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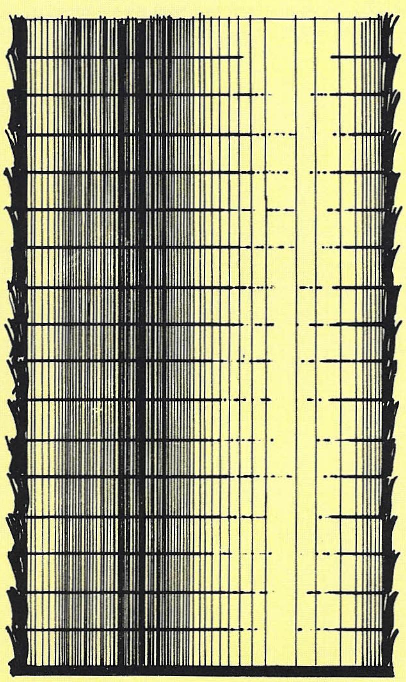

By Andrew F. Brimmer

A general consensus has emerged among most economic forecasters with respect to expectations about prospects for the American economy during 1978. Most observers now anticipate only a modest rebound from last year's sluggish pace of economic activity over the next two quarters, followed by a marked slowing in the second half of the year. On the other hand, opinions differ significantly over the degree to which economic policies of the Federal Government should be modified in the near future to offset the prospective slow-down.

The shape of the consensus regarding the contours of economic activity through the end of 1978 can be traced in a number of forecasts. The one followed in this presentation was prepared by Data Resources, Inc. (DRI). Several elements in the latest DRI forecast (made at the end of October) are summarized in Table A. Also, some of the key components of a forecast for 1978 made by the Business Council are shown in the table.

A moderation is anticipated this year in the overall rate of national economic expansion between January and June—a period during which the real gross national product (GNP) may rise by 4.4 percent (seasonally adjusted annual rate—SAAR). But in the third quarter, the rate may ease to 4.0 percent—and further to 3.4 percent in the final quarter. For the two quarters combined, the rate of growth may average 3.6 percent. For the year as a whole, real GNP may increase by about 4.3 percent.

If the rate of increase in real GNP does fall to the neighborhood of 3½ percent in the second half of 1978, the nation would probably experience what economists call a "growth recession." This means, the actual rate of expansion would be too low to prevent unemployment from rising. A figure close to 4 percent is required to achieve that result.

All of the major sectors of the economy (except state and local governments) are forecast by DRI to register lower real growth rates in 1978, when compared with 1977. For example, total consumer spending, 3.9 percent vs. 4.4 percent; business fixed investment, 6.0 percent vs. 8.8 percent; Federal Government, 4.7 percent vs. 6.3 percent; and state and local government 4.7 percent vs. 1.3 percent.

Business Fixed Investment

It is the outlook for business fixed investment that is causing the most uncertainty. Trends in this sector suggest a modest strength throughout 1978. For 1977, the gain was approximately 8.8 percent in real terms. For the three quarters ending in December, the rate of increase was forecast to average approximately 5.8 percent, with a fairly large proportion of the rise reflecting outlays for equipment rather than construction of plants and other facilities.

For 1978, according to preliminary results in McGraw-Hill's annual fall survey of spending plans released late in 1977, businessmen may lift outlays for plant and equipment by only 3 percent in real terms during 1978. And capital expenditures may total approximately $153.1 billion—a gain of about 11 percent over 1977. However, prices of capital goods may climb by 8 percent in 1978, holding the rise to 3 percent in real terms.

As shown in Table A, DRI and the Business Council are forecasting somewhat higher growth rates for 1978—6.0 percent and 7.5 percent, respectively. Nevertheless, it seems highly unlikely that this sector will achieve the goal set by the Carter Administration, which calls for business fixed investment to rise at an annual average pace of 9 to 10 percent through 1981. On the basis of current policies, it appears that the growth rate may average no more than 7 percent.

One reason for the short-fall in investment is the uncertainty on the part of businessmen regarding the outlook for sales. In the corporate sector, a substantial volume of new investment outlays has been approved, but funds have not been appropriated. The explanation is straightforward: considerable doubt exists about the strength of demand at the time the output from expanded facilities reaches the market. In the meantime, the rate of return on the existing capital stock (corrected for inflation) remains low by historical standards. As a consequence, the directors of many companies are restraining new investment until increased demand lifts profit margins.

