RECORD OF SOCIETY OF ACTUARIES
1976 VOL. 2 NO. 4

Vol. 2, No. 4 October, 1976

RECORD

CAN INTERNATIONAL ECONOMIC STABILITY BE REGAINED?

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One of the key questions we have as we think about current and recent economic developments, including such developments internationally, is what to make out of the very evident slowing down in the rate of expansion of economic activities which we have seen in most of the countries of the industrial world during the last year or two. This is a question which has been a matter of substantial concern to the business and financial communities, to students of economics, and certainly to those who have responsibilities for managing economic policy.

It has been a matter of some concern for a couple of reasons. First, if we look back historically, we can identify at least a couple of situations where there was a slowing down in the rate of expansion in economic activity and, although attitudes at the time were fairly sanguine, they turned out in retrospect to have been the prologue to outright declines in economic activity even before economies had reached reasonably full employment. Let me give you a couple of illustrations. About 16 years ago, in 1960, the U.S. economy had begun to move essentially laterally. There was no real perception until quite a bit later that, in fact, the economy, even though it had not yet regained reasonably full employment, at least by the conventional standards of that era, was moving laterally antecedent to an outright decline into the 1960-61 recession. A more recent experience is the 1974-75 recession. There was in September, 1974, a conclave at the White House of some of the better known economists in the United States to discuss the economic situation, with the President himself sitting in for half a day. Six or eight months later, the President noted that he could not recall from that discussion that there was any very clear indication that the U.S. economy was on the brink of a particularly sharp recession in business activity.

On the basis of these earlier experiences then, the tendency for the rather sharp gradient of the expansion up to about the middle of this year to start leveling out understandably raises some questions. Moreover, these questions become even more urgent by virtue of the fact that this slowing down is a fairly pervasive thing throughout the industrial world. If you look at the profile of economic developments during the current year, you will find, for example, that the rate of expansion in recent months in Canada has not been as great as it was earlier this year. This has also been true in the case of several other countries. It does not seem to be true in the case of Germany. But, generally speaking, one can say that this deceleration has had an international dimension and that is not irrelevant to our consideration.

As far as the U.S. economy is concerned, the facts about this deceleration are evident enough. In the first quarter of this year, civilian employment in the

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United States increased 1.3 million; in the second quarter, 808,000; and, in the third quarter, 240,000. These increases in employment are, of course, very parallel to rates of increase in such things as industrial production or retail sales.

I will turn my attention to the U.S. economy, partly because the data are a little more up to date, and partly because what happens to the U.S. economy is pretty important to the state of the international economy. One of the widely-quoted aphorisms from the prime minister of Canada occurred a few years ago when he was talking about the enormous impact which swings in the U.S. economy have on other economies and, of course, specifically on the Canadian economy. His comment was that having your economy next to the United States is a little bit like sleeping with an elephant. No matter how benevolent the beast, you feel every twitch and groan.

Let me summarize my own review of the U.S. economy in this way. In spite of the very evident slowing down in the rate of expansion, the evidence does not seem to indicate that we are, in fact, on the verge of an outright decline in business activity. This is a perplexing and puzzling thing. Are we seeing simply a flat spot in the inevitably uneven pace of an economic advance or are we seeing something antecedent to an outright decline? One of the most significant pieces of information is that we do not see any evidence yet of any weakening in the capital goods area. In fact, we can state more positively that the evidence we have in hand is indicating a growing strength in the capital goods area, that is, in outlays for new machinery, new equipment, new facilities, etc.

Plant and equipment outlays in the U.S. economy in the second half of last year actually declined in current dollar at a 2.3% seasonally-adjusted annual rate. If you apply to that a factor for the rise in the price level of 5% to 6%, you can see that there was a rather sharp contraction in the real volume of business purchases. In the first half of this year, these outlays rose at an 11.6% rate, a substantial swing from the minus 2.3% annual rate in the previous six months. This is one area where we have projections based on surveys of businesses as to what they see in terms of their own situations. These projections have been reasonably good throughout the last twenty years that we have had them. Businesses are projecting a 15.7% rise in the second half of this year. For the last three half-years, beginning with the second half of last year, the increases went from minus 2.3% to plus 15.7%. If that is antecedent to a decline in capital outlays, it would be a pattern which has not shown up in earlier periods when we were on the verge of a downswing.

Moreover, strength is also indicated if we look at the new orders being placed for capital goods, excluding the defense area. In the first quarter of this year, the average monthly rate of placement of new orders for capital goods was 10.7 billion; in the second quarter, the average monthly rate was 11.7 billion; and, in the third quarter, 12.5 billion. This is not the kind of progression which one would expect to see if businesses, in fact, were pulling in their horns in any significant way.

