# 1975 – Year of Economic Turnaround

NORMAN N. BOWSHER

THE past year was one of significant economic turnaround, with the influence of monetary and fiscal developments superimposed on the continuing transition from the economic disarray of the two previous years. In 1973 and 1974 the economy was subjected to a sharp rise in the cost of energy, crop failures, price controls, and the implementation of environmental, safety, and consumer protection programs which directly reduced productive capabilities across the economy. As a result, total real output declined from the fall of 1973 to the fall of 1974, even though growth of aggregate demand for goods and services slowed only moderately. Continued strength in demand, at a time when production was shackled, resulted inevitably in a substantial increase in the price level. Then, in late 1974, growth of total demand was curtailed, intensifying the decline in production and prolonging the recession.

Economic recovery began in 1975, aided in large part by several factors. Most price controls were eliminated in 1974, harvests improved in 1975, and the economy gradually adapted to the higher energy prices and other restraining influences on output. Productive capabilities expanded during the year, albeit from a much smaller base, permitting output of goods and services to increase in a more usual manner in response to the growth of total spending.

In addition, monetary and fiscal actions, which in late 1974 had aggravated the recession, became stimulative in 1975, thereby influencing the timing of the economic turnaround and speed of recovery. The Federal government reduced taxes, granted rebates, and increased its expenditures sharply, adding significantly to disposable incomes of households and businesses. Monetary growth was accelerated in an effort ". . . to foster financial conditions conducive to stimulating economic recovery, while resisting inflationary pressures. . . ."[1]

These two developments — adjustments to supply constraints and stimulative policy actions — contributed to a pronounced economic recovery during the summer and fall. In addition, the rate of inflation subsided as the adjustment to supply limitations of 1973 and 1974 neared completion. Despite these improvements, overall economic performance at yearend was disappointing to many observers. In December about 8 million people said they wanted work but could not find a satisfactory job at the wage desired. Inflation still continued at a relatively high rate.

## PRIOR INFLUENCES ON ECONOMIC DEVELOPMENTS

Economic developments in 1975 were greatly influenced by events in the immediately preceding years. An understanding of these events is crucial in ascertaining what factors contributed to the depressed state of the economy in early 1975, the subsequent economic turnaround, and the moderation in the rate of inflation.

[1]"Record of Policy Actions" of the Federal Open Market Committee, Federal Reserve *Bulletin* (August 1975), pp. 505-12.

Economic performance depends on both the demand for goods and services and the ability of the economy to supply them. Productive capacity generally expands as a result of growth in the labor force, additions to plant and equipment, improved skills of workers, better management techniques, and the expectation of long-term profit. Because these developments have generally provided for a fairly steady rate of growth of productive capability, nearly all attention in aggregate economic analysis has been focused on forces affecting the demand for goods and services. The ability of the economy to produce has generally been projected to grow at some trend rate varying from about 3 to 4.5 percent a year.

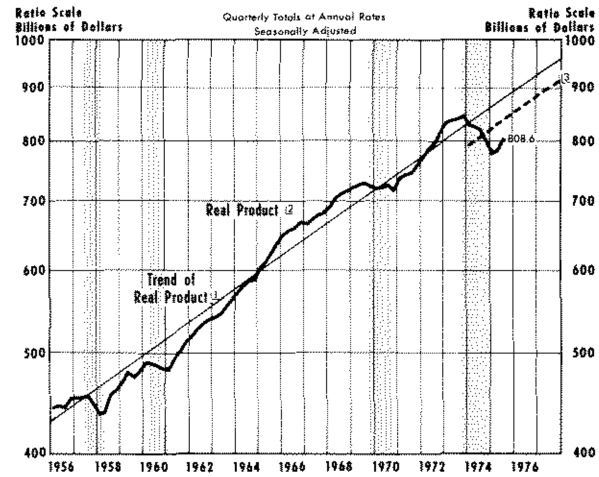
However, since the imposition of price controls in 1971, changes in normal supply relationships have become an important force in shaping economic developments, especially since 1973. While total spending for goods and services was rising rapidly, the economy was hit by a number of supply constraints. Through the monopolistic actions of OPEC (Organization of Petroleum Exporting Countries) and other producing nations, oil supplies were reduced and energy costs increased sharply. Adverse weather conditions, both here and abroad, resulted in widespread crop failures and increases in food prices.

