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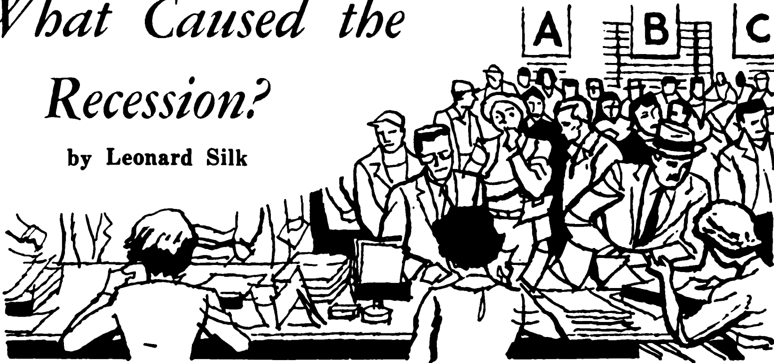
What Caused the Recession?

by Leonard Silk



A slowdown in government and consumer spending, plus sluggish monetary reflexes, caught blithe business optimism unawares

THE INQUEST into the cause of death of the late boom has begun, and it will grow more intense in the months leading up to the November elections. Did the 1954-57 boom die a natural death, or was it assassinated by misconceived Federal Reserve Board or Administration policies? Years from now, when the politicians have long since moved on to other issues, the economists' efforts to explain the third postwar recession will go on—but, as is true of all important historical events, there will never be any definite proof of what really happened or what would have happened, *if*.

Nevertheless, our civic (and professional) responsibilities impose on us the necessity of trying to understand the past, to make judgments about causation, and to profit from experience, if we can. This, then, will be one economist's premature and imperfectly objective account of the chronology and pathology of the present recession.

Every contraction in business grows out of the preceding expansion, as Wesley C. Mitchell taught all economists to say. My own inquest, therefore, starts with the events that followed the 1953-54 recession.

Although it was by no means obvious at the time, the previous recession ended in the third quarter of 1954.

The boom in 1955 went beyond virtually every economist's and businessman's expectations. By the fourth quarter of 1955, GNP had risen to an annual rate of 402.7 billion dollars—better than nine per cent above the same quarter in 1954. One remarkable thing about

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this expansion was that it was accompanied by virtually no increase in prices; the consumer price index in December, 1955 was 114.7 compared with 114.8 in December, 1953. To some extent, the continuing price stability in 1955 may have been due to the ease with which production could be expanded after the 1953-54 recession. But falling farm prices certainly were a major factor, too —wholesale farm prices fell six per cent in 1955.

In any case, the Administration congratulated itself on achieving the economist's dream performance—rapid growth at stable prices. It assumed that it had accomplished this by a wise combination of monetary and fiscal policies.

On fiscal policy, the Administration thought it had been prudently flexible. The tax reduction of 1954, put through at least in part as an antirecession measure, had reduced revenues and helped to produce a fiscal 1955 deficit of 4.2 billion dollars. But in fiscal 1956, with the boom rolling, the Administration held expenditures to a modest two-billion-dollar increase, kept a tight grip on tax rates, and produced a budget surplus of 1.6 billion dollars, which was regarded as at least mildly deflationary.

Leonard Silk is economics editor of *Business Week* magazine.

On monetary policy, the Federal Reserve—with Administration support—also performed flexibly. After flooding the economy with credit to help end the 1953-54 recession, the Fed very gradually began to shift to a more restrictive monetary policy.

To satisfy their appetites for the new pastel, multitoned automobiles and for other durable goods, consumers not only cut down their rate of saving—from a range of seven to eight per cent in the preceding four years to 5.8 per cent in 1955—but they also went heavily into debt. After virtually no change in consumer debt outstanding during the first three quarters of 1954, consumers began to step up their borrowing during the last quarter of 1954 and, during 1955, added 5.5 billion dollars to installment debt. At the same time, they borrowed heavily to acquire new houses; mortgage debt on nonfarm houses rose by 12.5 billion dollars. Since this consumer spending boom occurred at a time when the consumer price index was virtually stable, those who worried about the possibly excessive rise in consumer debt were in a small minority.