It is against this background that a number of business leaders have called for a sizable tax reduction in 1978, with a significant portion designed to stimulate capital formation.

Prospects for Jobs

One consequence of the slower pace of economic activity would be a further reduction in the rate of unemployment during 1978. This rate stuck in the neighborhood of 7 percent during the last half of 1977. Therefore, the jobless rate may still remain around 6.5 percent by the end of this year. Among some of the groups on the margins of the economy (such as Blacks and teenagers), proportionately less improvement is anticipated.

There were 91,339 thousand persons at work in the United States in October and 6,897 thousand were unemployed. The latter figure represents 7.0 percent of the civilian labor force, which totaled 98,236 thousand. Several features of these data note the differential positions of Blacks and young people.

While Blacks constitute 11.6 percent of the civilian labor force and held 10.7 percent of the jobs, they accounted for 22.8 percent of total unemployment. At 13.9 percent, Blacks' unemployment rate was 2.28 times the 6.1 percent recorded for whites. Teenagers of all races represent 9.5 percent of the labor force and held 8.5 percent of the jobs, but they accounted for 23.4 percent of unemployment. The jobless rate was 17.3 percent for teenagers as a group and 37.9 percent for Blacks alone in 1977.

The figures in Table B illustrate even more dramatically the differential job experience of Black and white workers in recent years. In general, during the 1973-75 recession, Blacks had to bear a disproportionate share of the burden of increased unemployment. Moreover, during the last 30 months of the recovery, they have gotten a small fraction of the added jobs, compared with their relative position in the labor market. Over the same period, the level of unemployment among Blacks has risen significantly. For example, from March 1975 through October 1977, the total labor force rose by 6,355 thousand, and the Black component climbed by 1,045 thousand. Thus, Blacks accounted for 16.4 percent of the total expansion. However, jobs held by Blacks rose by only 869 thousand and represented 11.6 percent of the increase in total employment. As a result, the level of unemployment among Blacks rose by 149 thousand—compared with a drop of 1,014 thousand among whites and 865 thousand in the economy as a whole.

If the overall unemployment rate is about 6.5 percent at the end of 1978, the rate for Blacks may still be in the neighborhood of 13 percent; for whites about 5.7 percent. Thus, the historical Black-white ratio of more than 2 to 1 would still prevail.

These data illustrate once again the importance of vigorous economic expansion as an underpinning for increased employment opportunities for those on the margin of society. While job training and other specialized programs are clearly needed, a sustained, high level of real economic growth is a necessary foundation for the expansion of jobs for the disadvantaged.

Outlook for Inflation

The general price level has been rising at a trend rate of 6 percent for quite a while. Fluctuations around the trend (associated mainly with variations in food prices) have dampened or boosted the rate compared with the basic trend for a few months. But the hard core rate of inflation appears to be lodged in the neighborhood of 6 percent.

The jump in the wholesale price index (WPI) last October by 0.8 percent illustrates the pattern. Most of that rise can be traced to significant advances in prices of farm products and processed foods and feeds. Prices of farm products alone rose at an annual rate of 28.8 percent. In the preceding five consecutive months, these prices had declined.

In 1978, one should expect little change in the pace of inflation. In its latest forecast, DRI estimated that the consumer price index (CPI) may rise by 6.0 percent, compared with 6.5 percent in 1977. (See Table A). The Business Council forecast a 6.2 percent rate of inflation during 1978. If one were to measure the pace of inflation by the GNP deflator, the rate of increase may amount to 5.9 percent this year vs. 5.6 percent in 1977.

A key point to keep in mind is this: the prospective pace of inflation at least through 1978 (and perhaps for a year or so beyond) is not a reflection of excess demand. It cannot be traced to "too much money chasing too few goods." Instead, it is a reflection of a number of other factors, including higher costs stemming from rises in labor costs in excess of gains in productivity and sharply higher fuel prices. In the economy as a whole, utilization rates in manufacturing (approximately 83 percent) are well below capacity—even if the latter is discounted for marginal facilities. This situation is not likely to change very much over the coming months.

Outlook for Monetary Policy

Turning to monetary policy, it is evident that the Federal Reserve System is caught in a serious dilemma: it is faced with a choice between pressing its commitment to check what it sees as excessive rates of monetary growth and providing the money and credit needed to enhance the prospects of sustained economic expansion.

