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REVIEW

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1975 – Year of Economic Turnaround

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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.

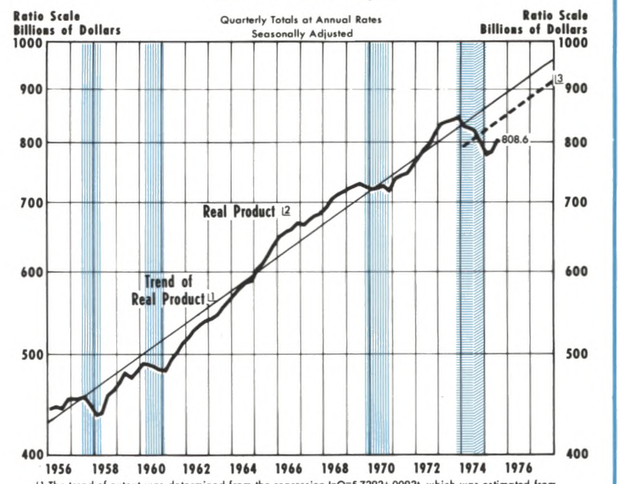
However, since the imposition of price controls in 1971, changes in normal supply relationships have become an important force in shaping economic developments, especially since 1973. While total spending for goods and services was rising rapidly, the economy was hit by a number of supply constraints. 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

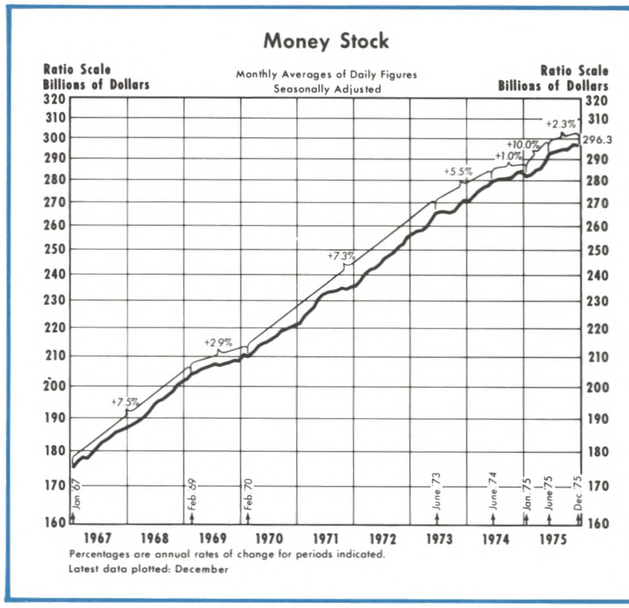
Early in 1975 monetary actions became much more expansionary, but the pace of monetary injections moderated after June. Growth in the monetary base, which is dominated by the Federal Reserve credit component, increased at an 8 percent average annual rate from January to December 1975. From January to 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.

RESPONSE OF THE ECONOMY IN 1975

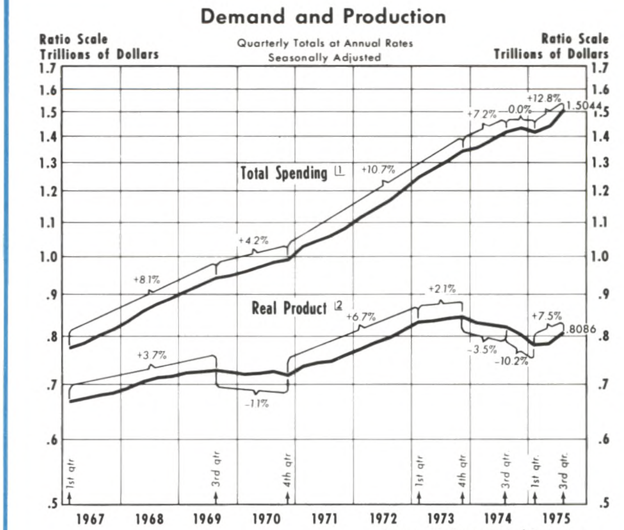
The response of the economy to expansionary developments in 1975 was not immediate. The recession deepened in early 1975, with the turnaround delayed until spring. Inflation, on the other hand, began subsiding early in the year.

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



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

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.

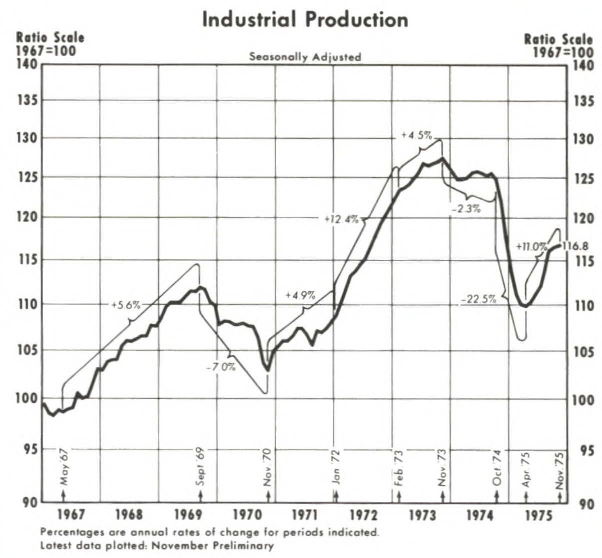
Real output, which began contracting in late 1973, declined sharply in late 1974 and early 1975. From the third quarter of 1974 to the first quarter of 1975 the gross national product in real terms fell at a 10 percent annual rate. Industrial production dropped at a precipitous 23 percent rate from October 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.



