

U. S. Economic Recovery: Sustainable or Sputtering Out?

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It is always good to be in Canada, and I've been fortunate enough to have spent a considerable amount of time here over the years. My close associations, both business and personal, add to the pleasure I have from your Club's invitation and from my being able to be with you today.

Thinking back to the period after World War II when I traveled extensively throughout Canada as the man responsible for my bank's business here, I clearly remember that the conventional wisdom in both our countries had been that the U.S. economy in the postwar period would plunge back into depression. In fact, it turned out to be a time of prosperity.

Today the United States is in a period that had been forecast - by Morgan Guaranty and others - as a period of strong economic recovery. The fact is, there is widespread nervousness about the underlying health of the economy. People who otherwise don't know the GNP from the NHL examine each newly issued economic indicator with the same breathlessness that in other times has been accorded to hospital reports of the bodily functions of some famous figure who lies gravely ill.

The general concern seems particularly acute now, just two weeks from the Presidential election, with speculation about what implications a new Carter Administration or a continued Ford Administration would have on the country's economic outlook.

You will recall that three or four months ago, when signs of economic slowdown first began to appear, no one was overly worried. Indeed, many observers then regarded the slowing as a healthy development - one that had shifted the U.S. economy from a dangerously fast track to a course that seemed to be more clear of hazards.

Some of that initial satisfaction has been eroded by more recent reports and indices that can be read either as aberrations from a generally expansive thrust or as early indications of a new, downward trend.

One recent development that deserves hard and continuing analysis is the Ford Motor Company settlement with the United Auto Workers. If its effects upset what had been a generally moderating pattern of wage gains in the economy at large, it would constitute an important negative factor in the effort to control inflation.

Another concern is the level of the unemployment rate - nearly 8% of the labor force. Although this is about a full percentage point below the peak rate reached in the recession, it represents a worsening from where the rate was earlier this year. Employment in the absolute headcount of people at work has continued to rise, but new jobs have not been created fast enough to keep up with the number of people looking for them.

Particularly worrisome during much of the summer period was the listlessness of retail sales. The glimmer of improvement in more recent reports has not given merchants confidence that there is a solid upturn in consumer buying. Prolonged weakness in retail sales could be expected to put pressure on prices and profit margins, and discourage businessmen from investing in new capacity.

At Morgan Guaranty, our economics staff has worked hard at trying to assess the meaning of this situation. Our best judgment is that the recovery which began a year and a half ago is still alive and well. On balance, we think that the recent slowing of activity will give way to renewed upward momentum through the winter and the new year.

We are forecasting a rise in "real" GNP next year of better than 5% - following on the heels of what is likely to be a 1976 gain of more than 6%. We haven't put numbers on the 1978 outlook yet, but are inclined to think that prospects are good for continued expansion beyond the coming year.

Our estimation for price inflation falls into a band of between 5% and 6% - a level that this year's recovery seems able to tolerate, particularly when the U.S. inflation rate is measured against rates in most other countries.

Needless to say, we also make forecasts of interest rates, and it is almost obligatory for a banker to give his viewpoint on the interest-rate outlook. Rates, especially short-term, now seem to be bumping on a bottom. They are as low as they were at any point during the recession, so we see no appreciable downside potential. With the pickup of business activity - and of loan demand - that we expect as 1977 unfolds, we think there will be a rise of perhaps 1/2% to 3/4% in short rates.

The trend of long-term rates is likely to be closely locked to what happens to both inflation and expectations about inflation. If we are right about a 5% to 6% inflation rate, the trading range for

Aa utility bonds should be something like 8% to 9%. We've worked down to the lower part of such a range now, so I don't think it probable that any large further decline in long-term yields lies immediately ahead.

I share these forecasts with you with confidence from our economic analysis that the really fundamental strengths of the recovery are intact and have not been jarred loose by the troublesome recent developments.

One of those fundamentals is the extremely strong financial position of consumers. Their "real" disposable income has continued to grow, even through the summer while so much evidence of sluggishness was showing up in various areas. Given the liquid financial position of consumers, it seems highly likely that the modest improvement registered in August and September retail sales will be further extended through the current period and into 1977, thereby laying a base for expanded business investment.

One measure of consumer willingness to spend will be automobile sales. Good news on the movement of new models will do a lot to dispel the general apprehensiveness.

