

Economic Environment and Business Strategy
Prof. Sukumar Vellakkal
Department of Economic Sciences
Indian Institute of Technology Kanpur
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Major Business Cycles – II

Hello, everyone. Welcome back to our series on business cycles in the economic environment and business strategy courses. In this session, we will examine three pivotal macroeconomic episodes that have shaped modern economic thinking and policy. We begin with the 1973-75 recession, the first major global downturn after World War II, marked by stagflation, a rare combination of high inflation and high unemployment, driven by the oil crisis, the collapse of the Bretton Woods system, and increased global competition. Next is the 1981-1982 recession, which was largely caused by tight monetary policy aimed at controlling inflation. Although inflation decreased, the policy triggered deep and prolonged unemployment.

We then move to the era of the Great Moderation, a period of relative macroeconomic stability from the mid-1980s to 2007. This period saw fewer recessions but ended with the global financial crisis of 2007, 2008, and 2009, which exposed hidden vulnerabilities in economic activity. These episodes highlight how the nature of economic shocks and policy responses has evolved over time. Let's start with the oil shock and the 1973–75 recession.

Regarding the 1973-75 recession, why was it different? You are likely aware that the Great Depression of 1929 marked the emergence of macroeconomics, and our understanding of the macroeconomy has since evolved. Following the Keynesian revolution, most countries worldwide began to increase government expenditure and public spending programs to revive their economies. Everyone thought the economic future was so bright. However, this optimism gave way to the pessimism of the 1970s. It was the first major recession after World War II.

For the first time, the economy experienced both high unemployment and low economic growth rates simultaneously, a phenomenon known as stagflation. Stagflation refers to a combination of low output, which leads to high unemployment, and low output paired with high inflation. That means low GDP plus high inflation. This was a phenomenon that economists had never experienced before. It took place during the 1970s.

Stagflation is a condition characterized by slow economic growth and relatively high unemployment, accompanied by economic stagnation and rising prices or inflation. Let's

have a quick overview. What are the conditions preceding the recession? In the United States, the Soviet Union, Western European countries, and East Asian countries, all experienced unusually high and sustained economic growth. Even the countries devastated by World War II experienced high economic growth during this period. Moreover, the prices of oil and petroleum were quite low during this period.

Most Western countries experienced full employment in the early 1970s. However, as I have already mentioned, the 1973-75 recession is one of the major recessions following the 1930s recession, and a series of events led to the recession of 1973-1979. One notable event was the 1973 oil crisis, which followed the formation of OPEC by the Arab nations. Then came the second, the fall of the Bretton Woods system. Then came the third, the newly industrialized countries.

They increased competition, which led to the steel crisis in the developed world. There was also a stock market crash in 1973-74. Returning to the first one, the 1973 oil price crisis, also known as the first oil price shock in economic history. It was caused by the Arab-Israeli war, especially because many Western countries supported Israel in the war. As a result, in 1973, the Arab countries formed an organization called OPEC, the Organization of Petroleum Exporting Countries. And then they created a monopoly. As a result, they announced an embargo on the U.S. and its allies for supporting Israel in the war. Then, as a result, the price of oil rose from \$3 per barrel to \$12 globally.

And then you know that oil is one of the key inputs for all the manufacturing industries. As a result of the increase in oil prices, which translates into higher input costs, production costs rise, and consequently, aggregate supply decreases; this is essentially a supply-side shock. We can call it a supply-side shock mainly because the shock was on the input side, as oil is one of the major inputs for the manufacturing sector. As shown in this figure, oil prices in 1970, 1971, and 1973 exhibit an upward trend. So, by 1975 and 1977, you can say that there is a skyrocketing increase in oil prices.

The second event that led to the 1970-75 recession was the collapse of the Bretton Woods system. In a previous lecture, we discussed the Bretton Woods system. The Bretton Woods system was the outcome of the Bretton Woods agreement in 1945. It made the US dollar the benchmark or reserve currency for the Western world. All countries followed a fixed exchange rate regime, and the United States agreed to link the dollar to gold at a fixed rate of \$35 per ounce. Countries that agreed to this fixed exchange rate, mainly developed countries, could exchange dollars for gold at any time.

The international economic situation began to change in the 1960s. During that period, the U.S. increased its imports, which required printing more currency for international trade. So, they decided to increase the money supply. The issue was that the U.S. was now running a large trade deficit. Dollars continued to flow overseas. You know that

because they had been importing and were making payments in dollars. And most nations, like Switzerland and France, accumulated large amounts of dollars and demanded redemption for gold. President Nixon, during this period, understood the magnitude of the problem because, at the same time, the U.S. economy had been growing, its import requirements had also been growing, and as a result, they needed more currency, but they did not have sufficient gold to keep it as a backup, as a reserve.

