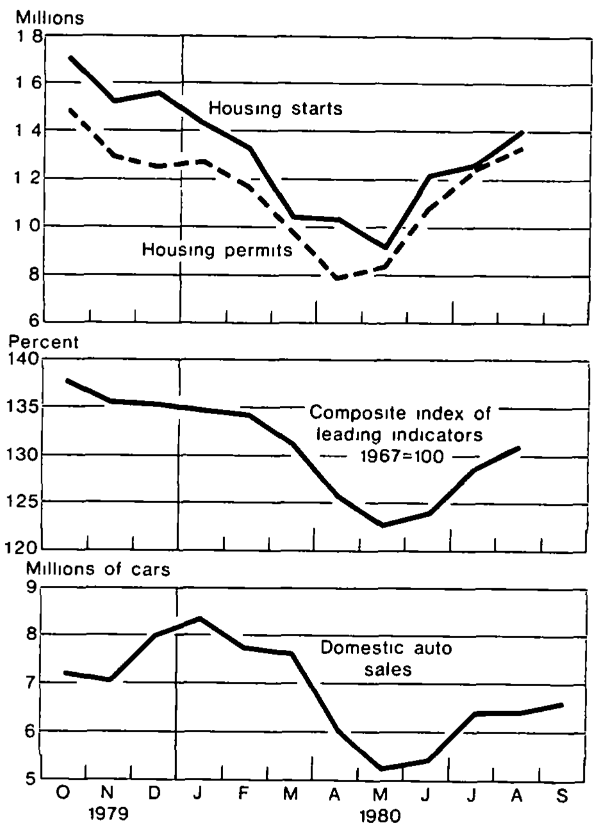
The business situation
Current developments

Chart 1

During the summer months, economic indicators signaled that the recession was coming to an end.



Sources United States Department of Commerce and Board of Governors of the Federal Reserve System

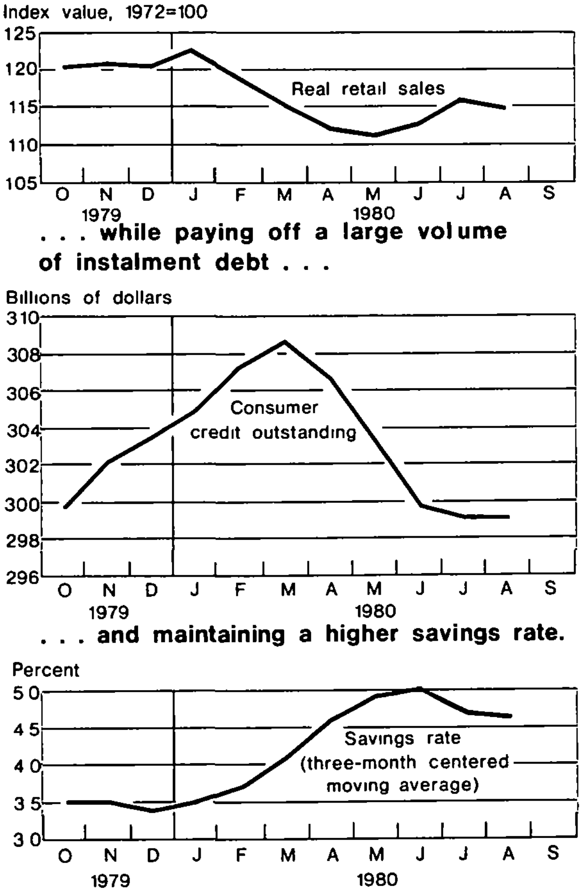
During the summer months, economic statistics seemed to indicate that the recession was ending The index of leading economic indicators rose in June, July, and August Automobile sales increased from the very low spring levels, and consumer purchases of other goods and services picked up as well Homebuilding activity also rebounded during the summer, as mortgage rates declined rapidly from the record levels attained during the spring (Chart 1). As the summer ended, however, sharp increases in both short- and long-term rates raised questions about whether the rebound in housing activity could be sustained and about how strong the economic recovery would be

