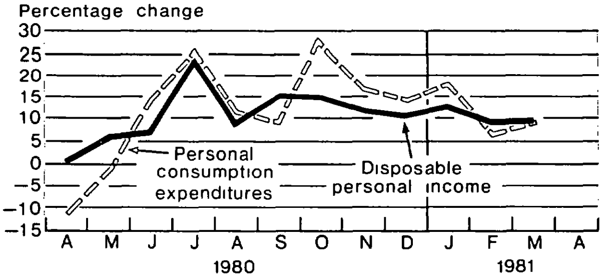
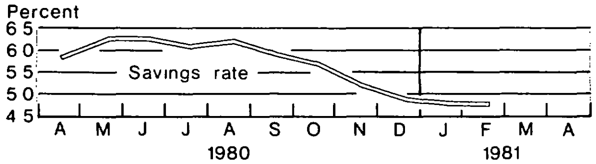
Chart 1

After increasing more rapidly than income, consumption spending has begun to grow at a slower pace . . .



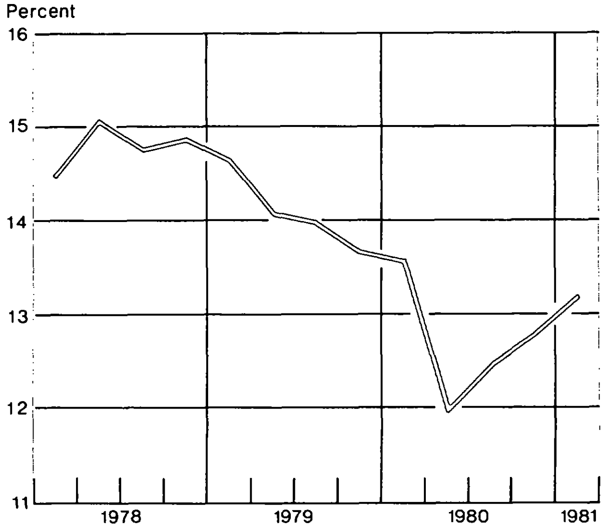
. . . and the savings rate has stopped declining.



Source United States Department of Commerce, Bureau of Economic Analysis

Chart 2

Durable Consumption Expenditures as a Percentage of Total Consumption



Source United States Department of Commerce, Bureau of Economic Analysis

The business situation

Current developments

The economy displayed considerable vigor in early 1981, with gross national product (GNP) growing by 6½ percent in real terms in the first quarter Consumer spending remained generally strong, particularly relative to disposable income—as it has been throughout the recovery. Generous rebates on the part of automobile manufacturers helped bolster demand; in fact, car sales plummeted in late March as these programs were phased out. Also contributing to the sharp rise in real GNP was a surge in business investment in the first quarter, breaking out of a sluggish pattern during the second half of 1980. Despite this strong growth of the economy overall, the unemployment rate was little changed over the quarter. In addition, there were mixed signals about the degree of inflationary pressures in the economy.

Historically, the early part of business recoveries has been characterized by strong growth of consumer spending and housing-related outlays, while business investment has tended to remain sluggish in the face of low capacity utilization As recovery proceeds, investment spending tends to gather strength, while higher interest rates and reduced credit availability slow the momentum of consumer outlays By and large the current expansion is following this basic pattern, but the transitions from one stage to the next seem to be taking place much faster than normal

Consumption spending was a major factor in the first quarter's strong growth. After rising very rapidly in the latter part of 1980, consumption maintained its momentum in January, although growth slowed over the next two months. The surge in household spending over the past three quarters has brought the personal savings rate to an abnormally low level (Chart 1).

