# CH. 6 – THE DECLINING ECONOMY
# DOMESTIC RECESSION

Ch. 6 - The Declining Economy
Domestic Recession



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# Learning Intentions

In this section, you should understand:

- The reasons for the declining economy.
- The role of international competition.

# THE REASONS FOR THE DECLINING ECONOMY

*the reasons for the declining economy*

# Introduction

The booming American economy of the 1950s and the 1960s began to show signs of decline by the late 1960s.

During the 20 years prior to 1965, the US experienced economic stability and increasing output and employment. Minor recessions were corrected by government policy. Many came to believe that this would continue.

However, in 1965 these conditions began to change. The cost of the **Vietnam War** led to inflation (price rises). This was worsened by the **Oil Crisis in 1973**, which quadrupled the price of oil. The **Iranian Revolution of 1979** further increased the cost of oil. Between 1981 and 1983, the US experienced its worst economic recession since the Great Depression of the 1930s.

# The Economic Consequences of the Vietnam War

In 1966, President Johnson said to Congress, *'I believe that we can continue the Great Society while we fight in Vietnam.'* Like most Americans at the time, Johnson believed that the American economy was powerful enough to pay for both. In the late 1960s, President Johnson increased spending on the Great Society programme and on the Vietnam War.

# Budget Deficit

Balancing the federal budget was the normal target of US governments in the 1950s. Deficit budgeting began under President Kennedy - but it was on a small scale. Part of the prosperity of the 1960s was due to increased government spending. But this increased spending was not matched by increased taxes. Indeed, in 1964 the Johnson government brought in tax cuts, so government revenue (taxes) did not equal spending. This caused a **budget deficit**.

There was a federal deficit in previous years. But throughout the 1960s, under the influence of Keynesian economics, the budget was in deficit every year from 1961-8. However, these deficits were small compared to the 1970s and 1980s. The average deficit in the 1960s (1 per cent of GDP) doubled in the 1970s and doubled again in the 1980s. Since the government did not increase taxes to pay for the deficit, it **borrowed**. This put more money into the economy, which caused **inflation** (price rises).

# Domestic Recession

By 1975-76, after the impact of the Oil Crisis of 1973, unemployment rose to 8.5 per cent. Unemployment hit teenagers, women, blacks and other minority groups hardest. During the 1970s the US was hit by both unemployment and inflation troubles. Unemployment averaged over 6 per cent compared to 4 per cent during the 1960s. Inflation went from over 2 per cent to 13 per cent. The combination of unemployment and inflation became known as **stagflation**.

The US **balance of payments** (the balance of imports and exports) also worsened. At the end of the 1940s, the US held large gold reserves. But during the 1950s and early 1960s the US gave over $140 billion in economic and military aid abroad. This was mostly balanced by US exports, but gradually the US gold reserves fell to one-third of what they had been. By the end of the 1960s, US imports were greater than exports so payments so the US had a huge deficit (shortage).

# REVIEW QUESTIONS

1. How were each of the following effected in the recession:
   a. Prices
   b. Labour costs
   c. Unemployment
   d. Balance of payments

# Government Reaction

**Nixon** took measures to improve the economy in the early 1970s, as he was faced with **stagflation**. Nixon's immediate solution - **rising interest rates** - drove the US economy into recession. In 1971, he put a **freeze** on wages and prices for three months, later making them voluntary. He also abandoned the **fixed exchange rate system** set up after the Second World War. The US dollar was the backbone of the system. The US dollar was **devalued**, which made exports cheaper and imports dearer. Nixon also placed a **tariff** (taxes) on imported Japanese cars. But these actions only led to temporary improvements so that inflation and unemployment continued to be high during the 1970s.

The economic policies followed by **Ford** and **Carter** did not help the economy either. Ford cut government spending, while Carter tried the opposite. When Carter increased government spending, this only added to inflation, as well as increasing imports, including foreign cars.

By 1980, inflation had reached 13 per cent and interest rates were 20 per cent. The Iranian Revolution led to a doubling of the price of oil and Carter was given powers to ration petrol. At the same time, the states reacted against **big-spending governments**. This began in California, where a state referendum passed Proposition 13, which cut state taxes.

**KEY CONCEPT: IMPERIALISM**

**Imperialism** occurs when one country has a great deal of power or influence over others, especially in political and economic affairs. Sometimes the imperial power may actually take over the weaker countries.

