

THE ECONOMIC OUTLOOK

Leon Taub, Chase Econometrics

There is surprisingly little to discuss about the short-term forecast environment. There is much comment about the disagreement among economic forecasters. In particular, the "demand side" econometric models are said not to be as optimistic as the "supply side" Administration. This is not correct. For 1981 and 1982, in terms of real growth, the Chase forecast and the Administration forecast for the two-year period differ by less than half a percentage point. That is well within the range of likely forecast error, not to mention the changes due to revision of the GNP estimates. (Table 1).

As we go out to 1983 and 1984, there are significant differences in the forecasts of real growth. Before turning to the longer term outlook for real growth, consider first the inflation rate. For 1981 there is no substantial difference between the two forecasts. Even in 1982 the differences are not great. However, they are significant. Chase Econometrics expects inflation of almost ten percent, year over year, while the Administration expects only 8.3 percent. How to explain these differences is a major forecasting issue. A major reason for Chase's belief that inflation cannot be contained in the short-run is clear from Table 2. Prices of virtually all raw materials are today lower than in 1979. For many of these items, including most metal prices, and many farm goods, current prices are below the long-run costs of production. This means that as soon as the economy recovers, there will be great upward pressure on these prices. Farm prices are set to rise fairly rapidly, both because the slowdown in demand has depressed beef prices, and because there has been mass liquidation, now ending, of beef herds.

There is another reason Chase expects inflation to be much higher than the Administration thinks during the next two years. Even if all raw material prices could fall dramatically, from supply side economics, tighter monetary policy, or other reasons, there is still a structural problem built into our economy. Two-thirds of all prices are wage rates. Wage rates are set to rise fairly rapidly during the next two years. First, those workers covered by union contracts are automatically indexed to the rate of inflation with a slight lag. Those wage rates will be rising rapidly. Second, most nonunionized workers' wages have lagged not only behind the Consumer Price Index but also behind unionized workers' wage rates, so there is substantial upward pressure on wage rates from the non-unionized sector. All this means that inflation in the United States is not an expectational phenomenon. The U.S. is not in a situation where people are fleeing from goods, trying to buy things now because they will not be available next year or because there will be big differences in prices next year. Rather, the situation is that prices are being bid up because costs are rising. Costs of raw materials will be rising because they are now below costs of production. Labor costs will rise because wage rates are in large part determined in real terms, and a substantial "catch up" is necessary to restore parity.

Turning back to real growth prospects for the next two years, one reason Chase expects slightly lower growth than the Administration in 1983 is that the rate of inflation will be higher. There are other reasons as well. Simulating the Administration's scenario in the Chase Macroeconomic Model shows several economic events which appear inconsistent. For example, in the period 1982 through 1984 the

Administration expects real growth to increase 14.5 percent. However, they expect profits to rise from 1980 to 1984 by only 51 percent in nominal terms. This means that profits will rise only 4 percent a year in real terms. So the Administration, basing its forecast on rational expectations, expects a massive investment boom, and yet no increase in profits as a share of national income. If rational expectations are fueling the economy, the lack of incentive for business investment seems inconsistent.

Another area of concern for the consistency of the Administration's forecast is the unemployment rate. During the period 1982 through 1984, real growth is expected to be about 15 percent. However, the unemployment rate is expected to fall only by 1.5 percentage points, far less than would be expected from Okun's law. The argument is that the Administration's tax proposal may cause a tremendous increase in aggregate supply, like the Kennedy tax proposals. This is hardly likely. Suppose, however, that real growth is as fast as it was after the Kennedy-Johnson tax cuts in the 1960's. In that case the unemployment rate should fall by well over two percentage points. Thus the economy is expected to perform better than in the 1960's despite the fact that it is almost inconceivable that productivity would grow as fast as during the 1960's or that labor force growth will be as fast.

The problem, however, runs even deeper. The Administration does not pin its hopes on a rapid growth in the labor force participation rate. However, if there is rapid growth in the economy, no decline in unemployment, and little or no growth in profits, there must be a tremendous shift of income to the labor sector. In fact, the Administration forecasts do include very rapid gains in real wages. However, how is it possible to have rapid gains in real wages unless inflation is pushed upward, or productivity explodes? As already noted, commodity prices are relatively low and in any case are now a very small part of the economy. Unless one is willing to make extremely optimistic productivity forecasts to get the Administration scenario, one has to assume declines in food prices and declines in oil prices just for the arithmetic to work out.