Far reaching price controls and resource allocation programs, in effect until early 1974, prevented firms from adjusting to higher production costs, prompting some marginal facilities to be closed and plant expansions to be postponed. Production in "downstream" industries was hampered by "shortages" for a time, and later by higher prices for inputs. Compliance with environmental and safety laws consumed resources and added further to costs, while making adjustment to all the other changing forces more difficult and costly.

Also, during the past several years laws and regulations which were adopted for consumer, environmental, or other purposes have tended to discourage saving and investment — the ingredients essential for future economic growth. For example, more of the nation's income has been channelled through social security, the food stamp program, and other transfer payments which tend to bolster consumption relative to saving. Maximum returns on savings accounts in banks and thrift institutions were held nearly constant while the inflation rate increased, causing real losses to holders of these funds.

These interferences to the production process reduced the output capabilities of the nation. In response, real output peaked in late 1973 and began declining, despite a 7 percent annual rate of increase in aggregate demand. From the fourth quarter of 1973 to the third quarter of 1974 real product decreased at a 3.5 percent annual rate. The rate of inflation intensified as the economy moved into the recession. This development appeared contradictory to some, but is just what must be expected when the amount of goods available is cut unexpectedly and demand continues to increase. The constraints on production caused the bulge in the rate of price increases by reducing the availability of goods and services relative to the demand for them.

The Trend of Output




1 The trend of output was determined from the regression lnQ=5.7292+.0092t, which was estimated from quarterly data for the I/1947 - II/1971 period. The coefficient (.0092) is the estimate of the trend rate of increase of output for the period. The line has been extrapolated beyond II/1971.

2 Gross National Product at 1958 prices.

3 Dashed line is an estimate of the trend of real growth after the supply constraints. The new trend rate of growth of capacity is tentative at this time.

The shaded area in 1973-75 represents the recent economic contraction. The first section (1973-74) represents the period of constraints on aggregate supply, while the portion since late 1974 was induced by restriction of aggregate demand. The remaining shaded areas represent periods of business recessions as defined by the National Bureau of Economic Research.

Latest data plotted: 3rd quarter

In addition, the growth rate of the money stock, which had averaged 6 percent per year since 1965, slowed markedly to a one percent rate from June 1974 to January 1975. The pause in the growth of the money stock was followed, as it usually is, by a slower expansion in total spending on goods and services in the fall of 1974, and the recession was intensified.

The economy was thus in great disorder as the year 1974 ended. Production was falling sharply from both the influence of constraints on supply and a slower growth in aggregate demand. Industrial production, which had declined at a 2 percent annual rate from November 1973 to September 1974, dropped at a 24 percent rate in the final three months of 1974. At the same time, inflation was severe, with consumer prices having risen 12 percent and wholesale prices 21 percent in 1974.

## DEVELOPMENTS IN 1975 INFLUENCING THE ECONOMY

In such a climate, some stimulation from monetary and fiscal actions was believed appropriate, and early in 1975 policies were adopted which were designed to expand total spending. Although little was done by the government to remove or relax the existing supply constraints, or even to facilitate adjustment, the economic system continued to adapt to their influence.

### *Expansionary Monetary Actions*

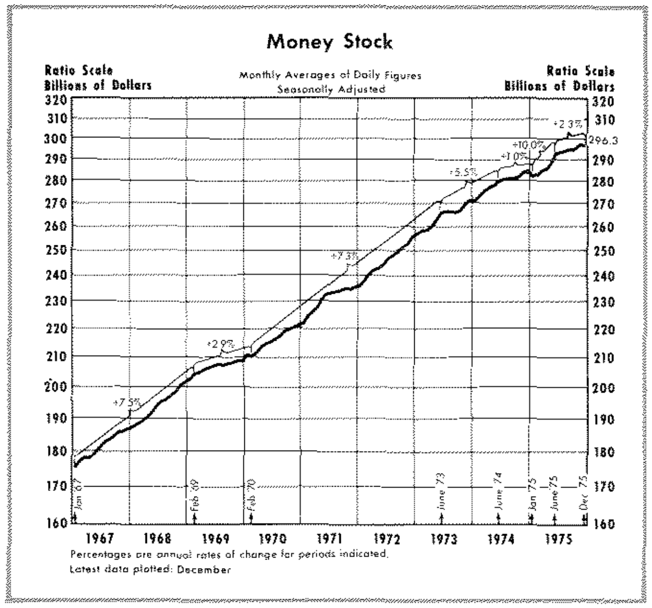
Early in 1975 monetary actions became much more expansionary, but the pace of monetary injections moderated after June. Growth in the monetary base, which is dominated by the Federal Reserve credit component, increased at an 8 percent average annual rate from January to December 1975. From January to June, the increase was at a 10 percent rate, but thereafter it was at a 6 percent pace. The base supports expansion of the money stock, and over extended time periods growth rates of base and money have usually been similar.