Consumer spending was the primary factor contributing to the stronger outlook for the economy. Retail sales in constant dollars rose 3 3 percent from May to August, reversing about one third of the decline of the January-May period Consumers, nonetheless, remained cautious, repaying an unprecedented $9.5 billion in debt and maintaining a higher savings rate (Chart 2) In part, the upturn in consumer spending may have been spurred by the July cost-of-living adjustment in social security benefits, which amounted to almost $18 billion at an annual rate The lifting of the March credit control program also contributed to the rebound in consumer spending However, it is difficult at this time to assess whether there has been a lasting change in consumer spending attitudes

Automobile sales, which had accounted for roughly three fourths of the decline in retail sales earlier in the year, gave a large boost to consumer spending during the July-September period. Consumers, however, still are showing a strong preference for foreign cars, and the domestic auto producers' share of the market remains at a low level. The new lines of fuel-efficient cars may help domestic producers gain a

Chart 2

Consumers have increased expenditures . . .



Sources United States Department of Commerce and Board of Governors of the Federal Reserve System

larger market share At the same time, the demand for these cars will be an important factor in determining the strength of the prospective recovery

Another key factor in determining the strength of the recovery will be the performance of the housing market. Largely as a result of the decline in mortgage rates during the summer, the housing market rebounded sharply. Housing starts rose from a 900,000-unit annual rate in May to 1 4 million in August, and permits to build new housing units also increased by more than 50 percent during these months Despite these large increases, housing production remains well below the levels recorded during the third quarter of 1979

An increase in industrial production also signaled a turn in the economy After six consecutive monthly declines, the Federal Reserve Board's index rose in August and September The two-month advance in the index was broadly based Indeed, the sizable increase in production of durable goods was surprising because the inventory-to-sales ratio in the durables manufacturing sector has not declined significantly from levels comparable to the highest reached in the last recession

The labor market reflected the improvement in economic activity After rising steadily from February to May, the unemployment rate edged down to 7 5 percent during the summer At the same time, the number of employed persons began to rise A drop in initial claims for unemployment benefits also signaled improvement in the labor market

Indeed, developments in the labor market—a decline in the layoff rate and an increase in the workweek—were important factors behind the summer advance in the leading economic indicators This index rose in June, July, and August, the first series of three consecutive increases since the summer of 1978 Besides recent developments in the labor market, the strength in M-2 since June also contributed to the rise in the leading indicators

Even as the recession seemed to be bottoming out, inflation continued at a rapid rate Led by a sharp increase in food prices during July and August, the producer price index advanced at an annual rate of nearly 20 percent Though the index edged down in September, its three-month gain was still more than twice the 6 percent rate of the second quarter

The summer's food price increases at the producer level are beginning to be reflected at the consumer level as well In August, consumer food prices rose at nearly a 30 percent annual rate Despite the rise in food prices, the consumer price index has increased at a relatively moderate rate in recent months, largely as a result of the rapid decline in mortgage rates during the spring and summer and a decrease in energy prices In coming months, however, some of the factors affecting the consumer price index are likely to shift again There is some evidence that the rapid rise in food prices is winding down for the time being By October, however, the rise in mortgage rates that began at the end of August will add to the rate of increase in the index In addition, energy prices are likely to rise as a result of the continuing removal of domestic price controls and the disruptive effects of the military conflict in the Middle East

All in all, the recent economic signals seemed to suggest that the recession was ending. Some of the recent developments, however, raise questions about how strong the recovery will be and leave open the possibility that economic activity could decline again after a brief upturn The strong increase in consumer spending, to the extent that it reflects the increase in social security payments and the lifting of credit controls, may not be sustainable over the next several months. For the automobile industry, tighter credit conditions and possible consumer resistance to the high prices for the new-model year point to an uncertain sales picture.

Home buyers also will be facing a tighter credit market this fall. If mortgage rates rise to spring levels, the housing recovery would be curtailed. In the business sector, inventory levels that were more comfortable during the summer could become burdensome again if sales taper off, particularly in light of higher financing costs. And businesses continue to be cautious in their investment plans, reducing their planned capital expenditures for the rest of the year. Thus, even with business indicators pointing to an end to the recession, the economic outlook remains uncertain.