As can be seen from Table C, the narrowly defined money supply, M_1 (consisting of checking accounts and currency in the hands of the public) grew by 8.8 percent (SAAR) during the month ending October 19, 1977. For the 8-week period, the rate was 10.2 percent, and it was 9.2 percent over the previous three months. The six-month rate was 8.9 percent. The long-term growth rate (52-weeks) was 7.7 percent.

For the more broadly defined money supply, M_2 (consisting of M_1 plus bank time and savings deposits other than large negotiable certificates of deposit), the pattern of growth was as follows: October, 8.4 percent; 8-weeks 8.9 percent; three months, 8.9 percent; 26-weeks, 9.3 percent, and 52-weeks, 10.4 percent.

These growth rates are well above the targets set by the Federal Open Market Committee (FOMC). The latest announced targets are (percent):

Category	1977:2 to 1978:2	September-October, 1977
M_1	4 to 6½	2 to 7
M_2	7 to 9½	4 to 8

The growth in the monetary aggregates above the Federal Reserve's upper limit occurred in two sharp spurts centering in April-May and late-July-mid-September. In April, M_1 rose by 19.4 percent (SAAR) and in July-September 15.6 percent.

To curb the rapid rise in the money supply last spring, the FOMC lifted the federal funds rate from an average of 4.60 percent in the week ending April 6 to 5.45 percent in the week ending May 25. In response to this move, the rate of growth for M_1 eased off from 9.8 percent (SAAR) in the second week of May to 7.8 percent in late July. However, the growth rate took another large jump to 11.4 percent in mid-September. To counter the second advance, the FOMC through restraint on bank reserves, raised the federal funds rate from an average of 5.42 percent in July to 6.56 percent in the week ending October 26.

Many market participants seem to believe that the FOMC has a target of 6.5 percent for the federal funds rate. A few think the FOMC is prepared to see the rate move as high as 6.75 percent—if necessary to bring the growth of the monetary aggregates within the long-term range.

The growth targets for the monetary aggregates projected for the year ending in the second quarter of 1978 are prob-

Table A.
Selected Elements in the Economic Outlook (Annual Rates of Change)

Period (Year and Quarter)	Real GNP		Real Business Fixed Investment		Inflation (Consumer Price Index)		Unemployment Rate (Percent)[3]	
	DRI[1]	BC[2]	DRI	BC	DRI	BC	DRI	BC
1976	6.0	6.0	3.6	3.6	5.7	5.7	7.7	7.7
1977	4.8	5.0	8.8	9.0	6.5	6.5	7.1	7.0
I	7.5	7.5	19.0	19.0	8.4	8.4	7.4	7.4
II	6.1	6.1	6.9	6.9	8.8	8.8	7.0	7.0
III	3.8		4.2		5.3		7.0	7.0
IV	4.2		6.2		4.8		6.9	
1978	4.3	4.5	6.0	7.5	6.0		6.5	
I	4.6		4.7		6.3		6.6	
II	4.2		6.6		6.4		6.5	
III	4.0		8.2		6.0		6.5	
IV	3.4		6.1		5.8	6.2	6.5	6.6

Notes:
[1] Data Resources, Inc.
[2] Business Council
[3] Percent of Civilian Labor Force

Table B.
Changes in the Civilian Labor Force, Employment, and Unemployment, By color, March 1975-October 1977 (Number in Thousands)

Category	March, 1975	October, 1977	Change: March, 1975, October, 1977
Total			
Civilian Labor Force	91,881	98,236	6,355
Employment	84,119	91,339	7,720
Unemployment	7,762	6,897	−865
White			
Civilian Labor Force	81,551	86,861	5,310
Employment	75,216	81,540	6,324
Unemployment	6,335	5,321	−1,014
Black			
Civilian Labor Force	10,330	11,375	1,045
Employment	8,903	9,799	896
Unemployment	1,427	1,576	149
Black As Percent of Total			
Civilian Labor Force	11.2	11.6	16.4
Employment	10.6	10.7	11.6
Unemployment	18.4	22.9	−17.2

Source: Calculated by Brimmer & Co., Inc. from U. S. Bureau of Labor Statistics Data.

