14302

The Economic Outlook

PROGRAM ANALYSIS DIVISION
Economic Analysis Staff

FIRST QUARTER DEVELOPMENTS
CONTROLS ON CONSUMER CREDIT
HOUSING AND AUTOMOBILES
FINANCIAL MARKETS
THE RECESSION OUTLOOK

011332

(OTHER)

THE ECONOMIC OUTLOOK: THE RECESSION HAS ARRIVED

June 1980

Indications clearly show that the United States economy has entered a recession. Automobile production has been cut back; housing starts have fallen; and commodity prices, after rising sharply, have plummeted. Recently, Government statistics show declines in retail sales and industrial production. Unemployment rose substantially in April (from 6.2 to 7 percent) and again in May (from 7.0 to 7.8 percent). Historically, these are the harbingers of recession. There will likely be further declines in output and employment for at least the next 6 months. The key question that surrounds the current economic situation is the length and depth of the recession.

This report describes the factors which have contributed to the onset of the current recession including the following topics:

--economic developments in the first quarter of 1980.

--the credit controls imposed by the Federal Reserve in March.

--conditions in the markets for automobiles and housing and in financial markets.

--the current predictions of the major econometric forecasting services.

FIRST QUARTER DEVELOPMENTS

The inflationary boom which began to gather steam in 1978 persisted throughout 1979 and continued to push up prices at an accelerating rate well into the first quarter of 1980. At the end of 1979, the Consumer Price Index (CPI) was rising at 14 percent a year. In January the rate of increase jumped to 18 percent where it remained for 3 months. The Producer Price Index (PPI) for finished goods rose 14 percent in 1979. In January its rate of increase jumped to 20 percent where it stayed until April when it fell to a 6.2 percent annual rate.

The upsurge in inflation included rapidly rising prices for petroleum products and some new features. The apparel and upkeep component of the CPI rose only 6.4 percent in 1979, but in the first quarter it shot up at an annual rate of 15.3 percent. Similar increases occurred in the medical care and entertainment components.

Food prices, which had contributed significantly to the inflation as recently as a year ago, were the slowest rising component of the CPI and actually fell at the wholesale level in the last several months. Since food prices are volatile, a clearer picture of the underlying price trends can often be obtained by deleting them from the averages. Without them, the first quarter increase in the CPI exceeded 20 percent and the rise in the PPI for finished goods was 26 percent at annual rates.

This outburst of inflation has been attributed to a number of special factors--OPEC, speculation in gold and silver, mortgage interest rates, and anticipations of mandatory price controls. In addition, the expectation of large increases in defense spending may have led some businessmen to believe that expansive fiscal policy would postpone the recession and prolong the economic expansion.

Accelerating Inflation and the Business Cycle

The acceleration of inflation in the first quarter of 1980 was the final episode in the economic expansion which began in the summer of 1975, nearly 5 years ago. Since then there has been a continuing increase in the rate of inflation, gradual at first but culminating in the past few months in the most rapid inflation since the aftermath of World War II. Table I shows the percentage increase in the CPI for 12 month intervals beginning in June 1975.

TABLE I

INFLATION DURING THE CURRENT EXPANSION
(percentage increase in the CPI)

June 1975 to June 1976	5.9
June 1976 to June 1977	6.9
June 1977 to June 1978	7.4
June 1978 to June 1979	10.9
June 1979 to March 1980*	14.5

*Annualized rate

Historically, there is a tendency in the U.S. economy for inflation to accelerate during the recovery from the low point of a business cycle. The acceleration is gradual at first. As demands are met from unused capacity, output and employment are able to grow faster than normal, absorbing much of the pressure on prices. Ultimately, spare capacity is reemployed and further increases in demand can only be choked off by more rapidly accelerating rates of price increase. In the current cycle this point was reached more than a year ago. Beyond this point further stimulus contributes primarily to rising inflation.

