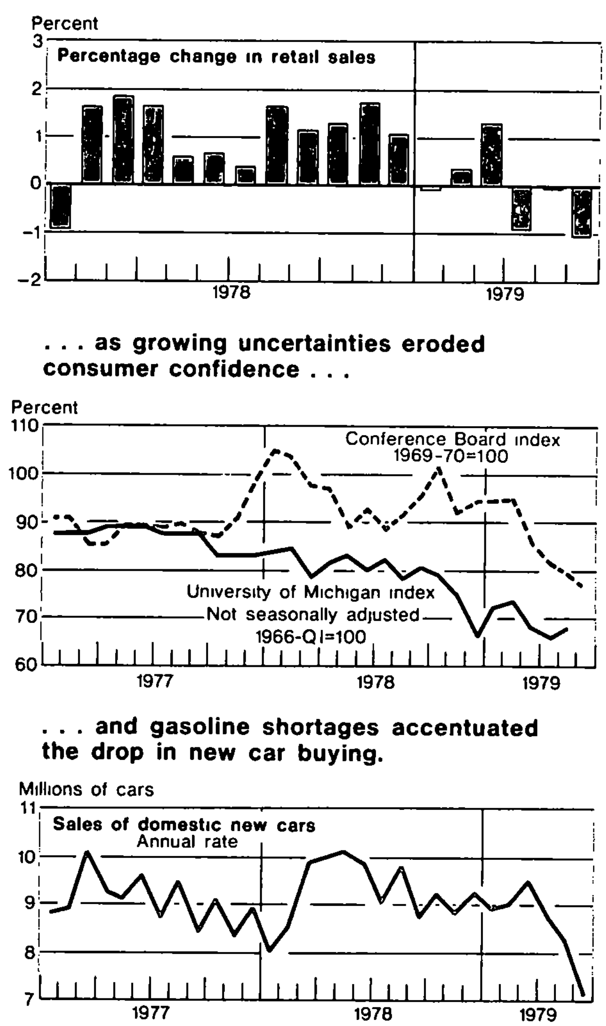
The business situation
Current developments

Chart 1

Consumer spending declined in the second quarter . . .

. . . as growing uncertainties eroded consumer confidence . . .

. . . and gasoline shortages accentuated the drop in new car buying.



All data seasonally adjusted, except where noted

Sources United States Department of Commerce, University of Michigan, The Conference Board, Inc , and Board of Governors of the Federal Reserve System

With the slowdown in business activity in 1979, symptoms of an economic recession have begun to emerge. At the start of the year, harsh winter weather exaggerated the slowdown. In the second quarter, the sharp rise in fuel prices and sporadic shortages of gasoline accentuated the economic decline. In many respects, recent energy developments—the sharp rise in fuel prices and reduced availability of gasoline—are reminiscent of the 1973-74 oil embargo which tripped the United States economy into its worst recession in postwar history Consumer confidence has been shaken by the growing uncertainties over energy, worsening inflation, and the economic outlook

Manufacturing activity began the second quarter on a note of unexpected weakness. Industrial production declined sharply, employment growth faltered, and the workweek declined Much of the weakness could be attributed to the effects of the teamsters' strike. In addition, a ready list of other factors—including the steel haulers' work stoppage and technical quirks of the business statistics (which captured the effects of religious holidays)—also helped explain the apparent weakness in the April data. While economic activity recovered in May and June, the rebound in production, employment, and the workweek failed to recoup the April declines.

In large measure, the slowdown in manufacturing activity reflected producers' response to the pronounced weakening in consumer expenditures, most notably new car purchases Monthly retail spending declined from April through June (upper panel of Chart 1) After making adjustment for the effect of rising prices, the decline in real consumer spending in the second quarter was precipitous.

The weakness in consumer buying in recent months has been accentuated by declining real incomes, shortages of gasoline, and growing uncertainties over the strength of the expansion. Led by the skyrocketing price of gasoline, the accelerating inflation outstripped the growth of earnings, eroding the real purchasing power of households' incomes. Reflecting these losses and heightening concerns over inflation, consumer confidence appears to have dropped sharply. Indeed, in recent months two widely followed measures of consumer confidence were close to their lowest levels in the past four years (middle panel of Chart 1).