Despite these problems, the discrepancy between the Chase forecasts and the Administration forecasts for 1983 and 1984 is neither serious, nor a consequence of supply side economics. There has never been a time since Chase began forecasting that the Administration's forecasts for two years, three years, and four years out have not been more optimistic than those of private forecasters. The real difference has been in the differing justifications for those forecasts.

Nevertheless, the Chase forecast is pretty optimistic. Chase expects fairly rapid real growth and declining inflation. Therefore we should discuss why we expect the rate of inflation to decline. The most important single factor is that Chase expects the rate of oil price increases to moderate. This is not a very exciting forecast. It is clear that, barring some event in Saudi Arabia, we will not have the kind of oil price increases in 1981 and 1982 that we had in 1979 and 1980. Even though this forecast is almost a truism, it is an important, often neglected component of our forecasts of a substantial decline in inflation. Since domestic oil decontrol is now virtually behind us, this statement is even more relevant for our economy than for the world price of oil.

The second reason Chase expects lower inflation is the major secular conservative trend in American

Table 1. Forecast comparison (percent change).

	1980	1981		1982		1983	
	Actual	CE Stand.	Admin.	CE Stand.	Admin.	CE Stand.	Admin.
Real GNP	- 0.1	1.3	1.1	3.6	4.2	3.9	5.0
CPI	13.4	11.4	11.1	9.7	8.3	8.4	6.2

Table 2. Cash market prices for major nonferrous and precious metals.

(cents/lb. equiv.)	1979	1980	Fourth	Mid-Month		
	Average	Average	Quarter	Dec.	Jan.	Feb.
Aluminum, LME	72.7	87.2	68.9	63.9	65.4	65.8
Copper, Comex	88.5	96.7	89.7	81.1	82.6	82.1
Lead, LME	54.5	41.1	36.7	33.2	32.1	31.3
Zinc, LME	33.6	34.5	36.1	35.4	36.0	33.1
Nickel, LME	267.0*	295.6	295.4	288.5	291.6	288.1
Tin, LME	701.7	761.4	710.4	663.5	655.3	623.2
(\$/tr.oz)						
Gold, London Final	306.7	612.6	626.5	584.2	562.7	502.9
Silver, Handy and Harmon	11.1	20.6	18.4	15.9	15.0	13.3
Platinum, Merc. Exchange	442.3	682.7	636.7	579.8	544.1	491.8

* Half-year only.

society. There are many nations that cannot control their inflation rate, because they lack sufficient economic power. During times when oil prices are exploding, or when there is a massive worldwide food shortage, the U.S. finds itself in that same position. But barring those exceptional circumstances, the United States can control its economic destiny. Therefore, to a great extent, Americans get the kind of inflation they want. In the 1960's and 1970's, when the country was turning liberal, real growth was considered a top priority, and controlling inflation was increasingly considered to be a much lower priority. As a result, we had fiscal policies which, in retrospect, would be considered overly expansionary. We also had monetary policies which, in retrospect, would be considered overly expansionary. As a result inflation increased.

For a variety of reasons to be discussed here, there is a massive, conservative trend occurring in American society. Fiscal policy is already more conservative. Budget deficits of \$50 billion certainly do not sound conservative, but state and local governments are running substantial surpluses, including their pension funds. In addition, \$50 billion is only two percent of GNP. In any case deficits of two percent of GNP are much less than some of the deficits during the 1970's.

The same is true of monetary policy. After tax real interest rates have been negative for the last three years. However, they have now turned positive and there is every indication from both the Administration and the Federal Reserve Board that interest rates will stay positive in real terms for a year, or two years, or whatever it takes to reduce the rate of inflation.