This pattern was clearly present in the recent expansion. It was aggravated by a combination of two adverse long-term trends. First is the sustained rate of price inflation. Prices have continued to rise throughout the 1970's--uninterrupted by the 1974-75 recession. As a result, the inflation during the most recent expansion began from a higher base than normal and this helped it reach its current record level. Second is the economy's disappointing productivity performance. Normally in an expansion, rising productivity contributes to the growth in output and postpones the point at which rising demand leads to increasing inflation. During the recent expansion there has been little productivity growth--and negative growth in 1979.

Until there is a downturn in economic activity, inflation will continue to accelerate. If the recession had been postponed again, it is highly unlikely that inflation would have stabilized, even at the high rate reached last year. Instead, inflation would have been closer to 20 percent in 1980.

Changes in Monetary and Fiscal Policy

The Federal Government's monetary and fiscal policies have a significant influence on the timing of business cycle turning points. When the Federal Reserve (Fed) reduced the rate of monetary expansion in October 1979 and permitted a sharp increase in interest rates, it set in motion the forces which have contributed to the culmination of the economic expansion.

During the past 6 months the rate of growth in the money supply has fallen nearly 50 percent, from over 10 percent to approximately 5 percent. The economy continued to grow and inflation accelerated for sometime following this policy change, but that does not mean the policy failed. Historically, there have been long lags between changes in monetary policy and the economy's reaction to them. Typically, it takes about 6 months for a change in the growth rate of money to begin to affect economic activity. Therefore, the onset of the current recession is consistent with previous patterns. Moreover, it will be some months yet before the reduced rate of monetary expansion results in a pattern of lower prices.

The actions taken in March by the Administration, the Congress, and the Fed served primarily to reaffirm the new policy direction announced by the Fed in October.

In themselves the new measures are not likely to have a significant short run effect on inflation. In concert with the Fed actions of last October, a complete anti-inflation package is now in place. In total, the package signals a refusal to accomodate the rapid price increases of the first quarter and a willingness to accept the probability of recession which such a refusal entailed.

A policy innovation in the March actions was the invocation of the Credit Control Act. The need for this measure and its probable effects are analyzed in the next section.

CONTROLS ON CONSUMER CREDIT

The credit controls imposed by the Fed are aimed at the plastic cards we carry around in our wallets and purses which permit us to buy now and pay later. New extensions of consumer credit will now entail a 15 percent reserve requirement. This means, for example, that if Sears permits a customer to charge $10 using a new Sears credit card, it will have to forward $1.50 to the Federal Reserve for deposit--a deposit on which it will earn no interest. Similarly, a bank which issues new credit cards (e.g., VISA) will have to deposit 15 percent of any increase in its revolving credit with the Federal Reserve. As in Sears' case, the deposit at the Fed will earn no interest. This requirement raises the cost of supplying consumer credit which is its intention.

The new reserve requirement does not restrict the total amount of credit outstanding in the economy. Since it applies to only a part of the nation's supply of credit its main effect may be to reallocate credit from consumers to other borrowers. Only if the banks observe the voluntary limits of 6 to 9 percent on the growth of total lending suggested by the Fed, will total credit in the economy be restricted. Thus, the real effect of these credit controls is problematic.

The two sectors of the economy most dependent on consumer borrowing are the housing and automobile industries. The next section of this report describes recent developments in these important industries.*

HOUSING AND AUTOMOBILES

The present recession is not news in Detroit or to the nation's real estate brokers and building contractors. The housing and automobile industries have been in a slump for months. Both industries traditionally experience larger business cycle fluctuations than the economy as a whole. Their current difficulties are severe but not unprecedented. Special factors, particularly in the automobile industry, are also contributing to their problems.

The demand for both houses and automobiles is more dependent on interest rates than are other consumer expenditures. When interest rates rise, relative to the rate of inflation, there is a marked increase in the relative costs of housing and automobiles. Typically, the purchase of

---

*Automobile loans and home mortgages were exempted from credit controls.

either can be postponed so that when the cost rises there is a pronounced decline in demand. This is also a factor when rising unemployment and falling incomes increase economic uncertainty. Under these circumstances consumers normally postpone some purchases and this further depresses the demand for houses and cars.