The 1955 consumer spending boom was, of course, a joy to business. As industry moved toward capacity operations, corporate profits leaped from 33.5 billion

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in 1954 to 42.5 billion dollars in 1955. Manufacturers' new orders, which had lagged behind sales until the last quarter of 1954, now climbed strongly ahead of rising sales; the monthly gap between new orders and sales averaged more than one billion dollars during 1955. Backlogs grew.

Invigorating challenge

Faced with the invigorating challenge of keeping up with booming demand—and armed with sharply increased earnings and abundant credit—business went on a spending spree of its own, building up inventories. In 1956, spending on new plant and equipment went up 6.4 billion dollars, reaching the 35.1 billion level. Capacity grew rapidly.

But in 1956, several things happened which tolled the bell for the boom:

- The rate of increase in consumer borrowing and spending was slowing down. In 1955, in current dollars, consumers boosted their spending by nearly eight per cent; in 1956, by only five per cent—and, in terms of constant prices, by little more than two per cent.
- The beautiful 1952-55 price lull had ended. During 1956, wholesale prices rose 4.5 per cent, and by the end of the year consumer prices were nearly three per cent higher.
- To check rising prices, the Federal Reserve Board tightened its grip on money and credit. Interest rates began to climb sharply. The impact on capital spending, however, was at first slight, because the banks and business firms were in a position to sell off government bonds and thereby acquire extra funds for investment.

These developments had a number of important, though delayed, boom-arresting consequences:

- The pressure for additional capacity was waning as the rise in consumer spending slowed down; while new plants—the result of past spending—were coming on stream fast.
- Tighter money and higher interest rates had a differential effect on the economy. Most significantly, FHA and especially VA mortgages, at pegged rates, became less attractive to investors; housing starts fell 15 per cent and sales of related consumer goods like appliances and house furnishings were affected.
- Consumers felt poorer—because they were. Per capita disposable income in constant dollars reached its peak in the second quarter of 1956, and started an uneven, but persistent decline that hasn't stopped yet. Well-stocked with cars and durables after their 1955 splurge, consumers sought to increase their rate of saving and

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to reduce their rate of borrowing.

- Corporate profits stopped growing; in constant prices, they declined. Some industries were able to increase profits by putting up prices faster than wages and other costs were rising. But other industries, harder pressed competitively, felt a real squeeze on profits developing.

Regarded from the standpoint of the private economy, the boom was over by the end of 1956.

But three main factors helped disguise this fact: (1) the extraordinary climb in national security expenditures which reached an annual rate of 46.3 billion dollars in the second quarter of 1957—nearly five billion dollars more than in the same quarter of 1956; (2) the Suez crisis which stimulated net foreign investments and exports; (3) rising consumer prices, which helped create the illusion of a continuing movement upward.

Indicators and evidences

Nevertheless, a number of indicators registered declines from the end of 1956 on.

Manufacturers' new orders declined continuously—from 30 billion in November, 1956 to 27 billion dollars in June, 1957, and 25 billion dollars in December. Average overtime hours of manufacturing production workers declined steadily from 3.1 in December, 1956 to 2.0 a year later. So did average weekly hours—from 41.0 in December, 1956 to 39.4 in December, 1957. Steel production dropped, and the industrial production index throughout 1957 never regained its December, 1956 peak of 147.

Despite these evidences of a waning boom, the Federal Reserve was determined to press on with its all-out war against "inflation," roughly defined as a rising consumer price index. However, with bank reserves unchanged, and time deposits sharply increased, the nation's money supply (demand deposits and currency) in 1957 declined by 1.5 billion dollars. Banks were no longer able to sell off government securities as they had done in 1955 and 1956, because their liquidity had already been drawn down about as far as they could go. However, business firms and individuals, in an effort to maintain their spending, did sell off more governments and sought to live with smaller cash holdings. As a result, their liquidity was further impaired.