In the early summer, the Federal Reserve System announced publicly its longer-run targets for monetary policy, which included a target range of money growth of 5 to 7.5 percent from the second quarter of 1975 to the second quarter of 1976.[2] From January to June, when the recession was at its deepest stage, money was expanded at a 10 percent pace, up considerably from the one percent rate which prevailed during the previous seven months.

After June 1975, the expansion of the money stock slowed, bringing the growth rate of money within the target range. From the second quarter to the fourth quarter of 1975, money rose at an estimated average 5 percent annual rate, slightly less than the average since 1965.

### *Stimulative Fiscal Actions*

Taxing and expenditure actions by the Federal government, which had already become stimulative in late 1974, were even more expansionary in 1975. A decline in tax receipts and an increased growth in ex-




penditures had caused the deficit in the national income accounts budget to rise to a $25 billion annual rate in the fourth quarter of 1974 — substantially higher than the $2 billion average rate in the previous five quarters.

In the first three quarters of 1975, tax receipts in the national income accounts budget were $20 billion (annual rate) lower than in the three previous quarters, partially as a result of the rebates in the spring and early summer and lower withholding rates effective June 1. Moreover, Federal expenditures jumped at a 19 percent annual rate in the first three quarters of 1975, after rising at an already rapid 11 percent pace from the end of 1970 to the end of 1974. As a result, in the first three quarters of the year, the national income accounts deficit leaped to $76 billion (annual rate). The largest previous annual deficit since World War II was $22 billion in 1971, and the peak war deficit was $55 billion in 1944.

### *Market Adaptation to Supply Constraints*

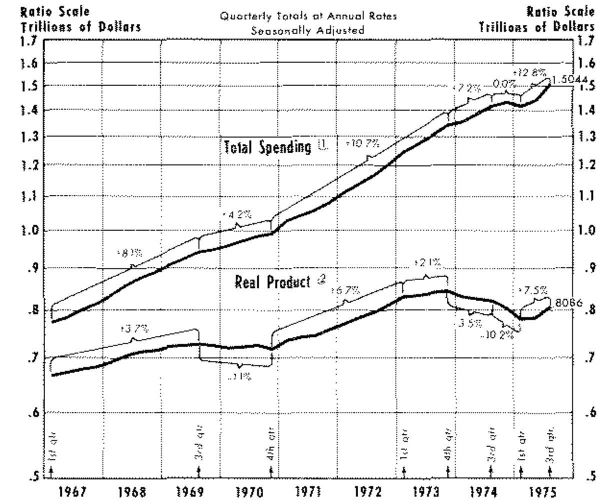
Decisions are made and actions are taken by economic agents which move resources to their highest expected returns; once a resource plan is implemented, however, it is costly and time-consuming to change. For example, machinery designed to produce one commodity is not easily converted to the production of another. Employees cannot be quickly retrained in jobs requiring different skills. Hence, when unexpected supply constraints, such as the increase in energy prices, cause many forms of activity to be curtailed, total output decreases markedly. Since adjustment to such a development takes time, the produc-

[2] Of course, such targets can be revised at any time as economic conditions change. Initially, the 5 to 7.5 percent target for money was from March 1975 to March 1976.

tive capacity of the system recovers only gradually. To the extent that these events and regulations make some of the existing productive equipment obsolete, the ability to produce goods and services is reduced permanently.

The performance of productivity is consistent with the view that the markets did adjust somewhat to the supply constraints. Output per hour of all persons, after a slight contraction in the first quarter of 1975, rose at a 7 percent annual rate from the first to the third quarter. This was a marked reversal from the 4 percent decline during 1974 when higher energy costs, combined with environmental and other controls, made existing capital less efficient. For comparison, during the 1969-70 recession, output per hour of all persons rose at a 1.7 percent pace, and in the first two quarters of recovery increased at a 5 percent rate.

