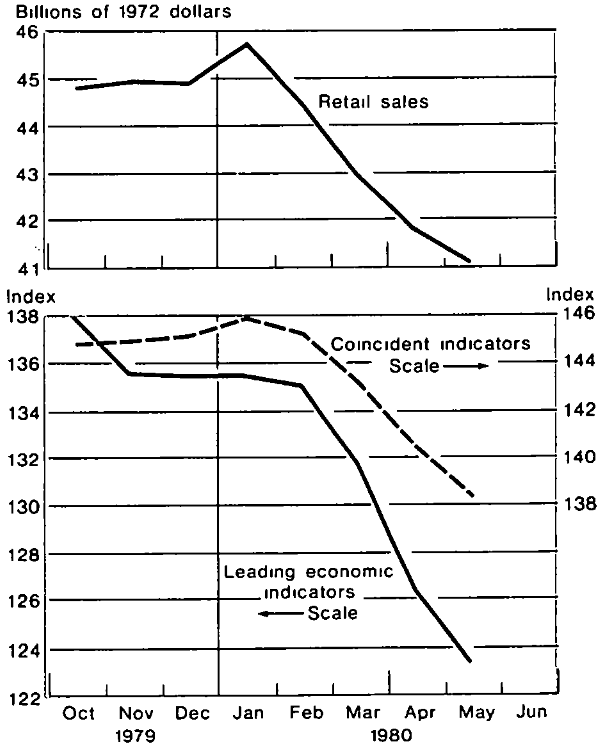
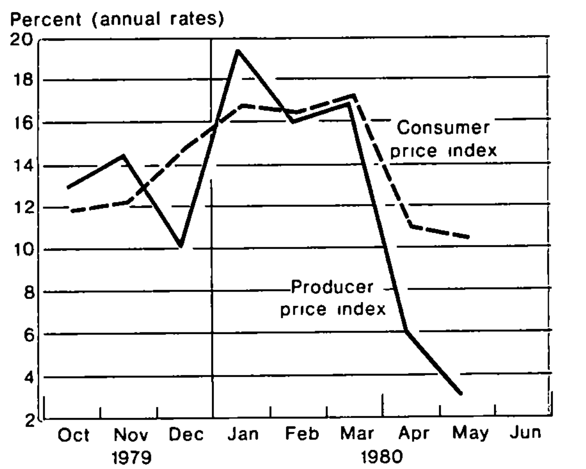
Chart 1

Economic indicators during the opening months of 1980 signaled the beginning of a recession . . .



. . . and inflation began to ease in the second quarter.



Sources: United States Department of Commerce, Bureau of the Census, United States Department of Labor, Bureau of Labor Statistics, and Bureau of Economic Analysis, Business Conditions Digest

The business situation

Current developments

In the opening months of 1980, the long-awaited recession began. The sharp decline already evident in the housing and automotive sectors spread rapidly throughout the economy. As demand dropped, so did production and employment. By late spring, capacity utilization fell to the lowest level in four years, and the unemployment rate, particularly among blue collar workers, rose sharply. All in all, the economic data released during the spring and early summer suggest that the decline in economic activity in the second quarter was one of the largest on record. Indeed, the severity of the downturn prompted the National Bureau of Economic Research to set January 1980 as marking the onset of the recession. As business activity declined, signs of a significant easing in the inflation rate began to appear in April, with both producer and consumer price increases slowing from the very rapid rates posted in the first quarter (Chart 1).

Nowhere were the signs of a recession more evident than in the housing and automotive sectors. Although these sectors have been declining for some time, in the late spring housing starts and domestic automobile sales fell to levels comparable to the lowest recorded in the 1973-75 recession (Chart 2). Reflecting the production cutbacks, unemployment in the construction industry surged to 16.5 percent by June and in the automobile industry to 25 percent. High financing costs and, in some cases, reduced credit availability had contributed to the declines in these sectors.

Consumers have cut back on other purchases as well. From January to May, retail sales excluding automobiles declined 5.7 percent in constant dollars. This is in sharp contrast to 1979 when consumers continued to increase spending, despite falling incomes, by borrowing more and reducing their rate of saving. Now consumer behavior has shifted dramatically. The savings rate increased to 4.5 percent in April from 3.7 percent in the first quarter, and during April and May consumers reduced outstanding instalment debt by a record $5.4 billion.

The weakening in consumer demand along with the increasing certainty of a recession led manufacturers to curtail output sharply. Industrial production declined steadily from January through June. Most major market groupings posted sizable declines. Even business equipment production, which had been strong through March, showed some signs of weakening, reflecting a cutback in new orders for capital equipment.

