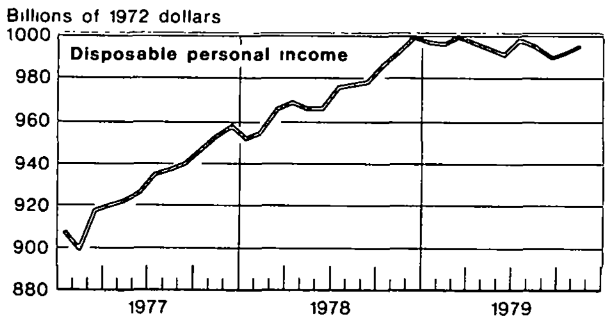
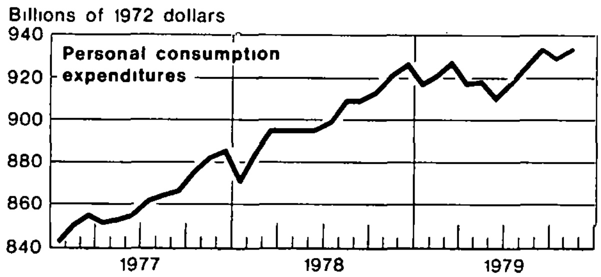
The business situation
Current developments

Chart 1

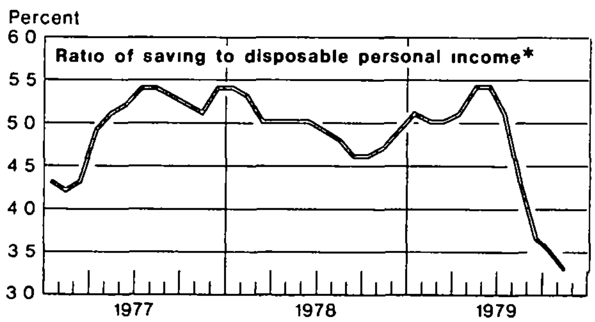
Income growth slowed in late 1979 . . .



. . . but consumer spending continued to rise . . .



. . . as consumers sharply reduced their rate of saving.



*Centered three-month moving average

Source United States Department of Commerce, Bureau of Economic Analysis

The economy ended 1979 with an unexpected display of strength. Despite a weakening in automobile sales and production and in housing, consumer spending advanced quite strongly, and employment posted surprising gains At the same time, the sudden heightening of world political tensions at the year-end raised the possibility of new upward forces spreading from a defense buildup Nevertheless, the weakness in the automobile industry and in housing, the sharp fall in the savings rate, and the stubborn persistence of inflation pose uncertainties over the prospects of further gains in business activity

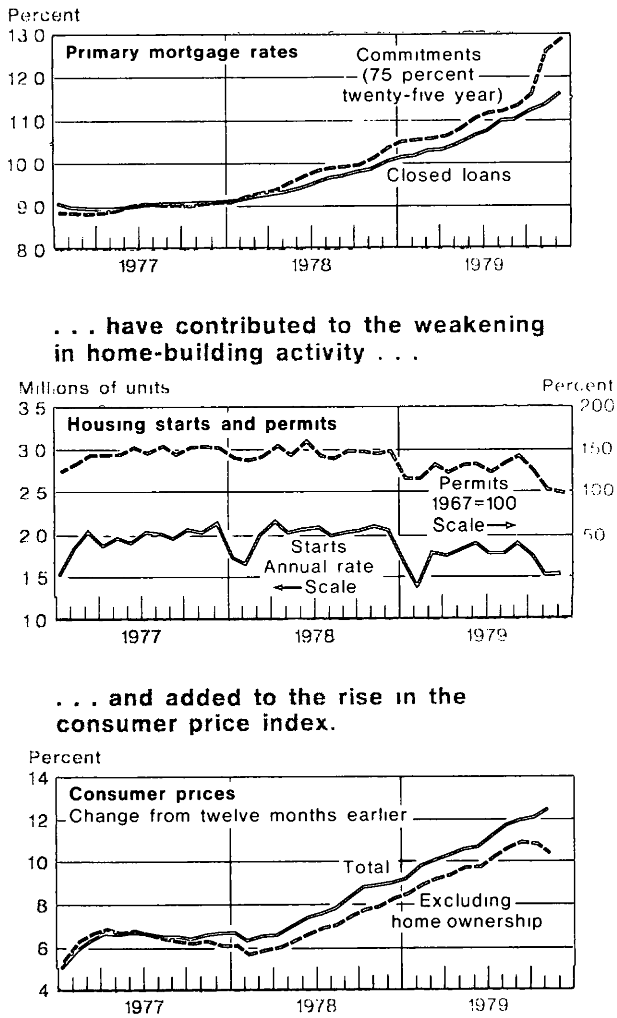
Consumer spending provided most of the strength to the economy during the final quarter of 1979 Purchases of apparel, general merchandise, and services paced the gain. In contrast, sales of new domestic cars fell sharply to an annual rate of 7 2 million units, 1 3 million units below the sales rate posted in the third quarter.

With the drop in new car sales, stocks of unsold models mounted quickly, and United States automakers closed the year with a heavy inventory of cars. In response to the inventory imbalance, automakers curtailed production and laid off nearly 200,000 workers Outside the automotive sector, however, there was little evidence of imbalances Indeed, because businesses have generally followed cautious inventory policies, the surge in year-end sales depleted stocks of some products so that isolated shortages were reported

In spite of the major employment layoffs in the automobile industry, employment continued to expand in the final quarter In fact, although the automobile layoffs increased over the course of the quarter, the monthly gain in payroll employment accelerated and, in December, amounted to more than 300,000 persons

Chart 2

Tightening mortgage markets . .