Besides the financial strength of consumers, we take heart at positive factors to be found in the industrial sector. Companies have generally strengthened their financial positions in this period when corporate profits have rebounded sharply from their recession lows - for the full year 1976 they are likely to be up 25% or more over 1975.

This high level of corporate liquidity, in combination with higher plant utilization rates, gives us further reason to believe that the current moderate uptrend of capital spending will pick up greater momentum early next year.

Another positive note is that stockpiling has proceeded cautiously, so there would seem to be little threat of downward pressures from forced reduction of inventories.

As we examine economic indicators broadly, we see a balance that is more important than any single indicator's strength. We have confidence in the durability of the recovery because we don't see signs of the kinds of strain and trouble that generally produce recessions. To be sure, there are soft spots. In housing in particular the residue of past excessive cyclical exuberance is still being worked out, but even in this area most of the lumps already seem to have been taken and conditions have gradually been improving.

The recovery thus far has gained from strong advances in labor productivity and relatively moderate wage pressures. As I mentioned earlier, it is still too early to calculate the precise impact of the Ford Motor settlement, but prior union-management agreements have been consistent with progress on the inflation front.

Wages and fringe benefits for the total work force have been rising this year at a rate of about 8%. This particular rate is compatible with a price inflation of 5% or thereabouts so long as the economy can keep near its current annual productivity gain of between 2 1/2% and 3%, which is a return to its long-term norm.

To these measurable strengths of the U.S. economy I would add a subjective one that may surprise you - a generally confident feeling

about the political processes and mood of the American people. In the excesses of Presidential campaign rhetoric - which historically has been an unreliable guide to postelection policies - we sometimes lose sight of the resiliency and the responsibility of the political system in the United States.

This is not to say that the business community has generally found itself comfortable with Mr. Carter's espousal of the Humphrey-Hawkins bill - and the uncertain course it plots for achieving a 3% adult unemployment rate by 1980. Nor have his comments about standby wage and price controls been reassuring. More recent statements by Mr. Carter suggest that he may exercise greater caution in formulating economic plans for an administration under his presidency. This possibility gets some support from Mr. Carter's current position that social initiatives would not be undertaken unless they were consistent with the balancing of the budget by 1980.

President Ford is, of course, much more a known quantity than his opponent. He is running in large part on his record as a checkrein on an activist Congress - a role that has generally won business approval.

Whatever the Presidential outcome of the election in 15 days, one thing is quite certain. That is the character of the Congress the new President will have to work with. It will continue to be predominantly activist with Democratic majorities in both Houses.

No matter what the inherent inclinations of any politician, I believe our system makes him sensitive to shifts in popular mood, particularly when election time brings him into direct contact with the people. It seems clear to me that there has been a shift toward

an emerging grassroots conservatism on fiscal matters. You can see abundant evidence of this trend, ranging from the data gathered by a variety of polls to the statistics on personal savings and individual debt. Also significant are citizens' responses to the financial problems of cities and states, and the sudden political appeal of such a concept as "zero-base budgeting."

The full effect of the new relatively conservative cast of our citizenry is yet to be seen, but I think its influence will be exerted on government at all levels and I hope it will encourage policies for the control of inflation.

Another essentially political development is the more effective use of the budgetary process at the federal level. There has been an encouraging start under the Congressional Budget Office toward integrated treatment of both sides of the federal budget, expenditures and receipts. Despite the well publicized differences between the Ford Administration and the Democratic Congress, the federal budget has been a more effective tool in managing a stable economy in the last two years, and I think we can count on its becoming used even more efficiently from here on out.

A final point on the recovery and the business environment is the continued acceleration of foreign direct investment in the United States. This is a clear signal that the international business community recognizes the vigor and stability of the U.S. economy relative to those elsewhere in the world. At this time such investment is also a source of strength to the American economy because the amounts have reached significant proportions, although they still appear modest when measured against the massive U.S. investment outside its own borders.

The 15-year trend of foreign ownership of U.S. assets is instructive. In 1960 the book value of all foreign direct investments in the United States was close to \$7 billion. By the end of last year that figure had almost quadrupled to nearly \$27 billion.

Even more significant is the recent acceleration in the growth of these investments. For the years between 1960 and 1972 the annual rise was well under a billion dollars, but in 1973 and '74 the increases shot up to more than \$3 billion and in 1975 the increase exceeded \$4 billion.

