per cent rate, compared to a 3.6 per cent rate from December 1968 to September 1969.

Conclusions

If, instead of a myopic concentration on the rapid increase in prices, analysis of current economic conditions is broadened to take into account lags between policy actions and their effects on policy goals such as the growth of real output, production, employment and real income, then a downward turn in economic activity has begun. Now that the restrictive effects of policy actions are definitely evident in the real sector of the economy, attention should be focused on the questions of how far and how fast will the downturn go, and when should the Federal Reserve move to a moderately easier policy?

Prices have shown very little sign of slowing their rapid rates of increase, and market interest rates remain at very high levels. However, economic theory and empirical evidence indicate that after a prolonged period of inflation, a downward adjustment of prices and interest rates follows only slowly after real output, real income, and employment adjust downward. Given the difference between the lags of adjustment of prices and interest rates to a restrictive monetary policy and real output and employment, a policy of "waiting to see the whites of the eyes" of the inflation enemy manifested in prices and interest rates, can have considerable unnecessary adverse consequences for real output, income, and employment.

One step that monetary policy should avoid is a sharp reversal to a very expansionary policy such as occurred during the 1967 pause in economic activity. However, if a restrictive policy is pushed too far too fast, by creating a large rise in unemployment, such a policy may lay the groundwork for just such a sharp reversal. If after mid-1970 policymakers face a 5.5 or 6.0 per cent unemployment rate, then it may be very difficult to avoid a sharp reversal of policy. In such a case, the chance of throwing all the hard-won effects of monetary restraint to the winds becomes very great.