Among the factors affecting consumer spending may be expectations of prospective tax cuts A portion of the recent strength in consumption may be attributable to spending in anticipation of the Administration's proposed cuts Consumers may have already taken account of them in calculating their longer term (permanent) income As a result, they may generally have been spending more out of current income than they otherwise would Moreover, consumers may have increased their demand for the services provided by durable goods in response to the higher permanent income levels, requiring a large initial outlay to acquire those goods Thus, anticipatory spending could also explain part of the strong rebound in purchases of consumer durables as a percentage of total consumption (Chart 2)

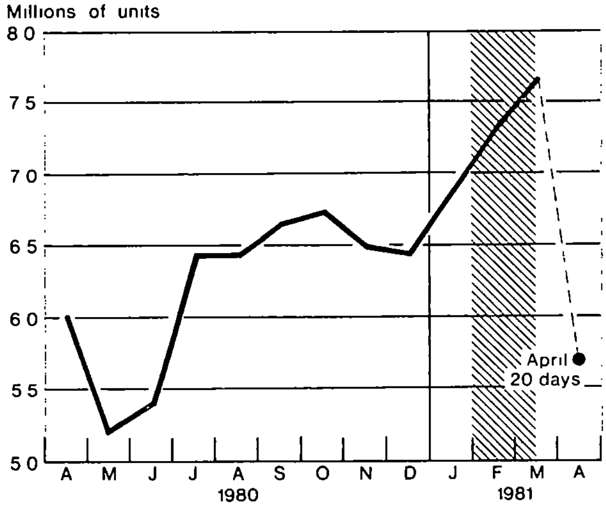
There are other ways of looking at the recent data, however For one thing, although the anticipation of tax cuts may have been a factor in generating increased consumer spending, the subsequent postponements of the tax reductions may cause consumers to reappraise their estimated permanent income levels Apart from this, the recovery in durable goods spending from its extremely low level of the second quarter of 1980 could represent no more than a one-time replenishment of depleted stocks Therefore, the recent fall in the savings rate may be more of a temporary phenomenon, not simply a result of any tax cut expectations On this reasoning, consumption would decline to more normal levels with respect to current disposable income as savings rates recover

Questions about the resiliency of consumer expenditures naturally arise in analyzing the impact of the automobile rebate program that began in February From an annual rate of 6 9 million units in January, sales of domestically produced cars climbed to 7 3 million and 7 7 million in February and March, respectively The end of the rebate programs in late March brought with it a reversal of this surge, as car sales dropped to 5 7 million units during the first twenty days of April (Chart 3) This mirrored the sharp declines in sales that occurred following similar rebate programs in 1975 and 1980, since many car buyers undoubtedly pushed up their planned purchases to take advantage of the cash inducement Moreover, the recently announced price increases by major auto manufacturers could exacerbate the expected decline in sales All in all, uncertainty regarding savings patterns and regarding the overall timing of consumer durables purchases, including cars, clouds the outlook for the expansion of demand over the next few quarters.

Housing, an important sector in its own right and a key determinant of consumer purchases of household durable goods, has decidedly weakened over recent months From last September to January, housing

Chart 3

Domestic Automobile Sales

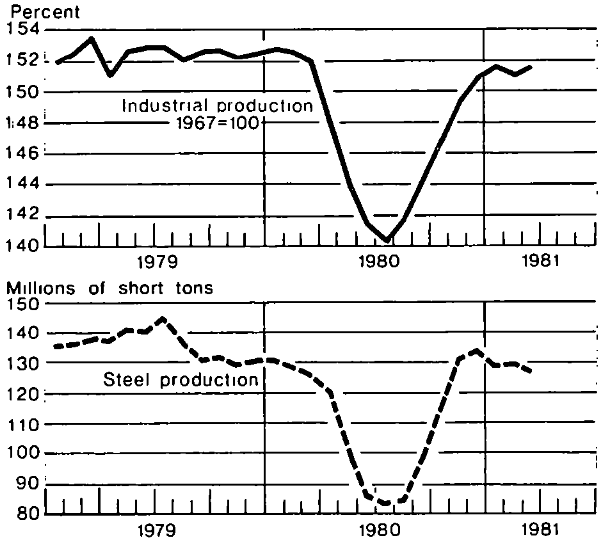


Shaded area represents the rebate program (February to mid-March for most popular models)

Source Board of Governors of the Federal Reserve System

Chart 4

The recovery in production has stalled.



