The Early 1960s: A Guide to the Late 1970s

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LESSONS can be learned from a study of the past. Future mistakes can be avoided, using the information gained through analysis of the policy actions that were taken and evaluating the resulting economic performance. Similarly, for these periods when economic performance was successful, an analysis of the contributing forces provides some positive guidance to policymakers. From an economic growth and stabilization viewpoint, the four-year period from 1961 to 1965 was one of the most successful in our history.

Throughout the early 1960s, as in other periods of economic expansion, the desires of the public for rapid gains were strong. Policymakers sought to increase economic welfare by additional stimulus. Taxes were reduced, Government spending was increased, and money growth was accelerated. Yet, the net stimulus from policy actions was more moderate and steadier than in other periods of economic expansion.

Although the economic policy actions which evolved were not necessarily completely intended, in retrospect it appears that they were appropriate. As such, this earlier period can serve as a useful guide to the present by analyzing the economy's responses to the chief causal forces in operation over this period.

Policy Actions and Other Causal Forces Operating on the Economy

The record of the early 1960s demonstrates the strength of the private economy and its movements in the absence of shocks from outside forces. In part, the lack of shocks was the result of fortuitous circumstances. Although there was apprehension caused by the Berlin crisis, resulting in some precautionary buildup of U.S. defenses, no outside force such as a foreign war, an international commodity cartel, or major adverse weather developments caused any material constraints on supply or huge shifts in demand.

However, much of the credit for developments in the early 1960s should probably go to Governmental economic policies followed during that period. These policies were both less restrictive and less stimulative to the economy than those prevailing during most other expansionary periods in our history.

Reliance was placed primarily on competition as a means of regulating economic activity in the late 1950s and early 1960s. There were some Government regulations, price guidelines, and a major confrontation with the steel industry on pricing, but, on balance, it was a period of relative regulatory calm. As pointed out at the time by Beryl W. Sprinkle, "A surprising number of political actions have been consistent with the free market doctrine."[1] This is in sharp contrast to the period of the early 1970s when the Government engaged in a massive regulatory effort in the areas of prices, the environment, safety, and employment.

[1]Discussion of a paper by Neil H. Jacoby, "The Fiscal Policy of the Kennedy-Johnson Administration," *Journal of Finance* (May 1964), p. 391.

Fiscal actions of the Federal Government, when used, were relatively moderate during the early 1960s. Government spending expanded at a 5 percent annual rate from 1961 to 1965 (national income accounts budget). However, from 1955 to 1961 Government expenditures rose at a 7 percent rate, and since 1965 have increased at an average 11 percent rate.

Tax reductions were also implemented, but amounts were relatively small. New depreciation guidelines combined with an investment tax credit enacted in 1962, increased the annual cash flow to corporations by about $2.5 billion and raised the after-tax rate of return on new investment projects. After a prolonged debate, which began in the summer of 1962, taxes were finally lowered in early 1964 by $11 billion on personal incomes and $3 billion on corporate profits to add further stimulus.

The tax decrease and the rise in Government outlays only partially offset a so-called "fiscal drag" emanating from an increase in Government tax receipts as consumer and business incomes grew during the period of pronounced expansion. As a result, the average Federal budget deficit from 1960 through 1965 was just over $1 billion per year. By comparison, in the last three years of the 1950s the average annual deficit was $3 billion. During 1966 through 1970, which included most of the Vietnam buildup, the deficit averaged $5 billion, and since 1970 the deficit has averaged $32 billion.

Monetary actions in the early 1960s were expansionary, but the acceleration of money growth came later than in most other periods of economic recovery and growth. Inflation changed little in that period since most of the increased monetary expansion came after 1963. Nevertheless, these monetary actions contributed to an increase in the rate of inflation in the late 1960s. The money stock grew at an average 2.4 percent rate from 1960 to 1963, and at a 4 percent rate in 1964 and 1965, compared with a 2 percent rate in the 1952-60 period. By contrast, money has been growing at an average 6 percent rate since 1965.

