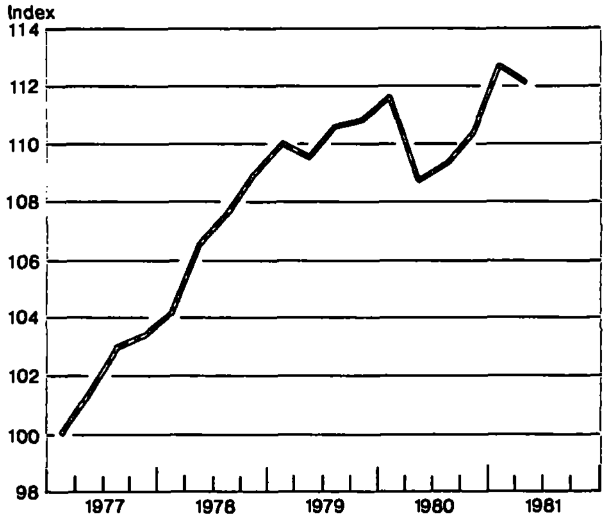
The business situation
Current developments

Chart 1

Real Gross National Product

1977-I=100; seasonally adjusted annual rate

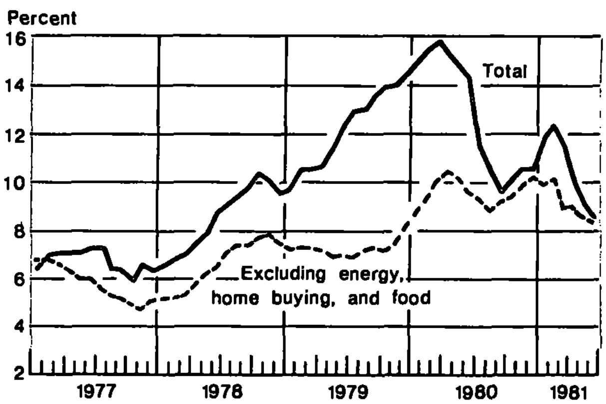


Source: United States Department of Commerce.

Chart 2

Consumer Price Index

Change from six months earlier; seasonally adjusted annual rate



Source: United States Bureau of Labor Statistics.

Following the surge in economic activity at the beginning of the year, real gross national product declined somewhat in the second quarter (Chart 1). Industrial production has increased only modestly since January, and housing starts have tumbled. Real consumer outlays have fallen below their January level, reflecting weakness not only in auto sales but in other consumer durables purchases as well. Employment growth also appears to have leveled off in recent months, and on balance the unemployment rate held steady at about 7.3 percent during the first half of the year.

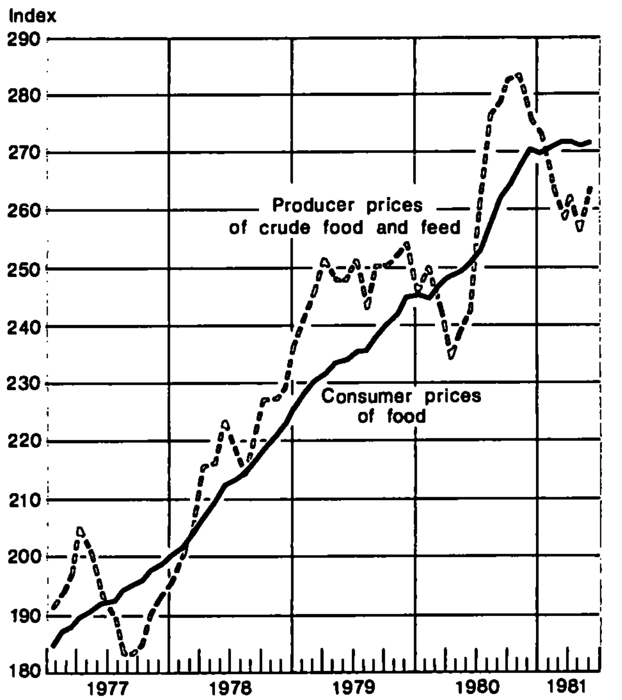
The first half of 1981 witnessed a welcome slowdown in inflation, particularly in the consumer price index (Chart 2). Retail food prices, which had risen at over a 15 percent annual rate in the second half of 1980, were virtually unchanged during the first six months of 1981. The decline in home prices late in 1980 showed up in the consumer price index at the start of 1981. Although mortgage interest rates continued to post hefty increases, they have been rising less rapidly than at the end of last year. This moderation in food and home-buying costs allowed the index to decelerate despite the sharp jump in oil prices at the start of the year. The subsequent fall in petroleum prices has allowed the slower rate of increase in the index to continue despite a recent acceleration in home prices.

