CAUSE FOR OPTIMISM

WHY IT'S NOT A RE-RUN OF 1929

by SAUL ESLAKE

Drastic though the October crash was, by some measures its effects may have been over-estimated. Sustained corporate profits should hold recession at bay.

Uncertainty over the economic impact of last October's global sharemarket collapse will linger for a considerable time. In the author's view, the crash will not lead inevitably to recession, either globally or in Australia. Growth will, however, be somewhat slower than might have obtained otherwise.

Nevertheless, there are solid grounds for confidence that the corporate profits share of Australia's national income will be maintained at around current levels in this environment. This is because the behaviour of three key variables affecting profits — namely real wages, inventory levels and interest rates — will be very different from that in previous periods when the profits share has fallen substantially.

Virtually every participant in the securities industry is aware that, in terms of its magnitude and suddenness and the speed of its transmission around the globe, October's sharemarket crash is without parallel. What seems to be less well appreciated is that, because the collapse followed an equally unprecedented period of share-price appreciation, the wealth gains of only a small period have been erased.

For example, the S&P 500 Index rose by as much over the five years to October 1987 as over the previous 22 years. Conversely, October's collapse took the index back to its level of just 11 months previously. By contrast, the 1982 bear market erased the previous 30 months' gains, while the losses of 1973-74 wiped out more than 11 years of advances.

Similar conclusions can be drawn for other markets, including Australia's. Since both economic theory and empirical evidence suggest that wealth must be held for some time before it becomes a significant influence on spending behaviour, it follows that, in general, the direct effect of the crash on household spending should not be particularly significant.

That is not to deny the relevance of the shock to consumer sentiment (although in both the US and Australia the initial adverse reaction in sentiment indexes has been partly reversed). However, the generally lower level of global interest rates provides an important offsetting influence.

A second important point is that, in contrast to the experience of 1929 (to say nothing of 1973-74 or 1982), economic activity was accelerating ahead of the October sharemarket collapse. Industrial production was strengthening, while labour and commodities markets were tightening. The global economy acquired considerable momentum which, as initial post-crash data clearly indicate, has not been halted overnight.

In the United States (where there is some evidence that the rising sharemarket had underpinned consumer spending by facilitating an unprecedented decline in the household savings ratio) the effect of the crash and the