Finally, Chase sees a major change occurring in the structure of American society. To our way of thinking, the U.S. economy is not basically sick. There are two industries which are extremely sick. Those industries happen to be fairly large, both in their employment impacts, and in their impacts upon the rest of the society. The two sick industries are dragging down an American economy which, in most sectors, has been quite healthy. In sectors such as electronics, energy exploration, business services, consumer services, and many others, the U.S. economy has been fairly healthy. Only two types of industries are in trouble. Credit sensitive industries, although basically healthy, are suffering from extreme policies designed to control inflation. The other problems are the steel industry and the automotive industry. Those industries have one aspect in common, that wage rates paid to workers substantially exceed the average

Figure 1. Total index of industrial production.

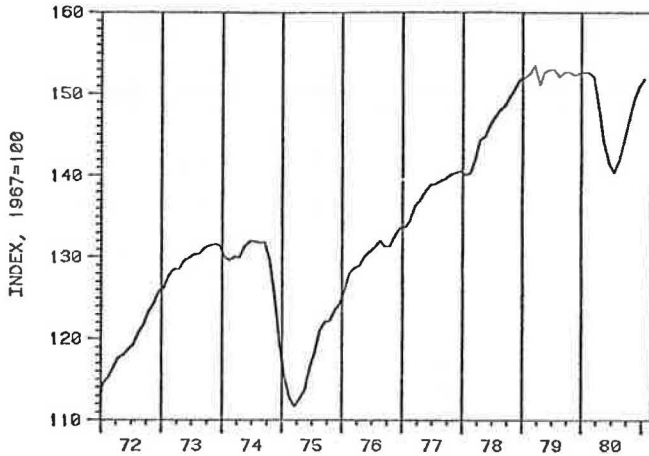
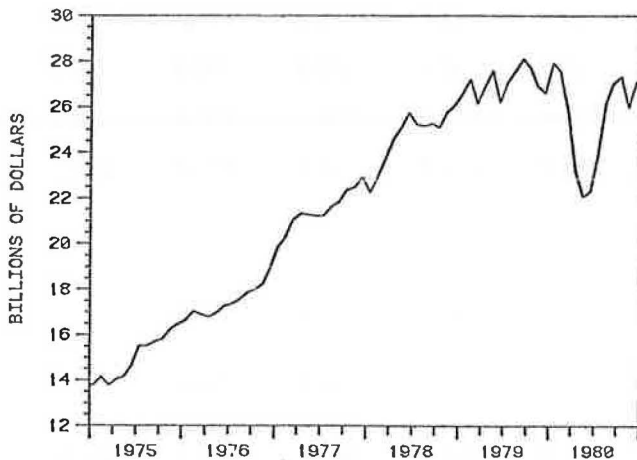


Figure 2. Consumer installment credit extensions.



manufacturing wage rate. In the automotive industry the difference is about 60 percent, including fringe benefits. In the steel industry the difference is about 40 percent. This contrasts sharply with our major trade competitors, particularly Japan, where workers in the steel and automotive industries receive about the same pay as the average manufacturing worker.

Chase believes that this discrepancy in large part explains much of the current difficulties in the steel industry and the automotive industry. It is true that three years ago the U.S. automotive industry did not have the products Americans wanted to buy. This is no longer true, and it certainly will be less true next year as General Motors and Ford bring out their new products. However, the problem which remains is a price phenomenon, and a large part of that price phenomenon can be explained by the differential between automobile worker wages in the U.S. and those in Japan, when compared to the average wage rates in these countries. Of even more importance, this argument is now recognized in Detroit by both management and by the United Automobile Workers Union. This puts the economy in a very different situation from that of only two years ago when, despite a slumping automotive industry, automobile workers received a wage package which was substantially greater than the rate of inflation, substantially greater than the national

Administration's guidelines, and substantially greater than earned by workers in other industries. That is not going to happen next year. In addition, the United Automobile Workers and United Steel Workers settlements tend to affect other union settlements. This recognition will have a dampening effect upon wage rate growth in the rest of the economy, but this is a very slow process.