According to a number of studies, the trend growth of money over a period of four years or more primarily determines the rate of inflation.[2] The results of these studies strongly suggest that the moderate money growth from 1952 through 1963 was a major factor in the relative price stability of the early 1960s, and that the more rapid money growth since 1965 has been largely responsible for the much higher inflation rates in recent years.

There were no large prolonged decreases in the growth rate of money in the 1961-65 period, except for a brief period preceding the pause in activity during 1962. Marked and sustained declines in the rate of money growth, such as occurred from early 1969 to early 1970 and from mid-1973 to early 1975, are usually followed within a few months by a decline in the demand for goods and services, resulting in decreased production, employment, and incomes. The absence of any large and sustained slowing in money growth during the 1961-65 period eliminated a force which has preceded most recessions in this country as well as many countries abroad.[3]

Policy Performance Versus Expectations

Despite a robust expansion with little inflation, public desire for aggressive policies to obtain further gains remained strong, as is usually the case during economic expansions. Many analysts in the early 1960s concluded that the pronounced and sustained growth of the economy was not "fast enough." Although unemployment declined from 7 percent of the labor force in early 1961 to 5 percent in 1964 and to 4.5 percent in 1965, these analysts considered such performance inadequate when compared with an "interim target" of 4 percent or less. As late as 1965, the President's Council of Economic Advisers calculated that "a gap of $25-30 billion still remains between the nation's actual output and its potential output . . . 4 percent of our current potential."[4]

Because of the challenge to policymakers to achieve even greater levels of production, employment, and purchasing power, pressures for more expansive fiscal

[2]See W. Philip Gramm, "Inflation: Its Cause and Cure," this *Review* (February 1975), pp. 2-7. Leonall C. Andersen and Denis S. Karnosky, "The Appropriate Time Frame for Controlling Monetary Aggregates: The St. Louis Evidence" (Paper presented at the Federal Reserve Bank of Boston Conference on "Controlling Monetary Aggregate II; The Implementation," Melvin Village, New Hampshire, September 8, 1972); Milton Friedman, *The Optimum Quantity of Money and Other Essays* (Chicago: Aldine Publishing Company 1969); and Irving Fisher, *The Purchasing Power of Money* (New York: Augustus M. Kelley, 1963).

[3]See "Production, Prices, and Money in Four Industrial Countries," this *Review* (September 1972), pp. 11-15; Leonall C. Andersen and Jerry L. Jordan, "Monetary and Fiscal Actions: A Test of Their Relative Importance in Economic Stabilization," this *Review* (November 1968); Milton Friedman and Anna Schwartz, *A Monetary History of the United States 1867-1960"* (Princeton, New Jersey: Princeton University Press, 1963).

[4]*Economic Report of the President* (Washington, D.C.: United States Government Printing Office, 1965), p. 39.

policies increased. With prices relatively stable and an observed "excess" capacity believed plaguing the economy, inflationary potentialities received only nominal attention. However, "The record suggests that the Kennedy-Johnson Administrations were frustrated in their efforts to attain professed goals. It reveals the great power of Congress which, by pulling against the Executive Branch . . ., kept them chained near the middle of the fiscal road."[5] As noted above, Government expenditures were increased and tax rates reduced, but the actual extent of these actions was both moderate and delayed.

Actual monetary developments were not as stimulative as some would have desired for domestic purposes. The monetary authorities accepted, as a prime objective during much of this period, the reduced cost and increased availability of borrowed funds. It was contended that through this goal growth in the nation's liquidity would contribute to continued orderly economic expansion.[6] However, during much of the time the nation also faced a large deficit in the balance of payments and a sizable net outflow of gold. This situation apparently called for maintaining or raising short-term interest rates in order to discourage an outflow of funds seeking more favorable interest rates abroad. These two objectives were partially conflicting, and the dilemma brought compromises.