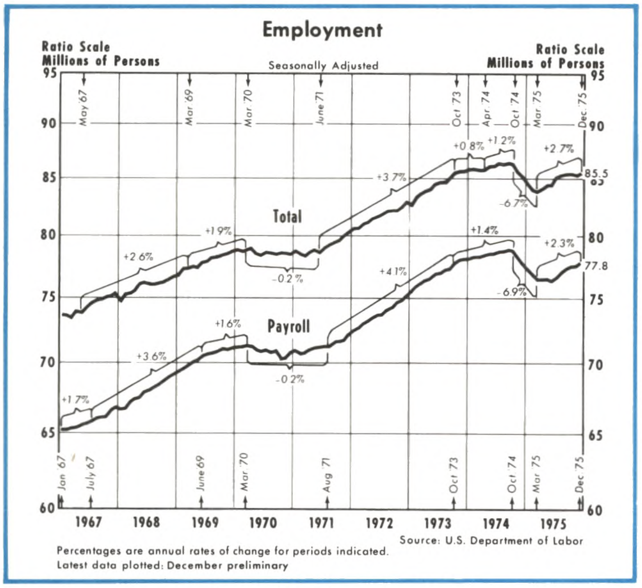
Turnaround Occurred In The Spring

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.

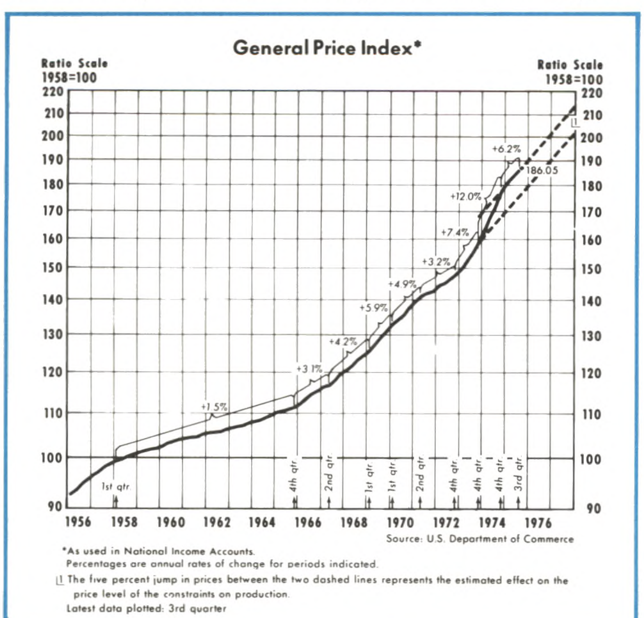
As a result of expanding output, employment rose at a 4 percent annual rate from March to September, about double the growth rate of population of working force age. From September to December employment changed little, but payroll employment, which usually



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.

Foreign Trade and Exchange Rate Movements in 1975

HANS H. HELBLING

INTERNATIONAL economic relations of the United States, just as domestic ones, were heavily influenced by the recession of 1974-75 and by the resultant economic policies undertaken by most U.S. trading partners. U.S. merchandise trade responded to both the longer-term depreciation of the dollar and to differences in the severity and timing of the recessions here and abroad. Short-term fluctuations in capital movements and exchange rates were dominated by differential growth in output, differences in monetary and fiscal policies, and differences in interest rates among trading nations.

After briefly sketching economic conditions prior to 1975, this article discusses the trade and exchange rate developments which occurred during 1975. In addition, a listing of some institutional developments which will probably have an influence on international economic activity in the future is provided.

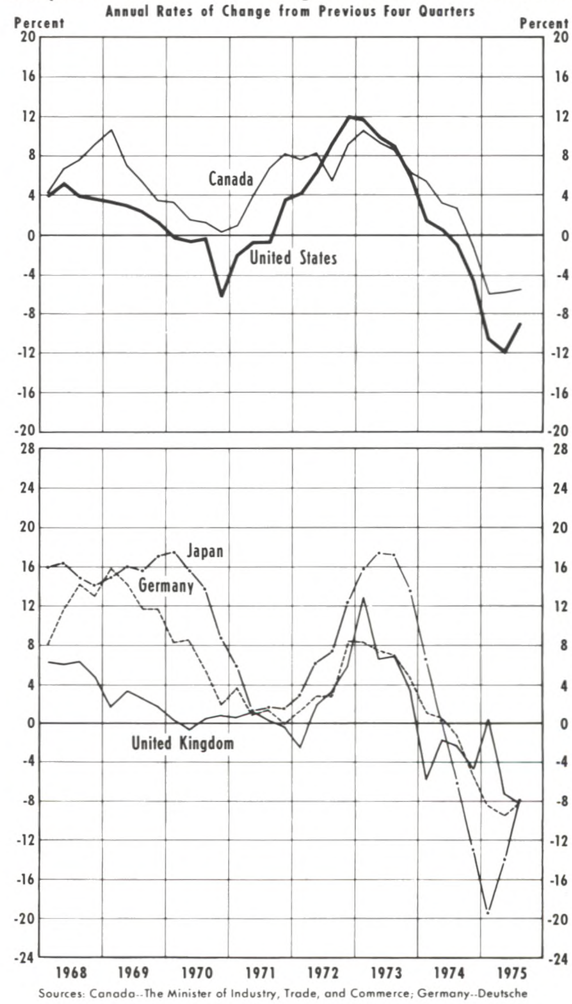
ECONOMIC SETTING

The recessions experienced in the major industrial countries in 1975 represented a continuation of a cyclical downswing which started in late 1973. In early to mid-1973, most countries had been concerned about high and accelerating rates of inflation and had adopted policies intended to reduce inflationary pressures. These policies usually took the form of reduced rates of monetary growth. This was most pronounced in Germany, Japan, the Netherlands, Switzerland, and the United Kingdom.

The recessions were aggravated in late 1973 when the Organization of Petroleum Exporting Countries (OPEC) imposed an embargo on oil exports. Expectations were that the embargo would adversely affect real economic growth in the industrial countries, but that business slowdowns would not degenerate into severe recessions. In addition, stimulative economic policies were considered inappropriate at this time, as policymakers were still concerned with inflation.

