

Wertheimer, Robert G.

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# The Economic Outlook for 1976

Professor Robert G. Wertheimer, Cambridge/Mass. \*

**While in the United States economic growth finally broke through scoring in excess of 12 p.c. in real terms in the third quarter of 1975, there was some slowdown in the recovery toward the end of the year. What is to be expected in the internal and external economic sphere during 1976, while the election contest is heating up?**

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**W**hile everything went wrong early in 1975, the worst was over by April but subsequently, neither production nor the labor market nor the financial sector and not even the Government could detect steady signals of improvement or firm trends ahead. The generally expected lows in the economy and stock market did occur but from then on the paths were divided.

## How to Confuse an Economy

Some economists, mainly those attached to the Government, saw the rise of a robust economy with a too fast expansion to be maintainable and soon called for a careful monitoring of the economy, fiscal and monetary restraints and better deficit controls. Others continue to view the path of the recovery as fragile pointing out to the vast excess capacities, still rising unemployment and lagging corporate investment spending. A push here and there might abort the economy, they argue, and hence easier money and larger federal spending and deficits are required <sup>1</sup>.

Whatever the speed of the US recovery, everybody agrees, it is part of a worldwide upsurge though more visible and sooner here than elsewhere. The consumer taken through the wringer by explosively rising food and oil prices in 1974 found some encouragement in the tax cut but soon was disappointed again by rising unemployment and continued inflation. Ultimately, spending on cars and housing as key factors moved upward accompanied by rising retail sales in real terms. To the extent that the sharp economic decline that had started late in 1973 lasting through April 1975 was inventory-related, the subsequent liquidation

of these excesses was vital in clearing the decks for new orders late in the year. While the economy finally gave tangible signs of improvement of production, employment, exports and unit labor costs, the financial sector opened up dangerous prospects. The threat of a financial crisis moved into the center of considerations in case of bankruptcy of New York City and spreading elsewhere provoking political and financial problems beyond immediate controls.

The Federal Government riveting one eye on the election in 1976, reduced the tax burden by about 10 p.c. of total tax revenues channeling \$ 28 bn back to the average income taxpayer and business in 1975. The large deficits of \$ 50 bn in fiscal 1975 and \$ 70 bn expected for fiscal 1976 so far have not been accompanied by a drying up of the private capital market predicted by some. Finally, the stock market did well in 1975 regaining its posture <sup>2</sup> encouraged by better than expected profits. Unemployment at 8 p.c. and over remained the most unsatisfactory sector in the economy without the prospect of much improvement but total employment remained well maintained after an early decline and continues to grow. While economic growth finally broke through scoring in excess of 12 p.c. in real terms in the third quarter 1975, there was some slowdown in the pace of recovery toward the end of the year and many questions particularly in the financial and banking sector have remained unresolved. In summary, the outstanding events in 1975 were more inflation than expected, a far more precipitous economic decline than predicted, a dramatic inventory liquidation, rising unemployment rates in spite of rising employment, an amazing turnaround in the balance of trade and payments and federal deficits vastly exceeding any previous experience in peacetime.

\* Babson College.

<sup>1</sup> Actually, a recovery once under way averaged 3 years in length in recent decades. These economists, incidentally, impute one-half of the recession to the increase in oil prices and the failure of governments to cushion their economies accordingly. Furthermore, they hold, most governments overreacted to inflation and belittled the potential of the recession.

<sup>2</sup> It rose from a low of 630 early in the year to a high of 880 D-J Industrial in July, fluctuated downward to 820 by fall, moving to about 860 later but then declined toward the earlier ranges early in December.

## Production, Consumption and Employment

Industrial production which advanced from the 110 low early in 1975 (of the 1967 level at 100) to 116 in October, is expected to rise by another 10 points in 1976 corresponding to a gain in the still low level of capacity utilization in manufacturing at 72 p.c. presently (the Oct. 1974 rate was 81.5 p.c.) to an average of 79 p.c. during 1976. This slow advance<sup>3</sup>, it is expected, will prevent a return of the inflation spiral that had resulted from a renewed supply/demand imbalance in 1973. Car-making and housing starts continue to project satisfactory outputs. Domestic car sales of 7.0 mn in 1975 (7.5 mn in 1974) will have been at the lowest level since 1970 and are expected to climb to 8 mn in 1976<sup>4</sup>. In housing, total starts are expected to reach 1.45 mn units<sup>5</sup>, predominantly single units, against the low of a total of 1.1 mn in 1975. While this falls far short of the 2 mn starts in 1973, it will be an improvement over the 1974/1975 low (Sept. 1974/Aug. 1975) of 750,000 units.

