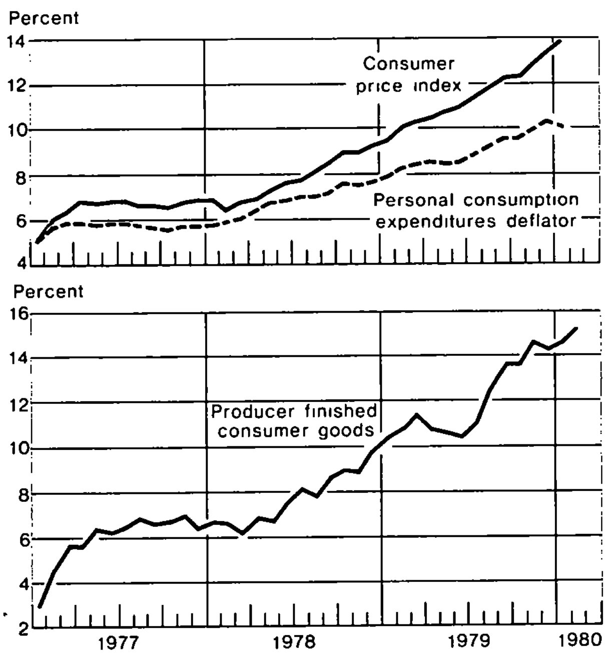
The business situation
Current developments

Price inflation has worsened markedly in recent months.



Data are expressed as the percentage change from twelve months earlier

Sources United States Bureau of Labor Statistics and United States Department of Commerce, Bureau of Economic Analysis

The distressing performance of prices dominated economic developments at the beginning of 1980 At both the consumer and producer levels, inflation accelerated sharply Part of the acceleration was due to higher energy prices, which reflected the repeated increases in Organization of Petroleum Exporting Countries (OPEC) oil prices last year In addition, fears of price controls also may have prompted some increases in posted prices More generally, however, the virulence of the inflation appeared to mirror the demand pressures of an unexpectedly resilient economy

As the actual price situation worsened, concern over future inflation intensified dramatically This marked worsening in inflation expectations precipitated an unprecedented upward adjustment in long-term interest rates. In this atmosphere, in March the President announced a broad program of fiscal, energy, and credit measures aimed at moderating and reducing the growing inflationary forces (For discussion of the Federal Reserve System's credit restraint program, see the article beginning on page 32)

The recent consumer price statistics have made alarming reading In January, the consumer price index spurted at an annual rate of 18 percent This jump represented a sharp worsening from the less than 14 percent advance posted in 1979. While monthly changes in prices obviously are volatile, looking at the sources of inflation offers little hope for a near-term significant easing in the rate of increase in the consumer price index The acceleration in recent months has been due largely to skyrocketing energy prices and mortgage interest costs. Although energy prices have jumped at dizzying rates, the full impact of the recent OPEC oil price increase has yet to be felt at the retail level. Gasoline prices, which surged in January, apparently posted another sizable increase in February. In addition to spiraling energy prices, higher mortgage interest rates will continue to add to the upward pressures on the consumer price index. This index measures rates on mortgage closings. With rates on new commitments to lend substantially above rates charged on mortgages actually being closed, further rises in the housing finance component of the index are certain. More importantly, however, prices of nonenergy commodities are likely to escalate as the effects of higher energy prices are transmitted through the economy.

The sharp jump in prices is all the more discouraging in view of the recent slowdown in food prices. Consumer food prices were unchanged in January. At the same time, favorable weather conditions continued to bolster supplies of fresh produce, and producer prices for finished foods declined in February for the second consecutive month.

In contrast to the declines in food prices, the upward pressures on prices of nonfood commodities were acute at the producer level. The surge in producer prices in January and February was led by higher energy prices. But the acceleration was not limited to energy prices. Indeed, the run-up in prices was widespread. Prices of nonfood, nonenergy commodities rose sharply at the intermediate and crude stages of fabrication.