Comparative Rates of Change of Industrial Production

Annual Rates of Change from Previous Four Quarters



Sources: Canada--The Minister of Industry, Trade, and Commerce; Germany--Deutsche Bundesbank; Japan--The Bank of Japan; United Kingdom--Central Statistical Office; United States--Federal Reserve Board

Toward the end of 1974 and into early 1975, however, economic conditions in most countries deteriorated more rapidly than expected, and most foreign countries responded with stimulative monetary policies. In contrast, monetary growth declined in the United States from the third quarter of 1974 through the first quarter of 1975.

Table I

INDUSTRIAL PRODUCTION

Compounded Annual Rates of Change

		United States	Belgium	Canada	France	Germany	Italy	Japan	Netherlands	United Kingdom
1974	November	−26%	−26%	−12%	−40%	−10%	−35%	−28%	0%	− 4%
	December	−35	−52	− 8	−27	−43	−32	−33	−45	−21
1975	January	−32	53	−25	11	0	19	−43	−10	16
	February	−23	−19	12	0	0	46	−16	0	− 1
	March	−12	−35	− 7	−27	0	−40	4	36	−19
	April	− 1	12	− 2	0	−11	12	50	−41	−18
	May	2	−55	− 8	−35	−11	−44	7	11	−21
	June	12	97	3	72	0	88	19	0	0
	July	13	−55	− 2	−28	−21	3	29	−48	8
	August	24	−45	1	0	27	NA	−17	39	−12
	September	22	305	−21	−10	12	NA	21	24	10
	October	5	NA	NA	NA	NA	NA	8	NA	NA
	November	2	NA	NA	NA	NA	NA	NA	NA	NA

NA — Not Available

Sources: *Canadian Statistical Review*, The Minister of Industry, Trade, and Commerce; *Economic Statistics Monthly*, The Bank of Japan; *Economic Trends*, U.K. Central Statistical Office; *International Financial Statistics*, IMF; *Main Economic Indicators*, OECD; *Monthly Report of the Deutsche Bundesbank*, Deutsche Bundesbank; Federal Reserve Board.

In early 1975 the consensus among analysts was that real economic growth in most industrial countries would resume in the second half of 1975, with recovery abroad preceding that of the United States. By mid-year, however, the U.S. economy appeared to be moving out of the recession, while its major trading partners were still searching the economic horizon for signs of a turnaround.[1]

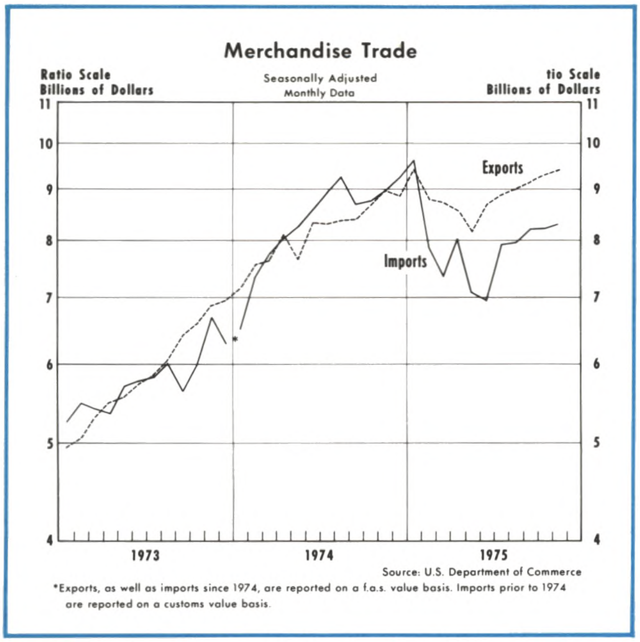
As economic activity in the United States improved early in the second half of 1975, many foreign policymakers became impatient with the pace of recovery (or lack thereof) in their own countries. Suspecting that more stimulus on the part of the United States would not be forthcoming, many foreign governments adopted a new series of economic policy measures, mainly in the fiscal area. For example, in August Germany announced a supplementary budget proposing an increase in expenditures of more than 15 billion marks for new construction programs and unemployment assistance. Denmark, at that time, also announced a new program to stimulate the economy via a combination of tax reductions and expenditure increases. Beginning in September, various other governments, including Belgium, France, Japan, the Netherlands, and the United Kingdom, also announced the introduction of stimulative fiscal measures. At this time it appears that the economies of Canada, Germany, and Japan, in addition to the United States, have moved out of the recession, while for many other countries a turnaround has not yet materialized.

In summary, the economies of major industrial countries were in different stages of recovery during 1975. Adjustments to prior output shocks and restraints were nearing completion and stimulative fiscal and monetary policies were beginning to take effect. While the recovery was relatively strong in the United States, it was just beginning to manifest itself in some of the foreign trading nations in the latter half of the year. Thus, the differential rates of economic recovery were primarily responsible in shaping international transactions in 1975.

MERCHANDISE TRADE DURING 1975

The depth of the U.S. recession, as well as the decline in the international value of the dollar which began in 1971, manifested itself in smaller U.S. purchases from, and relatively larger U.S. sales to, foreign trading partners. This resulted in a $10.6 billion excess of U.S. merchandise exports over imports in the first eleven months of 1975. Beside the depreciation of the

[1]For example, an economic forecast issued in October by OECD for the organization's 24 member countries suggested a combined annual rate of decline of 2.5 percent. In July, for comparison, the organization's forecast suggested a decline of GNP of only 1.5 percent. However, in its October forecast, the OECD noted, that for the member countries as a whole, the low point in economic activity has already passed.