Demand and Production




Source: U.S. Department of Commerce

[1] GNP in current dollars.
[2] GNP in 1958 dollars.
Percentages are annual rates of change for periods indicated
Latest data plotted: 3rd quarter

## RESPONSE OF THE ECONOMY IN 1975

The response of the economy to expansionary developments in 1975 was not immediate. The recession deepened in early 1975, with the turnaround delayed until spring. Inflation, on the other hand, began subsiding early in the year.

### *Recession Continues In Early 1975*

Total spending on goods and services changed little from the third quarter of 1974 to the first quarter of 1975. By contrast, total spending had risen at an average 8 percent annual rate from 1965 to 1974. A contributing factor in bringing the growth of spending to a halt was the marked reduction in the growth of the money stock which had begun in mid-1974.

Although *total* spending was about unchanged from the fall of 1974 to the spring of 1975, market forces and government actions produced different impacts on various sectors of the economy. Sales of automobiles fell at a 31 percent annual rate from the third quarter of 1974 to the first quarter of 1975. This drop reflected many factors, including the jump in gasoline prices, higher auto prices resulting from mandated safety and pollution devices, and the inability of automobile manufacturers to quickly alter the types of autos produced in response to changed consumer demand. Housing expenditures dropped at a 42 percent rate, in part because of a large existing stock of homes and a pronounced rise in construction and land costs in recent years.

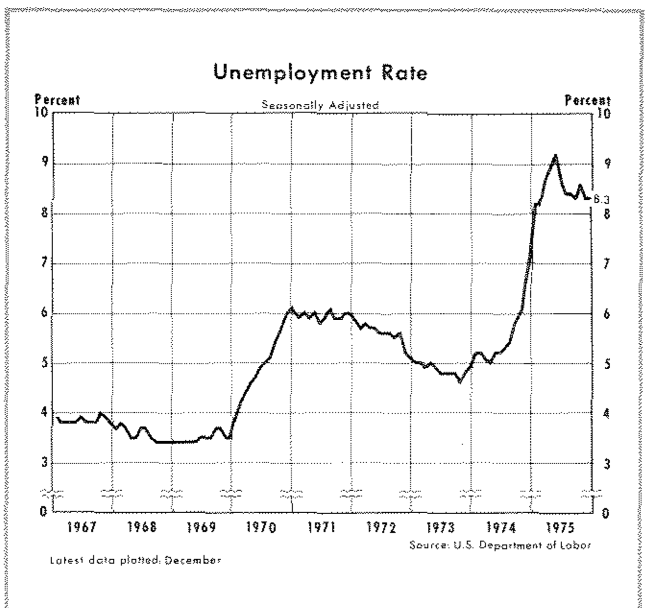
Also, after growth of spending on goods and services began to falter in late 1974, business inventories began to contract sharply. From the fourth quarter of 1974 to the first quarter of 1975, the decline was at a $19 billion annual rate. Earlier, businessmen had built up inventories to unusually high levels relative to sales, partly to hedge against possible shortages if price controls were reimposed and partly because of profit opportunities with sharply rising prices. By contrast, consumer expenditures for services and nondurable goods and government purchases continued to expand in late 1974 and early 1975.

Real output, which began contracting in late 1973, declined sharply in late 1974 and early 1975. From the third quarter of 1974 to the first quarter of 1975 the gross national product in real terms fell at a 10 percent annual rate. Industrial production dropped at a precipitous 23 percent rate from October 1974 to the trough in April 1975, with firms in most industrial categories sharing in the decrease. The greater drop in output beginning in the fall of 1974 reflected primarily the pause in growth of total spending.

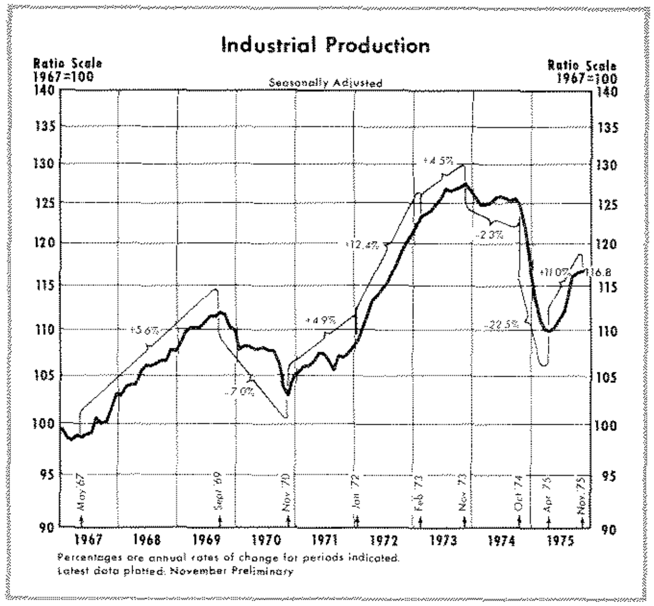
According to most measures of economic activity the 1973-75 recession was the deepest since the 1930s. For example, from the peak in late 1973 to the trough in early 1975, real output declined 8 percent. By comparison, in the 1969-70 contraction real output decreased 1.4 percent. Nevertheless, the 1973-75 adjustment was mild when compared with the 31 percent drop in real output from 1929-33.

