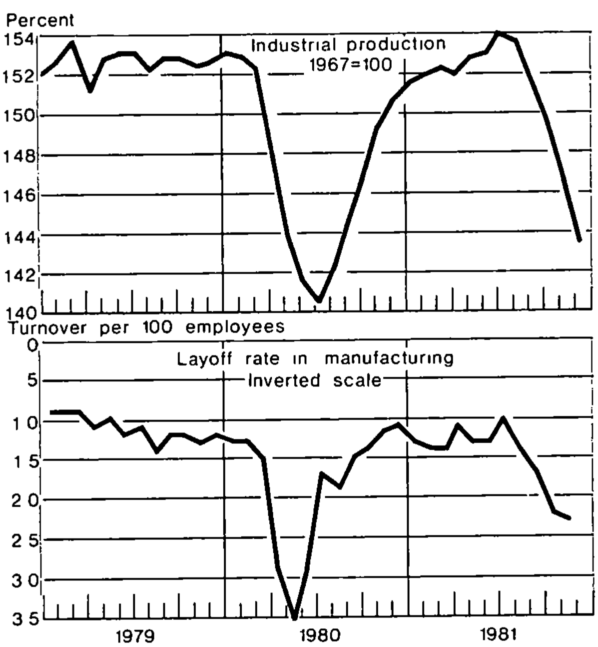
Current economic developments

Chart 1

Industrial activity began to turn down in late summer of 1981.



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

In the closing months of 1981, the economy slid deeper into recession Symptomatic of the downturn were the drop in industrial production, the sharp rise in layoffs, and the surge in unemployment (Chart 1) The weakening in economic activity was also reflected in the financial markets Interest rates, particularly the short-term rates, receded sharply in November from the record high levels attained earlier in the year However, conditions in the financial markets changed in early December, and yields backed up briskly in the closing weeks of 1981 and the opening weeks of 1982

Industrial activity has been sliding since midyear Industrial production peaked in July, marking the end of a year-long expansion Thus far, this recession has been unfolding at a somewhat rapid pace Industrial output fell 6 9 percent from July to December, whereas in the seven previous postwar recessions the decline in output averaged almost 5 percent during the first five months of the downturn At the same time, unemployment climbed sharply from 7 percent in July to 8 9 percent in December

Signs of weakness in the economy first began to be noticeable late last spring and have become increasingly abundant since then Net exports have gotten progressively weaker over the year, reflecting both the slackening in economic conditions abroad and the appreciation of the United States dollar in relation to other currencies that started late in 1980 A surge in mortgage interest rates that began in May carried them to a level in October and early November in excess of 18 percent Though mortgage rates have declined since then, new housing construction remains in its worst slump since World War II. Spending by state and local governments has also slipped in real terms over the course of 1981 These governmental units are being squeezed by the steep reductions of Federal spending, the austere mood of taxpayers, the recession-induced declines in tax revenues, and the extremely high rates prevailing in the municipal bond markets

As the economy was faltering, cutbacks in consumer spending made matters worse. New car sales, in particular, fell sharply As soon as United States automakers ended their price rebates and other sales-promotion schemes in early September, domestic car sales plummeted Over the last three months of 1981, new domestic car sales averaged 5.1 million units at an annual rate, the lowest level in over twenty years. Smaller but still substantial declines also occurred in real consumer purchases of other kinds of goods In real terms, spending on nondurable consumer goods peaked in August and purchases of non-automotive durables fell further in October after holding steady in the previous two months By the year-end, however, the decline in consumption spending appeared to have tapered off.