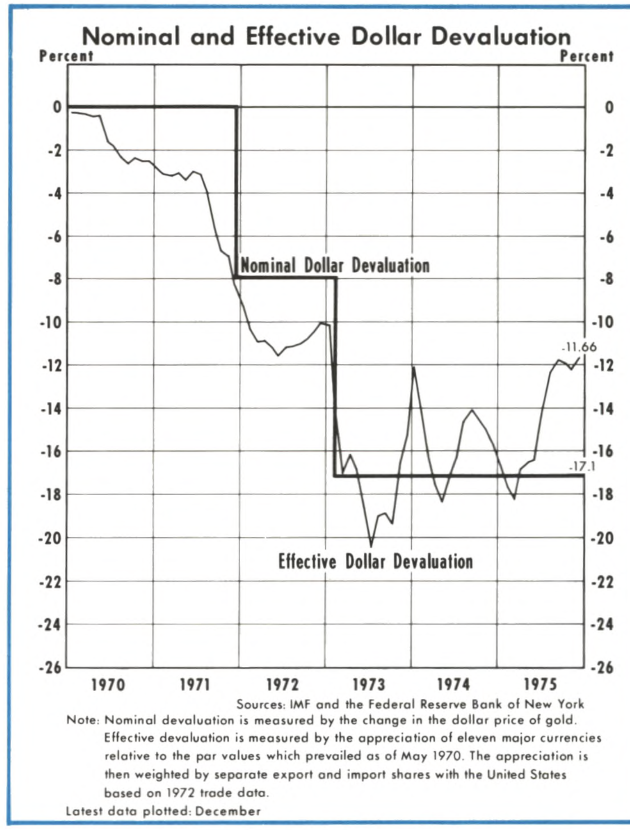
dollar, some additional factors contributed to this turnaround in U.S. merchandise trade. Agricultural exports remained relatively high and OPEC purchases of U.S. goods increased from about $4 billion in the first three quarters of 1974 to about $7 billion in the first three quarters of 1975.

While in the first quarter of 1975 the rate of increase of U.S. merchandise exports slowed to a 9 percent annual rate (compared to a 28 percent annual rate in the fourth quarter of 1974), U.S. imports decreased absolutely at a 33 percent annual rate (compared to a 10 percent annual rate of increase in the fourth quarter).[2]

During the second quarter of 1975, U.S. merchandise exports exceeded merchandise imports by an impressive $13.4 billion annual rate. In this period both exports and imports declined absolutely at annual rates of 20 percent and 40 percent, respectively.

During the third quarter, U.S. merchandise exports still exceeded imports, but by less than during the second quarter. This occurred as both merchandise exports and imports shifted from negative to positive rates of growth. In terms of product categories, U.S. agricultural exports increased somewhat compared to last year, and manufactured goods, such as machinery and transport equipment, increased substantially over 1974. While merchandise exports to Japan declined during the first half of 1975, those to Western Europe increased.

[2]The growth rates of merchandise trade are calculated from balance-of-payments data.



THE U.S. DOLLAR EXCHANGE RATE

On balance, the U.S. dollar appreciated during 1975. However, there were two distinct exchange rate phases in 1975 during which the U.S. dollar first fell and then rose in value vis a vis the major foreign currencies. The first phase extended through the first quarter of 1975; the second phase extended from April to the present.

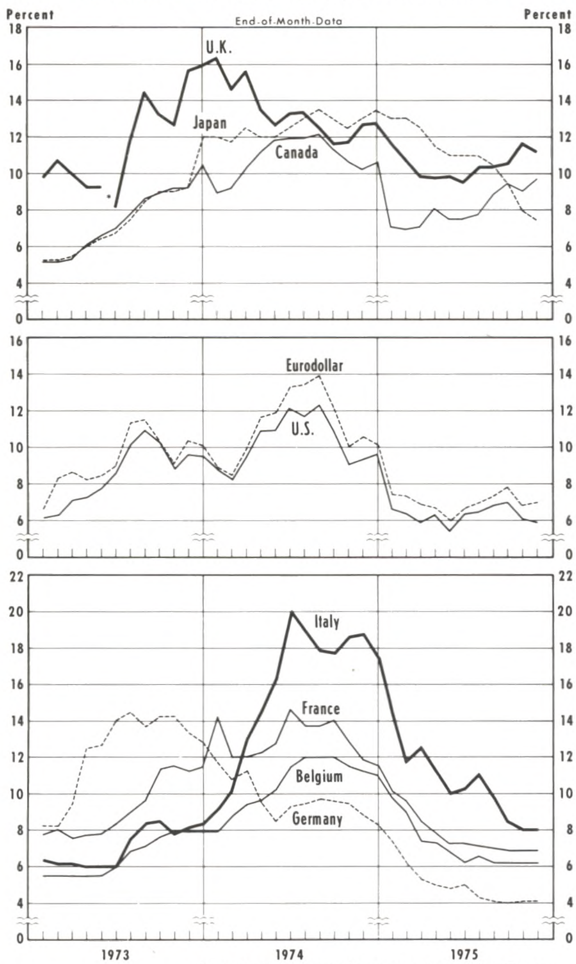
First Phase

The dollar exchange rate began to depreciate in September 1974 and continued to decline through the middle of the first quarter of 1975. As measured on a trade-weighted basis, the international value of the dollar in September 1974 was 14 percent below its May 1970 value.[3] In March 1975 the dollar's value had fallen 18 percent below its May 1970 value — a 29 percent decline from September 1974.

The general decline in the value of the dollar during this period may be attributed to interest sensitive short-term capital outflows. Because the decline in business activity was generally more pronounced in the United States than abroad, a sharp drop in the

[3]The trade-weighted dollar depreciation is measured by the appreciation of eleven major currencies relative to the par values which prevailed as of May 1970.