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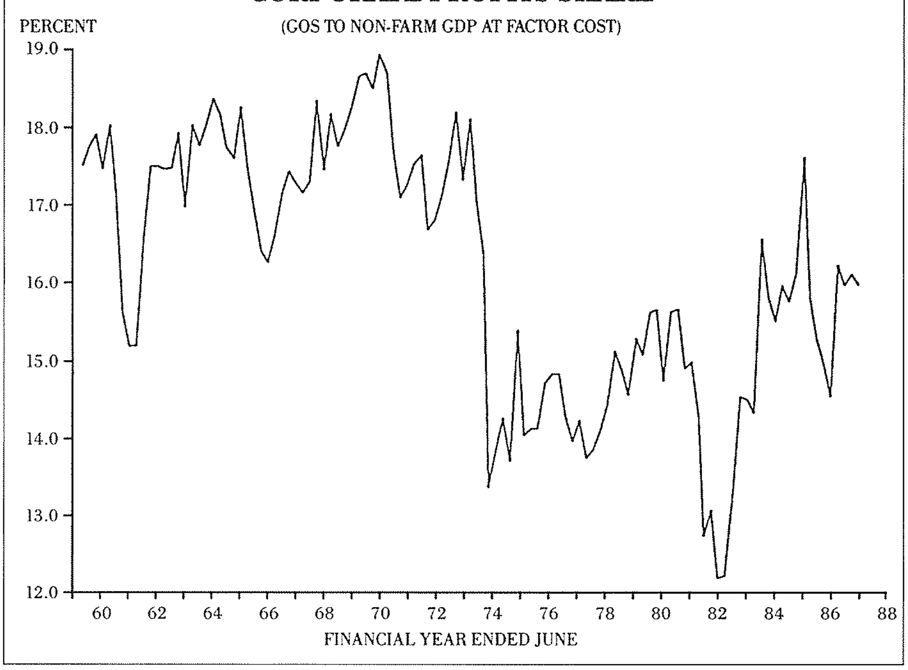
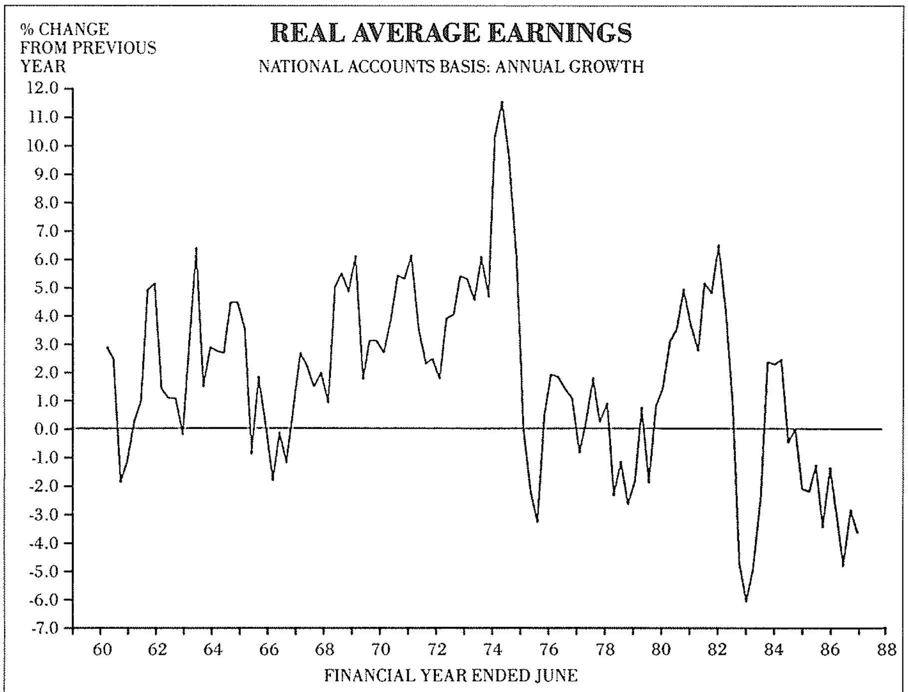


CORPORATE PROFITS SHARE



REAL AVERAGE EARNINGS

subsequent fall in the $US will be to *reinforce* trends which had *already emerged* in 1987 — in particular towards slower growth in consumer spending and a reduction in the trade deficit in volume terms. GNP growth will slow from 2.9 per cent to around 2 per cent with half the 1988 figure derived from net exports.

However, in most other economies GNP growth will be a little faster than in 1987, reflecting the more stimulating stance of fiscal policy (especially in Japan), the more accommodative stance of monetary authorities since the crash, and the real income gains accruing to households outside the US as the result of appreciating currencies and falling oil prices.

Overall, then, OECD GNP growth should be around 2.5 per cent in 1988, only marginally less than in 1987. A start will be made on reducing international current account imbalances (though this will need to be reinforced by policy measures in 1989 and beyond); while world inflation should average about 3.5 per cent.

Impact on Australia

If our world view is correct then Australia will not experience a recession during the remainder of the current decade. As in recent years, however,

Consumption spending growth will not be seriously dislocated as a result of the crash.

Australia's balance of payments position (which may show little further improvement, at least in dollar terms, in 1988-89) and foreign debt liability will represent continuing constraints on permissible growth in domestic demand.

