THE WHITE HOUSE

WASHINGTON

September 24, 1975

ADMINISTRATIVELY CONFIDENTIAL

MEMORANDUM FOR: ALAN GREENSPAN

FROM: JAMES E. CONNOR JEC

SUBJECT: Article from Grand Rapids Chamber of Commerce Magazine

The attached article was returned in the President's outbox with the following notation:

> "Noticed this in the Grand Rapids Chamber of Commerce monthly magazine. We need more of this kind of local propaganda."

Please follow-up with appropriate action.

cc: Don Rumsfeld

THE WHITE HOUSE
WASHINGTON

Alan Greenspan

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guest editorial

The Recession: *The Corner Has Been Turned*

by Professor
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THE LAST TWO years have been rough times for the U.S. economy. The immediate problems which comprise both very high unemployment and high inflation rates began at the end of 1973 with the quadrupling of oil prices. This and other factors contributed to a sharp decline in real economic activity in the first quarter of 1974 and mild declines next two quarters as the higher energy prices worked their way through the economy and reduced the potential supply of goods and services below what it would have been without those price increases.

Then, in the Summer of 1974, Detroit brought out its 1975 model cars which went largely unsold due to higher price tags, apparently unwanted equipment, lower consumer real incomes, anticipatory buying early in the year, and the public's pessimistic view of the short-term and long-term prospects of the economy.

At the same time, it became apparent in other industries, as well, that inventories were piling up rather than being sold — a fact that had been obscured by the distortion of inventory-sales ratios because of inflation. Thus, pronounced weakness in demand became evident to the business sector.

As auto makers cut back production and other businesses attempted to liquidate their inventories, the economy took a sharp nosedive — one of the sharpest declines on record. Gross National Product, after adjustment for inflation, dropped at an annual rate of about 10% in the six months ending March, 1975. Unemployment skyrocketed to its highest level since the Great Depression hitting 8.5 million people — a rate of 9.2% — in May 1975.

The purpose of this piece is to indicate that the recession is over and that an upturn is probably underway. Even though the headlines may continue to convey some bad news, there are strong and almost universal signs that the trough has been reached. This does not mean, however, that our economic problems are over, by any means. Unemployment will fall slowly and real income will probably rise moderately in the near term, and other problems may be lurking in the wings.

Overall, then the outlook is cautiously optimistic. The reasons for this view are several. Consumer confidence has improved and the Federal tax-rate reductions and rebates, in the first half of 1975, have raised the National Personal Disposable Income of the household sector. Both have stimulated consumer demand. Also monetary policy has eased tremendously since mid 1974, stock prices have risen strongly and inflation has slowed to about one-half the 1974 rate.

The tax cuts and escalating expenditures at the Federal level have raised the spector of record peacetime deficits that some argue will ultimately be inflationary. While not dismissing this possibility, it should be noted that the deficits are premised on a depressed economy, and an upturn will generate higher tax revenue and take some pressure off government spending for "income maintenance" purposes. Thus, the projected deficits may overstate the deficits that will, in fact, materialize. In addition, the financing of the deficits will be done largely out of loanable funds not being used by the housing industry and for business investment. Indeed, commercial bank lending to business firms has been declining since the end of 1974. Ultimately, however, some part of the deficit will be financed by increased money creation, and appropriate increase in the stock of money is also needed to help stimulate the economy. This does not mean to say that the financing of Federal Deficits in the securities markets will not crowd out some private financing and expenditures, but this is not expected to be significant until 1976.

Indeed, the growth of the stock of money (variously defined) has been so rapid since January 1975 that the Federal Reserve has, of late, been attempting to get new money creation under control before inflation is restimulated. The monetary growth, in the first half of 1975, has been well above the "Fed's" announced targets of a 5-7½% increase for the 12 month period starting in March 1975. After dropping to about 5% (less than one-half of their 1974 summer highs), short-term interest rates have turned sharply upward in mid 1975 as the Fed has attempted to regain control over money expansion. However, long-term rates have not moved significantly lower over the last 12 months, due to the expected effects of Federal deficit spending, continued but reduced inflation, and attempts by business to fund short-term debt with more appropriate long-term obligations.

Total demand will be marginally stimulated by other sectoral tax changes, such as the tax credit on new homes which should help new home construction even with the very high mortgage rates still with us. Also, the increased investment tax credit for business-fixed investment will also help in 1975 but will have most of its effect after the recovery is well under way because business investment lags behind overall economic activity. Although this could provide stimulus later, rather than sooner when it is most needed, it is imperative that business be given more incentive for capital formation to head off the enormous shortages of real capital projected for the decades ahead.