The US gold reserves began to decline, and most foreign countries that had been holding US dollars started requesting conversion of their US dollars into gold. This led the US to consider abandoning the fixed gold-dollar exchange rate. President Nixon announced that the United States was abandoning the Bretton Woods system and that foreign countries holding US dollars could no longer request conversion into gold. Thus, President Nixon's 10 percent import tax was one of the policy measures aimed at dissuading imports and reducing the trade deficit. In addition, the president imposed a 90-day wage and price freeze to curtail inflation, as there was two-digit inflation at the time. In other words, the government intervened in the labor market and the output market.

Normally, if the free market is allowed to work, the market mechanism of supply and demand would determine prices in both the labor and output markets. However, with government intervention, the wage cap for 90 days resulted in wage price controls that forced companies to maintain high wages, leading businesses to lay off workers to reduce costs. Because they cannot reduce wages, they must lay off some workers to cut costs. At the same time, a price cap was in effect, and since aggregate demand was declining, firms sought to lower their prices. However, because of the freeze, firms were unable to reduce prices to stimulate demand.

Then, another crisis, another issue that occurred in parallel, was the steel crisis. It mainly happened because newly industrialized countries ramped up steel production, saturating global markets. As a result, there was overproduction of steel in the global market, and consequently, global competition rose. As a result, steel prices declined, and the industrial sector was severely impacted. The policy also affected steel-consuming industries, leading to cost inflation, job losses, and further pressures on the economy, exacerbating stagflation.

I am showing you the steel production, especially in the 1970s; you can see that during this period, the global steel production market was drastically high. Another event that contributed to the 1972–75 crisis was the stock market crash. This crash came after the collapse of the Bretton Woods system over the previous two years, along with the associated Nixon shock and the devaluation of the United States dollar. It was further compounded by the 1973 oil crisis. So, I have some text here to show the magnitude of the problem.

You can see that the Dow Jones index fell, and the same problem was reflected in the United Kingdom as well. As a result, during this period, unemployment reached 9%, GDP declined by 3.2%, and inflation rose to 8.8%. Then the tax cut of 1975 is one of the policy interventions.

The investment purchases, financed partly by private borrowing, increased by over 19% in the third quarter. Let's also take a quick note on how it ended. It took another Fed chairman and a brutal contractionary monetary policy for inflation to return to single digits. However, in the meantime, unemployment continued to increase, and the US endured jobless rates that exceeded 10 percent, affecting millions of people until the late 1970s. Let us now have a brief overview of the recession in the UK during the 1970s.

From this figure, you can see that inflation in the UK reached 25 percent in 1975, and that two-digit inflation in 1974 and 1975 persisted until 1977. It accelerated to over 20 percent, primarily due to rising wages, the inflationary 1972 budget, growth in credit and consumer spending, and the global oil price shock of 1973, which led to a 70 percent increase in oil prices. To address inflation belatedly, the government sought to mitigate it through higher interest rates and wage caps. This fueled industrial unrest, leading to frequent and widespread strikes in UK factories. Coal and coal factories were shut down, which at the time produced most of the nation's power.

At the height of the strike, Britain was on a three-day week, and the government made a public appeal to conserve energy. This illustrates the magnitude of the issues related to the UK's current account deficit. You can see that the current account deficit turned negative during this period, indicating that the UK faced a significant trade deficit. In 1976, the UK required an IMF bailout due to a high budget deficit and concerns about the value of the pound.

The market believed sterling was overvalued, so it kept selling, causing the pound to depreciate. In 1977, the economy showed signs of recovery, aided by oil revenues, and the balance of payments improved. So, the IMF lent loans to the UK. However, over time, since the pound also strengthened after the loan, the UK did not need to draw on the full amount of the loan. So, this is the UK's net borrowing as a percentage of GDP.

You can see, especially during this period, that this is a time of crisis; net borrowing as a percentage of GDP has increased. Let's also take a quick look at another recession that occurred from 1981 to 1982. The recession of the early 1980s can be defined as two distinct periods of recession. The first lasted 6 months, starting in January 1980, and the second lasted 16 months, from July 1981. The US ended the recession in January 1980 and returned to growth six months later, in July 1980.