Consumer spending power will continue to rise assisted by wage increases, rising employment, profits and various forms of transfer payments, not excluding a repeated tax cut. This spending in real terms already gained at an annual rate of 7 p.c. since June 1975 while the savings quota at 7.7 p.c. of disposable incomes remained well maintained and the consumer continues to improve his liquidity. According to Sindlinger and Michigan Surveys, the consumer wishes to reflect rising confidence but he does not see the economy being stable and solidly advancing. The promise of renewed tax cuts is a hopeful factor but the threat of more inflation and financial crises are causes of alarm imposing more cautious responses than in preceding recoveries. Food and energy expenditures remain the major burden to which rising state and local taxes should be added. The consumer's maximum contribution to spending in 1976 should be set at 6 p.c. in real terms.

Unemployment at 8.3 to 8.6 p.c. of the labor force today could become political dynamite but it has lost much of its economic impact as a result of extended unemployment and welfare payments that have become a routine factor preventing outright despair of those who have little chance to recoup their jobs. Also, the record of jobless

<sup>3</sup> Already, the leading indicator index has sputtered in its continuous advance after Sept. 1975. Steel shippers, too, i.e., expect another flat year with finished steel shipments of 95 mn tons in 1976 against 110 mn each in 1973 and 1974 (but better than the 82 mn shipped in 1975).

<sup>4</sup> Total car sales including imports — small cars now representing 75 p.c. of all sales — are expected to grow from 8.6 mn in 1975 to 9.6 mn in 1976, imports holding a ratio of 17 p.c. of the total (during the months of low sales in 1975 this ratio climbed to 20 p.c.).

<sup>5</sup> Stimulated by Federal mortgage subsidies, a \$ 2,000 tax credit per house purchase of new homes started before March 25, 1975, and ample mortgage funds.

married men who are the typical family supporters is much better at 5.2 p.c. Structural changes in the economy based on the rapidly increasing number of women and young in the labor force as well as regional shifts accompanied by an economic decline in the East and prosperity in Southern and Western states have built an unemployment bias into the economy. The net entrance of new job-seekers due to population growth after 1946 — close to 2 mn annually — has been outrunning even significant increases in available jobs in good years creating a growing residual of unemployed<sup>6</sup>. Of course, by juggling the concept of full employment to 96 p.c. or even 95 p.c. of the labor force (instead of the conventional 97 p.c.), the unemployed, at least statistically speaking, can be made to melt away. However, political pressures to reduce unemployment below the currently 8 mn (though only 5.4 mn qualify for jobless state and all other benefits) by some Public Job Program might be growing during an election year. For the first time in recent history of the labor unions a reduction of the workweek by 4 hours is being proposed by the auto union leadership in their talks with General Motors. Assuming a 6 p.c. real growth rate of the economy in 1976, the rate of unemployment should be expected to stabilize at 7 p.c. though some lower rates could occur sometime during the year.

## Business Investment, Inventories and Profits

In 1975, business investment spending on new plant and equipment was disappointing at \$ 113 bn rising only at the rate of inflation over 1974 scoring no real gains and, furthermore, many planned projects were "stretched out". Overhanging excess capacities and the huge inventory carry-over were responsible for this lag. 1975 did bring the elimination of most inventory excesses (with a swing from \$ 18 bn addition in the fourth quarter 1974 to a rate of liquidation of \$ 31 bn in the second quarter 1975) as most significant contribution to the improvement of the economic climate. While this liquidation improved corporate liquidity and reduced credit demands, it did not clear the way for more investment spending. Looking to 1976, we should expect a repetition of the lagging investment pace with business still smarting under excess capacities<sup>7</sup>.

Concerning corporate profits, estimates made early in 1975 proved to be amazingly astute. They did decline from the 1974 high, but less than one should have expected under the circumstances (by only 15 p.c.) and their recovery, too, set in

<sup>6</sup> Even though accompanied by large unemployment, total employment at 85.5 mn today is running not far below its all-time high of 86.3 mn in 1974, after the low of 84.6 mn early in 1975.

<sup>7</sup> A recent McGraw-Hill projection for 1976 estimates such spending at \$ 123 bn or only in line with rising costs over 1975.

early in the third quarter 1975. Gross profits are expected to reach \$ 150 bn in 1976 (against the high of \$ 141 bn in 1974) after the low of \$ 121 bn in 1975<sup>8</sup>. Large cash flows, thus, will be generated providing greater liquidity and a rising share of internal financing funds.