Consumption spending growth will not be seriously dislocated as a result of the crash. In particular, consumption spending will not turn negative in real terms. That last happened in 1952-53, under vastly different circumstances from those likely to be encountered over the next two years. Lower interest rates and a rapid recovery in farm incomes along with continued employment growth will ensure that consumer spending grows by around 1.5 per cent a year over the next two years. The housing sector will enjoy its best activity levels since 1984-85. Non-dwelling construction investment will be affected to some extent; however, the impact on plant and equipment investment should be fairly minor.

Overall, real GDP growth should amount to 2.75 per cent in the current financial year and 2 per cent in 1988-89. Inflation will fall further, probably to less than 6 per cent by June next year. The net public sector borrowing requirement (which has already been reduced to an estimated 1.9 per cent of GDP in 1987-88) will fall further in 1988-89 after this year's May Statement and given that growth in State outlays is (at last) beginning to be wound back.

Corporate profits outlook

Of critical importance to participants in the securities industry is the outlook for corporate profits. The corporate profits share of national income (defined here as the gross operating surplus of trading enterprise companies as a percentage of GDP at factor cost) has fallen sharply on three occasions during the past three decades — in 1961, 1974 and 1982-83 (less dramatic falls also occurred in 1966, 1971 and 1986).

On each of these three occasions, three major contributors to the performance of the profits share were real wages, inventory costs and interest rates.

In real terms, average wages, salaries and supplements per person employed rose by 5.5 per cent over the two years to 1960-61, by 14.4 per cent over the two years to 1974-75, and by 8.6 per cent over the two years to 1982-83. In each case the consequences for corporate profitability were devastating. By contrast, real average earnings have *fallen* by 5.1 per cent over the two years to 1986-87 and indeed by 6.9 per cent over the past four years. We expect that real wages will decline a little further in 1987-88 and in 1988-89, suggesting that wages are highly unlikely to be as negative an influence on profits as they were in the three previous recessions. That is to say, it will be the *wages share* of national income, rather, than the profits share, which will be "squeezed".

A second significant source of pressure on profits during 1974-75 and 1982-83 (data for 1960-61 are not available) was the requirement to carry and finance a high level of inventories in the face of a sudden downturn in domestic demand. In both cases, the downturn followed a period of relatively rapid economic growth in which official forecasts had been particularly optimistic, so that companies (which had not, in any event, devoted much attention to inventory management) were carrying relatively high stock levels.

During both periods production virtually stopped while stocks were run down — subtracting 1.2 percentage points from real GDP growth in 1975-76 and 1.7 percentage points in 1982-83. However, during the mid- and late-80s inventory control has become a more important aspect of corporate management, with the result that the aggregate non-farm stocks-to-sales ratio reached record low levels during 1987. This suggests that inventory costs will be less of a drag on corporate cashflows than in 1982-83 or 1974-75.

Third, interest rates on corporate loans rose significantly during each of these three previous downturns. The maximum overdraft rate rose from 6 per cent to 7 per cent between June 1960 and June 1961; from 7.75 per cent to 11.5 per cent between June 1973 and July 1974; and from 12.5 per cent to 17.5 per cent between December 1981 and June 1982. These increases in interest rates would have greatly exacerbated the impact of real wage rises and inventory carrying costs on corporate profitability during these periods. By contrast, the prime overdraft rate has declined from 19 per cent to 13.5 per cent over the past year, and in our view is unlikely to increase over the next 12 months.

For these reasons, the corporate profits share should be maintained at around 15.5 per cent over the next two years, with corporate GOS rising (in nominal terms) by around 11.5-12 per cent in 1987-88 and by 7.5-8 per cent in 1988-89.

Hence, the fact that corporate profits slumped dramatically in 1960-61, 1974-75 and 1982-83 does not mean they will do so again in 1987-88 or 1988-89, because of the contrasting behaviour of real wages, inventory levels and interest rates in the current period compared with earlier recessions. Indeed, because declines in corporate profitability usually tend to lead recessions rather than occur simultaneously with recession, these factors may be seen as providing additional reasons why a recession in 1988-89 is unlikely. □