Selected Short-Term Money Market Rates [1]



Source: World Financial Markets, Morgan Guaranty Trust Company

[1] The following rates were used:
Belgium—4-month Fondes des Rentes certificates
Canada—3-month prime finance company paper
France—3-month interbank money against private paper
Germany—3-month interbank deposits
Italy—interbank deposits of up to one-month maturity
Japan—call money rate
United Kingdom—3-month local authority deposits;
*3-month interbank deposits
United States—3-month prime industrial paper
Eurodollar—prime bank's bid rate for 3-month deposits in London

demand for credit resulted in a decline in U.S. short-term interest rates *relative* to those in other countries. As illustrated in the accompanying chart and in Table II, during the first quarter of 1975, U.S. short-term interest rates were falling relative to those in Belgium, France, Germany, and the United Kingdom. As a result, the incentive to invest in these countries increased and holders of short-term dollar-denominated assets switched to short-term assets denominated in other currencies.

Second Phase

Several developments began during the second quarter of 1975 which led to the appreciation of the dollar. Various economic indicators in the United States conveyed signs of impending economic recovery, while, as was mentioned earlier, recovery abroad was not yet visible. In addition, U.S. short-term interest rates began to rise relative to short-term rates in other countries. As a result, the incentives for short-term capital inflows began to shift in favor of the United States. During the second quarter, net short-term private capital outflows decreased from the first quarter annual rate of $25.5 billion to an annual rate of $10.6 billion.

During the third quarter a continuation of the second quarter trend led to a further appreciation of the dollar. Short-term interest rate differentials increasingly favored inflows of short-term private capital into the United States, and the United States registered a third quarter net *inflow* of short-term private capital of $18.5 billion. Thus, the appreciation of the U.S. dollar during the second and third quarter can be largely attributed to both the rise in U.S. short-term interest rates relative to those in other countries and the subsequent changes in short-term capital flows.

SOME INSTITUTIONAL CHANGES IN 1975

Related to Exchange Rates

The first quarter decline of the dollar exchange rate precipitated changes in some institutional arrangements within the area of international finance. For example, in mid-March four Middle East countries severed the link between their currencies and the U.S. dollar. Iran, Saudi Arabia, Kuwait, and Quatar announced the decision to tie the exchange rates of their currencies to SDRs.

In addition, the European Economic Community in late March decided to terminate the relationship between the communities' Unit of Account (UA) and the U.S. dollar.[4] The UA is now valued in terms of a basket of member country currencies. The intent was to insulate internal EEC financial settlements from fluctuations in exchange rates of member countries vis à vis the U.S. dollar.

In June, OPEC decided to replace the U.S. dollar with SDRs for valuation of oil as of October 1. However, on October 1 OPEC reversed its previous decision and decided to *retain* the U.S. dollar as the currency in which oil prices are denominated. In June

[4]The Unit of Account (UA) is the basis for each member countries' financial relationship with the community. For example, payments and contributions under the common agricultural policy and the community budget are expressed in terms of Units of Account.

Table II

INTEREST RATE DIFFERENTIALS BETWEEN THE UNITED STATES AND SELECTED FOREIGN COUNTRIES

		Belgium	Canada	France	Germany	Italy	Japan	United Kingdom
1974	January	0.86%	−0.14%	−5.44%	−2.94%	−0.32%	−3.19%	−7.57%
	February	−0.47	−0.93	−3.72	−2.47	−1.85	−3.47	−6.28
	March	0.07	−0.79	−2.53	−1.78	−3.53	−3.03	−6.16
	April	1.21	−0.27	−1.34	+1.41	−3.59	−1.09	−2.65
	May	0.68	−0.91	−1.82	+2.43	−5.32	−1.07	−1.76
	June	0.61	+0.14	−2.52	+2.81	−7.89	−0.39	−1.20
	July	−0.29	−0.26	−2.04	+2.21	−7.29	−1.29	−1.67
	August	0.37	+0.26	−1.38	+2.67	−5.51	−1.13	−0.19
	September	−1.09	−0.40	−3.09	+1.31	−6.84	−2.09	−0.78
	October	−2.42	−1.57	−3.80	−0.42	−9.55	−3.42	−2.67
	November	−1.92	−0.94	−2.55	+0.53	−9.42	−3.67	−3.30
	December	−1.40	−0.92	−1.90	+1.30	−7.90	−3.90	−3.15
1975	January	−3.14	−0.39	−3.52	−0.79	−7.89	−6.39	−5.02
	February	−2.65	−0.52	−3.28	+0.15	−5.40	−6.65	−4.40
	March	−1.44	−1.04	−2.54	+0.66	−6.54	−6.54	−3.92
	April	−1.03	−1.81	−1.66	+1.22	−5.03	−5.28	−3.53
	May	−1.30	−2.06	−1.80	+0.65	−4.55	−5.55	−4.36
	June	+0.10	−1.16	−0.90	+1.35	−3.90	−4.65	−3.21
	July	−0.02	−1.29	−0.65	+2.18	−4.52	−4.52	−3.90
	August	+0.63	−1.99	−0.17	+2.73	−2.92	−3.67	−3.55
	September	+0.76	−2.51	+0.08	+2.96	−1.54	−2.54	−3.60
	October	−0.15	−3.03	−0.83	+1.95	−1.95	−1.95	−5.58
	November	−0.29	−3.82	−0.97	+1.81	−2.09	−1.59	−5.28

Note: The interest rate series used for each country is delineated in the chart entitled "Selected Short-Term Money Market Rates." The interest rate differential is computed by subtracting the respective foreign interest rate from the U.S. interest rate.
Source: World Financial Markets, Morgan Guaranty Trust Company.

the SDR was equivalent to about $1.25 and the dollar had been declining. Currently, the SDR is equivalent to about $1.17 and the dollar has been rising. As a result of this rise in the value of the dollar relative to the SDR, it became advantageous for OPEC to continue the dollar-oil price valuation.

