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Turnaround?

The business recovery to date has been based entirely on a consumer-spending upsurge, an export boom, and an improved inventory situation. But if the upturn is to continue in 1976, other sectors must also make a contribution, beginning with business capital investment. This sector has now begun to recover from its worst decline of the past generation—a steep 17-percent decline (in real terms) between mid-1974 and mid-1975. This is not surprising, since spending normally turns around about one quarter after the business-cycle trough. Happily, the latest Commerce Dept. survey of future spending plans suggests that the turn-around can be sustained next year.

Some analysts question the strength of capital spending, arguing that the recent improvement reflects the impact of a higher investment tax credit rather than the influence of any basic turn-around factors. In addition, the Conference Board's quarterly appropriations survey—a key spending indicator—suggests that actual expenditures may remain somewhat sluggish in 1976. (Capital spending normally lags about a year behind appropriations.) Still, this survey may be less pessimistic than it appears, since backlogs of unspent funds from earlier appropriations are now quite high.

Brighter prospects
Most importantly, the latest Commerce survey suggests a definite turnaround in the first quarter of 1976. The survey shows a 12-percent annual rate of gain in (current-dollar) spending plans—the first significant increase in over a year's time, in either current-dollar or real terms. Projected spending gains are rather widespread, with very strong increases expected in electric utilities—the largest industry in the survey—and also in other key industries such as primary metals. The upturn in utility spending represents a reversal of the significant decline of the past year, and the strength in primary metals and petroleum represents a continuation of their prolonged spending boom.

The investment figures could turn out even better than indicated, because of the tendency for actual spending to outpace projected expenditures in a typical business upturn. In 1975, the current-dollar gain may be no more than 1.0 percent, compared with the 3.3-percent increase projected in last February's survey. Judging from past history, this pattern should be reversed in 1976.

Plus and minus
Corporate managers reduced their spending plans during the recession because of declining profits and declining capacity-utilization rates, and the latter factor still tends to limit their future expansion plans. The steep recession sharply reduced utilization rates, and thus removed any real threat of near-term capacity shortages despite the sharp decline in real capital spending in 1975. In-

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dustrial capacity has experienced little decline, because of projects begun during the earlier period of severe shortages. Supply capabilities thus are greater than they were even two years ago, while the demand for basic materials is no longer artificially inflated by speculative factors.

Despite continued overcapacity problems, business capital spending has several other factors going for it. Internally generated funds are much larger and more significant than a year ago, especially since the price slowdown makes profit and depreciation data more realistic measures than heretofore. With the end of double-digit cost increases for new plant and equipment, appropriated investment funds should go farther than earlier anticipated.

In addition, business planners are now working with a sharply higher carryover—the amount still to be spent on projects already underway—because the dollar volume of new starts has consistently exceeded capital spending since the beginning of the decade. Carryover in manufacturing has risen from roughly $20 billion to about $40 billion over the past five years, and in the utility industry, from about $25 billion to more than $100 billion. (The growth in physical terms would be smaller, yet still quite significant.) Spending on ongoing projects could be deferred or even cancelled, but for the most part, funds carried over should represent a significant element of strength in the near-term outlook.

Case study—utilities

The electric-utility industry presents an instructive case study in the vicissitudes of capital spending. The industry has reduced such spending by 3½ percent in 1975, in contrast to its 14-percent average annual growth of the preceding decade. This spending decline has gone hand-in-hand with the 1973-75 weakening of electricity demand—compared with the 7½-percent annual growth of the 1965-72 period—caused by the recent decline in industrial activity, higher fuel costs (and thus higher utility rates), and customers' increased attention to energy conservation. With power demand falling sharply below projections, the industry has been left with a sizeable amount of excess capacity. This situation has led the Federal Power Commission to lower its estimate of 1980 power demand by 10 percent, and to reduce estimated needs for new generating capacity accordingly.

The electric-utility industry is highly capital intensive, requiring approximately four dollars of fixed investment for each dollar of annual revenue—about four times the requirement for iron and steel, the most capital-intensive manufacturing industry. Also, electric-power projects are

planned far in advance, and once started, require several years for completion. The industry's investment plans thus are somewhat rigid in the short-term, creating problems of overcapacity whenever demand weakens as it has recently.

The industry's planning has been complicated also by revenue problems. Its internally-generated funds last year covered only one-quarter of its capital-spending requirements, as against one-half a decade ago. However, rate increases recently have begun to catch up with higher costs, boosting the industry's ability to pay for new facilities out of retained earnings. The improved revenue situation of utilities, plus their huge carryover of ongoing projects, thus should help bolster at least the short-term spending outlook—just as the latest Commerce Dept. survey suggests.

Growing needs

Capital spending generally in 1976 could be a mirror image of the 1975 pattern, with the reversal of several factors—disappointing sales, soaring labor costs, falling profits, and growing excess capacity—which characterized this recession year. Despite that probable improvement, business planners are faced with the question of whether the nation's industrial plant should grow even faster. Thus far in the 1970s, the amount of new fixed investment put in place, per person added to the civilian labor force, has averaged about $75,000, compared with almost $100,000 in the first half of the 1960s and about $80,000 in the last half of the 1960s (expressed in 1975 dollars). This downtrend has unfavorable implications for productivity and thereby for economic growth.

Actually, business fixed investment as a share of GNP has exceeded its long-term ratio of 10 percent throughout most of the past decade. But with a fast-growing labor force and various structural changes in the economy, a higher investment ratio may be needed in coming years. Recent studies of the nation's capital requirements suggest that the optimum ratio over the next decade would average about 11 percent of GNP.

The demand for capital obviously is growing in the environmental and health-and-safety fields, which contribute little, if anything, to productivity growth. (About 9 percent of each investment dollar is now spent in meeting pollution and health-and-safety requirements, up from about 3 percent in 1968.) Rising capital demands are also evident in mass transit and in energy development. In contrast, there may be a diminished demand—because of demographic shifts—for new housing, schools and similar projects. But overall, the investment needs of the economy promise to be substantial through 1980.

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