Table 2 shows the volatility of these two industries over the course of the last business cycle. The first column shows the cumulative decline in the real value of Gross National Product from the business cycle peak in 1973 to the trough in 1975, and its cumulative expansion over the next 4 years. The second column shows comparable figures for an index of automobile production and the third column gives the fall and rise for housing starts.

TABLE 2

CYCLICAL CONTRACTION AND EXPANSION: 1973-1979
(Percentage Change from Peak to Trough and Trough to Peak)

		Real GNP	Automobile Production	Housing Starts
Recession:	1973-1975	-6.6%	-47.3%	-59.7%
Expansion:	1975-1979	24.1	109.4	114.9

In the previous recession automobile production and housing starts declined about 50 percent while real GNP was falling by less than 10 percent. In the succeeding expansion they rose more than 100 percent, making up the ground they had lost, while real GNP rose less than 25 percent. Moreover, both had peaked in 1978 while real GNP continued to grow for another year.

After several good years, housing and automobiles are again suffering the full effects of the current recession. They have already experienced greater declines than other sectors of the economy.

Automobiles

Automobile sales fell nearly 27 percent in April compared to a year ago, and the first 10 day selling period in May showed a futher decline of 42 percent.

Currently, car sales are running at an annual rate of about 8 million, but this includes 2.3 million imports. Domestic sales are at their lowest level since the 1975 slump.

Sales peaked in the auto industry in 1978, but the decline in 1979 was relatively mild. Total sales fell only about 5 percent. More noteworthy was the pronounced shift from larger cars toward compacts and subcompacts. This was accompanied by record sales of imported cars. The sales of imports rose 15 percent in 1979 while domestic sales were falling by 16 percent. The trend has continued this year. In the first 4 months of 1980 imports accounted for nearly 27 percent of all cars sold in the United States.

The main cause of this shift in demand was the surge in gasoline prices during 1979. Not only did it raise the cost of driving, it also rekindled fears about the future availability and cost of fuel. The American automobile producers were not prepared for this massive shift in consumers' preferences. As they work to adapt their assembly lines to the production of smaller cars, the share of imports continues to grow.

In recent months higher interest rates have depressed sales for all makes of cars. The drop in April and May was not limited to the larger models. It included small cars and imports as well. Although interest rates have declined, after peaking in the first quarter, auto sales are likely to be depressed for some time to come. The cost of financing a car will fall somewhat, but rising unemployment and falling real incomes will continue to restrain demand. Although further sales declines are possible, the major forecasting services are currently predicting that sales will not fall much further in the months ahead and that a recovery will be underway by the end of the year.

One significant difference between this recession and previous cyclical downturns is the continued high level of capital formation expected in the automobile industry. This is related to the shift in demand already mentioned. The automakers must modify their plants to produce the smaller cars for which consumers have expressed so strong a preference. To do so requires massive investment, and even though car sales are down and losses are common, the investment is being made. Capital formation in the industry is proceeding at a rate two to four times greater than normal.

The U.S. General Accounting Office became involved with analysis of the Chrysler Corporation and the U.S. automobile industry on December 20, 1979, when the Chrysler Corporation Loan Guarantee Act was passed by Congress. The legislation established a Board consisting of the Secretary of Treasury, the Chairman of the Board of Governors of the Federal Reserve System and the Comptroller General of the United States acting as voting members, and the Secretaries of Labor and Transportation acting as non-voting members. The Board was charged with the responsibility of making numerous determinations prior to deciding to approve a Federal loan guarantee for the Chrysler Corporation. Among the most important of these is the finding that the Chrysler Corporation has reasonable prospects for remaining a going concern in the automobile industry and the ability to repay up to $1.5 billion in Federal loan guarantees.

The Program Analysis Division and the Detroit Regional Office have provided in-house, independent analysis for the Comptroller General since last December. One staff member from the Economic Analysis Group of PAD has served as the Comptroller General's representative on the Board staff. The Comptroller General was briefed regularly on developments in the auto industry as well as those specific to the Chrysler Corporation. On May 12, 1980, the Board decided to approve up to $1.5 billion in Federal loan guarantees and the first take-down of $500 million is planned in June. The staffs of PAD and DRO are monitoring market developments and tracking the extent to which Chrysler's actual operating results conform with their projected results.

