The U.S. Economy in 1977 and 1978

Thomas M. Supel

Senior Economist
Research Department
Federal Reserve Bank of Minneapolis

The longest and deepest economic recession since the end of World War II began in the late fall of 1973 and hit bottom in midwinter 1975. Since then the economy has grown vigorously: by the end of last year, production had increased at least 16 percent, and more than 7.7 million workers had found new jobs.

The relative strength of the current recovery is evident; we need only look at the figures for real gross national product (GNP) to see that we have been doing somewhat better than in most of the other five postwar recoveries. But the character of this recovery is perplexing; for while production and civilian employment have been high, so, too, have inflation and unemployment. For this, there are no postwar precedents.

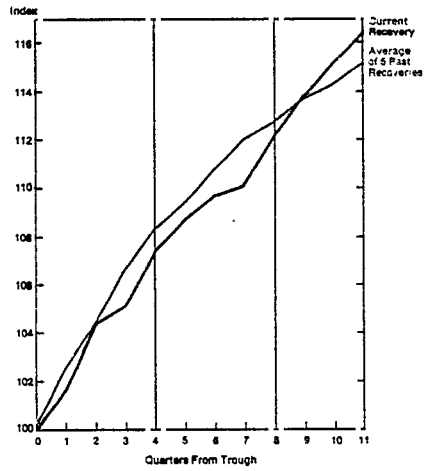
The unusual concurrence of high inflation and unemployment should continue with the recovery in 1978, but how high they will be and how strong the recovery will be is somewhat uncertain. Based on activity in 1977 and assumptions about economic policy in 1978, the recovery's pace and unusual character are not likely to change much in the next four quarters. Real GNP should grow from 4.5 to 5 percent while the inflation rate stays in the 6 to 6.5 percent range and the unemployment rate hovers just above 6 percent. This forecast may be too optimistic, however, in view of early 1978 events. Severe weather and the coal strike appear to have noticeably disrupted the economy this winter, reducing, for example, production, retail sales, and homebuilding. If these are not temporary effects, the recovery would likely still continue this year, but at a significantly slower pace and possibly with even higher inflation and unemployment.

Putting the Recovery in Perspective

According to the National Bureau of Economic Research, the current business cycle reached its recessionary low point in the first quarter of 1975. By the end of 1977, then, the recovery phase had been under way for eleven quarters, nearly three years. So far, how does it compare with other recoveries in the postwar era?

The first chart shows real GNP—the value of goods and services produced in the economy, adjusted for price changes—during the six recovery periods. For ease of comparison, the five earlier recoveries are averaged, and all the recoveries are indexed to show the rate of growth from their trough

Chart 1
Real Gross National Product

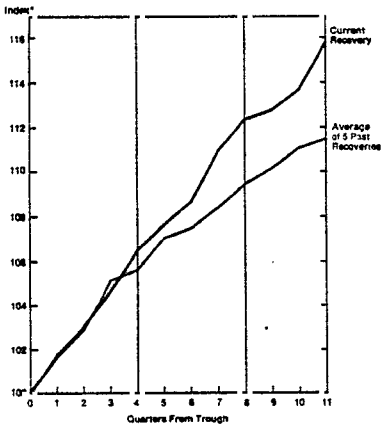


levels. After eleven quarters, the current recovery's index was 116.4, which means real GNP was 16.4 percent higher than in the first quarter of 1975. On average in the past five recoveries real GNP was 15.1 percent higher than in the trough quarter. At average annual rates, real GNP increased 5.7 percent in the latest recovery and 5.2 percent in the earlier recoveries. Obviously, this recovery is slightly ahead.

How did it get there?

Consumers have been the main prop of GNP (Chart 2). By the end of 1977, real consumer spending in general had grown about 7 percentage points more than in the earlier recoveries, and spending for residential construction in particular was a phenomenal 47 percentage points higher (Chart 3). Much of the impetus for residential construction came from the highly unusual decline of interest rates during this expansion.

Chart 2
Real Personal Consumption



Government spending contributed little to the growth of GNP. Real federal government purchases of goods and services grew more than average, when the recovery which included the Korean War is ignored (Chart 4), but state and local government spending did not grow nearly as much as in the previous recoveries (Chart 5). Many state and local governments—New York City is the prime example—have had strapping financial problems in the last few years which have forced them to cut back.