Another event which was related to exchange rates was the decision by France in July to rejoin the European currency float known as the "Snake." This arrangement was instituted in March 1973 in order to maintain a maximum margin of ± 2.25 percent for exchange rate fluctuations in transactions among member currencies. France had withdrawn from the "Snake" in January 1974. Presently, the countries participating in the "Snake" are Belgium, Denmark, Germany, Luxembourg, the Netherlands, Norway, Sweden, and France.

Related to the International Monetary System

In early September, the International Monetary Fund (IMF) held its annual meeting and reached agreement on steps to reduce further the role of gold in the international monetary system. In essence, the 127 member countries of the IMF agreed to terminate the concept of the "official price" of gold. It was agreed that one-sixth of the gold stock currently held by the IMF (25.6 million ounces) would be gradually sold over the next two years. Another one-sixth will be returned to member countries in proportion to their original contributions. No agreement was reached, however, regarding the nature of a future exchange rate system.

In mid-November an economic summit meeting of the heads of state and finance ministers of the United States, France, Germany, Great Britain, Italy, and Japan was held in Rambouillet, France. The purpose of the meeting was to coordinate economic policies of the participating countries. The communique issued at the end of the meeting consisted primarily of general statements about the common pursuit of policies that would reduce unemployment and inflation. Of significance, however, was the agreement to counter *erratic* fluctuations in exchange rates.

Although the communique did not specify how *erratic* exchange rate fluctuations are to be removed, outside observers generally believed that official intervention in foreign exchange markets was the tool with which to achieve these goals. Moreover, the communique noted that a rapprochement of U.S. and French views regarding the international monetary system was achieved and that this would facilitate agreement on outstanding issues of international monetary reform.

Finally, in early January 1976 a meeting of the Interim Committee of the IMF was convened in Jamaica for the purpose of discussing these outstanding issues. At this meeting an agreement was reached among the 127 member countries of the IMF permitting individual member countries the option to choose from among three types of exchange rate systems. Individual countries will have the option of either adopting a floating exchange rate system, pegging their currencies to other currencies, or establishing a par value for their currency in terms of SDRs. In addition, it was agreed that a general par value system could be reintroduced if 85 percent of the member countries' votes favored such a step. Presently, the votes of the United States represent about 20 percent of the total.

Of particular significance was the agreement that the floating exchange rate system would take the form of a "clean" float. That is, countries who avail themselves of floating exchange rates should "avoid manipulating exchange rates . . . in order to prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members."[5]

To achieve a "clean" float, countries are required to "seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions."[6] The above requirement is consistent with the view that stable underlying economic conditions are conducive to stable exchange market conditions.

SUMMARY

During 1975 the world economy was subjected to the forces of recession. The U.S. recession was both more severe and more short-lived than that of its trading partners. This, in turn, was conducive to first a declining and then to a rising U.S. dollar exchange rate. U.S. trade performance was affected by these developments, as witnessed by the fact that U.S. merchandise exports exceeded U.S. merchandise imports by $10.6 billion during the first eleven months of 1975.

Although early in 1975 there were expectations that foreign economic recovery would precede that of the United States, it turned out that foreign economic recovery was, and in some cases still is, lagging behind that of the United States. It is expected, however, that economic growth in most industrial countries will resume in 1976, though at relatively low rates.

[5] *The Wall Street Journal*, January 12, 1976.

[6] Ibid.

Food Production and Prices – Perspective and Outlook

CLIFTON B. LUTTRELL

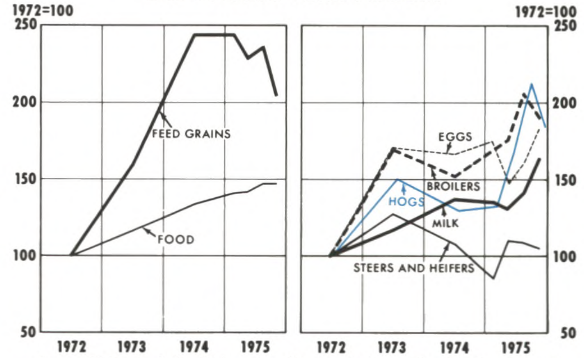
THE United States Department of Agriculture (USDA) provides an annual appraisal of the outlook for food prices and consumption. The outlook for 1976 was presented at the National Agricultural Outlook Conference, Washington, D.C., November 17-20, 1975. This article discusses the outlook as presented by the USDA within the context of some recent food industry developments which had a major impact on food prices.

From the consumer viewpoint the outlook for food production and food prices this year is improving. Food prices turned sharply upward in 1972 and rose at an annual rate of 13 percent during the three years ending in July 1975. Since July, however, they have advanced at a 2 percent annual rate and are not expected to rise at more than a 4 to 5 percent annual rate during the first half of 1976.

In contrast to the generally declining per capita production and sharply rising prices experienced since 1972, food production this year is expected to increase and the rate of food price inflation is expected to decline. The larger quantity of crops harvested last fall, as compared to a year earlier, will provide greater amounts of fruits, vegetables, sugar crops, and livestock feed, and will likely contribute to an expected upturn in the production of most livestock products in the months ahead. The greater production of food will tend to have a dampening effect on price increases.

Much of the rise in food prices since 1972 was caused by a series of short-run supply constraints and unexpected surges in demand in the food industry. A number of short-run disturbances, such as those associated with the operation of the OPEC (Organization of Petroleum Exporting Countries) cartel, erratic domestic crop production, a number of health and environmental protection measures, and the imposition of wage-price controls, led to reduced short-run per capita supplies of farm products and food. The realignment of world currencies coupled with some crop failures abroad led to an unanticipated increase in export demand for U.S. farm products. Also contributing was an increase in domestic demand for food resulting from the rapid increase in government food assistance programs such as food stamps and various child nutrition programs. The cost to the government of such programs totaled $6.9 billion in 1975, about 45 percent more than in 1974 and five times that of 1969.