Housing

Housing starts tumbled in March to a seasonally adjusted rate of 1.04 million, a decline of 22 percent from the month earlier. Experts are now predicting a housing slump at least as severe as that experienced in 1974 and 1975.

The main factor depressing housing in recent months has been the high rate of interest on home mortgages. In some areas it reached 16 to 17 percent in the first quarter. Unlike earlier recessions, when mortgage funds became unavailable as interest rates rose, mortgages have been available this time but at rates which few home buyers can afford.

Interest rates have reached their peak and are now declining. This will reduce the cost of financing the purchase of housing, but in the near term housing demand only in the fall in interest rates but also in the reestablishment of the normal rate structure in which long term rates exceed short term rates. Finally, the volatility of rates is, to some degree, the result of the change in the way the Federal Reserve conducts monetary policy. By orienting its policy toward the control of bank reserves and the monetary aggregates, the Fed has left interest rates freer to vary both up and down.

As rates decline, funds should begin to return to the Savings and Loan Associations which are the prime lenders to the housing market. Corporations and State and local governments will be able to issue bonds and ease the pressure on bank loans. Longer term securities will regain some of their attractiveness to investors. However, there are definite limits to the probable decline in interest rates. They will likely continue to be high by historical standards.

Although inflation will decline, few expect it to fall much below 10 percent for the foreseeable future. This should put a floor on interest rates of approximately the same magnitude. Moreover, the Federal Reserve remains committed to slowing the growth in the nation's money supply. Although this promises future relief from both inflation and high interest rates, that relief may come some time in the future. Currently, the major forecasting services do not predict further substantial declines in interest rates during the next year and a half.

THE RECESSION OUTLOOK

In April the rate of unemployment jumped from 6.2 to 7.0 percent and in May it jumped to 7.8 percent. These were the largest one month increases since 1975. These jumps provide clear evidence that the 1980 recession is underway. The question now is will the recession be short and shallow or will it be deep and protracted.

Most private forecasters now believe the risks are on the downside. If they are wrong, they believe it will be because they have not been bearish enough. The huge jump in unemployment and the sharp drop in auto sales in April already may be causing revisions in the forecasts.

The largest proportionate increases in unemployment were experienced by workers in construction and durable goods manufacturing. Unemployment among adult men rose 36 percent. As the effects of these losses are felt on consumer spending, further cutbacks in production and employment are likely. The recession is beginning with larger declines in jobs and sales than many had predicted at this stage.

Table 3 summarizes the predictions of the major econometric forecasting services for the cumulative decline in real outut during the recession. It also shows the actual experience from 1973 to 1975 for comparison. The predictions for the peak unemployment rate are also presented.

TABLE 3

RECESSION PREDICTIONS

	Chase	Wharton	DRI	Actual 1973-1975
Cumulative Decline In Real GNP (in percent)	-3.0	-0.9	-2.4	-6.6
Peak Unemployment Rate (in percent)	8.1	7.9	8.0	8.9

The forecasters agree that a recession began in the second quarter of 1980. They expect it to end in the fourth quarter. According to the forecasters, real GNP should begin to grow again in early 1981. None of the forecasters currently expects the recession to be as deep or prolonged as the downturn from 1973 to 1975, but both Chase and DRI expect it to be more severe than the two recessions of 1960 and 1969-1970.

The severity of the recession may in the end depend on the inventory to sales ratio. If there is no sudden plunge in consumer spending, inventories which have been "lean" in anticipation of the downturn will not have to be "run off" or "dumped" causing futher sharp cutbacks in production. However, even "lean" inventories may prove excessive if consumers decide a major retrenchment is necessary.

None of the forecasters expect a sharp or rapid recovery of economic activity in 1981 and all expect inflation to remain near 10 percent for the foreseeable future after peaking in the current quarter.