The second set of evidence has to do with consumer psychology. The University of Michigan Institute for Social Research and, specifically, the unit within it called the Survey Research Center is the largest university-based research organization of this type in the world. For the survey of consumer sentiment (consumer psychology), the results were released last week based on the surveys finished about a month ago. The index which they construct from these

responses, which they call their index of consumer sentiment, showed a very substantial rise from the second quarter. To be specific, the index rose 6.6 points, from 82.2 to 88.8.

Interestingly, the improvement in consumer sentiment was particularly strong among those in the middle and lower income groups. If I had been asked to guess if there was any divergence between what you might call the bottom half and the top half in terms of income recipients, I would have thought the improvement would have been a little stronger in the top half. That did not turn out to be the case. It is very interesting that in this survey, for the first time in about three years, the number who said it was a good time to buy household durable goods was in the majority. One thing that comes out of these surveys that is rather significant is that, if you want to get information about what people are going to do in the way of spending money, you don't just ring the doorbell and say "Good morning, are you planning to buy a refrigerator in the next six months?" "Or an automobile?" If you do that you get information on buying intentions. If you resurvey the same sample six months later you will find that a surprisingly large proportion of the actual purchases will turn out to have been made by those who, six months earlier, said they did not plan to buy. Similarly, a surprisingly large proportion of those who indicated that they did plan to buy will not have made the purchase.

Evidence about what consumers may do can be determined by questions which get at their general view of the economy. Do you think job conditions in your community are getting better, about the same, or getting worse? Do you expect your own financial situation to be better off a year from now? Five years from now? It is this kind of general attitude that tends to determine whether, once the issue comes to a head, they decide that the old car will do or that things look pretty good so they will buy a new car. This confidence factor, on the basis of these surveys, is looking better.

I do want to make a caveat here. While consumer confidence in the longer run, defined in the survey as five years, has improved, it is not yet back to where it was a few years ago. It is obviously a great deal better than it was a year or two ago, but it is still well below, say, ten years ago. In fact, it is only about one-half of what it was at that time. This suggests to me that we do not have the kind of gyroscopic stabilizer in consumer sentiment that might be helpful if we got a spate of bad news. There is still volatility here. Consumer sentiment could readjust and respond negatively rather quickly if other conditions made them decide that, once again, things were not working out well.

If you want to watch one thing that spells danger for the economy and indicates the possibility of a decline in business activity, watch to see if heavy inventories and tight credit are on a collision course. It is evident that if one looks as far back as we have reasonably good data, certainly the last fifty years, in the United States the sharp recessions in economic activity (excluding the 1929-33 recession because that was one of those pathological situations where the managers of economic policy consistently did something wrong if there was any opportunity to do it wrong) occurred when businesses got overloaded with inventories and that collided with very sharply tightening credit conditions. That is a very explosive combination. If you see those trains on the same track headed toward each other, you had better be careful.

There is not now any evidence at all of that situation. When you look at inventories in relation to sales, you must use data in constant prices. Conventional inventory/sales ratios are almost meaningless in a period of inflation since inflation affects the sales figures almost simultaneous with the inflation but, using conventional accounting methods for handling inventories, the impact of inflation hits inventories at a slower pace. We were misled in 1974 due to the sharp inflation. With inflation influencing the inventory statistics rather slowly but influencing sales figures immediately, we were looking at rather benign inventory/sales ratios which did not seem to be any problem. Then the Department of Commerce belatedly published some figures with inventories and sales both in constant prices and the evidence was very clear that we had a heavy inventory situation in 1974 at a time when the credit situation was becoming very tight and businesses were finding it very difficult to finance further additions to inventory. This is simply not a description of the situation we have at the present time. Our credit conditions are fairly easy. The rates of monetary expansion in most countries of the world are in the ballpark. Some are higher than I would prescribe, some are lower, but there is no area where you can talk about really tight credit in the meaningful sense of the rate of monetary and credit expansion.

One other factor as we look at what has happened in the U.S. economy this year is that a significant role must be assigned to changes in our external payments position, in other words, to changes in our balance of trade. Our merchandise exports went from a surplus position of 2.2 billion in the fourth quarter of last year (an annual rate of 8.8 billion), to a preliminary estimate of a 3 to 4 billion deficit in the third quarter of this year. If one were to assume that this deterioration in the U.S. trade position had not occurred and that other elements of our gross national product had turned in the performance they did, what would have happened? The answer is that employment today in the U.S. would be about three-quarters of a million higher than in fact is the case.

