The business situation

Current developments

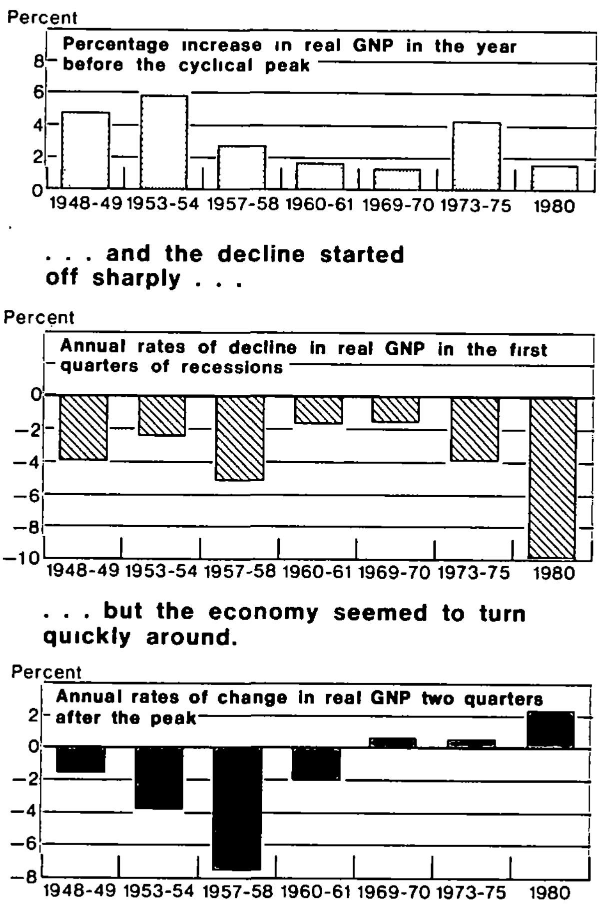
Chart 1

The 1980 recession is unique by postwar standards.*

The advance in economic activity during the year before the downturn was very weak . . .

. . . and the decline started off sharply . . .

. . . but the economy seemed to turn quickly around.



*Data for periods preceding 1969 do not reflect latest revisions

Source United States Department of Commerce, Bureau of Economic Analysis

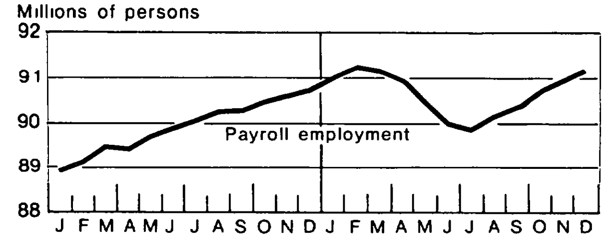
Economic activity advanced in both the third and fourth quarters following the sharp second-quarter decline. The recovery surprised many observers, because it was earlier and more vigorous than had been expected Industrial production rose more than 7 percent from July to December, reversing about 80 percent of the January-July decline. Construction activity also picked up substantially, and sizable gains were recorded in payroll employment At the same time, however, there were indications that further substantial growth in early 1981 is unlikely. Retail sales, in constant dollars, were essentially flat from July to November and then tailed off. Domestic auto sales were sluggish, and permits for housing construction began to decline at the end of the year, as interest rates reached the very high levels attained last spring While the business indicators were mixed, strong inflationary pressures persisted

The current business cycle has been very different from earlier ones (Chart 1). The 1980 recession was preceded by a year of weak economic growth, and the ensuing downturn in economic activity was very rapid The 9.9 percent annual rate of decline of real gross national product (GNP) during the second quarter—led by rapid declines in the auto and housing sectors—was the steepest on record in the postwar era and by far the largest decline at the start of a recession. After this abrupt slowdown, the pace of business activity picked up again in the third quarter By most conventional measures, the 1980 recession should be one of the shortest on record. In terms of its overall magnitude, however, its peak-to-trough decline would be close to the average for previous postwar recessions.

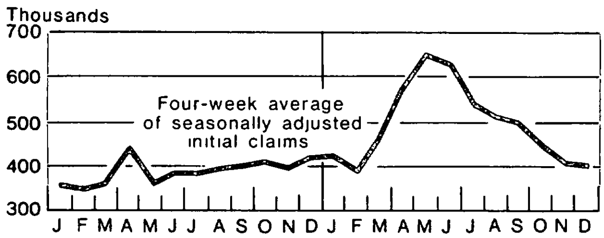
The pattern of the current business cycle has been reflected in the movements of both industrial produc-

Chart 2

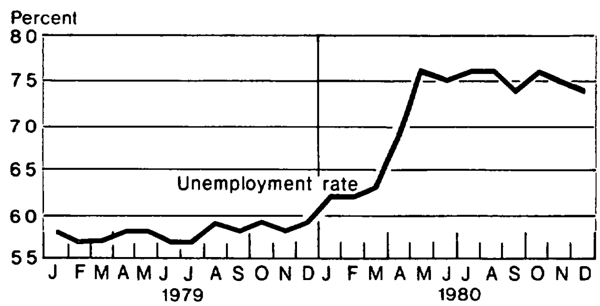
Although there have been significant gains in employment in recent months . . .