Sources Board of Governors of the Federal Reserve System and the American Iron and Steel Institute starts remained on a plateau in the 1.5 million to 1 7 million units range, as gains in multifamily starts largely offset the declines in the single-family category. In February, however, starts plummeted to 1 2 million, its lowest level since June 1980, as both single-family and multifamily units decreased, and there was only a slight recovery in March.

Many questions arise regarding the housing outlook. First, to what extent will the Administration's plans to reduce Federal housing subsidies decrease starts of rental units. A second issue concerns the response of home buyers to a persistence of high mortgage interest rates. So long as home prices were rising and were expected to continue to do so, home buyers seemed to be prepared to accept steep mortgage rates. But recent declines in home prices may be altering these expectations and making potential home buyers more cautious, even though by themselves these price declines make houses more affordable. Moreover, the increase in rates precludes some families from meeting the higher income requirements for mortgage payments, which may counteract the increased affordability of homes.

Although housing has weakened, real business fixed investment has shown remarkable strength. It rose by 12.5 percent in the first quarter, following an increase of 3.9 percent in the fourth quarter of 1980. The recovery in business investment is occurring more rapidly than is usual so soon after a recession One factor may be firms' expectations of a tax cut in the form of liberalized depreciation allowances. Also, while capacity utilization is relatively low by historical standards, this measure may not be a good indicator of the need to invest in plant and equipment. Much of the existing stock of capital was acquired during an era of significantly lower energy prices, implying that the available capital stock is energy inefficient Thus, under the new environment of higher energy prices, there exists a stimulus for spending to replace capital, rather than just for expanding productive capacity.

Moreover, the growth of defense spending is a factor in the strength of capital spending, as firms gear up to expand production of these items. Since increased Government spending for military purposes is widely expected to continue, this impetus for business investment is likely to be sustained.

Reflecting the strength in private-sector demand in the early winter, industrial production continued its upward momentum in January, but then fell back in February, and recovered only to its January level in March. The performance of the steel industry is particularly instructive. After posting very strong gains earlier in the recovery, steel production flattened out during the first quarter. A major part of this slowdown is attributable to a weak prospective pattern for domestic auto sales in the absence of rebates or other special incentives. While steel demand has been supported by the surge in oil and gas drilling activity, the prospect of slower growth of outlays for housing-related consumer durables may also have exerted a dampening influence (Chart 4)

Notwithstanding the recent strength of output growth, the unemployment rate has hovered around the relatively high 7.3-7.4 percent range since December, as an increase in the labor force largely offset the 1.1 million rise in the number employed. Hours worked in February declined following six successive months of growth and rose only marginally in March.

The economy's recovery in recent quarters has also not brought about a similar resurgence in the demand for petroleum products. In fact, the ratio of petroleum consumption to real GNP has continued its secular decline, mainly as a result of additional conservation induced by the accelerated decontrol of oil prices

The close to double-digit rates of increase in the consumer and producer price indexes were in large part due to the Administration's decision to decontrol oil prices immediately, as prices of finished energy goods climbed at an annual rate of 73.6 percent in March. The effects of these energy price increases will be felt over the longer term. As they filter through the stages of production, they will be manifested in higher materials costs and eventually in higher prices for final goods and services. Moreover, as already mentioned regarding investment, energy price increases reduce the efficiency of older, energy-intensive capital equipment This reduces the amount of slack available in the economy, adding to inflationary pressures at any level of output. While the rate of increase in the implicit GNP deflator declined to 7.8 percent in the first quarter from 10 7 percent in last year's final quarter, this partly reflects a switching-away from higher priced items, such as gasoline. An alternative indicator of the economy's inflationary pressures is the fixed-weight deflator, which rose almost 10 percent, about the same as in the fourth quarter of 1980.

On the other hand, there are some indications of an abatement of inflation. Prices of nonfood finished goods excluding energy increased at an annual rate of 8.4 percent in the past half year, after rising 9.6 percent in the previous six months And unit labor costs increased only 7.5 percent at an annual rate in the first quarter following a 10.1 percent jump in the last quarter of 1980