However, by July 1981, the recession hit the US again, and the second recession began, with the unemployment rate remaining unchanged during this period. As shown in this

figure, inflation surged again during this period, like in the early 1980s. The consumer price index increased, inflation rose, and output also declined. In this saga of recession, the oil price and the supply-side shock also played a role. The oil shock led to a decrease in aggregate supply again, shifting the aggregate supply curve to the left.

This is primarily due to the increase in the cost of inputs, which has led to a corresponding rise in production costs. This created a supply-side shock, and consequently, the aggregate supply curve shifted to the left. This led to a decrease in output and an increase in the price level, and, in parallel, it also led to an increase in the unemployment rate. You know that when the level of economic activity declines, GDP also declines, and the demand for factors of production declines, which means unemployment will occur.

There are additional insights to consider. This is the prime rate, the short-run interest rate in the U.S. You can see that during this period, the short-run interest rate increased. The Fed funds rate, the rate at which banks borrow from each other, has also increased.

It became two digits, and as a result, the cost of borrowing for the firms has increased. Additionally, you are aware that this has led to higher production costs for the firms. I am also showing you more data on how annual inflation looked in 1982 and 1984. This is the monthly data from the 1980s, showing two-digit inflation. Then, in 1981, two-digit inflation reappeared, but by the end of 1982 and 1983, its magnitude had declined.

I am also providing you with additional data to give a clearer picture and a better understanding of the recession's severity during that period. You can see how the unemployment rate has changed over the years, as well as the trend in inflation. You can see that it has been increasing over time. I have some more data. I suggest you review these slides to gain a deeper understanding of the unemployment data.

I would also suggest collecting a large amount of data on unemployment, output, and prices during this period to gain a more in-depth understanding of the recession. Let us also discuss the policy interventions that have been initiated to address the recession. One is loosening the contractionary monetary policy; they began to follow an expansionary monetary policy so that the interest rate will decline. The other policy intervention is primarily driven by supply-side economics, a key economic principle also espoused by President Reagan. He believed that strengthening the supply side of the economy is critical because, until 1970, it was the Keynesian revolution; Keynesian economists believe in demand-side economics.

But President Reagan, in the 1970s, argued that supply-side economics is key. That means the supply side of the economy should be incentivized through tax cuts and subsidies. So, he began giving tax cuts to firms in the industrial and agricultural sectors.

He also aggressively cut the income tax for the top bracket from 70% to 28%. Moreover, he reduced the corporate tax on corporate profits from 48% to 34%.

The idea is that the supply side of the economy should be incentivized. As a result, people should have more money. Therefore, he believed that providing additional tax cuts and supply-side economic incentives would be beneficial. He also increased government spending.

Under Reagan, government spending increased by 2.5 percent annually. They also tried to reduce the oil price. Then comes the third episode in economic history, called the period of great moderation. The period between the 1980s and 2007 was considered a time of macroeconomic stability.

It is called the period of great moderation. Although recessions occurred in 1990-91 and 2000, they were not as severe. Apart from those, from the 1980s to 2007, there was no major recession. However, the period of great moderation came to an end in 2007-2009 with the onset of the Great Recession. Initially, it was a real estate crisis; later, it evolved into a financial crisis, and by 2009, it had become a full-fledged economic crisis, characterized by a recession. Let me show you some data and insights from the period of the Great Recession.

Consider the percentage change in GDP over time. As you can see, there was a slight fluctuation from this period to the next, especially between 1950 and 1955, and again between 1982 and 2007. This is a period of stability. Therefore, we refer to this period as the Great Moderation. The wide fluctuations and business cycle during the early decades of the postwar period were present; however, they dampened out between 1980 and 2007, and, as I mentioned, this period is known as the Great Moderation. When it comes to inflation, you can observe this variable before 1985 and after 1985. During the period of the Great Moderation, inflation was stable compared to the previous period.

Similarly, regarding long-term unemployment during the 1930s, there is a degree of moderation or stability. In this session, we discussed three major macroeconomic episodes. One was the 1970s crisis, which we examined in terms of three or four major causes, including the oil price shock, the collapse of the Bretton Woods system, and the steel crisis. We then discussed the 1981-82 crisis and the period from 1980 to 2007 as the era of the Great Moderation. An important point to remember is that, from 1980 to 2007, there was no major economic crisis; overall, most economic variables remained stable; however, some hidden vulnerabilities existed.

Although the economy may have seemed calm and quiet, this calm conceals hidden vulnerabilities that became apparent during the 2007-2009 crisis. We will discuss this in the next session. Thank you for watching. I look forward to seeing you at the next session. Thank you.