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ARE WE HEADED FOR A CAPITAL SHORTAGE?

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Given the gradual pace of recovery, today's economic news has tended to alleviate our worries about the adequacy of capital investment. However, unless serious attention is given to the problems of capital formation in the economy, today's "good" economic news may be replaced not too far down the road by news of renewed inflation, reduced rates of economic growth, and insufficient new jobs for our growing labor force.

To be sure, the near-term business outlook is encouraging. The economic recovery is showing considerable internal energy. The momentum of expansion is solid, and well-founded. And few economists doubt the upturn will last more than a year, despite recent slowdowns.

Is The Present Recovery Sound?

Consumer outlays have spearheaded the economic recovery. Automobile sales promise to total close to 10 million in 1976, with imports down and domestic output up. Retail sales are also holding up, and consumer confidence is likely to receive another shot in the arm with a tax cut early this year. Moreover, recent moderation in consumer spending encourages the belief that the expansion will avoid excesses, thereby prolonging its duration. In the meantime, retail, wholesale, and manufacturing inventories have had to be replenished in order to keep pace with sales, while the inventory sales ratio shows a need for greater production to maintain adequate supplies.

The *housing sector* has not only turned up, but is beginning to show considerable vigor. It seems reasonable to expect that total new housing starts in 1976 will reach well over 1.5 million.

Inflation should hover around 6 percent for the beginning of this calendar year. Although the GNP price deflator came in just under 4 percent during the first quarter of 1976, this low rate will probably not be repeated soon. One reason is that the decline in wholesale food prices of a year ago is not likely to continue; the consumer price index also indicates a 6 percent inflation rate.

Interest rates, short-term, may move upward in early 1977, as bank loans rise to finance increased short-term demands and as the Federal Reserve System tries to maintain an even-keel posture. Long-term rates will probably not show any marked increase. The reason for moderate long-term credit demands by the corporate sector is that profits are expected to rise 25 to 30 percent in 1976, and perhaps another 10 to 15 percent in 1977. Retained earnings will thus provide financial resources which would otherwise have to be supplied externally. Of course, any serious heating up of inflation will be reflected in long-term interest rates, but this development is not anticipated for the coming year.

New plant and equipment spending is sluggish compared to the relatively optimistic trends in consumer spending, inventory accumulation, housing, inflation, and interest rates. While capital investments typically lag behind business cycle turns, the lag is generally no more than six months. The economy is now more than a year beyond the low point of the recession, however, and capital spending has yet to show a marked improvement. According to a Commerce Department survey taken in April and May, business planned to spend $121.03 billion on plant and equipment in 1976. While this is a 7.3 percent gain over 1975, it represents only an 0.8 percent rise in "real" capital spending after stripping away the effects of inflation. This is considerably below the increases in real growth that hovered around 5 percent following the recession periods of 1957-58 and 1960-61, and around 2 percent following the recessions of 1953-54 and 1970-71.

This apparent stagnation in real business spending is disconcerting to economists, since 1976 was expected to be a "boom" year for capital goods industries. While a further rise in capital investment is expected in 1977, a *prolonged* sluggishness in investment activity could dampen prospects for a sustained recovery over the next few years. Indeed, unless capital spending rises more vigorously, bottlenecks and selected shortages will begin to appear, thus intensifying inflationary pressures.

What are America's Capital Needs?

While the near-term economic outlook is bullish, there are growing fears among a number of economists concerning the long-run growth of the economy. Will there be, for example, major capital shortages in the decade ahead—similar to the credit crunches of 1966 and 1969 and the extreme capital stringency in 1973-74?

To corporate financial officers, those periods of capital shortage were not an abstract economic projection. Only the biggest and best-rated firms were able to obtain funds in the financial markets. For intermediate and smaller firms, for the more innovative and risk-oriented, the pickings were lean and costs were high. Those were years when equity financing dried up, when market prices often dropped below book values, and when P/E ratios collapsed. The only recourse, even for some of the larger companies, was debt. The nation's financial structure emerged from these periods with a top-heavy debt structure and an uncomfortably high proportion of short-term corporate debt.

The New York Stock Exchange, concerned over the future adequacy of capital in the United States, undertook a major research program to quantify the magnitude of America's capital needs—and its capacity to meet them.

The Exchange's projections, which were published in September 1974, covered the interval between 1974 and 1985. They assumed a 3.6 percent rate of growth in real GNP and a 5 percent annual rate of inflation. These estimates were based on extremely conservative assumptions. For example, the Exchange study assumed cumulative *federal* capital needs of $145 billion between 1974 and 1985, based upon peacetime budgetary patterns in the post-war period. This works out to roughly $12 billion a year. Recent events clearly show how unrealistic that estimate was. In fiscal 1975, the deficit totaled $43.6 billion; in 1976 , $76 billion; and in the new fiscal year ending in 1977, it will probably approach $60 billion. That adds up to almost $180 billion—$35 billion more than the estimate for the full decade—and this is only to the end of 1977, not 1985.