The last point to address before turning to the long run is that, by the fall of 1981, real growth will be relatively strong. As earlier mentioned, inflation will be much more moderate. In addition, there will be cyclical recovery in the economy. Figures 1 and 2 explain the current position of the economy quite well. In consumer installment credit extensions, the impact of the Federal Reserve's credit rationing policy in the spring of last year is quite dramatic. If one adjusts for that factor one can see that consumer credit extensions have been basically flat for about two years. Furthermore, the same pattern is quite evident in industrial production, shown in Figure 1. Essentially, we have had two years of stagnation. As a result the economy is poised for an upturn for several reasons. Business inventories are lean, businesses have been cutting back on their hirings, and their staffing is much leaner than it was in 1978 and 1979 before the stagnation. Consumer durable holdings of automobiles and also of other products are lean. Finally, the stock of business equipment has been aging. This puts the U.S. in a position poised for expansion once real growth starts increasing. Therefore when we do get the stimulative impact of the tax cuts proposed by the Administration, as modified by the Congress, we can have substantial real growth in the economy in the short run.

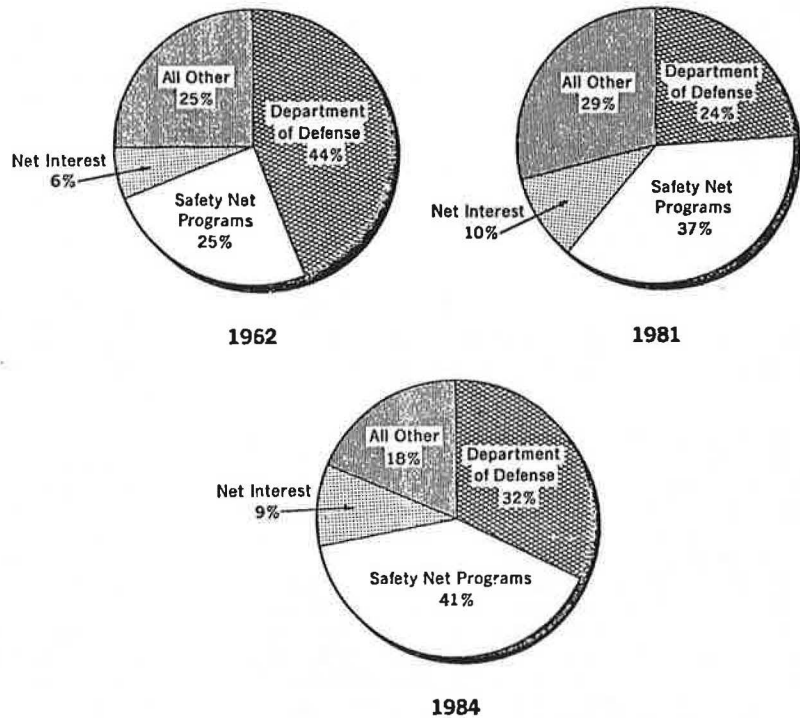
Chase's long run outlook is for about three percent real growth. This real growth is composed of about 1.8 percent growth in the labor force (which is substantially more rapid than the growth in the working age population), 1.8 percent growth in technological change, which is substantially better than we had in the last decade, and minus 0.5 percent growth because hours worked per week are in a secular decline as the labor force keeps accommodating more part-time workers.

Chase foresees several long trends during the 1980's upon which our long run forecasts hinge. First, there will be slower growth in the labor force during the 1980's than in the 1970's. Part of the slower growth is due to a slowdown in the growth in the female labor force participation rate. However, that is not the major factor. We expect the female labor force participation rate to be increasing almost as rapidly during the 1980's as during the 1970's. However, the age cohorts in which this growth occurs will be different. Much of the growth in the female labor force participation rate has been among women under 35. During the 1980's, as the population ages, we will have the same participation rates in the under 35 group but a much greater participation in the over 35 group. The slowdown in labor force growth comes from another area -- the ending of the baby boom. The peak of the baby boom was in 1957. Almost all of these people have now entered the labor force. Because the population birth rate declined quite dramatically during the subsequent ten years, the growth rate in the labor force will decline quite dramatically in the next ten years.

To gain some estimate of how dramatic this impact will be, note the following:

If, in 1990 we are employing the same number of persons 18 to 22 as we are today -- assuming no addition due to the real growth in the economy or to the population increases -- unemployment in that

Figure 3. Shift in budget priorities (percent composition of outlays).



age bracket will be zero. The decline in the number of people in that age group is greater than the number of people in that age group presently unemployed.

