The Economy in 1980 and the Outlook for 1981

By Dan M. Bechter

Several significant events occurred in the U.S. economy during 1980. A business cycle peak was reached early in the year, marking the end of the second-longest postwar economic expansion. The subsequent recession set a postwar record for a quarterly rate of decline in output.

The cyclical swing in economic activity that took place in the first half of 1980 was accompanied by, and related to, two other dramatic economic developments: a record-challenging rate of inflation, and an exceptionally rapid run-up in interest rates to new record levels. Early in the second half of 1980 the recession ended, thereby becoming the shortest one in over 60 years. The uncharacteristically slow expansion which followed the trough of the recession is another significant, although less dramatic, event of 1980. The sluggish recovery of 1980 is especially noteworthy because it suggests the kind of path the economy will continue to follow in 1981.

THE ECONOMY OF 1980

The economic expansion that began in the first quarter of 1975 ended, after 58 months, in the first quarter of 1980. The only longer expansion in the post-World War II era was the one that spanned most of the 1960s.

From its cyclical peak in January 1980, the economy plunged at an alarmingly rapid rate. Even so, the first quarter of 1980 as a whole did show a small increase in output over the final quarter of 1979—partly because economic activity in January had been quite strong. But the die was cast. Between January and May, consumer spending adjusted for inflation declined at a 12 per cent annual rate. Between January and April, sales of new houses fell 41 per cent. These and other declines in final demand resulted in precipitous reductions in new orders for manufactured goods, and production was cut back accordingly. Between January and July, industrial production dropped at a 16 per cent annual rate, payroll employment went down by 1.2 million, and the unemployment rate rose from 6.2 to 7.8 per cent of the labor force.

If one uses quarterly data for gross national product (GNP) the recession of 1980 shows up as only one quarter of decline. But that decline set a post-World War II record. From the first quarter to the second quarter, real GNP, that is, GNP adjusted for inflation, fell at a 9.6 per cent annual rate. The quarter-to-quarter decline in final sales was slightly greater, as some production ended up as additions to inventories.

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High rates of inflation, more than any other single factor, brought on the recession. During the first three months of 1980, consumer prices rose at an 18 per cent annual rate, and during the first six months at a 16 per cent annual rate. Disposable personal income growth did not keep up with these rapid rates of inflation. As a consequence, consumers cut their spending. Rapidly rising prices also were recorded by the producer price index, where finished goods prices rose at a 19 per cent annual rate in the first quarter. Business confidence, like consumer confidence, suffered from news of these price increases.

Besides the direct harmful effects of high inflation on economic activity, accelerating inflation was also indirectly responsible for exacerbating the recession. Rapidly rising prices early in 1980 were accompanied by excessive growth in money and credit. Moving to slow the rate of expansion of the monetary aggregates, and thereby the rate of inflation, the Federal Reserve, at the request of President Carter, imposed credit controls. A rapid run-up of interest rates ensued as the Federal Reserve, aided by these controls, brought down the growth of credit.

Sour as most second quarter developments were, they included some that were favorable to an early recovery. Reduced pressure on wages and prices accompanied the sudden drop in economic activity. By the end of the second quarter, declines in inflation and interest rates were beginning to turn the economy around.

The trough of the recession of 1980 came in July or August. As a six- or seven-month recession, it was either shorter than or just as short as the seven-month recession of 1918, which was the shortest since adequate records began to be kept in 1850. Most categories of economic activity showed improvement during the summer months, and real GNP rose during the third quarter a little above its depressed second quarter pace.

In contrast to recoveries from earlier recessions, the expansion following the recession of 1980 has been very slow. The main reasons for the sluggish rate of growth of the economy during the early stages of the expansion were the continued high rate of inflation and the restrictive effects of monetary and fiscal policies.

By early in the third quarter, Federal Reserve policy aimed at keeping growth of the monetary aggregates within specified limits had been accompanied by a decline in interest rates. Partly as a result, credit flows picked up. Fiscal policy, too, stimulated recovery early in the third quarter by giving a boost to personal income in the form of a 14 per cent increase in Social Security benefits. In August and September, however, fiscal policy became more restrictive in that federal budget receipts rose. This contractionary impact of fiscal policy, which was primarily a result of passive rather than active developments, was fortified by increases in interest rates as growth in money and credit threatened to exceed the longer-run ranges adopted by the Federal Reserve.