Capital Needs and Savings Potential of the US Economy, 1975-1985
(Trillions)

Capital needs		
Gross private domestic investment		
New plant and equipment	$2.568	
Residential construction	1.085	
Other (private hospitals, schools, etc.)	.850	
		$4.503
Financing federal deficits and federally sponsored credit agencies	.145	
Net state and local government deficits	.030	
		.175
Total capital needs		$4.678
Savings potential		
Business saving		
Capital consumption allowances	2.359	
Corporate retained earnings	.564	
		$2.923
Personal saving		1.109
Total savings potential		$4.032
Capital shortfall or "gap"		($ .646)

What capital might be available to meet such needs? The Exchange's report also projected that the savings capacity of the economy—both corporate and personal—was just over $4.0 trillion. The difference between that figure and the $4.7 trillion in capital needs represents a shortfall, or gap, of some $650 billion.

However, the Exchange may have understated the potential for a capital shortage. Research on the savings behavior of consumers by Professor Martin Feldstein of Harvard concludes that participation in the Social Security System entails a decrease in private savings and a consequent net decrease in national savings. This is not a criticism of the Social Security System, which has gone a long way toward providing financial independence for millions of retired Americans. But with a pay-as-you-go method of financing Social Security, benefits are paid out of current receipts and are not accumulated in a capital market sense. Social Security is really a system for transferring vast amounts of income from the current generation of workers to retired workers. Its effect on longer-run saving propensities was inadequately reflected in the Exchange's saving projections.

Economists recognize, of course, that the idea of a "gap" is simply a convenient way of dramatizing the prospect of insufficiency. No one knows for sure whether the "gap" wil be $650 billion, or $250 billion, or $850 billion, or any other number. The gap is merely a description of a long-run tendency for financial demands to outrun supplies. An actual shortage would never be observable, since the normal interplay of economic forces would balance the demand and supply of funds. The phenomenon of a capital shortage would be evident in rising interest rates—promoted by increasing competition for an inadequate supply of savings—and by reduced credit availability to all but the strongest borrowers.

The result would be an accelerating stream of economic problems—among them forced postponement of worthwhile projects for which no financing is available, declining productivity, rising prices and, inevitably, renewed inflationary pressures.

Is there a Shortage?

In the past year, little has been heard about a capital shortage—and for good reason. Periods of recession are marked by declining financial demands, as working capital needs decrease, as inventory buying eases, and as capital spending declines. At such times, mortgage loans and consumer credit demands also diminish.

In the summer of 1974, when the New York Stock Exchange prepared its widely publicized projections of capital needs for the next decade, it was recognized that a decline in economic activity would resolve any problems of capital scarcity. Such shortages will not develop at times of ample productive capacity and excessive unemployment. Simply put, a stagnant economy will not exhibit symptoms of a capital shortage. But obviously, a state of recession is hardly the way to "solve" a capital shortage.

Clearly then, capital shortages will not occur in *every* year between now and 1985. The Exchange's projections simply point to the distinct likelihood that major financial disruptions will occur from time to time over the next decade—similar to the severe capital shortage situations experienced three times in the past decade.

In A.D. 260 in Oxyrhynchus, during the short rule of Macrianus and Quietus, the tremendous depreciation of the currency led to a formal strike of the managers of the banks of exchange. They closed their doors and refused to accept and to exchange the imperial currency.

—M. ROSTOVTZEFF

While the recent recession has served to ease current capital requirements, it would be shortsighted to assume that capital shortages are a thing of the past. Indeed corporate financial officers are keeping their fingers crossed and their powder dry. Though they have improved the structure of their financial statements by refunding short-term debt, and are currently using the good flow of corporate profits to strengthen their equity base and liquid asset position, there is still a long way to go. In this regard, several indicators still show heavy pressure on balance sheet positions. For example, the interest coverage ratio, the sum of pre-tax earnings plus interest expenses divided by interest expense, remains at a relatively low level. The interest burden becomes even heavier when pre-tax earnings are adjusted for inventory profits. Also, while cash flow is showing marked improvement, inadequate depreciation set-asides continue to erode the corporate capital base. In many instances, corporate dividends are still in excess of retained earnings adjusted to account for inventory profits and replacement cost depreciation.

The restraint shown by corporate financial officers in their plant and equipment expenditures undoubtedly reflects the influence of past capital shortages. While this new conservatism should enable business to face the future with greater financial strength, it may have the deleterious effect of inhibiting needed capital formation.