Efforts were made by the Federal Reserve System to reconcile the conflict by "twisting the yield curve." This was supposed to be accomplished by buying long-term obligations to provide bank reserves and to obtain lower capital market yields for domestic purposes, and by selling some short-term Treasury bills to maintain the higher rates in this sector for international balance-of-payments objectives. During 1961 through 1965 about $8 billion of Government securities with maturities over one year were purchased by the System.[7] On balance, short-term interest rates did rise relative to long-term rates in this period. However, cost and availability of domestic credit changed only marginally, and the shift in the yield curve was similar to that which occurred in other periods of expansion where no massive purchases of longer-term obligations by the System occurred.[8]

There was a sizable growth in total credit extended in the early 1960s. Total new funds raised by individuals, businesses, and state and local governments advanced steadily by a 16 percent annual rate from early 1961 to 1965, compared with an average 9 percent rate since 1965. Large personal and business saving contributed to the growth. Monetary authorities attempted to bolster the availability of credit by maintaining net "free" reserves at member banks(that is, smaller borrowings from Reserve Banks than reserves held in excess of requirements) throughout most of the period. However, the free reserves were a misleading measure of bank credit availability. The small borrowings from Reserve Banks reflected the position of the discount rate, which remained at higher levels than market rates on alternative sources of bank funds.

The Economy's Response to Moderate Policies

The economy's performance in the period 1961-65 was exceptional. There was little inflation, and production grew at a relatively rapid and steady pace for one of the longest spans on record. Over that period industrial production rose at nearly an 8 percent average annual rate, and total real output increased at over a 5 percent rate (see accompanying chart). Employment rose faster than the population of labor force age, and real output per capita expanded at about a 4 percent rate — or double the trend rate since 1965. Corporate profits (after taxes) increased at a 15 percent pace. Notwithstanding, the consumer price index inched up at only a 1.3 percent rate.

The 1961-65 period was characterized by growth. The recession of 1960-61 had been relatively mild, and the upward movement after early 1961 was not a quick rebound, but a period of relatively steady expansion of capacity as well as demand. Investment

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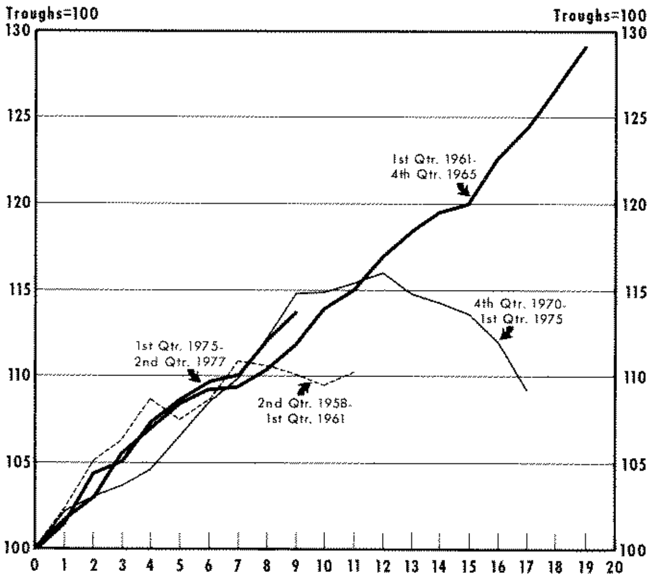
[5]Neil H. Jacoby, "The Fiscal Policy of the Kennedy-Johnson Administration," *Journal of Finance* (May 1964), p. 357.

[6]See *Annual Report of the Board of Governors of the Federal Reserve System*, covering operations for the year 1964, p. 9.

[7]The System received a powerful assist in twisting the yield curve from debt-management policy aimed at heavy concentration of Treasury financing in short-term paper. See John J. Balles, "The Outlook for Fiscal, Monetary and Debt Management Policies," *Journal of Finance* (May 1964), p. 407.