Canada of course has been a prominent investor in my country. Historically, only the United Kingdom has exceeded your totals, and you are substantially ahead of The Netherlands, which holds the position of third-largest investor. Over the 15-year span from 1960 to 1975 Canada's stake in U.S. operations grew from just under \$2 billion to over \$5 billion. And more than \$1 billion was invested in the last three-year period alone.

My expectation is that Canadian and other foreign investors will continue to be drawn by the U. S. economy. One of its notable attractions is the improvement in unit labor costs, with a narrowing of the gap between unit labor costs in the United States and those in most other developed countries.

I have reviewed what we consider the foundation blocks of the U.S. economy. We have examined them and find them sound, which convinces us that the recovery does have underlying vitality. It is not a flashy recovery, but its very lack of fire gives us confidence in its staying power. We would argue that for economic recoveries, there is virtue in moderation.

At the same time the outlook is not free of uncertainties. A major one is the OPEC price review in December. The possibility of petroleum prices rising in January is good cause for widespread concern. There has been disturbing talk of a price increase in excess of 10% - a level of increase that would not be justified by appeal to relative price movements. I would hope that the OPEC decision-making will be guided by recognition of the member countries' long-term and interdependent interests in a stable world community.

There is another kind of uncertainty that bothers me deeply. It's the tendency of our policy makers and the general public to shrug off past economic lessons and suddenly find tolerable what previously was known to be bad.

The particular fear I have is that a 6% mark seems to be becoming an acceptable rate for inflation. You'll recall that Morgan Guaranty's estimate for the 1976 inflation rate is under 6% but over 5%. I can report that figure as a fact of life in 1976. I can even accept it as a substantial improvement compared with recent double-digit rates. But I must challenge any notion that 6% is good enough and that maybe it's all right as a kind of norm.

We simply cannot allow ourselves to be lulled into complacency about inflation. If past experience and observation of what is happening elsewhere in the world count for anything, we know that an inflation rate that high is dangerous. The banker in me is very conscious of the effect of compounding, with this year's inflationary rise becoming part of next year's inflationary base. Even if 6% inflation is better than 10%, that rate means a doubling of prices over 12 years.

When we consider inflation's corrosive effect, we are not dealing with inanimate numbers alone, but with crippling penalties exacted from every individual in a society, from those in the productive, governmental, and social sectors paid by wages and salaries, to those who are retired or unable to work and living on fixed incomes. As you know, the leech of inflation also saps the future growth of productive capacity by making capital formation more difficult. We must not permit these lessons to be ignored.

Related to inflation is another lesson I wish we could get across effectively to those in government. That's the necessity to keep spending within productive capacity. The penalties of attempting to spend a society into prosperity should be evident by examples around the world and as close to home as my own city of New York. Again, we must not let those lessons be ignored.

We in the business community are accustomed to dealing with income and outgo, and matching up the totals. This discipline is critical to the existence of our businesses, no matter how many commas are needed to punctuate the figures on our balance sheets and income statements. I know that those of us here are convinced that this same discipline is equally essential in the setting of national - and international - economic policy.

There is real evidence that our conviction is becoming more widely shared. I have already cited the spread in the United States of a relatively more conservative cast in popular thinking. There seem to be more businessmen speaking out on issues and taking part in public matters that lie afield from their specific commercial interests. Even more encouraging, there are increasing instances when government turns to the business community for views and direct assistance on matters of public policy - most frequently, of course, when there are problems.

These are positive developments. But they are not inevitable, nor are they easy. They call for all of us to take on more - to take on new, troublesome activities that may not seem at first to be related to how we earn a return for our stockholders.

We in the private sector - here in Canada, in the United States, and throughout the world - must recognize that our economic roles do not end with the operation of our individual businesses. We must also impart the insights of our experience to the policymaking process.

Since I have expressed a willingness to speak out on public issues, I suppose I should say a few words about the white paper proposing changes in your Bank Act. Morgan's specific comments have been properly submitted to Ottawa.

My personal reactions to the white paper may have been shaped by my service in 1971 on the President's Commission on Financial Structure and Regulation for meeting future needs in the United States. I think your white paper was on very sound ground in placing reliance on competition to build the financial institutions and resources to serve your country's growth.

I very much appreciate being here to share my thoughts about the U.S. economy and the need for those of us in the private sector to make our views known to policy makers. Thank you.

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