The Challenge of Capital Formation

Increased levels of capital formation are needed if the US is to achieve economic growth with low inflation. Even Great Britain is beginning to learn—one hopes not too late—that without adequate production and productivity, a nation can neither meet the aspirations of its people nor survive in an internationally competitive marketplace.

As previously noted, capital spending plans in the United States still appear too restrained for this phase of the business cycle. Unless capital spending begins to rise more vigorously, inflation may indeed intensify down the road, as bottlenecks and selected shortages begin to mar the economic scene.

Some economists have been belittling the dangers of shortages down the road because of what they perceive to be our reserve capacity for production. However, one should not be misled by official figures on operating rates. It is true that for the first quarter of this year, industry generally was reported to be producing at only 72 percent of capacity, compared with a preferred operating rate of around 95 percent.

However, the Federal Reserve System has now changed its method of computing capacity utilization figures, and the revised figures show that operating rates were closer to 80 percent. Indeed, in some materials-producing industries, actual capacity utilization is already in the mid-80's and in some instances heading into the 90 percent range. In any event, as output rises against existing capacity, bottleneck situations are likely to develop.

Overall, it appears that if business does not soon make a commitment for stronger capital investment, physical shortages may begin to occur in selected industries in another year or two—assuming that the economy continues to expand under the push of consumer and government spending. It is, of course, always possible that the recovery itself will run out of steam, and that, as a result, operating rates will not rise further. America could also place greater reliance on imports to meet domestic needs. These are indeed possibilities. Nonetheless, it behooves economic policymakers not to ignore the possibility of bottlenecks appearing in the supply of such key industrial commodities as paper, steel, plastics, and textiles. The possibility of such a situation points up the importance of adequate investment incentives to capital formation, not only to meet longer-term economic goals, but to accommodate shorter-run needs as well.

If no such settlement is made [by money changers] they shall be proclaimed bankrupt and disgraced by the public crier in the places in which they failed and throughout Catalonia. They shall be beheaded, and their property shall be sold for the satisfaction of their creditors by the court.

—ACTS OF THE CORTEZ

Fortunately, there is a growing recognition of the problem among economists, corporate financial officers, and others. For example, the Brookings Institution concluded in a recent report that unless the federal government ran a surplus—not merely a balanced budget—a capital shortage was likely. Other scholars, including Professor Benjamin Friedman of Harvard and Dr. Henry Wallich of the Federal Reserve Board, have expressed similar conclusions.

The President's Economic Report for 1976 contained, for the first time, a section entitled, "Will Capital Requirements for the Remainder of This Decade be Met?" Based upon a detailed input-output analysis by industry, prepared by the Commerce Department, the report concluded that capital needs may go unsatisfied in the years ahead, resulting in inadequate capacity, growth, and jobs. The analysis stressed that the capital needs of both the private and public sectors would need to be supplemented by large expenditures to provide for (1) meeting environmental objectives and (2) responding to our national energy needs.

In an article published last spring by the Morgan Guaranty Bank, Professor John Kendrick of George Washington University concluded that "if after-tax profit rates are not adequate, the growth of capital per person engaged in production will be less than in the past, which will tend to reduce the growth of labor productivity and real income per capita. Even worse, capacity bottlenecks may again appear in the latter 1970s, as in 1973 and 1974, making more unlikely the achievement of high-level employment."

Much more work needs to be done to impress upon policymakers the urgent task of promoting capital formation. It is not enough for professionals to talk to one another. Obviously, this is a pocketbook issue which will ultimately affect everybody in this country. Still, it is encouraging that, in a period when the economy is leaving recession behind, so many experts are pointing to the longer-run importance of stimulating private investment.

Conclusion

Unless this nation can find a viable way of increasing its commitment to productive investment, demand through the next decade will continue to press against supply—with the inevitable consequences of renewed inflationary pressures, industrial bottlenecks, and inadequate job opportunities. To be sure, many of these potential problems have been obscured by the past recession; but as the economy continues to move upward, policymakers had better begin planning how to avoid a replay of the dismal economic scenario of the recent past.

It would require another article, or several, to address adequately the long-run policies needed to spur capital investments. Included would be the need for eliminating Federal deficits in periods of economic prosperity which siphon funds away from private investments; more realistic depreciation guidelines; and tax policies to encourage risk taking. Such tax policies might include a liberalization of the current method of taxing capital gains and a phase-out of the double taxation of dividends—which has produced a mountain of corporate debt instead of more equity investment.

By worrying now about the prospect of a major investment capital shortage, we can stimulate constructive planning to avoid it. By contrast, complacency can only cause far deeper worry—and necessitate far more drastic corrective measures—later.