[8]Two studies found little, if any, effect on the term structure of interest rates from a shift in the maturity composition of the debt. Frank De Leeuw, "A Model of Financial Behavior," Chapter 13 in *The Brookings Quarterly Economic Model of the United States Economy*, ed. James S. Duesenberry et al. (Chicago: Rand McNally & Company, 1965); and Franco Modigliani and Richard Sutch, "Debt Management and the Term Structure of Interest Rates: An Empirical Analysis of Recent Experience" (Paper delivered at the Conference of University Professors, The American Bankers Association, September 1966). See also Richard W. Lang and Robert H. Rasche, "Debt-Management Policy and the Own Price Elasticity of Demand for U.S. Government Notes and Bonds," this *Review* (September 1977), pp. 8-22.

Real Gross National Product



Latest data plotted: 2nd quarter 1977

expenditures accelerated in response to an increase in demand for final products, improved rates of profit and cash flow, relatively steady interest rates, reduced taxes, and an improved outlook. From the previous cyclical peak in 1960 to 1965, real output grew at an average 4.7 percent rate, compared with 2.8 percent in the previous cycle and about a 3 percent average in the period since 1965.

During this period there were relatively few large fluctuations in demand or constraints on supply, and the economy expanded in a balanced fashion. Balance was maintained between production and sales at relatively stable prices, thus avoiding both temporary shortages and sizable inventory accumulation. Balance was maintained between the expansion of effective demand and the expansion of productive capacity to satisfy that demand, avoiding the need for cutbacks in capital expenditures. Also, balance was maintained between wages and productivity, and unit labor costs as well as prices changed little. Hence, few destabilizing endogenous forces developed during this extended period.

Recent Period of Recovery and Expansion

The current economic expansion, which began in the spring of 1975, started with an economic situation much worse than the one in the early 1960s. Inflation, as measured by the GNP deflator, had risen at an 11 percent annual rate in the previous six quarters, compared with near price stability in the early 1960s. Also, real production had dropped at a 5 percent annual rate from late 1973 to early 1975 versus a moderate net increase in real output from 1960 to 1961.

The dramatic change in supply and demand conditions for energy resources since 1973 has had a substantial adverse effect on the productive capabilities of the U.S. economy.[9] Hence, even though real production had dropped sharply from 1973 to early 1975, excess economic capacity did not rise proportionately, and was probably about similar to that in 1961. This decrease in capacity, without an offsetting decrease in money growth, also accounted for much of the rise in the rate of increase in the price level,from 5 percent in the early 1970s to 11 percent from late 1973 to early 1975.[10]

After turning up in the early spring of 1975, the economy has progressed in the past two and one-half years at a pace remarkably similar to or even stronger than that of the early sixties. There was a very rapid recovery in the first year following the business trough of early 1975 as activity rebounded from the previous drop, but expansion was fairly rapid in most of 1961 also. Then, there was a hesitation in the rate of the upswing during much of 1976, similar to the pause in 1962, and in both cases the slowdown was attributable to a decline in the rate of inventory accumulation. So far in 1977, economic expansion has been vigorous, similar to that in 1963.

On balance, real production rose at a 5.9 percent annual rate from early 1975 to the second quarter of 1977, somewhat faster than the 5.1 percent rate recorded in the first nine quarters of the expansion in the early 1960s. Other indicators of the strength of the recent expansion have been a 10 percent rate of increase in industrial production and a rise in employment at a rate about 25 percent faster than the population of labor force age since March 1975. Personal income has grown at an 11 percent rate in the same period.

Rasche and Tatom, using a production function which accounts explicitly for capital and energy resources, calculated that because of the new energy regime imposed in 1974, current production is cur-

[9]Robert H. Rasche and John A. Tatom, "The Effects of the New Energy Regime on Economic Capacity, Production, and Prices," this *Review* (May 1977), pp. 2-12.

[10]See Denis S. Karnosky, "Another Recession, But Different," this *Review* (December 1974), pp. 15-18.

rently near potential output.[11] Hence, they concluded that attempts to obtain much greater output now through stimulative policy actions are likely to fail and will add to inflationary pressures. There is little prospect for an extended period of real growth at rates higher than the rate of potential output expansion, which is currently about 3.5 percent a year.