Price Changes for Food and Selected Farm Products



Source: U.S.D.A. Agricultural Prices, Dairy Situation, Poultry and Egg Situation, Livestock and Meat Situation, and U.S. Department of Labor.

Livestock Feeding Costs Led Food Price Increases

The accelerated rate of food price inflation since 1972 was led by a sharp increase in feed prices and livestock feeding costs. Production of feed grain (about 80 percent corn) declined somewhat in 1972 from the 208 million short tons of the previous year; however, demand for feed grain rose. As a result of unfavorable weather conditions abroad and, thus, unexpected grain purchases, export demand rose sharply. Exports increased from 27 million tons in the marketing year 1971-72 to 43 million tons in 1972-73. Domestic demand for grain was likewise rising. Domestic grain feeding rose from 149 million tons in 1971-72 to 156 million tons in 1972-73. Total feed grain usage rose to 216 million tons in 1972-73, well above 1972 production, and carryover stocks declined

Table I

FEED GRAINS

	Acres (millions)	Production (million short tons)	Usage (million short tons) Domestic	Exports	Total	End of Year Stocks (million short tons)
1972-73	115.1	199.9	173.2	43.1	216.3	32.4
1973-74	121.4	205.0	171.0	44.4	215.4	22.2
1974-75	122.6	165.1	132.8	39.2	172.0	15.8
1975-76*	122.9	204.1	147.0	50.0	197.0	24.0

*Forecast.
Source: "Outlook for Feed" (a presentation) by James J. Naive at the National Agricultural Outlook Conference, November 19, 1975.

about one-third to 32 million tons. Consequently, feed grain prices spurted (see accompanying chart). For example, corn prices, which averaged $1.08 per bushel in the marketing year 1971-72, rose to $1.57 in 1972-73, and $2.55 in 1973-74. Protein feed costs likewise rose sharply, more than doubling from late 1971 to 1972. The price of protein declined somewhat in 1973 and 1974, but remains about 50 percent above the late 1971 level.

Higher Prices Serve as an Incentive for Increased Feed Production

In response to higher prices in 1972, feed grain production rose somewhat in 1973 (Table I). Acreage planted to feed grains was increased about 5 percent, and production rose about 3 percent over the prior year. Both export and domestic demand for feed, however, continued upward; consequently, total usage in the marketing year 1973-74 again exceeded production, resulting in the second sizable decline in carryover stocks.

Feed grain prices continued to rise sharply into 1974 and acreage planted to feed grains was again increased. Extremely poor weather conditions, however, resulted in a 20 percent decline in feed grain yields from the 1973 level. Corn prices, representative of all feed grains, continued up, rising from $2.55 per bushel in the 1973-74 marketing year to $2.95 per bushel in 1974-75.

Incentive for Feeding Declined

Prices of food and livestock products generally did not rise as fast as feed prices, however, and profit from feeding operations declined (see chart). For example, the average price of choice steers at Omaha rose 17 percent from 1972 to 1974, while feed grain prices jumped 77 percent. In the first three quarters of 1975, prices of choice steers averaged 22 percent above the 1972 level, while feed grain prices averaged 62 percent higher. Since feed is the major portion of the total cost of cattle feedlot operations, the result has been losses over the past two years. Hence, cattle feeding declined, dropping from 26.1 million head in 1972 to an estimated 22.4 million in 1975. The total number of cattle on farms, however, continued to increase throughout 1975.

The number of cattle on farms takes a relatively long time period to adjust to changes in supply and demand conditions for beef. The sharp buildup in cattle herds in the 1971-73 period reflected favorable feeder cattle prices. The number of cattle and calves on farms rose from 171 million head in early 1971, to 197 million in early 1975. With the reduced feeding and sharp decline in prices of feeder cattle in 1974, packers began to buy increasing numbers of cattle directly off pastures and the rate of increase in the number of cattle on farms declined. The number on farms is expected to level off this year, despite some improvement in the feed/beef price relationships.

Hog farmers were able to adjust production to the higher feeding costs more rapidly than cattle producers. Sow farrowings began to decline sharply in early 1971. The decline moderated in late 1972 and through 1973, but farrowings turned down sharply again in late 1973 and continued down through most of 1974. The number of hogs on farms rose slightly in early 1974 as a result of a larger feed grain crop in 1973, but declined about mid-year after it became apparent that the 1974 corn crop would be substantially below the average of recent years.

Nonfed Cattle Slaughter Rose . . .

Part of the negative impact on meat production resulting from the decline in livestock feeding was offset in 1974 and 1975 by the increased slaughter of lower quality nonfed cattle. Such animals declined in price until it became profitable to slaughter them directly off the farms and ranches. Consequently, total beef production in 1975 exceeded that of a year earlier.

. . . But Per Capita Production of Livestock Products Declined

Per capita production of all animal products declined about 4 percent from 1971 to 1975, with declines occurring each year except 1974. The decline would have been much sharper had not cattle farmers and ranchers shifted from herd-building toward herd-reduction.

While per capita beef consumption rose 2 percent in 1975, total per capita meat production and consumption declined. The decline reflected a 17 percent drop in pork consumption. Meat consumption per person generally declined from 1971 through 1975, dropping 6 percent during the five-year period.

Dairy and poultry production have generally followed the pattern of beef cattle and hogs, with declining per capita production in most years since 1972. Such production of broilers and turkeys declined 5 percent and 10 percent, respectively, from 1972 to 1975. Per capita egg production declined 10 percent during the period and milk production declined a fraction of one percent.