Growth in real capital outlays by the business sector has been even more sluggish—by the end of 1977 it was 33 percent below average (Chart 6). Explanations for this are both numerous and varied. The rate of capacity utilization may have been so low that business investment has not really been necessary. Or, the foundering stock market may have made it more profitable to buy existing rather than new plant and equipment. Or, equally possible, uncertainty about the federal energy and tax programs

Chart 3
Real Residential Construction

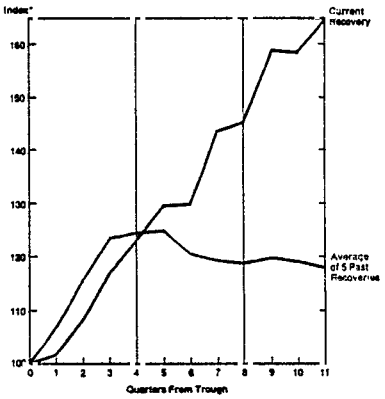
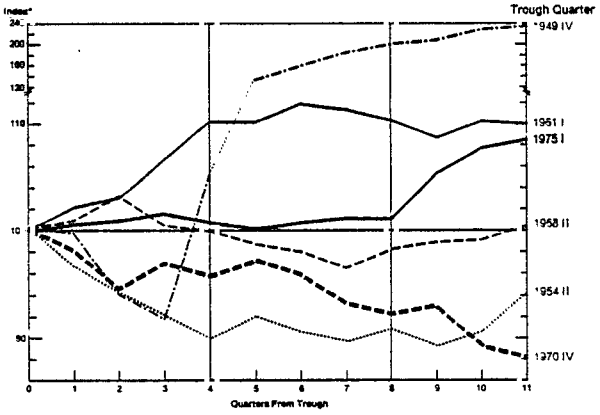


Chart 4
Real Federal Government Purchases



may have discouraged business spending.

As might be expected during a period of expansion, more and more jobs have been created, but labor market conditions have been unusual in this recovery. A larger share of the population was employed at the end of 1977 than ever before (Chart 7). However, the extremely fast growth of the labor force (Chart 8) kept the unemployment rate from dropping (Chart 9). If the labor force had grown near an average rate, by the fourth quarter of 1977 the unemployment rate would have been 2.5 rather than 6.6 percent. Unfortunately this is merely an arithmetic exercise and does not explain why a growing economy has not been able to use more of its labor force.

Also unusual in this recovery: Coupled with the high unemployment rate has been a very high rate of inflation (Chart 10).

Chart 5
Real State & Local Government Purchases

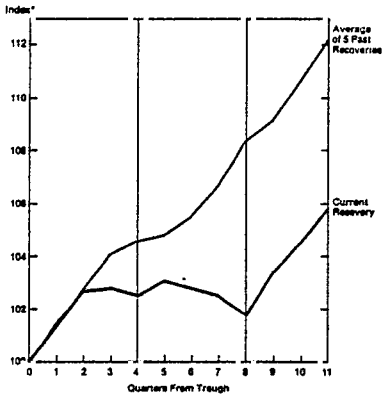


Chart 6
Real Business Fixed Investment

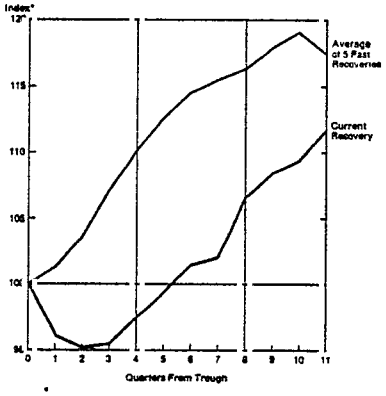


Chart 7
Employment Rate
Total Civilian Employment as a Percent of Total Civilian Population Age 16 and Over