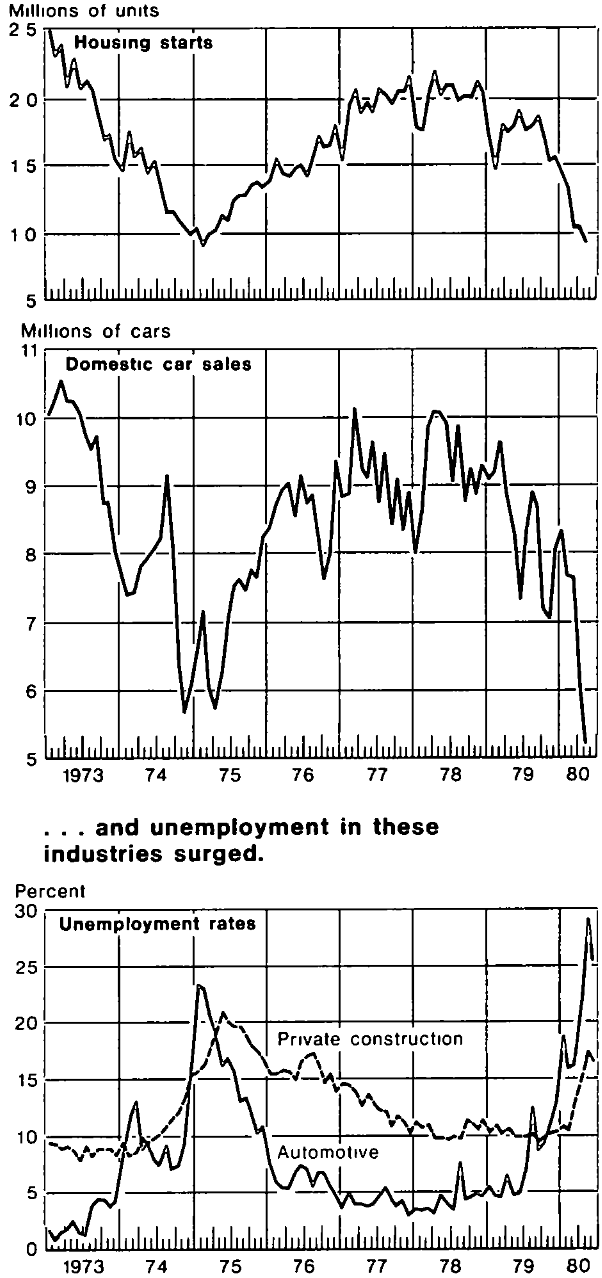
As the economy entered the recession early in the year, inventories appeared in rather good balance with sales. In April, however, inventories rose sharply while sales plummeted, and the constant dollar inventory-sales ratio for manufacturing and trade soared to a level approaching the maximum attained in the 1973-75 recession. This sudden buildup in inventories increases the likelihood that production will be cut further until inventories are worked back in line with sales.

The extent of unintended accumulation of stocks, however, is likely to be much less severe than in the 1973-75 downturn. Despite the large increase in the inventory-sales ratio in April, stocks have not swelled nearly so much over the past year as occurred in the comparable period of the 1973-75 recession. During that time, firms continued to expand inventories because of shortages of materials and expectations of rapidly rising prices. Also, many businesses expected the downturn to be short-lived. In contrast, during 1979 and early 1980, businesses were very sensitive to inventory levels because of high financing costs and expectations of a decline in demand. As a result, firms have been adjusting stocks much sooner than in the previous recession. Reflecting this, the overall decline in output is likely to be concentrated in the early part of the downturn.

With firms cutting production to avoid accumulating large stocks of inventories, unemployment has risen sharply. The unemployment rate increased to 7.7 percent in June from 6 percent in February. For blue collar workers, whose joblessness is more cyclically sensitive, the unemployment rate rose almost 4 percentage points from February to June to a level of 11.5 percent, the highest rate posted since early in the 1975 recovery. Total employment declined precipitously by almost one and a half million from February to June, and the average workweek edged down as well—all pointing

Chart 2

The sharp decline in business activity was led by the housing and automotive sectors . . .



Sources: United States Department of Commerce, Bureau of the Census, United States Department of Labor, Bureau of Labor Statistics, and Board of Governors of the Federal Reserve System.

to a large decrease in income during the second quarter. This sharp drop in employment early in the downturn is in marked contrast to the 1973-75 recession when employment was maintained during the early stages of the downturn as firms continued building inventories.

The weakness in the labor market was mirrored by the drop in capacity utilization during the opening months of 1980. Capacity utilization, as measured by the Federal Reserve Board's manufacturing index, fell sharply during the second quarter. Since peaking in March 1979 at a level just below the maximum attained in 1973, capacity utilization has declined about half of the peak-to-trough drop of 19 percentage points that occurred during the 1973-75 recession.

Along with the recent decline in economic activity has come some relief from the rapid rate of inflation. Producer prices slowed to an average annual rate of 6.2 percent in April, May, and June, compared with an 18 percent rate of increase in the first three months of 1980. The easing in producer prices, coupled with declining mortgage rates, should result in a slowing of inflation at the consumer level as well over the next several months. Already in April and May the rise in consumer prices showed some signs of moderating, but this was largely the result of a marked slowing of energy prices.

The 1980 recession began with a sharp contraction in economic activity, raising the question of how the overall downturn will compare with the 1973-75 decline In that recession, output dropped by the largest amount in the postwar period. There are important differences, however, that suggest the current recession will be less pronounced. The most important difference is the rapid decline in interest rates since late April. As a result, deposits at thrift institutions—the primary source of financing for the housing market—have strengthened somewhat following only very weak growth earlier this year. At the same time, the average cost of deposits for these institutions has dropped sharply from the extremely high levels during the first quarter. Reflecting the recent easing in the cost of funds to thrift institutions as maturing six-month certificates are rolled over at far lower rates, mortgage rates began to decline laying the groundwork for a recovery in housing With inventories of unsold homes at relatively low levels, any strength in demand should translate fairly quickly into new production. A turnaround in this sector along with the elimination of the March 14 credit control program could lead to some strengthening in the demand for other consumer durables as well. Also, consumption could be bolstered somewhat during the summer months by the large increase in social security benefits resulting from a cost-of-living adjustment for the rapid rise in the consumer price index over the past year.

Lower interest rates will contribute to a turnaround in the business sector as well. Because financing demands have not been increased significantly as a result of a large buildup of inventories, short-term credit is readily available either at banks or in the commercial paper market. Moreover, capital spending may not weaken all that much. Most businesses had allowed for a recession in their long-range plans. With financing available in large amounts in the bond market again, many firms are likely to proceed with those plans—although at a reduced pace in some cases—despite the current downturn in business activity.