The Fed's continuing squeeze on the bank reserves helped to push interest rates to levels unseen since 1929. In August, the Federal Reserve Board boosted the discount rate to 3.5 per cent.

Here were the classic boom's-end circumstances of a desperate struggle by business and the

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banks for liquidity, with the traditional postboom peak level of interest rates to help ensure that the downturn would be sharp.

Yet the event that decisively tipped the economy toward recession and unemployment was not, as in many historical breaks in prewar booms, a financial panic, but rather a budgetary decision by the Administration. In August, Defense Secretary Wilson ordered sharp cutbacks in defense spending, then running at an annual rate of about 42 billion dollars. The new order imposed a 38-billion-dollar ceiling on defense expenditures for fiscal 1958—which meant that outlays would actually have to drop well below an annual rate of 38 billion dollars for the rest of the year, since the Pentagon was already spending well above that level. Procurement orders were slashed. Air Force contractors, except those on ballistic missile projects, were ordered to reduce payroll costs five per cent by November. Progress payments were cut or held up. Many defense plants began laying off workers and slashing inventories. Coming on top of all the boom-softening factors that had gone before, that did it.

By early fall, the signs of recession were unmistakable. The industrial production index fell from 144 in September, 1957 to 130 in February, 1958. In the last quarter of 1957, business inventories swung from a rate of three billion accumulation to 2.7-billion-dollar inventory reduction—a 5.7-billion-dollar shock to the economy. Unemployment—seasonally adjusted—began shooting up from 4.3 per cent of the labor force in August (it had been 3.9 in March) to five per cent in December, and 5.8 per cent in January. Gross national product dropped from its third quarter 1957 peak of 440 billions to 432.6 billion dollars in the year's final quarter.

Genuine recession

By the time 1957 ended, it was obvious to nearly everyone (except, judging from the published record, the President's Council of Economic Advisers) that the economy was in a genuine recession. The McGraw-Hill capital spending survey in November reported that business was planning to reduce its capital spending in 1958 by seven per cent. (A later Commerce Department survey in March, 1958 found that business had reduced capital spending plans still further—to 13 per cent below 1957.)

Since this article is a postmortem and not a forecast, I shall go no further. I have already disclosed, in the above account of events from 1954 through 1957, my own principal conclusions

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about the causes of this recession. Perhaps I should very briefly sum them up:

- The extraordinary consumer spending boom of 1955, fed by cheap and abundant credit, boosted corporate earnings, pressed against the capacity limits of industry, and greatly raised business expectations.
- These events triggered rapid business inventory accumulation and greatly increased spending for new plant and equipment.
- During 1956 and 1957, consumer demand grew at a slower pace than business had anticipated, and the capital spending boom bred excess capacity. At the same time, the slower rate of rise in demand meant that further inventory building was unnecessary—indeed, that inventories were too heavy.
- The impending downtrend was delayed in early 1957 by rising military outlays and by Suez. But increasingly tight monetary policy coupled with the drastic cut in defense orders and defense spending in the late summer and early fall helped to aggravate the recessive factors that had developed during the preceding two years and to produce the sharp downturn in the fourth quarter of 1957.

The cynic says that history teaches us only that history teaches us nothing. At minimum, though, I believe that events of the past few years have raised some basic questions for which we must find answers if we are to preserve the stability, health and life of the next economic expansion more successfully than we did the last one.

Does the economy need more freedom or more effective direction and regulation? If the latter, have we relied too heavily on general monetary controls, too little on selective regulation not only of credit but perhaps also of wages and prices in key industries, and too little on fiscal policy? Do we need a new top-level agency for determining and coordinating national economic policy? What weight should be given to the aim of preventing inflation—of what amount—as against the aim of preventing unemployment—of what amount?

Before the "great debate" on these economic issues had got very far last year, the problems of prosperity gave way to those of recession. Let's hope that worries over how to handle a boom will be back with us soon—and that next time we'll have better answers to them. ■

Record in Spending

CURRENT annual expenditures of state and local governments total a record 37 billion dollars—about 8.5 per cent of total national output.

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