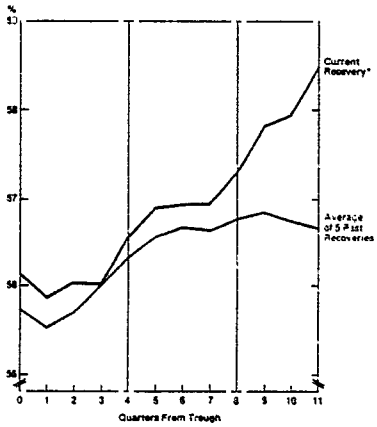


Chart 8
Civilian Labor Force

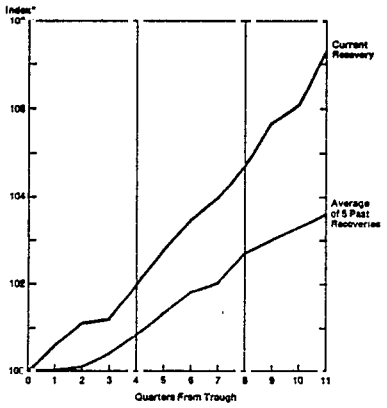


Chart 9
Unemployment Rate
Unemployment as a Percent of the Labor Force

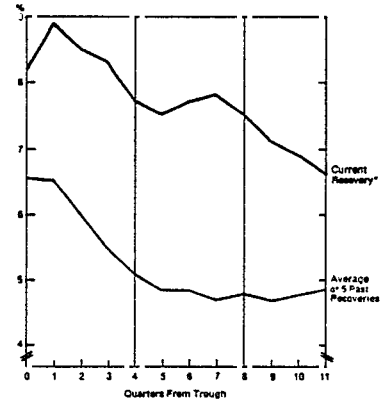
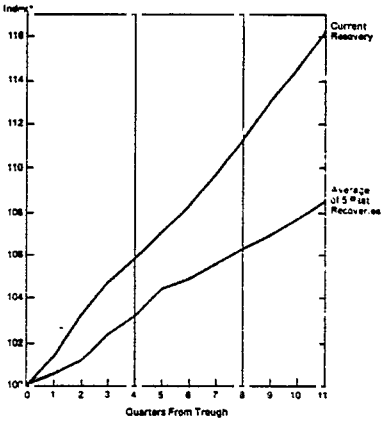


Chart 10
Price Level



*Trough quarter = 100; the current recovery is from the first quarter of 1975.
Source: U.S. Department of Commerce

What's to come in 1978? . . .

To make predictions for this year, we need to make some assumptions about government policies. Let's assume that the narrowly defined money supply will be expanded from 4 to 6.5 percent as targeted by the Federal Reserve last fall. Let's also assume that federal government expenditures for fiscal 1978 will be about $462 billion, as announced in President Carter's January budget message. During the past year or so, the federal government has spent less than its budget, but we will assume it will spend the full amount in 1978. Let's assume that Congress will pass a moderate tax cut, about the size of the Administration's $25 billion proposal, which won't take effect until October. Finally, let's assume that before spring Congress will also pass an energy bill which, because of its offsetting tax changes, won't affect overall income in 1978, though it may cause some relative price adjustments.

In addition to these assumptions about government policies, we will assume that the OPEC nations will not hike oil prices, that the value of the dollar will not plummet enough to force the monetary authorities to adopt new policies, and that economic growth in foreign countries will not quite match the United States'. It's too early to tell what the coal strike will do to the economy, but we will assume that there will be no other major strikes; during 1978 only about 2.4 million workers' contracts are terminating.

. . . The recovery will continue

Under these assumptions, and based on a closer look at activity last year, we think the recovery will continue in 1978 about as strong as it has been.

In the final quarter of 1977, real GNP grew at an annual rate of only 4.2 percent, but real final sales (total production less inventory changes) grew 6.8 percent. The ratio of inventories to final sales thus dropped far enough that in 1978 inventory growth should at least match sales growth.

Business investment should contribute to economic growth in 1978. Although sluggish over most of the eleven recovery quarters, it picked up in 1977 and grew at an annual rate of nearly 15 percent. We expect this to moderate only slightly in 1978 since year-end appropriations for new plant and equipment and new orders for nondefense capital goods were strong.

Revenues of state and local governments also rebounded in 1977, so their purchases of goods and services should help increase aggregate demand this year. With some financial constraints lifted, these governments had built up a combined budget surplus of about $30 billion at the end of last year. Their spending in 1978, therefore, could grow as much as 13 percent.

Most of housing's exceptional strength at the end of the year should carry into 1978 too. December marked the sixth consecutive month in which an annual rate of more than 2 million units were started. The very high number of unsold new homes could hold starts somewhat below that this year, but they will undoubtedly still be strong. And despite higher new home prices, personal income growth is likely to keep sales of new homes fairly brisk.

Personal income growth, in fact, will probably support consumers' overall spending, though not quite at such high rates. During 1977, consumer spending grew unusually fast, and people were saving an unusually small part of their income. Even if the savings rate returns to more normal levels in 1978, though, spending should remain fairly strong because consumers will probably be earning more.