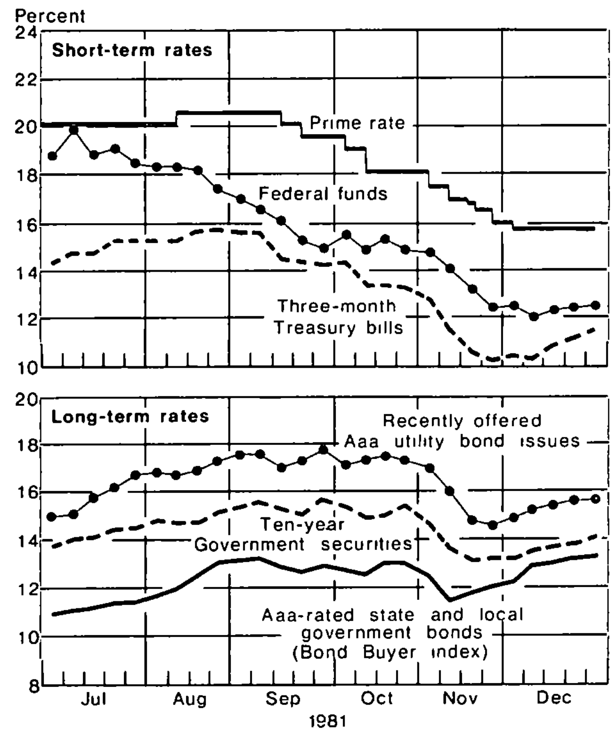
Coming in the last quarter of 1981, the downturn in consumer spending seems to have caught most businesses off guard With the 5 percent tax cut scheduled to take effect on October 1, many observers had foreseen a pickup in consumer spending over the fourth quarter Why the anticipated increase did not occur is still not clear Consumers may have decided to cut back or postpone their purchases of goods in order to take advantage of the all savers certificates and other savings incentives included in the Economic Recovery Tax Act of 1981 It is also possible that the high interest rates posted earlier in the year exerted a cumulatively depressing effect on consumer spending.

Despite the close scrutiny that businesses have kept on their inventories, an imbalance has developed over recent months Over the year ended in March 1981, total business inventories had fallen by slightly more than $2 billion in real terms But from then until October (the latest month for which there are data), roughly $7 billion worth of inventories were amassed. Much of this increase, especially the portion accruing in recent months, was unintended, and businesses reacted quickly by curtailing production and laying off workers Overall, the total buildup of stocks has not been unmanageably large, so that it should not take businesses too long to run down their excess inventories Once the inventory correction has been completed, the stage will be set for an economic recovery.

In the wake of the weakening economy, interest rates tumbled (Chart 2). After peaking at 15 85 per-

Chart 2

After declining sharply in recent months interest rates backed up a bit in the final weeks of the year.



Sources Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, and The Bond Buyer

cent in late August, for example, the three-month Treasury bill rate plummeted more than 5 percentage points by late-November. Other short-term rates posted similarly sharp declines In response, commercial banks lowered their prime rates The Federal Reserve System first lowered the discount rate and reduced the surcharge on certain discount window borrowings by large banks in early November and then, one month later, lowered the discount rate further and eliminated the surcharge altogether The rally petered out in early December At that time, short rates bottomed out and then backed up by more than 1½ percentage points in the closing weeks of 1981.

The vigorous rally in the money markets extended over into the capital markets. There, bond prices rose sharply throughout November, climbing to their highest levels since last spring. In the process, the rate on twenty-year Government securities declined by 2½ percentage points while the Aaa rate on corporate securities fell by a bit less than 2 percentage points. New bond issues swelled. In November, gross new corporate issues amounted to $7.3 billion, almost double the monthly volume averaged over the first ten months of the year.

In early December, however, conditions changed perceptibly in the capital markets. Long-term yields bottomed out and then began to rise, though rates at the year-end were still well below the peaks attained earlier in the year. No doubt the heavy congestion of new bond issues contributed to the flattening-out of yields. Probably even more important, however, were the newly issued estimates of the Federal deficit, indicating that the Federal Government would be borrowing huge sums over the next several years

Notwithstanding the contraction in economic activity, the growth of the monetary aggregates quickened in the last two months of 1981. In November, M-1B grew at a rapid 13.6 percent annual rate and M-2 surged 17.2 percent. In December, both M-1B and M-2 slowed down a bit from the previous month but still increased at a much faster pace than they had earlier in 1981. Over the four quarters of 1981, M-1B—adjusted for funds shifted into negotiable order of withdrawal (NOW) accounts from sources other than demand deposits—increased slightly more than 2 percent and ended up roughly 1¼ percentage points below the lower bound of its annual range. At the same time, M-2 increased about 9½ percent over the year, winding up slightly above the upper limit of its targeted range.

Interpreting the significance of M-1B and M-2 relative to their respective target ranges was complicated by the rapid pace of financial innovation during the year. Money market funds, for example, more than doubled over 1981 Attracted by the high yields offered by these mutual funds, investors drew down their demand deposits and cashed in some of their money market assets, placing the proceeds into money market funds. Because money market funds are excluded from M-1B but included in M-2, these transfers lowered the growth rate of M-1B while increasing that of M-2. (See "Money Market Mutual Funds and Monetary Control" in this issue of the *Review*)