Sources Federal Home Loan Bank Board, United States Department of Commerce Bureau of the Census, United States Department of Labor Bureau of Labor Statistics

The overall rate of joblessness stayed within the narrow 5½ to 6 percent range of the past eighteen months and ended the year at 5.9 percent. At the same time, the ratio of employment to population rose to a record high in the final quarter.

The growth of employment bolstered earnings, but the gain in income was outstripped by inflation, which eroded the purchasing power of households' incomes. Consumers kept up their spending by continuing to borrow and by reducing savings, and the overall rate of savings declined sharply further (Chart 1). A key question in the outlook, of course, is whether consumers can continue to borrow so much and save so little. In the last inflationary outburst, in 1974, the savings rate held up in part because of the widespread expectation that double-digit inflation would soon disappear. This time around, in contrast, the fear that inflation is unlikely to diminish soon appears to be pushing consumers to spend ahead of their incomes notwithstanding the growing strains on family budgets

While consumer spending rose, business spending on fixed capital weakened in the final quarter of 1979. Shipments of nondefense capital goods dropped sharply, led by a decline in truck and automobile deliveries Other near-term barometers of capital spending, however, are mixed—new orders have risen, while contracts for commercial and industrial buildings have declined Looking to 1980 as a whole, the November-December Commerce Department survey of planned plant and equipment spending points to an advance of 10.9 percent. This would represent a marked slowing from the spending gain of 14 7 percent posted in 1979 After allowing for the effect of rising prices, the planned increase suggests only very modest real growth

Residential fixed investment also weakened in the closing months of 1979, as mortgage credit became less available and available only at substantially higher interest rates. Housing starts, as well as permits to build in the future, declined sharply in the closing months of the year (Chart 2), and sales of new and existing homes slumped New single-family house sales in November actually posted their sharpest decline in almost a decade.

In the face of weakening demand, signs of a softening in housing prices began to appear. Indeed, several broad measures of house prices recorded actual declines in November. A sustained weakening in home prices could, of course, affect the economic outlook. In the inflationary environment of the 1970's, housing had emerged as a primary hedge against ever-rising prices and the rapid run-up of home prices served to buttress inflationary expectations. In the process, consumers tapped their ballooning housing equity—through stepped-up borrowing and home sales—to finance increased expenditures. To the extent that future increases in real estate values become less certain, an important base of inflationary expectations and consumer spending would be eroded

Some continued weakening in housing activity seems likely as a result of the tightened mortgage market. Interest rates on mortgage loan closings have risen to record levels, and rates on new mortgage commitments have increased even more sharply. In December, the rate on a 25-year mortgage with a 25 percent downpayment was close to 13 percent—up about 2½ percentage points since the start of the year and more than 1 percentage point in just the last two months. At the same time, deposit flows at thrift institutions have slowed markedly. Part of this slowing could be offset if the newly introduced 2½-year savings certificate proves successful in attracting funds to thrift institutions (see article beginning on page 54). The temporary Federal suspension of state usury mortgage rate ceilings could also cushion the prospective decline in housing to some extent

The rise in mortgage rates added substantially to the upward spiral in the consumer price index in the closing months of 1979. The rise in the homeownership component of the index accelerated markedly, not just because of rising mortgage costs but also because of continuing increases in the housing prices that are used in the construction of the index. (These are Federal Housing Administration market price data which tend to measure the lower priced segment of the housing market They differ from other measures of housing prices—Census Bureau and National Association of Realtors—not used in the index, which appear to be much broader and have recently shown declines.) Over the first eleven months of 1979, the consumer price index rose at an annual rate of 13 percent. Excluding the homeownership component, however, the rise in consumer prices slowed late in the year (bottom panel of Chart 2). From December 1978 through November 1979, consumer prices other than homeownership costs rose at an annual rate of 10 4 percent.

Measuring changes in consumer prices is a difficult undertaking. Last year's run-up in mortgage rates and house prices appears to have led to an overstatement in homeownership costs. Only current prices of houses and current mortgage interest rates enter the consumer price index. In a period of rapid inflation the index also tends to exaggerate underlying price changes because it measures the cost of purchasing a fixed market basket of items whose composition does not change Consumers do change their spending habits and tend to cut back on items whose prices rise particularly rapidly Recent reductions of energy consumption by households are the most striking example. The deflator of personal consumption expenditures, an alternative measure of consumer buying power used in the construction of national income accounts and now published monthly, avoids both these problems of the consumer price index The deflator uses a measure of current homeownership costs which is more difficult to construct and which takes account of changes in consumer spending patterns In the first eleven months of 1979 this measure showed a consumer price inflation of 10 percent at an annual rate, or 3 percentage points below the consumer price index.

The consumer price index is the nation's most prominent barometer of price change. As such, its overestimate of the rise in the cost of living can create actual upward price pressures It tends indirectly to raise inflation by reinforcing expectations of high rates of price advance and strengthens workers' demands for large catch-up wage increases At the same time, the exaggerated increase in the index directly aggravates inflation by raising the wages of more than 8½ million workers who are covered by cost-of-living adjustments.

Regardless of the problems of measurement, price pressures remain intense. Despite evidence of a weakening in some components of aggregate demand, inflation continues to pose the greatest threat to prosperity in the 1980's Prospects for any quick reduction of inflation are limited not just by the jump in world oil prices but also by the legacy of inflation in the past decade. Over these years expectations of virulent inflation have become increasingly entrenched. The apparent softening in home prices is one straw in the wind pointing to the possibility of dampening these expectations. More concretely, the monetary actions of late 1979 which were designed to slow the growth of the monetary aggregates will act to reduce the underlying rate of inflation in the 1980's. Maintaining judicious monetary discipline is a prerequisite for a return to sustained price stability.