During the recession, employment displayed more strength than most other broad measures of activity. Demand for goods and services rose relatively rapidly during much of the recession, and employment continued to rise during most of the period. Environmental and energy constraints affected capital intensive industries most severely, and consumption patterns shifted toward services and those commodities which utilize a relatively large proportion of labor. Total employment rose in the initial state — November 1973 to September 1974. From September 1974 to March 1975, when production fell sharply, employment did decline. However, even before production turned up, employment began to expand. Relative strength in employment is reflected by the fact that 63 percent of the noninstitutional population of labor force age (16 through 64) was employed in early spring, compared to 62.4 percent in the relatively prosperous year of 1965.

Despite the large number of people working, the number unemployed rose substantially during the 1973-75 recession. Unemployment rose from less than 5 percent of the labor force in 1973 to a peak of about 9 percent in May 1975. During the previous recession the unemployment rate rose to about the 6 percent level. In some areas of the nation, however, a number of jobs remained unfilled, despite large unemployment in the area.




The paradox of high unemployment at a time when a large portion of the population held jobs reflects a rise in the labor force participation rate. A larger proportion of women have entered the labor force in recent years. Also, second and third members of many households have sought jobs to maintain income or to meet the higher costs of living.



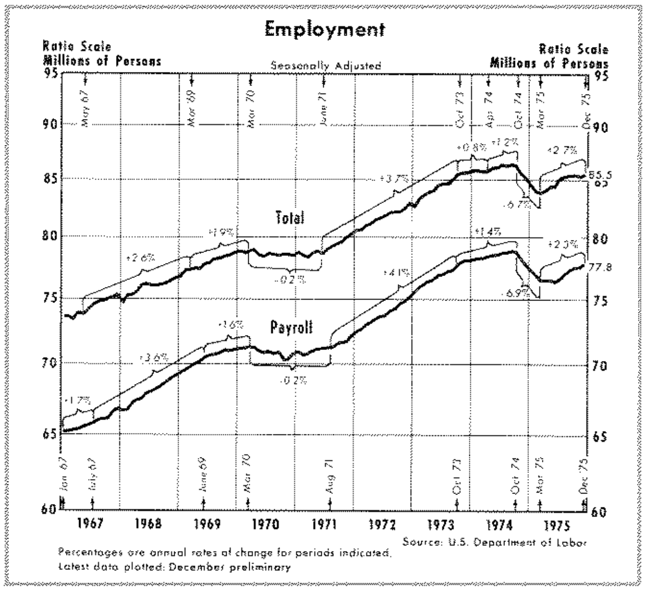

## *Turnaround Occurred In The Spring*

In the spring of 1975, growth of total spending on goods and services began to accelerate. Short-run stimulative forces affecting total spending included the tax reductions and rebates which added to disposable incomes of households. In addition, there was a rapid increase in Government spending. The rate of money stock growth increased sharply early in the year.

As a result of these expansive forces, total spending on goods and services rose at a 13 percent average annual rate from the first to the third quarter of 1975. Starting in the spring of 1975, production began increasing, in response to both the increase in spending and a continued dissipation of the constraints on production. From the first to the second quarter real gross national product rose at a slow 2 percent annual rate, but in the following quarter it jumped at a 13 percent pace. Industrial production inched up from April to May and increased at a 17 percent annual rate from May to September.

The pace of the economic recovery moderated during the fall. Growth in retail sales hesitated from July to September, and industrial production increased at a 4 percent annual rate from September to November. Both fiscal and monetary developments became less expansive after mid-year.