Thus, the United States will be moving from a labor surplus economy to a labor short economy. Also, there will be a change in the age distribution of the labor force. Because the baby boom age cohort was preceded by a generation which was extremely small -- the depression and World War II babies -- and is followed by an age cohort which is also quite small -- the baby bust period -- that age cohort has a tremendous impact upon American economic and social thought. As mentioned earlier, it was not a coincidence that the 1960's and 1970's, when the baby boom generation was in college, was a time of liberal thinking in the United States. It will not be a coincidence that during the 1980's and 1990's, when the baby boom generation is in the family growth stages of life, there will be a trend away from that liberalism toward conservatism. These trends will be magnified because in the 1970's vast numbers of entry level, relatively unskilled, persons came into the labor force. Under those circumstances, overly expansionary fiscal and monetary policies were almost a necessity, simply to keep the new entrants employed and to avoid the societal problems which would otherwise result in an even more explosive form than they actually did. During the 1980's that problem will disappear of its own accord. As a result excessively expansionary fiscal and monetary policies will not be needed. In fact, conservative policies will be needed to avoid a labor shortage. In addition, productivity will grow more rapidly during the 1980's, and the disappearance of the current labor surplus will cause wages to increase.

Another major difference between the 1980's and the 1970's will be in the energy environment. First, Chase does not expect oil prices to decline but rather expects them to rise in real terms. However, a rise in oil prices in real terms of two percent a year is extremely small compared to the rise in the last decade. As a result of the lesser increase in oil prices, the shift in income to OPEC

nations that occurred in the 1970's will be much less severe in the 1980's.

In addition, there is a factor in economics that we may call a flow-stock lag. It was the key causal factor for the results discussed in "The Limits to Growth," popularized by the Club of Rome. Whenever a nation has a huge capital stock, as in the United States, small changes in additions to that stock do not have a significant impact upon the economy for five to ten years. This flow-stock lag in large part explains our current energy situation. Last year the fleet of cars in the United States was not significantly more efficient than the fleet of cars in 1973, despite the higher oil prices and despite the fact that last year's new cars were substantially more efficient than the 1973 "gas guzzlers." However, during the 1980's, when the 1971-1975 gas guzzlers are phased out (a car has an average life of about ten years) the average efficiency of the American fleet will increase dramatically. This is also happening in the aviation sector and with a longer lag, but one adjusted to reflect "add on" modifications. It will happen to commercial and residential buildings, and throughout American society.

One last point is illustrated by Figure 3. This figure is reproduced from the February budget report of President Reagan. Note that several types of programs have been considered uncontrollable by the Reagan Administration -- primarily Defense and Social Security -- which have been called the Defense and Safety Net Programs. The remainder of the budget, except net interest which is obviously uncontrollable, is expected to shrink dramatically, from 29 percent in 1981 to 18 percent in 1984. The situation is even worse today, because the Reagan Administration cut out an extra \$10 billion from the "all other" category.

It is even worse under the Congressional Budget Office (CBO) estimates, which show that by 1984 an additional \$60 billion will have to be cut from the budget. Since the CBO projections and the Administration's projections differ primarily with respect

to growth in prices, virtually all of the additional \$40 to \$60 billion will have to be cut out of the "all other" category. That is impossible since this category contains many things such as the Internal Revenue Service, the Federal Bureau of Investigation, and the staff of the Executive Office. Either the Reagan Administration will soon have to go after the Safety Net Programs, or defense spending, or the budget targets will have to be substantially greater than those projected. That is another choice to be faced during the 1980's.

THE OUTLOOK AND POLICY CHOICES FOR THE 1980's
Nariman Behraves, Wharton Econometric Forecasting
Associates

When asked to predict the future, economists refer to historical experience, because history is a guide, and because events leading up to the current period set the stage, and define the policy choices.