### The Financial Sector

The cost and availability of money, the international position of the dollar and the financing of private and public spending needs turned out satisfactorily in 1975 and promise to continue to do so. Chairman Burns of the Federal Reserve has now been faced with too many challenges not to see eye to eye with all issues making himself fully responsive to the wider implications of the Federal Reserve's financial management for the economic situation of the country<sup>9</sup>. Obviously, the Federal has to use Argus eyes, too, relating its policies to sound money and sound economic growth, unemployment, liquidity, the international position of the dollar but also the financing of private and federal debt, and above all inflation. To serve these many Lords, the Federal now has built its official policy around an annual growth target of the money supply M1 (currency & demand deposits) at 5 to 7 p.c. At this juncture, the Federal has to watch liquidity and the soundness of the banking system in particular and also to allow for problems of solvency of municipalities and even states<sup>10</sup>.

The fluctuations of short-term interest rates in 1975 were wider than expected with 3-months Treasury Bills, for example, moving from 7 p.c. to a low of 4.8 p.c., to climb back to 6 p.c. but then down again. The commercial prime rate took a sharper downturn from 10.5 to 7 p.c. corresponding to a reduction of the Discount Rate from 8 to 6 p.c. On the other hand, long-term rates fluctuated little around 9 p.c. and better reflecting the "inflationary bonus" investors expect to earn permanently. While the Federal has reassured the public that it will not obstruct the pace of the recovery there actually is little pres-

<sup>8</sup> However, while profits in 1974 contained 30 p.c. inventory gains, such gains will be minor this year.

<sup>9</sup> Monetarists, however, continue to argue that tight monetary policies early in 1974 turned a recovery under way into a recession by the second quarter of 1974. A. Brimmer, former member of the Board of Governors, too, continues to argue that "the growth of the money supply had been too slow and interest rates had remained too high to meet the requirements of the economy to overcome the worst recession since the Great Depression".

<sup>10</sup> Of course, the Federal always has the statutory duty to stand by as Lender of Last Resort and as Dr Burns has reiterated: "No solvent bank in case of need will be denied this privilege." However, concerning New York, he first had no strong views tending toward the position that a default of N.Y. City issues would not lead to "a chain reaction". Soberly, he got increasingly concerned though; crying wolf about what Opec would do — leading to a collapse of the Euro-\$ market — or the collapse of the Penn Central were false alarms — but we should not be misled to expect no consequences or snowballing effects of a bankruptcy of the leading city in the US.

sure for more bank borrowing on the part of business<sup>11</sup>.

The international position of the dollar continues to be strong reflecting appreciation gains of 7 p.c. above the lows but even so experts consider it still moderately undervalued. In any case, even this rise in the exchange value of the dollar did not interfere with an excellent performance in the US Balances of Trade and Payments in 1975. For the first time in many years, these balances according to whatever calculation, will be in surplus, the balance of trade leading with a plus of \$ 11 bn. Strong agricultural and capital goods exports as well as capital inflows versus lesser imports as result of the recession — in spite of the oil bill of \$ 25 bn — explain this favourable reversal<sup>12</sup>. For 1976, the trade balance is expected to hold its own with a surplus of \$ 4 bn though imports now responding to the faster pace of recovery are expected to rise swiftly. Except for international financial complications a New York crisis could bring on<sup>13</sup> the dollar is expected to perform strongly.

The stock market moved up steadily to the high of 880 by July 1975, easily overcoming the lows of 630 of January. Since then, it experienced a setback of larger proportions early in December fluctuating again in a narrow trading range around 820 as it had during much of the year. The 1976 outlook is not unfavourable. Investable funds also from abroad abound and fundamental factors such as corporate earnings are expected to be good at about 24 p.c. above 1975. At a moderate price-earnings ratio of 10<sup>14</sup> expected D-J Industrial earnings of \$ 100 in 1976 promise to support a market of a D-J of 1,000. As usual, there will be fluctuations probably larger in an election year than otherwise. A stronger than expected economy should move the market to the upper limits of 1,100 while unsettling financial, political or international news could push emotionally below a down-range of 750.

### The Government Sector

While the conservative Administration emphasizes that its 1975 tax cuts furnished the basis of the proper speed of recovery, the unplanned federal deficits of \$ 50 bn in fiscal 1975 and \$ 70 bn for

<sup>11</sup> Moderate investment spending plans, cash from inventory liquidation and lingering uncertainties have kept down credit demand; in fact, nationwide business loans declined by \$ 4.5 billion in 1975. N.Y. banks alone reported a decline of \$ 5 billion.

<sup>12</sup> Incidentally, except for these expenses, "the energy crisis" vanished into thin air so far.

<sup>13</sup> With loans to be made available by the US Government, bankruptcy, in one way or another, apparently, will be avoided permanently.

<sup>14</sup> This is a low average by any historic standard; at the top of a bull market this multiple has been 17. Early in Dec. 1975, this ratio was 10.3 based on earnings of \$ 84 (from July 1974 to June 1975).

