U.S. Economy Crossing Over Into Production Decline

BUSINESS OUTLOOK

The month-long fall of world commodity prices, following the weakness of raw material orders by key U.S. industrial sectors, indicates that the U.S. economy is now reversing course from an economic uptick into a production decline.

At the same time, this means that the money markets, generally flush with funds, will gradually become less investment-oriented, as there will be ever fewer outlets to invest those monies. This will bring on the "deflationary" consequences which Arthur Burns has tried to staunch by following a policy which didn't jerk interest rates up too sharply.

Such a decline — coming off a production level that is the lowest of any of the five post-World War II recoveries might go considerably deep, as several OECD countries, including Japan and the BRD, are also heading into downturns, and the level of trade among Third World and weaker OECD countries is already at deficit.

A world trade downturn would make it very much harder for the U.S. to pick up production levels again, because the U.S. would have to overcome more than a localized economic problem. U.S. foreign trade may make up only 6 or 7 percent of U.S. GNP, but it makes up perhaps 15 to 18 percent of U.S. goods production.

Last week, the Commodity Research Bureau's index of 27 key futures fell 7.5 points to close at 213. Three weeks ago the index stood at 232. By June 14, the index dropped a further 3.2 points to 209.8. The fall includes both crops and metals. July coffee prices (effectivley spot rates) closed June 17 at $2.25 per pound, down 37.2 cents this week, and a long way from highs earlier in the year that approached $4.00 per pound. Both the wheat and soybean complexes were under double pressures of excellent crop weather and a *slackening of export orders*. Wheat is selling just a few cents above the $2.25 per bushel level at which the Federal government comes in to purchase directly from farmers to support the price.

Copper is still very depressed at 58.50 cents per pound, although lead and aluminum are at fairly high price plateaus. The *New York Times* commodity specialist, H.J. Maidenberg reported June 14 that the reason for the fall in the commodity future index is the cutback in orders of raw materials by industry. Maidenberg told a reporter, "The commodity prices are falling because no one is buying. Manufacturers, particularly in Europe, are living hand to mouth, buying only what they need for the moment." Maidenberg debunked the rosy picture of the Wall Street newsletters: "In my view, the economy is in very bad shape. If you read last month's economic figures correctly, you would see that when you take account of inflation, consumer spending declined significantly last month. Real retail sales increased only 0.7 percent for May."

It is questionable whether auto and business equipment sales and housing starts will hold up economic activity for the next few weeks. First of all, industry laid particular stress on the purchase of business equipment without making large expenditures for plant construction or much added capacity. This occurred because of business realization that the absolute drop in productivity in the manufacturing industries in the fourth quarter of last year, and first quarter of this year arose principally from outmoded equipment which mandated either immediate partial replacement or else would continue to cripple further productivity development and cut into short-term retained earnings. Since the start of the year, fundamental overall economic expansion of the type characterized by added new facilities is not occuring.

Second, consumer spending, which totaled a record $2.72 billion in March and $2.6 billion in April, will have to slacken, because consumer savings has fallen to a post-war record low of 4.8 percent in the first quarter and can't remain at such low levels.

Thus, the outline for a reversal in production trends is developed.

Financial Press Overreaction Is Strong

It is the perception that production will soon start stagnating — and its immediately predictable further deleterious effects on trade — which underscored the debate this week in the financial press over whether inflation rates would ever ease down this year.

It is during economic downturns, when drops in workers' productivity historically occur, that unit labor costs jump, and the hoary specter of wage-inflation is undraped.

Thus, by such interpretation, one can make sense of the *New York Times* economic editor Leonard Silk's complaint June 14 that either the growth of money supply aggregates must be turned loose to near double digit, or the increase of the GNP must be dampered in the likely event that the velocity of money were to fall from its current high levels.

Silk warned of setting up an immoderately high interest rate regime, which could bring on a sudden halt to production. Precisely such a fear motivated the actions by Federal Reserve Board Chairman Arthur Burns during the last few weeks, not to jerk interest rates up sharply, despite a 10 percent inflation rate for the first four months of the year.

At the same time, the *Wall Street Journal* on June 15 called for a cure of inflation with higher interest rates, and warned that wage increases were the chief culprit, running at a 10.6 percent rate of increase during the first quarter.

"The cost of labor ... already rising briskly," the *Wall*

Street Journal declared, "is widely expected to increase still more rapidly late this year and in 1978." Among the labor contracts coming up later this year are 105,000 aerospace workers, 125,000 coal miners, 469,000 rail workers, and 650,000 employees of the Bell Telephone System. Sixty percent of workers covered by major labor contracts are now protected by cost of living clauses versus twenty-eight percent in 1971.

But as the *Wall Street Journal* provides evidence to confirm, when looked at in per unit terms and compared to previous years, labor costs haven't really been rising that fast. In the first quarter of 1977 labor costs per unit rose at a 5.9 percent annual rate, nearly double to rate in early 1976, but far behind the rates for 1975 (7.5 percent), and 1974 (13.2 percent).

Only when viewed from the perspective that output will decline, dragging down labor efficiency, is it permissible to make the judgment, as Kidder, Peabody economist Sam Nakagama does, "that the first quarter rate increase of per unit labor costs is expected to be the *low* for the year."

In an attempt to turn the tide, the Phelps Dodge Co., a major copper concern but within a weak industry, susceptible to all sorts of pressures, is offering its workers 10 cents per hour wage increase over three years, plus a cap on their cost of living relating it to the collapsing price of copper. Such a hard-line offer seems certain to create a strike, which would not only define a new super-austerity labor policy for the U.S. including heavy emphasis on speedup, but, if the strike were long enough, attempt to boost the sagging price of copper, which is depressed by a world supply of 21 million tons of unsold copper.

Were world indebtedness not so heavily built into the book value of U.S. plant and equipment, the transition by industry to replacements of outmoded equipment by high technology equipment could take place, putting the labor cost question in proper perspective and thereby to rest.

However, the Phelps Dodge wage-busting remedy, a leading part of Rockefeller's Pocantico Hills "deal" with conservatives, includes the optimal adoption by industry of the whole package of anti-inflation and war economy measures that Nazi Finance Minister Schacht used so efficiently to ruin the German economy.

This model would shortly destroy the non-military consumer and capital spending markets, unless it is foolishly hoped that the demand for shell encasements will at last increase the sagging price of copper.