The recent acceleration in the price measures is disturbing. Careful examination of the consumer price index, however, leaves little doubt that it has tended to overstate the ongoing rate of inflation. The exaggeration is due to the index's treatment of energy and homeownership costs (for more on this point, see this *Review*, Winter 1979-80, page 49). The deflator for personal consumption expenditures, which avoids most of the problems of the consumer price index, also shows a worsening in inflation. However, the rate of increase recorded by the deflator is well below the rate of increase registered by the index. Still, while the degree of worsening differs dramatically according to the measure employed, inflation has accelerated by both measures. *E.g.* the lower rate of inflation captured by the deflator continues to point to a consumer inflation rate rarely exceeded in the postwar period.

In spite of the pickup in the rate of inflation, the pace of wage gains has not quickened. Indeed, in January and February, average hourly earnings rose at an annual rate of less than 7 percent, well below the increases posted in 1979. The slowing in the rise in wages is all the more remarkable in view of the increase in the Federal minimum wage. On January 1, 1980 the hourly wage of an estimated five million workers—which is more than the total number of workers covered by major collective bargaining agreements whose contracts are scheduled for negotiation this year—was raised from $2.90 to $3.10.

The flare-up of inflation has led to a sharp rise in interest rates. In the mortgage market, rates on new commitments to lend have jumped to record levels. In part, the rise reflected the temporary lifting of state usury ceilings, which resulted from Congressional action. In addition, some institutions have posted rates well above 15 percent in a conscious attempt to deter prospective borrowers. The run-up in open market rates over the past several years has narrowed the interest margins of thrift institutions. The profitability of thrift institutions has been further eroded by their increased dependence on high-cost sources of funds such as money market certificates and large-denomination certificates of deposit. Amidst these mounting financial pressures, thrift institutions are losing deposits and their liquidity is declining.

The further tightening in the mortgage market has led to a steep falloff in sales of existing homes as well as the continued decline in new home-building activity. Housing starts and permits to build in the future dropped sharply in the initial months of the year. The decline in the volume of thrift institutions' commitments to lend in the future presages continued weakness in home-building activity.

In contrast to the weakening in residential fixed investment, business capital spending so far offers little evidence of being affected by the record costs of financing. The latest Commerce Department survey of planned plant and equipment spending, which was taken in January and February, was little changed from the spending anticipated at the close of 1979. After adjusting for the impact of rising prices, capital spending is expected to rise about 1 or 2 percent over the course of this year. The robustness of the near-term barometers of capital outlays—shipments, orders, and backlogs of unfilled orders—all suggest that much of this prospective strength will occur in the early months of the year.

The record cost of financing has probably caused businesses to tighten further their rein on inventories. Barring a pronounced drop in sales, inventory stocks can be adjusted relatively quickly to the costs of borrowing by changing orders relative to sales. Of course, the pattern of inventory investment depends on factors besides financing costs, most importantly on sales and businesses' anticipation of sales. For the economy as a whole, inventories generally appear to be in balance with sales. The enormous inventory imbalance of automobiles has been pared back by production curtailments and price rebates. As a result, overall stocks of new cars have been brought into line with sales.

With the automobile inventory correction largely completed, new car production has been stepped up. Reflecting this higher output, industrial production posted a slight gain in February. Outside the motor vehicle industry, however, output was essentially unchanged. The slight output gain in February was reflected in labor market developments. Employment posted a very small increase, and the average workweek declined. Despite the apparent softening in demand for labor, the overall rate of unemployment dipped to 6 percent.

Reflecting the slowing in employment gains, personal income growth moderated. Personal consumption expenditures also slowed notably in February, after recording a large increase in January. The early experience of 1980 stands in sharp contrast to developments during most of last year. In 1979, households continued to spend in the face of declining real incomes, and the savings rate dropped precipitously. At least in the beginning months of 1980 the savings rate appears to have stabilized—albeit at a historically low rate. Most certainly, consumer behavior is a key determinant of the future gains in business activity and the inflation outlook.