Early in the current recovery some progress had been made at reducing inflation. Overall prices (GNP deflator) rose at an average 5.5 percent rate from the first quarter of 1975 to the fourth quarter of 1976, considerably faster than the 1.6 percent pace observed in the corresponding period in the early 1960s. Experience indicates that eliminating inflation takes time, and the 1975-76 price developments should be judged against the 1970-75 average rate of 7 percent. In the first two quarters of 1977, however, these prices rose at a faster 6.2 percent rate, reflecting both constraints on supply from the severe weather last winter and a faster money growth since early 1976.

On balance, the causal forces bearing on economic activity since early 1975 have moderated from those of the earlier 1970s. Although business has been hampered by numerous Governmental regulations and much higher energy prices, the constraints on production recently have been less than in the immediately preceding period. During the 1972-74 period, the economy received a host of shocks to production which contributed to both the inflationary bulge and the recession. Major shocks include a marked rise in energy prices caused by the cartel of oil producing nations, a hampering of production by Governmental price, environmental, safety, and other regulations, a pronounced realignment of exchange rates among currencies, and a drouth which adversely affected food production.

Fortunately, most of these constraints on production have not intensified. For example, general price controls were abolished in 1974, although selective controls remain in place. The weather generally has been better for crops since early 1975, and energy prices have been much more stable, albeit at a higher level. However, Government continues to regulate business in a myriad of ways, and expectations are that Government regulation will increase in the future. However, the absence of further shocks to production to date, combined with the same underlying strength and resiliency of the private enterprise system as was exhibited in the early 1960s, has been a contributing force to the economic expansion since early 1975.

In addition, Governmental actions bearing on the economy have been more moderate, on balance, than in the immediately preceding period. Since the second quarter of 1975, total Federal outlays have risen at an 8 percent annual rate, or at about a 2 percent rate in real terms. In the early 1960s, nominal expenditures rose at a 5 percent rate, or at about a 3 percent rate in real terms. By contrast, from 1970 to 1975, Government outlays rose at a 12 percent rate (a 5 percent real rate). Although deficits have been enormous (averaging about $62 billion per year since early 1975), they have been financed primarily through saving.

Despite an acceleration of money stock growth recently, money increased at an average 5.8 percent annual rate from early 1975 to mid-1977. This was faster than in the early 1960s, but the rate was moderated from the 7 percent average rate which occurred from early 1971 to mid-1974. The average monetary growth since early 1975 has lowered the trend growth of money slightly, contributing to a slightly lower fundamental rate of inflation. Large and sustained fluctuations in money, such as occurred from mid-1974 to early 1975 when the pace abruptly fell to a 3 percent rate, were avoided. The avoidance of such fluctuations in the pace of money growth has prevented shocks to the economy from this source.

The current situation and many evaluations of it are similar to the situation in early 1963, which was described by the President's Council of Economic Advisers as follows:

> Despite the gains of the past 2 years, the economy has not yet regained full use of its labor and capital resources . . . As 1963 begins, too many workers remain without jobs; too many machines continue idle; too much output goes unrealized as our economy runs below its potential.[12]

Reflecting this evaluation, President Kennedy recommended a "major tax reduction" and an increase in Federal purchases for stepping up the U.S. growth rate. His report also suggested that monetary policy, as well as debt policy, must be coordinated with fiscal policy to secure the objectives of higher employment and growth. But, as mentioned earlier, there were delays in implementing these recommendations, and some were scaled down as a result of changing cir-

[11]Robert H. Rasche and John A. Tatom, "Energy Resources and Potential GNP," this *Review* (June 1977), pp. 10-24.

[12]*Economic Report of the President* (Washington, D.C.: United States Government Printing Office, 1963), p. 9.

cumstances and conflicting objectives. As a result, actions became only moderately more expansive, but the stimulation was comparatively even.