OPTIMISM NOTED

The strong rise in stock prices since the end of 1974, even with the mid 1975 "correction", has increased the monetary wealth and the confidence of the consumer sector and reflects the optimism of stock market participants that the recession is over and the belief that the recession would reduce inflationary pressures. Indeed, the inflation rate has been moderating far faster than most observers had anticipated. This is reflected in the Consumer Price Index, the overall GNP price deflator, and in the Wholesale Price Index. Also, the rise in the prices of industrial commodities on the wholesale level, has been very moderate compared to last year. All of this in spite of the mid-year blips in consumer and wholesale prices which, hopefully, are temporary and not the beginning of a new round of virulent inflation.

Solid indications that the bottom has been reached can be seen in the "leading indicators" and in industrial production. The index of key indicators that "lead" overall economic activity has been rising strongly since February and the index of total production in factories, utilities and mines bottomed out in April and May and has risen moderately since. The vast majority of the less comprehensive indicators of economic activity are consistent with the assessment that the economy has stopped its slide and that some sort of recovery is beginning.

The decline in real GNP stopped in the second quarter of 1975. The GNP increased in the Second Quarter — the first increase since late 1973. The components of aggregate demand are also beginning to show strength. Consumption expenditures in real terms have risen in the first half from their fourth-quarter decline in 1974. A strong contributor to this was a rise in purchases of durables led by auto sales. Additional strength was evident in purchases of nondurables and services which narrowly outpaced the inflation rate on the CPI. Retail sales have been rising sharply throughout 1975 after sharp declines in the latter part of 1974. The situation with investment expenditures is still mixed, however. Business fixed investment continues to decline in both money and real terms, but it traditionally lags the economy and wouldn't be expected to turn around this early, even without the uncertainty concerning the future on the part of business and the continued high long-term interest rates. The huge overhang of business inventories is being worked off at a record rate in the first six months of 1975. Most analysts believe the purge of unwanted inventory is near its end, and this is a harbinger of increased production in the near term. Residential construction has bottomed out at about 1 million starts (seasonally adjusted annual rate) and is showing sporadic growth.

Government purchases of goods and services, at all levels of government, continues to hold roughly constant in real terms. This does not include the explosion in transfer payments (unemployment compensation, food stamps, ADC payments, etc.), in the Federal budget, which is closely but not totally related to the recession.

Although the recovery is very young, there are welcome signs that it is starting to have a positive impact on the labor market. The number of unemployed workers has declined from the May high, and the number of employed workers has been rising for several months. The employment rate also fell to 8.4% in July. Even the auto ... 1974, has been showing output and employment increases through most of 1975.

It is doubtful, however, that the turnaround will produce a "V" shaped recession (the first half of which we have already seen), because the stimulus to demand of two basic industries — auto and construction will be muted by higher prices on those items, the pessimism of consumers concerning the long-run economic outlook, and continued high long-term interest rates. These industries are classic cases of deficient demand accompanied by upward pressure on costs and prices. Although these are problems pertinent to particular industries, they will tend to prevent a sharp recovery for the economy as a whole, will hold the unemployment rate high and allow it to decline only slowly.

Although the above assessments may still prove to be premature in terms of the ascent from the recession, there are still many pit-falls ahead that could abort the recovery on one hand, or send it out of control, on the other. The federal government must be responsible in its spending and taxing policies and get expenditures under control. More fiscal stimulus than already projected would probably have its impact when the upturn is well underway and add to the inflationary pressures. Monetary policy must, within a short time, begin to hold monetary growth to a much less inflationary rate that we had seen in the last decade. Labor unions must be moderate in their wage and fringe package demands so unit labor costs can be held to non inflationary levels. This means that "catchup" and anticipatory wage increases will have to be minimal. If not, we will be back to the cost-push inflation phase of the price-wage spiral. In addition, the anticipated "bumper-crop" surplus in agriculture is being reduced by drought and strong export demand. This will prevent some of the relief earlier anticipated in food prices. Even barring further sizable rises in the price of imported petroleum and more setbacks in agriculture, the recovery is very fragile and adverse results in the above areas could turn it into a disaster. Coming out of a severe recession with six per cent price inflation leaves us in a very precarious position. ■

The views expressed in this editorial do not necessarily reflect the view of grand rapids Magazine or the Grand Rapids Area ...