Research Department
Federal Reserve
Bank of
San Francisco

August 8, 1975

Consumer Recession/Recovery

If economists were to attach names to recessions as weather forecasters do to hurricanes, the recession from which we are just emerging might well be christened the "consumer recession." Consumers as individuals are always affected by the melancholy accompaniments of recession—unemployment and reduced income—but as a group, they normally react passively in each business cycle to a decline (and subsequent upturn) in the more volatile areas of the economy. Their behavior in this cycle has been somewhat different. The 6-percent annual rate of decline in real consumer spending in late 1973 and early 1974 helped generate the recession, and the 4-percent rate of gain in spending in the first half of 1975 helped set the stage for recovery. These significant shifts were magnified by the fact that the consumer sector traditionally accounts for about two-thirds of total GNP.

To a large extent, inflation was at the root of the consumer recession, since inflation eroded consumers' real purchasing power even before unemployment became a major problem. And as the prices of certain commodities rose sharply relative to others, consumers were forced to make additional adjustments in their consumption patterns.

Real income and spending
Shifts in purchasing power are best measured by real disposable income, which strips away the inflation-based gains in income that have occurred throughout the recession, and also reflects the tax-cut-related boosts in income that consumers have recently received. Disposable income in real terms dropped nearly 6 percent between fourth-quarter 1973 and first-quarter 1975, the apparent recession lowpoint for this series. This is by far the largest fall of consumer income in nearly forty years—just about double the declines recorded in the recessions of 1948-49 and 1957-58. Moreover, the rate of growth of real disposable income slowed perceptibly throughout most of 1973, before the recession even began.

Real consumer spending closely paralleled real income throughout this period—not surprisingly, in view of the severe impact of inflation on both series. During most of 1973, real spending grew at only a fraction of the previous year's pace, and with the onset of recession, it dropped 4 percent between late 1973 and early 1975.

The signs of inflation have been most evident in two areas of consumer spending—food and energy. Food prices increased 31 percent between first-quarter 1973

(continued on page 2)

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and second-quarter 1975, with about one-half of that increase taking place by fall 1973. Energy costs jumped 43 percent over the same period, but in this case, the bulk of the increase occured after the OPEC price hike in late 1973.

Food and energy

Food is a matter of basic necessity, so demand for food generally is inelastic. With prices soaring, consumers thus raised food spending from 17 to 19½ percent of disposable income between early 1973 and mid-1975. But the price impact was so severe that per capita consumption, in real terms, dropped 4 percent over this period.

This decline reflected the flexibility shown by shoppers in shifting away from more expensive foods to less expensive items. For example, per capita beef consumption declined in 1973 for the first time in two decades, and consumers increasingly deserted costly convenience food for "scratch" recipes. In another economy move, home vegetable gardens took on a popularity unknown since the "Victory gardens" of World War II.

Despite popular belief to the contrary, energy spending has proven to be strongly elastic, at least since OPEC policies began to dominate the market. Energy consumption rose in real terms throughout most of 1973 in the face of moderate price increases, but between third-quarter 1973 and second-quarter 1975, real consumption fell 5½ percent. (In current-dollar terms, of course, spending jumped 32 percent.) Unlike the situation in food, the energy share of disposable income dropped from 9½ to 7 percent between the pre-embargo period and today.

The impact has been felt in other consumer areas also. Concerned over higher gasoline costs as well as auto costs, consumers have opted either to hold on to their present cars or to buy smaller ones. Auto

sales in real terms dropped nearly 23 percent below the pre-embargo level by the second quarter of this year. Real consumer purchases of gasoline and oil remain about 9 percent below the level of two years ago. Meanwhile, the residential demand for energy remains below the pre-embargo peak, in real terms, despite a sharp upturn recently in spending for utilities.

Consumer recovery

Just as the consumer sector weakened prior to the onset of recession in the general economy, consumption spending now appears to be leading the recovery. In real terms, consumer expenditures rose at more than a 6-percent annual rate during the April-June quarter, with durable goods, nondurable goods and services all rising significantly. Behind that development was an unparalleled 21-percent rate of gain in real disposable income, which offset practically all of the prolonged decline since late 1973 in that series. Take-home pay was boosted about $48 billion this spring by the provisions of the Tax Reduction Act, including actual tax cuts as well as increases in social-security and other transfer payments. That stimulus was reinforced by a slowing of the inflation rate, which also helped significantly to boost real income.

Consumers saved more than 10½ percent of their after-tax income during the second-quarter—well above the normal 6-to-8 percent figure—reflecting their tendency to adjust only slowly to changes in real income. Armed with this cash reserve, consumers are now in an excellent position to increase their spending further. As their demands move merchandise off the shelves, businessmen will re-order to replenish their depleted stocks. In turn, manufacturers will have to increase production and recall workers that were laid off during the slump. By year-end, the recovery should be solidly in place as this script unfolds.

Herbert Runyon