In short, the economy's momentum at the end of 1977 should carry through 1978, with real GNP growing in the range of 4.5 to 5 percent. Despite the continuing recovery, though, unemployment and inflation are both likely to remain unusually high.

Starting from the 6.4 percent rate in December 1977, the unemployment rate may drift closer to 6 percent by year-end. It could even settle below 6 percent, if labor force growth slows significantly, but that is not likely.

The inflation rate will almost certainly be higher than last year's 5.6 percent—probably in the 6 to 6.5 percent range—and it could easily be higher. Labor contracts, which last year averaged 9 percent increases for the total compensation package, will be boosting unit labor costs. Higher minimum wages, increased social security taxes, and other government policies seem to preclude any reduction of inflation.

Major Uncertainties

Economists, much like weather forecasters, never promise 100 percent accuracy. Too many unknowns can throw their predictions off.

One of the biggest uncertainties this year is business fixed investment. We have predicted that capital outlays in 1978 will be nearly as strong as in 1977. But this may be too optimistic. Surveys of business spending intentions, the latest Commerce Department survey among them, show that business plans to spend only 10 percent more this year on new plant and equipment. That small an increase would undercut our GNP forecast.

Similarly, we have predicted 1978 consumer spending to be close to 1977's. But in doing so we have discounted the effect of sagging domestic auto sales on the economy because consumers have been buying other goods and services. If car sales don't pick up, though, and sales of other consumer items don't keep making up the difference, the projection for total production would be off.

The economic impact of the tax cut is also uncertain. We may have underplayed it in this forecast by assuming the tax cut will only be $25 billion. A larger cut would certainly have a larger effect on the economy, however. And some members of Congress are pushing for a $40 billion cut or fewer tax reforms than outlined in the Carter package. But even at $25 billion we may have overplayed the impact of the tax cut; consumers and businesspeople may see it as inflationary and reserve spending decisions until they feel more confident about their economic futures.

Another uncertainty not reflected in this forecast is oil price increases by the OPEC nations. Should large increases occur, of course, they would ring in a new round of inflation.

And finally, but perhaps most important, we have discounted the economic disruptions in early 1978. Retail sales, housing starts, and industrial production all slowed, mostly, we believe, because of the bad winter weather and the coal strike. If these slowdowns turn out to be more than temporary, however, due, perhaps, to more general economic uncertainties, both our production and inflation projections would be too optimistic.

Just how much can the policy maker do?

We are looking for a fairly strong economy in 1978. Yet we see no end to either the 6 percent unemployment rate or the 6 percent inflation rate. This is not a very pleasant prospect. Why aren't the policy makers doing something? Instead of the 6-6 forecasted, why aren't policies being formulated and implemented to give us a 4-4 combination? Or something even better?

In the 1960s we saw a relationship between inflation and unemployment that led many to believe a trade-off exists: when the unemployment rate is low, the inflation rate will be high and vice versa (Chart 11). Many policy makers assumed their task was to choose a particular inflation-unemployment target and adopt policies to achieve it.

But in the 1970s we have discovered that the trade-off apparently has disappeared. Inflation has not decreased as unemployment has increased. On Chart 11, the points from 1970 to 1977 do not form a downward sloping curve as the 1960-1969 points do.

Chart 11
Inflation vs. Unemployment
actual 1960-77, projected 1978

This experience has caused a debate among economists as well as policy makers.

Traditionalists maintain that the trade-off still exists, but that it has been thrown off by a number of special factors. The most obvious is the sharp rise in energy prices since 1973. But other factors such as the dollar's devaluation, weather, and environmental regulations—factors independent of monetary and fiscal policy—have also contributed to inflation. Consequently, the traditionalists argue, the

policy maker can still exploit the unemployment-inflation relationship; the target will just have to be different than in the 1960s.

Nontraditionalists assert that a trade-off does not now, and never did, exist. They reason that since it's in the interest of workers and employers to anticipate government policies and act accordingly, they do. Therefore systematic monetary and fiscal stabilization policies can do little to move the economy in one direction or the other.

The existence of the inflation-unemployment trade-off is obviously a critical issue for an economy with both inflation and unemployment around 6 percent. Until it's resolved, finding the best policy to improve this situation will continue to be at least as uncertain as economic forecasting.*

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*A more thorough analysis of the inflation-unemployment trade-off follows in the speech by John Kareken.

The views expressed herein are those of the author and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.