Now, in the fall of 1977, the economic recovery is roughly 2½ years old. To some analysts the volume of unused resources appears sizable. Official reports indicate that unemployment has recently been at about 7 percent of the labor force, and that output has been running at roughly 83 percent of measured capacity.[13] There is considerable discussion in the business community of a marked slowdown in the rate of economic expansion in the near future. A number are calling for increased stimulation to accelerate the progress toward a higher level of resource utilization.

The announced policies of the Government to date have been similar to those followed in the 1961-65 period. The Administration has stated its intention to trim Government expenditures and to attain a balanced budget by fiscal 1981. Monetary policies have been directed to holding money growth at a moderate rate and gradually reducing this rate over time. Since early 1975 the long-range money targets have been lowered. Also, it is the stated policy to reduce the burden of Government on the private enterprise system by eliminating regulations which cannot be justified on a cost-benefit basis.

Nevertheless, recent Government actions have tended to approximate those in other expansionary periods when heavy reliance was placed on increased Government stimulation to bring about more rapid expansion, and when more Government controls were substituted for competition in regulating business activity. Despite a Federal budget deficit of over $40 billion in the first half of 1977, the probabilities are relatively high that there will be some net tax rate reductions and further increases in Government expenditures in the near future. Money growth, which had been at a 4.1 percent annual rate from the second quarter of 1974 to the first quarter of 1976 when the recession was halted and a rapid expansion was launched, has accelerated to an average 6.5 percent rate since the first quarter of 1976 and then about a 9 percent rate since February of this year. Current discussions and actions concerning the energy program indicate more Government involvement in the productive process.

[13]These statistics probably greatly underestimate the degree that potential output is being utilized. See Rasche and Tatom, "Energy Resources and Potential GNP."

Summary and Conclusions

The early 1960s was a period of relative regulatory calm and few disruptions from fiscal and monetary actions. Although no two periods in our history are identical, support for using the early sixties as a guide to the late seventies is strengthened by a large body of economic analysis, based on an examination of policy actions and economic responses over a wide range of circumstances. These studies support the conclusions that the experience of the early 1960s was not unusual, but, upon reflection, was the result expected from the policies pursued.

In the early 1960s the private sector of the economy was not shocked or stimulated greatly by outside forces. There were no large shifts in factors determining either demands or supplies, and the economy responded commendably. The early 1960s was one of the longest periods on record of rapid economic growth with little inflation. All during the period, desires of the public for still better performance were strong; the record indicates that policymakers generally sought to provide more stimulus, but they were partially thwarted in their attempts by conflicting objectives, lack of agreement, and inertia.

The economy has expanded rapidly for about two and one-half years, just as it had in 1963; if anything, the more recent expansion has been even more pronounced than in the corresponding earlier period. When capacity is adjusted for energy developments and other constraints on production, output currently is rapidly approaching potential. In the early 1960s relative price stability was maintained, and during 1975 and 1976 there was a slowing in the rate of inflation. Yet, as in most periods of expansion, the desire for even better short-run economic performance is strong.

Typically, in periods of economic expansion, the attraction of expected short-run benefits to production and employment from ever increasing stimulation has become irresistable. However, these actions have led to boom-bust situations. With more stimulation, upward pressures on prices develop. Removal of the stimulation, once it becomes anticipated, depresses production and employment for a time, but the inflation built up during the period of stimulation remains for several years.

Now, it would seem prudent to adopt intentionally moderate economic policies. This would imply a reduction in the growth rate of Government spending, and a gradual move toward a balanced Federal budget, a policy advocated by the current Administration. Monetary authorities might well follow the course which they have charted since 1975 — that of relatively steady and moderate money growth and a gradual reduction of this rate over time. Regulations on the private sector might be critically assessed, and those that cannot be justified on a rigorous cost-benefit basis removed. Uncertainties caused by potential changes in the energy program and by possible tax law revisions should be clarified soon as they only serve to hamper investment decisions.