There is universal concern on the slowdown in real growth during the 1970's, and the rapid rise of inflation. In the 1960's real growth in the U.S. averaged about four percent; the average was closer to 2.5 percent in the 1970's. At the same time, the underlying inflation rate rose from about 2.5 percent to about ten percent. The critical link is the decline in productivity growth: from 2.5 percent in the 1960's to 1.2 percent in the 1970's and even lower in the past two years. Productivity, defined as output per man hour, is an essential ingredient of real GNP growth, and plays a central role in the design of an anti-inflationary policy. The reasoning is that with high productivity growth the economy can absorb demands for higher real income with less upward pressure on prices. But if productivity growth slows, the pressing of these demands leads to accelerating inflation, changes in relative income shares and strains in the social fabric. This is the difference between being happy with fixed shares of a growing pie, and fighting over the shares of a shrinking pie. In this latter kind of world inflationary momentum can build up rapidly. Therefore, policies to improve productivity growth must be at the heart of any long term anti-inflationary program.

Since productivity is critical in the long-run outlook, this discussion will involve the factors that have brought about a slowdown, policies that could reverse this trend, and how effective the Reagan program might be in this.

These trends must be put into some kind of perspective. The U.S. has not been alone. Nearly all the industrialized economies have suffered the same kinds of reverses. In Japan during the 1970's, real growth slowed from ten percent to six percent, and productivity growth dropped from 9.5 percent to 4.5 percent. Similarly, real growth in West Germany declined from five percent to three percent, and productivity growth fell from 4.5 percent to 3.5 percent. The experience is the same for Canada and the other European countries.

Clearly, there are common factors affecting productivity growth in all these countries. Two of them are the rapid rise in energy prices and the baby boom. It appears that higher energy prices contributed significantly to the productivity slowdown in every industrialized country after 1973. Rising energy prices adversely affected labor productivity in several ways. Parts of the capital stock that were energy inefficient were outmoded. The focus of investment and innovation shifted toward energy efficiency rather than labor

efficiency. At the same time, businesses tended to substitute labor for more expensive energy. Finally, uncertainty about economic conditions was increased.

Although the U.S. imports a smaller part of its total energy consumption than most other industrialized countries, the impact of higher energy prices on productivity may have been more severe in the U.S. than elsewhere. First, except for Canada, U.S. industry is more energy intensive than industry in the other OECD countries. Second, most of the other countries had by the mid-1970's adjusted to higher energy prices through higher gasoline taxes and other measures. The United States economy has begun to adjust to a world of more expensive energy, but this adjustment is a long one and the payoffs in better productivity growth will be slow in coming.

Oil and gas deregulation, praiseworthy in themselves, will not help overall productivity or inflation in the short run. On the other hand, policies aimed at energy conservation which reduce worldwide demand for energy, will reduce the world price of oil, and should thus improve the prospects for productivity growth. Furthermore, programs that encourage development of nuclear power, coal, synthetic fuels and other energy sources should help productivity. An overriding concern of any comprehensive energy program should be to reduce the uncertainty about the impact of energy price increases. Reducing this uncertainty would help businesses better decide how much and what type of capital they want. Unfortunately U.S. energy policy has not been very successful in this regard.

The second common factor that has contributed to the slowdown in productivity growth is the change in the labor force from the baby boom. This change not only contributed to the increase in the labor participation rate, but also increased the percentage of young, inexperienced and therefore low-productivity workers during the 1970's. Except for government programs to encourage on-the-job training and improve secondary school education there is not much that either U.S. or other governments could do about these trends. Fortunately, as the baby boom cohort grows up, its work experience, training, and productivity should all improve. This fact, and other trends that should reduce labor force growth, could add as much as one-half of one percentage point to U.S. productivity growth in the latter half of the decade.

Wharton projects that productivity growth in the non-farm private sector of the U.S. economy will average close to three percent, about what it was in the 1960's. The difference between these two sets of numbers is largely due to growth of the service sector, which has lower increases in productivity than manufacturing. The general improvement that we see in productivity is in part due to better energy efficiency, and in part due to changes in demographic trends.

There are two particular determinants of productivity growth which, in the U.S. economy, have probably exacerbated the declining growth. They may even account for lower U.S. productivity growth than in Japan and Germany. These are matters of capital formation and regulation. They are related to the Reagan economic program.

A frequently cited reason for the productivity slowdown is the low savings rate. Americans save too small a portion of current output. Economists may disagree about what too small means, but the savings rate in the U.S. is clearly lower than in some other countries. For example, gross household savings in the U.S. as a percent of gross