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THE PRESIDENT HAS SEEN....

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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

November 12, 1975

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MEMORANDUM FOR THE PRESIDENT

From: Alan Greenspan

Subject: Background Information for Summit Meeting on the U.S. economy

As inflation spiralled upward in 1974 consumers became progressively concerned over their financial capability of meeting the ever rising costs of necessities such as food, rent and utilities. In order to be sure they could meet these future fixed costs they became very cautious spenders, especially on postponable big ticket items such as homes, automobiles and household goods. Hence starting in the fall of 1974 consumers started to retrench. Retail sales in real terms fell, and manufacturers, unprepared for the consumer retrenchment, found themselves confronted with an unexpected and unwanted accumulation of inventories. Cutbacks in production could not be implemented quickly enough to prevent inventories from piling up in late 1974. Worse, the decline in production caused a sharp rise in layoffs and aggravated consumer uncertainty and induced a still further retrenchment in retail buying.

Hence at the beginning of 1975, manufacturers, wholesalers and retailers found themselves choked with inventories forcing a further sharp cutback in production in order to reduce excessive stocks. As a consequence unemployment rose sharply.

Fortunately, retail sales and housing starts stabilized in early 1975 reflecting the sustaining of consumer incomes partly as a consequence of the major expansion of unemployment insurance coverage. Inventories began to run off at an increasing rate as production fell far below sales. The rate of liquidation peaked in May. For the second quarter as a whole real GNP (i.e. production) was 2.1 percent below final sales (i.e. consumption). This huge gap virtually guaranteed a significant recovery throughout the rest of this year. By September the gap was virtually closed as inventory liquidation became negligible and the level of inventories started to bottom out. For the third quarter as a whole rapidly rising real GNP was only 0.6 percent below final sales, which rose at a 4.4 percent seasonally adjusted annual rate during the third quarter. It is quite likely that the inventory correction has been overdone forcing producers to build back inventories in 1976 thereby accelerating the recovery.

But even though the inventory cycle has been the major short-term dynamic force pressing the economy upward, housing starts have risen 41 percent since December and although still quite low in historic terms, should increase from the present levels of 1-1/4 million (seasonally adjusted annual rate) to 1-3/4 million starts by the end of 1976. With the inflation rate and the layoff rate now both down significantly from their late 1974 levels, consumers are moving back into the market and retail sales have firmed measurably. Of course, the $10 billion of tax rebates and one-shot social security payments mailed out in May and June have added to consumer outlays but the best we can judge at this stage is that more than half of the $10 billion has as yet to be spent. In that sense there is a large potential nestegg to support consumer markets in the quarters ahead.

The most recent private survey (McGraw-Hill) of business plans for 1976 plant and equipment expenditures is consistent with our view that this market is reviving and should add considerably to the underlying strength in the economy during 1976. The curtailments in State and local government revenues as a consequence of the recession has slowed the growth rate in State and local government outlays quite considerably. This new trend was set in motion earlier this year and is unlikely to be affected in a meaningful way by a New York City default. All in all we are projecting a growth rate in real GNP of 7 percent between the third quarter of 1975 and the third quarter of 1976.

It is thus clear that the Administration's policy of allowing the private sector to recover without excessive stimulus is clearly bearing fruit.

We are disappointed that long-term interest rates especially mortgage rates have not fallen more but these rates reflect the inflation bias which still remains in our system. This is an element which dictates continued vigilance on the fiscal side.

The trend in unemployment is down. The temporary uptick from an 8.3% rate in September to 8.6% for October resulted mainly from quirks in the seasonal adjustment process. Our estimate based upon weekly unemployment insurance data indicates the unemployment rate this month is down. The rate at which people are being hired now consistently exceeds those being laid off. We are projecting unemployment to work its way down to a 7 to 7-1/2 percent rate by the end of 1976 and I would not be surprised if we reached that range earlier in the year.

The inflation outlook is mixed, but encouraging. The wholesale price index after being up 1.8 percent in October (but only 5.1 percent over October, 1974) may be close to zero change in November as farm and food prices are down. The CPI (released November 20) for October may be uncomfortably high. Food prices were up. However, November looks better. The underlying inflationary forces stemming from a prolonged period of very large budget deficits is something that may cause problems for us next year and in 1977. Hence your economic policy reflecting concern for inflation as well as unemployment is clearly the appropriate one.

All available evidence indicates that the U.S. is going to do appreciably better during the next year both on the production and on the inflation front than most of our trading partners in the OECD. Germany, as you know, is having difficulty working its way out of its recession (although it is doing better than we on inflation) and this is a problem which is general in Western Europe. The U.K. is, of course, an especially difficult problem owing to its own internal politics.