The uncertainties over shortages of gasoline and higher prices of fuel led to an abrupt decline in purchases of domestic new cars, the main factor in the drop of household spending (bottom panel of Chart 1). Sales of domestic new cars weakened each month of the second quarter, closing the quarter at the lowest monthly rate since June 1975.

The fuel situation also led to a sharp shift in buyers' preferences for smaller, more fuel-efficient cars. Demand for large domestic cars and used cars, which tend to be less fuel-efficient, has fallen sharply. The trade-in value of used cars has dropped in recent months, and this drop in turn is depressing the demand for new cars still further.

While sales of standard-sized cars plummeted, sales of both imports and fuel-efficient domestically produced cars strengthened. Sales of imported cars in the second quarter averaged 2.5 million units at an annual rate, the highest quarterly sales pace ever posted.

The unexpected decline in the sales of standard-sized cars led to a backup in dealer inventories. As sales dropped, dealer inventories rose to the equivalent of 83 days of sales in June. The imbalance of auto inventories is underscored by trade reports of heavy price discounting of slow-selling large models, while some desirable subcompact models are in such short supply that waiting periods are up to a year.

Outside the inventory accumulation in the automotive sector, the inventory buildup in manufacturing and trade appears, for the most part, to have matched the growth of shipments through the late spring. While there were undoubtedly some elements of involuntary accumulation of stocks in the second quarter, the extent of current inventory excesses is unclear. However, any correction is likely to be relatively small because of the cautious inventory policies followed earlier by businesses.

Sporadic shortages of gasoline played a role in curtailing consumer spending in recent months. From a longer term perspective, however, the run-up in crude oil prices is likely to be more important in paring demand because it has sharply reduced purchasing power. To be sure, the more than 60 percent increase in the average price of imported oil this year is dwarfed by the fourfold increase in 1974. But, more importantly, in dollar terms the 1979 increase in oil prices is about the same as in 1974. Moreover, the United States has grown increasingly dependent on imported oil (Chart 2). In 1974, the United States imported about 6½ million barrels per day. So far this

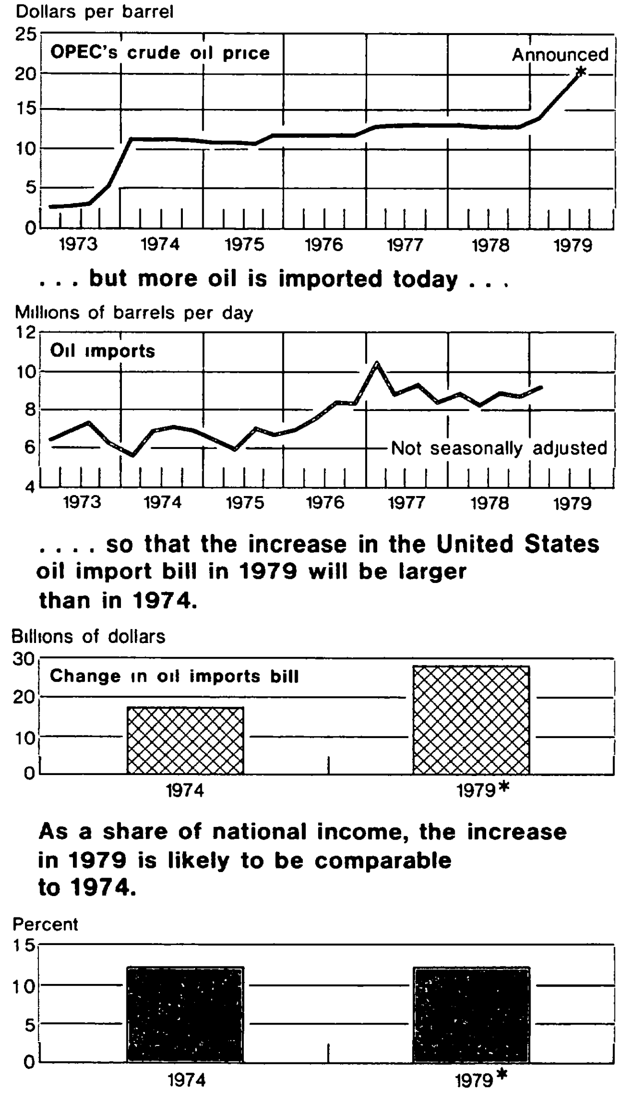
Chart 2

The dollar increase in oil prices in 1979 is about the same as in 1974 . . .