The reduced output and sharp increase in prices of animal food products caused increased demand for other foods. Consumption of fresh and processed fruits per person rose 10 and 8 percent, respectively, from 1972 to 1975; that of processed vegetables rose 6 percent, and consumption of fresh vegetables remained unchanged. Nevertheless, total food consumption per person declined about 3 percent from 1972 to 1975.

Share of Income Spent on Food Rose

With rising prices and relatively inelastic demand for food, the percent of disposable personal income spent on food increased even as the amount of food consumed declined (Table II). The percent of such income spent on food had generally trended downward for several decades. In 1972, however, it began to increase, with the share spent on food for home use rising from 12 percent to 13.4 percent during the three years ending in 1975. The proportion spent on all food rose from 15.4 to 17 percent during this period.

Declining Rate of Food Inflation This Year

Large crops were harvested in 1975, and larger supplies of most foods are in prospect for 1976. Total crop production was about 10 percent above that of a year earlier. While the production of livestock products this year probably will not greatly exceed that of a year ago, a turnaround from the low rate of production in mid-1975 is in prospect. This rebound is expected to contribute to a slowdown in the rate of increase of food prices. With a lower rate of food price inflation in prospect, food expenditures as a proportion of total personal income will tend to level off and the downtrend could well be resumed.

Table II

PERCENT OF DISPOSABLE PERSONAL INCOME SPENT ON FOOD

	Food for Use at Home	Food at Home and Away from Home
1960	16.2%	20.0%
1965	14.6	18.1
1970	12.7	16.2
1972	12.0	15.4
1973	12.5	15.9
1974	13.3	16.8
1975*	13.4	17.0

*Average for first three quarters of year only.

Source: USDA *National Food Situation* (November 1975), p. 11.

The turnaround in food production and price prospects for 1976 largely reflects a return to longer-run supply and demand conditions following the short-run disturbances which occurred during the period from 1971 through 1974. Such disturbances in a market economy are self-correcting. Farmers wili adjust their capital, labor, and other inputs to increase the production of those commodities for which expected prices and costs of production provide sufficient profit incentive. Farm production is more responsive to price changes in the long run than in the short run.

The higher prices for livestock feed provided the incentive for the large crops last year. With the increased incentive and the termination of government restrictions on planting, total production of grain and soybeans was sufficiently large to more than offset the rising demand for domestic use plus exports. Feed grain production was up about 23 percent from 1974. The larger quantity has resulted in lower feed prices and greater incentive for increased feeding. Feed prices in mid-December 1975 averaged 13 percent less than a year earlier, while the average price of all livestock products was 20 percent higher.

Farmers are responding to this improved potential for profit. Placements of cattle on feedlots began to pick up in late 1975 after a two-year decline. On December 1 the number of cattle on feed in seven major feeding states was up 25 percent from a year earlier. On September 1, hog producers indicated plans to increase farrowings (for the December-February pig crop) 6 percent from the previous year; if realized, this would be the first quarterly increase

Table III

YEAR-TO-YEAR CHANGES IN WHOLESALE FOOD PRICES

	Fruits and Vegetables		Meats	Poultry	Eggs	Dairy Products	All Food
	Fresh and Dried	Processed					
1970-71	+ 7.6%	+ 3.5%	— 0.8%	— 0.8%	—20.5%	+ 3.8%	+ 1.8%
1971-72	+ 6.2	+ 4.7	+12.6	+ 3.0	+ 2.9	+ 2.8	+ 5.5
1972-73	+31.7	+ 8.3	+27.2	+53.0	+59.8	+10.5	+20.6
1973-74	+14.4	+19.3	— 2.3	—11.2	— 3.1	+11.7	+18.7
1974-75*	— 7.4	+13.9	+15.1	+17.3	— 1.5	+ 3.6	+ 9.3
1975-76**	up seasonally	up moderately	beef up moderately; pork down slightly	down slightly	down slightly	up moderately	up moderately

*Average of first nine months of each year.

**Expected change in retail prices from late 1975 to the first half of 1976.

Source: USDA *National Food Situation* (November 1975), pp. 7-10 and 35.

in farrowings since the December 1972-February 1973 quarter. Total red meat production in the first half of this year will likely be about the same as in the first half of 1975, but production in the second half should be greater than a year earlier. With the more favorable milk-feed price relationships, milk production in early 1976 is likely to exceed that of early 1975. With the decline in feed prices, egg production increased in late 1975 and is expected to continue upward in early 1976. Favorable feed/broiler price ratios point to an increase in broiler production in the first half of 1976, up to 10 percent above the level of a year earlier.

SUMMARY

In contrast to the sharp increase in food prices experienced since 1972, only moderate increases are expected this year. Large crops of grain and soybeans were harvested last fall which resulted in lower prices for livestock feed. The lower feed prices and the relatively high prices for livestock products provided greater incentive for livestock production. Consequently, livestock production is beginning to increase. Larger quantities of fed beef, pork, poultry, eggs, and milk are in prospect for the second half of the year.

The prospective slowing in the rate of increase in food prices this year reflects the adjustments of our market economy to longer-run conditions. This adjustment to more fundamental determinants follows a period from 1972 to 1974 when short-run, price-increasing disturbances dominated. As a result of poor weather conditions in both the United States and abroad, as well as the depletion of domestic grain stocks, the price of livestock feed more than doubled in the 1972-74 period. The prices of livestock products rose more slowly and the incentive for livestock production declined in this period. Last year, however, farmers responded to the higher priced feed with near record crops and the feed/livestock prices have returned to more normal relationships. Hence, a rising rate of output of livestock foods is in prospect, and the larger output will result in a slower rate of price increase for such products. In addition, the prices of fruits and vegetables may rise only moderately.

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