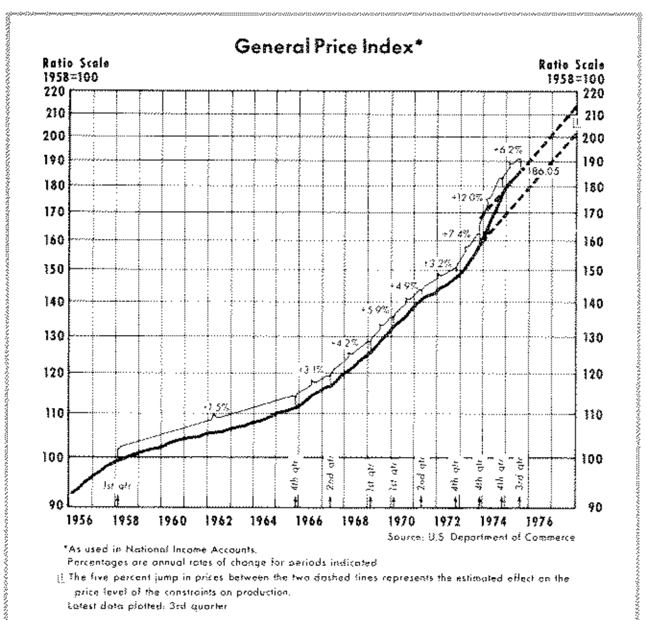
As a result of expanding output, employment rose at a 4 percent annual rate from March to September, about double the growth rate of population of working force age. From September to December employment changed little, but payroll employment, which usually




fluctuates less within short periods, increased at a 2.5 percent rate. By December the unemployment rate declined to 8.3 percent, a marked decrease for an early recovery period when producers usually expand production by using existing employees more efficiently.

## *Inflation Subsides*

The bulge in the pace of inflation, which was felt in 1973 and 1974, peaked in late 1974, and the recorded rate of price increases decelerated in 1975. The economy was again able to expand production in 1975, and consumption patterns shifted in response to the earlier sharp shifts in relative prices. Consumer prices




advanced at a 7 percent annual rate in the first eleven months of 1975, following a 12 percent jump in 1974. The general level of prices (GNP deflator) increased at a 6 percent pace in the first three quarters of 1975, after rising 12 percent in 1974.

Despite these gains in 1975, the rate of inflation remained relatively rapid. From 1955 to 1965, general prices crept up at an average 2 percent per year rate, and from 1965 to 1973 prices rose at an average 4 percent rate. The 6 or 7 percent rate of inflation in 1975 reflected primarily demand conditions. Earlier fiscal and monetary developments had stimulated total spending excessively and had gradually built up higher price expectations and upward price pressures as some prices responded sooner than others to the expansion in demand. In addition, some constraints remained which probably reduced the ability of the economy to produce certain commodities.

## ECONOMIC OUTLOOK

The bicentennial year of 1976 will probably be one of continued increases in output. The upward thrust of spending, production, and employment, despite some loss of momentum last fall, appears to be strong as the new year commences. Although starting from a much lower base than in previous recovery periods, productive capacity is now rising at a more normal rate. Moreover, monetary developments in 1975 were expansionary, on balance, and the targeted money growth through the first three quarters of 1976, if attained, should contribute to a further strengthening in total spending during the year. Although the data probably understate the degree of capacity utilization, the nation still has idle resources, and the individuals and businesses that own these resources have an incentive to make them productive and profitable. Hence, it is likely that 1976 will be a year of continued economic recovery and expansion.

The rate of inflation, which moderated in 1975, should slow further in early 1976. Continued adjustments by businesses and consumers to the higher cost of energy and other constraints on output should cause the rate of price increase to moderate. Nevertheless, significant progress in reducing inflation during 1976 is unlikely in view of the price expectations generated by the average 6 percent rate of growth in the money stock since 1965 and the continued upward push on prices as the adjustment to this trend of money permeates the economy.

Despite the generally optimistic outlook, it is likely that both underutilization of resources and inflation will remain problems throughout 1976 in view of the current state of production, dislocations caused by the exogenous constraints on production, and the price expectations gradually built up over the past decade. Vigorous attempts to solve quickly either the unemployment or inflation problem singly would probably cause the other to intensify.

Faster progress could be made at reducing the rate of inflation while contributing to economic expansion by improving the functioning of the nation's market system. Actions should be taken to make prices more responsive to demand and supply shifts and to improve economic efficiency and incentives. These include reducing subsidies, tariffs, and import quotas, eliminating restrictions on production, encouraging capital formation, improving skills of workers, and modifying minimum wage laws to improve job opportunities for the inexperienced and handicapped.