Policies restricting growth to below-normal rates of recovery are generally considered to be necessary to prevent an acceleration in the rate of inflation. Signs of just such an acceleration did in fact appear during the third quarter. The prices of producer goods at the finished stage of processing, for example, rose at a 20 per cent annual rate in July and August.

Despite efforts to relieve demand pressures on prices, both the consumer and the producer price indexes for October showed inflation continuing at an annual rate of somewhere between 10 and 13 per cent. This persistence of double-digit inflation together with the run-up in interest rates during the second half of the 1980s threatened to set back the young expansion before the end of the year. Even with 1980 finishing on a weakening note, however, enough forward momentum probably was generated during the third quarter to produce some additional expansion in the fourth quarter.

THE FORECAST FOR 1981

The economic outlook for 1981 is for a continuation of the recovery which began in the summer of 1980. The expansion in 1981 will not be a strong one. At best, economic growth will be moderate—if as much as 2-3 per cent, it will be just adequate to keep the unemployment rate around 7.5 per cent. More likely, the economy will grow at a slower pace in 1981, too slowly to absorb additions to the labor force, and the unemployment rate will drift upwards.

This forecast for slow-to-moderate growth in 1981 assumes a tax cut of $30-40 billion, effective early in the year. The immediate effect of this tax cut will be increased fiscal stimulus to the economy arising from higher deficit spending. The forecast also assumes moderate growth in money and credit, consistent with permitting some expansion in the economy without accelerating the rate of inflation. Since not much deceleration in inflation can be expected, these assumptions imply relatively high interest rates during 1981.

Most major sources of demand in the economy will contribute added stimulus to business activity in 1981.

Consumer spending will receive a boost from the increase in personal income which will take up the lion's share of the tax cut. No spending spree by consumers can be expected, however. Household budgets will be strained further in 1981 by rapidly rising prices of food and fuel. The cost of instalment credit will also remain too high to encourage much of an increase in spending on autos and other consumer durables. And the rate of saving out of disposable personal income will likely remain below 5 per cent, held down by the rising prices of necessities and by some increase in instalment debt.

Business spending for plant and equipment also will be stimulated directly by the tax cut, as well as by rising demand. A capital spending boom is still at least a year or two away, however. Profits and capacity utilization rates will not increase enough in 1981 to justify more than a weak increase in real fixed investment. Businesses will not add much to their inventories in 1981, but inventory investment will not be the drag on the economy that it was in 1980.

Residential construction will show modest gains in 1981. Demographic factors continue to favor increases in household formation, although at a somewhat slower pace than in the late 1970s. House prices are likely to show further increases, but they are not expected to outpace the general rate of price increase in the economy by the wide margins seen in the last expansion. The potential for another boom in homebuilding exists, but will not be realized in 1981 because of high mortgage rates.

Federal government purchases could become a stronger contributor to aggregate demand in 1981, even though new curbs on government spending are expected. National defense purchases, which were already rising, may provide even more stimulus under the new admininstration. The Federal government spending categories that are likely to see their growth curtailed are those classified as transfer payments, including grants-in-aid to state and local governments. *State and local government purchases,* in turn, may decline, offsetting some of the increase at the Federal level.

The outlook for inflation in 1981 cannot be regarded as optimistic. Food prices will probably rise faster than they did in 1980. The past year's respite from gasoline price increases due to the temporary oil glut will end, especially if the Iran-Iraq conflict continues. These two special factors, food and fuel, are likely to keep inflation in the neighborhood of 10-12 per cent in 1981.

Continued sizable increases in labor costs will also keep upward pressure on the inflation rate.

Labor contracts already negotiated for 1981 call for an average increase in wages of 11.9 per cent in contracts without cost-of-living-adjustment clauses. Contracts settled with such clauses call for an average increase of 8.2 per cent for the first year. Even a slow rate of inflation would raise the initial-year increases under these contracts to well over 12 per cent. Only a large gain in productivity can hold inflation under 10 per cent in 1981, but prospects for a strong productivity performance are slim.

A forecast is seldom better than the assumptions upon which it rests, and the forecast for 1981 is no exception. Major changes in economic policy, in foreign policy, in oil prices, or even in the weather would alter the projected probable path of the economy in 1981. Aside from such shocks, however, 1981 promises to be a year of slow growth in real output and a continued high rate of inflation.