Last year's jump in retail food prices and this year's subsequent moderation reflected wide swings in prices of raw agricultural commodities (Chart 3). Hog and steer prices rose rapidly in the early summer of 1980 before starting to decline in August. Wheat and corn prices peaked later in the year. Volatility in food prices is nothing new. For example, farm prices fell throughout 1976, resulting in stable retail food prices that year.

Chart 3

Food Prices

1967=100; seasonally adjusted



Source: United States Bureau of Labor Statistics.

By 1978 and 1979, however, rapid increases at the farm level showed up as double-digit inflation in food prices paid by consumers.

Another factor contributing to the recent slowdown in food prices was the omission of the April 1, 1981 adjustment to dairy price supports. In recent years support prices have been adjusted semiannually in response to movements in the parity price of milk.* Large surplus stocks of dairy products have accumulated as supply has constantly exceeded demand. The new farm bills before the Congress propose reductions in the support levels from 80 percent of parity to 75 or 70 percent. The likely effect of these proposals would be the elimination or reduction of the scheduled October 1, 1981 dairy support price increase and, possibly, some reduction of the 1982 increase. The elimination of the April 1, 1981 increase helped reduce dairy price growth between February and May to 3.4 percent at an annual rate from the 12.3 percent rate of the previous three months, shaving 1.2 percentage points off the growth rate of the food-at-home component.

The fall in meat prices is partly a result of the poor outlook faced by cattle farmers in the second half of 1980 and early this year. Confronted with high feed prices, a reduction of pasturage because of drought, and high carrying costs of cattle, farmers in the second half of 1980 decided to reduce the size of their herds, temporarily increasing meat supplies. An indication of both the unavailability of forage and the unprofitability of intensive feeding is that a relatively high proportion of the cattle slaughter came from "nonfed" cattle, cattle which had not been fattened on feedlots prior to slaughter. The relatively mild winter further increased meat supplies by reducing losses and permitting rapid weight gains by cattle. All these factors contributed to a beef and veal supply in the first five months of the year which was 4 percent above that of the same period in 1980. This held down prices not only for beef but, indirectly, for pork as well. As of this June, however, hog herds were significantly smaller than they had been a year ago, and pork farmers surveyed by the United States Department of Agriculture indicated intentions of producing substantially smaller pig crops in coming months.

The outlook for meat prices hinges on some very unpredictable factors. If good weather makes corn prices fall, the meat supply could decline in the near term, as farmers place more of their cattle in feedlots for fattening rather than have them slaughtered. Conversely, with low corn supplies and poor pasturage, the slaughter of nonfed cattle could approach last year's high rates. This would produce a temporary glut on the market but, over the longer term, would result in a smaller livestock herd and thus smaller meat supplies. Another important source of uncertainty is interest rates, which help determine the cost of withholding cattle from the market.

Farm prices now account for only 30-35 percent of the retail food dollar; the remaining 65-70 percent covers processing and distribution costs. These costs increased markedly at the beginning of 1981, as accelerated oil price decontrol, the January increase in social security taxes, and the minimum wage increase provided upward pressure. The Department of Agriculture's food marketing cost index rose at a 16.4 percent annual rate in the first quarter of 1981, the largest increase in over a year.

The effects of these upward cost pressures were particularly evident in the prices of foods for which processing and distribution account for especially large shares of total costs. For example, in contrast

* The parity price of milk is the price which would give dairy farmers the same purchasing power for their milk as they enjoyed during the 1910-14 period.

to the overall stability of food prices so far this year, prices for bakery products, fats and oils, and other prepared foods have been increasing at double-digit rates. The only category of highly processed food which showed price moderation was nonalcoholic beverages, and this reflected steep declines in coffee and sugar prices.

All in all, however, food prices at the retail level have moderated. Together with fuel price declines, they have helped reduce the rate of inflation as measured by the consumer price index. These favorable factors reflect for the most part temporary expansions of supplies of certain commodities relative to the demand for them. Food and fuel prices, therefore, cannot necessarily be counted on to continue having such a big slowing effect on the index. More heartening for the longer term is the fact that the index excluding food, energy, and home buying has decelerated this year, albeit to a lesser degree than the overall index. Since these other prices are generally less subject to wide, transitory swings, their slowdown may represent a more sustainable reduction of inflation.