1976 obviously are phenomenal economic stimuli of old-fashioned pump priming<sup>15</sup>. For political reasons, some additional tax cuts should be expected to give momentum to pre-election consumer confidence and spending<sup>16</sup>. If unemployment by August should have become an even thornier political problem than now a more active public works program creating at least 1 mn jobs might be in the making. About inflation, the Government should not be expected to do much while the slowing down of the rate to 7 p.c. or less is viewed with certainty<sup>17</sup>. Wage increases in contracts covering 4.5 mn workers which are due for settlement in 1976 and productivity gains will have a major bearing on the trend of costs and hence prices<sup>18</sup>. The Government is counseling moderation to hold the line at 7 p.c. hourly wage increases in order to restrain inflation (in 1975, annual wage increases over the life of the contract were 7.5 p.c. while average first year settlements for this year are estimated at 10 p.c.). These increases together with even a minor income tax cut would achieve moderate growth of real wages and secure a favourable response, so does President Ford hope, on part of the electorate. Concerning the fear of some economists that a too rapid 1976 recovery may yield once more to the cycle of excessive inflation followed by tight money and a return to an even deeper recession by 1978 at the latest — this does not alarm the Administration: today's needs particularly in view of elections must not be stymied by future caveats!

How does the picture add up? We should expect a GNP of 1,660 bn in 1976 equal to a money gain of 12.5 p.c. and a real gain of 5.5 p.c. over 1975<sup>19</sup>. Inflation and unemployment will be on a similar course of 7 p.c. each or somewhat below particularly for the GNP price deflator. Renewed gains in productivity at 4 p.c. in the private economy may mitigate the bases of inflationary pressures. Likewise, the slowing down of the influx into the labor force<sup>20</sup> may reduce unemployment more effectively while employment gains of another 1.4 mn should be expected. The D-J Industrial will move between wide ranges of a high of 1,050

or better and lows of 750 not allowing for emotional excesses due to financial mishaps in connection with New York City or otherwise<sup>21</sup>. Obviously, the Federal Reserve will implement the needs of a recovering economy by providing sufficient credit and liquidity and also influence the pattern of interest rates toward moderation around a discount rate of 5.5 p.c. The Administration is expected not to take any risks — by financial stringency either in not aiding New York City or in similar situations if they should arise — that could antagonize the entire recovery or financial stability by too narrow policies to please certain ultra-conservatives<sup>22</sup>. In this heating up election contest, those who are looking ahead and already have fallen in love with a *déjà vu* for 1977/78 — more boom, inflation and recession — will be swept aside for the time being. A Democratic victory, too, except for the speeding up of some public employment schemes is not expected to change this scenario.

<sup>15</sup> The fear that such deficits would crowd out private borrowers, push up interest rates and abort the recovery turned out to be spurious, at least so far.

<sup>16</sup> Of course, President Ford, so far, insists that any tax cut must be accompanied by a corresponding cut in spending — a challenge equal to that of squaring the circle. Fiscal 1976 projects \$ 302 billion tax revenues and \$ 374 billion outlays. For 1977, budget spending must not exceed \$ 395 billion.

<sup>17</sup> However, the recent New Zealand election defeating the Party in power that kept unemployment at 1 p.c. but failed to cope with inflation should be taken as a warning as to the preferences and mood of the electorate.

<sup>18</sup> According to T. Murphy, chairman of GM, "America cannot afford more cost and hence without provisions for productivity improvement no further commitment to labor costs should be undertaken if the ability of American industry to compete is to prevail". As to productivity, gains of 9.5 p.c. annual rate in the third quarter 1975 accompanied the 12 p.c. increase in the GNP during this period — reducing labor unit costs by 2.4 p.c.

<sup>19</sup> Allowing for a GNP of 1,475 bn for 1975 and an inflation rate of 7.0 p.c. in 1976. In comparison, the GNP of 1975 while \$ 75 bn above the 1,400 bn GNP of 1974 and showing a money gain of 5.4 p.c. showed a decline of 2.9 p.c. in real terms allowing for the rate of inflation of 8.3 p.c. in 1975.

<sup>20</sup> For example, if enough housewives should decide to withdraw from the labor market because husbands are finding jobs and will earn more. A return of more young to education instead of joining the labor market at the age of 16 could be another factor.

<sup>21</sup> Improving liquidity, rebounding corporate profits and rising productivity will benefit the market. These estimates are based on share earnings of the D-J-I of \$ 100 in 1976 against \$ 70 in 1975. Consumer staple groups, some durables and utilities are favored. As a windfall from the better stock market in 1976, the entire economy will get an uplift in the same way the 1973/74 plunge deepened the recession that followed by depressing consumer and business spending.

<sup>22</sup> Otherwise, the situation might become reminiscent of the Great Depression when the conventional recession of 1929 that had given way to some recovery forces was followed by a financial collapse triggered from abroad in 1931.

## KONJUNKTUR VON MORGEN

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