There was a time in the U.S. when our interest in the rest of the world's economy was pretty casual to put it mildly. We felt that we should be doing our Christian duty to those poor people outside the U.S., but the idea that what happened out there might affect our economy was hard for us to imagine. It is easy to understand that since, if you go back only twenty years, the world economy was a very different place than it is at the present time. Japan today is the free world's second largest economy, a rich industrially-powerful economy with a per capita income now about 70% of that in the United States. What do you suppose it was twenty years ago? Per capita income in Japan in 1955 was about 16% of that in the U.S., and it was about a third of that in the U.K. Japanese per capita income is now significantly higher than per capita income in the U.K. in real terms. It is a very different place and what happens out there does importantly determine what happens to the U.S. economy at home.

We have a Japanese economy whose per capita income is 70% of that of the U.S. We have a German economy whose per capita income is almost, for all practical purposes, equal to ours. The French economy is not quite up to the German economy but is not far away. Any kind of appraisal of what is happening to the economic situation in the U.S. involves examining what is happening out there and what the feedback effect is on domestic economic conditions at home. If you look at U.S. economic data, we had a tremendous improvement in our foreign trade position during the 1974-75 recession. If that improvement

had not occurred, unemployment would have been well over one million higher than in fact it was.

I would like to end on a somewhat longer-run note. We are facing in the free world economies generally a key problem of managing this expansion so that it will, this time, remain orderly and enduring. For ten years, the industrial economy of the free world has been off balance. Since about the latter part of 1965, we have not had what might be called a stable and orderly and enduring economic expansion. We have had spurts of expansion that required slamming on the brakes. The phrase "stop, go" has often been applied to U.K. economic policies but, in one way or another, it has really been applicable to much of the industrial world during this period. This time it is very important that the economies be managed in a way that can be more stable and enduring. If we do not, then what is at stake is not just a little more inflation or another painful little recession, but increasingly in jeopardy will be the liberal institutions of a market-organized economic system and possibly even political democracy itself. I think our economic performance has contributed to an erosion in the strength and stability of our liberal democratic and market-organized economic institutions.

Governments generally are going to have to find ways to pursue a more disciplined monetary fiscal or budget policy than has been true in the past. Here the key is the budget. It is, in most countries, the budget which tends to draw central bank policy off course, whether one is talking about the Bank of Canada or the Federal Reserve or the Bank of England or whatever it may be. The key is the budget and there is no question but that in many of these countries, including the U.S., these budgets have been on a course which is threatening our liberal institutions. In the U.S., the rise in total government spending in the decade of the 1970's has been equal to 50% of the rise in our national income. That ratio would be slightly lower for Canada. Government spending as a percentage of the national income in the U.K. is about 60% now; for the Netherlands, about 63%. With this kind of undisciplined budgetary trend, there is no real way by which the demands on total economic resources can be arbitrated out in a way that can give us a reasonable chance of price level stability.

The old U.S. role as the world's island of stability, that is, a stabilizing factor in the world economy that could help the whole world economy be more stable, now probably has to be played jointly by the United States and Germany and Japan. These are the three strongest economies. They account for about two-thirds of the total economic activity of the 24 OECD countries, which are essentially the industrial countries. Ways must be found by which these three governments can consult and coordinate their decisions so at least each government is aware of the implications for it of what the other governments are talking about.

My final point is one which is directed more specifically to the life insurance industry. It seems increasingly clear to me as I look at survey results coming out of University of Michigan studies that inflation must entail severe displacement effects in terms of the economic welfare of families. Yet one of the striking things is that, if you want to document empirically the enormity of these displacement effects, you will find yourself astonishingly empty-handed. For all of the agony and concern and the tons of speeches that have been given about the evil effects of inflation, the empirical evidence about the displacement effects of inflation is astonishingly scanty. There is a little evidence that it seems to adversely affect both

the low income and the highest income groups. The generalized statement that inflation is bad for those on fixed incomes is self-evident. Are these the people on Social Security? No, since their incomes are not fixed. This is an illustration of how easy it is to deal in clichés until somebody calls you on it and points out the facts. The life insurance industry probably has more of a stake than anybody else in making sure that studies of the factual evidence as to the displacement effect of inflation on the family situation are made. Managers of economic policy are not, you know, above making decisions without any facts. It is helpful if there are some facts, but on this urgently important world-wide issue, the facts are just not there. This must be remedied.

I will close on the note that I have a fairly sanguine view of the relatively short-term economic situation. But I do want to leave with a warning that time is running out on us in terms of getting our basic economies back on a track where the expansion can be enduring and orderly and sustainable. My guess is that people are not going to be willing to go up and down the roller coaster very many more times. There will be demands for the kinds of controls which probably will be highly disappointing in their results but which will be tried.