Table C.
Recent Trends in Monetary Aggregate [1]

Category	October	Last 8 Weeks	Last 13 Weeks	Last 26 Weeks	Last 52 Weeks
Money Supply					
(Week ending Oct. 19, 1977)					
$M^{*}1$	8.8	10.2	9.2	8.9	7.7
$M^{*}2$	8.4	8.9	8.9	9.3	10.4
Nonborrowed Reserves***					
(Week ending Oct. 26, 1977)	−5.1	1.8	−5.0	0.3	0.7
Monetary Base					
(Week ending Oct. 26, 1977)	10.2	10.2	10.6	8.1	8.8
Adjusted Federal Reserve Credit					
(Week ending Oct. 26, 1977)	13.2	12.1	11.6	10.5	9.7

[1] Percent change, simple annual rates, 4-week average ending on date indicated from 4-week average ending at the earlier period.

* Latest announced growth targets (percent):

	1977:2 to 1978:2	September-October, 1977
M_1	4 to 6½	2 to 7
M_2	7 to 9½	4 to 8

***Unadjusted for changes in reserve requirements.

Source: Data Resources, Inc.

ably too low. Given the prospective expansion in GNP (in 1977 dollars) through mid-1978, the Federal Reserve's money growth rates would require another large increase in income velocity (GNP ÷ by M_1). This requirement is unlikely to be met. For example, in 1976, velocity rose by 6.3 percent—far above the 3.7 percent recorded in 1975 and also well above the average annual gain of roughly 2.7 percent which occurred during the last decade. To a considerable extent, the sharp rise in velocity in 1976 is traceable to the sizable switch of funds from demand balances to interest-bearing accounts. It is also partly a reflection of technological changes that have been underway for several years—which enable businesses and households to be more efficient in managing their money balances.

The DRI forecast suggests that GNP may average $2,060.4 billion in the second quarter of 1978—compared with $1,869.9 billion in the same period last year. The figures for the money supply (M_1) in each of these quarters are $321.1 billion and $342.8 billion, respectively. Thus, income velocity was 5.82 in the second quarter of 1977, and it may climb to 6.01 in the second quarter of 1978. This would represent an annual rate of growth of 3.3 percent.

The advance in velocity implied by the Federal Reserve's money growth targets are: 6.5 percent for the bottom of the M_1 range; 5.2 percent for the mid-point, and 4.0 percent for the top of the range. In each case, the implied rate of increase is well above the long-term trend of less than 3.0 percent.

Judged in terms of the demand for money to finance the expansion of economic activity—in the face of a further rise in the general price level—the Federal Reserve's money growth targets also seem inadequate. For example, if real GNP rises by about 4.2 percent in the 12 months ending in mid-1978—and if the GNP implicit price deflator climbs by 5.7 percent, the total demand for money might grow by 10 to 11 percent. This figure might be partly offset by an increase in velocity—perhaps in the neighborhood of .3 percent. Nevertheless, these prospects still suggest that the money stock might need to expand by 7 to 8 percent through mid-1978. Even if the Federal Reserve succeeds in getting the money stock to grow by the amount implied by the figure at the top of the M_1 range, it might still fall short of meeting the economy's needs.

Moreover, the Federal Reserve has stressed that its long-run objective is to reduce the growth rate of the monetary aggregates to a pace consistent with price stability.

The above analysis has been cast in the framework of the prospective behavior of the money supply because the Federal Reserve formulates its own monetary policy objectives in those terms. But however one chooses to express monetary goals, the economy will need more stimulus during 1978. Some of it should come through an accommodating monetary policy.

I believe fiscal policy should make a contribution to assuring that economic expansion does not subside during 1978. For this reason, I would support a tax reduction in the range of $20 to $23 billion this year. A division of $13 to $15 billion for individuals and $7 to $8 billion for business would be appropriate. Equally important is the timing of the decrease, which ought to come before the end of the summer if it is to have a significant impact before the end of the year. I can appreciate the Carter Administration's strong desire to achieve meaningful tax reform, and it is clearly hopeful of making the tax cut dependent on such reform. However, I doubt that any tax reform would be possible in a shrinking economy. Consequently, a tax cut is necessary to assure continued economic expansion, and should come in a timely fashion. □

Andrew Brimmer, formerly a member of the Board of Governors of the Federal Reserve System, is now president of Brimmer & Company, Inc., an economic and financial consulting firm based in Washington, D. C. He spoke recently on monetary policy and economic prospects for 1978 at a lecture sponsored by the Departments of Economics, Philosophy, and Educational Foundations, Howard University. Earlier in November, he testified on the same topic before the Senate Committee on Banking, Housing and Urban Affairs.