. . . but more oil is imported today . . .

. . . . so that the increase in the United States oil import bill in 1979 will be larger than in 1974.

As a share of national income, the increase in 1979 is likely to be comparable to 1974.



*Federal Reserve Bank of New York estimates

Sources Central Intelligence Agency and United States Department of Commerce year, imports have been running about 9 million barrels per day. As a consequence of the higher level of oil prices and the greater dependence on imports, the increase in the United States oil imports bill in the fourth quarter of 1979 from the final quarter of last year is likely to be about $28 billion, compared with the $17 billion jump between the fourth quarter of 1973 and that of 1974 After taking into account the growth of national income over this period, it appears that the direct impact of oil import costs relative to gross national product is similar to 1974—about 1 2 percent of GNP. Of course, the final impact on economic growth depends on a host of factors, such as the spending behavior of the OPEC (Organization of Petroleum Exporting Countries) cartel, but this calculation is suggestive of the adverse consequences posed by this substantial transfer of purchasing power to the oil-exporting nations.

Amidst the decline in consumer spending, homebuilding activity in the second quarter recovered from the weather-depressed level of the first quarter. Still, the pace of housing starts remained below recent levels. Some continued weakening seems likely, given the tightening of the mortgage market. Deposit flows at thrift institutions have slowed sharply in recent months, and interest rates on new mortgage commitments have jumped.

Nonresidential construction activity also recovered in the spring. The latest readings as to prospects of business spending on plant and equipment, however, are mixed. Businessmen have raised plant and equipment spending plans slightly, and capital appropriations of major manufacturing corporations jumped sharply after the turn of the year to the highest level on record. Against this strength, contracts for new commercial and industrial construction, as well as new orders for capital goods, have fallen in recent months.

Price pressures remain intense. Over the five months ended in May, consumer prices have jumped at an annual rate of close to 13 percent—the worst experience since late 1974. In the early months of this year, surging food prices led the growing inflationary pressures. More recently, the upward spiral of consumers' food prices appears to have moderated a bit Currently, skyrocketing energy prices—most notably for gasoline and fuel oil—have led the upward spiral of prices. Reflecting the run-up of world oil prices, gasoline prices in May were 20 percent above their year-end level. Even excluding the direct effects of higher food and energy prices, consumer prices have risen at a 10 percent annual rate in the first five months of 1979. Obviously, part of this inflation reflects the working through of higher food and energy prices. In addition, the price increase continues to capture the lagged effects of the 1977-78 decline in the international value of the dollar (see article on page 49).

From a broad perspective, the decline in activity in the second quarter represents an interruption in a long pattern of business advance. The economy has come to operate near effective capacity, with the unemployment rate in June at its lowest level in several years. Indeed, because the economy has been working with so little spare room, some easing in upward demand pressures is not in itself alarming.

What would be alarming would be failure to take advantage of any pause in economic activity to work toward restoration of price stability and deal with other impediments to economic growth in the future—factors that only increase the vulnerability of the economy to a severe downturn at some point. Certainly, monetary policy has a key role to play in that process. In that connection, the Federal Open Market Committee recently reaffirmed the policy of gradually reducing the growth of the monetary aggregates in order to curb inflation (see the article on page 32).

Whether the projected monetary growth will provide enough money to finance early and sizable restoration of growth depends in large part on supply and cost pressures. The division of nominal growth between real output and inflation can be improved by removing impediments to price stability. Some of the difficulties arise from government itself. The point has often been made that many regulatory policies tend to add to the upward pressures on prices Scheduled increases in payroll taxes need review. Similarly, the scheduled increases in the Federal minimum wage need to be reexamined. The effects fall hardest on those workers who are inexperienced and less skilled—teenagers and minorities. With the prices of many grains at high levels, the continuation of crop set-aside programs seems unnecessary In addition to removing impediments, tax policy can be used to promote investment which reduces cost pressures by increasing productivity and raising supply.

Energy policies seem likely to raise prices in the short run, but in the long run conserving fuel and encouraging production will help contribute to the goals of price stability and economic growth. President Carter's energy proposals should serve as a springboard for the creation of a forceful energy program. While any solution to the energy problem is bound to be controversial, policies need to be forged that will reduce the vulnerability of the United States to the disruptive pricing and output decisions of the OPEC cartel.