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# Reaganomics

When Ronald Reagan became President in 1980, he rejected Carter's economic policies. In his **Program for Economic Recovery**, he wanted to create employment and growth through improvements in productivity and output. He intended to do this with major tax cuts of 25 per cent to encourage people to work and to reduce government spending. Reagan believed in what was called **supply-side economics**. He said cutting personal and business taxes would boost the economy and create jobs. Business and industry would put money they would have paid in taxes into the economy. This would create jobs and increase the overall tax take.

The economy grew under Reagan but not because of what he did with cutting taxes and spending programmes. Instead the Federal Reserve Board kept **control of the money supply** and this brought down inflation from 14 per cent in 1980 to 3.5 per cent in 1984. Interest rates declined, oil prices dropped and the economy expanded due to **deficit spending**. While Reagan cut federal spending on 300 domestic programmes, he increased spending on **defence**. This was the biggest peacetime build-up of US armed forces. This caused a huge **federal deficit**. But the economy grew by 10 per cent by the end of 1984 and unemployment fell to 7 per cent. However, much of the economic success benefitted the 'yuppies' or super rich who became richer.

In 1985, Congress passed the **Gramm-Rudman Act** to reduce the federal deficit gradually. It was planned to disappear by the 1991 Budget. But the next President, George Bush Sr, continued to face these problems when he took office in 1989.

# REVIEW QUESTIONS

1. What was Reagan's economic policy?
2. What were the effects of his policy?

# THE ROLE OF INTERNATIONAL COMPETITION

the role of international competition

# International Competition - Impact on U.S. Economy

One of the factors which worsened the US economy in the 1970s and the 1980s was **international competition** from Western Europe and Japan. While the US remained the largest economy, other economies were catching up. Between 1966 and 1987, other economies grew faster than the US (3.3 per cent), e.g. the Japanese (6.5 per cent) and the West Germans (13 per cent). These countries also invested more of their income in business.

The increased international competition led to more imports coming into the US, the decline of some manufacturing industry, rising unemployment and a worsening balance of payments.

# Growth of Japan and West Germany

One of the competing economies was the **Japanese**, which grew faster than the US economy in the 1970s. Japanese productivity also grew faster than the US. In manufacturing, the average output per worker grew at three times the US average between 1960 and 1973. Some believed that Japanese success was due to their management style.

Another country was **West Germany**, which led the Western European challenge to the US. West Germany recovered rapidly in the 1950s, aided by the Marshall Plan and its own economic policies of free trade, government support for industries, large firms and cartels, the banking sector and skilled workers. Between 1965 and 1979, German productivity grew faster than the US. The West German economy depended more on exports (30 per cent of manufacturing output) compared to the US (7 per cent) and Japanese (11 per cent). West Germany was the world's leading exporting country because it spent less on consumer goods and paid its employees less than the US.

Even though the US economy was still much larger than the Japanese or the West German's, these countries had improved their position. In particular, they closed the gap in chemicals, machinery, communications equipment, cars and trucks. They competed against the US in a global market and in the US domestic market.

# Growth of Japan and West Germany

The US share of **world trade** also declined from 25 per cent in 1948 to 15 per cent in 1964 and 10 per cent by 1970. The US was no longer the largest trading bloc - the EEC was. The US was no longer the fastest-growing economy - Japan was. US imports amounted to 6 per cent in the early 1960s; by 1970 this had risen to 16 per cent.

Some claimed that the US was going through a process of **deindustrialisation** - as shown by the decline of such basic industries such as steel and the shift out of manufacturing to the service industry, the transfer of manufacturing facilities abroad, the loss of some foreign markets and the increased share of the domestic market taken by foreign goods.

However, the decline was only relative; the US economy continued to be far larger than the others.

# CAUSES OF ECONOMIC DECLINE, 1969-89 – SUMMARY

- Johnson paid for **Vietnam War & Great Society** without rising taxes - greater deficit - borrowing - greater money supply-inflation
- **Stiff competition** from cheaper, high-quality goods especially from **Japan** & **Germany** - US slow to change policies - Japanese government subsidised certain industries - percentage of foreign cars rose from 4 per cent to 17 per cent during 1960s, 33 per cent by 1980 - greater US trade deficit.
- **Oil** - after Yom Kippur War 1973 - OPEC sanctions on US - Oil price increase inflation 5 per cent 1972 - 10 per cent at end 1973
- **Structural unemployment** - slow increase in US productivity - industrial workers' jobs filled by robots or computers or lost altogether due to foreign competition
- **Failure of government/presidential policies to solve economic problems** (Nixon, Ford, Carter, Reagan)