. . . and initial claims for unemployment benefits have declined . . .



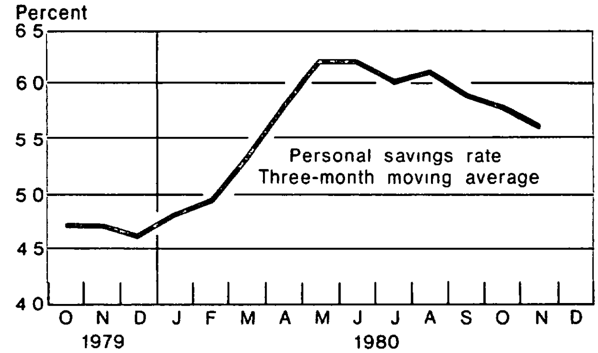
. . . the unemployment rate has remained well above 1979 levels.



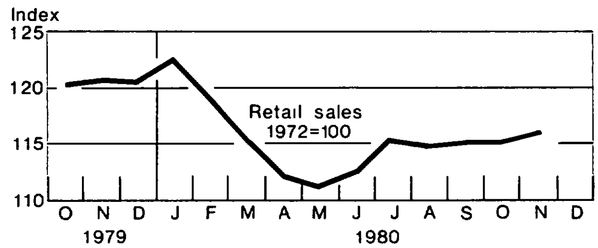
Source United States Department of Labor, Bureau of Labor Statistics

Chart 3

Consumers have maintained a higher savings rate . . .



. . . and have not increased purchases.



Source United States Department of Commerce, Bureau of Economic Analysis

tion and payroll employment. Industrial output rose more than 7 percent from July to December, the largest five-month gain since late 1975, when the economy was recovering from the last recession. The recent strength has been broadly based, stemming from advances in the production of consumer durables, intermediate products, and basic materials. Reflecting the pickup in economic activity, employment has been rising in recent months, recovering about 95 percent of the February-July decline But, with the total labor force expanding vigorously through November, the unemployment rate has been in the 7.4 to 7.6 percent range for eight consecutive months (Chart 2).

The domestic auto industry had a central role in the first months of the upturn. Sales were sluggish going into the recession, dropped further during the second quarter, and rebounded—although to still fairly low levels—in the third quarter. By and large, automobile sales for the new-model year have not met producers' expectations Domestically produced autos sold at an annual rate of 6.5 million in the fourth quarter, just matching the third quarter's sales pace The new fuel-efficient models were expected to be very popular, but high prices and tight credit conditions still cloud the sales outlook. Uncertain sales prospects and high financing costs have encouraged dealers to maintain low inventories, and this could temporarily delay sales even if demand strengthens.

By historical standards, the housing recovery also has been less than vigorous. Nevertheless, the advance in housing starts—from a 900,000 unit annual rate in May to more than 1.5 million in October, November, and December—contributed substantially to economic growth in the fourth quarter With interest rates markedly higher at the year-end, however, building activity showed signs of turning down once more. Single-family housing starts and building permits registered modest declines, but the pace of multifamily starts increased, sustained by work on new apartment buildings to be occupied under Federal rent subsidies Nevertheless, the total issuance of single- and multifamily permits in December was more than 300,000 below September's rate, signaling a likely reduction of housing activity in coming months.

Weakening demands for new homes and autos fit into a broader picture of stagnant consumer spending. In constant dollars, retail sales were essentially unchanged from July to November after rising by almost 4 percent from May to July. A number of factors make the outlook for consumer spending uncertain. The savings rate remains high in comparison to its level in late 1979 (Chart 3), suggesting that consumers have remained cautious. (Recent data revisions have raised the level of the savings rate but without changing its pattern in the 1979-80 period.) On the other hand, there is evidence that consumers are beginning to borrow once again after the precipitous decline that occurred during the credit restraint program. Outstanding consumer credit grew by $3 billion from July to November, offsetting 40 percent of the March-July decline.

Despite the legacy of the sharp recession in the first half of 1980, inflation continued at a rapid rate. The consumer price index increased at a 12 percent annual rate in the September-November period, boosted by the volatile mortgage rate and food price components. The latest statistics on wage increases also suggest strong inflationary pressure. Average hourly earnings in manufacturing, adjusted for interindustry shifts, rose at a strong 9 percent annual rate in the fourth quarter However, this was considerably slower than the previous three quarters, suggesting that inflationary pressure, while still strong, may be easing somewhat.

With the uncertain outlook for auto sales, and high interest rates causing housing to slow, it is unlikely that the recent advance in business activity—if it lasts—will have the vigor of the early stages of past expansions. Given current economic conditions, it would take remarkable strength in several sectors of the economy to achieve a robust expansion, despite the prospects for some additional stimulus in the coming year from tax cuts and increased defense spending. Moreover, these sources of strength are likely to be offset, at least in part, by weakening export demand as the economies of other major industrial nations experience slowdowns.